Do Public Pension Benefits for Uncovered Workers Meet Federal Standards?

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Benefits offered to uncovered workers must be of “equal generosity” to Social Security.

- The Social Security Act of 1935 initially excluded state and local workers.

- Amendments in the 1950s allowed governments to enroll workers through contractual “218 Agreements” with SSA.

- Today, while most state and local workers are covered by Social Security, 25 percent are in retirement plans that must meet federal generosity standards.
The test for “equal generosity” is described in the IRS’ Employment Tax Regulations.

• Every state/local employee in a DB plan must have:
  o an accrued annuity equal to the Social Security PIA; and
  o a retirement age no older than the Social Security FRA; or
  o a benefit that matches an IRS “Safe Harbor” plan.

• The Safe Harbor plan is intended to match the benefit provided by Social Security at the FRA (age 67 for current workers).

Source: IRC Section § 31.3121(b)(7)-2.
Given recent state/local benefit cuts, do plans for new hires pass the generosity test?

Number of State and Local Benefit Cuts by Employee Group Affected

To answer the question, this project performs three analyses:

1) Examines the Safe Harbor plan to see if it provides Social Security-equivalent benefits at age 67.

2) Looks beyond current requirements to see whether uncovered plans provide the same lifetime pension wealth as Social Security.

3) Considers the issue of plan funding, which is not federally regulated and may affect future benefits.
The sample of plans comes from 13 states containing 80 percent of uncovered workers.

Number of Pension Plans and Benefit Designs Audited by State

Note: P = number of plans, and T = number of benefit designs.
In those states, teachers and police were most likely to be uncovered.

Percentage of State and Local Government Employees Uncovered in Sample States by Occupation

Source: Authors’ estimates.
Comparing provisions shows that uncovered defined benefit plans for new hires currently match the Safe Harbor plan.

### Regulated Parameters of Uncovered State and Local Defined Benefit Plans

<table>
<thead>
<tr>
<th>Plan parameters</th>
<th>Safe Harbor plan</th>
<th>Uncovered plans (sample mean)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Benefit multiplier</td>
<td>1.6%</td>
<td>2.4%</td>
</tr>
<tr>
<td>Final average salary period</td>
<td>Highest five years</td>
<td>Highest 4.5 years</td>
</tr>
<tr>
<td>Normal retirement age</td>
<td>65</td>
<td>62</td>
</tr>
</tbody>
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Sources: Revenue procedure 91-40; authors’ survey of retirement system administrators; National Association of State Retirement Administrators’ survey of retirement systems; and Actuarial Valuation Reports.
The next step is to see if the Safe Harbor plan provides sufficient benefits at age 67.

- Safe Harbor and WEP-adjusted Social Security benefits are calculated for a hypothetical worker who:
  - Enters the labor market in 2018 at age 25.
  - Takes an uncovered job at age 35 with a $50,000 salary, consistent with state and local *Actuarial Valuation Reports*.
  - Experiences economic conditions consistent with the long-run assumptions in the 2018 OASDI Trustees Report.
The Safe Harbor, plus WEP-adjusted Social Security, provides reasonable income at 67.

Safe Harbor Benefit + Covered Social Security Benefit at Age 67, in 2060 Nominal Dollars

Source: Authors’ simulation.
However, the Safe Harbor requirements do not incorporate key benefit parameters:

1) Do not specify a vesting period.
2) Do not require COLAs.
3) But also do not reward early retirement ages.
Incorporating these parameters into a generosity test requires using lifetime wealth:

$$\frac{Public \text{ Pension Wealth} + Social \text{ Security Wealth}}{Counterfactual \text{ Social Security Wealth}} \geq 1$$

Where counterfactual Social Security wealth is calculated as if the worker had never entered the government.

Uncovered workers whose benefits pass the test are no worse off for having entered the government.
The baseline estimate of pension wealth assumes 12 years in an uncovered job.

Distribution of Separators from State/Local Government by Years of Tenure

Under the baseline, 43 percent of sample plans fall short of counterfactual Social Security.

Pension + Outside Social Security Wealth Relative to Counterfactual Social Security

Note: Percentages may not sum due to rounding.

Source: Authors’ simulation.
But the results are sensitive to the tenure assumption. If workers spend only a few years uncovered, no plans fall short.

Pension + Outside Social Security Wealth Relative to Counterfactual Social Security by Uncovered Tenure

Source: Authors’ simulation.
The final exercise considers plan funding, which is not federally regulated but affects whether promised benefits will be paid.

- State statutes typically grant contractual rights to disbursements from the pension trust fund (Munnell and Quinby, 2012).

- However, state and local retirees do not have a right to general appropriations (Monahan, 2017).

- This logic enabled several states to reduce promised benefits even before trust funds were fully depleted (e.g. Ohio, Rhode Island).
Projecting cash flows shows that eight sample trust funds could exhaust by 2035.

Defined Benefit Retirement Systems for Uncovered Workers by Year of Trust-Fund Exhaustion

Source: Authors’ estimates from the Public Plans Data Website (2012-2016).
Conclusion

• Pensions for uncovered state and local workers satisfy federal rules, but the rules allow long vesting periods and focus on age-67 income.

• A generosity test that incorporates vesting, the COLA, and the NRA shows some plans falling short, but the results are sensitive to tenure assumptions.

• A bigger issue is that a number of plans could soon exhaust the assets in their trust funds, putting future benefit payments at risk.

• Federal generosity standards may not have been of wide interest in the past, but are likely to become the subject of more discussion.