Are Uncovered State and Local Plans Complying with Tax Law?

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

- The Social Security Act of 1935 excluded state/local workers.
- Amendments in the 1950s allowed governments to enroll workers through contractual “218 Agreements” with SSA.
- Governments that do not enroll their workers in Social Security are supposed to meet generosity standards for pension benefits.
The test for “equal generosity” is described in the IRS’ Employment Tax Regulations.

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

- A key assumption underlying this test is that state/local workers spend a full career with their public sector employer.

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

Number of Pensions Cutting Benefits by Employee Group Affected

Answering the question is technically simple.

• While a standard that assumes full career public employment seems reasonable, few workers actually fit this pattern. As a result, virtually no plan passes the test for every employee.

• DB plans provide little to short and medium-tenure workers.

• And the law does not account for Social Security benefits earned in the private sector.
Public workers often have limited stints in government.

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

As a result, even the IRS’ Safe Harbor plan often falls short in terms of age-67 income.

Nominal Annuity at Age 67 Calculated According to the “Letter of the Law”

Source: Authors’ simulation.
But combining Social Security from private sector work with public pension benefits eliminates most of the gap in age-67 income.

Income at Age 67 from Pension and Social Security
If Years Outside of Government Are Spent in the Private Sector

Source: Authors’ simulation.
But age-67 income does not capture the effects of two key drivers of plan generosity:

1) Normal retirement age; and

2) Cost-of-living adjustment.

To incorporate these drivers, we need to move from annual income at age 67 to lifetime wealth.
Including outside Social Security benefits, retirement age, and COLA, the test becomes:

\[
\text{Is } \frac{\text{Public Pension Wealth} + \text{Social Security Wealth}}{\text{Counterfactual Social Security Wealth}} \geq 100% \ ?
\]

Where counterfactual Social Security wealth is calculated as if the worker had never entered the government.
We applied this test to large plans in the 13 states that employ most uncovered workers.

Number of Pension Plans and Benefit Designs Audited by State

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

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

- Teachers: 94%
- Police: 57%
- General: 37%

Source: Authors’ estimates.
The results show some plans falling short, but are very sensitive to workers’ wages.

Source: Authors’ simulation.
So what is the answer?

- The comprehensive test shows that the answer depends not only on plan provisions, but also on worker characteristics.

- And it assumes that benefits in underfunded systems – public plans and Social Security – will be paid as promised.

- On balance, some plans seem to be falling short.
Moreover, several plans could exhaust their reserves, putting promised benefits at risk.

## Characteristics of Pensions for Uncovered State/Local Employees

<table>
<thead>
<tr>
<th>State</th>
<th>Employee group</th>
<th>Estimated exhaustion</th>
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<tbody>
<tr>
<td>Illinois</td>
<td>State Police</td>
<td>2033</td>
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<td>Chicago Municipal</td>
<td>2025</td>
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<tr>
<td>Louisiana</td>
<td>State Employees</td>
<td>2031</td>
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</tbody>
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*Source: Authors’ simulations.*
The material discussed today is the first half of a four-part project:

1. Compare the generosity of uncovered public pensions to federal requirements.

2. Project the likelihood that plans will exhaust their assets going forward.

3. Consider mechanisms for enrolling in Social Security those state/local participants in insufficiently generous plans.

4. Explore how states and localities might adjust to new FICA taxes.
Conclusion

• The generosity test described in the Employment Tax Regulations does not account for the:
  o experience of non-career workers;
  o differences in the retirement age; and
  o differences in the COLA.

• A comprehensive interpretation of the law shows some plans falling short for at least some employees.

• In addition, a few plans may merit monitoring because they are at risk of exhausting their assets.