In 2018, one-quarter of all state and local government employees – approximately 5 million workers – were not covered by Social Security on their current job. The Social Security Act of 1935 excluded all state and local government employees from coverage because of constitutional ambiguity over the federal government's authority to impose FICA taxes on public employers and because these employees were already covered by defined benefit pensions (Internal Revenue Service, 2014). Beginning in the 1950s, a series of amendments allowed government employers to enroll certain employees in Social Security, and by 1991, most state and local government employees were covered by the program. Today, government employees are permitted to remain outside of Social Security only if they are enrolled in a retirement plan that meets federal regulations for sufficiently generous benefits.

The legal requirements for benefit generosity are specified in the Employment Tax Regulations. Defined benefit pensions – the dominant benefit structure in the state and local sector – must provide members with an annuity, commencing on or before the Social Security full retirement age (67 for workers born after 1959), of equal value to the Primary Insurance Amount (PIA) that the member would have received at age 67 had he participated in Social Security. To help public plans determine whether they are in compliance with the regulations, the government has established "Safe Harbor" parameters intended to generate a benefit equal to that provided by Social Security for a typical uncovered public employee. Legally, state and local pensions that meet the Safe Harbor requirements comply with the Employment Tax Regulations.

The question is whether state and local governments are currently satisfying these Safe Harbor standards and whether the standards continue to provide benefits equal in generosity to Social Security. The need to assess whether state and local pensions are compliant with government standards has increased, given that financial downturns in 2001 and 2008 dramatically reduced the assets held by state and local funds and triggered a wave of benefit reductions, most often for new hires (Aubry and Crawford, 2017; Aubry, Crawford, and Munnell, 2017; Munnell et al., 2013; and Munnell, Aubry, and Cafarelli, 2014). Additionally, a couple of government plans without Social Security – the Policemen's Annuity and Benefit Fund of Chicago and the Municipal Employees Annuity and Benefit Fund of Chicago – could soon exhaust their assets and revert to pay-as-you-go, seriously endangering future benefit payments and putting them in violation of federal generosity requirements (Monahan, 2017).

Given recent benefit cuts and looming future reductions for some plans, this paper explores the extent to which uncovered public employees are receiving benefits commensurate with what they would have received under Social Security. The first step is to determine whether the retirement plans for uncovered state and local government employees satisfy the Safe Harbor parameters and whether these parameters provide Social Security-equivalent income at age 67. Comparing benefit designs for a large sample of uncovered plans to the legislated parameters of the Safe Harbor plans shows that all meet the Safe Harbor requirements. To determine whether the legislated Safe Harbor parameters produce the required income at age 67 involves calculating benefit accruals over the work life of a typical employee under a Safe Harbor plan and under Social Security. This exercise suggests that participation in the Safe Harbor plan produces about the same level of benefits at age 67 as Social Security.

Although both the public plans and the Safe Harbor plans satisfy the letter of the law, uncovered state and local government employees do not necessarily receive Social Security equivalent resources in retirement for two reasons. State and local pensions often set very long vesting periods and are increasingly unlikely to grant full cost-of-living adjustments (COLA) after retirement. This lack of generosity is partially offset by much younger normal retirement ages (NRA) in state and local pensions. Incorporating vesting, the COLA, and the normal retirement age into a generosity test requires calculating the present value of lifetime retirement benefits – arguably a more meaningful measure of retirement resources – for a typical uncovered public employee and for a worker continuously covered by Social Security. This calculation shows that 43 percent of plans fall short, although it is very sensitive to the employment and earnings patterns of the uncovered employees.

Finally, the paper grapples with an additional complication caused by very low funded ratios in a number of pensions for uncovered state and local government employees. A simple projection of pension cash flows, using data from the Public Plans Data website (PPD), reveals that two Chicago plans could exhaust their assets within 10 years. The paper summarizes the ongoing debate over the legal responsibility of state and local governments to provide full benefits once trust funds are exhausted.

The paper has a total of six sections. The second section presents an overview of federal regulations around benefit generosity and frames the exercise within the existing literature on state and local pension finances. The third section compares the designs currently offered to uncovered state and local government employees to the Safe Harbor requirements and examines whether the Safe Harbor designs provide Social Security-equivalent benefits at age 67. The fourth section introduces the differing provisions for vesting, COLAs, and normal retirement ages before calculating lifetime retirement wealth for the typical uncovered state and local employee and for a worker continuously covered by Social Security. The fifth section addresses the issues surrounding the exhaustion of pension trust fund assets. The final section concludes with a discussion of potential policy responses should a public plan violate federal standards. Figures and tables follow the references; methodological details and supporting materials can be found in the Appendices.

To read full paper go to: http://crr.bc.edu/wp-content/uploads/2018/09/wp_2018-9.pdf

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