

William M. Mercer—Meidinger, Incorporated

TASK FORCE REPORT

IMPACT OF FEDERAL
SOCIAL SECURITY LEGISLATION
ON THE TEACHERS' RETIREMENT SYSTEM

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ABSTRACT

Teachers are not now covered by Social Security, although other state employees are. Because mandatory coverage of teachers is possible in the near future, the legislature set up a task force to "evaluate the impact of federal Social Security legislation on the Teachers' Retirement System".

The basic findings of the task force were:

1. That mandatory coverage, at least of new teachers, is highly probable in the near future.
2. The cost to continue providing current benefits would increase significantly.
3. Thus, coverage of teachers by Social Security is not in the best interest of the teachers nor of the state.

The report discusses basic alternatives for integrating the system with Social Security, and identifies pros and cons of the alternatives. Specific recommendations are not made, because additional discussion of the various trade-offs involved is still needed. This discussion can best be done at the time Social Security coverage becomes mandatory. One point was agreed upon: a new system that is integrated with Social Security should bear as close a resemblance as possible to the current system, both from a cost and benefit perspective, a task which will prove to be quite formidable.

BACKGROUND

Since the initial Social Security Act was first passed in 1935, the scope of Social Security coverage has steadily increased. At the present time, the only employee groups of any significant size not covered by the Social Security programs are employed by state and local governments; even then, more than 70% of the 12 million state and local government employees are currently covered.

Many Social Security watchers feel that mandatory Social Security participation for state and local government workers is coming. Because of the uncertainties that would arise on account of such participation, the legislature created a task force to "evaluate the impact of federal Social Security legislation on the Teacher's Retirement System". Unlike other state employees, the teachers are currently not enrolled in Social Security.

The task force met several times in 1986. During these meetings, a basic objective of the study emerged that was endorsed by all parties: if Social Security is required, a new system that is integrated with Social Security should bear as close a resemblance as possible to the current system, both from a cost and benefit perspective.

This report presents the findings of the task force in pursuit of this goal. Although much work will be required when Social Security coverage is required, the work performed by this task force should provide the foundation for later study.

A basic understanding of the Social Security System is helpful in understanding specific areas described in this report. Following the appendices is a booklet that provides detailed information about Social Security. Appendix A gives a summary comparison of the current system and Social Security. Appendix B gives a summary of the major differences between Social Security and other retirement systems that make it difficult to compare costs or duplicate benefits.

HISTORY OF MANDATORY SOCIAL SECURITY

Over the years, the Social Security Program has had its shares of financial woes. Congress has tended to deal with these problems on an "as needed" basis, as opposed to operating from a long-term plan. Despite this, there are clearly discernible trends in Social Security coverage.

There are two basic reasons why Social Security is becoming a universal program:

1. The primary reason is that added Social Security participants mean additional Social Security revenue. For example, if the teachers became covered by Social Security, their wages would immediately be covered by the Federal Insurance Contributions Act (FICA), although they would probably not be able to receive an equivalent value of benefits. Since the Social Security program is financed on a "pay-as-you-go" basis, contributions that would be made by newly participating teachers would be used to pay benefits to previously retired workers.
2. A second important reason for extending Social Security coverage results from the perception of "double-dipping". In the past, many workers who were not covered by Social Security would "moonlight" to the extent necessary to qualify for Social Security benefits. At retirement, the worker would receive double benefits: those from his regular covered employment plus a supplemental Social Security amount. Although this issue has been dealt with under current law, the media and general public still perceives a double-dipping issue to exist.

At the current time, only certain employees of state and local governments are exempt from Social Security. For years, it was felt that the federal government could not compel state employers to participate in Social Security for constitutional reasons; this argument is given less weight in the current environment. The task force agreed that mandatory Social Security coverage would arrive; the only question concerned the when and the hows. Note: State and local voluntary coverage agreements were made irrevocable in 1983; this was upheld by the U.S. Supreme Court in 1986.

It is impossible to project the future course of Congress on the Social Security issue. However, looking at the manner in which recent previously excluded groups were enrolled in Social Security provides some enlightenment.

Coverage for non-profit organizations was voluntary until 1984 when it became mandatory. Congress required that all employees of these organizations become enrolled in Social Security. Such an approach is referred to as the "all employees" approach elsewhere in this report.

In contrast, federal government employees were excluded from Social Security coverage for many years also. Effective January 1, 1983, however, federal employees became covered by Social Security -- but only for new hires. This approach is significantly different than the treatment accorded to non-profit organizations. Throughout this report, this is referred to as the "new hire" method.

It should also be noted that the universal Social Security coverage study group (HEW) in 1980 recommended mandatory coverage of only new state and local government employees to minimize costs in first years and allow legislatures time to design coordinated benefit formulas and also in recognition of political realities.

LIVING WITH MANDATORY SOCIAL SECURITY

The preceding section outlined the reasons why the task force felt that Social Security would one day be mandated for teachers. This section of the report identifies probable ramifications of such a requirement.

Three approaches to Social Security Coverage were identified in total. The first two, "all employees" and "new hires" were discussed in the preceding section. A third option would involve early, voluntary Social Security coverage. Voluntary coverage can be elected if a majority of eligible teachers so elect. At the current time, 70 percent of state and local employees are, in fact, covered by Social Security. Under this option, the state may designate a "coverage group" and can exclude certain classes of employees from consideration, including part-timers. Such a vote is binding on all eligible employees, although Congress will generally permit the state to allow employees who are covered under a state retirement system to choose to remain under that system if other employees and all new hires are covered by Social Security.

Teacher Contributions

The current teachers' retirement system requires that each teacher contribute 6.0 percent of their pay each year. In 1986, the portion of an individual's FICA tax attributable to Social Security benefits other than Medicare was 5.7 percent of pay, with earnings in excess of \$42,000 not considered.

In general, the differences between contributions to the teachers' system and currently to Social Security are minor. In the event that Social Security becomes mandatory, it was generally agreed that:

1. If any teachers are not covered by Social Security, they should continue to make the 6 percent contributions as they have historically.
2. Teachers who are covered by Social Security should cease to make contributions to the teachers' system, as they will be making contributions of a similar amount to Social Security.

However, while the contribution rates are currently similar, it is important to note that under the current schedule of rates, the Social Security contribution will rise another 1/2 percent by 1990. It has also been calculated that, without some major changes in Social Security benefits, contributions after that time will have to rise substantially.

Introduction to Social Security Integration

Before getting into any of the details of how a teachers' retirement formula would work under Social Security, an introduction to the concept of "Social Security Integration" seems helpful.

Fully Integrated Approach

The concept is best illustrated through an example. Consider a teacher who retires after 20 years of service with earnings of \$30,000. The current plan annual benefit would be derived as follows:

$$\begin{aligned}\text{Annual Benefit} &= 2.0 \text{ percent} \times \$30,000 \times 20 \text{ years} \\ &= \$12,000\end{aligned}$$

Thus, under the current system, the teacher would receive a \$12,000 annual benefit. Based on the task force's objective of leaving benefits unchanged, and assuming that an individual was covered for 20 years under Social Security and thus was eligible for a Social Security retirement benefit of \$6,024, the following calculation would control:

Redesigned Formula Target:	\$ 5,976
Social Security:	<u>6,024</u>
Total:	\$12,000

This approach is referred to as the "fully integrated" approach; it is also sometimes referred to as the 100% offset approach.

The primary advantage of the fully integrated approach is that it best meets the task force's "equal benefit" objective. In general, this approach works well regardless of whether Social Security is implemented for new hires only, everyone, or if elected for certain current teachers plus all new hires.

A disadvantage of this approach is that it is not common in the public sector. In addition, this approach is not legal for private sector "qualified" plans. The reason that this approach is not allowed is a concern that the employer's pension will discriminate in favor of highly paid employees. This could happen because Social Security "discriminates" in favor of lower paid employees. The rationale of private sector pension law is that it is acceptable for the employer's FICA tax plus pension contributions to provide a pension benefit that is the same percentage of pay for both high paid and low paid employees. However, with regard to the employee's FICA tax, the law requires that the lower paid employee get a larger benefit (as a percentage of pay) than the higher paid employee. The teachers' system is not legally bound by this rationale, so the task force is free to either accept or reject it.

Other Integration Approaches

During the course of the study, the task force also reviewed additional methods of integrating. These are described below.

The first of these is called "step-rate" integration. Under step-rate integration, the system provides a two tier benefit: a percent of pay for each year of coverage up to a certain amount (called the integration level) plus a higher benefit based on earnings in excess of that amount. This approach is currently used by Connecticut employees who are covered by Social Security. This approach is generally considered to be less efficient than direct integration. As with the 50% integrated approach, a change in the basic formula would be required, and separate treatment would be necessary for teachers covered and teachers not covered by Social Security.

It was noted by the task force that the step-rate approach is used by more public sector plans than the offset approach. However, it was felt that this was due more to prevailing practice in the private sector at the time plans were first integrated than to the inherent benefits under the step-rate approach. The task force did not feel that step-rate integration was appropriate for the teacher's system.

Finally, the task force also considered whether any explicit integration with Social Security was necessary. Under such an approach, the system benefit would not be tied either directly or indirectly to Social Security. It was noted that although this was the most common approach in the public sector, the change in benefits from the current system would be the most magnified. Since this approach would also require a change in the basic formula and is the least efficient manner of providing the "same benefits", the task force felt that like step-rate integration, the "no integration" option should not be considered further.

Conclusions

The task force felt that both the fully integrated approach and the 50% integrated approach were worthy of further study. Appendix C includes illustrations of benefits calculated under the current system, as well as both approved integrated approaches. Appendix D provides a further description of how the alternative approaches would work.

FINANCIAL ANALYSIS

The preceding sections of this report have described reasons behind the study as well as major benefit changes. This section of the report reviews the financial impact that alternative means of implementing Social Security might have.

To the extent that a program integrated with Social Security would produce a cost to the state in excess of the current system, alternative design changes were sought that would result in the same cost to the state as the current plan. It must be kept in mind that any such changes in benefits were for illustrative purposes only to assist the task force in understanding better the relative values of certain plan components. By no means did the task force endorse, (or even seriously consider) any of these possible changes in benefits.

Teacher Contributions

As described in the preceding section, the task force felt that when Social Security coverage became effective for some or all teachers, each teacher should contribute to either Social Security or the teachers' plan but not both. On the current basis, teachers contribute approximately \$61.4 million each year to the teachers' plan. If all teachers contributed to Social Security (ignoring Medicare), the contributions would be \$58.4 million.

The task force felt that this confirmed their earlier assessment.

State Contributions

The following figures represent benchmark costs against which other figures presented later can be compared:

Actual Contribution	\$204.0 million
Full Actuarial Contribution	290.8 million

Costs of "Same Benefits"

In the analysis that follows, both the fully integrated and the 50% integrated approaches have essentially the same cost. Keep in mind that the fully integrated approach reproduces current benefits for each retiring member, while the 50% integrated approach reproduces current benefits for the current teachers as a group; there is, however, some "slippage" in benefits between individual teachers.

The incidence of costs under an integrated approach will be quite dependent on whether only new teachers are covered or if coverage is mandated for all current teachers. Basically, if new teachers only are covered there will be a transition over the next 25 years that will trend towards the cost shown for all members.

The contributions shown below are the total of state contributions to the system and the employer FICA tax.

<u>New Entrants Only</u>	<u>Actual Contribution Basis</u>	<u>Full Actuarial Contribution</u>
Current	\$204.0	\$290.8
Added cost if new entrants only	<u>2.2</u>	<u>2.2</u>
Total	<u>\$206.2</u>	<u>\$293.0</u>
 <u>All Members</u>		
Current	\$204.0	\$290.8
Added cost if all members	<u>55.0</u>	<u>55.0</u>
Total	<u>\$259.0</u>	<u>\$345.8</u>

As can be seen from the table shown above, the "same benefits" would result in a significantly increased total cost to the state.

It should be noted that one reason the same retirement benefits cost so much more if the teachers are covered by Social Security is that Social Security has some significant benefits the teachers' system does not have as outlined in Appendix B. However, the increase in the cost to integrate the system with Social Security is far more than the value of added benefits from Social Security.

One aspect of pension funding that is sometimes considered to depress cost levels is a loosening of the actuarial basis. However, the actuarial assumptions that were used are based on the most recent assumptions used for the plan, which have been developed to be as realistic as possible. The task force felt that it would not be prudent to reduce the apparent costs of integrating with Social Security by any changes in the actuarial basis of the calculations.

Alternative Design Changes

As an aid to better understanding the situation, the task force wanted information on design alternatives that would permit integration with Social Security without costing the state more than the current system. This information is intended to provide a starting point for future discussions, integration becomes mandated, and if it is necessary to consider cost saving design alternatives.

Three such alternatives were looked at. These were:

1. Limiting post-retirement cost-of-living increases to 3 percent a year (instead of a 5 percent maximum).

2. Adding a 3 percent member contribution (in addition to the Social Security tax).
3. Increasing to age 62 (from age 60) the age at which unreduced benefits are available with 20 years of service.

A cost analysis of these three alternatives showed the following decrease in fiscal 1987 state contributions if all members were covered:

● 3 percent cap on cost-of-living	\$24.0 million
● 3 percent member contributions	25.0 million
● Age 62 retirement	12.0 million

None of these alternatives alone would offset the \$55.0 million additional cost of integrating with Social Security. The following is an example of how these alternatives could be combined to produce an "equal cost" integrated plan design for the system.

● 3 percent cap on cost-of-living	\$24.0 million
● 2 percent member contributions (= 2/3 x \$25.0 million)	16.7 million
● Age 62 retirement	<u>12.0 million</u>
● Total	\$52.7 million

The \$52.7 million cost reduction is close enough to the \$55.0 million cost increase from integrating with Social Security to consider an integrated plan that included these design features as an equal cost alternative.

CONCLUSION

Although many questions remain, the task force did develop a consensus on several important issues:

- The task force does not favor extension of Social Security coverage to teachers. The task force found that mandatory coverage by Social Security of the teachers is undesirable. In essence, if teachers are covered by Social Security, the current benefits cannot be provided at the current price. The conclusion to be drawn here, as mentioned earlier, is that either benefits must be reduced, costs must be increased, or a little of both -- a situation which clearly helps none of the parties involved.

Any action that can be taken by any parties involved to discourage or delay mandatory Social Security would seem recommended. Also, the impact of Social Security implementation would be minimized if Social Security was required for new hires only.

- Plan Design Issues. Although the task force considered alternative benefit designs that would integrate with Social Security, no specific conclusions were drawn. A consensus of the task force was that an implementation group (perhaps through another legislature sanctioned task force) should be convened at such time as Social Security would become mandatory. Because Social Security coverage will require careful study and changes in costs and or benefits, the members of the task force thought it premature to adopt specific recommended changes at this time in light of the uncertainty yet surrounding this issue.

APPENDIX A: SUMMARY COMPARISON OF CURRENT SYSTEM AND SOCIAL SECURITY

	<u>Current System</u>	<u>Social Security</u>
UNREDUCED RETIREMENT		
Eligibility	Age 60 and 10 years <u>or</u> 35 years	Age 65 (for individuals now under 50)
Benefit	2.0% x 3-Year Average Pay x Years (maximum 75% Pay) <u>plus</u> Benefit from 6th percent and voluntary contributions	Complex Formula (see table on next page)
EARLY RETIREMENT		
Eligibility	Age 55 and 20 years <u>or</u> 25 years	Age 62
Benefit	Actuarial Reduction	Actuarial Reduction
SPOUSE BENEFIT	None	50% of individual's benefit
COST-OF-LIVING INCREASES	Based on CPI, maximum 5.0% per year and minimum 3.0%	Based on CPI, no maximum
TERMINATION OF EMPLOYMENT	10 Year Vesting	Fully Portable
PRE-RETIREMENT DEATH	Complex Formula	Complex Formula
POST-RETIREMENT DEATH	None, unless teachers' benefit is reduced	100% of individual's benefit
DISABILITY	Complex Formula	Complex Formula
TEACHER CONTRIBUTIONS	6.0% of Pay	5.70% of Pay up to \$42,000
STATE CONTRIBUTION	18.0% Pay (Actual) 27.6% Pay (Full Actuarial)	5.70% of Pay up to \$42,000
TAX STATUS	Taxable	Generally non-taxable

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Annual Social Security benefit payable starting at age 62 for person retiring at age 60 in 1986, who had been covered by Social Security during entire career:

<u>1985 Salary</u>	<u>Annual Social Security Benefit Payable Starting at Age 62</u>
\$18,000	\$7,620
21,000	8,424
24,000	8,892
27,000	9,096
30,000	9,216
33,000	9,336
36,000	9,420

APPENDIX B

The Social Security program provides many benefits and has many characteristics that are difficult to integrate in a single plan and make it difficult to compare costs. Some of these characteristics of the Social Security program are:

1. At retirement, in addition to the employee's benefit, Social Security pays a spouse's benefit equal to 50 percent of the employee's benefit, unless the spouse receives a larger benefit from his or her own employment record. At the employee's death, this benefit increases to 100 percent of the employee's benefit.
2. Benefits automatically index with changes in the Consumer Price Index. Benefits include those in the course of payment, survivorship protection as well as benefits which might be payable to future retirees and disability retirees.
3. Types and level of benefits change automatically when an employee's family status changes (without any change in FICA tax payable).
4. When an employee changes employers, he takes his accrued benefit frozen at current salary levels to the extent he has satisfied vesting requirements. Social Security is fully portable and immediately vested.
5. Survivorship and disability protection involve unusually different standards.

6. Social Security benefits are currently for the most part not subject to Federal taxes. Up to 1/2 of the benefits in the future can be taxable if income including tax-exempt income and 1/2 of the Social Security benefits exceeds \$25,000 for a single taxpayer or \$32,000 for a joint tax payer. These levels are currently not indexed.
7. Social Security benefits are subject to an earnings test; i.e., are not paid in full if certain income levels are attained.
8. Changes in Social Security gradually will affect the level of retirement age and level of benefits after normal retirement age.

APPENDIX C

Normal Retirement Benefit Illustrations
 (Social Security would start at Age 62; before then the Total Benefit would be paid by the System)

Final Average Pay	Years of Service	Current System	Social Security	Fully Integrated Approach			50% Integrated Approach		
				System Benefit	Total Benefit	As % Current	System Benefit	Total Benefit	As % Current
\$24,000 (low for new retirees)	20 Years	\$ 9,600	\$ 5,532	\$ 4,068	\$ 9,600	100%	\$ 4,434	\$ 9,966	104%
	30 Years	14,400	7,104	7,296	14,400	100%	7,248	14,352	100%
	40 Years	18,000	7,164	10,836	18,000	100%	9,918	17,082	95%
\$30,000 (average pay for new retirees)	20 Years	12,000	6,024	5,976	12,000	100%	5,988	12,012	100%
	30 Years	18,000	7,356	10,644	18,000	100%	9,822	17,178	95%
	40 Years	22,500	7,392	15,108	22,500	100%	13,179	20,517	91%
\$48,000 (high for new retirees)	20 Years	19,200	6,384	12,816	19,200	100%	11,208	17,592	92%
	30 Years	28,800	7,524	21,276	28,800	100%	17,838	25,362	88%
	40 years	36,000	7,560	28,440	36,000	100%	23,220	30,780	86%

APPENDIX D

System Benefits Under Current System and Alternative Integrated Approaches

1. Normal Retirement (eligibility is age 60 with 20 years of service or any age with 35 years of service).

<u>Current System</u>	<u>Fully Integrated Approach</u>	<u>50% Integrated Approach*</u>
2% of 3-year average pay per year of service with a maximum of 37-1/2 years.	2% of 3-year average pay per year of service with a maximum of 37-1/2 years. Starting at age 62, or actual retirement age if later, the benefit is reduced by the Social Security.	1.5% of 3-year average pay per year of service with a maximum of 37-1/2 years. Before age 62, the formula benefit is increased by 50% of Social Security. Starting at age 62, or actual retirement age if later, the formula benefit is reduced by 50% of Social Security.

2. Early Retirement (eligibility is age 55 with 20 years of service, or any age with 25 years of service).

<u>Current System</u>	<u>Fully Integrated Approach</u>	<u>50% Integrated Approach*</u>
Calculated the same as for normal retirement but actuarially reduced.	Same benefit as current system up to age 62. At 62, benefit is reduced by Social Security.	1.5% of 3-year average pay per year of service with a maximum of 37-1/2 years, then actuarially reduced. Before age 62, the formula benefit is increased by 50% of Social Security. After age 62, the formula benefit is reduced by 50% of Social Security.

Definition of Social Security: The Social Security benefit payable to the member at age 62, or actual retirement age if later, based only on earnings covered by Social Security while a member of the System and on the law as in effect at retirement. If retirement is before age 62, Social Security equals the benefit payable at age 62 assuming that the member has no further earnings.

*Illustrates benefits for new hires. A more complex formula would be necessary for mid-career teachers.