RESEARCH REPORT

Reforming the Social Security WEP Exposes Weaknesses in State and Local Pensions

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Approximately 25 percent of state and local government workers, about 5 million people, are currently working in jobs not covered by Social Security.[1] Instead, these workers participate in government pension plans that are required to provide benefits at least equivalent to those provided by Social Security. Many of these workers will also hold jobs in Social Security–covered employment over the course of their careers and will become eligible for benefits under both systems. Under current law, retirees receiving pension benefits from a noncovered job may have their Social Security benefits reduced by the Windfall Elimination Provision (WEP). The WEP is intended to ensure that the Social Security benefit formula does not replace a higher share of earnings for these workers than for those who only worked in jobs covered by Social Security. Unfortunately, the WEP does not treat all workers fairly and is poorly understood by beneficiaries, catching many by surprise once they reach retirement and failing to identify other beneficiaries who should have their benefits reduced. These concerns have generated bipartisan support to reform the WEP and some groups have called for its full repeal.

The Equal Treatment of Public Servants Act,[2] last proposed in 2018 by Representative Kevin Brady, aims to fix the WEP by replacing it with a more equitable formula for reducing Social Security benefits that uses newly available data on workers' covered and noncovered earnings. It establishes a new formula, known as the Public Servant Fairness Formula (PSF), that would make important and needed improvements to the WEP. The proposed formula would increase benefits for most workers who would normally be affected by the WEP. But it would also impose new benefit reductions on millions more beneficiaries who never receive a public pension or only a very small one, many of who would not have their benefits reduced by the WEP.

This brief explores how Social Security benefits would be affected for workers facing new reductions under the PSF. Those who would be most affected by new reductions are beneficiaries who never receive a benefit in retirement from their government pension plan, either because they do not vest for benefits or because they withdraw their contributions when they separate from their job. These workers have relatively shorter careers in state or local government and, consequently, also receive less in public pension benefits because those plans typically structure benefits to generously reward long careers. The retirement security of these workers, many of whom are teachers, may also be

undermined because their public pension plans fail to provide benefits truly equivalent to those offered by Social Security (Aldeman 2016; Quinby, Aubry, and Munnell 2018). For some of these workers, the PSF would reduce Social Security benefits by more than the amount of their noncovered pension. It would also reduce benefits most for those who are already getting the least out of their noncovered pensions.

Policymakers considering legislation to improve the WEP could request further analysis of how future beneficiaries would be affected by the proposed bill. They could also consider shoring up the regulations governing noncovered pension plans, building in protections to the PSF for short-tenure workers, identifying new methods to administer the WEP, and developing a pathway to achieve universal Social Security coverage to improve retirement security for all workers.

Social Security Coverage

Social Security was designed to provide universal social insurance to all American workers. When the Social Security Act was passed in 1935, however, it exempted all state and local government employees from coverage because of constitutional concerns about the right of the federal government to impose taxes on the states (Solomon 1986). Further, most state and local government workers were already covered by comparable pension plans.

Over time, the constitutional concern eased, and Congress passed new laws that expanded coverage to most government workers, including all federal employees. In 1990, Congress passed the Omnibus Budget Reconciliation Act and established the system for coverage we have now. That act required states and localities to adopt Social Security for their workers unless they provided an alternative pension benefit equivalent to Social Security. Moreover, once a government employer adopted Social Security coverage, it could not drop it. State and local governments that continued to offer pension plans in lieu of Social Security had to ensure that the benefits provided through their plans were at least equivalent to those provided by Social Security.

Today, Social Security covers approximately 94 percent of all US workers.[3] The remaining 6 percent are primarily state and local government employees. Although most state and local government employees are covered by Social Security, about a quarter of them, almost 5 million, are not (Quinby, Aubry, and Munnell 2018), including many teachers. Although some of these government employees will work their entire career in jobs not covered by Social Security, many will work in a mix of covered and noncovered employment over the course of their careers.

Treatment of Noncovered Earnings in Social Security

Workers who split their careers between covered and noncovered employment pose a problem for Social Security because of how the benefit formula is designed and the way that earnings are tracked by the Social Security Administration (SSA).

QUARTERS OF COVERAGE

Social Security benefits are determined based on a person's earnings while in Social Security–covered employment. Covered workers and their employers pay payroll taxes on their earnings up to the taxable maximum, and these taxes are deposited into the Social Security trust funds and used to finance benefits. Workers become insured for Social Security retirement benefits when they earn 40 quarters of coverage, which is equal to about 10 years of covered work. In 2019, a worker must earn $1,360 to gain a quarter of coverage. Eligibility for disability insurance benefits requires fewer years of coverage for younger workers, but some of those years must be recent (SSA 2019). For any years in which a worker was not employed, had earnings below the threshold, or worked in employment not covered by Social Security, SSA records their earnings as zero. For people who were actually employed in noncovered work and earning noncovered pension benefits, those years of zero recorded earnings can distort benefits calculated under Social Security's progressive benefit formula, described in the next section.

SOCIAL SECURITY BENEFIT FORMULA

Social Security benefits are calculated by first indexing a worker's earnings based on annual changes in average wages nationwide. SSA then determines a person's highest 35 years of covered earnings and averages them to yield the his or her average indexed monthly earnings, or AIME. If a worker has less than 35 years of covered earnings, zeros are included in the calculation.

The AIME is then used to calculate the primary insurance amount (PIA), which represents the monthly benefit amount that the beneficiary receives before any adjustments are made. The PIA is calculated by segmenting the AIME between "bend points." A separate benefit rate is applied to the earnings in each bracket. The bend points are indexed annually for workers becoming newly eligible for benefits by the average wage index. For workers becoming newly eligible in 2018, the formula replaced 90 percent of earnings up to $895, 32 percent of earnings between $895 and $5,397, and 15 percent of earnings over $5,397.

For example, if a worker collecting a benefit in 2018 had an AIME of $6,000, then his or her PIA would be calculated using the following formula:

$$PIA = 0.90 \times (\$895) + 0.32 \times (\$5,397 - \$895) + 0.15 \times (\$6,000 - \$5,397) = \mathbf{\$2,336}$$

The benefit formula replaces a higher share of a person's lowest earnings than of his or her higher earnings, making Social Security benefits progressive. Consequently, lower-earning workers and those with fewer years of employment receive a higher replacement rate than higher-earning workers. This is an important feature of the Social Security program for protecting lower-income beneficiaries from poverty. But for noncovered workers, whose earnings are also recorded as zeros, the formula also increases their replacement rate as if they were a low-income earner. If not adjusted for these workers, the regular Social Security benefit formula would fail to account for the fact that noncovered workers have additional earnings and may be accruing additional retirement benefits through their government employer's pension plan.

WINDFALL ELIMINATION PROVISION

The WEP[4] modifies the Social Security benefit formula for noncovered workers. The provision is intended to ensure that workers with the same earnings histories but different patterns of covered earnings are treated the same. It reduces benefits for workers who receive a pension from noncovered employment so that they do not receive more Social Security benefits relative to their covered earnings than workers who only worked in covered employment.

The WEP addresses this issue by lowering the replacement rate on the first bend point from 90 percent to 40 percent for affected workers with 20 years or less of covered employment. For example, if the worker previously discussed were subject to the WEP, the new PIA would be about 20 percent less than the original benefit:

$$PIA = 0.40 \times \$895 + 0.32 \times (\$5,397 - \$895) + 0.15\% \times (\$6,000 - \$5,397) = \mathbf{\$1,889}$$

Three provisions in the WEP provide additional protections for beneficiaries. First, the WEP is only applied to those who receive a noncovered pension; second, benefits cannot be reduced by more than one-half of the noncovered pension benefit; and third, the size of the WEP reduction is phased down for workers with between 20 and 30 years of Social Security coverage.

CONCERNS WITH THE DESIGN OF WEP

The WEP adjustment serves a legitimate policy purpose, but its design raises several concerns, as illustrated by Brown and Weisbenner (2013). The authors find that although the WEP roughly achieves the intended policy goal, it also reduces benefits more for lower-earning workers than for higher-earning workers and can produce large adjustments in benefits based on small changes in years of coverage. The WEP has other problems as currently administered. First, it relies on individuals to self-

report to SSA whether they receive a noncovered pension.[5] This approach was originally adopted because SSA did not track noncovered earnings. The reliance on self-reported data and other administrative challenges have led to large improper payments (GAO 1998; SSA OIG 2011). Second, the WEP is often not factored into estimates of future benefits, leading to many workers being surprised by the reduction when they go to claim their benefits and perceiving the adjustment as a cut to their earned benefits.

The issues with WEP have led to significant opposition from groups representing state and local government employees and retirees. Some of these groups have advocated for a complete repeal of the WEP; others have supported proposals to reform the provision. One bill in particular, the Equal Treatment of Public Servants Act of 2018, has recently generated bipartisan support to reform the WEP. In the following sections we discuss what the legislation would do, which problems it would fix, and what new concerns it would raise for the retirement security of workers who split their careers between covered and noncovered employment.

# The Equal Treatment of Public Servants Act of 2018

In response to concerns about the WEP, the Equal Treatment of Public Servants Act was introduced in 2015 and again in 2018 by Representative Kevin Brady (then chair of the Ways and Means Committee) and Representative Richard Neal (then ranking member, and now chair, of the Ways and Means Committee).[6] The act would replace the WEP with a new approach to calculating Social Security benefits known as the PSF. This approach would make use of data now available to SSA on noncovered earnings for years after 1977. Armed with full earnings records for covered and noncovered earnings, SSA could now apply a more equitable formula for computing Social Security benefits based on the overall benefit replacement rate that would apply if all earnings had been covered, instead of relying on a reduction of the 90 percent benefit rate for the first AIME bracket to as little as 40 percent under WEP.

Under the PSF, SSA would first calculate a new preliminary PIA using the normal benefit formula, except the preliminary AIME would include both covered and noncovered earnings. The new preliminary PIA would then be multiplied by the ratio of the regular AIME (based on only covered earnings) to the preliminary AIME (based on covered and noncovered earnings). The resulting PIA is the monthly benefit amount (before any other necessary adjustments are made).

PSF PIA = Prelim PIA × (Reg AIME/Prelim AIME)

Importantly, the PSF applies to all beneficiaries with noncovered earnings without exception. It does not include the two protections contained in the WEP that prevent or limit reductions for beneficiaries who do not receive a benefit from their noncovered plan or only receive a small benefit.

Monthly Social Security Benefits for Hypothetical Workers under the WEP and PSF
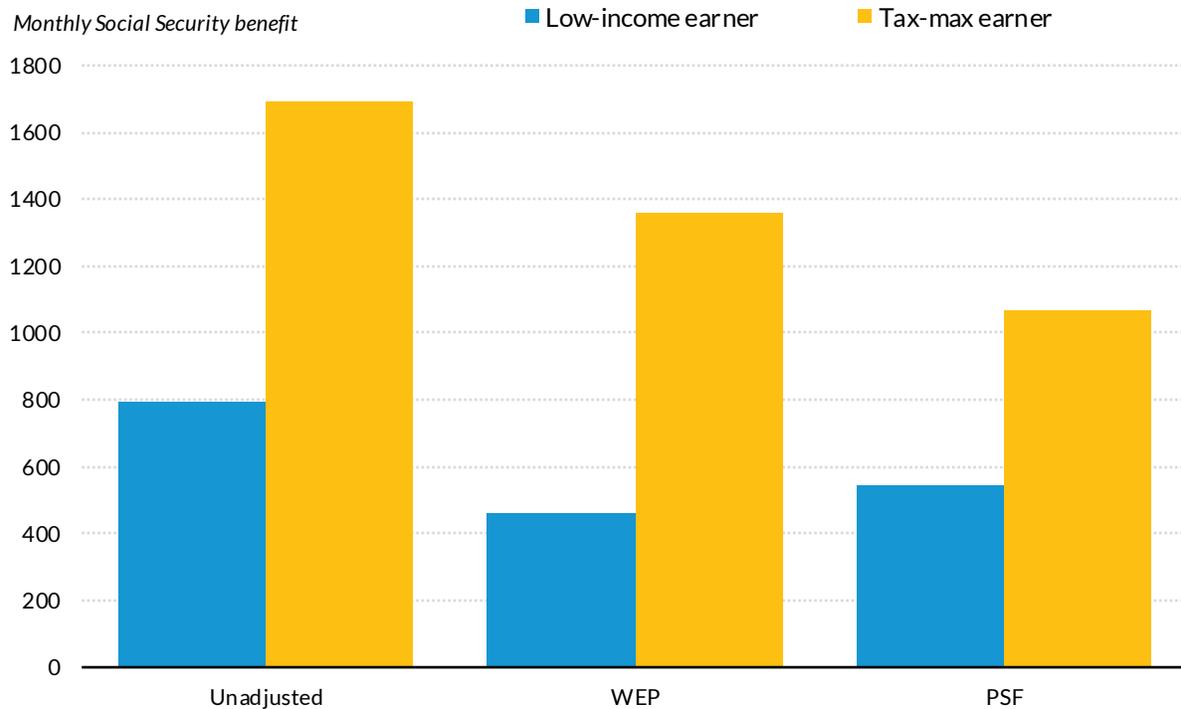
Monthly Social Security benefit

Source: Calculations from authors.
Notes: PSF = the Public Servant Fairness Formula; WEP = the Windfall Elimination Provision. Calculations assume that the low-income earner starts employment at age 25 in 2018 with a nominal salary of $40,000. We then apply an annual salary growth rate of 3.8 percent. The tax max earner starts off with $128,400 and stays at the tax max in all future years. These results assume that both earners work 20 years in covered employment followed by 15 years in noncovered employment and that benefits are claimed at the full retirement age.

Figure 1 illustrates how the PSF approach improves equity between workers by comparing how monthly benefits for two types of new hires in 2018 would be affected by the WEP and PSF. The first is a low-wage worker who starts making $40,000 at age 25; the second is a worker who earns the Social Security taxable maximum in every year (tax-max earner), starting with $128,400 in 2018. Relative to the WEP, the PSF leads to a higher benefit for the low-income earner and a lower benefit for the tax-max earner. Under PSF, the low-income earner would receive 69 percent of his or her base Social Security benefit compared with 58 percent under WEP, while the tax-max earner would receive 63 percent rather than 80 percent under the WEP. The PSF fixes one of the problems with WEP by

providing the lower-wage worker with a higher replacement rate than the tax-max earner, making the adjustments consistent with the normal Social Security benefit formula. Further, because the formula contains no thresholds for years of coverage, the adjustments are linear and not "lumpy" as they were under the WEP, which phases down between 20 and 30 years of coverage.[7] These estimates are based on projections of future Social Security benefits that are then discounted to yield a present value.

Estimated Impact on Beneficiaries

The PSF would improve the fairness of the Social Security benefit formula for many workers who would already face a reduction under the WEP. However, it would also impose new benefit reductions on a much larger group of future beneficiaries, and according to analysis from the Social Security Office of the Chief Actuary (OCACT), some of those reductions could be substantial.[8] OCACT estimated that the bill would increase net program costs over 10 years by about $25 billion but reduce long-range costs over 75 years by about 0.04 percent of taxable payroll.

According to OCACT's estimates, if the PSF were fully implemented for all current beneficiaries in 2018, it would affect a total of about 19.6 million beneficiaries. Of this group, only about 1.6 million would have their benefit reduced by the WEP under current law. Most of those beneficiaries, about 1.1 million, would see a smaller reduction in monthly benefits from switching to the PSF. The average increase in benefits for this group would be about $74 a month. The remaining 0.5 million beneficiaries would receive a larger reduction from switching to the PSF, with an average decrease in benefits of about $55 a month.

The vast majority of beneficiaries who would be affected by the switch to the PSF, about 18 million, would not have their benefit reduced under the current law WEP, but they would face reductions under the PSF. These beneficiaries would be exempt from the WEP for several reasons, including having more than 30 years of Social Security coverage, not receiving a pension because they never vested for one or withdrew their contributions early, or meeting another criterion for exemption under SSA rules.[9] For about half of this group, 9 million beneficiaries, the impact from adopting the PSF would be negligible, with average benefit cuts of less than $1 a month.

For the other 9 million beneficiaries, the average monthly benefit cut from PSF would be about $43. The average Social Security monthly benefit for this group is estimated to be about $1,402. Within this group, OCACT's analysis suggests that the reductions would be concentrated among about 4.5 million beneficiaries with five or more years of noncovered work. This group is likely to have a lower average Social Security benefit, and the expected cuts could easily be double the $43 a month average.

The proposed PSF could impose substantial new benefit reductions on many future beneficiaries. For people in this group, reduced Social Security benefits might be warranted if their non–Social Security retirement benefits grow in tandem with the number of years they spend in noncovered employment. On this premise, the PSF adjustment makes sense and achieves an important policy goal of improving equity between workers with similar earnings histories but different patterns of covered and noncovered employment. As discussed in the next section, however, recent analysis of the adequacy of state and local government pensions relative to Social Security, particularly for teachers and short-tenured workers, as well as the underfunding of public pension plans, suggest that this group may be more vulnerable than previously thought. This may be particularly true for younger workers and future hires who may be more likely to change jobs than older workers and current beneficiaries, who were the focus of the OCACT analysis.

Noncovered State and Local Government Workers and Their Pensions

In considering the potential impact of the proposed PSF adjustment, it is important to examine the adequacy of retirement benefits provided to noncovered government workers. This is particularly important for those who split their careers between covered and noncovered employment since they would be the largest group affected by the proposed legislation.

Under current law, state and local government employees who are not covered by Social Security must be enrolled in pension plans that offer benefits at least equivalent to those offered by Social Security. This requirement was established in the Omnibus Budget Reconciliation Act of 1990.[10] The specific requirements for determining whether the benefits provided by a government pension plan are equivalent to those provided by Social Security are detailed in the IRS's employment tax regulations. According to a recent analysis of the largest plans covering 80 percent of noncovered workers, the surveyed plans meet the legal requirements of equivalency, but the parameters used to establish the safe harbor fail to take into account critical elements of Social Security benefits (Quinby, Aubry, and Munnell 2018). These elements include vesting requirements, cost-of-living adjustments, and different retirement ages. The authors find that when these elements are factored in, roughly 43 percent of sampled noncovered plans do not provide lifetime benefits equivalent to Social Security for newly hired workers. The authors also note that the equivalency test makes no requirement for public pensions to provide other types of benefits included in Social Security, such as disability, spousal, and survivor benefits.

The adequacy of public pension benefits changed significantly in the wake of the 2008 financial crisis as governments faced with underfunding in their pension plans enacted changes to reduce costs and improve their funded ratios. These changes, though not violating the letter of the law with respect to the Social Security equivalency rules, have important consequences for the retirement security of noncovered workers, particularly for those workers who are younger, newly hired, or future hires. Typical changes adopted by public pension plans include increasing employee contributions; lengthening of vesting requirements, sometimes to 10 years; increasing retirement ages; and enacting other benefit formula changes (Aubry and Crawford 2017; Munnell and Aubry 2014).

According to our analysis of noncovered public pension plans using the Urban Institute State and Local Employee Pension Plan Database, on average, contribution rates increased 9 percentage points, vesting requirements increased by roughly 0.4 years (or 6.6 percent), and the final average salary period increased by about 0.43 years (or 10 percent) from 2008 to 2018.[11] The impact of these changes on expected benefits is shown in figure 2. Typical workers newly hired in 2018 would have to wait over 20 years before their standard benefits surpassed the value of their personal contributions. Employees who separate earlier do not receive any employer-funded retirement benefits. In contrast, as a worker nears the end of his or her career, promised benefits increase rapidly as the impact of the back-loaded benefit structure takes effect.

Workers who leave their job before retiring usually have the option of withdrawing their personal contributions when they leave or, if they are vested, of receiving the standard annuity when they retire. Because the standard annuity might be very modest, even after 10 or 15 years of service, many instead choose a refund of their personal contributions. Among California teachers, for example, 24 percent of women hired between ages 25 and 29 choose a refund of their contributions after 15 years of service; the remainder choose the standard pension benefit (CalSTRS Valuation 2017). Withdrawals are taxed as income unless they are rolled over into another retirement savings plan and therefore do not count toward retirement income. Although workers have the option to save this money for retirement, most do not. One study found that approximately three-quarters of nonvested workers never reclaim their employee contributions at all. This could be because of plan rules that require workers who leave their job to actively seek their refund. Of those who do withdraw their contributions, 90 percent choose to receive a cash transfer rather rolling their savings over into a retirement account (Clark, Morrill, and Vanderweide 2014). Consequently, many short-tenure workers leave noncovered employment without securing a pension or additional savings for retirement.

FIGURE 2

Comparison of Lifetime Pension Benefits and Employee Contributions for a Typical Worker in a Noncovered Plan Hired in 2018

Lifetime pension benefits in thousands of 2018 dollars as a function of service years
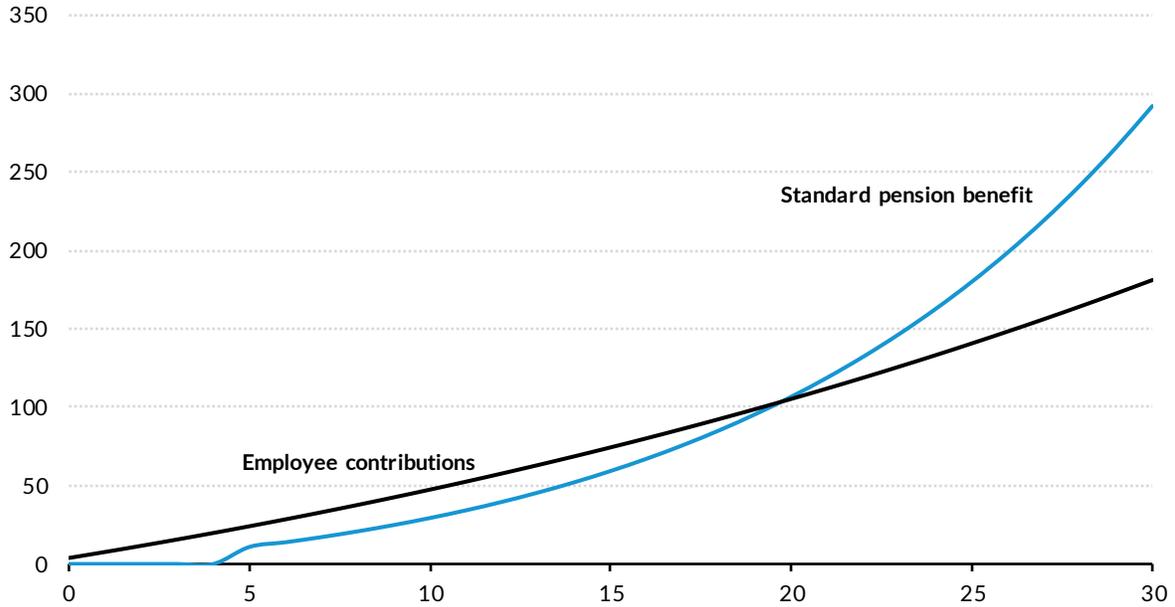
Source: Calculations from authors.

Notes: Calculations assume that the worker starts employment at age 25 in 2018 with a nominal salary of $40,000. We then apply an annual salary growth rate of 3.8 percent. We assume an employee contribution rate of 9.6 percent, a multiplier rate of 2.2 percent, a vesting period of five years, and a final average salary period of five years. We use a discount rate of 5.3 percent to calculate the annuity factors that help determine the lifetime benefits. This rate is the same as the intermediate long-term nominal interest rate adopted in the 2018 Trustees Report from the Social Security Administration. The assumed inflation rate is 3 percent.

One of the largest groups of noncovered workers is teachers, whose pension plans have been subject to the same types of reforms as the other noncovered plans described earlier in this report (Aldeman and Rotherham 2014; Kan and Aldeman 2014). In addition, analysis of teacher pension plans indicates that although the typical plan promises generous benefits for long-tenure teachers who complete their career in the same plan, those larger benefits are financed by shorter-tenure teachers who receive far lower benefits. One study found that roughly half of a newly hired cohort's pension wealth is redistributed to long-career teachers (Costrell and Podgursky 2010). This is especially troubling given that over half of teachers will not stay in their jobs long enough to earn a pension at all (Aldeman and Rotherham 2014).

Another concern for noncovered workers with traditional defined-benefit pension plans is that their benefits are not portable. Whereas most government workers have retirement benefits that are

offered in addition to Social Security, noncovered workers can generally only contribute to and accrue benefits within their particular government plan. These workers must depend more heavily on the adequacy of the pension plan offered by their employer. And although it takes 10 years of earnings to become insured for Social Security, those 10 years apply to any covered job. One caveat to this is that some noncovered workers who switch jobs may be offered an option to purchase plan credits, which could help mitigate the impact of changing jobs on their retirement savings.

For workers who spend time in both covered and noncovered employment, including many teachers, the PSF approach to reducing benefits, which looks only at whether the individual had noncovered earnings and the amount of those earnings, means that a large number of workers would see lower Social Security benefits even though they never receive a benefit from their public pension plan. Some of these workers will not receive a pension because they fail to vest before switching jobs. Others will choose to withdraw their contributions when they leave their job because their expected pension benefit is lower than their contributions, as shown in figure 3. Still others will choose to receive a small pension benefit in retirement, but it will be worth less than their contributions and often fall short of what they could have received if they had participated in Social Security.

In the next section, we explore hypothetical examples of workers who would be affected by the WEP and PSF and look at the impact on estimated monthly benefits.

Analysis

As shown in figure 1, adopting the PSF approach to adjusting Social Security benefits to account for receipt of a noncovered pension would improve the fairness of the adjustment for many workers. However, it would also expand the number of beneficiaries who have their benefit reduced because of noncovered work. Analysis by the Social Security actuaries suggests that 13.5 million beneficiaries would see a new benefit reduction under the PSF approach if it applied to new beneficiaries beginning in 2018. Most of these beneficiaries would see very small reductions, with the largest cuts concentrated on about 4.5 million beneficiaries who have five or more years of noncovered earnings.

Detailed distributional analysis describing which beneficiaries would be affected is not available. But to illustrate the potential impact of the proposal, we examine three examples of workers who start their careers in noncovered employment earning an annual salary of $40,000, which is about the national average salary for new teachers. Worker A spends nine years in noncovered employment and fails to vest for a pension. Worker B spends 15 years in noncovered employment and also fails to vest

because of job changes. Worker C also spends 15 years in noncovered employment, becomes vested for benefits, and chooses to receive her benefit in retirement. The impact of the WEP and PSF on each of these examples is shown in figures 3, 4, and 5.

Figure 3 shows hypothetical Worker A. In states with 10-year vesting requirements, this worker would not earn a benefit from his government pension before he left his job. Based on his earnings in Social Security covered employment, however, he would earn an unadjusted Social Security benefit of approximately $902 a month. Under the WEP, this worker would not see a reduction in his Social Security benefit because the WEP only applies to beneficiaries who receive a pension from a noncovered job. But under the PSF, he would see a $213 reduction to his monthly Social Security benefit, or almost a quarter of his total monthly benefit.

FIGURE 3

**Present Value of Monthly Social Security Benefits for Hypothetical Worker A**
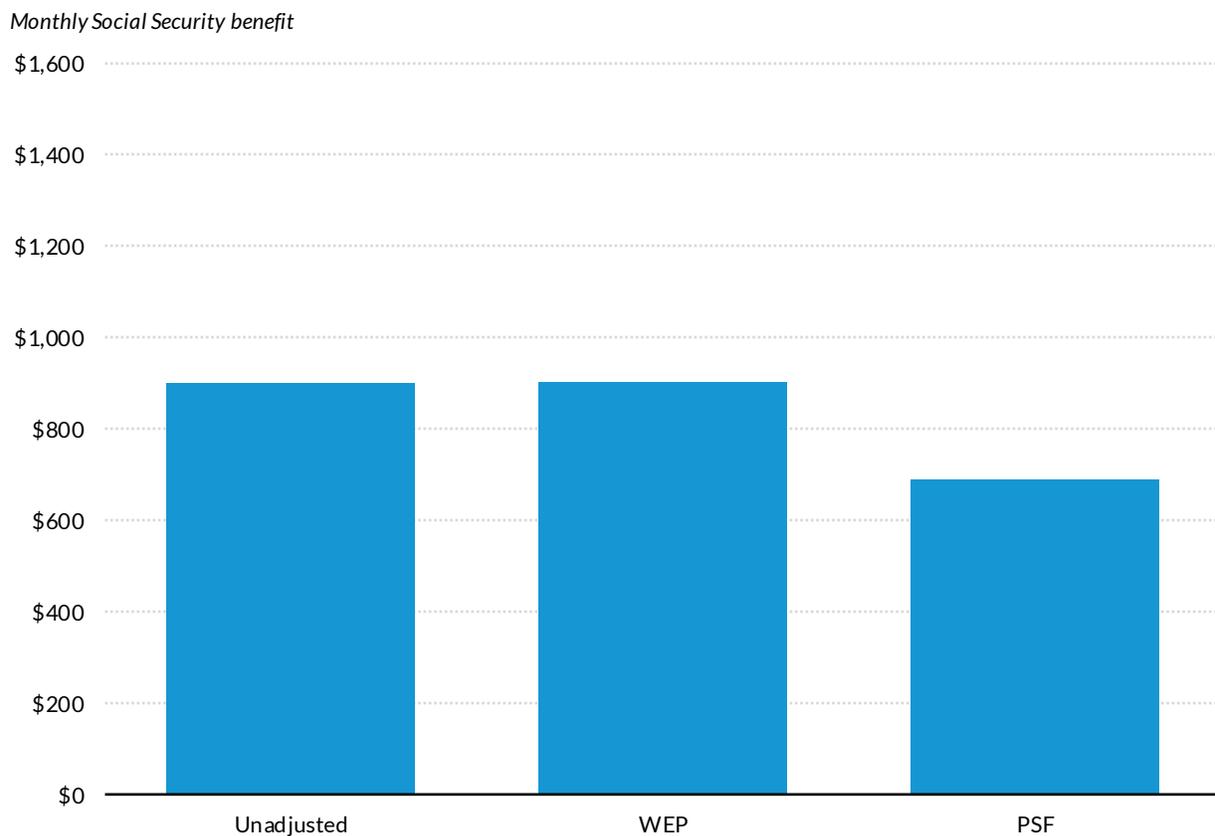
Monthly Social Security benefit

Source: Calculations from authors.
Notes: PSF = the Public Servant Fairness Formula; WEP = the Windfall Elimination Provision. Calculations assume that the worker starts employment at age 25 in 2018 with a nominal salary of $40,000. We then apply an annual salary growth rate of 3.8 percent. These results assume he or she works 9 years of noncovered employment followed by 26 years of covered employment. We also assume the worker claims benefits at the full retirement age.

Although this worker did not earn a pension benefit from his government plan, he would have been entitled to a refund of his personal contributions under most plan rules. Using typical plan assumptions (described in more detail in appendix A), we estimate that he would have received a lump-sum payment of approximately $34,851. This amount would have counted as income in the year it was received and subject to taxation.

Present Value of Monthly Social Security Benefits for Hypothetical Worker B
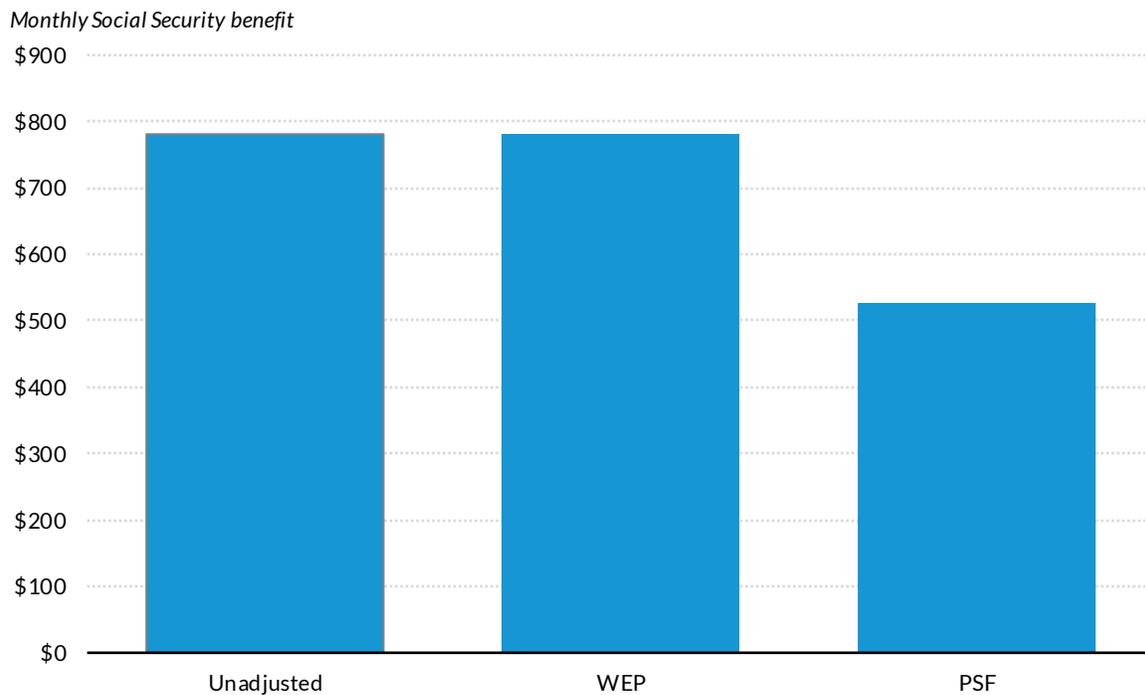
Monthly Social Security benefit
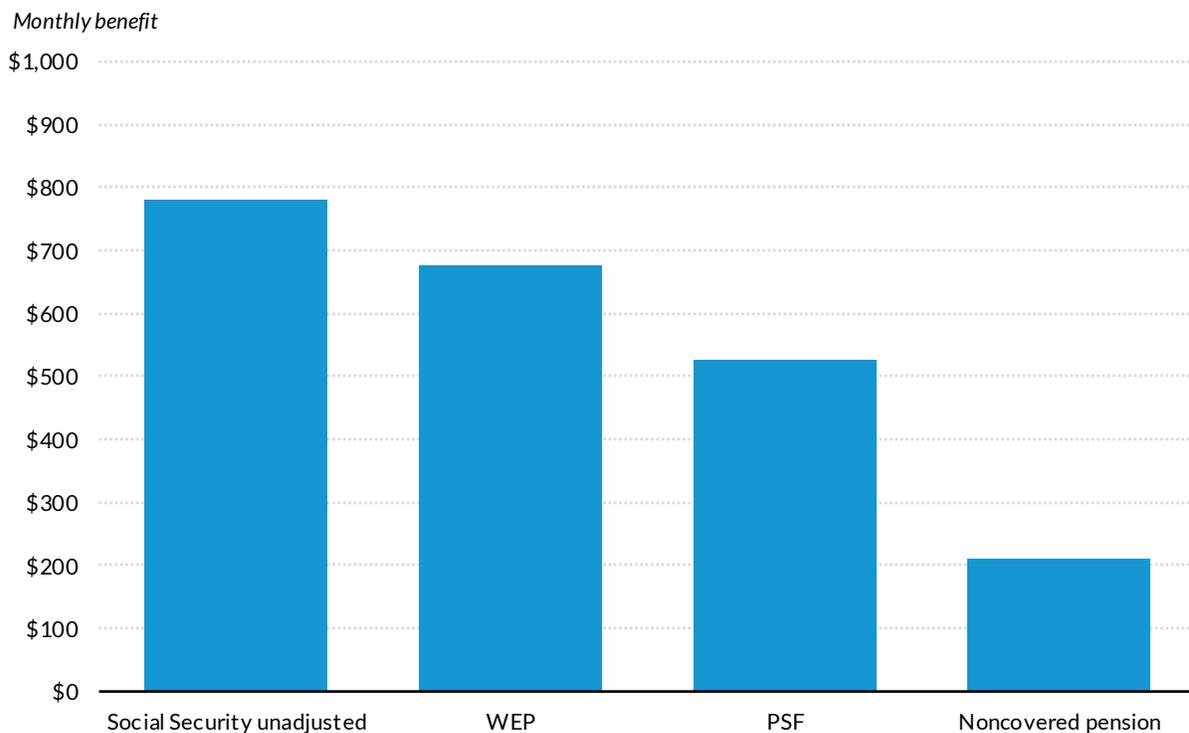

Source: Calculations from authors.
Notes: PSF = the Public Servant Fairness Formula; WEP = the Windfall Elimination Provision. Calculations assume that the worker starts employment at age 25 in 2018 with a nominal salary of $40,000. We then apply an annual salary growth rate of 3.8 percent. These results assume he or she works 15 years of noncovered employment followed by 20 years of covered employment. We also assume the worker claims benefits at the full retirement age.

Figure 4 shows Worker B, who works in noncovered employment for 15 years. In this example, the worker does not receive a pension benefit from her public plan, either because she changed jobs and therefore did not vest for benefits in any plan or because she withdrew her contributions instead of claiming a pension benefit in retirement worth less than her own contributions. Under WEP, this beneficiary would not have her Social Security benefit reduced. Under PSF, however, she would see her unadjusted benefit of $781 lowered by $254 under the PSF, a reduction of over 30 percent of her monthly Social Security benefit at retirement. If she withdrew her contributions and took a lump-sum

payment, she would have received roughly $103,000 in taxable income in the year she withdrew. Further, this worker may have had an opportunity to purchase service credit based on years of work in another pension system, which would allow her to vest for a pension benefit. The next example looks at a similar worker who vests in her plan.

In figure 5 we consider Worker C, who also spends 15 years in noncovered employment but who vests for benefits in her public pension plan. This worker would be entitled to $781 in monthly Social Security benefits before any adjustments are made and to $210 in monthly noncovered pension benefits. Under the PSF, this worker would see her Social Security benefit reduced by $254. This is a reduction of 27 percent of her base Social Security benefit and 122 percent of her noncovered pension benefit. Consequently, Worker C would have roughly $150 less in total monthly retirement benefits under PSF than under WEP.

FIGURE 5

Present Value of Monthly Benefits for Hypothetical Worker C

Source: Calculations from authors.
Notes: PSF = the Public Servant Fairness Formula; WEP = the Windfall Elimination Provision. Calculations assume that the worker starts employment at age 25 in 2018 with a nominal salary of $40,000. We then apply an annual salary growth rate of 3.8 percent. These results assume he or she works 15 years of noncovered employment first followed by 20 years of covered employment. We also assume the worker claims benefits at the full retirement age.

Under WEP, this worker would also have her benefits reduced because she receives a noncovered pension. But because her pension is very small, she does better under WEP because of the protection that limits the size of the Social Security benefit reduction to one-half of the noncovered pension received. With this protection, Worker C's Social Security benefit is only reduced by $105 per month, allowing her to receive higher total combined benefits in retirement. This worker is an example of the 0.5 million beneficiaries estimated by OCACT to receive a larger cut under PSF than WEP if it were applied to new beneficiaries in 2018.

Policy Options

Many pension plans for noncovered state and local government employees do not provide retirement benefits for short-tenured workers that are equivalent to Social Security. This shortcoming already undermines the retirement security of many government workers. PSF may further compound the retirement challenges of these workers. As shown in the previous examples, short-tenured workers who are not able to vest in their pension, or whose contributions are worth more than their promised benefits, could try to partially mitigate these risks by rolling over the retirement contributions they withdraw into a retirement savings account. But these employees miss out on any benefits that would have been financed by their employers' contributions. Instead, those employer contributions are used to fund benefits for long-tenured workers. Further, many who could roll over their retirement contributions into another account do not, and research from the private sector shows that this type of leakage has a significant impact on retirement savings (Munnell and Webb 2015). For these workers who split their careers between covered and noncovered employment, the portable Social Security benefits they earned and retain under WEP are critical to protecting their retirement security.

Policymakers interested in improving protections for workers who split their careers between covered and noncovered work under the PSF proposal could consider a range of options, including requesting more detailed distributional analysis of affected beneficiaries, changing regulations to improve the adequacy of noncovered pensions, adding some of the WEP protections to the proposed PSF legislation, improving administration of the existing WEP using new data and analytical tools, and making Social Security coverage universal.

Request Additional Analysis

The examples given in this brief illustrate some of the types of workers whose retirement security could be undermined by the PSF proposal, but more data and analysis is needed. SSA could conduct a more detailed distributional analysis of the proposal using their extensive data on worker's earnings histories to more fully understand the impact of the legislation on future retirees. SSA could simulate how the PSF would affect future beneficiaries based on existing work histories in covered and noncovered earnings. Given the tens of millions of retirees who will be affected by this policy, more extensive distributional analysis would help target protections for vulnerable beneficiaries and estimate the costs of those options.

Update Regulations Governing Noncovered Pensions

The regulations that establish the standards for testing whether noncovered government pension plans provide benefits equivalent to Social Security are contained in the employment tax regulations. These regulations could be revised to protect short-tenured workers. Currently, these regulations only consider whether a worker who stayed in a noncovered plan for his or her entire career will receive a benefit comparable to Social Security. Although the Treasury Department could amend the regulations under its current authority, such changes could be controversial and entail significant costs to state and local budgets and would therefore be smoother if Congress provided direction to the Treasury in legislation addressing the PSF proposal.

Modify PSF and Improve Administration

The PSF benefit calculation could be modified to provide protections for workers who have substantial noncovered earnings and no pension benefit or whose benefit is smaller than the proposed reduction. Provisions similar to those included in WEP that (1) prevent Social Security benefits from being reduced when no pension is received and (2) limit the amount of the reduction to one-half of the noncovered pension would protect short-tenured workers and those who change jobs but lack portability of their benefits. Importantly, one analysis found that limiting the size of the benefit reduction to one-half of the noncovered pension provides some protection to lower-earning households (Gustman, Steinmeier, and Tabatabai 2014). A significant drawback of adding these types of protections to the PSF is that they would increase the cost of the proposed legislation. Further analysis is needed to develop options that strike a balance between these competing goals.

An attractive feature of the PSF is that it eliminates the need for beneficiaries to report whether they receive a pension. Instead, SSA can calculate the formula and administer the reduction using data it already collects. However, SSA may be able to use other data sources and methods to determine whether workers receive a pension, including data on tax form 1099-R (Distributions from Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.). Accessing this data would require authorization for IRS to share these reports with SSA. SSA could also consider developing a database on pension plan rules that would help identify which beneficiaries receive a noncovered pension. SSA could also explore using data analytics to compare employment and earnings histories of new applicants with data already available on current retirees subject to WEP to identify who would be subject to a reduction under either provision.

Implement Universal Coverage

Improving how benefits are reduced to account for noncovered pensions would improve the retirement security of millions of workers. This would be a step forward in many ways, but it would not address the larger and more fundamental challenge posed by not having all workers covered by Social Security. Proposals to achieve universal Social Security coverage have been included in past commissions focused on addressing Social Security solvency because of the benefits to workers and because it would improve the fairness of the overall system. Some also point to the risks posed to noncovered workers by underfunding in government plans as a reason to consider universal coverage (Gale, Holmes, and John 2015). Most proposals would expand coverage over time starting with new hires. But doing so would entail increased costs to state and local governments and is likely to be opposed by many groups representing noncovered workers. To facilitate the transition, policymakers should consider options to ease the burden of transition costs for the affected state and local governments, particularly if coverage is achieved in the context of a larger package of Social Security reforms.

Conclusion

The Equal Treatment of Public Servants Act of 2018 would replace the WEP adjustment for workers who receive a government pension from noncovered employment with a new approach known as the PSF. The new approach would improve retirement security for millions of state and local government workers across the country who would receive a larger benefit reduction under the WEP. It would also improve fairness by reducing benefits for some workers who fail to report receiving a noncovered pension and those who receive too small of a reduction under WEP. It would do so by replacing a

somewhat arbitrary adjustment with a more intuitive and straightforward approach. However, this brief raises concerns about the large number of beneficiaries who would be subject to benefit reductions despite never receiving a noncovered pension or receiving a pension that does not provide benefits that are equivalent to Social Security, as required under law.

Noncovered state and local pensions provide retirement security for millions of workers who have long careers with the same employer. However, the benefit design of most noncovered plans effectively redistributes benefits from younger, mobile workers to older, longer-tenure workers. Further, the protections in law that should ensure that all noncovered workers enjoy benefits at least equivalent to Social Security—and would provide a valid premise for a reduction under the PSF—fail to account for key features of those plans such as vesting requirements, contribution rates, and back-loaded benefit structures. These plan features have been used in recent years by state and local government plans to cut pension costs and address funding shortfalls while remaining within the Social Security safe harbor. These changes undermine the retirement security of noncovered workers and the rationale for the WEP and PSF adjustments.

Unfortunately, the PSF approach unintentionally exacerbates some of these same problems. By reducing benefits solely on the basis of years of noncovered earnings, the PSF could leave millions with lower Social Security benefits and little or no government pension from years of work outside of Social Security. Our analysis shows that workers could face reductions of 25 to 30 percent of their monthly Social Security benefit while receiving no pension from their years of noncovered work or, if they receive a pension, the PSF could reduce benefits by more than the amount of the monthly noncovered pension. Further, it reduces benefits most for shorter-tenure workers who are already getting the least out of their noncovered pension plans because of the back-loaded benefit design and loopholes in the regulations governing benefit adequacy.

Replacing WEP with the PSF could be an important step forward in improving equity between Social Security beneficiaries if it is also combined with changes to protect the retirement security of noncovered workers. Policymakers could consider a range of options, beginning with a request for additional analysis of how beneficiaries would be affected. They could also consider revising the regulations governing the adequacy of noncovered pension benefits to include a more comprehensive test of plan provisions that ensures noncovered workers receive benefits truly equivalent to Social Security, as required by law. Moreover, certain protections for short-tenure workers could also be included in the PSF to prevent reductions from applying to beneficiaries who do not receive a pension and to limit the amount of the reduction relative to the size of the noncovered pension. Alternative

approaches to administering either the PSF or the WEP that make use of new and existing tools could also be explored to address concerns with improper payments.

Addressing these issues with the WEP and PSF would be an improvement over the current system, but they would not address the more fundamental concerns that stem from failing to cover all workers in Social Security. Noncovered workers lack portability of their benefits, and future promised benefits are at risk from underfunding in government pension plans. In the past, commissions addressing Social Security solvency recognized these concerns and recommended making Social Security coverage universal. Achieving universal coverage would entail significant costs to state and local governments. Policymakers could consider options to ease the costs of transitioning to universal coverage for affected state and local governments in the context of a larger package of reforms to achieve Social Security solvency.

Appendix A. Brief Primer on Actuarial Methodology

For all the actuarial models in this brief, we used the mortality assumptions found in the RP-2014 tables provided by the Society of Actuaries (Society of Actuaries 2014). Our mortality figures specifically come from the total dataset of males and females, which we blended together equally to have a unified mortality vector. We then applied a static projection with Scale MP-2014 defined in calendar year 2018 (Society of Actuaries 2014). The purpose of this projection is to adjust the original mortality rates so that they can apply to someone in the present and not to someone back in 2014, when the original tables were compiled.

Figure 2 showed lifetime benefits for typical workers in noncovered plans. To model these benefits, we calculated and compared the present value of the standard pension annuity and the value of the employee contributions growing with interest. We assumed that employee contributions grow at an annual rate of 5.3 percent, an assumption that matches the discount rate used in the report. The value of the standard annuity is calculated using the traditional formula for defined-benefit plans:

$$\text{Benefit} = \text{Multiplier} \times \text{Years of Service} \times \text{Final Average Salary}$$

The multiplier represents a constant percentage set by the state or the employer, the final average salary is the average of some set of highest salaries, and the years of service is the number of creditable service years that the employee has earned. We then discount these future expected benefits back to the entry age so that we can get a sense of what they are worth today. The normal retirement eligibility is set at age 62 with 5 years of service, reflecting recent trends that are pushing the normal retirement age higher among noncovered plans. We did not model early retirement, but including it could increase lifetime pension benefits because it would allow the early retiree to draw a pension for longer periods of time than someone who had to wait until normal retirement.

The provisions used to generate the lifetime benefits for typical workers in noncovered employment came from an assessment of data compiled in the Urban Institute State and Local Employee Pension Plan Database.[12] Table A.1 lists the main provisions for this portion of the analysis. We obtained these numbers by averaging over all plans, but we weighted our results by the number of active members in each plan so that we could prevent smaller pension systems from having an outsize influence on the averages.

Actuarial Assumptions for Typical Noncovered Worker in America

Parameter	Value
Discount rate	5.3%
Employee contribution rate	9.6%
Vesting	5 years
Final average salary	5 years
Multiplier	2.2%

Source: Authors' estimates based on data from Urban Institute's State and Local Employee Pension Plan Database. These provisions are weighted averages that account for the number of active members in noncovered pension plans.

To calculate future Social Security benefits, we projected the bend points and index factors according to the rules specified by SSA. We assumed that the person began working at age 25 and entered the workforce in 2018. We adopted a starting salary of $40,000, a salary growth rate of 3.8 percent, and a cost-of-living-adjustment rate of 3 percent for benefit growth. We also adjusted future expected benefits by taking mortality into account. We then discounted our results back to the entry age using the intermediate nominal interest rate of 5.3 percent from the 2018 Social Security Trustees Report.

Appendix B. PSF and Pattern of Earnings

In figure 1, we showed the impact of PSF on a low-income earner compared to a worker with earnings equal to the Social Security taxable maximum in every year. The results assumed that both workers spent 20 years in covered and 15 years in noncovered employment and that both worked in covered employment first. In that example, the PSF provides the low earner with a higher benefit (and higher replacement rate) than the WEP. However, this result is sensitive to assumptions about the pattern of covered versus noncovered earnings.

In figure A.1, we show two workers who have the same earnings history with one key difference. Worker 1 starts her career in covered employment (exactly the same as the original worker from figure 1). Worker 2 starts in noncovered employment. When we switch the pattern of earnings in this way, we see that while Worker 1 does better under the PSF, Worker 2 fares better under the WEP. This is because of two factors: the benefit structure of most government pension plans and the design of the WEP.

First, Worker 2 spends his lowest earning years (early in his career) in noncovered employment. Because most government pension plans base benefits off of the last years of earnings, this worker earns only a small pension benefit of about $210 a month. Worker 1, conversely, spends her highest earning years in noncovered employment and earns a much larger benefit of $1,351 a month. So even though they both spend 15 years in a government pension plan, Worker 1 is rewarded more by her public pension plan because she was a relatively higher earner. Meanwhile, both workers earn similar Social Security benefits, reflecting the program's progressive benefit formula that averages more years of earnings and replaces a higher share of earnings for lower income workers.

Second, the WEP limits the amount that a worker's Social Security benefit can be reduced for a noncovered pension to one-half of the amount of the pension, but PSF does not. Worker 1's noncovered pension is so large that it does not trigger the limitation under the WEP; therefore, she receives a higher benefit under the PSF. Worker 2, however, would face a benefit reduction of $254 under the PSF, or one-third of his unadjusted benefit. The reduction exceeds the amount of his noncovered pension by over 20 percent, or $44 a month, leaving him with total combined benefits of $737 a month.

Under WEP, Worker 2's reduction is limited to $105 a month, or 13 percent of his benefit (versus $334 under WEP without the limit). Worker 2 earns higher combined benefits under WEP of $886 a month. The result is that the PSF overcompensates for noncovered earnings of shorter-tenure workers and reduces benefits most for those who are already getting the least out of their noncovered pension.

Comparison of Monthly Benefits for Hypothetical Low-Income Earners with Reversed Pattern of Earnings

Source: Calculations from authors.
Notes: PSF = the Public Servant Fairness Formula; WEP = the Windfall Elimination Provision. Worker 1 has 20 years of covered work followed by 15 years noncovered work; Worker 2 has 15 years of noncovered work followed by 20 years of covered work. Calculations assume that both workers start employment at age 25 in 2018 with a nominal salary of $40,000. We then apply an annual salary growth rate of 3.8 percent. The results shown here are future projections discounted back to yield present values. We also assume that the workers claim their benefits at the full retirement age.

Notes

[1] See Government Accountability Office, Coverage of Public Employees and Implications for Reform, June 9, 2005, https://www.gao.gov/assets/120/111755.pdf.

[2] Equal Treatment of Public Servants Act, H.R. 6933, 115th Cong. (2018).

[3] See Social Security Administration, "Fact Sheet on the Old-Age, Survivors, and Disability Insurance Program," accessed March 4, 2019, https://www.ssa.gov/OACT/FACTS/fs2018_06.pdf.

[4] For this report, we only address the WEP, but the analysis is largely the same with regard to Government Pension Offset. The president's budget for fiscal year 2017 proposed changing how both the WEP and Government Pension Offset are administered to make full use of covered and noncovered earnings records. The Equal Pay for Public Servants Act does not change the Government Pension Offset.

[5] SSA relies on self-reported data for beneficiaries, except for federal government employees. SSA has an automated data match with the Office of Personnel Management that identifies workers with a noncovered pension.

[6] Equal Treatment of Public Servants Act, H.R. 6933, 115th Cong. (2018).

[7] For more detailed analysis of the implications of the WEP, see Brown and Weisbenner (2013).

[8] See Social Security Office of the Chief Actuary, Letter to Chairman Brady, October 4, 2018, https://www.ssa.gov/oact/solvency/KBrady_20181004.pdf.

[9] See Social Security Administration, "Program Explainer: Windfall Elimination Provision," accessed March 4, 2019, https://www.ssa.gov/policy/docs/program-explainers/windfall-elimination-provision.html.

[10] See the Omnibus Budget Reconciliation Act of 1990, Pub. L. No: 101-508, 104 Stat. 1388 (1990). https://www.congress.gov/bill/101st-congress/house-bill/5835/text.

[11] Authors' calculations based on data from the Urban Institute State and Local Employee Pension Plan Database. See "The Urban Institute State and Local Employee Pension Plan Database," Urban Institute, accessed February 27, 2019, https://www.urban.org/policy-centers/cross-center-initiatives/program-retirement-policy/projects/urban-institute-state-and-local-employee-pension-plan-database.

[12] See "The Urban Institute State and Local Employee Pension Plan Database," Urban Institute, accessed February 27, 2019, https://www.urban.org/policy-centers/cross-center-initiatives/program-retirement-policy/projects/urban-institute-state-and-local-employee-pension-plan-database.

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