**COMMISSION ON CALIFORNIA STATE GOVERNMENT ORGANIZATION AND ECONOMY**
11th & L BUILDING, SUITE 550, (916) 445-2125
SACRAMENTO 95814



# SHOULD SOCIAL SECURITY COVERAGE BE CONTINUED FOR CALIFORNIA STATE EMPLOYEES?

STATE OF CALIFORNIA

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# A D D E N D U M

The conclusion of the Commission on California State Government Organization and Economy that it is not in the best interests of the State or its employees to opt out of the Social Security System should not be interpreted to apply to local government jurisdictions and their employees having different retirement systems. Local government policy determing bodies might well reach different conclusions.

# SHOULD SOCIAL SECURITY COVERAGE BE CONTINUED FOR CALIFORNIA STATE EMPLOYEES?

A Study By The

Commission on California State Government Organization and Economy

April, 1977

STATE OF CALIFORNIA EDMUND G. BROWN JR., *Governor*

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SACRAMENTO 95814



April 1977

Honorable Edmund G. Brown Jr.
Governor, State of California

Honorable James R. Mills
President pro Tempore, and to Members of the Senate

Honorable Leo T. McCarthy
Speaker, and to Members of the Assembly

Ever since California State employees joined the Social Security System in 1961--and even before that--there has been considerable controversy over whether Social Security coverage is the best buy from the standpoint of comparing benefits received to cash paid out. Many feel that the amount paid into Social Security by the employee and the State could purchase better benefits--or the same benefits at a savings--if it were used to improve the Public Employees' Retirement System (PERS). That annual combined employee-employer contribution increases annually as salaries rise. In 1972-73 it was approximately $100 million. It rose to more than $165 million in 1976.

On the other hand, others feel that the wide range of steadily improving benefits provided under Social Security--especially those related to Medicare--could not possibly be provided by PERS alone without a significant increase in costs.

Adding fuel to the debate is the fact that many public jurisdictions, including 140 in California alone, have exercised their option to withdraw from Social Security, on grounds that the system is not the most economical way to provide employee benefits. In addition, recent increases in Social Security benefits without comparable increases in contributions have put the system in a situation where it is now paying out about 1 percent more than it is taking in. That disparity is expected to increase to about 8 percent in the next 75 years if changes are not made.

In light of these pressures both for and against continued State participation in Social Security, the Commission undertook a detailed study of the entire matter in order to provide solid

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background information for the legislative and executive branches to make a decision. A Commission Subcommittee comprised of Donald G. Livingston, Chairman, Robert J. DeMonte, Assemblyman Jack R. Fenton, and H. Herbert Jackson provided policy guidance and direction to the Commission staff in the conduct of the study.

First, the Commission contracted with the Wyatt Company, a nationally recognized actuarial and employee benefit consulting firm to provide an independent analysis of the complex issues. The report of the actuary, Allen Arnold, is included as Exhibit A in the appendix of this report.

Second, PERS complied with the Commission's request for an analysis of which benefits provided under social security would be lost upon termination, and to estimate the cost to the State of replacing them under PERS.

Third, the Commission held three public hearings in 1976--July 19 in Sacramento, August 11 in San Francisco, and September 1 in Los Angeles. Witnesses included representatives of major employee organizations, PERS, the Wyatt Company, the Social Security Administration, the Legislative Analyst's Office, the State Department of Finance, taxpayer organizations and two cities which have withdrawn from social security--San Jose and West Covina.

It was on the basis of these reports and testimony, plus research of considerable nationwide analysis on this controversial issue, that the Commission has developed its recommendation that it is not in the best interest of the State or its employees to opt out of the Social Security System. The Commission further proposes that the Legislature urge Congress to correct financing and benefit shortcomings in the Social Security System and expand Social Security to mandate universal coverage for all employees. Finally, it is suggested that the Legislature and PERS provide better integration of the PERS system with social security.

Respectfully,

Donald G. Livingston

DONALD G. LIVINGSTON
Subcommittee Chairman

Nathan Shapell

NATHAN SHAPELL
Chairman

| | |
|---|---|
| Senator Alfred E. Alquist | H. Herbert Jackson |
| Maurice Rene Chez | Senator Milton Marks |
| Robert J. DeMonte | Manning J. Post |
| Assemblyman Jack R. Fenton | Lloyd Rigler |
| Assemblyman Richard D. Hayden* | Carmen H. Warschaw |

*Appointed to Commission on March 15, 1977, therefore, did not participate in the study.

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## A. BACKGROUND

When the social security system was created in 1937, all employees of private employers were required to join. But due to the constitutional ban against the federal government unilaterally imposing taxes (such as the social security payroll tax) on state and local governments, they were exempted from mandatory coverage.

However, 1950 amendments to the Social Security Act allowed state and local government agencies to voluntarily join social security if their employees were not covered by another retirement system already. Further amendments in 1954 allowed social security coverage even to those who had their own systems, as California does, as long as the individual employee agrees to join.

Police officers and fire fighters were excluded from coverage. Employees of non-profit organizations are allowed to voluntarily join social security. But, strangely enough, the 2.5 million federal government employees are not included in social security at all, either on a mandatory or voluntary basis. They have a retirement system of their own.

California state employees rejected social security coverage in votes during 1955 and 1959. However, legislation was signed into law by Governor Edmund G. Brown in 1961 adding the state to the social security system, with employees given the option of whether to join. Of the 131,000 state and University of California employees eligible to become "coordinated" with PERS and social security, only one-quarter of them

(33,390) chose to do so in 1961. The remaining 97,610 voted to remain with PERS alone. In 1965, legislation was enacted giving the original abstainers a second chance to join social security, but only 4,900 of the 68,870 who were eligible chose to do so.

In 1967, the California State Employees' Association polled its membership on the withdrawal, although it was not a scientifically structured survey. Of those who responded, roughly 29,000 favored withdrawal while about 23,000 favored staying in social security.

The ranks of those who remain with PERS alone have shrunk to about 30,000 now, due to retirements and death and the fact that they are not being replenished; all employees joining state service after 1961 are required to be coordinated with social security.

In 1959, the Social Security Act was amended to allow California to provide social security coverage for their police and fire employees covered by a retirement system. California has not chosen to do so. Consequently, state employees who are designated "police officers" or "firefighters" are not covered by social security, and instead are in the "patrol" and "safety" categories of PERS. These members have generally higher retirement benefits than the remaining bulk of the state work force who fall in the "miscellaneous" member category of PERS.

The state classes exempt from social security coverage and added to the safety category have increased in recent years, due to being determined to properly fall under the police or firefighter category. These transfers included 4,400 Department of Forestry employees (December 1969); 6,600 in the departments of Corrections and Youth Authority (March 1973); as well as smaller numbers of fish and game wardens, narcotics enforcement employees and certain Criminal Identification and Information employees (November 1970) and State Police officers (March 1972). Because safety and patrol members are not currently in social security, the Commission limited its general study to the effects of potential withdrawal on miscellaneous members of PERS.

PERS has provided a breakdown (Table 1) of membership in its various categories and the numbers who have the minimum five years' service required to qualify for a retirement benefit.

## B. HISTORY OF WITHDRAWALS

A local or state entity which opts for social security coverage must remain in the system for at least five years. After that, it may withdraw from social security after giving two years' advance notice, which may be rescinded any time in that period. Under current law, once a government agency withdraws from social security, it may never rejoin even if re-entry is desired by future administrators or every single one of the employees. This could be a considerable drawback if future federal legislation should provide for a major new benefit, such as national health insurance, and ties it to social security coverage.

The 1950s saw a rapid increase in the number of state and local government employees covered by social security (Table 2). In recent years the proportion of covered employees has generally stabilized around 70 percent

## TABLE 1

### SOCIAL SECURITY COVERAGE FOR CALIFORNIA STATE EMPLOYEES

| Length of Employment | With Soc. Sec. | Without Soc. Sec. | Total |
|---|---|---|---|
| State Miscellaneous | | | |
| 0 -4.99 Yrs. | 58,600 | 1,628 | 60,228 |
| 5.00 + | 51,119 | 32,377 | 83,495 |
| S - Total | 109,719 | 34,005 | 143,724 |
| California Highway Patrol | | | |
| 0 - 4.99 Yrs. | | 1,147 | 1,147 |
| 5.00 + | | 4,323 | 4,323 |
| Total | | 5,470 | 5,470 |
| State Safety | | | |
| 0 -4.99 Yrs. | | 5,989 | 5,989 |
| 5.00 + | | 5,958 | 5,958 |
| Total | | 11,947 | 11,947 |

The above information is based upon data as of June 30, 1975. The data for the State Miscellaneous member category includes approximately 10,000 University of California members who elected to remain under PERS.

TABLE 2

TABLES ON SOCIAL SECURITY COVERAGE
OF GOVERNMENTAL EMPLOYEES PREPARED BY THE
HOUSE WAYS AND MEANS SUBCOMMITTEE ON SOCIAL SECURITY

EXTENT OF SOCIAL SECURITY COVERAGE OF
EMPLOYEES OF STATE AND LOCAL GOVERNMENTS, 1951-75
(In thousands of workers in June of each year)

| Year | Total number of employees | Number of employees covered under social security | Number of employees not covered under social security | Percentage of employees covered by social security |
|---|---|---|---|---|
| 1951 | 3,400 | N/A | N/A | N/A |
| 1952 | 3,830 | 500 | 3,330 | 13.0 |
| 1953 | 3,670 | 730 | 2,940 | 19.9 |
| 1954 | 4,200 | 960 | 3,240 | 22.9 |
| 1955 | 4,340 | 1,210 | 3,130 | 27.9 |
| 1956 | 4,480 | 1,840 | 2,640 | 41.1 |
| 1957 | 4,610 | 2,136 | 2,474 | 49.6 |
| 1958 | 4,960 | 3,000 | 1,960 | 60.5 |
| 1959 | 5,210 | 3,100 | 2,110 | 59.5 |
| 1960 | 5,410 | 3,300 | 2,110 | 61.0 |
| 1961 | 5,590 | 3,200 | 2,390 | 57.2 |
| 1962 | 6,020 | 3,800 | 2,220 | 63.1 |
| 1963 | 6,460 | 4,000 | 2,460 | 61.9 |
| 1964 | 6,600 | 4,700 | 1,900 | 71.2 |
| 1965 | 6,890 | 4,900 | 1,990 | 71.1 |
| 1966 | 7,260 | 5,600 | 1,660 | 77.1 |
| 1967 | 8,030 | 6,200 | 1,830 | 77.2 |
| 1968 | 8,710 | 6,300 | 2,410 | 72.3 |
| 1969 | 8,890 | 6,600 | 2,290 | 74.2 |
| 1970 | 9,700 | 6,600 | 3,100 | 68.0 |
| 1971 | 10,380 | 7,060 | 3,320 | 68.0 |
| 1972 | 10,730 | 7,300 | 3,430 | 68.0 |
| 1973 | 11,100 | 7,550 | 3,550 | 68.0 |
| 1974 | 11,570 | 7,870 | 3,700 | 68.0 |
| 1975 | 12,390 | 8,670 | 3,720 | 69.9 |

Source: Social Security Administration, Bureau of Data Processing.

of the state and local government work force. Social security officials note that the few withdrawals which occurred through the 1960s were usually because the employing governmental agency was abolished. However, a trend developed in the 1970s for governmental units to withdraw in order to invest the social security contributions of the employer and employee in retirement systems of their own. As of March 1972, only 133 groups had withdrawn, accounting for fewer than 10,000 employees. But by March 1976, the number of terminated agencies had more than doubled and the number of withdrawn employees had increased four-fold. Social security officials say that if current termination notices are implemented, 232 more government agencies employing about 454,000 workers will be withdrawn in the next two years.

Although the state and local government employees joining the system still outnumber those leaving it, the terminations are of mounting concern, particularly when they involve large numbers of employees as those in California have done (Table 3). So far, 140 California jurisdictions have either withdrawn or given notice they intend to do so. Alaska is the only state to announce its intent to withdraw its state employees. Withdrawal of large single groups of employees is a major factor in discussions about the soundness of the social security system. The largest so far is New York City, which has given notice it intends to withdraw its 150,000 employees to save an estimated $250 million a year in contributions and thus avert layoffs.

In an August 1976 report, the Bureau of National Affairs comments on government concern about the increasing number of withdrawals:

> "In the face of many calls for mandatory coverage of state and local entities, some governments have given the two-year notice

TABLE 3

NUMBER OF STATE AND LOCAL GOVERNMENT GROUPS AND EMPLOYEES NEWLY COVERED UNDER SOCIAL SECURITY OR WHOSE COVERAGE HAS BEEN TERMINATED IN THE PERIOD 1973-75--BY STATE [1]

| State | Coverage extended: Number of groups | Coverage extended: Number of employees[2] | Coverage terminated: Number of groups | Coverage terminated: Number of employees | Net gain or loss of coverage of employees |
|---|---|---|---|---|---|
| Alabama | 74 | 750 | 0 | 0 | +750 |
| Alaska | 20 | 921 | 0 | 0 | +921 |
| Arizona | 13 | 942 | 0 | 0 | +942 |
| Arkansas | 38 | 162 | 0 | 0 | +162 |
| California | 88 | 2,931 | 77 | 18,414 | -15,433 |
| Colorado | 38 | 205 | 4 | 382 | -177 |
| Connecticut | 25 | 256 | 0 | 0 | +256 |
| Delaware | 8 | 108 | 0 | 0 | +108 |
| Florida | 60 | 1,306 | 0 | 0 | +1,306 |
| Georgia | 60 | 3,098 | 4 | 615 | +2,483 |
| Hawaii | 0 | 0 | 0 | 0 | 0 |
| Idaho | 40 | 92 | 0 | 0 | +92 |
| Illinois | 230 | 3,354 | 0 | 0 | +3,354 |
| Indiana | 49 | 3,308 | 0 | 0 | +3,308 |
| Iowa | 70 | 704 | 0 | 0 | +704 |
| Kansas | 63 | 485 | 0 | 0 | +485 |
| Kentucky | 71 | 1,638 | 0 | 0 | +1,638 |
| Louisiana | 26 | 441 | 33 | 5,331 | +4,890 |
| Maine | 23 | 212 | 1 | 14 | +198 |
| Maryland | 16 | 1,639 | 0 | 0 | +1,689 |
| Massachusetts | 0 | 0 | 0 | 0 | 0 |
| Michigan | 93 | 1,363 | 0 | 0 | +1,363 |
| Minnesota | 119 | 926 | 0 | 0 | +926 |
| Mississippi | 50 | 974 | 0 | 0 | +974 |
| Missouri | 132 | 1,576 | 0 | 0 | +1,576 |
| Montana | 21 | 83 | 0 | 0 | +83 |
| Nebraska | 45 | 2,565 | 0 | 0 | +2,565 |
| Nevada | 8 | 181 | 0 | 0 | +181 |
| New Hampshire | 11 | 58 | 0 | 0 | +58 |
| New Jersey | 55 | 1,935 | 0 | 0 | +1,935 |
| New Mexico | 21 | 697 | 0 | 0 | +697 |
| New York | 62 | 1,734 | 0 | 0 | +1,734 |
| North Carolina | 94 | 6,918 | 0 | 0 | +6,918 |
| North Dakota | 30 | 61 | 0 | 0 | +61 |
| Ohio | 1 | 3 | 0 | 0 | +3 |
| Oklahoma | 62 | 1,655 | 0 | 0 | +1,655 |
| Oregon | 59 | 328 | 0 | 0 | +328 |
| Pennsylvania | 219 | 1,920 | 0 | 0 | +1,920 |
| Puerto Rico | 0 | 0 | 0 | 0 | 0 |
| Rhode Island | 3 | 21 | 0 | 0 | +21 |
| South Carolina | 54 | 638 | 0 | 0 | +638 |

(continued on next page)

TABLE 3 (cont.)

| State | Number of groups | Number of employees[2] | Number of groups | Number of employees | Net gain or loss of coverage of employees |
|---|---|---|---|---|---|
| South Dakota | 23 | 93 | 0 | 0 | +93 |
| Tennessee | 58 | 799 | 0 | 0 | +799 |
| Texas | 117 | 3,044 | 24 | 2,842 | +202 |
| Utah | 12 | 154 | 0 | 0 | +154 |
| Vermont | 30 | 240 | 0 | 0 | +240 |
| Virginia | 36 | 2,228 | 0 | 0 | +2,228 |
| Virgin Islands | 1 | 198 | 0 | 0 | +198 |
| Washington | 38 | 1,581 | 9 | 804 | +777 |
| West Virginia | 34 | 357 | 0 | 0 | +357 |
| Wisconsin | 52 | 1,183 | 0 | 0 | +1,183 |
| Wyoming | 29 | 2,211 | 0 | 0 | +2,211 |
| Instrumentalities | 6 | 146 | 0 | 0 | +146 |
| Total | 2,587 | 58,522 | 152 | 28,402 | +30,120 |

[1]The term "groups" for termination purposes is generally broader than for coverage which is a single group for termination purposes may include a number of groups within the city that were covered at different times (e.g. groups of employees under policemen, firemen, teachers', and city retirement systems).

[2]Represents the number of positions covered for the first time due to modification of State coverage agreements. Does not include increases in the number of covered positions which result from automatic coverage when (1) the work force in a covered entity is expanded, or (2) a job vacated by an employee who had not elected coverage in entity in which coverage was effected by the divided retirement system approach is filled by a new employee, or (3) there are noncovered positions in a groups that becomes a part of another group that had been previously covered.

Source: Social Security Administration, Bureau of Data Processing.

of termination in an effort to leave the option open in case Congress decides to outlaw further withdrawals. The Social Security Administration is concerned that a domino effect may materialize, and some experts are urging state and local governments to study the question of withdrawal before giving notice, warning that a flurry of withdrawal notices may push forward legislation to make participation in the social security system compulsory."

## C. SOCIAL SECURITY COSTS

Soaring social security payroll taxes levied against both the employee and employer have provided the major impetus for many jurisdictions to opt out of social security, and for many more to be currently considering to do the same. The contribution rate for both employee and employer is currently 5.85 percent of earnings (4.95 percent for social security plus 0.90 percent for Medicare). That produces a total contribution by the state and its employees of 11.7 percent of payroll. The Social Security Act provides for regular increases in the rate, to an eventual 7.45 percent in the year 2011 (5.95 percent for social security and 1.50 percent for Medicare), for a total employer-employee contribution of 14.9 percent (Table 4).

The second factor in the overall cost increase is the steadily rising "earnings base," the maximum amount of annual income which is subject to the social security tax. Before 1972, the earnings base was set by legislation and, for many years, it went unchanged although earnings increased. However, 1972 amendments to the Social Security Act provided a built-in escalator by

TABLE 4

Earnings base and tax rate for the employee and employer, each, for Social Security by OASDI and HI from 1966 and projected to 1985, and legislated tax rate until 2011.

| Year | Earnings Base | Tax Rate | | |
|---|---|---|---|---|
| | | Total | OASDI | HI |
| 1966 | $ 6,600 | 4.20 | 3.85 | 0.35 |
| 1967 | 6,600 | 4.40 | 3.90 | 0.50 |
| 1968 | 7,800 | 4.40 | 3.80 | 0.60 |
| 1969-1970 | 7,800 | 4.80 | 4.20 | 0.60 |
| 1971 | 7,800 | 5.20 | 4.60 | 0.60 |
| 1972 | 9,000 | 5.20 | 4.60 | 0.60 |
| 1973 | 10,800 | 5.85 | 4.85 | 1.00 |
| 1974 | 13,200 | 5.85 | 4.95 | 0.90 |
| 1975 | 14,100 | 5.85 | 4.95 | 0.90 |
| 1976 | 15,300 | 5.85 | 4.95 | 0.90 |
| 1977 | 16,500 | 5.85 | 4.95 | 0.90 |
| 1978 | 18,300 | 6.05 | 4.95 | 1.10 |
| 1979 | 19,800 | 6.05 | 4.95 | 1.10 |
| 1980 | 21,300 | 6.05 | 4.95 | 1.10 |
| 1981-1985 | a | 6.30 | 4.95 | 1.35 |
| 1986-2010 | a | 6.45 | 4.95 | 1.50 |
| 2011-on | a | 7.45 | 5.95 | 1.50 |

SOURCE: U.S. Congress, House, Committee on Ways and Means, Hearings: Financing the Social Security System, 94th Cong., 1st Sess. (May 1975), pp. 28 and 38.

[a]Estimates beyond 1980 are not publicly available.

"indexing" the earnings base to any nationwide increase in income. Thus, when overall wages go up, the amount of income which is taxed increases proportionately.

The earnings base has more than doubled in the past six years, from $7,800 in 1971 to $16,500 in 1977. Because of the relatively low earnings base in earlier years, persons with middle to high incomes once paid a lower percentage of their annual income than did the low-paid, many of whom paid social security on all of their earnings. However, the recent rapid rise in the earnings base has made a sharp impact on the contribution which middle-income workers must pay. For example, a person earning $16,000 in 1971, paid tax on roughly half of his income. But in 1977, that same income is taxed in full. And over the same period, the tax rate itself has risen from 5.20 percent to 5.85 percent.

The State Department of Finance notes that the state government's contribution to social security has increased 50 percent the past four years--from $46.8 million in fiscal 1971-72 to $70.3 million in 1975-76. PERS estimates that the total contribution, counting the state's and its employees', will rise to $232 million in 1980 (Table 5). And Finance projects that if social security costs continue to increase at their current rate, California state government's tax could reach $3.2 billion annually by the year 2000, shared equally by employer and employee.

On the subject of employee contributions, the Commission has heard comments to the effect that, "There is no chance I can ever get back benefits at all comparable to all the money I've put into the social security system."

TABLE 5

**PUBLIC EMPLOYEES' RETIREMENT SYSTEM**

**Estimated Covered State Employees and**

**Member/Employer Social Security Contributions**

| Calendar Year* | Estimated Covered Members | Estimated Contributions: (Millions) | | |
|---|---|---|---|---|
| | | Member | Employer | Total |
| 1976 | 115,470 | $ 82.7 | $ 82.7 | $165.4 |
| 1977 | 117,779 | 91.0 | 91.0 | 182.0 |
| 1978 | 120,134 | 101.2 | 101.2 | 202.4 |
| 1979 | 122,537 | 108.6 | 108.6 | 217.2 |
| 1980 | 124,988 | 116.2 | 116.2 | 232.4 |

* Calendar year basis: one Social Security contribution rate per year, single maximum covered wage effective January 1, 1976.

**Assumptions:**

20% reduction for employees under maximum

5% annual increase in maximum covered wage

2% increase in number of employees covered by Social Security each year

However, this sentiment is clearly inaccurate. The Social Security Administration says that even if a person has been paying the maximum social security tax since the system was founded in 1937, his total contribution by 1976 would be only $7,700. If that person retired immediately, he would get his full investment back in only 19 months of typical social security benefits.

In that same vein, although perhaps with some exaggeration, the noted economist Paul Samuelson has said: "The beauty of social insurance is that it is actuarily unsound. Everyone who reaches retirement age is given benefits and privileges that far exceed anything he has paid in."

In addition to social security, state employees must pay into the PERS retirement system; they cannot belong to social security alone. The employee's contribution to PERS depends on whether he is coordinated with social security (Table 6). For coordinated members, the rate is 5 percent of the monthly salary which exceeds $513. For those covered by PERS only, the rate is 6 percent of the salary over $317. Patrol and safety members, who are not in social security, pay a higher rate to receive their higher retirement benefits. Note that for a coordinated member earning $1,000 a month (which is close to the average state employee salary), his $994.20 total contribution is 8.3 percent of his annual salary. The same salaried employee paying only to PERS contributes 4.1 percent of yearly salary.

## D. BENEFIT COMPARISONS AND REPLACEMENT COSTS

### 1. Benefit Structures

For most coordinated state employees, their social security benefits are

TABLE 6

**PUBLIC EMPLOYEES' RETIREMENT SYSTEM**

**State Miscellaneous Member Contributions**

**(PERS and Social Security)**

**Examples -- Calendar Year 1976**

| Monthly Compensation | | | | Annual Member Contributions | | |
|---|---|---|---|---|---|---|
| Gross | Excluded From PERS | Subject to PERS | Rate* | PERS | Social Security @ 5.85% | Total |
| $ 700 | $317 | $383 | 6% | $ 275.76 | $ -0- | $ 275.76 |
| 700 | 513 | 187 | 5% | 112.20 | 491.40 | 603.60 |
| 1000 | 317 | 683 | 6% | 491.76 | -0- | 491.76 |
| 1000 | 513 | 487 | 5% | 292.20 | 702.00 | 994.20 |
| 1500 | 317 | 1183 | 6% | 851.76 | -0- | 851.76 |
| 1500 | 513 | 987 | 5% | 592.20 | 895.05 | 1487.25 |
| 2000 | 317 | 1683 | 6% | 1211.76 | -0- | 1211.76 |
| 2000 | 513 | 1487 | 5% | 892.20 | 895.05 | 1787.25 |

***Rate** - We have shown two (2) calculations for each pay rate. The 5% member rate applies to miscellaneous members who have Social Security and a modified 1/50th benefit formula under PERS.

The 6% member rate applies to miscellaneous members who do not have Social Security and have the full 1/50th benefit formula under PERS.

basically supplemental to those received from PERS, as the latter benefits are generally higher. A coordinated employee's PERS allowance is reduced somewhat if he is receiving social security as well, but the amount of the cut is small compared to the added benefits derived from social security.

PERS says that, as a rule of thumb, the PERS benefit is reduced by $3 for every year of state service covered by social security. (Actually, the reduction is $2.67 at age 60 and $3.22 at the age 65.) Thus, a coordinated member with 10 years' service receives a PERS allowance about $30 less than a comparable employee who is outside social security. But in return, the coordinated member receives $247 from social security (assuming the current average benefit) plus a spouse benefit if his wife is age 62 or over.

Tables 7 and 8 provide a comparison of a typical service allowance under PERS alone and the combination of PERS and social security. Illustrated are various levels of service time and "final compensation", the average salary for the employee's three highest-paid consecutive years. The first chart is for males, the second for females. Because the benefit structure for social security and PERS are not entirely comparable, PERS has simplified the example by using the current average social security benefit of $246.65 (sometimes rounded off to $247) in developing comparison tables. In actuality, the 1976 social security benefits ranged from a minimum of $107.90 to a top of $387, depending on the average income level.

One significant feature of the social security system is that it favors those with low income. During a person's working years, the taxing system is actually "regressive." A low-income employee must pay a proportionately

PUBLIC EMPLOYEES' RETIREMENT SYSTEM

TABLE 7

**Male**, age 65, retiring 7/1/76 with female beneficiary, age 62
**Final** Compensation -- $700.00, $1,000.00, $1,500.00 and $2,000.00
Service -- 5 years, 10 years and 20 years.

Comparison of Allowance Results
1/50th Full Formula
1/50th Modified and Social Security*

### 1/50TH FULL FORMULA

| Service | Final Compensation | PERS Allowance Only |
|---|---|---|
| 5 years | $ 700.00 | $ 84.63 |
| 5 years | 1,000.00 | 120.90 |
| 5 years | 1,500.00 | 181.35 |
| 5 years | 2,000.00 | 241.80 |
| 10 years | 700.00 | 169.26 |
| 10 years | 1,000.00 | 241.80 |
| 10 years | 1,500.00 | 362.70 |
| 10 years | 2,000.00 | 483.60 |
| 20 years | 700.00 | 338.52 |
| 20 years | 1,000.00 | 483.60 |
| 20 years | 1,500.00 | 725.40 |
| 20 years | 2,000.00 | 967.20 |

### 1/50TH MODIFIED FORMULA AND SOCIAL SECURITY

| Service | Final Compensation | PERS Modified Allowance | Social Security Benefits* Man | Social Security Benefits* Wife | Total PERS Allowance & Social Security Without Wife's Ben. | Total PERS Allowance & Social Security With Wife's Ben. |
|---|---|---|---|---|---|---|
| 5 years | $ 700.00 | $ 68.51 | $246.65 | $105.24 | $ 315.16 | $ 420.40 |
| 5 years | 1,000.00 | 104.78 | " | " | 351.43 | 456.67 |
| 5 years | 1,500.00 | 165.23 | " | " | 411.88 | 517.12 |
| 5 years | 2,000.00 | 225.68 | " | " | 472.33 | 577.57 |
| 10 years | 700.00 | 137.02 | " | " | 383.67 | 488.91 |
| 10 years | 1,000.00 | 209.56 | " | " | 456.21 | 561.45 |
| 10 years | 1,500.00 | 330.46 | " | " | 577.11 | 682.35 |
| 10 years | 2,000.00 | 451.36 | " | " | 698.00 | 803.25 |
| 20 years | 700.00 | 274.04 | " | " | 520.69 | 625.93 |
| 20 years | 1,000.00 | 419.12 | " | " | 665.77 | 771.01 |
| 20 years | 1,500.00 | 660.92 | " | " | 907.57 | 1012.81 |
| 20 years | 2,000.00 | 902.72 | " | " | 1149.37 | 1254.61 |

* Assumes average social security benefits.

## TABLE 8

**PUBLIC EMPLOYEES' RETIREMENT SYSTEM**

**Female**, age 65, retiring 7/1/76
**Final** Compensation -- $500.00, $700.00 and $1,000.00
**Service** -- 5 years, 10 years and 20 years.

Comparison of Allowance Results
1/50th Full Formula
1/50th Modified and Social Security*

### 1/50TH FULL FORMULA

| Service | Final Compensation | PERS Allowance Only |
|---|---|---|
| 5 years | $ 500.00 | $ 60.00 |
| 5 years | 700.00 | 84.00 |
| 5 years | 1,000.00 | 120.00 |
| 10 years | 500.00 | 120.00 |
| 10 years | 700.00 | 168.00 |
| 10 years | 1,000.00 | 240.00 |
| 20 years | 500.00 | 240.00 |
| 20 years | 700.00 | 336.00 |
| 20 years | 1,000.00 | 480.00 |

### 1/50TH MODIFIED FORMULA AND SOCIAL SECURITY

| Service | Final Compen-sation | Social Security Benefit* | PERS Modified Formula Allowance | Total PERS Allowance & Social Security |
|---|---|---|---|---|
| 5 years | $ 500.00 | $199.61 | $ 44.00 | $243.61 |
| 5 years | 700.00 | " | 68.00 | 267.61 |
| 5 years | 1,000.00 | " | 104.00 | 303.61 |
| 10 years | 500.00 | " | 88.00 | 287.61 |
| 10 years | 700.00 | " | 136.00 | 335.61 |
| 10 years | 1,000.00 | " | 208.00 | 407.61 |
| 20 years | 500.00 | " | 176.00 | 375.61 |
| 20 years | 700.00 | " | 272.00 | 471.61 |
| 20 years | 1,000.00 | " | 416.00 | 615.61 |

* Assumes average social security benefits.

higher percentage of his income in taxes than a higher income person pays. For example, a person whose income was at the maximum earnings base of $15,300 in 1976 paid the 5.85 rate on his full salary. In contrast, a person earning $50,000 paid taxes on only the first $15,300, so it amounted to less than 2 percent of his total income. But in the retirement years, the picture reverses. The social security system favors the low-income employee by providing him a monthly allowance which is a far greater percentage ("replacement rate") of his pre-retirement earning than the percentage given to the high-income worker. This concept was adopted out of general recognition that those who have earned more throughout their working years will usually have sources of income during their retirement other than social security alone, on which many low-income workers must exist.

A comparison of benefits under PERS alone and coordinated with social security must include five areas: service retirement, disability, survivor benefits, health coverage and cost-of-living adjustments. The following four pages (Table 9) are a summary by PERS of benefits provided to state miscellaneous members who belong to PERS alone and those who are covered by social security, too. It also indicates possible substitute benefits which the state could provide to currently coordinated members to replace the benefits they would lose if the state should withdraw from social security.

2. Replacement of Social Security Benefits

Table 10 is the PERS estimate of the massive cost the state would have to bear for replacing the major benefits which would be lost with termination. PERS has provided the Commission with additional comments on its benefit replacement analysis:

TABLE 9

**SUMMARY OF BENEFITS**
**PRESENT PERS, STATE**
**MISCELLANEOUS MEMBERS 1/**

| ITEM | PERS ONLY | PERS/SOCIAL SECURITY COMBINATION | SUBSTITUTE FOR SS BENEFITS IF ANY 2/ |
|---|---|---|---|
| I. SERVICE RETIREMENT ALLOWANCE (NON-DISABILITY)<br>A. Member Benefit | The allowance depends on length of service, age at retirement and final compensation. For Example: 2.4% x years of service x final compensation (highest 3 consecutive years) at age 63. | The allowance for the coordinated member consists of two parts: A benefit from PERS and one from Social Security. The PERS allowance is computed as indicated in the column to the left, less a certain amount ($2.67 at age 60; $3.22 at age 65) for each year of service covered by Social Security since January 1, 1956. The Social Security benefit is based on average monthly wage under covered employment -- since 1956 for most state employees. | Improve present formula to add the average Social Security benefit. (presently $247. per month at age 65) |
| B. Wife's Benefit | None | In addition to the above, the wife of the coordinated employee may be entitled to a wife's benefit equal to one-half of the employee's Social Security retirement benefit at age 65. If she is also entitled to a Social Security benefit on her own account, she receives the highest one -- but not both. | Add a spouse's benefit (approximately 1/2 the member benefit - $124. per month) |
| C. Children's | None | If the retiree has dependent children under age 18, some additional Social Security retirement benefits are payable. | None |



TABLE 9

| ITEM | PERS ONLY | PERS/SOCIAL SECURITY COMBINATION | SUBSTITUTE FOR SS BENEFITS IF ANY 2/ |
|---|---|---|---|
| II. DISABILITY RETIREMENT | If incapacitated for performance of his job, an employee may retire for disability. The benefit is 1.8% of final compensation for each year of service with an improvement in some cases to one-third of final compensation if credited service exceeds 10 years. | The coordinated member is entitled to the same benefit from PERS without reduction. In addition he may be entitled to a disability retirement benefit from Social Security. The Social Security disability test is generally more rigorous than that of PERS. Benefits are also payable by Social Security for dependents of disabled worker. | Increase the PERS disability benefit factor per year of service from 1.8% to 2.7%. |
| III. SURVIVOR BENEFITS<br>A. Benefits on Death <u>Prior</u> to Retirement<br>1. Lump sum Death Benefit | If the member is below age 50 or over age 50 with less than 5 years of service then the beneficiary receives:<br>a. the Group Term Life Insurance Benefit of $5000; and 50% of annual compensation earnable (salary rate) during the 12 months immediately preceding death. A proportionate part of 50% is payable if the member also has service in an ineligible employment such as with a local contracting agency.<br>b. The Basic Death Benefit, which consists of the employee's contributions with interest.<br>If the member is eligible to retire (member's age 50 and over with at least 5 years of service) then the beneficiary receives:<br>a. The Group Term Life Insurance Benefit, which consists of:<br>1. The employee's contributions and interest; and<br>b. One month's salary for each year of service to a maximum of 6 months salary; or<br><u>OR</u> | The beneficiary receives the same benefit from PERS (the amount of the accumulated contributions will be less since the rate of contribution to PERS is reduced by one-third on the first $400 of salary). Social Security pays a lump sum burial benefit of up to $255. | Add the lump sum presently paid by Social Security ($255.) to the PERS benefits. |

| ITEM | PERS ONLY | PERS/SOCIAL SECURITY COMBINATION | SUBSTITUTE FOR SS BENEFITS IF ANY 2/ |
|---|---|---|---|
| III. SURVIVOR BENEFITS<br>A. Benefits on Death Prior to Retirement -- cont'd<br>2. 1957 Survivor Benefit | c. 1957 Survivor Benefit where in the surviving spouse may elect to take this benefit in lieu of the Basic Death Benefit. If surviving spouse has not been married to the member for at least 1 year prior to death then this benefit can be paid to unmarried children until they reach age 18. This benefit equals one-half of the un-modified allowance or an allowance equal to the Option 2 amount calculated as if the member retired on the date of death. | The same 1957 benefit is payable from PERS on death of a coordinated member. (The amount of the benefit will be smaller since the PERS service retirement benefit the member would have been entitled to receive is reduced.) The Social Security death and survivor benefits referred to above are payable in addition. | PERS 1957 Survivors would be paid on full formula withou modification for 1/ of $400. salary. |
| 3. 1959 Survivor Benefit | In addition to the basic death benefit, an eligible beneficiary (widow age 62, dependent child alone) is entitled to $225 a month; 2 beneficiaries, $450; 3 or more, $530. Member pays $2.00 per month. This benefit can be payable in addition to the 1957 Survivor Benefit or to any pre-retirement death benefits the survivors may be entitled to receive. | This benefit does not apply to members covered by Social Security. Beneficiaries of the coordinated member receive comparable survivor benefits from Social Security. | Restore 1959 Survivor coverage t the group. |
| B. Benefits on Death After Retirement<br>1. Survivor Benefits | The PERS member may provide an income for a beneficiary by selecting one of 3 optional retirement allowances offered by PERS. When an optional settlement is chosen the retirement allowance is reduced while the member is alive. Regardless of the option chosen ¼ or ½ of the unmodified allowance is payable to an eligible surviving spouse or unmarried children under age 18 (½ for service not covered by Social Security plus ¼ for service covered by Social Security). | Social Security survivor benefits are payable plus any benefits payable from PERS if member has selected an option. | Continue the full amount equal to the member Social Security benefit (as indicated in IA) to the surviving spous or other eligible survivor. |

TABLE 9 (cont.)

TABLE 9 (cont.

| ITEM | PERS ONLY | PERS/SOCIAL SECURITY COMBINATION | SUBSTITUTE FOR SS BENEFITS IF ANY 2/ |
|---|---|---|---|
| III. SURVIVOR BENEFITS<br>B. Benefits on Death After Retirement -- cont'd<br>2. Burial Benefit | On the death of a retired member, PERS provides a benefit of $500. | The PERS benefit is also payable on the death of a retired member who was under the coordinated plan. In addition, there is a Social Security lump sum death benefit of up to $255. | Add lump sum present paid by Social Security ($255.) to PERS benefit. |
| IV. HEALTH INSURANCE | Continuation of Employee Medical and Hospital Care Act (Supplemental plans at age 65 if covered by Medicare) Federal Medicare Part A Hospital insurance available for those ineligible for Social Security at a present monthly premium of $45.00. | Medicare is available to the Social Security covered member at no cost for Part A. Part B (Supplemental Medical) is $7.20 per month. | Increase coverage under the State's health insurance plans to replace Medicare. |
| V. COST-OF-LIVING | Currently all retired members of the Public Employees' Retirement System receive an "automatic" cost-of-living increase at a maximum rate of 2% per year, assuming an appropriate rise in the Consumer Price Index. | The coordinated member is entitled to the same cost-of-living increases in PERS benefits.<br>Social Security benefits increase each June if U.S. Consumer Price Index is up 3% or more since last previous cost-of living computation quarter or since most recent calendar quarter benefits were increased by Congress. | Provide annual cost-of-living adjustment up to 5% per year on the amount equal to the Social Security benefit (as indicate in IA) |

1/ Members of Legislative Retirement System will also be dropped from Social Security. However, Social Security coverage is in addition to LRS benefits.

2/ Members with Social Security coverage retain current Social Security credits, and any eligibility for benefits derived therefrom.

TABLE 10

COST ESTIMATE FOR SOCIAL SECURITY REPLACEMENT BENEFIT

PRESENT PERS STATE EMPLOYEE MEMBERS COVERED BY SOCIAL SECURITY

A. Retirement Benefits

| | First Year Cost | Rate |
|---|---|---|
| 1. Member benefit at age 65 ($247 per month) | $ 162.3 Million | 12.14% |
| 2. Spouse benefit at age 65 ($124 per month) | 67.3 " | 5.04 |
| 3. Survivor benefit (additional $123 per month) | 39.1 " | 2.91 |

These retirement benefits are based on the assumption that $247 retirement benefits will increase at the rate of 5% per year on account of inflation and further the automatic cost-of-living adjustment of 5% per year would be applied after the retirement. The same assumption was applied to all 3 benefits (member, spouse, and survivors).

| | | |
|---|---|---|
| B. Disability Retirement Benefits from 1.8% to 2.7% | $ 12.9 Million | 0.96% |

This benefit also contains 5% inflation before retirement as well as 5% cost-of-living adjustment after retirement. Further, disability had to occur as active member and no coverage for those who retired prior to disability.

C. Death Benefit

| | | |
|---|---|---|
| 1. Lump sum payment of $255 for both pre and post retirement | $ 0.6 Million | 0.04% |
| 2. Provide 1959 Survivors benefit at the employer cost | 5.9 " | 0.44 |

Both lump sum and 1959 Survivor benefit coverage is limited to death while active and assumes no coverage for those who terminated employment prior to death.

D. Medicare Coverage

| | | |
|---|---|---|
| | $ 90.0 Million | 6.75% |

This benefit is also limited to those who reach age 65 and retired from the State.

These costs are based on the assumption that the replacement benefit would be funded over the future working lifetime of the involved members. Had funding for replacement benefits started when the involved members were hired, the annual cost would be reduced to approximately 1/3 of the above rates. We also assumed that there would be no reduction in coverage on account of Social Security payment.

"It does not deal with some of the more sophisticated and difficult features of social security, such as the fact that social security benefits are not subject to the income tax. It is a selection of certain basic benefit replacements which would appear necessary. The indicated first-year annual cost of replacing retirement benefits, improving the disability retirement benefits under PERS by 50 percent and providing replacement for the death benefits is $288.1 million. This would require 21.53 percent of payroll. In addition, there would be a $90 million first-year cost for the replacement of Medicare coverage, which would require a rate of 6.75 percent. This, then gives a <u>total annual first-year cost of $378.1 million and a total combined rate of 28.23 percent of payroll.</u>" (emphasis added).

The PERS cost analysis is based on 1976 payroll, as if the state had given notice of termination in 1974 and it had become effective in 1976. However, PERS considers that, although the dollar figure would change for a future termination year, the payroll percentages would be essentially those listed.

Thus, even if the full $165 million which the state and its employees contributed to social security in 1976 were diverted into PERS, it would still require an additional $213 million in state funds to make up for the lost benefits. The Commission feels this would be an enormous additional burden on the state's budget for no apparent benefit, and especially at a time when taxpayers are clamoring for relief and major new court-mandated expenditures in education are anticipated.

Incidentally, as a comparison with another alternative, this 28 percent replacement rate is very close to a recent estimate of what it would cost a 30-year-old employee to purchase an annuity which would provide an income at age 65 equal to the social security benefit. An October 1976 analysis by the Teachers Insurance and Annuity Association noted that such an annuity would cost roughly 31 percent of salary.

3. Portability

The Commission's analysis of benefit comparisons has included several significant factors which may be important to some employees and may be of no consequence to others. Many of these considerations are difficult to cost out. One such issue is the "portability" of social security coverage.

Any employee who has paid into social security for 10 years (40 quarters) is eligible for some social security benefit upon retirement, even if he does not retire from social security-covered employment. The employee is credited with the total number of social security quarters he has earned in his lifetime, no matter whether he earns them from several employers or with long gaps between covered quarters. Thus, the term "portability"; he can take his quarters wherever he goes in his working career.

This portability is increasingly important as job mobility expands, with employees moving more frequently from one employer to another, in both public and private jurisdictions. This factor could have considerable impact on the desirability of working for California state government. Should the decision be made to withdraw from social security, a prospective employee who has worked under social security could very well be discouraged from joining state service. If he has less than 10 years in social security, it all would be forfeited unless he later returns to "covered" employment. If he has 10 years or more in the system, his eventual social security benefit would be severely reduced if he makes a career of non-covered state service. Monthly benefits are based on the average wages earned while in the social security system. Years of wages earned outside the system are counted as zero earnings, thus lowering the annual average and the resulting benefit.

Some local governments which have opted out of social security say they consider the portability factor negligible. A spokesman for the City of San Jose, which withdrew its 3,500 employees in July 1975, notes there was no apparent exodus of employees fleeing to covered employment, and the number of people seeking employment with the city did not decrease. However, the city did not attempt an in-depth analysis of this intangible factor.

Actuarial consultant Allen Arnold has informed the Commission: "It is reasonable to conclude that the ability of the state to compete in the employment market would be impaired by withdrawal from social security." In view of California's traditional efforts to attract the best possible employees from the entire job market, the Commission suggests that portability is a factor which should not be ignored.

4. Disability Benefits

Although an employee who has 10 covered years with social security is entitled to a retirement benefit, no matter how small, there is one benefit which is not guaranteed for long: disability coverage. This benefit--which is considered generally richer than its PERS counterpart, although the standards for qualifying are more rigorous--lapses after the employee is out of social security for more than five years.

5. Employees Near Retirement

Another concern is the effect which withdrawal would have on employees who are fully insured under social security and who are nearing retirement. Consultant Arnold notes that excluding these employees' final years of employment from the earnings which are used to compute social security benefits could result in a considerable cut in social security benefits. In a typical hypothetical example in his report (see appendix, page 21), the benefit is reduced from $585 a month to $428. Arnold states:

> "Withdrawal from social security could reduce the total pensions of older employees very significantly and the cost to the state of replacing such benefits through PERS would greatly exceed the social security taxes otherwise payable. The potential social security benefit losses of older employees therefore constitute another argument for retention of social security coverage."

6. Cost-of-Living Adjustments

Another factor of sizeable proportions to retired employees in these days of soaring costs is the inflation escalator built into the social security benefit. The 1972 amendments to the Social Security Act provide for increasing the monthly benefit equivalent to the Consumer Price Index increase, any time the CPI exceeds 3 percent. So far, this feature has produced an increase of 8 percent in 1975 and 6.4 percent in 1976. This adjustment has no maximum "ceiling".

7. Tax-free Benefits

One feature in the social security structure which many overlook is the fact that social security benefits are not taxable at all, while that portion of the PERS benefit which derives from the state's contribution is taxable. Depending on the income at retirement, this hidden bonus can present a considerable dollar value. Therefore, benefit analysts generally recommend that any system intended to replace social security benefits should be designed to provide an "after-tax" income comparable to the social security income which is lost. Actuarial consultant Allen Arnold provides this comment:

> "Since it is difficult to cover all potential tax situations, let us consider the case where deductions and personal exemptions would exactly offset income from sources other than social security. Then, if half the social security retirement benefits were transferred to PERS at state expense, a retired employee would lose 1 to 4 percent of the amounts so transferred in additional taxes. If the whole amount of social security were provided through PERS at state expense, this retired employee would pay 11 to 15 percent of what are now nontaxable social security benefits in additional income taxes.
>
> "For retired employees whose other income was low, the percentage would be smaller. Those with income sufficient to require taxes in any event, would be in higher tax brackets and the percentage

applicable would consequently be higher. In the case of higher-paid employees, income taxes could amount to 25 percent or more of the increase in PERS benefits if half the social security benefits were provided by PERS. In summary, then, there seems to be better than a break-even relationship between social security taxes and benefits, particularly in consideration of the income tax treatment of benefits."

8. Related Equity Issues

Consideration must be given to several other factors which are not included in the PERS analysis of replacement benefit costs, but which will naturally be significant issues in any legislative debate over termination of social security. First, a replacement program must provide parallel benefit increases of some magnitude for those who have never been in social security. Although their numbers will be reduced significantly within the next five to six years, a significant matter of equity still exists if the state should pump hundreds of millions of dollars into the pensions of their fellow, formerly coordinated workers while providing the never-coordinated workers with nothing more. Similarly, there is bound to be lobbying for improved benefit structures for the patrol and safety members of PERS, who are also not coordinated. And finally, termination of state employees would also terminate coverage for members of the Legislative Retirement System. Although the PERS analysis does not address itself to replacement costs for these three groups of employees, there will doubtlessly be considerable pressure to provide some additional benefits for them, and the resulting additional costs easily could run into many more millions of dollars.

## E. CURRENT AND FUTURE STRUCTURE OF SOCIAL SECURITY

Financing of social security differs significantly from that of private pension plans. Private systems, including PERS, operate on a "funded" basis, meaning the current resources of the plan are always enough to cover all benefits promised to its participants upon retirement. In contrast, social security is on a "pay-as-you-go" basis. The tax contributions of today's workers support the retired generation. In turn, future workers will support the today's generation in their retirement years. Thus the system operates as a direct "income transfer" procedure, rather than one which banks funds for future disbursement. The social security system does have funds in reserve, but these trust funds serve only as a buffer to absorb any initial impact of benefit increases and any decreases in social security tax revenue due to higher than expected unemployment.

However, as mentioned earlier in this report, the social security system's outgo is starting to exceed its income, due to recent benefit increases, high inflation and unemployment, and increased disability claims. A prime reason for this gloomy projection is that a "double escalation" feature was, apparently unintentionally, built into the system by the 1972 amendments. First, any increase in the cost of living produces an increase in the wage base. This, in turn, increases the proportion of a worker's income which is counted toward his average annual compensation. And this increases his monthly benefit. Second, the benefit formula itself increases with the cost of living. If this "double indexing" system goes on unchecked, economists project significant increases in the income "replacement rate"--the percentage of a worker's average pre-retirement income which the social security benefit provides. Currently, this rate is around 44 percent. But the double escalation feature can create eventual ridiculous situations in which a person's initial social security benefit is actually higher than his monthly pre-retirement earned income.

Most observers are confident that Congress will act within the next year or so to eliminate this potentially disastrous situation, by "decoupling" the cost-of-living ndex from either the wage base or the benefit formula. Indeed, despite the potential future problems which loom due to the current structure, no observers are so pessimistic that they assert that the system will become hopelessly insolvent.

In 1975, a special panel of actuaries and economists was appointed to recommend to Congress changes to the social security financing and benefits structure. The panel suggested a number of reforms designed to hold future benefits down to more realistic, predictable levels. In addition, the advisory panel recommended two changes which should take care of the short-term deficit in the social security picture: a 0.15 percent increase in both the employer and employee payroll tax, along with an increase in the maximum earnings base so that 90 percent of all workers would have their entire earnings covered. Recommended is a wage base of $18,900 in 1977.

The advisory panel, which some observers describe as having a "high batting average" in Congress, also recommends that the overall base for the social security system be broadened by requiring universal coverage, thus bringing in federal employees and various other groups not now covered.

Another significant change suggested is elimination of the "free" spouse benefit, under which retired employee's wife age 65 or over receives an amount equal to half the retiree's benefit--even if she hasn't worked a day in her life. If she has worked, she is entitled to either the spouse benefit or the benefit derived from her own earnings--but not both. As this benefit has drawn considerable criticism, particularly in the recent years of women's changing status in the labor market, the advisory panel recommends that it be replaced by a system under which a couple has the option of combining their income for benefit purposes.

Another consideration which is crucial to any study of termination is the possibility that Congress may decide to use some general tax revenue as part of the funding of social security. This would mean that an employee outside the social security system would nevertheless be paying a portion of his federal income tax to support those within social security.

Actuarial consultant Allen Arnold notes that "there would be a very significant subsidy to the state and its employees if the state continued in social security, and social security funding should tap general federal revenues." And unless the law were changed, termination of California state employees would put them in precisely this position, with no chance of re-entry to recoup some of their income tax contributions. The advisory panel has recommended against general revenue financing, but other congressional observers note the pressure to adopt it persists at a rather high level.

## F. MORAL CONSIDERATIONS

One factor, discounted by some and strongly felt by others, is whether it would be ethical for an employer as large and influential as the State of California to withdraw from social security, which after all, is designed as a semi-universal system of social insurance. In fact, this consideration--along with recent social security benefit increases--was a main reason Legislative Analyst A. Alan Post gave the Commission for reversing his 1971 position and now recommending that the state stay within social security. At the July 19 Commission hearing Post commented:

> "The $200 million annual drop in state and employee contributions to the federal social security fund would be a blow to the fund; there is no question about that. I think we have a public responsibility to the social security system. I think that if all public employees generally throughout the country were to drop out and shift that burden to those that remain in the system, it would be socially undesirable. I think that this is not something that I could support in good conscience."

Actuarial consultant Allen Arnold advises the Commission:

> "If the state withdrew from social security, the action would likely cause at least an acceleration of withdrawals by California local governments and would encourage other states to consider withdrawing. ...The state has been a leader in many areas and its prestige and resources would lend credence to a movement, up to now has been confined to relatively few local governments. ...while the state's own withdrawal, by itself, might not be a great national setback to social security (110,000 or so employees out of $78.3 million), the effect of the state's withdrawal might be amplified greatly by those who would follow the state's leadership."

As a related issue, there is considerable concern that the withdrawal of large groups, such as the State of California, would hasten the move to general revenue financing to shore up the system, and would add to the growing pressure for mandatory participation by all employees.

## G. PROPONENTS AND OPPONENTS OF WITHDRAWAL

The predominent testimony of individuals and organizations at the Commission's three hearings was in favor of remaining in the social security system. Proponents included Legislative Analyst A. Alan Post, actuary Allen Arnold, UCLA economist Yung-Ping Chen, the California Taxpayers Association, the Clerical and Allied Services Employees, the California Rehabilitation Workers Union, the California Nurses Association, the American Federation of State, County and Municipal Employees and the Service Employees International Union.

Mr. Post commented that "at present time, there is no question that if you take the dollars that (are) the state's cost for social security benefits for its employees and you were to convert those into employee benefits that were specifically geared to the characteristics of state employees, you could get more for your money...In the long run, if you combine both the state general fund taxpayer's best interest plus our share of the national best interest... we would be losers."

Consultant Arnold states, at the conclusion of his report to the Commission:

> "Even though some of these issues involve unknowns and even though some issues involve cost comparisons which cannot be quantified, the state decision should be to continue social security coverage. The resolution of the unknowns would be expected to be favorable or neutral to continued coverage, while a weighing of the knowns produces a clear verdict in favor of coverage."

The leading force in the minority sentiment for withdrawal is the California State Employees Association, which has sponsored termination legislation--without success--in 1970, 1972 and 1973.

CSEA's position at the hearings was shared by the State Association of Real Property Agents; a state employee group named SECURE (State Employees Committed to Undivided Retirement Equity) and several individual employees.

It is significant to note that the employee organizations which favor termination are generally dominated by the higher-paid employees while those which favor retaining social security derive their predominant membership from the ranks of the lower-paid. This is in concert with national trends, and is understandable in view of the social security benefit structure being generally weighted toward the lower-paid.

The Commission also heard testimony from representatives of the cities of West Covina and San Jose, both of which have terminated from social security. Ed Overton, retirement benefits administrator for San Jose, noted the city has only been out of social security since July 1975 so they don't have any hard statistical data yet on the effect of the withdrawal. However, he said the city has created its own system which provides increased retirement allowances, plus substantial survivorship and disability allowances. At the same time, employee payroll taxes were reduced from an average of 9.89 percent to 6.8 percent, and employer costs were reduced by three-tenths of one percent, he said.

The Commission notes, though, that some of these claims are disputed in an actuarial study ordered by the Social Security Administration and performed by Robert Myers, former chief actuary of the Administration and currently a professor of actuary science at Temple University. In his September 1976 report, Mr. Myers states:

> "It has been widely asserted that both the employees and the City of San Jose profited significantly by terminating social security coverage and then liberalizing the previously-existing complementary retirement system. The facts do not bear out these assertions...
>
> "My analysis indicates there will be many instances where the new plan provides lower benefit protection, and that a number of categories will be adversely affected, such as part-time employees, short-service employees and many disability pensioners...
>
> "There is considerable doubt that the cost of the pension plan that has replaced the combination of social security and the former complementary plan will be anywhere near as low as estimated by the city actuary. The effect, then, of this very liberal plan--with its extremely low early-retirement conditions, although in many significant instances not providing as good benefit protection as formerly--may well cost the City of San Jose far more than is currently estimated."

## H. RECOMMENDATIONS

The Commission realizes that for some state employees it may very well be advantageous to withdraw from social security and have their contributions and the state's payments on their behalf contributed instead into an improved state retirement system. However, the Commission is of the opinion that, considering all factors reviewed in this report, it would be in the overall best interest of the state, its employees, its taxpayers and the nation as a whole for the State of California to keep its employees in the social security system. Accordingly, the Commission makes the following recommendations:

1. State employees should not be terminated from social security.

2. The Legislature should urge the federal government to take prompt action to correct the short-term and long-term financing and benefit shortcomings in the social security system.

3. The Legislature should urge the Congress to expand social security to mandatory universal coverage for all employees, including those of the federal government, and to prohibit further withdrawals by public jurisdictions.

4. The Legislature and PERS should take action to improve the integration of the PERS system with social security to provide the best possible benefits at the lowest cost.

I. EXHIBIT

# SOCIAL SECURITY COVERAGE

# FOR

# CALIFORNIA STATE EMPLOYEES

A Report Prepared

for

The Commission on California State

Government Organization and Economy

by

THE WYATT COMPANY

August 2, 1976

# SOCIAL SECURITY COVERAGE

# FOR

# CALIFORNIA STATE EMPLOYEES

## Introduction

The question of Social Security coverage for government employees is not an easy one because of its complexity and because of unknowns. All too often a tendency to oversimplify the issues prevails in discussions of Social Security.

This report analyzes the major issues and recommends a course of action to the State. It is the aim of the report to be brief enough to encourage its being read while being thorough enough to avoid oversimplication. Difficult and nebulous as it may seem, the Social Security question is not beyond the understanding of the layman who diligently reviews all the pertinent facts and issues.

Because Social Security is an intricate plan of benefit and eligibility provisions, a careful examination of its principal provisions is a necessary step toward understanding the System.

It is certain that Congress will amend the Social Security Act in the near future in consideration of crucial financial, benefit design and coverage problems of the System. These problems are closely connected. The coverage question mainly relates to mandatory public employee coverage. The questions of how the benefit formula will be corrected and how financing will be restored to a sound basis also are germane to the government employee coverage question.

This report therefore contains the following parts:

| | | |
|---|---|---|
| Part I | - | Summary of Principal Provisions of Social Security |
| Part II | - | The Social Security Design Problem |
| Part III | - | Social Security Financing Problems |
| Part IV | - | The Question of Mandatory Social Security Coverage for Government Employees |
| Part V | - | Should the State of California Continue Social Security Coverage? |

The analysis in this report leads to the recommendation in Part V that the State continue in Social Security. Although sentiment for withdrawal has developed from legitimate concerns about the high total costs of benefits to employer and employee alike and the illogical patterns of the combined benefits of various programs, withdrawal is not the best way to solve these problems. A superior alternative is suggested in Part V.

## Part I

## Summary of Principal Provisions of Social Security

### General

Social Security is a plan of social insurance containing certain features which are characteristic of public retirement systems and private benefit programs. Its purpose, essentially a social one, is to provide security to a very large number of private and public employees and their families. While the benefits provided are designed to meet more kinds of employee needs than is usual in public retirement systems or private programs, eligibility for benefits and benefit determinations are somewhat similar to the provisions of employer-sponsored and negotiated benefit programs.

On the other hand, Social Security is financed strictly as a program of social insurance since Social Security taxes are used to pay current benefits to pensioners and beneficiaries. Social Security financing thus is entirely different from that of programs like PERS, under which employer contributions are placed into funds to provide future benefits for specific groups of employees and employee contributions are accumulated in individual accounts for employees.

### Present Social Security Law

Many changes were made in Social Security in 1972. These included a general 20 per cent benefit increase, higher benefits for widows, a more favorable retirement test and extension of Medicare to the disabled. The legislated changes since 1972 have been relatively minor.

Perhaps the most important 1972 change was the automatic indexing of the benefit formula to changes in the cost-of-living index and an automatic indexing of the wage base to increases in average earnings. Given increases in the cost of living and in average earnings, this change permits Social Security automatically to provide greater benefits without separate legislative amendment. This characteristic of Social Security, if continued, could effect a considerable change in the degree to which Social Security provides for total retirement needs. It would be very likely to decrease the supplementation required by other pension plans and personal savings.

Insofar as the State is concerned, two important features of Social Security have not been changed. These permit the State to withdraw only after two years notice and prohibit re-entry.

The next two pages (pages 2-a and 2-b), entitled "Highlights of Federal Social Security Act," outline the principal Social Security provisions of interest to the State and to State employees. Following the "Highlights" is a chart (1976 Maximum Monthly Social Security Amounts, on page 2-c) which shows the maximum amounts of Social Security benefits under various circumstances according to year of birth; the figures in this chart are based on the law in effect

# Highlights of Federal Social Security Act
## (Effective June, 1976)

**A. Insured Status Definitions**

| | |
|---|---|
| 1. "Fully Insured": | One quarter of coverage for each calendar year after 1950 or after year in which worker became 21, if later; minimum is 6 quarters of coverage; 40 quarters of coverage means fully insured for life. |
| 2. "Currently Insured": | At least 6 quarters of coverage during 13 quarter period ending with quarter in which worker (a) died; (b) became entitled to Disability Income Benefit (DIB); (c) became entitled to Old Age Insurance Benefit (OAB). |
| 3. "Insured Status" for Disability Benefits: | Both (a) fully insured, and (b) 20 quarters of coverage during 40 quarter period ending with quarter in which disability commenced (or if disabled before age 31, must be able to meet special requirements). |

**B. Conditions for Benefit Payments and Amounts of Benefit**

| Situation for Eligibility | Insured Status Requirements for Worker | Amount of Benefit |
|---|---|---|
| 1.a. Retirement of worker 62-65 | Fully Insured | PIA (reduced if first payments before 65 by 5/9%, or 1/180th, per month before age 65) |
| b. Retirement of worker over 65 | Fully Insured | Old Age Benefit (not PIA) increased by 1/12% for each month worked after age 65 (or each month worked after 1970, if later) up to age 72 |
| 2. Disabled worker under 65 | Insured status requirements met | PIA |
| 3. Wife of person entitled to DIB or OAB, if she is: (a) 62 or over, or (b) Caring for child entitled to child's benefits, if under 18 or disabled | Insured for OAB or DIB, whichever is applicable | 1/2 PIA, subject to family maximum, except wife's benefit is reduced if first payments are made before age 65 unless she has her husband's child under 18 in her care. Reduction for wife 62-65 (no children under 18) is 25/36%, or 1/144th per month before age 65 |
| 4. Dependent, unmarried child of person entitled to DIB or OAB, if child is: (a) Under age 18, or (b) Age 18 or over, under 22, and attending school full-time, or (c) Age 18 or over, and under a disability which began before 22 | Insured for OAB or DIB, whichever is applicable | 1/2 PIA, subject to family maximum |
| 5. Dependent husband, 62 or over, of woman entitled to DIB or OAB | Insured for OAB or DIB, whichever is applicable | 1/2 PIA, subject to family maximum, reduced 25/36% or 1/144th per month before age 65 |
| 6. Widow or widower age 60 or over* | Fully insured | 100%** PIA (reduced 19/40% per month before age 65) |
| 7. Widow if caring for child entitled to benefits if child is under 18 or disabled | Either fully or currently insured | 75% PIA, subject to family maximum |
| 8. Dependent, unmarried child of deceased worker, if child is: (a) Under age 18, or (b) Age 18 or over but under 22 and attending school full-time, or (c) Age 18 or over and under disability which began before age 22 | Either fully or currently insured | 75% PIA, subject to family maximum |
| 9. Dependent parents, age 62 or over of deceased worker | Fully insured | (a) Sole dependent parent living - 82-1/2% PIA (b) Two dependent parents - 75% PIA each (all subject to family maximum) |
| 10. Lump sum death benefit (a) To widow (widower) if living in household with worker at his death, or (b) To funeral home or to person paying burial expenses if no eligible widow or widower | Either fully or currently insured | Benefit equals $255 |

* Disabled widows and widowers may be entitled to benefits between ages 50 and 60, with a benefit reduced to 50% of the PIA at age 50, grading up to 71-1/2% at age 60.

** Reduced if spouse was receiving actuarially reduced benefit at time of death.

THE Wyatt COMPANY

NOTES: All numbers shown below ignore any possible increases in benefits after June, 1976 because of future wage increases and/or cost-of-living increases.

1. The minimum PIA is $107.90. The minimum OAB at 62 is $86.40. The minimum survivor benefit where there is only one survivor is $107.90, except for widows becoming entitled to benefits before age 62. The "special" minimum benefit is $9.00 times the number of years worked in excess of 10 years (maximum benefit is $180).

2. Formula 1/ to determine approximate monthly PIA from Average Monthly Earnings (AME)

| | | |
|---|---|---|
| 137.768% | of first | $110 AME |
| 50.113% | " next | $290 " |
| 46.823% | " " | $150 " |
| 55.037% | " " | $100 " |
| 30.612% | " " | $100 " |
| 25.510% | " " | $250 " |
| 22.982% | " " | $175 " |
| 21.280% | " " | $100 " |

(Subject to maximum monthly PIA of $577.60)

Percentages shown above will produce PIA amounts which will differ by perhaps as much as $1 from amounts in Social Security Table, but percentages will be utilized for benefit statement purposes.

3. Maximum Family Benefit (MFB)

| If AME is: | Then MFB equals: |
|---|---|
| (a) less than $240 | 150% of PIA |
| (b) $240 to $436 | 134.694% of AME at top bracket in table |
| (c) $437 to $627 | $587.40 plus 67.346% of (AME less $436) |
| (d) $628 or more | 175% of PIA |

4. If MFB reduces benefits otherwise payable, benefits other than those of worker are reduced proportionately.

5. Benefits for Social Security beneficiaries are always rounded to the next higher 10¢ (and, thus, total family benefits can exceed family maximum in Note 4). Benefit statements, however, will show benefits in dollars only and we will round to the next lower dollar in each instance.

- - - - - - - - - - - - - - - - -

1/ PIA amounts under the Social Security Act as amended in 1969, 1971, 1972 and 1973 are actually equal to 1967 PIA x the percentages shown below rounding to the next higher 10¢ at each step -- if not already a multiple of 10¢.

| Effective date of Increase | Amount of Increase | Compounded Increase based on 1967 Table * |
|---|---|---|
| January, 1970 | 15.0% | 15.0% |
| January, 1971 | 10.0 | 26.5 |
| September, 1972 | 20.0 | 51.8 |
| March, 1974 | 7.0 | 62.4 |
| June, 1974 | 4.0 | 68.5 |
| June, 1975 | 8.0 | 82.0 |
| June, 1976 | 6.4 | 93.6 |

*Except 11%, two-step increase in 1974 was not compounded.

## 1976 Maximum Monthly Social Security Amounts

(Based on the Law as of June 1, 1976)

| Worker's Year of Birth | Worker's Disability Benefit 1/ | Family Disability Benefits to Eligible Dependent Spouse With: No Children Under 18 2/ | 1 Child Under 18 1/ | 2 or More Children Under 18 1/ | Family Death Benefits to Eligible Dependent Spouse With: No Children Under 18 3/ | 1 Child Under 18 4/ | 2 or More Children Under 18 4/ | Spouse's age 65 Retirement Benefit | Worker's age 65 Retirement Benefit |
|---|---|---|---|---|---|---|---|---|---|
| 1911 (Male) | $389 | $193 | $302 | $302 | $387 | $581 | $689 | $193 | $387 |
| (Female) | 403 | 201 | 305 | 305 | 403 | 604 | 708 | 201 | 403 |
| 1912 (Male) | 387. | 193 | 302 | 302 | 387 | 581 | 689 | 206 | 412 |
| (Female) | 393 | 196 | 303 | 303 | 393 | 590 | 696 | 211 | 422 |
| 1913 | 387 | 193 | 302 | 302 | 387 | 581 | 689 | 216 | 432 |
| 1914-1929 | 379 | 189 | 300 | 300 | 379 | 569 | 680 | Varies by Year of Birth | Varies by Year of Birth |
| 1930 | 387 | 193 | 302 | 302 | 387 | 581 | 689 | 255 | 511 |
| 1931 | 393 | 196 | 303 | 303 | 393 | 590 | 696 | 258 | 517 |
| 1932 | 403 | 201 | 305 | 305 | 403 | 604 | 708 | 261 | 522 |
| 1933 | 408 | 204 | 307 | 307 | 408 | 613 | 716 | 264 | 528 |
| 1934 | 416 | 208 | 312 | 312 | 416 | 625 | 729 | 267 | 534 |
| 1935 | 424 | 212 | 318 | 318 | 424 | 637 | 743 | 270 | 540 |
| 1936 | 430 | 215 | 323 | 323 | 430 | 646 | 754 | 273 | 545 |
| 1937 | 438 | 219 | 328 | 328 | 438 | 657 | 767 | 275 | 550 |
| 1938 | 446 | 223 | 334 | 334 | 446 | 669 | 780 | 277 | 555 |
| 1939 | 456 | 228 | 342 | 342 | 456 | 684 | 798 | 279 | 559 |
| 1940 | 462 | 231 | 346 | 346 | 462 | 693 | 809 | 281 | 562 |
| 1941 | 468 | 234 | 351 | 351 | 468 | 703 | 820 | 283 | 566 |
| 1942 | 475 | 237 | 356 | 356 | 475 | 712 | 831 | 285 | 571 |
| 1943 | 483 | 241 | 362 | 362 | 483 | 724 | 845 | 287 | 574 |
| 1944 | 494 | 247 | 370 | 370 | 494 | 741 | 865 | 288 | 576 |
| 1945 | 512 | 256 | 384 | 384 | 512 | 768 | 896 | 288 | 577 |
| 1946 | 529 | 264 | 397 | 397 | 529 | 794 | 927 | 288 | 577 |
| 1947 or later | 548 | 274 | 411 | 411 | 548 | 822 | 959 | 288 | 577 |

### Reduction Factors

(Death, Disability and Retirement)

| Years of Reduction Prior to Age 65 | Spouse's Age 65 Retirement Benefit or Disability Benefit | Worker's Age 65 Retirement Benefit | Surviving Spouse's Benefit |
|---|---|---|---|
| 1 | 11/12 = .91667 | 14/15 = .93333 | .94300 |
| 2 | 10/12 = .83333 | 13/15 = .86667 | .88600 |
| 3 | 9/12 = .75000 | 12/15 = .80000 | .82900 |
| 4 | - | - | .77200 |
| 5 | - | - | .71500 |
| (1 month) | (.00694) | (.00556) | (.00475) |

1/ Starting when employee becomes eligible for a Social Security disability benefit.
2/ Starting at and after spouse is age 65. Reduced benefits are available as early as age 62.
3/ Starting at and after spouse is age 65. Reduced benefits are available as early as age 60.
4/ Starting with the month of employee's death.
NOTE: For death and disability benefits, it is assumed that death or disability occurs in January 1976 (i.e., 1976 earnings are not included in determining the employee's Average Monthly Wage).

## SECOND 1976 TABLE - AGE 65 RETIREMENT

### PRIMARY SOCIAL SECURITY BENEFIT BASED ON MAXIMUM COVERED EARNINGS EACH YEAR TO AGE 65 1/

| Year of Birth (1) | Year in Which 65th Birthday Occurs (2) | Male: Average Maximum Earnings (3) | Male: Social Security Benefit Payable at Age 65 2/ (4) Per Month | Male: Social Security Benefit Payable at Age 65 2/ (5) Per Year | Female: Average Maximum Earnings (6) | Female: Social Security Benefit Payable at Age 65 2/ (7) Per Month | Female: Social Security Benefit Payable at Age 65 2/ (8) Per Year |
|---|---|---|---|---|---|---|---|
| 1911 | 1976 | $ 585 | $387.30 | 4,647.60 | $613 | $403.10 | $4,837.20 |
| 1912 | 1977 | 634 | 412.70 | 4,952.40 | 650 | 422.40 | 5,068.80 |
| 1913 | 1978 | 682 | 432.40 | 5,188.80 | | | |
| 1914 | 1979 | 712 | 441.60 | 5,299.20 | Same as Male amounts for 1978 and there-after. | | |
| 1915 | 1980 | 739 | 449.30 | 5,391.60 | | | |
| 1916 | 1981 | 763 | 456.20 | 5,474.40 | | | |
| 1917 | 1982 | 785 | 461.30 | 5,535.60 | | | |
| 1918 | 1983 | 806 | 467.70 | 5,612.40 | | | |
| 1919 | 1984 | 825 | 471.50 | 5,658.00 | | | |
| 1920 | 1985 | 842 | 476.50 | 5,718.00 | | | |
| 1921 | 1986 | 858 | 480.40 | 5,764.80 | | | |
| 1922 | 1987 | 873 | 484.30 | 5,811.60 | | | |
| 1923 | 1988 | 887 | 488.00 | 5,856.00 | | | |
| 1924 | 1989 | 900 | 490.60 | 5,887.20 | | | |
| 1925 | 1990 | 912 | 494.50 | 5,934.00 | | | |
| 1926 | 1991 | 923 | 496.90 | 5,962.80 | | | |
| 1927 | 1992 | 934 | 499.50 | 5,994.00 | | | |
| 1928 | 1993 | 944 | 502.00 | 6,024.00 | | | |
| 1929 | 1994 | 953 | 504.70 | 6,056.40 | | | |
| 1930 | 1995 | 978 | 511.00 | 6,132.00 | | | |
| 1931 | 1996 | 1,003 | 517.20 | 6,206.40 | | | |
| 1932 | 1997 | 1,028 | 522.90 | 6,274.80 | | | |
| 1933 | 1998 | 1,053 | 528.60 | 6,343.20 | | | |
| 1934 | 1999 | 1,078 | 534.40 | 6,412.80 | | | |
| 1935 | 2000 | 1,103 | 540.10 | 6,481.20 | | | |
| 1936 | 2001 | 1,128 | 545.90 | 6,550.80 | | | |
| 1937 | 2002 | 1,149 | 550.60 | 6,607.20 | | | |
| 1938 | 2003 | 1,170 | 555.10 | 6,661.20 | | | |
| 1939 | 2004 | 1,187 | 559.50 | 6,714.00 | | | |
| 1940 | 2005 | 1,205 | 562.70 | 6,752.40 | | | |
| 1941 | 2006 | 1,223 | 566.90 | 6,802.80 | | | |
| 1942 | 2007 | 1,241 | 571.20 | 6,854.40 | | | |
| 1943 | 2008 | 1,256 | 574.40 | 6,892.80 | | | |
| 1944 | 2009 | 1,267 | 576.50 | 6,918.00 | | | |
| 1945 | 2010 | 1,272 | 577.60 | 6,931.20 | | | |
| 1946 | 2011 | 1,275 | 577.60 | 6,931.20 | | | |
| 1947 | 2012 | Maximum | | | | | |

1/ Takes into account 6.4% increase in benefits in mid-1976 (but no future increases) and assumes continuation of $15,300 wage base.

2/ Based on wages earned prior to the calendar year of the 65th birthday.

4/26/76

as of June 1, 1976 without allowance for further escalation in either wage base or the benefit formula. On page 2-d, a "Second 1976 Table - Age 65 Retirement" shows the maximum age retirement benefits payable on the same June 1, 1976 basis from 1976 until 2010, when the benefit would level off.

The conclusions one can draw from pages 2-a, 2-b, 2-c and 2-d are that:

(1) Social Security benefits are comprehensive;

(2) For persons currently becoming entitled to benefits and for those who will become entitled to benefits in the future, the current law provides or would provide benefits which should cover a substantial part of the basic needs for income;

(3) Benefits for younger employees are larger than those for older employees,

(4) Benefits for lower-paid employees are a greater proportion of pay than those of employees at or above the maximum wage base; and

(5) Benefits at retirement will be much higher in the future than they are now, even without escalation of benefits due to indexing.

The last item is a very significant feature to consider in making a decision on State Social Security coverage. The reason that the amount of the old age benefit initially payable in the future under the present law (even without escalation) is larger than the initial amount now is the annual increase in the average wage upon which the benefit is based. As time passes, the earlier wage bases of $3,000, $3,600, $4,200 and so forth are dropped out of the average to be replaced by $15,300 (the 1976 maximum wage) in future years (or by more than $15,300 with further escalation). The maximum benefit in 1976 for a male age 65 is $387.30, but by 2010 it would have grown to $577.60 (based on the $15,300 maximum per year for covered wages and no future CPI inflation of the benefit formula).

Thus, without any change due to new legislation or to economic conditions, this retirement benefit would increase by almost 50% from the current level. This kind of progressive Social Security benefit increase has been the rule for many years now, but the 1972 amendment has accelerated the rate of increase. Part of the current problem of PERS and Social Security benefits in combination is that the PERS benefit formula does not recognize this automatic upward progression of Social Security benefits.

When the escalation feature is taken into account, the PERS-Social Security integration problem is potentially much more severe. Since there is double escalation, as the wage base and the benefit formula both escalate, the present benefit provisions of Social Security are creating a severe financial problem for the Social Security System as well as possibly irrational total amounts of benefits for employees covered by both Social Security and an independent retirement plan.

## The Indexing Feature - A Description

The indexing feature introduced in 1972 places in Social Security an automatic response of benefit levels to the wage and other economic trends noted. An understanding of this feature is absolutely fundamental to an analysis of Social Security into the future since benefit levels no longer are static during intervals between specific legislative change.

Social Security benefits are scheduled to increase in June of any year when the Consumer Price Index has increased by at least 3% during the test period; such increases are proportionate to the increases in the C.P.I. Whenever the Social Security benefit formula is increased in this way, a corresponding increase in the wage base may occur.

The test period for determining escalation of the benefit formula is the period between "base quarters" or "cost-of-living computation quarters." The initial base quarter considered is the first quarter of the last calendar year in which an automatic increase occurred, or, in the event of a legislated increase in the formula, the quarter in which the most recent legislated change became effective. The ending base quarter of the period is the first quarter of the calendar year in which (as of June) an automatic escalation in the formula might take place.

The first such automatic escalation occurred in June 1975 and increased benefits by 8%; the second, in June 1976, increased benefits by 6.4%.

Escalation in the wage base occurs after:

(1) An automatic escalation of the benefit formula has become effective, and

(2) The average taxable wages in the first quarter of the year of benefit escalation exceed the average taxable wages in the first quarter of the most recent year in which the wage base has escalated.

The new wage base becomes effective on the January next following the benefit increase; the new wage base equals the old wage base multiplied by the ratio of the average taxable wages of the first quarter of the year of determination to the average taxable wages of the first quarter of the most recent year of wage base escalation (the result being rounded so that the increase is always a multiple of $300 annually). The wage base has increased from $9,000 in 1972 to $15,300 in 1976, with the increases above $12,000 having resulted from increases after the 1972 amendment.

## Part II

## The Social Security Design Problem

The 1972 Amendment provides Social Security benefits reflecting general increases in the standard of living through escalation of the wage base and reflecting inflation through escalating both the wage base and the benefit formula. Under certain long-term economic conditions this double escalation of wage base and benefit formula would succeed, but under many conditions which economists consider more likely the Amendment would produce ridiculous results (initial benefit rates at retirement which would exceed wages, for example).

This problem was recognized by some experts several years ago. Early in 1973 a Wyatt Company study indicated that "replacement ratios" could vary extremely, depending on the relative rates of escalation in the wage base and the benefit formula. Examples extracted from this study were incorporated in one of the parts of a Cresap, McCormick & Paget May 1973 report to the State Personnel Board for which The Wyatt Company was responsible. Replacement ratios ranging from only 11% to 154% were included in these examples. Since these "replacement ratios" were the percentages that Social Security retirement benefits would bear to final wage bases, such variations indicated a potentially severe malfunction of the Social Security System. According to A. Haeworth Robertson, chief actuary for Social Security, in a speech last month to the National Association of Life Companies, the current (1976) 44% replacement ratio for a median wage earner could increase to 97%. Under other reasonable expectations, it might increase to only 48%.

Many other private individuals and organizations, officials of the Social Security Administration and Congress itself now have taken note of the problem. Because "decoupling" (eliminating "double indexing") is almost universally advocated and because the present basis for benefit determination is a principal cause of the Social Security System's financing difficulties, early Congressional action should be expected.

One proposed solution is to develop a formula which will produce constant replacement ratios for various wage levels. The lower the average or final wage, the higher would be the replacement ratio, as now is true, but regardless of the movement of general wages indexed and the Consumers' Price Index, the replacement ratio would remain fixed for employees in similar economic circumstances. The Administration and the Social Security Advisory Council advocate this approach, which would be based on wage indexing.

The Consultant Panel on Social Security to the Congressional Reseach Service has proposed an alternative - indexing according to the Consumers' Price Index instead of a wage index. The aim of this approach is to maintain the initial purchasing power of benefits at or near current levels, rather than to produce constant replacement ratios.

Although more than one approach has been suggested to developing this formula, all approaches agree that some sort of single indexing must replace the double indexing of the 1972 Amendment. The details prior to benefit commencement can be worked out; the important thing is that now the need for decoupling has been recognized widely enough to assure early correction.

It is only fair to take notice of the fact that other Social Security design problems exist - those relating to equal treatment for the sexes, the changing roles of women and the disparity of benefits by age, for example. The one overriding design problem is double-indexing, however, and it is the one most pertinent to any discussion of Social Security and public employees.

## Part III

## Social Security Financing Problems

The Social Security System, being a vast and complex system of benefits, eligibility provisions and taxes, can and does incur financing problems in more than one area. For example, there have been recent problems with Medicare and with disability insurance utilization.

The financing problems of greatest importance to this report are those derived from economic conditions, current and prospective, from demographic trends and from non-universal coverage. The coverage problem is discussed in the next part of this report, Part IV.

Trends in fertility and mortality rates and annual immigration will impact the System drastically. The current and prospective tax rates established in the 1972 Amendment were based upon much higher fertility rates than recently have been experienced. Demographers now expect a much lower ultimate ratio of covered workers to beneficiaries receiving benefits. Due to the essentially pay-as-you-go financing of the System, the financial support required is expected to be much greater than the current schedule of payroll taxes will provide.

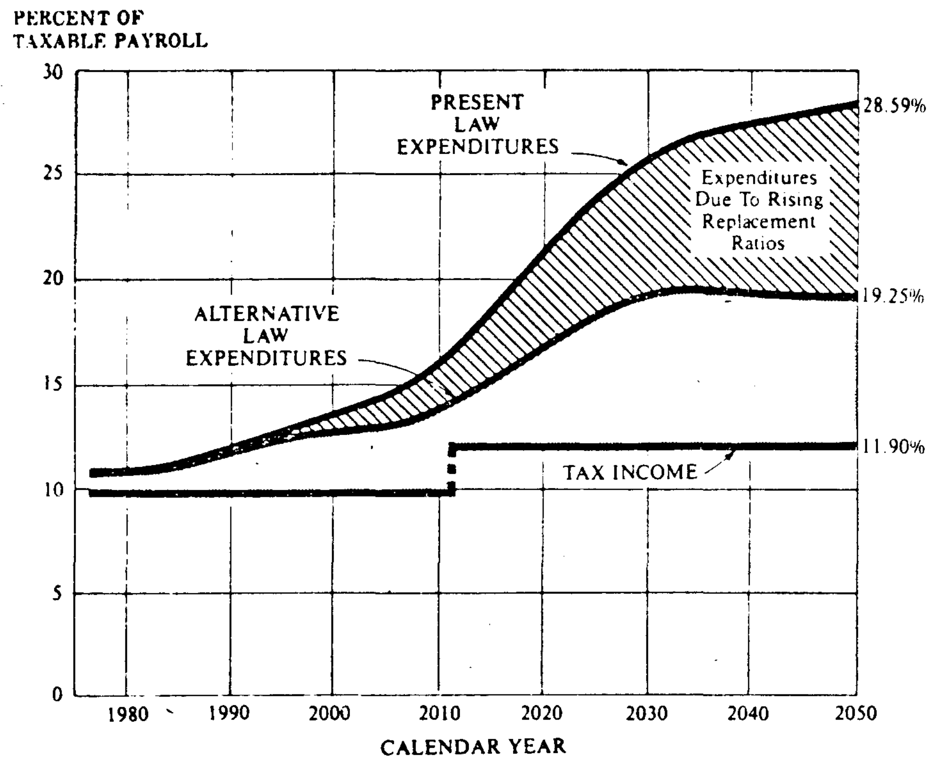
Economic trends likewise are expected to differ from those assumed in setting the tax schedule. Through double indexing, they would create much higher benefits than originally anticipated.

According to Mr. Robertson the combined effect of the demographic and economic trends now considered most likely would be an eventual increase in the present total tax rate for Social Security (excluding Medicare) from the current 9.90% of covered payroll to nearly 29%, almost tripling. The present law provides for an ultimate increase in 2011 to 11.90%. The future rates required cannot be predicted accurately, of course, but there now is very little argument about their needing to be much higher than those established by the 1972 Amendment.

Even if Congress should correct the double-indexing feature of Social Security to provide reasonable and predictable replacement ratios, a large future increase in taxes will be required because of expected demographic conditions. There are now 31 beneficiaries for every 100 workers, but according to a recent Social Security demographic projection, there will be over 50 beneficiaries per 100 workers by the middle of the next century.

In the meantime, a short-term financing crisis also needs remedying, partly due to double indexing and partly to other factors, including unfavorable disability experience and high unemployment.

Mr. Robertson presented the chart below during his July speech to the NALC. It illustrates the expected effects of demographic and economic trends on OASDI expenditures under the current law and under an "alternative law" which has decoupled the indexing feature on the basis of wage indexing.




ARITHMETIC AVERAGE OF EXPENDITURES, TAX INCOME, AND DEFICITS UNDER PRESENT LAW AND ILLUSTRATIVE ALTERNATIVE LAW EXPRESSED AS A PERCENTAGE OF TAXABLE PAYROLL

| | Present Law | | | Illustrative Alternative Law | | |
|---|---|---|---|---|---|---|
| Time Period | Expenditures | Tax Income | Deficit | Expenditures | Tax Income | Deficit |
| 1976-2000 | 11.81% | 9.90% | 1.91% | 11.58% | 9.90% | 1.68% |
| 2001-2025 | 17.95 | 11.10 | 6.85 | 14.91 | 11.10 | 3.81 |
| 2026-2050 | 27.04 | 11.90 | 15.14 | 19.30 | 11.90 | 7.40 |
| 1976-2050 | 18.93 | 10.97 | 7.96 | 15.25 | 10.97 | 4.28 |

Even with such decoupling Congress thus must find new taxes not only to meet a large potential 21st century deficiency, but to meet a current deficiency which is growing. Some alternatives which have been discussed are:

(1) General revenue financing,

(2) Higher payroll tax rates,

(3) Increasing the maximum wage base,

(4) Taxing Social Security benefits,

(5) Higher payroll taxes for the self-employed.

Not every one of these would be sufficient in itself to correct the problem.

The two which would have the greatest effect upon public employers and public employees are the adoption of general revenue financing, which would provide a subsidy to the non-federal public sector, and the impostion of taxes on Social Security benefits, which would remove an important existing subsidy.

The 1975 report of the Advisory Council on Social Security recommended no increase in the total tax rates for Social Security, but merely a reallocation from Medicare to OASDI (Old Age, Survivors, and Disability Insurance). The Medicare deficiency, however, as it increased, would be met by general revenue financing. In addition, self-employed taxes would be increased.

The Advisory Council's recommendation is significant because of its high batting average in Congress with its previous recommendations. Although many responsible officials and experts have opposed general revenue financing strongly for many years, the labor movement and a number of liberal groups and individuals have supported it. Now general revenue financing may be coming in through the back door.

Right now, more than half the cost of SMI (Supplemental Medical Insurance) is being paid from general revenues. Although SMI is not supported by payroll taxes but by participants' premiums and general revenues, the trend toward greater general revenue support here may influence thinking on the question of general revenue financing vs general revenue payroll taxes.

The Consultant Panel's recommendation of single indexing based on the CPI instead of on wages virtually would solve the financing problem. Average wages are expected to increase more rapidly than average prices, as has been true in the past. Therefore the adoption of a 10.3% combined tax rate now not only would take care of the current deficiency but should eliminate increases even for the demographic changes underway. The taxes on this basis would grow faster than benefits under static demographic conditions, and this additional growth would be available to offset the actual growth in Social Security beneficiaries relative to the work force.

This year a number of bills have been introduced to solve the benefit formula and financing problems, but just three proposals really are receiving serious consideration - those of the Administration, the Advisory Council and the Consultant Panel. Although a sub-committee of the House Ways and Means Committee has been reviewing these proposals, action is unlikely to be taken in 1976. Action next year, however, seems assured.

## Part IV

## Mandatory Social Security Coverage

## Of Government Employees

The subject of Social Security coverage for government employees should be examined from several viewpoints, those of:

(1) the government employee,
(2) the government agency as an employer,
(3) the Social Security System, with respect to financing, and
(4) overall national policy.

### Employee's Viewpoint

There is no single viewpoint which can be ascribed to government employees in general. Furthermore, it is a rare employee who understands Social Security well enough to determine whether or not coverage is in his own best interest.

The three broadest categories of interests, or possible viewpoints, are those of:

(1) Police and firemen and other "safety" employees, who typically are covered by public retirement systems with liberal early retirement benefits. Relatively few police and firemen are covered by Social Security. Many "retire" at ages 45 to 55 (often at half pay) to work for private employers, thereby earning private pensions and acquiring Social Security benefits as well. The status quo, no Social Security coverage for most police and firemen, would appear to coincide with these employees' interests.

(2) Career general employees. Because of the fairly heavy employee contributions usually required for public retirement systems, many career public employees would prefer not to be covered by Social Security. Their viewpoint is that the higher total benefits available with Social Security coverage should be provided through their own retirement systems, with their own employer absorbing the extra cost. Since Social Security portability is not necessary for career employees, and the costs of portability could be avoided, the employers could provide fully adequate benefits from the retirement systems at a cost which would be less than the amount of payroll taxes. The costs of spouse's benefits provided under Social Security, but not payable when both marriage partners work, would be avoided also. While these often-heard arguments are valid, they do not constitute a complete assessment of the situation -- overlooked are the non-taxability of Social Security (a hidden Federal subsidy) and the possibility of efficient integration of each public retirement system's benefits and contributions with

those of Social Security. It therefore is not at all clear that career employees' true interests are to remain out of, or to leave, the Social Security System.

(3) Non-career employees. At any one time, a large number, perhaps as many as one-half, of a public employer's general work force may not be career employees. An even greater proportion of all employees hired, perhaps 70 or 80%, do not stay until retirement. The Social Security benefits of such employees would be smaller, on the average, if the employees lacked continuous coverage.

A number of these employees will become disabled at their next jobs, and, because of short service, be entitled to no disability benefits at all. In such situations, and in some cases of death, the loss or non-acquisition of Social Security's portable disability and survivor benefits can create extreme hardship. The interest of that very substantial number of employees who devote a portion of their careers to public employment lies in public employee Social Security coverage.

In spite of the disadvantages of non-coverage, many non-career employees nevertheless would prefer to give up some of their Social Security benefits in order to avoid paying Social Security taxes.

These various viewpoints of public employees cannot be blended to form a single composite viewpoint. The police and firemen viewpoint favoring non-coverage probably is correct insofar as their self-interest is concerned. A common viewpoint among career general employees that non-coverage is desirable is correct for some individuals but not for others. Without doubt, the large number of non-career public employees would suffer as a group if not covered by Social Security. It is reasonable to conclude, considering all factors, that coverage for general employees is beneficial to the employees as a group.

## Employer's Viewpoint

With the present concern about financing future Social Security benefits, it would appear that the public employer (other than the Federal government) for the time being, at least, should prefer to remain in Social Security or to seek Social Security coverage -- since one possible means of balancing outgo with income is general revenue financing. For a state or local government general revenue financing would produce a Federal subsidization of retirement expenses. (An indirect Federal subsidy exists already, the non-taxability of Social Security benefits.)

In the absence of such a new subsidy, the various government employers as a group should expect at least to break even in the long run with respect to taxes and benefits.

When a public employer faces employee discontent because combined Social Security taxes and retirement system contributions are too high, or fiscal problems exist for similar reasons, withdrawal from Social Security may seem the easiest course to take. A more reasonable alternative too often is neglected: adopting an effective basis of integrating the retirement system with Social Security. Total benefits can be developed which are both adequate and equitable, and total employer and total employee contributions can be maintained at acceptable levels, with proper retirement system design.

## Financial Impact on Social Security System

The exclusion of public employees from Social Security coverage reduces both the benefits and the taxes of the Social Security System. The combination of moonlighting, early "retirement" in order to work under covered employment and higher spouse benefits nevertheless produces a financial drain upon the System. The bias in the benefit formula in favor of lower average wages and the non-offsetting of spouse benefits by the public employee's (the spouse's) own Social Security benefits produce benefits which will not be reimbursed in full by the additional taxes collected.

The provision in the Social Security Act which permits coverage and subsequent withdrawal of public employee groups similarly provides an unfavorable effect on tax receipts vs. benefit disbursements. These options, if exercised intelligently, provide a means of taking further advantage of the System: antiselection by groups of older employees who come into the System just long enough to achieve fully insured status.

Mandatory coverage of all public employees (including all Federal employees) would eliminate these drains upon the System under the present payroll tax financing basis. The adoption of general revenue financing, of course, would change the situation drastically: it would create a Social Security subsidy for covered groups.

## National Policy

Although universal Social Security coverage never has been a stated national policy, Congress gradually has broadened the Social Security Act by either requiring or permitting new kinds of employees (including public employees) to become covered. It appears that the intent of Congress has been to make Social Security coverage as broad as political and other considerations have permitted from time to time.

When Social Security first was enacted in the 1930's, few private employees were covered by retirement plans, but a large proportion of public employees were covered, in particular Federal employees (including the armed forces). Now a large proportion of private employees also are covered by retirement plans (and profit-sharing, savings and other deferred benefit plans). Although pension coverage in certain kinds of private employment still is deficient, the overall pension plan coverage in private employment now probably is similar to that of public employment in the 1930's. While there might have been apparently sound reasons for Social Security's disparate treatment of private and public employees in the '30's, those reasons no longer are valid.

The enactment of the Employee Retirement Income Security Act of 1974 was prompted by the desire of Congress to protect employee benefit rights, including those of employees who move from one job to another. It would appear that Congress also should be concerned about the portability of Social Security benefits for non-career public employees.

It therefore is logical now to adopt universal coverage as a recognized national policy. We have been moving in that direction for over a quarter of a century; inequities to individual employees need correcting; and although coverage would appear to injure the interests of certain groups, in reality, coverage merely would eliminate unintended subsidies from other groups to those presently favored. The only sizable groups of employees not yet covered by Social Security are in public employment (railroad employees are covered indirectly). The mandatory extension of Social Security to all public employees would create almost universal coverage. Congressional action to mandate coverage for public employees is not at all unlikely.

## Part V

## Should the State Withdraw from Social Security?

### Issues of Withdrawal

On behalf of itself and its covered employees, the State has the option to stay in Social Security or to withdraw - in other words, to "buy" or not to "buy" Social Security benefits with payroll taxes paid by the State and covered employees.

The key issues to be considered in reaching this decision are:

- Would State employees receive Social Security benefits worth more, less, or about the same as the taxes paid (on their behalf by themselves and the State) if Social Security coverage continued?

- Does the relationship of payments to benefits under PERS appear to be better, about the same, or worse than the relationship of taxes to benefits under Social Security?

- Could a better-designed State program be developed without Social Security?

- Could a superior program be developed with better integration of PERS and Social Security benefits?

- How would the cessation of Social Security coverage affect non-career employees?

- Would State employment be more attractive to potential employees with Social Security or without it?

- How would withdrawal affect covered employees approaching retirement?

- Should the philosophy underlying Social Security (of providing virtually universal, portable protection) be a factor in the decision?

- Should the State be concerned with the influence of its action upon other public agencies in California and upon other state and local governments?

- How equitable is Social Security?

### Benefits Versus Taxes - Social Security

In recent years there have been many articles purporting to illustrate that our Federal Social Security System really offers less in benefits than could be purchased with the same dollars from an insurance company. Many actuaries have observed that the prospective taxes payable by a young employee first entering the System, and by his employers, have a present value well in excess of the benefits he could expect to receive under the Social Security program. Professor Colin Campbell of Dartmouth and others from academe have commented on this unfavorable relationship between benefits and taxes not only for the new entrant, but also for the single male and the married working female. This purported unfavorable relationship stems from the fact that employee-employer payroll taxes are not intended to cover the entry age normal costs for the present workers who are paying taxes (as is the case for PERS). Rather, the taxes are set at a level where they will support the current benefit payout to retired employees, widows, children, aged parents and the disabled who are collecting benefits now.

One of the assumptions implicitly made in this type of comparison of the value of benefits and taxes is that the present Social Security System will remain unchanged in the future. The benefits and taxes set forth in the current law are used for these comparisons, almost as though a private pension program were being valued and inflation might be ignored. This, of course, is quite reasonable on the surface, since the level of benefits and taxes in the current law is all that is known as a matter of cold, hard fact. At the same time, this approach overlooks the obvious - if Social Security is frequently amended or automatic escalation in benefits and taxes occurs, the total amount of taxes paid by an individual is affected less by the amendments or escalation than is the total amount of benefits he ultimately gets. This is because the changes made are not retroactive and the taxes precede the benefits by a good many years.

The next Social Security amendment of substance is expected to cut back future benefits under certain conditions from the excessive levels they otherwise could reach. It is expected that all benefits will continue to increase above present levels, however, as the average wage base increases and CPI increases produce escalation.

Reduced to the simplest terms, the Social Security System operates to balance tax income and benefit outgo. Thus over the very long run, a large and continuing employer such as the State and its employees as a group may expect to break even on taxes versus benefits. Currently, the situation appears to be better than break-even because the tax base source is so much larger than the benefit recipient group and current benefit payout levels are lower than they will become. If fertility rates remain low, however, there will be a day of reckoning early in the 21st century as the proportion of Social Security pensioners to workers increases dramatically when the post-war babies start collecting pensions. At that time, the working generation will bear a heavier tax burden resulting from applying the pay-as-you-go approach to benefits for a cohort of pensioners whose size will exceed any previous one by a large margin. Thus, the current favorable situation will recede. Even so, the State and its employee should tend to get their money's worth as a group because of the basic character of the Social Security System.

While the Social Security tax-benefit relationship is currently favorable and should never decline below break-even, there is a minor disadvantage. It is likely that Social Security taxes paid on behalf of State civil service employees subsidize benefits for employees in other states. This is because pay levels in California are generally higher than national averages. In consequence, the average Social Security tax is likely higher in California and the average benefit in relation to prior income is possibly lower here than elsewhere because Social Security benefits favor low-paid employees. It is not possible to determine the extent of such subsidy nor to predict whether or not it would continue.

For reasons discussed in Part III the Federal government may abandon the payroll tax as the sole basis for financing Social Security. If this occurred, the State and its employees would fare much worse if Social Security coverage were dropped than if it were continued. First, the State would give up a subsidy from general Federal taxes of perhaps a third (or more) of the costs of Social Security. Second, State employees would be paying, through Federal taxes, for Social Security benefits for other employees.

While the possibility of general revnue financing deserves a great deal of attention, the existence of a current indirect subsidy should not be ignored. The income tax treatment of Social Security benefits constitutes an important existing Federal subsidy to public employees and employers with Social Security coverage.

Social Security benefits are not taxable at all, whereas the benefits provided by the State contributions to PERS are taxable. Since it is difficult to cover all potential tax situations, let us consider the case where deductions and personal exemptions would exactly offset income from sources other than Social Security. Then, if half the Social Security retirement benefits were transferred to PERS at State expense, a retired employee would lose 1 to 4 per cent of the amounts so transferred in additional taxes. If the whole amount of Social Security were provided through PERS at State expense, this retired employee would pay 11 to 15 per cent of what are now nontaxable Social Security benefits in additional income taxes.

For retired employees whose other income was low, the percentage would be smaller. Those with income sufficient to require taxes in any event would be in higher tax brackets and the percentages applicable would consequently be higher. In the case of higher-paid employees income taxes could amount to 25 per cent or more of the increase in PERS benefits if half the Social Security benefits were to be provided by PERS.

In summary, then, there seems to be a better than break-even relationship between Social Security taxes and benefits, particularly in consideration of the income tax treatment of benefits. There is a minor and possibly temporary subsidy from California employers and employees to those beyond the State inherent in the Social Security System. However, there would be a very significant subsidy to the State and its employees if the State continued in Social Security and Social Security funding should tap general Federal revenues.

## Cost Comparisons - PERS Versus Social Security

If the State chose to withdraw from Social Security, PERS presumably would be the medium for State employees to receive social-security-type benefits. Thus, the efficiency of PERS as an investment medium needs to be considered.

The level of PERS future investment earnings obviously is not predictable. The higher the long term average earnings, however, the more favorable PERS funding would be compared with Social Security. Studies of investment performance have shown that equities have out-performed fixed income securities by large margins over long periods in the past. Since PERS investment in equities is limited to 25%, such studies, if predictive of future investment performance, would lead to the conclusion that PERS investment results will be well under their potential (note: this criticism by no means is intended to disparage PERS's current investment results). The relatively low investment in equities actually might be an un-conservative and costly investment policy, since it provides only a limited hedge against the higher costs which would occur with higher rates of inflation than anticipated.

Because of all the uncertainties surrounding the future course of Social Security and because of the difficulty in making a comprehensive enough study of the alternative costs under PERS of Social Security benefits, the relative efficiency of PERS vs. Social Security for various PERS earnings assumptions is not calculable.

Differences in administrative expenses relative to benefit-payouts now are minor and probably will continue to be so.

The Wyatt Company evaluated the costs of replacing certain Social Security benefits for a group of 3,600 public agency members of PERS in 1975. The benefits evaluated were not the total of all Social Security benefits, but just those of the kind which might be replaced by an independent retirement system in the event of withdrawal from Social Security. The total cost as a percentage of total payroll was 12.32% vs. the 9.90% of the wage base payable for all OASDI benefits. Although this valuation indicated that Social Security is a bargain, it must be regarded as inconclusive because of uncertainties with respect to the future experience and the future of Social Security and because the cost of some benefits was omitted. As a practical matter, it is impossible to develop a reliable mathematical comparison of Social Security vs. alternative financing of benefits.

The Wyatt valuation did allow for the escalation feature of Social Security. It undoubtedly was a much more realistic appraisal of costs than those which have produced a conclusion that Social Security benefits as now constituted could be provided more inexpensively outside of the Social Security System.

## Improved Benefit Design - With and Without Social Security

If the State withdrew from Social Security, it would be possible to improve benefit design from two standpoints:

- Because the whole benefit program would be under State control, the design of the program for career employees could be tailored exactly to State objectives without concern for the current intricacies of Social Security or for future Social Security amendments.

- The resulting program doubtless would be simpler to administer and to understand since, typically, few employees now understand Social Security benefits, much less the combination of Social Security and PERS benefits.

While the design could be improved for career employees without Social Security, it could be improved for all employees while continuing Social Security coverage. In 1973 the State of New York's Permanent Commission on Public Employee Pension and Retirement Systems recommended, for example, an approach which would provide benefits similar to those which would exist without Social Security; mainly: deducting 100 per cent of employee Social Security benefits from New York State service retirement and disability retirement benefits.

While the New York Commission's recommendation may be ideal from a theoretical design standpoint, it would be likely to create dissatisfaction among employees as payroll taxes increased while their total benefits did not. A better solution to integrating with Social Security would be to deduct only half of the Social Security benefits (prorated for short-service employees retiring because of age, as in the New York proposal) on the basis that employees and employers had paid equal Social Security taxes.

This approach would favor lower paid employees because of the bias of Social Security benefits toward the lower paid, and no special differention in benefits according to pay (as proposed in New York) then would be necessary to achieve this goal. A bias in favor of low paid employees is desirable on two counts. Their needs as a proportion of take-home pay before retirement are greater than those of higher paid employees. Also, pre-retirement taxes reduce the take-home pay of higher paid employees proportionately more than that of lower paid employees and the former thus need relatively less retirement income in relation to total pay.

The issues concerning benefit design would favor eliminating Social Security insofar as career employees are concerned because of the simplification of benefits and the greater ease of tailoring benefits to their needs. Before drawing any final conclusions relative to design, however, the impact of withdrawal from Social Security upon non-career employees also must be considered.

## Non-Career Employees

Employees who will not remain in employment until first eligible for retirement comprise a large proportion of State miscellaneous employees. Using factors based on PERS actuarial experience, a Wyatt Company 1973 study indicated that 32 per cent of the male engineers and 57 per cent of the female clerks then on the payroll were not likely to remain in service until age 55 (or the completion of five years, if later). The male engineer's age and service distribution naturally reflects a career orientation, while the distribution of clerks reflects far less of such an orientation. It seems reasonable to infer that 40 to 50 per cent of the current miscellaneous employees will not qualify for service retirement. And of all employees to be hired in the future, the proportion who would not remain until retirement would be expected to be much higher than 50 per cent if only because of initial turnover. Also, many employees who satisfy service retirement eligibility conditions nevertheless withdraw their PERS accounts and thus forfeit their PERS retirement allowances.

While withdrawal would be advantageous to the design of benefits for career employees, a decision to withdraw from Social Security would have an entirely different impact on employees who shift back and forth from one job to another, whether to a job with another government or to one with private industry. When an individual leaves his job in private industry or in a government unit which is covered by Social Security and starts to work within a governmental unit without Social Security, he can, over the years, lose out on significant benefits from Social Security.

For example, an employee must have five covered years in the ten years preceding a disability in order to be eligible for Social Security disability benefits. Thus, the full-time employee with ten years under Social Security will have disability protection in declining amounts for the first five years of his subsequent, noncovered employment, but then will lose the protection. Thereafter he must rely on his current employer's retirement system to provide his full disability benefit and that system must go it alone, so to speak. Moreover, if this particular individual, after six years of noncovered service, say, left that job and joined yet another employer with Social Security, the employee would still not be eligible for the Social Security disability protection for a period of five years.

As another example, consider the survivor benefits payable to a widow any age caring for children under 18. An employee needs either 40 quarters of coverage or one quarter of coverage for each year after age 21 (with a minimum of six quarters) in order to qualify for the survivor benefits. If an individual of age 24 with 10 quarters of coverage shifts from an employer providing Social Security to another that does not, he will fail to meet the requirements for fully insured status at age 32 and thereafter will not be eligible for the survivor benefits. Here again, even if this individual eventually moved back into covered employment, it would be some time before he could requalify as currently insured.

With our present economy characterized by considerable job mobility, these potential losses of benefits through loss of Social Security coverage are very important. This is particularly so because the potential loss of Social Security benefits for long periods of time cannot be met by liberal vesting provisions other than for the service retirement benefit itself. It is simply not possible to withdraw from Social Security and make up for this decision by the provision of generous benefits. Many employees would lose out in the process, probably at least half. Viewed in these terms, it can be fairly stated that the State could not possibly replace all of the benefits that might potentially be forfeited by its employees in the future as a result of a decision to withdraw from the Social Security system. Thus overall benefit design considerations suggest quite strongly that it would be desirable to remain in Social Security.

## Desirability Of State Employment

For the reasons given in the preceding paragraphs, potential employees, and particularly those who do not expect to spend the balance of their careers with the State, could be expected to seek to avoid giving up valuable current Social Security benefits and a portion of their eventual Social Security pensions. Admittedly, employees in general are not sufficiently aware of Social Security mechanics, e.g., how their eligibility for benefits or the benefits themselves are calculated. Nevertheless, persons in the work force generally, and perhaps those in the private sector particularly, are very much aware in a philosophical sense of the overall value of Social Security.

It is reasonable to conclude that the ability of the State to compete in the employment market would be impaired by withdrawal from Social Security, especially in consideration of the alternative of PERS revision, which would avoid the burdensome duplication of employee contributions.

## Effect of Withdrawal on Covered Employees Approaching Retirement

Concern exists about the effect of withdrawal on State employees who have qualified as "fully insured" under Social Security and who are approaching retirement. It is questionable whether or not the effect on a relatively small group of employees should be a major factor in determining the coverage of hundreds of thousands of future employees, but this concern still is a valid one to consider along with others.

Such "fully insured" employees will become entitled to Social Security old age benefits whether or not they and the State continue to pay Social Security taxes. Their Social Security benefits are not frozen, however, and in fact will increase in amount for each year of future coverage.

If the State had withdrawn from Social Security as of January 1, 1971, then, for example, a male employee retiring at age 65 in 1976 with maximum Social Security benefits would lose $76.10 per month in old age benefits for himself, or $114.20 including a spouse benefit for a wive age 65, as well as $76.10 of potential widow's benefits to the wife for life. The value of all these benefits together (at a 6% interest rate) is over $14,000 without future escalation, compared with about $7,000 of employer and employee taxes, including interest to January 1, 1976. Thus the average loss would be over $7,000.

Allowing for future inflation of 3% per year would increase the value of the male employee's benefits to over $18,000, making his net loss due to withdrawal from Social Security more than $11,000 worth of benefits.

For an unmarried female employee the net loss under these conditions would be about $2 to $3 thousand without allowing for escalation of benefits or about $5,000 with future benefits increasing at a 3% inflation rate.

Only the costs of old-age and spouse benefits were estimated above. Other potential benefits were not evaluated.

The reason that employees could lose such valuable benefits is that withdrawal from Social Security would reduce the average Social Security wages used in the formula for determining benefits. As a result of excluding the higher wages of 1971 through 1975, for example, the average Social Security wages for these two employees would have been $428 per month instead of $585.

For lower-paid employees, the value of the benefits lost by withdrawal would be higher in proportion to the Social Security taxes because of the bias in the benefit formula in favor of lower-paid employees.

The conclusion therefore is that such older employees would profit and the State and employee Social Security taxes would "buy" benefits very economically if Social Security coverage were continued. Withdrawal from Social Security could reduce the total pensions of older employees very significantly, and the cost to the State of replacing such benefits through PERS would greatly exceed the Social Security taxes otherwise payable. The potential Social Security benefit losses of older employees therefore constitute another argument for retention of Social Security coverage.

## Philosophy

The philosophy of Social Security requires the broadest coverage possible in order that this system of social insurance may function effectively. If the public policy of the State of California supports the idea of portable pensions and other benefits designed to meet a large range of individual and family needs, then a conflict with such policy would develop by withdrawing. Withdrawal would run counter to the current strong sentiment nationally for stronger vesting and for pension portability in all pension plans, since withdrawal would decrease the portability of miscellaneous employees' benefits considerably.

This question of philosophy may or may not be important to the State. The Federal government, which sponsors both Social Security and the Federal Civil Service Retirement System, is not consistent in its own philosophy, since Social Security does not cover Federal civil service employees.

## Impact on Other State and Local Governments

If the State withdrew from Social Security, the action would likely cause at least an acceleration of withdrawals by California local governments and would encourage other states to consider withdrawing. Such withdrawals have occurred and are occurring because the costs and retirement benefits of local benefit systems are considered high enough, because high employee contributions combined with Social Security taxes reduce take-home pay too much, and because of a belief that Social Security is not economical. A State withdrawal presumably would have the greatest impact upon those systems which are affiliated with PERS, and withdrawal also could generate portability problems in transfers between State employment and the local agencies affiliated with PERS that also are covered by Social Security.

Forty-four of the fifty states provide Social Security benefits, the latest to join being Illinois in 1969. No state has ever withdrawn from Social Security. Colorado, Louisiana, Maine, Massachusetts, Nevada and Ohio have never joined. It would seem that if California, the most populous state, were to withdraw after several years of employee pressures and of study of withdrawal, then other states and local governments in other states might be influenced to follow suit. The State has been a leader in many areas, and its prestige and resources would lend credence to a movement, which up to now has been confined to relatively few local governments.

The importance which the State should accord its influence on other governments in this matter depends mainly upon the seriousness with which the State views the current counter-trend among local governments against the philosophy of universality of Social Security and that of pension portability. While the State's own withdrawal, by itself, might not be a great national setback to Social Security (110,000 or so employees out of 78.3 million), the effect of the State's withdrawal might be amplified greatly by those who would follow the State's leadership.

By early this year, 322 local governments with 44,667 employees had withdrawn and 207 more with 53,187 employees had started the process. What earlier was a mere trickle of withdrawals has grown to a moderate stream. According to a recent Wall Street Journal article (July 22, 1976, by Jonathan Spivak), this moderate stream threatens to become a torrent: 500,000 employees of such governments as New York City, Detroit, Milwaukee and the states of Alaska, Hawaii, Maryland and Wyoming may pull out in the next two years. (The proposed New York City withdrawal is motivated by severe budget problems and is strongly opposed by the unions.)

Action by the State of California could change that potential torrent into a flood which could drain the System of a major part of its 8.9 million state and local members.

Furthermore, the benefit security of employees of many local governments who dropped out of Social Security would be decreased, particulary in the case of those retirement systems were not actuarially sound. The massive population movements and shifts of industry which have continued in this country for many years have reduced populations and tax bases in many areas of the country, including even some California localities. In a given retirement system, this trend could lead to a disproportionately large group of retirees and older employees in combination with a shrunken tax base insufficient to support benefits. Social Security benefits, being of national scope, are not affected by such redistributions of population and industry.

The State's withdrawal from Social Security therefore would be likely to have serious effect not only upon the benefits of its own employees, but upon the benefit portability and the benefit security of a great many other public employees.

## Impact on Federal Legislation

One change in Social Security which is not at all unlikely is mandatory coverage for government employees. The effect upon Social Security financing of the withdrawal of a large segment of the public employees now covered would be significant.

Furthermore, such withdrawals might be counter to public policy on universality of coverage and portability of benefits, as seen by Congress. The probability of compulsory coverage or some other change which at least would attempt to rectify the resulting problems would be increased.

In the event of compulsory coverage, it is likely that some State modifications of benefits made after withdrawal would be considered, in retrospect, to have been unwise. It might be quite difficult to correct the benefit program.

In addition, past unpaid Social Security taxes might need to be made up.

Another possible congressional action would be to impose a penalty on the withdrawn employees, such as removal of the cost-of-living benefit.

## Social Security Equity

Social Security is not intended to be an equitable program and, in fact, provides neither equivalent benefits to married men, single employees and married women, nor benefits proportionate to pay. Its aim is to provide for broad social needs through taxation.

These inequities generally need not concern individual employees, particularly if their benefit program as a whole is well balanced with respect to both benefit adequacy and required employee contributions. All well-designed programs differentiate benefits to the extent of recognizing that the needs of employees are not identical.

A married female employee nevertheless would profit by earning PERS benefits instead of Social Security benefits, since the latter at retirement in effect are reduced by the Social Security spouse benefit. PERS retirement allowances, of course, are not affected by marital status. On the other hand, this feature of Social Security does not in any way affect the adequacy of benefits, which should be the major concern of both the State and the employees.

Among the proposals currently being considered for inclusion in the next Social Security amendment are (1) elimination of the spouse benefit or (2) offsetting the spouse benefit by benefits earned in non-covered employment. Either of these would remove the appearance of inequity for the married female public employee.

## Social Security Earned after Early Retirement

One minor issue needs consideration - the fact that an early retiree not covered by Social Security could take other employment and earn Social Security benefits worth far more than his taxes in a few additional years of work. This part of the Social Security law is becoming less attractive to early retirees with the passage of time, as the minimum period of coverage required increases to 10 years. The current situation does not support withdrawal, since by providing an adequate retirement allowance (with or without Social Security) the State would have fulfilled its obligation to such an employee. However, this current facet of the law could be an incentive for miscellaneous employees to quit (not retire) at age 50 or so if the State withdrew. Such an incentive presumably would be counter to personnel policy.

## Summary

The current structure of Social Security yields a presently favorable relationship between current taxes and eventual benefits, a relationship which may decline after the 20th century but which should never descend below equilibrium for large continuing employee groups over a long period of time even with the expected revisions in the law. Relative to PERS, Social Security can be expected to provide better benefits when income taxes are considered. Older employees approaching retirement would be hurt by withdrawal. PERS and Social Security programs can be integrated through redesign to meet career employees' needs more efficiently and economically than now is the case. These issues, all based upon the current features of Social Security and PERS, argue strongly against withdrawal.

An even stronger argument emerges when likely future changes in Social Security are considered. If Social Security were to tap general Federal revenue sources in the future after the State withdrew, the State would give up a future subsidy and State employees would subsidize through their income taxes the Social Security payments to others. Also, the Social Security law now prohibits reentry after withdrawal. This feature could be changed. However, the intent of Congress appears to be that state and local governments should not be permitted to enter and leave Social Security as benefits and taxes seem favorable or unfavorable. Thus, it should be expected that any future change to permit reentry would require the restitution of substantial taxes. For the State, it would not take many years for back Social Security taxes to amount to a billion dollars.

In addition, mandatory public employee coverage is a possibility which also adds to the unattractiveness of withdrawal.

Other issues provide further support for a decision against withdrawal. In particular, withdrawal would have a major adverse effect upon those employees who will not retire from State service, a sizable element of the State's total current work force. Withdrawal would also be likely to be detrimental to the attractiveness of the State as a potential employer. Finally and on matters admittedly requiring policy judgment, withdrawal would be counter to current and increasing national sentiment concerning pensions and related benefits, and could trigger similar actions by other governments that would be detrimental to large groups of employees.

Certain of the issues discussed definitely would support a decision to withdraw. Foremost of these is benefit design - the State unquestionably could arrange a more simple pattern of benefits and eligibilities if it withdrew from Social Security. This would be an administrative advantage and it would yield an easier program for employees to understand. Also the State would be able to operate its program independent of the complications of any future Social Security amendments (but not necessarily independent of Social Security cost implications, as noted).

Withdrawal would affect the interests of various employees differently - some favorably and some unfavorably. There is an almost universal misunderstanding of Social Security because of its complexity. If each State employee fully understood Social Security as it affected his own self interest and then voted accordingly, the following would be the potential line-up of employees:

For withdrawal:
- Younger career employees who moonlight or who expect to work after retirement
- Female employees married to covered employees
- Higher paid employees

Against withdrawal:
- Employees subject to greater risk of disability
- Older career employees
- Career employees who don't expect to earn Social Security elsewhere
- Non-career employees
- Employees with many dependents
- Lower paid employees
- Married employees with non-covered spouses

These groups overlap considerably, and it is difficult, except for older employees, to be sure of one's own status as a career employee. Nevertheless, if each State miscellaneous employee were to vote according to his own self interest as it really is, the majority would vote for continued coverage. Much of the current sentiment among public employees for withdrawal - not that such sentiment is by any means overwhelming - is based on a lack of comprehension of where that self-interest lies.

## Recommendations

It is recommended that the State not withdraw from Social Security. At the same time, it is recommended that the State revise its own benefit program to increase benefits in deficient areas, lower them in areas of excess, and increase take-home pay through a reduction of contributions to State benefit plans.

The recommended revisions outline the same sorts of actions that would be contemplated if Social Security were dropped, namely: reduce some benefits, fill in gaps and increase take-home pay. The treatments for employees already on the payroll and for future employees would differ, however, because of the legal and practical difficulties involved with a complete overhaul of PERS for the former.

Future State miscellaneous employees should have a new PERS package which would require no employee contributions and which would provide adequate benefits in all respects, when financially possible, in combination with Social Security. This ideal plan might involve benefit increases for service retirement before Social Security became payable and for disability in some circumstances. PERS benefits would be less, however, when the combined benefits otherwise would produce too high a replacement ratio. Cost-of-living adjustments would be liberalized so that eventually there would be no COL ceiling (now 2% in PERS for State employees). The key to proper design would be to offset PERS benefits directly by a proportion of the Social Security benefits actually payable.

To the extent possible these kinds of changes ought to be made for employees already covered by PERS as money becomes available through the TEC process established by the Berryhill Total Compensation Act of 1974. Some progress has been made in this direction, such as reducing employee contributions. Nothing yet has been done toward reaching the best long-term solution, however, the establishment of a new program of benefits for future miscellaneous employees.

In making the recommended kinds of changes in PERS while retaining Social Security coverage, the State would gain by fulfilling the aims of employees while eliminating the disadvantages of leaving Social Security. Furthermore, the development of a balanced benefit program with Social Security coverage not only would solve current practical problems, but would implement in the most economical way the long-range objectives of meeting needs adequately and equitably, and of facilitating personnel policy.

In any event the State should not begin the withdrawal procedure before certain important decisions affecting the future of the Social Security System have been made - those relating to decoupling the benefit formula, to future financing and to coverage of public employees. It would be especially unfortunate to withdraw if general revenue financing subsequently were adopted. The loss to employees and to taxpayers could be enormous.

A premature notice to withdraw, even if the intent were to reconsider it later, might be difficult to reverse and it would tend to encourage other public bodies to withdraw.

The Wyatt Company's recommendations therefore are:

(1) Do not withdraw from Social Security and

(2) Revise PERS to accomodate Social Security efficiently; or

(3) If the State nevertheless should lean toward withdrawal, do not begin the process until crucial Federal decisions affecting the future of Social Security have been made.

It appears that many, if not all, of the public groups which have withdrawn from Social Security to date have done so after superficial and incomplete analyses of the real issues and in ignorance of how the Social Security System operates and of how it might be changed. They may not have considered the alternative of proper integration of Social Security into their own benefit programs. These earlier withdrawals there fore should not provide any encouragement to the State of California to withdraw. The State should make its own decision after careful deliberation on the issues.

Even though some of these issues involve unknowns and even though some issues involve cost comparisons which cannot be quantified, that State decision should be to continue Social Security coverage. The resolution of the unknowns would be expected to be favorable or neutral to continued coverage, while a weighing of the knowns produces a clear verdict in favor of coverage.

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