Social Security's Unsafe Harbor

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March 2016

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FIXING AN UNFAIR AND INSECURE SYSTEM

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Acknowledgements

The author thanks all those who offered generous feedback on earlier working drafts of this paper, especially Andrew Biggs, Jessica Handy, Tamara Hiler, Leslie Kan, Andrew Rotherham, and Michelle Welch. Thanks also to Dave Baker and Five Line Creative for copy-editing and design support, and to the Laura and John Arnold Foundation for providing funding for this paper.

The views and analysis in this report are the responsibility of the author alone.

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Introduction

Social Security was designed to provide all workers with a solid foundation of retirement savings. For the majority of retirees today, Social Security makes up the largest portion of their retirement income. Yet despite Social Security's importance, and its prominence as a political issue, most Americans aren't aware that not all workers enjoy the benefits of Social Security. In fact, 6.5 million state and local government workers, including 1.2 million public school teachers, lack the protection of Social Security.[1]

Most Americans aren't aware that not all workers enjoy the benefits of Social Security.

Beginning in the 1950s, state and local governments were given the option to enroll their workers in Social Security. A minority of states chose not to, on the theory that their state pension plans could offer better benefits than Social Security could. Those states do tend to offer slightly more generous pension formulas to make up for the fact that they don't offer Social Security coverage. However, that trade-off works well for only a small group of workers—the few who spend their entire career in one place—while the majority of workers retire with much lower benefits.

The IRS has a formula for testing whether state and local government retirement plans provide sufficient retirement benefits to their workers. If a retirement plan fails the IRS test, the state or local government *must* offer its workers Social Security instead.

In theory, this "safe harbor" provision sets a base floor for the retirement plans offered by state and local governments. Even in the worst economic times, state and local policymakers know that they can't cut benefits by too much, or they risk being forced into Social Security and into paying the taxes that come with participation.

In practice, however, this safe harbor provision fails to protect the majority of workers who aren't covered by Social Security. Like state pension plans, the safe harbor provision relies on a backloaded formula that delivers sufficient retirement benefits only to those employees who stay with one pension plan for their entire career. In the process, the vast majority of workers who leave a workplace before retirement fail to qualify for sufficient savings. Worse, the safe harbor formula covering defined benefit (DB) retirement plans focuses on only a few components of pension formulas while ignoring other variables that ultimately determine the benefit workers actually receive.

This brief looks at how the safe harbor provision affects workers across the entire career cycle. When we look at the full cycle, not just the final benefit delivered to late-career workers, it's clear that the safe harbor guarantees only a very minimal benefit to state and local workers. That protection varies based on the type of plan offered to workers. The IRS rules subtly bias states to select less generous DB plans over defined contribution (DC) options. The result is that workers with DB plans are given less protection than are workers in DC plans. Worse, the safe harbor provision fails to ensure that workers receive retirement benefits at least as generous as Social Security itself.

By allowing states to avoid offering Social Security coverage, the safe harbor provision provides a false sense of protection and leaves millions of workers without sufficient retirement savings.

Finally, as a concrete example, the brief looks at the case of Illinois teachers. Illinois does not participate in Social Security, meaning its teachers neither pay into nor receive benefits. That decision harms teachers because the vast majority of them would be better off participating in Social Security, even after subtracting employee and employer contributions. The added security and savings for teachers participating in Social Security would be significant, especially for teachers who receive very little from their state pension plans. This is particularly true given that about half of all new teachers will not stay in their jobs long enough to qualify for any pension at all.[2] Extending Social Security would ensure that 100 percent of teachers earn retirement benefits, as compared with the less than half covered today. By allowing states to avoid offering Social Security coverage, the safe harbor provision provides a false sense of protection and leaves millions of workers without sufficient retirement savings.

Social Security's Safe Harbor Provision

When Congress enacted Social Security in 1935, it excluded federal, state, and local government employees from coverage because of concerns over the federal government's authority to tax state government agencies. As a result, the initial law covered only private-sector workers. Over time, Congress extended the law so that state and local governments could choose to voluntarily provide Social Security coverage to their employees.[3]

> Nationwide, about 1.2 million teachers are not covered by Social Security.

The result became an uneven distribution of Social Security coverage across and even within the states. Among those currently without coverage are 40 percent of public school teachers in states or districts that have chosen not to participate. Nationwide, about 1.2 million teachers are not covered by Social Security. Those teachers are concentrated in 15 states—Alaska, California, Colorado, Connecticut, Georgia, Illinois, Kentucky, Louisiana, Maine, Massachusetts, Missouri, Nevada, Ohio, Rhode Island, and Texas—and the District of Columbia, where many or all public school teachers lack coverage.

Social Security coverage varies even *within* states. For example, in California all state government employees, state legislators, and judges are covered by Social Security, while teachers must rely solely on their pensions. Social Security coverage also varies within California schools and districts—superintendents and district employees tend to be covered by Social Security, while classroom teachers are not.

In 1991, partly out of concern that state and local governments were not providing sufficient retirement benefits to their workers, Congress required Social Security coverage for all state and local government employees who were not enrolled in a "qualified" public retirement system. The IRS says that a public-sector worker is enrolled in a qualified retirement system if "he or she participates in a system that provides retirement benefits, and has an accrued benefit or receives an allocation under the system that is comparable to the benefits he or she would have or receive under Social Security."[4]

For DB pension plans, like those offered to 90 percent of public school teachers, the IRS regulations define what this "comparability" means:

> A defined benefit retirement system maintained by a State, political subdivision or instrumentality thereof meets the requirements of this paragraph (e)(2) with respect to an employee on a given day if and only if, on that day, the employee has an accrued benefit under the system that entitles the employee to an annual benefit commencing on or before his or her Social Security retirement age that is at least equal to the annual [retirement benefit] the employee would have under Social Security.[5]

The test is intended to assess whether plans deliver benefits that provide sufficient retirement savings for each individual on every single day he or she is employed. A plan could be considered a qualifying retirement plan for some workers, at some point in their career, and not for other workers or at all points in their career.[6]

Since 1991, the IRS has implemented the safe harbor provision for pension plans through a simple test: A DB plan qualifies if it pays out at least 1.5 percent of the employee's salary, averaged over the last three years of service, multiplied by his or her years of service, beginning no later than age 65.[7] If an employee is enrolled in a pension plan with at least these provisions, the plan passes the safe harbor test.

The Safe Harbor Formula Offers Little Protection

The safe harbor formula is easy to execute—bureaucrats need to look at only a few basic details about the plan—but doing so ignores some important variables. First, the safe harbor rules specifically carve out an exception for states to employ "vesting periods" that impose minimum requirements on the number of years an employee must work before becoming eligible for pension benefits.[8] With no constraints on vesting requirements, states can and do set vesting periods that are longer than what would be required in the private sector. For example, non-Social Security states like Connecticut, Illinois, Georgia, and Massachusetts withhold all employer-provided retirement benefits from teachers until they have reached 10 years of service. (Social Security imposes its own requirement that workers contribute at least 10 years to qualify for some benefit. This works like a vesting requirement, except, unlike a vesting period in a single retirement plan, Social Security is not tied to a specific employer or state and more than 95 percent of jobs are covered by Social Security. The main exception is state and local government workers, including teachers in the 15 states without coverage.[9]) These long vesting periods would be illegal in the private sector, where federal law requires all employees to vest within seven years.

> The safe harbor formula is easy to execute, but it ignores some important variables.

In the 15 states that do not offer Social Security coverage to their teachers, an average of 52 percent of new teachers will fail to vest into their state retirement system, leaving them with no retirement benefit at all.[10] The safe harbor provision specifically allows this.

Second, even after an employee has vested into a state retirement system, pension formulas deliver wealth in a backloaded way. Many teachers and other public-sector employees will leave their service before qualifying for larger, late-career benefits. This delayed delivery of benefits violates the "on a given day" language in the IRS regulations, which were designed to ensure that all workers accrue retirement benefits on *every day* they work. As this brief will demonstrate, the safe harbor provision does not ensure that all workers have retirement benefits equivalent to what Social Security offers.

Third, the safe harbor provision judges state pension plans solely based on a few variables while ignoring many other rules that govern how plans work in practice for individual workers. For example, the safe harbor provision is silent on whether employee benefits should rise with inflation. Worse, by ignoring employee contribution rates and rules on withdrawals, such as whether a teacher qualifies for any interest on his or her contributions, the safe harbor provision sets no minimums for employee asset accumulation.

From a worker's perspective, it matters a great deal whether the worker or the employer is bearing the brunt of the responsibility for making contributions to the plan. But the DB safe harbor formula ignores this question. In Illinois, for example, teachers hired after 2011 are required to contribute 9.4 percent of their salary to the state pension plan, but the pension plan itself estimates that benefits are worth only 7 percent of a teacher's salary.[11] That means the average Illinois teacher hired today is not receiving a retirement benefit at all—he or she is just paying a tax. The safe harbor provision does not look at nor protect against situations like this.

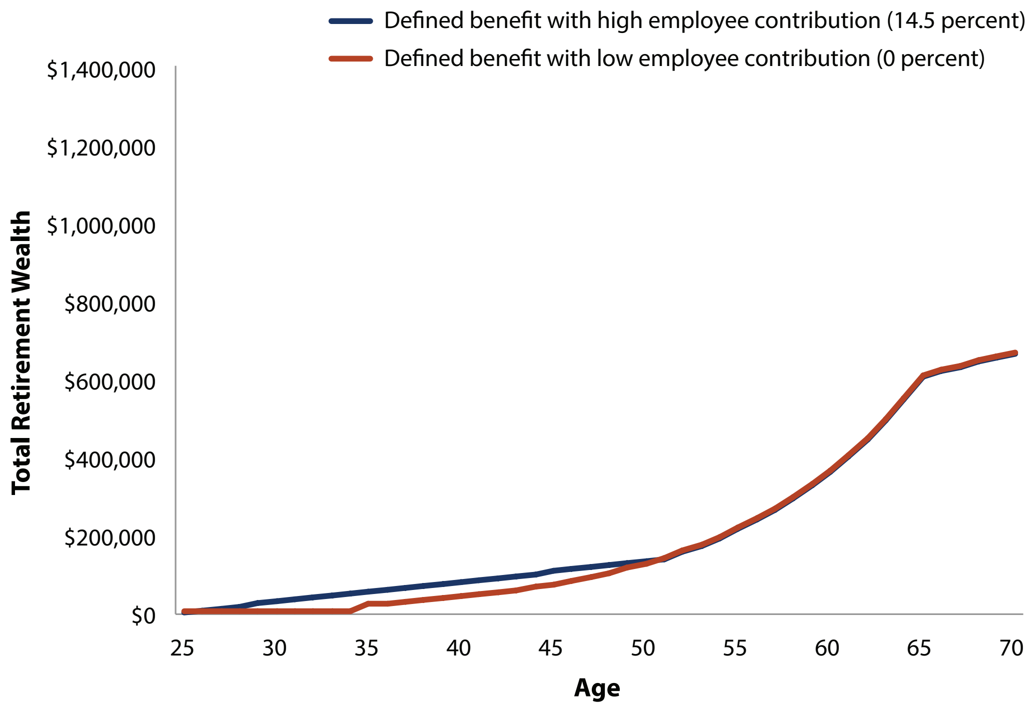
The root of the problem with the DB safe harbor provision is that actual benefits delivered to workers are untethered from their contributions. That is, a worker in a DB plan receives what's promised based on the plan formula, regardless of how much he or she contributes or how much the employer contributes on the worker's behalf.

This is an enormous oversight, especially for teachers who may not stay in a single pension plan for their entire career. Even under otherwise identical pension formulas, an individual teacher will receive dramatically different retirement benefits depending on his or her contributions and the state's rules on withdrawals, such as whether the teacher is eligible for any share of the employer's contributions or for any interest on his or her contributions if the teacher leaves the pension system early. By ignoring these elements, the IRS cannot guarantee that a state is providing sufficient retirement savings for each year an employee works.

By ignoring certain elements, the IRS cannot guarantee that a state is providing sufficient retirement savings for each year an employee works.

To illustrate how this works, figure 1 shows how an employee would accumulate retirement wealth in two pension plans that both qualify for the safe harbor provision. The two lines use the same pension *formula* (1.5 percent times the worker's final three years of salary times years of service) but with two different contribution rates. The blue line shows the state with the highest teacher contribution rate in the country, the 14.5 percent required of Massachusetts teachers. The green line shows the same pension plan but assumes the employee contributed 0 percent of his or her salary, the rate currently required in six states. (In this hypothetical comparison, employer contributions would make up the difference between the two plans.) As the graph shows, the worker will accumulate retirement savings faster if he or she, not the employer, contributes to the plan.[12] That's because the value of the teacher's contributions exceed the value of the pension until he or she reaches 26 years of service. At that point, the two lines converge. Most workers do not stay in their jobs for that long, and in states with low contribution rates and long vesting periods, departing workers are not protected from long periods with low retirement savings.

Figure 1 In Teacher Pension Plans, Retirement Wealth Depends on Employee Contribution Rates



Source: DB calculations use the methodology articulated in Robert Costrell and Mike Podgursky, "Peaks, Cliffs, and Valleys: The Peculiar Incentives in Teacher Retirement Systems and Their Consequences for School Staffing," *Education Finance and Policy* 4, no. 2 (2009): 175–211; and Robert Costrell and Josh McGee, "Teacher Pension Incentives, Retirement Behavior, and Potential for Reform in Arkansas," *Education Finance and Policy* 5, no. 4 (2010): 492–518. Benefits are based on the Society of Actuaries RP-2014 Mortality Tables, a discount rate of 5 percent, and a starting salary of $40,000 with annual increases of 2.75 percent. Both plans assume a 10-year vesting requirement. Calculations do not include withdrawal rules or benefit caps. The "high contributions" line uses an employee contribution rate of 14.5 percent, while the "low contributions" line uses an employee contribution rate of 0 percent.

To be clear, each of these lines represents a plan that would qualify under Social Security's safe harbor provision. The formulas are exactly the same, and both meet the bare minimum requirement. But as the graph shows, the same formula can deliver very different benefits depending on other policy choices that states may make. Perhaps most important, the safe harbor threshold can be appallingly low depending on how the state chooses to manipulate other variables at its disposal.

The IRS Is More Lenient With DB Plans, to the Detriment of Workers

When analyzing DB plans, the IRS has chosen to focus on incomplete benefit formulas that ignore total retirement assets. That leaves workers exposed to the possibility of low retirement savings, but there's another problem: It's a different approach from what the IRS uses to judge public-sector defined contribution plans. The IRS' tool for evaluating DC plans focuses on asset accumulation, not formulas, resulting in a more worker-friendly baseline that ensures all workers are accumulating positive retirement assets every year they work.

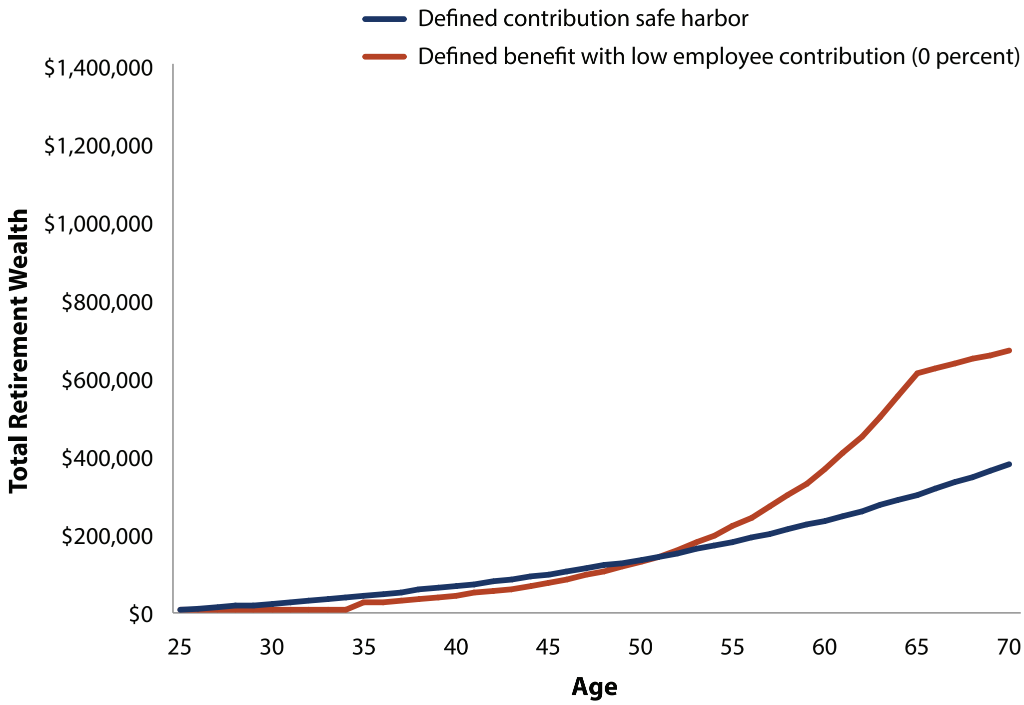
This is an important distinction. Under 401(k)-style DC plans, workers earn benefits that are directly tied to how much they contribute, how much their employer contributes, and how much those contributions grow over time. In turn, the IRS applies a different safe harbor test to determine whether state and local government DC plans qualify for an exemption from Social Security. At least 7.5 percent of each worker's salary must be put into a retirement savings account, which can comprise any combination of employer and employee contributions.[13] Further, those contributions must be placed in investments that grow over time. The IRS stipulates that workers must be allowed to invest those contributions in general mutual funds exposed to stock and bond markets or must be guaranteed a "reasonable" interest rate. The IRS gives an example of a reasonable interest rate as a return that at least equals the return on long-term Treasury bonds.[14]

The safe harbor rules for DC plans do a better job of protecting all workers than the safe harbor provision applied to DB plans. Figure 2 compares the safe harbor rules for DB and DC plans. For the DC plan, it assumes annual contributions of 7.5 percent of salary and a rate of return of 2.94 percent (the real, inflation-adjusted return on long-term Treasury bonds as of May 19, 2015).[15] This is the worst DC plan a state could offer—with the lowest contribution rates and the most conservative investment approach—and still be exempt from offering Social Security coverage. To compare apples to apples, figure 2 also includes the meager DB plan from figure 1. As stated above, this is the worst DB plan a state could offer and still meet all the safe harbor requirements, including a long vesting period and low contribution rates.

The safe harbor rules for DC plans do a better job of protecting all workers than the safe harbor provision applied to DB plans.

Under this comparison, the DC minimum provides a better benefit than does the DB minimum for the employee's first 26 years on the job, at which point the backloaded DB plan becomes the better deal. Of course, most employees, especially early-career workers, do not stick with one employer for 26 years. The vast majority of teachers and other public-sector workers will move on before then. They would be better off in a DC plan or another plan that allows them to accumulate retirement assets more evenly throughout their career.

Figure 2 Comparing Public-Sector Safe Harbor Rules for Defined Benefit and Defined Contribution Plans



Source: DB calculations use the methodology articulated in Robert Costrell and Mike Podgursky, "Peaks, Cliffs, and Valleys: The Peculiar Incentives in Teacher Retirement Systems and Their Consequences for School Staffing," *Education Finance and Policy* 4, no. 2 (2009): 175–211; and Robert Costrell and Josh McGee, "Teacher Pension Incentives, Retirement Behavior, and Potential for Reform in Arkansas," *Education Finance and Policy* 5, no. 4 (2010): 492–518. Benefits are based on the Society of Actuaries RP-2014 Mortality Tables, a discount rate of 5 percent, and a starting salary of $40,000 with annual increases of 2.75 percent. DB calculations use an employee contribution rate of 0 percent and do not include withdrawal rules or benefit caps. DC calculations use the same salary, a 7.5 percent contribution rate, and an annual investment return of 2.94 percent (the real, inflation-adjusted return on long-term Treasuries as of May 19, 2015).

To be clear, each of these lines represents a plan that would qualify under Social Security's safe harbor provision. But the plans deliver very different benefits to employees because the safe harbor provision focuses on different things for each plan. While the DC plan focuses on an individual's total assets, the DB safe harbor provision's incomplete formula leaves workers exposed to the possibility of years of inadequate savings.

The Safe Harbor Provision Is Often Worse Than Social Security Itself

Although IRS rules declare that all public-sector employees should be entitled to retirement benefits at least as generous as Social Security benefits are, the safe harbor provision fails this test. Recall that IRS regulations require all full-time employees to be enrolled in Social Security unless "the employee has an accrued benefit … that is at least equal to the annual [retirement benefit] the employee would have under Social Security."[16]

Social Security benefits are calculated using a worker's 35 highest-earning years of contributing to Social Security. As discussed above, Social Security imposes its own requirement that workers contribute for at least 10 years to qualify for some benefit. This works like a vesting requirement, except that unlike a vesting period in a single retirement plan, Social Security is not tied to a specific employer or state, and more than 95 percent of jobs are covered by Social Security. The main exception is state and local government workers, including teachers in the 15 states without coverage.[17] Employees cannot purchase credits to make up for lost years, so a teacher working in an uncovered position would have no way to apply any of his or her years in the classroom to Social Security.

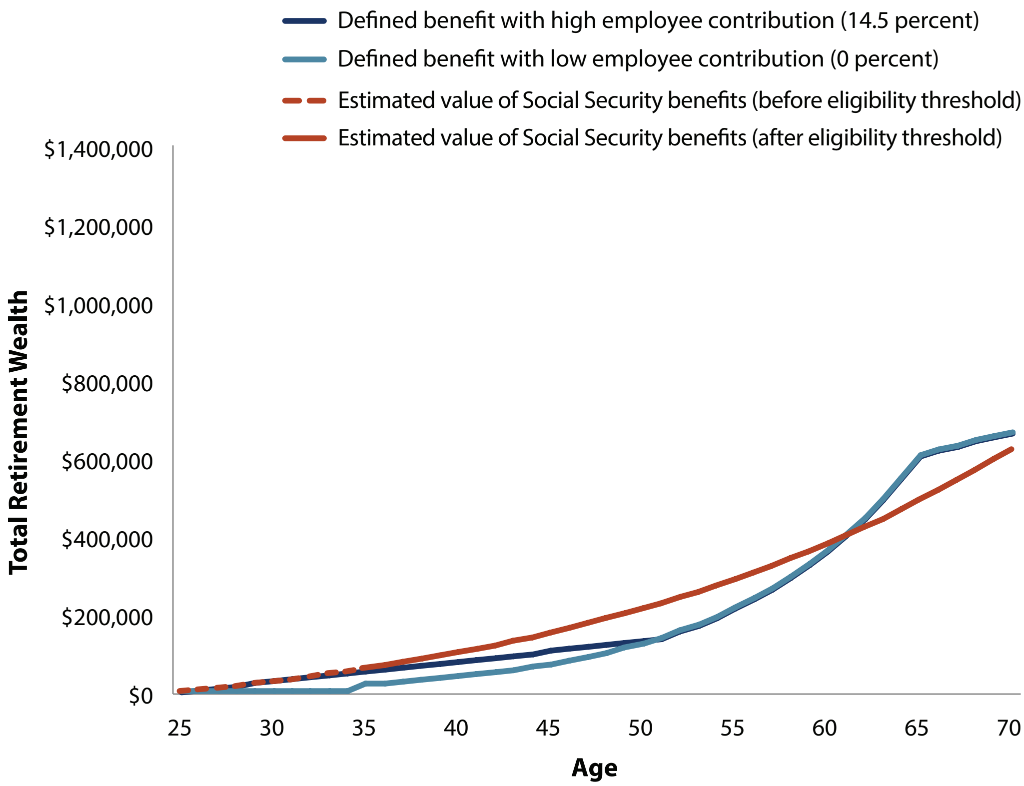
To estimate how Social Security benefits accrue over a worker's lifetime, I rely on Social Security's estimates of the program's real rate of return. In a regular series of publications, Social Security estimates the annual investment return of a worker's contribution, both under present law and under alternative scenarios. As the Social Security Administration describes it, these calculations attempt to answer the question "If a group of workers with selected characteristics were to invest contributions to fund future benefits (including dependents), what real annual yield would be required to finance those future benefits?" To estimate teacher benefits going forward, I use Social Security's estimates for middle-class workers born in 1985. According to Social Security's most recent estimates, these workers earn a benefit equivalent to their own and their employers' contributions, compounded annually at a rate of 2.93 percent above inflation.

To model how teacher benefits under Social Security would accrue over time, I use the current combined Social Security contribution rate for employees and employers (12.4 percent of salary) and a 2.93 percent real rate of return, which factors in inflation and life expectancies.[18] Although Social Security benefits are not eligible for a lump-sum withdrawal, this method provides a conservative comparison for what a teacher would receive in total lifetime benefits by participating in Social Security.[19]

Workers must stay with one employer for 36 years before finally qualifying for a pension worth more than Social Security.

Figures 3A and 3B compare this benefit with what workers would qualify for under the DB and DC safe harbor rules, respectively. The red line in both graphs represents an estimate of how benefits accrue under Social Security, using the 12.4 percent contribution rate and 2.93 percent real investment return, as outlined above.[20] The red line is dotted from years 0 to 10 to show that the employee has not yet qualified for the benefit. Any employee who continues working will receive credits for those years once he or she reaches at least 10 years of employment. This stands in contrast to teachers enrolled in a DB pension plan, who will not qualify for any employer-provided retirement benefits if they leave before vesting and cannot continue accruing service unless they remain employed under that specific pension plan. In both graphs, the blue and green lines represent total retirement savings under the safe harbor provision.

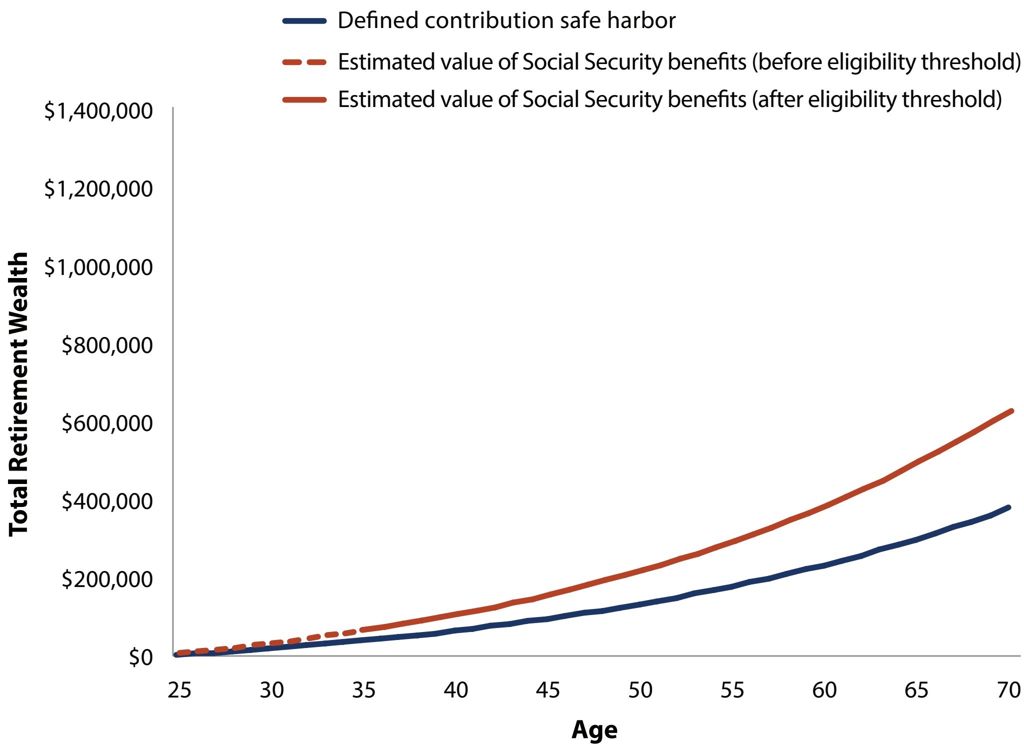
Figure 3A Social Security Benefits Grow Faster Than the Safe Harbor Provision



Source: Calculations are based on a starting salary of $40,000 with annual increases of 2.75 percent. Social Security is estimated using contribution rates of 12.4 percent and the rate of return for single, medium-wage females born in 1985, as estimated in Michael Clingman, Kyle Burkhalter, and Chris Chaplain, *Internal Real Rates of Return under the OASDI Program for Hypothetical Workers* (Baltimore, MD: Social Security Administration, 2014). DC calculations use the same salary but with a 7.5 percent contribution rate and an annual investment return of 2.94 percent (the real, inflation-adjusted return on long-term Treasuries as of May 19, 2015).

Figure 3A compares Social Security with the safe harbor provision governing DB plans. It uses the two sample DB plans from Figure 1, both of which meet the technical requirements of the safe harbor formula. Both guarantee the employee a benefit worth 1.5 percent multiplied by years of service and his or her highest three years of salary. As before, the graphs show that contribution rates matter. The DB plan with high contribution rates slightly outperforms Social Security in the early years, but both types of DB plans trail Social Security for many years. Workers who begin their employment at age 25 must stay with their employer for 36 years, until age 61, before finally qualifying for a pension worth more than Social Security. Workers who leave in the interim fail to earn a retirement benefit worth at least the value of Social Security.

Figure 3B Social Security Benefits Grow Faster Than the Defined Contribution Safe Harbor Provision



Source: Calculations are based on a starting salary of $40,000 with annual increases of 2.75 percent. Social Security is estimated using contribution rates of 12.4 percent and the rate of return for single, medium-wage females born in 1985, as estimated in Michael Clingman, Kyle Burkhalter, and Chris Chaplain, *Internal Real Rates of Return under the OASDI Program for Hypothetical Workers* (Baltimore, MD: Social Security Administration, 2014). DC calculations use the same salary but with a 7.5 percent contribution rate and an annual investment return of 2.94 percent (the real, inflation-adjusted return on long-term Treasuries as of May 19, 2015).

Figure 3B shows the same comparison, except for the DC safe harbor provision. Because contributions are much higher under Social Security (12.4 percent versus 7.5 percent) and investment returns are nearly identical (2.93 percent versus 2.94 percent), once the worker qualifies for Social Security, the DC plan never catches up to the value of the Social Security benefit.

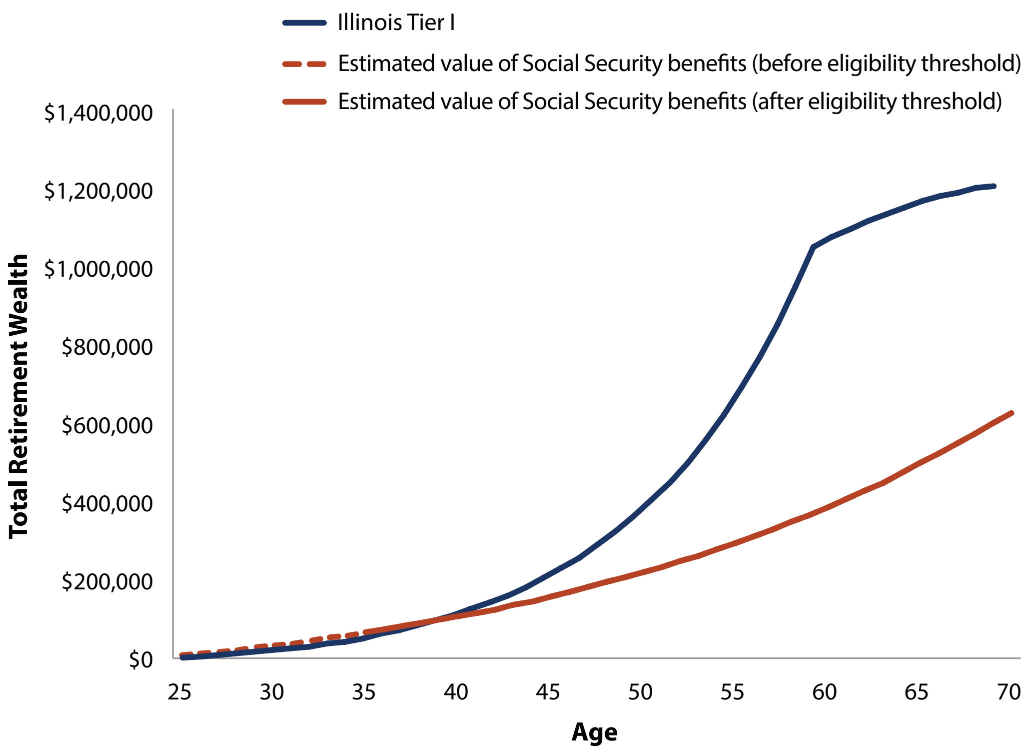
Even though the safe harbor provision was designed to be roughly equivalent to Social Security, it falls far short for large groups of workers. Many state and local government workers would be better off under Social Security than under the safe harbor rules.

In Practice, the Safe Harbor Provision Fails to Protect Workers

This brief has thus far focused only on how the safe harbor provision works in theory. The next section looks at how it plays out for one particular group of workers—Illinois public school teachers. Illinois does not offer its teachers Social Security coverage. Instead, it places teachers into two different DB pension tiers based on when they were hired.[21] All teachers hired before January 1, 2011, are placed in Tier I, which offers a more generous pension benefit than does Tier II, the plan offered to teachers hired on or after January 1, 2011. Although the plans differ significantly and both pass the IRS' safe harbor test, both plans offer, to at least a portion of teachers, benefits that are worse than the benefits from Social Security. Illinois should be in violation of IRS rules.

Figures 4A and 4B show the pension wealth accrual under Illinois' Tier I (figure 4A) and Tier II (figure 4B). Each graph shows two lines, one of which is the same in both figures. The red line in both graphs shows the Social Security benefit accrual that is modeled in Figures 3A and 3B above, representing what Illinois teachers could receive if they participated in Social Security.

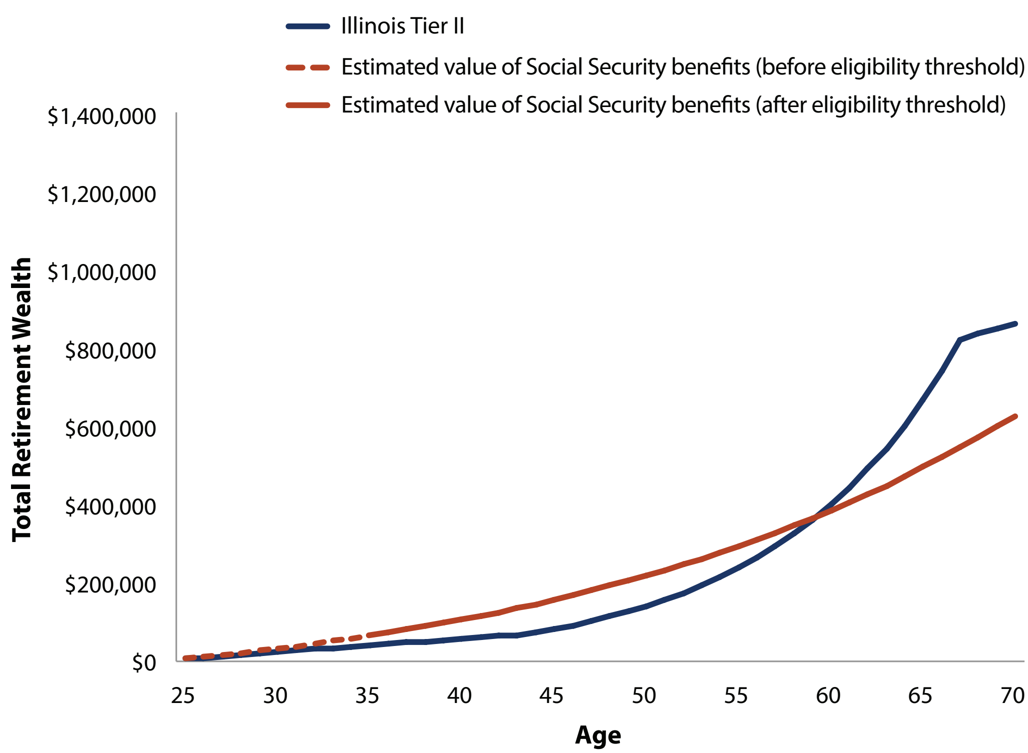
Figure 4A The Retirement Benefits Offered to Veteran Illinois Teachers Can Fall Below the Value of Social Security



Source: Calculations use the methodology articulated in Robert Costrell and Mike Podgursky, "Peaks, Cliffs, and Valleys: The Peculiar Incentives in Teacher Retirement Systems and Their Consequences for School Staffing," *Education Finance and Policy* 4, no. 2 (2009): 175–211; and Robert Costrell and Josh McGee, "Teacher Pension Incentives, Retirement Behavior, and Potential for Reform in Arkansas," *Education Finance and Policy* 5, no. 4 (2010): 492–518. Benefits are based on the Society of Actuaries RP-2014 Mortality Tables, a discount rate of 5 percent, and a starting salary of $40,000 with annual increases of 2.75 percent. Calculations do not include withdrawal rules or benefit caps. Social Security's rate of return comes from Michael Clingman, Kyle Burkhalter, and Chris Chaplain, *Internal Real Rates of Return under the OASDI Program for Hypothetical Workers* (Baltimore, MD: Social Security Administration, 2014). Calculations use Social Security's estimated internal rate of return for single, medium-wage females born in 1985.

The blue line in each graph shows the pension wealth accrual for the represented tier. Teachers in Tier I accrue benefits faster than do the teachers in Tier II, but for their first 14 years of teaching their benefit is also less valuable than what they could be earning under Social Security. If these teachers were to leave their service, they would not qualify for accrued retirement benefits worth at least the equivalent of what Social Security would have credited them with. They should be enrolled in Social Security but aren't.

Figure 4B The Retirement Benefits Offered to New Illinois Teachers Often Falls Below the Value of Social Security



Source: Calculations use the methodology articulated in Robert Costrell and Mike Podgursky, "Peaks, Cliffs, and Valleys: The Peculiar Incentives in Teacher Retirement Systems and Their Consequences for School Staffing," *Education Finance and Policy* 4, no. 2 (2009): 175–211; and Robert Costrell and Josh McGee, "Teacher Pension Incentives, Retirement Behavior, and Potential for Reform in Arkansas," *Education Finance and Policy* 5, no. 4 (2010): 492–518. Benefits are based on the Society of Actuaries RP-2014 Mortality Tables, a discount rate of 5 percent, and a starting salary of $40,000 with annual increases of 2.75 percent. Calculations do not include withdrawal rules or benefit caps. Social Security's rate of return comes from Michael Clingman, Kyle Burkhalter, and Chris Chaplain, *Internal Real Rates of Return under the OASDI Program for Hypothetical Workers* (Baltimore, MD: Social Security Administration, 2014). Calculations use Social Security's estimated internal rate of return for single, medium-wage females born in 1985.

Tier II is even less generous. As of 2011, 25-year-olds who begin teaching in Illinois must work for 35 consecutive years before their state-provided pensions finally surpass Social Security benefits for good. According to the most recent Illinois data, 98.7 percent of Illinois teachers have less than 35 years of experience. Illinois teachers will face long stretches of time in which their accumulated retirement benefits are worse than the bare minimum given to all private-sector workers.

Conclusion

The odds are stacked against teachers and other public-sector workers who don't have Social Security coverage. The Social Security safe harbor provision is supposed to protect these workers, but the provision is not functioning as intended for DB pension plans. Thousands, perhaps millions of state and local government workers are enrolled in plans that officially meet the safe harbor formula, but these workers will leave before qualifying for retirement benefits comparable to Social Security. The safe harbor formula covering DB plans, as currently enforced, ensures only a very small retirement benefit, a benefit that's well below what individual workers would earn if they participate in the Social Security program.

> Thousands, perhaps millions of state and local government workers are enrolled in plans that officially meet the safe harbor formula but would be better off in the Social Security program.

There are three potential paths forward. At the national level, Congress could decide that all public workers deserve the retirement and disability protections afforded by Social Security. After all, states will never match the national portability provided by Social Security, let alone the progressive, inflation-adjusted benefits it offers.

> States will never match the national portability provided by Social Security.

Short of universal Social Security coverage, IRS should revisit the safe harbor rules and ensure that its enforcement of retirement plans matches the legislative intent of ensuring that state and local government workers earn retirement benefits that are at least equal to Social Security benefits on each and every day they work. Workers shouldn't have to wait for a long time to receive sufficient retirement benefits. Even better, the IRS should shift to an asset-accumulation approach that requires states to provide all workers with retirement benefits that are at least equal to what the workers could earn under Social Security. The disparities between the DB and DC safe harbor rules subtly encourage state and local governments to keep their existing pension plans rather than switch to plans that may offer all workers higher retirement benefits.

Even in the absence of federal action, states that don't offer Social Security coverage should re-evaluate how they provide retirement benefits to workers. Too many teachers serve in a system that will provide retirement-sufficient benefits only if they stay with the system for a long time. That arrangement works well for the small minority of workers who remain with a school system for their entire career and qualify for a sizable pension, but not at all for the majority of teachers. Teachers who don't vest into their state's pension system or who qualify for only a modest pension are losing out. States should offer Social Security coverage to build a solid foundation and guarantee a steady accumulation of retirement wealth for all workers, regardless of how long they teach in the state. Integrating Social Security into a state retirement system would help provide all teachers with secure retirement benefits.

Endnotes

1 For more on how a lack of Social Security coverage harms teachers, see Leslie Kan and Chad Aldeman, *Uncovered: Social Security, Retirement Uncertainty, and 1 Million Teachers* (Washington, DC: Bellwether Education Partners, 2014), http://www.teacherpensions.org/sites/default/files/UncoveredReportFinal.pdf.

2 Chad Aldeman and Andrew J. Rotherham, *Friends Without Benefits* (Washington, DC: Bellwether Education Partners, 2014), http://bellwethereducation.org/sites/default/files/BW_PensionPaper_031314.pdf.

3 In the 1980s, Congress provided all new federal workers with Social Security coverage.

4 26 C.F.R. § 31.3121(b)(7)-2(b).

5 26 C.F.R. § 31.3121(b)(7)-2.

6 26 C.F.R. § 3121(b)(7)-2(e)(2)(i).

7 For plans that average salaries over longer time periods, Social Security requires higher multipliers. For example, if the plan averaged the employee's salary over 10 years, the annual benefit must be at least 2 percent times the employee's years of service and average salary.

8 26 C.F.R. § 3121(b)(7)-2(d)(1)(i).

9 About 6.5 million state and local government workers remain uncovered by Social Security, compared with 166 million workers who contributed in 2015. See US Social Security Administration. *The 2015 Annual Report of the Board of Trustees of the Federal Old Age and Survivors Insurance and Federal Disability Insurance Trust Funds*; accessed January 27, 2016, https://www.ssa.gov/oact/tr/2015/tr2015.pdf; and Dawn Nuschler, Alison M. Shelton, and John J. Topoleski, *Social Security: Mandatory Coverage of New State and Local Government Employees* (Washington, DC: Congressional Research Service, 2011), http://www.nasra.org/Files/Topical%20Reports/Social%20Security/CRS%202011%20Report.pdf.

10 Aldeman and Rotherham, Friends Without Benefits.

11 Dick Ingram, "Executive Director's Report (Teachers' Retirement System of the State of Illinois, Winter 2015), http://trs.illinois.gov/pubs/topics/winter15.pdf.

12 Note that this is in terms of total retirement savings. In terms of net retirement savings, workers could be enrolled in qualified retirement plans while still facing very low or even negative retirement savings accumulation for much of their career.

13 Internal Revenue Service, *Federal-State Reference Guide*, accessed January 27, 2016, http://www.irs.gov/pub/irs-pdf/p963.pdf.

14 26 C.F.R. § 31.3121(b)(7)-2.

15 The Treasury data were pulled from http://www.treasury.gov/resource-center/data-chart-center/interest-rates/Pages/TextView.aspx?data=longtermrate. The most recent inflation rate is 0.1 percent: see http://www.bls.gov/news.release/pdf/cpi.pdf.

16 26 C.F.R. § 31.3121(b)(7)-2.

17 Ibid.

18 The Social Security Administration has also modeled alternative scenarios in which Congress increased contributions or reduced benefits. Even under those alternatives, the rate of return remains positive, although slightly lower.

19 I use the same starting wage, salary growth, and employment history to calculate the employee's Average Indexed Monthly Earnings and Primary Insurance Amount under Social Security, and for all ages the internal rate of return calculation produced a lower result.

20 Workers do not qualify for Social Security benefits until they've paid into the system for 40 quarters (10 years), leading to a theoretical spike in benefit value at 10 years. The graphs in this paper, however, assume teachers will meet that requirement, either in their teaching career or in other employment, and thus do not show this spike. That's because Social Security benefits would accrue for teachers no matter where they work, whereas under an employer-provided defined benefit plan, workers earn benefits only for each year they remain with that particular employer.

21 Chicago teachers are technically in a separate plan from all other Illinois teachers, but the benefit structures in both plans are the same.