



Social Security funding needs could translate to new municipal pension risk

Summary

Social Security revenue will increase if all new state and local government employees are required to participate

Local governments could face difficult benefit design decisions that constrain the cash flow of current retirement systems

The federal government is likely to eventually take action to balance Social Security revenues and expenses

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Summary

Rising Social Security costs are one component of a difficult fiscal trajectory facing the federal government (Aa1 stable). One mechanism that could moderately boost payroll tax inflows to the Social Security retirement system would be to require all state and local government employees to participate in the program (officially known as Federal Old-Age and Survivors Insurance and Federal Disability Insurance, or **OASDI**).

Currently, about one-quarter of local government workers do not participate, particularly teachers and public safety workers. Such a change has been proposed in the past, for example, in the Fiscal Sustainability Act of 2013, but it has not been enacted. If such a move were enacted in the future, it would pose a downstream pension challenge for

some state and local governments, particularly those with large unfunded liabilities and that rely heavily on employee contributions to support pension cash flow.

- **Social Security revenue will increase if state and local government employees are required to participate.** The Chief Actuary of Social Security projects that such a move, applicable solely to new employees, would reduce the system's long-range deficit by about 4%. The Congressional Research Service estimates that more than 5 million state and local government employees do not currently participate in the program.
- **State and local governments could face difficult benefit design decisions that constrain the cash flow of their current retirement systems.** A required Social Security contribution of 6.2% of salary, on top of contributions to an existing state or local government retirement system, could prove unpalatable to new municipal employees. As such, a social security requirement could prompt the creation of new benefit tiers with lower contributions, or even the closure of legacy systems to new hires. But such moves stand to reduce contribution inflows to existing municipal retirement systems, a challenge for those with large unfunded liabilities and high reliance on member contributions relative to pension system assets to support cash flow.
- **The federal government is likely to eventually take action to balance Social Security revenues and expenses.** The program's benefit outflows exceed payroll tax inflows, a gap that will continue to widen and is likely to be closed through a combination of new revenue, reduced benefits, or redirected other federal spending. Because the system's trust fund will have assets, which effectively amount to intergovernmental receivables, until 2034, any such action is unlikely to be imminent.

Social Security revenue will increase if all new state and local government employees are required to participate

Boosting state and local government employee participation in Social Security would increase revenue into the system. One provision that has been incorporated into past legislative proposals to help address the Social Security deficit, and that is annually modeled by the system's Chief Actuary, is a requirement that all new state and local government employees participate in the program.

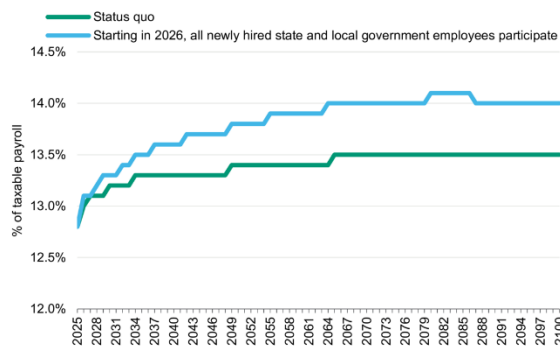
Between 20% and 30% of state and local government employees, mostly teachers and those in public safety roles, do not currently participate in the Social Security program, according to the National Conference of State Legislatures. These employees receive retirement benefits from their government employers' respective defined benefit pension systems instead.

The Chief Actuary projects that if all newly hired state and local government employees were required to participate in Social Security starting in 2026, the system's revenue would eventually rise to about 14% of taxable payroll, inclusive of contributions and taxes on benefits, about 0.5% higher than the status quo. While the additional expense associated with these employees' participation would eventually (estimated in the 2070s) eclipse the revenue added to the system associated with their participation, the Chief Actuary nevertheless estimates that about 4% of the system's long-term imbalance on a present value basis could be eliminated by implementing such a provision (Exhibits 1 and 2).

EXHIBIT 1

Requiring all state and local government employees to participate in Social Security would boost revenue into the program...

Social Security revenue as % of taxable payroll



Source: Office of the Chief Actuary of the Social Security Administration

EXHIBIT 2

...and would close about 4% of the program's long-range actuarial deficit

	% of covered payroll
Long-range actuarial balance	-3.82%
Effect of covering newly hired state and local government employees	+0.14%
Long-range actuarial balance, incorporating provision	-3.68%
<hr/>	
% of long-range shortfall eliminated	4%

Source: Office of the Chief Actuary of the Social Security Administration

Local governments could face difficult benefit design decisions that constrain the cash flow of current retirement systems

If the federal government were to require all state and local government employees to participate in Social Security, those governments with retirement systems that have large unfunded liabilities, heavy benefit outflows, and a high reliance on member contributions to support annual cash flow stand to be most negatively affected. More specifically, unfunded retirement systems that have both significant negative non-investment cash flow (NICF) and relatively large member contributions relative to investment assets would be most at risk from changes that cause new members to contribute less to the system or not participate at all.

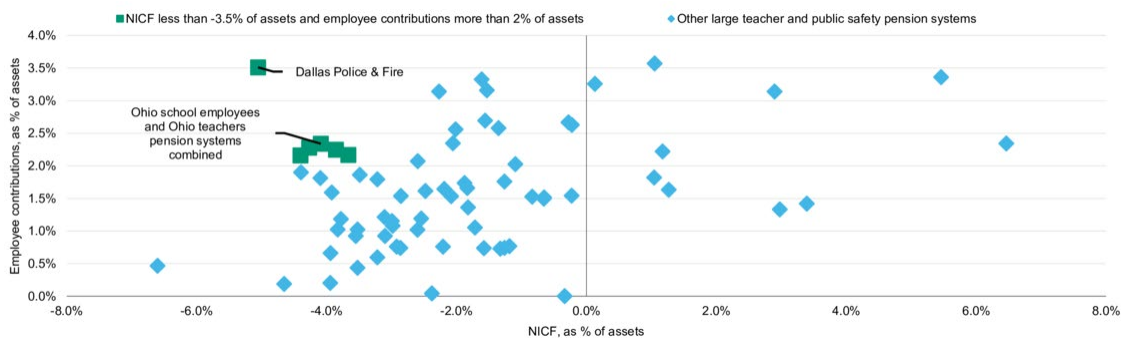
Materially negative NICF relative to assets can constrain pension asset accumulation, particularly during periods of volatile returns. Since a retirement system with negative NICF must use its assets to cover benefit payments in years with low or negative

returns, any subsequently positive investment returns accumulate on a reduced asset base.

Based on a sample from our database comprised of large retirement systems that cover teachers and public safety employees, we estimate that about 10% of systems have negative NICF amounting to -3.5% of assets or less and rely on employee contributions amounting to at least 2% of their assets, as of their most recent financial reporting. Without employee contributions, these systems would have exceptionally negative NICF, amounting to -5.5% of assets or less (Exhibit 3).

EXHIBIT 3

Roughly 10% of large US public pension systems covering teachers and public safety employees have both materially negative NICF and significant employee contributions relative to assets



As for the most recently available financial reporting, in most cases covering the fiscal year 2024

Source: Moody's Ratings

As we see it, state and local governments will essentially have three broad choices in this scenario: 1) do nothing; 2) create a new benefit tier within their current retirement systems that is supplemental to Social Security participation; 3) close their current systems to new entrants.

Option 1: do nothing

If state or local governments take no action, their retirement costs would rise by 6.2% of payroll above their current share of normal costs for new employees because employer contributions for Social Security are 6.2% of taxable payroll. New employees' contribution requirements would also rise by 6.2% of payroll in comparison to current employees in the same benefit tier.

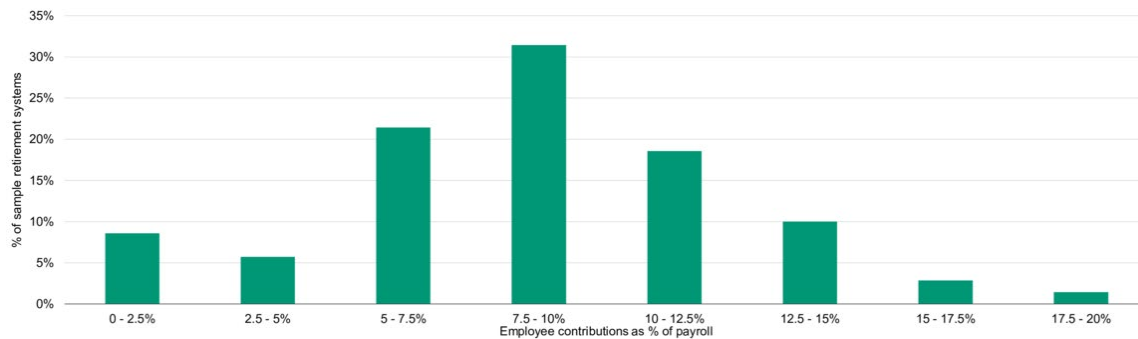
We view this scenario as unlikely because of the current magnitude of employee contributions and the differences in employer costs and total retirement benefit generosity that would arise between currently active and prospective employees. Based on a sample from our database of statewide retirement systems in which teachers participate, as well as large public safety pension systems, employee contributions amount to 8.6% of payroll on average, meaning another 6.2% of payroll contribution for

Social Security would boost prospective employees' total mandatory contributions toward retirement to nearly 15% of payroll in the average case.

Some employee contribution requirements are already near or above 15% of payroll. Firefighters for Austin, Texas (Aa1 stable), who, for example, do not currently participate in Social Security, make contributions toward their retirement amounting to nearly 19% of payroll as of December 2024 retirement system financial reporting (Exhibit 4).

EXHIBIT 4

Employee contribution requirements to teacher and public safety systems currently range from very little to almost 20% of payroll, with an average of around 9%



Reflects Moody's Ratings sample of large teacher and public safety systems, in most cases reflecting 2024 financial reporting

Source: Moody's Ratings

Option 2: create a new benefit tier within existing retirement systems

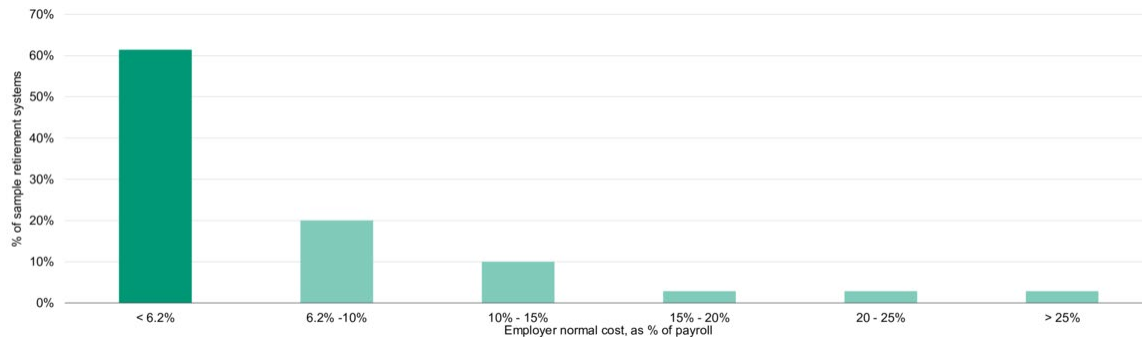
If governments create a new benefit tier within their current retirement systems, that tier would likely carry lower employee contribution requirements to help offset mandatory Social Security contributions. As a result, NICF for the retirement system would be more negative than under the status quo, unless offset by higher government contributions.

Where possible, we expect governments to also attempt to structure any new benefit tier so it would be at most as costly as current benefit tiers when also considering the cost of Social Security participation for new employees. Consequently, governments would likely strive to reduce their share of normal costs by at least 6.2% of payroll.

However, in more than half of the large retirement systems we sampled in which teachers and public safety employees participate, governments' shares of normal costs (also called "employer normal costs") are currently less than 6.2% of payroll, based on reported actuarial assumptions. Normal costs represent the present value of benefits accrued by active employees in a given year. In cases where governments' employer normal costs are currently below 6.2% of payroll, their retirement benefit contributions for new employees will be higher, even if those employees participate only in Social Security and receive no additional retirement benefit funded by their municipal employer (Exhibit 5).

EXHIBIT 5

Social Security contributions of 6.2% of payroll would exceed the employer normal costs that many governments currently face for their retirement systems



Reflects Moody's Ratings sample of large teacher and public safety systems, in most cases reflecting 2024 financial reporting.

Source: Moody's Ratings

Option 3: close current retirement systems to new entrants

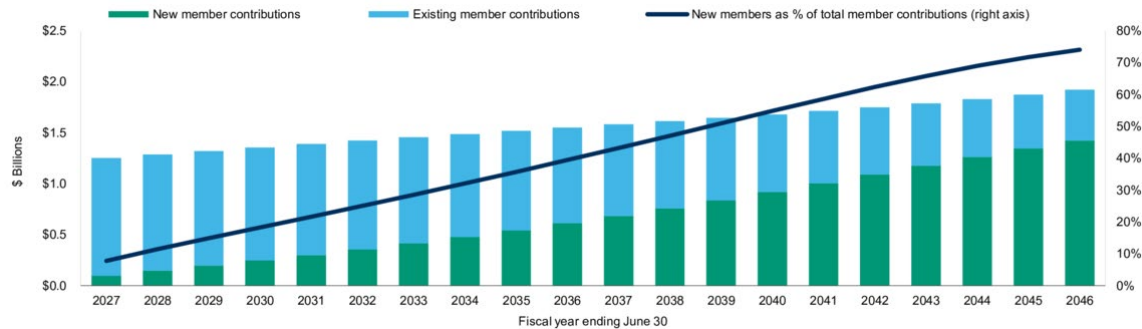
If municipalities choose to close their current systems to new entrants, the effects will be similar to Option 2. Unless offset by higher government contributions, however, the effect on legacy retirement systems' NICF would be even more pronounced than under Option 2 because all new employee contributions and any related employer normal cost contributions would be entirely diverted away from the legacy retirement system. Total retirement costs for a state or local government in this scenario would depend on the generosity of any benefits offered to new employees, in addition to Social Security, outside the legacy retirement system.

Under either option 2 or 3, however, if any new Social Security participation rules apply only to new employees, the cash flow impact on existing retirement systems would be gradual. For example, the Teachers' Retirement System of the State of Illinois (IL TRS) projects that by 2030, about 18% of employee contributions will come from new employees (i.e., future hires). By 2040, over half of employee contributions will come from future hires, reaching 75% by the mid-2040s (Exhibit 6).

EXHIBIT 6

Illinois' TRS anticipates that by 2040, over half of employee contributions will come from future hires, rather than current members

Projected cash inflows from employee (i.e. member) contributions



Source: Teachers' Retirement System of the State of Illinois actuarial valuation

The federal government is likely to eventually take action to balance Social Security revenues and expenses

Social Security benefit outflows exceed payroll tax inflows, a gap that will continue to widen and will likely be closed through some combination of new revenue, benefit cuts, or redirection of other federal spending. The system is funded primarily through a 6.2% payroll tax on both participating employees and their employers, for a total of 12.4%. Benefits and expenses have exceeded non-interest income to the system since 2010. The payroll tax, plus taxes on benefits, generated \$1.35 trillion in revenue in 2024, compared with about \$1.48 trillion in benefits and expenses, for a difference of about \$136 billion (Exhibit 7).

The gap between Social Security's revenue and expenses will continue to grow in the coming decades, according to the system's Chief Actuary, whether measured as a percentage of taxable payroll or relative to the US economy as measured by gross domestic product (GDP). For example, the Chief Actuary projects that benefits and expenses will amount to about 17% of payroll by 2050, compared with non-interest income amounting to around 13.4% of payroll (Exhibit 8).

EXHIBIT 7

The Social Security system now takes in less tax revenue than it sends out in benefits...

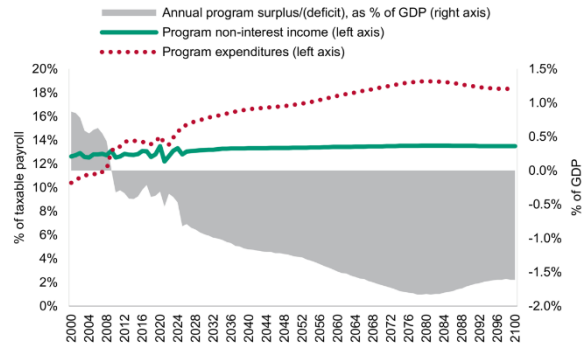
OASDI 2024 non-interest income versus benefits and expenses, \$ in billions

	OASDI
Payroll tax contribution rate for employees and employers, each	6.2%
Payroll tax contribution rate for self-employed persons	12.4%
Net payroll tax contributions	\$1,293.3
Taxation of benefits	\$55.1
Sub-total	\$1,348.4
Benefit payments	\$1,471.4
Administrative expenses	\$7.4
Other	\$5.9
Sub-total	\$1,484.8
Program income, less cost	(\$136.4)

Source: Board of Trustees of the Federal OASDI Trust Funds

EXHIBIT 8

...a gap that is projected to grow under current payroll tax and benefit provisions



Source: Board of Trustees of the Federal OASDI Trust Funds

Non-interest income to the system stems from payroll taxes and benefit taxes. From the federal government's own accounting and budgetary standpoint, the Social Security Trust Fund also has reserved assets that accrue interest. However, these reserves are a special type of government debt obligation whereby the federal government will repay the system's trust fund. In other words, one part of the government has shifted money from another part of the government and is now shifting it back with interest.

Even though the exhaustion of Social Security Trust Fund reserves is only on paper, it could still serve as a key political motivator and a potential trigger for legislative action. Because the system will not exhaust these special reserves until 2034 based on the Chief Actuary's latest projections, however, near-term legislative action to address the ongoing Social Security deficit is unlikely in our view.

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