CBO TESTIMONY

Statement of
James L. Blum
Deputy Director
Congressional Budget Office

on
Reducing the Size of the Federal Civilian Work Force

before the
Subcommittee on Civil Service and the
Subcommittee on Compensation and Employee Benefits
Committee on Post Office and Civil Service
U.S. House of Representatives

February 1, 1994

NOTICE

This statement is not available for public release until it is delivered at 10:00 a.m. (EST), Tuesday, February 1, 1994.

CONGRESSIONAL BUDGET OFFICE
SECOND AND D STREETS, S.W.
WASHINGTON, D.C. 20515

Madam Chair, Mr. Chair, and Members of the Subcommittees, I appreciate this opportunity to discuss voluntary separation incentives and the restructuring of the federal work force. Last week, the Congressional Budget Office (CBO) released a study, *Reducing the Size of the Federal Civilian Work Force*, that examines three standard approaches to reducing employment--hiring freezes, layoffs, and early retirements. My testimony today will review the highlights of this study. Our major findings were:

- Permanent cuts in staff will always save money by reducing the continuing costs of government. The relative cost advantages of different approaches to cutting staff, however, depend on the period of time considered. Also, arbitrary or across-the-board cuts may cause backlogs and delays in providing needed services and could leave the government with little in the way of savings.

- The costs of various approaches to cutting staff may not be a paramount concern. In addition to costs, agencies engaged in cutting employment must be concerned with ensuring fairness to employees, preserving needed skills, and preventing increases in average salary.

- With careful management, agencies can accommodate personnel reductions of several percent a year by relying on a partial hiring

freeze with only a modest level of layoffs. If reductions are large or highly concentrated in time or by occupation or region--as could be the case under current budgetary constraints and the reductions proposed by the National Performance Review (NPR)--agencies would probably find it harder to reduce employment without laying off more workers. In these cases, separation incentives could help to avoid layoffs.

COSTS AND SAVINGS FROM CUTTING EMPLOYMENT

Each of the major approaches to cutting staff analyzed in this study has costs--for example, the severance payments to which laid-off workers may be entitled. The magnitude of these costs varies among the approaches and can be substantial. CBO's analysis suggests, however, that savings in pay and benefits over time can far exceed the costs of separating workers regardless of which approach is used. CBO's near-term cash estimates show net savings over five years for each of the major methods of separating workers. The long-term estimates, which consider the effects of separating workers that occur beyond the period covered by standard five-year estimates, show savings far exceeding costs. Federal decisionmakers, therefore, may want to give as much consideration to the impact of each approach on the structure of the work force and other noncost considerations as they do to costs.

Estimating the Costs and Savings of Abolishing Jobs

Both the near- and long-term estimates compare the savings in pay and benefits the government achieves when it abolishes a job with the costs of separating the worker in that job. The estimates rely heavily on data from the Department of Defense (DoD), the agency that has the most extensive experience with cutting employment. The CBO savings estimates assume that the positions abolished have an average salary of $34,500 in 1994, which corresponds to the average at DoD. The CBO analysis assumes that the same position is abolished under each strategy for cutting staff. The implicit assumption made is that agencies reassign the remaining workers so that even though different workers leave under each strategy, ultimately the same job is abolished and the same savings are obtained. Thus, all strategies yield the same gross savings.

The gross savings estimates also incorporate the government's cost for health insurance and retirement. As regards retirement, the near-term cash estimates incorporate amounts saved because of reduced contributions by employers to the Thrift Savings Plan, which is part of the Federal Employees' Retirement System (other retirement contributions to federal retirement systems occur between budget accounts and do not affect near-term cash disbursements). Long-term estimates, however, cover the full, lifetime costs to the government of providing pensions to employees.

In contrast, costs charged against these gross savings vary because each strategy has unique implementation costs and affects different employees. Using data from the Department of Defense, whose average civilian worker has a profile similar to that of the average for all government workers, CBO prepared cost estimates for each strategy. In some cases a particular agency's costs may differ from those estimates. The effects on the work force may also differ among agencies. In such cases, CBO's ranking by cost might not indicate the true merits of alternative strategies. In any given reduction, moreover, agencies may use more than one approach. The estimates simply set out the major costs and basic cost principles that pertain to each method of separation.

Cash Costs and Savings in the Near Term

The near-term estimates cover changes in the government's cash disbursements over five years. These estimates reflect both the costs associated with separating employees under various methods and the savings in pay and benefits that result. Based on CBO's near-term estimates, the government may save more by separating workers through a hiring freeze or a layoff than through early retirement (see Table 1). Over the long term, however, early retirement may actually be a bargain for government, as described in the next section. The near-term cash cost of early retirement is high because the option results in

Table 1.
Cash Costs and Savings of Strategies for Cutting Employment
(In thousands of dollars per job abolished)

	Layoff		Hiring Freeze		Early Retirement	
	First Year	Five-Year Cumulative	First Year	Five-Year Cumulative	First Year	Five-Year Cumulative
Total Savings in Pay and Benefits	37.7	202.6	37.7	202.6	37.7	202.6
Costs of Separating Workers						
Holding cost	n.a.	n.a.	18.8	18.8	n.a.	n.a.
Severance pay	4.5	4.5	n.a.	n.a.	n.a.	n.a.
Relocation	3.5	3.5	3.5	3.5	n.a.	n.a.
Leave refunded	1.4	1.4	n.a.	n.a.	n.a.	n.a.
Retraining	1.9	1.9	1.9	1.9	n.a.	n.a.
Retirement refund	1.7	1.7	n.a.	n.a.	n.a.	n.a.
Grade retention	4.8	6.5	n.a.	n.a.	n.a.	n.a.
Administration	0.1	0.1	n.a.	n.a.	n.a.	n.a.
Change in pension disbursements	n.a.	n.a.	n.a.	n.a.	20.8	77.0
Total	18.0	19.6	24.3	24.3	20.8	77.0
Net Costs (-) or Savings	19.7	183.0	13.4	178.4	16.8	125.6

SOURCE: Congressional Budget Office.

NOTE: n.a. = not applicable.

recurring costs--the early-retirement pension--rather than the largely one-time costs that occur under a freeze or layoff.

Costs and Savings of Laying Off Workers. The most direct method of cutting employment is to lay off people through what the government refers to as a reduction in force, or RIF. The costs for this option--$18,000 per job abolished in the first year and $19,600 over five years--consist largely of benefits available to affected workers. One of the largest costs--$4,500--is for severance payments to workers who have been fired. Net savings total $19,700 per separated worker in the first year and $183,000 over five years.

Costs and Savings of a Hiring Freeze. In lieu of firing employees, the government can wait for the required number of employees to leave voluntarily for retirement, new jobs, or other reasons and then not replace some or all of them. To reduce the work force by 3 percent to 4 percent a year, an agency would have to limit replacement to two of every three workers who left. According to CBO's estimates, the average cost per job abolished of such afreeze on hiring is $24,300, all of which occurs in the first year. Net savings total $13,400 per job abolished in the first year and $178,400 over five years. Almost the entire cost of this option covers the pay and benefit costs the government incurs as it waits for employees to leave. The estimate also includes $5,400 for retraining and relocation.

Costs and Savings of Early Retirement. The Office of Personnel Management may grant agencies facing major cutbacks the authority to offer employees the opportunity to retire at a younger age and with fewer years of service than they would have otherwise needed to qualify for retirement. In so doing, an agency frees up positions it can use to help meet employment reduction goals without layoffs. CBO has estimated the cost of this option to be $20,800 per job abolished in the first year and $77,000 over five years. Net savings over five years total $125,600 per job abolished. Almost all of the considerable cash cost of this option reflects the payment of pensions to employees who leave the federal work force earlier than they would have without the early-retirement program.

Costs and Savings of Offering Cash Incentives. The Defense Authorization Act of 1993 provides the Secretary of Defense with the authority to offer employees who resign or retire during the next five years a lump-sum cash payment of $25,000 or severance pay, whichever is less. The intent is to encourage voluntary separations and avoid layoffs. These incentives greatly increase the cost of separating a worker. (For CBO's estimates of the cash cost of offering employees the opportunity to take early retirement, take regular retirement, or resign with an incentive such as the one in use at DoD, see Table 2). The costs associated with such an effort, primarily because of the cost of the cash incentives, more than offset savings in pay or benefits in the first year. Over

Table 2.
Costs and Savings of Offering Employees Cash Incentives to Separate
(In thousands of dollars per layoff avoided)

	First Year	Five-Year Cumulative
Total Savings in Pay and Benefits	37.7	202.6
Costs of Separating Workers		
Early retirement		
Change in pension disbursements	20.6	80.0
Cost of incentive	40.0	40.0
Total	60.6	120.0
Retirement		
Change in pension disbursements	20.6	35.2[a]
Cost of incentive	56.3	56.3
Total	76.8	91.5
Resignation		
Refund of unused leave	2.8	2.8
Refund of retirement contributions	15.3	15.3
Cost of incentive	24.9	24.9
Total	43.0	43.0
Net Costs (-) or Savings		
Early retirement	-22.9	82.6
Retirement	-39.2	111.2
Resignation	-5.3	159.6

SOURCE: Congressional Budget Office.

a. This cost, as described in the discussion of early retirement, represents the difference between the pension earned and the pension that would have been earned. As these employees would probably have retired eventually anyway in the absence of an incentive, the cost is low compared with that of early retirement.

five years, however, savings from lower salaries and benefits exceed costs under each alternative. (Official cost estimates of recent legislative proposals concerning cash incentives do not take into account savings in pay and benefits because the proposals only increase retirements or resignations; they do not require reductions in the work force.)

What can make incentives so expensive is that organizations may end up paying many more employees to leave than they have layoffs to avoid. For example, agencies may offer incentives broadly to ensure equity, and payments may also go to employees who would have left anyway but who nonetheless qualify to receive an incentive. CBO's estimates of incentive payments assume that agencies pay bonuses to all employees who would be laid off and to half of all employees who would leave if incentives were not offered.

Of course, policymakers may feel that the added costs of incentives are justified as a means of avoiding the hardships that layoffs cause for bothworkers and managers. Incentives can be particularly helpful in avoiding layoffs when proposed reductions are concentrated by location, occupation, or agency. Some reductions proposed by the NPR would fall in that category.

Long-Term Costs and Savings

The effects of abolishing a job and separating a worker extend well beyond the period covered by CBO's standard five-year estimates. The impact of changing a person's retirement plans under an early-retirement program, for example, extends far into the future. Accordingly, CBO also prepared estimates of the long-term costs and savings for different methods of separating workers. These estimates are given in their present value--defined as the total amount of funds needed today to meet all future payments, taking into account the interest that those funds would earn over the period.

Over the long term, early retirement represents a better deal for the government than the short-term estimates indicate. The estimates show that an early-retirement pension stream is lower than the regular-retirement stream it replaces--to the tune of $7,800 per job abolished (see Table 3). The same observation probably explains why few workers accept an offer of early retirement. The highest cost--$81,900 per job abolished--is incurred when a worker eligible for regular retirement leaves with an incentive payment.

These costs, however, seem small in comparison with the savings available when the government abolishes a job for an extended period of time. Over 30 years, savings in pay and benefits for an average position abolished

Table 3.
Long-Term Costs and Savings of Strategies for Cutting Employment
(In thousands of 1994 dollars per job abolished)

				With Incentive		
	Layoff	Hiring Freeze	Early Retirement	Early Retirement	Retirement	Resignation
Total Savings in Pay and Benefits	979.9	979.9	979.9	979.9	979.9	979.9
Costs of Separating Workers						
Holding cost	n.a.	22.7	n.a.	n.a.	n.a.	n.a.
Severance pay	4.5	n.a.	n.a.	n.a.	n.a.	n.a.
Administration	0.1	n.a.	n.a.	n.a.	n.a.	n.a.
Relocation	3.5	3.5	n.a.	n.a.	n.a.	n.a.
Retraining	1.9	1.9	n.a.	n.a.	n.a.	n.a.
Grade retention	6.4	n.a.	n.a.	n.a.	n.a.	n.a.
Leave refunded	1.4	n.a.	n.a.	n.a.	n.a.	2.8
Annuity cost						
Annuity	10.8	n.a.	309.5	309.5	210.6	15.9
Annuity given up	n.a.	n.a.	317.3	319.8	184.9	n.a.
Subtotal	10.8	n.a.	-7.8[a]	-10.3[a]	25.7	15.9
Incentive payment	n.a.	n.a.	n.a.	40.0	56.3	24.9
Total	28.7	28.1	-7.8[a]	29.7	81.9	43.6
Net Costs (-) or Savings	951.2	951.8	987.7	950.2	897.9	936.2

SOURCE: Congressional Budget Office.

NOTES: Costs and savings are given on a present-value basis.

n.a. = not applicable.

a. Savings.

total $980,000--many times the costs. (Consistent with the method adopted in calculating near-term effects, the long-term effects assume that the same job is abolished, and the same gross savings therefore accrue under each method of separating workers. In this analysis, however, savings are appropriately discounted.) The large savings under all alternatives over the long term suggest that cost may not be the most important consideration in determining how to separate workers.

The savings estimates cover the reductions in pay and benefits that the government achieves over 30 years by abolishing a job. The savings also reflect the full cost to government of employee retirement and other benefits. The cost estimates cover the various expenses the government incurs in abolishing jobs. As described in the discussion of the near-term cash effects, these expenses include such things as severance pay and relocation costs.

The major difference between the near-term and long-term estimates is the treatment of retirement costs. The long-term estimates cover the full difference in the government's cost of paying a pension now as opposed to later, rather than only the difference in the next five years.

CBO's analysis suggests that the ranking of various strategies depends heavily on how and over what period one chooses to measure. Near-term costs

are very different from those incurred over an employee's full 30-year career. The perspective adopted depends, in part, on whether reductions in employment are likely to be sustained over the long term. Should reductions be made permanent, savings will be many times greater than near-term costs. Given these differences, CBO's analysis suggests that the government should give equal weight to the non-cost-related consequences of the different strategies.

MANAGING EMPLOYMENT REDUCTIONS

Agencies facing reductions in civilian employment are typically concerned not only with cost but also with minimizing layoffs, ensuring fairness to employees, preserving needed skills, and preventing increases in average salary. Many people believe that layoffs must be avoided because of their potential negative effects on morale, that early retirement cannot attract sufficient workers to be a useful alternative, and that hiring freezes increase average salary and eliminate needed skills. Separation incentives are seen as a way to avoid these potential problems.

The Congressional Budget Office's analysis of these issues suggests that with careful management, government agencies can, with only a modest number of layoffs, reduce employment by several percent a year by relying on partial hiring freezes. If drawdowns were large or highly concentrated in time or by

occupation or region, agencies would probably find it more difficult to cut employment without laying off more workers. Such drawdowns may well occur given current budgetary constraints and the cuts in employment proposed by the National Performance Review. The use of separation incentives could help to avoid layoffs in such cases. These conclusions stem largely from analysis of DoD's recent experience with both concentrated and more dispersed reductions in civilian employment. They assume that turnover rates are at historical levels.

Layoffs

CBO found that even with steady decreases in employment of several percent annually, layoffs are likely to be small--less than 1 percent of the work force. Nevertheless, agencies are concerned about using layoffs, primarily because of effects on the morale of the remaining work force. Negative effects on morale can be mitigated, however, by informing workers early and involving employees in reorganizations.

The other chief concern about layoffs is the equity issue--the possibility that female and minority workers are more likely to be laid off and that the work force will become less diverse. Based on DoD's experience, which workers are most likely to be laid off depends more on where reductions in the

work load occur rather than on the sex or race of the workers. At DoD, for example, men were more likely to be laid off because most of the jobs abolished were in the predominantly male, blue-collar work force. Even in the case of the white-collar work force, which is made up of equal numbers of men and women, layoffs were proportional.

Hiring Freezes

If managed effectively, partial hiring freezes--that is, replacing a fraction of the workers who leave--can both reduce employment and minimize layoffs. To ensure that essential work is not affected, agencies seldom use complete hiring freezes. Under a partial hiring freeze, managers can adopt different replacement rates for different occupations to ensure that there are sufficient workers with the appropriate skills to carry out work requirements. Although limiting replacement modestly increases the average salary of workers, such increases may be offset by policy changes such as limiting promotions. Moreover, increases in average salary are small compared with savings in payroll (total salary) resulting from decreases in the size of the work force.

Reductions at DoD reflected both gradual, dispersed decreases and more rapid or concentrated decreases resulting from a sharp drop in work load,

management reforms, or base closures. Reductions in other agencies may reflect a different mix of circumstances. The more concentrated the reductions are in time, by occupation, or by location, the more difficult it tends to be for agencies to rely primarily on hiring freezes.

Early Retirement

Under an early-retirement option, employees can retire at a younger age and with fewer years of service than under regular retirement. Applied broadly, early retirement can create employment opportunities for workers facing layoffs and reduce employment moderately, even if only a small fraction of eligible workers decide to retire early.

SEPARATION INCENTIVES

Incentives are seen as a way for organizations facing employment reductions to avoid a large number of layoffs, provide a "soft landing" for workers who lose their jobs, and reshape the work force. The U.S. Postal Service and the Department of Defense both offered incentives to substantial numbers of employees in 1992 and 1993. To help agencies meet employment reductions

proposed in the National Performance Review, the Congress is currently considering extending to all other agencies the authority to offer incentives.

CBO's analysis of recent experience at the Postal Service and DoD suggests that separation incentives have helped these agencies to minimize layoffs, increase voluntary turnover, and eliminate particular positions. Nonetheless, DoD still had to lay off 3,000 workers, and the work forces of both agencies experienced some disruptions caused by extensive transfers of workers who were in abolished jobs. Moreover, turnover appears to have increased above normal rates only enough to offset the lower turnover experienced before the period in which incentives were offered.

Finally, agencies may have considerable difficulty in targeting incentives toward workers who are no longer needed and may therefore incur a relatively high cost for each job abolished. Legislation that would extend the authority to offer separation incentives to other agencies would permit agencies to target payments toward particular organizations, occupations, and locations. If such legislation is enacted, agency policymakers will need to evaluate their particular circumstances in order to decide which method of reducing the size of their work force is most appropriate.