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Report to Congressional Committees

November 2003

POSTAL PENSION FUNDING REFORM

Review of Military Service Funding Proposals

GAO

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GAO-04-281

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Highlights

Highlights of GAO-04-281, a report to the Committee on Governmental Affairs, United States Senate, and the Committee on Government Reform, House of Representatives

November 2003

POSTAL PENSION FUNDING REFORM

Review of Military Service Funding Proposals

Why GAO Did This Study

The Postal Civil Service Retirement System Funding Reform Act of 2003 (the Act) required the United States Postal Service, Department of the Treasury, and Office of Personnel Management (OPM) to prepare proposals detailing whether and to what extent the Treasury and Postal Service should fund the benefits attributable to the military service of the Postal Service's current and former Civil Service Retirement System (CSRS) employees. The Act required GAO to evaluate the proposals. Our objective in doing so was to assess the agencies' positions and provide additional information where it may be useful.

What GAO Recommends

GAO suggests that Congress consider requiring that, similar to Postal Service, all other self-supporting agencies pay the full dynamic cost of CSRS pension benefits. If the Congress requires the Postal Service to fund the military service component of CSRS benefits, then it may wish to have other self-supporting agencies do so as well. Further, GAO recommends that OPM provide estimates of the added cost to Treasury of making Postal Service responsible for only the cost of benefits that had not yet vested as of June 30, 1971. Postal Service and OPM/Treasury provided some clarifying comments and expanded views on several issues discussed in our report.

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To view the full product, including the scope and methodology, click on the link above. For more information, contact Linda Calbom at (202) 512-8341 or calboml@gao.gov.

What GAO Found

The positions taken by OPM and Treasury and the Postal Service were driven in part by differing views on the nature and extent of the relationship between military service and an entity's operations. The Postal Service favors returning the responsibility for funding benefits attributable to military service to the Treasury, making arguments that include Treasury's historic responsibility for these benefits, the legislative history surrounding the Postal Service's funding of retirement benefits, the fact that the majority of military service by CSRS employees was rendered before the current Postal Service was created, and that military service has no connection to the Postal Service's functions or operations. OPM and Treasury favor the recently enacted law, arguing that the Postal Service was intended to be self-supporting, military service is a benefit like other CSRS benefits that should be allocated proportionally over an employee's career, and the current law is one in a series that developed today's approach to funding the Postal Service's CSRS costs.

GAO observed that there is no direct relationship between an employee's military service and an entity's operations, but an indirect relationship is established once an employee is hired into a position whose retirement plan provisions credit military service when computing a civilian benefit. GAO has long held the position that federal entities should be charged the full costs of retirement benefits not covered by employee contributions in the belief that it enhances recognition of costs and budgetary discipline at the same time it promotes sounder fiscal and legislative decisions. However, our previous recommendations and matters for congressional consideration did not specifically address whether the cost of military service benefits should be included in CSRS employee benefit costs. Currently there is inconsistency in how various self-supporting government entities treat these costs.

The military service of many Postal Service retirees was already creditable to a civilian pension when the Postal Service began operations in 1971. OPM's current approach, however, allocated the years of creditable military service of these employees over their entire civilian careers. If Congress decides that the Postal Service should be responsible for military service costs applicable to its employees, then consideration of an allocation alternative reflecting the extent to which the military service of current and former employees was already creditable towards a civilian pension when the Postal Service began operating would enhance the decision-making process.

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Abbreviations

COLA	cost-of-living adjustment
CSRDF	Civil Service Retirement and Disability Fund
CSRS	Civil Service Retirement System
DOE	Department of Energy
FDIC	Federal Deposit Insurance Corporation
FEHBP	Federal Employees Health Benefits Program
FERS	Federal Employees' Retirement System
MWAA	Metropolitan Washington Airports Authority
OPM	Office of Personnel Management
PBGC	Pension Benefit Guaranty Corporation
PMA	Power Marketing Administration
PRA	Postal Reorganization Act

United States General Accounting Office
Washington, D.C. 20548

November 26, 2003

The Honorable Tom Davis
Chairman
The Honorable Henry A. Waxman
Ranking Minority Member
Committee on Government Reform
House of Representatives

The Honorable Susan M. Collins
Chairman
The Honorable Joseph I. Lieberman
Ranking Minority Member
Committee on Governmental Affairs
United States Senate

This report reflects the results of our review of the military service funding proposal submitted by the United States Postal Service and the joint proposal submitted by the Office of Personnel Management (OPM) and the Department of the Treasury. The Postal Civil Service Retirement System Funding Reform Act of 2003[1] (P.L. 108-18) required that these agencies prepare and submit to the President, the Congress, and the GAO proposals detailing whether and to what extent the Treasury or the Postal Service should be responsible for funding the benefits attributable to the military service of current and former employees of the Postal Service that, prior to enactment of the 2003 Act, had been provided for by the Treasury under section 8348(g)(2) of title 5, United States Code.[2] The Act also mandated that we prepare and submit a written evaluation of each proposal no later than 60 days after the aforementioned agencies had submitted them. We received the agencies' proposals on the mandated September 30, 2003, due date.

[1]Pub. L. No. 108-18, 117 Stat. 624.

[2]Section 8348(g)(2) requires that OPM notify the Secretary of the Treasury at the end of each fiscal year of the amount of that year's Civil Service Retirement System (CSRS) annuity payments OPM estimates is attributable to credit allowed for military service, less an amount for employee deposits made in accordance with section 8334(j) of title 5. Section 8348(g)(2) also requires that the Secretary of the Treasury credit the Civil Service Retirement and Disability Fund (CSRDF) out of money in the Treasury not otherwise appropriated a percentage of OPM's calculated amount, starting with 10 percent in 1971 and increasing in 10 percent increments until the total percentage Treasury pays reaches 100 percent for fiscal year 1980 and for each fiscal year thereafter.

The objective of our evaluation was to identify and assess the agencies' respective positions and to provide additional information where such information may be useful. In assessing the agencies' positions, we considered the accuracy of the various assertions presented, those aspects of equity and consistency raised by the agencies, the Postal Service's unique role in the financing of CSRS and Federal Employees' Retirement System (FERS) benefits,[3] and its status as a self-supporting agency. There may be other issues or perspectives that the agencies did not present and we did not assess that the Congress may want to consider in deciding whether and to what extent the Postal Service should fund military service benefits.

We also provide our observations on the alternative approaches for allocating the cost of military service benefits that are discussed in the OPM and Treasury proposal. The Postal Service and, jointly, OPM and Treasury put forth various arguments and assertions to justify their opposing positions. We organized each of the agencies' arguments and assertions into four common, overarching issues raised by the agencies to facilitate a comparison and discussion of the differences between the two proposals. The reader may find it helpful to read the body of this report along with the full text of the agencies' proposals that are reproduced in appendix I (OPM / Treasury) and appendix II (Postal Service).

To achieve our objective, we obtained documentation from the agencies to support their assertions and interviewed agency officials. We also reviewed various laws and their legislative histories, including those mentioned below, along with applicable regulations and OPM guidance:

1. Those laws preceding P.L. 108-18, which established the approach to the Postal Service's funding of CSRS benefits,[4]

2. the Civil Service Retirement Amendments of 1969,[5] (P.L. 91-93) which established the current pay-as-you-go approach to funding the

[3]FERS has three components – a defined benefit plan, a defined contribution plan, and Social Security. For purposes of this report, any reference to FERS means the defined benefit plan.

[4]See U.S. General Accounting Office, *Review of the Office of Personnel Management's Analysis of the United States Postal Service's Funding of Civil Service Retirement System Costs*, Appendix I– Key Legislation Affecting USPS's Funding of CSRS Costs, GAO-03-448R (Washington, D.C.: Jan. 31, 2003).

government's share of the cost of CSRS military service benefits that continues to generally apply to employees of entities other than the Postal Service,

3. the Omnibus Budget Reconciliation Act of 1982,[6] which required employees to make deposits in certain circumstances towards the cost of military service benefits, and

4. the Federal Employees' Retirement System Act of 1986,[7] which established the cost attribution and funding method OPM cites as being the model for its analyses and the administration's original legislative proposal.

Our discussion of the alternative cost allocation methods was based on figures calculated by OPM. The OPM and Treasury proposal presented five possible approaches for assigning the cost of benefits attributable to military service between the Treasury and the Postal Service. OPM calculated the financial effects of each approach using CSRS-wide actuarial assumptions.[8]

We did not perform an actuarial review of OPM's estimates of the total cost to the Treasury of each alternative funding method or test the accuracy of the underlying data; consequently, we are not expressing an opinion on the material accuracy of these estimates. Furthermore, we did not attempt to present here all other possible approaches for allocating the cost of military service benefits or determine which allocation methodology is the most appropriate. We performed our work from October through November 2003 in accordance with generally accepted government auditing standards.

We requested comments on a draft of this report from the Postmaster General, the Director of OPM, and the Secretary of the Treasury, or his/her designee. Written comments from the Postmaster General are reprinted in

[5]Pub. L. No. 91-93, sec. 103(a)(2), 83 Stat. 117, 136.

[6]Pub. L. No. 97-253, sec. 306, 96 Stat. 763, 795.

[7]Pub. L. No. 99-335, sec. 101(a), 100 Stat. 514, 517.

[8]We presented OPM's calculations for three of these five approaches using Postal Service-specific actuarial assumptions in our January 31, 2003, report on OPM's analyses (GAO-03-448R).

appendix III. Joint written comments from the Secretary of the Treasury and Director of OPM are reprinted in appendix IV

Results in Brief

The Postal Service favors returning to the Treasury the responsibility for funding all CSRS benefits attributable to military service rendered by its current and former employees. The Postal Service makes various arguments, including that this responsibility has historically been Treasury's and that, prior to passage of P.L. 108-18, the Congress had reaffirmed this view each time legislation was enacted that changed the Postal Service's CSRS contributions. The Postal Service also notes that its CSRS employees rendered the vast majority of their military service before the Postal Service was even created and, moreover, argues that military service has no connection with the Postal Service's functions or operations. Furthermore, the Postal Service argues that CSRS was never required to be fully funded like FERS and believes that it should not have to fund the military service benefits of its CSRS employees as the price for receiving its share of the higher than expected investment returns earned on contributions the Service made since 1971. The Postal Service asserts that no agency other than the Postal Service – including other self-supporting agencies[9] – fully funds the cost of their employees' CSRS benefits, including military service benefits. The President's Commission on the United States Postal Service agreed with the Postal Service's positions and recommended repeal of this requirement.

OPM and Treasury favor what is now current law as outlined in P.L. 108-18. They argue that the Postal Service was reorganized in 1971 with a primary goal of being self-supporting and should, therefore, bear all costs attributable to service after its reorganization. OPM and Treasury further contend that military service credit is a benefit just like other CSRS benefits, the cost of which should be allocated proportionally over an employee's civilian career in a manner that is consistent with the funding system that exists for the FERS. They also view P.L. 108-18 as one in a series of laws that over time developed the approach that exists today for the Postal Service's funding of CSRS costs. OPM and Treasury further assert that, while the Postal Service was not required to fund CSRS military service benefits prior to enactment of P.L. 108-18, it also did not have to assume any of the actuarial risk of the system. Consequently, OPM and

[9]Self-supporting government entities are those that are generally required to recover their costs through rates or fees charged to the users of their services.

Treasury contend that the Postal Service should not share in the higher than expected investment returns[10] of the CSRDF without assuming the military service costs that could have been funded with any such investment gains. OPM and Treasury provided estimates of five alternative approaches to allocating the cost of the military service benefits of the Service's current and former CSRS employees and provided their views of the strengths or limitations of the alternatives.

In our review of both proposals we observed that the parties' positions as to whether the Postal Service should be responsible for the cost of CSRS military service benefits were driven in part by differing views of the nature and extent of the relationship between military service and an agency's operations. We agree that there is no direct relationship between an employee's military service and an agency's operations. Consequently, one can reasonably argue that, as a matter of equity and attribution accuracy, the entity that directly benefited from an employee's military service should be required to fund any related retirement costs. However, one might also argue that the employing entities should bear this cost because the right to receive credit for past military service arises only as a result of employment in a civilian position covered by CSRS or FERS. It should, however, be noted that this military service feature is a mandate for all federal entities with covered CSRS and FERS employees and that such service credit is not required or common for private sector entities.

As a matter of consistency, one might also reasonably argue that the Postal Service should be treated like other entities with respect to the funding of pension costs, which it is for purposes of funding the FERS normal cost. However, the Postal Service is unlike most if not all other entities in certain respects. First, the Postal Service must pay for any actuarial losses and may benefit from any actuarial gains attributable to the pension obligations of its employees, retirees, and their survivors. In this sense, the Postal Service is treated as a separate employer for purposes of financing the CSRS and FERS plans. Second, it is required to fund the dynamic normal cost[11] of CSRS benefits, whereas most other agencies pay only a portion of this cost.

[10]The OPM and Treasury proposal focuses on the higher than expected investment returns because this is the one component of the actuarial risk of the system that is believed to be the most significant and is easily identifiable. However, their argument would presumably extend to other actuarial gains resulting from the demographic experience of the population of Postal Service's CSRS employees.

[11]Dynamic normal cost is defined in the background section of this report.

Third, the Postal Service is intended to be self-supporting and, therefore, expected to cover all of its costs through postal rates. There are, however, other self-supporting agencies, such as the Federal Deposit Insurance Corporation (FDIC) and Pension Benefit Guaranty Corporation (PBGC), that are not required to fund military service costs and do not otherwise fully fund the dynamic normal cost of their CSRS employees' benefits as the Postal Service is now required to do. On the other hand, there are a few self-supporting entities that have either been required by law or have voluntarily chosen to fund the dynamic normal cost, including military service costs, of employees who retained CSRS coverage. Therefore, there is no consistency in this regard.

Our long-standing position has been that employer agencies should fund the dynamic cost of the government's retirement programs not otherwise funded with employee withholdings and deposits. We also observed on numerous occasions that, as a result of charging less than the dynamic cost of CSRS not otherwise provided by employee withholdings, agencies whose operations are intended to be self-supporting receive large subsidies that are not recognized in the cost of their goods and services. However, our previous recommendations and matters for congressional consideration did not specifically address whether the cost of military service benefits should be included as part of a dynamic normal cost factor. Nor did we examine the issue of whether the entity that benefited from the service should ultimately pay for any related benefits. Additionally, with the exception of self-supporting agencies that pay the dynamic cost of these benefits, taxpayers ultimately fund the benefits, regardless of whether or not these costs are included in individual agency budgets. Therefore, charging the self-supporting agencies' customers for the government's share of the dynamic normal cost of pension benefits results in real savings to the taxpayers and, therefore, is not just a change in the timing and source of funding.

The agencies present opposing views on whether FERS funding requirements can or should be applied to CSRS benefits. Whether or not the obligation to fund military service benefits should be linked with the benefit of higher than expected investment returns is crucial to their respective arguments. In addressing this issue, we found nothing that precludes changing how the Postal Service's contributions are calculated under CSRS to a method similar to FERS. At the same time, we also did not find any requirement that past military service be included in the dynamic normal cost factor used for funding purposes in order to also benefit from past investment gains.

For purposes of determining the extent to which the Postal Service should be responsible for military service costs, OPM's current pro-rata approach allocates the years of creditable military service proportionally over employees' entire civilian careers. The OPM and Treasury proposal included four allocation alternatives. However, it did not include an allocation alternative that reflects the extent to which the Postal Service's current and former employees had, by the time the Service commenced operations in 1971, completed the 5 years of civilian service needed to have their past military service creditable towards the computation of an annuity. We believe this alternative would be important to consider in the overall decision-making process, if the Congress decides that the Postal Service should be responsible for CSRS military service costs associated with their civilian employees.

We offered a matter for congressional consideration, namely that, similar to the Postal Service, all other self supporting federal entities be required to fund the dynamic cost of CSRS pension benefits. If the Congress decides to include funding of the military service component in its definition of full pension funding for the Postal Service, we believe it should consider doing so for all self-supporting federal entities. We also recommended that, if the Postal Service is made responsible for funding military service pension benefit costs, then OPM should provide a sixth alternative funding scenario by providing an estimate of the cost to the Treasury and the Postal Service of having Postal Service assume only the cost of benefits that had not yet vested when the former Post Office Department was converted to its presented form.

Both the Postal Service and OPM/Treasury provided written comments on a draft of this report. The Postmaster General expressed concern with what he saw as an inference that the Postal Service should be responsible for the cost of an employee's military service because it hires the employee knowing of the past military service. The Postmaster General also reaffirmed the Postal Service's commitment to the fundamental policy of veterans' preference. Our report did not imply that knowing of past military service was a relevant factor in determining whether the Postal Service should bear this cost. We simply stated the fact that the right to receive credit for past military service arises only as a result of employment in a civilian position covered by CSRS or FERS.

The Secretary of the Treasury and Director of OPM disagreed with our position that there is no direct relationship between an employee's prior military service and the operations of the Postal Service. They stated that granting credit for military service in calculating civilian pensions enables the Postal Service to recruit and retain veterans, who provide direct benefits to the operations of their employer. We agree that the crediting of military service facilitates the recruitment and retention of veterans who, subsequent to their military service, contribute to postal operations. However, we continue to view the relationship between military service and postal operations as indirect because the activities performed while serving in the military did not directly contribute to the daily operations of the Postal Service at the time the military service was rendered. The Secretary of the Treasury and Director of OPM also provided certain clarifications with respect to their policy positions and beliefs.

Background

Public Law 108-18 was enacted after we reported on the results of our review of an analysis of the funded status of the Postal Service's CSRS pension obligations that OPM prepared at our request.[12] This act adopted the administration's proposal that the Postal Service be responsible for funding the value of benefits attributable to military and volunteer service of all employees first hired into civilian service after June 30, 1971, and a pro-rata share of those benefits for employees hired before the July 1, 1971, effective date of the Postal Reorganization Act (PRA).[13]

In order to determine the funded status of the Postal Service's CSRS obligations, OPM estimated the portion of the Civil Service Retirement and Disability Fund (CSRDF) that was attributable to the Postal Service, taking into consideration all past CSRS-related payments to CSRDF by the Service and its employees, including earnings on those payments, and the Service's pro-rata share of all CSRS-related payments from CSRDF, including benefits attributable to military service, since July 1, 1971.

[12]See GAO-03-448R.

[13]For purposes of its initial and subsequent analyses, OPM estimated this pro-rata share of benefits by first allocating an employee's total creditable military service based on the pro-rata amount of civilian service the employee accrued both before and after the effective date of PRA. OPM's methodology also assumed that the Postal Service should be responsible for (1) the effect of post-1971 general pay increases and increasing benefit accrual rates on the final amount of military service benefits at retirement, including those military service credits allocated to the federal government, and (2) a proportional amount of post-1971 annuitant cost-of-living adjustments.

The act also requires that the Postal Service begin funding the portion of CSRS dynamic normal cost not otherwise funded with employee withholdings. When calculated on a dynamic basis, normal cost represents an amount of money that if set aside during employees' working years will, with investment earnings, be sufficient to cover future benefits and expenses when due, so long as the plan's economic and demographic assumptions hold true. Dynamic normal cost reflects the effect of assumed future general pay increases and annuitant cost-of-living adjustments (COLA) on the amount of benefits that will be ultimately paid. Consequently, when a plan's dynamic normal cost is fully funded, unfunded liabilities due to inflation in salaries and annuity payments are avoided. This contrasts with static normal cost, wherein assumed future general pay increases and annuitant COLAs are not considered. With static funding, new unfunded liabilities are created as salary and annuity inflation actually occur.[14]

There are different actuarial methods for determining dynamic normal cost. OPM calculates the dynamic normal cost for the CSRS and FERS plans using an actuarial cost method – aggregate entry age normal – which expresses normal cost as a level percentage of aggregate basic pay for a group of new plan entrants. Consequently, this method allocates costs without regard to how benefits actually accrue. It is calculated by dividing the actuarial present value of expected future benefits a group of new plan entrants is expected to receive after retirement by the actuarial present value of the group's expected salaries over their working lives. OPM includes the past military service of new plan entrants in its calculation of expected future benefits. Consequently, OPM's aggregate entry age normal method allocates the cost of military service benefits proportionally over an employee's civilian career. For fiscal year 2003, the dynamic normal cost percentage for regular CSRS employees was 24.4 percent of basic pay, of which employees pay 7.0 percent and the Postal Service the remaining 17.4 percent. Similarly, the dynamic normal cost of FERS, currently 11.5 percent of basic pay for regular employees, is fully funded with employer contributions of 10.7 percent and employee withholdings of 0.8 percent.

Public Law 108-18 also requires that starting on September 30, 2004, the Postal Service begin funding any projected underfunding of its CSRS

[14]P.L. 91-93 increased the required employer contributions and employee withholdings each from 6.5 percent to 7 percent of basic pay for regular CSRS employees, the total of which at that time approximated the CSRS static normal cost.

obligations calculated by OPM as of September 30, 2003.[15] This funding is to occur over a total of 40 years, with OPM recalculating the projected underfunding and the amortization payments as of the close of each subsequent fiscal year.[16] In the event that a surplus exists as of September 30, 2025,[17] the Postmaster General is required to submit a report to the Congress describing how the Postal Service proposes to use such surplus.

By changing the funding of military service benefits, the act made the Postal Service (1) retroactively responsible for funding a portion of military service benefits that have already been paid to annuitants and funded by Treasury on a pay-as-you-go basis and (2) prospectively responsible for funding some or all of the military service benefits expected to be paid to current and future Postal Service annuitants. The cumulative effect of this change in law was to shift responsibility for funding approximately $27 billion (net present value as of September 30, 2002) in military service costs from taxpayers to postal ratepayers.

Summary of Key Issues and Our Observations

The agencies made various arguments and assertions throughout their proposals, which we organize into the following four common, overarching issues:

- relationship of military service to employing agency operations,
- historical funding of CSRS benefits payable to Postal Service employees,
- applicability of FERS cost allocation and funding methods to CSRS, and
- funding of military service benefits by federal and other entities.

[15]The law refers to the projected underfunding as a “supplemental liability” calculated as the estimated excess of the present value of future benefits over allocated assets and the present value of future normal cost contributions. In a fully funded plan, supplemental liabilities, as they are defined here, typically occur when the plan incurs actuarial losses resulting from such things as lower than expected investment returns or actual demographic experience of the participants (i.e., retirement, disability, death) being less favorable than was previously assumed.

[16]A similar definition in the FERS statute applies to the Postal Service, the most significant difference being that any supplemental liability is amortized over a period of 30 years.

[17]Or at an earlier date when OPM determines that all CSRS Postal Service employees have retired.

The agencies’ positions reflect their own perceptions of what is fair to the taxpayers and ratepayers and how the Postal Service should be treated vis-à-vis other federal agencies and considering its mandate to be self-supporting. As stated previously, in assessing the agencies' positions, we considered the accuracy of the various assertions presented, those aspects of equity and consistency raised by the agencies, the Postal Service's unique role in the financing of CSRS and FERS benefits, and its status as a self-supporting agency. The agencies’ positions with respect to each of these issues, as well as our observations on them, are presented below. We presented the agencies’ positions in the order that best framed the issue at hand.

Relationship of Military Service to Employing Agency Operations

Postal Service Position

Military service has no relation to Postal Service operations, on which postal rates are based, and, in fact, had no relation to the operations of the former Post Office Department. Each of the federal employment services – military and civilian – have separate compensation, retirement benefit, and other benefits programs. Furthermore, the use of military service in the calculation of CSRS retirement benefits is a matter beyond the control of employer agencies.

OPM and Treasury Position

Receiving credit for past military service is a civilian retirement benefit that Postal Service employees receive just like other benefits, such as cost-of-living increases on annuitant benefit payments. Furthermore, individuals retiring from the Postal Service receive CSRS credit for their military service only because of their employment with the Postal Service.

GAO Observations

To a large extent, whether or not an employee’s military service has any relationship to agency operations is a function of whether or not the Congress requires that agencies fund a portion of the costs related to this service. The positions noted above go beyond mandated financial responsibilities and seek to first define more specifically the nature and extent of this relationship before deciding on whether postal ratepayers or taxpayers should fund CSRS military service benefits.

Clearly, any service that is creditable towards a CSRS or FERS benefit but is rendered while employed by an entity other than the Postal Service has no direct relationship to the Service's operations. This includes military service, service performed while employed by another agency and covered by CSRS or FERS, and service covered by another of the federal government's defined benefit retirement plans, but is subsequently credited towards a CSRS or FERS benefit upon an employee's acceptance of an appointment to a covered position and meeting other requirements.[18] In addition to the uniformed services, a number of other federal agencies have compensation systems and benefit programs that are separate from those covering Postal Service employees. Having a retirement system that covers so many civilian employees and permitting the transfer of service between federal retirement systems[19] promotes the portability of benefits, and so eases the movement of employees to other positions within the federal government.

The crediting of military service towards a civilian service retirement benefit has been a feature of CSRS since it was established in 1920 and of FERS since it was established in 1986. This feature is one of many that collectively constitute a plan of benefits that defers a portion of an employee's total compensation until retirement. Agencies and other entities whose employees are covered by CSRS and FERS have no control over the features offered, among them employee elections such as whether to provide a survivor benefit to a spouse, because the plan's provisions are established by the plan sponsor, which in this case is the federal government.

OPM and Treasury view military service of federal employees as related to employing agency operations by virtue of the fact that credit for such service is a feature of the CSRS and FERS plans in which the employees

[18] These requirements may include employees making deposits for their share of the costs of the transferred service and waiving any right to benefits under their predecessor retirement system.

[19] For example, some reciprocal transfer is permitted between the CSRS and FERS plans and the Foreign Service and the Board of the Federal Reserve Plans. However, the plan sponsored by the Tennessee Valley Authority is one example of a plan that does not accept the transfer of CSRS and FERS service.

participate. They further note that it is only because an employee serves in a covered civilian position for a minimum of 5 years that the employee's military service can be used in the calculation of a CSRS or FERS benefit.

The Postal Service's statements suggest a view of military service as involving the performance of duties unrelated to the delivery of the mail and further imply that any related compensation – including retirement benefits – should be paid for by the taxpayer. Defining this relationship is particularly important for the Postal Service because the costs associated with its retirees' service credits earned while employed by any other entity and which are not funded by the retiree while employed by the Postal Service must be passed onto postal ratepayers. This contrasts to those agencies that receive the vast majority of their funding through appropriations, where taxpayers ultimately fund all benefits regardless of whether and to what extent agencies recognize employee retirement costs in their budgets. One can reasonably argue that the cost of military service benefits would more equitably be borne by the entity that benefited from the military service (Department of Defense), which, in essence, would mean that taxpayers would ultimately bear these costs.

Historical Funding of the CSRS Benefits Payable to Postal Service Employees

OPM and Treasury Position

The funding of military service benefits by the Treasury Department was a feature of a funding methodology established by law in 1969 that did not require employer agencies to fund the full cost of all benefits not otherwise funded by employees. The prior funding mechanism for the Postal Service under CSRS (including the special treatment of military service) was developed in piecemeal fashion that never fully addressed all of the factors that affect the costs of the system. The special treatment of military service that applied to Postal Service employees can be viewed as more of an historic accident than a deliberate policy choice. This is supported by the fact that each time a comprehensive system for funding federal annuities was developed there was no special treatment of military service. In view of the long history of congressional action, it is reasonable to assume that the Congress may have taken action to address the issues of excess interest earnings and the costs of military service, even if OPM had not identified the problems with the static funding methodology.

Postal Service Position

Since 1969 the Treasury Department has been responsible for funding CSRS benefits attributable to military service. The Treasury Department remained responsible for funding these benefits for employees of all federal agencies even after laws had been subsequently enacted to make the Postal Service responsible for additional retirement costs attributable to its decisions and actions that result in increases in employee pay on which benefits are computed. Retroactively making the Postal Service responsible for funding military service benefits would result in a cost transfer of $27 billion to postal ratepayers, the great majority of which has already been paid for by Treasury. Furthermore, approximately 90 percent of the cost of military service was earned before the Postal Service was created in 1971.

GAO Observations

The fact that the Congress had not acted until just recently to make the Postal Service responsible for funding the creditable military service of its employees is taken by the opposing parties to mean different things, which they assert, not surprisingly, support their respective positions. Both parties acknowledge that, prior to P.L. 108-18, when previously presented with the opportunity to reconsider the Postal Service's funding of its employees' CSRS benefits, the Congress chose to leave Treasury responsible for funding all CSRS military service benefits.

The Postal Service contends that the passage of successive legislation relating to the financing of its CSRS costs without ever requiring that it fund CSRS military service costs was the Congress's way of reaffirming its intention of having the Treasury fund these costs for Postal Service employees just as they do now for all other federal agency employees. OPM and Treasury contend that the piecemeal fashion with which the Congress made the Postal Service responsible for funding an increasing share of the CSRS benefits of its employees constitutes a pattern that indicates the Congress could have eventually made the Service responsible for military service costs.

It is difficult to discern or even infer from the legislative history of the laws that preceded P.L. 108-18 any particular policy choice that can be seen as indicative of the Congress's future intentions or predictive of what ultimately led to enactment of P.L. 108-18. Any legislative action must be viewed within the context of the particular facts and circumstances that existed at the time the Congress was considering specific legislation, including budgetary and fiscal considerations. For these reasons, we consider both parties' arguments and assertions in connection with this point to be speculative and inconclusive.

With respect to the Postal Service's assertion that approximately 90 percent of the cost of military service was earned before the Service was created in 1971, we asked OPM to calculate the additional cost to the Treasury of making it responsible for the entire cost of benefits attributable to all military service estimated to have been rendered before 1972 by both former and current employees of the Postal Service. OPM estimated the additional cost to be approximately 75 percent of the $27 billion total cost to Treasury to fund all CSRS military service benefits.[20]

Based on our review of the documentation provided by the Postal Service's actuarial consultants, it appears that the Service's assertion was meant to convey that approximately 90 percent of the military service in years allocated to it by OPM's pro-rata methodology was estimated to have occurred before 1972.[21]

Applicability of FERS Cost Allocation and Funding Methods to CSRS

[20]OPM's calculations assume that Treasury is responsible for the effect of post-1971 general pay increases and increasing benefit accrual rates on the final amount of military service benefits at retirement and a proportional amount of post-1971 annuitant COLAs on these benefits. Furthermore, as a matter of clarification, the $27 billion figure is not the total value of military service benefits for Postal Service employees covered by CSRS and who retired after 1971. Rather, it is the additional cost to the Treasury beyond what Treasury is already responsible for under OPM's P.L. 108-18 pro-rata methodology.

[21]OPM's data indicates that approximately 94 percent of the military service in years rendered by employees who retired between fiscal years 1972 and 2002 was estimated to have been rendered before fiscal year 1972.

OPM and Treasury Position

The payment of military service costs for Postal Service employees is consistent with the funding of FERS, the funding system on which the new law was patterned. Although the method for funding CSRS benefits prior to P.L. 108-18 did not require the Postal Service to fund the cost of military service, it also did not contemplate that the actuarial gains or losses of the retirement system would be attributed to the Postal Service. Consequently, the Postal Service should not benefit from the positive experience of the CSRDF without assuming the other responsibilities that come with an approach that funds the full cost of all benefits, including military service.

Postal Service Position

There is no identity between FERS funding and CSRS funding. FERS was created on a dynamically funded basis to phase out CSRS and to establish a more limited federal employment benefits program that would be fully funded by employees and employer agencies. CSRS is a totally different program from FERS, with different benefits and levels of contribution. In fact, CSRS was never fully funded by employees and employer agencies, with the exception of the Postal Service. Therefore, a change in funding methods that allows the Postal Service to receive credit for its share of higher than expected investment returns on contributions it made in accordance with the prior funding method does not justify the transfer of military service costs. There is no basis to substantiate this rationale either in accepted actuarial or financial practice.

GAO Observations

The agencies present opposing views on whether FERS funding requirements can or should be applied to CSRS benefits. Whether or not the obligation to fund military service benefits should be linked with the benefit of higher than expected investment returns is crucial to their respective arguments. There are numerous similarities and differences between CSRS and FERS,[22] one difference being the manner and extent to

[22]Various publicly available documents exist that compare and contrast the features and funding of CSRS and FERS, and provide a detailed history of what led to enactment of the Federal Employees' Retirement System Act of 1986. For more information, see the following: (1) *The Federal Employees' Retirement System Act of 1986*, R. G. Schreitmueller, Transactions of the Society of Actuaries, 1988 Vol. 40 PT 1, (2) *Federal Civilian and Military Retirement Systems*, E. C. Hustead and T. Hustead, Pensions in the Public Sector, Pension Research Council, The Wharton School of the University of Pennsylvania, (3) U.S. General Accounting Office, *Proposed Civil Service Supplemental Retirement System*, 128278 (Washington, D.C.: Oct. 28, 1985), and (4) U.S. General Accounting Office, *Overview of Federal Retirement Programs*, GAO/T-GGD-95-172 (Washington, D.C.: May 22, 1995).

which the full cost of plan benefits have been funded, including military service benefits. The fact that there are currently differences between CSRS and FERS benefits and funding requirements does not preclude changing how the Postal Service's contributions are calculated under CSRS to a method similar to FERS. That said, we also did not find any requirement that past military service be included in the dynamic normal cost factor used for funding purposes in order for the Postal Service to be treated as a separate employer for purposes of financing CSRS and, thus, benefit from past investment gains. In fact, there are actuarial methods that would fund the cost of military service benefits in a manner different than the one OPM currently uses. Therefore, there is nothing that inextricably links the past investment experience of the CSRDF to how military service benefits are funded.

Funding of Military Service Benefits by Federal and Other Entities

Postal Service Position

No agency other than the Postal Service – including other self-supporting agencies – fully funds the cost of its employees' CSRS benefits, including military service benefits. Furthermore, private sector companies are not responsible for funding military service costs.

OPM and Treasury Position

With respect to the argument that it is not fair to ask the Postal Service to finance the cost of military service because it would be the only agency required to do so, the fact that Treasury funds CSRS benefits attributable to military service rather than employer agencies merely shifts the timing of when the contributions are made and whether they are charged to a Treasury appropriation or to agency budgets. In either case, the costs would still ultimately be borne by the taxpayer. In contrast, one of the primary goals of the Postal Reorganization Act was to ensure that all of the Postal Service's costs are recovered through postal revenues, not taxpayer dollars. Therefore, all pension costs for employees that are attributable to service after the reorganization should be borne by the Postal Service.

GAO Observations

There are numerous government entities whose programs are required by law to be financed by the users of their services and that pay less than the portion of the CSRS dynamic normal cost not otherwise paid for by employee withholdings, including military service costs. These include the Federal Deposit Insurance Corporation (FDIC) and the Pension Benefit Guaranty Corporation (PBGC).

However, there have also been a few entities that have either been required by law or have voluntarily chosen to fund the dynamic normal cost of employees who retained CSRS or FERS coverage. For example, the Metropolitan Washington Airports Act of 1986[23] required that the Metropolitan Washington Airports Authority (MWAA) pay the difference between the dynamic normal cost of CSRS benefits (including military service costs) and the contributions made by those career civilian employees of the Federal Aviation Administration who transferred to MWAA with the leasing of the Metropolitan Washington Airports in 1986. In addition, the Power Marketing Administrations (PMA)[24] agreed to recover the dynamic normal cost of CSRS (including military service costs) through their power rates prospectively beginning in fiscal year 1998.[25] The PMAs agreed to do so in response to a series of reports we issued.[26]

One might reasonably argue that the Postal Service should be treated like other agencies with respect to its funding of pension costs. However, the fact that other federal entities are not currently fully funding the

[23]Pub. L. No. 99-500, title VI, secs. 6005, 6008, 100 Stat. 1783, 1783-373, 1783-375, 1783-382; Pub. L. No. 99-591, title VI, secs. 6005, 6008, 100 Stat. 3341, 3341-376, 3341-378, 3341-385.

[24]The PMAs are part of the Department of Energy (DOE) and were established to sell and transmit electricity generated mainly from federal hydropower facilities and are required to be generally self-supporting.

[25]The PMAs also agreed to recover the dynamic normal cost for the postretirement health benefits available to eligible retirees through the Federal Employees Health Benefits Program (FEHBP).

[26]See the following General Accounting Office products: (1) *Power Marketing Administrations: Cost Recovery, Financing, and Comparison to Nonfederal Utilities*, GAO/AIMD-96-145 (Washington, D.C.: Sept. 19, 1996), (2) *Federal Electricity Activities: The Federal Government's Net Cost and Potential for Future Losses*, GAO/AIMD-97-110 and 110A (Washington, D.C.: Sept. 19, 1997), (3) *Federal Power: Options for Selected Power Marketing Administration's Role in a Changing Electricity Industry*, GAO/RCED-98-43, (Washington, D.C. March 6, 1998) and (4) *Power Marketing Administrations: Repayment of Power Costs Needs Closer Monitoring*, GAO/AIMD-98-164 (Washington, D.C.: June 30, 1998).

government's share of CSRS normal costs does not necessarily support the argument that the Postal Service should not fund them. Likewise, it does not necessarily support the argument that other agencies start paying for these costs. Rather, it merely demonstrates the inconsistent treatment of agencies in this regard.

Our long-standing position has been that employer agencies should fund the dynamic cost of the government's retirement programs not otherwise funded with employee withholdings and deposits.[27] We also observed on numerous occasions that, as a result of charging less than the dynamic cost of CSRS not otherwise provided by employee withholdings, agencies whose operations are intended to be self-supporting receive large subsidies that are not recognized in the cost of their goods and services.[28] However, our previous recommendations and observations did not specifically address whether the cost of military service benefits should be included as part of a dynamic normal cost factor. Nor did we examine the issue of whether the entity that benefited from the service should ultimately pay for any related benefits. Additionally, with the exception of self-supporting agencies that pay the dynamic cost of these benefits, taxpayers ultimately fund the benefits, regardless of whether these costs are included in individual agency budgets. Therefore, charging the self-supporting agencies' customers for the government's share of the dynamic normal cost of pension benefits results in real savings to the taxpayers and, therefore, is not just a change in the timing and source of funding.

Regarding the Postal Service's statement that private sector companies are not responsible for military service costs, it is true that private sector companies are not required to give credit for past military service in their defined benefit pension plans. However, it should also be noted that the taxes these companies pay to the general fund of the Treasury are used to

[27]For example, see the following General Accounting Office products: (1) Federal Retirement Systems: Unrecognized Costs, Inadequate Funding, Inconsistent Benefits, GAO-FPCD-77-48 (Washington, D.C.: Aug. 3, 1977), (2) Need for Overall Policy and Coordinated Management of Federal Retirement Systems, GAO/FPCD-78-49 (Washington, D.C.: Dec. 29, 1978), and (3) Overview of Federal Retirement Programs, GAO/T-GGD-95-172 (Washington, D.C.: May 22, 1995).

[28]For example, see the following General Accounting Office products: (1) *Need for Recognition of the Full Cost of Retirement Benefits for Federal Work Force*, GAO-FPCD-79-49 (Washington, D.C.: Apr. 11, 1979), (2) *Federal Retirement Issues*, 109874 (Washington, D.C.: July 12, 1979), and (3) *Analysis of Grace Commission Proposals To Change the Civil Service Retirement System*, GAO-GGD-85-31 (Washington, D.C.: Feb. 13, 1985).

pay for various costs incurred by the federal government, including the military service benefits of military retirees and those employees who retired from agencies other than the Postal Service. The Postal Service is exempt from paying any corporate income taxes.

Observations on Alternative Military Service Cost Allocation Approaches

The OPM and Treasury proposal presented five possible approaches for allocating the cost of benefits attributable to military service between the Treasury and the Postal Service. The Postal Service's position is that taxpayers, not postal ratepayers, should be responsible for the full cost of CSRS military service benefits, and it did not offer any other funding alternatives as part of its military service funding proposal.

The information from the OPM and Treasury proposal is reprinted below in table 1. OPM calculated the estimated cost to the Treasury of each approach using the pro-rata approach to allocating military service set forth in P.L. 108-18 as the baseline.[29]

[29]The OPM and Treasury proposal estimates were calculated using CSRS-wide demographic assumptions. The use of Postal Service-specific demographic assumptions in the calculation of the present value of future benefits and future normal cost and other contributions produces slightly different results. The ultimate cost of any particular alternative is determined once all benefits and other expenses have been paid to Postal Service annuitants.

Table 1: Estimated Costs to Treasury of Alternative Allocation Approaches

Alternative	Postal Service responsibility[a]	Total estimated additional cost to Treasury (in billions)
Postal Service pays all	All military service for post-71 retirees	$ (20.7)[b]
P.L. 108-18: Postal Service pays a pro-rata share	All military for post-71 hires, pro-rata share for pre-71 hires	$ 0
Treasury pays for pre-1971 hires	All military for post-71 hires, no military for pre-71 hires	$ 7.1
Postal Service pays post-9/30/02 military service benefits	Only for military service benefits paid in the future	$ 16.6
Treasury pays all	No military service, past or future	$ 27.2

Source: Based on data provided by OPM.

[a]Reference to "post-71" and "pre-1971" mean post June 30, 1971, and pre July 1, 1971, respectively.

[b]The total estimated additional cost to the Treasury of the "Postal Service pays all" alternative does not agree with the "Treasury pays all" alternative because the baseline pro-rata alternative did not result in an equal split of costs between the Postal Service and Treasury.

OPM's P.L. 108-18 pro-rata approach requires that the Postal Service fund (1) all CSRS military service benefits of employees hired into a civilian position after June 30, 1971, and (2) a pro-rata share of these benefits for employees hired before July 1, 1971. OPM estimated this pro-rata share of benefits by first allocating an employee's total creditable military service based on the ratio of pre-1971 civilian service to the total civilian service which the employee accrued both before and after the effective date of the Postal Reorganization Act. OPM's methodology also assumed that the Postal Service should be responsible for (1) the effect of post-1971 general pay increases and increasing benefit accrual rates on the final amount of military service benefits at retirement, including those military service credits allocated to the federal government, and (2) a proportional amount of post-1971 annuitant cost-of-living adjustments. These aspects of OPM's methodology apply to the second, third, and fourth funding alternatives presented in the OPM and Treasury proposal. The other two alternatives – Treasury pays the entire cost of military service or Postal Service pays the entire cost after September 30, 2002 – have the responsible agency funding all CSRS benefits attributable to military service, including all annuitant

COLAs. Appendix B of the OPM and Treasury proposal provides examples of how an example retiree's benefit payment would be allocated into civilian and military service portions and how the federal government's share of those amounts would be determined for each of the funding alternatives.

The total estimated additional cost to the Treasury for each funding alternative is equal to the difference between the projected funded status – or "supplemental liability" – of the current law pro-rata approach with that of each alternative. Appendix C of the OPM and Treasury proposal provides the net asset, present value of future benefits, and present value of future contributions components of the "supplemental liability" for each funding alternative.

In addition to providing the total impact of each funding alternative on the Treasury as compared to the current law pro-rata approach, the OPM and Treasury proposal also provides their views of the strengths or limitations of the alternatives. Most of the commentary in this section of the OPM and Treasury proposal repeats assertions and arguments presented elsewhere. However, we believe some clarification of the following statements made in the first funding alternative is needed:

"Because military service only becomes creditable at the time when an employee actually retires, it would not be unreasonable to charge Postal Service for the entire amount of military service for all employees who retired from the Postal Service after June 30, 1971. It was only because these employees retired from the Postal Service that they received credit for their military service."

"Civil Service rules required that to receive a regular retirement benefit the employees must have at least five years of civilian service and then attain additional age and service requirements."

The rules governing the crediting of military service are established in law and regulation. Generally, military service can be used in the computation of any annuity after having completed 5 years of civilian service and if the following three conditions are met: (1) the military service was active and terminated under honorable conditions, (2) the military service was performed before separating from a civilian position covered by CSRS, and (3) the employee makes any required deposits.

The OPM and Treasury statement that an employee must meet additional age and service requirements beyond the first 5 years to receive a regular (voluntary) retirement benefit is accurate, as is the statement that an employee must retire – in this case from the Postal Service – in order for military service to be counted in the computation of an annuity benefit. However, an employee is entitled to receive a disability retirement benefit at any age with 5 years of civilian service and a deferred annuity beginning at age 62 with 5 years of civilian service. Once employees meet the minimum years of civilian service necessary to be entitled to any type of annuity and meet the conditions listed above, they are entitled to have all of their military service included in the computation of their annuity.

For purposes of determining how best to allocate CSRS military service benefits, it is important to note that OPM assumed that employees render military service prior to when they first enter civilian service. This leads to the presumption that the military service credits of many of the Postal Service's retirees were already creditable towards an annuity by the time the Service commenced operations in 1971.[30] Yet, for purposes of estimating the Postal Service's share of the CSRS portion of CSRDF assets and the actuarial present value of future benefits, OPM allocated the years of creditable military service of former and current Postal Service employees proportionally over the employees' civilian career.

For example, an employee who retired in 1991 with 10 years of civilian service before July 1, 1971, and 20 years after June 30, 1971, would have two-thirds of any military service allocated to the Postal Service, even though OPM assumes that all military service was rendered before the employee was hired into a covered civilian position. Consequently, this example employee's military service would have been creditable towards a civilian pension benefit before the Postal Service commenced operations. The OPM and Treasury proposal did not include an allocation alternative that reflects the extent to which military service became creditable after the Postal Service commenced operations.

The scoring of each alternative approach to funding military service hinges on how Postal Service would spend any additional savings. The Postal Service was required by P.L. 108-18 to submit a proposal detailing how it would expend any savings accruing to it after fiscal year 2005 as a result of enactment of P.L. 108-18. In that separate proposal, the Postal Service provided two alternatives to spending any savings. The first alternative assumes the responsibility for funding the CSRS military service benefits of

[30]Due to limitations in the data readily available to it, OPM also assumed that all creditable civilian service occurred without breaks in between.

its current and former employees will return to the Treasury, while the other alternative assumes that the Postal Service will retain this responsibility as defined under P.L. 108-18. Consequently, we present our estimates of the budgetary implications of only these two military service funding alternatives in our companion report on the results of our mandated review of the Postal Service's savings plan proposal. This report is entitled *Postal Pension Funding Reform: Issues Related to the Postal Service's Proposed Use of Pension Savings*, GAO-04-238.

Conclusion

The agencies made various arguments as to which agency – Postal Service or Treasury – should fund the cost of CSRS military service benefits. We made various observations that considered the accuracy of the various assertions presented, those aspects of equity and consistency raised by the agencies, the Postal Service's unique role in the financing of CSRS and FERS benefits, and its status as a self-supporting agency. Ultimately, the Congress must make this decision. Should the Congress decide that the Postal Service should be responsible for funding CSRS military service benefits attributable to its employees, the Congress should then decide the extent to which these benefits should be attributed to the Postal Service and perhaps to other self-supporting agencies. Even if the Congress decides that self-supporting agencies should not be required to fund CSRS military service benefits, the Congress should still consider whether these agencies should be required to fund the dynamic normal cost of their CSRS employees' benefits that excludes the military service component.

The OPM and Treasury proposal provided five alternative allocation approaches; however, none of their approaches included an allocation alternative that reflects the extent to which the Postal Service's current and former employees had, by the time the Service commenced operations in 1971, completed the 5 years of civilian service needed to be entitled to have their past military service credits used in the computation of an annuity. This alternative would provide an estimate of Postal Service's obligation that includes only military service benefits that became creditable after the Postal Service commenced operations.

Matters for Congressional Consideration

To help promote full and consistent funding of CSRS benefits among self-supporting federal agencies, we suggest that the Congress consider

- requiring all self-supporting federal entities to pay the dynamic cost of employee pension benefit costs not paid for by employee contributions and deposits, excluding military service costs, and
- treating all self-supporting federal entities consistently with regard to whatever decision is made on Postal Service funding of the military service component of CSRS employee benefits.

Recommendation for Executive Action

If the Congress decides that the Postal Service should be responsible for military service costs associated with its employees, we recommend that OPM provide the Congress with estimates of the additional cost to the Treasury of making the Postal Service responsible only for employee military service that became creditable after June 30, 1971.

Agency Comments and Our Evaluation

Postal Service

In written comments on a draft of this report the Postmaster General expressed concern with what he saw as an inference that the Postal Service should be responsible for the cost of an employee's military service because it hires the employee knowing of the past military service. The Postmaster General also reaffirmed the Postal Service's commitment to the fundamental policy of veterans' preferences.

Our report did not imply that knowing of past military service was a relevant factor in determining whether the Postal Service should bear this cost, but rather simply stated the fact that the right to receive credit for past military service arises only as a result of employment in a civilian position covered by CSRS or FERS.

The Postmaster General also stated that our suggestion that the Congress consider requiring all self-supporting entities to fund the dynamic costs of employee pension benefits is not an issue for the Postal Service because it began doing so as of April 2003. Our report states that there are other self-supporting agencies that are not required to fund military service costs and do not otherwise fully fund the dynamic normal cost of their CSRS employees' benefits as the Postal Service is now required to do. We highlighted this difference in funding requirements to illustrate an inconsistency that the Congress may want to consider as it contemplates CSRS employee benefits funding by the Postal Service. The Postmaster General's written comments are reprinted in appendix III.

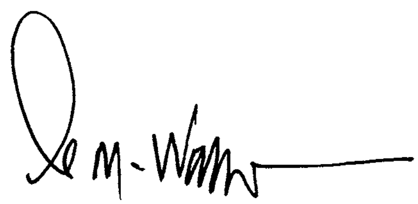
OPM and Treasury

In written comments on a draft of this report, the Secretary of the Treasury and Director of OPM disagreed with our statement that there is no direct relationship between an employee's prior military service and the operations of the Postal Service. They stated that granting credit for military service in calculating civilian pensions enables the Postal Service to recruit and retain veterans, who provide direct benefits to the operations of their employer. We agree that the crediting of military service facilitates the recruitment and retention of veterans who, subsequent to their military service, contribute to postal operations. However, we continue to view the relationship between military service and postal operations as indirect because the activities performed while serving in the military did not directly contribute to the daily operations of the Postal Service at the time the military service was rendered.

In their comment letter, the Secretary of the Treasury and Director of OPM also provided certain clarifications with respect to their policy positions and beliefs. For example, they stated that their estimate, made at our request, of the value of benefit costs due to military service before 1971 includes all increases in the value of those benefits that resulted from pay raises granted by the Postal Service, but that they do not endorse this method, especially insofar as it permits Postal Service pay increases to then increase the cost allocated to the Treasury. We do not endorse this or any other cost allocation method. As stated in our report, our position is that the Congress needs to decide whether the Postal Service should fund the cost of military service attributable to military service of its current and former employees. If the Congress decides that the Postal Service should fund these costs, then it needs to decide which method to use in allocating costs to the Postal Service. The written comments from the Secretary of the Treasury and Director of OPM are reprinted in appendix IV.

We are sending copies of this report to the Director of the Office of Personnel Management, the Postmaster General, the Secretary of the Treasury, the Director of the Office of Management and Budget, and other interested parties. We are also sending this report to the Honorable John M. McHugh, House of Representatives, as the Chairman of the Special Panel on Postal Reform and Oversight, House Committee on Government

Reform. The report is also available at no charge on GAO's home page at http://wwww.gao.gov. If you have any questions about this report, please contact Linda Calbom, Director, Financial Management and Assurance, at (202) 512-8341, or Robert Martin, Acting Director, at (202) 512-6131. You may reach them by e-mail at calboml@gao.gov and martinr@gao.gov. Other key contributors to this report were Joseph Applebaum, Richard Cambosos, Lisa Crye, Frederick Evans, Darren Goode, Scott McNulty, and Brooke Whittaker.



David M. Walker
Comptroller General
of the United States

Report from OPM and Treasury

UNITED STATES
OFFICE OF PERSONNEL MANAGEMENT
WASHINGTON, DC 20415-0001

OFFICE OF THE DIRECTOR

SEP 3 0 2003

The Honorable David M. Walker
Comptroller General of the United States
Washington, DC 20548

Dear Mr. Walker:

On April 23, 2003, the President approved Public Law 108-18, the "Postal Civil Service Retirement System Funding Reform Act of 2003." Section 2(e) of the Act requires that the Office of Personnel Management, the Department of the Treasury, and the United States Postal Service each prepare and submit, by September 30, 2003, to the President, the Congress, and the General Accounting Office proposals detailing whether and to what extent the Department of the Treasury or the Postal Service should be responsible for the funding of benefits attributable to the military service of current and former employees of the Postal Service that, prior to the date of enactment of this statute, were the responsibility of the Department of the Treasury under section 8348 of title 5, United States Code.

The Office of Personnel Management and the Department of the Treasury have prepared a joint report in accordance with these provisions which we are pleased to transmit to you.

The Office of Management and Budget advises that there is no objection to the submission of this report from the standpoint of the Administration's program.

Similar letters will be sent to the President of the United States, the President of the Senate, and the Speaker of the House of Representatives.

Sincerely,

Kay Coles James
Director of the Office of Personnel Management

John W. Snow
Secretary of the Treasury

Enclosure

CON 131-64-
September 19

Report to Congress on the Financing of Benefits Attributable to the Military Service of Current and Former Employees of the Postal Service

The Postal Civil Service Retirement System Funding Reform Act of 2003, P.L. 108-18 requires that:

"The United States Postal Service, the Department of the Treasury, and the Office of Personnel Management shall, by September 30, 2003, each prepare and submit to the President, the Congress, and the General Accounting Office proposals detailing whether and to what extent the Department of the Treasury or the Postal Service should be responsible for the funding of benefits attributable to the military service of current and former employees of the Postal Service that, prior to the date of the enactment of this Act, were provided for under section 8348(g)(2) of title 5, United States Code."

Executive Summary

It is the Administration's position that the U.S. Postal Service (USPS) should be responsible for a share of the costs paid to retired employees of the Postal Service that arise from increasing Civil Service pension benefits because of military service. One of the primary goals for the reorganization of the Post Office into the USPS was to ensure that all the costs associated with the new organization be paid through stamp revenue and not through taxpayer dollars. Therefore, all pension costs for employees that are attributable to service after the reorganization should be borne by the Postal Service.

The question then is how to determine what portion of the cost of military credit is attributable to service since the Postal Service became independent in 1971. We maintain that the attribution method adopted in the new legislation (P.L. 108-18) is an easy-to-administer method that is fair to both the Postal Service and the Federal taxpayer.

The Postal Service should be Responsible for the Cost of Military Service Credits Attributable to Service Since the Postal Service Became Independent in 1971

<u>The Postal Service Should Pay the Full Cost of Benefits Received by its Employees</u>

We maintain that it has been a basic principle of the legislation that created the Postal Service that revenue and expenses for Postal Service should be kept separate from the rest of the Federal Government, and that the Postal Service should pay for all of its expenses through Postal rates. The benefits attributable to military service are a retirement benefit that Postal employees receive just like other benefits, such as the Cost of Living Allowances (COLAs) increases for annuitants, and Postal Service customers should pay for the full cost of all benefits received by its employees.

Some have argued that it is not fair to ask the Postal Service to finance the cost of military service for Civil Service Retirement System (CSRS) employees, as it would be the only agency required to operate under this financing mechanism. However, for other agencies the special treatment of military service under the CSRS merely shifts the timing of when the contributions are made and whether they are charged to the Treasury or charged to agency budgets. In either case, the costs would still ultimately be borne by the taxpayer. By contrast, Postal Service costs are paid through postage revenues rather than funded by the Treasury.

<u>The special treatment of military service that applied to Postal Service employees under the old law can be viewed as more of an historic accident than a deliberate policy choice.</u>

As described in Appendix A, the prior funding mechanism for the Postal Service under CSRS (including the special treatment of military service) was developed in a piecemeal fashion that never fully addressed all of the factors that affect the costs of the system.

By contrast to CSRS, each time a comprehensive system for funding Federal annuities was developed there was no special treatment of military service. For example, in the Federal Employees' Retirement System (FERS) that was enacted in 1984, the cost of benefits attributable to military service is borne by the agencies (including the Postal Service) through the normal cost. The Administration has also proposed the same method for funding the cost of CSRS benefits attributable to military service for non-Postal agencies under the Managerial Flexibility Act.

In view of the long history of Congressional action, it is reasonable to assume that Congress may have taken further action to address the issues of excess interest earnings and the costs of military service, if OPM had not identified the problems with the static funding methodology.

<u>The payment of military service costs for Postal Service employees is consistent with the funding of FERS, the funding system on which the new law was patterned.</u>

The adoption of a new financing system for the Postal Service under P.L. 108-18 provided an opportunity to design a *complete* funding system for the Postal Service retroactive to when the Postal Service became independent in 1971. Although the old law static funding of CSRS did not require the Postal Service to fund the cost of military service, it also did not contemplate that the actuarial gains or losses of the retirement system would be attributed to the Postal Service. Experience shows that the retirement system benefited from extremely high interest rates during the 1980's. The gains from interest earnings in excess of the static interest rate far exceed the additional costs of military service. The Postal Service should not benefit from the positive dynamic experience of the pension fund without assuming the other responsibilities that come with dynamic funding.

The Attribution Method Adopted in P.L. 108-18 is a Fair Approach for Determining the Benefits Attributable to Pre-1971 Military Service.

Although it is clear that the Postal Service should be responsible for all employee benefit costs that arise due to employment under its tenure, there remains the question of what its responsibility should be for military service costs for employees who worked for both organizations.

The Postal Service should be responsible for a share of the costs associated with military service based on the portion of the career that is served with the Postal Service. This is the method that was adopted in the Postal Civil Service Retirement System Funding Reform Act of 2003 (P.L. 108-18). It is consistent with the funding provisions of FERS and with the policy that the Postal Service should pay for all of its expenses through Postal rates.

The following describes several ways to allocate military costs for Postal Service employees. An illustrative example of each method is shown in Appendix B.

<u>"USPS Pays All" for Post-1971 Retirement</u>

The most straightforward method of allocating costs would be to assume that the Treasury should be responsible for the cost of military service for employees who retired from the old Post Office Department before July 1, 1971, and that the Postal Service should be responsible for the cost for employees who retired after June 30, 1971.

Because military service only becomes creditable at the time when an employee actually retires, it would not be unreasonable to charge Postal Service for the entire amount of military service for all employees who retired from the Postal Service after June 30, 1971. It was only because these employees retired from the Postal Service that they received credit for their military service.

Civil Service rules required that to receive a regular retirement benefit the employees must have at least five years of civilian service and then attain additional age and service requirements.

<u>"P.L. 108-18 -- USPS Pays Pro-rata Share" Based on the Portion of Total Career Served under the Post Office Department</u>

Under the Administration's approach (as adopted in P.L. 108-18) the cost of military service for employees who were hired before July 1, 1971, but who retired on or after this date, is pro-rated based on the ratio of pre-1971 civilian service to total civilian service. We believe this pro-rata method provides a fair way of allocating the cost of military service for these employees and is the most consistent with FERS funding.

<u>"Treasury Pays for Pre-1971 Hires"</u>

Under this allocation the Postal Service would only be responsible for the cost of military service for employees hired after June 30, 1971. For example, an employee hired in 1970 who spends almost all of his/her career at the Postal Service would, of course, receive credit for their military service. However, under this approach, the Postal Service would not be charged with any of the cost of these benefits, even though they are being paid as a result of the employee having worked for almost an entire career at the Postal Service.

"USPS Pays for Post-September 30, 2002 Military Service Benefits"

An allocation suggested in discussions with Congressional staff was to charge the Postal Service only for the cost of military service benefits that are payable after September 30, 2002. This method was based on the notion that "the Treasury already paid for the military service" before this date. However if the objective after Postal Service reorganization was to raise revenue to pay the employment costs of Postal workers from the sale of stamps instead of the payment of taxes, this proposed method continues to require Government revenues to fund benefits paid to Postal employees.

It is our position that the Postal Service should not benefit from the positive dynamic experience of the pension fund without assuming the other responsibilities that come with dynamic funding.[1] As was mentioned previously, we believe that Postal Service should be responsible for all of its retirement costs, and it is irrelevant what may or may not have been paid for by Treasury under the old law. This method does not provide a reasonable way of allocating the cost based on pre-1971 and post-1971 service.

"Treasury Pays All"

Treasury would be responsible to pay all of the costs of military service and the Postal Service would pay none of the costs of military service.

It is our position that this policy violates the principle that the Postal Service should pay for its own expenses through Postal rates. Individuals retiring from the Postal Service receive CSRS credit for their military service only because of their employment with the Postal Service.

[1] The gains from interest earnings in excess of the static interest rate far exceed the additional costs of military service. Assuming that the Treasury were to fund all military costs, the present value of all interest gains to the Postal Service from July 1, 1971 through September 30, 2002 would be approximately $106.6 billion. The cost to the Treasury of military service would be $16.6 billion, resulting in a net gain of $90 billion.

The following table summarizes the costs of these different ways of treating military service, with more complete information shown in Appendix C:

	USPS Responsible for:	Total Additional Cost To Treasury (in billions of dollars)
USPS Pays All	All military for post-71 retirees	(20.7)
P.L 108-18 - - USPS Pays a Pro-Rata Share	All military for post-71 hires, pro-rata share for pre-71 hires	0
Treasury Pays for Pre-1971 Hires	All military for post-71 hires, no military for pre-71 hires	7.1
USPS Pays post-9/30/02 Military Service Benefits	Only for military service benefits paid in the future	16.6
Treasury Pays All	No military service, past or future	27.2

Budgetary Implications of the Allocations Presented Above

Under P.L. 108-18, the military service for pre-1971 hires is allocated between Treasury and the Postal Service based on the ratio of pre-1971 civilian service to total civilian service. Appendix C shows that, as of September 30, 2002, USPS is still required to fund a supplemental liability of $4.8 billion under this approach. This supplemental liability would be amortized by the Postal Service through 40-year amortization payments. Current law (P.L. 108-18) has already incorporated these supplemental liability payments into the scoring of the legislation.

If the Postal Service paid for all of the cost of military service for its post-1971 retirees, the supplemental liability to be amortized by the Postal Service would be $25.5 billion, an increase of $20.7 billion over the current law.

Under the allocation where the Postal Service is responsible only for the cost of military service benefits that are paid after September 30, 2002 ("USPS Pays for Post-9/30/02 Military Service"), USPS would carry a supplemental liability of negative $11.8 billion, or, in other words, there would be an over-funding of $11.8 billion. This assumes that the Postal Service would continue to pay the full normal cost of 24.4 percent of payroll. However the over-funding position would likely necessitate the elimination of all future Postal agency contributions (only the employee contributions would remain). The $16.6 billion difference between the $4.8 billion supplemental liability under P.L. 108-18 and the negative $11.8 billion under the "USPS Pays for Post-9/30/02 Military Service" Method represents the additional cost to the Treasury.

Appendix A

Background

The benefit payments under Civil Service Retirement System (CSRS) include credit for military service. Generally, employees must pay a deposit of the 7 percent employee contributions on their military pay to receive this credit. The policy issue addressed here is to what degree the cost of the benefits attributable to military service in excess of the employee deposits should be paid for by the Postal Service. The U.S. Department of the Treasury must pay any portion of this cost not paid by the Postal Service.

Static Funding of CSRS – 1969 Law

P.L. 91-93, which was passed in 1969, set up the basic funding methodology for CSRS Government-wide. This methodology did not provide full funding of CSRS under private sector standards that were later incorporated into the Employee Retirement Income Security Act (ERISA) and into the dynamic funding methodology for the Federal Employees' Retirement System (FERS). Under the static funding of CSRS, the increases in retirement costs due to general salary increases and Cost of Living Allowances COLAs for annuitants are not anticipated or financed in advance. Each general salary increase is financed by means of a new series of 30-year amortization payments that is set up after that salary increase has occurred. Under the original law, there was no separate financing of the cost of COLAs for annuitants, although this was later added for the Postal Service only.

Employees and agencies each contribute 7 percent of pay, which approximates the ongoing or normal cost, and which does not pay for the cost of salary increases or COLAs for annuitants.

The Treasury is required to pay for the cost of military service through military service payments that are made each year, which are equal to the total amount of benefits attributable to military service that were paid out during that fiscal year. Finally, the Treasury also pays interest on the static unfunded liability, which covers any costs that are not otherwise being financed, such as the cost of COLAs for annuitants. [2] Any gains from excess interest earnings, beyond what were assumed under the static interest rate assumption, would reduce the unfunded liability, and thus lower the Treasury payments of interest on the unfunded liability. Thus, all of the gains due to excess interest earnings flow through to the Treasury.

Postal Service Financing of CSRS

Shortly after the Postal Service became independent in 1971, Congress passed P.L. 93-349 which required the Postal Service to finance the cost of all Postal salary increases by means of separate thirty-year amortization payments. These payments covered the entire cost of all

[2] More precisely, the Treasury was required to contribute 10 percent of the interest on the static unfunded liability and 10 percent of the military service benefits in FY1971, and to contribute 20 percent in FY1972, and so on through 100 percent in FY1980 and future years.

Postal salary increases, and did not distinguish between the portions of the salary increases attributable to the pre- or the post-1971 service of Postal employees.

Under the Omnibus Budget Reconciliation Acts of 1987, 1989, 1990, and 1993, Congress gradually instituted a series of measures that eventually required the Postal Service to finance the entire cost of COLAs for Postal annuitants attributable to service since 1971 by means of fifteen-year amortization payments.[3]

In summary, the Postal Service financing of CSRS gradually evolved over time through a series of steps that resulted in the Postal Service paying for the full cost of all salary increases and the cost of COLAs attributable to post-1971 service. There was no comprehensive plan for Postal financing of CSRS such as was adopted under FERS. Any gains from excess interest earnings, and the costs of military service, stayed with the Treasury.

FERS Financing Provisions

FERS was a result of Congress taking a comprehensive approach to designing a new retirement system for Federal employees who were also covered under Social Security. Under the dynamic funding methodology that was adopted for FERS in 1986, there was separate accounting for the assets and liabilities for Postal and non-Postal employees. Postal Service was required to pay for all of the retirement costs for Postal employees, including the cost of military service.

[3] These statutes were P.L. 100-203, P.L. 101-239, P.L.101-508, and P.L.103-66.

Appendix B

Examples of Methods for Allocating the Cost of Military Service For an Employee Hired Before 1971 Who Retired After 1971

Employee Retired in 1991 (on 7/1/1991) with 30 years total service (including 3 yrs. military and 1 yr. sick leave)
1991 Final Average Salary: $50,000
1971 Salary: $20,000 (= High-3 Average Salary in 1991 assuming no post-1971 pay increases)

CSRS Benefit Formula: 1.5% of High-3 Average Salary for first 5 years of service, 1.75% for next 5 years of service, 2.0% for remaining years of service.

Total Service = 30 yrs.

Total Benefit = $ 50,000 * [(5 yrs.) * 0.015 + (5 yrs.) * 0.0175 + (20 yrs.) * 0.02]
= $ 50,000 * 0.5625
= $ 28,125

Civilian Service = 30 – 3 = 27 yrs

Civilian Service Benefit = $ 50,000 * [(5 yrs.) * 0.015 + (5 yrs.) * 0.0175 + (17 yrs.) * 0.02]
= $ 50,000 * 0.5025
= $ 25,125

Military Service Benefit = Total Benefit – Civilian Service Benefit
= $ 28,125 - $25,125
= $ 3,000

Military Service = 3 yrs.
Sick Leave = 1 yr.
Actual Civilian Service = 27 yrs. – 1 yr. = 26 yrs.
Civilian Year of Hire = 1991 – (30 – 3 – 1) = 1965
Pre-1971 Actual Civilian Service = 1971 – 1965 = 6 yrs.
Ratio of Pre-1971 Actual Civilian Service to Actual Civilian Service = (6 / 26)

Method 1 - "USPS Pays All" for Post-1971 Retirement

Federal Civilian Service = 6 yrs. + [1 yr. * (6 / 26)] = 6.231 yrs.

Federal Share = Federal Civilian Service Benefit
= $ 20,000 * [(5 yrs.) * 0.015 + (1.231 yrs.) * 0.0175]
= $ 20,000 * 0.09654
= $ 1,931

Method 2 - "P.L. 108-18 -- USPS Pays Pro-rata Share" Based on the Portion of Total Career Served under the Post Office Department

Federal Service = 6 yrs. + [(3 yrs. + 1 yr.) * (6 / 26)] = 6.923 yrs.

Federal Share = $ 20,000 * [(5 yrs.) * 0.015 + (1.923 yrs.) * 0.0175]
= $ 20,000 * [0.10865]
= $ 2,173

2

Method 3 - "Treasury Pays for Pre-1971 Hires"

Federal Service = Federal Civilian Service + Military Service = 6 + [1 * (6/26)] + 3 = 9.231 years

Federal Share = $ 20,000 * [(5 yrs.) * .015 + (4.231 yrs.) * .0175]
= $ 20,000 * .14904
= $ 2,981

Method 4 - "USPS Pays for Post-September 30, 2002 Military Service Benefits"

Federal Civilian Service = 6 + [1 * (6 / 26)] = 6.231 yrs.

Federal Civilian Service Benefit = $ 20,000 * [(5 yrs.) * 0.015 + (1.231 yrs.) * 0.0175]
= $ 20,000 * 0.09654
= $ 1,931

Federal Share before 10/1/2002 = Federal Civilian Service Benefit + Military Service Benefit
= $1,931 + $3,000 = $4,931 initial benefit, adjusted by COLA's

Federal Share after 9/30/2002 = Federal Civilian Service Benefit
= $ 1,931 initial benefit, adjusted by COLA's

Method 5 - "Treasury Pays All"

Federal Civilian Service = 6 + [1 * (6 / 26)] = 6.231 yrs.

Federal Civilian Service Benefit = $ 20,000 * [(5 yrs.) * 0.015 + (1.231 yrs.) * 0.0175]
= $ 20,000 * 0.09654
= $ 1,931

Federal Share = Federal Civilian Service Benefit + Military Service Benefit
= $ 1,931 + $ 3,000
= $ 4,931

Appendix C

Comparison of Allocation Methods for Postal CSRS Benefits Attributable to Military Service

(in billions of dollars)

	USPS Responsible for:	PV Future Benefits	- Postal Fund	= Current Liability	- PV Future Contributions	= Projected Supplemental Liability	Total Additional Cost To Treasury
USPS Pays All	All military for post-71 retirees	192.1	149.4	42.7	17.2	25.5	(20.7)
P.L 108-18 -- USPS Pays a Pro-Rata Share	All military for post-71 hires, pro-rata share for pre-71 hires	190.4	168.4	22.0	17.2	4.8	0
Treasury Pays for Pre-1971 Hires	All military for post-71 hires, no military for pre-71 hires	189.1	174.2	14.9	17.2	(2.3)	7.1
USPS Pays post-9/30/02 Military Service Benefits	Only for military service benefits paid in the future	190.4	185.0	5.4	17.2	(11.8)	16.6
Treasury Pays All	No military service, past or future	179.1	185.0	(5.9)	16.5	(22.4)	27.2

Report from the United States Postal Service

JOHN E. POTTER
POSTMASTER GENERAL, CEO

UNITED STATES POSTAL SERVICE

September 30, 2003

The Honorable David M. Walker
Comptroller General of the United States
United States General Accounting Office
441 G Street, NW
Washington, DC 20548-0001

Dear Mr. Comptroller General:

Pursuant to the requirements of P.L. 108-18, the *Postal Civil Service Retirement System Funding Reform Act of 2003*, I am transmitting two reports. The first addresses the funding of benefits attributable to military service of current and former employees of the U.S. Postal Service. The second details how the Postal Service proposes to expend savings accruing to the Postal Service as a result of P.L. 108-18.

I would be happy to answer any questions you may have regarding these reports.

Sincerely,

John E. Potter

John E. Potter

Enclosures

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**POSTAL SERVICE PROPOSAL
MILITARY SERVICE PAYMENTS REQUIREMENTS
P. L. 108-18**

P. L. 108-18, the Postal Civil Service Retirement System Funding Reform Act (the Act) recognized that postal ratepayers would over-fund Postal Service Civil Service Retirement System (CSRS) pension obligations and was enacted to avert such over-funding. The Act also transferred from the United States Treasury to the Postal Service the responsibility for funding the costs of CSRS benefits that current and former Postal Service employees have earned through military service. Over 90% of the cost of military service, now charged to the Postal Service under the Act, was earned before the creation of the Postal Service on July 1, 1971. In fact, the majority of this service was performed in World War II, The Korean War and the Viet Nam War.

In relieving the Treasury of its historic responsibility for these costs of military service, the Act has created a direct cost transfer of $27 billion from U.S. taxpayers to Postal ratepayers. Of this amount, $17 billion is wholly retroactive, relating to funding between the years 1971 and 2002 by the United States Treasury in accordance with section 8348(g)(2) of Title 5, United States Code. No agency other than the Postal Service is responsible for these CSRS costs that Treasury continues to pay for all other federal employees. Neither is any private sector company responsible for these costs.

Because this change departs from fundamental public policy, P. L. 108-18 provides an opportunity to reconsider funding responsibility of these costs. The United States Postal Service, the Department of the Treasury, and the Office of Personnel Management are each to submit proposals "detailing whether and to what extent the Department of the Treasury or the Postal Service should be responsible for the funding of benefits attributable to the military service of current and former employees of the Postal Service."

P. L. 108-18 evolved from the Comptroller General's request that the Office of Personnel Management (OPM) reexamine Postal Service CSRS funding. OPM determined that, without change, the Postal Service would over fund its CSRS obligations by $78 billion. As a correction, OPM proposed that the Postal Service fund CSRS on a dynamic rather than a static basis. OPM included the cost of retirement benefits earned through military service in the dynamic funding rate assessed to the Postal Service. GAO, in its January 31, 2003 report to Congress, stated that this was a departure from current law under which the Department of the Treasury is responsible for funding these military service costs. GAO revealed that this change amounted to a $27 billion

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cost transfer from Treasury to the Postal Service. Without this cost transfer, USPS over-funding of CSRS would exceed $105 billion.

The Postal Service recommends that the responsibility for funding CSRS benefits of military service be returned to the U.S. Treasury. This proposal is consistent with the treatment of military service costs specified in Civil Service law and still accorded to all other federal agencies and all private sector companies. Charging the CSRS cost of military service to the Postal Service is not justified because the majority of this cost relates to military service performed before the creation of the Postal Service; the military service had no connection with Postal Service functions or operations; and because doing so creates an unmerited disparate impact on the Postal Service under CSRS.

Returning the obligation for payment of military service costs to the Treasury results in the Postal Service having not only fully funded its CSRS obligations as of the end of FY 2002; but over-funding these obligations by $10 billion. The Postal Service proposes that the $10 billion in over-funding remain in the Civil Service Retirement and Disability Fund in a separate account designated as the "Postal Service Retiree Health Benefit Fund." With this change, the Postal Service would be in a financial position to pre-fund retiree health benefits for its employees and retirees, a cost that is directly related to the operations of the Postal Service. The Postal Service has incorporated this recommendation in its proposal, also filed today as required by P. L. 108-18, detailing the use of "savings" to be achieved under the Act for years after FY 2005.

THE POSTAL SERVICE BELIEVES THAT THE FUNDING OF THESE COSTS SHOULD BE MAINTAINED BY THE UNITED STATES TREASURY FOR THE FOLLOWING REASONS:

<u>Military service and federal civilian service are separate and distinct</u>.
Each of the federal employment services, military and civilian, has separate compensation, retirement and benefits programs. Qualified federal employees may elect to have the term of their military service credited in the calculation of CSRS retirement benefits they earn through civilian service. The federal agency employer has no role in this election and the qualified employee and the Treasury pay the cost associated with it.

<u>Funding the costs of military service is the historic responsibility of the Treasury</u>.
In 1969, P. L. 91-93 established a mechanism for the Treasury to make annual payments to the Civil Service Retirement and Disability Fund (CSRDF) to pay for CSRS military service costs. That same legislation required that the Treasury bear the funding responsibility for the CSRS

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unfunded liability resulting from increases in pay. In 1973, P. L. 93-349 made the Postal Service liable for any increases in the CSRS unfunded liability resulting from increases in Postal Service employee pay based on the same provisions as contained in P. L. 91-93. While making the Postal Service responsible for costs attributable to its decisions and actions, the 1973 law still maintained the responsibility of the Treasury to pay the costs of CSRS military service as they do now for all other federal agencies.

The Act creates a retroactive cost transfer for CSRS military service credit earned prior to the creation of the Postal Service and unrelated to its operations.

In considering the merits of who should bear responsibility for military service costs, it must be understood that approximately 90% of CSRS military service costs for postal employees and retirees earned by military service was completed before the establishment of the Postal Service in July, 1971. As the CSRS was closed to new enrollment in 1983, all Postal Service employees covered by CSRS had to begin their civilian service before January 1, 1984, and most would have completed their military service before 1971. By charging the cost of their military service to the Postal Service, P. L. 108-18 assigns it the liability for military service performed before the USPS was founded. Further, the Treasury has already paid the great majority of these costs on an annual basis since 1969. Clearly, charging the Postal Service for these past obligations and payments of the U.S. Treasury is a retroactive cost transfer of $27 billion to postal ratepayers. The military service itself had no relation to Postal Service operations, on which postal rates are based. In fact, that military service had no relation to the operations of the former Post Office Department.

Crediting the Postal Service with actual interest earned does not justify the transfer of military service costs.

GAO found in its report that shifting the cost of military service to the Postal Service had been proposed on the basis of a belief that this was "appropriate because under [the] proposal the 'Postal Fund' would be credited with a proportional share of the excess investment returns earned by the CSRDF over the past 30 years." Neither in accepted actuarial nor accepted financial practice can we find a substantiating basis for this rationale. Under previous law, the Postal Service was charged for the full cost of CSRS benefits resulting from Postal Service pay increases and retiree COLAs. Accordingly, it should receive the full benefit of actual investment returns on its funding of those costs. No price should be imposed and no penalty exacted from the Postal Service because it is to be credited with earnings of its own funds.

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There is no identity between FERS funding and CSRS funding.

FERS was created on a dynamically funded basis to phase out CSRS and to establish a more limited federal employment benefits program that would be funded fully by the employee and the employing agency. CSRS was left standing whole and intact as a fully functioning retirement program on which both employees and employers depend. It is a totally different program from FERS, with different benefits and different levels of contribution. In fact, CSRS was never fully funded by employers and employees, with the exception of the U. S. Postal Service.

Under FERS, all federal agencies are treated consistently and years of service are compensated at a maximum of 1% compared to the 2% maximum rate of CSRS. Moreover, upon creation of FERS, military costs were applied to new employees only. No retroactive assessments were charged and all agencies were treated equally. Finally, it is by statute that FERS is funded on a dynamic basis and it is by statute that, under FERS, military service costs are included in the dynamic normal cost assumptions. There is no statute or regulation that requires CSRS to be funded on a dynamic basis and, under CSRS, the statute requires that the U.S. Treasury pay the cost associated with military service.

No self-supporting federal agencies other than the Postal Service fully fund the costs of Civil Service retirement.

Like the Postal Service, some other federal agencies and government corporations are self supporting, earning revenues from fees charged for services performed. However, the Postal Service is alone when it comes to funding the full costs of its obligations under the Civil Service Retirement System. All other self-supporting federal entities, as well as all appropriated agencies, contribute the CSRS static normal cost of 7 percent on the pay of their covered CSRS employees. No other agency, however, is charged additional funds required to fund the increase in pension costs resulting from employees' pay increases and retirees' COLAs. The U.S. Treasury fully funds other agencies' CSRS pension costs relating to pay increases, and also pays 5 percent interest on the increase in the CSRS unfunded liability resulting from COLA increases. Only the Postal Service has been accountable for fully funding these costs for its employees and retirees, and only the Postal Service is now charged with funding the CSRS military service retirement cost of its employees and retirees.

The President's Commission on the United States Postal Service recommended that "taxpayers, not ratepayers, should finance costs associated with military service."

The July 31, 2003 report of the President's Commission on the United States Postal Service stated that "no other Federal agency is required to pay such costs for its retirees under CSRS" and concluded that "it is inappropriate to require the Postal Service, as a

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self-financing entity that is charged with operating as a business, to fund costs" unrelated to its operations. Further, the Commission stated that the Act "asks those who use the nation's postal system to subsidize the U.S. military every time they use the mail. The Commission recommends repeal of this requirement."

PROPOSAL OF THE UNITED STATES POSTAL SERVICE

The Postal Service proposes to the President, the Congress and the General Accounting Office that the military payments requirements of P. L. 108-18 be amended, that the obligation for payments of military service retirement benefits credited to Postal Service employees be returned to the United States Treasury, and that the $27 billion costs of these payments be returned to the credit of the Postal Service, to remain in the CSRDF in a separate sub-fund for Postal Service pre-funding of retiree health care benefits, as detailed in the separate required Postal Service proposal for utilization of savings under the Act.

The Postal Service believes this proposal is in the public interest. It will help stabilize postal rates, use funds already paid by the Postal Service for the general purpose for which they were intended and collected from postal ratepayers, maintain these funds in the CSRDF for the benefit of all CSRS and FERS employees and retirees, and address the concerns surfaced by the GAO and reflected in the Sense of Congress statements enacted in P. L. 108-18. This proposal is consistent with the intent and practice of historic Civil Service law and regulation and with the requirements of Title 39.

In returning to Treasury its historic responsibility for payment of CSRS military service benefits, this proposal honors the service of military veterans as Congress intended.

Comments from the United States Postal Service

JOHN E. POTTER
POSTMASTER GENERAL, CEO

UNITED STATES POSTAL SERVICE

November 21, 2003

Mr. David M. Walker
Comptroller General of the United States
United States General Accounting Office
Washington, DC 20548-0001

Dear Mr. Walker:

Thank you for providing the Postal Service the opportunity to review and comment on the General Accounting Office (GAO) draft report, Postal Pension Funding Reform: Review of Military Service Funding Proposals (GAO-04-281).

We are in full agreement with the GAO conclusion, contained on page 14 of the report, that an employee's military service "has no direct relationship to the Service's operations." We also are pleased to note the GAO's clear recognition that military service benefits all taxpayers. As the report states on page 16, "One can reasonably argue that the cost of military service benefits would more equitably be borne by the entity that benefited from the military service (Department of Defense), which, in essence, would mean that taxpayers would ultimately bear these costs." We also agree with your conclusion on page 22 that, contrary to the Office of Personnel Management and Department of Treasury's premise, "there is nothing that inextricably links the past investment experience (i.e. investment gains or shortfalls) of the CSRDF to how military service benefits are funded."

We disagree, however, with the GAO's apparent inference that it might be reasonable to argue that the Postal Service should be responsible for the cost of an employee's military service because it hires the employee knowing of the past military service. We find this inconsistent with the conclusions that military service has no direct bearing on postal operations and that all taxpayers benefit from military service. More importantly, the inference runs counter to public law and policy, as well as a specific provision of the law creating the Postal Service. Veteran's preference has been fundamental public policy of the federal government since the Civil War and has long been instituted in law. The Postal Service could not, and certainly would not, refuse to hire a job applicant because the applicant had past military service. Also, as part of the transition from the Post Office Department to the Postal Service, Public Law 91-375, Section 8, August 12, 1970, provided that all officers and employees of the Post Office Department automatically became officers and employees of the new Postal Service, so that the Postal Service had no discretion in the matter.

We also note that the GAO recommends that Congress consider requiring all self-supporting federal entities to fund the full dynamic costs of employee pension benefits. This is not an issue for the Postal Service. As of April 2003, we began funding employee pension benefits on a dynamic basis, and this funding will cost the Postal Service $2.2 billion in FY2004.

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Finally, we stress that the $10 billion by which the Postal Service had overfunded the Civil Service Retirement System, coupled with making military pension costs the responsibility of the Department of the Treasury, will allow the Postal Service to prefund retiree health benefits. Addressing these other long-term obligations of the system is fully in line with previous recommendations of the GAO and the President's Commission.

If you or your staff would like to discuss any of these comments, we are available at your convenience.

Sincerely,

John E. Potter

John E. Potter

Comments from OPM and Treasury

UNITED STATES
OFFICE OF PERSONNEL MANAGEMENT
WASHINGTON, DC 20415-1000

OFFICE OF THE DIRECTOR

November 24, 2003

The Honorable David M. Walker
Comptroller General
General Accounting Office
441 G Street, NW
Washington, DC 20548 - 0001

Dear Mr. Walker:

Thank you for the opportunity to comment on your report to Congress entitled, "Review of Military Service Funding Proposals." After reviewing your report, we remain convinced that the approach to funding military service credits that was adopted in P.L. 108-08 is appropriate. We believe the following additional observations will be informative in the review of your report, and ask that they be included in its submission to Congress.

We disagree with the report's conclusion that there is no direct relationship between an employee's prior military service and Postal Service's operations. Granting credit for military service in the determination of pension benefits enables the Postal Service to recruit and retain veterans as part of its team. Providing these benefits gives the organization a competitive advantage in hiring employees whose professionalism, level of experience, dedication to service and commitment to excellence is well-demonstrated and who provide direct benefits to the operations of their employer.

At your request we provided, and your report includes, an estimate of the value of benefit costs due to military service before 1971 which includes all increases in the value of those benefits that resulted from pay raises granted by the Postal Service. However, we in no way endorse this method, especially insofar as it permits Postal compensation increases to increase the cost allocated to the Treasury. In this regard, we believe any proposed alternative method for allocating such costs should preserve the principle that any taxpayer-funded subsidy for military service should not allow the Postal Service to avoid responsibility for any increased cost to benefit accruals due to salary increases it provided. This principle was established in 1974 by P.L. 93-349 and is the foundation of the allocation method we have adopted.

Finally, we would like to address inconsistencies highlighted by the report between the Postal Service and other self supporting agencies that do not pay the CSRS dynamic normal cost including the portion for military service. First, there is absolutely no inconsistency since the advent of FERS. All participants in that system pay the dynamic normal cost, including the portion that funds military service. Second, unlike for the Postal Service, Congress never enacted special funding provisions for self-supporting

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September 21

The Honorable David M. Walker 2

agencies. As a consequence, the lack of funding for military service should not be taken as an indicator of Congressional intent concerning the appropriate funding methodology.

Sincerely,

Kay Coles James
Director

John W. Snow
Secretary of the Treasury

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