

# **CBO TESTIMONY**

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Statement of  
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on  
Financing Retirement for  
Federal Civilian Employees

before the  
Subcommittee on Civil Service  
Committee on Government  
Reform and Oversight  
U.S. House of Representatives

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## **NOTICE**

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Mr. Chairman and Members of the Subcommittee, I appreciate the opportunity to discuss the financing of the Civil Service Retirement and Disability Fund (CSRDF).

In my statement today, I will make five points:

- o The CSRDF is a set of accounts, common in the federal budget, for recognizing the cost of deferred compensation as it is earned and the liabilities that have accumulated for future payments. That accounting may give the illusion that the government is setting aside funds to pay future benefits. Unlike private pension funds, however, the trust fund has no independent capacity to make future payments.
- o Financing for civil service retirement benefits is on a pay-as-you-go basis. Benefits paid each year are financed by federal revenues received that year, including payroll tax contributions paid by federal employees.
- o The retirement fund does not face a financial crisis. Over time, the ratio of beneficiaries to the revenue base does not surge. In fact, the demand on the general fund declines in constant dollar terms after 2015.
- o The Administration's proposal to increase agency contributions for Civil Service Retirement System (CSRS) employees could make



agencies more aware of the cost of doing business but is not intended to cause additional changes in the budget.

- o Turning the CSRDF into a pension fund comparable to those sponsored by state and local governments or private firms would entail a fundamental policy change. Financial resources would have to be accumulated outside of government as retirement benefits were earned. A substantial increase in federal debt held by the public would be required in the near term to finance the new pension fund.

## AN OVERVIEW OF FINANCING FOR FEDERAL RETIREMENT

Federal retirement benefits are an important part of the total compensation offered by the government to attract and retain a skilled workforce. Most civilian federal employees are covered by one of two retirement programs. The Federal Employees' Retirement System (FERS) covers civilian employees hired since January 1984 and earlier hires who elected to join--a total of 1.3 million employees. FERS is integrated with Social Security, in which workers covered by FERS also participate. In addition to the defined benefits of FERS, the government makes automatic and matching contributions on the behalf of workers covered by FERS to the Thrift



Savings Plan (TSP), a defined contribution plan similar to 401(k) plans offered by private employers. The defined benefit program of the Civil Service Retirement System covers most civilian employees not in FERS. Only a few of the 1.5 million employees who are covered under CSRS participate in Social Security as part of their federal employment. Both FERS and CSRS defined benefit payments are made out of the Civil Service Retirement and Disability Fund.

### What Is the Civil Service Retirement and Disability Fund?

The CSRDF is a federal trust fund--an accounting entity used to report the cost of retirement to the government and the inflow of employee payroll taxes (contributions) to the defined benefit plans. Even though it is referred to as a trust fund, the CSRDF bears almost no resemblance to a private pension fund, nor was it intended to do so. A private pension fund consists of a pool of assets--that is, claims on real resources set aside and managed by fiduciaries for the exclusive benefit of recipients. By contrast, the CSRDF is a set of entries on the government's books. Although the fund is effective in accounting for contributions from employees and agencies and for amounts to be paid to annuitants, the only asset the account holds consists of paper balances at the Treasury. Those balances do not constitute a claim on specific assets outside the government but rather rely on the power of the government to levy taxes in the future.





The CSRDF is simply a ledger that is useful in measuring costs and liabilities. Unfortunately, it is also a source of misinformation and confusion. When the government collects payroll taxes from its employees, it earmarks those receipts by crediting the collection to the trust fund. Those monies, however, go directly into the Treasury's cash balances where they are used to pay the government's bills as those come due--including the current month's federal retirement benefits. When the flow of collections from current employees is insufficient to cover all of the current period's expenses for benefits, the Treasury must obtain resources from taxpayers now or later by borrowing. Thus, the federal retirement system for civilian employees is on a pay-as-you-go basis, as is military retirement, Social Security, and the rest of the federal government.

The government could hardly do otherwise because a federal account cannot "fund" future payments without purchasing claims on private resources. If the government attempted to purchase and hold stocks and privately issued bonds to pay future federal pensions, it would require more than \$850 billion of such assets just for the civil service retirement program. Another \$630 billion would be required for the military retirement program. If borrowing and investing that amount were to occur, federal outlays and the deficit would increase and the government's pension fund could become the country's largest stockholder.



Funding the federal pension liability with private assets is not necessary to ensure that retirees receive their benefits. Private pension funds are required to be funded to protect workers' pension benefits in case the employer goes out of business. The federal government does not risk business failure, since it has the sovereign authority to tax.

#### How Does the Retirement Fund Accumulate Balances?

Balances in the CSRDF represent the cumulative difference between income to the fund from all sources and the benefits paid out of the fund. As shown in Table 1, the retirement fund collects two types of income--intragovernmental transfers and payments from those outside the government (federal employees and the Postal Service, whose employees are eligible for federal pensions). Most workers covered by CSRS contribute 7 percent of their salaries to the fund, but they pay no Social Security taxes. Most FERS employees also pay 7 percent of salary toward their retirement, but only 0.8 percent goes to the CSRDF with the remainder used to pay their 6.2 percent share of the Social Security tax. Employees contributed \$4.7 billion to the fund in 1993, the most recent fiscal year for which a complete report is available from the Office of Personnel Management. The Postal Service, which is technically off-budget, paid in \$4.8 billion.



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TABLE 1. TRANSACTIONS OF THE CIVIL SERVICE RETIREMENT AND  
DISABILITY FUND, FISCAL YEAR 1993 (In billions of dollars)

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Transaction	Amount
Employee Contributions	4.7
Postal Service Payments	4.8
Agency Contributions (Non-postal)	7.7
Government Payments for Past Service Liabilities (Non-postal)	20.2
Treasury Interest Payments	25.5
Total Fund Income	62.9
Total Fund Expense	35.1
Net Effect on the Budget Deficit (Employee contributions and Postal Service payments minus fund expenses)	25.6

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SOURCE: Office of Personnel Management.

NOTE: The shaded entries reflect the purely bookkeeping entries. Postal Service contributions are treated differently than other agency contributions because those payments are assumed to be recouped through stamp charges.

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The government--that is, taxpayers--must pay all of the costs of federal retirement not financed by employee contributions and Postal Service payments. The concept of normal cost provides a convenient measure of that total. Normal cost is the constant percentage of pay that would have to be invested at a specified rate of interest each year over the working life of a typical group of new employees to finance fully all of their retirement benefits. Currently, the normal cost of defined benefits is estimated to be 12.2 percent of payroll for FERS employees and 25.1 percent for CSRS employees. Inasmuch as FERS and CSRS employees contribute 0.8 percent and 7 percent of pay to the CSRDF, respectively, agencies must contribute 11.4 percent of pay for FERS employees (plus 6.2 percent for Social Security and 3.6 percent for the TSP) and 18.1 percent for CSRS employees to fully cover normal costs. Agencies currently make the requisite payment for FERS employees. For CSRS employees, however, agencies only match the employee contribution of 7 percent of pay. That partial payment by the employing agencies results in a normal cost shortfall of 11.1 percent for CSRS employees.

Financing flows from the agencies to the CSRDF are nearly \$8 billion a year, even though the agencies are not covering normal costs for CSRS employees. The deficiency in agency payments means that CSRDF inflows are less than the normal cost of benefits to be paid. That shortfall has necessitated payments to the CSRDF for past service liabilities, which are intended to make up for the failure of agencies to contribute full normal costs in the past. Although those adjusting transfers





amounted to more than \$20 billion in 1993, they are less than is needed to close the normal cost gap. Accordingly, even with those extra credits, the accounting shortfall, which has accumulated to \$540 billion, is projected to increase until CSRS employees retire.

Another source of income to the retirement fund is interest from the Treasury. Those intragovernmental interest payments are critical to CSRDF because normal cost--the basis for agency FERS payments--is calculated as the amount that, if invested at interest, would grow to the value of benefits to be paid to retirees in the future. The use of normal cost, therefore, requires that interest be earned on CSRDF balances.

The retirement fund paid out \$35.1 billion in benefits and operating expenses in 1993. That outflow was almost \$28 billion less than the \$62.9 billion in total income of the account in the same period. That excess of income over outgo added to the fund's interest-bearing balance at the Treasury, bringing the total balance to \$317 billion at the end of 1993. Note, however, that in terms of the transactions between the government and the public (those payments that involve cash), the fund paid out more than it received. In fact, CSRDF transactions with others increased the federal borrowing requirement by \$25.6 billion in 1993.



### What Is the Significance of the Unfunded Liability?

As of October 1, 1993, the value of retirement benefits already earned by current employees and annuitants was \$857.5 billion (see Table 2). The retirement fund account had interest-bearing claims on the Treasury of \$317.4 billion. That amount leaves an "unfunded liability" of \$540.1 billion, almost all of which is the result of underfunding CSRS benefits.

Some people have described that unfunded liability incorrectly as the cost of federal retirement that future taxpayers must bear. In fact, unless the federal government renegotiates its pension promises, future taxpayers must pay the entire earned benefit of \$857.5 billion. The retirement fund's balance of \$317.4 billion at the Treasury is merely the cumulative excess of credits to that account over and beyond payments it made to others. The difference between that balance and the total liabilities of the fund reveals only the extent to which the cost of future benefits has not yet been recognized in the budget. But it is the whole of future benefits that taxpayers will have to pay, funded or not.

Of course, the retirement fund could be fully funded by an intragovernmental transfer of \$540.1 billion from the Treasury to the fund. That bookkeeping entry, which would require that the federal debt ceiling be raised by that amount, would cost taxpayers and the government nothing, but it would increase the CSRDF's



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TABLE 2. STATUS OF THE CIVIL SERVICE RETIREMENT AND DISABILITY FUND  
ON OCTOBER 1, 1993 (In billions of dollars)

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	CSRS	FERS	Total
Actuarial Accrued Liability	815.0	42.5	857.5
Less: Net Assets in Fund	276.7	40.7	317.4
Unfunded Actuarial Accrued Liability	538.3	1.8	540.1

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SOURCE: Office of Personnel Management.

NOTE: CSRS = Civil Service Retirement System; FERS = Federal Employee's Retirement System.

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balance with the Treasury. Nevertheless, the burden on future taxpayers, who are ultimately liable for all obligations of the federal government, would be unaffected. Inasmuch as that bookkeeping transfer would not change the liability of taxpayers, "full funding" would not afford additional protection to annuitants against the risk of future reductions in pension benefits.

### Is the Civil Service Trust Fund Facing a Financial Crisis?

Since employee payroll taxes and Postal Service payments are the only source of real resources to the CSRDF, one can gauge the extent of its call on taxpayers by the annual difference between cash inflows from those sources and cash outflows. In 1993, cash outflows exceeded inflows by \$25.6 billion. Projections prepared by the Office of Personnel Management and reported in Table 3 show the cash flow deficit increasing to \$95 billion in 2015 and \$185 billion in 2035. Stated in constant 1994 dollars, however, the fund's deficit in 2015 is \$41 billion and declines to \$33 billion in 2035.

Although the projected cash flow deficits of the retirement fund appear to be manageable under the current pay-as-you-go policy, the Congress has two means of reducing the burden to future taxpayers: reducing net pension benefits or increasing national saving and investment.





**TABLE 3. LONG-RANGE PROJECTIONS OF CSRDF CASH INFLOWS AND OUTFLOWS**  
(In billions of current dollars)

	2015	2025	2035
Employee Contributions	3.1	3.6	5.6
Postal Service Payments	16.7	24.4	28.1
Total Cash Inflows	19.8	28.0	33.7
Cash Outflows	114.6	166.2	218.5
Net Effect on the Budget Deficit	94.8	138.2	184.8
Net Effect on the Budget Deficit (In constant 1994 dollars)	40.8	38.3	32.9

SOURCE: Congressional Budget Office estimates based on projections by the Office of Personnel Management.

NOTE: Figures assume that the Postal Service is 20 percent of payroll.



The cost of deferred compensation to the government can be reduced by either raising the employee contribution rate or lowering the pension benefit. A cutback in pension payments can be achieved through such policies as smaller cost-of-living adjustments ("diet COLAs"), COLA delays, the use of the highest five years of pay (rather than three), or a reduced benefit accrual rate per year of service. Reducing the federal workforce, including what is already planned, will also reduce total compensation, deferred as well as current. Higher payroll contributions by federal employees would help future cash flow, although that form of financing is not common in private pensions.

The greater national income is, the more tolerable will be future tax burdens from financing federal pension benefits when they come due. One way the government can contribute to a larger national economy in the future is to increase saving and investment now. The most direct means of achieving that result would be to reduce the federal deficit. All of the measures reducing normal cost, as illustrated above, would reduce the deficit, but so would policy actions far removed from the federal retirement arena.

Neither the \$540 billion unfunded liability nor the annual cash deficit of the retirement fund signals a financial crisis. The government will be able to meet its retirement obligations from anticipated tax revenues. Efforts to reduce the cost of the system and limit taxpayer burdens further should weigh the effects of such actions



on hiring and retaining employees and on the credibility of the government as an employer.

## THE ADMINISTRATION'S PROPOSAL

The Administration believes that accurately measuring federal program costs is essential to improving the effectiveness of the federal government. The failure of agencies to pay full normal cost in unfunded plans and for CSRS employees means that both agency operating expenses and retirement trust fund collections understate deferred compensation earned by federal employees in the current period. That understatement may misinform managerial decisions relating to the size and composition of the federal workforce, the use of more capital-intensive production processes, initiatives for early retirement, and contracting out. Accordingly, the Administration proposes charging all federal agencies the full cost of pension benefits as earned. The intent is to establish a consistent, comprehensive, and timely measure of labor costs, even though that would not affect the current pay-as-you-go financing of federal retirement.

For all pension plans, including those in several federal agencies that currently recognize no accrual of pension costs, the Administration's plan would



increase agency labor costs by \$5.3 billion per year. Those intragovernmental transfers, however, would not affect budget outlays or the budget deficit. If the discretionary spending cap that limits budget resources under the Budget Enforcement Act (BEA) was adjusted upward by \$5.3 billion, then no staff reductions or other cuts in agency spending would be necessary. However, if the cap was not adjusted, those other cash outlays would have to be reduced. The Office of Management and Budget proposed that the cap be adjusted.

The Administration also proposes a series of intragovernmental transfers from the Treasury to the CSRDF that would eliminate the trust fund's \$540 billion unfunded liability over 40 years. The only advantage of spreading that transfer over 40 years is to avoid an immediate, large increase in the federal debt limit, which includes government trust fund holdings of Treasury securities. If, however, it is desirable to improve the accuracy of the accounting through full funding, then it would be desirable to do so sooner rather than later. Moreover, inasmuch as that transfer could be accomplished entirely on the books of the federal government, there is no economic cost of doing so. Such a one-time accounting transfer would enable the fund balances to reflect more accurately the amounts that the government has committed itself to pay.

In sum, accounting proposals that reduce or extinguish the unfunded liability do not affect the retirement program's soundness or affordability. The





Administration's proposal to convey a half a trillion dollars in Treasury securities to the retirement fund over 40 years can only be explained as an effort to improve the informational content of the CSRDF's asset balance. If that is the goal, the payment might be made all at once because it creates no burden. Another view is that the pertinent information already exists in the annual actuarial reports of the CSRDF. That information need not be registered in a retirement trust fund at all.

#### MOVING THE CSRDF EITHER OFF-BUDGET OR OUTSIDE THE BUDGET

Social Security and the Postal Service are off-budget entities under current law. As such, their accounts are segregated within the unified budget. In addition, Social Security by law is exempt from enforcement of pay-as-you-go procedures under the BEA. To provide federal retirees with protection similar to that of Social Security recipients, some analysts have advocated off-budget status for the retirement funds. H.R. 103, introduced by Congressman Bilirakis, is an example of giving off-budget status to the Civil Service Retirement and Disability Fund, although it may not provide the same protection that is given to Social Security recipients. The BEA, however, already exempts federal retirement payments from being cut in a sequestration. A change in budget status will not necessarily further insulate federal retirement benefits from cutbacks. Moreover, placing the retirement fund into the



off-budget category changes neither the pay-as-you-go financing of federal retirement nor the budget totals.

In contrast, placing the CSRDF outside the budget, rather than merely off-budget, implies a fundamental change in financing retirement benefits. Following the state and local government and Thrift Savings Plan model, funds would be invested outside the government as benefits were earned. That approach would require the government to provide the pension fund with \$857.5 billion in cash or government securities--the amount needed to pay benefits already earned. That transaction might have significant short-run macroeconomic consequences, unless it was spread over time. It would also require a major increase in the debt ceiling.

Moving the CSRDF outside the budget would also mean that transactions between the retirement fund and other government accounts would no longer be intragovernmental. Agency contributions and Treasury interest payments to the CSRDF would increase budget outlays and the deficit, as shown in Table 4. In fact, shifting the budget status of the CSRDF would increase the deficit by about \$50 billion annually. Despite that change in the budget, neither the benefit payments to current annuitants, the benefits earned by current employees, nor the cost to the government would change. Over the long term, federal outlays would be unaffected. Spending now projected to occur in distant out-years would be reduced by shifting spending to nearer-term budgets.



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TABLE 4. THE BUDGET'S REACH: WHAT IS COUNTED IN THE DEFICIT?

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Transaction	<u>Civil Service Retirement and Disability Fund</u>	
	In the Budget	Outside the Budget
Employee Contributions	Yes	No
Postal Service Payments	Yes	No
Agency Contributions	No	Yes
Treasury Interest Payments	No	Yes
Benefit Payments	Yes	No

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SOURCE: Congressional Budget Office.

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If only FERS was fully funded and moved outside the budget, the effects on the deficit and debt held by the public would be less than from moving the entire CSRDF outside the budget. A one-time budget outlay of \$42.5 billion would have fully funded FERS in 1993. The annual deficit would have been about \$8.5 billion higher.

Moving the retirement funds outside the budget raises a number of non-budgetary issues. The new retirement fund, which might invest in private securities, would need a well-defined policy on the extent to which it would exercise its authority over management of private firms. If the investment returns to the new CSRDF were less than expected, the government would have to make additional contributions to the system, unless the retirement plan was converted to a defined contribution system. To maintain the current level of indexing for price inflation, the new pension fund would probably need to hold assets whose income is also indexed. Such dollar-denominated assets do not currently exist in the quantities required to fund federal pension benefits.

Putting the retirement fund outside the budget would have three potential advantages. First, the budget would recognize retirement costs as they are incurred, which is when they are most controllable. Second, retirees would have more assurance that their earned benefits would be paid in full. Third, current taxpayers would pay the current cost of providing government services, which might improve





intergenerational equity. In sum, moving the fund outside the budget might encourage better planning up front by the Congress, agencies, and employees.

Besides increasing the deficit and debt held by the public, moving the fund outside the budget has three potential costs. First, it would create new opportunities to report budgetary savings that might be illusory. For example, critics charge that state and local governments have artificially lowered their budget outlays by manipulating the assumptions that determine their required contributions to the plans. Second, revisions in the actuarial estimates of costs and liabilities could result in shifts of billions of dollars in either direction between the Treasury and the retirement funds, which would reduce budget stability. Third, no matter how cleverly the option is legislated, many budget experts believe that the Congress will still be able to reduce the deficit by cutting benefit payments to retirees. In fact, the only way to protect earned benefits completely would be to switch to defined contribution plans like the TSP.

## CONCLUSION

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In sum, Mr. Chairman, it is fair to say that if the accumulated unfunded liability of the retirement fund is perceived as a problem, it could be corrected at the stroke of



a pen without economic costs. The unfunded liability appears to be a problem only because of the financial illusion created by the retirement trust fund. In fact, the government has no assets that can be used to spare the American taxpayer the burden of paying all of the liabilities that the government has accumulated for future pension benefits. Seen in perspective, however, that burden does not appear unmanageable. In constant 1994 dollars, the draw on the general fund actually declines after 2015.

The Administration's proposal is designed to perfect the budgetary accounting for retirement benefits so that all normal cost is recognized on the books of the federal government as benefits are earned. Moving the retirement fund to off-budget status, as has been done for Social Security, would have no significant effect on the financing of benefits. Moving the retirement fund outside the budget would require a fundamental change in financing and could have significant macroeconomic consequences.

In closing, Mr. Chairman, I would urge the Committee to evaluate those proposals not only in terms of their costs but also in light of their effects on the ability of the government to recruit and retain a skilled workforce and, relatedly, on the credibility of the federal government as an employer.

