Statement of

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before the

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Mr. Chairman:

Last year the House Budget Committee asked the Congressional Budget Office to study the financing of the civil service retirement system, including possible changes in employee contribution rates. It was requested as a follow-up to previous CBO papers that have focused on existing retirement benefits. I am pleased to highlight the results of our analysis.

My statement this afternoon will address four questions:

- Does current financing provide adequate income to the civil service retirement (CSR) fund?

- Should federal operating programs reflect the full cost of future retirement benefits for active workers?

- How reasonable is the cost to the government for civil service retirement?

- What possibilities could be considered for changing the present system?

## Financial Condition of the CSR Fund

Currently about 2.4 million federal civilian employees must contribute 7 percent of pay to the civil service retirement system. These withholdings, together with matching agency contributions, are not sufficient to fund future cost-of-living adjustments for annuitants or all retirement costs associated with pay adjustments for active workers. Thus, current contribution rates are inadequate to finance future retirement benefits for active federal employees and benefit payments to existing CSR annuitants. The solvency of the CSR system thus depends upon annual federal payments from the general fund of the U.S. Treasury.

Annual payments from the U.S. Treasury in fiscal year 1982 will reach $14.1 billion and account for 46 percent of CSR fund income. These payments, authorized in 1969, mainly reimburse the fund for: (a) interest forgone on the system's unfunded liability; and (b) increased long-term retirement costs that are associated with benefit liberalizations or pay increases. So long as these federal payments continue under current law, the fund will have substantial resources to meet future requirements.

In fiscal year 1980, annual CSR income from all sources exceeded annual outlays by some $9.5 billion, and balances in the fund increased to $73.3 billion--a ratio of five times annual outlays. According to economic assumptions of the CSR Board of Actuaries, this ratio of reserves to outlays will remain relatively constant over the next 50 years--signaling a sound cash position for the fund over the long run. Without the federal payments, however, the financial condition of the CSR fund would change dramatically. If there had been no federal payments from fiscal year 1970 through 1980, balances in the CSR fund would have declined to negligible levels in 1979 and the CSR fund would have been depleted in 1980 and subsequent years. On this basis, annual losses through 1986 would accumulate to an estimated $80 billion.

Although the government--through its taxing power--provides the ultimate assurance that CSR obligations will be met, some view the system as if it were similar to a private pension plan. From this perspective the system is not actuarially sound--largely because cost-of-living provisions are not fully recognized under current financing. The actuarial deficiency, commonly referred to as unfunded liability, represents the difference between the system's assets (current reserves plus future income) and the cost of future benefits for current employees and annuitants.

According to traditional calculations by the Office of Personnel Management, CSR unfunded liability has increased from $52.8 billion in fiscal year 1970 to $166.4 billion at the end of fiscal year 1980. This 215 percent increase has occurred largely because of statutory provisions that automatically adjust benefits for increases in the cost of living. For example, the two cost-of-living adjustments (COLAs) effective in 1980 (6.0 percent in March and 7.7 percent in September) increased unfunded liability by $20.4 billion. Based on traditional calculations, CSR unfunded liability could reach an estimated $244 billion by fiscal year 1986, reflecting only estimated COLAs up to that time.

Traditional calculations of unfunded liability do not take into account the impact of future pay raises and cost-of-living adjustments. If these two factors were incorporated and contribution rates remained the same, the resulting dynamic unfunded liability could be more than three times the traditional estimate--$780 billion rather than the estimated $244 billion. Such estimates of unfunded liability are limited to the number of participants--employees and annuitants--covered by the CSR system at the time the calculation is made. Thus, the financial impact of new employees is not considered.

Because CSR is a public pension program, cash position is a more relevant measure of the fund's solvency than calculations of unfunded liability. It is important to keep in mind that the CSR trust fund serves mainly bookkeeping purposes within the federal budget and that, in reality, the program operates on a pay-as-you-go basis. That is, the payroll withholdings and federal taxes from the current generation of federal employees and other taxpayers finance the benefits of current annuitants.

Recognition of CSR Costs in Agency Budgets

Because the current CSR withholding rates do not reflect all retirement costs associated with annual pay raises or post-retirement cost-of-living increases, agency operating budgets greatly understate the true cost of federal activities.

The long-term CSR cost to the government, expressed as a level percentage of payroll, is estimated by the CSR Board of Actuaries at 29.5 percent as contrasted with the current agency contribution rate of 7.0 percent. The estimate, representing the difference between the current employee contribution rate of 7.0 percent of pay and the estimated full CSR cost of 36.5 percent of pay, includes the impact of future salary increases and annuity cost-of-living adjustments.

Even though the CSR fund depends upon federal payments as partial compensation for the low current contribution rate, federal managers are not required systematically to use accurate data on the true cost of their programs. The current agency contribution rate for CSR noticeably understates the average personnel cost for most agencies. For example, the accrued CSR costs for the IRS and the National Park Service are understated by some $28 million and $59 million, respectively, in fiscal year 1981.

Earlier reports by the General Accounting Office and the Congressional Budget Office have observed that increasing the agency contribution rate to reflect the full CSR cost to the government would improve cost accounting and the basis for program and budgetary decisions. GAO also notes that the existing agency contribution rate results in unrecognized subsidies to the U.S. Postal Service and other public enterprises. Off-budget agencies also receive another indirect subsidy because they are not charged for a portion of the payments in lieu of interest on CSR unfunded liability, even though they account for part of the cost. Taken together, the existing contribution rate and federal payments for interest forgone generate indirect subsidies for the Postal Service and other off-budget agencies estimated at $4.8 billion in fiscal year 1982.

## The Government's Obligation of Future CSR Costs

The rate of CSR outlay growth is increasing rapidly. In fiscal year 1986, total outlays from the CSR fund are projected at $30.8 million. This represents a 55 percent, or $10.9 billion, increase over 1982 outlay levels. From another perspective, annual CSR outlays over the past decade have increased at more than one and one-half times the rate of increase for federal purchases of defense and non-defense goods and services. Under current law the trend is expected to continue at a lower differential--the CSR rate of increase being 30 percent greater than for federal purchases from 1982 through 1986.

Under existing employee withholding rates, the federal government will ultimately pay approximately 80 percent of the retirement costs for federal employees as a group. In the short run, the annual out-of-pocket burden of CSR on the federal budget represents the portion of outlays not covered by receipts from employee withholdings and payments from off-budget federal agencies such as the U.S. Postal Service. These annual costs, in 1980 dollars, are estimated to triple during the next 50 years--reaching $27 billion in the year 2030.

Before discussing the reasonableness of these costs to the government, it might be helpful to identify some of the major CSR benefit provisions that have greatly contributed to the high costs and rapid increase of CSR outlays--namely early retirement, favorable benefit computations, and full cost-of-living adjustments.

Early Retirement and Benefit Computations. Federal employees retire at much earlier ages than do employees in the private sector. Under the CSR system, federal employees may retire as early as age 55, if they have 30 years of federal service. Private pension and Social Security benefits are usually based on retirement at age 65. Although private pension plans often provide for earlier retirement, the benefits are substantially reduced to reflect the longer pay-out period. In addition, Social Security may not be received (even at a reduced level) until age 62, therefore influencing the retirement age in the private sector. According to our earlier findings, approximately 80 percent of male retirements under private plans occur at age 62 or later, as compared with 36 percent for male civil servants. Nearly half of all male civil service retirements occur before age 60, as compared with less than 10 percent of the male work force covered by Social Security and a company pension.

The amount of a federal employee's civil service annuity is determined by his average annual salary for the three years of highest earnings (referred to as the "high three"). A representative plan in the private sector provides an annuity based on an employee's average annual salary for the five years of his highest earnings and a lower benefit rate for each year of service. Given the same wage history, the civil servant's annuity will be higher than that for his private-sector counterpart.

Cost-of-Living Adjustments. Under current law, civil service retirees receive automatic adjustments for increases in the cost of living. The adjustments occur twice a year and represent, without limitation, the full increase in inflation as measured by changes in the Consumer Price Index (CPI). The cost-of-living adjustments provided federal employees are becoming progressively more expensive every year. For example, in October 1980 each percentage-point adjustment caused annual outlays to increase by $175 million, while in October 1985 each percentage-point adjustment is projected to add $308 million to outlays.

According to the General Accounting Office, federal cost-of-living adjustment provisions are far superior to those available to private industry and state and local government retirees. Various other studies agree that federal retirees receive better protection from inflation than is generally available in the private sector. Most significantly:

- Only a small percentage of private-sector plans (4 to 8 percent) have an explicit COLA provision, and a large majority of these limit the adjustment to a maximum annual increase of 2 to 5 percent. Nearly 40 percent of private-sector plans do not grant cost-of-living increases of any kind;

- Retirees with private pension plans receive, as a group, COLAs averaging between 30 and 33 percent of changes in the CPI;

- Bankers Trust surveyed plans that granted post-retirement increases of any kind during the six-year period 1975-1981: none granted increases every year; 45 percent gave one increase; 35 percent gave two increases; 10 percent gave three to four increases; and only 10 percent gave five increases; and

- o If federal employees, as a group, retired under Social Security and a representative private pension plan, they would recover approximately 70 percent of the annual rate of inflation over a period of years--although adjustments in a company plan are unlikely to occur each year.

Are Federal Costs Reasonable?

There is no statutory or generally agreed-upon criterion for evaluating the reasonableness of CSR benefits and associated federal costs. Employee organizations and others maintain that the costs incurred by the government are justifiable in view of its commitment to existing retirees and its responsibility as a model employer. From this perspective, the standard for evaluating federal costs would not be comparability with retirement practices in the private sector. It is also argued that a more liberal federal retirement system is recompense for federal salary levels that were comparatively low until the 1960s and in recent years have been held below pay comparability as currently defined.

Taxpayers, as well as some civil servants and federal managers, may on the other hand view CSR costs as excessive, especially when compared to private-sector pay and benefit practices. From a managerial viewpoint, recruitment and retention of qualified federal employees could be enhanced if deferred fringe benefits such as retirement were decreased somewhat in order to raise current salaries. Many professionals and younger employees, who do not foresee long federal careers, may give greater weight to salaries than to retirement benefits if they are offered higher salaries in the nonfederal sector. This issue is especially critical in view of the caps imposed on federal pay in each of the last three years and proposed again for fiscal year 1982.

Civil Service Retirement Compared to Private Sector Practice. Civil service retirement benefits are much greater than those typically available in the private sector. From this point of view, the costs to government of the current CSR system are excessive.

Most private pension plans are noncontributory--that is, the costs are paid entirely by the employer. Employees in the private sector do, however, contribute to the Social Security system, which has the advantage of providing tax-free retirement income. The federal employee, by contrast, pays a higher contribution but receives more liberal benefits--mainly because of provisions for retirement before age 65, the way initial benefits are calculated, and the automatic cost-of-living adjustments.

If federal white-collar employees, as a group, were covered by a representative private plan plus Social Security, the benefits paid by the federal government would cost 18 to 22 percent of salary. We estimate that this would be two to eight percentage points of pay lower than the cost of current CSR provisions--depending on the particular methodology, data, and assumptions used in the comparison.

Putting it another way, if existing CSR employee contributions were increased from 7 to 9 percent of pay, or by two percentage points, the value of retirement benefits not paid by employees would still be competitive with those available in the private sector--incorporating the estimated tax-free advantage of Social Security income. The cost to the government could also be reduced, of course, by continuing current contribution rates but changing certain benefit provisions such as early retirement and cost-of-living.

Possibilities for Changing CSR

Proponents of the current CSR system point out that current financing will provide adequate income to maintain substantial reserve levels in the CSR fund over the next 50 years, and argue that the government has a responsibility for maintaining a model retirement program fully protecting annuitants from erosion due to inflation.

Advocates for change make the following counterarguments:

- Existing contribution rates do not recognize "true" costs because they exclude the impact of future cost-of-living adjustments and annual pay raises;

- According to estimates of unfunded liability, the funding of the CSR system is grossly inadequate on an accrual basis; and

- The federal costs of the CSR system are excessive because benefits are more liberal than those provided in the private sector.

Several possibilities exist for changing the current CSR system either as a means of improving the recognition of retirement costs in the budget, helping reduce the cost to the government, or bringing the government's cost for civilian retirement closer to that which would obtain if private-sector practices were adopted.

This afternoon I would like to summarize the types of changes that would reduce costs to the government--either through changing benefit provisions or increasing CSR contribution rates.

Once-a-Year COLAs. The Carter and Reagan budget messages, and CBO's report Reducing the Federal Budget, identify various options for changing CSR cost-of-living adjustments to a once-a-year cycle. The current semiannual adjustments are more frequent than the once-a-year increases provided Social Security beneficiaries, and in recent years have exceeded the pay adjustments provided active employees. From October 1978 through October 1980, cumulative adjustments for federal retirees totaled 33 percent while the comparable pay adjustments for federal white-collar employees totaled 23 percent.

The Carter and Reagan administrations have both proposed that the October COLA be eliminated beginning in 1981 and that annual adjustments occur each March beginning in 1982. The CBO budget reduction report (pages 146 and 147) indicates that more stringent indexation provisions could also be considered: the calculation period could be from first quarter to first quarter, as with Social Security, and the size of future increases could be limited to the lesser of increases in prices or wages as measured by the CPI and the average wage index. These more severe changes would increase potential savings in fiscal year 1982 to $1.1 billion, using published CBO baseline estimates.

Limits on Benefits for Early Retirement and on the Size of COLAs. In addition to once-a-year COLAs, the size of the adjustments could be limited and benefits reduced for persons who choose to retire before age 65. The annuity reductions for early retirement could begin at 1 percent for employees retiring at age 64 and progressively increase up to 20 percent for retirement at age 55. The size of annual COLAs could be based on private-sector practices--limited to about 70 percent of changes in the CPI.

These changes in indexation and early retirement provisions would together bring CSR benefits and long-term costs closer to those that would prevail if private-sector retirement practices were adopted. In the short run, the lower benefits would reduce CSR outlays by $4.8 billion in fiscal year 1986 and by some $14.1 billion over the five-year period 1982-1986. The five-year outlay savings would equate to additional pay raises accumulating to 6.3 percent over the same period.

Opponents of limitations on cost-of-living adjustments and on changes in early retirement argue that the government has a responsibility--as a model employer--to provide an exemplary retirement system, and that such changes would be a breach of faith with existing employees.

Increase in CSR Contribution Rates. Numerous possibilities exist for reducing CSR costs by increasing current contribution rates. Proposals to change the agency contribution rate are advanced mainly as a means to improve cost accounting, but could reduce the CSR subsidy enjoyed by off-budget agencies.

If the agency contribution were to reflect the full actuarial cost to the government, the rate would need to be increased from 7 to 29.5 percent of payrolls. For most agencies this would represent an internal budget transaction from one budget account to another. For off-budget agencies, however, mainly the U.S. Postal Service and the D.C. Government, the additional income could reduce annual costs to the government by $4.2 billion in fiscal year 1986 and $18.7 billion over the five-year period 1982-1986.

A much greater reduction in long-term costs could be achieved if some of the burden for increased CSR withholdings were shifted to federal employees. One approach would increase employee contribution rates from 7 to 9 percent of pay. This two-percentage-point increase would represent about half the estimated additional actuarial cost of providing COLAs equal to 100 percent of changes in the CPI rather than to the 70 percent estimated under private-sector practices. Thus, federal retirees would continue to receive greater protection against inflation but would pay part of the extra cost while employed.

A two-percentage-point increase could be phased in over three or four years and would bring the long-term costs to the government into line with those that would be experienced if the government adopted practices equivalent to Social Security and a representative private pension plan. The higher employee withholdings, together with existing retirement benefits, would not place CSR at a comparative disadvantage with prevailing private-sector retirement practices.

The higher employee contributions would substantially increase receipts to the government, and thus its ability to meet future obligations. The additional, receipts from employee contributions and off-budget agencies could reach $5.8 billion in fiscal year 1986 and $18.4 billion over the five-year period 1982-1986.

Employee organizations would strongly oppose a mandatory increase in withholding rates because most private plans, albeit providing less liberal benefits, do not require employee contributions. Moreover, an increase in the CSR withholding rate would widen an existing take-home pay disparity between many federal and non-federal employees. Current disparities exist largely because of limits on federal salary adjustments and the frequent use of across-the-board adjustments rather than differential increases for various levels of work and job responsibility.

In conclusion, Mr. Chairman, I would like to reiterate that there are different perspectives for evaluating CSR benefits, financing provisions, and associated costs to the federal government. As the Congress moves to constrain federal spending, numerous possibilities could be considered for changing the current CSR system through two basic approaches--reducing future benefits or increasing contributions by employees and off-budget agencies. I appreciate this opportunity to share CBO's findings regarding the civil service retirement system.

Thank you, Mr. Chairman.