REPORT TO THE CONGRESS

BY THE COMPTROLLER GENERAL OF THE UNITED STATES

Cost-Of-Living Adjustment Processes For Federal Annuities Need To Be Changed

The cost-of-living adjustment processes for Federal retirement annuities have resulted in annuities' increasing faster than the cost of living and Federal white-collar pay rates. This has been caused by the extra 1-percent increases which are granted to annuitants, by law, each time their annuities are adjusted for increases in the cost of living. The Federal annuity adjustment processes are more liberal than those of non-Federal pension systems. Existing law also permits new retirees to benefit from increases in the cost of living which occurred long before they retired.

FPCD-76-80 ~~703178~~ JULY 27, 1976

COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON, D.C. 20548

B-130150

To the President of the Senate and the
Speaker of the House of Representatives

This report discusses needed changes in the Federal annuity cost-of-living adjustment processes for the Congress to consider in evaluating proposed legislation to modify the processes.

The existing processes have resulted in annuities' increasing faster than the cost of living and Federal white-collar pay rates. Annuity adjustments since 1969 have totaled 72 percent, although the Consumer Price Index has increased only about 56 percent and white-collar pay rates have increased 58 percent. The adjustments are extremely costly--the 72-percent increase added about $28 billion to the civil service system's already high unfunded liability. They are more liberal than those of non-Federal and other Federal pension systems.

The initial adjustment for new retirees inflates the basic annuity, encourages valuable employees to retire, and escalates the cost of retirement.

We made our review pursuant to the Budget and Accounting Act, 1921 (31 U.S.C. 53), and the Accounting and Auditing Act of 1950 (31 U.S.C. 67).

Comptroller General
of the United States

Contents

ABBREVIATIONS

CPI Consumer Price Index

GAO General Accounting Office

COST-OF-LIVING ADJUSTMENT PROCESSES FOR FEDERAL ANNUITIES NEED TO BE CHANGED

A pension system operates on the premise that those who have worked are entitled someday to stop working and to receive a retirement income as a right earned through their past service. Inflation--particularly the recent double-digit inflation--shrinks the purchasing power of all Americans. Pensioners, annuitants, and others on fixed incomes are the most adversely affected.

The annuities of those under the civil service, uniformed services, foreign service, Central Intelligence Agency, Federal Reserve Board, District of Columbia judges, and District of Columbia public school teachers retirement systems are automatically adjusted whenever the Consumer Price Index (CPI) increases at least 3 percent over the CPI of the previous base month and remains at this higher level for 3 consecutive months. Annuitants receive cost-of-living adjustments equal to the highest CPI percentage increase during the 3-month period, plus 1 percent. Annuity increases are effective on the first day of the third month following this period.

The 1-percent add-on has resulted in annuity increases in excess of the amount needed to maintain annuitants' purchasing power at retirement.

There have been several proposals to revise the annuity adjustment processes, ranging from the President's proposal for outright elimination of the extra 1-percent increase to other modifications which would also eliminate the add-on but make other changes in the process. (See app. I for the legislative status and brief descriptions of the bills.)

This report updates GAO's comments to various congressional committees and to individual Congressmen on the cost-of-living adjustment processes for annuities. The following comments are generally limited to the civil service retirement system, since it is the largest system and often leads the other systems to change. Most of our observations also pertain to the other Federal systems.

Public Law 94-350 dated July 12, 1976, provides that the 1-percent add-on provision of the foreign service system be repealed if the civil service add-on is repealed. Public Law 94-361 dated July 14, 1976, provides that any changes which are made in the method of computing cost-of-living adjustments for civil service retirees automatically apply to military and Central Intelligence Agency retirees.

ONE-PERCENT ADD-ON RESULTS IN INCREASED PURCHASING POWER OF ANNUITIES

The commonly held conception of the purpose of the annuity adjustment process is that it is intended to protect the purchasing power of retirees' annuities. But the legislative history is not clear.

The record indicates that the House Post Office and Civil Service Committee, in approving the 1-percent add-on feature in 1969, intended to insure maintaining purchasing power by compensating for the time lag between advances in the CPI and the actual adjustment of annuities. The Senate Post Office and Civil Service Committee said it wanted the adjustment process to result in an improved standard of living for retirees, thereby indicating that increases merely to maintain purchasing power were insufficient.

Retirees have received increases in excess of the amount needed to maintain their purchasing power at retirement. Since enactment of the formula in 1969, annuities have been adjusted upward by 72 percent, but the CPI on which these adjustments were based has risen by only about 56 percent. This variance occurred because the 1-percent add-ons, which become a permanent part of the annuity base, were not considered in the CPI base when computing succeeding adjustments.

The following table shows the increases in the CPI and the resulting annuity increases for an employee who retired on October 31, 1969, with a $10,000 annuity.

Effective date of increase	Percent increase CPI	Percent increase Annuity	Annuity	Amount needed to maintain $10,000 purchasing power
Nov. 69	a/4.0	a/5.0	$10,500	$10,400
Aug. 70	4.6	5.6	11,088	10,878
June 71	3.5	4.5	11,587	11,259
July 72	3.8	4.8	12,143	11,687
July 73	5.1	6.1	12,884	12,283
Jan. 74	4.5	5.5	13,593	12,836
July 74	5.3	6.3	14,449	13,516
Jan. 75	6.3	7.3	15,504	14,368
Aug. 75	4.1	5.1	16,295	14,957
Mar. 76	4.4	5.4	17,174	15,615
Cumulative increases (compounded)	56.1	71.7		

a/Based on the increase in the CPI since December 1968, which was the base month for the preceding annuity adjustment.

The extent of overcompensation for an individual annuitant, of course, depends upon the length of time in retirement status and the rates of inflation during that time.

Annuities have been increasing faster than white-collar pay

Since 1969 white-collar pay has increased 58 percent compared with the 72-percent increase in annuities.

Annuity increases Date	Annuity increases Percent	Pay increases Date	Pay increases Percent
Nov. 1969	5.0	July 1969	9.1
Aug. 1970	5.6	Dec. 1969	6.0
June 1971	4.5	Jan. 1971	6.0
July 1972	4.8	Jan. 1972	5.5
July 1973	6.1	Jan. 1973	5.1
Jan. 1974	5.5	Oct. 1973	4.8
July 1974	6.3	Oct. 1974	5.5
Jan. 1975	7.3	Oct. 1975	5.0
Aug. 1975	5.1		
March 1976	5.4		
Cumulative increases (compounded)	71.7		57.6

Adjustments more liberal than those of non-Federal and some Federal systems

The civil service annuity adjustment process bears no relationship to the processes most non-Federal employers use for adjusting pensions. A 1974 survey by the Conference Board--an independent, nonprofit business research corporation--of the benefit programs of 1,800 major private employers revealed that only 4 percent had pension plans which were automatically adjusted for cost-of-living increases and that none provided payments in excess of the percentage rise in the CPI. In fact, the few non-Federal plans that have adjustment processes generally limit the amount of increase that can be granted in any one year. This approach is also followed by the Tennessee Valley Authority whose policy provides that cost-of-living adjustments not exceed 5 percent annually.

The civil service adjustment provision is also more liberal than that provided by social security and the Federal Employees Compensation Act (workers' compensation). Like civil service annuitants, workers' compensation recipients receive benefit increases whenever the CPI increases by 3 percent and remains at least 3 percent higher for 3 consecutive months. Workers' compensation recipients are not entitled to the extra 1-percent increase, but their benefit increases are effective 2 months earlier. Social security recipients are entitled to annual cost-of-living increases in their benefits representing the actual rise in the CPI.

Adjustments are costly

Annuity adjustments are extremely costly--adjustments of 72 percent since November 1969 have increased the civil service system's liability by about $28 billion, of which $5 billion is due to the 1-percent add-on. Looking ahead, the cost of the 1-percent provision depends upon the annual rates of inflation, but the adjustment formula will generate at least $4 billion in additional liability for each 6-percent increase in annuities.

The Government's contributions to the Civil Service Retirement and Disability Fund, as well as the unfunded liability, are growing at alarming rates. During fiscal years 1970 to 1974 the Government's contributions to the retirement fund increased by 147 percent, to $4.8 billion, or 14.7 percent of payroll. The unfunded liability increased by 46 percent, to $77 billion. Assuming the same yearly average pay and cost-of-living increases (6 percent) as occurred in fiscal years 1970 to 1974, by 1985 the Government's annual contributions to the fund will increase another 350 percent, to $21.6 billion, or about 34 percent of payroll, and the unfunded liability will increase another 168 percent, to about $207 billion.

Government contributions have increased, for the most part, because, in addition to matching the employee contributions of 7 percent of pay, the Government makes additional annual contributions to the retirement fund, including (1) interest on the unfunded liability and (2) the cost of allowing retirement credit for military service, new liabilities created by employee pay increases, liberalization of retirement benefits, or extension of retirement coverage to new groups of employees. The unfunded liability continues to increase because the annuity cost-of-living adjustments are not funded. These adjustments have occurred frequently and in large amounts.

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If the 1 percent add-on is considered necessary to compensate for the 2-month period required to effect an adjustment, it would be a fairly simple matter to revise the process to remove its overcompensating effect. For example, the CPI base could, for each succeeding adjustment, also be increased by 1 percent. Each annuity adjustment would be about the same size as that produced by the current method, but adjustments would occur less frequently--the difference's being the number of months it would take for the CPI to rise by an additional 1 percent. The same end result could be achieved by eliminating the 1-percent add-on and making the adjustment effective 2 months earlier.

INITIAL ADJUSTMENT FOR NEW RETIREES NEEDS MODIFICATION

The law permits retiring employees to benefit from CPI increases which occurred while they were still actively employed, which (1) inflates the basic annuity upon which succeeding adjustments are applied, (2) encourages experienced employees to retire rather than to continue working, and (3) escalates the costs of retirement.

The amount of a civil service retirement annuity is determined by a formula which considers an employee's average salary during his 3 consecutive highest paid years and his years and months of service, including unused sick leave. The earned annuity is a direct function of the average salary and length of service and usually increases proportionately to those two factors.

But an anomaly was introduced into the retirement system along with the periodic CPI-related adjustment provision in 1965. The 1965 law--Public Law 89-205--provided that cost-of-living adjustments be applicable to all annuities payable on the effective date of the increase. That provision permitted an employee who retired on that date to receive a higher starting annuity than an employee who retired the following day.

Historically, pay increases have exceeded CPI increases, but this is no longer true. Beginning with 1973, the high rates of inflation and the provision permitting immediate annuity increases for new retirees created an inversion problem for employees who were eligible to retire. For the most part, a decision to remain on the job resulted in lower future annuity payments.

To correct this anomaly, the law was changed in 1973--Public Law 93-136--to guarantee that a retiring employee would always receive a basic annuity at least equal to the annuity which he could have earned at the time of the last cost-of-living increase plus that increase. That amendment, which was designed to deter mass retirements immediately before a scheduled cost-of-living increase, actually encourages retirement. It allows an employee who retires immediately before a cost-of-living increase to receive that increase and to have the preceeding cost-of-living increase considered in his basic annuity calculation.

Our analysis of civil service retirements indicates that most eligible employees have timed their retirements to coincide with scheduled annuity increases. This has enabled them to receive higher starting annuities.

Federal employees should always earn a higher basic annuity by continuing to work rather than by retiring early. We believe that the annuity adjustment policy should be changed to require prorating each retiree's first annuity adjustment to reflect only CPI increases after the effective date of his retirement. This would insure higher basic annuities for continued Federal service and would encourage valuable employees who are considering retirement to remain. Additionally, it would eliminate the need for the annuity guarantee provision of the 1973 amendment.

FREQUENCY OF ANNUITY ADJUSTMENTS SHOULD BE REGULARIZED

Annuity checks are sent monthly to 1.4 million annuitants under the civil service retirement system. Each cost-of-living adjustment adds to the administrative workload and costs of the Civil Service Commission to prepare the changes 13
and the Department of the Treasury to send the initial check. 38
Also each scheduled annuity increase seems to cause a large number of additional retirements which add to the workload.

The present policy of granting adjustments each time the CPI increases by 3 percent may have outlived its usefulness. Automatic adjustments began in 1962. At that time the process called for an annual adjustment if the CPI had risen at least 3 percent during the preceding year. The process was changed in 1965 to gear adjustments to monthly changes in the CPI, because the annual process had not produced an adjustment. The legislative history of the 1965 law is silent with respect to the anticipated frequency of adjustments, but it appears that the monthly process was never intended to trigger an adjustment more often than annually. The annual rate of inflation in 1965 was slightly less than 3 percent, and it would have taken over 1 year for the process to trigger an adjustment. Annuitants received a legislated increase in 1965, but the first automatic adjustment did not occur until January 1, 1967. The next two adjustments occurred at approximately 1-year intervals.

But the situation today is vastly different. The high inflation rates experienced since 1973 have resulted in annuity adjustments about every 6 months. There have been six adjustments since the beginning of fiscal year 1974.

We believe that annual cost-of-living adjustments in annuities are desirable. They would be consistent with the process used under social security and with the processes used for adjusting the pay of active Federal employees. Annual adjustments should also reduce the administrative costs of the retirement system.

RECOMMENDATIONS TO THE CONGRESS

The Congress should enact legislation making the annuity cost-of-living adjustment formula and related provisions of the civil service, uniformed services, foreign service, Central Intelligence Agency, Federal Reserve Board, District of Columbia judges, and District of Columbia public school teachers retirement systems more equitable and more consistent with those of non-Federal and other Federal pension programs by:

--Repealing the 1-percent add-on feature or, as a minimum, eliminating its overcompensating effect by adjusting the CPI base by 1 percent each time an adjustment occurs.

--Regularizing the adjustment process by repealing the current CPI triggering mechanism and providing for annual adjustments based on the actual percentage rise in the CPI during the preceding year.

--Repealing the provisions which permit retiring employees to receive higher starting annuities because of changes in the CPI before their retirement and providing that new retirees' initial cost-of-living adjustments be prorated to reflect only CPI increases after their effective dates of retirement.

PROPOSED LEGISLATION AFFECTING ANNUITY ADJUSTMENTS

Bill number and title	Annuity adjustment provision	Status as of July 16, 1976						
		House		Senate				
		Committee	Floor	Committee	Floor	Conference	Passed	President
H.R. 12438--Authorizing appropriations for fiscal year 1977 for military procurement, research and development, and active duty, selected reserve, and civilian personnel strengths and for other purposes	Conferees agreed on language which will insure that whatever action is taken modifying the retired pay increase formula, authority will be available to apply the change to military and Central Intelligence Agency retirees, as well as to civil service retirees.	(a)	(a)	(a)	(a)	(a)	(a)	(a,b)
H.R. 14262--Department of Defense appropriation bill, 1977	Includes an amendment to cut from the bill $111.7 million for the 1-percent "kicker" on cost-of-living increases in military retired pay.	(a)	(a)	(c)				
H.R. 14520--To amend title 5, U.S.C., to revise the method of determining cost-of-living increases payable to civil service annuitants (H.R. 4331 is an identical bill.) (note d)	Will eliminate the 1-percent add-on from future civil service adjustments and accelerate the process by making adjustments effective 3 months earlier. Adjustments, equal to the percentage rise in the CPI, would be effective on the first day of the second month following at least a 3-percent rise in the CPI. (See app. II.)	(c)						

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Bill number and title	Annuity adjustment provision	Status as of July 16, 1976: House Committee	House Floor	Senate Committee	Senate Floor	Conference	Passed	President
H.R. 12891--To amend the Central Intelligence Agency Retirement Act of 1964 to eliminate the extra 1 percent added to each cost-of-living annuity adjustment	Will eliminate the 1-percent add-on from future Central Intelligence Agency annuity adjustments which would continue to occur at the same intervals as the current process	(c)						
H.R. 12921--To amend the formula for cost-of-living adjustments of annuities under the civil service retirement system	Will eliminate the 1-percent add-on from future civil service annuity adjustments which would continue to occur at the same intervals as the current process. (See app. II.)	(c)						
S.3168--To authorize fiscal year 1977 appropriations for the Department of State, the United States Information Agency, and the Board for International Broadcasting, and for other purposes	Provides that, if the 1-percent add-on is repealed for civil service retirees, it will be repealed for foreign service retirees	(a)	(a)	(a)	(a)	(a)	(a)	(a,e)
S.3134--To eliminate the 1-percent add-on to the cost-of-living increases for certain retirement benefits	Will eliminate the 1-percent add-on from future civil service, uniformed services, and foreign service annuity adjustments which would continue to occur at the same intervals as the current process. (See app. III.)			(c)				

a/Action completed.

b/Signed July 14, 1976, Public Law 94-361.

c/Under consideration.

d/Replaced H.R. 3310, 94th Cong., 1st sess.

e/Signed July 12, 1976, Public Law 94-350.

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APPENDIX I

COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON, D.C. 20548

APR 26 1976

B-130393

The Honorable David N. Henderson, Chairman
Committee on Post Office and Civil Service
House of Representatives

Dear Mr. Chairman:

By letter of April 6, 1976, you asked for our views on H.R. 12921, 94th Congress, 2d Session, a bill, "[t]o amend the formula for cost-of-living adjustments of annuities under the Civil Service Retirement System" and H.R. 3310, 94th Congress, 1st Session, a bill "[t]o amend Title 5, United States Code, to revise the method of determining cost-of-living increases payable to civil service annuitants."

I am pleased to have the opportunity to express the General Accounting Office's views on these bills. As you know, we have been concerned about the annuity adjustment processes under the civil service and other major retirement systems for Federal and District of Columbia employees. We testified on the civil service process before your Subcommittee on Retirement and Employee Benefits in November 1975. In our letters of April 2, 1976, to you and other Chairmen of key House and Senate Committees, we endorsed the elimination of the 1 percent add-on which is granted over and above the actual increase in the Consumer Price Index (CPI) each time annuities are adjusted for increases in the cost of living.

Under current law--5 U.S.C. § 8340(b)--civil service annuities are adjusted whenever the CPI rises at least 3 percent above the point which triggered the preceding adjustment and remains at least 3 percent higher for 3 consecutive months. Annuity adjustments, equal to the highest percentage rise in the CPI during the 3-month measuring period plus 1 percent, are effective the first day of the third month following that period.

Since enactment of the 1 percent add-on provision in 1969--Public Law 91-93--annuity adjustments have totaled 72 percent but the CPI on which these adjustments were based has risen by only about 56 percent. This variance occurred because the add-ons become a permanent part of the annuity base and are not considered when computing succeeding adjustments.

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H.R. 12921 and H.R. 3310 would both eliminate from future civil service annuity adjustments the 1 percent add-on feature. But, H.R. 3310 would accelerate the adjustment process by making adjustments effective 3 months earlier than either the current process or H.R. 12921. Either bill would protect retirees' purchasing power as the cost of living rises by providing periodic annuity adjustments reflecting actual increases in the CPI.

Under H.R. 12921, annuitants would receive adjustments, equal to the actual rise in the CPI, at the same intervals as under the current process, but they would not receive the added 1 percent increases. There would continue to be a 2-month lag between the time an adjustment is triggered and its effective date, but it appears to us that this process provides the adjustments as quickly as is practicable.

The enactment of H.R. 3310 would mean that adjustments, equal to the actual rise in the CPI, would be effective on the first day of the second month following at least a 3 percent rise in the CPI above that point which triggered the preceding adjustment. Thus, in addition to eliminating the add-on, H.R. 3310 would eliminate the requirement that the CPI remain at least 3 percent above the previous base for 2 additional months and 1 month of the 2-month lag before the adjustment becomes effective. Adjustments under H.R. 3310 would be smaller than those under the current law or H.R. 12921, but they would occur more frequently. For example, the Civil Service Commission estimates that between now and September 1981, H.R. 3310 would result in 8 annuity increases totaling 29 percent, while H.R. 12921 would result in 6 increases totaling 28.2 percent. It is estimated that the current law will result in 6 increases totaling almost 36 percent over that same period.

H.R. 3310 could pose administrative problems for the Commission and for the Department of the Treasury which prepares and sends annuity checks. It might necessitate a restructuring of Commission and Treasury retirement record updating and check processing schedules or the issuance of supplemental annuity checks to fully effect the adjustments. The Commission cannot determine the annuity adjustment percentage until the CPI is reported by the Bureau of Labor Statistics. The CPI for a given

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month is not available until the 20th day of the following month. Thus, H.R. 3310 would allow only about 40 calendar days to reflect the CPI increase in annuity checks which are delivered at the end of the effective month.

We fully endorse the purpose of the two bills which is to eliminate the over-compensating effect of the current adjustment process. This result would be accomplished by either bill through removal of the 1 percent add-on. We would point out, however, that excessive adjustments do not result from the add-on itself. Rather, it is the failure to consider the previously granted add-on when determining subsequent adjustments that causes the overcompensation.

Under the current method, annuitants are granted adjustments equal to the actual rise in the CPI, plus 1 percent. But there are no corresponding 1 percent adjustments made to the CPI upon which succeeding annuity increases are based. In effect, annuitants are compensated twice for increases in the CPI during each 2-month period required to effect an annuity adjustment. For example, May 1975 was the base month for the August 1, 1975, annuity adjustment of 5.1 percent--a 4.1 percent rise in the CPI, plus 1 percent. The add-on compensated annuitants for CPI increases during the months of June and July 1975. The formula produced another adjustment in December 1975. That adjustment--5.4 percent effective March 1, 1976--reflected the CPI rise between May 1975 and December 1975, plus 1 percent. Thus, annuitants were, in effect, compensated twice for CPI increases during June and July 1975.

It would be a fairly simple matter to retain the 1 percent add-on to cover the time lag inherent in the adjustment process and, at the same time, remove its over-compensating effect. The CPI base could, for purposes of each succeeding adjustment, also be increased by 1 percent. Each resulting annuity adjustment would be about the same magnitude as that produced by the current method, but adjustments would occur less frequently. The difference would be the number of months it would take for the CPI to rise by an additional 1 percent.

Using published CPI data, we restructured civil service annuity adjustments since August 1969--the base month for the November 1, 1969, adjustment which first included the 1 percent add-on--by adjusting the CPI base by 1 percent each time an adjustment was triggered under the formula. Our analysis shows that if such a practice had been followed since 1969, annuitants would have received 8 annuity adjustments totaling 54 percent as of April 1, 1976. By comparison, the current law produced 10 adjustments totaling 72 percent over that same period; H.R. 12921 would have resulted in 10 adjustments totaling 56 percent; and H.R. 3310 would have resulted in 13 adjustments totaling 53 percent. Such comparisons should not be considered absolute, however, since at any given point in time each method would be in varying stages of producing another adjustment. Any of the alternate methods would result in comparable long-term savings in annuity payments when compared to the current process.

Since you indicated that the adjustment process will receive early consideration by your Committee, there are two other matters which we believe should be considered before any changes are made. These matters are the frequency of adjustments and the initial adjustment for new retirees.

Frequency of adjustments

The present policy of granting adjustments each time the CPI increases by 3 percent may have outlived its usefulness. Automatic adjustments began in 1962. At that time, the process called for an annual annuity adjustment if the CPI had risen by at least 3 percent during the preceding year. The process was changed in 1965 to gear adjustments to monthly changes in the CPI because the annual process had not produced an adjustment.

The legislative history of the 1965 law is silent with respect to the anticipated frequency of adjustments but it appears that the monthly process was never intended to produce an adjustment more often than annually. The annual rate of inflation in 1965 was slightly less than 3 percent and it would have taken over a year for the monthly process to trigger an adjustment. Annuitants received a legislated increase in 1965 but the first automatic adjustment under the monthly process did not occur until January 1, 1967. The next two automatic adjustments occurred at approximately 1-year intervals.

But the situation today is vastly different. The high inflation rates experienced since 1973 have resulted in annuity

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adjustments about every 6 months. There have been 6 adjustments since the beginning of fiscal year 1974. Adjustments would occur even more frequently under H.R. 3310.

Your Committee may want to consider regularizing the annuity adjustment process by providing for annual adjustments. A policy of annual adjustments would be consistent with the processes used under social security and several other Federal benefit programs and the processes used for adjusting the pay of active Federal employees. Such a policy should also reduce the administrative workload and costs associated with frequent annuity adjustments during periods of high inflation.

An annual adjustment based on the percentage increase in the CPI during the preceding year could be handled in several different ways. It could be structured so as to (1) fully restore annuitants' lost purchasing power as a result of increases in the CPI or (2) partially restore purchasing power by limiting the percentage increase which could be granted, adjusting only a portion of the annuity, or providing flat dollar amount increases to all annuitants. The few non-Federal plans that have adjustment processes generally limit the amount of increase that can be granted in any one year. The Tennessee Valley Authority has a similar policy--cost-of-living adjustments may not exceed 5 percent annually.

Initial adjustment for new retirees

The law permits retiring employees to benefit from CPI increases which occurred while they were still actively employed. Theyreceive a higher starting annuity which reflects the preceding general annuity cost-of-living adjustment, and they are eligible to receive an additional adjustment immediately upon retirement. Such increases serve to (1) inflate the basic annuity upon which succeeding adjustments are applied, (2) encourage experienced employees to retire rather than to continue working, and (3) escalate the costs of retirement.

The amount of a civil service retirement annuity is determined by a formula which considers an employee's average salary during his 3 consecutive highest paid years and his years and months of service, including unused sick leave. The earned annuity is a direct function of the average salary and length of service and usually increases proportionately to those two factors.

But an anomaly was introduced into the retirement system along with the periodic CPI-related adjustment provision in 1965. The 1965 law--Public Law 89-205--removed the requirement that, to be eligible for a cost-of-living adjustment, retirees had to be on the retirement rolls for more than a year prior to the effective date of the adjustment. It provides that cost-of-living adjustments are applicable to all annuities payable on the effective date of the increase. That provision, which also exists in both H.R. 12921 and H.R. 3310, permits an employee who retires on that date to receive a higher starting annuity than an employee who retires the following day. For the most part, a decision to remain on the job resulted in lower future annuity payments. This problem was particularly significant for those employees whose pay rates were frozen.

To correct this anomaly, the law was changed in 1973--Public Law 93-136--to guarantee that a retiring employee would always receive a basic annuity at least equal to the annuity which could have been earned at the time of the last cost-of-living increase plus that increase. That amendment, which was designed to deter mass retirements immediately before a scheduled cost-of-living increase, actually serves to encourage retirement. It allows employees who retire immediately before a cost-of-living increase to receive that increase and to have the preceding cost-of-living increase considered in their basic annuity calculation. For example, employees who retired on February 29, 1976, had considered in their basic annuity calculation the August 1, 1975, increase of 5.1 percent which represented the percentage rise in the CPI from October 1974 through May 1975, plus 1 percent. The resulting annuity would generally have been greater than an annuity based solely on salary and service. Additionally, the new retiree would have received the full 5.4 percent annuity increase of March 1, 1976, which was based on the percentage change in the CPI from May 1975 through December 1975, plus 1 percent. Thus, retiring employees received immediate annuity adjustments which were based on CPI increases long before their date of retirement.

Our analysis of civil service retirements in fiscal years 1972, 1973, and 1974 indicates that most eligible employees have timed their retirements to coincide with scheduled annuity increases. That has enabled them to receive higher starting annuities.

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Federal employees should earn a higher basic annuity by continuing to work rather than by retiring early. We believe that the annuity adjustment policy should be changed to require proration of each retiree's first adjustment to reflect CPI increases after the effective date of retirement. Such a policy should better insure higher basic annuities for continued Federal service and should encourage valuable employees who are considering retirement to remain. A similar policy exists for the Federal Employees Compensation Act program--to be eligible for a cost-of-living adjustment, the recipient's disability must have occurred more than 1 year before the effective date of the adjustment.

I trust that these comments on H.R. 12921, H.R. 3310, and related matters will assist your Committee in its consideration of proposed changes in the annuity cost-of-living adjustment process.

Sincerely yours,

(Signed) ELMER B. STAATS

Comptroller General
of the United States

94TH CONGRESS
2D SESSION

H. R. 12921

IN THE HOUSE OF REPRESENTATIVES

MARCH 31, 1976

Mr. DERWINSKI introduced the following bill; which was referred to the Committee on Post Office and Civil Service

A BILL

To amend the formula for cost-of-living adjustments of annuities under the Civil Service Retirement System.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That subsection (b) of section 8340 of title 5, United States Code, is amended to read as follows:

"(b) Each month the Commission shall determine the percent change in the price index. Effective the first day of the third month that begins after the price index change equals a rise of at least 3 percent for 3 consecutive months over the price index for the base month, each annuity payable from the Fund having a commencing date not later than that effective date shall be increased by the percent rise

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in the price index (calculated on the highest level of the price index during the 3 consecutive months) adjusted to the nearest one-tenth of 1 percent.".

SEC. 2. This Act is effective on July 1, 1976.

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94TH CONGRESS
1ST SESSION

H. R. 3310

IN THE HOUSE OF REPRESENTATIVES

FEBRUARY 19, 1975

Mr. HENDERSON introduced the following bill; which was referred to the Committee on Post Office and Civil Service

A BILL

To amend title 5, United States Code, to revise the method of determining cost-of-living increases payable to civil service annuitants.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That section 8340(b) of title 5, United States Code, is amended to read as follows:

"(b) Each month the Commission shall determine the percent change in the price index. Effective the first day of the second month that begins after the price index change equals a rise of at least 3 per centum for a month over the price index for the base month, each annuity payable from the Fund having a commencing date not later than that

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effective date shall be increased by the percent rise in the price index adjusted to the nearest 1/10 of 1 percent."

SEC. 2. (a) Except as provided in subsection (b) of this section, the amendment made by the first section of this Act shall become effective on the date of enactment of this Act.

(b) In the event the price index change, as determined by the Civil Service Commission under section 8340 of title 5, United States Code, for the month during which this provision is enacted, equals a rise of at least 3 per centum over the price index for the base month currently in effect under such section 8340, each annuity payable from the Civil Service Retirement and Disability Fund shall be increased, effective on the first day of the second month that begins after the date of enactment of this Act, by the per centum rise in the price index adjusted to the nearest 1/10 of 1 per centum.

GAO note: This bill, in effect, was replaced by H.R. 14520.

APPENDIX II

94TH CONGRESS
2D SESSION

H. R. 14520

IN THE HOUSE OF REPRESENTATIVES

JUNE 23, 1976

Mr. HENDERSON (for himself, Mr. WHITE, Mr. DERWINSKI, and Mr. TAYLOR of Missouri) introduced the following bill; which was referred to the Committee on Post Office and Civil Service

A BILL

To amend title 5, United States Code, to revise the method of determining cost-of-living increases payable to civil service annuitants.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That section 8340 (b) of title 5, United States Code, relating to cost-of-living adjustment of annuities, is amended to read as follows:

"(b) Each month the Commission shall determine the percent change in the price index. Effective the first day of the second month which begins after the price index change equals a rise of at least 3 percent for a month over the price

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index for the base month, each annuity payable from the Fund having a commencing date not later than that effective date shall be increased by such percentage rise in the price index, adjusted to the nearest one-tenth of 1 percent.".

SEC. 2. (a) Except as provided in subsection (b) of this section, the amendment made by the first section of this Act shall take effect—

(1) on the date of the enactment of this Act; or

(2) October 1, 1976;

whichever is later.

(b) In the event the price index change, as determined by the Civil Service Commission for the month in which the effective date prescribed under subsection (a) of this section occurs, equals a rise of at least 3 percent over the price index for the base month then currently in effect under section 8340 of title 5, United States Code, each annuity payable from the Civil Service Retirement and Disability Fund shall be increased, effective on the first day of the second month that begins after such effective date, by the percentage rise in the price index for the month in which such effective date occurs, adjusted to the nearest one-tenth of 1 percent.

GAO note: This bill, in effect, replaced H.R. 3310.

COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON, D.C. 20548

B-130393 May 25, 1976

The Honorable Gale W. McGee, Chairman
Committee on Post Office and Civil Service
United States Senate

Dear Mr. Chairman:

By letter of March 16, 1976, you asked for our comments on S. 3134, 94th Congress, 2d Session, a bill, "[t]o eliminate the 1 per centum add-on to the cost-of-living increases for certain retirement benefits."

I am pleased to have the opportunity to express the General Accounting Office's views on this bill. As you know, we have been concerned about the annuity adjustment processes under the civil service and other major retirement systems for Federal and District of Columbia employees. We testified on the civil service process before the Subcommittee on Retirement and Employee Benefits, House Committee on Post Office and Civil Service, in November 1975. In our letter of April 2, 1976, to you and other Chairmen of key Senate and House Committees, we endorsed the elimination of the 1 percent add-on which is granted over and above the actual increase in the Consumer Price Index (CPI) each time annuities are adjusted for increases in the cost of living.

Under current law--5 U.S.C. § 8340(b)--civil service annuities are adjusted whenever the CPI rises by at least 3 percent above the point which triggered the preceding adjustment and remains at least 3 percent higher for 3 consecutive months. Annuity adjustments, equal to the highest percentage rise in the CPI during the 3-month measuring period plus 1 percent, are effective the first day of the third month following that period.

Since enactment of the 1 percent add-on provision in 1969--Public Law 91-93, 5 U.S.C. § 8340--annuity adjustments have totaled 72 percent but the CPI on which these adjustments were based has risen by only about 56 percent. This variance occurred because the add-ons become a permanent part of the annuity base and are not considered when computing succeeding adjustments.

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Senate bill 3134 would eliminate from future civil service, uniformed service, and foreign service annuity adjustments the 1 percent add-on feature. It would protect the annuitant's purchasing power as the cost of living rises by providing periodic annuity adjustments reflecting actual increases in the CPI. Under S. 3134, annuitants would receive adjustments, equal to the actual rise in the CPI, at the same intervals as under the current process, but they would not receive the added 1 percent increases. There would continue to be a 2-month lag between the time an adjustment is triggered and its effective date, but it appears to us that this process provides the adjustments as quickly as is practicable.

We fully endorse the purpose of S. 3134 which is to eliminate the over-compensating effect of the current adjustment process. This result would be accomplished by S. 3134 through removal of the 1 percent add-on. We would point out, however, that excessive adjustments do not result from the add-on itself. Rather, it is the failure to consider the previously granted add-on when determining subsequent adjustments that causes the overcompensation.

Under the current method, annuitants are granted adjustments equal to the actual rise in the CPI, plus 1 percent. But there are no corresponding 1 percent adjustments made to the CPI upon which succeeding annuity increases are based. In effect, annuitants are compensated twice for increases in the CPI during each 2-month period required to effect an annuity adjustment. For example, May 1975 was the base month for the August 1, 1975, annuity adjustment of 5.1 percent--a 4.1 percent rise in the CPI, plus 1 percent. The add-on compensated annuitants for anticipated increases in the CPI during the months of June and July 1975. The formula produced another adjustment in December 1975. That adjustment--5.4 percent effective March 1, 1976--reflected the CPI rise between May 1975 and December 1975, plus 1 percent. Thus, annuitants were, in effect, compensated twice for CPI increases during June and July 1976.

It would be a fairly simple matter to retain the 1 percent add-on to cover the time lag inherent in the adjustment process and, at the same time, remove its over-compensating effect. The CPI base could, for purposes of each succeeding adjustment, also be increased by 1 percent. Each resulting annuity adjustment

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would be about the same magnitude as that produced by the current method, but adjustments would occur less frequently. The difference would be the number of months it would take for the CPI to rise by an additional 1 percent.

Using published CPI data, we restructured civil service annuity adjustments since August 1969--the base month for the November 1, 1969, adjustment which first included the 1 percent add-on--by adjusting the CPI base by 1 percent each time an adjustment was triggered under the formula. Our analysis shows that if such a practice had been followed since 1969, annuitants would have received eight annuity adjustments totaling 54 percent as of April 1, 1976. By comparison, the current law produced 10 adjustments totaling 72 percent over that same period. Senate bill 3134 would have resulted in 10 adjustments totaling 56 percent. Either S. 3134 or the CPI base adjustment method would result in substantial long-term savings in annuity payments when compared to the current process.

There are two other matters relating to annuity adjustments which we believe should be considered. These matters are the frequency of adjustments and the initial adjustment for new retirees.

Frequency of adjustments

The present policy of granting adjustments each time the CPI increases by 3 percent may have outlived its usefulness. Automatic adjustments begin in 1962. At that time, the process called for an annual annuity adjustment if the CPI had risen by at least 3 percent during the preceding year. The process was changed in 1965 to gear adjustments to monthly changes in the CPI because the annual process had not produced an adjustment.

The legislative history of the 1965 law is silent with respect to the anticipated frequency of adjustments but it appears that the monthly process was never intended to produce an adjustment more often than annually. The annual rate of inflation in 1965 was slightly less than 3 percent and it would have taken over a year for the monthly process to trigger an adjustment. Annuitants received a legislated increase in 1965 but the first automatic adjustment under the monthly process did not occur until January 1, 1967. The next two automatic adjustments occurred at approximately 1-year intervals.

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But the situation today is vastly different. The high inflation rates experienced since 1973 have resulted in annuity adjustments about every 6 months. There have been six adjustments since the beginning of fiscal year 1974.

Your Committee may want to consider regularizing the annuity adjustment process by providing for annual adjustments. A policy of annual adjustments would be consistent with the processes used under social security and several other Federal benefit programs and the processes used for adjusting the pay of active Federal employees. Such a policy should also reduce the administrative workload and costs associated with frequent annuity adjustments during periods of high inflation.

An annual adjustment based on the percentage increase in the CPI during the preceding year could be handled in several different ways. It could be structured so as to (1) fully restore annuitants' lost purchasing power as a result of increases in the CPI or (2) partially restore purchasing power by limiting the percentage increase which could be granted, adjusting only a portion of the annuity, or providing flat dollar amount increases to all annuitants. The few non-Federal plans that have adjustment processes generally limit the amount of increase that can be granted in any one year. The Tennessee Valley Authority has a similar policy--cost-of-living adjustments may not exceed 5 percent annually.

Initial adjustment for new retirees

The law permits retiring employees to benefit from CPI increases which occurred while they were still actively employed. They receive a higher starting annuity which reflects the preceding general annuity cost-of-living adjustment, and they are eligible to receive an additional adjustment immediately upon retirement. Such increases serve to (1) inflate the basic annuity upon which succeeding adjustments are applied, (2) encourage experienced employees to retire rather than to continue working, and (3) escalate the costs of retirement.

The amount of a civil service retirement annuity is determined by a formula which considers an employee's average salary during his 3 consecutive highest-paid years and his years and months of service, including unused sick leave. The earned annuity is a direct function of the average salary and length of service and usually increases proportionately to those two factors.

But an anomaly was introduced into the retirement system along with the periodic CPI-related adjustment provision in 1965. The 1965 law--Public Law 89-205--removed the requirement that, to be eligible for a cost-of-living adjustment, retirees had to be on the retirement rolls for more than a year prior to the effective date of the adjustment. It provides that cost-of-living adjustments are applicable to all annuities payable on the effective date of the increase. That provision, which would continue if S. 3134 is enacted, permits an employee who retires on that date to receive a higher starting annuity than an employee who retires the following day. For the most part, a decision to remain on the job resulted in lower future annuity payments. This problem was particularly significant for those employees whose pay rates were frozen.

To correct this anomaly, the law was changed in 1973--Public Law 93-136--to guarantee that a retiring employee would always receive a basic annuity at least equal to the annuity which could have been earned at the time of the last cost-of-living increase plus that increase. That amendment, which was designed to deter mass retirements immediately before a scheduled cost-of-living increase, actually serves to encourage retirement. It allows employees who retire immediately before a cost-of-living increase to receive that increase and to have the preceding cost-of-living increase considered in their basic annuity calculation. For example, employees who retired on February 29, 1976, had considered in their basic annuity calculation the August 1, 1975, increase of 5.1 percent which represented the percentage rise in the CPI from October 1974 through May 1975, plus 1 percent. The resulting annuity would generally have been greater than an annuity based solely on salary and service. Additionally, the new retiree would have received the full 5.4 percent annuity increase of March 1, 1976, which was based on the percentage change in the CPI from May 1975 through December 1975, plus 1 percent. Thus, retiring employees received immediate annuity adjustments which were based on CPI increases long before their date of retirement.

Our analysis of civil service retirements in fiscal years 1972, 1973, and 1974 indicates that most eligible employees have timed their retirements to coincide with scheduled annuity increases. That has enabled them to receive higher starting annuities.

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Federal employees should earn a higher basic annuity by continuing to work rather than by retiring early. We believe that the annuity adjustment policy should be changed to require proration of each retiree's first adjustment to reflect CPI increases after the effective date of retirement. Such a policy should better insure higher basic annuities for continued Federal service and should encourage valuable employees who are considering retirement to remain. A similar policy exists for the Federal Employees Compensation Act program--to be eligible for a cost-of-living adjustment, the recipient's disability must have occurred more than 1 year before the effective date of the adjustment.

I trust that these comments on S. 3134 and related matters will assist your Committee in its consideration of proposed changes in the civil service adjustment process.

Sincerely yours,

Elmer B. Staats

Comptroller General
of the United States

 APPENDIX III

94TH CONGRESS
2D SESSION

S. 3134

IN THE SENATE OF THE UNITED STATES

MARCH 11, 1976

Mr. BUCKLEY (for himself and Mr. MONDALE) introduced the following bill; which was read twice and referred to the Committees on Post Office and Civil Service, Armed Services, and Foreign Relations jointly by unanimous consent

A BILL

To eliminate the 1 per centum add-on to the cost-of-living increases for certain retirement benefits.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That section 8340(b) of title 5, United States Code, is amended by striking out "1 percent plus".

SEC. 2. Section 1401a of title 10, United States Code, is amended by striking out "the per centum obtained by adding 1 per centum and".

SEC. 3. Section 882(b) of the Foreign Service Act of 1946 (22 U.S.C. 1121(b)) is amended by striking out "1 per centum plus".

APPENDIX III

SEC. 4. The amendments made by the first section and section 3 of this Act shall apply to any increase in annuities after the date of the enactment of this Act. The amendment made by section 2 of this Act shall apply to any increase in retired pay or retainer pay after such date.

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