United States General Accounting Office

GAO

Report to the Honorable
Andy Ireland, House of Representatives

June 1992

DOD BUDGET

Budget Impact of Proposed Reduced Retirement Fund Payments

146689

GAO/NSIAD-92-80

GAO

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

National Security and
International Affairs Division

B-238512

June 5, 1992

The Honorable Andy Ireland
House of Representatives

Dear Mr. Ireland:

In response to your request that we report on issues involving the Future Years Defense Program (FYDP),[1] we have examined a DOD proposal to reduce its contributions to the Military Retirement Fund by $11 billion. Specifically, our objective was to assess the impact of the proposed reduction under current federal budget guidelines.

Background

The Department of Defense Authorization Act for 1984 changed the way DOD's military retirement costs are financed. Before October 1, 1984, the retirement system was funded on a "pay-as-you-go" basis; that is, appropriations were provided each year to cover the cost of retirees' pensions to be paid out for that year. Since October 1, 1984, DOD has made monthly payments to a U.S. Treasury interest-bearing fund—the DOD Military Retirement Fund—to cover estimated future retirement benefits earned for military service after October 1, 1984.

The payments are based on actuarial estimates, which project future retirement benefit costs. The act established the Military Retirement Board of Actuaries to oversee the actuarial estimates. The Board periodically reviews the actuarial assumptions supporting its estimates and makes any necessary adjustments.

The 1984 act requires the U.S. Treasury to pay for the benefits earned for military service prior to October 1, 1984. At the time of the act, the liability for pre-1984 benefits totaled an estimated $528.7 billion. The Board of Actuaries has established an annual payment schedule for the Treasury to make payments to the Military Retirement Fund over a 60-year period to cover the cost of the unfunded pre-1984 liability.

[1] Section 114a of title 10 of the U.S. Code provides that "the Secretary of Defense shall submit to Congress each year, at or about the time that the President's budget is submitted . . . a multiyear defense program . . . reflecting the estimated expenditures and proposed appropriations included in that budget." FYDP represents the Department of Defense's (DOD) 6-year plan of estimated expenditures and anticipated appropriations needs.

The Treasury's annual payment to the fund is subject to change. The 1984 act requires the annual Treasury payment to be adjusted—increased or decreased—to reflect any actuarial gains or losses to the fund. Historically, the Treasury's annual payment has been reduced to reflect actuarial gains resulting from lower-than-expected military retirement pay increases, lower cost-of-living adjustments, higher interest earnings, and changes in actuarial assumptions. Since 1984, actuarial gains have reduced Treasury payments on the unfunded pre-1984 liability by a total of $22.9 billion.

Results in Brief

DOD reduced its February 1991 FYDP submission by $10.7 billion for fiscal years 1994 through 1997 to reflect a DOD proposal to change the method for calculating annual payments to the retirement fund. The change would reduce DOD's payments to the fund and, therefore, was expected to reduce or eliminate actuarial gains. Without this reduction, other FYDP reductions would have been required to be consistent with the spending levels contained in the President's budget.

Following the February 1991 FYDP submission, the Office of Management and Budget (OMB), according to DOD officials, made a preliminary determination that the proposed change would have required a reduction in discretionary military spending because of legislated budget ceilings. In addition, an independent panel commissioned by DOD determined that the proposed change generally lacked merit. DOD subsequently decided not to pursue the change. This decision had the effect of adding $10.7 billion back to FYDP.

Prior to submitting the January 1992 FYDP, DOD proposed to reduce payments to the retirement fund based on anticipated assumption changes for long-term interest rates and salaries. On the basis of this proposal, the January 1992 FYDP was reduced by $11 billion to reflect reduced payments to the retirement fund for fiscal years 1994 to 1997. This reduction offset the impact of deleting the $10.7 billion in negative entries contained in the February 1991 FYDP submission.

This latest proposal, like the previous proposal, is subject to review and approval by the Military Retirement Board of Actuaries. Should the proposed changes not be accepted, DOD would have to make offsetting program reductions. The proposed reduced payments to the retirement fund currently account for about 12 percent of the cumulative planned defense spending cuts between 1993 and 1997.

The reduction in DOD retirement fund payments will not result in a federal budgetary savings because such reductions will eventually require offsetting increases in Treasury payments to the unfunded liability account.

Actuarial Gains Have Reduced Treasury Payments

Since 1984, actuarial gains have reduced the Treasury's payments on the unfunded liability by $22.9 billion, as shown in table 1.

Table 1: Treasury Retirement Fund Payments on Pre-1984 Unfunded Liability Since 1984

Dollars in billions

Fiscal year	Amortization schedule for the unfunded retirement benefits	Reduction to Treasury's payments resulting from actuarial gains and losses	Treasury's actual payment
1984	$9.5	0	$9.5
1985	10.5	0	10.5
1986	11.0	$0.5	10.5
1987	11.7	1.4	10.3
1988	12.0	2.2	9.8
1989	16.3	5.7	10.6
1990	17.2	6.4	10.8
1991[a]	18.2	6.7	11.5
Total	$106.4	$22.9	$83.5

[a]The figures for 1991 are estimated.

Proposed Changes to Reduce DOD's Contributions to the Retirement Fund and FYDP

DOD's February 1991 FYDP submission reflected a proposal to change the method for calculating annual payments to the retirement fund. The change would have reduced payments to the retirement fund and hence reduced the annual actuarial surplus. According to some DOD officials, this calculation change would have more quickly and accurately reflected actual personnel retention, pay, and interest rate experience. These officials believed the revised method would have allowed for more effective work-force management and would have resulted in more accurate annual contributions in the retirement fund.

According to DOD officials, the proposal, which would have likely required legislation to implement, would have reduced the Department's total contributions to the fund from $63.6 billion to $52.9 billion during fiscal years 1994 through 1997, a $10.7 billion reduction. The February 1991

FYDP submission showed the $10.7 billion reduction as negative entries to planned annual spending levels. According to DOD officials, the negative FYDP entries are customary for proposals that may require legislation or congressional approval.

The negative entries reduce the FYDP spending levels to be consistent with the President's budget. Section 114a of title 10 of the U.S. Code requires FYDP to be consistent with the amounts reported in the President's annual budget submission. Without the negative entries associated with the reduction in retirement contributions, DOD's planned spending would exceed the spending levels contained in the President's budget by $10.7 billion.

Proposal Reduced Spending Caps

The Budget Enforcement Act places individual caps on discretionary defense, domestic, and foreign assistance spending through fiscal year 1993. For fiscal years 1994 and 1995, budget authority and outlay caps are set for discretionary spending as a whole. Under the act, spending caps are to be adjusted to reflect "changes in concepts and definitions." DOD officials did not believe the proposed change in calculating payments to the retirement fund would have required adjusting the discretionary spending caps. However, according to DOD officials, OMB subsequently determined that the proposed change would require a reduction in discretionary spending ceilings.

Following the OMB determination and a generally unfavorable report on the merits of the proposal by an independent panel, DOD decided not to pursue the change. This decision had the effect of eliminating $10.7 billion in negative FYDP entries.

January 1992 FYDP Adjusted to Reflect Another Proposal

DOD proposed assumption changes reduced its estimated annual payment to the retirement fund and more than offset the FYDP increase from eliminating the negative entries.

Prior to submitting the January 1992 FYDP, DOD assumed that the Military Retirement Board of Actuaries would revise some of the actuarial assumptions used in determining DOD's retirement fund payments. DOD officials believed that the revisions would better reflect recent trends. Specifically, DOD assumed that the Military Retirement Board of Actuaries would increase the assumed rate of interest earned on retirement fund deposits from 7 percent to 7.6 percent and reduce the assumed average annual salary increase from 5.75 percent to 5.5 percent.

According to DOD officials, the January 1992 FYDP submission was reduced $11 billion for fiscal years 1994 to 1997 based on the proposed assumption changes. The reduction was made in the military personnel appropriation account and was reflected in the President's budget for fiscal year 1993. The reduction in the military personnel account offset the impact of deleting the $10.7 billion in negative entries contained in the 1991 FYDP submission. Table 2 shows the annual impact of the assumption changes on payments to the retirement fund.

Table 2: Projected DOD Contributions to the Military Retirement Fund

Then-year dollars in billions

	Fiscal year				
	1994	**1995**	**1996**	**1997**	**Total**
Approved actuarial estimates	$15.1	$15.0	$15.2	$15.4	**$60.7**
DOD's estimates using revised assumptions	12.4	12.3	12.4	12.6	**49.7**
Reduction	$2.7	$2.7	$2.8	$2.8	**$11.0**

Proposal Subject to Review and Approval

Changes to actuarial assumptions are determined by the Military Retirement Board of Actuaries. The congressional committee report on the act establishing the military retirement fund states:

> "Care must be exercised to minimize the ability to manipulate the interest rate. The committee recommends that an independent Board of Actuaries be established and that they, alone, be charged with the responsibility for determining the interest rate and other actuarial assumptions in accordance with generally accepted actuarial principles and practices."

DOD's projected retirement fund payments for fiscal years 1994 through 1997 are based on DOD's expectation that the Military Retirement Board of Actuaries will agree to change economic assumptions that DOD believes are at variance with recent trends. The Military Retirement Board of Actuaries is not scheduled to meet until July 1992 to set the assumptions to be used to estimate DOD contributions for fiscal years 1994 and 1995. Therefore, DOD's projected retirement fund payments are based on actuarial estimates that have not been approved by the Military Retirement Board of Actuaries.

Reduced Retirement Fund Payments Included in Proposed Defense Budget Savings

The President's fiscal year 1993 budget submission proposes that defense spending in constant 1993 dollars decrease from $267.6 billion in fiscal year 1993 to $237.5 billion in fiscal year 1997, a cumulative $82.7 billion reduction. According to DOD officials, the defense spending cuts include the $11 billion in reduced payments to the Military Retirement Fund—$10 billion in constant 1993 dollars. These reduced payments account for approximately 12 percent of the cumulative defense spending reductions and about 22 percent of the cumulative military personnel spending reductions for the period. Annually, the reduced payments represent an increasing percentage of proposed defense spending reductions, from 27 percent in fiscal year 1994 to 56 percent in fiscal year 1997.

Reduced Retirement Fund Payments Would Not Reduce Total Federal Spending

Reduced DOD payments to the retirement fund would eventually require offsetting increases in Treasury payments to the unfunded liability account. Consequently, a reduction in retirement fund payments, as has been proposed by DOD, would not result in a federal budgetary savings. According to DOD actuaries, no actuarial assumption has any impact on the ultimate obligations of a retirement system. If fewer dollars are paid into the retirement fund in the early years, more dollars will be required in the later years.

Matters for Congressional Consideration

The Congress, in its budget deliberations, should consider that

- changes in DOD's retirement fund payment calculations account for a significant part of defense budget reductions,
- retirement fund reductions caused by actuarial assumption changes do not represent reductions in defense programs or in long-term federal retirement obligations, and
- actuarial estimates used in DOD's FYDP have not been approved and will not be considered by the Military Retirement Board of Actuaries until July 1992.

Scope and Methodology

We reviewed the fiscal years 1992 and 1993 FYDPs, the executive branch's fiscal years 1992 and 1993 budget submissions, and the legislative history concerning the establishment of the Military Retirement Fund. We also reviewed DOD's report, Valuation of the Military Retirement System (as of September 30, 1990), as well as draft studies dated February 1991 and July 1991 prepared by the Rand Corporation under contract for DOD.

We also obtained information on the proposals and the projected DOD savings from officials at DOD, OMB, the Congressional Budget Office, and the Department of the Treasury.

We conducted our review from August 1991 to April 1992 in accordance with generally accepted government auditing standards. We did not obtain DOD comments on this report; however, we provided DOD program officials a draft of this report and have incorporated their views where appropriate.

We are sending copies of this report to the Secretary of Defense, the Director of the Office of Management and Budget, and interested congressional committees. We will also make copies available to others upon request.

Please contact me on (202) 275-4587 if you or your staff have any questions concerning this report. Major contributors to this report were James Wiggins, Assistant Director; Steven Sternlieb, Assistant Director; Russ Reiter, Evaluator-in-Charge; and John Wood, Actuary.

Sincerely yours,

Paul F. Math

Paul F. Math
Director, Research, Development,
Acquisition, and Procurement Issues

Ordering Information

The first copy of each GAO report and testimony is free. Additional copies are $2 each. Orders should be sent to the following address, accompanied by a check or money order made out to the Superintendent of Documents, when necessary. Orders for 100 or more copies to be mailed to a single address are discounted 25 percent.

U.S. General Accounting Office
P.O. Box 6015
Gaithersburg, MD 20877

Orders may also be placed by calling (202) 275-6241.

United States
General Accounting Office
Washington D.C. 20548

Official Business
Penalty for Private Use $300

First Class Mail
Postage & Fees Paid
GAO
Permit No. G100