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STATEMENT OF
H. L. KRIEGER, DIRECTOR
FEDERAL PERSONNEL AND COMPENSATION DIVISION
U.S. GENERAL ACCOUNTING OFFICE

BEFORE THE
SUBCOMMITTEE ON CIVIL SERVICE AND GENERAL SERVICES
OF THE COMMITTEE ON GOVERNMENTAL AFFAIRS
UNITED STATES SENATE

ON

[FEDERAL RETIREMENT ISSUES]

Sen 06610

Mr. Chairman and Members of the Subcommittee:

I am pleased to be here to present the General Accounting Office's views on what we consider to be the major issues confronting Federal retirement programs today. Where appropriate, my comments will focus primarily on the civil service retirement system.

GAO has long been concerned about the civil service and other Federal retirement systems. Next to pay, retirement programs are the most significant and costly means the Government uses to compensate its personnel, and the liabilities that accrue under Federal retirement systems represent a sizeable financial commitment of the Government.

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Beginning in 1974, we have issued a series of reports covering a number of issues related to basic policies, financing, administration, and benefits of the various retirement programs. I will briefly discuss the issues addressed in these reports as well as mention some of our ongoing work in the retirement area.

In essence, our work has shown that Federal retirement programs have not received the management attention they deserve in view of their importance and tremendous costs. As we noted in a December 1978 report entitled, "Need for Overall Policy and Coordinated Management of Federal Retirement Systems" (FPCD-78-49), the systems have evolved without policy guidance. In the absence of an overall Federal retirement policy, the benefit structures of Federal retirement programs have developed and continue to develop on a piecemeal basis.

We identified 38 retirement systems that are maintained for various groups of personnel by Federal agencies and instrumentabilities. Their provisions vary considerably. In many cases, we could find no explanation why different provisions were adopted. In others, the circumstances existing at the time of adoption have changed but the benefits have continued.

The issues I will cover fall into four areas:

- Need for Federal retirement policy,
- Costing and funding practices,
- Disability retirement, and
- Cost-of-living adjustments.

RETIREMENT POLICY

In our opinion, the primary issue that needs congressional attention is the establishment of an overall, coherent, coordinated Federal retirement policy to guide the future development of the Government's retirement systems. Let me mention some of the reasons that led us to that conclusion.

There is a lack of central focus on Federal retirement. For 12 of the systems that are clearly Federally-administered and providing benefits to military and civilian retirees and their survivors, 11 committees in the House and 10 committees in the Senate could have legislative responsibilities, and 16 different organizations have legal responsibilities for system administration. These fragmented responsibilities have surely contributed to the piecemeal evolution of the systems. We believe the Congress should consider centralizing committee jurisdiction over retirement matters to better assure consistent application of retirement policy. An alternative might be to establish a temporary joint committee to review all retirement systems and recommend needed policy changes. We also suggest that the Congress consider

establishing a permanent, independent board with authority and responsibility for monitoring the systems' development, improvement, and administration.

Covered personnel are treated quite differently depending on the retirement system that applies to their employment. All the systems have the same basic objectives--to provide employees a continuing income after completion of active service or upon becoming disabled and to provide financial protection to survivors upon the death of employees and retirees. Yet, the systems' provisions vary substantially in areas such as (1) employee contribution rates, (2) benefit formulas, (3) retirement eligibility requirements, (4) creditable service, (5) disability policies and benefits, (6) survivor benefits, and (7) reemployed annuitant practices.

Even within the civil service system, certain groups receive special benefits. Most employees are covered by the system's general provisions, but separate provisions allowing higher annuities and/or earlier retirement ages exist for Members of Congress, law enforcement and firefighter personnel, air traffic controllers, and congressional staff.

Different retirement benefits for personnel in the separate branches of Government or for certain positions within a branch may well be justified, particularly when such benefits are recognized as part of the total compensation paid

to attract and retain needed personnel. We have long maintained that both Federal pay and benefits, including retirement, should be established and adjusted within the context of total compensation comparability with the non-Federal sector. However, under the pay comparability processes now in effect, benefit programs are excluded.

Our review of the historical development of each of the systems, including the civil service system, showed it is difficult, in most cases, to clearly identify any current management or compensation policies that are being served by the systems as they are now designed. For example, Federal law enforcement and firefighter personnel are allowed to retire earlier and with more generous annuities than most other employees under the civil service system. In a February 1977 report ("Special Retirement Policy for Federal Law Enforcement and Firefighter Personnel Needs Reevaluation," FPCD-76-97), we concluded that the continued need for the early retirement policy for such personnel was questionable and recommended that the Congress reevaluate the need for these preferential and very costly benefits.

In establishing a Federal retirement policy, we believe the Congress should recognize that special provisions may be justified for particular groups, but the guiding principle should be that all Federal personnel are to receive consistent benefits.

The criteria used for participation in Federal retirement systems are inconsistent, confusing, and often conflicting. A primary reason for the proliferation of retirement systems in the Government is the lack of definitive eligibility criteria for participation in a Federal system. Many of the smaller retirement programs for civilian employees, such as the Foreign Service and Tennessee Valley Authority retirement systems, were established because criteria for participation in the civil service system at the time precluded their coverage. Moreover, the various criteria used have been inconsistently applied.

The lack of definitive participation criteria has caused difficulty in determining retirement system coverage for several groups. This problem is perhaps best exemplified by the employees who work for nonappropriated fund instrumentalities (NAFI) providing morale, welfare, and recreation programs in the Department of Defense (DOD) and Coast Guard.

NAFIs are units of the Federal Government, and their personnel meet the general criteria used to define Federal employees. However, the law exempts many NAFI personnel from coverage under the civil service retirement system, and seven different retirement systems have been developed for NAFI employees. The exception from civil service coverage was made in response to a DOD request basically because

NAFIs operate with nonappropriated funds. The exception from full Federal employee status does not apply to morale, welfare, and recreation employees paid from appropriated funds. DOD commissaries are often considered to be morale and general welfare activities, and their jobs are similar to those of NAFI employees. However, since they are paid from appropriated funds, they receive civil service retirement coverage.

Also, the exception does not apply to NAFI employees of other than DOD and Coast Guard activities such as the Veterans Canteen Service. Canteen Service employees participate in the civil service system.

The civil service system covers many other groups who are paid from nonappropriated funds including employees of the Postal Service, Social Security Administration, Federal Deposit Insurance Corporation, and other organizations.

In 1974, the Congress established a private non-profit corporation known as the Legal Services Corporation. The enabling legislation provides that the Corporation is not a Federal agency and its officers and employees are not Federal. However, the law included the employees under the civil service retirement system.

We believe the Congress as a matter of policy must clarify the participation requirements for the civil service and other retirement systems. Until this done, the many inequities will continue.

There is no consistent policy on social security coverage for Federal personnel. One of the major inconsistencies of Federal retirement systems is that social security coverage is provided to some employees but denied to others. Employees covered by 25 of the 38 systems are also covered by social security. The civil service system is, by far, the largest of the 13 systems that do not allow social security coverage.

It seems to us that, if all Federal personnel are to receive consistent and equitable benefits, social security should be provided to all or none. Social security was designed to be supported on a universal basis and we found no persuasive reasons to exclude many Federal workers from the program. Two of the consequences of the exclusion are that a large number of Federal personnel do not receive the basic protection afforded by social security and do not share in the responsibility of meeting the basic needs of the Nation's elderly and disabled persons.

I should point out that our report did not recommend merger of the civil service retirement system with social security. The report urged the Congress to adopt an overall retirement policy outlining the principles, objectives, and standards to be followed in providing retirement benefits to military and civilian personnel. The issue of whether social security should form the base for Federal retirement

benefits is one of many matters that must be considered in formulating such a policy. Our recommendations were not directed toward any specific system--they applied to all the systems.

In view of our findings, we believe it would be a mistake to limit the social security debate to the civil service system alone. We are convinced, for example, that there is no justification for the military retirement system with its very generous benefits to be a total add-on to social security, as is now the case. We believe the larger issue of what appropriate overall policy the Government should follow in providing retirement benefits to its personnel should be resolved first before addressing the question of whether the civil service and social security programs should be merged. A narrower approach would be the type of piecemeal, uncoordinated development of Federal retirement programs that has caused the many inequities and inconsistencies that exist today.

Our report discussed several alternative methods that could be used to integrate Federal retirement programs and social security. We did not necessarily push any of these alternatives, but we tend to favor what the report called the complementary approach. Under this approach, a staff plan would supplement social security by providing benefits necessary to bring the total retirement package to whatever

level the Government, through an established retirement policy, wants to provide to its personnel. This approach would allow the staff plan to emphasize individual equity and personnel management objectives while the social security program would be primarily relied upon to provide the plan's social needs such as disability and survivorship protection. Even in these latter areas, the staff plan could provide supplementary benefits wherever social security is deemed to be insufficient.

Probably the most difficult aspect of any decision to integrate Federal retirement programs and social security is how such a change would be implemented. Basically, this is a decision the Congress would have to make. Our report discussed the advantages and disadvantages of three ways it could be done: (1) make the new integrated plan applicable only to new employees and leave current employees under existing plans; (2) make the integrated plan retroactive to cover all past service of current employees; or (3) allow current employees to retain any vested benefits earned to date and make the integrated plan applicable to subsequent service. There are undoubtedly many others. We did not recommend any particular approach in the report, but the first alternative of grandfathering current personnel in existing systems would probably be perceived to be the fairest by most observers.

COSTING AND FUNDING

The costing and funding procedures used by many of the systems understate the full cost of providing retirement benefits. No uniform method is used in determining the liabilities associated with Federal retirement systems, and costing and funding practices differ considerably. In most cases, the systems' funding requirements are less stringent than those imposed by law on private pension plans. Some systems are financed on a contributory basis; some on a non-contributory basis; some provide for fully funding benefits as they accrue; some provide for partial funding; and others are completely unfunded. In 1976, three major retirement systems--uniformed services, civil service, and Foreign Service--reported unfunded liabilities in excess of \$273 billion, and these liabilities are estimated to increase to at least \$349 billion by the end of fiscal year 1986.

If the Congress does not receive realistic and consistent information on the cost of Federal retirement programs, its ability to make sound fiscal and legislative decisions on establishing, amending, and funding retirement and agency programs is impaired. When the full costs are not recognized, there may be a tendency to adopt benefits which could jeopardize the eventual affordability of the retirement systems. Full recognition of accruing retirement

costs is essential not only in determining and allocating the cost of Government operations, but also in determining the present and future financial condition of the United States. Unfortunately, the Congress and the taxpayers are not being provided realistic and consistent information on the costs of Federal retirement programs.

Because of the uncertainty of such future events as death, disability, or retirement, the ultimate cost of a retirement system can be determined only as actual expenditures emerge throughout the life of the system. By the very nature of a retirement system, there is a time lag between the accrual of benefit rights and the actual payment of benefits. Under most Federal retirement systems, benefit rights accrue during an employee's years of service. That is, each year of service has an associated benefit value.

In actuarial terminology, the value of benefit rights earned (accrued) annually by employees covered by a retirement system is referred to as the "normal cost." Normal cost is commonly expressed as a percentage of payroll, and from a financing point of view, represents an estimate of the amount of funds which, if accumulated annually and invested over covered employees' careers, will be enough to meet their future benefit payments.

The costs of benefits accruing each year under the civil service retirement system are understated because the system's normal cost is calculated on a "static" basis, whereby no consideration is given to the effect of future general pay increases and annuity cost-of-living adjustments on ultimate benefit payments. Benefits payable under the system are based on employees' average annual earnings during their 3 highest-paid years, and, after retirement, semi-annual adjustments are made to compensate retirees for increases in the cost of living. Pay increases and annuity adjustments add significantly to the retirement system's liability, and ignoring them in the cost calculations does not mean that they won't occur.

The static normal cost of the civil service system is currently estimated to be 13.66 percent of pay, which is about equal to the combined rate of contributions being made to the retirement fund by agencies and their employees (generally 7 percent of pay each). However, the Office of Management and Budget (OMB) has estimated that the "dynamic" normal cost of the system is 27.4 percent of pay, assuming that future pay increases and interest on fund investments will average 1.5 percent and 2.5 percent, respectively, above the future rate of inflation. Based on this OMB estimate, Federal agencies should be contributing 20.4 percent of their covered employees' pay to the fund (27.4 percent

less 7 percent employee contributions) if their budgets are to reflect the full cost to the Government of benefits accruing under the system.

The total payroll for employees covered by the system is estimated to be about \$48.6 billion during fiscal year 1980. At 20.4 percent of pay, the estimated cost to the Government of benefits accruing during the year will be \$9.9 billion--\$6.5 billion more than the \$3.4 billion agencies will contribute based on the covered payroll.

Because agencies are being charged only a portion of the costs accruing to the Government for the civil service retirement system, those agencies whose operations are intending to be self-supporting are annually receiving large unrecognized subsidies. In an August 1977 report ("Federal Retirement Systems: Unrecognized Costs, Inadequate Funding, Inconsistent Benefits", FPCD-77-48), we discussed in considerable detail how a number of selected "self-supporting" agencies were being subsidized through the retirement system. We identified subsidies ranging from \$800,000 for the Farm Credit Administration to over \$1 billion annually for the U.S. Postal Service. The understatement of operational costs and the subsidies will continue until the full dynamic normal cost of the system is recognized and allocated to those agencies and instrumentalities whose employees are covered by the retirement system.

Our recommendations in reports on retirement system costing and funding policies have been fairly simple and straightforward--the Government should adopt actuarial valuation methods and funding provisions that reflect the full cost of accruing retirement benefits and charge to agency operations all costs not covered by employee contributions.

The Office of Personnel Management has told us that it agrees that its present method of determining and presenting civil service retirement costs results in an understatement of such costs. However, OPM maintains that a movement to dynamic financing is not an urgent concern. OPM has declined to take a position on the need to charge agencies their full share of accruing retirement costs stating that the issue is one of budgetary and cost allocation policy which is not its major concern as administrator of the retirement system.

DISABILITY RETIREMENT

One feature of the civil service retirement system on which we have issued several reports is its disability retirement provisions. Many employees retire on disability, and these retirements have added substantially to the cost of the system. At the end of fiscal year 1978, there were about 323,000 disabled retirees who collect annuities totaling about \$2.2 billion annually. During 1978, about 32 percent of all new retirees during the year retired on

disability. Based on our work, we believe it is highly questionable that all these retirees were incapable of further Government service.

Under the civil service system, employees are considered to be legally disabled if they are unable, because of disease or injury, to perform usefully and efficiently in the grade or class of position last occupied. As interpreted by the Office of Personnel Management, this means that an employee unable to do one essential function of his job is entitled to disability retirement. All disabled employees retire on full disability because no provision exists for partial disability.

(If a disabled employee can perform in other positions and the agency can find a position for which the employee is qualified, we believe an agency should have reassignment authority and actively seek an alternative position.) In a November 1976 report on disability retirement ("Civil Service Disability Retirement: Needed Improvements," FPCD-76-61), we estimated that about 15,000 annuitants receiving disability benefits in 1975 were probably capable of performing other types of work at the time of retirement. Disability retirement applications require information regarding agency efforts to reassign the employee to a suitable position. However, our report noted that this information was not included in 62 percent of the cases sampled.

The Office of Personnel Management has no procedures for determining whether permanently or temporarily disabled annuitants are performing functions similar or identical to those performed in their last Government job. Our November 1976 report showed that of 51 disability cases reviewed 18 annuitants could be performing jobs similar to their prior Government jobs. The files, however, contained no evidence that attempts had been made to obtain more details on the nature of the work.

Disability payments continue until annuitants become medically or economically recovered. Economic recovery is assumed if, in each of 2 consecutive years, annuitants' earnings equal or exceed 80 percent of the current rate of compensation for their last Government job. This income limitation provision can be manipulated. Annuitants have earned more than the pay for their prior Government jobs over a 2-year span, received sizeable annuity payments, and yet were not considered economically recovered. We reported examples of annuitants who earned from \$17,000 to \$42,000 more in 2 years than their Government job would have paid but were continued on the disability roles because they did not exceed the 80-percent maximum in each of the 2 years. For example, we found one retiree who was determined to be disabled for a job paying \$22,000 a year and who earned \$16,777 and \$47,480 in other employment in 2 consecutive

years. The annuitant continued to receive his disability annuity, because he was not economically recovered under the law.

We made numerous recommendations to the Civil Service Commission (now the Office of Personnel Management) for improvements in disability retirement policies and administration. In a July 1976 letter to us, the Commission reserved comment on most of our recommendations until it could complete a study it said it was conducting which would address many of the areas discussed in our report. We issued a follow-up report on disability retirement in July 1978 ("Disability Provisions of Federal and District of Columbia Employee Retirement Systems Need Reform" FPCD-78-48). During this latter review, the Commission advised us that its promised study had not been completed because of higher priority work. To our knowledge, this study has still not been completed.

We also made certain recommendations to the Congress for changes to the disability retirement laws. We recommended that the Congress (1) enact legislation that would encourage, instead of discourage, retention of potentially productive employees by requiring agencies to assign employees to vacant positions within the same occupational class when the applicants are able to do that job and (2) revise the definition of economic security to preclude

annuitants from earning more than the current pay for their former Government jobs and yet retaining their annuities.

Disability reform would assist considerably in reducing civil service retirement costs and assuring greater equity for all covered employees.

COST-OF-LIVING ADJUSTMENTS

Considerable attention is now being given in the Congress and elsewhere to the annuity cost-of-living adjustment provisions of Federal retirement systems. We have also issued reports on this subject.

In July 1976, we reported ("Cost-of-living Adjustment Processes for Federal Annuities Need To Be Changed," FPCD-76-80) that the cost-of-living adjustment processes then in effect had caused Federal retirement annuities to increase faster than the cost-of-living. At that time, the processes were tied to the monthly increase in the Consumer Price Index (CPI), and an extra 1 percent increase was granted to annuitants each time their annuities were adjusted.

Our report showed that the Federal annuity adjustment processes were far more generous than the processes used by most non-Federal employers to adjust pensions, and because of the 1 percent "kicker," actually over-compensated retirees for increases in the cost-of-living. According to a 1974 Conference Board survey, few non-Federal pension plans

(about 4 percent) provided for automatic cost-of-living adjustments, and they generally limited the amount of increase that could be granted in any one year. We made three recommendations for changes to the adjustment processes. These were:

- Repeal the 1 percent kicker. (This action was subsequently taken by the Congress.)
- Regularize the adjustment process by providing for annual adjustments based on the actual percentage rise in the CPI during the preceding year. (The Congress later repealed the existing adjustment mechanism which was based on monthly CPI increases, but provided for adjustments to be granted every 6 months instead of annually.)
- Repeal the provisions which permit retiring employees to receive higher starting annuities because of changes in the CPI before their retirement and provide that new retirees' initial cost-of-living adjustments be prorated to reflect only CPI increases after their effective dates of retirement. (No action has been taken on this recommendation.)

We issued another report in November 1977 ("Cost-of-Living Adjustments for New Federal Retirees: More Rational and Less Costly Processes Are Needed," FPCD-78-2), which

provided further information in support of our recommendation on new retirees' initial adjustments. We pointed out that the processes overcompensate retiring employees since, by law, they can receive a higher starting annuity which reflects the preceding cost-of-living adjustment granted while they were still employed and, depending on the timing of their retirement, may be eligible for an additional adjustment immediately upon retirement. Such increases escalate the already high costs of Federal retirement by inflating the basic annuity upon which succeeding adjustments are applied and can encourage valuable, experienced employees to retire. We estimated that a change in law to provide that new retirees' adjustments be prorated to include only the cost-of-living increases that occur after retirement would save over \$800 million in annuity payments over the remaining lifespans of civil service employees retiring in 1978 alone.

If the changes that we have recommended are adopted, the Federal cost-of-living adjustment processes would still be more generous than those of non-Federal pension plans and more consistent with those provided by the social security program. Federal retirees are the only groups of which we are aware who receive unlimited cost-of-living adjustments automatically twice a year.

Our work in the retirement area is continuing. We have ongoing reviews in various stages of completion on (1) the investment policies, practices, and performance of Federal retirement systems, (2) the minimum disability benefit provisions of the civil service system, (3) the early voluntary and involuntary retirement practices associated with reductions-in-force, agency reorganizations, and transfers of function, and (4) the total compensation comparability process that the Administration is proposing for comparing and adjusting the pay and benefits, including retirement, of Federal personnel.

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In summary, we believe there are several major issues confronting the civil service retirement system that need attention. Many of these issues are not limited to the civil service system alone, but are basic issues that apply to Federal retirement programs in general. We stand ready to assist the Subcommittee in any way you deem necessary in addressing these matters of great importance to the Government, its employees, and the Nation's taxpayers.

That concludes my statement, Mr. Chairman. My colleagues and I would be pleased to answer any questions you may have.