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OVERVIEW OF FEDERAL RETIREMENT PROGRAMS

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OVERVIEW OF FEDERAL RETIREMENT PROGRAMS

Summary of Statement by
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The purpose of GAO's statement is to assist the Subcommittee as it examines federal retirement issues by describing how the retirement systems work, the benefits they provide, and how they compare with programs in the nonfederal sector. The statement concentrates on the Civil Service Retirement System (CSRS) and the Federal Employees Retirement System (FERS) because they are the largest retirement systems for federal civilian personnel.

CSRS has been closed to new entrants since 1983. It is a "stand alone" pension system with no Social Security coverage or other source of employment-related retirement income. FERS generally applies to employees who entered federal service after 1983. It includes Social Security coverage, a pension plan, and a Thrift Savings Plan to which most covered employees and the government each contribute. At the end of fiscal year 1994, CSRS and the FERS pension plan, together, were paying annuities to about 1.7 million retirees and about 600,000 survivors of deceased employees and retirees at an annual rate of about $36 billion.

GAO describes the history of CSRS and FERS and discusses four issues that are often raised in relation to federal retirement: (1) retirement eligibility provisions, (2) benefit formulas, (3) cost-of-living adjustments, and (4) system financing. Among GAO's observations are:

--Although CSRS allows employees to retire at age 55, employees must have 30 years of service to retire at this age. Most employees do not have 30 years of service at age 55 or elect not to retire when first eligible. Thus, the average CSRS retirement age is about 61.5. FERS raises the retirement age requirement to 57 over a period of time. Employees in FERS have retired, on average, at age 63.5.

--CSRS generally provided greater benefits at age 55 than nonfederal plans, but nonfederal benefits were superior at age 62 when Social Security benefits become available to nonfederal retirees. As mentioned previously, retirees in CSRS averaged age 61.5. GAO has not yet compared nonfederal plans with FERS.

--CSRS provides greater inflation protection for retirees than do typical nonfederal plans. However, nonfederal plans often adjust benefit amounts, and CSRS adjustments have been cut back significantly in the past 10 years. The FERS pension plan affords less inflation protection than CSRS.

--CSRS, FERS, and the Social Security funds all share the common characteristic of being financed through investments in Treasury securities.

Mr. Chairman and Members of the Subcommittee:

We are pleased to be here today to discuss federal retirement issues. This is an area in which we have done considerable work over the years. This work has given us a basis from which we can offer some perspectives that the Subcommittee may find useful as it examines these issues.

Our observations today are based on the premise that retirement programs are an integral part of the employee compensation package. We recognize the pragmatic concerns raised by budget issues. However, we also believe that budget concerns should be viewed, at least in part, from the context that retirement benefits are income that employees earn while performing service for their country during their working years but receive when their working years are over. As with private sector, state, and local government employees, federal employees should be able to expect that the benefits they earn while they are working will, in fact, be paid to them when they retire.

While important to employees, retirement programs also have important management objectives. Retirement programs are tools that can help an organization keep its workforce vibrant and productive. They can be key employee recruitment and retention tools for employees and managers alike. It seems reasonable to assume that quality employees will be much more likely to want to work for and stay with an organization that has a good retirement program.

We also believe it is important to keep in mind that, about 10 years ago, the retirement program for most federal civilian employees was completely reformed. The resulting Federal Employees Retirement System (FERS) bears little resemblance to CSRS. CSRS has been closed to new entrants since the end of 1983. Currently, the great majority of retirees on the retirement rolls retired under CSRS, but CSRS and FERS each now cover about half of the 2.8 million active federal civilian employees not covered under other federal retirement systems such as the Foreign Service, Central Intelligence Agency, and Federal Reserve Board retirement systems. These other systems are much smaller than CSRS or FERS and cover a minor percentage of all federal civilian employees.

None of the above should be interpreted to suggest that we believe there are no federal retirement issues that should be considered. Quite the contrary. We believe it is important for all decisionmakers to know how the retirement systems work, the benefits they provide, and how they compare with programs in the nonfederal sector. To the extent that we are able, the chief purpose of our statement today is to help get the facts on the table. Because they are, by far, the largest retirement systems for federal civilian employees, our statement concentrates on CSRS and FERS.

RETIREMENT PROGRAM STATISTICS

In a government with a civilian workforce as large as ours, it stands to reason that the number of retirees and the total amount of retirement benefit payments they receive each year will dwarf the statistics of any nonfederal retirement program. According to Office of Personnel Management (OPM) statistics, at the end of fiscal year 1994, approximately 2.3 million people, including retirees and survivors of retirees and employees, were receiving monthly annuity payments from either CSRS or the FERS pension plan. At the monthly rates they were being paid, the annual payments would amount to about $36 billion.

For the 1.6 million CSRS retirees, the average monthly benefit was $1,537, or $18,444 a year. Of the just over 41,000 FERS retirees, the average monthly benefit was $662, or $7,944 a year. These averages included all the various types of retirement available under the systems, including optional, disability, deferred, early voluntary, and early involuntary, as well as the amounts for retirees who were covered by the special provisions for Members of Congress, congressional staff, law enforcement officers, firefighters, and air traffic controllers. When limited to general employees who retired at age 55 or older under the optional retirement provisions, the averages were $1,665 a month, or $19,980 a year, for CSRS retirees and $627 a month, or $7,524 a year, for FERS retirees. Since FERS retirees also receive benefits from Social Security and the Thrift Savings Plan, any benefits from those programs would be in addition to their pension plan amounts.

One statistic that may be surprising to many observers is that about a quarter of the 2.3 million annuitants receiving CSRS and FERS benefit payments at the end of fiscal year 1994 were widows, widowers, children, and other survivors of deceased employees and retirees. In total, about 600,000 survivors were receiving monthly benefits from CSRS and the FERS pension plan. Their benefits averaged $791 a month, or $9,492 a year, under CSRS and $262 a month, or $3,144 a year under the FERS pension plan.

HISTORY OF RETIREMENT PROGRAMS FOR FEDERAL CIVILIAN EMPLOYEES

You asked that we include in our statement a discussion of the history of CSRS and FERS.

CSRS has a much longer history as it was established in 1920. It even pre-dates the Social Security system by several years. It was the first retirement program for employees in the federal civil service and was born out of a pressing management need to remove from employment permanently tenured personnel who could no longer perform effectively because of age or infirmities. Many employees had grown quite old and often became inefficient in their work and incompetent for continued service. Because most elderly workers had not been able to make provisions for their old age, and because isolated instances of removing them had drawn adverse public reaction, it was very difficult to induce managers to dismiss them. As a result, an unofficial, unauthorized pension system had evolved that simply retained on the employment rolls, under various pretexts, all superannuated employees with many years of service and paying them full salary for little or no work. Needless to say, this practice impaired the efficiency of government operations and retarded the advancement of more competent employees.

When initially enacted, CSRS provided only two types of retirement--mandatory and disability. Mandatory retirement was set at age 70, and if employees had completed at least 15 years of service at that age, they were paid annuities. Disability retirement annuities were paid to all employees with at least 15 years of service who became totally disabled for useful and efficient service before reaching the mandatory retirement age. Mandatory and disability annuities were determined in the same manner and provided annuity amounts ranging from a minimum of $180 to a maximum of $720 a year.

Many changes were made to CSRS in ensuing years. Optional retirement provisions were added in 1930. They allowed employees who had completed 30 or more years of service to retire 2 years earlier than the mandatory separation age with no reduction in annuity. The rationale behind the provisions was that certain individuals become superannuated and inefficient earlier in life than others and affording such employees the opportunity to retire a few years early with fair remuneration for long service would enhance government efficiency.
In 1942, the optional retirement provisions were liberalized. The new provisions permitted voluntary retirement at age 60 with 30 years of service, at age 62 with 15 years, or (with a reduced annuity) between ages 55 and 60 with 30 years. According to the legislative history, this change was made because most other public retirement systems provided earlier retirement options and the change would reduce the number of employees retiring on disability, thereby effecting a savings in administrative costs.

The current CSRS optional retirement provisions for general employees were adopted in 1956 and 1967. In 1956, the provision for optional retirement at age 62 with 15 years of service was changed to age 62 and 5 years, and the annuity reduction for employees electing to retire at age 55 with 30 years of service was eliminated in 1967. Also in 1967, the service requirement for optional retirement at age 60 was changed from 30 to 20 years. The legislative history shows that these changes were prompted by arguments that 30 years is a full career, justifying retirement without penalty, and a report to the President by a Cabinet committee recommending the age 55, 30 years service option with unreduced annuity be adopted. The Cabinet committee also recommended the age 60, 20 years service option as a meaningful intermediate option between the 55/30 and 62/5 provisions and to establish a more consistent relationship between age and service requirements.

An annuity formula was first used for CSRS in 1926. Under that formula, annuities were based on employees' annual average salaries during their final 10 years of service (not to exceed $1,500) and years of service (up to 30). The formula produced a maximum annuity of $1,000. In 1930, the formula and salary base were changed. The new base was a 5-year average (limited to $1,600). The new formula produced a maximum annuity of $1,200.

Through the years, several other changes were made to the benefit formula. In 1942, the ceiling on the high-5 average salary was eliminated, and, in 1948, a new formula was adopted that computed benefits by multiplying the high-5 salary by 1.5 percent for each year of service or, if a greater amount would result, by 1 percent plus $25. The 1948 legislation also established a maximum annuity of 80 percent of high 5.

The current 3-step benefit formula, using a high-5 salary base, was adopted in 1956. It calculated benefits for general employees at 1.5 percent of high 5 for each of the first 5 years of service, 1.75 percent for each of the next 5 years, and 2 percent for each year of service greater than 10. This formula was an apparent compromise between a formula contained in a federal employee union-supported bill and a formula recommended by the Civil Service Commission, the predecessor of OPM. The union-supported bill provided for using the 1948 formula for the first 5 years of service and using 2 percent of high 5 for all remaining years. This would have produced a basic annuity of 57.5 percent of high 5 after 30 years of service. The Commission's proposed formula would have provided a 30-year benefit of 52.5 percent of high 5. The formula ultimately adopted provided 56.25 percent of high 5 for 30 years of service.

In 1969, the salary base for computing annuities was changed from the high-5 average to a high-3 average. The rationale for this change was that the high 5 tended to keep employees working beyond the time they would have, or should have, retired because pay increases prompted employees to postpone their retirements in order to improve their high-5 averages which could increase appreciably with each additional year of service.

Over the years, many other changes were made to CSRS. The disability retirement provisions were revised at least six times; discontinued service and deferred retirement provisions were added and also changed several times; and, since 1939, the system has provided annuities to surviving spouses and children of employees who die during their working years and of retirees who elect survivorship coverage by accepting reduced annuities.

CSRS was also frequently changed to extend coverage and/or provide preferential benefits to particular employee groups, including Members of Congress, congressional staff, law enforcement and firefighter personnel, and air traffic controllers. Separate provisions for these groups allow higher annuities and/or earlier retirement eligibility than provided to general employees.

Several changes to the CSRS statute have reduced its costs substantially. Much of the savings have come from changes to the retiree cost-of-living adjustment (COLA) provisions. From 1969 to 1976, CSRS COLAs were based on monthly increases in the Consumer Price Index (CPI), and a 1 percent "kicker" was added to each adjustment. The add-on was eliminated and twice-a-year adjustments equal to the percentage increase in the CPI were instituted in 1976. In 1981, the manner in which initial adjustment amounts after retirement were determined was changed to reduce them considerably, and annual adjustments were adopted in 1981. We recommended all these changes based on our analytical findings that the practices tended to overcompensate retirees for their loss of purchasing power.

Other changes to CSRS COLAs have been primarily budget driven. Scheduled COLAs have often been reduced, delayed, or skipped as part of budget reduction efforts. For example, in 1983, the CSRS COLA was delayed 1 month and was limited to one-half the increase in the CPI for nondisabled retirees under age 62; the 1984 COLA was delayed for 9 months; in 1986, the President and Congress decided not to grant any COLAs to federal retirees that year; and for fiscal years 1994, 1995, and 1996, the COLAS were delayed to April of each year instead of the scheduled January effective dates. Our calculations indicate that the COLA delays and reductions imposed during the 10-year period from 1985 through 1994 caused the COLAs to be equal to about 80 percent of the CPI increase during that period.

Other significant savings have come from changes we recommended to tighten the CSRS disability and early retirement provisions to eliminate system abuses and close loopholes. As a result, the conditions under which disability and early retirement can be granted were changed, and disability benefits were reduced or eliminated for many individuals who were receiving benefits under conditions that were not in keeping with system objectives.

FERS has a much shorter history. It was adopted because the Social Security Amendments of 1983 brought all federal civilian employees first hired after December 1983 under Social Security. The amendments were primarily intended to resolve financial difficulties in the Social Security system, but they also had the effect of requiring that a new federal retirement program be developed to supplement the benefits new employees would earn from Social Security. The ultimate design of FERS was determined after extensive analyses of nonfederal retirement programs and how nonfederal practices could be applied in the government. FERS adopted the nonfederal approach of providing Social Security coverage, a defined benefit pension plan, and the Thrift Savings Plan in which employees may participate to increase the retirement income provided by the other two parts of the FERS package. The FERS pension plan also provides substantially reduced retiree COLAs as compared to the full COLAs provided by the CSRS statute.

FERS was implemented in 1987. For employees who entered the government during the 3-year interim between January 1984, when Social Security coverage began and CSRS was closed to new entrants, and January 1987, a "CSRS offset" plan was instituted whereby employees were covered by both CSRS and Social Security. Under this arrangement, the Social Security contributions employees made and any Social Security benefits they received from their federal service were deducted from their CSRS contributions and benefits, respectively. Also, Members of Congress were covered by Social Security in January 1984, regardless of when they entered Congress. Members in CSRS were given the option of participating in the offset plan or being fully covered by both CSRS and Social Security. After FERS became operational in 1987, Members and employees in CSRS and the offset plan were given the option to switch to FERS.

To our knowledge, no substantive changes have been made to FERS since its inception other than the same COLA delays applied to CSRS retirees in fiscal years 1994, 1995, and 1996.

FEDERAL RETIREMENT MATTERS OFTEN AT ISSUE

The issues we most often see raised in relation to federal retirement are (1) the ages at which employees are allowed to retire, (2) the amount of benefits the systems pay to retirees, (3) the federal COLA provisions in comparison to the COLAs paid by nonfederal retirement programs, and (4) how the systems are financed. Our observations based on current and past work on each of these issues are discussed below.

Retirement Age

As mentioned previously, CSRS provides general employees the options to retire at age 55 with 30 years of service, at age 60 with 20 years, and at age 62 with 5 years. Earlier optional retirement provisions are available to Members of Congress, law enforcement officers, firefighters, and air traffic controllers.

One of the frequent criticisms of CSRS is that the option of unreduced benefits at age 55 is generally not available in nonfederal pension plans. Indeed, our 1984 analysis of private sector plan features showed that age 62 or younger was the prevailing age at which unreduced benefits were available.[1] However, we also found that the age requirement should not be

[1]See Features of Nonfederal Retirement Programs (GAO/OCG-84-2, June 26, 1984).

considered in a vacuum. Rather, it should be viewed in the context of the length of service requirement that accompanies the age requirement. Some private sector plans allowed long-service employees to retire with unreduced benefits at ages younger than 62, and very few private sector plans that used age 62 required employees to have 30 years of service before benefits would be paid.

More recent data indicate that retirement age provisions in private plans have changed little, if at all. For example, a 1993 Bureau of Labor Statistics (BLS) survey of benefits provided to employees in a representative sample of private establishments employing 100 or more workers showed that about half of the employees were in plans that would provide unreduced benefits at age 62 or younger, often with 10 or fewer years of service. The survey also showed about 8 percent of the employees were in plans that allowed retirement at age 55 with 30 or fewer years of service. Another 3 percent were in plans that allowed retirement at any age when an employee's combined age and years of service totaled 80 or less. Thus, a number of private plans follow the CSRS practice of distinguishing between long- and short-service employees in their retirement eligibility provisions, as was the CSRS framers' objective.

The practice of allowing employees to retire on unreduced annuities at ages younger than 62 is quite prevalent in retirement plans for state and local government employees. According to a 1992 BLS survey of benefit programs in a sample of governmental units employing 100 or more workers, about 34 percent of all employees were in plans that allowed optional retirement at any age with 30 or fewer years of service. Another 23 percent were in plans that allowed optional retirement at age 55 with 30 or fewer years of service, and 5 percent were in plans that allowed optional retirement when an employee's age and years of service together totaled 85 or less.

It should also be recognized that, because of the 30-year service requirement, most federal employees do not qualify for optional retirement at age 55. And, many of the employees who have 30 years of service do not retire immediately upon reaching retirement eligibility. In fact, on average, the 38,550 employees retiring under CSRS' optional retirement provisions in fiscal year 1994 were age 61.5 and had 30 years of service. About 35 percent of these employees retired at the ages of 55 to 59. They averaged age 57 and had almost 35 years of service.

Consideration of the retirement age issue should also take into account the fact that the optional retirement age has been raised under FERS. FERS instituted a Minimum Retirement Age (MRA) concept that gradually increases, from age 55 to age 57, the earliest age at which general employees under FERS are eligible for optional retirement.[2] Like in CSRS, employees in FERS must have 30 years of service to retire without a benefit reduction at the MRA.

FERS has another provision intended to serve as an incentive for employees to extend their careers beyond the MRA. Employees who retire at age 62 or older and have completed at least 20 years of service receive annuities calculated at a formula that provides a 10 percent greater benefit amount than the formula applied to employees who retire before age 62. The provision may be having an effect on the average FERS retirement age. The 5,965 employees who retired optionally under FERS in fiscal year 1994 averaged age 63.5, 2 years older than CSRS retirees in that year.

In our view, the incentive in FERS for employees to extend their careers is in keeping with demographic changes that are occurring. In a 1992 report[3], we described the significant demographic changes that have occurred and are occurring in the U.S. labor force, including its increasing age as a result of the "middle-aging" of the baby boom generation and the comparatively low birthrates that followed the baby-boom era. The report observed that workforce aging is a trend that may have a profound impact on the world of work in the first half of the 21st century. The median age of the Nation's civilian workforce rose from 34.3 in 1980 to 36.6 in 1990, and is expected to reach 40.6 by 2005. The government's workforce in 1990 was, on average, 5 years older than the workforce in general.

In a 1993 report[4], we discussed how the government and most nonfederal employers had done little to prepare for the challenges presented by workforce aging. Among the actions most experts agreed employers should be taking was to encourage their valued older workers to extend their careers.

A 1991 survey we made of federal employees who were within 5 years of retirement eligibility showed that many of the government's older workers would be willing to extend their careers if certain incentives were included in the retirement programs.[5] For example, 59 percent of the respondents said they would probably stay longer than they had planned if the benefit

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[2]The FERS MRA is age 55 for employees born before January 1, 1948. The MRA gradually increases until it reaches age 57 for individuals born after December 31, 1969.

[3]The Changing Workforce: Demographic Issues Facing the Federal Government (GAO/GGD-92-38, March 24, 1992).

[4]Federal Personnel: Employment Policy Challenges Created by an Aging Workforce (GAO/GGD-93-138, Sept. 23, 1993).

[5]Federal Employment: How Federal Employees View the Government as a Place to Work GAO/GGD-92-91, June 18, 1992.

formula for retirement-eligible employees were increased; about 41 percent said an increase in the government's contributions to their thrift savings plans after they were eligible to retire would make it likely that they would delay their retirements; and about 33 percent said a reduction in employee contribution requirements after retirement eligibility would probably cause them to extend their careers. These findings suggest that exploring the possibility of adding incentives for later retirements to CSRS and FERS could help enhance workforce capacity by retaining employees with needed knowledge, skills and abilities. Such incentives could also possibly generate cost savings in that the government would not be paying concurrent retirement benefits to a retiree and salary to a current employee to achieve the performance of a given job.

The data show that almost all private and state and local government plans allow employees to retire before they attain the age and service requirements necessary for the payment of unreduced benefits. Typically, they allow employees to retire by age 55 with 10 or fewer years of service at reduced benefit amounts. FERS incorporated this concept by allowing employees to retire at the MRA if they have at least 10 years of service. Benefits for employees who elect this option are reduced by 5 percent for each year they are younger than 62. CSRS does not have a similar provision.

Benefit Comparisons

Comparing retirement benefits is not an easy task. There is wide variation in the designs of retirement programs and the amounts of benefits they provide. As we noted earlier, even CSRS and FERS bear little resemblance to one another.

When FERS was being developed, the congressional committees of jurisdiction asked us to assist by identifying the features and benefit levels typically found in nonfederal retirement programs. We issued two reports in response to this request.[6] At your and the House Subcommittee on Civil Service's requests, we are updating these analyses. We have not yet completed this work, but, thus far, we have seen nothing to indicate that significant changes have occurred in the design of nonfederal retirement programs or the level of benefits they provide.

In our earlier reports we found that, like the eventual design of FERS, private companies' retirement programs typically consisted of three parts--a defined benefit pension plan, one or more capital accumulation plans (most commonly, a thrift savings plan to which the employees and companies contributed, but also including programs such as profit-sharing plans and stock-

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[6]Features of Nonfederal Retirement Programs (GAO/OCG-84-2, June 26, 1984) and Benefit Levels of Nonfederal Retirement Programs (GAO/GGD-85-30, Feb. 26, 1985).

ownership plans), and Social Security. It appears from our current work that the basic structure of nonfederal programs is essentially the same. As one 1994 study[7] of nonfederal retirement programs noted, "Defined benefit pension plans...continue to play an integral role in most organizations' benefit packages. A majority [of the organizations studied] offer a defined benefit plan, and almost all of these...supplement their plan with some type of [capital accumulation plan]."

All the states have retirement programs, and most states also cover their employees under Social Security. The states often have capital accumulation plans as well, but the plans generally do not provide for employer matching of employee contributions.

Very few private pension plans require employee contributions toward plan costs. State pension plans generally require employee contributions, but in most cases the states have "employer pick-up" plans whereby taxes on the part of the employee's income used for pension plan contributions are deferred.

Our earlier analyses disclosed that benefit formulas in the nonfederal pension plans varied considerably. The majority of private plans based benefit amounts on employees' average salaries earned during their 5 highest paid years. Some private plans, particularly in large companies, and a majority of the state plans used a high 3-year average. The benefit accrual rates differed, and the approaches to recognizing Social Security benefits and the early retirement reduction provisions also differed from plan to plan.

We could not identify one formula as being representative of all plans included in our various data sources. Accordingly, we applied the plan formulas to a series of salary levels, retiree ages, and years of service and calculated the benefit amounts produced by the formulas as a percentage of final salary. In this manner, we could determine the average benefit levels provided by the plans. We also calculated the benefits available from Social Security and the typical thrift savings plan to determine the total retirement income the retirees would receive. The benefits varied somewhat by salary level, but, to illustrate our findings, Table 1 shows the retirement incomes available to private sector and state employees from all three sources at a final salary of $40,000 and at various ages and years of service. The retirement incomes available from CSRS are also shown. We have not yet compared FERS and nonfederal program benefits.

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Table 1: Benefits as a Percentage of Final Salary

Age	Years of service	Private sector retiree[a]	State retiree	CSRS retiree[b]
55	10	12.2 to 14.0%	9.6%	None
55	30	38.8 to 45.5	35.9	56.25
62	20	45.6 to 48.7	40.5	36.25
62	30	65.1 to 70.3	57.8	56.25
65	20	53.9 to 56.5	48.5	36.25
65	30	74.2 to 77.3	64.5	56.25

[a]Because our various data sources covered different pension plans, the average benefits available from the plans also varied somewhat by data source. The higher amounts were generally provided by the larger plans.

[b]The benefits for the CSRS retiree are as a percentage of high 3 rather than final salary.

The retirement amounts for state retirees were generally lower than the amounts for private sector retirees principally because, at the time of our analyses, most state governments did not make contributions to employee capital accumulation plans. Thus, we did not include any benefits from capital accumulation plans in the retirement calculations for state retirees.

It is apparent that the relative benefits of CSRS and nonfederal programs depended heavily on when employees retired and how much service they had. CSRS provided greater benefit amounts to general employees retiring optionally at age 55 and 30 years of service than did the typical nonfederal program. On average, retirees in CSRS were age 61.5 in fiscal year 1994. However, nonfederal benefits were superior at age 62 when Social Security benefits were available to nonfederal employees. Also, even though the benefit amounts available to nonfederal employees at age 55 with 10 years of service were rather small, general employees in CSRS can receive no optional retirement benefits at age 55 unless they have at least 30 years of service.

It is possible that the more current data we are developing will show different results. However, nonfederal employers would have had to make major changes to their retirement programs since we did our earlier work if appreciable differences in comparisons with the CSRS are to be found.

Another factor that makes comparisons difficult is Social Security coverage that provides additional benefits, such as spousal and dependent benefits. Our comparisons and those of others focused only on the benefits accruing to individuals and did not include these additional Social Security benefits. The Social Security spousal benefit is 50 percent of the primary benefit and is paid in addition to the primary benefit while both spouses are alive (unless the spouse is eligible for a larger primary benefit in his or her own right). The primary benefit is paid to the surviving spouse upon the other spouse's death. Neither CSRS nor the FERS pension plan provides a spousal benefit while the retiree is living, and survivor benefits are less than the amount the retiree was receiving before death.

Cost-of-Living Adjustments

The CSRS statute calls for annual adjustments equal to the increase in the CPI. This was instituted to protect the purchasing power of retirees' annuities. Without inflation protection, the value of an annuity after several years of retirement could be far less than its value at the time of retirement.

The private sector has also recognized this concept, but to a more limited degree and in a less structured way. Our earlier studies showed that private sector pension plans often adjusted benefit amounts in recognition of the effects of inflation on retirees' purchasing power. These adjustments were generally granted ad hoc rather than the result of a pension plan feature. Moreover, the amount and frequency of the ad hoc adjustments tended to vary with plan size. According to a Department of Labor study of a statistical sample of private sector retirees completed in the late 1970s, the retirees received average adjustments during 1973-1979 equal to 37.9 percent of the increase in the CPI, ranging from 5.5 percent for retirees in the smallest plans (1 to 99 participants) to 57.2 percent for retirees in the largest plans (10,000 and more participants).

More current information from BLS and several benefits consulting firms again shows wide variation in adjustment practices by employer size as well as by industry. A study of 50 large companies showed 70 percent of them gave at least one adjustment during the 10-year period of 1984 to 1993, some of which were sizeable. For example, one company gave adjustments in 1985 ranging from 1.5 to 18 percent depending on the date of retirement, and in 1991 the company gave another adjustment of 2 to 20 percent, again based on date of retirement. Another study of employers of all sizes showed 38 percent had given at least one adjustment during the same 10-year period. As a rule, the more current studies contain very limited information on the size of the adjustments.

In addition to the cost-of-living adjustments that may be made to their pension amounts, private sector retirees receive annual adjustments to their Social Security benefits to offset the effects of inflation. It is important to note that federal employees in CSRS are not in Social Security. Also, annual

Social Security COLAs have been given without exception for many years, while CSRS COLAs have often been reduced, delayed, or skipped for budgetary reasons in the past 10 years.

FERS retirees receive full inflation protection for their Social Security benefits, but their pension plan adjustments are limited. Pension plan COLAs for nondisabled FERS retirees are not paid until the retirees reach age 62. When paid, the COLAs are equal to the increase in the CPI if the price increase is 2 percent or less. The adjustment is 2 percent if the price increase is between 2 and 3 percent. If the price increase is 3 percent or greater, the adjustment is equal to the price increase less 1 percent. Thus, the current pension plan for federal employees has less inflation protection than the CSRS plan.

<u>Retirement System Financing</u>

There are several similarities in how CSRS and FERS are financed, but there are significant differences as well. It is our understanding that the witness from the Congressional Research Service plans to provide an indepth discussion of system financing, so we will limit our discussion to the highlights of the issue and an explanation of the positions we have taken in the past.

CSRS and the FERS pension plan require employees to contribute toward system costs. As the employer, the government is responsible for funding all costs not covered by employee contributions. If there were no cost to the government, employees, in effect, would not be receiving any retirement benefits from their federal employment. We believe this reality must be kept in mind when one hears concerns being expressed about taxpayers being required to "subsidize" the systems. The cost of the retirement system is part of the overall costs taxpayers pay for the government services they receive.

Both CSRS and the FERS pension plan are "funded" programs, in that amounts are set aside (in the same fund) from which benefit payments are made. Both plans are funded using a "normal cost" approach. Normal cost is expressed as a percentage of payroll and represents the amount of money that should be set aside during employees' working years that, with investment earnings, will be sufficient to cover future benefit payments. Normal cost calculations require that many assumptions be made about the future, including mortality rates, quit rates, interest rates, employee salary increases, and cost-of-living increases over the lifespans of current and future retirees.

The amounts employees in CSRS and their agencies contribute to the retirement fund are approximately equal to the system's "static" normal cost, that is, the cost of future benefits calculated under the assumptions that employees will receive no pay increases and retirees will receive no COLAs. However, when normal cost is calculated on a "dynamic basis", including assumptions for future pay increases and COLAs, the cost is about doubled. It has long been our position that the dynamic approach is the appropriate way to calculate and fund CSRS costs since it identifies the full cost of providing benefits to covered employees. Unlike CSRS, the FERS pension plan is funded on a dynamic normal cost basis. Agencies are required to contribute the difference between dynamic normal cost and employee contributions.

Even though the amount of agency contributions covers far less than the actual cost to the government of providing CSRS benefits, much of the remaining costs are covered by other government contributions to the retirement fund. OPM makes annual contributions to the fund from its appropriation to amortize the liabilities created by employee pay raises and other benefit improvements; the Postal Service makes contributions to the fund to cover retirement system liabilities resulting from collective bargaining agreements with its employee unions and COLAs postal retirees receive; and Treasury pays the cost of benefits attributable to military service and interest on the system's unfunded liability as if it were funded. No provision exists to fund COLAs received by nonpostal retirees.

Because of the manner in which CSRS costs are determined and funded, the system has accumulated a sizeable unfunded liability. However, that liability is dealt with by the FERS statute. That statute requires that, when the amount in the retirement fund set aside to pay CSRS benefits is exhausted (because of CSRS' unfunded liability), annual appropriations will be made to amortize the shortfall over 30 years.

An understanding of CSRS and FERS financing practices and unfunded liabilities requires a realization that federal retirement benefits are not prefunded in the manner that private pension plans set aside money during employees' working years to cover the accruing costs of their retirement benefits. Rather, the federal retirement fund is "invested" in special issue Treasury securities. These are nonmarketable securities available only to the retirement fund. There is no cash in the fund. It is only when the securities are redeemed to pay retirement benefits that Treasury must obtain the necessary money through tax receipts or borrowing. This is the point at which actual outlays occur. To the extent that these outlays are met by borrowing, they add to the deficit. (It should be noted that the Social Security trust fund is invested in the same manner as the CSRS and FERS fund.)

Thus, the CSRS and FERS retirement fund represents that portion of estimated future benefit obligations that the government has recognized <u>on paper</u>. The unfunded liability is that portion of estimated future benefit obligations that has no paper backing in the form of special issue Treasury securities. Being simply an actuarial estimate, the unfunded liability itself has no effect on the budget or current outlays and is not a measure of the government's ability to pay retirement benefits in the future. In fact, appropriations to increase the amount of nonmarketable Treasury securities in the fund so as to eliminate the unfunded liability (as the FERS statute requires be done eventually) would not affect federal outlays or the deficit or require additional payments by employees or the taxpayers.

Our major concern with the funding process has been that agencies are charged less than the full accruing cost of CSRS, thus understating the cost of government programs. Our recommendation to charge agencies all accruing retirement costs not covered by employee contributions was adopted for the FERS pension plan but not for CSRS. The President's budget proposals for fiscal years 1995 and 1996 called for the FERS funding approach to be applied to CSRS as well.

IS A NEW RETIREMENT SYSTEM NEEDED?

You asked for our views on whether Congress should consider a new federal pension system as a refinement of CSRS and FERS. You also asked if we had any thoughts on whether there should be another "open season" for employees in CSRS to join FERS and, if so, how employees could be encouraged to switch to FERS and how much money Congress might have to appropriate to cover any added costs.

The budgetary implications related to federal employee retirement, as with any other government program, would certainly be a consideration in deciding whether a new pension system is needed. While recognizing this, our assessments of retirement matters have traditionally used the criteria of what practices make good retirement policy, including reasonableness and competitiveness with nonfederal plans. Also, since CSRS has been closed to new entrants for several years, our comments are primarily focused on FERS.

We have seen nothing thus far in our work that would suggest that FERS is a poorly designed program or that it will not meet the government's and employees' needs. The three-part FERS is designed like many private sector plans. It is a much more portable system than CSRS because it includes Social Security coverage that applies to all other employment in the country and the thrift plan that a separating employee can convert to another plan outside the government or keep with the government when he or she leaves before retirement eligibility. Moreover, FERS includes incentives to encourage employees to make the federal service their careers and to continue those careers beyond the minimum retirement age. It seems to us that this is a reasonable, balanced design for accomplishing portability and career service objectives.

Thus, the central question on this issue is whether there is a better approach than FERS, and if so, what it would be. Some options to explore might include moving more towards a defined contribution program by making the thrift plan a greater part of the package, or even eliminating the pension plan portion in favor of an enhanced thrift plan and Social Security. In this manner, government costs could be more easily identified and controlled. COLAs, for example, would not be an issue. However, our work shows that having both defined benefit and defined contribution plans is a common approach in nonfederal retirement programs. Moreover, defined benefit plans, including CSRS and FERS, generally include protections for employees who die or become disabled early in their careers. Such employees would have had insufficient time to earn benefit amounts of any significance from a thrift plan. From our perspective, considerable additional study is needed to develop possible courses of action on this issue.

You asked about another open season to allow employees in CSRS to switch to FERS. According to OPM, the total current cost of the three FERS components is very similar to the cost of CSRS, when measured on a dynamic normal cost basis. Thus, there would be no apparent savings to the government from allowing employees to switch plans. The employees in question have already had an opportunity to elect FERS coverage and did not do so. We have seen no information to indicate that sizeable numbers of employees in CSRS would elect FERS coverage if given another opportunity.

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That concludes my statement, Mr. Chairman. We would be pleased to answer any questions the Subcommittee may have.

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