# EBRI ISSUE BRIEF

EMPLOYEE BENEFIT RESEARCH INSTITUTE • 1920 N Street, NW Suite 520 Washington, DC 20036 • (202) 659-0670

July 1982 #10


## FEDERAL PENSIONS: AN ISLAND OF PRIVILEGE IN A SEA OF BUDGET AUSTERITY

The battle of the budget has become more focused in recent weeks. It is virtually certain that there will be some scaling back of the tax perquisites private pensions now have. This is a move to enhance revenues, i.e., raise taxes. Congress is also scrutinizing federal pension programs in an effort to reduce expenditures.

The recent budget resolution for fiscal 1983 anticipated that federal pension beneficiaries would have their cost-of-living allowances (COLAs) capped at 4 percent per year over the next three years. The Senate Governmental Affairs Committee approved the COLA cap on July 20. The measure would save an estimated $5 billion by the end of fiscal 1985.

The House Post Office and Civil Service Committee, however, has rejected the COLA ceiling for recipients of federal civilian annuities. (They do not have jurisdiction over the military retirement program.) Instead they approved two measures that would reduce federal pension costs by $113 million over the next three years. The first measure would round down monthly pension benefits to the next lowest dollar instead of the current rounding to the nearest whole dollar. The second measure would start payments at the beginning of the first month after retirement. Now benefits start the day after retirement.

The budget reconciliation process requires the various Congressional committees to provide $27.2 billion in savings to comply with three-year budget targets. Some feel that taking $5 billion of this out of the hide of federal annuitants is too extreme. The reason capping the COLA would provide such significant savings lies in the basic structure of federal retirement programs.

### The Major Programs

There are two retirement systems that account for most of federal retirement costs. These are the Civil Service Retirement System (CSRS) and the Military Retirement System (MRS). These two programs account for more than 90 percent of all active participants in federal retirement programs and a comparable percentage of annuitants. For example, in 1980, CSRS had 2.7 million active participants and MRS had 2.9 million, including reservists. In comparison, all of the remaining federal retirement programs had less than one-quarter million active participants at that time. In 1980, there were 1.8 million CSRS annuitants and survivors while the MRS had 1.3 million beneficiaries.

The CSRS bases benefits on the highest three consecutive years of average salary. The benefit formula replaces 7.5 percent of the high three years salary for the first five years of credited service, 8.75 percent for the next five years and 2 percent replacement for each year of service beyond ten years. The program provides normal retirement benefits for individuals at age fifty-five with thirty years of service, at age sixty with twenty years and at age sixty-two or above with five years of service. An annuitant retiring after thirty years receives 56.25 percent of his or her high three years of average salary. The program's maximum earnings replacement is 80 percent; this is accrued after slightly less than forty-two years of service.

The MRS bases benefits on final pay. The benefit formula replaces 2.5 percent of pay for each year of service. The program provides normal retirement after twenty years of service, replacing 50 percent of final pay under those circumstances. The maximum replacement rate is 75 percent; this is achieved after thirty years of service.

CSRS, MRS and most federal retirement programs provide full benefit adjustment based on the CPI. One notable exception is the Tennessee Valley Authority (TVA) retirement program. This program is integrated with Social Security and limits its COLA increases.

The Cost of Federal Retirement Programs

The cost of federal retirement programs can be considered from different perspectives. One common way to estimate the cost of a retirement program is to use what actuaries call the "entry age normal cost method." This method estimates the percentage of a worker's salary that would have to be set aside each year to fully fund benefit entitlements before retirement. Aggregating the normal cost of all workers provides an estimate of the employer's total normal cost. Public Law 95-595, passed in 1978, requires that all federal pension plans submit an annual report to Congress on their actuarial status. These reports provide normal cost estimates based on a consistent set of economic assumptions.

Table 1 shows what the estimated costs of the two largest federal retirement programs would have been in 1980, if these programs had been funded on the normal cost basis. Neither program is actually funded in this manner, however. The CSRS is partially funded, while the MRS is strictly pay-as-you-go. At the end of fiscal 1980, the accrued unfunded liabilities were $469.5 billion for CSRS and $431.1 billion for MRS.

TABLE 1

Entry Age Normal Cost of CSRS and MRS as Percent of Payroll

| Program | Employee Contribution | Employer Cost | Total Normal Cost |
|---|---|---|---|
| Civil Service | 7.0% | 29.7% | 36.7% |
| Military Retirement | 0.0 | 49.3 | 49.3 |

Source: P.L.- 95-595 Reports filed with U.S. Congress for fiscal 1980.

Private, tax-qualified, defined benefit pension plans are required to amortize their unfunded liabilities in compliance with the 1974 Employee Retirement Income Security Act (ERISA). Table 2 shows the cost that taxpayers would bear if CSRS and MRS were required to comply with the federal standards that are imposed on private plans. Such requirements would have raised the cost of CSRS to United States taxpayers to 87.1 percent of payroll in 1981; while the MRS cost would have been raised to 171.2 percent of military payroll. Under both programs, actual contributions were significantly less than half the level that was legally required of private plans. In fiscal 1980, CSRS and MRS paid out $26.7 billion dollars in benefits. Employee contributions to CSRS were $3.6 billion; MRS is noncontributory. The direct budget outlay was $23.1 billion.

TABLE 2

Taxpayer Liabilities as Percent of Payroll for CSRS and MRS
Compliance with ERISA in 1980

| Program | Taxpayers Liabilities: Employer Normal Cost | Taxpayers Liabilities: Amortization of Unfunded Liabilities | Total Cost | Actual Contributions |
|---|---|---|---|---|
| Civil Service | 29.7% | 57.4% | 87.1% | 37.7% |
| Military Retirement | 49.3 | 121.9 | 171.2 | 61.2 |

Source: P.L. - 95-595 Reports filed with the U.S. Congress for fiscal 1980.

While this cost is significant, it does not adequately represent the implications of these programs from a taxpayer's perspective.

The underfunding of federal pensions will have poignant ramifications for future taxpayers. Unfunded federal pension promises are obligations that taxpayers will ultimately have to pay. While they are not reflected in the federal debt, they are claims on future government revenues which are defined by federal pension statutes. Table 3 shows that by the end of fiscal 1980, the unfunded benefit promises in these two programs were more than $900 billion. Even more spectacular was the growth in unfunded liabilities--over $141 billion in a single year. While the financial markets and Congress now fuss over the prospect of a $100-billion deficit, there is ample evidence to suggest that the real deficits accumulating in federal retirement programs have exceeded that amount for some time.

TABLE 3

Unfunded Liabilities of CSRS and MRS for 1979 and 1980

| Programs | Unfunded Liabilities 1979 | Unfunded Liabilities 1980 | Growth in Unfunded Liabilities for fiscal 1980 | |
|---|---|---|---|---|
| | (billions) | (billions) | (billions) | (percent) |
| Civil Service | $403.1 | $469.5 | $66.4 | 16.5% |
| Military Retirement | 355.8 | 431.1 | 75.3 | 21.2 |
| Total | $758.9 | $900.6 | $141.7 | 18.7% |

Sources: P.L.- 95-595 Reports filed with the U.S. Congress for fiscal years 1979 and 1980.

## Why Federal Pensions Are Expensive

Comparison of federal pension costs with private sector retirement costs gives some perspective on the relative cost of these programs. The average cost of retirement programs in Fortune 500 firms ranges from 7 to 10 percent of payroll. In addition, the employer contributes to Social Security on the basis of employees' salaries. A generous private sector retirement program including Social Security contributions would cost the employer less than 20 percent of payroll. While CSRS participants are not covered by Social Security, the federal government -- i.e., the taxpayers -- would have to contribute nearly 30 percent of payroll throughout a workers' lifetime to fund his or her benefit. In the military, the cost would be nearly 50 percent; additionally, the government provides Social Security coverage.

There are three basic reasons that federal pensions are relatively expensive. First, federal programs provide early retirement with unreduced benefits. Second, they provide high initial benefits. Third, they provide a fully indexed benefit.

The median retirement age under CSRS is below fifty-eight. Under the MRS, the median retirement age is thirty-nine. For most private retirement programs, the normal retirement age is sixty-five.

The second reason is actually related to the first. Private pensions often aim to provide income replacement rates which, when combined with Social Security for full career workers, are comparable to the maximum rates attainable under CSRS or MRS. However, the later normal retirement ages under private plans generally result in shorter benefit payment periods. While most private plans allow early retirement, benefits are often actuarially reduced, especially for workers retiring before age sixty. Such actuarial reductions are rare in federal retirement programs.

Finally, private plans rarely maintain full CPI indexation of benefits. Most private pension beneficiaries do receive periodic benefit increases, but virtually none receive the kinds of protection afforded federal annuitants. A military retiree who retired at age forty-five with twenty-five years of service in 1965 will receive a 1982 pension that is more than three times his final military pay. He will be age sixty-two this year and eligible for Social Security.

## Relative Benefit Levels

During 1979, federal retirement programs paid more in benefits than all private pension programs combined. Median federal pension benefit levels are about three times the benefit levels of private beneficiaries. Considering that active and retired federal pension participants make up less than 5 percent of the total United States population, there are basic equity questions that should be considered. These questions arise because of the nature of taxpayer support and the relative generosity of federal pensions.

TABLE 4

Pension Receipt and Benefits -- 1979

| Type of Pension | Number of Families Receiving Benefits (thousands) | Total Benefits (billions) | Median Benefit |
|---|---|---|---|
| Private | 5,773.4 | $18.77 | $2,199 |
| State or Local | 1,898.8 | 8.14 | 3,171 |
| Federal Civilian | 1,210.2 | 10.08 | 6,728 |
| Military | 1,221.5 | 9.57 | 6,496 |

Source: EBRI tabulations of March 1980 Current Population Survey.

## Congressional Considerations

Congress is now faced with the unpleasant choice of deciding whether to cap federal pension COLAs at 4 percent per year for the next three years. Some might argue that this measure does not go far enough. Tabulations of the March 1980 Current Population Survey show that 71.4 percent of military pension recipients are under age sixty-two and that more than two-thirds of this group continue to work. While only 34.5 percent of federal civilian pensioners are under age sixty-two, more than half of them continue to work.

Private sector workers, including the overwhelming majority of taxpayers, are not eligible for indexed Social Security benefits until age sixty-two. Is it fair that they pay for the indexation of annuities for federal program beneficiaries who are below sixty-two and who are able to work? Freezing federal annuities for those who are below age sixty-two and able to work and providing a full catch up at age sixty-two would, in the long run, save far more than the proposed three-year cap. Such a policy may be consistent with other budget cuts that have reduced welfare, food stamps, Medicaid, school lunch and other benefits for the needy.

At some point, the Administration and Congress should step back and broadly assess their own retirement programs and goals. Indeed, Senator Ted Stevens of Alaska, Chairman of the Senate Government Operations Committee has begun this process for the CSRS. Given the rethinking of federal priorities, military pension policy may also deserve serious review.

During this period of budget austerity, a basic policy issue facing the Congress is whether federal pensioners should be granted an island of privilege against the cuts affecting most other segments of society.

The Employee Benefit Research Institute's Education and Research Fund (EBRI) was established to contribute to the expansion of knowledge in the employee benefit field. The Education and Research Fund is tax exempt under section 501(c) (3) of the Internal Revenue Code and is not a private foundation. Individuals, corporations, companies, associations and foundations are eligible to support EBRI's work through tax-deductible contributions.

EBRI's policy forums, research studies, issue briefs, pamphlets and other publications aid public and private sector decision makers, managers, the press and the general public in formulating and articulating positions on employee benefit issues. As health and retirement issues receive increasing attention, EBRI strives to make effective and responsible contributions to public policy.

**RETURN TO: EBRI, 1920 N Street, NW/Suite 520/Washington, DC 20036 (202) 659-0670**

***EBRI NOTES,*** a bimonthly newsletter, includes information about: 1) newly released employee benefit statistics; 2) brief summaries of EBRI's ongoing research studies and forum discussions; and 3) reviews of outside research and publications.

***ISSUE BRIEFS,*** published monthly, offer summary information and critical analysis of evolving employee benefit issues and trends.

EBRI's sponsors automatically receive an annual subscription to *EBRI Notes/Issue Briefs.* Others can subscribe to these publications for $100 annually.

☐ I would like information on becoming an EBRI sponsor.

☐ I would like to subscribe to *EBRI Notes/Issue Briefs.* My check for $100 is enclosed.

**NAME** **TITLE** **TELEPHONE**

**STREET ADDRESS** **CITY** **STATE** **ZIP CODE**

**ORGANIZATION** **TYPE OF ORGANIZATION** **AREA OF INTEREST**

*Articles published in* Notes *and* Briefs *do not necessarily represent the views of EBRI's sponsors, and they are not intended to support or oppose any legislation before Congress. Reproduction is granted provided proper attribution is given.*

EBRI

EMPLOYEE BENEFIT RESEARCH INSTITUTE
EDUCATION AND RESEARCH FUND
1920 N Street NW/Suite 520/Washington, DC 20036

Address Correction Requested
Return Postage Guaranteed

Nonprofit Organization
U.S. Postage
PAID
Washington, DC
Permit No. 3968