EBRI ISSUE BRIEF

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

December 1982 #13

HAS THE TIME FOR CONSISTENT FEDERAL RETIREMENT INCOME POLICY ARRIVED?

The federal government establishes retirement income policy that affects every retiree. Federal policy determines Social Security benefits and federal civil service and military pension benefits. It also determines the rules, which private sector and state and local government retirement income plans must follow in order to receive federal tax-qualified status.

There is little consistency among such policies. This is partially due to the fragmentation of policymaking responsibilities within the Congress and the executive branch. The General Accounting Office has found that 119 out of 306 congressional committees and subcommittees have policymaking, fiscal or oversight responsibilities for income security programs. Ten out of twelve cabinet departments in the executive branch and at least seven independent agencies administer income security programs.1/ Not all of these programs deal specifically with retirement issues. Nonetheless, these findings demonstrate that coordinated policymaking may be difficult within current legislative and administrative structures.

Diffusion of policymaking responsibilities leads to inconsistencies in the treatment of retirees. Recent debates and legislative actions affecting current and future retirees offer an example. The Social Security system and the private pension system are facing severe downward adjustments. Social Security is undergoing close scrutiny by Congress and the members of a presidential commission--the National Commission on Social Security Reform. Since Social Security is expected to run out of money in mid-1984, benefit adjustments, payroll-tax increases or both may be necessary. Furthermore, the 1982 Tax Equity and Fiscal Responsibility Act (TEFRA) cut back the private pension system. It cut certain benefits and reduced employer contribution levels. Congress appears to be telling the private sector that it should be frugal in designing retirement income programs.

The Congress has taken the opposite approach with federal workers. This will lead to increased federal budget costs. Until this year, civil service retirees who were eligible for Social Security could not include their military service earnings toward both their Social Security and Civil Service Retirement System (CSRS) benefit calculations. As of September 1982, however, civil service retirees with military service experience will be able to claim both Social Security and civil service credits for time served in the military. This provision of the 1982 Budget Act,2/ affects over one million federal civilian

1/ U.S. General Accounting Office, U.S. Income Security System Needs Leadership, Policy, and Effective Management (Washington, D.C.: U.S. Government Printing Office, 1980).

2/ Omnibus Budget Reconciliation Act of 1982.

workers. As a result of this change, the Office of Personnel Management (OPM) estimates that two-thirds of all male federal employees will receive higher CSRS retirement incomes.

How Federal Pension Benefits Are Credited

Armed services personnel were brought under the Social Security system in 1956. Servicemen and their employer (the government) pay Social Security payroll taxes based on cash wages. Servicemen also receive credits that reflect the imputed value of in-kind elements of military compensation. This avoids penalizing the Social Security earnings record for the portion of military pay, which is provided in the form of benefits (e.g., health care and housing aid). Although such credits are included in the Social Security earnings record, no employer or employee contributions are paid on these credits.

If a former serviceman enters the federal civil service, his CSRS pension will be based on his combined military and civil service. During the period when a serviceman is employed by the federal government, both he and his agency make CSRS pension contributions. However, no contributions are made for the CSRS pension credits that are provided for military service. Therefore, free CSRS credits and free Social Security credits (for the noncash component of military compensation) are given.

Catch 62

Prior to the 1982 Budget Act, federal civilian retirees with military service received an annuity adjustment at age sixty-two if they were eligible for Social Security. This controversial benefit treatment has come to be known as "Catch 62." The adjustment was made because post-1956 military service for these persons had also been credited under Social Security. Some retirees thus received lower benefits because CSRS annuities are generally higher than Social Security benefits. CSRS annuities are higher because the Social Security benefit formula is redistributive. High earnings, therefore, do not benefit the Social Security recipient as much as they do the CSRS pension recipient.

Retired federal employees, however, are no longer vulnerable to Catch 62. Military service will now be included in the CSRS annuity computation at no cost to the retiree. Current and future federal employees will also be saved from Catch 62 when they retire--but at a price. By paying the CSRS fund 7 percent of military earnings, current and future federal workers will avoid a reduction in their CSRS annuities.[3/] This price, however, is relatively small for the increased benefits.

The Effect of the 1982 Budget Act

Although individual circumstances will vary, it is possible to estimate the effect of the change on various workers. Actual gain for any one worker will depend on: (1) assumed salary growth; (2) current pay scale; (3) life

3/ New federal workers who do not pay the 7 percent will incur the reduction at age fifty-five, should they choose to retire at that age. Workers have two years from October 1, 1982, or their hiring date, to pay this sum without interest. After that time, interest will be charged on the amount owed.

expectancy; and (4) length of military service. Generally, the longer a worker's military service, the greater the gain.

A civil servant with four years of military service, who earns $30,000 in 1982, could expect to receive a net lifetime increase in benefits of over $65,000. If that same civil servant earned $50,000 in 1982, he would gain over $83,000 in benefits. If the civil servant was a private in the military between 1957 and 1960, he would be required to pay $334 to avoid Catch 62. If he was a captain during that time, he would pay $1,344. See Table 1.

No one knows how many retirees will be affected or what the long-term costs of this buy-back provision will be. In the short term, it is expected to increase net federal revenues. Current federal workers will probably be willing to make the relatively small payments needed to reap the large future benefit gains. The Congressional Budget Office estimates that revenues from the buy-back provision will total $116 million through 1985. Net outlays (reflecting the larger annuities to workers already retired) will grow by only $37 million during that time. OPM is responsible for long-term cost projections, but has made no estimates of what this new provision will cost. Furthermore, it does not plan to do so until it makes its next scheduled CSRS actuarial valuation. It appears that Congress has made a major commitment of future taxpayers' money without knowing what the commitment will cost. One thing is certain, it will cost future taxpayers billions of dollars.

Comparing Private and Federal Retirement Income Programs

The CSRS's assumption of the added benefit obligations illustrates some sharp contrasts between the financial management of private and federal retirement income programs. Most private pension plans are advance funded.[4] Most federally sponsored plans are pay-as-you-go. Pay-as-you-go funding contributes to the current, high costs of federal plans. Large private plans, for example, required 8.1 percent of payroll in 1981. See Table 2. In contrast, the Military Retirement System (MRS) required 57.3 percent and the CSRS required 39.9 percent of payroll in 1981. Part of this difference can be attributed to the greater generosity of federal pensions. Regardless, these contributions would not be adequate if federal plans were subject to Employee Retirement Income Security Act (ERISA) requirements. To comply with ERISA, the MRS would have needed over 159 percent and the CSRS would have needed over 92 percent of payroll in 1981.

Conclusion

The Congress and the Administration have shown that they believe current budget problems require sacrifices--tax increases and budget cuts--from various segments of the population. As a result of TEFRA and potential changes in Social Security, private sector workers are facing retirement income cutbacks on all sides. On the other hand, the 1982 Budget Act will give many public workers much larger benefits.

Congress and the executive branch could benefit from reexamining the recommendations of the President's Commission on Pension Policy, which are contained in the Nickles-Erlenborn bill of the 97th Congress (H. R. 4330/S. 1741). The Commission recommended centralizing retirement program policymaking. Equitable treatment of public and private sector workers would be more easily accomplished if federal policymaking emanated from fewer sources.

4/ See Sophie Korczyk, Retirement Income Opportunities in an Aging America: Pensions and the Economy (Washington, D.C.: EBRI, 1982), pp. 23-44.

TABLE 1

The Effect of the Military Service Buy-Back Provision on Various Workers Aged 47 in 1982

Civil Service Salary in 1982	Projected Pay for these Workers Retiring at Age 62 1/	Projected Annual Civil Service Pension Discounted for Military Service 2/	Projected Annual Pension Not Discounted for Military Service 2/	Lifetime Increase in Benefits 3/		Required Buy Back 5/	
				Current Dollars	Discounted Dollars 4/	Private	Captain
$30,000	$54,028	$25,079	$29,237	$65,696	$41,948	$334	$1,344
50,000	67,293	31,836	37,115	83,408	53,256	334	1,344

Source: EBRI calculations.

1/ The lower salary is projected to grow at 4 percent annually through 1997, while the higher salary is projected to grow at 2 percent annually because the higher-paid worker is close to the civil service salary cap.

2/ Calculations assume four years of military service and twenty-six years of civilian service.

3/ Computations assume that all workers live to age sixty-two and have a life expectancy of 15.8 years at that age.

4/ This value is the lifetime increase in benefits discounted to 1982 assuming a 2 percent real discount rate. If some workers were assumed to die before age sixty-two the discount rate would be higher and the present value smaller.

5/ Based on average monthly salary at appropriate rank during years of service.

TABLE 2

Civil Service Retirement System,
Military Retirement System and
Private Pension Costs as a Percent of Payroll--1981

Plan	Current Costs as Percent of Payroll	Current Costs as Percent of Payroll Based on ERISA Requirements 1/
Civil Service	39.9%	92.1%
Military	57.3	159.3
Large Private Plans	8.1	8.1

Sources: Civil Service and Military data from P.L. 95-595 reports filed with U.S. Congress; private plan data from Johnson & Higgins, Funding Costs and Liabilities of Large Corporate Plans: 1981 Executive Report (New York, 1982), p. 30.

1/Normal cost plus forty-year level amortization of unfunded liability.

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**

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