Statement of

Sylvester J. Schieber
Research Director

Employee Benefit Research Institute

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The views in this statement are those of the author and do not necessarily reflect the views of the Employee Benefit Research Institute, its Trustees, members, or other staff.

Mr. Chairman, I am pleased to appear before you today to discuss the financing of federal work related retirement entitlement programs. I appear in my capacity as Research Director of the Employee Benefit Research Institute. EBRI is a nonprofit organization dedicated to providing research and analysis which can serve as a basis for sound policy toward employee benefits. EBRI as an institution does not take positions on public policy issues. Today I am going to direct my prepared comments primarily toward the Civil Service Retirement System (CSRS) and the military's retirement program. I will also discuss the budgetary implications of covering new federal workers under Social Security.

BACKGROUND

The earliest predecessor to today's federal retirement progams can be traced back to 1636 when the settlers at Plymouth Colony decreed "that any man sent forth as a soldier and returned maimed should be maintained by the colony during his life." The colonies made similar provisions for men who were disabled and for survivors of men who were killed in military expeditions against the Indians. The first national pension law, which dates back to 1776, provided half pay for life, or during disability, for soldiers disabled during the Revolutionary War. Military provisions based on service date back to 1780. Gradually, service pensions came to be provided separately for veterans of each war. In 1861, the first major nondisability program provided for voluntary retirement of military officers after forty years of duty. In 1885, nondisability retirement was extended to Marine and Army enlistees, providing voluntary retirement after thirty years of service. 1/ The federal Civil Service Retirement System was started in 1920. The Social Security Act established the Social Security program in 1935 although monthly benefits were not paid until 1940. After a couple of unsuccessful efforts the Railroad Retirement System, a federally administered railroad employee retirement program, was established in 1937. In addition to these there are a host of other federally sponsored retirement programs. These other programs are much smaller than the first four programs delineated above. My comments today will focus almost totally on the financing situations or problems associated with the Civil Service Retirement System (CSRS) and the Military Retirement Program. If there are questions on these or on Social Security I will be glad to respond, to the extent I am able.

Retirement Programs for Federal Workers

With a couple of notable exceptions the retirement programs for federal workers, both military and civilian, are largely unfunded. The military program is funded strictly on a pay-as-you-go basis. The CSRS does have a trust fund and there has traditionally been a pattern of matching contributions to this fund by employees and their agency. Since 1969, there have been additional appropriations from the general fund to pay interest on, and amortize certain of the unfunded liabilities.

There is a considerable amount of confusion about the cost and funding of federal pensions, particularly the CSRS. For example, there is a prevalent belief that the cost of the CSRS is roughly 14 percent of payroll -- being shared equally by the workers and their employing agency. The confusion may

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1/ Office of the Actuary, Defense Manpower Data Center, Valuation of the Military Retirement System: Fiscal Year 1980 (Washington, D.C.: U.S. Government Printing Office, 1981), p.2.

arise because there are various ways to estimate or calculate the cost of a retirement program.

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 the estimated normal cost of the CSRS and the military program based on the P.L. 95-595 report filed with Congress during 1982.

TABLE 1

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

Program	Employee Contributions	Employer Cost	Total Normal Cost
Civil Service	7.0%	29.8%	36.8%
Military Retirement	0.0	47.0	47.0

SOURCE: P.L. 95-595 Reports filed with U.S. Congress for fiscal year 1981.

Some policy analysts argue that federal pensions should really be financed on the same basis that the Employee Retirement Income Security Act (ERISA) requires private sector employers to fund their pension plans. Specifically, ERISA requires tax-qualified defined benefit plans to amortize their unfunded liabilities. Table 2 shows the cost that taxpayers would bear

TABLE 2

Taxpayer Liabilities as Percent of Payroll for CSRS and Military Retirement Compliance with ERISA in 1981

Program	Taxpayers Liabilities: Employer Normal Cost	Taxpayers Liabilities: Amortization of Unfunded Liabilities	Taxpayers Liabilities: Total Cost	Actual Contributions
Civil Service	29.8%	56.3%	85.1%	32.3%
Military Retirement	47.0	108.0	155.0	58.0

SOURCE: P.L. 95-595 Reports filed with the U.S. Congress for fiscal 1981.

if CSRS and the military program were required to comply with the federal standards that were imposed on pre-ERISA plans. Such compliance would have raised the cost of CSRS to the taxpayers to 56.3 percent of payroll in 1981 while the military program would have cost taxpayers 155 percent of basic military pay plus the employer portion of the FICA tax, since military personnel are covered under Social Security,

In fiscal 1981 the employee contributions to CSRS were $4.0 billion; while the military personnel do not contribute to their retirement program. During the 1981 fiscal year these two programs had disbursements of $31.5 billion in benefits. The net budgetary cost to the taxpayer then was $27.5 billion (i.e., $31.5 b - $4.0 b = $27.5 b) in 1981.

Furthermore, since neither the CSRS nor military pension is funded the federal pension burden will increase 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 the recent levels and growth of unfunded benefit promises in the two largest federal pension programs.

TABLE 3

Unfunded Liabilities of CSRS and Military Retirement

Program	Unfunded Liabilities 1979 (billions)	1980 (billions)	1981 (billions)	Growth in Unfunded Liabilities FY 1980 (billions)	FY 1981 (billions)	Two Year Increase (Percent)
CSRS	$403.1	$469.5	$498.9	$66.4	$29.4	23.8
Military Retirement	355.8	431.1	476.9	75.3	45.8	34.0
Total	$758.9	$900.6	$975.8	$141.7	75.2	28.6

SOURCES: P.L. 95-595 Reports filed with the U.S. Congress for fiscal years 1979, 1980 and 1981.

There is some contention on the part of various federal civilian employee groups that it was past imprudence on the part of the federal government that accounts for most of the current unfunded liabilities in CSRS. For example, the National Federation of Federal Employees, in printed materials opposing Social Security coverage of new federal workers, argues that the current CSRS "unfunded deficit originated because the federal government failed to pay its share into the fund from 1920 to 1956." It is not clear what the government's "share" was during this period but employee contributions, net of refunds, were only one-quarter of one billion dollars more than government appropriations and contributions for the period 1920 to 1955. The total unfunded liabilities of the CSRS at the end of 1955 were less than $10 billion. By comparison, of the roughly $500 billion in unfunded benefit promises on the CSRS books at the end of fiscal 1981, nearly one-quarter (23.8 percent) arose during 1980 and 1981. The growth in the CSRS unfunded liability in 1980 and 1981 was more than 10 times the total accumulation of unfunded liability over the first 35 years of the program's existence.

The prospects for the future are that the costs of these programs, if not modified, are projected to rise relative to payroll costs for active federal workers between now and the turn of the century. Table 4 shows the projected taxpayer burden of CSRS and military retirement as a percentage of pay for workers covered by these programs. Over the next twenty years the relative cost of the military retirement is projected to increase about one-sixth over current levels. CSRS relative costs are projected to rise by nearly one-third over current levels by the turn of the century.

TABLE 4

Estimated Net Budgetary Outlays for Federal Pension Programs
as Percent of Covered Payroll

	CSRS 1/	Military Retirement
1982	24.9	54.7
1983	26.8	55.9
1984	27.8	55.9
1985	28.6	56.8
1986	29.3	57.4
1987	29.8	57.8
1988	30.4	58.3
1989	30.9	59.0
1990	31.1	59.6
1991	31.6	60.0
1992	31.9	60.7
1993	32.0	61.0
1994	32.2	61.5
1995	32.3	61.9
1996	32.4	62.1
1997	32.5	62.6
1998	32.5	63.0
1999	32.6	63.4
2000	32.6	63.7

SOURCE: Computed by the author from P.L. 95-595 Reports filed with the U.S. Congress for fiscal 1981.

1/ The net budgetary cost is computed as total benefits paid less employee contributions. This difference is then divided by projected covered payroll.

The only ways that short-term budgetary savings can be realized from pay-as-you-go retirement programs are to increase employee contributions over current levels or to decrease benefits that would be paid under current law. From a casual reading of the 1984 Budget it is clear that the OMB understands this principle. If the CSRS recommendations included in the Budget are implemented the CSRS employee contribution rate will increase by 57 percent in only two years. At the same time a 40 percent phased reduction of the normal cost of CSRS would begin. In other words employee contributions would rise by nearly 60 percent for 40 percent lower average future benefits.

While budgetary constraints are important in the design and implementation of retirement programs it is not clear that relatively instantaneous changes of great magnitude are desirable for these programs. It was largely the government's concern that pension programs be stable and dependable that led to the passage of ERISA in 1974. This is not to say that federal pensions should or should not be modified. Rather it suggests that the Congress should consider what it wants to accomplish through the federal retirement programs. The Congress should also consider how much of the federal retirement costs should be borne by the taxpayers. Then the actual design of a long-term retirement program can be considered. There is a good example of this process now underway.

CSRS UNDER REVIEW

The National Commnission on Social Security Reform has recommended that federal workers hired after January 1, 1984 should be covered by Social Security and a modified federal pension program. This proposal is being attacked by several organizations that represent federal workers. One of their major contentions is that this proposal will raise the burden of federal retirement on taxpayers. Covering federal workers under Social Security can only raise the costs of federal retirement if benefits are raised or employee contributions decreased. As an example of the implications of the National Commission's proposal the costs of the current system must be compared to an alternative federal program. The first thing such an analysis must estimate is the cost of the current system.

The budgetary cost of the current CSRS 2/ can be described by the following simple formula:

(1) CSRS Budgetary Cost = benefits plus refunds minus employee contributions.

If new federal workers are covered under Social Security and a supplemental pension is established the implications for taxpayers will depend on several factors. There have been several coordinated pension plans of this type designed in recent years that could apply to federal workers. In order to show the budgetary impact of covering new federal workers under Social Security and a modified pension I have analyzed a proposal that captures the essence of the bill (S2905) introduced by Senator Ted Stevens (R.-Alaska) during 1982. Senator Stevens' proposal modification would cover new federal workers under Social Security and a defined contribution pension plan costing the government (i.e., the taxpayers) an estimated 14.5 percent of payroll.

The particular method for modifying the system analyzed here and included in Senator Stevens' bill calls for Social Security coverage coordinated with a modified federal pension for new federal employees beginning in 1983. The analysis here assumes the policy change would be implemented at

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2/ See Sylvester J. Schieber, The Cost and Funding Implications of Modifying the Civil Service Retirement System (Washington, D.C.: EBRI, 1982) for a complete discussion of the derivation of these estimates.

the beginning of 1983 in correspondence with the Stevens' bill. Implementing such a program in 1984 would not significantly affect the analysis or results. That means that the ongoing costs of the total system have to be estimated separately for the closed system that applied to old hires, and for the new system covering future employees. The budgetary costs of the separate systems can be aggregated to get the combined systems cost.

The total budgetary impact of modifying CSRS would be different from the effect on the various accounts taken separately. Both CSRS and Social Security are now within the unified budget. Because the proposal analyzed here would segregate the old and new systems, the costs for the various accounts can be considered as follows:

(2) Closed CSRS costs = benefits (old) plus refunds minus employee contributions.

(3) New CSRS costs = benefits (new) plus refunds minus employee contributions.

(4) Social Security costs = benefits (SS) minus employee contributions.

(5) Total Budget cost = old CSRS cost plus new CSRS cost plus Social Security cost. 3/

Equation (2) is essentially the same as equation (1) discussed earlier, which applied to the current system. The difference is that equation (2) applied only to those workers on the payroll or persons entitled to CSRS benefits (receiving or deferred) on the assumed date the modified system would be put into operation. Equation (1), in contrast, assumed that future new

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3/ See Sylvester J. Schieber, The Cost and Funding Implications of Modifying the Civil Service Retirement System (Washington, D.C.: EBRI, 1982) for the detailed projections of the component elements of each of these equations.

workers would continue to be covered under the current system. Equation (3) represents the budgetary cost of the new federal retirement program.

Equation (4) shows the budgetary effects of Social Security coverage of new hires. The budgetary effect is different from the effect on the OASDHI accounts, in that the specific account would be credited for both employer and employee contributions. Since Social Security is in the unified budget, the employer contribution would show up as an expense in the agencies' budget and as equal trust fund income in the Social Security accounts. The two would cancel each other out.

The total budgetary costs, modifying CSRS as considered here, can be calculated according to equation (5) and compared with the cost of the current system derived on the basis of equation (1). Table 5 shows the projected budgetary cost of the current system and the proposed modified system and the net differences. Based on projections, moving to the modified system on January 1, 1983, would reduce the budgetary costs of federal retirement by $1 billion over the first five years. While the cost savings during the early years would be moderate in relative terms, the actual numbers that would show up in the unified budget might be affected by moving accounts in or out of the budget. This would not affect taxpayer costs for federal retirement.

The Stevens legislation would cover newly hired workers mandatorily and offer incentives for current workers to move to the new system. The savings from modifying CSRS in accordance with this proposal would grow significantly after the turn of the century as the federal work force becomes predominantly covered by the new system. Ultimately, the savings would grow to nearly one-quarter of the current system's cost if it were to be perpetuated. The net savings estimates of moving to the modified system do not include any savings

TABLE 5

FEDERAL AGENCY AND GENERAL REVENUE EXPENDITURE PROJECTIONS FOR THE CURRENT CIVIL SERVICE RETIREMENT SYSTEM AND MODIFIED SYSTEM IN CONJUNCTION WITH NEWLY HIRED WORKERS UNDER SOCIAL SECURITY, SELECTED YEARS 1983-2050

	Current System (billions)	Modified System (billions)	Net Savings (billions)
1983	$17.9	$17.7	$0.2
1984	20.0	19.2	0.1
1985	22.4	22.2	0.2
1986	24.3	24.1	0.2
1987	26.3	26.1	0.2
1988	28.4	28.1	0.3
1989	30.2	30.1	0.3
1990	31.3	31.7	0.6
1991	34.2	33.7	0.5
1995	42.4	41.7	0.8
2000	54.5	54.7	-0.2
2005	70.8	68.1	2.7
2010	93.2	86.1	7.1
2015	122.4	102.9	19.5
2020	161.8	130.8	31.0
2025	216.6	167.3	45.3
2030	277.7	211.8	65.9
2035	360.0	273.6	86.4
2040	465.7	360.3	105.4
2045	604.1	499.2	104.9
2050	786.7	683.6	103.1

SOURCE: Sylvester J. Schieber, The Cost and Funding Implications of Modifying the Civil Service Retirement System, (Washington, D.C.: EBRI, August 9, 1982). Tables 2,6, and 8.

that could be realized if a Social Security windfall reduction provision current workers were implemented simultaneously.

In sum, modifying the CSRS along the lines of the Stevens proposal would result in significant budgetary savings over both the short and long term. Coverage of new hires under Social Security would maintain the level of employee contributions for retirement purposes. In a budgetary sense then, any proposal coupled with Social Security coverage that just maintains or does not increase total federal retirement benefits cannot cost the taxpayers more than the current system.

MILITARY REITREMENT POLICY REVISITED

In 1870 when the Congress established voluntary retirement for officers it permitted them to retire after thirty years of service upon approval of the President. The retired pay was to be 75 percent of the regular pay at the officer's grade. In 1885 parallel provisions were extended to Army and Marine enlistees. In 1916 the Congress established Naval promotion boards to select Rear Admirals, Captains and Commanders on the basis of age-in-grades. Officers not promoted were retired at 2.5 percent of pay per year of service. The reason for this legislation was to unclog promotion channels. By 1938 the Navy was again experiencing promotions bottlenecks and Congress provided for voluntary retirement with twenty years of service at the discretion of the President. The Army and Air Force Vitalization Act of 1948 established 20 years as the minimum service requirement for voluntary retirement, corresponding with the Navy's earlier provision. The Career Compensation Act of 1947 created the military's disability retirement system which remains basically unchanged today. 3/

The primary findings of the President's Commission on Military Compensation under President Carter was that: "The military retirement program, which allows retirement after 20 years of service at half of basic pay, can no longer be justified." 4/ The Commission's analysis of historical

3/ Office of the Actuary, Defense Manpower Data Center, Valuation of the Military Retirement System: Fiscal Year 1980 (Washington, D.C.: U.S. Government Printing Office, 1981) pp. 3-4.

4/ Report of the President's Commission on Military Compensation (Washington, D.C.: U.S. Government Printing Office, 1978) p. 2.

job assignments showed a considerable shift in the occupational distribution of military personnel after World War II. There has been a significant shift out of combat positions into white- and blue-collar occupations. They concluded that the current system was a clumsy mechanism for maintaining a vigorous military. In the retirement area the Commission recommended "establishing a new noncontributory retirement plan consisting of three parts: a retirement annuity to provide for old age needs; a trust fund to provide deferred compensation; and along with the trust fund, severance pay to assist former service members in their adjustment to civilian life." 5/

Other Considerations for Federal Pension Policy

Without going further on the Commission's analysis or other specific policy recommendations, it is important to understand that the inherent cost of federal pensions, both military and civilian, should not be addressed solely on a short-term budgetary basis. The federal government hires, compensates and retires people within the national economy. At this time the federal government as an employer pays disproportionately large retirement benefits relative to virtually all other segments of the economy. There is considerable evidence to suggest that this has distorted other elements of the government's compensation policy and workforce behavior.

For example, the average retirement age under CSRS is below age fifty-eight. The average retirement age in the military retirement program is age forty-two. 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

5/ *Ibid.*, p. 3.

of them continue to work. The average worker in the private sector, on the other hand, is facing a normal retirement age of sixty-five in his or her pension plan. They can probably retire prior to that age but their benefits will be actuarially reduced to account for their early retirement. They are not eligible for indexed Social Security benefits until age sixty-two and then only at 80 percent of the full benefit. As a result the average age of people claiming Social Security retirement benefits is sixty-four. Possibly the federal government wants to continue to occupy a unique niche in the labor market but it is not clear that the current position is one that has been attained purposefully. If the Congress seeks to adjust federal pension policy they should consider both the long-term cost implications as well as the broader retirement policy impacts of the options they consider.

SOCIAL SECURITY

The cash benefits provided by Social Security are also financed on a pay-as-you-go basis. This means that the revenues collected from current workers and their employers are paid out almost immediately as benefits to retirees. Given the small balances in the trust funds, revenues must closely match benefits during any particular time period for the program to be solvent. It is improbable that Social Security will ever be financed on any other basis. I have done considerable research on Social Security but will limit my comments in this area to specific inquiries that the Committee may have in this regard.