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REMARKS OF H. L. KRIEGER
DIRECTOR

FEDERAL PERSONNEL AND COMPENSATION
DIVISION

U.S. General Accounting Office

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DEVELOPMENT AND ADMINISTRATION OF PENSION POLICIES

I am pleased to be here to discuss the General Accounting Office's views on the development and administration of pension policies for Federal personnel.

When should employees retire? How much should they receive? What is the purpose of retirement? Under what circumstances should special or preferential benefits be provided to certain groups of employees? These and many other basic questions need answers before a rational retirement system can be established. However, Federal retirement systems have developed without such overall guidance.

Since 1974, GAO has issued a series of reports covering a number of issues concerning basic policies, financing, administration, and benefits of various Federal retirement systems. Next to pay, these systems are the most significant and costly means used to compensate Federal personnel, and

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the liabilities associated with them represent a sizeable long-term financial commitment of the Government. In essence, our work has shown that Federal retirement programs have not received the management attention they deserve in view of their importance and tremendous costs. The systems have evolved without overall policy guidance. In the absence of such guidance, the programs have developed and continue to develop on an independent, piecemeal basis, resulting in a patchwork of systems providing inconsistent and different benefits to various groups of employees.

Based on our studies, I believe the primary issue that needs attention is the establishment of an overall, coherent, coordinated Federal retirement policy--a policy which outlines the principles, objectives, and standards to be followed in providing retirement benefits to military and civilian personnel. The policy should serve both management and employee needs and cover such matters as benefit levels, funding, social security coverage, vesting, and administration. While recognizing that special retirement provisions may be justified for particular groups, the policy's guiding principle should be that all Federal personnel receive consistent benefits. Let me mention some of the reasons why we have reached this conclusion.

We identified 38 separate retirement systems that are maintained for various groups of personnel by Federal agencies and instrumentalities. Many inconsistencies and inequities exist among the systems. Even though the personnel covered by them work for the same employer--the United States Government--they are treated quite differently depending on which retirement system applies to their employment.

All of the systems have the same basic objectives--to provide employees a continuing income during retirement or upon becoming disabled and to provide financial protection to survivors upon the death of active and retired employees. Yet, the systems differ substantially in areas such as (1) employee contribution rates, (2) benefit formulas, (3) retirement eligibility requirements, (4) creditable service, (5) disability policies and benefits, (6) survivor benefits, and (7) reemployed annuitant practices. Differences exist even within some of the retirement systems. Under the civil service retirement system--which covers most Federal civilian employees--certain groups receive special benefits. While most participants are covered by the plan's general provisions, separate provisions grant higher annuities and/or allow earlier retirement ages for Members of Congress, congressional staff, law enforcement and firefighter personnel, and air traffic controllers.

In reviewing the historical development of each of the systems, including the civil service system, we found that it is often difficult to clearly identify any current management or compensation policies that are being served by the systems as they are now designed. In many cases, we could find no explanation why different provisions were adopted. In others, we found that the circumstances which existed at the time of adoption have changed, but that the provisions have been continued.

Different retirement benefits for personnel in the separate branches of Government or for certain positions within a branch may well be justified, particularly when such benefits are recognized as part of the total compensation paid to attract and retain needed personnel. We have long maintained that both Federal pay and benefits, including retirement, should be established and adjusted within the context of total compensation comparability with the non-Federal sector. However, under the pay comparability processes now in effect, benefit programs are excluded.

Whether social security should form the base for Federal retirement benefits is one of the many matters that must be considered in formulating an overall policy. One of the major inconsistencies among Federal retirement systems is that social security coverage is provided to some employees but denied to others. Employees covered by 25 of the 38 systems are also covered by social security. The civil service system is, by far, the largest of the

13 systems that do not allow social security coverage. Two of the consequences of excluding personnel from social security are that they do not receive the basic protection afforded by the program and do not share in the responsibility of meeting the basic needs of the Nation's elderly and disabled persons. If all Federal personnel are to receive consistent and equitable benefits, social security should be provided to all or none.

In addition to not having an overall policy to guide the development of Federal retirement systems, there is a lack of central focus in the Government on retirement. Congressional committee jurisdictions and responsibilities over retirement matters are fragmented. For example, up to 11 committees in the House and 10 committees in the Senate could have legislative responsibilities for 12 of the Federal systems. Furthermore, the administration of these 12 systems is fragmented among 16 different organizations. We believe that the Congress should consider centralizing committee jurisdiction over retirement policy. We also believe that the Congress should consider establishing a permanent, independent board with authority and responsibility for monitoring the development, improvement, and administration of Federal retirement systems. Until there is some centralized management focus on retirement matters, it will be difficult to accomplish needed reforms.

RETIREMENT FUNDING

A very critical issue involving public pension plans today--at least one which has received widespread publicity--is funding. GAO has reviewed the funding practices of both Federal and State and local plans. However, I am going to limit my remarks to Federal pension funding policies this morning since my colleagues will be providing information on GAO studies of State and local funding practices this afternoon.

Costing and funding procedures used by many Federal systems understate the full cost of providing retirement benefits. No uniform method is used in determining the liabilities associated with the systems, and costing and funding practices differ considerably. In most cases, the systems' funding requirements are less stringent than those imposed on private pension plans by the Employee Retirement Income Security Act (ERISA). Some systems are financed on a contributory basis; some on a noncontributory basis; some provide for fully funding benefits as they accrue; some provide for partial funding; and others are completely unfunded. Three major Federal retirement systems--military, civil service, and Foreign Service--have reported unfunded liabilities in excess of $851 billion.

If the Congress does not receive realistic and consistent information on the cost of Federal retirement programs, its ability to make sound fiscal and legislative decisions on establishing, amending, and funding retirement and agency programs is impaired. When the full costs are not recognized, benefits may be adopted which could jeopardize the eventual affordability of the retirement systems. Many would probably suggest that this has already happended. Full recognition of accruing retirement costs is essential not only in determining and allocating the cost of Government operations, but also in determining the present and future financial condition of the United States.

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

The static cost of benefits accruing annually under the civil service system is currently estimated to be 13.73 percent of pay, which is about equal to the combined rate of contributions being made to the retirement fund by agencies and their employees--generally, 7 percent of pay each. However, the estimated "dynamic" cost of the systems, including factors for pay and annuity cost-of-living increases, is 38.81 percent of pay. Based on this estimate, Federal agencies should be contributing 31.81 percent of their covered employees' pay to the fund if their budgets are to reflect the full cost to the Government of benefits accruing under the system.

The total payroll for employees covered by the system was approximately $48.6 billion during fiscal year 1980. At 31.81 percent of pay, the estimated cost to the Government for benefits which accrued during the year was $15.4 billion--$12 billion more than the $3.4 billion agencies contributed to the retirement fund.

In contrast to the funding policies of the civil service system, the military retirement system is operated on a noncontributory, pay-as-you-go basis. No fund is maintained and benefit payments are financed by annual appropriations. Consequently, the Department of Defense budget reflects the cost of retirement benefits earned in prior years, but does not include <u>any</u> accrual of retirement costs for current military personnel.

The Department of Defense has estimated the dynamic cost of the military system to be 49.27 percent of basic pay.

The 1980 Defense budget included approximately $18.1 billion in basic pay for active military personnel. At a dynamic cost of 49.27 percent of pay, the cost of retirement benefits which accrued during the year would be $8.9 billion. However, because the system operates on a pay-as-you-go basis, none of this cost was shown in DOD's budget.

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

I should mention that 2 years ago legislation was enacted requiring Federal retirement systems to submit annual reports to the Congress and to the Comptroller General fully disclosing their financial condition. 1/ This requirement is similar to that imposed on private pension plans by ERISA. GAO and the executive branch were jointly responsible for developing the reporting standards to be followed by pension plans in complying with this new law. We believe this new requirement is a step in the right direction toward developing rational and affordable retirement systems. It will not only disclose to the

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1/ Public Law 95-595, approved November 4, 1978.

Congress, to plan participants, and to interested taxpayers previously unreported financial information on Government retirement plans, but also provide plan adminstrators an opportunity to assess the present and probable future ability of their plans to meet benefit obligations.

PENSION INDEXING POLICY

Finally, I would like to briefly discuss pension indexing policy. Considerable attention has been given in the Congress and elsewhere to the annuity cost-of-living adjustment provisions of Federal retirement systems. We have long been concerned about the equity and costs of the Government's policy of full, automatic cost-of-living increases for Federal civilian and military retirees and have issued several reports on the subject. Federal retirees are the only groups we are aware of who receive unlimited cost-of-living adjustments automatically twice a year.

The erosion of the purchasing power of retirement benefits is certainly a serious issue. Inflation shrinks the purchasing power of all Americans. While the established policy of full, automatic indexation of Federal retirement benefits is a laudable, humanistic objective, it is highly inequitable to others not similarly treated and costly. We believe it should be discontinued.

We have urged the Congress to consider adopting a modified policy of less than full indexation of Federal retirement benefits. On the surface, such a change may seem unduly harsh. But less than full indexation of retirement income is the prevailing non-Federal practice. Generally, the purchasing power of non-Federal retirees' income, if protected at all, is only partially protected from inflation. They are no less deserving of full purchasing power protection, but it is a matter of affordability.

We have estimated that, in general, 70 to 80 percent of the typical non-Federal retiree's total pension (social security and private plan benefits combined) is indexed to inflation. We have suggested that annual adjustments for Federal retirees should be limited either to 75 percent of the full increase in the Consumer Price Index (CPI) or to the average percentage pay increase granted to active employees.

Adjusting pensions to keep pace with inflation can be a very expensive proposition, as the Government has learned from experience with its own retirement programs. We believe it is unreasonable for taxpayers whose incomes (pay or retirement) are not fully protected from inflation to have to pay for full, automatic indexation of Federal retirees' benefits. Because of the costs involved, this places a financial burden on current as well as future taxpayers.

We have also recommended to the Congress that cost-of-living adjustments for Federal retirees be granted only once a year and that initial adjustments for new civil service retirees be prorated to reflect only increases in the CPI which occur after their retirement. With regard to this latter recommendation, I should point out that under existing law new civil service retirees can benefit from cost-of-living increases which occurred while they were still employed. We estimated that a change in the law to provide for prorating initial adjustments would have saved over $800 million in annuity payments during the remaining lifespans of civil service employees retiring in 1978 alone.

CONCLUSIONS

In concluding, I would like to say that resolving the many issues facing public pension plans will take a great deal of time and energy. But the effort will be a small price to pay in comparison to the cost of doing nothing. I think that the establishment of this Commission and those chosen to participate in it is evidence of the importance of the issues involved. We look forward to your final report and believe it will provide a greatly needed springboard for the future development of rational and affordable pension systems.

Thank you. My colleagues and I will be glad to answer any questions.