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COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON, D.C. 20548

JUL 1 1980

B-130150

The Honorable Walter F. Mondale
President of the Senate

Dear Mr. President:

The General Accounting Office (GAO) has 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.

We were pleased to see that the First Concurrent Budget Resolution for fiscal year 1981 assumes enactment of our recommendations to the Congress to (1) provide retirement cost-of-living adjustments annually and (2) prorate the initial adjustments of new civil service retirees to reflect only Consumer Price Index (CPI) increases occurring after their date of retirement. We strongly urge the Congress to enact the legislation necessary to effect these needed changes. Besides making the adjustment process more rational, more consistent with prevailing non-Federal practices, and less costly, such changes also should help encourage valuable, experienced employees, particularly top Federal officials whose pay rates have been depressed, to continue working instead of retiring.

To fully satisfy these objectives, however, we believe an additional change should be made to limit the amount of the adjustment provided to something less than the full percentage increase in the CPI.

Inflation shrinks the purchasing power of all Americans. The established policy of full, automatic indexation of Federal retirement was, and still is, a laudable, humanistic objective. But because it is highly inequitable to others not similarly treated and costly, it should not be continued.

The cost-of-living adjustment provisions for Federal retirees (even with the proposed changes the Congress is now considering) are far superior to those enjoyed by retirees of private industry and State and local governments. The only

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non-Federal retirees who receive comparable purchasing power protection are those who receive only social security benefits--a maximum of about $800 monthly. Perhaps more importantly, the annuity adjustment provisions result in Federal retirees receiving far greater increases than active Federal employees. These inequities could be minimized by limiting the amount of annuity cost-of-living increases to something less than the full percentage rise in the CPI. For example, the adjustments could be limited to 75 percent of the full CPI increase or to the average percentage pay increase granted to active Federal employees.

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 is only partially protected from inflation. They are no less deserving of full purchasing power protection; it is simply a matter of affordability.

We believe it is unreasonable to force taxpayers whose incomes (pay or retirement) are not fully protected from inflation 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.

For the reasons stated herein and elaborated on in the enclosure, we urge the Congress to consider adopting a modified policy of less than full indexation of Federal retirement benefits. We understand that the Administration plans to study the possibility of such a modification in Federal retirement, as well as social security and other Federal income security programs, and include any recommendations for change in its proposed budget for fiscal year 1982.

This letter also is being sent today to the Speaker of the House of Representatives and to various Senate and House committees who have an interest in Federal retirement matters.

Sincerely yours,

Milton J. Socolar

Acting Comptroller General
of the United States

Enclosure

FULL INDEXATION OF FEDERAL RETIREMENT BENEFITS IS INEQUITABLE AND COSTLY

With the exception of social security and other Federal income security programs, Federal retirement systems are, for the most part, the only retirement plans which grant automatic, unlimited cost-of-living increases to fully protect the purchasing power of the retirement annuity. These automatic adjustments completely insulate Federal retirement income from inflation. Non-Federal retirees generally are not that fortunate.

Some private firms and State/local governments do, however, grant periodic ad hoc cost-of-living increases to their retirees. The timing of such ad hoc increases generally depends upon the annual rate of inflation being experienced, the date and amount of previous cost-of-living adjustments granted, and the financial condition of the employer and/or the pension plan. Ad hoc increases differ from employer to employer and usually vary depending on the length of retirement; newer retirees frequently receive smaller percentage increases than those who have been retired longer.

PRIVATE PENSION PLANS ARE NOT INDEXED

Private pensions have not kept pace with inflation the way Federal retirement programs and social security have. A 1975 study of corporate pension plans by the Bankers Trust Company revealed that only 6 percent of the plans provided automatic cost-of-living adjustments; most plans limited the adjustment to 3 percent annually. Similarly, a 1977 survey by Hay Associates revealed that only 7 percent of the pension plans had automatic adjustments; most plans had a specified limitation. The Congressional Budget Office reported in 1978 that only 3 percent of private pension plans have explicit cost-of-living adjustment features.

Although most private pensions do not have automatic adjustment provisions, they frequently provide periodic "ad hoc" pension increases. The Bankers Trust Study pointed out that 70 percent of the companies surveyed had provided some pension increases over the 5-year period ended in 1975. The average increase granted to a person who had retired in the mid-1960s was 16 percent as compared with a 39 percent rise in the CPI during that same period. The Bankers Trust Company has begun its 1980 study of corporate pension plans. Preliminary data from 103 private firms shows that 81 percent have granted pension increases to some or all retirees at least once since 1975; 29 percent of the firms provided more than one increase.

A 1979 study of pension increases for retired employees of 94 large U.S. employers by a major consulting firm revealed that

--more than one-half of the surveyed companies provided at least one pension increase in 1978 or 1979;

--the most common form of benefit increase was a varying percentage adjustment based on the retirees' year of retirement; more than one-half the reported increases took this form;

--flat uniform percentage increases or flat dollar increases graded by length of service, together, were the next most common approaches; they accounted for about 20 percent of the reported increases;

--only 3 percent of the companies reported automatic provisions related to the CPI; and

--the average period between successive ad hoc increases was about 3 years.

The firm's report said that it was not possible to determine the average level of benefit increase for the survey group, either as a percentage or in dollars. The variety of increase forms and the differences among retiree groups were simply too great to permit such an analysis.

As a general rule, however, ad hoc increases rarely, if ever, equal the rate of inflation since retirement or since the preceding pension increase. The President's Commission on Pension Policy recently reported that, over time, private pension annuities are increased by about one-third of the full CPI increase.

STATE AND LOCAL PENSION PLANS ARE ONLY PARTIALLY INDEXED

Most State and local plans offer some sort of post-retirement cost-of-living adjustments, but those adjustments rarely represent the full percentage increase in the CPI. The President's Commission on Pension Policy found that one-half of State and local pensions are adjusted for inflation with a 3-percent cap.

According to a 1978 Pension Task Force report by the House Committee on Education and Labor, over 45 percent of all State and local government employees are in plans which make cost-of-living adjustments automatically but with a specified limit, generally 3 percent annually. The report stated that 61 percent of all State and local government employees are in pension plans which provide ad hoc increases from time to time after special consideration by a retirement board, legislature, or other official body. Less than 5 percent of all State and local government employees are covered by pension plans which adjust benefits automatically without limitation.

THE ROLE OF SOCIAL SECURITY IN PROTECTING NON-FEDERAL RETIREES' PURCHASING POWER

Social security benefits are the principal source of retirement income for non-Federal retirees. All retirees of private industry and most retirees of State and local governments receive social security; this is the only source of retirement income for many retirees. But most retirees of State and local governments and approximately 50 percent of all private industry retirees also receive an employer-provided pension. Social security serves as the base level of benefits. The employers' plans generally are designed to supplement social security and guarantee retirees a specified level of total retirement income--typically 50 percent to 70 percent of their preretirement level of earnings. Although the social security component is fully indexed, the supplemental pension generally is only partially indexed. Consequently, the retirement income of most non-Federal retirees is not fully protected from inflation.

Social security benefits, which are fully indexed for inflation, are structured to favor lower-paid workers. Also, the benefits of married workers are approximately 50 percent greater than those of single workers. Available studies suggest that social security typically provides benefits ranging from 30 percent to 45 percent of preretirement earnings, depending upon employees' preretirement earnings and marital status.

As mentioned earlier, the supplemental pension plans of private industry and State and local governments are integrated with social security to provide a combined retirement income of anywhere from 50 percent to 70 percent of preretirement earnings. Although benefit levels vary from employer to employer, available studies suggest that private sector pension plans typically provide benefits averaging from 20 percent to 30 percent of preretirement earnings, depending upon the level of replacement benefits provided by the social security system.

Of the total retirement income of non-Federal retirees receiving both social security and a supplemental employer pension, available studies suggest that social security provides about 60 percent and the employer plan provides about 40 percent.

Since the social security component of non-Federal pensions is fully indexed for inflation and a typical private or governmental supplemental pension plan is partially indexed by an amount equal to 30 percent to 50 percent of the full percentage increase in the CPI through automatic and/or ad hoc cost-of-living adjustments, we estimate that 70 percent to 80 percent of the typical non-Federal retiree's total pension is indexed to inflation. Like Federal retirees, the pension of non-Federal retirees receiving only social security benefits is, of course, 100 percent indexed to inflation.

RETIREES' INCREASES HAVE EXCEEDED THOSE OF ACTIVE FEDERAL EMPLOYEES

The full, automatic cost-of-living increases in Federal retirees' benefits have greatly exceeded the pay increases granted to active Federal civilian employees and military personnel. This is illogical, highly inequitable, and encourages valuable, experienced Federal employees to retire rather than to continue working. This problem has been particularly acute for top Federal officials who have received smaller and less frequent pay increases than other Federal personnel.

Since the Federal Pay Comparability Act became law in 1971, Federal white-collar employees have been granted 10 pay increases totaling 73 percent. During that same period, Federal retirees received 15 automatic cost-of-living increases totaling 114 percent; 8 of those retiree increases included the 1-percent add-on which the Congress eliminated in October 1976. Since repeal of the 1-percent "kicker" in 1976, Federal retirees' annuities have increased 38 percent; Federal white-collar pay rates have increased only 27 percent.

Compared with the 114 percent increase in Federal civil service retirees' annuities since 1970, top Federal officials' pay rates (Executive Level V) have increased only 39 percent; 33 percent since 1977. Thus, the pay increases received by top Federal officials (GS-16 through GS-18 and Executive Level V) have been considerably less than those received by regular civil service employees and former Federal employees and officials who chose to retire rather than to continue working.

These variances between pay increases for active Federal employees and annuity cost-of-living adjustments for Federal retirees have caused and are causing valuable, experienced employees who would probably prefer to continue their public service to retire prematurely. For example, thousands of valuable Federal employees retired in February 1980 to receive the March 1 annuity increase of 6 percent and to have the preceding 6.9 percent increase of September 1, 1979, considered in their basic annuity calculation. These premature retirements are placing an added burden on Federal retirement systems which already have unfunded liabilities estimated to be almost $400 billion.

The First Concurrent Budget Resolution for fiscal year 1981, and legislation pending in the Senate (S. 2450), if adopted, would moderate this problem by prorating the initial adjustments of new Federal civil service retirees to reflect only cost-of-living increases occurring after their date of retirement.

Besides enticing valuable, experienced employees to retirement prematurely, the wide variance between the size of pay increases and annuity cost-of-living adjustments adversely affects the morale of active Federal employees and military personnel. Federal employees, particularly top level officials whose pay rates have been depressed because of the Executive Level V pay ceiling, understandably resent having their pay "capped" while former Federal employees who have retired receive full, automatic cost-of-living increases based upon the CPI. We can appreciate their concern. This situation is very inequitable.

From the standpoint of sound personnel management, we have serious reservations about the existing policy and practice which results in retired Federal employees consistently receiving much larger increases than their Federal counterparts who are still actively employed. This is illogical and inconsistent with the practices of most non-Federal employers. While the objective of full purchasing power protection for retirees is certainly a worthwhile objective, protecting the purchasing power, and thus the standard of living, of active Federal employees is equally or perhaps more important. Since it is obviously not desirable or feasible to index Federal employees' pay rates for inflation, it makes little sense to continue full indexation for retired Federal employees. The practice followed in recent years of "capping" active employees' pay raises to even less than their private counterparts receive while granting full cost-of-living increases to Federal retirees is, we believe, particularly questionable.

A new policy of limiting annual annuity cost-of-living increases to the average percentage pay increase granted to active Federal employees would be more logical, more equitable, and less costly. It also would help encourage retirement-eligible employees to remain in the active work force and result in annuity increases that are more consistent with those received by most non-Federal retirees who receive both social security and a supplemental private or State/local government pension.

LESS THAN FULL INDEXATION OF RETIREMENT BENEFITS WOULD RESULT IN SUBSTANTIAL REDUCTIONS IN OUTLAYS

Full, automatic annuity cost-of-living adjustments are costly. With outlays for Federal civilian and military retirement approaching $30 billion annually, a 1-percent annuity cost-of-living adjustment increases retirement outlays by about $300 million. The last two adjustments--March 1, 1980, and September 1, 1979--of 6.0 percent and 6.9 percent, respectively, resulted in outlay increases of at least $3 billion. Given the magnitude of retirement outlays and the double-digit inflation we are experiencing, limiting the adjustments could reduce current and future retirement outlays substantially.

In the civil service retirement system--the largest retirement program for Federal civilian employees--cost-of-living adjustments are ignored in determining and funding the system's future liabilities. Such adjustments add dollar-for-dollar to the unfunded liability. Since 1965, for example, cost-of-living increases of 176 percent (compounded) have added about $68 billion to the system's unfunded liability; $50 billion of that liability has occurred in the last 5 years. Each 1-percent annuity increase in the future will add over $1 billion to the unfunded liability.

Limiting annuity cost-of-living adjustments to less than the full percentage increase in the CPI could reduce retirement outlays by hundreds of millions of dollars annually. For example, Federal retirement outlays were about $22 billion in 1979 and Federal retirees received two adjustments totaling 10.8 percent during the year. Had those adjustments been limited to 75 percent of the full percentage increase in the CPI or 8.1 percent, 1979 retirement outlays would have been about $600 million lower. If the adjustments had been limited to the 7-percent pay increase granted to Federal white-collar employees in 1979, 1979 retirement outlays would have been over $800 million lower. The effects that such limitations would have had on the annuities of Federal retirees and survivors are shown in tables 1 and 2 at the end of this enclosure.

During 1980, the Administration estimates that Federal retirement outlays will total about $27 billion. Federal retirees received a 6-percent annuity cost-of-living increase in March 1980 and, if the current semi-annual adjustment process is still in effect in September 1980, retirees are expected to receive another 8-percent adjustment. If these adjustments were limited to 75 percent (10.5 percent) of the anticipated full CPI increase of 14 percent, we estimate that 1980 retirement outlays would be almost $1 billion lower. If the annuity cost-of-living adjustments were limited to the restricted General Schedule pay increase of 6.2 percent now in the budget or to even the estimated 11 percent increase that would be required to maintain pay comparability with the private sector, 1980 retirement outlays would be over $2 billion or $810 million lower, respectively. The effects that such limitations would have on the annuities of Federal retirees and survivors are shown in tables 3 and 4 at the end of this enclosure.

Looking ahead, the outlay reductions that could result from providing less than full indexation of Federal retirement benefits would, of course, depend upon the annual rate of inflation. But as mentioned earlier, each 1-percent reduction in Federal annuity cost-of-living increases would reduce civilian and military retirement outlays by almost $300 million annually. Each such 1-percent reduction also would retard the growth in the unfunded liability of the civil service retirement system alone by over $1 billion.

TABLE 1

Table Showing the Effect Less Than Full Indexation Would Have Had on the Average Federal Retiree and the Average Survivor in 1979

Average civil service retiree's annuity @ 9/30/78	Full CPI increase (10.8 percent)	75 percent of the CPI increase (8.1 percent)	Average pay increase for active employees (7 percent)
$8,505	$9,424	$9,194	$9,100
Average civil service survivor's annuity @ 9/30/78			
$3,552	$3,936	$3,840	$3,801

TABLE 2

Table Showing the Effect Less
Than Full Indexation Would Have
Had on Individual Annuities in 1979

Amount of annuity	Full CPI increase (10.8%)	75% of CPI (8.1%)	Average pay increase (7.0%)
$ 5,000	$ 5,540	$ 5,405	$ 5,350
10,000	11,080	10,800	10,700
15,000	16,620	16,215	16,050
20,000	22,160	21,620	21,400
25,000	27,700	27,025	26,750
30,000	33,240	32,430	32,100
35,000	38,780	37,835	37,450
40,000	44,320	43,240	42,800

TABLE 3

Table Showing the Effect Less than Full Indexation Could Have on the Average Federal Retiree and the Average Survivor in 1980

Average civil service retiree's annuity @ 9/30/79 (estimated)	Full CPI increase (est.—14%)	75% of the CPI increase (est.—10.5%)	Average pay increase for active employees: Budgeted (6.2%)	Average pay increase for active employees: Pay Comparability (est.—11%)
$9,424	$10,743	$10,414	$10,008	$10,461
Average civil service survivor's annuity @ 9/30/79 (estimated)				
$3,936	$ 4,487	$ 4,349	$ 4,180	$ 4,369

TABLE 4

Table Showing the Effect Less Than Full Indexation Could Have on Individual Annuities in 1980

Amount of annuity	Full CPI increase (est.—14%)	75% of CPI (est.—10.5%)	Average pay increase Budgeted (6.2%)	Pay comparability (est.—11%)
$ 5,000	$ 5,700	$ 5,525	$ 5,310	$ 5,550
10,000	11,400	11,050	10,620	11,100
15,000	17,100	16,575	15,930	16,650
20,000	22,800	22,100	21,240	22,200
25,000	28,500	27,625	26,550	27,750
30,000	34,200	33,150	31,860	33,300
35,000	39,900	38,675	37,170	38,850
40,000	45,600	44,200	42,480	44,400