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FEDERAL RETIREMENT SYSTEM FINANCING

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Mr. Chairman and Members of the Subcommittee:

We are pleased to be here today to discuss federal retirement system financing. This issue is quite complicated and complex. The purpose of our statement is to attempt to bring some perspective to the issue by describing how the government finances its retirement systems and discussing the budget implications of the financing methods being used and possible changes to these methods. Our statement concentrates on the Civil Service Retirement System (CSRS) and the Federal Employees Retirement System (FERS) because they are the largest retirement programs for federal civilian personnel.

Since we noted that you asked the Office of Personnel Management to provide considerable information on the cost, liabilities, and outlays of the two systems, we have not included such data in our statement.

RETIREMENT FINANCING PRACTICES NOW BEING FOLLOWED

There are several similarities in how CSRS and FERS are financed, but there are significant differences as well.

CSRS and the FERS pension plan require employees to contribute toward system costs. As the employer, the government is responsible for funding all costs not covered by employee contributions. If there were no cost to the government, employees, in effect, would not be receiving any retirement benefits from their employer. Thus, the cost of the retirement systems is part of the overall costs taxpayers pay for the government services they receive.

Both CSRS and the FERS pension plan are "funded" programs, in that amounts are set aside (in the same fund) to cover benefit payments. A "normal cost" is calculated for each plan. Normal cost is expressed as a percentage of payroll and represents the amount of money that should be set aside during employees' working years that, with investment earnings, will be sufficient to cover future benefit payments. Normal cost calculations require that many assumptions be made about the future, including mortality rates, quit rates, interest rates, employee salary increases, and cost-of-living increases over the lifespans of current and future retirees.

The amounts employees in CSRS and their agencies contribute to the retirement fund are approximately equal to the system's "static" normal cost, that is, the cost of future benefits calculated under the assumptions that federal pay schedules will not increase and employees will receive no cost-of-living adjustments (COLA) after they retire. However, when normal cost is calculated on a "dynamic" basis, including assumptions for future pay increases and COLAs, the cost percentage is about doubled. It has long been our position that the dynamic approach is the appropriate way to calculate and provide budget authority for CSRS costs since it identifies the full cost of providing benefits to covered employees. When done properly, recognizing retirement costs as they are being accrued reflects the full costs of providing retirement benefits to federal personnel at the time their services are rendered.

Unlike CSRS, the FERS pension plan is funded on a dynamic normal cost basis. Agencies are required to contribute the difference between dynamic normal cost and employee contributions. The differing approaches result in employing agencies making greater contributions per employee toward the cost of FERS than they make to CSRS, even though the overall costs of the two systems are roughly comparable.

Although the amount of agency contributions covers less than the actual cost to the government of providing CSRS benefits, much of the remaining costs are covered by other government contributions to the retirement fund. OPM makes annual contributions to the fund from its appropriation to amortize the liabilities created by employee pay raises, once enacted, and other benefit improvements when they are made; the Postal Service makes contributions to the fund to cover retirement system liabilities resulting from collective bargaining agreements with its employee unions and COLAs postal retirees receive; and the Treasury pays the cost of benefits attributable to military service and interest on the system's unfunded liability as if it were funded. No provision exists to fund COLAs received by nonpostal retirees.

Because of the manner in which CSRS costs are determined and funded, the system has accumulated a sizeable unfunded liability. However, that liability is dealt with by the FERS statute.[1] That statute requires that, when the budget authority in the retirement fund for CSRS benefits is exhausted, automatic annual appropriations will be made to amortize the shortfall over 30 years. Thus, provisions have been made for the retirement fund to always have sufficient budget authority to cover future benefit payments.

An understanding of CSRS and FERS financing practices and unfunded liabilities also requires a realization that federal retirement benefits are not prefunded in the manner that private pension plans set aside money during employees' working years to cover the accruing costs of their retirement benefits. Private companies are required by law to fully fund their pension plans, and are not allowed to invest pension funds in their own securities. The chief purpose of these requirements was to protect employees against the loss of earned pension benefits if

[1] Public Law 99-335, approved June 6, 1986.

their employers went out of business or had not properly funded their pension liabilities.

The pension financing law does not apply to federal or state and local government pension plans because of Congress' presumption that governments will continue to exist, as is not always the case for private companies.

The federal retirement fund is "invested" in special issue Treasury securities. These are nonmarketable securities available only to the retirement fund. There is no cash in the fund. It is only when the securities are redeemed to pay retirement benefits that the Treasury must obtain the necessary money through tax receipts or borrowing. This is the point at which actual outlays occur. To the extent that these outlays are met by borrowing, they add to the deficit.

Thus, the CSRS and FERS pension plan retirement fund represents that portion of estimated future benefit obligations that the government has recognized on paper. The unfunded liability is that portion of estimated future benefit obligations that has no paper backing in the form of special issue Treasury securities. Being simply an actuarial estimate, the unfunded liability itself has no effect on the budget or current outlays and is not a measure of the government's ability to pay retirement benefits in the future. In fact, appropriations to increase the amount of nonmarketable Treasury securities in the fund so as to eliminate the unfunded liability (as the FERS statute requires be done eventually) would not affect federal outlays or the deficit or require additional payments by employees or the taxpayers.

Our major concern with the retirement funding process has been that agencies are charged less than the full accruing cost of CSRS, thus understating the cost of government programs. Our recommendation to charge agencies all accruing retirement costs not covered by employee contributions was adopted for the FERS pension plan (and the Military Retirement System) but not for CSRS.

PRESIDENT'S BUDGET PROPOSALS ON RETIREMENT SYSTEM FINANCING

The President's budget proposals for fiscal years 1995 and 1996 called for the dynamic normal cost approach to be applied to CSRS and for CSRS' unfunded liability to be amortized over a 40-year period. No legislation to implement the proposal was forwarded to Congress last year, and, to our knowledge, none has yet been forwarded this year. While we would prefer to see the actual manner in which the funding change is proposed to be implemented before we express an opinion on it, we agree with the general objective of the proposal as described in the budgets. The effect of the change would be to recognize the full government cost of CSRS in agency budgets without increasing the deficit.

BUDGETARY TREATMENT OF THE RETIREMENT TRUST FUND

On occasion, consideration has been given to moving the retirement fund out of the unified budget. In our opinion, no purpose would be currently served by such an action. On budget, or off budget, the Treasury would still have to secure the money necessary to make benefit payments from general revenues or borrowing. We have long supported the principle of the unified budget, believing that the budget should be a comprehensive statement of receipts and expenditures of activities of the federal government.

Changing the investment policy from nonmarketable Treasury securities to private sector securities would result in significant cash outlays which would further exacerbate the deficit situation. If investments in outside securities are made, the agency, employee, and other contributions to the fund that are now mostly transfers of appropriations rather than cash, would have to be converted to cash in order to make the investments. In the current deficit situation, this means the government would have to borrow the money to make the investments and then run the risk that the investment returns would be less than sufficient to cover its obligations.

Moreover, the accruing costs of CSRS and the FERS pension plan for active employees are greater than the outlays to retirees each year. Thus, requiring outside investments would cause an increase in outlay requirements over the amounts required under the current investment policy. If outside investments were used for the government's other retirement systems, Social Security, and other trust funds, the increased outlay requirements would be even greater.

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That concludes our prepared statement Mr. Chairman. We would be pleased to answer any questions the Subcommittee may have.

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