CIVIL SERVICE RETIREMENT: FINANCING AND COSTS

The Congress of the United States
Congressional Budget Office

NOTES

Unless otherwise stated, all dates are expressed in fiscal years.

Projections to the year 2030 are presented in 1980 dollars; annual discounts through 1986 are based on CBO five-year economic assumptions (March 1981) and on an annual 6 percent rate for the remaining years.

The various measures of long-term retirement costs are based on economic assumptions used by the CSR Board of Actuaries: long-term annual rates of 6 percent inflation, 7 percent interest, and 6.5 percent pay increases (in addition to promotions and other increases).

Details in tables may not add exactly to totals because of rounding.

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PREFACE

Current debate about the costs of the Civil Service Retirement (CSR) system has raised concerns about the financial condition of the system, its costs to the government, and the rates at which federal employees and agencies contribute to it. This study, undertaken at the request of the House Budget Committee, addresses these questions and poses several alternative approaches to financing CSR benefits.

Civil Service Retirement was prepared by Sherri Kaplan of the General Government Management staff of CBO's Office of Intergovernmental Relations, under the supervision of Stanley L. Greigg and Earl A. Armbrust. The author gratefully acknowledges the special assistance given by David DelQuadro, Stacy Sheffrin, and Mark Thurber. Johanna Zacharias edited the paper, and Norma Leake typed the various drafts and prepared the paper for publication. In keeping with CBO's mandate to provide objective analysis, the paper offers no recommendations.

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Director

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SUMMARY

At present, the Civil Service Retirement (CSR) system provides pension coverage for some 2.7 million active federal civilian employees and 1.8 million annuitants. In each of the coming five years, an average of 92,500 more civil servants will retire and begin to draw CSR pensions.

COMPARISON WITH PRIVATE SECTOR RETIREMENT

Retirement under CSR differs markedly from that in the private sector. Benefits under CSR are relatively large when compared to the two-part retirement income of private-sector retirees: an employer-provided pension plan plus Social Security. The two areas in which differences have the most significant cost effects are age of eligibility for retirement and cost-of-living adjustments (COLAs) of benefits. CSR enrollees may draw pensions as early as age 55, and their benefits are kept abreast of inflation by being adjusted twice annually to reflect changes in the Consumer Price Index. These two features are largely responsible for the recent and projected steep growth in CSR outlays.

Under current law, CSR's annual outlays will increase from $14.7 billion to $30.1 between 1980 and 1986. About $10.6 billion (69 percent) of this increase will result from COLAs, and such adjustments become progressively more expensive every year. For example, in October 1980, each one-percentage-point adjustment caused annual outlays to rise by $161 million. By October 1985, each such increase will add some $341 million to annual CSR outlays.

HOW THE SYSTEM IS FINANCED

Despite large and growing outlays, the system's statutory financing provisions assure its present and future solvency. Last year, the CSR trust fund's reserves of $73.6 billion were five times annual outlays; although this ratio is expected to decline in the long run, the reserves will still provide adequate resources at a ratio of more than one and a half times annual outlays.

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Income from five sources finances the CSR trust fund. By far the largest portion--46.5 percent--comes in the form of annual appropriations from the general fund of the U.S. Treasury. Interest on fund balances furnishes a further 20.7 percent. Another large portion comes from contributions from employing agencies and employees, for most of whom participation is mandatory; the employee and agency shares (each set at 7 percent of payroll) together constitute 26.5 percent to CSR trust fund income. The balance, 6.2 percent, comes from off-budget agencies such as the U.S. Postal Service.

Maintaining the CSR trust fund according to current financing provisions involves considerable out-of-pocket cost to the federal government. This sum is calculated as the difference between the annual income from employee contributions and payments from off-budget agencies, less that year's outlays. In 1980, the CSR cost to the government was $9.6 billion (65.3 percent of outlays), and over the coming five decades, it is projected to grow in 1980 dollars to $20.2 billion (78.0 percent of outlays).

PROS AND CONS OF CSR

Proponents of the CSR system and of maintaining it in its present form stress three points in particular. First, they note that the federal government has the obligation, as a model employer, to protect its retired personnel fully against inflation; this goal is served by the COLA provision of CSR. Second, they point to the tax-exempt status of the Social Security income of private-sector retirees; the generosity of CSR pensions is viewed in part as offsetting this relative private-sector advantage. Third, they point to the relatively lower pay the federal government offers for many comparable jobs in the private sector; again, generous pensions are cited as fair recompense for salary inequities.

On the other side of the debate, the cost to the government is one of the causes of concern about the CSR system. Critics of the present system view its expense as excessive and seek ways of reducing it.

The fact that employing agencies pay only a small share of CSR's federal cost is another source of criticism. The full expense of this important fringe benefit is not accurately reflected in operating agency budgets. Increasing the employing agencies' contributions to CSR has been cited as a way to improve cost accounting and, in turn, budgeting and decisionmaking.

A third criticism arises from the wide disparity between CSR and private-sector retirement practices. Opponents of the present system would like to see the costs or benefits of CSR brought more into line with the private-sector combination of company pensions plus Social Security.

POSSIBLE SOLUTIONS

In response to the above concerns about CSR, the effects of maintaining current law (Option I) and adopting one of three alternatives are outlined below. The net reductions in costs to the government that could be achieved by the three alternatives (Options II-IV) are summarized in the table on the next page.

Option I: Continue Current Financing

Advocates of continuing the status quo point out that current financing mechanisms will continue to provide adequate income to the CSR fund. Opponents argue that the present employee and agency contribution rates do not provide sufficient income to cover the full cost of benefits for either current annuitants or active employees. They further point out that the cost to the government is excessive in comparison with retirement practices in the private sector.

Option II: Increase Agency Contribution Rates to Reflect the Full Cost to the Government

If the agency contribution were to reflect the full cost to the government as computed by actuaries, the rate would have to be increased from 7 to 29.5 percent of payroll. For most agencies, this increase would be offset by a corresponding adjustment in annual appropriations, and thus it would simply represent an internal transfer from one budget account to another with no effect on federal receipts. For off-budget agencies, however, the increased rate could result in additional CSR fund income that would reduce annual costs to the government by $3.2 billion (23 percent) in 1982 and accumulate to $17.8 billion (20 percent) through 1986.

SUMMARY TABLE. PROJECTED CSR COSTS TO THE GOVERNMENT UNDER CURRENT LAW FINANCING AND RELATIVE SAVINGS FROM ALTERNATIVES: 1982-1986, IN BILLIONS OF DOLLARS

	1982	1983	1984	1985	1986	Cumulative Costs to the Government
Costs Under Current Financing (Option I)	14.2	16.2	18.4	20.2	22.2	91.2
	(NET REDUCTIONS UNDER ALTERNATIVES)					
Increase Agency Contribution Rates (Option II)	3.2	3.3	3.3	4.0	4.0	73.4
Increase Employee and Agency Contribution Rates (Option III)	1.0	2.1	3.3	5.1	5.2	74.5
Retain Present Contribution Rates but Limit Certain Benefit Provisions (Option IV)	0.8	1.4	2.1	2.8	3.4	80.7

SOURCE: Congressional Budget Office.

The General Accounting Office believes that this alternative would improve management decisions about the level and nature of federal programs, because personnel costs of federal operations would be more visible and accurately recorded. This approach would not change CSR benefit provisions or employee withholding rates. It would, however, result in substantial increases in CSR reserve levels, with trust fund balances reaching 12.5 times annual outlays in 1986.

Option III: Increase Agency and Employee Contribution Rates

This alternative would incorporate essentially the same CSR funding provisions as Option II, but it would require federal employees to shoulder some of the rate adjustment. Specifically, over the next four years, employee contributions to the CSR fund would increase from 7 to 9 percent of pay, while employing agency rates (reflecting the remaining actuarial cost) would increase from 7 to 27.5 percent of payroll.

Because of phased-in implementation, this alternative would initially yield a smaller reduction in federal costs than would Option II. But in 1986, it would yield the greatest annual savings to the government among the alternatives considered--$5.2 billion (23 percent) below current financing.

Increasing the employee withholding rate from 7 to 9 percent of pay would bring CSR's long-term cost to the government into line with private-sector standards. Employee organizations would oppose this alternative, because any mandatory increase in employee withholding rates would widen existing disparities in take-home pay between many federal employees and their private-sector counterparts.

Option IV: Retain Current Contribution Rates but Limit Benefits for Early Retirement and Cost-of-Living Adjustments

This approach would reduce the government's cost for CSR by limiting cost-of-living adjustments in benefits to once a year and to 70 percent of changes in the Consumer Price Index. Also, a reduction in initial benefits for persons who choose to retire before age 65 would be phased in over 20 years, eventually reaching 10 percent at age 60 and 20 percent at age 55. The 20 percent maximum reduction would still be less severe than early retirement reductions required by private pension plans and Social Security. The government's cumulative five-year savings, relative to current law, could total $10.5 billion (12 percent).

This option would be supported by critics who view current CSR cost-of-living and early retirement provisions as too generous and costly to the government when compared to private-sector practices. CSR beneficiaries might point to the argument mentioned above concerning the federal government's responsibility as a model employer. Obviously, this plan would have particularly little appeal to retirees during a period of high inflation.

CHAPTER I. INTRODUCTION

The Civil Service Retirement (CSR) system now covers some 2.7 million active federal civilian workers and 1.8 million annuitants currently drawing retirement, disability, or survivor benefits. 1/ From 1981 through 1986, an average of 92,500 federal employees will retire each year under the CSR program. Participation in CSR is mandatory for most federal employees and usually requires a payroll withholding fixed by law at 7 percent of salary. 2/ The employee contribution, equivalent to a payroll tax, is matched dollar-for-dollar by the employing agency. Employee and agency contributions are far from adequate to finance future benefits for current employees, however; nor do they cover annual benefit payments to present CSR annuitants. The remaining amounts needed are paid by the federal government.

The costs of CSR have been rising sharply. For instance, between 1970 and 1980, annual CSR outlays have grown from $2.7 billion to $14.7, and they are estimated to reach $30.1 billion in 1986. This represents a $15.4 billion increase in annual outlays in the next six years, of which $10.6 billion (69 percent) will result from automatic post-retirement cost-of-living adjustments (COLAs). These adjustments are becoming progressively more expensive every year, because of increases in the numbers of annuitants, the upward trend of wages, and the compounding of COLAs on previous such adjustments. In October 1980, each one-percentage-point adjustment caused annual outlays to increase by $161 million, while in October 1985, each one-percentage-point adjustment is projected to add $341 million to annual outlays.

1/ Appendix A provides summary information on the characteristics of CSR annuitants.

2/ The statutory provisions for financing CSR were last changed by the Civil Service Retirement Amendments of 1969 (Public Law 91-93). Contribution rates differ slightly for certain groups of federal employees. For example, Congressional staff and workers on hazardous duty contribute 7.5 percent of pay; Members of Congress contribute 8 percent of pay.

These trends of growing costs have given rise to concern about the adequacy of current CSR financing, the accountability of CSR costs in federal programs, as well as whether or not CSR costs and benefits should be reduced. In response to these concerns, this paper addresses the following questions:

- Should federal programs reflect the full cost of CSR?
- Is the system's cost to the federal government excessive?
- Do current provisions ensure the CSR fund an adequate income?

The remainder of this chapter presents an overview of the current CSR program--its financing provisions, its costs to the government, and a comparison with retirement provisions in the private sector. Chapter II analyzes CSR financing issues; and Chapter III describes possible modifications to the current system.

CSR FINANCING

In practice, the CSR program operates on a pay-as-you-go basis, inasmuch as current income from CSR employee withholdings and general revenues pays for the benefits of current annuitants. With the exception of payments from certain off-budget federal agencies (discussed below), only federal employee contributions directly offset the budgetary costs of CSR. The CSR trust fund serves mainly a bookkeeping purpose within the federal budget. 3/

The CSR Fund. The CSR program is reflected in the federal budget as a trust fund account. The fund serves as a repository into which various payments are deposited as income and from which benefits and administrative expenses are paid. Payments into the fund, counted as budget authority, consist of payroll withholdings from federal employees, agency contributions, interest earned on fund investments, and appropriations from the general fund of the U.S. Treasury--the major source of CSR financing (see Table 1).

3/ For a discussion of the budgetary impact of federal trust fund accounts see CBO, Federal Financial Reporting (June 1977), pp. 12-15.

TABLE 1. CSR TRUST FUND FINANCING, BY SOURCE: FISCAL YEAR 1980

Source	Dollar Amount Contributed (in Billions)	Percent of Total Funding
Employee Contributions	3.6	14.9
Employing Agency Contributions	2.8	11.6
Off-Budget Agency Contributions	1.5	6.2
Earned Interest and Other Income	5.0	20.7
Appropriations from the General Fund of the U.S. Treasury	11.2	46.5
Total Trust Fund Income	24.2	100.0

SOURCE: U.S. Budget Appendix for Fiscal Year 1982, p. I-V118.

Annual appropriations from the Treasury, authorized by the Civil Service Retirement Amendments of 1969, currently make up 46 percent of income to the CSR trust fund. These payments reimburse the CSR fund for costs associated with prior military service by CSR annuitants, annual pay raises for federal civilian workers, and interest earnings not realized, primarily because the fund does not receive sufficient income from employee and employing agency contributions.

Only two sources of CSR fund income--employee withholdings and payments from off-budget agencies--constitute budget receipts and thus offset CSR costs. The U.S. Postal Service (USPS) accounts for nearly all of the payments from off-budget agencies. Current law requires USPS to match its employee contributions to CSR and to pay additional amounts for retirement liabilities associated with collective bargaining agreements affecting postal salaries. The other sources of CSR income are merely internal transactions among budget accounts. They do not affect budget receipts or CSR costs because they are only internal accounting entries, not payments to or from the federal government. As income to the CSR fund, however, they affect budget authority totals.

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TABLE 2. PROJECTED ANNUAL CSR COST TO THE GOVERNMENT: SELECTED FISCAL YEARS TO 2030, IN BILLIONS OF 1980 DOLLARS

	1980	1990	2000	2010	2020	2030
Total Outlays	14.7	18.1	20.4	22.3	24.4	25.9
Income from Employee Withholdings and Off-Budget Agencies (-)	-5.1	-4.5	-5.0	-5.2	-5.4	-5.7
Cost to the Government	9.6	13.6	15.4	17.1	19.0	20.2
As a percent of total outlays	(65.3)	(75.1)	(75.5)	(76.7)	(77.9)	(78.0)

SOURCE: Derived by the Congressional Budget Office from estimates prepared by the Office of Personnel Management.

The Costs to the Government of CSR

The cost to the government of CSR--that is, the government's annual out-of-pocket expense--is calculated as the difference between CSR outlays and receipts from employee withholdings and from off-budget agencies. Over the next half century, the annual cost to the government will reach $20.2 billion (in 1980 dollars), an increase of 110 percent over present levels (see Table 2). A substantial part of CSR's cost increases will result from cost-of-living adjustment provisions, which automatically increase CSR benefits for inflation. For example, by 1986, the estimated annual cost to the government will rise from $12.1 billion in 1981 to $22.2 billion (nominal dollars). About 89 percent of this $10.1 billion increase will result from COLAs that have not yet occurred (September 1981 through March 1986). The remainder will be caused by changes in the number of annuitants and their wage and work histories.

CSR COMPARED WITH RETIREMENT IN THE PRIVATE SECTOR

Comparing the retirement provisions for federal civilian employees with retirement in the private sector involves contrasting a single, one-source pension program--CSR--against a dual one: a private pension plan in tandem with Social Security. (In reality, however, only half of the workers covered by Social Security also participate in a private-pension plan.) Federal civil service is not covered by Social Security, and the CSR system is therefore designed to provide adequate retirement income that substitutes for the combination of a private employer's retirement plan and Social Security. Unless otherwise indicated, the information on private-sector retirement practices is based mainly on a 1977 survey of 448 companies, which together employed a total of 5 million workers. 4/

The CSR system shares certain features with both private retirement plans and Social Security, but in more ways, it differs. A major distinction concerns the redistribution of income. Social Security is unique in this regard, in that recipients whose earnings were low throughout their careers tend to receive proportionately greater Social Security benefits. The same applies to retirees with greater needs associated with a nonworking spouse or with a large number of dependents. Neither CSR nor most private-sector plans have this redistribution effect; they base benefits on salary and length of service. A related distinction results from the tax-exempt status of Social Security income, a feature not shared either by CSR or any private pension plan. 5/

5/ The private-sector advantage from tax-exempt Social Security income is described in CBO, Compensation Reform for Federal White-Collar Employees (May 1980), pp. 22-24. For further description of the taxation of retirement income, see Congressional Research Service, Federal Income Tax Treatment of Retirement and Disability Income (July 13, 1977).

4/ The data were drawn from the annual Hay/Huggins Non-Cash Compensation Survey (Spring/Summer 1977) and were analyzed for CBO by Hay Associates (see Appendix C). For information on CSR benefit levels and those provided in the private sector, see previous CBO studies: Options for Federal Civil Service Retirement: An Analysis of Costs and Benefit Provisions (December 1978); Federal White Collar Employees--Their Pay and Fringe Benefits (April 1979); Compensation Reform for Federal White Collar Employees: The Administration's Proposal and Budgetary Options for 1981 (May 1980); and Alternative Approaches to Adjusting Compensation for Federal Blue-Collar Employees (November 1980).

Other major points of comparison include the following:

- o Employee contributions,
- o Age of retirement, and
- o Adjustments for the cost of living.

Employee Contributions. All but a few employees in the private sector contribute to the Social Security system (now 5.35 percent of pay--if the portion for Health Insurance is excluded--on earnings up to a maximum annual amount of $29,700) but not to private pension plans, most of which are fully paid for by employers. If federal white-collar employees, as a group, contributed only to Social Security according to future withholding increases scheduled by the Social Security Amendments of 1977, the withholding rate for retirement would average 5 percent of payroll. (This estimate, expressed as a percent of total employee earnings, reflects the average withholding over the careers of active federal white-collar workers as a group.)

Although the federal employee contributes 7 percent of pay for CSR, retirement benefits are more generous--mainly because of provisions for retirement before age 65 and for automatic cost-of-living adjustments. These two features most sharply distinguish CSR from retirement practices in the private sector and contribute significantly to CSR outlays--the COLA provisions being the single most important cause of rising CSR costs.

Age of Retirement. Federal employees retire at much earlier ages than do employees in the private sector. 6/ Under the CSR system, federal employees may retire as early as age 55 if they have served 30 years in government employment. 7/ Both private

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6/ Appendix B compares CSR and private-sector age retirement.

7/ Some civil service employees may receive a pension before age 55 if they retire under special provisions for law enforcement officers or firefighters, if they are employed by an agency undergoing a cutback or reorganization, or if they are laid off for reasons other than misconduct or delinquency. In the latter two cases, the annuity is reduced by 2 percent for each year the employee is under age 55. For further discussion see, General Accounting Office, Voluntary Early Retirements in the Civil Services Too Often Misused (December 31, 1980).

pension and Social Security benefits are usually based on retirement at age 65. Most private plans do allow earlier retirement, but the benefits are reduced, typically by 3.5 percent for each year from age 64 down to age 60 and by 4 percent for each year below age 60. Persons younger than 62 cannot receive Social Security benefits, and for persons between ages 62 and 64, these benefits are reduced by 6.66 percent per year.

Cost-of-Living Adjustments. Like Social Security recipients, CSR annuitants receive automatic adjustments for increases in the cost of living, but the CSR adjustments occur twice rather than once a year. In both programs, the adjustments recover the full increase in inflation as measured by changes in the Consumer Price Index (CPI). 8/ According to the General Accounting Office (GAO), federal COLA provisions are far superior to those available to retirees from private industry or from other employment not covered by CSR. 9/

Various studies of post-retirement cost-of-living adjustments support the conclusion that federal retirees receive better protection from inflation than is generally available in the private sector. (Appendix C summarizes recent surveys that have collected data on cost-of-living adjustments available to private-sector retirees.) Most significantly, only a small proportion of private-sector plans (3 to 8 percent) have an explicit COLA provision, and most of these limit the adjustment to a maximum annual increase of 2 to 5 percent. Nearly 40 percent of private-sector plans do not grant cost-of-living increases of any kind. As a group, retirees with private pension plans receive COLAs averaging between only 30

8/ The CPI is criticized as a measure for adjusting federal benefit programs because it has overstated the decline in purchasing power in recent years. See for example, CBO, Paying for Social Security: Funding Options for the New Term (February 1981); An Analysis of President Reagan's Budget Revisions for Fiscal Year 1982 (March 1981); and a forthcoming CBO study on the CPI and alternative measures of inflation.

9/ Letter report from the Comptroller General of the United States to the Honorable James M. Hanley, July 1, 1980.

and 33 percent of changes in the CPI. If CSR COLAs were adjusted according to provisions of a typical private pension plan in combination with Social Security, the pension adjustments would recover--over a period of years--approximately 70 percent of the annual rate of inflation. 10/

10/ The estimated 70 percent recovery from inflation for private-sector retirement is described in CBO, Options for Federal Civil Service Retirement (December 1980), pp. 16-20.

CHAPTER II. CSR FINANCING ISSUES--SOLVENCY, ACCOUNTABILITY, AND COSTS TO THE GOVERNMENT

Changing the financing mechanisms of the CSR system could be considered primarily for two purposes:

- To improve the accountability of CSR costs in agency operations, and

- To lower the system's costs to the federal government.

In addition, the future solvency of the system has been questioned, and there have been recommendations advanced to enhance CSR's financial solidity. The first portion of this chapter assesses the need to fortify the CSR system further.

THE FINANCIAL CONDITION OF THE CSR TRUST FUND

According to analysis of projections by the Office of Personnel Management (OPM), which administers CSR, the CSR system's present financing provisions will continue to keep the system on a sound footing--mainly because of appropriations from the general fund of the U.S. Treasury, which now make up roughly half of the fund's annual income (see Table 1 in Chapter I). This suggests that concern about CSR's future solvency is unwarranted.

The financial condition of the CSR fund, as an internal budget account, can be assessed by analyzing its cash position--that is, the relationship of annual fund income to outgo. 1/ In fiscal year 1980, CSR income from all sources exceeded the year's outlays by about $9.5 billion, and balances in the fund increased from $64.1 billion to $73.6 billion--a ratio of five times the year's outlays. CBO analysis of long-range OPM projections shows this ratio steadily declining throughout the next 50 years, but it shows CSR still operating from a sound cash position in the year 2030, when the margin will be more than one and a half times annual outlays (see Table 3).

1/ This analysis should not be confused with the CSR cost to the federal government. This aspect is addressed in the last portion of this chapter.

TABLE 3. PROJECTED RATIO OF CSR RESERVES TO OUTLAYS: SELECTED FISCAL YEARS TO 2030, IN BILLIONS OF 1980 DOLLARS

	1980	1990	2000	2010	2020	2030
Reserves	73.6	84.5	87.9	82.7	65.9	41.0
Outlays	14.7	18.1	20.4	22.3	24.4	25.9
Ratio of Reserves to Outlays	5.0:1	4.7:1	4.3:1	3.7:1	2.7:1	1.6:1

SOURCE: Prepared by the Congressional Budget Office from data supplied by the Office of Personnel Management.

Between 1970 and 1980, general fund appropriations (plus interest) added some $59.7 billion to the CSR fund. Without these sizable payments, CSR fund balances would be exhausted during 1982, leading to larger deficits in subsequent years. By 1986, the deficit would have accumulated to about $79.3 billion. But the continued appropriation of general funds called for under current law assures the availability of substantial fund balances to meet future CSR requirements. During the next five decades, general fund appropriations to the CSR trust fund will increase from $11.2 billion to $14.8 billion (in 1980 dollars).

The CSR fund's dependency on general fund appropriations can be illustrated by identifying annual CSR outlays not covered by contributions from either employees or from employing agencies. Dependency on general fund appropriations is estimated to increase from $6.7 billion in 1980 to $17.3 billion (in 1980 dollars) in the year 2030, when general fund payments will cover two-thirds of annual CSR outlays (see Table 4).

Another Perspective--Viewing CSR as a Private Pension Plan

Although CSR is not a private pension plan, some people assess it as such. Judged in the same terms as a private plan, the CSR system is not actuarially sound, largely because future cost-of-living adjustments are not now fully taken into account. From this

TABLE 4. PROJECTED CSR DEPENDENCY ON GENERAL FUND APPROPRIATIONS: SELECTED FISCAL YEARS TO 2030, IN BILLIONS OF 1980 DOLLARS

	1980	1990	2000	2010	2020	2030
Total CSR Outlays	14.7	18.1	20.4	22.3	24.4	25.9
Contributions from Employees and Employing Agencies (-)	-8.0	-6.9	-7.6	-7.9	-8.2	-8.6
Dependency on General Fund Appropriations	6.7	11.2	12.8	14.4	16.2	17.3
As a percent of total outlays	(45.6)	(61.9)	(62.7)	(64.6)	(66.4)	(66.8)

SOURCE: Derived from estimates prepared by the Office of Personnel Management.

perspective, financial inadequacy is often measured by estimates of "unfunded liability." In the CSR system, unfunded liability is the cost of future benefits for current employees and annuitants, less the trust fund's assets (that is, current reserves plus future income).

CSR's "Unfunded Liability." According to calculations by OPM, CSR unfunded liability more than doubled, from $52.8 billion to $166.4 billion, in the decade 1970-1980. 2/ This increase occurred largely because of the automatic cost-of-living adjustments in benefits. For example, the two COLA raises effective in 1980 (6.0 percent in March and 7.7 percent in September) increased CSR unfunded liability by $20.4 billion. Based on traditional calculations, CSR's unfunded liability could reach $255 billion by the end of 1986, reflecting only estimated COLAs up to that time.

2/ According to the OPM, the $52.8 billion in unfunded liability as of June 30, 1970 included $1.6 billion that was incurred when the system was created, $4.3 billion for deficiency in subsequent government contributions, and $46.9 billion for pay and benefit increases and COLAs.

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Traditional OPM calculations of CSR unfunded liability fail to take into account both future pay raises and COLAs. If these two factors were included in the computation (assuming present contribution rates), the resulting unfunded liability would be more than three times the traditional estimate--some $840 billion, rather than the estimated $255 billion. 3/ On this basis, about 63 percent of CSR liability is unfunded.

Shortcomings of Unfunded Liability Measures. For several reasons, measures of unfunded liability do not provide a useful standard for assessing the financial condition of CSR as a public pension plan. They reflect only the revenues and costs associated with however many participants (active employees and annuitants) are covered at the time the calculation is made; thus, they disregard the cash-flow effects of new participants in the system.

More important, because CSR is backed by a permanent institution--the federal government--the system does not need full funding as a safeguard against bankruptcy or insolvency, prospects that cannot be overlooked in private pension plans. The taxing power of the federal government provides the ultimate assurance that federal retirement benefits can be paid.

ACCOUNTABILITY OF CSR COSTS IN AGENCY BUDGETS

The long-term actuarial cost of CSR, expressed as a level percent of payroll, is estimated by the CSR Board of Actuaries at 36.5 percent. Subtracting the employee contribution (7 percent of payroll) leaves a federal cost for CSR of 29.5 percent of

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3/ The unfunded liability estimate of $840 billion for 1986, revised from a previous CBO estimate, is based on long-term economic assumptions used in the most recent valuation by the CSR Board of Actuaries. Over the next 50 years, annual inflation is assumed to average 6 percent; CSR rate of return on investments 7 percent; and annual pay increases (in addition to promotions and longevity pay increases) 6.5 percent. The estimate reflects the existing contribution rates, cost and financing of past and future pay raises, and the exclusion of appropriations for interest forgone on unfunded liability.

payroll. 4/ This estimate includes the effects of both future salary increases and future annuity adjustments. Because the employing agency contribution rate is now set at 7 percent of pay, rather than at the full federal cost of 29.5 percent, the true cost is greatly understated in agency operations.

Even though federal payments partly compensate the CSR fund for the lower contribution rate, program managers are not required systematically to use accurate data on the true costs of their programs. For example, the 7 percent agency contribution rate understates the average personnel cost (pay and fringe benefits) for the Internal Revenue Service and the Social Security Administration. Consequently, the 1981 operating costs for these two agencies are understated by $28 million (17 percent) and $329 million (12 percent), respectively.

Both GAO and CBO have observed that raising the employing agencies' contribution rates to reflect the full federal cost of CSR could, by improving cost accounting, also improve programmatic and budgetary decisionmaking. 5/ The Office of Management and Budget requires agencies to consider the full cost of CSR when deciding whether to assign work in-house or to contractors. 6/ For other decisions, however, managers do not uniformly include the full federal cost of CSR when assessing program costs and benefits, levels of service, methods of operation, or capital investment decisions.

4/ The long-term actuarial cost of CSR is calculated as the present value of prospective CSR benefits as a percent of the present value of payroll during active employment. The estimate (based on workforce characteristics concerning years of federal work, age, income, sex, and marital status) reflects the number of employees expected to die, become disabled, retire, or otherwise terminate employment at different ages.

5/ See General Accounting Office, Federal Retirement Systems: Unrecognized Costs, Inadequate Funding, Inconsistent Benefits (August 1977) and CBO, Retirement Accounting Changes: Budget and Policy Impacts (April 1977). The CBO study addresses the need for cost recognition for military and civilian retirement within the defense agencies.

6/ Executive Office of the President, Office of Management and Budget, Cost Comparison Handbook, Supplement No. 1 to OMB Circular No. A-76 (March 1979), and Transmittal Memorandum No. 5 (September 1980).

GAO further notes that the present 7 percent agency contribution rate results in unrecognized subsidies to various public enterprises. 7/ These subsidies, amounting to an estimted $2.7 billion in 1981, mainly benefit the U.S. Postal Service and the government of the District of Columbia.

Because of its size and its unique financial relationship to the CSR program, the Postal Service deserves special attention in considering agency accountability for retirement costs. The USPS contributions to CSR (described in Chapter I) have the effect of reducing federal outlays somewhat, but they do not cover the full cost of CSR benefits for postal employees. The resulting indirect subsidy to USPS derives from two aspects of current CSR financing: that the 7 percent agency contribution rate does not reflect the full federal CSR cost; and that the USPS is not charged for its share of general fund payments for reduced interest earnings in the CSR fund. Together, these two features generate indirect subsidies--in the form of lower costs to USPS--estimated at $3.7 billion for 1981.

Estimates of CSR cost, as a level percent of pay, are highly sensitive to long-term economic assumptions and actuarial techniques. For example, OPM analysis indicates that a one-percentage-point increase in the assumed interest rate could decrease overall CSR costs from 36.5 percent of pay to about 27 percent. On the other hand, a comparable increase in the annual rates assumed for either federal pay raises or inflation could raise overall CSR costs to nearly 41 percent of pay. Given the sensitivity to long-term economic assumptions, one can argue that actuarial measures of CSR costs are unreliable bases for altering the agency contribution rate.

THE REASONABLENESS OF CSR COSTS

No statutory or generally agreed-upon criterion exists for evaluating the reasonableness of CSR benefits and the associated federal costs. Employee organizations, for example, maintain that CSR's costs to the government are warranted by the government's commitment to retirees and by its responsibility as a model employer. From this perspective, retirement practices in the private sector are not a proper basis for comparison. Other

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7/ GAO, Federal Retirement Systems. The $2.7 billion in estimated subsidies derives from the current agency contribution rate that does not reflect the full federal costs of CSR.

justifications maintain that a liberal federal retirement system is fair recompense for federal salary levels, which, in many cases, are lower than earnings for equivalent work in the private sector.

On the other hand, taxpayers as well as some civil servants and federal managers may view CSR costs as excessive--especially when compared to private-sector pay and benefit practices. From a managerial viewpoint, recruitment and retention of qualified federal employees might be enhanced if a deferred fringe benefit such as retirement were decreased somewhat to permit higher salaries. Many professionals and younger employees, who do not foresee long government careers, or who have a choice between federal and nonfederal work, may attach greater importance to salaries than to retirement benefits.

This tradeoff is especially critical in view of the limitations on federal pay raises that have been imposed in each of the last three years and that are proposed again for this year. The Administration has proposed legislation that would significantly limit the October 1981 federal pay adjustments; the proposal involves inclusion of the dollar value of fringe benefits. Under the new plan, the size of annual pay adjustments through 1983 would be further reduced to reflect a policy that federal compensation (pay and fringe benefits) be lower than that for similar nonfederal jobs. 8/

Civil Service Retirement Compared to Private Sector Practice

Although federal employees contribute more toward their retirement program than they would under a private plan combined with Social Security (see Chapter I), CSR annuitants receive greater benefits. From this point of view, CSR's costs to government as employer are excessive.

If federal white-collar employees, as a group, were covered by a representative private plan plus Social Security, the federal cost (as a level percent of payroll) could range between 21 and 23

8/ For detailed analysis of previous pay reform proposals see CBO, Compensation Reform for Federal White-Collar Employees (May 1980) and Alternative Approaches to Adjusting Compensation for Federal Blue-Collar Employees (November 1980).

TABLE 5. CSR COMPARED TO PRIVATE SECTOR RETIREMENT PRACTICE--COSTS NOT PAID BY EMPLOYEES: AS A LEVEL PERCENT OF PAYROLL

	High Differential	Low Differential
(Civil Service Retirement)		
Total Cost	36.5	30.3 a/
Employee Contribution (-)	-7.0	-7.0
Cost not paid by employees	29.5	23.3
(Private Sector Retirement)		
Total Cost	24.2 b/	23.7 a/
Advantage from Tax-Exempt Income (+)	+3.5	+2.7
Value of Employee Contribution to Social Security (-)	-5.0	-5.0
Cost not paid by employees	22.7	21.4
Difference Between CSR and Private Sector Retirement	6.8	1.9

NOTES: Costs and contributions expressed as a level percent of payroll. Private-sector retirement includes representative private pension plans plus a constant value for Social Security of 15.7 percent of pay.

a/ Estimates incorporate data supplied by Hay Associates.

b/ Estimates incorporate illustrative data supplied by the Office of Personnel Management, Standardized Cost Estimates of 'Typical' Benefit Plans (May 25, 1979).