Military Retirement Accounting Changes: The Administration's Proposals

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MILITARY RETIREMENT ACCOUNTING CHANGES: THE ADMINISTRATION'S PROPOSALS

The Congress of the United States
Congressional Budget Office

PREFACE

In April 1978, the Administration submitted to the Congress a legislative proposal calling for major changes in the way the federal budget accounts for the costs of military retirement. Under the proposal, the federal budget would reflect costs of retirement benefits being earned by today's military personnel, whereas the current budget reflects only the costs of those already retired. Legislation incorporating these changes has been introduced in the House of Representatives as H.R. 12392. This study, prepared at the request of the National Security Task Force of the House Committee on the Budget, describes the Administration's proposals, estimates their impact on the federal budget, and cites the arguments for and against the changes.

Although the study itself makes no recommendations about the desirability of these accounting changes, it is the judgment of the Congressional Budget Office that the accounting concepts underlying the Administration's proposals are sound and should be implemented. Some details of the proposals--particularly the economic assumptions used to estimate retirement costs and the exclusion of the civil service retirement system from the proposals--may need to be modified, but the basic approach proposed in the legislation would greatly improve the usefulness of the budget by making the full costs of military manpower more visible. The approach would also assist future debates over changes in military retirement benefits by clarifying the cost effects.

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SUMMARY

The Administration has proposed major changes in the way the federal budget accounts for military retirement costs. If these changes are accepted by the Congress, the Administration proposes to revise the fiscal year 1979 budget to reflect them, although implementation could be delayed until the fiscal year 1980 budget. The changes would require legislation, which has been introduced in the House of Representatives as H.R. 12392 and referred to the Committee on Armed Services. The Budget and Appropriations Committees must also be consulted about the proposed changes.

These proposed modifications are simply adjustments in accounting procedures; they would not affect the amount of retirement benefits paid to an employee when he retires, nor would they affect the cost to the federal government. Their major purpose is to improve management by making the full costs of manpower more visible, to increase the visibility of any cost changes stemming from modification in retirement benefits, and to make the defense function of the budget a better measure of the cost of today's defense activity.

PROPOSED CHANGES

The Administration has proposed three major changes:

- The Defense Retired Pay appropriation would be transferred out of the defense function of the budget and would be absorbed into a trust fund discussed below. (The Defense Retired Pay appropriation pays benefits to former military personnel currently on the retired rolls and to their survivors.)

- A charge for retirement costs of today's military personnel would be added to the defense function. The charge would equal the amount actuaries estimate would fully fund the retirement benefits earned each year by today's military personnel. This charge would reflect expected future growth in wages and prices and future interest rates.

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- o A military trust fund would be created in the income security function. This fund would pay all retirement benefits. The fund would also receive the annual accrual charge, and it would receive an annual payment for retirement liabilities built up before the fund's existence as well as interest on the money the fund holds to pay future retirement benefits. The fund would be required to invest in government securities.

EFFECTS ON OUTLAYS AND BUDGET AUTHORITY

Because the proposed accounting changes would not affect retirement benefits, these accounting modifications would not alter total outlays in the federal budget. Outlays in some functions would change, however. For example, if all three modifications were implemented, CBO estimates that outlays in the defense function would decrease by $3 billion in fiscal year 1979.

In contrast to outlays, budget authority in the budget as a whole would increase as the budget began to recognize fully costs of future retirement benefits. In fiscal year 1979, if all three changes were implemented, the increase in budget authority would amount to about $7.4 billion in the federal budget as a whole. There would also be changes in specific functions. For example, budget authority in the defense function would decrease by $3 billion.

These estimates of changes in outlays and budget authority are very sensitive to economic assumptions, particularly those about future wage growth and interest rates. The numbers above are based on Administration assumptions that wage growth will exceed inflation by 1.5 percent annually, while interest rates will exceed inflation by 2.5 percent. An alternative assumption--that wages and interest would each exceed the inflation rate by 1 percent--would mean no net effect on outlays and budget authority in the defense function, versus the $3 billion decrease under the Administration's economic assumptions. Particularly for interest rates, the 1 percent assumption is more consistent with the past history of returns on government bonds than are the Administration's assumptions.

ADVANTAGES AND DISADVANTAGES

Implementation of all three accounting changes together would offer several advantages. The institution of a charge for military retirement would make retirement costs of current employees more visible. This may make planners in the Department of Defense more frugal in their use of manpower and could prompt a clarification of the debate over changing military retirement benefits by displaying long-run savings more clearly. Also, the size of the defense function is sometimes used to evaluate current activity and to make comparisons with past levels of defense activity. When applied consistently to past and future defense spending, the proposed accounting changes would make the numbers in the defense budget function better measures for such comparisons.

Probably the major disadvantage of these accounting modifications is that the retirement accrual charge depends on technical assumptions--such as those about future prices, wages, and interest rates. This renders the charge--and hence the defense budget--subject to manipulation. The Administration has proposed, however, that an independent board of actuaries be created to advise on the assumptions. Another potential disadvantage is confusion during the transition to a new system. During the transition, the defense function might appear larger or smaller even if there were no changes in real activity. This disadvantage, however, could be minimized by restating past defense budgets in terms of the new accounting procedures.

After weighing these pros and cons, most of these accounting changes were recommended by the Defense Manpower Commission and the General Accounting Office. The Congressional Budget Office also supports implementation of the accounting concepts underlying the Administration's proposals.

ACCOUNTING FOR CIVIL SERVICE RETIREMENT

The Administration has not proposed any changes in the way the budget accounts for civil service retirement. The agency budgets already contain a charge for future retirement costs of today's civil service employees. But the charge is understated because it assumes no future growth in wages and prices. To be consistent with the proposed changes for military retirement, it might be desirable to increase the agency charges for civil service retirement to reflect future growth. Like the proposed changes for the military, the increased civil service charge would be an accounting change. But it would involve some complexities--including changes in most budget functions and the possibility of increasing the deficit of some off-budget agencies such as the Postal Service--that would not be introduced by the military retirement accounting changes.

CHAPTER I. PROPOSED CHANGES

The Administration has proposed changes in the way the federal budget accounts for military retirement costs. 1/ If accepted, the Administration proposes to restate the budget for fiscal year 1979 based on these new procedures, though implementation could be delayed until the fiscal year 1980 budget. The changes would only be accounting modifications; they would not affect the pay and benefits of any military employee, nor would they affect costs to the government. (Other, separate proposals are being considered that could affect benefits.)

The shifts are designed to improve management by making the full cost of manpower more visible, to increase the visibility of any cost changes stemming from modification in retirement benefits, and to make the defense function of the budget a better measure of the cost of today's defense activity. 2/ Under the provisions of the Congressional Budget Act of 1974, implementation of the accounting changes would require consultation with the Budget and Appropriations Committees. 3/ Some of the proposals would also require enabling legislation, which has been submitted by the Administration and introduced in the House of Representatives as H.R. 12392. 4/ The legislation has been referred to the Committee on Armed Services.

1/ Letter, General Counsel of the Department of Defense to the Honorable Thomas P. O'Neill, Jr. (April 3, 1978), pp. 1-7.

2/ The Congressional Budget and Impoundment Control Act of 1974 (P.L. 93-344) divided the budget into various numbered functions--for example, national defense (050), income security (600), and interest (900). These functions are used throughout this paper in discussing the effects of the proposed accounting changes.

3/ Section 802, Congressional Budget Act of 1974.

4/ When this paper was published, legislation had not been introduced in the Senate.

The Administration has proposed three major changes:

- The Defense Retired Pay appropriation, which pays for retirement benefits to former military personnel now on the retired rolls and for benefits to their survivors, would be transferred out of the defense function (050) and would be absorbed into the trust fund discussed below.

- In place of the retirement costs of past employees, a charge for retirement costs of today's military personnel (both active-duty and reservists) would be added to the defense function. The charge would be the amount that actuaries estimate would have to be set aside to fund fully the future retirement liabilities that military personnel earn, or "accrue," each year. 5/ This accrual charge would reflect future expected prices, wages, and interest rates. Under these proposals, the charge would be paid entirely by the Department of Defense and would appear in the personnel appropriations within the defense function.

- A military trust fund would be created in the income security function (600). This fund, like the existing civil service fund, would pay all military retired and survivor benefits. The fund would receive the annual accrual charge that sets aside money for benefits earned that year. Since substantial benefits would already have been earned before the fund's existence, the fund would also receive a payment that would gradually pay off

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5/ For the more technically inclined reader, the annual accrual charge is the amount that must be set aside each year so that the discounted present value of the charges--set aside over the entire career of a group of military employees--is equal to the discounted present value of retirement benefits that must be paid to those employees who remain in the service long enough to retire. Thus, the calculation considers all employees, not just those who retire, and depends on how long people stay in the service. The charge also depends on future inflation, wage growth, and interest rates and is usually expressed as a percentage of the annual military basic payroll.

this "unfunded liability." 6/ Finally, the fund would receive interest on the money it holds to pay future benefits.

Implementing these accounting changes would require projecting future wage and interest rates, as well as many detailed calculations. To provide advice on these matters, the Administration has proposed creating a three-man, independent board of actuaries that would set appropriate assumptions. In addition, the Administration has proposed creating a payment that would reflect changes necessary to correct for inaccurate projections, such as those about future inflation or interest rates.

Chapter II of this study shows the effects that these proposed changes would have on budget authority and outlays. Chapter III discusses the pros and cons of the changes and points out some unresolved issues.

The Administration has not proposed any changes in the method of accounting for civil service retirement. The agency budgets already show a charge for accrued costs of retirement benefits for today's civil service employees, but the charges do not take into account future increases in prices or wages. Chapter IV of this study provides a brief discussion of possible increases in the civil service charge to reflect future wage and price growth.

6/ Under the Administration's proposal, the amount of the annual payment would equal the cost of retirement benefits paid in that year but earned before contributions to the trust fund began.

CHAPTER II. EFFECTS ON OUTLAYS AND BUDGET AUTHORITY

The effect of the retirement accounting changes on outlays and budget authority depends critically on economic assumptions about future growth in prices and wages and about the interest rates that the trust fund would earn on its investments. This study evaluates changes in outlays and budget authority under two sets of economic assumptions: the Administration's proposed assumptions and an alternative. This chapter first discusses the two sets of assumptions, followed by estimates of changes in outlays and budget authority.

Projections of economic trends--especially those appropriate for long-term funding of retirement costs--are highly uncertain. Thus, the exact choice of assumptions is less important than the existence of a means of correcting estimates if the assumptions turn out to be inaccurate. As was discussed in Chapter I, the Administration's proposed accounting changes provide such a mechanism.

ECONOMIC ASSUMPTIONS

The Administration's proposed long-run economic assumptions were recommended by the Council of Economic Advisers. 1/ The Administration assumes a 4 percent annual rate of price growth, which is its long-run goal. Its proposed assumptions about wage growth and interest rates are stated in terms of "real growth"--that is, the amount of growth above the rate of inflation. The Administration assumes annual real wage growth of 1.5 percent and a real interest rate of 2.5 percent. (Thus, if inflation were 4 percent, the Administration would assume an annual pay raise of about 5.5 percent and an interest rate of about 6.5 percent.)

1/ Federal Register, vol. 42, no. 224 (November 21, 1977), p. 59821. These assumptions were determined for use in OMB Circular A-76, which specifies the costs of civil service retirement to be used in cost comparisons that lead to a decision about whether to contract out federal work to the private sector.

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Assumptions about real wage growth and interest rates have a particularly critical effect on outlays and budget authority. To help judge whether the Administration's assumptions are appropriate, Table 1 shows real interest and real military pay raises during the last 30 years. (The Appendix to this study shows rates during each of the years since 1948.) The table suggests that, since the military retirement trust fund would be required to invest in public debt securities, the assumption of a real interest rate of 2.5 percent is optimistically high. 2/ Such a rate has not been achieved in any of the periods shown in Table 1, either by government bonds that mature in three to five years or by long-term bonds with maturities of ten years. Thus, in addition to the Administration's 2.5 percent estimate, this study evaluates effects on the budget assuming that the trust fund earns 1 percent in real interest. This rate has been achieved or exceeded frequently over the last 30 years, which may suggest it would be achieved in the future as well.

Table 1 shows that there has been wide variation in the rate of real growth in military pay. Historical pay raises depended not only on the particular time periods, but also on the seniority of military employees. The Administration's assumption of annual real wage growth of 1.5 percent falls within the range achieved over the last 30 years. But it is significantly higher than real wage growth over the last five years, which has actually been negative. This paper also evaluates the effects of a 1 percent real rate of wage growth, which is more consistent with recent trends though still substantially higher.

The economic assumptions that would be used in preparing the budget would be those recommended by the board of actuaries. Their recommendations would likely fall within the range of the alternative assumptions discussed above.

2/ Choice of a real interest rate need not be based on returns on government bonds. It might, for example, be based on the interest rate deemed appropriate for comparing alternative public investments; this is often taken to be 10 percent. The appropriate rate of interest is a subject of much debate among economists. But since the trust fund is required to invest in government securities, this study assumes that real returns on government securities are the appropriate basis for choosing an interest rate.

TABLE 1. HISTORICAL ECONOMIC TRENDS (SELECTED PERIODS DURING CALENDAR YEARS 1948-1977)

	Average Annual Real Percentage Returns on Government Bonds a/		Average Annual Percentage Increase in Real Military Pay b/	
	Three to Five Year	Long Term	All Military Personnel	Personnel With 20 or More Years' Service
30-year period				
1948-1977	0.9	1.0	2.1	1.8
20-year periods				
1948-1967	1.1	1.4	1.8	2.0
1953-1972	1.9	1.9	3.3	3.0
1958-1977	1.4	1.3	2.6	2.2
10-year periods				
1948-1957	-0.1	0.4	1.1	1.0
1953-1962	1.9	2.1	0.4	1.2
1958-1967	2.3	2.4	2.5	3.0
1963-1972	2.0	1.8	6.3	4.8
1968-1977	0.6	0.2	2.6	1.4
5-year periods				
1948-1952	-1.7	-1.0	1.5	1.0
1953-1957	1.5	1.8	0.7	0.9
1958-1962	2.2	2.4	0.2	1.5
1963-1967	2.4	2.3	5.0	4.5
1968-1972	1.6	1.2	7.7	5.1
1973-1977	-0.4	-0.8	-2.2	-2.2

a/ Interest rates are from the Economic Report of the President, January 1978, Table B-5. These nominal rates are divided by the Consumer Price Index (all items) from Table B-54 of the same report. (Division rather than subtraction is used to calculate real rates because that form of real rates is usually entered in the models that calculate military accrual costs.) Table 1 shows geometric averages of the quotients.

b/ Pay raises are from the Department of Defense actuary (Table 2022) and are divided by the Consumer Price Index as discussed in the footnote above. Table 1 shows geometric averages of the quotients. Before 1963, pay raises were not granted annually, and raises in a given period may therefore reflect responses to conditions before that period.

EFFECTS IN FISCAL YEAR 1979

Because the proposed accounting changes would not affect retirement benefits, they would not change outlays in the budget as a whole. This is true regardless of future economic assumptions. Outlays within some functions would change, however. Under the Administration's economic assumptions, Table 2 shows that, if all three proposed modifications were implemented, outlays in the defense function would decrease by $3 billion in fiscal year 1979. This decrease would occur because the reduction in outlays caused by transferring out the Defense Retired Pay appropriation would more than offset the addition of the accrual charge. Outlays would also change in the income security function, in which the trust fund would be created, and in the functions that include interest on the federal debt and offsetting receipts.

In contrast to outlays, budget authority in the budget as a whole would increase under these proposed modifications. If all three modifications were made, budget authority would increase by $7.4 billion in fiscal year 1979 under the Administration's economic assumptions. Budget authority would increase because the federal budget would begin recognizing the future cost of retirement benefits even though they would not yet have been translated into outlays. There would also be changes in budget authority within functions. In defense, for example, transferring out the Defense Retired Pay appropriation and adding the accrual charge would cause budget authority to fall by about $3 billion.

Changes in outlays within individual budget functions and changes in budget authority are both quite sensitive to future economic assumptions, particularly those about real wages and interest. If, for example, one assumes lower real interest, then more money must be contributed to the fund since that money earns less while it is in the fund. Thus, under the lower real wage and interest rate assumptions in Table 3 (1 percent real growth for each), the higher contribution required of the Department of Defense means no net change in the defense function, versus a $3 billion decline under the Administration's assumptions (Table 2). 3/ The higher contribution means that budget authority

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3/ Reducing the real wage rate reduces the size of the required contribution, whereas reducing the real interest rate raises it. Both these effects are reflected in Table 3.

TABLE 2. FISCAL YEAR 1979 BUDGET CHANGES (ADMINISTRATION ECONOMIC ASSUMPTIONS a/): IN BILLIONS OF DOLLARS

Budget Function	Change Due to Transferring Retired Pay Account	+	Change Due to Institution of Accrual Charge	+	Change Due to Creation of Military Trust Fund	=	Change in Budget
			Outlays				
Defense (050)	-10.1		7.1		0		-3.0
Income Security (600)							
Fund's payments to retirees	10.1		0		0		10.1
Interest and Offsetting Receipts (900/950)	0		-7.1		0		- 7.1
Total	0		0		0		0
			Budget Authority				
Defense (050)	-10.1		7.1		0		-3.0
Income Security (600)							
Fund's payments to retirees	10.1		0		0		10.1
Fund's receipts							
Accrual charge	0		0		7.1		7.1
Payment for unfunded liability	0		0		10.1		10.1
Interest	0		0		0.3		0.3
Interest and Offsetting Receipts (900/950)	0		-7.1		-10.1		-17.2
Total	0		0		7.4		7.4

a/ Estimates of the accrual charge are based on the Administration's long-term economic assumptions (annual real wage growth of 1.5 percent and real interest of 2.5 percent). Estimates of actual payments to retirees and of interest received by the fund are based on the CBO economic assumptions (for fiscal year 1979) of February 1978.

TABLE 3. FISCAL YEAR 1979 BUDGET CHANGES (ALTERNATIVE ECONOMIC ASSUMPTIONS a/): IN BILLIONS OF DOLLARS

Budget Function	Change Due to Transferring Retired Pay Account	+	Change Due to Institution of Accrual Charge	+	Change Due to Creation of Military Trust Fund	=	Change in Budget
			Outlays				
Defense (050)	-10.1		10.1		0		0
Income Security (600)							
Fund's payments to retirees	10.1		0		0		10.1
Interest and Offsetting Receipts (900/950)	0		-10.1		0		-10.1
Total	0		0		0		0
			Budget Authority				
Defense (050)	-10.1		10.1		0		0
Income Security (600)							
Fund's payments to retirees	10.1		0		0		10.1
Fund's receipts							
Accrual charge	0		0		10.1		10.1
Payment for unfunded liability	0		0		10.1		10.1
Interest	0		0		0.4		0.4
Interest and Offsetting Receipts (900/950)	0		-10.1		-10.1		-20.2
Total	0		0		10.5		10.5

a/ Estimates of the accrual charge assume long-term annual real wage growth of 1 percent and real interest of 1 percent. Estimates of actual payments to retirees and of actual interest received by the fund are based on CBO economic assumptions (for fiscal year 1979) of February 1978.

in the budget as a whole goes up by $10.5 billion, versus only $7.4 billion shown in Table 2. There are also changes in other budget functions. 4/

Effects on outlays and budget authority also depend on which of the accounting modifications are implemented. The numbers above assume that all three of the proposed changes are implemented. But if, for example, the only action was to transfer the Defense Retired Pay appropriation out of the defense function, then defense outlays and budget authority would fall by $10.1 billion in fiscal year 1979.

EFFECTS BEYOND FISCAL YEAR 1979

Table 4 estimates the effects of the proposed changes on the budget functions in fiscal years 1979-1983. The table shows changes relative to what the functions would be if current law and policy prevailed. The estimates are based on the Administration's long-term economic assumptions. For simplicity, Table 4 assumes that all three of the proposed modifications are implemented together.

As Table 4 shows, in the years beyond fiscal year 1979, the change in accounting procedures would result in increasingly large reductions in budget authority and outlays in the defense function. This would occur because the Defense Retired Pay appropriation--which would be transferred out of the defense function--would grow faster than the accrual charge during fiscal years 1979 to 1983. 5/

4/ Other plausible combinations of real interest rates and annual wage growth would yield different results. For example, a 1 percent real interest rate (as assumed in Table 3) and 2 percent real annual wage growth would result in an increase in budget authority and outlays in the defense function of about $1.5 billion in fiscal year 1979.

5/ The reduction would not necessarily continue growing indefinitely. In the absence of changes in the number of military employees, the reduction should eventually reflect only increases in real wage levels.

TABLE 4. EFFECTS ON OUTLAYS AND BUDGET AUTHORITY OF RETIREMENT ACCOUNTING CHANGES, RELATIVE TO CURRENT-LAW COSTS (ADMINISTRATION ECONOMIC ASSUMPTIONS a/): BY FISCAL YEAR, IN BILLIONS OF DOLLARS

Budget Function	1979	1980	1981	1982	1983
			Outlays		
Defense (050)	-3.0	-3.4	-3.8	-4.2	-4.7
Income Security (600)	10.1	11.0	12.0	13.0	14.0
Interest (900)	0.3	0.9	1.5	2.3	3.1
Offsetting Receipts (950)	-7.4	-8.5	-9.7	-11.1	-12.4
Total	0	0	0	0	0
			Budget Authority		
Defense (050)	-3.0	-3.4	-3.8	-4.3	-4.7
Income Security (600)	17.5	19.5	21.6	23.8	26.1
Interest (900)	0.3	0.9	1.5	2.3	3.1
Offsetting Receipts (950)	-7.4	-8.5	-9.7	-11.0	-12.4
Total	7.4	8.5	9.6	10.8	12.1

a/ Estimates of the accrual charge are based on the Administration's long-term economic assumptions (annual real wage growth of 1.5 percent and real interest of 2.5 percent). Estimates of actual payments to retirees and of interest received by the fund are based on the CBO economic assumptions (for fiscal years 1979-1983) of February 1978. Estimates assume that, except for the accounting modifications, there are no changes in current law or policy. Specifically, military basic pay is assumed to increase only by the amount of wage growth.

Table 4 also shows trends in other budget functions and in the federal budget as a whole. The accounting changes would never affect outlays in the budget as a whole. But increases in budget authority would grow in the federal budget as a whole both because the budget would recognize future retirement liabilities that are growing because of higher prices and wages and because the budget would still be paying off the unfunded liability built up before the fund's existence. 6/

6/ While budget authority would continue to rise for some years, the increase would eventually level off to the amount dictated by price and wage increases.

CHAPTER III. ADVANTAGES, DISADVANTAGES, AND UNRESOLVED ISSUES

If implemented together, these accounting changes should increase the visibility of defense manpower costs and hence the incentive to economize on manpower. Retirement costs are an important part of total manpower costs; for the average military employee, CBO estimates that benefits are worth 35 percent or more of military basic pay. But if--as is now the case--these costs do not appear in the military personnel accounts, it is less likely that they will be considered in determining the total number of employees and other resource allocation issues. At a time when the Defense Department and other agencies are attempting to economize, improving the visibility of retirement costs is certainly desirable.

Even though the proposed accounting changes would not in themselves affect retirement benefits, they may help clarify the long-run budgetary effects of changes in the military retirement system that may soon be before the Congress. The Department of Defense is currently reviewing proposals made by the President's Commission on Military Compensation that would change retirement benefits, and the Congress may be considering proposals next year. Most military retirement changes would not reduce outlays during at least the first five years because of "grandfather" clauses which protect individuals already in the military. In fact, most military retirement changes would actually increase outlays in the first years because some improved features, such as earlier vesting of benefits, would be effective soon after implementation. In the long run, however, the benefit changes would cut costs. If the accounting changes were implemented and retirement changes were considered in terms of their effects on money that must be set aside to pay future costs, these long-term savings would be immediately apparent.

Another advantage of the changes would be their effect on the accuracy of budget comparisons. If implemented together, the proposed changes would make the budget numbers in the defense function a better measure for such comparisons. Under the present accounting system, the defense function includes retirement costs of former military employees who do not contribute to today's defense, but it does not include charges for current military employees. The proposed accounting changes would reflect the full retirement costs of today's military employees but would exclude retirement benefits paid to former employees. 1/

The accounting changes would also make budgeting for military retirement costs more consistent with budgeting for civil service retirement costs. At present, a retirement charge for today's civil service employees appears in each function that has a civil service payroll, but there is no charge in any function for today's military employees. Furthermore, while retirement costs of past military employees appear in the defense function, the retirement costs of former civil service employees are excluded from the agency functions. While the proposed accounting changes would rectify these inconsistencies, some differences would remain (see Chapter IV).

Perhaps the major disadvantage of the proposed accounting changes is the sensitivity of the accrual charge to technical assumptions. As Chapter II made clear, a change of from 2.5 to 1 percent in the assumed future real interest rate and from 1.5 to 1 percent in the assumed real wage growth could raise the charge to the Defense Department by $3 billion. There are many other detailed assumptions that also affect the charge. This sensitivity to technical assumptions raises the possibility of changing the defense function totals by changing the technical assumptions. While accounting manipulations are possible, they would not be unique to retirement; assumptions about future inflation rates play an important part in procurement and other costs. And the possibility of manipulation could be minimized by appointment of a board of independent actuaries--such as the one proposed by the Administration--to review data and propose reasonable assumptions. These actuaries might still disagree on assumptions, but presumably their disagreement would be for technical rather than political reasons.

The proposed accounting changes could also lead to some confusion during the transition from the old system to the new

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1/ While the proposed modifications would make the defense function a better measure of current activities, further improvements might still be possible. Some costs that could be attributable to national defense, such as veterans' benefits, still would not be included in the defense function under the proposed modifications.

one. The size of the defense function could appear to change even if there was no change in real activity. This might confuse the comparison between spending for defense versus nondefense activities. But this confusion could be minimized by restating past defense budgets in terms of the new accounting procedures.

If only some of the accounting changes were implemented, there might be other important disadvantages. If, for example, the only change was to transfer the Defense Retired Pay appropriation out of the defense function, then the defense function would not contain any costs for military retirement, even though retirement is an important component of defense manpower costs.

After considering the pros and cons, several groups have recommended implementation of some or all of these accounting changes. The Defense Manpower Commission, for example, endorsed a charge for the full retirement costs of today's employees, although it specifically recommended against creating a military trust fund. 2/ Also, the General Accounting Office has recommended full funding of each year's military retirement costs. 3/ In testimony before the Senate Budget Committee, the Director of the Congressional Budget Office recommended implementation of the concepts underlying the Administration's accounting proposals. 4/

There are some questions left unresolved by the proposed legislation that the Congress may wish to have answered. The Administration's proposals, for example, do not indicate which committees would handle authorization of the various flows of financing. Nor do the proposals indicate where in the budget the corrections account would appear. (This account would show changes needed because economic or actuarial projections were not realized.)

2/ Defense Manpower Commission, Defense Manpower: The Keystone of National Security, Report to the President and the Congress (April 1976), pp. 379-382.

3/ U.S. General Accounting Office, Federal Retirement Systems: Unrecognized Costs, Inadequate Funding, Inconsistent Benefits FPCD-77-48 (August 3, 1977), p. i.

4/ First Concurrent Resolution on the Budget--Fiscal Year 1979, Hearings before the Senate Committee on the Budget, 95:2 (April 1978), Volume I, p. 9.

The Congress may also wish to consider alternatives to some of the Administration's proposals. For example, as Chapter II indicated, the Administration's assumptions about real interest rates are optimistic; the Congress may wish to request that the board of actuaries evaluate carefully the economic assumptions. Also, the Administration has proposed revising the budget for fiscal year 1979 if these accounting changes are approved. To avoid confusion caused by changes in defense and other functions, and to allow the board of actuaries time to prepare accurate forecasts, the Congress may wish to enact legislation this year but postpone implementation until next year's budget. Finally, as the next chapter indicates, the Administration has not proposed changes in accounting for civil service retirement; the Congress may wish to direct the Administration to make such proposals.

CHAPTER IV. ACCOUNTING CHANGES FOR CIVIL SERVICE RETIREMENT

The Administration has not recommended changes in the method of accounting for civil service retirement. The budget already contains a civil service retirement trust fund, and agency budgets show an accrual charge for the future retirement costs of today's civil service employees. That charge is now 14 percent, with half paid by employees and half by the agency employers. The charges, however, assume no future growth in wages and prices, whereas the Administration proposes that the military charge reflect expected growth. 1/ To be consistent with the military retirement accounting changes, it might be desirable to increase the civil service agency charge to reflect economic assumptions about future growth in wages and prices. Such a change has been recommended by the Civil Service Board of Actuaries. 2/ Since this paper deals only with accounting changes, it is assumed that any increase in the civil service charge would be paid by the agency employers; the contribution by employees would not change.

EFFECTS ON OUTLAYS AND BUDGET AUTHORITY

Increasing the civil service charge would affect outlays and budget authority in the federal budget, as shown in Table 5. As with the military retirement changes, the amount of change would depend on economic assumptions about future growth in wages and interest rates. Table 5 is based on the Administration's long-term economic assumptions of 1.5 percent real wage growth and 2.5 percent real interest.

1/ There is a charge outside the agency budgets that pays for added retirement costs because of pay raises. But no such payment is made for added costs because of price increases.

2/ Board of Actuaries of the Civil Service Retirement System, Fifty-Fourth Annual Report, quoted in Communication from the Chairman of the U.S. Civil Service Commission, House Committee on Post Office and Civil Service, Committee Print 94-18, 94:2 (September 20, 1976), p. 26.

TABLE 5. EFFECTS ON FISCAL YEAR 1979 BUDGET OF INCREASING CIVIL SERVICE ACCRUAL CHARGE a/: IN BILLIONS OF DOLLARS

Budget Function	Outlays	Budget Authority
Defense (050)	2.3	2.3
Other Agency Functions (100-800)	4.1	4.1
Income Security (600)	0	6.3
Interest/Offsetting Receipts (900/950)	-6.4	-6.4
Total	0	6.3

a/ The increased total charge (for agency and employee combined) is assumed to equal 27.4 percent, with agencies paying 20.4 percent versus today's agency contribution of 7 percent. This 20.4 percent charge is being used in the draft of OMB Circular A-76 and is based on the Administration's long-term economic assumptions of 1.5 percent annual real wage growth and 2.5 percent real interest. Except in determining the long-term accrual charge, this table estimates costs assuming CBO's economic assumptions (for fiscal year 1979) of February 1978. The table assumes no change in the method for determining the payments to the civil service fund for military liabilities, wage growth, and interest on the unfunded liability. The table also assumes that the increase in the accrual charge that must be paid by the Postal Service is offset by an equal increase in the Postal Service's subsidy.

As with the military retirement changes, the increase in the civil service charge would not affect outlays in the federal budget as a whole, at least for on-budget agencies. It is possible, though unlikely, that outlays in the budget as a whole could be lowered because of certain "off-budget" federal entities, such as the Postal Service, that have employees covered by the civil service retirement system. The fiscal activities of these off-budget entities are excluded by law from appearing in the budget, but their contributions to the civil service retirement fund do show up in the budget as an offsetting receipt. Thus, if the civil service accrual charge was increased, higher contributions of off-budget agencies could show up in the budget only once--as offsetting receipts--and thus could lower outlays in the budget as a whole. (In contrast, higher contributions from on-budget agencies would show up twice--once as agency outlays and once as offsetting receipts--and so cancel each other out.) Higher contributions from the Postal Service alone could lower outlays by $1.4 billion (given the Administration's economic assumptions). But these reduced outlays would probably be offset by increasing the Postal Service subsidy, as Table 5 assumes.

While outlays in the budget as a whole would not change--at least for on-budget agencies--outlays in specific functions would change (see Table 5). Also budget authority in some budget functions and in the budget as a whole would increase as the budget began to recognize the full amount of future civil service retirement liabilities.

PROS AND CONS

Chapter III discussed the advantages of changing the military retirement accounting procedures. Many of these same advantages would be achieved by increasing the civil service charge. Manpower costs would be made fully visible, which might lead to more efficient utilization, and the costs in the various budget functions would be better measures of the costs of current activity. Moreover, the civil service change discussed in this chapter--along with the changes proposed by the Administration for military retirement accounting--would make the two methods of accounting consistent.

Increasing the civil service charge would, however, involve complexities not introduced by the military accounting changes. The charge borne by off-budget agencies such as the Postal Service and the District of Columbia city government would increase, which might necessitate changes in their federal subsidies. Depending on changes in federal subsidies, outlays in the budget as a whole could be affected (see above). And many more Congressional committees might be involved in review of an increase in the civil service charge, since an increase would affect costs in virtually every federal agency's budget.

The Civil Service Commission has also considered changes in the method of funding civil service retirement. The Commission's proposals could involve not only increases in the agency accrual charge to reflect future wage and price growth, but also changes in the current method for paying off the unfunded liability in the civil service retirement fund.

These added complexities may make it desirable to postpone increasing the civil service charge until a full review has been completed.

A P P E N D I X

TABLE A-1. HISTORICAL ECONOMIC TRENDS, CALENDAR YEARS 1948-1977

	Annual Real Percent Returns on Government Bonds a/		Annual Percentage Increase in Real Military Pay b/	
	Three to Five Year	Long Term	All Military Personnel	Personnel with 20 or More Years' Service
1948	-5.7	-5.0	0.0	0.0
1949	2.5	3.3	24.1	21.2
1950	0.5	1.3	0.0	0.0
1951	-5.5	-4.9	0.0	0.0
1952	-0.1	0.5	1.8	1.9
1953	1.7	2.1	0.0	0.0
1954	1.3	2.0	0.0	0.0
1955	2.9	3.3	10.4	11.5
1956	1.6	1.6	0.0	0.0
1957	0.0	-0.1	0.0	0.0
1958	0.2	0.7	5.5	12.6
1959	3.5	3.2	0.0	0.0
1960	2.4	2.4	0.0	0.0
1961	2.6	2.9	0.0	0.0
1962	2.4	2.8	0.0	0.0
1963	2.5	2.8	12.8	13.3
1964	2.7	2.8	1.0	1.2
1965	2.5	2.5	8.6	5.6
1966	2.2	1.7	0.3	0.3
1967	2.1	1.9	2.6	2.6
1968	1.3	1.0	2.6	2.6
1969	1.4	0.7	6.8	6.8
1970	1.4	0.7	2.1	2.1
1971	1.4	1.4	17.2	3.5
1972	2.5	2.3	10.7	10.7
1973	0.7	0.1	0.0	0.0
1974	-2.9	-3.6	-5.0	-5.0
1975	-1.4	-1.9	-3.8	-3.8
1976	1.1	0.9	-2.1	-2.1
1977	0.3	0.5	-0.3	-0.3

a/ Interest rates are from the Economic Report of the President, January 1978, Table B-5. These nominal rates are divided by the Consumer Price Index (all items) from Table B-54 of the same report. (Division rather than subtraction is used to calculate real rates because that form of real rates is usually entered in the models that calculate military accrual costs.) This table shows geometric averages of the quotients.

b/ Pay raises are from the Department of Defense actuary (Table 2022) and are divided by the Consumer Price Index as discussed in the footnote above. This table shows geometric averages of the quotients.