OVERVIEW OF CIVIL SERVICE RETIREMENT: COSTS AND FINANCING

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BACKGROUND

The Civil Service Retirement (CSR) system now covers some 2.7 million active federal workers (including some 600 million employees of the U.S. Postal Service) and 1.8 million annuitants, who currently draw retirement, disability or survivor benefits. In each of the next 5 years, an average of 84,000 more civil servants will retire and begin to receive CSR pensions. Participation in CSR is mandatory for most federal employees and requires a payroll withholding fixed by law at 7 percent of salary. 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; nor do they cover annual benefit payments to present CSR annuitants. The remaining amounts needed are paid by the federal government.

The size of an individual's CSR annuity depends on his average final salary (three years of highest earnings) and his total years of government service, including military. The annuity, as a percentage of final average salary, increases with the length of government service--16.25 percent after the first 10 years of service and an additional 2 percentage points per year thereafter. A maximum of 80 percent may be attained after slightly more than 41 years and 10 months of employment.

Retirement under CSR differs markedly from that in the private sector. Benefits under CSR are relatively large when compared with 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. Under current law, CSR enrollees may draw pensions at age 55, if they have at least 30 years of service, and their benefits are kept abreast of inflation through annual COLAs. These two features are largely responsible for the recent growth in CSR outlays. For example, between 1970 and 1980, annual CSR outlays have grown from $2.7 billion to $14.7, and are projected to reach $22.6 billion in 1984.

The CSR system offers generous benefits to career civil servants who retire directly from the government at a relatively young age. These workers can then elect to work in the nonfederal sector and eventually could receive Social Security benefits, a private pension, and a CSR annuity. (The Congress is currently considering legislative proposals that would reduce prospective Social Security payments for CSR retirees.)

On the other hand, most newly-hired federal workers (about 62 percent) never draw CSR payments; more than 1 out of 3 leave within the first 5 years of federal employment. Once an employee has accrued 10 or more years of federal service, however, the prospect of drawing his accrued pension benefits discourages him from leaving. During this time, his CSR contributions have been considerably higher than his private-sector counterpart's, but have not earned him benefits that can be transferred if he accepts a nonfederal job. Extension of Social Security coverage to new federal workers would greatly improve the future portability of survivor and disability benefit protection.

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 (mainly the U.S. Postal Service), only federal employee contributions directly offset the budgetary costs of CSR. The CSR trust fund serves mainly a bookkeeping purpose within the federal budget.

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 an annual federal contribution from the U.S. Treasury--the major source of CSR financing (see Table 1).

Only two sources of CSR fund income--employee withholdings (revenue) and payments from off-budget agencies (offsetting receipts) reduce the budgetary costs of CSR payments. 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 accounting entries, not payments to or from the federal government. As income to the CSR fund, however, they affect budget authority totals. But increases or decreases in employing agency (versus off-budget agency) contributions, earned interest, and annual federal payments would not influence the future financial responsibility confronting U.S. taxpayers, because such changes do not affect the amount of future CSR benefits, the time at which those payments come due, or the size of the budget deficit.

TABLE 1. CSR TRUST FUND FINANCING, BY SOURCE IN FISCAL YEAR 1983

Source of Budget Authority	Dollar Amount Contributed (in Billions)	Percent of Total Funding
Employee Contributions a/	4.2	12.2
Employing Agency Contributions	3.3	9.6
Off-Budget Agency Contributions a/	1.8	5.2
Earned Interest and Other Income	9.6	27.8
Federal Contribution from the U.S. Treasury	15.6	45.2
Total Trust Fund Income	34.5	100.0

a. Employee and off-budget agency contributions, in addition to adding budget authority to the CSR account, reduce the budget deficit because they represent federal revenues and offsetting receipts, respectively.

Annual federal payments appropriated from the Treasury, authorized by the Civil Service Retirement Amendments of 1969, currently make up 45 percent of income to the CSR trust fund. These payments reimburse the CSR system for costs not funded by the combination of employee and employer contributions, and cover: a steadily growing number of 30-year payments to amortize benefit increases resulting from annual pay adjustments, extensions of CSR coverage, and liberalizations of CSR benefit provisions--excluding COLAs; costs associated with prior military service of CSR retirees; and interest forgone on the CSR's 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 (current reserves plus future income but without regard to new employees). If contributions adequate to meet this deficiency were deposited within the trust fund, CSR's investments in government securities would increase and more interest would accrue. Under current law, a portion of the government's annual payment compensates for the interest that would otherwise be earned.

Traditional unfunded liability calculations performed by the Office of Personnel Management do not anticipate future federal pay raises or COLAs. Since cost increases resulting from COLAs are not amortized by 30-year payments, each COLA increases the estimated size of the unfunded liability and, accordingly, the size of the government's annual payment. (Estimates of CSR's unfunded liability are described in more detail later on.)

THE FINANCIAL CONDITION OF THE CSR TRUST FUND

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. In fiscal year 1983, CSR income from all sources will exceed the year's outlays by about $13.4 billion, and balances in the fund shall rise from $96 billion to $109 billion--a ratio of reserves to annual outlays of about 5.2 to 1. By the end of fiscal year 1988, outlays and reserves are projected to increase to $30 billion and $188 billion, respectively, under current law. Even if no new federal employees participate in the system as of calendar year 1984, the projected 1988 reserve level would still exceed $180 billion--more than 6 times the year's outlays. An important distinction must be made, however, between the internal balances in the CSR trust fund and the annual cost to the government of CSR benefits.

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 contributions from off-budget agencies and employee payroll withholdings.

In 1988, the annual cost to the government will reach $22.1 billion, an increase of 47 percent over the 1983 level (see Table 2). About 63 percent of the $7.1 billion increase in the government's annual cost (1988 over 1983) will result from COLAs that have yet to occur. The remainder will be caused by changes in the number of annuitants and their wage and work histories. Finally, if employee and off-budget agency contributions were limited to federal employees covered by CSR as of December 1983, the annual cost to the government for CSR annuities would gradually increase by an additional $0.9 billion dollars over the next five years (see Table 2).

CSR's "Unfunded Liability"

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 current financing does not anticipate the budgetary cost of future COLAs. From this perspective, financial inadequacy

TABLE 2. PROJECTED ANNUAL CSR COST TO THE GOVERNMENT

	(By fiscal years, in billions of dollars)					
	1983	1984	1985	1986	1987	1988
Outlays	21.1	22.6	24.2	26.3	28.1	30.0
Employee Contributions	-4.2	-4.4	-4.7	-4.9	-5.1	-5.4
U.S. Postal Service Contributions	-1.8	-1.8	-2.3	-2.4	-2.4	-2.5
Cost to the Government	15.0	16.4	17.2	19.0	20.5	22.1
Government's Cost Without New Employee Participation a/	15.1	16.5	17.5	19.4	21.2	23.0

NOTE: Totals may not add because of rounding.

a. Assumes that federal workers hired after January 1984 would not participate in CSR.

is often measured by estimates of unfunded liability. The unfunded liability estimate is based on a closed group of employees and annuitants (no new participants) and equals the shortfall of assets and projected income relative to the costs of the closed group's future retirement benefits.

According to traditional calculations by the Office of Personnel Management (OPM), the unfunded liability of the CSR system at the beginning of 1983 was $200 billion. Because this estimate does not recognize the effects future pay increases and COLAs have on CSR benefits--until after the increases become effective--the traditional estimates of unfunded liability increase each year. Thus, between 1983 and 1988, the estimated unfunded liability would have grown from $200 billion to about $213 billion, based on CBO assumptions for COLAs and federal pay adjustments. 1/

1. Less than $10 billion of the 1983 unfunded liability ($200 billion) was incurred when the system was created in 1920, or as a result of government contributions prior to July 1970 that were less than employee payroll witholdings.

Recently, the OPM published a dynamic estimate of unfunded liability that assumed future federal pay increases of 5.5 percent per year, annual COLAs of 5 percent, and a 6 percent rate of return on investments. (The 5 percent COLA assumption was specified under Public Law 95-595.) On this basis, the OPM estimated the CSR's dynamic unfunded liability at $499 billion. But the estimate presumes that employing agency contributions would increase from 7 percent to about 28.8 percent of payroll. If not, the dynamic unfunded liability estimate--under current financing--would equal about $600 billion.

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. Because the calculation of unfunded liability is based on a closed group of employees and annuitants, it disregards the cash-flow effects of new participants in the system. More important, because CSR is backed by 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.