CBO TESTIMONY

Statement of
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on
Voluntary Separation Incentives

before the
Subcommittee on Civil Service
Committee on Government
Reform and Oversight
U.S. House of Representatives

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NOTICE

This statement is not available for public release until it is delivered at 10:00 a.m. (EDT) on Wednesday, May 17, 1995.

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Mr. Chairman and Members of the Subcommittee, I am pleased to participate in your review of the government's experience with the voluntary separation incentives authorized by the Federal Workforce Restructuring Act of 1994. Since the authority of civilian agencies to offer incentives under that act expired in March, pressure may mount to reinstate that authority as agencies face the prospect of further employment cuts.

In accord with the Chairman's letter of invitation, my testimony today will focus on three concerns.

- Are separation incentives an effective way to reduce federal employment?

- What are the costs and savings of the other methods by which the government may reduce staff?

- How will the separation incentives affect the financing of the retirement system?

My answers to these questions will be drawn largely from the 1993 Congressional Budget Office (CBO) study *Reducing the Size of the Federal Civilian Work Force*. The report examined the costs, savings, and other consequences of separation incentives and the various other methods the government can use to separate employees and reduce federal employment.

ARE SEPARATION INCENTIVES AN EFFECTIVE WAY TO REDUCE FEDERAL EMPLOYMENT?

Before enactment of the National Defense Authorization Act of Fiscal Year 1993 and the Federal Workforce Restructuring Act of 1994, the government relied on layoffs, hiring freezes, and early retirements to reduce employment. In granting authority to use voluntary separation incentives, the Congress gave federal agencies a tool for reducing the workforce that state and local governments and many private firms have used. Under both acts, agencies have been able to pay a lump sum to encourage eligible employees to retire or resign. The amount of separation pay is the lesser of $25,000 per employee or the amount of severance pay for which the employee would qualify under involuntary separation.

Our 1993 analysis suggested that separation incentives can be an effective way to cut employment, but much depends on the objectives of the planned employment reductions and the way the incentives are implemented. In the short run, using separation incentives can be more expensive than the other approaches to cutting staff. In fact, costs can exceed savings in the first year. In the long run, however, reductions in pay and benefits will amount to many times the near-term costs as long as cuts in employment are permanent. Specifically, CBO estimates that the government saves two to five times the near-term cost by the fifth year and 12 to 33 times by the 30th year, provided that workers who leave are not replaced later on.

Separation incentives also offer certain advantages over other methods of reducing staff that may be worth the higher near-term costs.

Before discussing those advantages, however, let me tell you a little more about the near-term costs. In our 1993 analysis, CBO observed that separation incentives can be expensive in the short term because an organization may end up making many more payments than it has jobs to abolish. Organizations may choose to offer incentives broadly to ensure equity. The Postal Service, for example, offered incentives to all employees who were eligible for early or regular retirement. Based on that experience, the Federal Workforce Restructuring Act directed that total agency staff positions be reduced by the number of people who were given voluntary separation payments.

Even in agencies that try to target incentives, some payments may go to employees who were planning to leave voluntarily but delayed plans to separate in order to receive a cash payment. That phenomenon may help to explain both the drop in the retirement rates for civilian agencies in 1992 and 1993, when separation incentives were being considered, and the rise in retirements in 1994 after the Congress granted those agencies authority to offer cash separation incentives (see Table 1). A similar pattern occurred at the Department of Defense and the U.S. Postal Service just before and just after incentives were offered.

TABLE 1. RECENT RETIREMENTS FROM FEDERAL CIVILIAN AGENCIES
(By calendar year)

	Average Annual Retirements Before Debate on Incentives[a]	Retirements			Average Annual Retirements, 1992-1994
		1992	1993	1994[b]	
Number (Thousands)	19.1	13.9	15.8	31.2	20.3
Rate (Percent)[c]	2.2	1.5	1.7	3.4	2.2

SOURCE: Congressional Budget Office.

a. Based on data for 1989 through 1991.

b. Includes 5,500 early retirements.

c. Number of retirements per 100 employees.

Data for the 1992-1994 period suggest that the government did not retire many more employees than it would have in the absence of an incentive program: many employees who retired might have left federal service anyway but delayed their retirement plans to qualify for a separation incentive. Of course, those data are preliminary and do not reflect experience in 1995. In addition, they cover many early retirements. The decision of some employees to delay their plans may have had more to do with the long period over which the government considered offering incentives than with any limitation inherent in incentive programs.

The benefits of voluntary separation incentives may justify near-term costs in several ways. Separation incentive programs, for example, help to avoid layoffs, especially if planned reductions are concentrated by occupation or area, as was the case with base closings at the Department of Defense. Separation incentives can also help with efforts to restructure a workforce. The National Performance Review has called for streamlining government and reducing administrative overhead. Consistent with those objectives, about 70 percent of the payments made in 1994 to General Schedule employees in civilian agencies went to those in the highest five grades, 11 through 15. In addition, the largest occupational group affected was general administration and support, alone accounting for almost 25 percent of all separation incentives paid. Finally, separation incentives are thought to bolster employee morale, which can be shaken by employment cuts.

THE COSTS, SAVINGS, AND OTHER CONSEQUENCES OF LAYOFFS, HIRING FREEZES, AND EARLY RETIREMENTS

We were asked to describe the costs and savings of the other methods the government uses to cut employment. Those methods--laying off employees, imposing a freeze on hiring, and increasing the number of employees who can retire early--do not involve the near-term net costs that separation incentives do and in fact offer first-year savings. Like separation incentives, those methods generate substantial savings over the long run, assuming the employment reductions are permanent. Each method also has advantages and disadvantages.

Laying Off Employees

Layoffs have low initial costs compared with other methods and offer the advantages of speed and directness. Most of the costs of layoffs cover payments to separated workers, the largest being for severance pay. Firing employees, however, is the approach most damaging to morale. Agencies also cite the disruption associated with layoffs that occurs because employees in jobs abolished during layoffs can replace one another, causing a ripple effect through the workforce.

Imposing a Hiring Freeze

Instead of laying off workers, an agency may choose to impose a freeze on hiring--that is, forgo replacing some or all of the employees who leave for retirement or for other reasons. The Department of Defense has relied primarily on that method in the substantial downsizing of its civilian workforce. Since the department has had the authority to provide separation incentives, about a third of the workers who have left have done so as a result of a separation incentive.

A hiring freeze avoids many of the negative consequences of layoffs. Among the major disadvantages of the approach, however, is that it is slow--agencies must wait for the desired number of people to leave voluntarily. In fact, the major cost associated with a freeze on hiring is the salary and benefits the government continues to pay as it waits for employees to leave federal service. Agencies may also have difficulty reaching their goal for employment reductions if turnover drops. Finally, agencies may have to transfer workers if those who leave are not in the jobs that are being abolished.

Offering Early Retirement

Another approach to cutting employment is to encourage early retirement. Like hiring freezes, this approach avoids the negative effects of layoffs and can have low near-term costs. The government's practice has been to allow employees faced with layoffs to retire with pensions at an earlier age and with fewer years of service than are normally required. Employees who have at least 20 years of service and are at least age 50 may take early retirement under the federal program, as may employees of any age who have at least 25 years of service. Under normal circumstances, in contrast, an employee covered by the Civil Service Retirement System cannot retire until at least age 55. Early-retirement pensions are reduced by 2 percent for each year an employee retires before the age of 55. Generally, the Office of Personnel Management has responsibility for granting agencies authority to use the early-retirement option.

The government has rarely used the early-retirement option. But when it has, as many as one of every five employees who have been offered early retirement has taken the option. More recently, however, agencies have had some difficulty encouraging large numbers of employees to do so.

We were also asked to consider the impacts of the Federal Workforce Restructuring Act on the financing of the federal retirement system. Based on preliminary data from the Office of Personnel Management, about 13,000 separation incentives offered in 1994 went to employees taking normal or early retirement.

A fuller understanding of any long-term consequences of those separations will have to await final reports on retirements under the incentive program. However, we do not anticipate any major consequences on retirement financing, for three reasons. First, using separation incentives will not change the total number of employees who retire, and the differences in the timing of retirements that do occur are likely to be small. Second, for the 5,500 employees who took early retirement, agencies were required to deposit with the retirement fund an amount equal to 9 percent of final salary. That payment covers the long-run cost to government of early retirement as estimated by the Office of Personnel Management. Finally, the Federal Workforce Restructuring Act required agencies to make four annual payments of $80 per employee to the retirement trust fund to offset increased retirement costs in the short run.

CONCLUSION

Our analysis suggests that separation incentives may be an effective way to reduce employment and limit layoffs. In addition, separation incentives can be targeted to specific kinds of jobs for purposes of restructuring a workforce. In the near term, such efforts will have costs that may exceed those of other methods of reducing federal employment since some payments will go to employees who would have left anyway. We do not know how often that occurred because the data are still being collected. Over the long term, however, savings from reduced employment levels should more than offset any short-term costs of separating workers.