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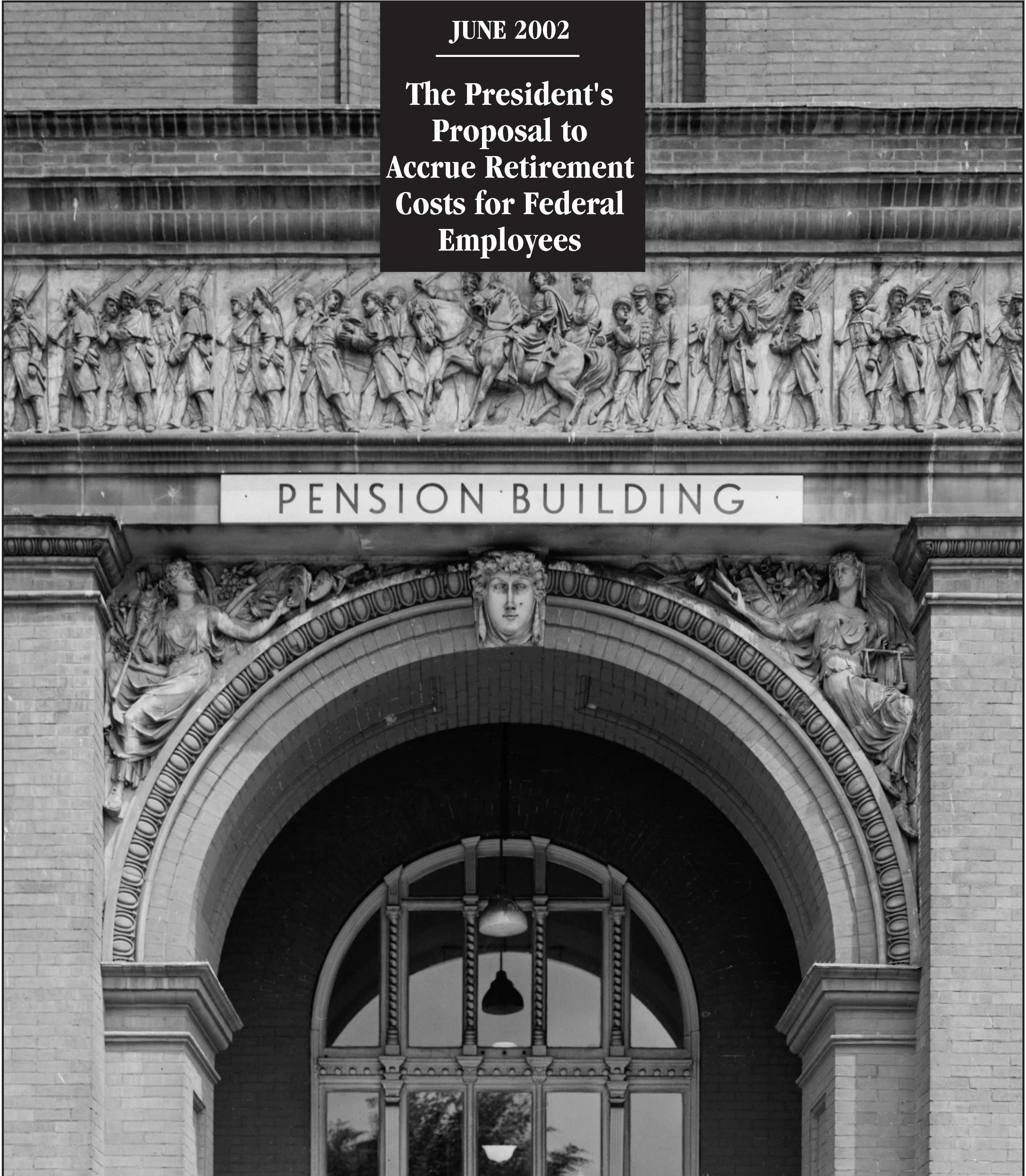
The President's Proposal to Accrue Retirement Costs for Federal Employees



THE PRESIDENT'S PROPOSAL TO ACCRUE RETIREMENT COSTS FOR FEDERAL EMPLOYEES

June 2002

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NOTE

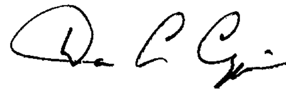
Cover photo of the south entrance of the Pension Building (now the National Building Museum) appears courtesy of the Library of Congress, Prints and Photographs Division, Historic American Buildings Survey, HABS, DC, WASH, 76-7 (photographer: Jack E. Boucher).

PREFACE

This report is a supplement to the *Analysis of the President's Budgetary Proposals for Fiscal Year 2003*, issued by the Congressional Budget Office (CBO) in March 2002. It analyzes the President's proposal that federal agencies pay the full cost of their employees' pension benefits and health benefits in retirement as such benefits accrue.

David Torregrosa of CBO's Microeconomic and Financial Studies Division prepared the analysis under the supervision of Roger Hitchner and Marvin Phaup. Ed Callicot, Ron Gresh, and Mike Virga, all of the Office of Personnel Management, supplied data on health care and pension costs as well as liability estimates. Barry Anderson, Russ Beland, Paul Cullinan, Pete Fontaine, William Gainer, Geoffrey Gerhardt, Mark Grabowicz, Arlene Holen, Deborah Lucas, David Moore, Robert Murphy, and Mark Musell, all of CBO, provided valuable comments.

Christine Bogusz edited the report, and John Skeen proofread it. Rae Roy prepared the manuscript for publication, and Rae Wiseman produced the figure with assistance from Kathryn Winstead. Annette Kalicki prepared the electronic versions for CBO's Web site (www.cbo.gov).



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Director

June 2002

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SUMMARY AND INTRODUCTION

The President's 2003 budget proposes that federal agencies pay the full cost of their employees' pension benefits and health benefits in retirement as such benefits are earned starting in 2003. Currently, federal agencies pay all of the pension costs as those benefits accrue for employees covered by the Federal Employees' Retirement System (FERS) but only about 40 percent of the pension costs for employees covered by the older Civil Service Retirement System (CSRS).[1] None of the costs of retirees' earned health care benefits are recorded in the federal budget until they are paid.

The main reason for the proposed change is to provide policymakers and agency managers with a more complete measure of the cost of providing current services. Because the payments federal agencies make for accrual costs are counted as receipts to on-budget retirement accounts, the proposed change would not increase total outlays, nor would it affect the budget surplus or deficit. Furthermore, the President proposes no changes in employee contributions or benefits.

The President's proposal would expand the accrual accounting system now in place for certain retirement programs, treating the cost of current pay and all deferred compensation equivalently in each agency's budget. Federal agencies already recognize the full cost of pensions and postretirement health care in their financial statements, and they are instructed to consider the full cost, including all accruals, when deciding whether to contract out services.[2]

Under the proposal, introduced as S. 1612 (the Managerial Flexibility Act of 2001), agencies' payments to the Civil Service Retirement and Disability Fund for employees' pensions would rise from 7 percent of pay in 2002 to an estimated 17.2 percent of pay in 2003 for most employees covered by CSRS.[3] (The appendix to this paper describes the federal retirement programs.) The Administration estimates that the proposed legislation would increase pension costs for those agencies by $3.7

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1. The President's proposal also applies to employees of the Central Intelligence Agency, the Foreign Service, the Coast Guard, the Public Health Service, and the National Oceanic and Atmospheric Administration's Commissioned Corps. However, those employees are covered by separate pension programs.

2. Federal Accounting Standards Advisory Board, *Accounting for the Liabilities of the Federal Government*, Statement of Federal Financial Accounting Standards No. 5; and Office of Management and Budget, Circular A-76 (revised June 14, 1999).

3. The charge will be higher for certain workers, including air traffic controllers, law enforcement officers, firefighters, and Congressional employees. Those employees receive more generous government pensions than other federal employees receive. For example, based on information from the Office of Personnel Management, the accrual charge for Congressional employees in CSRS will rise from 7.5 percent in 2002 to 25 percent of pay in 2003.

billion in 2003 and by $27.2 billion over 10 years.[4] For employees covered by FERS, who will constitute just over 70 percent of the federal civilian workforce in 2003, agencies already pay the full accrual cost for their pensions (see Table 1).[5]

The President's proposal would also charge agencies (except the U.S. Postal Service) for the accrual cost of postretirement health benefits for employees covered by CSRS and FERS.[6] Under current law, agencies do not recognize in their annual budgets any of that cost—either while employees are working (that is, on an accrual basis) or after they retire (that is, on a cash basis). Instead, the cost of postretirement health care is attributed to the Office of Personnel Management (OPM), which pays the government's share of the Federal Employees Health Benefits (FEHB) program for retirees. According to the latest estimates from OPM, the accrual cost of post-retirement health benefits is roughly $3,475 a year per employee.[7] The President's budget estimates that under this proposal, agencies would pay about $5.6 billion to accrue health benefits to the FEHB fund in 2003 and $76.9 billion through 2012.

ACCOUNTING FOR RETIREMENT BENEFITS IN THE FEDERAL BUDGET

Accruing retirement costs would result in increased payments from government agencies to the government's retirement accounts, or trust funds (see Figure 1). Those intragovernmental payments are shown in Figure 1 as payments that do not leave the budget "box." As such, they do not affect the surplus or deficit. (Only payments that flow from or to entities outside the government affect the budget.)

The accrual charges, which will be paid out of agencies' salary and expense accounts, are generally classified in the budget as discretionary spending.[8] Under the President's proposal, agencies would not need to cut spending for other discretionary

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4. The Congressional Budget Office did not independently estimate those costs. It made some changes to the estimates of rates of spending and offsetting collections for some accounts, but those changes did not significantly alter the total cost of the proposal.

5. The Military Retirement System is also already on a full accrual basis.

6. Beginning in 2004, the military is scheduled to pay the accrual cost of retirees' health care for benefits received by annuitants who are eligible for Medicare. In addition, the President proposes that the armed services pay the full accrual cost for all postretirement health benefits. See Congressional Budget Office, *Accrual Budgeting for Military Retirees' Health Care*, CBO Paper (March 2002).

7. The estimate of the accrual cost for fiscal year 2002 is the 2001 cost of $3,246 per employee inflated by 7 percent to account for rising health care costs.

8. See Carolyn L. Merck, *Pre-Funding Federal Retiree Health Insurance*, CRS Memorandum (Congressional Research Service, February 13, 2002).

TABLE 1. EFFECT OF THE PRESIDENT'S PROPOSAL ON PAYMENTS TO RETIREMENT FUNDS, FISCAL YEAR 2003 (In million of dollars)

Retirement Plan	Current Payment	Proposed Payment	Increase
Civil Service Retirement System			
Non-Postal Service workers	2,593	6,319	3,726
Postal Service workers	4,830 [a]	4,830 [a]	0
Federal Employees' Retirement System			
Non-Postal Service workers	8,354	8,354	0
Postal Service workers	2,301	2,301	0
Thrift Savings Plan	4,408	4,408	0
Federal Employees Health Benefits			
Non-Postal Service workers	0	5,602	5,602
Postal Service workers	1,032 [b]	1,032 [b]	0
Total	23,518	32,846	9,328

SOURCES: The Congressional Budget Office for the estimates of current payments; *Budget of the United States Government, Fiscal Year 2003: Appendix* for the current payment figure for the Thrift Savings Plan; and the Office of Personnel Management for the estimates of increased payments under the President's proposal.

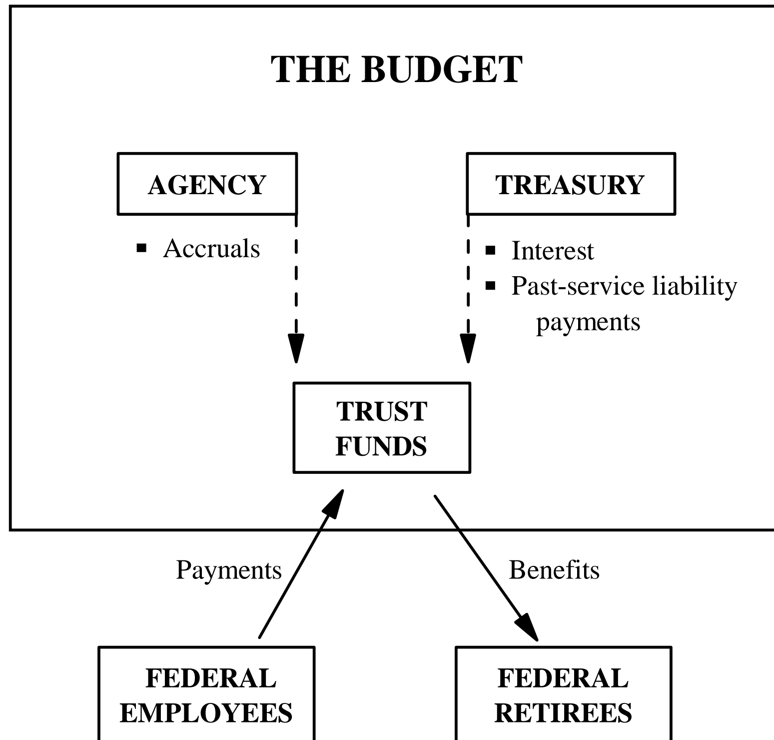
a. Like most other agencies, the Postal Service contributes 7 percent of pay—$929 million in 2003—for current Civil Service Retirement System (CSRS) employees. In addition, it makes a series of other annual payments—totaling $3,901 million in 2003—for cost-of-living adjustments for annuitants and increases in liabilities associated with growth in annual salaries for CSRS-covered employees.

b. The Postal Service pays the government's share of premiums for current annuitants.

expenses or reduce employment to pay the increased accrual charges because the Administration would increase the agencies' budget authority to cover that newly recognized expense. Payments from the trust funds to annuitants and to health insurers for annuitants would continue to be classified as mandatory spending.

In addition, employees' unrecognized (or "unfunded") but previously earned pension benefits (about $510 billion) and health benefits (just over $190 billion) would be paid to the trust funds over the next 40 years through a series of annual

FIGURE 1. THE BUDGETARY TREATMENT OF FEDERAL RETIREMENT COSTS



SOURCE: Congressional Budget Office.

NOTE: Intragovernmental payments (those amounts paid by one part of the government to another) are indicated by dashed lines.

payments from the Treasury.[9] Under current law, the Treasury pays for some employee services that have already been rendered (so-called past-service liabilities). Those payments, like the current payments from the Treasury, would be classified as mandatory. As a result of amortizing those past costs, the gross federal debt would gradually increase by the amount of the payments because the trust funds would hold the added balances in interest-bearing Treasury securities. Gains and losses to the trust funds stemming from reestimates of pension benefits and health care costs for retirees would also be amortized through changes in Treasury payments, but over shorter periods.[10]

9. Unfunded liability is a program's total liability minus its trust fund balances (the "funded" portion). Only the funded portion is included in the government's total debt. OPM actuaries provided the liability estimate for the Civil Service Retirement System as of September 30, 2000 (the latest valuation), and the liability estimate for the Federal Employees Health Benefits program. The entire FEHB liability is "unfunded."

10. Gains and losses result when the actuaries change their assumptions about factors such as life expectancy, interest rates, and future health costs. Actuaries generally change their major economic assumptions infrequently—often only every five years. That interval allows agencies to plan their

SOME POTENTIAL IMPLICATIONS OF THE PRESIDENT'S PROPOSAL

Recognizing the accrual cost of pension and postretirement health benefits is not the same as prefunding those benefits.[11] Rather, an accrual is merely a disclosure to policymakers and citizens of the accumulating obligation to make benefit payments in the future. Recognizing those costs in intragovernmental payments does not provide the government with the resources to make payments when they are due. Indeed, the size of the balances held by the retirement trust funds does not alter the burden on future taxpayers, who ultimately are liable for all the obligations of the federal government—whether they are recognized or not.

Advantages

The potential advantages of the President's proposal flow from its aim of providing policymakers with more comprehensive information about costs. Recognizing the cost of retirement benefits as accrued would support the goals of the Government Performance and Results Act, which include measuring the costs of agencies' products and services. More-complete cost measures could improve the Congress's ability to compare costs among programs and assess performance more accurately. User fees intended to recover the cost of services could also be set more precisely.

Furthermore, accrual accounting would make it easier for policymakers to compare the costs of alternative pension or health benefit plans, including early-retirement incentive packages, which differ in the timing and amount of future benefits. The accrual treatment of benefits reflects in the cost of each alternative the present value of all changes in future payments.

Recognizing deferred compensation as it is earned could also help policymakers and agencies manage labor costs because retirement benefits could be more easily and equitably controlled as they were earned by employees, rather than when benefits were due to be paid to retirees. It could enable agency managers to better allocate resources, particularly when choosing the lowest-cost combination of labor and capital. The current accounting system understates labor costs and may encourage managers to rely too heavily on labor and to delay substituting more-

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budgets with some measure of certainty, and it reduces short-term volatility in accruing costs. Other balancing transfers between the Treasury and the trust funds adjust for differences between experience and the actuaries' assumptions.

11. The process of saving and accumulating assets for future needs is called prefunding because it sets aside current resources for future use. In contrast, the President's proposal would improve the actuarial balances of the trust funds, but it would not directly change the government's total spending or revenues and hence would not increase national saving as a whole. See Congressional Budget Office, *Social Security: A Primer* (September 2001), p. 8.

efficient capital technology and equipment.[12] Moreover, reported personnel costs would become more comparable for CSRS and FERS employees as well as civilian and military employees. The cost of CSRS employees is understated relative to the cost of FERS employees under the current system; similarly, the cost of federal civilian employees is understated relative to that of military personnel.

Although retirement liabilities are already disclosed in the *Financial Report of the United States Government* under the standards established by the Federal Accounting Standards Advisory Board, the general public and most policymakers may be unaware of those disclosures. Recognizing retirement costs in the budget process increases the likelihood that they will affect resource allocation decisions and, at the same time, promotes consistency between the government's financial statements and the federal budget.

Potential Limitations and Policy Implications

Accrual accounting could present several technical problems. To begin with, accruing retirement liabilities, particularly postretirement health care benefits, could be subject to large errors in estimating. The difficulties of projecting future health care costs are compounded by variability in medical costs, utilization rates, and changes in covered benefits.[13] Increases, but not exceptional volatility, are apparent in OPM's annual estimates of accrual health costs per employee (see Table 2). From 1997 to 2001, costs climbed by 38 percent (from nearly $2,350 to $3,250), while postretirement health care liabilities rose by just over 20 percent (from $159 billion to $192 billion).[14] Most of that increase resulted from the rising cost of health care—OPM's actuaries assume an annual growth rate of 7 percent. In 1999, however, the rate of increase was almost zero, in part because of a reduction in covered benefits.

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12. The actuarial method currently used by OPM to estimate pension costs—the aggregate entry age normal cost—recognizes retirement costs as a constant, or level, percentage of pay over an employee's working life. Some analysts have argued that the government might get a better measure of costs by switching to the projected unit credit method, which recognizes a higher retirement cost for older employees and is used by many private-sector firms. Compared with the projected unit credit method, OPM's method is front-loaded; that is, it recognizes a higher percentage of the cost of retirement benefits earlier in employees' careers. An advantage of OPM's method is its greater simplicity.

13. Health benefits for federal employees and annuitants are subject to frequent changes in covered services. Costs are also affected by participants' choice of plans.

14. OPM's latest estimate is from September 30, 2001.

TABLE 2. ESTIMATES OF THE ACCRUAL COST OF RETIREE HEALTH BENEFITS PER EMPLOYEE AND OF LIABILITIES, FISCAL YEARS 1997-2001

Fiscal Year	Accrual Cost per Employee (In dollars)	Aggregate Liabilities (In billions of dollars)
1997	2,349	158.9
1998	2,552	176.0
1999	2,554	175.4
2000	2,803	192.2
2001	3,246	191.5

SOURCE: Office of Personnel Management. The figures reflect OPM's latest estimate, from September 30, 2001.

Switching to accrual accounting might also cause some difficulty in analyzing historical data on appropriations. To bridge the gap between budget numbers with different bases of accounting, the President would require that the budget publish comparable accrual estimates for 2001 and 2002.

Recognition of accrued retirement costs of federal workers over the course of their careers could be interpreted as strengthening the commitment to provide promised benefits and limiting the Congress's latitude in changing them. The change, however, could also have the opposite effect, increasing the likelihood that the Congress would reduce benefits. Many analysts believe that such an effect resulted from a required accounting change for retiree health benefits in private firms. Specifically, Financial Accounting Standard No. 106 (FAS 106), which took effect in 1993, required most private firms to recognize the accrual cost of retiree health benefits and the liability for those benefits. Subsequently, some firms limited health benefits for their retirees. Survey data provide an inconclusive picture of the share of private firms that now provide health benefits for retirees.[15]

15. According to surveys cited in a General Accounting Office study, only about one-third of large employers and less than 10 percent of small employers offer such benefits. See the Statement of William J. Scanlon, Managing Director, Health Care, General Accounting Office, before the Subcommittee on Employer-Employee Relations of the House Committee on Education and the Workforce, published as General Accounting Office, *Retiree Health Insurance: Gaps in Coverage and Availability*, GAO-02-178T (November 1, 2001). In contrast, data from Watson Wyatt, a benefits consulting firm, show generally greater coverage for the larger firms in its database, with 63 percent of firms offering medical coverage for future retirees. See Watson Wyatt Worldwide, *Comparison 1999 Statistical Summary,* pp. 62-63.

Although FAS 106 might have contributed to firms' efforts to control the cost of benefits, other factors, especially the rapid rise in health care costs, were also important. Moreover, the likelihood of a federal response commensurate with that of private firms is mitigated by the intragovernmental nature of the proposed federal accrual for health care costs. Whereas FAS 106 directly reduced the net earnings of private companies, the President's proposal would leave the budget's most publicized summary measure—the surplus or deficit—unaffected. In addition, even if the surplus or deficit was affected, it is not clear that federal policy would be as responsive to changes in that measure as private firms are to changes in their earnings.

The change could lead to some reallocation of budgetary resources among agencies, depending on the response of the appropriations committees. Fuller recognition of labor costs could also induce a reduction in federal employment if appropriators were to trim agency personnel budgets, for example, or if the proposal induced substitution of capital for labor.

APPENDIX: FEDERAL RETIREMENT PLANS

Federal civilian retirement programs cover about 2.7 million active government employees, including those of the U.S. Postal Service. The Congressional Budget Office expects federal pension and annuitant health payments to 2.4 million civilian retirees and survivors to reach $56 billion in 2002. The Federal Employees' Retirement System (FERS) covers most civilian employees hired since January 1984. FERS supplements Social Security benefits, which workers who are covered under FERS also receive. When the system was created, workers hired before 1984 had the option to join FERS. Most civilian employees not in FERS are covered by the Civil Service Retirement System (CSRS), which is a closed system—that is, new employees are not eligible to join.

FERS was designed to provide income security during retirement comparable to that offered by large private employers. Retirement income for workers covered under FERS consists of three parts: Social Security benefits; a defined-benefit component; and the Thrift Savings Plan (TSP), which is a defined-contribution plan. The TSP is similar to the 401(k) plans offered by many private employers. Federal agencies automatically contribute 1 percent of a worker's pay to the TSP on behalf of any worker covered by FERS. In addition, the employing agency matches employees' voluntary contributions up to 5 percent of pay. (CSRS employees may participate in the TSP, but they receive no matching or automatic agency payments.) The FERS defined-benefit component bases retirement benefits on employees' years of service and final salary. In contrast to most private employers, the federal government requires that employees contribute to their defined-benefit pensions.

For most employees, the retirement benefits offered under FERS have a higher value than those provided under CSRS.[1] In part, that advantage exists because the TSP benefits are portable—they can be rolled over into an individual retirement account or 401(k) plan, usually with no loss in value, if an employee leaves government service.[2] The cost to the government of FERS (including Social Security and the TSP) is slightly higher than the cost of CSRS. Although CSRS offers a bigger defined benefit in total—CSRS-covered employees do not ordinarily participate in Social Security—and provides full protection against inflation, employees pay more for CSRS than they would pay for the defined benefit under FERS.

New retirees are generally eligible for the Federal Employees Health Benefits (FEHB) program if they participated in that program during their last five years of

1. Congressional Budget Office, *Comparing Federal Employee Benefits with Those in the Private Sector*, CBO Memorandum (August 1998).

2. Most FERS participants receive immediate vesting in agency matching contributions and vesting after three years of federal service in the agency automatic (1 percent) contribution.

government service and are eligible to receive an immediate annuity.[3] About 85 percent of eligible new retirees choose to receive health benefits. After age 65, the retirees' FEHB benefits are coordinated with those of Medicare; the program pays amounts not covered by Medicare (but no more than the amounts it would have paid in the absence of Medicare).[4] Participants and the government share the cost of the monthly premium. The government's share for annuitants (and current employees) is 72 percent of the weighted average of the premiums for all participating plans (up to a cap of 75 percent of the total premium). In 2002, the government expects to pay $6.2 billion in premiums for 1.9 million annuitants and their dependents and survivors.

3. The heath insurance benefits available to current employees and annuitants are generally similar, and annuitants pay the same FEHB premium as active employees pay. However, there are important differences in benefits for those retirees who are also covered by Medicare. For a detailed description of the differences, see Carolyn L. Merck, *Health Insurance for Federal Employees and Retirees*, CRS Report for Congress RL31231 (Congressional Research Service, January 2, 2002).

4. The FEHB program does not require annuitants to enroll in Medicare Part B, an option that covers physicians' services and most outpatient care not covered under Part A. There are advantages for FEHB participants to also enroll in Part B coverage, however, including lower coinsurance for outpatient drug benefits; as a result, most FEHB participants choose to enroll.

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