View metadata, citation and similar papers at core.ac.uk

brought to you by CORE

provided by ScholarlyCommons@Penn

University of Pennsylvania
ScholarlyCommons

Wharton Pension Research Council Working Papers

Wharton Pension Research Council

10-1-2008

Thinking About Funding Federal Retirement Plans

Toni Hustead
hustead@mac.com

Follow this and additional works at: https://repository.upenn.edu/prc_papers

Part of the Economics Commons

Hustead, Toni, "Thinking About Funding Federal Retirement Plans" (2008). *Wharton Pension Research Council Working Papers*. 247.
https://repository.upenn.edu/prc_papers/247

The published version of this Working Paper may be found in the 2009 publication: *The Future of Public Employee Retirement Systems.*

This paper is posted at ScholarlyCommons. https://repository.upenn.edu/prc_papers/247
For more information, please contact repository@pobox.upenn.edu.

Thinking About Funding Federal Retirement Plans

Abstract

Most U.S. Federal retirement plans are now fully funded, but since plan assets must legally be invested in Federal securities, fund surpluses are used to reduce overall Federal budget deficits. As a result, current taxpayers are not charged with the cost of future Federal retirement obligations. Nevertheless, Federal rules do require the employing Federal agency to budget for current personnel's accruing liability of retirement promises. Therefore policy decisions regarding the number of Federal civilian and military personnel and the design of their retirement benefits may be made with a better understanding of the costs.

Disciplines

Economics

Comments

The published version of this Working Paper may be found in the 2009 publication: *The Future of Public Employee Retirement Systems*.

This working paper is available at ScholarlyCommons: https://repository.upenn.edu/prc_papers/247

The Future of Public Employee Retirement Systems

EDITED BY

Olivia S. Mitchell and Gary Anderson

OXFORD
UNIVERSITY PRESS

OXFORD
UNIVERSITY PRESS

Great Clarendon Street, Oxford OX2 6DP

Oxford University Press is a department of the University of Oxford.
It furthers the University's objective of excellence in research, scholarship,
and education by publishing worldwide in

Oxford New York

Auckland Cape Town Dar es Salaam Hong Kong Karachi
Kuala Lumpur Madrid Melbourne Mexico City Nairobi
New Delhi Shanghai Taipei Toronto

With offices in

Argentina Austria Brazil Chile Czech Republic France Greece
Guatemala Hungary Italy Japan Poland Portugal Singapore
South Korea Switzerland Thailand Turkey Ukraine Vietnam

Oxford is a registered trade mark of Oxford University Press
in the UK and in certain other countries

Published in the United States
by Oxford University Press Inc., New York

© Pension Research Council, The Wharton School, University of Pennsylvania, 2009

The moral rights of the authors have been asserted
Database right Oxford University Press (maker)

First published 2009

All rights reserved. No part of this publication may be reproduced,
stored in a retrieval system, or transmitted, in any form or by any means,
without the prior permission in writing of Oxford University Press,
or as expressly permitted by law, or under terms agreed with the appropriate
reprographics rights organization. Enquiries concerning reproduction
outside the scope of the above should be sent to the Rights Department,
Oxford University Press, at the address above

You must not circulate this book in any other binding or cover
and you must impose the same condition on any acquirer

British Library Cataloguing in Publication Data
Data available

Library of Congress Cataloging in Publication Data
Data available

Typeset by SPI Publisher Services, Pondicherry, India
Printed in Great Britain
on acid-free paper by
MPG Books Group, Bodmin and King's Lynn

ISBN 978–0–19–957334–9

1 3 5 7 9 10 8 6 4 2

Chapter 8

Thinking about Funding Federal Retirement Plans

Toni Hustead

This chapter takes up the question of how to think about retirement plans for Federal employees. In the United States, a Federal retirement plan is one established or maintained by a Federal agency for any of its officers or employees. There are currently almost 34 Federal pension plans covering more than 10 million individual participants including employees, retirees, and survivors. In practice, since more than 97 percent of these members are concentrated in three plans, these are the focus of this chapter (GAO 1996). Two of the three plans which cover over 5 million participants are for Federal civilian employees. The Civil Service Retirement System (CSRS) covers civilian employees who entered service before 1984. The Federal Employees Retirement System (FERS) covers all new hires after 1983, plus employees who elected to transfer from CSRS to FERS during one of the two open seasons. The third plan, covering more than 4 million participants, is the Department of Defense (DoD) Military Retirement System.

A brief history of Federal retirement plan funding

The Employee Retirement Income Security Act (ERISA) of 1974 set minimum funding and reporting standards for corporate or private-sector pension systems. This law requires private firms to fully fund these pension plans by holding investments other than their own securities, to protect employees against the loss of earned benefits if the companies were to go out of business. Public Law 95–595, enacted in 1978, extended most of the reporting requirements of ERISA to Federal retirement plans. That law did not extend the funding and investment requirements of ERISA to Federal plans, because the presumption was and continues to be that the Federal government will not go out of business. In addition, reneging on promised pension benefits to Federal civilian employees (including

members of Congress) or military members is not considered a viable possibility. Currently, annual payments to Federal retirees are a small proportion of the overall Federal budget each year. For example, in FY 2007, Federal retirement benefits were $ 0.1 trillion (3.7%) of the $2.7 trillion net Federal outlays (OMB 2007).

Prior to this adoption of the ERISA-like reporting standard, most Federal retirement plans were either not funded, which means they pay benefits when due without any fund accumulations (referred to as 'pay-as-you-go'), or partially funded. For standard reporting purposes under the new law, each plan was required to determine and report to the public its unfunded liability and the annual cost of the benefit accrued by current employees. To determine these costs, most plans used the most common actuarial funding method used by large private employers at that time, the entry-age normal cost method. The reports were ultimately incorporated into the financial statements of the agencies.

These reports became instrumental in educating the public and policymakers on the true cost of Federal civilian and military employees, and they are likely the reason that pay-as-you-go financing was replaced with fully funded mechanisms in the 1980s for some of the larger systems. To fully fund each system, Congress passed legislation that set up unique Federal Trust Funds that annually receive payments to cover the benefits earned during the year as well as annual amortization payments to pay off the unfunded liabilities. The assets of the Trust Funds are invested in Federal securities, so the funds also receive annual investment income. Benefits payments are made out of the fund to plan participants. Hence, these Federal capital assets back the promises made to plan participants. In 1984, the existing Military Retirement System was fully funded. By contrast, the financing of the Civil Service Retirement System has not been changed. Since 1984, nearly all *new* major entitlements for civilian and military employees enacted have included legislative language that fully funds the new benefits. These include the new civilian Federal Employees Retirement System in 1984, new military education benefits for reservists in 1985, a new military retirement plan for those entering service after mid-1986, and a new plan to cover health benefits for military retirees over age 64 in 2001. Under these 'accrual budgeting' arrangements, Federal agencies transfer funds from their own budgets to the relevant Trust Funds equaling the benefits earned in that year, and Treasury is responsible for making unfunded liability payments to the funds as well and interest income payments. Agency budget appropriations include the accrual funds needed to make such transfers, and hence, they reflect a more 'transparent' view of the true cost of each Department's manpower and decisions.

Federal retirement fund assets

Federal retirement assets must be held by law in plan-specific Trust Funds that are invested in special issue US Treasury securities that yield interest comparable to marketable US obligations with similar maturities. Fund managers ensure that there is enough cash in the funds each year to cover benefits, and they invest all excess income over this amount. When securities are redeemed by fund managers to pay benefits, the Treasury either borrows from the public or uses then current tax receipts to cover its security obligation. When funds are moved from one account in the Federal government to another account there are equal and opposite accounting transactions that cancel each other out in the overall Federal financial statement. For example, when an agency transfers cash from its account to the Trust Fund, it is a debit to the agency and a credit to the Trust Fund for an equal amount, and the transactions cancel each other out inside the overall Federal budget. Likewise, when a Trust Fund invests excess cash in Federal securities, it is a debit to the Trust Fund and a credit to the Treasury, and these two transactions cancel each other out inside the overall Federal budget. When the Trust Fund pays benefits to plan participants, there is a debit but no associated credit in the Federal budget. Hence, while Trust Fund balances grow to large levels, the fact that they are 'self-invested' means that the overall Federal budget does not need to have the cash on hand until benefits fall due. This makes the process appear to be only a bookkeeping mechanism, since the end result is that Federal funding does not allow for the transfer of liabilities from future generations of taxpayers to today's taxpayers.

If the US government were to change the Federal Trust Fund investment policy from US Treasury special issue securities to private sector securities, this would result in significant new Federal budget outlays that would directly impact the Federal deficit. For example, at the end of FY 2007, all Federal Trust Fund balances equaled $3.7 trillion, and they are expected to increase by an average of $0.3 trillion a year over the next six years. These numbers are large because they include Social Security and Medicare Trust Funds. Focusing only on civilian and military retirement plans, the Federal Trust Fund balances equaled $0.9 trillion, and are expected to increase by an average of $0.1 trillion annually. Converting these current and/or future fund assets into private assets in the current deficit situation, would mean that the government would have to immediately borrow the money from the public (increasing the deficit), find an uncontroversial portfolio in which to invest these large sums, and then run the risk that the planned return on investment would be insufficient to cover obligations as they fall due. Investing trillions of dollars of Federal funds in the private market would also raise fears of political

interference in private corporations or place unwanted mandates on investments.

There are two groups of funds in the unified budget of the Federal government: Trust Funds and Federal Funds. Total Trust Fund outlays resulted in a $248.7 billion surplus in FY 2007, but federal fund outlays had a deficit of $410.7 billion for a combined total unified budget deficit of $162 billion.

The FY 2009 President's Budget stated that the Federal government would only be able to fund benefits in the true sense of the word by increasing saving and investment in the economy as a whole. It went on to state that this could only be accomplished if annual Trust Fund surpluses were not used to reduce the unified budget deficit, and if Federal fund deficits were unchanged. This would reduce Federal borrowing and increase future incomes and economic sources to support benefits, as long as this savings is not accompanied by a reduction in private savings. The FY 2009 budget did not envision this happening anytime soon, as the deficit for that budget year was projected to increase to $407.4 billion despite nearly a $300 billion Trust Fund surplus (OMB 2008).

If only a bookkeeping exercise, why 'fully fund' Federal pension plans?

Though fully funding Federal pension plans is recognized as bookkeeping exercise, the move to accrual budgeting has been embraced by policymakers, budget experts, and accounting organizations because it makes the cost of personnel transparent. With accrual budgeting, decisions on whether to increase hiring, enhance benefits, or use contractor support must be made with a full recognition of the total cost. For example, if a decision were made to double the size of the military force in FY 2009, the DoD budget would need an additional $17 billion to cover the new retirement accrual obligations in that year alone. If the accrual budgeting of the Military Retirement System were dismantled and replaced with a cash 'pay-as-you go' system, then the DoD would not have had to consider the cost of retirement benefits for the new personnel in its decision or its budget, as they would not show up for another 20 years (DoD 2006).

Several branches of the Federal government have supported the move to transparency. The President's FY 2003 Budget proposed to move all of the remaining Federal pension and retiree health benefits not yet fully funded to an accrual budgeting basis. This would have ensured that the employer's share of the annual cost of all Federal pensions and retiree health benefits would be reflected in the human resource budgets

of those agencies where employees worked. The Office of Management and Budget (OMB) Controller stated that it was the right time for such an improvement, given the increased sensitivity to the need for accuracy and transparency in accounting. The Comptroller General of the US and Chair of the Joint Financial Management Improvement Program (JFMIP) also issued a supportive statement on behalf of the JFMIP Principals stating that including these accrual costs in data used for budgetary decision-making would enhance the planning and the evaluation of the cost of operations, and improve consistency, transparency, and accountability for results. Similar statements were issued by the Association of Government Accountants and the American Institute of Certified Public Accountants.

These efforts to improve budgetary reporting were not favored by all. Congress did not pass legislation to enact the Administration's proposal in FY 2003 or in later years. In fact, there were several attempts by the Armed Services Committees to reverse DoD accrual budgeting and to reduce the transparency of the true cost of military manpower, by transferring certain defense accrual costs to the Department of Treasury and spending the resulting excess DoD appropriation on other projects. Such a move would have directly increased the budget deficit by the total accrual amount since it would have increased Federal outlays to the public.

The first Congressional attempt to alter accrual budgeting was successful. In 2003, Congress increased military retirement benefits for certain members receiving monthly Veterans Affairs (VA) disability benefits, and it required the Department of the Treasury to pay the annual marginal accrual increase associated with the new benefits instead of DoD. In FY 2007, for example, this gimmick understated DoD's annual manpower costs by $2.5 billion (4.7% of basic payroll) and increased the deficit by a like amount (DoD 2006). The second Congressional attempt to alter accrual budgeting was enacted in the National Defense Authorization Act for FY 2005. Section 725 of this law eliminated the requirement for DoD to use annual appropriations to pay the accruing cost of post-retirement health care for retirees over age 65, and it also transferred the requirement to the Department of Treasury. However, both the Office of Management and Budget and the Congressional Budget Committees have continued to charge the cost of this legislation against the DoD appropriation, essentially nullifying the intent of the enacted budget change. Without such a united agreement on technical scoring, this law would have caused the deficit to increase by more than $60 billion over five years or required enactment of offsetting reductions of the same magnitude in Federal programs (US Senate 2006).

Two years later, the House Armed Services Committee again included similar language in its version of the Defense Authorization Act for FY 2007,

and this time the proposed bill included language that would have made it difficult for OMB and the Congressional Budget Committees to charge the legislation against the DoD appropriation. The Senate version of the bill did not include the accrual change so, before the bill was conferenced, letters of strong opposition to the House version were written to the House and Senate Armed Services Committees by the Office of Management and Budget, the Secretary of Defense, the Department of Treasury, the Senate and House Budget Committees, and the Senate Appropriations Committee. The letters cited the $11 billion annual windfall that DoD would reap that would increase the deficit, as well as the importance of transparent costs in the budgets of Federal agencies. As a result of this strong opposition, the final enacted law dropped the language to remove DoD's accrual obligation (US Senate 2006).

Conclusion

Most US Federal retirement plans are now fully funded. Nevertheless, as the plan assets must legally be invested in Federal securities, fund surpluses are used to lower the overall Federal government budget deficit. As a result, unlike the private sector, current taxpayers are not charged with the cost of future Federal retirement obligations.

Since private-sector plans are not allowed to invest in company investments, full funding does result in charging current management with the cost of future retirement obligations. However, similar to the private sector, Federal funding does require the employing Federal agency to budget for the accruing liability of retirement for its current personnel. Policy decisions regarding the number of Federal civilian and military personnel and the design of their retirement benefits are then made with a better understanding of the cost. If decisions are made to increase personnel or benefits, then offsetting savings must be found in order to live within both agency and Federal budget totals. This allows for more fiscal security in the long-term.

References

US Department of Defense (DoD) (2006). *Valuation of the Military Retirement System as of September 30, 2006.* DoD Office of the Actuary. Washington, DC: US Department of Defense.

US Government Accountability Office (GAO) (1996). *Public Pensions, Summary of Federal Pension Plan Data.* Report to Congressional Requesters, (GAO/AIMD-96-6). Washington, DC: US Government Accountability Office, February.

US Office of Management and Budget (OMB) (2008). *FY 2009 President's Budget.* Washington, DC: US Office of Management and Budget, February.

US Office of Management and Budget (OMB) (various years). *News Release.* Washington, DC: US Office of Management and Budget.

US Senate (2006). *Budget Bulletin.* Senate Committee on the Budget. Washington, DC: US Senate, September 20.