

The Moment of Truth Project

The era of deficit denial is over.

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Shared Sacrifice: Reforming Federal Retirement Programs November 16, 2011

Introduction

The deadline for the Joint Select Committee on Deficit Reduction (“Select Committee”) to send to Congress its plan to bring this country’s debt under control is approaching. As the Select Committee continues to deliberate over how best to put our fiscal house in order, it must keep in mind the principle of shared sacrifice, and it must also ensure that it is doing everything possible to use taxpayer money wisely.

As the National Commission on Fiscal Responsibility and Reform (Bowles-Simpson) stated in its report, *The Moment of Truth*, “There is no easy way out of our debt problem, so everything must be on the table. A sensible, realistic plan requires shared sacrifice – and Washington must lead the way and tighten its belt.”

It was with this principle in mind – that the burden must be spread equally and that Washington must lead by example – that the Bowles-Simpson recommended that federal civil service and military retirement programs be re-evaluated by a federal workforce entitlement task force that would make recommendations for reforms to reduce the costs of those programs to taxpayers.

Military and civilian pensions are both out of line with pension benefits available to the average worker in the private sector, and in some cases, out of line with each other across different categories of federal employment. Bowles-Simpson recommended a review that examined both military and civil service retirement plans at the same time to ensure equity and consistency in the changes in each program.

The Moment of Truth (MOT) project is a non-profit effort that seeks to foster honest discussion about the nation’s fiscal challenges, the difficult choices that must be made to solve them, and the potential for bipartisan compromise that can move the debate forward and set our country on a sustainable path.

While some of the differences between the military and civil service retirement systems are a result of the differences between the military and civilian workforces, many of them are a product of the programs being administered by different agencies and under the jurisdiction of different Congressional Committees.

The task force would be directed to make recommendations in civil service and military retirement programs that would: 1) make rules more consistent across similar programs; 2) bring both systems more in line with private sector plans and; 3) achieve savings of \$70 billion over ten years. The recommendations would be considered by Congress under a fast track procedure.

Bowles-Simpson offered several areas in which the task force could find savings, including adjusting the ratio of employer/employee contributions, changing benefit calculations, deferring cost-of-living adjustment payments and making structural reforms to the military retirement system.

In light of the painful solutions we face, it is important that we bring the costs of federal military and civilian retirement under control. While many of the policies discussed in this paper would produce significant budgetary savings, just as importantly they would help correct inequities or flaws in the current federal retirement system while ensuring that federal and military retirees continue to have more generous retirement benefits than those typically received by employees in the private sector.

Background

Federal employees and military personnel have access to some of the most generous retirement systems in the country. Unfortunately, given the country's dire fiscal condition and the growing disparity between government and private sector pension plans, federal retirement programs are unsustainable on several levels.

In 2010, there were 4,424,377 federal employees, including postal workers and non-civilian workers. Paying all of these workers cost \$449 billion. Out of this total compensation amount, roughly \$135 billion, or about 30 percent of total federal civilian compensation, will come in the form of non-cash benefits, including health care, life insurance, and retirement benefits.¹

Federal and military retirement programs are currently financed to ensure that there will be no shortfalls when retirees begin receiving the pension benefits. For the most part however, taxpayers – rather than federal employees or members of the armed forces – are on the hook for funding both retirement plans. At a time when deficits are at record levels and Americans are bracing for possibly higher taxes and slower growth for Social Security and Medicare, it is only

¹ <http://www.whitehouse.gov/sites/default/files/omb/budget/fy2012/assets/spec.pdf>

fair for both federal workers and military personnel to contribute on a level more akin to the private sector for their own economic security.

Federal Civilian Employee Retirement Benefits

In 2010, the federal government paid \$69 billion in pension benefits to 2.5 million civilian retirees and their survivors, as well as \$51 billion to 2.2 million military retirees and their survivors.²

Civilian federal employees who were hired before 1984 are covered by the Civil Service Retirement System (CSRS). Under CSRS, a worker with 30 years of service can retire at 55; a worker with 20 years can retire at 60, and a worker with 5 or more years of service can retire at 62.

Civilian federal employees are covered by the Federal Employees' Retirement System (FERS) if hired after 1984. This system provides workers with a hybrid pension, which includes a 401(k)-style plan with a government match (the Thrift Savings Plan) *and* a defined-benefit payment. Employees can contribute up to \$16,500 annually to the Thrift Savings Plan and receive a match of up to five percent of pay. Private workers typically only get a 401(k) with a three percent match, while defined-benefit plans are all but extinct in the private sector. Federal workers contribute only 0.8 percent of their pay to the defined benefit portion of the Federal Employees Retirement System. The defined-benefit plan component allows workers to retire at 55³, although this would invoke reductions in annuity (with 62 years old being the age with no reduction)⁴ and draw an annual income equal to 1.1 percent of the average of their three highest year's salary times the number of years they worked. For the average federal worker who earns \$80,000 and retires after 30 years, that works out to \$26,400 a year. Any shortfall to meet payments to retirees is made up by taxpayers, who now chip in 11.7 percent of employees' salaries to keep the system solvent.⁵

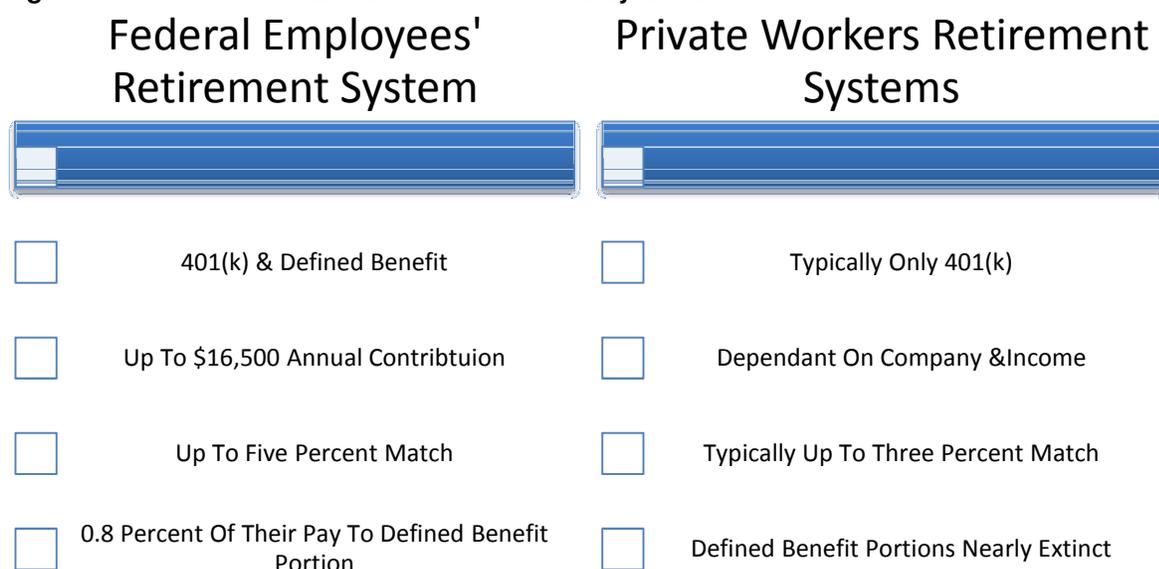
² <http://www.cbo.gov/ftpdocs/120xx/doc12085/03-10-ReducingTheDeficit.pdf>

³ If born in 1948 or earlier. Overall, if born after 1969 with the earliest retirement set at 57, each year retired in age earlier than this results in a 5 percent reduction in annuity payout.

⁴ Office of Personal Management <http://www.opm.gov/retire/pre/fers/earlyout.asp>

⁵ Staff writers, "Pension Reform Goes to Washington." *The Wall Street Journal*, June 6, 2011
Federal retiree benefits deserve a scrub..

Fig. 1: Federal and Private Workers Retirement Systems



The Office of Personnel Management (OPM) estimates the cost of CSRS to equal 25.8 percent of employee pay, of which the federal government pays 18.8 percent of this amount with employees paying the other 7 percent. The cost of the FERS basic annuity is equal to 12.5 percent of pay with the federal government contributing 11.7 percent and government workers paying 0.8 percent. Federal workers under FERS must also pay the employee share of Social Security taxes (6.2 percent) whereas those under CSRS do not.⁶

Military Retirement System

The military retirement system is arguably the best retirement deal around. If qualified for, unlike most retirement plans, the armed forces offers military retirees a pension, with benefits, that starts the day you serve the minimum of twenty years, no matter how old you are. That means an individual who served 20 years in the armed forces could start collecting a regular retirement pension, equal to half his or her salary, as early as 37 years old. That check will continue to grow with inflation (with the inflation and benefit calculation dependent on the specific retirement program) each year, and can be collected alongside a full salary from a second career. There are three different military plans that people can or are retired under. All allow service members to retire after a minimum to twenty years and multiply the pension by years of service and index benefits based on CPI (the newest system provides a COLA equal to CPI minus one percent, the older two systems provide COLAs at full CPI). The oldest system, available to personnel who joined before 9/8/1980, has the benefit calculation at 2.5% times the final rate of monthly pay, while those who joined between 9/8/1980 and 8/1/1986 and current system (REDUX) have their pay set at the highest three years of pay times 2.5%. Finally, REDUX

⁶ <http://www.bankrate.com/finance/retirement/CRS-report-on-federal-employees-retirement.pdf>

allows a \$30,000 bonus for those who commit to twenty years of service at fifteen years and see their benefits reduced by one percent for each year less than 30. See the below table for a full summary.⁷

Fig. 2: Military Retirement Systems

	Base Salary Used to Calculate Benefits	Formula Used for Calculating Benefits	Age Benefits Can Be Claimed	Cost of Living Adjustments
Joined Before 8/1/86	2.5% of Final Month of Pay	Multiplied by Years of Service	20 Years	CPI
High System	2.5% Average of 3 Highest Years	Multiplied by Years of Service	20 Years	CPI
REDUX (Current System)	2.5% Average of 3 Highest Years	Multiplied by Years of Service. \$30,000 bonus at 15 years if commit to another 5 years	20 Years. 1% Reduction for each year short of 30 at retirement. Benefits recalculated at age 62 equal to 2.5% of high three times years of service with one time catch-up COLA to provide full CPI date of retirement to age 62	CPI minus 1%

The military retirement program is a non-contributory, defined benefit system that has historically been viewed as a significant incentive in retaining a career military force. For active duty military personnel, there are three methods of calculating retired pay: the Final Basic Pay System, “High Three,” and Redux. The applicable retirement calculation is based on the date when the service member first entered active duty and their basic pay at the time of retirement, and, in the case of Redux, a voluntary election regarding a \$30,000 bonus. The active and reserve component retirement systems “vest” after 20 years of service. Vesting for the disability retiree occurs at their disability retirement date and, in some cases, at the personal choice of the service member.⁸

Why Reform Is Needed

The current retirement system is not sustainable in light of the nation’s dire fiscal condition. In 2010, there were 261,159 federal retirees and survivors receiving retirement payments. This is projected to grow to 296,180 in 2015 – a 13.4 percent increase.⁹ Unfunded US military-retirement obligations now amount to \$30,000 per household while unfunded federal civilian-employee

⁷ The Tenth Quadrennial Review of Military Compensation

⁸ <http://www.bankrate.com/finance/retirement/CRS-report-on-federal-employees-retirement.pdf>

⁹ <http://www.straight.com/article-360162/vancouver/kevin-gaudet-unfunded-federal-pension-liability-highlights-need-decisive-action>

pension obligations represent another \$16,000 per household.¹⁰ And the price tag for these retirement benefits is only getting higher. According to the Defense Business Board – tasked by former Defense Secretary Robert Gates to find ways to reduce the DOD budget – annual Treasury Department payments into the system to cover unfunded military pension liabilities will balloon from \$47.7 billion in 2010 to \$59.3 billion by 2020.¹¹

Most of the men and women who serve in our military never receive a penny of retirement benefits. For those who qualify, a military retirement is very generous deal. Unfortunately, most who serve in our armed forces are not eligible for retirement benefits, because retirement benefits do not vest until 20 years of service. According to outgoing Secretary of Defense Robert Gates, 70 to 80 percent of the force leaves before reaching the retirement age and thus leave with nothing, and it is estimated that less than 15 percent of enlisted and 47% of officers will eventually become eligible for the retirement annuity.¹² And the number of those receiving retirement benefits declines even more for combat and/or enlisted personnel, those who arguably deserve and need the assistance the most.

The retirement system does not serve in the best interest of our national security. Under the existing retirement system military personnel, when they reach 20 years, are incentivized to leave the armed forces even if they have experience and skills that are valuable because they receive no marginal benefit for service beyond 20 years. And in fact most do just that. As of 2008, the average enlisted member is 42 years old and has 21 years of service when they take retirement while the average officer is 46 years old and has 23 years of service.¹³

Unfortunately, these individuals are often at their most productive and experienced, and their continued service in the Army, Navy, Air Force, Marines, and Coast Guard would greatly benefit national security. Furthermore, those that do retire at 20 years enjoy very generous benefits, even though they can continue to work, in many cases as consultants to the Department of Defense or other military contractors.

At the same time, the 20-year minimum for full retirement benefits can also encourage military personnel to serve longer than would otherwise be appropriate. While many military occupations have optimal career lengths of less than 20 years, members who have served for 10 to 12 years – regardless of their specific occupation – are highly incentivized to continue service up until the 20-year mark (at which point they are highly incentivized to leave). After having

¹⁰ Stephen Meister, “Facing the pension mess,” *New York Post*, December 21, 2010

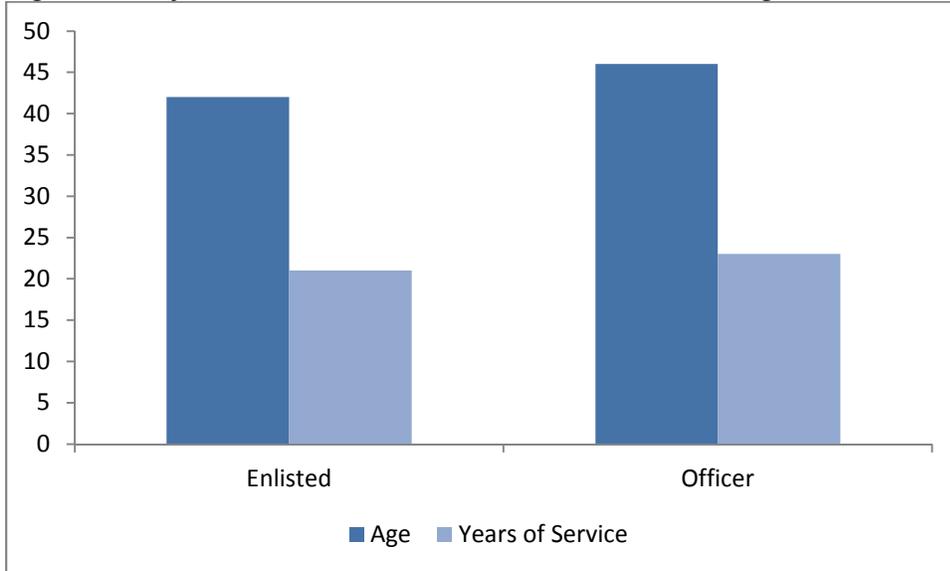
¹¹ Lisa Novak, “Military retirement system broken, board says,” *Stars and Stripes*, August 7, 2010.

¹² Secretary Robert Gates, June 16, 2011, hearing before the Senate Committee on Appropriations; Military Officers Association of America, “Military Retirement on the Chopping Block,” June 24, 2011; & Dept. of Defense, Valuation of the Military Retirement System, September 30, 2006, Office of the Actuary, November 2007, p. 12.

¹³ Charles A. Henning, “Military Retirement: Background and Recent Developments,” *Congressional Research Service*, November 17, 2008

served 15 years, even poor performers are unlikely to be separated from service before reaching 20 years due to the fact that they will leave with no retirement savings.

Fig. 3: Military Officer and Enlisted Years and Service and Age When Retiring



The bottom line, as explained in the most recent Quadrennial Review of Military Compensation (QRMC) from the Department of Defense: “The one-size-fits-all nature of the existing retirement system produces careers that are too uniform, too short, or too long, with career paths shaped by the structure of the retirement benefit rather than by the needs of the force or the characteristics of the occupation.”¹⁴

Federal and military retirement benefits are out of line in comparison to those offered by the private sector. Military personnel and federal employees have access to excellent retirement benefits if they qualify. According to BLS, “benefits are an important part of federal employee compensation.” Overall, about 60 percent of all private sector workers have access to both retirement and medical benefits compared to all federal workers.¹⁵

Unlike the retirement plans for federal employees and military personnel, the cost of private pensions are generally shared evenly between employees and employers. According to the Department of Labor, private employers have contributed on average 55 percent while employees have contributed 45 percent over the last ten years.¹⁶

¹⁴ Dept. of Defense, “Report of the Tenth Quadrennial Review of Military Compensation, Volume II: Deferred and Noncash Compensation”. July 2008. (page 16)

¹⁵ CBO 2007 Characteristics of Pay and Federal Civilian Employees

¹⁶ Dave Kendall & Jim Kessler, “Frequently Asked Questions about Federal Retirement Reform,” Third Way, June, 2011.

Fig. 4: Comparison of Federal and Private Retirement

Federal	Private
<ul style="list-style-type: none">• Medical & Retirement• Retirement Totally Funded By Government• Most Receive Defined Benefit & Defined Contribution• Military Personnel Do Not Contribute & Can Start Receiving Benefits As Early As Late 30's/Early 40's	<ul style="list-style-type: none">• 60 Percent have Access To Medical & Retirement• 45 Percent Of Retirement Costs Paid By Employees• 47 Percent Offered Either Defined Benefit or Defined Contribution, 45 Percent Offered Defined Contribution & 10 Percent Offered Both• Average Age Receiving Full Benefits Is 59.5

Most federal civilian employees are offered defined contribution and defined benefit pension plans under FERS. According to BLS, only 47 percent of private workers are offered either type of plans, with 45 percent offered defined contribution plans and only 10 percent (and declining) offered defined benefit plans. Furthermore, when calculating future pension benefits, the private sector generally sets pensions based on the highest five years of earnings while federal workers enrolled in pension plans have pensions based on the highest three years of earnings, which boosts annual benefits for federal workers by comparison.

Military retirees also receive much more generous retirement benefits than those in the private sector. Specifically, active service men and women do not contribute to their pension plan, can retire after only 20 years of service, and are guaranteed a lifetime benefit. As most members of the military enter service between the ages of 18 and 24, they can start receiving retirement benefits as early as their late 30s or early 40s – with the average age at only 42.¹⁷ By contrast, private sector employees typically have to work longer and wait until at least age 59½ to receive full retirement benefits.¹⁸

The protection against inflation in the form of cost of living adjustments (COLAs) offered by the Civil Service Retirement System and the pre-reform Military Retirement System (which covers new recruits before August 1, 1986) is also extremely generous when compared to that of the private sector. All retirees are provided with full cost-of-living protection, even if they retire

¹⁷ CBO “Analysis of Federal Civilian and Military Compensation”, January 20, 2011, p. 7.

¹⁸ Department of Defense, “Report of the Tenth Quadrennial Review of Military Compensation, Volume II: Deferred and Noncash Compensation”. July 2008.

before age 62. Even when compared to the largest and most generous pensions offered in the private sector, this protection is expensive.¹⁹

Washington Must Lead. Given that taxpayers are already going to be making sacrifices because there is just no way to balance the budget without reducing benefits, cutting programs, and raising revenue, are we going to make those cutbacks and revenue increases greater in order to preserve the existing (and generous) pension benefits enjoyed by government and military personnel? In order to make significant deficit reduction fair, there must be a semblance of shared sacrifice.

The current structuring of the federal retirement system is based on outdated assumptions and should be re-evaluated. For example, one of the factors in making full military retirement benefits available immediately upon retirement was the belief that military experience was not easily transferred to the private sector, thus military retirees would earn less than civilians who had similar education and work experience. While earlier research offered some support of this theory, the most recent research shows that military retirees with 20 or more years of service have earnings similar to those of civilians who have comparable levels of education and experience.²⁰ With that being the case, military retirees often retire in their early 40s after 20 years of service, earning a full military pension, only to take employment in the private sector with at times over 20 years left in their working life, earning a private pension as well while working in a second career.

The Bowles-Simpson Plan

Bowles-Simpson recommended the creation of a federal workforce entitlement task force to re-evaluate civil service and military retirement programs to identify savings of \$70 billion through 2020. In addition to finding savings for deficit reduction, the task force was also directed to make program rules more consistent across similar programs and to bring both systems more in line with standard practices from the private sector.

While the Commission Bowles-Simpson did not vote on an exact set of reforms, the report did suggest some specific proposals to reform the current retirement system for federal workers and military personnel that would meet the savings target and achieve the policy goals recommended by the Bowles-Simpson proposal. These include:

Change the way benefits are calculated: Use the highest five years of earnings to calculate civil service pension benefits for new retirees (rather than the highest three years prescribed under current law, to make benefit calculation match the private sector standard. Not only would this produce savings by lowering the average pension benefit for civil service employees, it would

¹⁹ Dept. of Defense, “Report of the Tenth Quadrennial Review of Military Compensation”

²⁰ Department of Defense, “Report of the Tenth Quadrennial Review of Military Compensation, Volume II: Deferred and Noncash Compensation”. July 2008. (page 8)

also encourage more experienced federal employees to spend more years in the workforce in order to record more higher-earning years. Finally, according to the Congressional Budget Office, having a five year calculation would have the federal government be more akin to the private sector, which commonly uses five year calculations. [**\$5 billion through 2021**]

Defer Cost-of-Living Adjustments: Instead of applying COLA's to retirement benefits at any age, defer COLA's for retirees in the CSRS and military plans until age 62 (FERS and the other plans already defer COLA's until age 62), including for civilian and military retirees who retire well before a conventional retirement age, which is already done under the FERS, whose COLA's are already delayed until age 62. The CSRS and the military pension system both allow workers to start receiving retirement benefits after twenty years of service, often much earlier than a "normal" retirement age, although for the CSRS, you have to be 60 for this and 55 if you retire with at least 30 years' experience. ²¹ In place of annual increases, this option would provide a one-time catch-up adjustment at age 62 to increase the benefit to the amount that would have been payable had full COLAs been in effect. [**\$17 billion through 2021**]

Increase employee pension contributions: Social Security and the CSRS generally have employers and employees each contribute half to employee pensions. Increasing pension contributions from federal employees so that they are ultimately paying half the costs (with the employer paying the other half) would bring the FERS more in line with these systems. Additionally, in the private sector, employers and employees split the cost of 401k's about evenly. With pension plans, the costs to the employee are hidden – but according to the Department of Labor, about 52 percent of all private sector pension funds (taking into account defined benefit and defined contribution plans) are contributed by the employer and 48 percent by the employee. [**\$51 billion through 2021**].

The enactment of any of these policies would bring federal retirement programs more in line with the private sector. And, with the numerous other benefits enjoyed by federal civilian employees and military servicemen, would still give federal and military employees a better deal compared to the private sector. In addition to achieving budgetary savings, these reforms would help achieve other policy goals for the federal workforce such as encouraging longer careers – as employees' pensions would reflect the higher salaries they would receive with more experience – and thus helping the federal government retain more experienced workers.²²

Adjusting federal employees' retirement contributions rather than reducing their benefits gives workers the ability to adjust by making smaller changes in spending over longer periods of time or by reducing their overall contributions to their retirement to keep their level of take-home pay the same.²³

²¹ Office of Personnel Management

<http://www.opm.gov/retire/pre/csrs/eligibility.asp>

²² CBO: Options to Cut Nondefense Spending, Feb 2001. Option 600-12.

²³ CBO: Budget Options, Volume 2. Option 47, p 238.

BOX 1-1: DEFENSE BUSINESS BOARD PROPOSAL ON MILITARY RETIREMENT

Military Retirement Reform proposals have also been tackled by an internal Defense Department board, the Defense Business Board, which is made up of a variety of business executives from the military industrial complex. This board proposed a system that would move military retirement to a new defined contribution plan, based on the Uniformed Military Personnel Thrift Savings Plan, but would also include annual contributions from the federal government. The Uniformed Military Personnel Thrift Savings Plan is a defined contribution plan where the retirement income received depends on how much the user contributed to the account, and the earnings on it, during the working years. The plan would include an option for military member contribution and the ability for the plan to be transferred to the private sector, and back to the military after that if needed. It would apply to both reserve and active duty personnel.

The plan would vest after three to five years and would be payable after ages 60-65 or when Social Security is taken (the ranges depending on type of military position, accounting for things like risks involved). This is different from the current system that vests after leaving the military, which can happen after only 20 years of service (as early as someone in their late 30's in some cases). Additionally, the level of government contribution is funded based on a percentage that is similar to the "highest end of a private sector plan". Moreover, the plan would allow for certain payouts for education, home ownership or business acquisition.

Finally, a key element of the plan would be the adjustment for different military roles, something that is currently lacking. The plan would double contributions for years in "combat zones or high risk positions", would increase contributions for "hardship tours," or could even have lower retirement ages based on similar metrics. The plan would not affect the current military retiree population and would exempt fully disabled veterans.

Overall, this plan, while not having a cost estimate as of yet, is a proposal that warrants attention from lawmakers and should be on the table for deficit reduction. As the Secretary of Defense Leon Panetta recently said, "[changes to retirement benefits are] the kind of thing you have to consider".

This option would be an improvement over the current system because it provides a benefit to members of military who serve less than 20 years, which is more than 85 percent of enlisted personnel and 53 percent of officers¹, as well as providing additional benefits for service beyond 20 years.

Even with the reforms suggested by Bowles-Simpson, retirement benefits for both federal and military retirees will still be greater than those for private sector employees. In fact, the benefit payouts for federal civilian employees will be the same, however federal workers will now have to contribute a fair share of their income, along the lines of what is required of private sector employees. And while those who serve in the armed forces will have to wait until they are older before than can collect their retirement benefits, more military personnel will receive some pension benefits than under current law. This is particularly true for combat veterans, the vast majority of which never receive pension benefits, while most military pension collectors are in fact civilian defense workers. Deferring COLA's for federal retirees until age 62 could also help encourage longer careers, and it would still leave federal pensions better protected from inflation than most of those in the private-sector.²⁴

It is also worth noting that the short-term savings within the ten-year budget window from the reforms described above are only a fraction of the long-term savings that would ultimately be produced. One reason is that different policy changes would produce savings at different times: while increasing employees' pension contributions would result in immediate savings, using a different formula to calculate benefits would result in savings only when current employees retire. Thus, it is important to acknowledge the potential long-term savings of these reforms when attempting to evaluate them.²⁵

Finally, reforming both civilian and military retirement programs at the same would have several benefits, including improving coordination and harmonization between the two systems as opposed to a legislative process in which two programs are authorized and appropriated under separate committee jurisdictions.

Conclusion

Federal retirement programs help to protect the economic security of those who serve in our military and work for the government, and they should continue to do so in the future. However, these programs must be sustainable, be made more equitable across the government, and savings from these programs should be included in any comprehensive deficit reduction package agreed to by the Select Committee.

²⁴ CBO: Budget Options, Feb 2001. Option 600-11-A, p 334.

²⁵ 2008 Quadrennial Review of Military Compensation