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Report to the Congress; by Elmer B. Staats, Comptroller General.

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To protect the purchasing power of retirement income, the annuities of Federal employees under the various retirement systems are automatically adjusted each March 1 and September 1 for the increase in the consumer price index during the preceding 6-month period ending December 31 and June 30, respectively. Since, by law, cost-of-living adjustments are applicable to all annuities payable on the effective date of the increase, retiring Federal employees benefit from cost-of-living increases which occurred while they were still employed. They can receive a higher starting annuity which reflects the preceding annuity cost-of-living adjustment and, depending on the timing of their retirement, may be eligible for an additional adjustment immediately. Such increases escalate the already high costs of Federal retirement by inflating the basic annuity upon which succeeding adjustments are applied and can encourage valuable, experienced employees to retire. Findings/Conclusions: The existing process overcompensates retiring employees by providing annuity increases based on changes in the consumer price index which occurred before their retirement. Eliminating the added enrichment of compensating retiring Federal employees and new Federal retirees for living cost increases which occur while they are still in an active status would still fully protect the purchasing power of retirement annuities. Federal annuity cost-of-living adjustment processes, which fully protect the purchasing power of retirement income as living costs rise, would still be more liberal than those of essentially all non-Federal pension systems. Few non-Federal plans have automatic adjustment provisions and those which do generally limit the amount of increase that can be granted in any 1 year. A more rational method of computing adjustments of new retirees would be to prorate their adjustments to reflect only the cost-of-living increases that occur after they retire. Proration of the annuity adjustments of new retirees would be much less costly than the existing process; over $800 million in annuity payments could be saved over the remaining lifespans of civil service employees retiring in 1978. Recommendations: Congress should enact legislation making the cost-of-living adjustment processes of the Civil Service, uniformed services, foreign service, Central Intelligence Agency, and Federal Reserve Board retirement systems more rational and less costly by: (1) repealing the provisions of existing law which permit retiring employees and new retirees to receive higher starting annuities because of changes in the consumer price index before their retirement; and (2) providing that new retirees' cost-of-living adjustments be prorated to reflect only consumer price index increases after their retirement. (Author/SW)

REPORT TO THE CONGRESS

BY THE COMPTROLLER GENERAL OF THE UNITED STATES

Cost-Of-Living Adjustments For New Federal Retirees: More Rational And Less Costly Processes Are Needed

Cost-of-living adjustments are intended to protect the purchasing power of Federal annuities, but existing law permits retiring employees and new retirees to benefit from cost-of-living increases which occur while they are still employed.

The law should be changed to provide that new retirees' adjustments be prorated to include only the cost-of-living increases that occur after retirement.

This change would be more rational and save over $800 million in annuity payments over the remaining lifespans of civil service employees retiring in 1978 alone.

FPCD-78-2

NOVEMBER 17, 1977

COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON, D.C. 20548

B-130150

To the President of the Senate and the
Speaker of the House of Representatives

This report discusses the need to repeal those provisions of various laws that permit retiring Federal employees and new Federal retirees to benefit from cost-of-living increases which occur before they retire.

As you know, we have long been concerned about the inequities, illogical and inconsistent benefits, and the affordability of Federal staff retirement systems. The adjustment process for new retirees is one of several extremely costly and generous special features which raise serious questions about the continued viability of those systems. It inflates the basic annuity upon which succeeding adjustments are applied and escalates the costs of retirement. We are recommending that the Congress amend the law to prorate the annuity cost-of-living adjustments of new Federal retirees to reflect only living cost increases after their date of retirement, since it would be more rational and substantially less costly.

We made our review pursuant to the Budget and Accounting Act, 1921 (31 U.S.C. 53), and the Accounting and Auditing Act of 1950 (31 U.S.C. 67).

Elmer B. Staats
Comptroller General
of the United States

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ABBREVIATIONS

CPI Consumer Price Index

GAO General Accounting Office

COST-OF-LIVING ADJUSTMENTS FOR NEW FEDERAL RETIREES:

MORE RATIONAL AND LESS COSTLY PROCESSES ARE NEEDED

A pension system operates on the premise that those who have worked are entitled someday to stop working and to receive a retirement income as a right earned through their past service. Inflation shrinks the purchasing power of all Americans, especially pensioners, annuitants, and others on fixed incomes.

To protect the purchasing power of retirement income, the annuities of those under the civil service, uniformed services, foreign service, Central Intelligence Agency, and Federal Reserve Board retirement systems are automatically adjusted each March 1 and September 1 for the increase in the Consumer Price Index (CPI) during the preceding 6-month period ending December 31 and June 30, respectively.

Since, by law, cost-of-living adjustments are applicable to all annuities payable on the effective date of the increase, retiring Federal employees benefit from cost-of-living increases which occurred while they were still employed. They can receive a higher starting annuity which reflects the preceding annuity cost-of-living adjustment and, depending on the timing of their retirement, may be eligible for an additional adjustment immediately. Such increases escalate the already high costs of Federal retirement by inflating the basic annuity upon which succeeding adjustments are applied and can encourage valuable, experienced employees to retire.

This report updates our comments to the Congress, various congressional committees, and individual Congressmen on the Government's annuity adjustment policy for new retirees. In this report, we are reiterating our concerns about the inflated starting benefits and the cost implications which will continue to result if the existing policy is not changed. The following comments are generally limited to the civil service system, since it is the largest system and often leads the other systems to change. Most of our observations, however, also pertain to other Federal retirement systems.

ADJUSTMENT PROCESS INFLATES PURCHASING POWER OF NEW RETIREES' ANNUITIES

The legislative purpose of the cost-of-living adjustment process is clearly to protect the purchasing power of the annuity at retirement. Thus, retiring employees should not benefit from a process designed for those already in a retired status. But the law permits new Federal retirees to receive annuity increases based on CPI changes that occurred while they were still employed. We believe it is inappropriate and inequitable for individuals drawing full salary when the CPI increases occur to reap the additional benefits of those increases in their annuities. Federal pay rates are adjusted periodically to maintain pay comparability with the private sector. To the extent that cost-of-living changes influence private sector pay levels, they are reflected in the Federal pay rates upon which retirement annuities are based.

The amount of a civil service retirement annuity is determined by an employee's average annual salary during his/her 3 consecutive highest paid years and his/her years and months of service, including unused sick leave. The earned annuity is a direct function of the average salary and length of service and usually increases proportionately to these two factors.

But an anomaly was introduced into the retirement system along with the periodic CPI-related adjustment provision in 1965. That law--Public Law 89-205--removed the requirement of prior law that, to be eligible for a cost-of-living adjustment, retirees had to be on the retirement rolls for more than a year prior to the effective date of the adjustment. When the automatic adjustment process became law in 1962, it called for an annual annuity adjustment if the CPI rose by at least 3 percent during the preceding year. The process was changed in 1965 to gear adjustments to monthly changes in the CPI because the annual process had not produced an adjustment. The legislative history of the 1965 law is not clear regarding the rationale for removing the 1-year waiting period for annuity adjustment eligibility, but it appears that the change was made so that all annuitants would receive the December 1965 legislated annuity adjustment--the first adjustment in almost 3 years.

The 1965 law provides that cost-of-living adjustments are applicable to all annuities payable on the effective date of the increase. Until 1973 that provision permitted an employee who retired on that date to receive a higher starting annuity than an employee who retired the following day. For the most part a decision to remain on the job resulted in lower future annuity payments and, consequently, large numbers of employees, particularly those whose pay rates were frozen, retired immediately before scheduled annuity increases.

To correct this anomaly, the law was changed in 1973--Public Law 93-136--to guarantee that retiring employees would receive a basic annuity at least equal to the annuity they could have earned if they had retired as of the effective date of the last cost-of-living adjustment. Retiring employees receive the higher of (1) an annuity based on their average salary and length of service at retirement or (2) an annuity based on their salary and service at the time of the preceding annuity cost-of-living adjustment, plus that adjustment which they would have received if they had retired at that time. Although the 1973 amendment has reduced the number of retirements occurring before a scheduled annuity increase, it allows employees who retire immediately before a cost-of-living increase to receive that increase and to have the preceding cost-of-living increase considered in their basic annuity calculation.

The existing process overcompensates retiring employees by providing annuity increases based on changes in the CPI which occurred before their retirement. For example, employees who retired August 31, 1977, had considered in their basic annuity calculation the March 1, 1977, 4.8-percent increase which represented the percentage rise in the CPI from December 1975 through December 1976. The resulting starting annuity frequently would have been greater than an annuity based solely on salary and service. Additionally, the new retiree would have received the full 4.3-percent annuity increase of September 1, 1977, which was based on the percentage change in the CPI for the 6-month period ended June 30, 1977.

Eliminating the added enrichment of compensating retiring Federal employees and new Federal retirees for living cost increases which occur while they are still in an active status would still fully protect the purchasing power of retirement annuities. Federal annuity cost-of-living adjustment processes, which fully protect the purchasing power of retirement income as living costs rise, would still be more liberal than those of essentially all non-Federal pension systems. Few non-Federal plans have automatic adjustment provisions and those which do generally limit the amount of increase that can be granted in any 1 year. A 1974 survey by the Conference Board--an independent, nonprofit business research corporation--revealed that only 4 percent of the benefit programs of 1,800 major private employers had pension plans which were automatically adjusted for increases in the cost of living. Further, a recent congressional task force survey disclosed that less than 5 percent of the 371 largest State and local government pension plans had unlimited automatic adjustments for cost-of-living increases.

ELIMINATING THE OVERCOMPENSATION ASSOCIATED WITH THE EXISTING POLICY WOULD RESULT IN CONSIDERABLE COST SAVINGS

Despite the fact that cost-of-living adjustments are designed to protect the purchasing power of those already in a retired status, existing law also permits new Federal retirees who were not retired when the living cost increases occurred to benefit equally from those adjustments. A more rational method of computing adjustments of new retirees would be to prorate their adjustments to reflect only the cost-of-living increases that occur after they retire.

Proration of the annuity adjustments of new retirees would be much less costly than the existing process. For the 92,000 civil service employees expected to retire in 1978, we estimate that the retirement fund would save over $800 million in annuity payments over their expected remaining lifespans. (See app. I.) This savings estimate is conservative since annuity payments to survivors of former civil service employees and retirees were not considered in the calculation.

To illustrate how prorating the adjustments would be less costly than the existing process, assume that a civil service employee retires February 28, 1978, is entitled to a $1,000 basic monthly benefit based on length of service and average salary, and the CPI rises by 3 percent each 6-month period ending June 30 and December 31. Under existing law, the retiring employee's basic monthly benefit would be increased to $1,030 the next day, March 1, 1978, to reflect the CPI increase occurring the 6-month period ending December 1977 when the employee is still working. Effective September 1, 1978, the retiree's monthly benefit would be increased to $1,061 to reflect the CPI increase during the 6-month period ending June 30, 1978, including the months of January and February when the employee is still working and drawing full salary. Under a policy of prorating adjustments to reflect only CPI increases after retirement, the same retiree would not be eligible for the March 1, 1978, adjustment since it would represent the percentage rise in the CPI during the last 6 months of 1977, when the individual is still working. Instead, the new retiree would continue to receive the basic $1,000 monthly benefit from March 1978 through August 1978. Effective September 1, 1978, the monthly benefit would be increased by 2 percent to $1,020 to reflect the 4 months--March 1978 through June 1978--the individual would actually be retired.

While we did not develop estimates of cost savings which could also be realized under the other Federal retirement systems if the annuity cost-of-living adjustments of new retirees were prorated, the savings would be considerable. For example, over 50,000 military personnel retired in fiscal years 1975 and 1976, and those trends are expected to continue.

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Federal employees should always earn a higher basic annuity by continuing to work rather than by retiring early. We believe that the annuity adjustment policy should be changed to require prorating new retirees' annuity adjustments to reflect only CPI increases after the effective date of retirement. A similar policy exists for the Federal Employees Compensation Act program--to be eligible for a cost-of-living adjustment a recipient's disability must have occurred more than 1 year before the effective date of the adjustment. Such a policy would insure higher basic annuities for continued Federal service and should encourage valuable employees who are considering retirement to remain.

Additionally, prorating new retirees' annuity adjustments would eliminate the need for the annuity guarantee provision of the 1973 amendment. In that regard, the alternate annuity calculations required by law are difficult and time consuming for the administering agency. The Civil Service Commission said that those required calculations have increased the administrative costs of the civil service retirement system which, like the benefits, are financed by employee and Government contributions.

RECOMMENDATIONS TO THE CONGRESS

The Congress should enact legislation making the cost-of-living adjustment processes of the civil service, uniformed services, foreign service, Central Intelligence Agency, and Federal Reserve Board retirement systems more rational and less costly by (1) repealing the provisions of existing law which permit retiring employees and new retirees to receive higher starting annuities because of changes in the CPI before their retirement and (2) providing that new retirees' cost-of-living adjustments be prorated to reflect only CPI increases after their retirement.

COMPARISON OF RETIREMENT PAYMENTS UNDER THE PRESENT METHOD AND THE PRORATION METHOD OVER THE REMAINING LIFESPANS OF CIVIL SERVICE EMPLOYEES EXPECTED TO RETIRE IN 1978 (note a)

Year	Population	Average age	Total annuity payments: Present method	Total annuity payments: Proration method	Potential savings (note b)
			(000 omitted)		
1978 (note c)	92,000	57	$ 429,364	$ 418,286	$ 11,078
1979	90,068	58	822,501	795,112	27,389
1980	87,996	59	851,801	822,669	29,132
1981	85,796	60	880,267	850,162	30,105
1982	83,480	61	907,595	876,555	31,040
1983	81,059	62	933,800	901,864	31,936
1984	78,[illegible]46	63	959,518	926,702	32,816
1985	75,875	64	982,430	948,831	33,599
1986	73,068	65	1,003,078	968,773	34,305
1987	70,145	66	1,021,031	986,112	34,919
1988	67,059	67	1,034,653	999,268	35,385
1989	63,840	68	1,044,103	1,008,395	35,708
1990	60,520	69	1,049,175	1,013,293	35,882
1991	57,070	70	1,048,718	1,012,852	35,866
1992	53,532	71	1,042,750	1,007,088	35,662
1993	49,892	72	1,030,170	994,938	35,232
1994	46,200	73	1,011,179	976,597	34,582
1995	42,504	74	986,093	952,369	3[illegible],724
1996	38,806	75	954,317	921,679	32,638
1997	35,158	76	916,464	885,121	3[illegible],343
1998	31,607	77	873,333	843,465	29,868
1999	28,099	78	822,992	794,846	28,146
2000	24,727	79	767,674	741,420	26,254
2001	21,463	80	706,326	682,170	24,156
2002	18,372	81	640,870	618,952	21,918
2003	15,451	82	571,316	551,777	19,539
2004	12,763	83	500,233	483,125	17,108
2005	10,313	84	428,464	413,811	14,653
2006	8,137	85	358,345	346,090	12,255
2007	6,217	86	2[illegible],216	280,291	9,[illegible]25
2008	4,563	[illegible]	22[illegible],786	218,064	7,722
2009	3,180	88	166,794	161,090	5,704
2010	2,077	89	115,477	111,528	3,949
2011	1,254	90	73,903	71,376	2,527
2012	683	91	42,667	41,208	1,459
2013	320	92	21,190	20,465	725
2014	117	93	8,212	7,931	281
2015	31	94	2,306	2,227	79
2016	4	95	315	304	11
Total			$25,525,426	$24,656,806	$868,620

a/Using a $700 anticipated av[illegible]age starting monthly annuity based on average salary and length of servic[illegible] 6-percent annual rate of inflation and mortality factors for those [illegible] groups.

b/Based on adjusting the $700 average monthly starting annuit[illegible] of 1978 retirees only for cost-of-living increases that occur after they retire.

c/1978 amounts based on an average of only about 6-1/2 months in retired status.

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