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Subcommittee on Federal Workforce, U.S. Postal Service and Labor Policy

Retirement Readiness: Strengthening the Federal Pension System

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The views expressed in this testimony are those of the author alone and do not necessarily represent those of the American Enterprise Institute.

Chairman Ross, Ranking Member Lynch and Members of the Committee,

Thank you for offering me the opportunity to testify with regard to federal employee retirement benefits. My name is Andrew Biggs and I am a resident scholar at the American Enterprise Institute. The views I express today are my own and do not represent those of AEI or any other institution.

Legislation has been proposed that would alter federal employee retirement benefits by increasing employee contributions and reducing the percentage of final earnings replaced by the FERS pension plan. Whether to increase federal employee pension contributions or reduce pension benefits depends in part upon how federal and private sector pension provisions compare. Most research indicates that federal employees receive salaries that are at least comparable to those of private sector workers with similar levels of education and experience. Other federal employee benefits, such as paid time off, are also at least comparable to private sector levels.

Thus, the relative generosity of federal employee pensions can influence the attractiveness of the overall federal compensation package. If federal compensation drops below private sector levels then the government may have difficulty attracting and retaining employees. If federal compensation exceeds private levels, however, then taxpayer resources may be wastefully employed.

Background

Federal employees hired prior to 1984 participate in the Civil Service Retirement System (CSRS), a defined benefit pension plan that provides the entirety of their employer-provided retirement benefits. CSRS coverage does not include Social Security eligibility, meaning that CSRS benefits are intended to provide for essentially the entirety of a full-career employee's retirement income. CSRS employees contribute 7 percent of their wages to the program.

Federal employees hired since 1984 participate in a mixed defined benefit/defined contribution plan. The Federal Employee Retirement System (FERS) provides a reduced defined benefit pension while the Thrift Savings Plan (TSP) provides a defined contribution pension similar to a private sector 401(k) or non-profit 403(b) plan.

Employees contribute 0.8 percent of their wages to FERS. Contributions to the TSP are voluntary, although the federal government makes a 1 percent of salary contribution even for employees who make no deposits of their own. In addition, the government makes matching contributions for employees who do participate in the TSP. The government matches contributions dollar-for-dollar for the first 3 percent of pay contributed by the employee and 50 cents on the dollar contributions above that level, to a maximum employer match of 5 percent of salary for workers who contribute 5 percent or more of pay.

In addition, FERS-covered workers participate in Social Security on the same terms as private sector employees. Thus, total retirement income for a full-career employee could be expected to be the sum of FERS, TSP and Social Security benefits.

Comparing federal and private sector retirement benefits: Assumptions

In this section I compare the retirement benefits available to a typical federal employee versus what a similarly-paid worker in private sector employment would be likely to receive. While no illustration accurately reflects all individuals, the assumptions made in these calculations are reasonable and small differences should not materially alter the results.

I began by creating a stylized salary history for a federal employee who begins federal service in 1984 at age 34 and retires in 2012 at age 62 with final earnings of $78,650, roughly equal to a typical federal employee's salary at that age.[1] I then estimate prior year earnings using annual wage growth factors reported in the FERS/CSRS annual report.[2] The working lifetime of 28 years is consistent with average federal experience.[3] I assume retirement at age 62 in order to simplify comparisons of Social Security benefits, although the average federal employee actually retires four years younger at age 58.[4]

This illustration differs from reality in one important sense: it calculates benefits available under the FERS/TSP/Social Security combination, even though most federal employees retiring today after 28 years of service would be covered under CSRS. Since CSRS is closed to new entrants, the intent of the example is to illustrate federal and private sector benefits payable under rules and practices in place today.

For defined contribution TSP and 401(k) plans, I assume that both federal and private sector employees contribute 6 percent of pay and receive the maximum employer matching contribution. I assume that the private sector employer provides a 401(k) matching contribution equal to 3 percent of worker salaries. This is the median value calculated by the Bureau of Labor Statistics for workers classified as "Management, professional, and related."[5] Likewise, I assume that the federal government makes the maximum employer match of 5 percent of pay. Table 1 illustrates assumed pension contribution rates for federal and private sector workers.

Table 1. Assumed Pension contributions

	Federal	Private
Defined benefit	0.8%	0.0%
Defined contribution	6.0%	6.0%
Employer DC match	5.0%	3.0%

For comparability between defined benefit and defined contribution pensions, I follow Congressional Budget Office practice in assuming that contributions to the TSP and 401(k) plans are

[1] Author's calculations from OPM Fedscope data.
[2] See "Annual Report of the Board of Actuaries, Civil Service Retirement and Disability Fund Fiscal Year Ended September 30, 2010. Released February 2011.
[3] Congressional Budget Office. "Characteristics and Pay of Federal Civilian Employees." March 2007.
[4] While broadly accurate, the specifics of this stylized earnings history matter little for comparisons of the relative generosity of federal and private sector pensions. The reason is that federal and private sector workers with the same earnings would receive the same Social Security benefits and their other pension benefits are proportional to their earnings.
[5] Source: National Compensation Survey. http://www.bls.gov/ncs/ebs/detailedprovisions/2010/ownership/private/table28a.txt

invested in government bonds.[6] This adjustment recognizes the trade-off between risk and return in investments such as stocks and produces a guaranteed retirement benefit whose value can easily be compared to guaranteed benefits received through a defined benefit pension.

I assume that workers convert their TSP or 401(k) balances to an inflation-adjusted life annuity at retirement using rates published by the Thrift Savings Plan. This allows for easy comparison of DC pensions, which produce lump sums at retirement, to the annual benefit payments provided under DB pension plans.

Comparing federal and private sector retirement benefits: Results

At retirement, the federal employee would be eligible for an annual FERS benefit of approximately $23,710 per year. FERS benefits are eligible for annual Cost of Living Adjustments, although not to the full extent that Social Security benefits are. The annual benefit payable based on the federal employee's TSP account, inclusive of both worker and employer contributions, would be roughly $8,610. This amount is also assumed to be inflation-adjusted post-retirement. Finally, the federal employee would be eligible for Social Security benefits at age 62 of approximately $18,264 per year.

Table 2. Annual pension benefits at age 62

	Federal	Private
Defined benefit	$23,710	$ -
Defined contribution	$8,610	$7,044
Social Security	$18,264	$18,264
Total	$50,583	$25,308
Percent of final earnings	64%	32%

Total annual federal employee retirement benefits would equal $50,583. This amount is equal to 64 percent of earnings immediately preceding retirement. Financial advisors generally recommend a "replacement rate" of 70 to 80 percent of final earnings for an adequate retirement income. Note, however, that this example assumes a very truncated working career, beginning at age 34 and ending at age 62. Thus, for neither the federal nor private sector worker can this example render judgment on the adequacy of retirement income for a typical full-career worker.

A worker employed in the private sector would most likely rely upon Social Security and a defined contribution 401(k) pension plan for retirement income. A private sector worker with the same earnings as a federal employee covered under FERS would receive the same Social Security benefit, in this case $18,264 per year. Based on a total employee/employer contribution of 9 percent of pay to a 401(k), annual income payable from the account at age 62 would be approximately $7,044. This payment, like benefits from the TSP, is assumed to be adjusted for inflation.

Total retirement income for the private sector worker would be approximately $25,308 per year. This is equal to 32 percent of pre-retirement earnings and is almost precisely half what a federal employee with similar earnings would be eligible to receive.

Variations in the generosity of federal pensions

[6] Congressional Budget Office. *"Evaluating and Accounting for Federal Investment in Corporate Stocks and Other Private Securities."* 2002.

The example above illustrates retirement benefits using a typical federal employee. However, the generosity of pension benefits is not uniform across the federal government. For instance, relative to the standard FERS package for ordinary civil service employees, the retirement plan offered to congressional staff is roughly 1.43 times more generous per year of work; to Members of Congress, 1.55 times more generous; and to air traffic controllers and law enforcement officers, roughly 2.15 times more generous.[7]

FERS relative to state and local government pensions

Federal employees contribute 0.8 percent of their salaries to FERS and receive a benefit equal to 1 percent of final earnings multiplied by the number of years of service. Very few private sector employers offer DB pensions and where in operation private sector DB plans are generally non-contributory. However, it is possible to compare federal employee pensions to those received by state and local government workers. For purposes of comparison, I restrict myself to state/local employees who also participate in Social Security. In these state/local pensions, the average employee contribution as of 2009 was 4.8 percent of pay and the average replacement factor was 1.9 percent of final salary, meaning that state/local employees contribute roughly 2.6 percentage points of salary for each percent of final earnings replaced by their plan.[8] Federal employees, by contrast, pay 0.8 percent of salary for each percentage point of final earnings replaced, less than one-third as much. I should warn that accounting differences between federal and state/local pensions complicate these comparisons. Nevertheless, the federal employee DB pension contribution is low, even by public sector standards.

Additional federal retirement benefits

The comparison above captures the relative generosity of federal and private sector retirement benefits through a stylized example. However, this example leaves out several important benefits that may be afforded to federal workers preparing for retirement:

FERS annuity supplement: Federal employees who retire prior to age 62 with unreduced benefits may be eligible to receive a FERS supplement which approximates the value of the Social Security benefit they will be eligible to claim once reaching the Social Security retirement age.[9] The supplement allows long-career federal employees to retire prior to age 62 while receiving what is in effect an “early-early” Social Security retirement benefit.

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[7] Office of Personnel Management. “Federal Employees’ Retirement System; Normal Cost Percentages.” Federal Register /Vol. 72, No. 109. Thursday, June 7, 2007

[8] Author’s calculations from Public Plans Database.

[9] The Office of Personnel Management first estimates the individual’s Social Security benefit as of age 62. OPM then multiplies this amount by the ratio of the individual’s years of service under FERS to 40 years, taken as a full working career. For instance, an individual who retires after 30 years of federal service would have his estimated Social Security benefit multiplied by $^{30}/_{40}$ and thus receive 75 percent of the age-62 Social Security benefit. This payment continues until the earlier of age 62 or when the individual first becomes eligible for Social Security benefits. More information on the FERS Annuity Supplement is available at http://www.opm.gov/retire/pre/fers/annuitysupp.asp.

TSP investment return subsidy: There is a significant implicit subsidy to federal employees investing in the TSP's government bond fund (known as the "G Fund"). The G fund is the largest fund in the TSP, holding $128.6 billion of the $291 billion TSP total as of December 21, 2010. The G Fund invests solely in special-issue, non-tradable short-term Treasury securities, which implies that there is neither credit nor interest rate risk on the fund. However, the interest rate attributed to those short-term securities is based upon the weighted average yield on all outstanding Treasury securities with durations to maturity of 4 or more years. In effect, federal employees receive the risk premium attached to long-term Treasury securities but enjoy the lower risk of short-term securities. According to the TSP, this provides a rate of return subsidy of almost 1.8 percentage points over the yields available to private investors, including private sector workers with 401(k) plans.[10] Given a current G Fund balance of around $129 billion, the annual subsidy equals $2.28 billion, which is equal to around 2.0 percent of total federal employee payroll.

Conclusions

The TSP is a more generous defined contribution plan than the typical 401(k) offered to private sector employees, with an employer match that is larger than that offered to roughly 80% of private sector employees.[11] In addition, federal employees continue to receive defined benefit pensions, something that relatively few private sector employees are eligible for. As a result, federal employees in general receive employer contributions toward retirement benefits that are significantly in excess of those paid to similar private sector workers. Combined with salaries and other benefits that most academic studies have determined to be at least comparable to private sector levels, more generous retirement benefits can increase total federal employee compensation significantly above what is received by private sector workers with similar levels of education and experience. Given this, and given ongoing pressures on the federal budget arising from a number of sources, some have proposed changes to federal employee retirement benefits. It is my position that any benefits already accrued should not be altered. Those benefits have been promised and earned, and the obligation to pay them should be honored.

However, in the private sector it is not uncommon that pension provisions be altered on a forward-looking basis. An employer might freeze its defined benefit pension or change contribution rates to defined contribution accounts. Market discipline prevents plan sponsors from doing too little or too much in terms of changes to retirement plans. There is no legal or policy reason why public sector employees should be exempt from such changes. For instance, if the defined benefit FERS program were phased out, the retirement package offered to federal government employees would remain competitive with the vast majority of private sector employers.

Given this, it is unlikely that increases in federal employee pension contributions or reductions in pension benefits for future federal retirees would lower total compensation below federal workers' reservation wage, which represents the minimum pay at which a worker will accept a particular type of job. As a result, a less-generous federal retirement package is unlikely to significantly affect the federal government's ability to attract and retain employees.

[10] Thrift Savings Plan. G Fund Fact Sheet. Available at https://www.tsp.gov/PDF/formspubs/GFund.pdf
[11] Author's calculations based on BLS data.

Andrew G. Biggs is a resident scholar at the American Enterprise Institute in Washington, DC. Prior to joining AEI he was the principal deputy commissioner of the Social Security Administration (SSA), where he oversaw SSA's policy research efforts and led the agency's participation in the Social Security Trustees working group. In 2005 he worked on Social Security reform at the National Economic Council and in 2001 was on the staff of the President's Commission to Strengthen Social Security. Andrew's work at AEI focuses on Social Security reform, state and local government pensions, and comparisons of public and private sector compensation. His work has appeared in academic publications as well as outlets such as the Wall Street Journal, New York Times and Washington Post, and he has testified before Congress on numerous occasions. He holds a Bachelors degree from the Queen's University of Belfast, Masters degrees from Cambridge University and the University of London and a Ph.D. from the London School of Economics.

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Education

2004-2008 M.Sc. financial economics, University of London

1992-1995 Ph.D. government, London School of Economics and Political Science

1991-1992 M.Phil. social and political theory, Cambridge University

1988-1990 B.A. philosophy (honors), Queen's University of Belfast

1986-1988 Middlebury College

Professional background

2008-present	Resident Scholar, American Enterprise Institute
2007-2008	Principal Deputy Commissioner, Social Security Administration
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2005	Associate Director, White House National Economic Council
2003-2007	Associate Commissioner for Retirement Policy, Social Security Administration
1999-2003	Social Security Analyst, Cato Institute
2001	Staff analyst, President's Commission to Strengthen Social Security
1998-1999	Director of Research, Congressional Institute
1996-1998	Assistant communications director, House Committee on Banking and Financial Services

Miscellaneous

Research associate, Center for Retirement Research, Boston College

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Published in the *New York Times*, *Wall Street Journal*, *Washington Post* and other major publications

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Recent Publications

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