Issue Brief

Federal Employees' Retirement System and the Thrift Savings Plan: Creating a Combined Approach to Retirement Security

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ABOUT THE AUTHOR

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Prior to her service on Capitol Hill, Ms. Oakley held leadership positions with TIAA-CREF, a leading financial services provider. During her 28-year tenure with the organization, she held a number of management, public policy, and technical positions. She began as an actuary and was promoted to positions including vice president for special consulting services and vice president for associations and government relations.

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ABOUT NIRS

The National Institute on Retirement Security is a non-profit research institute established to contribute to informed policy making by fostering a deep understanding of the value of retirement security to employees, employers, and the economy as a whole. NIRS works to fulfill this mission through research, education, and outreach programs than are national in scope.

Executive Summary

From the employer's perspective, the primary reason for offering a defined benefit (DB) pension plan is to attract, retain, and manage a qualified workforce. From the employee's perspective, they are interested in maintaining a reliable stream of income that will last throughout their retirement years while maximizing compensation during their working years.

Realizing that individual employees and employers have additional financial objectives and that the concerns of broader stakeholders may influence retirement plan design, there is an interest in how long-term retirement security objectives can be met through a combination of the group DB pensions and individual defined contribution (DC) savings plans.

KEY POINTS

- The retirement policy discourse in 1986 was much different than those occuring today.
- Knowledge of the experience of FERS and TSP can inform today's discussion on reform.
- Mandating all newly hired state and local employees participate in Social Security has sharply different budget consequences for state and local government than it did for the federal government.

The catalysts for creating DC plans that operate in conjunction with traditional DB plans will vary for each situation. One of the most well-known transformations of a pension system occurred when President Ronald Reagan signed the Federal Employees' Retirement System Act into law on June 6, 1986. This law moved federal employees from the Civil Service Retirement System (CSRS), to a retirement system that integrated Social Security, a DB pension, and a DC savings plan.

This issue brief reviews this new system, known as the Federal Employees' Retirement System (FERS). More specifically, this issue brief explores its impact on the funding of benefits and the adequacy of retirement income benefits for federal employees over the last twenty-five years. Developed in conjunction with a change that mandated new federal employees participate in Social Security, the 1986 law provides federal employees with retirement income from three components rather than the one annuity payment from CSRS.

What transpired in 1986 differs from the retirement policy discussions occurring today about DB and DC retirement plan approaches and their impact on plan costs. The impetus then was to adjust CSRS benefits levels to reflect the income benefits that would be paid to federal employees who would be covered by Social Security. The progressive nature of the Social Security benefits complicated the structure of the FERS system which Congress addressed by adopting a combination of DB and DC retirement plans.

Because Social Security retirement income benefits generally act like DB pension benefits, in that they provide a steady, secure source of income that cannot be outlived, the benefit multipliers in the FERS were designed to be significantly lower than those in the CSRS. For most covered employees, FERS retirement benefits accrue at the rate of 1.0 percent for each year of service. A worker with 30 years of service will receive a pension benefit that will replace 30 percent of the high-three year average salary. Benefits increase slightly in the formula for long service employees who retire after age 62. If the above worker retires after age 62, the benefit would increase to 33 percent of final average salary. Generally, FERS covered employees contribute 6.2 percent of salary to Social Security and an additional 0.8 percent of salary to the FERS pension. Due to a recent change in law, new federal employees will be required to contribute 3.1 percent of salary to FERS as of January 1, 2013.

The Thrift Savings Plan (TSP) is the individual DC savings portion of FERS. Federal employees covered under FERS receive a 1.0 percent of pay contribution to the TSP by their agency. To encourage employees to also save in the TSP, federal agencies match their employees' voluntary contributions. For the first 3 percent of pay each employee contributes to the TSP, the agency matches it on a dollar for dollar basis. For the next two percent of pay an employee contributes, the match is 50 cents on the dollar.

The investment choices in the TSP allow for diversification among four indexed investment funds and a government bond account. Since 2005, Lifecycle funds offer a packaged mix of the five core funds based on an anticipated retirement age. These L Funds are designed to provide employees a glide path for investing their retirement savings by moving from balanced portfolios with a riskier mix of assets early in careers and moving to less risky investment as the retirement date approaches.

For many federal employees, participation in Social Security, FERS, and the TSP for 30 years can translate into a lifetime retirement income similar to benefits under CSRS. The Office of Personnel Management (OPM) estimates the cost of the FERS pension to equal 12.7 percent of payroll. Offsetting that total cost by the employee's 0.8 percent of salary contribution, the agency cost for FERS is 11.9 percent of payroll in 2011. Combining that cost with the 6.2 percent of pay employer cost for Social Security and the automatic 1.0 percent of pay TSP contribution, the federal agencies pay about 19 percent of payroll for employees covered by FERS.

That cost is similar to the federal agency and general treasury cost for federal employees still covered under CSRS, which is 19 percent of payroll. If federal employees contribute five percent of salary and are eligible for the full TSP matching contribution then the cost of the retirement plans would exceed the cost of the original CSRS benefit by about 4 percent of payroll.

Origins of the Federal Retirement System and the Thrift Savings Plan

Congress created the Civil Service Retirement System (CSRS) in 1920 to provide a pension for civilian federal employees.[1] The annuity benefits under CSRS are based on a graded benefit formula with a multiplier that increases with three steps, starting at 1.5 percent of salary, jumping to 1.75 percent of salary in year six of service and reaching 2 percent of salary in the eleventh year of service then remaining at that level until retirement. Under CSRS, benefits are based on highest three-year average salary and the formula replaces 56.25% of final salary for a civilian employee who retires with 30 years of service.[2] Federal employees covered by CSRS, which currently constitute less than one-sixth of the federal workforce, contribute 7 percent of their pay to the program.

When the Social Security System was created during the Great Depression, there was no need to cover federal employees in Social Security because they had retirement benefits through CSRS. So, federal CSRS employees do not earn Social Security benefits when they work for the federal government. Voluntary Social Security coverage eventually was extended to state and local government employees during the 1950s. While about three-fourths of state and local employees are now covered by Social Security, significant numbers of public employees in certain states, such as California, Texas, Ohio, Illinois, and others do not participate in Social Security. Generally, the benefits provided by public pension systems in these states tend to be higher than those provided to other public employees covered under Social Security, and the employee plan contributions are greater.

In the early 1980s, the Social Security Trust Fund faced an immediate cash flow crisis. Part of the compromise legislation enacted in 1983 to bring long-term solvency to Social Security involved expanding the Social Security tax base by extending coverage to federal employees hired after December 31, 1984. Federal employees hired before that date remained outside of Social Security and were able to continue to participate in the CSRS.

After about three years of legislative deliberations, Congress passed the Federal Employees' Retirement System Act and President Ronald Reagan signed it into law on June 6, 1986.[3] Congress developed the Federal Employees' Retirement System (FERS) with Social Security as its first level of retirement income. Retirement income for new federal employees would come from the three components of what many in the retirement industry refer to as the three-legged stool: Social Security, a defined benefit (DB) pension, and individual defined contribution (DC) retirement savings accounts under the Thrift Savings Plan (TSP).

Developing the Federal Employees' Retirement System (FERS)

As Congress considered changes to the Federal retirement program that resulted in the creation of FERS, issues of appropriate benefit levels, sustainability and cost reduction also were discussed.[4] Without changes to the CSRS, newly hired federal employees would have contributed over 13 percent of pay for coverage under CSRS and Social Security. Legislators sought to avoid this, and the total employee contribution to Social Security and to FERS was set to equal the employee contribution to CSRS of 7 percent. In 2012, Federal employees covered by FERS contributed 6.2 percent of earnings to Social Security and contributed 0.8 percent of earnings into FERS.[5] With Social Security replacing a portion of preretirement earnings with lifetime benefits that are indexed for increases in the cost of living, the FERS benefit formula created in the law represented a reduction from the multipliers in the CSRS benefit formula.

Generally, workers covered under FERS can retire at age 62 once they have 5 years of service. However, FERS employees can retire as early as 55 if they were born before 1948. This early retirement age gradually increases until it will reach age 57 for those born in 1970 or later. In 2011, a worker who has completed at least 30 years of service can retire with an unreduced benefit at age 56. An employee with 20 or more years of service can retire with an unreduced benefit at age 60. For those who do not satisfy these requirements but want to start benefits before age 62, a reduced benefit is available for those who have 10 years of service.

FERS retirement benefits accrue at the rate of 1.0 percent for each year of service. A worker with 30 years of service will receive a pension benefit that will replace 30 percent of the high three-year average salary. FERS credits a slightly higher multiplier rate of 1.1 percent per year in the benefit formula when an employee has 20 or more years of service and retires at age 62 or older. So, for an employee with 30 years of service, delaying retirement until age 62 would increase retirement income benefits so as to replace 33 percent of high-three average salary.

Because Social Security retirement benefits cannot begin before age 62, Congress included in the FERS a temporary supplement for federal workers who retire before age 62. The FERS supplement is equal to the portion of the Social Security benefit to which the worker will be entitled at age 62 based on his or her years of federal employment under FERS. The supplement is paid until age 62 to workers who retire at the minimum retirement age (56) or older and are eligible to collect an unreduced FERS benefit based on age and service.[6]

In addition to increasing the minimum retirement age, one of the other provisions in FERS that would reduce costs involved the calculation of cost of living adjustments (COLA) for FERS benefits. Unlike the benefits paid under CSRS which are fully indexed for inflation using the Consumer Price Index for Wage and Salary Workers (CPI-W), FERS benefits are only partially inflation indexed. If the CPI-W increases by less than 2 percent, then the COLA for FERS is fully indexed. When the CPI-W increases by a greater percentage, then the COLA increase is the greater of 2 percent or CPI-W less 1 percent. For example, if CPI-W increases by 5 percent, then the FERS COLA is 4 percent. In addition, COLA payments under FERS are not made to retirees who are under age 62, unless they were disabled.[7]

Creating the Federal Thift Savings Plan

Crafters of the new FERS plan also wanted to include in the new package DC indvidual savings accounts. Employees of large companies at that time often had savings or stock option plans to supplement their DB pensions. During the years of debate that occurred prior the enactment of the legislation that created FERS and the TSP, Senator Ted Stevens (AK) served as Chairman of the Senate Government Affairs Subcommittee on Civil Service. Senator Stevens was instrumental in creating the new retirement program's DC component. According to Jamie Cowen, Chief Counsel to the Subcommittee, Senator Stevens' goal was to create "a voluntary defined contribution 'Thrift Savings Plan,' in which workers could contribute a percentage of pay to be matched in part by the government."[8]

The "thrift plan" terminology, which was the term of art for many DC plans offered by corporations, subsequently was replaced by referring to such savings plans by using Section 401(k) of the tax code. Created in 1978, Section 401(k) allowed employees to make pre-tax contribution to profit sharing and thrift plans as supplements to DB plans. 401(k) plans were just beginning to grow in popularity in the mid-1980s.

The Senate passed its FERS bill with a dollar for dollar match of contributions to the DC plan, while the House of Representatives passed a bill with a more modest DC component based on their concern that lower income workers would not be able to afford to participate in the plan. The final compromise that emerged from the FERS legislative conference that occurred between the House and Senate found a balance between the two versions of the bills.[9]

Under the compromise, all new employees would automatically participate in the TSP based on their agency contributing 1 percent of pay. Further matching funds from the agency would encourage employees to contribute to the TSP based on a match formula, which could add as much as 4 percent of pay. The total amount could equal up to 10 percent of salary based on a five percent contribution from the employee. The matching contributions made to the TSP by the employing Federal agency vary with the contributions made by the employee as follows:

Government Matching Rate on TSP Contributions by FERS Participants

(as a percentage of salary)

Employee	Government Agency	Total
0.0	1.0	1.0
1.0	2.0	3.0
2.0	3.0	5.0
3.0	4.0	7.0
4.0	4.5	8.5
5.0 or more	5.0	10.0

Source: Thrift Savings Plan

CSRS participants may voluntarily participate in the TSP, but no matching contributions are made on their behalf. Also, FERS participants can contribute more than the 5 percent of salary that the agency matches. The total amount that could be contributed to the TSP by Federal workers was initially limited to the lower of 10 percent of pay or the annual dollar limit under Section 402(g) of the tax code. The general structure of the TSP has remained steady since the law's passage; however, recent changes include eliminating the 10 percent cap on employee contributions, automatically enrolling new employees, and including a modest rage of additional investment options.

Newly hired employees are not eligible for employer matching contributions for 6 to 12 months, depending on the date on which they were hired.[10] All TSP participants are immediately and fully vested in their contributions to the plan, federal matching contributions, and any growth in the value of their accounts. Generally, participants are fully vested in the 1% agency automatic contributions to the TSP after three years.[11]

Another policy issue that needed to be resolved in the creation of the TSP dealt with private investments held by a federal government savings fund. The solution, developed with guidance from Senator William Roth (DE), was "a passive investment approach, where the eventual Federal Thrift Board would choose a stock index investment fund (such as a Standard & Poor's 500 stock index) into which employees could invest."[12] Initially, employees had three investment choices in the TSP:

- Special Treasury securities (G Fund)
- Fixed income securities or Guaranteed Investment Contracts (F Fund)
- The Indexed Stock Account (C Fund)

TSP — a Quarter of a Century Later

As of November 30, 2011, the assets in the Federal Thrift Savings Plan totaled $291.8 billion.[13] 4.5 million active and retired Federal employees participated in the TSP as of December 2011. The average TSP participant's account had a balance of $63,392 as of December 2011.[14] 85 percent of FERS employees eligible to participate in the TSP made payroll contributions in December 2011. TSP participation among the much smaller ranks of CSRS covered employees was 67%, which is still a significant participation level, considering that CSRS employees are not offered matching contributions to encourage participation.[15]

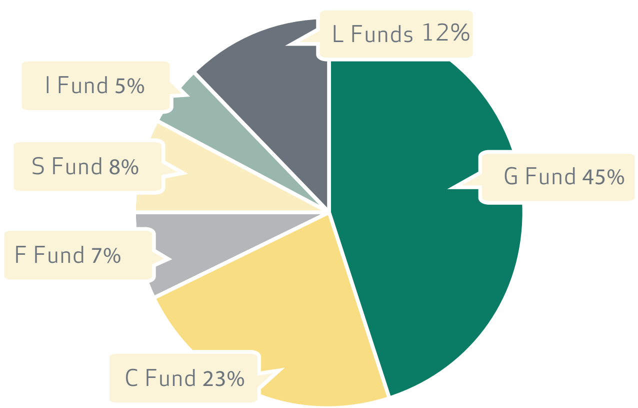
While the total amount that could be contributed to the TSP by federal workers was initially limited to no more than 10 percent of pay, today all employees can contribute up to the same limit that applies to 401(k) accounts, which is $17,000 in 2012. Additionally, federal employees who are age 50 and over can contribute up to $5,500 more in so called "catch-up" contributions.

Currently, participants in the TSP can invest in one or more of five funds directly or into Lifecycle Funds (L Funds), which invest in various combinations of the five existing TSP funds based on expected withdrawal dates. These L Funds are designed to provide employees a glide path for investing their retirement savings by moving from balanced portfolios with a riskier mix of assets early in careers to less risky investment allocations as the retirement date approaches. The core TSP funds are:

- The "C Fund," which invests in stocks of corporations represented in the Standard and Poor's 500 index.
- The "F Fund," which invests in fixed income securities represented in the Barclays Capital U.S. Aggregate Bond Index.
- The "G Fund," which consists of U.S. government securities and pays interest equal to the average rate of return on long-term U.S. government bonds.
- The "S Fund," which invests in the stocks of smaller companies that are represented in the Wilshire 4500 Index.
- The "I Fund," which invests in stocks of foreign companies based on the Morgan Stanley Capital Investment EAFE (Europe, Australia-Asia, Far East) Index.

As a share of TSP total assets on November 30, 2011: the G Fund held 45%, the C Fund held 23%, the F Fund held 7%, the S Fund held 8%, the I Fund held 5%, and the L Funds held 12%. The L Funds invest in the other five TSP funds.[16] The costs to administer the TSP are paid from its assets. Administrative costs of the TSP in 2010 reduced earnings in the funds by 0.025 percent or about 25 cents for each $1,000 invested.[17] By comparison, asset management fees for private sector 401(k) plans range from 60 to 170 basis points.[18] Actual investment performance for the TSP funds is available in the Thrift Savings Plan Fund Investment booklet an on their website at: https://www.tsp.gov/investmentfunds/returns/returnSummary.shtml.

Figure 1: Distribution of Thrift Savings Plan Assets
November 30, 2011



In actuality, higher income federal workers, earning more than $100,000 and covered by the FERS plan and the TSP, have reported holding a higher percent of their TSP accounts held in stocks. According to a 2008 survey of TSP participants, higher income workers between ages 40 and 50 invested 47 percent of their TSP accounts in the stock investment funds while lower income employees from the same age group invested only 29 percent of their assets in stocks.[19]

An analysis of the retirement start dates of federal employees after the financial crisis by Matthew Gustafson of the University of Rochester indicated that federal employees reduced their annual retirement rate from 20 percent to 15 percent.[20] Moreover, FERS employees lowered their retirement rate by 30 percent during the crisis, which is a 50 percent larger reduction in retirement than occurred among retirees covered by the CSRS plan. The trend to delay retirement was especially pronounced among FERS employees earning $100,000 or more. In fact, 37 percent of high income retirees delayed retirement until after the end of the crisis even though only about 20 percent of their retirement income wealth was based on the TSP.[21] The losses in the TSP translated to a 3 percent reduction for higher income FERS participants while lower income FERS participants a experienced a 1 percent loss.[22] This is not unexpected since the progressive nature of Social Security benefits and FERS benefits provide lower income federal employees with a higher portion of predictable retirement income.

Replacement Rate for FERS Covered Employees

Social Security is designed as a social insurance plan and it pays benefits under a progressive formula that replaces a higher percentage of income at lower career earnings levels. Thus, the combination of Social Security and the FERS annuity provide most career (30 years) federal workers at GS-4 level or lower with a lifetime retirement income of 57 percent or more of final three year salary, which is comparable the replacement income level (56.25%) that CSRS provides for a 30-year career. Moving up the GS pay scale, for workers at pay grade GS-8 to reach a par with the initial CSRS benefits, workers need not only Social Security and the FERS annuity but also the automatic TSP contribution of 1 percent of pay. Employees above the GS-8 level must make some employee contributions to the TSP, which together with matching agency contributions, would then replace at least 56.25 percent of income.[23] The results of an analysis of projected FERS, Social Security, and TSP benefits, as prepared by the Congressional Research Service (CRS), are summarized below:

Pre-tax Replacement as a Percent of Final Salary Under FERS

Employee Grade Projected Final Salary	GS-4 $48,331	GS-8 $74,180	GS-12 $118,819	GS-15 $196,401
FERS Retirement Annuity	32%	32%	32%	32%
Social Security	25%	21%	19%	14%
TSP Annuity (1% Agency Contribution)	3%	3%	3%	3%
Total Replacement Rate	60%	56%	54%	49%
TSP Annuity with 5%/5% Employee/ Agency Match	25%	25%	25%	25%
Total Replacement Rate with 10% TSP	82%	78%	76%	71%

Assuming: Employee Retiring at Age 62 After 30 Years of Service on December 31, 2040
An average annual nominal rate of return on TSP of 6.0%
Only Social Security benefits earned while a federal employee
TSP income based on single-life annuity at annuity interest rate of 3.125%.

Source: Estimates prepared by the Congressional Research Service, RL 30387, p.12-13

The progressive nature of old age benefits from Social Security means that it replaces a greater percentage of income for federal workers at the lower levels of the pay scale. For example, according to the CRS calculations in the above chart, a GS-4 employee who retires at the end of 2040 with a projected final salary of $48,331 at age 62 after 30 years would replace 25 percent of final salary from Social Security. A GS-15 employee who retires with a projected final salary of $196,401 would replace only 14 percent of final salary from Social Security with the same age and service history.[24]

Assuming the same retirement age and years of service, federal employees at all GS levels would replace the same percentage (32%) of final pay from their benefits earned in FERS.[25] Benefits from Social Security and FERS would increase over the years in retirement after age 62 based on COLA increases, but FERS benefits could increase at a slower pace if the rate of inflation increases by more than 2 percent.[26]

The level of income replaced by the TSP will also be the same for all GS salary levels assuming a given contribution rate and the same investment earnings over time. The actual value of assets in each participants account will vary, however, depending on a number of factors, including: the percentage of salary contributed to the TSP, the number of years participating in the TSP, the historical rates of return among the funds, the distribution of employer and employee contributions among the funds, and transfers of account balances among the funds by employees. For example, the 25 percent income replacement is based on a 6 percent investment earnings assumption. If investments returned 8 percent interest instead, then the TSP annuity would replace 34 percent of pre-retirement income instead of 25 percent.[27]

Funding

Initially, CSRS operated as a pay-as-you-go retirement system. In other words, benefits to retired workers were paid from current contributions made to the plan. This approach was often the case for many pensions, both public and private, before the passage the Employee Retirement Income Security Act of 1974 (ERISA).

Since the ERISA became law, private employers have had to comply with minimum funding requirements in order to take advantage of the employer tax benefits associated with offering what is often described as a "qualified" pension plan. While state and local government pension sponsors are not subject to ERISA, public pension plans have benefited from pre-funding, as interest earned on plan assets has reduced the direct outlay that otherwise would have been needed to make benefit payments.[28] By the early 2000s, public pensions reached funding levels that exceeded 100 percent in aggregate without any federal funding requirements.[29]

Under both CSRS and FERS, employees and their agencies must make contributions into the Civil Service Retirement and Disability Fund (CSRDF). In addition to the required 7 percent of pay employee contribution toward the cost of CSRS, the employing federal agency has to make a 7 percent of pay contribution as part of funding CSRS benefits, and the Federal government contributes an additional 12 percent of pay from general Treasury revenue. When Congress created FERS, it required the plan to be fully funded by employee and agency contributions. Since FERS-covered employees put 6.2 percent of pay into Social Security, they currently contribute 0.8 percent of pay into the CSRDF. So, the employing federal agencies must therefore make contributions equal to 11.9 percent of their FERS employees' pay into CSRDF.[30]

According to an analysis of the FERS prepared by a CRS team in July 1986, the total cost of the CSRS was 32.0 percent of payroll at the time. While the new FERS program, Social Security, and TSP was estimated to cost in total 32.8 percent of pay, the distribution of those cost resulted in a slight shift in costs to the federal employees. The total cost of the FERS pension was 14.8 percent, with employee contributions reducing the employer share to 13.6 percent. When federal agencies added their employer's 5.9 percent of pay contribution to Social Security (based on the payroll tax rate in 1986) and the automatic 1.0 percent contribution to TSP, the lowest total cost per employee was 20.5 percent of a new employee's salary. The federal government had an additional exposure for matching TSP contributions, but participation was much lower in the 1980s than it is today, so CRS estimated that agencies would have to add 2.4 percent of pay as the TSP match.[31]

The following chart makes the comparison of the sharing of pension costs in 1986 and in 2011:

Comparison of Employer-Employee Shares of Entry Age Normal Costs of FERS

	1986*		2011*	
	Employer	**Employee**	**Employer**	**Employee**
FERS DB Annuity	13.6%	1.2%	11.9%	0.8%
Social Security	5.9%	5.9%	6.2%	6.2%
TSP Automatic	1.0%	0.0%	1.0%	0.0%
TSP Voluntary	2.4%	2.8%	3.0%	3.0%
TOTAL	**22.9%**	**9.9%**	**22.1%**	**10.0%**

* 1986 breakdowns adapted from analysis in CRS Report 86-137 EPW
** Author's calculation, assuming 3 percent auto-enrollment

It is notable that according to the most recent figures from OPM, the cost of the CSRS annuity benefits is equal to 26 percent of pay and the cost of the FERS annuity and supplement is equal to 12.7 percent of pay.[32] Thus, the federal government's annual cost for the CSRS (19%) now approximates the minimum cost (19%) of the package of retirement benefits for FERS covered employees. Those costs include: Social Security at 6.2 percent of covered payroll, FERS at 11.9 percent of pay, and the automatic 1.0 percent of pay contribution to the TSP. In fact, the federal government's pension cost exposure runs even higher, given the high percentage of employees covered by FERS making contributions to the TSP. The matching formula could add as much 4 percent of pay to the federal agency's cost for each FERS employee. Based on the automatic enrollment of new federal employees into TSP with a 3 percent of pay contribution and 100 percent matching contribution by the federal agency, it is interesting to note that only a modest shift in the breakdown of retirement cost sharing for FERS employees occurred between 1986 and 2011. If federal employees contribute five percent of salary and are eligible for the full TSP matching contribution then the cost for the FERS plan would exceed the cost of the original CSRS benefit by about 4 percent of earnings.

At the end of FY 2010, the CSRDF had a balance of $774.2 billion, and the law requires this fund to hold only U.S. Treasury bonds. Since the assets supporting the federal retirement plans' promises are Treasury securities, the actual federal budget outlays are annuity payments to retirees and other beneficiaries. Because CSRS retirement benefits have never been fully funded by employer and employee contributions, the CSRDF has an unfunded liability. The unfunded liability was $673.1 billion in FY2009 will continue to rise until about 2023, when it will peak at $748.9 billion.33 When the CSRDF redeems the Treasury bonds that it holds, the Treasury must raise an equivalent amount of cash by collecting taxes or borrowing from the public.

While the CSRDF obtains income from its two main sources, employee and agency contributions, only the employee contributions are income to both the fund and the Federal government, since the agency contributions are intergovernmental transfers that have no effect on the government's annual budget deficit or surplus. If CSRDF could invest its assets in private-sector securities such as corporate stocks and bonds, it would result in higher Federal expenditures since money would go outside of the federal government.[34]

Concluding Observations

First, several panels of federal budget experts have suggested expanding the Social Security tax base to include all newly hired state and local employees. The rationale is that this could improve the overall solvency of Social Security or could reduce the Federal deficit. In that context, understanding the distinctions between such a proposal to expand Social Security coverage to the state and local employees currently not covered by Social Security and the expansion to federal employees in 1983, which became a driving force in the creation of FERS, could inform the policy discussion.

The budget issues in expanding Social Security to a wider group of public employees is more complex than the very modest impact that occurred to the federal budget in 1983. Bringing in new federal employees into Social Security improved the system's cash flow but was cost neutral to the federal government under the overall federal budget. Proposals for mandatory coverage of newly hired state and local employees result in the direct opposite for states and local governments should they be implemented. Those governments would face a significant budget cost increase.

In March 2011, the Congressional Budget Office (CBO) issued a report, Reducing the Deficit: Spending and Revenue Options, which found that extending the Social Security tax base to cover all state and local workers hired after December 31, 2011 would increase federal revenue by $96 billion over the next ten years.[35] While this would increase the number of beneficiaries who would eventually draw Social Security benefits, in most case decades in the future, it would have little impact on Social Security in the short term. The value of the additional Social Security benefits paid over the coming decades to the broader group of beneficiaries from the state and local governments would only be half of the increased federal revenue.[36]

From the viewpoint of many state and local governments, covering all new employees under Social Security would represent a significant increase in state budget outlays. It would require both the employee and public employer to pay an additional 6.2% of payroll. CBO acknowledges this situation when it further explains that "an argument against such a policy change is that it might place an added burden on some state and local governments, which already face significant budgetary challenges."[37] Billions of dollars that states could use to address local issues would be diverted to the federal government.

Second, in the wake of the financial crisis of 2008 and 2009, the vast majority of state and local governments have made adjustments to public pension plans to move the plans to more solid funding positions to ensure their long term sustainability. According to the National Conference of State Legislatures, some of the most frequent changes have been to increase employee contributions and to make adjustments to pension benefits, such as increasing retirement ages and reducing benefit multipliers.[38]

In that regard, it is interesting to note that the challenges that Congress struggled with as they explored ways to provide some parity of treatment between different groups of federal employees in 1986. For example, the TSP was adopted in part to address an inequity faced by some federal employees at the top of the GS pay scales who would get less retirement income from FERS and Social Security because of the progressive nature of Social Security benefits. In fact, the structure of FERS with a modified DB plan, Social Security, and the TSP as a DC savings plan today costs more than the cost of the older CSRS plan. This occurs because auto-enrollment has increased the participation levels in the TSP so that nearly all new employees contribute at least 3 percent of salary to the TSP which is then matched by federal agency contributions.

Lastly, recent actions taken by Congress suggest that while the federal government had not adopted major changes to the retirement systems covering federal workers since 1986 nor acted to achieve cost savings over the last decades, the current budget pressures have changed the environment. Prior concerns about fairness across employee groups have given way to a situation where cuts to compensation packages for the federal workforce are seen as possible offsets for other spending or tax relief for other Americans.

On February 22, 2012, The Middle Class Tax Relief and Job Creation Act of 2012 was signed into law by President Obama. Federal employees who are newly hired and rehired after December 31, 2012 and have less than five years of civilian service will have to contribute 3.1 percent of salary to FERS for retirement benefits, instead of the 0.8 percent of salary for existing FERS employees. Unlike the State governments where such additional employee contributions often help improve the solvency of the pension systems, the additional revenue generated by the higher employee contributions was used to offset other federal tax benefits and programs extended in the bill. This change represents a shift from the approach taken by Congress when it created FERS and worked to create an approximate balance between the two retirement systems that cover federal employees.

Endnotes

1 Civil Service Retirement Act of 1920. P.L. 66-215.

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