Legislator, Heal Thyself

The Two-Faced Tale of Pension Politics

An Honors Thesis (ID 499)

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INTRODUCTION

In the early seventies, a great hue and cry was raised concerning the Teamsters and their pension funds, rather, the lack of funds. Big business was blamed and backed to a wall. The public pointed an accusing finger at everyone involved from top management down to the lowly pencil-pusher in payables. The problem centered mostly around the accounting for the Teamsters' pension funds and the people responsible for that accounting.

Congress, in its desire for justice, passed the Pension Reform Act of 1974. It is a good, comprehensive piece of legislation. According to one source, "It attempts to safeguard employees' pension rights by mandating many pension plan requirements...... The Act is quite specific about the reporting requirements of pension plans that are administered as entities separate from the employer."¹

The accounting profession had not been blind to the topic of pensions before passage of the Act. As early as 1966, the Accounting Principles Board (APB) issued Opinion #8 to coordinate accounting policies relative to pensions.² The APB is part of a program designed for research. Its purpose is to guide the accounting profession in reducing the amount of inconsistency in practice. It was apparent that it was the concern of business and Congress that the retired employees be provided for adequately.

All pension plans operate under the same basic structure. The employees and the employer agree on the benefits that are to be provided upon retirement. The organization must determine how much it needs to begin saving now to be able to insure the availability of those benefits
to the employee upon retirement. This estimation process is a crucial one; it is usually done by actuaries and it is based on life expectancy, cost of benefits, and the effects of inflation. The company then funds, or provides money for, these benefits by making payments to an agency that is set up specifically to take this money from the company, invest it, and then distribute it in the form of benefits to retired employees. Some plans, however, are unfunded. Payments to retirees covered under this type of plan are made as they become due; there is no "saving" done. This type of system has been outlawed for private pensions. It is still in use by the government.

There are basically two ways to fund a pension system. One way is called non-contributory; the employer bears the full cost. The other is contributory; the cost is shared by the employee and the employer in some mutually agreed upon ratio.

EXPLANATION OF THE PROBLEM

The Results of the Pension Reform Act of 1974 in the Private Sector

Pursuant to the passage of the Act, the Financial Accounting Standards Board (FASB) issued its own statement. The FASB is an independent board which replaced the APB and was established to oversee the setting of financial accounting standards. The FASB in its Interpretation Statement said that no amendments were needed to the standards set in APB Opinion #8.

The Act itself sets many new guidelines. For example, reports,
complete with supporting schedules and any relative statements, must
be filed annually. These reports, statements, and schedules are to be
audited by certified public accountants.

In effect, the Pension Reform Act of 1974 only served to put more
stringent regulations on the funding of private retirement systems. The
private sector, under the leadership of organizations such as the APB
and the FASB, had already been heading in the direction indicated by the
Act. This Act, also known as the Employee Retirement Income Security
Act of 1974 (ERISA), merely hurried things along. This expediting measure
was not unnecessary.

From this account, one could conclude that all was rosy on the path
to retirement. There is, however, one large, ominous black cloud. These
storm warnings come from the mismanagement of federal pensions. The
Congress, in its infinite wisdom, did not see fit to make itself subject
to the Pension Reform Act. The reasons for this monumental exclusion are
obscure, to say the least. However, are federal retirement systems not
concerned with "security" for their retired employees? Are they not
concerned with adequate funding? Or, is it that federal retirement
systems already adhere to the guidelines established through the Act?
Hardly. One only needs to read further to determine by how much the
guidelines for public retirement systems miss the mark Congress set for
private systems.

The Current Situation in the Public Sector

Retirement, and the benefits involved therein, is a big selling point
for the federal government. What these jobs cannot match in current salaries they compensate for in retirement benefits. The government promises wonderful benefits with little or no contribution from the employees. To those farsighted individuals who are concerned about retirement, this sounds great. The problem does not lie in the ratio of employee-employer contributions, however. The problem lies in the management of those contributions.

Accounting for any funds of a government agency is different from accounting in private industry. Accounting for a governmental unit, federal, state, or any other, emphasizes legal form over economic substance. The opposite is true of financial accounting in industry. The reason for this difference is that the expenditures of the various government units must be authorized by their respective legislatures. Governmental units should be held accountable to more than the legislators defining these units' budgets. In fact, one accounting text defined this accountability as stewardship. "The primary responsibility of governmental entities in financial reporting is to demonstrate adequate stewardship for resources provided by their citizenry." In the matter of federal pensions, this stewardship is nonexistent.

While it is true that government accounting does not have available to it the same system of accruals and deferrals used by private industry, that is not an excuse for the unaccountability exhibited by the government. The amount of unfunded liability is more than $200 billion at the federal level. The unfunded liability is the amount by which the expense of benefits exceeds contributions to the fund. The type of funding done
will cause that amount to increase steadily. Some government-sponsored retirement systems are unfunded, as defined earlier. Admittedly, the blame does not rest totally with the method of funding; inflation has hurt, too. All of the pension plans in use at the federal level involve an automatic cost of living increase. Unfortunately, the amount of this increase is not taken into account when the funding occurs. This is the epitome of a vicious circle.

Tracing the reasons for this unfortunate state of affairs leads to another integral part of the federal pension formula: employees covered by those plans can retire as early as age 55. The General Accounting Office (GAO) has suggested an increase in that minimum limit to relieve some of the financial pressure. In 1976 actuaries estimated that contributions from employees and the government would have to exceed total payroll by 28% to stay even with increases due to inflation. In that same year, the federal government was financing the unfunded liability with money out of the general revenues, thus placing more of the burden on the taxpayer.

Like private pensions, the receipts from government retirement funds are invested. Unfortunately, government funds are invested at very low rates. They are required, by law, to be invested in federal securities. No cash is involved in this transaction, only bookkeeping entries. Therefore, the funding does not create a financial burden for the government.

When funds are needed to make benefit payments, the Treasury obtains cash through normal channels such as taxation and the issuance of bonds.
There are no uniform practices or principles that exist in financing and funding federal retirement systems. Some require employee contributions; some do not. The different requirements of some retirement systems are discussed later.

THE TWO-EDGED SWORD OF FEDERAL RETIREMENT

The Growing Unfunded Liability

A Widening Federal Pension Gap...
Contributions from civil service workers and government are expected to fall increasingly short of benefits paid.

...And Unfunded Liabilities
They will double in the next ten years for U.S. civil service employees alone.

These charts are perhaps the best way to illustrate the growing financial disorder in federal pensions. It can be plainly seen that benefits are being promised faster than money from contributions are being accrued. The unfunded liabilities are growing at an alarming rate. This is due partly to increased benefits and partly to unfunded cost of living.
adjustments. What cannot be seen from these graphs are the two facets of the problem. Not only is the liability grossly unfunded, but the benefits and portability of retirement credit vary from system to system.

The Basis of Computation

When a pension plan is adopted, there is usually some recognition given to service rendered before the date of adoption of a particular plan. This period of time, from the date of employee eligibility under the plan until the date of adoption, is known as past service time. The costs associated with funding benefits arising from this period are known as past service costs. There is a second time period associated with pension benefits. This time period runs from the date of adoption forward. Any costs associated with this period of time are called normal costs.

The normal cost of the federal offices researched is computed on a static basis. That is, future pay increases and cost of living increases to the annuitants are not taken into consideration. If they were included, the plan would then be functioning on a dynamic basis as are all of the private programs.

While most annuities are based on salary and length of service, general pay and annuity increases have occurred frequently and in large amounts. For example, white collar pay has increased 65% and annuity adjustments have gone up 80% since 1969.

Agencies and employers each contribute 7% of pay, as required by law. That would seem to cover the normal cost, computed on a static basis by
the Board of Actuaries, of 13.64%. However, in 1976, the Office of Management and Budget (OMB) asked the various federal agencies to use a new retirement cost factor of 24.7% of the employees' base pay. The new normal cost, computed on a dynamic basis was 31.7%. That percentage, less the 7% contribution from the employees, left an agency contribution of 24.7% as mentioned above. In June of 1977, the OMB temporarily suspended the use of the factor pending a complete review of the circular advocating it and its implementation. However, the GAO was informed by the OMB that the OMB had no reason to doubt the 31.7% figure issued in the circular. There are no plans to reinstate the 24.7% figure at this time. The obvious question of "why" goes unanswered by the government.

The primary purpose of government funding is to formally recognize the cost of the pension liability. This funding should promote sound fiscal and legislative responsibility and enhance budgetary discipline. However, because the funding is computed on a static basis, it falls short of its goals (See Appendix A).

The Inconsistencies in Benefits

As mentioned before, the eligibility requirements for age and years of service vary within the different federal retirement systems, (See Appendix A for details). Generally, retirement credits transfer from one system to another. There are some exceptions, though. For instance, the military does not grant credit for federal civilian service. However, military service is creditable under civilian retirement systems, with
only a few exceptions. 10

At the time of transfer to the Tennessee Valley Authority (TVA), an employee covered by the Civil Service Retirement System is required to continue contributions to the Civil Service System unless the transfer occurred over a break of more than three days. An employee transferring the other way, from the TVA back to the Civil Service System, receives credit for any service to the TVA. This is provided that the employee makes contributions to cover those years of service. 11

Employees under the Foreign Service Retirement System doing duty at certain designated "unhealthful posts" may receive 1.5 years of retirement credit for each year of service. 12 There is available, however, an election to receive a differential payable for that post. Civil Service employees who are working in the same area only have the differential payable available to them.

These are just a few of the transfer requirements that seem to follow no logical pattern. It seems to be a very haphazard collection of systems with rules developed along the way as they were needed. The methods of deriving the benefits seem to have a bit more reason to them. However, for the sake of clarity, they are better explained in a table. (See Appendix C).

The regulations covering this topic are as numerous and as variegated as those surrounding the transfer of benefits. For example,

Under voluntary retirement from the civil service and re-employment by the federal government, the individual's annuity continues, but the salary is reduced by the amount of the annuity.
Federal employees who retire under Washington D.C.'s policeman and fireman system may be reemployed without a reduction in salary or annuity. Retirement may be optional or for disability.

An annuitant under the Foreign Service System who is recalled to active duty in the Foreign Service receives a full salary, but the annuity is suspended. If s/he is reemployed in another federal agency, s/he receives the salary of the new agency. The amount of the annuity is decreased so that the total is not more than the salary received from the Foreign Service on the date of retirement.

When faced with a situation so confusing as this, even Daedalus would be hard pressed to find a way out of the maze of regulations. It is hoped that the Congress will take to heart the recommendation of the GAO that a blanket plan be introduced to cover all of the federal offices.

SOLUTIONS

An Answer--the Private Sector

There is a saying: if you are not part of the solution, you are part of the problem. Private industry, not wishing to be part of the latter, quickly took steps to assure that all would be well concerning pensions. In September of 1956, the American Institute of Certified Public Accountants (AICPA) issued Accounting Research Bulletin #47, "Accounting for Costs of Pension Plans." This document was the first in a series of pronouncements aimed at accounting for a secure pension
plan. It was followed, in 1965, by Accounting Research Study (ARS) #8, also sponsored by the AICPA. This publication and APB #8 were the first to try to bring together the various methods in reporting practices relative to pensions. APB #8 set forth standards in reporting the expenses and liabilities growing out of a pension plan. As was mentioned before, the excess of pension expense over the contributions is recorded as an unfunded liability. It is now required that a private pension fund be recorded on the accrual basis. In other words, accounting concepts of accruals, deferrals, and estimations must be used to allocate the proper pension cost to the appropriate time period. According to the guidelines set forth in ERISA, the minimum annual pension expense should equal the interest on any unfunded past service cost. The interest rate is determined by an actuary, as discussed previously.

The APB has established standards for a minimum and a maximum amount to be expensed for any pension plan in any one fiscal period. Not only are pensions and their related expenses recorded on a firm's income statement, but the amount of the unfunded liability must appear on the balance sheet. In addition, extensive information must appear in a footnote to these statements. This footnote must state:

1. a pension plan exists
2. the company's accounting and funding policies
3. the amount of the pension cost for the period
4. the excess of any benefits due over the amount funded
5. any other significant matters

The penalties associated with noncompliance extend beyond the legal ramifications in ERISA. Every year, publicly held companies must be
audited by independent certified public accountants. It is the responsibility of these auditors to attest to the fairness of the financial statements of an audited firm in an opinion accompanying the statements. If any of the information regarding pensions is erroneous, or excluded, the auditor may be forced to issue an adverse opinion. This kind of opinion will have a negative effect on lending institutions and investors, the lifeblood of large firms.

An Enigma--the Government

In contrast to the extensive accounting systems existing for private pension funds, the federal government uses a very simple formula. The amount of the unfunded liability is simply appropriated out of the general revenues, out of tax dollars. To be more succinct, when the government realizes it is unable to pay its bills, it borrows the necessary funds from the taxpayers, without informing anyone. This would seem to be a form of grand theft. In addition, this is not exactly in line with the sophisticated accounting methods Congress requested private pensions to use. The obvious question is why. Why are federal pensions exempt from such legislation? Why are the pension costs computed on a static basis, with no regard for inflation? Why has it taken so long for this problem to come to light?

An almost painfully obvious step in rectifying the situation would be to compute the normal cost on a dynamic basis rather than a static one. How can all the benefits be accrued and provided for if all the costs
are not known?

Another phase of the solution would by comprehensive coverage: a blanket plan for all federal employees. This type of plan would promote uniform funding, thus creating one system. There would be no doubt, on the part of an employee transferring from one branch to another, of the amount of contribution s/he was expected to make. There would no longer be such a complex jumble of rules and regulations surrounding the retirement credit following a transferring employee.

These suggestions would help, but not eliminate, the problem. The matter of the vast unfunded liability still looms large. This is undoubtedly the largest problem existing in the federal retirement systems today. The District of Columbia, when faced with virtually the same problem—an inordinate unfunded liability—hit upon a brilliant solution: full-funding.16 It should be carved in stone. In 1150 pages of hearings before a Congressional subcommittee, one page is devoted to solutions. The reason for this is simple; there really is only one solution and that is fully-funded retirement systems. There are at least three paths to this funding:

1. Increase contributions from employees. The reaction from the federal workers would be immediate and en masse: a negative.
2. Increase contributions from the employer. That would drive up the cost of the various agencies and the increased costs would have to be borne by all citizens. Another dead-end.
3. Increase the return on investments. Invest the money somewhere else, or in addition to federal
debt. But, how will business react to the government buying up great chunks of securities?

Admittedly, it is a sticky problem. It is time, however, to take the bull by the horns before all citizens are gored.

CONCLUSIONS

It is possible to move to a desert island to retire. On that island, pension problems are pointless. This problem must be dealt with now, before the unfunded liability becomes totally unmanageable.

Work is being done. The GAO is doing research on the feasibility of a blanket federal retirement program. President Carter has established a committee to examine the possibilities of halting the rapid growth of the unfunded liability.

All of this is good and it should be done. The research should not stop there, though. Why not legislate pension morality? The federal pensions should be subject to ERISA guidelines. Those laws were passed to make retirement benefits more secure. Presently, the future of the federal retirement systems is sadly insecure. "Sadly" because these systems are providing benefits to people. There is more at stake here than the fairness of financial presentation. Funds are already dwindling; what is to happen to the retirees if those funds become nonexistent? This is a very real problem that exists for very real people. What is needed now is some very realistic action. This is a situation that affects everyone; it is time all become concerned, concerned enough to become involved.
## APPENDIX A

Based on Total Payroll of Employees in the Civil Service System

<table>
<thead>
<tr>
<th>Computation method</th>
<th>Normal Cost</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Percent of pay</td>
<td>Amount (billions)</td>
</tr>
<tr>
<td>Dynamic</td>
<td>31.70%</td>
<td>$12.4</td>
</tr>
<tr>
<td>Static</td>
<td>13.64%</td>
<td>$ 5.3</td>
</tr>
<tr>
<td>Understated cost</td>
<td>17.06%</td>
<td>$ 7.1</td>
</tr>
</tbody>
</table>

## Retirement Eligibility

<table>
<thead>
<tr>
<th>Type of Retirement</th>
<th>Civil Service</th>
<th>Uniformed Services</th>
<th>Foreign Service</th>
<th>Federal Judiciary</th>
<th>U.S. Tax Court Judges</th>
<th>Federal Reserve Board</th>
<th>Tennessee Valley Authority</th>
</tr>
</thead>
<tbody>
<tr>
<td>Optional</td>
<td>(A) (B)</td>
<td>(A) (B)</td>
<td>(A) (B)</td>
<td>(A) (B)</td>
<td>(A) (B)</td>
<td>(A) (B)</td>
<td>(A) (B)</td>
</tr>
<tr>
<td></td>
<td>62 5</td>
<td>60 20</td>
<td>50 20</td>
<td>65 15</td>
<td>65 15</td>
<td>62 5</td>
<td>b/55 10</td>
</tr>
<tr>
<td></td>
<td>55 30</td>
<td></td>
<td></td>
<td>70 10</td>
<td>60 20</td>
<td>55 30</td>
<td></td>
</tr>
<tr>
<td>Discontinued Service (Involuntary)</td>
<td>a/none 25</td>
<td>no provision</td>
<td>depends on class of officer</td>
<td>no provision</td>
<td>none 15</td>
<td>a/none 25</td>
<td>none 5</td>
</tr>
<tr>
<td></td>
<td>a/50 20</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Deferred</td>
<td>payable at age 62</td>
<td>no provision</td>
<td>payable at age 60</td>
<td>no provision</td>
<td>no provision</td>
<td>payable at age 62</td>
<td>payable at age 55b/</td>
</tr>
<tr>
<td></td>
<td>5</td>
<td></td>
<td>5</td>
<td></td>
<td></td>
<td>5</td>
<td>10</td>
</tr>
<tr>
<td>Mandatory</td>
<td>70 15</td>
<td>varies depending on age, rank, promotion record, and length of service</td>
<td>60 none</td>
<td>no provision</td>
<td>70 none</td>
<td>65 any</td>
<td>65 none</td>
</tr>
<tr>
<td>Disability</td>
<td>none 5</td>
<td>no age or service requirements</td>
<td>none 5</td>
<td>no age or service requirements</td>
<td>none 5</td>
<td>none 5</td>
<td>none 5</td>
</tr>
</tbody>
</table>

- a/benefit is reduced if under age 55.
- b/benefit is reduced if under age 65.

*classes 1, 2, and 3 — immediate annuity upon selection out regardless of age or service; classes 4 and 5 are retained in service until age 50 and 20 year requirement met to receive an annuity; classes 6 and 7 — severance payment only.*
### APPENDIX C

<table>
<thead>
<tr>
<th>System</th>
<th>Benefit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Civil service:</td>
<td></td>
</tr>
<tr>
<td>Regular employee</td>
<td>56.25 percent of high-3</td>
</tr>
<tr>
<td>Congressional employee</td>
<td></td>
</tr>
<tr>
<td>Member of Congress</td>
<td></td>
</tr>
<tr>
<td>Law enforcement and</td>
<td></td>
</tr>
<tr>
<td>firefighter personnel</td>
<td></td>
</tr>
<tr>
<td>Foreign Service</td>
<td>60</td>
</tr>
<tr>
<td>Uniformed services (note a)</td>
<td>75 percent of final basic pay</td>
</tr>
<tr>
<td>Federal judiciary</td>
<td>100 percent of the salary of the office</td>
</tr>
<tr>
<td>U.S. Tax Court judges</td>
<td>100</td>
</tr>
<tr>
<td>Federal Reserve Board</td>
<td>56.25 percent of high-3</td>
</tr>
<tr>
<td>TVA (note a)</td>
<td>(b)</td>
</tr>
</tbody>
</table>

*a/Also covered under social security

*b/Varies depending on the actuarial value of the employee's contributions.

ENDNOTES


2 Ibid. p. 889.

3 Ibid. p. 911.


8 Ibid. p. 4.

9 Ibid. p. 4.

10 Ibid. p. 22.

11 Ibid. p. 25.

12 Ibid. p. 25.

ENDNOTES, Concluded


15 Ibid. p. 910

BIBLIOGRAPHY


ADDITIONAL SOURCES


