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April 25, 1997

The Honorable John L. Mica
Chairman, Subcommittee on Civil Service
Committee on Government Reform and Oversight
House of Representatives

Subject: Federal Retirement: Comparison of High-3, 4, and 5 Salary Factors

Dear Mr. Chairman:

This letter responds to your February 20, 1997, request for information on the effects of changing the high-3 salary factor in the formulas that are currently used to compute Civil Service Retirement System (CSRS) and Federal Employees Retirement System (FERS) pension benefits. Congressional consideration of modifications to high 3 has led to the impression that employees would need to work a number of years longer in order to earn annuities under high 4 or high 5 that would be comparable to their high-3 annuities. Our objective was to determine how much longer retiring employees would need to work to earn basic annuities under a high 4 or a high 5 that would be comparable to the annuities they would have received under a high 3, had they retired before the computation factor were changed.[1]

To meet this objective, we created illustrative CSRS and FERS general schedule employees who had met the age and service requirements for retirement and computed the basic annuities they would have received under the high-3, high-4, and high-5 average salaries. In making these computations, we took into account that the basic annuity a retiring employee receives is a function of the employee's high-average salary, creditable service, and the applicable accrual rate. An accrual rate is an annual benefit percentage that is multiplied by a high-average salary in computing an annuity. CSRS and FERS accrual rates differ. The CSRS accrual rate provides greater benefits because CSRS is a stand-alone pension program, while the FERS program includes pension benefits from Social Security and the Thrift Savings Plan, in addition to a basic

[1]In this report we use the term basic annuity to refer to the annuity a retiring employee would receive before any reductions for the retiree's share of survivor and/or health benefits.



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annuity.[2] In computing CSRS and FERS annuities, we developed salary histories for general schedule employees that we believed generally would capture the least and most number of months retiring employees might have to work under a high 4 or a high 5 to earn annuities comparable to those they would have received under a high 3, had they retired before any change went into effect. These salary histories were for two groups of employees at five different grade levels. The first group included employees with rising salary histories (i.e., those who, over their last 5 years of service, had promotions and/or in-grade step increases). The second group included employees with stable salary histories (i.e., those who, over their last 5 years of service, received the maximum salary for their grade level).

We did our work in Washington, D.C., between February and April 1997 in accordance with generally accepted government auditing standards. A more detailed description of the assumptions and methods used in our analysis is provided in enclosure I to this letter.

## RESULTS

Employees retiring under either CSRS or FERS would need to work longer to receive annuities under a high 4 or a high 5 that would be comparable to the annuities they would have received under a high 3, before any change in the annuity computation factor.[3] The amount of extra time, however, is measured in months rather than years. Reasons why include the fact that an employee's

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[2]The formula for CSRS annuities is: (a) 1.5 percent x high-3 average salary x the first 5 years of service, plus (b) 1.75 percent x high-3 average salary x the next 5 years of service, plus (c) 2.0 percent x high-3 average salary x all service over 10 years. For example, an employee retiring at age 60 with exactly 20 years of service would receive a basic annuity of 36.25 percent of his or her high-3 average salary. The accrual rate for FERS annuities is either 1.1 percent x high-3 average salary x years and months of service, if the employee is at least age 62, and has 20 or more years of service or 1.0 percent x high-3 average salary x years and months of service, if the employee is under age 62 or age 62 or older and has less than 20 years of service. For example, an employee retiring at age 62 with 20 years of service would receive a basic annuity of 22 percent of his or her high-3 average salary.

[3]As discussed in greater detail in enclosure I, we used the term comparable to mean an annuity that under a high 4 or a high 5 had become equal to or slightly larger than the high-3 annuity.

pay normally increases when he or she works longer, thus, so does the employee's annuity at retirement. Employees who work into the next calendar year in order to earn comparable annuities can receive general schedule pay increases early in the calendar year as well as step increases. In addition, the extra time employees work is added to their years of creditable service, which also increases the value of their annuities at retirement. For our illustrative employees, under a high 4, the least amount of extra time a retiring employee would need to work would be about 3 months, the most about 5. Under a high 5, the least number of extra months would be about 5, the most about 9. Tables 1 and 2 show these results in greater detail and provide comparisons of our illustrative employees. In the tables, employees with rising salary histories are those having service that culminated at step 3 or 4 of the grade; employees with stable salary histories are those having service that culminated at step 10 of the grade.

Table 1 shows that if a high 4 were used there would be a small difference in the length of time employees would need to work to earn annuities comparable to their high-3 annuities. The least number of extra months would be 3, the most 5. Table 1 also shows that, overall, those employees with rising salary histories would need to work somewhat longer than those with stable salary histories to earn annuities comparable to their high-3 annuities. For example, CSRS employees with 30 years of service and stable salary histories would need to work an extra 4 months, compared to 5 months for those with rising salary histories. Similarly, FERS employees with 15 years of service and stable salary histories would need to work an extra 3 months, compared to 4 months for those with rising salary histories.

Table 1: Additional Number of Months Employees at Selected Grade/Step Levels Would Need to Work Under a High 4 to Earn Annuities That Would Be Comparable to Those Available If a High-3 Formula Were Used to Calculate Basic Retirement Annuities

| Pension Plan/ Years of Service | 3 Months | 4 Months | 5 Months |
|---|---|---|---|
| CSRS with 30 years of service | | GS-5/10<br>GS-7/10<br>GS-9/10<br>GS-12/10<br>GS-15/10 | GS-5/4<br>GS-7/3<br>GS-9/3<br>GS-12/3<br>GS-15/3 |
| CSRS with 20 years of service | GS-5/10<br>GS-7/10<br>GS-9/10<br>GS-12/10<br>GS-15/10 | GS-5/4<br>GS-9/3<br>GS-12/3<br>GS-15/3 | GS-7/3 |
| FERS with 20 years of service | GS-5/10<br>GS-7/10<br>GS-9/10<br>GS-12/10<br>GS-15/10 | GS-5/4<br>GS-12/3<br>GS-15/3 | GS-7/3<br>GS-9/3 |
| FERS with 15 years of service | GS-5/10<br>GS-7/10<br>GS-9/10<br>GS-12/10<br>GS-15/10 | GS-5/4<br>GS-7/3<br>GS-9/3<br>GS-12/3<br>GS-15/3 | |

Source: GAO calculations.

Table 2 shows that if a high 5 were used there would be a larger difference in the length of time employees would need to work to earn annuities comparable to their high-3 annuities. They would need to work between 5 and 9 extra months. Also, under a high 5, employees with rising salary histories would continue to need to work longer than those with stable salary histories to earn annuities comparable to their high-3 annuities. However, the effects of salary history would become more pronounced under a high 5. For example, table 2 shows that CSRS employees with 30 years of service and stable salary histories would need to work about 7 extra months, compared to 9 extra months for those with rising salary histories. Similarly, FERS employees with 20 years of service and stable salary histories would need to work an extra 5 months, while those with rising salary histories would need to work as many as 9 extra months.

Table 2: Additional Number of Months Employees at Selected Grade/Step Levels Would Need to Work Under a High 5 to Earn Annuities That Would Be Comparable to Those Available If a High-3 Formula Were Used to Calculate Basic Retirement Annuities

| Pension Plan/Years of Service | 5 Months | 7 Months | 8 Months | 9 Months |
|---|---|---|---|---|
| CSRS with 30 years of service | | GS-5/10<br>GS-7/10<br>GS-9/10<br>GS-12/10<br>GS-15/10 | | GS-5/4<br>GS-7/3<br>GS-9/3<br>GS-12/3<br>GS-15/3 |
| CSRS with 20 years of service | GS-5/10<br>GS-7/10<br>GS-9/10<br>GS-12/10<br>GS-15/10 | | GS-5/4<br>GS-7/3<br>GS-9/3<br>GS-12/3<br>GS-15/3 | |
| FERS with 20 years of service | GS-5/10<br>GS-7/10<br>GS-9/10<br>GS-12/10<br>GS-15/10 | | GS-5/4<br>GS-9/3<br>GS-12/3 | GS-7/3<br>GS-15/3 |
| FERS with 15 years of service | GS-5/10<br>GS-7/10<br>GS-9/10<br>GS-12/10<br>GS-15/10 | GS-5/4<br>GS-12/3<br>GS-15/3 | GS-7/3<br>GS-9/3 | |

Source: GAO calculations.

AGENCY COMMENTS

We shared a draft of this letter with the Director of the Office of Personnel Management (OPM) for review and comment. In a letter dated April 11, 1997, the Director agreed that the scenarios presented in the letter accurately show how CSRS and FERS benefits would be reduced if an average salary change were implemented. He also stated that the Administration has not sought legislation to change benefit computations because it favors stability in long-term benefit programs for federal employees. OPM's written comments are reprinted as enclosure II to this letter.

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As we arranged with the Subcommittee, unless you publicly announce this letter's contents earlier, we plan no further distribution of it until 30 days after the date of this letter. We will then send copies to the Director of OPM, the Ranking Minority Member of your Subcommittee, and the Chairman and Ranking Minority Member of the Subcommittee on International Security, Proliferation, and Federal Services, Senate Committee on Governmental Affairs. We will also make copies available to others upon request.

The major contributors to this letter were Margaret Wrightson and Tyra DiPalma. Please contact me on (202) 512-9039 if you have any questions regarding this letter.

Sincerely yours,

Michael Brostek

Michael Brostek
Associate Director
Federal Management
and Workforce Issues

Enclosures - 2

## SCOPE AND METHODOLOGY

To determine how much longer employees would need to work to receive annuities under a high 4 or a high 5 that would be comparable to the annuities they would have received under a high 3, we created salary histories at five different grade levels and used them to compute annuities under each of the three high-average salaries. In creating the salary histories, we used a rising step level (step 2 or 3) as well as a stable step level (step 10). Table 3 shows the starting and ending points of these histories.[4] Specifically, we created salary histories for employees retiring in December 1996 under a high 3 at grades 5, 7, 9, 12, and 15 with step levels of either 2 or 3, and 10.[5] We also calculated annuities using these salary histories under a high 4 and a high 5. The salary histories were created using the actual general schedule rates for the years 1992 through 1997.[6] Our analysis included 1997 because the illustrative employees would have had to work for a period of months into the future (i.e., into 1997) to earn annuities under a high 4 or a high 5 that would be comparable to the high-3 annuities they would have received, had they retired in December 1996. We selected the various grade and step levels because logically these histories would provide the greatest contrast in the number of additional months retiring general schedule employees might have to work. They were logical because in averaging the salaries an employee might earn over a 3, 4, or 5-year period, the reduction in his or her initial annuity from shifting to a high 4 or a high 5 would be the smallest when the averaged salaries are equal--except for any general pay adjustments. The reductions in initial annuities would be larger when the salaries to be averaged increased each year--over and above any general pay adjustments. Other factors equal, the larger the increases in salary over the averaging period, the greater the reduction in the initial annuity.

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[4]While step 2 was one of the step-level starting points, it was not an ending point for any of the illustrative employees. In our analysis, none of the employee's service culminated at step-level 2 because of the way in which actual step increases are timed.

[5]The rising step-level histories included a promotion in 1995 from grades 4, 5, 7, 11, and 14, respectively.

[6]For the years 1994 through 1997, the general schedule rates used incorporated the locality pay area of Washington and Baltimore.

Table 3: Grade and Step Levels in 1994, 1995, and 1996

| Grade/Step in 1994 | Grade/Step After 1995 Promotion | Grade/Step If Retired in December 1996 Under High 3 |
|---|---|---|
| GS-4/3 | GS-5/2 | GS-5/3 |
| GS-5/3 | GS-7/1 | GS-7/2 |
| GS-7/3 | GS-9/1 | GS-9/2 |
| GS-11/3 | GS-12/1 | GS-12/2 |
| GS-14/3 | GS-15/1 | GS-15/2 |
| GS-5/10 | Not applicable | GS-5/10 |
| GS-7/10 | Not applicable | GS-7/10 |
| GS-9/10 | Not applicable | GS-9/10 |
| GS-12/10 | Not applicable | GS-12/10 |
| GS-15/10 | Not applicable | GS-15/10 |

Source: GAO calculations.

We created all salary histories under the assumption that the employees had met certain age eligibility requirements, under CSRS (age 55 or 60) and FERS (age 62).[7] We calculated CSRS retirement annuities for the various grade and step levels, assuming that the employees had either 20 or 30 years of service at the time of their retirement. We calculated FERS retirement annuities under the assumption that the employees retired at age 62 with either 15 or 20 years of service.[8] Based on the salary histories, we calculated the annuities for

[7]The FERS annuity formula applies to the basic annuity (e.g., defined benefit) portion administered by OPM. It does not include the Social Security or Thrift Savings Plan portions.

[8]The FERS retirement formula is different depending on whether the employee is at least 62 years of age and has 20 years or more of creditable service at the time of separation. We used 15 years in the FERS formula for employees retiring with less than 20 years of service. Had we chosen another number below 20, the amounts of the FERS annuities we computed would have been

employees retiring in December 1996 under a high 3 at the various grade and step levels described above. In addition, we calculated the annuities for each month thereafter under a high 4 and a high 5 until the basic annuities produced by our calculations were comparable with the employee's high-3 annuity of December 1996. These high-4 and high-5 calculations showed the additional length of time employees would need to work to receive an annuity comparable to the one they would have received under a high 3. In this letter, we used the term comparable to mean an annuity that under a high 4 or a high 5 had become equal to or slightly larger than the high-3 annuity. Had we defined comparable to mean an annuity slightly smaller than the high-3 annuity, our estimate of the number of extra months employees would have needed to work generally would have dropped by 1 month.

OPM's Chief, Retirement Policy Division, agreed that our methodology was reasonable and that it correctly demonstrated the range of extra months retiring employees potentially would need to work under a high 4 or a high 5 to earn annuities comparable to the ones they would have received under a high 3, had they retired before the change. OPM also told us that most federal employees retire with stable rather than rising salary histories.

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different. However, the proportional reductions in initial annuities resulting from a shift to a high 4 or a high 5 would have been similar to the ones we computed for 15 years of service.

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OFFICE OF PERSONNEL MANAGEMENT
WASHINGTON, DC 20415-0001

OFFICE OF THE DIRECTOR

Mr. Michael Brostek, Associate Director
Federal Management and Workforce Issues
United States General Accounting Office
General Government Division
Washington, D.C. 20548

Dear Mr. Brostek:

Thank you for the opportunity to review the draft correspondence on the comparison of retirement benefits under the Civil Service Retirement System (CSRS) and the Federal Employees Retirement System (FERS) using an average of the highest 4 and 5 years of salary rather than the current highest 3 years method.

The scenarios presented in the correspondence accurately show how CSRS and FERS benefits would be reduced if an average salary change were implemented. Reflecting our strong views in favor of stability in these long-term benefit programs for Federal employees, the Administration has not sought legislation to change benefit computations that employees have reasonably expected as a Government commitment.

Again, thank you for the opportunity to provide comments.

Sincerely,

James B. King
Director

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