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# Lessons for the States from the Federal Government's CSRS-to-FERS Transition

## Policy Brief

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# Introduction

In many policy-related situations, the states can be useful laboratories to determine the most appropriate federal actions. Variations across states in health care programs, earned income credit rules, minimum wages, and other policies have helped inform debates about federal interventions.

In this paper, we reverse that approach. Many state and local governments currently face difficulties financing future pension obligations for their workers. The federal government faced similar circumstances in the 1980s and implemented a substantial reform. Specifically, the federal government retained the existing Civil Service Retirement System (CSRS) for existing employees and created a new Federal Employees' Retirement System (FERS) for new employees. FERS combined a less generous defined benefit plan than CSRS, mandatory enrollment in Social Security, and a new defined contribution plan with extensive employer matching.

Although we do not wish to imply that a "one size fits all" solution applies to the very diverse situations that different states face, we nonetheless conclude that the elements of durable, effective, and just reforms for state pension plans will likely include the major elements of the federal reform listed above.

# The Federal Pension Transition

*The Creation and Evolution of CSRS*

CSRS has its beginnings in 1883. The civil service initiated a merit-based public employment system and protected public workers from having their employment terminated for arbitrary reasons, including old age (OPM 2015a, 2015c). As a result, over time, the federal work force became older and longer-tenured. These factors led to the creation of the Civil Service Retirement System (CSRS) in 1920.

CSRS created a defined benefit plan for government workers. Covered workers were required to contribute between 7 and 8 percent of pay, with their employing agency matching these contributions. Covered workers were generally eligible to retire at age 55 (with 30+ years of service), 60 (with 20+ years of service), or 62 (with 5+ years of service). Retirees received 1.5 percent of their high-3 pay for the first 5 years of service; plus higher amounts for longer tenure, with an overall limit of 80 percent of high-3 pay (OPM 2015a). Automatic cost-of-living adjustments began in 1962 and were linked to the consumer price index (CPI) (CRS 2013a).

Once it was enacted, CSRS quickly became an appealing benefit of working for the federal government.Several factors, however, led to stress in the system in the late 1970s and early 80s:

1. Current and projected costs in CSRS increased significantly as the government workforce expanded and aged.
2. The budget crunches of the early 1980s put pressure on CSRS.
3. In January 1983, the National Commission on Social Security Reform, chaired by Alan Greenspan, recommended that all newly-hired federal employees be covered under Social Security, partly in order to help that system address both short- and long-term funding problems. By March, that recommendation was made law with the Social Security Amendments of 1983, which called for all federal employees hired on or after January 1st, 1984 to be covered under Social Security (H.R.1900). In response, as a stop-gap measure, Congress reduced the contributions that federal employees were required to make to CSRS (Cowen 2011).

*The Creation and Implementation of FERS*

Congress created the Federal Employees' Retirement System (FERS) in 1987, a new system that includes all federal employees hired on or after January 1st, 1984 and federal workers who were hired before that date and chose to voluntarily switch over from CSRS. Unlike CSRS, which consisted of only a defined benefit plan, FERS offered a three-pronged approach to retirement: Social Security benefits, a smaller defined benefit plan than the one offered through CSRS, and the Thrift Savings Plan (TSP), a defined contribution platform. The legislation also included special provisions for people with careers in law enforcement, firefighting, air traffic control, and other specialized fields (OPM 1998).

Two of the three FERS components (Social Security and the TSP) are portable and move with the employee as he or she changes jobs either within or outside of the federal government (Table 1). Two components (Social Security and the DB plan) require employees to contribute part of their pay to the system. TSP is voluntary, but it depends heavily on employee contributions.

Participants accrue benefits in the defined benefit plan at slower rates than in CSRS. After the most recent FERS reforms, workers accrue a benefit equal to 1 percent per year of service, or 1.1 percent for workers retiring at age 62 or later with 20 or more years of service.

While it was originally viewed as a step down from the rich benefits offered through CSRS, FERS in many ways offers better benefits for many workers, including those who spend only a portion of their career with the federal government, those who are not with the federal government at the time of their retirement, those who work beyond the standard retirement age, and those who are savvy investors (Flanagan 2015). Under CSRS, annual benefits for a regular federal worker with 30 years

of service equal 56.25 percent of a retiree's high-three average pay (CRS 2014a). Under FERS, benefits accrue in all three components of the program. A worker with 30 years of service retiring at age 62 or later would receive 33 percent of high-three average pay from the defined benefit plan. In addition, if the worker contributed 10 percent of wages to TSP and earned a 6 percent (nominal) return, benefits from the defined contribution account would equal about another 32 percent of high-three average pay. And, of course, the worker would receive social security benefits as well.

Surveys indicate that current FERS participants strongly support the plan. The TSP is consistently the most popular federal employee benefit program, and the FERS DB plan is among the top three most popular (OPM 2013b).

The creation of FERS did not do away with, or even change, CSRS. Employees who were in that plan could stay in it. As of 2013, about 90 percent of federal civilian and Postal Service employees (2.5 million) participated in FERS, with the remaining 10 percent in CSRS. CSRS will continue to exist until its beneficiaries pass away.

## Pensions for State and Local Government Workers

*Historical Development*

The earliest public pensions for state and local government workers (SLGWs) predate the creation of CSRS in 1920. Even so, it took some time for public pensions to become de rigueur among the states. By 1930, only six states had created public pension systems for their civilian employees, and it took until 1947 for all states to offer plans (Rajnes 2001). As of March 2014, the take-up rate of retirement benefits among state and local government workers was 91 percent (BLS 2014).[1]

Despite its gradual enactment, the pension system for SLGWS has grown steadily and dramatically over the past 50 years. The number of state and local pension plans rose from less than 2,400 in 1962 to almost 4,000 in 2013 (Rajnes 2001; Census 2013). In 1962, there were just over 5 million participants. As of 2013, there were about 19.5 million participants.

However, while overall participation in state and local pension plans has been rising steadily for decades, active participation saw only modest gains between 1997 and 2009, and in the post-crisis years has been slowly declining.[2] Over the same period, the number of beneficiaries rose steadily (Census 1993-2013). As this trend continues and the number of retirees approaches the number of active participants, underfunded state and local governments will face even greater difficulties in meeting benefit payments.

Funding levels of state and local pension plans have also fluctuated over the years. The first comprehensive review of state and local pension plans was conducted in 1978 and revealed an average funding ratio of 50 percent (Peng 2008). During the 1980s and 1990s, funding ratios improved gradually, peaking in excess of 100 percent in 2001 after several years of rapid economic expansion and strong stock market growth (Peng 2008, CBO 2011, GAO 2012). Funding ratios fell in the early 2000s following the collapse of the dot-com bubble and hovered in the mid-80s until the 2007-09 financial crisis (CBO 2011, GAO 2012). During that crisis, funding ratios declined significantly.

Current funding levels are discussed further below. Brown et al. (2011) describe the 2007-09 financial crisis as "the proximate cause of the current funding problems facing many state and local pensions." In addition, however, longer-standing dysfunctional policies have played an important role in current funding problems. For example, Schieber (2011) reports that during fiscal year 2009, the states on average contributed 10.7 percent of payroll to their pension plans, about 15 percent less than the average actuarially required contribution of 12.6 percent of payroll.[3] This type of chronic underfunding occurs in both good time and bad, creating a financial hole that becomes almost impossible for the state or local government to fill without severe reductions in other services. Additionally, state and local governments have often raised retirement benefits when they are flush with cash—such as during economic booms—but are generally loathe to decrease them—or unable due to legal protections of pension benefits—when their budgets are tight, such as during recessions (Schieber 2011).

*Recent Policy Changes and Current Status*

Motivated primarily by fiscal distress, over 35 states and many local governments have made some reforms to their pension programs in recent years (GAO 2012). Munnell et al. (2014) distinguish recent pension changes by the underlying goals: (1) reduce existing defined benefit plan costs and (2) shift all or part of a given pension program into a defined contribution format. The first type of reform often takes the form of increased employee contributions, reduced benefits for new hires,

[1] This figure includes both DB pension plans and DC retirement plans. The take-up rate of DB plans and DC plans were 89 and 48 percent, respectively, in March 2014 (BLS 2014).

[2] Active participants are current workers and/or contributors to a pension system. Inactive workers are former contributors who have left the system but have not yet started receiving retirement benefits. Overall participation includes active participants, inactive participants, and beneficiaries.

[3] During the same time period, the states on average contributed 3.5 percent payroll to retiree health insurance plans, about one third of the average actuarially required contribution of 10.5 percent of payroll (Schieber 2011).

suspended or reduced cost-of-living adjustments, and/or increased age and tenure requirements (Bradford 2014). The second type of reform has shifted in scope and intent in recent years. Munnell et al. (2014) note that before the 2007-09 financial crisis, states were introducing optional DC plans. But in the aftermath of the crisis, many states have focused primarily on proposing mandatory DC plans that affect or would affect only new hires. The pre-crisis proposals, they note, were designed to give employees more retirement planning choices; the post-crisis proposals, on the other hand, have been designed almost exclusively to reduce costs. Even though these defined contribution proposals have generated significant press attention, Munnell et al. (2014) describe overall activity to date as “modest.” Most states that introduced pension changes have focused on new mixed plans including both DC and DB components and on cash balance plans rather than on a full-on transition from DB to DC.

Despite such changes, several studies show that many states continue to face serious pension underfunding problems. The studies reach different estimates due to different discounting methods for future liabilities. Novy-Marx and Rauh (2011) estimated that as of June 2009, the shortfall was between $1.2 trillion and $2.5 trillion, depending on the discount method. They later estimated that in order to achieve full funding over 30 years, taxes would need to increase by $1,385 per household per year (Novy-Marx and Rauh 2014). Pew (2014) calculated a total shortfall of $915 billion and an average funding ratio of 72 percent. State Budget Solutions (2014a) reported a shortfall of $4.7 trillion and a funding ratio of just 36 percent. Even the more modest numbers reported by Pew reveal a serious problem for certain states with extremely poor funding ratios; Illinois, Kentucky and Connecticut have the lowest funding ratios: 40, 47 and 49 percent, respectively. Table 1 shows which states have the largest unfunded liabilities, lowest funding ratios, and lowest percent paid of the Actuarial Required Contribution (ARC) – the contribution required annually to fully fund promised pension benefits.

## Comparing the Federal and State Situations

In many ways, the situations in the states with underfunding problems today compares closely to the one faced by the federal government in the early 1980s. Besides the most obvious consideration—the presence of sizable pension shortfalls—both the states now and the federal government then face the problem of ensuring appropriate and adequate retirement for an extremely diverse work force. They also both face the need to attract and retain high quality employees. Some government workers are in highly specialized occupations—such as law enforcement and firefighting—that have unique retirement needs. There are other similarities:

1. Within states, there are fundamental political disagreements about how generous and costly a pension plan should be, just as there were within the federal government during the 1980s. Many state and local government workers (SLGWs) strongly oppose pension reform, as did all but the senior-most federal employees when changes to CSRS were first considered.
2. A number of existing state DB plans, like the federal CSRS system, tend to be more generous than their private sector counterparts.
3. In the aftermath of the financial crisis, many states are still facing serious overall budgetary pressures, just as the federal government did the early-1980s.

The similarity between the states’ situations now and the federal government’s in the 1980s suggests that a reform along the same lines as those introduced in FERS could provide a suitable model for states to follow. The key elements of such a reform are clear:

- Leave existing workers in the unchanged old defined benefit system;
- Create a new defined benefit system that is somewhat less generous and less costly;
- Enroll all workers in Social Security who are not already in the program; and
- Create a defined contribution plan with generous matching contributions.

We take these points in turn. First, maintaining CSRS contributed to the success of FERS. By ensuring that current employees and retirees already drawing a pension could continue to participate in CSRS without major changes to that program, Congress removed a source of potential opposition to reform and ensured that the reforms were fair to existing workers, who had paid in and participated under the CSRS. Second, the three-part combination of a DB pension, Social Security, and a DC plan has much to offer. It balances savings for states with benefits for workers, including portability, equity with private sector plans, and access to Social Security, an important element of retirement security, disability, and survivors insurance. Diversifying SLGWs’ retirement portfolio into three components also helps insulate them from risk in the market place and the political arena.

We certainly do not wish to imply that there is a single strategy to pension reform for every state and municipal government. Each state faces a different pension, political, and economic situation and has its own traditions and norms. The results of any reforms must be thoroughly monitored to ensure that they adequately address a state’s fiscal issues and that any negative effects are quickly identified and appropriately handled. Nevertheless, states that find themselves in difficult situations today might learn valuable lessons from the federal government’s CSRS-to-FERS transition. States in

relatively comfortable situations today may be better prepared for the future if they keep the federal government's transition in mind as they move forward. Even allowing for variation in program design, the basic building blocks for effective reform could well be consistent across states and consistent with the federal government's response in the 1980s.

**Table 1. States with the largest unfunded liabilities, lowest funding ratios, and lowest percent of ARC paid in 2012**

| Largest unfunded liabilities (in millions) | | Lowest funding ratios | | Lowest percent of ARC paid | |
|---|---|---|---|---|---|
| California | $131,318 | Illinois | 40% | New Jersey | 39% |
| Illinois | $94,582 | Kentucky | 47% | Pennsylvania | 43% |
| Ohio | $63,143 | Connecticut | 49% | North Dakota | 53% |
| Pennsylvania | $47,286 | Alaska | 55% | Ohio | 57% |
| New Jersey | $47,209 | New Hampshire | 56% | Virginia | 59% |
| Texas | $31,670 | Kansas | 56% | Florida | 59% |
| Michigan | $31,159 | Louisiana | 56% | Kentucky | 65% |
| Florida | $28,956 | Rhode Island | 58% | Kansas | 67% |
| Virginia | $28,138 | Mississippi | 58% | Montana | 69% |
| Massachusetts | $28,104 | Hawaii | 59% | Texas | 69% |

*Source: Pew (2014b)*

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