ALTERNATIVES FOR U.S. POSTAL SERVICE FUNDING OF CERTAIN EMPLOYEE BENEFITS

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PREFACE

This Congressional Budget Office staff working paper analyzes the arrangements used by the U.S. Postal Service to fund certain benefits received by its employees: postretirement cost-of-living adjustments to pensions, compensation for job-related injuries, and health care coverage for retirees. The analysis identifies costs paid by the U.S. taxpayer and costs shifted to future generations of mail users. The paper also presents alternative ways of funding these benefits.

The paper, prepared at the request of the Senate Budget Committee, builds on previous CBO reports and studies that have dealt with the direct and indirect federal subsidies received by the Postal Service. In keeping with CBO's mandate, it contains no recommendations.

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SUMMARY

The accounting system used by the U.S. Postal Service (USPS) generally assigns labor and capital costs to the years when the resources are productive, regardless of when the cash payments for postal resources occur. This accrual cost approach is consistent with private business practices and provides a reasonable assignment of annual costs to each year's group of postal customers. It also provides a financial framework for USPS self-sufficiency as envisioned by the Congress: those who use postal services should bear the costs of those services.

An accrual cost approach is used to account for and fund workers' compensation benefits for postal employees, but not all postemployment benefits. In particular, the Postal Service uses a cash-based or pay-as-you-go approach in funding the employer's share of health insurance premiums for postal workers retiring since October 1986. Moreover, the USPS finances none of the postretirement cost-of-living adjustments (COLAs) for Civil Service Retirement benefits. Thus, the costs of COLAs received by postal retirees are borne by the federal taxpayer rather than the mail user.

To what extent are postal operations being paid for by federal taxpayers and by future generations of postal customers? How much higher would postage rates have to rise if certain indirect subsidies for postal employee benefits were eliminated? The answers depend on the particular timing and legislative approach enacted.

The Congress could, of course, continue the current funding arrangements, or provide direct appropriations to the Postal Service that would cover costs paid by taxpayers without affecting future postage rates. Direct appropriations would help frame debate about who should pay for certain postal employee benefits. Discontinuing the indirect benefit subsidies through higher postage rates would support a more efficient allocation of resources within the communication industry, and would lessen the burden on the federal budget.

Accrual Cost Alternatives

The next general adjustment in postage rates would provide a convenient occasion for applying an accrual cost approach to fund the costs of postretirement COLAs and of the USPS share of annuitant health insurance. Assuming that the adjustment took place in October 1990, it would require an additional increase in stamp prices of about 4 percent, relative to CBO's baseline, and could raise first-class letter prices by an extra penny.

- Cost-of-Living Adjustments. Increasing the USPS agency contribution rate for CSRS benefits from 7 percent to an estimated 17 percent of payroll would eliminate the indirect federal COLA subsidy. (The existing postal requirements for pay amortization payments and for the 7 percent withholding rate for employee contributions would remain.) In 1991 this option would raise postal operating costs by 3.2 percent or $1.4 billion.

- Health Insurance. Advance funding of the USPS share of annuitant health insurance premiums would require yearly investments of 3 percent of covered payroll. The Congress could phase in this option by limiting it to workers covered under the new Federal Employees Retirement System, which already is financed on an accrual cost basis. Shifting costs from future customers to current mail users, beginning in 1991, would increase postal operating costs by 0.6 percent or $0.25 billion.

Pay-As-You-Go Alternatives

Another way of shifting the costs of these benefits from taxpayers to those who use the mails would be to build on existing pay-as-you-go arrangements. But unlike accrual cost approaches, these options would not assign costs to the period when the future postal annuitants were actively employed and helped move the mail.

- In the case of COLAs, one option previously identified by CBO would limit the Postal Service's COLA liability to workers who retire in the future. The Administration's current proposal would expand the scope to all postal retirees and amortize the liability for each new COLA over 15 years. In 1991, these options would increase postal operating costs by $1.65 billion and $0.65 billion, respectively.

- Requiring the USPS to pay the employer's share of health care premiums for all postal annuitants--not just post-1986 retirees--would increase USPS costs in 1991 by about 2 percent or $0.9 billion. This alternative would remove the burden from the general taxpayer, but future generations of mail users would continue to subsidize the cost of annuitant health care benefits earned by today's postal work force.

Workers' Compensation

While every other federal agency uses a pay-as-you-go funding approach for workers' compensation claims, the Postal Service employs actuarial methods to develop a true accrual cost approach. This results in annual operating charges to mail users that exceed the cash payments made to postal employees for job-related illness or injury. At present, the USPS uses the surplus funds, which now exceed $3 billion, as a source of working capital. Obligations to pay outstanding claims will continue to grow and will, in 1993, approach $5 billion.

Creation of a separate account with dedicated investment earnings would minimize the possibility, already remote, of a financial burden falling on taxpayers. While this approach would complicate the budget, it would have no predictable effect on total government spending. It would, however, hamper the ability of the USPS to manage unforeseen cash needs, even though it would not have any direct effect on future postage rate increases.

I. INTRODUCTION

This year the U.S. Postal Service (USPS) will deliver about 160 billion pieces of mail at an average cost of 22.8 cents per piece. [1] Because mail sorting and delivery are labor-intensive, personnel compensation and related costs make up by far the largest category of expense--accounting for 83 percent of the Service's $36.5 billion budget. The Postal Reorganization Act of 1970, which transformed the old Post Office Department into the current USPS, envisioned that the USPS would operate much like a private corporation and that mail users would pay, with the exception of certain direct subsidies, for the cost of services they receive. [2] At present, however, the full cost of labor resources is not paid by current postal customers.

In general, the operating costs of the U.S. Postal Service are based on an accrual cost approach. This approach assigns labor and capital costs to the years in which the resources are used regardless of when the cash payments for these resources occur. For example, the USPS distributes capital investment costs over the projected useful life of the assets acquired. For many budget components, such as payroll, postal operating costs calculated on an accrual basis are essentially equal to the cash payments. But despite the emphasis given accrual cost accounting, the Postal Service does not use accrual costs for recognizing certain deferred personnel benefits. As a result, questions arise as to whether today's postal operations are being subsidized at the expense of future postal customers, as well as U.S. taxpayers generally. This paper addresses the USPS funding of costs, and examines alternative approaches, for three specific federal benefits that are provided to postal employees beyond their working careers:

- o Postretirement cost-of-living adjustments for Civil Service Retirement System benefits;
- o Compensation for medical expenses and lost wages resulting from job-related illness and injury, as administered by the Department of Labor for all federal employees; and
- o Retirees' health insurance premiums paid by their former employer.

The costs for the benefits addressed by this paper can be viewed either from a pay-as-you-go cash perspective or from an accrual cost perspective. (Accrual accounting for benefits received beyond active employment entails calculating the present value of expected future payments. The ratio of this value to the present value of payroll

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1 The price of postage varies by class of service and is adjusted periodically. In April 1988 the price of a first-class stamp increased from 22 cents to 25 cents; current CBO budget projections assume it will increase to 28 cents in October 1990 and to 30 cents in January 1993.

2 Direct postal subsidies currently derive from the appropriation of federal funds, now averaging around $560 million per year, that compensate the Postal Service for the reduced postage rates it gives not-for-profit organizations and other preferred mailers. For discussion of such subsidies see Congressional Budget Office, Reducing the Deficit: Spending and Revenue Options, 9th ed. (March 1988), pp. 211-212, and 8th ed. (January 1987), pp. 152-153.

represents a constant annual accrual cost.) The accounting methods used by the Postal Service are consistent with generally accepted accounting principles, as certified annually by independent accountants, and respond to various funding requirements set by the Congress. But the Postal Service treats the three subject employee benefits differently. It costs workers' compensation on an accrual basis, but uses a cash-based or pay-as-you-go approach for annuitant health insurance premiums covering postal employees who retire after October 1986. Moreover, the Service is not required to recognize at all the cost of automatic cost-of-living adjustments (COLAs) received by postal retirees to maintain the purchasing power of their annuities. These costs remain the responsibility of the taxpayer rather than the mail user.

Several important caveats should be kept in mind when reading this paper. First, the impact of changing the financing of postal employee benefits would not be felt by mail users and U.S. taxpayers until postage rates were actually increased. It is impossible to say precisely how any of the alternatives presented in this paper would affect future postage rates. Many factors, such as mail volume and postal operating expenses, will govern the size of future rate increases. Moreover, it is impossible to know what combination of funding changes, if any, the Congress might choose to adopt and when these changes would take effect.

As a general rule of thumb, this paper assumes that each $1.6 billion of added annual costs, together with associated contingency allowances, could add another penny to the price of a first-class stamp at the next postage rate adjustment, projected for October 1990. [3] Three of the alternatives presented in this paper could push 1991 revenue requirements up enough to cause a hike in first-class postage of one-half cent to one cent. The other options would have much smaller near-term impacts.

Second, the cost estimates in this paper represent costs to the U.S. Postal Service, unless otherwise stated. They should not be confused with federal budget outlays that derive from the cash flow difference between USPS **cash disbursements and cash income**. Such federal budget impacts, not explicitly identified in this paper, rest mainly on the timing and size of future postage-rate increases which, as noted, are difficult to predict.

Finally, the paper does not address the question of on-budget versus off-budget treatment of the USPS. The Postal Service has asked for off-budget status as a way to insulate itself further from prospective budgetary cutbacks. [4] Because current law requires postal operations to use businesslike accrual cost accounting principles and to break even, the USPS holds that postal revenues and expenses should be independent of the annual budget deficit debate. It believes that the cash accounting used in the federal budget process is at odds with generally accepted accounting principles and results in a misleading financial picture of postal operations.

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3 A $1.6 billion cost increase plus an associated contingency allowance would necessitate a general increase in postage rates of about 4 percent. In the first year, this would be accompanied by smaller growth in mail volume, lower operating costs of about $0.3 billion, and a jump in postal receipts of nearly $1.4 billion.

4 See testimony of Michael S. Coughlin, Deputy Postmaster General, before the joint hearings of the House Subcommittee on Postal Operations and Services and the House Subcommittee on Postal Personnel and Modernization, March 22-24, 1988, pp. 6-12 and 22-23.

The analyses set forth in later sections identify federal costs associated with three deferred benefits provided to postal employees: pension COLAs, workers' compensation, and employer cost-sharing of annuitant health care. The analyses also estimate the possible consequences to USPS funding that would result from options shifting costs from the federal taxpayer and the future mail user to today's postal customer. Doing so would eliminate certain indirect subsidies that are now provided by taxpayers and by future generations of mail users.

The rest of this section summarizes the general debate, including the USPS position, on indirect postal subsidies associated with the funding of postal employee benefits. The paper does not address other types of subsidies that accrue because USPS is exempt from state and local real estate taxes or other assessments. Nor does it address the costs incurred by USPS from its current dependence on the Treasury for banking, investment, and borrowing activities. (The Postal Service has estimated the net costs of this dependence at $36 million in 1987 or 0.1 percent of total expenses.) [5]

The Case for the Status Quo. Supporters of current employee benefit funding believe that eliminating the indirect benefit subsidies would add pressure to raise postage rates at a time when increases may be higher and more frequent than in the past. Postage rates were increased this spring, on average by 17 percent, and further adjustments will certainly be required to cover costs under current law over the next five years. (The USPS does not publish any planning assumptions for future rate increases; but CBO assumes for budget estimating purposes that rate increases through 1993 will push mail prices up by an average of 20 percent. Without any rate increases in the next five years, the Postal Service would incur large losses, which could accumulate through 1993 to more than $15 billion.)

Another argument against changing the way these employee benefits are funded by USPS is that unless other federal agencies are required to make similar changes it could be viewed as applying a double standard. A further objection is that it is much too early to change the funding of benefits because the Congress as recently as 1986 enacted changes in the financing of both retirement and annuitant health care costs.

Finally, some believe indirect subsidies now paid by taxpayers should continue in light of the many ways that federal statutes increase postal operating costs. For example, the Postal Service has limited authority to negotiate reductions in fringe benefits provided postal workers; it must deliver the mail six days a week; and it cannot close small post offices solely because they are not self-sustaining. Of course, if the Congress wants to discontinue indirect federal subsidies, or to compensate USPS for compliance with various statutes, it could always provide direct appropriations to the Postal Service. [6] While this approach would not relieve taxpayers from the burden of postal employee benefit costs, it would sharpen debate on who should pay.

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5 See Transcript of Proceedings before the U.S. Postal Service, vol. 1 (October 6, 1987), pp. 35-39.

6 Current law authorizes annual appropriations to the USPS of up to $460 million for public service costs. The Postal Service has not requested such appropriations since 1983; the year before the USPS received $12 million.

The Case for Curtailing Certain Indirect Subsidies. Advocates for changing current practice with regard to employee benefit funding believe that postal customers should bear the full cost of the service they receive, whatever the factors giving rise to such costs. Singling out the USPS for changes in employee benefit funding is viewed as appropriate in light of the size of its budget and its reliance on user charges. [7] Changing the funding of certain employee benefits would lessen the burden on the federal budget. It would also support a more efficient allocation of resources within the communications industry as new technologies enter the marketplace, as well as within the USPS as it plans to resume a $2 billion annual capital investment program.

Some argue that the postage rates resulting from indirect federal subsidies for retirement COLAs and from the shifting of annuitant health insurance costs to future generations of mailers give the USPS a price advantage over its private-sector competitors (ranging from small courier services to large common carriers). Such pricing may cause overuse of some classes of USPS service, since at higher postage prices some customers would find less costly alternatives or would reduce their demand for services. Higher postage rates would affect businesses more than households, because at least 90 percent of mail volume is business-related. [8]

Position of the Postal Service. Since its creation in 1972, the Postal Service has consistently agreed in principle that employee pay and benefit costs deriving from USPS employment are the financial responsibility of the postal ratepayer rather than the federal taxpayer. [9]

While no specific proposals concerning the elimination of indirect postal subsidies for retirement and annuitant health care have been advanced by the USPS, postal officials have argued for the following considerations: [10]

- Any new funding requirements should not apply to prior-year costs;
- Financial obligations that would have a substantial impact on postage rates should be phased in over a period of years;

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7 Under current law the U.S. Postal Fund is so far the only agency operating account that is charged for some annuitant health insurance costs, and for increased CSRS pension liabilities caused by pay raises.

8 U.S. Postal Service, The Household Diary Study Fiscal Year 1987 (July 1988), p. III-4.

9 See letter from Lewis A. Cox, General Counsel, U.S. Postal Service, to the Honorable Thaddeus J. Dulski, Chairman, House Committee on Post Office and Civil Service, March 27, 1973.

10 See letter from Albert V. Casey, Postmaster General, to the Honorable William D. Ford, Chairman, House Post Office and Civil Service Committee, February 14, 1986, and information submitted by the U.S. Postal Service to the House Appropriations Subcommittee on Treasury, Postal Service, and General Government during hearings on appropriations for fiscal year 1989 on April 12, 1988, p. 33.

- o Benefits attributable to periods when individuals were members of the armed services or were employed by the former Post Office Department should remain a liability of the federal taxpayer; and

- o Effective dates for transferring new financial responsibilities to the USPS should, in order to facilitate an orderly transition, be coordinated with future increases in postage rates.

The discussion of options in the following sections of the paper describes the arguments for and against the specific alternatives presented. It does not restate the entire debate on keeping or curtailing the indirect postal subsidies that may arise from current funding of postal employee benefits.

II. COST-OF-LIVING ADJUSTMENTS FOR CSRS PENSIONS

At present, over 500,000 postal employees still participate in the Civil Service Retirement System (CSRS), which provides pensions that are automatically adjusted each year after retirement to keep pace with inflation. These cost-of-living adjustments (COLAs) are determined by annual changes in the Consumer Price Index. Such postretirement indexation also applies to pensions (currently costing $5.2 billion) received by 500,000 postal beneficiaries--retirees and survivors. Automatic COLAs are expensive and, as they are paid for out of general revenues of the federal government rather than by postal customers, represent an indirect subsidy that is not recognized in setting the price of postal services.

Current Financing

The law requires that USPS, as an employer, make two types of payments to cover the future cost of CSRS benefits. One, set by law at 7 percent of pay, matches the contribution of CSRS postal employees. The other, referred to as "30-year amortization payments," helps finance the future benefit costs that result from collectively bargained pay raises. Neither the USPS payments, estimated at $2.6 billion for 1989, nor postal employee contributions, fund any of the costs associated with indexing CSRS benefits to increases in the cost of living. The unfunded COLA costs for CSRS represent more than a third of the annual accrual cost of CSRS benefits, estimated at 28.9 percent of payroll.[11] In 1988 this indirect postal subsidy totals about $1.5 billion, or 4.1 percent of the amount recognized by USPS as the total cost of moving the mail. On an accrual cost basis, the subsidy will gradually decline each year as the group of postal workers covered by CSRS shrinks.

Under retirement reforms enacted in June 1986, postal customers now fund the future COLA expenses for newly hired postal employees covered by the Federal Employees Retirement System (FERS). The FERS funding requirements, which apply to all federal agencies, use actuarial methods to estimate accrual cost as a percentage of the FERS payroll. The resulting amount is transferred to the government's retirement trust fund and invested in nonmarketable Treasury securities. At the time of retirement, sufficient resources should have accrued during the retirees' work careers to cover their benefit payments, including the effects of general wage increases during active employment as well as projected postretirement COLAs.

Background

Many proposals have been made to change the financing of postal employee retirement benefits. Since 1983, the annual deficit reduction reports prepared by CBO have included options to eliminate indirect postal subsidies that arise because the costs of employee retirement benefits are not fully paid by USPS. All of the alternatives, except the one

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11 For the most recent actuarial estimate of CSRS costs, see Civil Service Retirement and Disability Fund, Annual Report, September 30, 1986. The estimate assumes that the annual interest rate will exceed inflation by 2.0 percentage points and is quite sensitive to this difference.

included this year, would shift the cost of COLAs from the taxpayer to the postal customer by applying an accrual cost approach. This year's report identifies another approach. It would require USPS each year to advance-fund the full cost of future COLAs projected for that year's group of new retirees. [12]

The President's annual budget recommendations have also contained proposals to increase USPS contributions toward retirement costs. They were usually patterned on accrual cost concepts that assigned charges to USPS as a fixed percentage of payroll. However, the Administration's current proposal, transmitted to the Congress on May 18, 1988, by the Office of Personnel Management (OPM), would require USPS to fund the projected future costs of each year's COLA. Unlike the conventional accrual accounting now used by the FERS and the military retirement programs, the current OPM and CBO options would not assign COLA costs to the employment years of postal annuitants.

The notion of completely replacing CSRS financing with a comprehensive accrual cost system has gained little legislative interest since it was recommended by the General Accounting Office in 1977. [13] It was not adopted in the recent retirement reform legislation and is not now under active consideration. It has been applied, however, to the military retirement system since 1985, and covers servicemen hired after 1985 as well as before.

Alternatives

The Congress could decide to keep current postal funding for CSRS benefits. If, however, it wants to assign the COLA costs to the Postal Service, several alternatives are available. It could adopt the current OPM or CBO options or it could consider an accrual cost approach that would assign costs as a fixed percentage of payroll. Such a surcharge would increase the USPS contribution rate to CSRS by 10 percent of payroll. None of these alternatives would require USPS to shoulder the costs of COLAs already awarded but they would significantly increase postal costs. To ease the initial impacts, the Congress could, as it did when the 30-year amortization payments were instituted, provide direct appropriations to cover some of the added expense.

The following paragraphs describe each of the three alternatives in more detail and estimate the five-year cost impacts on USPS. Until postage rates are raised sufficiently to include the COLA costs, the costs would continue to be paid out of federal tax revenues as an indirect subsidy to the Postal Service. (CBO baseline estimates assume the next rate adjustment occurs October 1990.)

Option 1: Institute a Payroll Surcharge to Recognize and Fund COLA Liability on an Accrual Cost Basis.

Increasing the USPS agency contribution rate from 7 percent to an estimated 17 percent offers one approach to eliminating the indirect postal subsidy that arises from the

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12 Congressional Budget Office, Reducing the Deficit: Spending and Revenue Options (March 1988), pp. 270-271.

13 General Accounting Office, Federal Retirement Systems: Unrecognized Costs, Inadequate Funding, Inconsistent Benefits (August 3, 1977), pp. 18-20.

unfunded postretirement COLAs to be received by CSRS covered workers. [14] As a supplement to existing financing arrangements, Option 1 would not alter requirements for USPS amortization payments and for employee payroll withholdings. This option's increased contribution would raise total USPS costs in 1991 by an estimated 3.2 percent or $1.4 billion (see Table 1). The additional costs would push up 1991 postage revenue requirements by an amount just under that provided by a general rate increase equivalent to a one-cent hike for first-class stamps.

This option relies on accrual cost methods and has the advantage of simplicity. Once an actuarially determined surcharge was fixed (and perhaps periodically revised), no complex annual calculations would be required. Because Option 1 assigns costs as a percent of covered payroll, the USPS would not incur costs due to federal employment prior to 1989--whether workers were employed by the Postal Service or by another government agency. [15]

Several difficulties can be found in the 10 percent payroll surcharge option. First, the size of the surcharge--a 50 percent average increase over current law costs for CSRS benefits--derives from actuarial calculations that require making long-term assumptions about employee turnover, career advancement, mortality, salary adjustments, interest rates, and inflation. Such calculations, critics point out, are sensitive to changes in the underlying assumptions, particularly the economic assumptions. Moreover, the accrual costs prepared by OPM are based on the characteristics of a federal work force that includes both postal and nonpostal workers. [16] The USPS could argue that the surcharge should be adjusted to the characteristics of the postal work force. However, the recently enacted FERS program uses a common accrual factor for all workers--postal and nonpostal alike. Even so, critics might further argue that it would be unfair to assign a COLA surcharge to USPS alone without assigning it to other federal agencies as well. This objection overlooks the revenue-generating aspect of USPS, the size of its operating budget, and its legislative requirement to recover costs from mail users and thus operate on a self-sufficient basis.

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14 CBO staff developed the estimated 10 percent surcharge as a level percent of payroll by comparing the estimated value, at retirement, of lifetime CSRS benefits with and without COLAs. On this basis, estimated benefits without COLAs equal an accrual normal cost equivalent to 18.9 percent of payroll as compared to 28.9 percent of payroll with full COLAs. This relationship is consistent with actuarial calculations made by the Congressional Research Service using a comprehensive model for estimating CSRS normal costs. See House Committee on Post Office and Civil Service, Designing a Retirement System for Federal Workers Covered by Social Security, Committee Print 92-17 (December 1984), p. 84.

15 If a 10 percent surcharge for COLA costs was applied retroactively to 1972, the USPS would confront an estimated unfunded liability of $19 billion. (This estimate, measured in nominal dollars, disregards investment earnings for which some compensatory payments have been appropriated to the CSRS trust fund.)

16 CBO has previously attempted with considerable difficulty to determine an appropriate accrual cost estimate of CSRS pensions for postal workers. See Congressional Budget Office, Curtailing Indirect Federal Subsidies to the U.S. Postal Service (August 1984), pp. 13-25.

TABLE 1. COSTS ASSIGNED TO USPS FOR CIVIL SERVICE RETIREMENT BENEFITS (By fiscal year, in millions of dollars)

	1989	1990	1991	1992	1993
	Baseline Costs Under Current Law a/				
Agency Payroll Contributions b/	1,020	990	990	970	940
Amortization Payments for Pay Raise Liabilities	1,600	1,640	1,790	1,830	1,870
Total	2,620	2,630	2,780	2,800	2,810
	Possible Cost Increases Under Options				
Option 1: Apply a COLA Surcharge at 10% of Payroll c/	1,460	1,410	1,410	1,390	1,340
Option 2: Amortize COLA Liabilities as They Occur	220 d/	440	650	840	1,010
Option 3: Pay Full Liability for COLAs as Employees Retire e/	--	--	1,650	1,700	1,900

SOURCE: Congressional Budget Office from data provided by the U.S. Postal Service and the Office of Personnel Management. Estimates are rounded to the nearest $10 million.

a. Planning estimates prepared by USPS under CBO budget assumptions for postage rate increases.

b. Estimates exclude costs covered by employee contributions which remain unchanged under all options.

c. Estimates reflect projected U.S. Postal Service payroll covered by CSRS, as derived from data supplied by the Postal Service.

d. Estimates prepared by Office of Personnel Management as part of a legislative proposal. It would delay the initial payment until 1990.

e. Estimates prepared by CBO for its report Reducing the Deficit: Spending and Revenue Options (March 1988), pp. 270-271.

Option 2: Begin Charging for Full Costs at the Time COLAs are Awarded.

This option, recently proposed by the Administration, would fund full COLA costs for all postal annuitants as future postretirement CSRS benefit adjustments occur. [17] But it would spread the expense over an extended period in order to lessen the initial impact on postal rate payers. In particular, Option 2 would require the USPS to amortize over 15 years the estimated CSRS liability created by COLAs for postal annuitants. For each year's COLA, USPS would make 15 annual amortization payments to the retirement trust fund to cover the liability of the additional pension amount to be paid throughout the remaining life of the population of postal beneficiaries. Liabilities for all postal annuitants would be covered regardless of when employees retired or whether all or part of their postal careers preceded the 1972 reorganization. (This proposal does not meet the Postal Service criterion that it be exempt from paying for costs attributable to non-USPS employment.)

This approach parallels that currently taken for USPS in paying for CSRS liabilities created by collectively bargained wage increases. The main difference is that the amortization period for postretirement COLA liability would be 15 years instead of the 30 years used for wage increases, which is much too long a payout period for a population of annuitants.

Option 2 would require calculation of the present value of the current year's COLA liability but, in contrast to Option 1, some elements of uncertainty would be eliminated--namely, projecting the size of future COLAs and the size of the initial population entitled to receive it. Thus the actuarial estimates need only the appropriate interest rate and appropriate mortality factors. But the Administration approach has the disadvantage, relative to the payroll surcharge option, of placing successively higher cost burdens, at least for 15 years, on postal customers--beginning at 0.6 percent of total costs for 1989 and rising to 2.0 percent for 1993. Under the amortization stream, each year's operating costs would cover only 1/15 of the projected present value cost of that year's COLA; but over time, the stream would widen to include an increasing number of COLAs awarded since the date of enactment. By 1991 the OPM option would increase USPS costs by $0.65 billion. This 1.5 percent increase in the total cost of moving the mail would push up 1991 revenue requirements by about two-fifths of the sum generated from a rate hike equivalent to a penny increase in the price of mailing a letter.

Option 3: Recover Full COLA Costs as Employees Retire.

This alternative, presented in CBO's March 1988 report Reducing the Deficit: Spending and Revenue Options, is similar to the Administration's current plan but would limit COLA liability to postal workers who retire after October 1990. (The effective date was chosen to coincide with CBO's timing assumption for the next postage rate increase. Thus, the additional costs would not be incurred until the Postal Service had adjusted its rate structure.) The liability to be paid by USPS would be triggered, not by the award of each year's COLA as in Option 2, but by each year's class of new retirees.

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17 See the letters from Constance J. Horner, Director of the Office of Personnel Management, to the Honorable James Wright, Speaker of the House of Representatives, and to the Honorable George Bush, President of the Senate, May 13, 1988.

For each year's cohort of postal retirements, USPS would pay the estimated CSRS liability for postretirement COLAs projected for the remaining life of that group. The calculations would need to make assumptions about future interest rates, about the life expectancy of the group, and about the size of future COLAs. In this regard the actuarial valuations are somewhat more complex than under Option 2, where the initial cost of the COLA triggering the liability is known and assumptions are limited to interest rates and mortality.

This option, as prepared in March, does not include an amortization provision but it could be easily modified to do so. Without an amortization provision, Option 3 would increase USPS costs for 1991 by 3.7 percent or about $1.65 billion. The higher 1991 costs would clearly raise postage revenue requirements by the equivalent of an extra cent on the first-class stamp. Assuming the number of new CSRS beneficiaries remained relatively constant, the cost would grow slightly each year because of the larger initial pensions resulting from the higher average wages earned by successive groups of new USPS annuitants.

As with Option 2, this alternative would recover COLA costs for CSRS annuitants regardless of how an employee's career might have been divided between the old Post Office Department (POD) and the new USPS. Postal rate payers likely would object to the failure to exclude costs attributable to earlier POD service. With the advent of postal reorganization, of course, the new USPS was able to take advantage of an existing experienced labor force. Thus it could also be argued that the COLA expenses attributable to pre-1972 government service represent a type of buy-in cost that the USPS has not yet been required to pay. Moreover, taxpayers have funded these costs for all USPS retirees--without regard to POD versus USPS service. Now, 17 years after postal reorganization, some might say that postal customers should begin to shoulder the COLA costs of new postal retirees, regardless of any retirement credits the retirees have earned before 1972.

III. WORKERS' COMPENSATION FOR POSTAL EMPLOYEES

Like other federal civilian employees, postal workers who are injured on the job are not covered by the respective state workers' compensation programs. Instead, benefits are provided under the provisions of the Federal Employees' Compensation Act (FECA). [18] The Department of Labor (DOL) administers the program on a reimbursable basis such that each agency bears the financial responsibility for its own work force.

Because the USPS recognizes and charges mailers for the full accrual cost of workers' compensation, it does not realize any federal subsidy from its participation in the FECA program. The present-value cost estimating used by the Postal Service assumes investment earnings offset the future-year cost of current claims. [19] In practice, the Postal Service chooses not to set aside the positive cash flows generated by FECA funding. Instead, FECA-generated revenues are commingled with other sources of postal receipts and are used to finance postal operating costs.

Current Financing

FECA's accrual costs, as part of the rate base for setting the price of stamps, generate postage revenues. But the annual cash dispensed to pay claims is much smaller. The cash demands on USPS are limited to reimbursing DOL for the preceding year's cash expenses, regardless of the year claims were incurred. Under this arrangement, large present-value costs for long-term and permanent disabilities generate a significant amount of working capital for the Postal Service. Over the next half decade, the difference between accrual costs and cash disbursements will, on average, generate $226 million per year in working capital (see Table 2).

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18 For qualifying job-related illness and injury, the FECA program provides medical benefits, vocational rehabilitation, death benefits (including funeral expenses and survivor compensation), and generous disability compensation. Disability compensation usually begins 45 days after an injury occurs and replaces a percentage of employee pay. With one or more dependents, a worker can receive benefits up to three-fourths of regular pay. For single employees the replacement rate is generally two-thirds of pay. As all FECA benefit payments are exempt from federal income taxes, the effective replacement of after-tax or disposable income can approach or even exceed 100 percent. Compensation benefits, during the period of disability, are adjusted to keep pace with inflation.

19 The annual FECA cost charged to postal customers equals the present value of future payments projected for new claims plus an adjustment for investment earnings not realized. The accrual cost covers certain DOL administrative expenses and, in any given year, may also include certain adjustments for the cost of claims already incurred.

TABLE 2. POSTAL COSTS FOR WORKERS' COMPENSATION
(By fiscal year, in millions of dollars)

	1989	1990	1991	1992	1993
Accrual Cost	560	530	540	560	500
Cash Payments to DOL	290	300	310	320	340
Difference	270	230	230	240	160

SOURCE: Congressional Budget Office from data prepared by the U.S. Postal Service. Estimates are rounded to the nearest $10 million.

Because the resulting accumulation of capital for future use is not held in a dedicated FECA account it becomes indistinguishable from the total pool of USPS working capital that is held mainly in the form of short-term nonmarketable U.S. securities. These highly liquid assets help the USPS meet uneven cash flow and help back up competing financial commitments. (At the end of this year, the asset pool will likely total an estimated $3.8 billion versus outstanding noncapital obligations estimated at $8.3 billion. About two-fifths of these obligations are for FECA claims.)

The particular means used by private-sector firms to fund workers' compensation costs varies widely depending on state statutes and regulations, financial circumstances, and federal tax considerations. Overall, it is difficult to generalize about private practices or to use them as a guide for evaluating the Postal Service as a not-for-profit monopoly enterprise. Many private firms choose to finance workers' compensation by obtaining commercial insurance.[20] Other firms have chosen to self-insure as a means to optimize their cash flow. This keeps companies from tying up the resources that would be needed to prefund all outstanding workers' compensation claims. The exact form of self-insurance varies widely among firms and may, to satisfy state requirements, include some contingency measures.

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20 Workers' compensation insurance is provided by private companies as well as by some state agencies. The premiums are based on a wide variety of cost concepts that range from the estimated present value of expected claims to virtual pay-as-you-go schemes. Premium charges may also cover certain risks such as error in estimating costs, the possibility of encountering extraordinary claims, and the prospect of financial failure.

Alternatives

Creation of a dedicated account would provide an assured source of funding for FECA obligations. The new account would receive USPS payments equivalent to estimated accrual costs, make cash payments to the DOL on behalf of the Postal Service, and invest surplus funds in U.S. securities. To cover outstanding FECA obligations, a $3.4 billion transfer of assets to the new account would be necessary. [21] Because FECA's accrual costs have already been charged to postal operations, none of the money transferred would have a direct effect on future postage rates.

Under a dedicated account, the positive cash flow generated by FECA could no longer be commingled with other USPS assets. Such an assured source of funding would minimize the prospect of FECA liabilities falling on the taxpayer should the Postal Service, unlikely as this may be, face serious financial reversals. If the U.S. Postal Fund were to be taken off-budget, some might want a dedicated on-budget FECA account. While making the budget more complex, this approach would have no predictable effect on total government spending.

Some might oppose this option in the belief that it is based on an unwarranted fear that the USPS would be unable some day to meet cash requirements to pay FECA claims. In the 17 years since postal reorganization, the USPS has never defaulted on payments due its workers. Moreover, the Postal Service has substantial liquid assets, virtual unilateral authority--via due process--to increase postage rates, and unused authority to borrow for operating expenses. [22] In some situations, however, delays in adjusting postage rates as well as unexpected cost increases or drops in mail volume could create an overall adverse cash position for USPS; this would be further aggravated by the lack of financial flexibility caused by a segregated account.

The USPS would certainly view laws to create a new FECA account as micro-management by the Congress of postal finances. As long as workers' compensation costs are fully recognized, some would ask, why segregate FECA-generated revenue and associated interest earnings from other USPS-held investments? Many private and public financial managers, after all, prefer unified cash management to dividing an organization's finances into various segregated accounts. In the case of USPS, any perceived extra financial protection from a segregated account would essentially come at the expense of less financial backing for other postal obligations.

Others might prefer to see the current USPS accrual cost approach replaced by a cash-based one that would charge mail users for the DOL reimbursements. This would not be much different from the practice of employers who self-insure and thus recognize workers' compensation costs on a pay-as-you-go basis. Opponents of charging on a pay-as-you-go basis believe it would be inconsistent with the mandate that postal customers pay the full cost of delivering the mail. Such incorrect pricing, as previously noted, could cause misuse of mail services.

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21 The Congress could schedule the asset transfer over several years, since a one-time transfer would absorb most of the USPS financial reserves.

22 The USPS has not exercised its authority to borrow for operating expenses since September 1976. But projected borrowing through 1991, for capital investment alone, will deplete the $10 billion of total borrowing authority.

IV. HEALTH INSURANCE FOR POSTAL ANNUITANTS

Most postal workers who draw an immediate pension at retirement may continue health care coverage; the government, as former employer, pays from about 40 percent to 75 percent of annual premium costs. (The maximum federal contribution may not exceed 75 percent, but the share may be lower depending on the type of coverage and plan chosen by the annuitant.) Recent amendments to current law require the Postal Service to pay the employer's share for newly retired postal workers. [23] But this pay-as-you-go system, as contrasted to one based on accrual costs, assigns current work force costs to future generations of postal customers. This shifting of costs, in effect, subsidizes current-year postal operations.

Current Financing

Beginning in 1987, the Postal Service began reimbursing the Federal Employees Health Benefits program, administered by the Office of Personnel Management, for the employer's share of annuitant health care. The payments are limited to costs for workers who retired from the Postal Service after October 1986. The analogous costs for those who retired earlier continue to be paid by the federal taxpayer. (Apparently out of legislative oversight, the costs for post-1986 survivors of postal employees and of annuitants also remain the responsibility of the federal government.) As health care costs and utilization rates rise, and as the group of post-1986 retirees grows, the USPS anticipates its annual pay-as-you-go costs for annuitant health care premiums will increase from about $100 million in 1989 to almost $400 million in 1993.

Background

The liability associated with annuitant health insurance is receiving increased attention in the public and private sectors. For private employers, a key funding question is the federal tax consequence of prefunding annuitant health insurance premiums during employees' working careers. If money were set aside for future health care premiums, most of the investment earnings--unlike those in pension funds--would be subject to federal income taxes. Of course this does not apply to not-for-profit organizations like the USPS. But the recently enacted Medicare Catastrophic Coverage Act of 1988 could have a dramatic effect on future annuitant health care benefits and costs for all employers--especially the federal government. The government will need to tailor its health care coverage for federal annuitants in light of the expanded Medicare benefits. This adds another element of uncertainty to a federal benefit program that now confronts double-digit increases in annual per capita costs and that still produces certain accrual cost subsidies to the Postal Service.

The budget submitted by the President for 1988 proposed that the USPS begin to pay the employer's share of health insurance costs for all postal annuitants--not just new retirees. As under current law, costs would be assigned to USPS on a cash-reimbursement basis. No direct action was taken on that proposal, but the 1987 Budget Recon-

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[23] The Consolidated Omnibus Budget Reconciliation Act of 1985, Public Law 99-272, Section 15202(b), April 7, 1986.

ciliation Act requires postal payments to the Employee Health Benefits Fund in 1988 and in 1989 of $160 million and $270 million, respectively. These temporary requirements, which were arbitrarily determined, may suggest that the USPS should assume greater responsibility for its annuitant health care costs.

Alternatives

The newly created Federal Employee Retirement System (FERS) program provides an opportunity to adopt similar accrual cost funding for the health care costs of federal annuitants. (It could apply either governmentwide or only for the USPS.) The Congress could, of course, expand the current pay-as-you-go system to cover all annuitants or decide not to change the current system at all. Some planners may believe it premature to change annuitant health care financing before fundamental changes are considered in the benefit package in order to coordinate it with catastrophic Medicare coverage.

Option 1: Institute Accrual Cost Annuitant Health Care Changes for Postal Workers Covered by FERS.

Federal agencies currently fund FERS defined pension benefits on an accrual basis. The government's contribution to annuitant health care costs, which is financed on a pay-as-you-go basis, enhances annuitants' financial well-being by lessening their cost of insurance. Because the lifetime federal contribution for annuitant health benefits is akin, in many ways, to having a larger retirement pension with a setaside for health care, costs could also be recognized and funded as a level percentage of payroll during active employment. Some analysts believe that the pension kinship analogy is flawed by several unique characteristics of the annuitant health care program: that it is voluntary rather than mandatory (although coverage cannot be reinstated once an annuitant drops out), that the benefit level does not grow with years of employment, and that annuitant health care entitlements are usually vested during the last five years of federal employment.

Prospective annuitant health insurance costs could be advance-funded by requiring USPS, as well as other federal agencies, to contribute 3 percent of the FERS-covered payroll. (To carry out prefunding of annuitant health care, agency payroll contributions would be invested in U.S. securities.) Limiting this option to federal health care costs for active workers covered by FERS would be consistent with the recently enacted retirement reforms. (The accrual cost reforms did not apply to funding pensions for employees remaining under the old Civil Service Retirement System.) Moreover, Option 1 would not burden USPS with costs attributable to other federal employment. It would increase USPS operating costs in 1991 by 0.6 percent, or $0.25 billion (see Table 3). By itself, this increase would not add much to the size of the next postage rate increase.

If this accrual cost approach was adopted only for FERS employees, the Congress would likely want to retain the current cash payments for CSRS annuitants. (FERS-covered employees will not begin to retire in appreciable numbers for at least 25 years.) Instead, the Congress could apply the new funding to FERS and CSRS workers alike. This approach would increase five-year USPS costs by $1.6 billion, but it need not require USPS to make good on an estimated $12 billion unfunded liability that would arise because the annuitant health care surcharge was not retroactive to 1972. Whether extended or not, mail users would claim that the prefunding required by this option was advanced largely to improve the cash flow position of the U.S. Treasury.

TABLE 3. HEALTH CARE COSTS FOR USPS ANNUITANTS
(By fiscal year, in millions of dollars)

	1989	1990	1991	1992	1993
			Baseline Costs Under Current Law		
Pay-As-You-Go Payments for New Retirees a/	100	160	220	300	400
			Possible Cost Increases Under Options		
Option 1: New Accrual Cost Payments for FERS Workers b/	180	220	250	300	320
Option 2: Pay-As-You-Go Payments for All Postal Annuitants (retirees and survivors) c/	560	830	880	920	960

SOURCE: Congressional Budget Office from data prepared by the U.S. Postal Service and the Office of Personnel Management. Estimates are rounded to the nearest $10 million.

a. Planning estimates prepared for CBO by USPS staff.

b. The accrual cost estimates, as prepared by CBO, make critical assumptions concerning: the number of postal retirees who participate in the federal health insurance program, the projected cost of future benefits, and the actuarial cost as a level percentage of salary that needs to be invested each year to finance the expected benefits.

c. The estimates, which assume a January 1989 effective date, were prepared by the Office of Personnel Management.

Option 2: Expand the Current Pay-As-You-Go Approach to Cover All Annuitants.

The Congress could expand the current pay-as-you-go funding to cover all postal annuitants--not just post-1986 retirees. By 1991, Option 2 would increase total annual USPS costs by 2 percent, or $0.9 billion. The additional costs could increase postage rates in 1991 by the equivalent of 1/2 cent for the price of a first-class stamp. This option, advanced by the Administration in its 1988 budget, has the advantage of simplicity. It avoids complex and somewhat uncertain calculations of actuarial costs that entail assumptions about health plan participation rates and about future increases in premium costs. Critics of federal subsidies would characterize the financial burden placed on the Postal Service by this option as a mature enterprise's legitimate operating expense, which taxpayers have financed for 17 years. The USPS, however, would object to Option 2 because postal customers would have to pay for expenses resulting from mail services provided years earlier.