CONGRESSIONAL BUDGET OFFICE
U.S. Congress
Washington, DC 20515

January 27, 2003

Honorable Jim Nussle
Chairman
Committee on the Budget
U.S. House of Representatives
Washington, DC 20515

Dear Mr. Chairman:

The federal Office of Personnel Management (OPM) has prepared draft legislation that would allow the Postal Service to reduce its annual payments to the Civil Service Retirement System. In response to your request of January 15, 2003, the attached report examines the potential impact of that proposal on the federal budget and raises other relevant policy issues. CBO was specifically asked to consider the implications of the draft legislation on the federal retirement system in general (including retiree health benefits), on any unique aspects of the Postal Service as a federal employer, and on the competitive setting in which the Postal Service operates.

Although reducing the Postal Service's payments to the retirement fund would improve the agency's internal fiscal position, it could increase deficits or reduce surpluses in the unified budget by as much as $10 billion to $15 billion over the 2003-2007 period and by as much as $36 billion to $41 billion over the 2003-2013 period. The impact would depend on whether the Postal Service responded to its improved fiscal position by delaying increases in postage rates, by increasing spending, by repaying debt owed to the Treasury, or by some combination thereof.

A more-complete accounting for retirement costs, however, involves more than how pensions are funded. It takes into account all retirement costs, including health benefits. The Postal Service accounts for pension obligations as they are earned by its employees, but it does not do the same for retiree health benefits. Those benefits are paid for when its workers become retirees. Although that is true for all federal agencies, it is particularly important for the Postal Service, which is required to set postal rates to cover its full costs. Failure to recognize retiree health insurance benefits as workers accrue them will only push those costs into the future. If the

Postal Service accounted for and funded both retiree pensions and health benefits as they were earned by its employees, its operating costs would be higher, and some combination of increased postal rates or cost savings would be required. Those changes would reduce overall budget deficits or increase surpluses.

If you would like further information about this analysis, I would be happy to provide it. The CBO staff contacts are David Koitz (202-226-5872) and Paul Cullinan (202-226-2820).

Sincerely,

Barry B. Anderson

Barry B. Anderson
Acting Director

cc: Honorable John M. Spratt, Jr.
Ranking Democratic Member

The Proposal to Reduce Payments by the Postal Service to the Civil Service Retirement System

The federal Office of Personnel Management (OPM) has prepared draft legislation that would allow the Postal Service to reduce its annual payments to the Civil Service Retirement System. On the basis of a recent analysis by OPM's chief actuary, OPM believes that obligations to future Postal Service retirees could still be satisfied effectively if the agency made lower payments to the retirement system.

This Congressional Budget Office (CBO) analysis examines the potential impact of that proposal on the federal budget, on the federal retirement system in general (including health benefits for retirees), on the Postal Service as a federal employer, and on the competitive setting in which the Postal Service operates. Some of the proposal's impact would depend on how the Postal Service used its savings from lower retirement contributions, which is uncertain at this point. Nevertheless, CBO's analysis of the data supplied by OPM and the Postal Service yields several conclusions:

- Although reducing the Postal Service's payments to the retirement fund would improve the agency's internal fiscal position, it could increase deficits (or reduce surpluses) in the total (unified) budget by as much as $10 billion to $15 billion over the next five fiscal years and by as much as $36 billion to $41 billion through 2013.

- A more complete accounting for retirement costs involves more than how pensions are funded; it takes into account all retirement obligations, including health benefits. That wider view is particularly important for the Postal Service, which is required by law to set postage rates to cover its full costs.

- The Postal Service does not account for or fund retiree health benefits as they are earned by its employees. If the agency did so, its operating costs would be higher, and some combination of increased postage rates or reduced spending would be necessary. If they were funded up front, postal retirees' health benefits would not change, but the resulting payments by the Postal Service to fund those benefits would increase budgetary transfers to OPM and have the effect of lowering overall budget deficits (or increasing surpluses).

- The Postal Service's current accounting practices shift some retirement costs from today's postal ratepayers to future ratepayers or taxpayers—a shift that would be aggravated by the proposed change in the agency's retirement payments.

Background on the Postal Service

The Postal Service is an independent agency in the executive branch of the federal government. It is the largest government employer, with approximately 820,000 workers—31 percent of the total federal civilian workforce. In fiscal year 2002, the Postal Service generated $68.1 billion in revenues, mostly from postage and user fees, and $67.4 billion in expenses (as shown in the Treasury's *Monthly Financial Statement* for September 2002). The agency has the authority to borrow up to $15 billion from the Treasury; at the end of fiscal year 2002, its outstanding debt with the Treasury stood at $11.9 billion.

In 1970, with the Postal Service's operating deficits mounting and the quality of mail service deteriorating, the Congress and the President enacted the Postal Service Reorganization Act to restructure the Post Office as a government corporation. Although it was intended to remain an agency of the government, the Postal Service was allowed to set postage rates and classifications under the oversight of a new Postal Rate Commission. Those rates were supposed to be set according to the costs of services so that the Postal Service could eventually become self-sustaining and no longer require substantial federal subsidies. Moreover, although postal workers were to remain federal employees, their wages were to be made comparable to those in the private sector.

Under current law, postal workers participate in the two main pension systems for federal civilian employees: the Civil Service Retirement System (CSRS), which covers workers hired before 1984, and the Federal Employees Retirement System (FERS), which covers workers hired thereafter. Federal agencies, including the Postal Service, generally pay the full actuarial costs of the newer system, FERS, on an accrual basis. For workers covered by CSRS, most federal agencies contribute 7 percent of payroll from their operating budgets—an amount that represents less than a full actuarial rate.[1] The Postal Service, by contrast, is expected to cover the full actuarial costs of its CSRS employees and therefore contributes at a higher rate.

Postal employees and retirees also participate in the Federal Employees Health Benefits (FEHB) program. Unlike the case with postal pension costs, which are funded as workers accrue them, health benefits for retirees are paid on a "current" basis (as those costs arise during retirement) for both postal workers and federal employees at large.[2] In effect, those benefits are not taken into account as an expense

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1. CSRS's financing is supplemented by contributions from the government's general fund for the civilian workforce as a whole (albeit at a lesser amount than would be needed to cover the entire CSRS unfunded liability mentioned later in this report).

2. Federal agencies other than the Postal Service pay an employer share of health insurance premiums for their workers while those workers are employed. When those workers retire, OPM pays the employer share on behalf of the federal government. The Postal Service, by contrast, makes employer payments for both its workers and its retirees.

as workers earn them. (Legislation that was before the Congress last year, which the Administration supported, would have required federal agencies to pay for retiree health benefits on an accrual basis.)

The Proposal to Reduce CSRS Payments

On the basis of a recent analysis by its chief actuary, OPM believes that the Postal Service's participation in CSRS could become substantially overfunded and that the agency's obligations could be satisfied with lower future payments. Consequently, OPM has drafted legislation that would let the Postal Service reduce its yearly CSRS payment. (The legislation would not alter the Postal Service's payments for workers covered by FERS.)

OPM's analysis attempted to evaluate the Postal Service's impact on the Civil Service Retirement System separately from that of the rest of the government. (That evaluation was of necessity an estimate, since the contributions and benefits associated with individual agencies are not accounted for separately in the Civil Service Retirement and Disability Trust Fund.) According to OPM's analysis, if the Postal Service's payments to CSRS are not changed, they will eventually exceed the pension liabilities attributable to current postal workers by $71 billion in present-value terms (see Table 1).

Table 1.
Estimated Potential Overfunding of the Postal Service's Accrued Liability for Civil Service Retirement Benefits, as of September 30, 2002

	Billions of Dollars
Resources for Current Employees Covered by CSRS	
Net assets of hypothetical Postal Service retirement fund (as of September 30, 2002)	152.1
Future CSRS payments required under current law (present value)	91.5
Total Resources	243.6
Future CSRS Benefits (present value)	172.6
Difference—Potential Overfunding	71.0

SOURCE: Chief Actuary, Office of Personnel Management.

Table 2.
The Postal Service's Estimated Unfunded Accrued Liability for Civil Service Retirement Benefits Earned as of September 30, 2002

	Billions of Dollars
Actuarial Accrued Liability	157.1
Net Assets of Hypothetical Postal Service Retirement Fund	152.1
Difference—Hypothetical Unfunded Liability	5.0

SOURCE: Chief Actuary, Office of Personnel Management.

The main reason for that potential overfunding, according to OPM, is the assumption about future interest rates that was used in 1971 to calculate the Postal Service's annual payment. That rate was set at 5 percent per year and never revised. However, the actual return on Treasury securities has been much higher at various times during the past 30 years, which means that a hypothetical postal retirement fund invested in such securities would have accumulated a substantially larger balance than one that accrued interest at a steady 5 percent rate. According to OPM, that balance would have totaled $152.1 billion as of September 30, 2002. Under current law, the Postal Service will make another $91.5 billion worth of CSRS payments (in present-value terms) for its current employees, bringing the value of the hypothetical retirement fund to $243.6 billion. By comparison, those employees and annuitants are expected to receive only $172.6 billion in CSRS benefits (again, in present-value terms).

Despite that apparent $71 billion in eventual overfunding, current funding has not quite kept pace with current liabilities. OPM estimates that as of September 30, 2002, postal employees and annuitants had earned $157.1 billion (in present-value terms) in future CSRS benefits. That amount leaves a hypothetical "unfunded liability" of $5 billion (see Table 2).

Instead of the current payment structure, OPM proposes a two-part payment by the Postal Service to the CSRS fund: a "normal cost" payment to cover the future CSRS benefits being earned by current postal employees, and an amortization pay-

Table 3.
Proposed Changes in the Postal Service's Payments to the Civil Service Retirement System, 2003-2013 (By fiscal year, in billions of dollars)

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Current Payments											
Agency's Contribution	0.7	0.7	0.6	0.6	0.5	0.5	0.4	0.4	0.3	0.3	0.2
Payments for Unfunded Liability	4.0	4.1	4.3	4.3	4.4	4.6	4.8	5.1	5.4	5.6	5.9
Total	4.8	4.8	4.9	4.9	4.9	5.1	5.3	5.5	5.7	5.9	6.2
Proposed New Payments											
Agency's Contribution	1.3	1.7	1.6	1.5	1.3	1.2	1.1	1.0	0.8	0.7	0.6
Amortization Payments	0	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4
Total	1.3	2.1	2.0	1.9	1.8	1.7	1.5	1.4	1.3	1.2	1.0
Difference Between Current and Proposed Payments											
Change in Payments	-3.5	-2.7	-2.9	-2.9	-3.1	-3.5	-3.7	-4.1	-4.5	-4.7	-5.1

SOURCE: U.S. Postal Service (January 2003).

NOTE: Numbers may not add up to totals because of rounding.

ment to eliminate the $5 billion unfunded liability.[3] The estimated normal cost of the retirement system is 24.4 percent of CSRS payroll. Under the proposal, postal workers would continue to contribute 7 percent of their pay to the CSRS fund, but the Postal Service's payments as an employer would rise from 7 percent today to 17.4 percent, thus covering the entire normal cost of funding benefits as they are earned. According to the Postal Service, that change would increase the agency's payment this year to about $1.3 billion, compared with the $0.7 billion required under current law (see Table 3). In addition, starting in 2004, the Postal Service would make an annual "amortization payment" of $0.4 billion for 40 years to cover the $5 billion in unfunded benefits.

3. "Normal cost," or "entry age normal cost," is a measure often used for valuing pension benefits. It equals the percentage of payroll that an employer must set aside to finance promised future benefits. The calculation of normal cost includes assumptions about future pay raises and cost-of-living adjustments.

The new payment arrangement would replace not only the Postal Service's current 7 percent payment but also two special CSRS payments that the agency is now making, which are estimated to total $4.0 billion in 2003.[4] The first payment requires the Postal Service to amortize over 30 years any increase in its unfunded CSRS liability resulting from pay increases for postal employees. That payment was added because the existing 7 percent agency payment and 7 percent matching employee payment are insufficient to cover the 24.4 percent normal cost of CSRS. The second special payment requires the Postal Service to pay for retirees' cost-of-living adjustments through 15-year amortization payments. The current proposal would eliminate both of those special payments.

The Postal Service estimates that the proposal would reduce its total payment to CSRS in 2003 from $4.8 billion under current law to $1.3 billion, an amount that would rise to $2.1 billion in 2004 when the new amortization payment began. After that, the agency's total payment would decline each year, reaching $1.0 billion in 2013.

The Budgetary Impact of the Proposal

Although making smaller payments to CSRS would improve the Postal Service's internal fiscal position, CBO expects that it would have an adverse impact on the unified federal budget. Depending on how the agency used its savings from lower retirement contributions, unified deficits could rise (or surpluses fall) by as much as $10 billion to $15 billion between 2003 and 2007 and by as much as $36 billion to $41 billion over the 2003-2013 period.

How the Federal Budget Treats the Postal Service

The financial operations of the Postal Service are shown in the federal budget on a net basis as those transactions occur—in other words, the difference between the agency's collections (largely from postage receipts) and its expenditures is reflected as an outlay if the expenditures exceed the collections or as a negative outlay if the opposite is true. For example, in 2002, the Postal Service recorded expenditures of $67.4 billion and collections of $68.1 billion, for net receipts (negative outlays) of $0.7 billion.

By law, that outlay effect is considered "off-budget," just as the transactions of the Social Security program are. For most purposes, however, the outlays of both

4. The first of those payments was enacted in 1974 in Public Law 93-349; the second was enacted in the Omnibus Budget Reconciliation Act of 1990, Public Law 101-508.

Social Security and the Postal Service are included in budget totals along with other government programs to provide a complete picture of federal activities (which allows analysts to assess how those activities affect the economy and capital markets).

The payments that the Postal Service makes to CSRS for retirement costs and to the FEHB program for health insurance are intragovernmental payments. They are recorded as outlays of the Postal Service and as receipts of OPM, but those effects precisely offset each other and thus have no net impact on the unified budget. (They affect on-budget and off-budget totals, however. The Postal Service's payments are off-budget outlays, whereas OPM's receipts are on-budget offsetting receipts, or negative outlays.) Pensions and retiree health benefits for postal employees are paid from the same on-budget accounts as the benefits for other federal workers.

The distinction between on-budget and off-budget transactions has no bearing on the overall budgetary effect of the current proposal, but it can be important for certain budget enforcement rules. For example, under the pay-as-you-go (PAYGO) rules that existed from 1991 through 2002, legislated changes in on-budget payments received from the Postal Service affected the PAYGO scorecard. Under those rules, a reduction in on-budget receipts would have had to be offset by legislated increases in other receipts or reductions in spending. Those rules have expired, but the Senate extended a separate PAYGO legislative procedure through April 15, 2003, that applies only in that body.[5]

The Budgetary Effect of the Proposal

The impact of the Postal Service's actions on the unified budget is entirely a function of the agency's transactions with the public. The proposal to reduce the agency's CSRS contributions would affect intragovernmental payments from the Postal Service to another federal account, both of which are internal accounts of the Treasury. It would not, by itself, affect the Postal Service's expenditures for salaries, materials, equipment, and facilities or other transactions with the public. Thus, if nothing else changed, the proposal would reduce receipts to CSRS and outlays of the Postal Service by exactly the same amount, resulting in no net effect on the unified budget.

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5. The PAYGO requirement (section 252 of the Balanced Budget and Emergency Deficit Control Act of 1985) generally stipulated that new laws affecting mandatory spending or revenues through 2002 must be budget neutral (that is, not increase the deficit or reduce the surplus). The provision no longer applies for laws enacted after 2002. However, through a resolution (S.Res. 304), the Senate extended it by a rule allowing a point of order (and an accompanying 60-vote waiver requirement) to be raised against measures potentially violating the PAYGO requirement. That rule applies through April 15, 2003.

However, the proposal would improve the net income of the Postal Service, and its ultimate impact would depend on how the agency reacted to that improved fiscal position—in other words, what the agency did with the resulting savings. The Postal Service is supposed to operate on a cost-recovery basis, so its options for using the savings are limited. One of the possibilities suggested by postal officials is delaying an upcoming increase in postage rates—in effect, returning the savings to postage ratepayers. Alternatively, the Postal Service could spend the savings on other priorities, such as added capital investment; could use some of the savings to redeem its outstanding debt with the Treasury; or could pursue any combination of those various options. Redeeming federal debt does not affect budgetary totals, so that option would not change the unified budget deficit or surplus. The other possible uses of those savings, however, would add to federal outlays, as illustrated below.

CBO's baseline projections for the Postal Service, which reflect current law, assume that postage rates will not increase this year but that a 3-cent rise (to 40 cents for a first-class stamp) will be implemented late in fiscal year 2004 so that the agency's receipts will keep up with expected costs.[6] Beyond 2006, CBO's baseline assumes that the Postal Service will use a combination of rate increases and controls on spending to ensure that its income covers the costs of its services.

Impact on the Unified Budget. Because the Postal Service's response to the change in payments is uncertain, CBO examined the possible budgetary impact of the proposal during the 2003-2013 period under two alternative assumptions. In Alternative 1, the Postal Service uses the initial savings from the proposal to redeem part of its outstanding debt and subsequent savings to keep current postage rates in effect until early 2007. In Alternative 2, the entire savings are used to delay or reduce rate increases or to boost spending for other purposes.

Under either of those scenarios, lowering the Postal Service's payments to CSRS would have an adverse impact on the unified budget (increasing deficits or decreasing surpluses). Under Alternative 1, unified budget outlays would increase by as much as $10 billion over the next five years and $36 billion over the 2003-2013 period, compared with CBO's baseline. The impact would be larger under Alternative 2: net outlays would rise by as much as $15 billion through 2007 and $41 billion through 2013 (see Table 4). Those projections are based on the Postal Service's estimates of its CSRS payments rather than on estimates by CBO. However, a CBO estimate would be unlikely to differ greatly from the figures presented here.

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6. Those and other baseline projections can be found in the forthcoming CBO report *The Budget and Economic Outlook: Fiscal Years 2004-2013* (January 2003).

Table 4.
Estimated Effects of the Proposal on Net Federal Outlays
(By fiscal year, in billions of dollars)

	Effect on Net Outlays (Excluding interest)											Total, 2003-2013
	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	
Effect on Unified Budget												
Alternative 1	0	0.1	3.5	3.5	3.1	3.5	3.7	4.1	4.5	4.7	5.1	35.8
Alternative 2	3.5	2.7	2.9	2.9	3.1	3.5	3.7	4.1	4.5	4.7	5.1	40.7
Memorandum:												
Alternative 1												
On-budget effect	3.5	2.7	2.9	2.9	3.1	3.5	3.7	4.1	4.5	4.7	5.1	40.7
Off-budget effect	-3.5	-2.6	0.6	0.6	0	0	0	0	0	0	0	-4.9
Alternative 2												
On-budget effect	3.5	2.7	2.9	2.9	3.1	3.5	3.7	4.1	4.5	4.7	5.1	40.7
Off-budget effect	0	0	0	0	0	0	0	0	0	0	0	0

SOURCE: Congressional Budget Office based on data from the U.S. Postal Service.

NOTE: Net outlays represent gross outlays minus receipts. Numbers may not add up to totals because of rounding.

Alternative 1 shows no significant budgetary impact in 2003 or 2004 because the reduction in the Postal Service's intragovernmental payments to CSRS is assumed to have little effect on its transactions with the public. Under that scenario, the agency's savings in 2003 and 2004 are allocated to paying off some of its debt to the Treasury (thus producing no direct change in the budget). Beginning late in fiscal year 2004, the budgetary impact reflects the loss of receipts that would result from delaying the expected 2004 postage increase. That loss would be small in 2004, approximately $0.1 billion, but would swell to $3.5 billion in 2005 and 2006, representing the full-year effects of forgoing the 2004 rate increase.

Under Alternative 2, the budgetary impact would be much larger in 2003 and 2004 than under Alternative 1, but slightly smaller in 2005 and 2006, because all of the savings would be used to reduce or delay postage rate increases or incur higher spending (or some combination thereof).

From 2007 through 2013, the savings from making smaller CSRS payments would adversely affect the unified budget by the same amount under both alternatives (assuming that the Postal Service matched its receipts and expenses). That impact results from lower receipts (because of reduced or postponed rate increases), from increased spending, or from a combination of the two.

On-Budget Impact. On-budget totals would worsen by the same amount during the 2003-2013 period under both alternatives because of the smaller payments to the Civil Service Retirement and Disability Trust Fund (see Table 4).

Effect on Interest Costs. The Postal Service could accrue interest savings by reducing its Treasury debt, but that bookkeeping "exchange" between government accounts would not have an impact on the unified budget. However, because under either alternative unified deficits would increase (or surpluses would fall), total debt held by the public would rise, resulting in higher government interest payments on that debt.

Policy Issues Raised by the Proposal

Given the magnitude of the potential pension overfunding, the substantial budgetary impact of the proposed change in Postal Service payments, and the rapidly changing communications environment in which the Postal Service is trying to compete, some additional issues merit consideration. Those issues include considering the Postal Service's funding of retiree health benefits in any calculation of its over- or underfunding of retirement costs, recognizing the value of the federal government's overall liability for the retirement benefits of postal workers, weighing the effect of the proposal on the competitive balance in the postal industry, and considering the proposal in the larger context of possible restructuring of the Postal Service.

Inadequate Financing of Retiree Health Benefits

Although the Postal Service may be making disproportionately large payments for CSRS benefits under current assumptions, it may be paying too little for retiree health benefits under the FEHB program. As noted earlier, the Postal Service pays its share of the costs of retiree health insurance when those costs arise. But failure to recognize and reflect the retiree health costs of current workers as they accrue will only push those costs into the future, when they could seriously impair the Postal Service's ability to compete with the private sector. Estimates by OPM's actuaries of the costs of prefunding those health benefits put the unfunded liability (as of September 30, 2001) at $48 billion in present-value terms and the annual cost of amortizing that amount and future costs at $4.9 billion (in 2002 dollars).[7] Those

7. CBO estimated the Postal Service's payment for retiree health benefits to be approximately $1 billion in 2002. If the government charged for the cost of those benefits on an accrual basis and required 40-year amortization of the Postal Service's share of FEHB's unfunded liability (analogous to the proposal for the Postal Service's CSRS payment), the agency's payment to FEHB would be $5.9 billion, according to OPM estimates. That figure has two components. First, accruing retiree health benefits for the

costs are nearly twice the size of the annual reduction in pension payments that the Postal Service is seeking.

Liabilities for retiree health benefits are difficult to project, and estimates are highly sensitive to uncertain assumptions about future health care costs. Nevertheless, many private-sector companies are required to expense those costs under the prevailing accounting rules prescribed by the Financial Accounting Standards Board.[8] In general, participants in single-employer plans must expense future retiree health costs, but participants in multiemployer plans are exempt. (For more information about the accounting treatment of retiree health benefits, see the appendix.)

The Postal Service has taken the position in the past that its situation is similar to that of a participant in a multiemployer health plan and therefore that it should not have to expense or prefund accruing retiree health costs. An alternative view is that the circumstances of the Postal Service make it analogous to a participant in a single-employer plan (the federal government being the employer offering health benefits to all of its employees, no matter what department or agency they work for).

Regardless of what type of private company the Postal Service most resembles, its circumstances are unique in that they could impose an implicit liability on the federal government to provide the agency's retiree health benefits. A private company, confronted with the full possible cost of providing those benefits, can decide not to offer them. But the Postal Service, as a federal employer, is not likely to curtail those benefits—and indeed, according to the General Accounting Office, may not legally be able to do so.[9] Even without a legal requirement to provide health benefits to retirees, it is unlikely that benefits would or could be discontinued for Postal Service employees enrolled in the FEHB program or nearing retirement. The Postal Service is facing significant competitive pressures from a host of new private service providers as well as from rapid technological advancements in information transmission and communications. If that uncertain environment substantially

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more than 700,000 postal employees who participate in FEHB would cost $2.6 billion (assuming a cost per employee of $3,716 for funding retiree health benefits as they are earned). Second, the government's unfunded liability for retiree health care was $207 billion in 2001. Of that amount, the Postal Service's share is estimated at $48 billion (compared with its $5 billion share of CSRS's unfunded liability). If the government required the Postal Service to amortize that $48 billion over 40 years in equal amounts (as the Postal Service would do for its unfunded CSRS liability), the annual payment would be $3.3 billion.

8. Since 1973, the Financial Accounting Standards Board has been the designated organization in the private sector for establishing standards of financial accounting and reporting. Those standards govern the preparation of financial reports. They are officially recognized as authoritative by the Securities and Exchange Commission and the American Institute of Certified Public Accountants.

9. Letter from David Walker, Comptroller General, to John E. Potter, Postmaster General, published as General Accounting Office, *U.S. Postal Service: Accounting for Postretirement Benefits,* GAO-02-916R (September 12, 2002).

hindered the Postal Service's ability to produce income, the federal government could be left with the long-term burden of paying for the retiree health benefits of postal workers.

Last year, the Administration supported legislation (the Managerial Flexibility Act of 2001, S. 1612) to charge the operating budgets of other federal agencies for the full cost of retirement benefits. That legislation, which the Congress did not pass, would also have required the Postal Service and other agencies to pay the cost of retiree health benefits as they accrue.

The Implicit Value of the "Entitlement" Nature of Federal Retirement Benefits

Because the Postal Service is part of the federal government, its employees benefit from the entitlement nature of the federal retirement system just as other federal workers do. Postal Service employees enjoy the same ability to change jobs within the federal government without losing their pension or other benefits. Moreover, should current funding projections prove optimistic, they would benefit from the government's implicit liability to its employees as a whole. Even if the Postal Service failed or lost a major portion of its business, its employees' retirement benefits would be protected in full by the federal government. In effect, the government's implicit liability to the group has a value that straight actuarial calculations of the Postal Service's CSRS payments and expected benefits do not recognize.

As noted earlier, the Civil Service Retirement and Disability Trust Fund is generally not compartmentalized by agency. Only the Postal Service has a separate calculation comparing the appropriateness of its payments with potential future retirement commitments to its employees. If lawmakers enacted the proposed change, the Postal Service would pay its fair share, by OPM's actuarial calculations, but less money would be credited to CSRS, and the retirement system's unfunded liability would increase. According to OPM's chief actuary, that unfunded liability stood at $521.8 billion (in present-value terms) as of September 30, 2001.

Competitive Balance in the Postal Industry

The Postal Service differs from other federal agencies in that it is expected to generate receipts to cover its costs while competing with private industry in some of its operations—all while facing a changing communications environment. However, since the Postal Service is a federal entity, it is also subject to different pressures than its private-sector competitors. Reducing its obligations for one aspect of employee benefits while not assessing the implicit value it receives from its unique status as a federal entity could make it more competitive in some lines of business.

Unlike its private-sector competitors, the Postal Service is exempt from federal income taxes and related state and local taxes, and it can borrow money from the Treasury at favorable interest rates up to a limit of $15 billion—a limit that has been raised a number of times when lawmakers considered it necessary. Moreover, although the Postal Service is a sponsor of a defined-benefit retirement plan, it does not have to make payments to the Pension Benefit Guaranty Corporation. In addition, if it were a private employer, the Postal Service would most likely have to take the accrual costs of retiree health benefits into account in some way, either by expensing them each year, prefunding them, or reflecting them as a liability on its balance sheet.

The Issue of Postal Restructuring

Lawmakers may want to address the issue of altering the Postal Service's CSRS payments in the larger context of considering what the federal government's postal functions will be in the future—a task that the President recently delegated to a new blue-ribbon commission.[10] The change in payments that the Postal Service is seeking is substantial and long lasting. However, by the agency's own assessment, the future growth of mail volume is highly uncertain. If its workers are to remain covered by the federal umbrella of employee benefits, legislative changes as large as the one being proposed might best be evaluated in the broader context of financial risks to the federal government and to the compensation systems that the government has established for its workforce.

Lawmakers may determine that financial support of the Postal Service is necessary to continue the public purposes that the agency serves. If such support was reflected in the federal budget as a subsidy, it would provide transparency to lawmakers and the public. Adjusting the Postal Service's retirement payments to CSRS while failing to recognize its unfunded health-related retirement benefits obscures the real costs of the agency's services.

10. The President's Commission on the United States Postal Service, formed by Executive Order 13278, is required to report its recommendations for change by July 31, 2003.

Appendix: Accounting for Retiree Health Benefits

Since December 1992, accounting standards for the private sector have required most companies to recognize the cost of retiree health benefits on an accrual basis (that is, when the benefits are earned).[1] Consequently, firms record those accruals as an expense, which lowers their earnings. The previous accounting treatment, by contrast, used a "current" basis, focusing on the cost of benefits when they were paid to retirees. The current standard gives firms more flexibility in reporting postretirement health benefits that have already been earned—their so-called unfunded liability—on their balance sheets. Companies can recognize the entire amount of that liability immediately or recognize it gradually on their statement of income over the future service periods of health plan participants (up to 20 years of amortization), provided that they disclose the unrecognized amounts. That standard does not apply to multiemployer health plans for retirees, which continue to report costs on a current basis.[2]

Estimates of the present value of retiree health benefits are sensitive to assumptions about future medical cost inflation, utilization rates, and changes in Medicare coverage. Despite the imprecision of those estimates, the Financial Accounting Standards Board (FASB) believes that measuring retiree health obligations on the basis of best estimates is superior to recognizing no obligation until benefits are paid. The board concluded that "failure to recognize an obligation prior to its payment impairs the usefulness and integrity of the employer's financial statements."[3]

Having companies report the accrual cost of retiree health benefits allows investors to assess the financial consequences of employers' decisions about compensation. (Firms are required to account for pension benefits the same way.) Retiree health benefits are part of an employee's compensation for labor services; thus, firms incur those costs when service is rendered. The prices that firms charge in competitive markets must cover such costs as they are incurred. Otherwise, if firms waited

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1. See Financial Accounting Standards Board, *Employers' Accounting for Postretirement Benefits Other Than Pensions,* Statement No. 106 (December 1990), available in summary form at www.fasb.org. Implementation of that standard was delayed for two years; it took effect for most large firms on December 15, 1992. The change was widely anticipated by companies and stock analysts, however. The board had first put the issue on its agenda in 1979; moreover, a 1984 accounting standard by the board required that employers' financial statements report the unfunded liability for retiree health benefits if that amount was distinguishable from the benefit costs of current employees.

2. A multiemployer health plan is one to which two or more unrelated employers contribute and in which a participating employer does not exercise complete or significant control over the selection of insurance companies, the benefits available to its employees and retirees, the costs it incurs, or the assets it contributes to the plan. An example of a private-sector multiemployer plan is a union plan for various trucking companies.

3. Financial Accounting Standards Board, *Summary of Statement No. 106* (available at www.fasb.org).

to try to recover those costs when the benefits were paid to retirees, they could be at a competitive disadvantage at that point.

Although private companies are required to recognize an expense for accruing retiree health costs, many do not prefund those liabilities. According to one analysis, just 35 percent of *Fortune* 1000 companies have set aside assets to cover those liabilities. Moreover, those assets are only large enough to cover about one-third of the expected costs, on average.[4]

One reason for that situation is that the Congress and the President have enacted a series of laws to limit the prefunding of retiree health benefits. The Deficit Reduction Act of 1984 restricts tax-deductible contributions to funds for retiree health benefits. For example, employers cannot take into account medical cost inflation and utilization trends when funding future benefits. The Omnibus Budget Reconciliation Act of 1989 limits an employer's contributions to retiree health funds (so-called 401(h) contributions) to 25 percent of its total contributions to pension plans. Thus, a firm with an overfunded pension plan might not be able to make any deductible 401(h) contributions. The 1990 Omnibus Budget Reconciliation Act allowed firms with overfunded defined-benefit pension plans to transfer some of the excess amount into 401(h) accounts. However, those transferred assets can pay only for current retiree health liabilities in the tax year of the transfer.[5]

The fact that firms are required (under the Employee Retirement Income Security Act of 1974) to prefund pension benefits but face no such requirement for retiree health benefits puts health benefits at risk when firms experience financial stress.[6] In general, companies have more latitude to cut retiree health benefits than pension benefits. Pension benefits are contractual, and the Pension Benefit Guaranty Corporation insures them up to specified limits. No federal guarantee exists for retiree health benefits. According to a survey by Watson Wyatt, a benefits consulting firm, the number of medium and large companies offering retiree health benefits fell from 71 percent in 1988 to about 40 percent in 2001. And of the companies still offering those benefits, about 80 percent have cut future benefits for current employees, and most are requiring current retirees to bear a larger portion of the costs.[7] For

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4. Watson Wyatt, *Retiree Health Benefits: Time to Resuscitate?* Research Report (Washington, D.C.: Watson Wyatt, 2002), pp. 47-52.

5. Ibid., pp. 10-12.

6. See, for example, Mary Williams Walsh, "Another Cloud on the Horizon for Lucent Retirees," *New York Times*, November 20, 2002, p. C1.

7. The biggest reason for those cutbacks has been acceleration in the cost of providing retiree health benefits. Most analysts do not believe that the change in accounting treatment is driving the reductions. See Watson Wyatt, *Retiree Health Benefits*, pp. 13-26.

example, employers' typical premium contribution has fallen from 80 percent for current retirees to less than 60 percent for future retirees. In addition, eligibility standards have been tightened, and more firms are tying premium contributions to an employee's length of service. Firms are also capping their premium contributions. Moreover, about 15 percent of firms have eliminated retiree health benefits for their new employees.

Like private-sector companies, the Postal Service uses generally accepted accounting principles for accounting, rate-making, and internal budgeting purposes. But unlike those companies, the Postal Service accounts for retiree health costs on a current basis, on the theory that its circumstances are analogous to those of a participant in a multiemployer plan. The General Accounting Office (GAO) initially concurred with that view, noting that accruing and fully funding retiree health costs would have required a 3-cent increase in stamp prices starting in 1994.[8]

FASB's rationale for exempting multiemployer plans from accrual accounting was that the liability of an individual employer would be difficult to determine and would be of limited value. In general, firms participating in a multiemployer plan might need to make additional payments should another participating employer fail to make its contribution. However, the lack of recognition of accruing costs under multiemployer plans does not make those costs any less real. Moreover, FASB's rationale for exempting multiemployer plans from accruing costs does not apply well to the Postal Service. This year, GAO revisited the issue, and it now supports accrual treatment, in recognition of the unique characteristics of the Postal Service.[9]

The Postal Service's main competitors offer both multiemployer and single-employer retiree health plans, so they use a mix of accrual and current accounting. United Parcel Service (UPS) reported a net cost of $130 million for retiree health benefits in 2001—including a $55 million accrual cost and $118 million in interest on liabilities minus $42 million in expected returns on assets and a small adjustment for prior service costs.[10] UPS recorded a net liability for retiree health benefits of $1,130 million on its balance sheets as of September 30, 2001. The firm also had $372 million in funding for those benefits, and it had paid $75 million in health benefits for current retirees. Some UPS employees participate in multiemployer

8. GAO did favor reporting those costs in footnotes to financial statements, which the Postal Service chose not to do. See General Accounting Office, *Financial Reporting: Accounting for the Postal Service's Postretirement Health Care Costs,* GAO/AFMD-92-32 (May 1992).

9. Letter from David Walker, Comptroller General, to John E. Potter, Postmaster General, published as General Accounting Office, *U.S. Postal Service: Accounting for Postretirement Benefits*, GAO-02-916R (September 12, 2002).

10. United Parcel Service, *Annual Report 2001*, note 5 to Consolidated Financial Statements (Employee Benefit Plans).

plans, and the firm reported a total of $553 million in payments to those plans in 2001 for active and retired employees. (No distinction was made in UPS's reporting of those payments.)

Federal Express reported much smaller costs because it has a younger workforce—just 5 percent of its pension plan participants are retirees. In 2002, it reported $50 million in retiree health costs for its single-employer plan (a $27 million accrual cost and $25 million in interest).[11] The company paid out $13 million in benefits. It has an accrued liability of $385 million for retiree health benefits but no funding of those liabilities. Federal Express has capped its retiree health costs at 150 percent of its 1993 costs and has increased the length-of-service requirements for benefits.

Under FASB Statement No. 5 ("Accounting for Liabilities of the Federal Government"), issued in December 1995, federal agencies must report the accrual cost of retiree health benefits in their financial statements. Budgetary accounting is different, however. Agencies make no accrual payments to the Federal Employees Health Benefits program for retirees; and the Office of Personnel Management pays the cost of retiree health benefits (except for postal retirees, whose costs are paid for by the Postal Service). Legislation introduced in the 107th Congress (S. 1612, the Managerial Flexibility Act of 2001) would have charged agencies other than the Postal Service the accrual cost of retiree health benefits for employees covered by the Civil Service Retirement System and the Federal Employees Retirement System.

Recognizing the accrual cost of pension and retiree health benefits is not the same as prefunding those benefits. Prefunding would require actually setting resources aside. Recognizing those costs by making intragovernmental payments between agency accounts and the Treasury does not provide the government with the resources to make payments when they are due. Indeed, the size of balances in retirement trust funds does not alter the burden on future taxpayers—who are ultimately liable for all of the obligations of the federal government, whether they are recognized or not. Nonetheless, reflecting costs as they accrue is a means of showing policymakers and the public the government's accumulating obligation to make benefit payments in the future. For the Postal Service, however, such accounting could be a means of reflecting that burden in the price of postage or in lower costs elsewhere in the agency—which would generate resources by increasing the government's receipts or reducing its spending.

11. Federal Express, *Annual Report 2002,* note 12 to Consolidated Financial Statements on Employee Benefit Plans, pp. 42-44.