CBO TESTIMONY

Statement of
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before the
Subcommittee on Oversight
Committee on Ways and Means
U.S. House of Representatives

August 11, 1992

NOTICE

This statement is not available for public release until it is delivered at 9:00 a.m. (EDT), Tuesday, August 11, 1992.

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Mr. Chairman and Members of the Subcommittee, I appreciate this opportunity to appear before you today to discuss the financial condition and budgetary treatment of the Pension Benefit Guarantee Corporation (PBGC).

In my statement, I will make three points:

- o The federal government's exposure to financial loss from insurance against terminating pensions is large and growing;

- o Accumulated losses incurred by PBGC must be paid for through program changes such as higher premiums, lower benefits, or the use of taxpayer funds--all of which have significant public policy disadvantages; and

- o Changes in treating pension insurance in the budget and in allocating responsibility for PBGC's financial condition could facilitate reforms to control program costs.

Given the ongoing potential for financial loss and misallocation of resources under current policy, federally sponsored insurance for terminating pensions deserves Congressional attention.

ACCUMULATED AND EXPECTED LOSSES

PBGC's cumulative deficit is the difference between assets on hand and the present value of pension benefits to be paid under plans that have already been terminated. In 1991, it reached $2.5 billion for the Corporation's program for single-employer plans. That deficit was $600 million higher than at the end of the previous year. By 1997, PBGC expects the cumulative deficit for all of its programs to reach $18 billion. The accumulated loss results solely from federal insurance for single-employer plans. The insurance program for multi-employer plans runs a small surplus.

These PBGC deficits are caused by a continuing excess of costs over collections. The principal cost faced by the Corporation arises when sponsors of underfunded, defined benefit pension plans become insolvent, and their pension plans are terminated. Those firms have promised employees specific retirement benefits but have failed to put aside sufficient money to fund these promises fully. When a sponsor terminates a defined benefit pension plan, PBGC assumes responsibility for employee pension payments, subject to certain limits. These payments are financed by the assets of terminated plans plus insurance premiums paid by sponsors of defined benefit plans. Insurance premium rates are set by law.

PBGC expects its deficits to increase based on the continued underfunding of pension plans by financially troubled sponsors that could go bankrupt. Currently, liabilities exceed assets in underfunded single-employer plans by about $31 billion. PBGC regards termination of plans with current underfunding of $13 billion as "reasonably possible" in the foreseeable future. As with all estimates, the cost to the government may turn out to be more or less than expected. PBGC's experience suggests, however, that the current underfunding of plans whose failure is reasonably possible may be too low an estimate of losses, since the level of pension funding tends to fall precipitously in the period just before termination.

The concentration of underfunding in a few large pension plans makes PBGC losses even more difficult to anticipate. Fifty plans account for 70 percent of the total dollar amount of pension underfunding. The defined benefit plans of just five firms account for 50 percent of all underfunding of single-employer plans. Further, many of these firms are in the same or related industries. Adverse economic conditions in a single sector of the economy could trigger a surge in the termination of underfunded pension plans.

FINANCING ACCUMULATED LOSSES

The PBGC accumulated deficit will have to be funded in one of three ways: through higher premiums, reductions in costs, or a transfer from the general fund. All of these alternatives have significant disadvantages.

In both statute and hearings, the Congress has concluded that PBGC expenditures are to be financed wholly from premium income. This approach creates the presumption that the PBGC deficit will be financed by a legislated increase in premiums to be paid by sponsors of defined benefit plans. Several considerations, however, argue against this means of financing the PBGC's current deficit. First, it may be inequitable to raise the insurance premiums of today's pension sponsors to pay pensions promised by others who did not make adequate provision to finance those promises. In some cases, the surviving firms may have been disadvantaged by competition from the failed firms; with higher premiums they will be harmed again by having to pay deferred compensation costs incurred by their competitors.

Second, the existing structure of PBGC insurance premiums does not adequately reflect the large variation in risk to the PBGC from underfunded and fully funded pension plans. Although current policy provides for somewhat higher premiums for underfunded plans, the premium structure still

provides incentives for plans to behave in a manner that increases the risk of loss to the government. Raising the level of premiums without relating premiums more closely to risk would not offer any appreciable incentive for sponsors to reduce risk.

Third, raising premiums to pay past losses may increase the cost of federally sponsored insurance for terminating pensions above the future benefits that sponsors expect from the insurance. If so, some pension plan sponsors will switch from defined benefit plans to uninsured defined contribution plans or other forms of employee compensation. That shift may result in lower premium collections by PBGC and damage PBGC's financial condition.

The existing premium structure could fund PBGC's deficit, if outlays for pension payments can be reduced. Reducing insured payments for plans that have already been terminated would constitute an abrogation of an existing government commitment. Cost reductions, therefore, are feasible only for those plans that have not yet been terminated. The Administration has already proposed three means of achieving this result: higher funding requirements, limitations on federal insurance for increases in benefits promised by sponsors of underfunded plans, and an enhanced status for claims in bankruptcy by PBGC against insolvent sponsors.

If enacted, PBGC estimates that those changes would permit the accumulated deficit to be retired. The disadvantage of this approach varies with the manner in which the costs are reduced. For example, enhancing PBGC's bankruptcy claim may increase the cost of funds to firms with underfunded plans. Changing funding rules may force firms to interrupt future investment plans.

Finally, an appropriation from the general fund could be made to the PBGC. Such action, however, would constitute a complete reversal of federal funding policy toward PBGC. It could also have perverse effects on the distribution of income, since the beneficiaries of defined benefit pension plans tend to have higher incomes than those of the general population of taxpayers.

The disadvantages associated with each of the ways to fund PBGC's accumulated deficit indicate why it is preferable to avoid such deficits in the first place. If federally sponsored insurance for terminating pensions were designed to assure a more continuous balance between premiums and costs, the frequency of difficult choices would be reduced.

MAKING COST CONTROL MEASURES EASIER TO ADOPT

Given its current treatment in the budget and limited authority to adjust the terms of federal pension insurance, PBGC is handicapped in its efforts to control costs. One of the impediments to promptly adjusting the federal exposure to risk is the current budgetary treatment of PBGC, which does not recognize the costs of insurance until they are no longer controllable. Further, the current requirement that changes in premiums and other insurance terms be made by changing the law virtually assures that measures to contain costs are adopted more slowly than the insured increases cost. If the government does not closely monitor the behavior of the insured and quickly modify the terms of the insurance to counter the costly proclivities of insured firms, costs will tend to rise above collections from premiums.

Flawed Budgetary Treatment

The federal budget serves as a means of reporting, controlling, and planning the use of federal fiscal resources. In the case of PBGC, the current budgetary treatment fails on all counts: it does not accurately characterize the use of, motivate the control of, or provide for future resources. This functional failure in the budgetary treatment of PBGC contributes to its

neglect by policymakers and is one reason that PBGC continues to accumulate a deficit.

The budget accounts for PBGC on a cash basis. Cash receipts and outlays are recorded in the budget year in which they are received or paid. Annual cash receipts by the agency consist of collections from insurance premiums, payments from an off-budget fund that holds the assets of terminated plans, and interest from the Treasury on the balances held. Annual cash outlays are made for administrative expenses and payments to beneficiaries of terminated pension plans. The budget accounting for PBGC, therefore, depicts annual cash flows rather than the long-term imbalance between income from premiums and payments for insured pensions.

Since its creation in 1974, the PBGC has received more in cash receipts each year than it has paid out. In 1991, the excess of receipts over payments in the on-budget account was $788 million. After 1981, when PBGC was put on-budget, its positive budgetary cash flow has totaled $2.2 billion, even as PBGC was accumulating a loss of $2.5 billion. Under the current budgetary treatment, PBGC's operations will add to the federal budget deficit only when its receipts from premiums, payments from the off-budget fund, and interest earned no longer pay the current year's pension benefits and administrative costs. At that point, PBGC will already have incurred even

larger losses. In the meantime, the budget provides neither a signal of PBGC's deteriorating financial condition nor any incentive to modify current policy.

Improving the Budgetary Treatment of PBGC

One option for shortening the time to respond to emerging needs for modifications in federal insurance policy is to provide more relevant information about the financial condition of the PBGC and stronger motivation for the government to act.

In its fiscal year 1993 budget proposal, the Administration offered a new budgetary treatment of PBGC to increase the speed of the federal response to the financial disequilibria of the PBGC. The Administration's proposal would have provided for an annual federal appropriation to the PBGC equal to the annual increase in the value of the PBGC's future pension liabilities less that year's income from premiums. By focusing on the value of future liabilities and by forcing action that would increase the deficit whenever a payment was required, the Administration hoped to both inform better and motivate policy adjustments to contain costs.

Although these goals are laudable, the Administration's proposal has several flaws. One is that it made federal funding the first, rather than the last, line of defense against a financial shortfall at PBGC. Another is the complex method the Administration proposed to use in estimating current costs. That method would produce estimates that are very uncertain and subject to manipulation. Finally, the Administration proposed to use projected reductions in PBGC's 30-year liabilities from its proposals for reform to pay for increases in this year's spending for non-PBGC purposes under the pay-as-you-go (PAYGO) provisions of the Budget Enforcement Act of 1990. Thus, savings from reductions in PBGC costs would be used to pay for other budget initiatives. The Congressional Budget Office believes that any PBGC savings should first be applied to the newly estimated cost of insurance.

Variations on the Administration's proposal are feasible and may also be preferable. For example, federally sponsored insurance for terminating pensions could be accounted for in the budget to show the annual increase in the PBGC deficit as a federal outlay, without providing a subsidy from the general fund to PBGC. Such revised budgetary treatment, however, is not guaranteed to produce timely change in programs; it can only provide clearer information and stronger incentives for legislative changes in policy.

Another option short of changing the budgetary treatment would be to remove PBGC from the PAYGO scorecard as has been done for deposit insurance. Under the current cash basis of accounting, the Administration's proposed program reforms would add to the federal deficit in the near term and constitute a charge against PAYGO. This perverse outcome suggests a fundamental incompatibility of the current budgetary treatment of PBGC with the PAYGO rules. Removing PBGC from the PAYGO scorecard would eliminate the disincentive for the Congress to adopt policies that would reduce the cost of pension insurance.

Modifying the Allocation of Responsibility

Another approach to improve federal control of the cost of pension insurance involves shifting more responsibility for the long-term financial health of the program to the PBGC, much as has been done with the assigning of responsibility for federal deposit insurance to the FDIC. Such a shift in responsibility would require that PBGC be given authority equivalent to that of the Federal Deposit Insurance Corporation: for example, to require detailed reports from insured institutions, to examine the pension funds, to specify operating practices consistent with safety and soundness, and to impose insurance premiums that are more closely related to the risk of each

plan. Of course, this change would not assure that the PBGC would always take prompt corrective action. The Congress would still need to provide informed oversight. The need for such oversight means that improved information about PBGC's true financial condition would also be required under this option.

CONCLUSION

In summary, the PBGC's accumulated and anticipated future losses present the Congress with three distinct problems. The first is how to finance the accumulated loss for federally sponsored insurance of terminating pensions; the second involves the choice of programmatic changes to reduce anticipated costs; and the third concerns identifying changes in budgetary treatment and assignment of operating responsibility that will facilitate cost control in the future.

This Subcommittee clearly recognizes the potential for loss from PBGC. Many suggestions have been put forth to control this exposure to risk, and most of them seem to be aiming in the right direction. The Congressional Budget Office looks forward to working with the Subcommittee

on the task of fleshing out the details and assessing the consequences of these proposals for reforming PBGC.