

# **CBO TESTIMONY**

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

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## **NOTICE**

This statement is not available for public release until it is delivered at 9:00 a.m. (EST), Thursday, February 4, 1993.



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Mr. Chairman and Members of the Subcommittee, I appreciate this opportunity to discuss the federal pension insurance system and the federal agency that administers this program, the Pension Benefit Guaranty Corporation (PBGC). This topic is discussed in more detail in the Congressional Budget Office report on controlling losses of the PBGC that was prepared for this Subcommittee and is being released today. I intend to emphasize three points in my statement this morning.

First, the federal pension insurance system, which was intended to guarantee defined benefit pensions at no cost to taxpayers, has accumulated a sizable deficit. Unless the program is modified, this financial imbalance is expected to deteriorate significantly.

Second, although these accumulated and projected losses are unlikely to threaten the income security of retirees or workers whose pensions are guaranteed by the federal government, they may result in an unintended and costly bailout of PBGC by U.S. taxpayers.

Third, the Congress could adopt a combination of short-run policy adjustments and long-term structural reforms that would greatly improve the chances that this insurance program will operate in the future on a financially sound basis. The sooner the Congress adopts such measures, the less likely that a large infusion of taxpayer funds will be required.

## PBGC'S FINANCIAL IMBALANCE

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Federal insurance against losses from pension termination protects the retirement benefits of those citizens whose privately funded pension plans provide specified or defined benefits. PBGC insures--subject to limits--workers and retirees against the inability of their pension fund and its sponsor to pay promised benefits. When a firm sponsoring a pension plan terminates its underfunded plan (a pension plan whose assets are less than its pension liabilities), PBGC becomes the trustee for the plan, acquires the plan's assets, and pays guaranteed retirement benefits.

When a plan is terminated, PBGC becomes financially responsible for the gap between the value of acquired assets and insured pension benefits. PBGC's only source of funds to fill the gap consists of premiums paid by sponsors of defined benefit plans, augmented by a claim against the sponsor and by earnings on assets held.

Despite six increases in insurance premiums over the last 19 years, PBGC has run a deficit since it was created by the Employee Retirement Income Security Act of 1974 (ERISA). Today PBGC, which insures nearly 32 million workers in single-employer pension plans and more than \$900 billion in defined pension benefits, has \$2.5 billion more in pension liabilities than in assets. Furthermore, PBGC's obligations to pay pension benefits, in excess

of anticipated assets from terminated plans, are increasing. Currently, PBGC estimates that financially weak firms, whose failure is "reasonably possible," are sponsoring pension plans with \$12 billion more in pension liabilities than in assets. Studies focusing on a longer planning horizon have estimated that the present value of the foreseeable deficit for PBGC exceeds \$35 billion.

### ADVERSE EFFECTS OF PBGC LOSSES

Although ERISA states that the U.S. government is not liable for any obligation or liability incurred by PBGC, recent experience with deposit insurance and the farm credit system suggests that the Congress would not allow PBGC to default on federally insured pensions even if PBGC losses were to grow into tens of billions of dollars. The federal government's commitment to its insurance promises, expressed through repeated reforms of PBGC, does not appear in doubt.

Nonetheless, consistency with legislative intent as well as equity and efficiency require that losses in the federal pension insurance system be addressed and controlled. As originally enacted and as amended, ERISA contains an explicit provision governing the financing of the pension insurance system: costs are to be covered by premiums. This legislation allows firms to avoid paying these premiums, however, by terminating their defined benefit

pension plans and replacing them with defined contribution plans, which require no insurance.

The requirement that the pension insurance system be operated on a self-supporting basis has three important implications. The first is that voluntary participation of sponsors and workers in defined benefit plans prevents the federal government from raising premiums and other costs of insurance above the benefits the firms and employees receive from it. If sponsors of insured pension plans believe that their premiums are excessive, they may leave the insurance pool by terminating their defined benefit pension and establishing a noninsured plan. By terminating their defined benefit plans, firms can escape paying a premium that exceeds the benefits they expect from the insurance.

A second implication is that it is possible to collect premiums sufficient to cover expected losses from the sponsor of a terminated plan only before the losses have occurred--before costs are "sunk." After PBGC has taken over a plan to avoid a pension default, the failed sponsor will be unable to pay the costs it has imposed on the system, and surviving firms may be unwilling to pay premiums to cover old losses.

These two implications lead to a third. If PBGC continues to accumulate unfunded losses and if sponsors continue to leave the insurance pool, a form of involuntary assessment or tax may be necessary to pay these losses. Such taxes may have undesirable effects, however, as firms adjust to and try to avoid the new charge. For example, assume recurring surcharges are imposed on the surviving sponsors of defined benefit plans to finance past losses of PBGC. This factor will then tend to depress the number of defined benefit plans below the level that firms and employees would choose without the tax.

Thus, PBGC's losses should be controlled and funded by fair premiums before claims are made. This type of funding will ensure that those who impose losses on the insurance system have to bear the anticipated costs of their own actions; avoid the distorting effects of taxes to finance old losses; encourage the continuation of defined benefit plans; and minimize taxpayer costs and, thereby, strengthen the Congressional commitment to this program. Continuing current PBGC policy may encourage firms, especially those under financial stress, to engage in high-risk behavior such as not fully funding their pension plans or offering increased pension benefits as a substitute for wage increases.

PBGC's past losses have already resulted in some inequities. To the extent that past losses have been made up from program operations, these losses have been paid by surviving sponsors and their workers, whose premiums fund the operation of PBGC. To the extent that the losses remain on PBGC's books, they are implicitly paid by taxpayers, whose backing of PBGC gives its guarantee credibility even though its liabilities exceed its assets.

## OPTIONS FOR REFORM

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The Congress has a number of policy options available to it that would promote the prefunding of insurance losses and enable the system to avoid "sunk" costs, those that once incurred cannot be financed easily with avoidable premiums. These options are of two distinct types: short-term policy adjustments to restore financial balance and long-term structural changes to minimize the accumulation of sunk costs.

### Policy Adjustments

The current financial imbalance of the federal pension insurance system is the result of an excess of claims over premium income. Remedial policy

adjustments would reduce expected future claims by increasing the funding requirements for insured plans, aligning individual premium charges more closely with the expected claims from each pension plan, and--when the sponsoring firm is financially unable either to raise its plan's funding or to pay a fair premium--severely restricting the ability of the sponsor to increase insured pension benefits. Along with these policy adjustments, PBGC should continue correcting internal control weaknesses identified by the General Accounting Office.

Higher Funding Requirements. Guaranteed benefits in single-employer pension plans are underfunded by \$40 billion, according to PBGC. This sum is an increase of \$9 billion over last year. The 50 firms with the highest level of underfunding hold 60 percent of total underfunding; four firms hold 43 percent. Existing law permits pension plans to accumulate underfunding. For example, minimum funding rules allow firms to amortize increases in benefits, thereby spreading funding over many years. During the amortization period, firms may not have enough money in their pension plan to make good on their pension promises. In particular, flat-benefit plans (in which benefit payments are a flat dollar amount for each year of service) are often underfunded as they amortize recurring increases in pension promises. PBGC reports that flat-benefit plans, on average, are only 75 percent funded.



Several alternatives to current funding policy exist. The Congress could, as it did in 1987, shorten the time period over which firms can amortize benefit promises. Another option is to base one standard of the required funding of a pension plan on the amount of its cash outlays; funding over a year would have to equal at least as much as was paid out that same year. This type of "cash flow rule" for underfunded plans would be especially effective in accelerating full funding by firms with more retirees than current employees.

However, full funding comes at a cost. First, federal tax collections will decline with increases in tax-deferred pension funding. Second, requiring firms to fund their pensions limits their flexibility in finding the highest value for the use of their funds. Forcing some profitable firms to stockpile funds for payments to be made many years in the future could ultimately increase the risk of these firms failing.

Risk-Adjusted Premiums. PBGC currently charges insured firms a flat-rate premium of \$19 per participant and a variable-rate premium of \$9 per \$1,000 of plan underfunding per participant. Total premiums per participant are capped at \$72. The cap on premiums limits the degree to which they can increase with underfunding. Because of these limits, the current premium is fairly constant over a wide range of risk. Accordingly, firms that are suffering

financial stress and are more likely to make a claim against PBGC could pay about the same premium as financially healthy firms. The premium is restricted, therefore, in its ability to discourage firms from pension underfunding and other risky behavior. A number of reforms, such as linking the premium to the financial health of the firm or removing the cap, would provide a greater incentive to firms to take fewer risks with their pensions.

Restrict Ability of Troubled Firms to Grant Increases in Benefits. PBGC faces large claims from firms that are in financial trouble and that sponsor underfunded plans. PBGC has found that in the five years before a pension plan is terminated, the plan's funding ratio drops from 80 percent to 40 percent. Although much of this underfunding results from an increase in pension payouts linked to the reduction in a firm's work force, some of the increase develops from firms who cope with financial difficulty by increasing insured benefits in lieu of wages. For example, PBGC reports that Trans World Airlines increased its insured pension benefits by \$100 million while in bankruptcy. Without federal pension insurance, workers would be unlikely to accept pension promises from financially weak firms. To help reduce the losses from these high-risk firms, several reforms are aimed at limiting benefit increases by sponsors of underfunded plans, such as reforms requiring underfunded plans to collateralize all benefit increases, as proposed by Chairman Pickle.

## Structural Reforms

The current tendency of PBGC toward deficits reflects a structural deficiency: nothing in the current system permits the insurer to take remedial action in response to financial imbalance. The pension insurance system often needs prompt policy adjustments to offset the change in risk posed by some pension plans, but under the current system, adjustments are made by the Congress in a deliberative rather than a swift manner.

Because the budget--one of the most important instruments for informing and motivating Congressional action--misstates the financial performance of PBGC, it is not surprising that needed adjustments are often postponed. As the pension insurance program is accumulating losses, the budget shows this activity as being not only self-supporting but contributing to a lower federal deficit. Although PBGC has accumulated \$2.2 billion in losses since 1974, it has reduced the measured federal deficit by \$2.3 billion.

The budget provides this misleading information about PBGC because it currently focuses on financial data unrelated to PBGC's long-term financial condition. The essence of this condition is that PBGC is piling up liabilities faster than it is building assets. Since the budget only tracks cash, it counts

the excess of current premiums over benefit outlays. But the budget ignores the accumulation of assets and liabilities from terminated plans. PBGC's true financial position has little to do with today's payments and receipts. Rather, the commitments PBGC has made for pension payments in the future and the assets and premium payments it will receive determine PBGC's financial health.

Many alternative structural reforms for PBGC could be considered. For example, the current responsibility for PBGC policymaking could be reallocated so that the agency has more authority to adjust policy. The Congress, of course, could retain its authority to overrule agency decisions, or it could require that PBGC provide more timely information to it. This provision would allow the Congress to carry out its legislative duties with greater efficiency. If the Congress believes that neither it nor PBGC can manage the pension insurance program, then use of private-sector insurers and capital may be appropriate.

Given the current budgetary misinformation provided to the Congress, several budgetary reforms could also prove useful. In the short term, the Congress could remove PBGC from the pay-as-you-go scorecard. This change would prevent policy adjustments that improve PBGC's cash flow from financing spending increases in other programs. The Congress could also

change PBGC's budgetary treatment so that more forward-looking financial information is in the budget. Finally, mechanisms that make it costly for the Congress to postpone allowing PBGC to receive adequate funds to pay its liabilities could be instituted.

## CONCLUSION

Current federal pension insurance policy contains a statutory and structural inconsistency. On the one hand, the Congress clearly intends to protect workers from losing their pension benefits, and it intends to finance the cost of this protection from insurance premiums. The Congress has even gone so far as to disclaim in law the financial responsibility for the losses of PBGC. On the other hand, the government has not created an institutional structure that is capable of managing the program until self-sufficiency is reached.

Without reform, PBGC's deficit is expected to increase by tens of billions of dollars. These losses will squander scarce resources because they are unnecessary to provide the intended benefits to the insured. Consequently, if the federal pension insurance system is to achieve its mandated objectives, program adjustments and structural modifications such as those discussed here will be required.