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PBGC: Budget Process May Shape Pension Bill

A Congressional Budget Resolution may play a surprisingly large role in determining the ultimate design and fate of legislation to implement the Administration's pension reform proposal. The House version of the resolution is consistent with full implementation of the President's pension reform proposal, scored by the Office of Management and Budget (OMB) as adding $15 billion of revenue over five years and by the Congressional Budget Office (CBO) as raising $18 billion. The Senate version explicitly assumes that PBGC premium increases would be scaled back to add only $5.3 billion over five years compared to CBO's baseline assumption of premium levels without new legislation. The House and Senate will appoint a Conference Committee to work out a compromise bill. If such a bill passes, as has occurred in all but a few years, it will have a large effect on pension reform legislation.

Even the lower Senate figure of $5.3 billion of revenue over five years would create substantial pressure to pass pension legislation. Otherwise, the authorizing committees, "Health, Education, Labor, and Pensions" (HELP) in the Senate and "Education and Workforce" in the House, would be required to raise revenues or reduce outlays from other mandatory programs within their jurisdictions. Failure to do so gives the Budget Committee of that House the authority to impose its own changes, which is generally repugnant to the authorizing committees. The requirements of the Budget Resolution can be removed or modified by the full Congress, but this would require a super-majority of 60 votes under Senate budget rules.

A billion dollars a year of revenue could be squeezed out of other programs, if pension legislation fails, but the path of least resistance is likely to be implementation of the assumed rise in PBGC premiums. The Administration is already making a major push for a substantially greater increase, PBGC's deficits have been growing by $10 billion a year, and there have been no premium increases since 1994 for the variable premium and 1991 for the fixed premium. Despite the visceral dislike of premium increases by pension sponsors, it would very likely be politically easier to impose these hikes than to find the money in another program. (There are large-scale proposed changes to the student loan program which could conceivably be extended further to raise enough revenue to offset failure to increase PBGC premiums, but there is already very strong opposition to the Administration's student loan proposal.)

The House mandate of an $18 billion premium hike over five years would raise the stakes and introduce a major technical issue. First, it would be so hard to find $18 billion elsewhere as to virtually dictate a pension reform bill with a large PBGC premium increase. Second, it appears very unlikely as a technical matter that the Administration's pension reform proposal could actually raise an additional $18 billion, as explained below. If so, Congress would have the options of: (1) assuming the $18 billion will materialize anyway; (2)

altering the pension reform proposal to dramatically raise the fixed premium or use some other solution to make $18 billion feasible; (3) implementing a smaller premium increase and making the difference up elsewhere; or (4) accepting a lower level of deficit reduction.

The $18 billion calculation (as well as OMB's $15 billion figure) appears to rely on one of two unlikely events: (1) that a more than five-fold increase in the effective premium rate charged on underfunding will not cause firms to contribute significant additional amounts to their pension funds or (2) that systemwide pension underfunding will deteriorate for other reasons sufficiently strongly to more than offset the effect of increased contributions.

Background

PBGC charges two types of premiums, a premium of $19 per year for each employee, ex-employee, and retiree covered by an insured pension plan (the "fixed" premium) and a charge of 0.9% of the amount of a plan's underfunding that does not fall within certain broad exclusions (the "variable" premium.) Please see "PBGC: A Primer" and other papers on our website, www.coffi.org, for a fuller explanation of the current structure. The President's pension reform proposal would increase the fixed premium to $30 per participant, to reflect wage inflation since the last increase in 1991, causing the total amount to rise from roughly $600 million to $900 million in the first year. The rate would automatically rise with wage inflation thereafter.

The variable premium would change more significantly. First, the premium would be charged on every dollar of underfunding, eliminating all exceptions. This is a major change, since 80-95% of underfunding has been sheltered by these exceptions in recent years. Second, Congress would cease to set the variable premium rate, passing that responsibility on to PBGC's Board, composed of the Secretaries of Treasury, Labor, and Commerce. Third, important technical changes to funding rules would change the amount of calculated underfunding, generally increasing it.

The President's Budget implies an increase in variable premiums from 2004's $0.9 billion to $5.0 billion in 2007. (Page 305 of Analytical Perspectives on the Budget shows a $3.7 billion increase in premiums in that year; we assume that 2007's base level of total premiums is the same as 2006's budgeted $2.2 billion; and that fixed premiums will increase to $0.9 billion under the proposal, leaving $5.0 billion of the $5.9 billion to come from variable premiums.) CBO's projections result in a similar total premium collection, but they start with a lower assumption of baseline premiums without new legislation, resulting in a total increase of $18 billion over five years, compared to OMB's $15 billion number.

Analysis of the likely revenue increase is complicated by the fact that the pension reform proposal asks for authority to set rates in the future, rather than specifying a variable premium rate. However, there appears to be no rate likely to produce $5 billion of variable premiums, absent a major underlying increase in pension underfunding in the near term. We are not aware of any expert predicting such an underlying rise. On the contrary, most experts believe systemwide pension underfunding will fall from the recent historically high levels.

The Problem

The technical problem in producing $5 billion in variable premiums stems from the ability of companies to make additional, tax-deductible contributions to reduce their underfunding and therefore their premiums. For example, PBGC's most recent estimate of systemwide pension underfunding is that $450 billion existed at the end of calendar 2003. This number will be used as the base in the following calculations although the relevant underfunding figure for the variable premium calculation is actually likely to be lower, which would make achievement of the revenue target even tougher. (Interest rates have risen in the meantime, stock markets have recovered somewhat, and the discount rate for premium purposes is on a somewhat different basis than in PBGC's $450 billion calculation. Partially offsetting these factors are proposed changes to funding rules that would generally increase calculated liabilities.)

Collecting $5 billion in variable premiums on $450 billion in underfunding implies a rate of 1.11%, compared to 0.9% today. More importantly, companies with 80-95% of the underfunding have avoided ANY variable premium charge recently, due to exceptions that are being eliminated. Many of the underfunded companies will choose to contribute enough to avoid paying this more broadly assessed charge in the future. There are already significant accounting benefits to borrowing at perhaps 6%, tax deductible, in order to bolster pension assets, while recognizing accounting earnings on those pension assets at 8-10%, tax-exempt. (See "PBGC: Policy Options", p. 6, at www.coffi.org, for a longer explanation.)

Tacking on a charge of more than 1%, even tax deductible, is undoubtedly sufficient incentive to spur major additional funding by healthy companies. (One might argue that the accounting benefits may not be a major motivation, since they were not enough to avoid this historic level of pension underfunding in the first place. However, many firms were unsure as to how much of the underfunding was due to temporary conditions in the financial markets and they also faced little penalty for holding off on funding under current rules.)

This is more than a theoretical analysis. General Motors chose to borrow approximately $20 billion a couple of years ago to fix their pension underfunding, in part in order to avoid the 0.9% variable premium and to gain the accounting benefits noted above. Creditors were happy to provide the money, since they recognized that the new liability was replacing dollar-for-dollar an existing, real liability from pension underfunding.

PBGC reports that just under $100 billion of underfunding relates to companies with junk bond ratings, which means that $350 billion is with firms that clearly have borrowing capacity. As a starting point, let us assume that the changes would cause $150 billion of new funding, This roughly corresponds to the underfunding at firms with credit ratings of "A" or higher, which is a strong credit rating five notches above "junk." Such companies can easily obtain financing.

Taking account of the projected new funding, the rate would have to be set at 1.67% (5/300) to collect the projected $5 billion. However, a vicious spiral of projected rate levels and anticipatory new funding is likely to set in. An announced charge of this level could easily cause new funding of at least $250 billion, rather than $150 billion, resulting in a need to set the rate at (5/200) or 2.5%. An anticipated rate this high would probably cause every investment grade company to borrow and fund, leaving $5 billion to be spread over only $100 billion of underfunding, with a resulting variable premium of 5%. At this level, the healthier junk-rated companies would borrow and fund. In the end, there might be $50 billion of underfunding at companies so strapped that they could not borrow to fund. These fragile firms would be facing a 10% charge to produce the projected $5 billion and would generally go bankrupt to shed their pension obligation.

The deficit would be even more heavily affected by the new pension funding, since the great bulk of the funding would be at companies that can use the tax deductions they would receive for contributing to their pension plans. Even if only $100 billion of new funding resulted, tax revenues would likely decline in the short run by $30 billion or so.

In sum, whatever the budget procedures might dictate, it is difficult to envision higher variable premiums resulting in the deficit reduction projected by the President's Budget Proposal and the CBO estimates. There is a strong possibility that the changes would actually increase the deficit in the near-term. Budget scoring might not take account of this likelihood, but future budgets would start from a worsened position.

It is worth noting from a technical point of view that an increase in fixed premiums could in fact accomplish the stated deficit reduction. It would take an almost 10-fold increase in the fixed premium rate, which would have serious public policy disadvantages, but could be done. The only way for companies to avoid this increase would be to terminate their pension plans. Outside of bankruptcy, this would require paying an insurer to take over the obligation, which is very costly. Companies generally assume that their pension investments will earn 8% or more, while insurers charge for pension terminations based on rates of 4-5%. Given the massive size of pension plans, roughly $1.8 trillion of systemwide assets, this percentage difference translates to a much larger hit than simply paying the added premiums. For example, if the give-up is 3 percentage points, this would translate to $54 billion a year if every pension plan terminated. (See "PBGC: Policy Options", p.6, for more.) Companies are more likely to "freeze" their plans by ceasing to provide additional benefits for future years of work, but this does little to change the number of participants, and fixed premium, in the near-term. It would only be as participants died or left the firm without vested benefits that the fixed premium levels would come down.