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THE "OTHER" PENSION CRISIS:
Options for Avoiding a Taxpayer Bailout of the PBGC

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The ideas presented in this research are the author's and do not represent official positions of the Mercatus Center at George Mason University.

Introduction

In recent months, there has appropriately been substantial and growing attention to underfunding in state and local government pension plans. Best available estimates are that such underfunding equals roughly \$3 trillion dollars in present value,¹ creating an unsustainable situation that must compel corrective action by elected officials. At the state and local levels of government, those in office will need to effect measures to bridge the significant gap between these plans' projected assets and benefits.

Adequate legislative reforms are, however, unlikely to occur at the state and local levels unless federal officials convincingly clarify that no federal taxpayer bailout will be forthcoming. This predicament is the basis for pending federal legislation such as the Public Employee Pension Transparency Act,² which requires fuller disclosure of state/local pension-plan obligations and would withhold certain federal tax benefits from states that fail to comply. Closing off the avenue of a federal bailout will not by itself force states and localities to eliminate unfunded pension liabilities. Yet at the same time, the existence of these liabilities is already creating pressure for direct federal support to states. In any event, the current policy focus with respect to these public plans is on ameliorating their underfunding, as well as on limiting momentum for a general taxpayer-financed bailout.

At the same time, there exists a similar (though smaller) set of financing risks in the employer-sponsored pension plans covered by the Pension Benefit Guaranty Corporation (PBGC), the federally chartered corporation established to insure employer-provided pension benefits. Here, too, public-

¹ Rauh, Joshua, "Are State Public Pensions Sustainable?", *National Tax Journal*, September 2010, 63(3), 585-602. "Official" state measurements produce figures significantly smaller—closer to \$500 billion in underfunding—but these calculations account inadequately for risk, as discussed later in this paper.

² See H.R. 6484, <http://www.govtrack.us/congress/bill.xpd?bill=h111-6484>.

policy corrections are required to address underfunding and to contain the risk of a taxpayer-financed bailout.

While the inadequacy of funding information provided to the PBGC renders impossible a precise estimate of all underfunding in such plans, reasonable estimates are in the hundreds of billions of dollars.³ PBGC's latest annual report⁴ shows a net negative financial position for its insurance programs of more than \$23 billion, of which roughly \$21.6 billion is attributable to the PBGC's single-employer insurance program. PBGC's estimate of its exposure to reasonably possible terminations of such plans is approximately \$170 billion. While these figures may appear small relative to the large potential losses in state and local plans, percentage underfunding in employer-provided plans is nearly comparable.

As with state and local pension plans, the choices arising in the employer-provided pension system are relatively simple and stark. Either the substantial gap between pension plan assets and benefit obligations will be closed by plan sponsors, or the costs of underfunding will be passed to others—potentially including both vulnerable workers and taxpayers. This paper outlines potential frameworks for (as a first preference) resolving the financing shortfall in the pension insurance system, or for (in the worst-case scenario) fully disclosing to public scrutiny the estimated cost to affected taxpayers and workers of a bailout.

This paper begins by reviewing the magnitude of and reasons for the substantial underfunding in our employer-provided defined-benefit pension system. These reasons will include both localized *financial* factors—such as the recent recession, the opacity of asset/liability measurements, and the inadequacy of insurance premium assessments and funding rules—as well as the broader moral hazard and political economy factors that underlie these phenomena. This paper will further explore the moral

³ Blahous, "Pension Wise," Hoover Institution Press, 2010.

⁴ http://www.pbgc.gov/docs/2010_annual_report.pdf, pp. 19-21.

hazards that operate within virtually all defined-benefit pension plans in the U.S., from employer-sponsored plans, to state/local plans, to Social Security. These moral hazards in all defined-benefit sectors establish substantial incentives for sponsors to obscure a plan’s true funding status and to shift the risks of its underfunding to others.

In presenting frameworks for reform, this paper will begin with recommendations common to all of the options presented—namely, increasing the consistency, transparency, and accuracy of plan asset/liability measurements. After these global recommendations, three directional options will be presented:

Three Options for Pension Insurance Reform

<i>Option #1</i>	<i>Empower the PBGC with the tools necessary to fill the shortfall in the national pension insurance system.</i>
<i>Option #2</i>	<i>Eliminate the PBGC and replace it with compulsory private insurance that would charge market rates to participants.</i>
<i>Option #3</i>	<i>Unless and until the federal government requires that the PBGC’s financing risks be resolved via options #1 or #2, treat the shortfall for federal budgetary purposes as an obligation facing U.S. taxpayers.</i>

The third option above could be thought of as the “taxpayer bailout” option. For reasons that will be discussed later in this paper, a federal taxpayer bailout of private-sector pensions would be a grossly inequitable outcome. This third option is therefore not a recommendation for this policy course; rather, only that its potential consequences be disclosed for as long as there is a failure to take responsible action to prevent it. Under current law, the PBGC is not financed with taxpayer funds, though it does have some limited borrowing authority. The extent to which taxpayers are at risk is ultimately proportional to the extent of public expectation that the federal government will protect insured pension benefits, and to the extent that federal law permits a funding gap between pension

plan assets and benefits while at the same time denying the federally-chartered pension insurance system the means of resolving it. If public policy is to be oriented toward preventing a federal taxpayer bailout, one necessary component of the effort is full, advance disclosure of such a bailout's potential consequences.

The choices associated with pension plan funding are difficult, not least because of the delicate balancing act between ensuring (on the one hand) that plan contributions are sufficient to fund promised benefits, while (on the other) not so large that they trigger the insolvency of the plan sponsor amid economically perilous but otherwise survivable conditions. A pension insurer, whether federally chartered or wholly private, will fail to sustain itself if its premium and funding requirements are the factor that pushes its contributing sponsors into bankruptcy or into precipitously terminating their pension plans. On the other hand, if the pension insurance system can *never* impose sufficient premium and funding requirements to close its own financing shortfall, it is better to disclose this reality now and to limit the fiscal damage, rather than to allow potential liabilities facing taxpayers to continue to mount.

In sum, elected officials face a fundamental value choice as to whether employer-provided pensions should be fully funded and insured by plan sponsors alone, or whether others' (taxpayers') dollars should fill the gap. Either policy requires substantial changes to federal pension law. If the former policy is not effectuated, the approaching cost of the latter course should be disclosed. Neither is an attractive scenario, but each is preferable to the current situation in which taxpayers face a growing risk that is disguised rather than forestalled by the existence of the PBGC. Elected officials should choose among the three basic directions for federal pension policy outlined here before these risks of plan underfunding are manifested in the form of further income losses to vulnerable American workers and/or taxpayers.

The Financing Shortfall in the PBGC Pension Insurance System

Employer-provided defined-benefit pensions are insured by the PBGC, a federally chartered corporation. The PBGC insures both single-employer and multi-employer defined-benefit pensions. For purposes of simplification, this paper will focus primarily on the single-employer pension insurance system, where the vast majority of the PBGC financing shortfall is concentrated (roughly \$21.6 billion of a total \$23.0 billion net negative financial position).⁵

The PBGC's single-employer pension insurance program covers approximately 33.8 million participants in roughly 26,000 plans.⁶ If such a pension plan terminates, it is trustee'd by the PBGC. In that circumstance, the PBGC assumes both the assets as well as the benefit obligations of the plan. The PBGC then pays benefits accrued by plan workers up to a statutory cap of \$55,000 (this cap was unchanged from 2009 to 2010, though more commonly it rises from year to year with typical growth in the national average wage index). In 2010, PBGC made approximately \$5.6 billion in such payments to roughly 800,000 retirees.

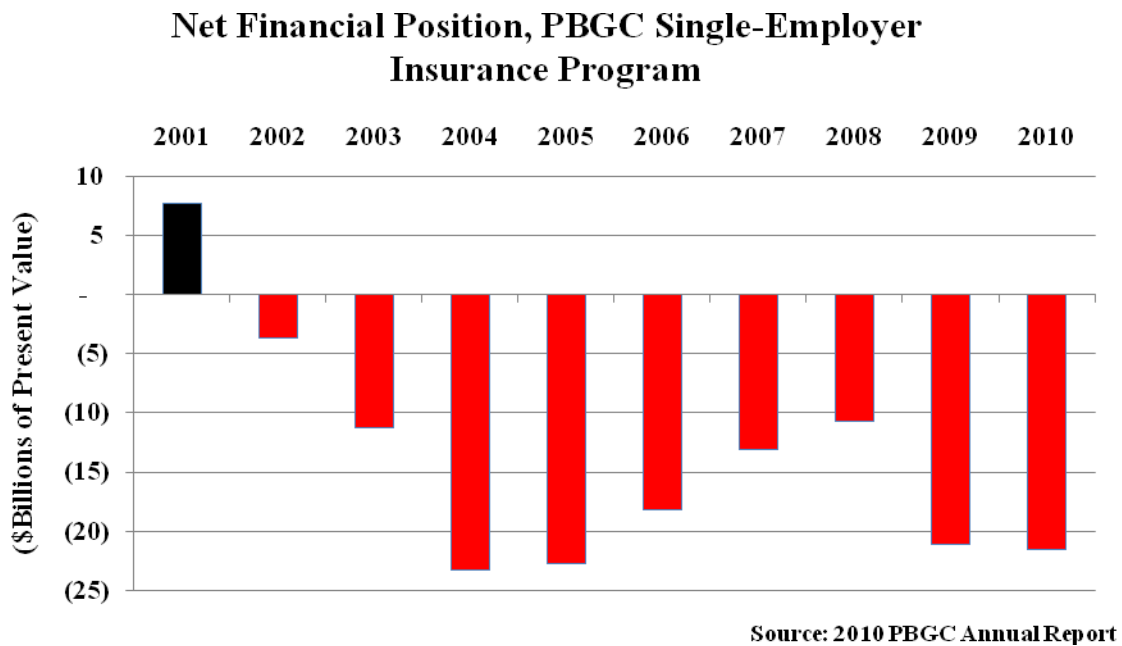
Whenever the projected cost of such benefit payments exceeds the value of assets assumed upon a plan's termination, the result is a worsening of the financial condition of the PBGC insurance

⁵ One of the reasons that the single-employer program makes up the vast majority of the PBGC shortfall is simply that the operations of the single- and multi-employer insurance programs are different, and are thus treated differently on the PBGC balance sheet. PBGC books both previous and probable future terminations within the single-employer program when determining its net financial position. When sponsors in the multi-employer system enter into bankruptcy, by contrast, the first recourse is to shift the cost of any resulting increase in plan underfunding to other employers within the same multi-employer plan. PBGC is more likely to be required to provide loans to a multi-employer plan than to put it under trusteeship. As a result, significant underfunding in the multi-employer system is not yet fully reflected on the PBGC balance sheet. Despite multi-employer plans seeming to embody a smaller fraction of the PBGC shortfall, pressure for a taxpayer bailout has already begun on the multi-employer side. A Casey-Pomeroy bill would have the PBGC assume the "orphan liabilities" of multi-employer pensions in addition to raising the cap on benefit payments from \$12,800 to \$21,000 per year.

⁶ http://www.pbgc.gov/docs/2010_annual_report.pdf. P. 2.

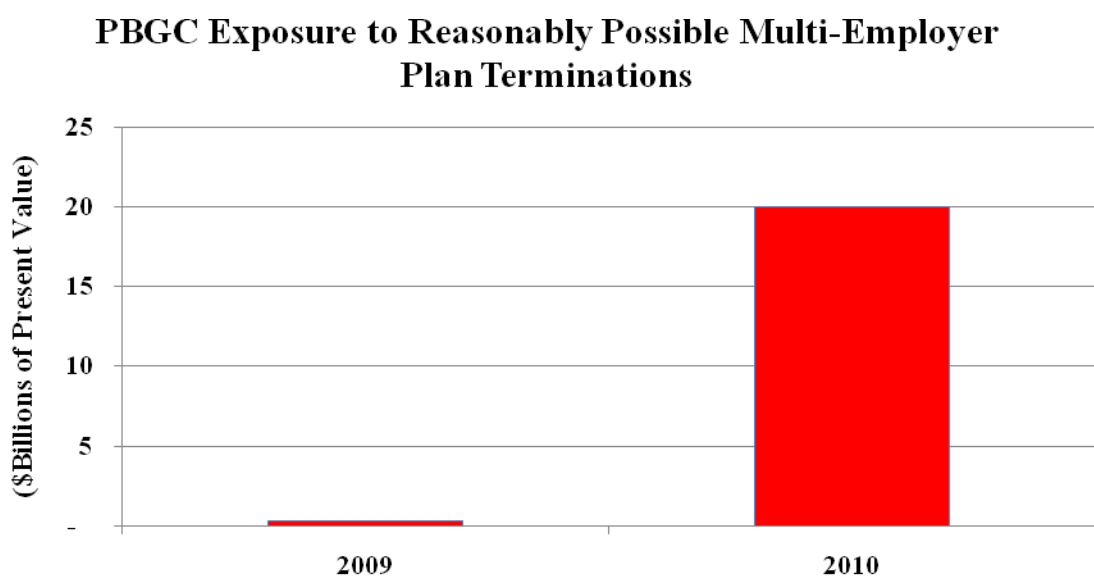
system. PBGC's "net financial position" is defined as the difference between its assets and its liabilities (the vast majority of which liabilities consist of such future benefit payment obligations). Estimates of these benefit payment obligations are in turn based both on already-completed and probable plan terminations.⁷

The \$21.6 billion deficit in PBGC's single-employer insurance program is nearly the largest on record, falling just behind the record deficits posted in 2004 and 2005. But while the size of the PBGC deficit fluctuates from year to year, it has remained persistently significant over most of the last decade (more than \$10 billion in each year since 2003, inclusive). In each of the last eight years, PBGC's liabilities have been measured as being at least 15 percent larger than its assets, and usually much more.



⁷ For a fuller explanation of the PBGC plan termination process, see Blahous, *Pension Wise* (Hoover Institution Press, 2010).

These figures fail to capture the full extent of PBGC’s potential downside risk. In 2010, PBGC estimated that its “reasonably possible” termination exposure—i.e., underfunding in plans with below-investment grade credit ratings—was roughly \$170 billion.⁸ Moreover, while the single-employer program accounts for the vast majority of PBGC’s current deficit, its multi-employer program is presenting increased risks as well; in 2010, “reasonably possible” exposure in multi-employer plans suddenly rose from roughly \$300 million to approximately \$20 billion.⁹



Source: 2010 PBGC Annual Report

While these figures are alarming, they are but indirect indicators of underfunding throughout the employer-provided pension system that presently eludes quantification. After 2008, due to the inadequacy of reporting data,¹⁰ PBGC ceased to estimate the amount of total underfunding in covered employer-provided pensions nationwide. Such underfunding is believed to be in the hundreds of

⁸ http://www.pbgc.gov/docs/2010_annual_report.pdf, p. 21.

⁹ *Ibid.* p. iii.

¹⁰ The PPA restricted 4010 filing requirements only to those plans that are less than 80 percent funded.

billions of dollars, but insufficient information now prevents the nation's pension insurer even from making a reasonably precise estimate.

The persistent financing shortfall in the pension-insurance system places the interests of pension-plan sponsors, workers, and taxpayers on a collision course. One way or the other, the imbalance between the obligations that the PBGC is taking on and the assets backing those obligations will need to be resolved. Put simply, the money to pay retiree benefits must come from somewhere.

The financing hole in America's pensions is now of a size that it cannot be expected to be closed without someone paying substantially greater costs out of pocket than is currently the case. In October, 2009, PBGC provided congressional staff with estimates indicating that to comply with existing law, pension contributions by plan sponsors would need to rise from roughly \$50 billion in 2008 to more than \$250 billion annually by the mid-2010s.¹¹ Other projections, like those produced in a March, 2010 Towers Watson study, show considerably smaller figures but nevertheless agree that substantial future contribution increases will be required from plan sponsors to progress toward statutory funding targets.¹²

Recently enacted funding relief could delay the full effects of these requirements, but it does not change the reality that ultimately such increased contributions will be necessary. Even under a highly optimistic scenario for economic conditions, pension plan sponsors would likely need to make contributions throughout the 2010s that are substantially higher than annual levels of 2008, if the financing hole is to be filled without reductions in worker benefits or a taxpayer bailout.

¹¹ "PBGC Modeling Results – H.R. 3936 and Possible Modification of H.R. 2989," PBGC memorandum, October 29, 2009.

¹² "DB Plans Still Face Sizable Funding Obligations Despite Market Run-Up in 2009," Towers Watson, March, 2010, <http://www.towerswatson.com/united-states/newsletters/insider/1178>.

A critical public-policy question, therefore, is to what extent the cost of filling the shortfall is to be met within the current pension insurance system, and to what extent risks and costs will be shifted to those now perceived to be outside of it. To inform our exploration of that question, we will first examine the underlying causes of pension plan underfunding.

Why is the Pension Insurance System Inadequately Financed?

The strength of the pension insurance system was weakened when the recent financial market decline both depressed pension plan asset values and undermined the financial health of plan sponsors. From 2008 to 2009, the size of PBGC's net deficit roughly doubled, in part due to a decline in interest rates (which increased the present value of plan liabilities), and also due to an increase in plan terminations. In 2009, PBGC reported¹³ that it had become responsible for paying benefits to more than 200,000 additional workers, the third-highest increase in its history and roughly nine times the number of new participants for which it had assumed responsibility in 2008. At the same time, PBGC's exposure to "reasonably possible" terminations drastically increased in 2009 from \$47 billion in 2008 to \$168 billion.

Though this represented a sharp downturn in PBGC's financial outlook, it must be remembered that the pension insurance system was showing persistent financial difficulties well before the recent market plunge. PBGC's net deficit, while large in 2009 and 2010, was even larger in 2004 and 2005 (see the graph on page 8). Thus even when financial market values were at their peak, PBGC finances were on an unsustainable course in the absence of policy changes, as evidenced by net deficits of more than \$10 billion in each year from 2003 through the present.

¹³ http://www.pbgc.gov/docs/2009_annual_report.pdf

The causes of PBGC's persistent financing shortfalls are various. Many of them are rooted in longstanding flaws in federal pension law. Although the 2006 Pension Protection Act (PPA) addressed many of these problems, their effects continue to permeate the pension system.

For various reasons, most of the adverse effects of long-term contributors to pension underfunding remain with us today despite the passage of the PPA. For one thing, the PPA provided up-front pension funding relief to most plan sponsors while establishing tighter funding targets for the long term. Meanwhile, other technical reforms in the PPA are being phased in only gradually. The PPA's near-term funding requirements were also further relaxed in subsequent legislation. Finally, any positive impact of the PPA upon pension funding is being swamped in the near term by funding deterioration resulting from worsened market conditions.

The following is a capsule list of factors that have contributed over time to pension underfunding. More details about all of these factors can be found in *Pension Wise* (Hoover Institution Press, 2010).

Systemic Pension Underfunding: 11 Culprits

1. Inaccurate measurements of plan assets
2. Inaccurate measurements of plan liabilities
3. Inadequate funding targets
4. Unfunded benefit increases
5. Loopholes and special preferences
6. Inadequate premiums
7. Limitations upon the national pension insurer
8. Moral hazard and political economy factors
9. Periodic contribution relief
10. Inadequate disclosure
11. Barriers to funding up during good times

Detailing each of these in turn:

1. *Inaccurate measurements of plan assets.* Plan underfunding can be successfully addressed only to the extent that contributions are based upon accurate, up-to-date measurements of plan assets, liabilities, and any gap between them. Prior to the PPA, pension plan sponsors could “smooth” the value of their plan assets over a four-year period for compliance purposes (even under the PPA, the plan sponsor still has two years to fully recognize any discrepancy between a plan’s actual and its previously projected plan assets, though assets cannot be valued more than 10 percent differently than their current market value). “Smoothing” has often delayed recognition of plan underfunding, causing delays in even the first payments that would otherwise be required under an amortized contribution schedule based on a plan’s current funding condition. “Smoothing” was often rationalized as being necessary to limit the volatility of and to prevent pro-cyclicality in contributions required of pension plan sponsors.¹⁴ This rationale, however, conflated two distinct, separable concepts—the accuracy of pension funding measurements on the one hand, and the policy for determining contribution requirements on the other. The critical distinctions between these will be discussed later in this paper. The PPA improved asset measurement accuracy by reducing smoothing somewhat, though considerable smoothing is still permitted and the effects of previous smoothing methods still linger.
2. *Inaccurate measurements of plan liabilities.* An accurate projection of plan liabilities requires both that future benefit payments be accurately estimated and that they are appropriately discounted into their present value. Accurate benefit payment projections in

¹⁴ American Benefits Council, “Averaging and Smoothing and the Myth of Accuracy.” ABC, 2006.

turn require accurate estimates of the number of individuals who will be receiving benefits, the amount and form of those benefits, and the time over which they will be paid. This further requires accurate projections of the ages at which individuals will first claim benefits, whether they will claim them as a lump sum or as a periodic benefit stream, and how long they are expected to live. The PPA required plan sponsors to use updated mortality tables, addressing a problem that had long persisted before the legislation. Pre-PPA law had also failed to take into account the empirical phenomenon of the “rush to the exits”—i.e., the likelihood that individuals in a troubled plan will claim benefits at the earliest possible age and in a lump sum when available (both choices drain a plan of assets in the near term). The PPA now requires liability measurements for “at-risk” plans that assume that participants will claim benefits at the earliest time and in their most expensive form. The PPA’s definition of “at-risk,” however, is based on a plan’s funding percentage rather than on an assessment of a plan’s actual risk of termination.¹⁵ Moreover, the PPA’s transition period has the effect of postponing recognition even of most of these “at-risk” plans. Finally, appropriate liability discounting requires an assessment of the degree of risk in pension plan benefits¹⁶ as well as the time period over which they will be paid. Current law discounts these liabilities according to a yield curve of corporate bond rates of different durations, which the sponsor has the option of “smoothing” over two years. A corporate-bond yield curve is potentially an appropriate means of discounting. It is, however, appropriate only to the extent that worker benefits *are* at risk whenever corporate financial health is also at

¹⁵ Because the funding percentage can itself only be calculated as a function of plan liabilities—which in turn depend on perceptions of a plan’s level of risk—this is something of a circular definition.

¹⁶ “Finance theory is unambiguous that the discount rate used to value future pension obligations should reflect the riskiness of the liabilities.” Brown, Jeffrey and Wilcox, David, “Discounting State and Local Pension Liabilities,” *American Economic Review: Papers and Proceedings* 2009, 99:2, 538–542.

risk; that is, when pension benefits are not backstopped by the taxpayer. Furthermore, it is accurate only to the extent that “smoothing” and other interest rate specifications do not introduce a distortion of up-to-date market conditions. Recently, for example, plan funding requirements were reduced by a temporary spike in corporate bond rates in October 2008, permitting sponsors the use of a discount rate that is unlikely to persist going forward. Additionally, the PPA also allowed certain politically favored industries (e.g., airlines) to employ arbitrarily higher discount rates in their pension funding calculations.

3. *Inadequate funding targets.* The core underlying principle of the PPA was that a pension plan’s appropriate funding target was 100 percent, with plan sponsors provided seven years to amortize contributions to address any shortfall. Multiple factors, however, have intertwined to prevent the 100 percent funding standard (and accompanying 7-year amortization) from becoming fully operative. First, prior to the PPA, there were multiple funding targets in the law, with many plan sponsors permitted to aim for a lower funding standard. Second, the PPA did not establish the 100 percent funding target immediately, instead phasing it in over several years. Thus, even the *first* sponsor payments pursuant to full funding were not to be required until at least five years after the PPA’s enactment. Finally in 2010, additional funding relief was enacted that, while it did not waive the 100 percent funding target, reduced contribution requirements in relation to it. Essentially, plan sponsors were permitted (providing that they make additional contributions in proportion to “excess compensation”¹⁷) to lengthen the amortization of underfunding arising in the years immediately following the recession, using either a 15-year amortization schedule or adding two years of interest-only payments prior to the commencement of 7-year

¹⁷ If a sponsor elects the contribution relief schedule, the employer must make additional contributions to the plan equal to the sum of excess employee compensation over \$1 million plus the amount of “extraordinary” dividends.

amortization.¹⁸ A Towers Watson study found that this legislation could result in roughly \$63 billion in additional funding relief for plan sponsors over the 2009–13 period.¹⁹ (A more recent Towers Watson survey found that less than one-third of companies that had already made a determination planned to elect the relief.²⁰) While it is understandable that Congress would choose to provide additional funding relief at a time when pension plan sponsors face unusual economic difficulties, the relief took effect in a funding environment that was already quite weak due to previous law’s longstanding failure to require full funding of employee pensions.

4. *Unfunded benefit increases.* Prior to the PPA, employers had the latitude to increase benefit promises without fully funding these increases before a plan was assumed by the PBGC. This had the effect of increasing the level of underfunding in some terminating plans. The root of the problem was that such benefit increases would immediately add to a plan’s liabilities while the contributions required to fund those increases could be amortized over several years. The PPA clamped down on such practices, imposing various limitations respectively upon lump-sum payments, unfunded benefit increases, and in some cases, even benefit accruals. Such limitations (though not the freezing of benefit accruals) affect plans measured as being less than 80 percent funded. 2010’s funding relief legislation eliminated some of the PPA’s prohibitions on benefit accruals by allowing plan sponsors to base such restriction tests on pre-recession funding levels.²¹ Again, most of the damage here was

¹⁸ <http://finance.senate.gov/legislation/details/?id=bed977dc-5056-a032-520f-49d7b04df18f>

¹⁹ <http://www.towerswatson.com/united-states/newsletters/insider/2389>

²⁰ “Towers-Watson Forbes Insights 2010 Pension Risk Survey,” <http://www.towerswatson.com/assets/pdf/3220/TowersWatson-Pension-Risk-Survey-Rpt-NA-2010-17315.pdf>, See figure 10a.

²¹ <http://www.towerswatson.com/assets/pdf/2342/TW-ClientAdvisory-06252010-v1.pdf>

done prior to the PPA, but the PPA's safeguards against these practices have yet to fully take effect.

5. *Loopholes and special preferences.* Pre-PPA law contained enormous loopholes, many of which made significant contributions to the current state of pension underfunding. Among these was the "credit balance" rule, which effectively allowed plan sponsors to double-count contributions made in excess of minimum statutory requirements. Specifically, if a contribution was made in excess of the statutory minimum, it was not only counted once in the sense of adding to a plan's funding percentage, but was also counted a second time in reducing the amount of future contributions that would otherwise be required. Moreover, plan sponsors were permitted to assume that the credit balance contribution had appreciated in value over time even if in practice the actual investment had not. The PPA corrected the worst abuses of the "credit balance" provisions (including correcting the double-counting problem), but permitted the basic concept to persist. The PPA, however, did not correct another set of loopholes in the form of special statutory preferences for politically favored industries. The PPA itself explicitly permitted airline sponsors of plans, for example, to use longer amortization periods to address underfunding and to employ a higher discount rate to artificially shrink the size of plan liabilities. More recently, one domestic automaker was permitted while receiving government assistance to establish a "follow-on" plan for union employees of an affiliated company whose plan was trusted by the PBGC, "topping up" these workers' pension benefits and circumventing the spirit of PBGC's statutory caps on benefit payments.²² Special deals for politically favored industries

²² <http://www.pbgc.gov/wr/large/delphi/delphifaq.html#3-b>

both directly reduce pension funding levels and establish troublesome precedents for containing the growth of PBGC's deficit.

6. *Inadequate premiums.* While premium income does not directly influence the adequacy of pension plan funding, it does affect the financial viability of the pension insurance system. Employers pay premiums to the PBGC that are intended to offset the insurance costs that arise when an underfunded plan is terminated. Plan sponsors pay both a flat-rate premium (\$35 per person per year), as well as a variable-rate premium (\$9 for each \$1,000 in unfunded vested benefits). A "termination premium" of \$1,250 per person is also charged when a pension plan is terminated. These premium levels are set in statute. Unlike a private insurer and other federal insurers (such as the Federal Deposit Insurance Corporation, or FDIC), the PBGC does not have the power to levy premium assessments that are adequate to pay for the cost of the insurance that it provides. In 2005, the Congressional Budget Office (CBO) calculated that PBGC's premium assessments would need to be roughly 6.5 times higher to fund the size of anticipated claims on the system.²³ The final report of President Obama's fiscal responsibility commission recently recommended that PBGC be given authority to raise premiums as necessary to restore solvency and to "reduce the likelihood of a government rescue."²⁴ Equally importantly, not only is the *level* of premium income inadequate to fund PBGC operations, but premium assessments do not fully reflect the level of *risk* associated with an individual pension plan,

²³ <http://www.cbo.gov/ftpdocs/66xx/doc6646/09-15-PBGC.pdf>

²⁴

http://www.fiscalcommission.gov/sites/fiscalcommission.gov/files/documents/TheMomentofTruth12_1_2010.pdf, pp.45–46

arising from such factors as its investment portfolio, its funding percentage and the health of its sponsor.²⁵

7. *Limitations upon the national pension insurer (PBGC).* Though premium assessments and contribution requirements are established in federal law, the PBGC has only limited power to enforce them. In one example from recent years, an airline sponsor of a large, terminating pension plan simply stopped making statutorily required contributions to the plan once the sponsor entered bankruptcy.²⁶ As an unsecured creditor, PBGC was unable during bankruptcy proceedings to perfect a lien placed against the skipped contributions. PBGC generally lacks the authority to regulate the investment policies of plan sponsors, or otherwise prevent them from taking actions that degrade its financial position.²⁷ Its legal powers are crude and its range of available action is largely limited to the threat of an involuntary plan termination. Moreover, PBGC has an ambiguous position in relation to the Department of Labor, in some respects appearing to sit within it, in others appearing to be independent.²⁸ This occasionally calls into question the PBGC's latitude to take fully independent actions to defend pension plan funding. This is particularly problematic in circumstances where a presidential administration chooses to advance a conflicting policy

²⁵ For more on this point see Brown, Jeffrey, "Guaranteed Trouble: The Economic Effects of the Pension Benefit Guaranty Corporation," *Journal of Economic Perspectives*, Volume 22, Number 1, Winter 2008. "Strikingly, aside from the extra premium paid for being underfunded, PBGC premiums contain no risk adjustment. A financially distressed firm with its pension plan assets invested in a portfolio of risky assets that is mismatched with the plan's liabilities pays the same annual premium as an AAA-rated firm that has fully immunized its pension liabilities from financial market fluctuations."

²⁶ "PBGC: Effects of U.S. Air and UAL Terminations," Douglas Elliott, Center on Federal Financial Institutions, November 15, 2004.

²⁷ The FDIC possesses some of these authorities. See <http://www.fdic.gov/regulations/laws/rules/1000-900.html>.

²⁸ See General Accounting Office, "Pension Benefit Guaranty Corporation: Governance Structure Needs Improvements to Ensure Policy Direction and Oversight," <http://www.gao.gov/new.items/d07808.pdf>, especially pages 18-21.

priority, whether that competing priority involves providing direct taxpayer-backed assistance to a pension sponsor in the automotive sector, or encouraging near-term job creation through other departments' regulations that have the effect of reducing pension funding requirements.

8. *Inadequate disclosure.* Beyond statutory contribution requirements, transparency and disclosure are effective spurs to stronger pension funding. Pension sponsors generally don't want to be seen as failing to fund their benefit promises, and thus concern themselves enormously with the strength and reach of public reporting requirements respecting pension funding. Present funding disclosure requirements can only be described as inadequate. As earlier described, the PBGC no longer receives sufficient information about pension plan funding even to make a reasonable estimate of the extent of systemic underfunding nationwide. Moreover, the 4010 form (PBGC's primary source of detailed plan funding information²⁹) is only required of plans deemed less than 80 percent funded. This has the dual adverse impact both of limiting information about some large plans that may pose a large aggregate risk to the PBGC, and of stigmatizing the comparatively few plan sponsors who must file the information.
9. *Barriers to funding up during good times.* During the late 1990s, annual contributions to pension plans shrank (and in some cases were eliminated altogether) as plan assets rose during the stock market's dot-com bubble. After the bubble burst, plan funding percentages declined to lower levels than they would have if sponsors had continued to consistently

²⁹ See testimony of PBGC Director Charles Millard before the U.S. Committee on Education and Labor, October 24, 2008, for a fuller description of the information provided uniquely on 4010 forms. <http://www.pbgc.gov/news/testimony/page/tm102408.html>. One significant distinction from the more widely-required form 5500 is that only the 4010 provides the PBGC with termination liability information, the measurement of greatest relevance to an insurer.

contribute to their plans and to “overfund” during good times. Pre-PPA law constrained the extent to which plan sponsors could fund up by limiting the tax-deductibility of excess pension contributions so as not to exceed 100 percent of the plan’s “current liability.”³⁰ The PPA increased employer flexibility to fund up during good times, allowing sponsors to fund to 150 percent of their target liability plus expenses based on future salary increases (a long-term reform that has unfortunately been of limited applicability in the recession environment). Although the PPA represented an improvement in this respect, current federal budget rules remain a problem. Because employer pension contributions are tax deductible, the federal government can still “raise revenue” by reducing employer contributions to pension plans, a tactic used as a budgetary offset for added federal spending in 2010.³¹ A better budget framework would recognize worsening pension underfunding as an *increase* in potential taxpayer exposure, rather than treat it as a cost-free source of financing for added federal spending. This issue will be further explored under reform option #3, which would more fully disclose the risk to taxpayers associated with PBGC underfunding.

10. *Moral hazard and political economy factors.* None of the various technical factors that have combined to weaken pension funding can be wholly explained without an understanding of the moral hazards and political economy factors that underlie these phenomena. The following section of this paper will review some of these factors in greater detail. The essence of the problem is that our pension insurance system’s funding requirements and premium assessments are determined not by market forces nor by economic realities but

³⁰ <http://www.irs.gov/pub/irs-drop/n-07-28.pdf>

³¹ http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_bills&docid=f:h3962enr.txt.pdf

rather by a political process. Because these critical requirements are set by law, elected officials remain under constant pressure to relax such requirements so that funds that would otherwise be contributed to a company's pension fund are instead made available for new hiring or for more immediate forms of compensation (e.g., wages). It is probably unreasonable to expect qualitative improvements in pension funding requirements so long as the critical variables that determine funding levels are decided by votes of elected officials, who themselves face substantial incentives to shift the risks of pension underfunding away from plan sponsors. As the next section will discuss, the current combination of pension insurance and defined-benefit pensions introduces great moral hazard in that it is in the sponsor's interest to finance the promised benefit at the least possible cost, while the worker's interest is primarily in being paid her promised benefit without regard for whether this is done by the employer or by a pension insurer. Moral hazards are common to all these defined-benefit systems and have caused significant underfunding risks to arise in each of employer-provided pensions, state/local pensions, and in Social Security.

11. *Periodic contribution relief.* One specific manifestation of the moral hazard inherent in the current pension system is the recurrent congressional behavior whenever previously enacted funding requirements begin to bind "too tightly." In the early 2000s, funding relief was first provided by allowing sponsors to discount using a widened corridor around Treasury bond rates, and then later by shifting to higher corporate bond rates. In 2006, the PPA provided additional near-term funding relief in exchange for a tightening of long-term funding standards. In subsequent years and most recently in 2010, further funding relief has repeatedly been justified by difficult economic conditions. While the funding relief may have been defensible in each of these separate individual circumstances, the overall pattern

has been unchanging; Congress has repeatedly used its authority over pension funding requirements to shift the risks of pension underfunding from plan sponsors to the pension insurance system as a whole.

The Common Moral Hazards Precipitating Underfunding in Public and Private Defined-Benefit Pensions

There is periodic, but largely separate, public attention to the funding issues facing each of Social Security, state/local pension plans, and employer-provided DB pensions. These systems each attempt to provide workers with defined retirement benefits through—respectively—the federal government, state/local governments, and private employers.

All of these systems are underfunded, all suffer from inadequate accounting, and all face analogous moral hazards. But while there has been substantial public attention to the financing issues facing these respective defined benefit systems, there has been comparatively little attention to the common factors that drive underfunding in all three.

While defined-contribution systems also face their challenges, a fundamental misalignment of interests is not one of them. A worker's ultimate defined contribution benefit is a direct function both of the adequacy of plan contributions and of the rate of appreciation on investments. It is clearly in the worker's interest to see that contributions are sufficient, that they are profitably invested, and that administrative expenses are held to a minimum. If any of these elements are poorly handled, the worker's ultimate retirement income will diminish. While the worker may lack sufficient *information* or *education* to assess these factors, the worker's *interest* is at least straightforwardly aligned.

In a defined-benefit system, however, the interests of different actors are split. Because the *sponsor* rather than the *worker* accepts the funding risk, it is in the sponsor's interest to minimize his

costs in providing a given benefit, while it is only in the worker's interest to maximize his chance of *receiving* the full benefit, *irrespective* of who pays for it or how it is funded. The current presence of pension insurance injects substantial moral hazard into this dynamic. When pension insurance is present, a plan sponsor can potentially reduce his pension funding costs by investing in higher-risk securities (unless specifically prevented by regulation from doing so). If the upside returns are received, the sponsor's pension liabilities are reduced; if the downside risk is realized, the pension insurance system is there to potentially absorb the loss.³² The presence of pension insurance at the same time reduces the *worker's* incentive to verify that pension contributions are both adequate and prudently invested.

Pennachi and Rastad have found evidence of an analogous dynamic in public pension plans. These plans are more likely to assume greater investment risk when plan participants sit on plan boards and have the opportunity and incentive to "gamble for higher benefits," knowing that the taxpayer can be called upon to cover the downside of investment risk.³³

Even beyond this, pension insurance can create incentives that are not only indifferent to pension funding but actually operate *against* it. If a worker's pension benefit will be paid *regardless* of the adequacy of employer pension contributions, then the worker has a further incentive to receive compensation in the form of higher wages or other benefits rather than to see such employer resources contributed to the pension plan. As a result, both employers and workers (and their representatives) actually face an incentive to see pension contributions *minimized* to the extent possible without jeopardizing the immediate solvency of the pension insurance system (and minimized even beyond that

³² The troublesome mixture of privatized upside gain coupled with shared downside risk has also been present in our national system of home mortgage insurance, with similarly problematic consequences.

³³ Pennachi, George, and Rastad, Mahdi, "Portfolio Allocation for Public Pension Funds," National Bureau of Economic Research Working Paper 16456, October 2010.

if a potential taxpayer bailout is available). The only counter-pressure to these moral hazards comes from those responsible for the financial viability of the pension insurance system—who, as we have seen, currently lack sufficient fiscal and legal tools to compel adequate funding.

Precisely the same problematic incentives exist in public-sector plans, including both state/local pension plans and the federal Social Security program. Elected officials responsible for controlling the finances of these plans have powerful incentives both to minimize costs faced by currently voting taxpayers, while maximizing benefits paid to program participants. This leads naturally to two predictable phenomena; first, to *aggregate underfunding* (an excess of promised benefits over contributed revenues); second, to rising *pay-as-you-go* obligations (that is, an escalation of obligations that must be financed by future contributors at the moment of benefit payment, as opposed to having been pre-funded via the saving of earlier contributions).

Though the specific manifestations are different in these respective public systems, the precipitating moral hazards as well as their funding consequences exhibit parallel forms. State and local plans, for example, have frequently³⁴ employed aggressive liability discount rate assumptions that reduce near-term funding and increase the share of benefit payments that must be funded by future taxpayers.

Similarly, the federal Social Security program has been persistently funded on a pay-as-you-go basis despite widely-recognized population aging, a long-predicted decline in the ratio of workers to

³⁴ Brown, Jeffrey and Wilcox, David, “Discounting State and Local Pension Liabilities,” *American Economic Review: Papers and Proceedings* 2009, 99:2, 538-542. This result occurs because aggressive discount rate assumptions cause plan liabilities to look artificially small in the near term, reducing apparent underfunding and thereby reducing near-term funding requirements. Because a greater share of actual underfunding remains unfinanced in the near term, a higher proportion of the real shortfall must be met by future contributors.

beneficiaries, and the recommendations of multiple bipartisan technical panels and advisory boards to shift toward partial pre-funding.³⁵

Many remain mistakenly under the impression that since the 1983 Social Security amendments, Social Security is now on a partially funded footing because a large trust fund has been amassed. This is, however, merely Social Security's version of the accounting opacity that also afflicts other defined-benefit systems. The Social Security Trust Fund consists entirely of Treasury bond debt that—just like future payroll tax contributions—must be paid for by future taxpayers.³⁶ Moreover, the empirical evidence is persuasive that not only have the decades of Social Security surpluses that amassed the trust fund financed federal government consumption, but there was actually no intent or belief on the part of legislators in 1983 that building up a large trust fund would effectively pre-fund future benefits.³⁷ Accordingly, Social Security funding risks have been transferred from current taxpayers to future ones, in a program that remains pay-as-you-go both in *fact* and in statutory *intent*.

Although the PBGC insures the pension promises made by private-sector employers, its operations are also greatly affected by political economy factors. Both premium assessments and funding requirements are established via a political process. The PBGC is not permitted to perform the equivalent of a private-sector insurer's pricing of insurance coverage, nor does it have the legal

³⁵ Perhaps the best example is the report of the 1994–96 Social Security Advisory Council, which unanimously recommended in favor of partial advance funding even as its members split into three feuding camps over the issue of personal accounts. See the council's "Findings, Recommendations and Statements," <http://www.ssa.gov/history/reports/adccouncil/report/findings.htm>.

³⁶ This simplifies somewhat. Even though Treasury bond debt must be redeemed by taxpayers, the Trust Fund could *theoretically* be a means of pre-funding future benefit obligations if it actually represented an incremental increase in saving. As noted in the remainder of this paragraph and elsewhere, this has not been the case empirically.

³⁷ Blahous, *Social Security: The Unfinished Work* (Hoover Institution Press).

authority enjoyed by the FDIC to change premium assessments as fiscally necessary.³⁸ Just as with state/local pensions and Social Security, private-sector pension funding levels are weakened by the substantial incentives facing legislators to value the near-term interests of employers and workers over the long-term health of the pension system. Each time that legislators must vote on a bill to determine premium levels or funding requirements, they are subject to enormous political pressure to relax each of these relative to what is required to achieve a fully funded pension system. Unless the process itself is changed, this phenomenon should be expected to continue.

A striking parallel between the three major forms of defined-benefit pensions is indeed the extent to which program accounting—specifically, both *asset* and *liability* measurement—has been used to reduce near-term funding obligations. The moral hazards associated with defined-benefit pensions have thus not only created inducements to shift financing risks transparently to third parties but also to overstate current funding levels. It is theoretically possible to imagine three hypothetical defined-benefit systems, each of which follows an ongoing tradition of fully disclosing financing shortfalls even as the knowing value judgment is made to postpone contribution requirements. Instead, near-term funding relief has often been provided through the manipulation of asset and liability measurements in all three sectors.

This paper has already discussed how the use of asset and liability smoothing, artificially high discount rates, credit balances and other techniques has delayed full recognition of the extent of underfunding in employer-provided pensions. In state/local plans, the chief accounting tool by which liabilities have been understated has been the use of aggressive liability discount rate assumptions.³⁹ In Social Security, trust fund accounting is the primary culprit, in that trust fund assets are deemed to

³⁸ <http://www.fdic.gov/regulations/laws/rules/1000-600.html#fdic1000sec5d>

³⁹ In addition to Brown/Wilcox, see Norcross/Biggs, *The Crisis in Public Sector Pension Plans*, June 23, 2010, Mercatus Center Working Paper.

reduce future funding shortfalls even though these assets are simply a further debt obligation facing federal taxpayers.⁴⁰

In each of these defined-benefit systems, the ongoing battle over transparent accounting is fought along predictable interest-group lines. In the employer-provided pension world, plan sponsors often argue for asset/liability smoothing and higher discount rates,⁴¹ while the opposing case is made by those responsible for the health of the pension insurance system.⁴² With state/local plans, both state officials and public employee unions advocate high discount rates,⁴³ while pushback comes from academics,⁴⁴ taxpayer-watchdog groups, and federal officials concerned about pressure for a federal bailout.⁴⁵ In Social Security, the beneficiary-advocacy group AARP has defended current trust fund

⁴⁰ See Hardy and Warshawsky, "When is a Trust Fund not a Trust Fund?", Roll Call, June 3, 2010. For a more general explanation of Trust Fund accounting, see Blahous, "Social Security: The Unfinished Work" (Hoover Institution Press, 2010).

⁴¹ American Benefits Council, "Averaging and Smoothing and the Myth of Accuracy." ABC, 2006.

⁴² See remarks of PBGC Executive Director Bradley D. Belt before the National Association for Business Economics, <http://www.pbgc.gov/news/testimony/speeches/sp031306.html>. "'Smoothing' is a seductive marketing word. It conveys the sense that we are sparing investors from the rude jolt they would receive if pension losses were reported at full value and saving companies from the terrible burden of repairing pension deficits as quickly as they were created. In the accounting context, smoothing allows companies to show pension losses to investors in small slivers over time rather than all at once. This helps make a company's reported earnings look smoother as well, which is to say, more divorced from economic reality."

⁴³ See Communications Workers of America, http://www.cwa-union.org/news/entry/public_workers_unions_scapegoated_in_effort_to_scrap_state_pensions. Finance theorists are in general consensus that these state discounting practices are inappropriate, though very rarely a scholar will echo the claims of public sector unions, as in <http://www.cbpp.org/cms/index.cfm?fa=view&id=3372>.

⁴⁴ See Brown/Wilcox, or Novy-Marx and Rauh, http://www.kellogg.northwestern.edu/faculty/rauh/research/JEP_Fall2009.pdf.

⁴⁵ See statements of Congressmen Nunes and Ryan on the Public Employee Pension Transparency Act, http://nunes.house.gov/index.cfm?FuseAction=PressOffice.PressReleases&ContentRecord_id=a8077553-19b9-b4b1-12e6-728d8d2ff3ad.

accounting methods,⁴⁶ while counter-pressure has come from bipartisan technical expert panels⁴⁷ and fiscal watchdog groups.⁴⁸ Unfortunately, in each of these cases, those who have argued to disguise funding inadequacy have generally carried the day, contributing to the significant funding shortfalls in all three systems.

In sum, underfunding in our national defined-benefit systems cannot be wholly explained without an understanding of how moral hazards and political economy factors create incentives to both understate existing underfunding and to shift the risks of that underfunding to third parties, whether to a pension insurance system (where present) or to future taxpayers (where not). Accordingly, the underfunding in these respective defined-benefit systems will only be ameliorated to the extent that the various forms of plan sponsors (both private and public) experience corrected incentives both to recognize and to fund the full extent of their projected benefit obligations.

⁴⁶ http://www.aarp.org/work/social-security/info-08-2009/financing_of_Social_Security.html

⁴⁷ 1999 Report of the Technical Panel on Assumptions and Methods of the Social Security Advisory Board, <http://www.ssab.gov/Publications/Financing/tech99.pdf>

⁴⁸ See Concord Coalition, "Social Security's Trust Funds Mask the Problem," <http://concordcoalition.org/publications/2005/0311/social-security-series-social-securitys-trust-funds-mask-problem>

Table 1: Moral Hazards Operating in Defined-Benefit Systems

System	Risks Shifted To	Method(s)	Result
Employer-provided pensions	PBGC pension insurance system	Asset/liability smoothing, discount rates, loopholes, inadequate funding rules	Underfunded
State/local pensions	Future taxpayers	Aggressive discounting assumptions	Underfunded
Social Security	Future taxpayers	Trust Fund accounting; pay-go financing	Underfunded

A further striking parallel between the three types of defined-benefit systems is that the *degree* of underfunding is comparable in all three. Recent estimates have varied as financial market conditions have fluctuated, but each of employer-provided, state/local pensions, and Social Security are roughly one-fifth to one-quarter underfunded depending on the particular estimate.⁴⁹

All of this is further testimony to the reality that this is not a story of the inherent superiority of public sector DB pensions to private sector ones, or vice versa. Nor will the problem be ameliorated by simply shifting either workers or financing responsibilities between the various sectors (despite the occasional suggestions by some, for example, that Social Security coverage should be expanded to include newly hired workers in state and local pension plans, or that Social Security benefits should be increased to offset the decline in private-sector DB plans). The basic moral hazards are common to all three spheres of defined-benefit pensions, and are having comparable problematic effects.

⁴⁹ Report of the Social Security and Medicare Trustees, <http://www.ssa.gov/OACT/TRSUM/index.html>, Pew Center on the States, http://www.pewcenteronthestates.org/ttw/trends_map_data_table.aspx?trendID=23.

Avoiding a Taxpayer Bailout of PBGC: Recommendations Common to All Options

The following section of this paper will present three optional directions for reform of the PBGC, two of which represent the primary alternatives to a taxpayer bailout, the third being a method of disclosing a bailout's potential consequences before it occurs.

This section outlines specific recommendations common to all three options. Regardless of the future structure of the PBGC, and regardless of future policy with respect to pension funding requirements, certain reform principles should be observed.

Universal Principles for Employer-Sponsored Pension Reform

1. Limit asset "smoothing" to the extent practicable.
2. In liability measurements, limit "smoothing," use up-to-date mortality tables, and account accurately for worker behavior.
3. Eliminate special deals for politically favored industries.
4. Enforce prohibitions on unfunded benefit increases by underfunded plans.
5. Increase disclosure of funding information.

Specifically:

- 1) *Limit asset "smoothing" to the extent practicable.* Pension funding policy cannot be sensibly constructed if it is not built on a foundation of measurement accuracy. Specifically, this requires that asset measurements should be minimally distorted via "smoothing." The only properly imposed limitation on the accuracy of asset measurements should reflect limits on *practicability* for plan sponsors. Plan sponsors cannot be expected to update plan asset measurements every hour; an annual assessment of asset values should suffice, on which

contributions for the following year can be based. If requiring an asset measurement on a specified date proves to be particularly distortive or otherwise disadvantageous for a plan sponsor, this outcome is best avoided by allowing the sponsor to select from valuation dates within a narrow time window. This would serve accuracy more than would allowing the sponsor to “smooth” with significantly older asset valuations that no longer reflect current funding information. To the extent that minimizing smoothing causes real asset volatility to be formally recognized, funding rules should be designed to limit volatility in annual required *contributions*—rather than relying on smoothed asset *valuations* to fulfill this policy objective. Asset and liability valuations should be conducted to produce the most *accurate* information about plan finances, not to steer toward a particular funding policy result.

- 2) *In liability measurements, limit “smoothing,” use up-to-date mortality tables, and account accurately for worker behavior.* Like asset measurements, liability measurements should be as accurate and up-to-date as is practicable. Specifically, liability measurements should reflect the most up-to-date mortality tables as well as the best available information about how and when workers are likely to claim benefits. This in turn requires that the pension insurer is able to ascertain the risk of a “rush to the exits” due to the sponsor itself becoming a credit risk. As with asset valuation, periodic fluctuations in liability discount rates are better handled by allowing a narrow time window during which a sponsor can choose a discount rate, rather than by smoothing with long-expired discount rates that no longer reflect existing market conditions.
- 3) *Eliminate special deals for politically-favored industries.* Whether pension insurance is provided through a public PBGC system or through a private insurer, the rules of play should

be applied equally across the board. There should be no special exemptions for politically favored industries as exist under current law. These are unfair, they undermine funding adequacy, and they establish troublesome and potentially costly precedents. A private insurer would not be allowed to discriminate between covered entities based on political preference; the public pension insurance system should be bound by a similar ethic.

- 4) *Enforce prohibitions on unfunded benefit increases by underfunded plans.* Even where plan sponsors are suffering from economic forces beyond their control, little good can arise from permitting plan sponsors to promise benefits that they cannot pay. Plans that are underfunded—and thus pose a risk of shifting costs to the PBGC—should not be permitted to increase their benefit promises without paying for those benefits up front. This restriction should apply to plan amendments that increase benefits as well as to the payment of lump sums, both of which drain a plan of assets. The 2006 PPA effected substantial reforms in this area. Such reforms, however, are only effective to the extent that they are enforced. Recent funding relief legislation has permitted plan sponsors to escape some of these benefit restrictions by allowing funding valuations to be made based on *pre-recession* conditions. However faultless a sponsor is with respect to the broader financial market decline, it should not then take the further irresponsible step of making further benefit promises that it cannot fund. The evident pressure on Congress to relax such restrictions during difficult economic times is one further reason to remove such decisions from the legislative process.
- 5) *Increase disclosure of funding information.* Sunshine and transparency are useful spurs to stronger pension funding. It is unacceptable for the PBGC as a result of inadequate filing information to be unable to make an accurate assessment of its potential exposure,

particularly when the economic environment remains so uncertain. 4010 submission requirements should be expanded to provide the PBGC with the information necessary to gauge the likelihood of further financial hits on the pension insurance system. Expanding the application of the 4010 form would also help to de-stigmatize those plan sponsors who must file it. To prevent small employers from undue reporting burdens and to focus information on the largest potential threats facing the PBGC, 4010 filing requirements should be based on *aggregate* plan underfunding rather than on a funding percentage. Prior to the PPA, all plans with more than \$50 million in underfunding were required to file a 4010 form. This filing threshold should be re-established at a level low enough to enable PBGC to see at least the majority of the underfunding in plans for which it is reasonably likely to become responsible.

The above principles for pension reform should be applied without regard to whether the PBGC is strengthened or eliminated, as well as in the “doomsday scenario” threatening a taxpayer bailout. No matter which of these paths is taken, assessments of plan assets and liabilities should be as accurate and up-to-date as possible, special preferences for specific industries should be eliminated, unfunded benefit increases in underfunded plans should be prohibited, and any pension insurer (public or private) should have the information necessary to make accurate assessments of potential fiscal threats.

Three Frameworks for Reform

Three Options for Pension Insurance Reform

<i>Option #1</i>	<i>Empower the PBGC with the tools necessary to fill the shortfall in the national pension insurance system.</i>
<i>Option #2</i>	<i>Eliminate the PBGC and replace it with compulsory private insurance that would charge market rates to participants.</i>
<i>Option #3</i>	<i>Unless and until the federal government requires that the PBGC's financing risks be resolved via options #1 or #2, treat the shortfall for federal budgetary purposes as an obligation facing U.S. taxpayers.</i>

Reviewing each of these in further detail:

Option #1: Empower the PBGC with the tools necessary to fill the shortfall in the national pension insurance system.

If the PBGC is to remain the nation's insurer of employer-provided pensions, and if it is to remain financially viable without taxpayer funds, then it must be provided with the resources required to close its funding shortfall. These must include enhancements of its financial, legal and organizational tools. Among them:

- A) *Premium income.* An insurance system cannot survive if it cannot adequately charge for the cost of insurance provided. The PBGC currently lacks the authority to charge premiums that are sufficient to fund anticipated claims on its insurance system. The recent proposals supported by a majority of President Obama's fiscal responsibility commission⁵⁰

⁵⁰ http://www.fiscalcommission.gov/sites/fiscalcommission.gov/files/documents/TheMomentofTruth12_1_2010.pdf, pp.45-46.

recommended that the PBGC be given the authority to raise premiums as necessary to prevent a government-financed rescue. Different methods of assessing such premiums are available that reflect different potential value choices by the PBGC. A higher flat-rate premium for all participants would reflect a judgment that the cost of filling the financing shortfall should be spread among the greatest number of plan sponsors (including those with well-funded plans). Alternatively, greater reliance on risk-based premiums would reflect a judgment that higher costs should be imposed on those sponsors who pose the greatest risk to the pension insurance system. In all likelihood, the funding shortfall is large enough that increased reliance on *each* form of premium will be required. A truly risk-based premium would provide greater incentives for full funding and should thus be a part of any solution.⁵¹ At the same time, it is unlikely that weak sponsors of underfunded plans will themselves be able to provide sufficient additional revenue to fill the PBGC's financing hole. If true, an increase in the flat premium paid by all plan sponsors would also be required. In 2007, CBO projected that if PBGC were given the authority to establish its own premium schedule, the variable rate premium would rise from \$9 per \$1,000 in underfunding to \$14,⁵² but this estimate was prepared before the recent financial-market downturn.

- B) *Adequate funding rules.* It is constitutionally impossible to prevent Congress from legislating on the subject of pensions forevermore. Ideally, however, Congress would aim for a path of policy consistency by establishing a comprehensive, uniform standard for PBGC to then implement in its regulations. In this ideal scenario Congress would thereafter adopt a general policy of non-interference in the funding rules as long as they conform to

⁵¹ See again Brown, Jeffrey, "Guaranteed Trouble."

⁵² <http://www.cbo.gov/ftpdocs/78xx/doc7878/03-21-PresidentsBudget.pdf>

longstanding congressional intent, as is customarily observed with respect to Federal Reserve and FDIC operations. Current law envisions a 7-year amortization schedule for addressing pension underfunding with 100 percent funding as the ultimate funding target. Recent amendments, however, gave plan sponsors the option of either employing a 15-year amortization schedule, or two years of interest-only payments before beginning the normal seven-year amortization schedule. Reestablishing such multiple amortization schedules has injected undesirable “complexity creep” into the funding rules, complexity that the PPA had previously been intended to eliminate. The law should be revised to provide plan sponsors once again with a single amortization schedule that all must use (with 100 percent funding still as the ultimate funding target). Under almost any scenario in which full funding is eventually accomplished, future contributions by plan sponsors will ultimately need to be much larger than they have been in the recent past. Clear thinking with respect to how long such increased contributions should be delayed must distinguish between different rationales, including each of: 1) relief from increased contributions required as a result of temporarily depressed financial markets, 2) relief deemed appropriate while plan sponsors are temporarily weak due to economic conditions, and 3) relief to avoid large spikes in contributions that will be required in *any* event on the way to full funding. These distinctions are important. Even without the recent financial market downturn and subsequent recession, plan sponsors would face substantial contribution increases going forward. Legislated funding relief should therefore be limited *only* to that required to offset recent economic events, and *not* aim to avoid the funding increases eventually required even under more typical economic conditions. One way of implementing this policy value judgment would be to eliminate recent law’s 15-year amortization schedule option, replacing it with a “2 + 7” policy for everyone (two years of interest-only payments, followed

by 7-year amortization). The policy rationale would be to allow for two further years of economic recovery before 7-year amortization again becomes the norm. Under this framework, Congress would also repeal the special discount rates and amortization schedules for the airline industry, repeal the other targeted exceptions to the funding rules, repeal the 15-year amortization schedule, and adopt a general policy of non-interference as PBGC implements the “2 + 7” policy. If economic conditions approximate historic norms within two years, the PBGC would then enforce the 7-year amortization schedule. If (and only if) macroeconomic conditions forbid the implementation of 7-year amortization at that point, PBGC could exercise an authority to temporarily extend the “interest-only” contribution period.

- C) *Strengthened legal tools for PBGC.* PBGC cannot adequately protect the pension insurance system and avoid a taxpayer bailout with its current set of crude legal tools. If the policy judgment is made to fill the shortfall within the current PBGC administrative structure, PBGC’s legal tools will need to be strengthened. Bankruptcy code changes could be enacted to give pension plan contributions the same status as wage payments, to move PBGC ahead of the line of other unsecured creditors. PBGC could also be given an authority comparable to that of the FDIC, to implement “cease and desist” orders⁵³ to prevent plan sponsors from taking actions injurious to the health of the pension insurance system.
- D) *PBGC Independence.* To fully empower the PBGC to close its own funding shortfall, Congress would clarify in law that the PBGC is an independent regulatory agency, and no longer a part of the Department of Labor. The current PBGC can never be wholly independent of White House direction because of the constitutional “unitary” nature of the federal executive

⁵³ <http://www.fdic.gov/regulations/laws/rules/1000-900.html>

branch. It could, nevertheless, wield a degree of *de facto* independence roughly comparable to that of the FDIC or Securities Exchange Commission (SEC). The goal would be to free PBGC to make determinations predicated exclusively on the health of the pension insurance system, without conscious subordination to the broader economic policy objectives of the presidential administration.

In sum, the basics of the approach in option #1 are to provide PBGC with the necessary funding rules, premium income, legal tools and organizational standing to address its own financing shortfall. Doing so in practice would mean the eventual imposition of higher (and increasingly risk-related) premium requirements as well as tighter funding requirements upon pension plan sponsors. If Congress is unwilling to permit this to happen within the present PBGC structure, it will need to choose between other alternatives.

Option #2: Eliminate the PBGC and replace it with compulsory private insurance that would charge market rates to participants.

Option #2 differs from option #1 primarily in the legal standing of the nation's pension insurance system; specifically, whether it is a compulsory system of private insurance or continues to be a government-chartered system. Either system would need to implement parallel reforms to adequately price pension insurance and to protect itself from risks taken by plan sponsors.

In theory, yet another option is available; to eliminate the PBGC *without* replacing it with private insurance. This is unlikely, however, given the many decades that have passed since the nation has permitted its workers' defined-benefit pensions to go uninsured altogether. Moreover, the number of

prominent analysts who believe that the government is ill-suited to optimize pension insurance is greater than the number who believe that compulsory pension insurance should be wholly eliminated.⁵⁴

Whether option #1 (a reformed, strengthened PBGC) or option #2 (compulsory private insurance) ultimately proves the more persuasive policy is thus primarily a political-economy question. Whether public or private, a pension insurer can only remain financially viable if the prices it charges for insurance are sufficient to offset the costs of providing that insurance. Similarly, whether public or private, a pension insurer must be able to limit its insurance pool to those sponsors who manage their plans within an acceptable (i.e., insurable) range of responsible practices. This means that the pension insurer must be able either to contain irresponsible actions by plan sponsors or to deny coverage in some cases. Neither is currently true of the PBGC system.

Certain core elements of reform, therefore, would be implemented in option #2 as they would be in option #1:

- A) *Premium reforms.* Just as with a strengthened PBGC, a private insurer would need to charge higher premiums than have been imposed to date, and would likely increase its reliance on risk-based premiums.

- B) *Adequate funding.* In a private insurance system, adequate funding would be facilitated not via government prescription but through the general requirement that the new system be self-financing.

⁵⁴ “[E]conomic reasoning establishes a rationale for insuring defined-benefit pensions against the risk that the plan sponsor will default on its promise to provide benefits. It does *not* establish a rationale for the *government* to provide such insurance. The federal government is probably not in the best position to carry out such a task.” See Bodie, Zvi, 1996. “What the Pension Benefit Guaranty Corporation Can Learn from the Federal Savings and Loan Insurance Corporation.” *Journal of Financial Services Research*. Vol. 10, No. 1 (March): 83 – 100.

- C) *Strengthened legal tools.* Whether public or private, a pension insurer could be provided with stronger legal tools in bankruptcy proceedings, such as a higher claim priority given to pension plan contributions.

- D) *Independence from other government departments.* This would be implicit in any private insurance model.

Choosing between options #1 and #2 therefore primarily represents a value judgment as to whether the above reforms are more likely to occur within a government-chartered or a privately administered system. If the conclusion is reached that persistent legislative tinkering will always prevent PBGC from charging adequate insurance premiums or from requiring responsible pension funding practices, then the private insurance model must be considered as an alternative.

The premium structure for pension insurance is of particular relevance when weighing whether to continue the PBGC or to transition to a private-sector model. A private insurer would be expected to assess premiums based in large part on risk, including each of sponsor default risk, underfunding risk and asset-liability mismatch risk, among other factors. The public sector has generally shown an unwillingness to implement true risk-based pricing.

An important policy specification for any private-sector successor to PBGC involves whether it must not only sustain its *future* operations, but also carry the burden of making up an inherited PBGC deficit of roughly \$23 billion. To require pension plan sponsors to make up this deficit is in effect to require that their future pension insurance costs are \$23 billion higher than the value of their future pension insurance. This introduces the policy dilemma as to whether it is reasonable to compel pension sponsors to carry private pension insurance that offers less value going forward than its assessed cost.

Some advocates of private pension insurance (see Ippolito, 2004⁵⁵) have therefore proposed that taxpayers shoulder the cost of financing the current PBGC deficit so that subsequent compulsory pension insurance can be given a “clean slate” free of legacy debt. At the time of that paper’s publication, the estimated cost of this buyout was roughly \$18.7 billion; based on PBGC’s current \$23 billion deficit, it would be substantially higher today.

Ippolito suggested that private market insurance could offer superior incentives to the current system if designed in a particular way. Plan sponsors would initially receive insurance through a self-insurance pool, but individual plans would eventually be permitted to move out of the pool and to purchase a separate, private insurance policy. Sponsors of underfunded plans, therefore, would face substantial incentives to limit the cost of the pooled insurance by addressing their own funding shortfalls, so as to reduce the risk that well-funded sponsors would exit the pool. Central to this design, however, is that the new system is able to maintain self-financing because it has been freed (by general taxpayers) of the PBGC’s current legacy debt.

Though PBGC’s legacy debt is a thorny problem for any transition to private insurance, it is important to understand that the problem is not *unique* to the private insurance model. Whether pension insurance is publicly or privately offered, the same policy dilemma exists: namely, whether to require pension plan sponsors alone to make up the PBGC shortfall, or whether to pass the cost of that shortfall to general taxpayers. Regardless of whether the system is public or private, PBGC’s legacy debt is such that plan sponsors will need to provide billions in additional future revenue to the pension insurance system beyond the value of future benefit claims—if costs are not to be passed to others.

⁵⁵ Ippolito, Richard, “How to Reduce the Cost of Federal Pension Insurance”, Cato Institute, 2004, <https://www.cato.org/pubs/pas/pa523.pdf>

Transition to a private insurance system introduces additional issues of timing and taxpayer assistance relative to continuation of the PBGC system. Transition options include:

- 1) requiring a private insurance system to begin operations while facing a \$23 billion deficit;
- 2) providing taxpayer assistance to eliminate the legacy debt prior to transition; or
- 3) eliminating (or at least reducing) the legacy debt within traditional PBGC operations before transitioning to the private sector.

For reasons that are described elsewhere in this paper, this author would judge general taxpayer assistance to the pension insurance system to be an inequitable outcome. On the other hand, it appears unrealistic to expect a private-sector insurance system to remain viable if it faces a \$23 billion debt from the moment of its creation. Accordingly, the most reasonable path for transition to a private-sector system might be via a two-stage process: during the first stage, reforms would be implemented to drastically curtail the size of the PBGC deficit. Only in the second stage would a transition be effected to a private-sector framework.

In this author's judgment, both stages of any such two-stage process would need to be established in law from the outset to permit successful conversion to a private-sector model. Measures to reduce PBGC's shortfall in the near term would need to be tied explicitly to such conversion. If, alternatively, reforms succeeded in eliminating the PBGC deficit *without* being an explicit component of a private-sector transition plan, the fiscal improvement would by itself eliminate much of the political momentum toward such conversion. Without establishing an explicit two-stage process, it appears very unlikely that such a transition would ultimately be facilitated.

Reform Options #1 vs. #2:

Similarities and Differences

Common Elements:

- Premium reforms
- Stronger funding rules implemented without persistent legislative revision
- Strengthened legal tools for the pension insurer
- Independence of the pension insurer

The Key Difference:

Option #1: A reformed, strengthened PBGC

Option #2: Transition to a system of compulsory private insurance

Option #3: Unless and until the federal government requires that the PBGC's financing risks be resolved via options #1 or #2, treat the shortfall for federal budgetary purposes as an obligation facing U.S. taxpayers.

The policy objective underlying options #1 and #2 is to enable the pension insurance system to meet its obligations without an infusion of taxpayer-provided revenue. If, however, policy makers are unwilling both to require and to empower the pension insurance system to be self-sustaining, there exists a substantial risk that taxpayers will be ultimately called upon to resolve the shortfall.

There are a number of reasons why a taxpayer bailout of employer-provided pension insurance is an undesirable policy outcome. First and foremost, it would be inequitable. Approximately 21

percent of American workers⁵⁶ have been promised defined-benefit retirement income by their employers—meaning that the other 79 percent have not. To require these taxpayers to bail out pension promises made by others' employers is to require the vast majority of taxpayers to subsidize a benefit that only a minority is eligible to receive.

Beyond this, the mere potential for a taxpayer-financed bailout injects additional moral hazard into a retirement income system already fraught with it. Pension benefits represent a particular form of compensation promised by an employer to an employee. Ideally, the employer alone would be responsible for fulfilling that promise; to the extent that resources other than employer funds are used to fulfill it, the employer is in effect compensating the employee with third-party money.

The presence of pension insurance creates moral hazard, in that there is valid *reason* to believe that an entity other than the employer will provide the financing for the promised benefit. Within the current pension insurance system this moral hazard exists to the extent that other pension plan sponsors absorb the costs of underfunding. To open up the pension system to an injection of general taxpayer financing is to expand the potential moral hazard considerably; in that circumstance, the possibility is held out that even if neither the original pension sponsor nor other pension sponsors provide the resources to fund the benefit, it will still be paid. This considerably reduces incentives for employers, even as an aggregate group, to fund the pension-benefit promises that they make.

For general taxpayers to bail out private-sector defined benefit promises also renders it difficult to draw a clear line limiting potential taxpayer exposure. If defined-benefit promises are to be made good by the federal government, why should there not also be relief to workers who have only defined-contribution accounts severely weakened by the recent financial markets plunge? Once the federal

⁵⁶ Bureau of Labor Statistics, "Retirement Benefits, March 2009." Table 2a.

government goes down the road of assuming responsibility for the retirement income promises made in private employment, there is no obvious limit at which the potential costs will be contained.

Finally, the federal government is itself already in dire fiscal circumstances, facing a historically unprecedented level of accumulated debt even without assuming the further cost of unfunded benefit promises in the private sector. Among other obligations, the federal government is already responsible for financing the benefits of its own Social Security program, currently projected to be insolvent over the long term. The deficit of the PBGC is smaller than the deficits in state/local public plans or Social Security, and could theoretically be financed more easily; it nevertheless lacks the direct claim upon taxpayer resources that the Social Security program has. Unless and until the federal government has an effective plan for financing the fiscal obligations it has already taken on, it is not in a position to be shouldering the retirement benefit obligations of the private sector.

For these and other reasons, a taxpayer bailout of the PBGC should be regarded as a “doomsday scenario.” If, however, policy makers decline to enable the PBGC pension insurance system to be self-financing, they are creating a risk that this “doomsday scenario” will come to pass. Policy option #3 is to disclose the full amount of this risk to taxpayers for as long as it persists.

The procedures for bringing the costs of systems like the PBGC onto the federal budget are not free of ambiguity; scorekeeping decisions of the Congressional Budget Office and the Office of Management and Budget sometimes diverge (as they have with respect to the budgetary treatment of the Government-Sponsored housing Enterprises, Fannie Mae and Freddie Mac).⁵⁷ To appropriately show the full extent of taxpayer exposure to the obligations of the PBGC, both PBGC assets and liabilities

⁵⁷ <http://www.cbo.gov/ftpdocs/117xx/doc11745/09-16-Frank-Letter.pdf>. See also http://www.cbo.gov/ftpdocs/113xx/doc11343/03-15-Student_Loan_Letter.pdf. CBO states that the size of a fair-value subsidy should be calculated to reflect the market cost of taking on a particular set of obligations: “In general, a fair-value subsidy arises when the government accepts terms on the financing or services it provides that are less stringent than the terms that participants in private markets would require to take on comparable obligations and risks.”

would need to be measured with methods that reflect their degree of risk, with any administrative costs incorporated that are essential to the preservation of asset values. This methodology would reflect a policy outcome in which taxpayers (as opposed to insured workers) bear the risks of financing benefit payment obligations. Any net negative cash flows projected based on this methodology would be scored as a general revenue obligation facing U.S. taxpayers.

Clearly, merely reporting this information within federal budgetary documents would by itself be an inadequate public warning of the potential cost of a taxpayer bailout of the PBGC. To secure the public attention required to deflect momentum from a bailout, periodic separate reporting of the size of the PBGC obligations facing taxpayers would likely be required in a manner similar to the annual reports of the Social Security and Medicare Trustees. This could be required either of CBO, the Office of Management and Budget, the General Accounting Office, or of the PBGC itself.

Also, to have a sufficient deterrent effect, any such reporting requirement should disclose not only the potential cost to taxpayers but also the potential losses in worker benefits. Unless PBGC's statutory cap on benefits is waived, even a "taxpayer bailout" would not result in taxpayers making up the entirety of the funding shortfall in pension plans under PBGC trusteeship. The remainder of the gap would be resolved by the loss of all worker benefits exceeding PBGC's statutory limit. Merely reporting an implicit taxpayer liability as an explicit liability is likely insufficient to compel policy corrections. Reporting as well the projected worker benefit losses could add substantial cogency.

Scoring the potential cost of a taxpayer bailout would have another beneficial side effect, in that it would deter the use of pension funding relief as a budgetary offset for new federal spending. In the past, Congress has "raised revenue" by reducing requirements for (tax-deductible) employer pension contributions, and has used the revenue increases to finance its additional spending desires. This practice could be deterred if an increase in the projected PBGC deficit was simultaneously scored as a

direct spending obligation facing taxpayers. Insofar as such a projection is to have an impact upon the application of congressional “pay-go” or “cut-go” procedural rules, CBO’s score of these effects is likely to be most relevant.⁵⁸

The chief purpose of such a reporting requirement would be to publicly disclose the fiscal consequences of a continuation of current policies that allow deficits in the pension insurance system to persist and to grow. It is hoped that disclosing this potential cost to taxpayers and workers would act as a spur to enact reforms along the lines of options #1 or #2.

Questions that Must Be Answered Under All Three Reform Approaches

Implicit throughout this paper has been the value judgment that action must be taken to close the substantial gap between, on the one hand, the projected values of promised employer-provided pension benefits and, on the other, the values of assets held within employer-provided pension plans. The tools provided to the pension insurer in options #1 and #2 are designed to be sufficient, by definition, to close the financing gap. What cannot be quantified in advance is the relative reliance upon each policy tool. To the extent that enhanced legal powers for the pension insurer and full funding requirements together prove insufficient to fill the shortfall, premium assessments would be altered to make up the gap.

Though one way or the other this gap must ultimately be closed with tools such as these, this does not imply that it would be optimal policy to require that this substantial funding shortfall be made up immediately and all at once. Indeed, to require this in the current economic environment could well

⁵⁸ Congressional rules sometimes prohibit the addition of spending to the deficit; Congress has generally relied upon CBO scoring to implement these rules.

be self-defeating. It would require rapid increases in annual contributions to pension plans, indeed potentially quadrupling annual contribution levels⁵⁹ at a time when many employers are expected to struggle to recover from the recent economic downturn.

Accordingly, no matter which of the preceding reform models is adopted, a contribution funding schedule will be required, and almost certainly one in which employers' near-term funding contributions are limited to levels substantially lower than will ultimately be necessitated. Even under the 7-year amortization schedule established under the PPA, PBGC has estimated that total pension contributions that were roughly \$50 billion in 2008 would need to exceed \$250 billion annually by the middle of this decade. As long as unemployment continues to exceed 9 percent annually and elected officials remain focused on near-term job creation, it is very unlikely that policy makers will choose to require contribution increases of this magnitude over the next couple of years within any pension insurance system. This inevitably means that there will be some persistent risk of system insolvency, even after reforms are enacted, before they are fully phased in.

If past history is any guide, however, policy makers' relative weighting of near-term and long-term funding considerations will be far from optimal, at least so long as PBGC's present position within the political process remains unchanged. Long before the recent financial markets downturn, legislators repeatedly valued near-term funding relief for employers above the long-term financing health of the pension insurance system. Evidence of this exists in the repeated delivery of additional funding relief relative to previous law, including the provision of higher liability discount rates in 2002 and 2004 as well as the near-term funding relief provided in the 2006 PPA itself.

⁵⁹ Modeling results provided by PBGC to Congressional staff, October 2009. Again, competing estimates from Towers Watson anticipate smaller increases.

The further funding relief provided in 2010 was simply a continuation of a long-standing trend of relieving previous-law funding requirements whenever they begin to have a significant effect on employer finances. It is reasonable to expect that legislators, especially in challenging economic times, will continue to subordinate pension funding integrity to the interest of ameliorating conditions immediately facing employers—that is, to continue to further shift the risk of underfunding from employers to workers, to the PBGC and, beyond this, potentially to taxpayers.

There are two important considerations to bear in mind when reforming the PBGC to better make this judgment call; first, the difficult balancing act of weighing *employers' near-term viability* against the pension system's long-term funding needs; second, the demonstrated habit of the *political system* to subordinate long-term funding considerations to near-term exigencies. Reforming the structure of the PBGC system (along the lines of options #1 or #2) would only address the *second* of these considerations. It would not by itself provide answers to the first set of considerations.

To arrive at an optimal schedule for funding requirements, we must further distinguish between two related but nevertheless distinct set of factors, namely:

- 1) *The effect of near-term funding requirements on the health of the pension system itself*; that is to say, whether near-term funding requirements are so onerous that they are counter-productive, either by triggering the insolvency of plan sponsors or by otherwise inducing them to unnecessarily terminate their plans.
- 2) *The competition between the policy objective of sound pension financing vs. other near-term economic needs*; that is, whether near-term pension funding requirements collide with other pressing considerations facing policy makers, such as interfering with economic recovery or job creation.

These considerations are sometimes mixed or even conflated in the public discussion about pension funding requirements. It is often argued, for example, that requiring employers to make significantly larger contributions to their pension plans would be counterproductive—because doing so might actually harm the PBGC by triggering additional near-term plan terminations—or because doing so would interfere with employers’ abilities to create jobs.

While these arguments may all sound similarly compelling to policy makers, it is important to remember that they are nevertheless *distinct* concerns. Whether an onerous funding contribution requirement would cause an otherwise viable pension plan to terminate would be a concern to *any* pension insurance system, whether our current PBGC system or a reformed alternative. But whether a funding contribution requirement interferes with *other* economic policy goals is a fundamentally different concern: it speaks instead to the question of whether broader economic policy goals should be achieved through weakening of worker pension funding.

This leads us to the following policy principles:

- 1) Whether policy makers choose option #1 (a reformed, strengthened PBGC) or option #2 (a compulsory system of private insurance), or whether the current PBGC system continues to operate without significant alteration, the insurer *must* give careful consideration to the timing of pension funding requirements. These requirements must become effective rapidly enough to bolster the health of the pension insurance system, but must still be gradual enough to avoid counterproductive effects such as the avoidable termination of pension plans, which would worsen pension insurance system finances. If and after policy makers choose among the reform options outlined in this paper, the work of such important calibrations would fully remain.

2) Funding requirements should *not*, under any structure, be manipulated to serve larger economic policy goals of the Congress or of the presidential administration. While fostering job creation and economic growth are important goals of both the President and of Congress, these should not be pursued by deliberately weakening pension funding requirements. The logical extension of such thinking would be that the more desperate the national employment situation, the more that pension promises to workers should go unfinanced. But the purpose of pension funding rules is not to serve larger economic policy objectives; the purpose of pension funding rules is solely to serve the policy goal of adequately funded pensions. To do otherwise is to perpetuate an ongoing, irresistible temptation to subordinate the soundness of pension funding to other economic exigencies, of which there will always be plenty. The removal of this temptation is one of the principal reasons to alter the current political process by which pension insurance premiums and funding requirements are determined.

To summarize: regardless of whether policy makers prefer reform option #1 or reform option #2, care must be taken by the pension insurer to moderate near-term funding requirements so that pension plan sponsors are not pushed into unnecessarily terminating their plans. Indeed, one basis for choosing between option #1 or option #2 could be a judgment as to which type of pension insurer is more likely to make a prudent assessment of these factors.

Regardless, however, these decisions should be made *irrespective* of their effects on broader federal policy goals with respect to job creation and economic growth. Our national policies for facilitating job growth should not be predicated on deliberate underfunding of the pension benefit promises made to workers.

Summary and Conclusions

Like other defined-benefit (DB) pension systems in the public sector, America's employer-provided DB pensions are significantly underfunded. Like public sector DB pensions, employer-provided pensions embody a significant risk to taxpayers unless this underfunding is addressed. Sound public policy would focus on ameliorating the underfunding in the employer-provided DB system and on containing the potential risk of a taxpayer bailout.

The present risk to taxpayers of underfunding in the employer-provided DB system is embodied in the large deficit of the nation's pension insurance system operated by the PBGC. The PBGC currently faces a net deficit of \$23 billion, of which nearly \$22 billion is in the single-employer pension insurance program. Though the size of PBGC's deficit worsened with the recent financial markets downturn the fundamental problems preceded the recession, as evidenced by the persistence of a significant PBGC deficit even when financial markets were at their recent peak. The PBGC is not under current law backed with the full faith and credit of the U.S. government. But one way or the other, the PBGC shortfall must manifest itself in increased costs facing either employers, workers, taxpayers or some combination of the three.

The shortfall in the private-sector defined-benefit pension system is a product of many factors, including; inaccuracy in the measurement of plan assets and liabilities, inadequate funding rules, unfunded benefit increases in unhealthy pension plans, loopholes and special preferences in the law, inadequate premium assessments, legal constraints upon the PBGC, inadequate funding disclosure, and moral hazard and political economy factors. The 2006 Pension Protection Act addressed several such flaws of previous law, but an ensuing market downturn weakened pension funding before many of the PPA's constructive reforms could fully take effect.

Many of the problems facing the employer-provided defined-benefit system arise from moral hazards common to all forms of defined-benefit pensions, including not only employer-provided pensions but also state/local systems as well as the federal Social Security program. In all of these systems, persistent underfunding reflects the temptation and opportunity to shift the risks of underfunding to third parties; in the employer-provided pension world, to the pension insurance system; in the public pension arena, to future taxpayers. In all of these systems, accounting methods have been employed to understate the risks of underfunding.

This paper has presented three fundamental directional options for reform of the employer-provided pension insurance system. Common to all three of these reform options are recommendations that asset/liability “smoothing” be eliminated to the extent practicable, that special preferences for politically-favored industries be eliminated, that unfunded benefit increases within underfunded plans be prevented, and that funding status disclosure be significantly enhanced.

Within these common reform principles, policy makers should choose between three basic options for reform of the PBGC: 1) equipping PBGC with the tools required to close its shortfall without taxpayer assistance; 2) replacing the PBGC with compulsory private pension insurance, and; 3) unless and until one of these two approaches is adopted, fully disclosing the cost of a taxpayer bailout of PBGC within the federal budget as well as in a periodic, separate report.

Under the first of these reform options, PBGC would be made independent of the Department of Labor, and would be empowered to collect adequate premium income, enforce adequate funding rules, and to have a higher standing in bankruptcy proceedings.

Under the second of these reform options, a private-sector pension insurance system would be given similar powers. Legislation to effect the conversion to a private-sector system would employ a two-stage process. During the first stage, measures would be implemented within the traditional PBGC

system to reduce the present value of its financing shortfall. Once the deficit was either eliminated or small enough to be handled by a viable private-sector alternative, PBGC would be replaced by a compulsory private insurance model. This second option would be implemented if policy makers reached the conclusion that the pension insurance system was more likely to remain free of political interference, and to make prudent determinations of premiums and funding requirements, if operated at a further move from the legislative process.

Under the third of these options, the full amount of any projected gap between the pension insurance system's (risk-adjusted) assets and projected liabilities would be counted as a general revenue obligation facing taxpayers, and projected amounts of worker benefit losses would also be reported.

Under all of these options, prudent decisions will be required to balance the competing objectives of long-term funding adequacy and near-term sponsor viability. This paper recommends, however, that these decisions *only* take into account the long-term health of the pension benefit insurance system, and not remain a vehicle for advancing broader economic policy objectives by worsening the risks of benefit underfunding facing American workers.

The substantial financing deficit of the pension insurance system will, one way or the other, exact a significant cost from some combination of employers, workers or taxpayers. Because such pension benefits represent a particular form of compensation promised by employers, and because most Americans do not enjoy access to such benefits, it would be inequitable to deploy general taxpayer resources to close this funding shortfall. Public policy, therefore, should be aimed at reducing such underfunding within the sponsor-financed system. This is best done by empowering the pension insurance system with the tools required to eliminate this underfunding or, as an interim fallback measure, fully disclosing the public cost of our persistent failure to do so.

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