BUDGET BULLETIN
A WEEKLY BULLETIN PRODUCED WHEN THE SENATE IS IN SESSION.
COMMITTEE ON THE BUDGET Republican Staff
Judd Gregg, Chairman
202/224-0642 http://budget.senate.gov/republican

109th Congress, 1st Session: No. 7 September 26, 2005

INFORMED BUDGETEER

THE COMMITMENTS

- In lieu of an update to the Katrina summary table included in the last *Bulletin* (for now, the figures in that table have remained nearly unchanged; the table will be updated periodically as warranted), this week the *Bulletin* examines the language – both budgetary and colloquial – used to describe the federal fiscal response to disasters.

- By August 30th, Katrina had already passed over the Gulf Coast, its aftermath had become apparent, and the response had begun. Three days later, Congress enacted the first supplemental of $10.5 billion. In the days that followed, it was popular to quote vague statements that the federal government had a "burn rate" of $500 million per day, which was subsequently, and incredibly, heightened to "spending $2 billion per day." Six days later on September 8th, the President requested and Congress enacted a $52 billion supplemental bill.

- Did the government really spend $10 billion in six days? To answer that, we have to understand such terms, especially in the context of the federal budget and disaster relief.

- In both budgetary jargon and everyday vernacular, we say it is money spent when we write the check or hand over the cash to pay for what we are buying. We say the federal government spends money when the outlays, or checks, go out the door. All else being equal, right now the deficit goes up when outlays go out, and we have to borrow money to cover those checks that go out.

- The step that occurs before outlays is another familiar budgetary term, though used not so much in everyday life – "obligations." Federal agencies record obligations when they commit the agency to buying a good or service or to providing assistance by signing a contract, awarding grants, or having employees show up for work. There is often a lag between the time an agency records an obligation and when it actually pays for, or spends money on, the good or service being purchased.

- The reason that agencies record obligations is to make sure that they do not spend more money than they actually have. The amount they have to spend is the amount of enacted appropriations they have received (can be either discretionary or mandatory), which is otherwise known as budget authority, or simply "BA." If an agency enters into more commitments than it has available in budget authority, then it would be "deficient," which is against the law under the Anti Deficiency Act.

- In review: the Congress enacts appropriations or budget authority, agencies then enter into commitments or obligations based on that authority and will eventually write checks when goods or services have been received.

- Now comes the perhaps less familiar language of disaster relief and budget execution in executive branch agencies. When a disaster strikes, the Federal Emergency Management Agency (FEMA) responds through its regional and field offices. When FEMA headquarters received $10 billion on September 2nd, it did not keep track of every commitment that every FEMA officer entered into. Instead, FEMA "allocates" funds from that $10 billion to major activities, either at regional or state offices or at other federal agencies, for a certain disaster declaration (in this case, Katrina) based on all the likely needs for 30 days as estimated in the field by those offices. That way each agency and the FEMA office on the front line knows how much money it has to work with and can focus on the response.

DISASTER RELIEF BUDGET EXECUTION

BUDGET AUTHORITY = APPROPRIATIONS
↓
ALLOCATION TO FIELD
↓
COMMITMENTS
↓
OBLIGATIONS
↓
OUTLAYS = EXPENDITURES = SPENDING

- Once given an allocation, those FEMA offices record (and here's the potentially confusing part) "commitments," which are funds reserved in the financial system based on specific requisitions (requests for the supply of water, ice, housing etc.) <u>in anticipation of</u> actually obligating (or signing the contract for) those funds. In this usage, these commitments are a planning-tool precursor to the step when an agency records obligations (defined earlier as committing, or binding, the federal government in a contract to make a payment). The table above puts all these steps together.

- Last week, the Administration sent to Congress the second set of reports as required by the second Katrina supplemental (see following table). One of those reports indicates that as of September 21, FEMA had allocated $15.8 billion of the $60 billion in Katrina appropriations it had received, and had only obligated $11.6 billion. The report also shows the level of commitments that have not yet been obligated ($3 billion), as well as the amount of outlays that have actually occurred ($1.7 billion). For the entire $62 billion appropriated in the two supplementals, Congressional Budget Office estimated that only $1.3 billion would be outlayed (or spent) in 2005, with about $30 billion of outlays occurring in 2006, and the remaining $30 billion in outlays in 2007 and thereafter.

DISASTER RELIEF FUND, KATRINA ACTIVITY
($ in billions)

Program Area	(1) Allocation	(2) Commitments (un-obligated)	(3) Obligations (un-liquidated)	(4) Expenditures	(1-2-3-4) Remaining allocation
Human Serv.	6.5	2.2	2.5	1.4	0.4
Infrastructure	1.0	*	0.6	0.3	0.1
Ops./Admin	8.3	0.8	6.8	*	0.7
Total	**15.8**	**3.0**	**9.9**	**1.7**	**1.2**

*Less than $50 million.
Source: Department of Homeland Security report of 9/22 to the Committees on Appropriations (required under PL 109-62)

- Because most of the early references to "burn rate" lacked a source, the *Bulletin* assumes that a $2-billion-per-day figure resulted from the initial burst of FEMA activity over Labor Day weekend, when assets of the military and Army Corps of Engineers were activated. FEMA allocated, or set aside, several billion dollars to these agencies and its various field offices involved in responding to the disaster. In fact, one of the largest allocations, $4 billion, was for temporary mobile housing, some of which will not even be built for more than a year from now (much longer than the 30-day needs normally associated with allocations). So it is clear that not all of FEMA's $60 billion will actually be <u>spent</u> any time soon. In fact, $44 billion remains unallocated.

THE PRICE OF UNKEPT PROMISES

- Cash-strapped from rising fuel costs and facing huge unfunded pension liabilities from promises made long before hurricane Katrina or 9/11, Delta and Northwest Airlines recently announced they were filing for Chapter 11 bankruptcy protection from creditors. This is on top of the bankruptcies of United Airlines (which logged a record pension default of $9.8 billion, $6.6 billion of which has shifted to the federal government corporation that insures private pensions – the Pension Benefit Guaranty Corporation, or PBGC), U.S. Airways, and much of the steel industry in recent years. These events pose increasingly stark questions about the future of the defined benefit pension system for 44 million Americans, the solvency of the PBGC that partially insures those pensions, and the potential effect on taxpayers.

BACKGROUND ON PBGC SHORTFALL

Definition of PBGC Shortfall: the unfunded (i.e., there are no private-plan assets to back them) pension liabilities (but only that portion which the PBGC is allowed to pay under caps set in law) shifted to PBGC from plans that have already terminated or whose termination is "imminent" in the eyes of PBGC (in net present value). Because this shortfall is already considered to be on the books of the PBGC, it is considered a retrospective or backwards-looking indicator.

As of September 30, 2004 PBGC:

- Insured $1.7 trillion in private pension plan promises nationwide, of which $450 billion were underfunded.
- Had a shortfall = accumulated deficit = negative net position = $23 billion

- In response to the red ink, the President's FY 2006 budget in February proposed to eliminate the PBGC deficit by imposing stronger cash-pension contribution and transparency requirements on plan sponsors along with higher insurance premiums paid to the PBGC. While premium increases are an important component of any legislative fix, the majority of the reduction in PBGC's deficit would occur by requiring companies to fund their plans faster or more fully, thereby securing the retirement of millions of workers and significantly reducing the likelihood and magnitude of future pension defaults that land on the PBGC.

- Attentive budgeteers will appreciate that, under current law, there is no legal risk to the taxpayer from the default of private pension plans whose liabilities have shifted over to the PBGC. PBGC insurance is not like FDIC insurance of bank deposits, which are insured up to $100,000 by the full faith and credit of the U.S. Instead, PBGC can make good on its insurance coverage only to the extent resources are available from 1) insurance premiums paid by plan sponsors, 2) assets turned over to the PBGC by distressed companies, and 3) investment returns on these premiums and assets (see *A Guide to Understanding the Pension Benefit Guaranty Corporation*, http://www.cbo.gov/ftpdocs/66xx/doc6657/09-23-GuideToPBGC.pdf). Nonetheless, budgeteers and taxpayers should be concerned because of the political risk that there will be pressure to enact legislation that requires taxpayers to foot the bill rather than have pension promises, even at the PBGC-reduced levels, totally evaporate.

- In light of the increasing problems and the legislative interest in the pension and PBGC arena, the Congressional Budget Office (CBO) recently released *The Risk Exposure of the PBGC* (http://www.cbo.gov/ftpdocs/66xx/doc6646/09-15-PBGC.pdf). The report extends the scope and the time horizon (beyond the accustomed backwards look) for estimating the PBGC's "shortfall" by estimating 1) the likely future losses at the PBGC, 2) the market value of federal pension insurance, 3) policy options to reduce future shortfalls, and 4) options to improve the transparency of the financial health of the PBGC.

- One key takeaway is the estimated hole in PBGC's ability to make good on pension liabilities that it inherits over the next 10 years (from the current and likely insurance claims), which will amount to $87 billion (and $142 billion over the next 20 years) under current funding rules and premium levels. These estimates include, but go beyond, the shortfall of $23 billion that is already on PBGC's books. While these revised figures reinforce the sobering pension news reported earlier this summer in testimony by CBO as well as in other takes by the Government Accountability Office and the PBGC, the figures have been misunderstood all over again.

By Any Measure, the PBGC is Insolvent

- Some have reported that the CBO analysis reveals that the likely PBGC deficit has now "*grown* to nearly $90 billion over the next 10 years and possibly well over $140 billion in the next 20 years." Another erroneous take has been that CBO's report predicts that PBGC "would have a larger-than-expected debt over the next 10 years." But these assessments miss the point. CBO's estimates cannot be "larger than expected" because federal decisionmakers were not doing these kind of forward-looking estimates before, so no one knew what to expect the numbers to look like. Further, estimates cannot be said to have "grown" just because they are answering a different question than the question people were asking when they were looking only at the $23 billion figure.

- The CBO report takes pains to distinguish among the various ways one can think about PBGC's problems. For example, CBO emphasizes that its ***cost projections*** reflect the shortfall to date plus prospective net costs, which are the market's valuation (the price private insurers would charge to accept the obligations of PBGC for all plans that will shift over to PBGC) of the claims on the PBGC going forward (calculated on a present value basis). This market value reflects the cost of market risk that "arises because investors demand compensation for the fact that new claims are likely to be higher in bad economic times." Alternatively, CBO provides an estimate of $32 billion (in net present value) for the unfunded pension liabilities that PBGC will absorb over the next 10 years (beyond the $23 billion shortfall), which does not reflect a premium for market risk. Even without the risk premium, under current law the PBGC deficit is $55 billion.

The Window for Action is Shrinking

- Fortunately for PBGC, retirees whose pension plans have shifted over to the PBGC cannot demand upfront, like a lottery winner or a bank depositor, all the payments that they are owed. PBGC pays out each retiree's pension benefit (at a reduced level if applicable) only monthly and as its resources allow. But absent significant policy changes in law, the pension insurance program will indeed run short of cash from premiums in the near future, possibly in the next five to eight years. (Currently, PBGC payments are expected to increase from $3.9 billion paid to 500,000 retirees in 2005 to $5.1 billion in 2006, while premium and investment income is expected to be $5.8 billion in 2006.) When the cash runs dry, PBGC will need to draw on assets inherited from defaulted pension plans to cover monthly obligations. In 10-20 years, not even premium receipts and asset liquidation will be sufficient to pay projected claims.

- It is often said that Congress does not act until there is a crisis. By significantly tightening funding rules of pension plans, addressing the interaction of bankruptcies with pension law (lowering the risk that plans end in default), updating and revising the insurance premium structure, and removing the secrecy surrounding the financial health of plans, Congress can secure the retirement of workers and return the PBGC to a path of solvency. Otherwise, the crisis will worsen: even higher premiums for companies that remain in the system, significant economic losses to beneficiaries and investors, pressure for a taxpayer bailout, and the likely demise of defined-benefit pension system altogether.