CBO TESTIMONY

Statement of
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on
Financing Government Employee
Retirement Systems

before the
Subcommittee on Civil Service
Committee on Government
Reform and Oversight
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NOTICE

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Mr. Chairman and Members of the Subcommittee, I appreciate the opportunity to discuss the President's proposal for the District of Columbia's pension plan for teachers, judges, police, and firefighters. My statement assesses the consequences of the Administration's approach for beneficiaries and taxpayers, compares the President's proposal with alternative forms of assistance, and discusses some implications for the federal pension system.

CONSEQUENCES OF THE PRESIDENT'S PROPOSAL

As part of its plan to provide fiscal relief to the District of Columbia, the President's proposal would convert the District of Columbia's pension plan for teachers, judges, police, and firefighters into a federal retirement system. Under that proposal, the District would terminate the plan and transfer to the federal government all assets currently held by that plan and most of its liabilities. (As initially proposed, the District would retain responsibility for about $1 billion of pension liabilities.) If the District plan's assets matched its liabilities, the proposed transfer would be of little consequence to federal taxpayers. However, assets are $4.75 billion less than liabilities, and the long-term cost to taxpayers will be determined by the amount of that unfunded liability that is assumed by the federal government. That cost cannot be changed by juggling the budgetary accounting of the transfer.

The proposal takes advantage of cash-based budgetary accounting to delay recognition of the assumption of the District's unfunded pension liabilities. The proposal would have no effect on the budget deficit for at least 10 years. Assets would begin being consumed immediately in order to pay annuities to beneficiaries. The liquidation and drawdown of plan assets would continue for 10 years or until the transferred portfolio was completely exhausted. At that time, the federal government would begin to pay the remaining pension obligations out of general federal revenues. After the assets were exhausted, annual federal outlays for the assumed plan would initially amount to between $700 million and $800 million.

The President's plan would shift most of the cost of the $4.75 billion unfunded liability to future federal taxpayers and change the nature of risk to beneficiaries of District pensions. Those effects can be seen by comparing the financial characteristics of the current District plan with those of the federal retirement system and by examining the economic consequences of the President's plan.

Differences Between the District and Federal Pension Plans

The current District pension plan differs from the federal system in several major respects: the quantity and kind of assets held and the independence of plans from the sponsoring employer.

Plan Assets. A major difference between the District and federal pension plans lies in asset holdings. The District pension plan holds a diversified portfolio of prime-quality securities issued by private entities. The plan holds no debt obligations of the District of Columbia. Avoiding debt issued by the plan sponsor is consistent with the aim of reducing the plan's exposure to risk from deterioration in the financial condition of the District. The District plan also avoids investments in obligations issued by firms in Maryland and Virginia to minimize the concentration of regional economic risks.

By contrast, the federal government's defined benefit pension plans hold only nonmarketable debt securities issued by the government itself. The federal system makes no attempt to acquire claims on third parties or to diversify its assets. Instead, pension obligations are backed by the power of the national government to raise money through taxes and borrow when payments fall due. Federal practice in that regard can be justified by the fiscal capacity of the U.S. government and by the diversification of tax revenues among all taxpayers. Nonetheless, the use of

nonmarketable Treasury debt securities, which creates the appearance of funding, can be compared to a housekeeper who in anticipation of future bills deposits his or her own IOUs into a cookie jar each week. Although the cookie jar deposits can help remind the housekeeper of looming obligations and thereby restrain current spending, they provide no direct, independent assistance in paying off the bills.

Plan Funding. Another difference between the District and federal plans is in their respective funding levels. Currently, the District pension plan for teachers, judges, police, and firefighters has about $3.75 billion in assets and about $8.5 billion in actuarial liabilities. Thus, about 56 percent ($4.75 billion) of the plan's liabilities to present and former employees is not funded. The federal defined benefits pension systems for civilian and military employees holds about $500 billion in Treasury IOUs and owes about $1.5 trillion in benefits. Accordingly, about two-thirds ($1 trillion) of federal liabilities to beneficiaries appear to be unfunded. But those federal securities are merely the promise of the federal government to itself. The left pocket owes the right pocket, but combined trouser assets are exactly zero. By increasing the volume of IOUs to $1.5 trillion, the federal government could pretend to "fully fund" its retirement system. Such funding would cost current taxpayers nothing. Nor would it directly reduce the burden on future taxpayers. From the perspective of the federal government as a whole, none of the $1.5 trillion in promised annuities is funded.

Independence. The District and federal pension systems also differ significantly in the extent to which the plans are independent of the employer. The District plan is under the direction of a Retirement Board, whereas the federal pension systems are administered by executive branch agencies—the Office of Personnel and Management (OPM) and the Department of Defense (DoD). The District's Retirement Board manages fund assets for the exclusive benefit of employees. The District Board has demonstrated its fiduciary responsibility and commitment to plan beneficiaries by obtaining court orders to require the District to make payments to the pension fund. By contrast, neither OPM nor DoD can be expected to place the interests of employees above those of the government.

Meaning of Differences in Plan Funding

The significance of the Administration's proposed changes in the District's plan stems from its effects on the security of pension promises to current and former employees and on who bears the burden of paying the costs of the retirement benefits. The level of pension plan funding, however, is not a reliable guide to either pension security or the incidence of pension costs on current or future taxpayers.

False Assurances of Plan Funding. The security of benefits and the distribution of financing costs for a public pension plan cannot be determined solely on the basis of

its financial condition. Rather, the size of the total fiscal burden being shifted by government to future taxpayers—in relation to their ability to bear it—is critical to that determination.

The equivocal significance of a plan's funding level can be demonstrated by a hypothetical public plan that holds a diversified portfolio of blue chip assets in excess of the current actuarial value of plan liabilities. From all appearances, annuity payments are secure. Past and current taxpayers also appear to have paid taxes or forgone other spending to acquire the assets held by the plan. But the financial condition of the plan itself reveals nothing about the other assets and liabilities of the government. For example, the government may have an outstanding public debt equal to the full amount of its pension obligations, precisely because it acquired those pension assets with money borrowed through the issue of general obligation bonds. In that case, current and past generations of taxpayers have paid for none of the accumulated pension benefits. Instead, they have left future taxpayers with the full burden of paying for pensions.

Funding pension liabilities with marketable assets may also fail to protect the security of benefits. If the total tax burden shifted to future citizens is so heavy as to be intolerable, it will not be borne, and the government will not be able to meet all its promises. When a government is subject to severe fiscal pressures, assets in its defined benefit pension plans are unlikely to be regarded as untouchable. Accord-

ingly, a government forced to scale back some of its obligations can offer no assurances to creditors, including its retired employees, that they will be paid in full.

Usefulness of Plan Funding. Even though the level of plan funding is an unreliable guide to cost incidence and benefit security, the act of funding a pension plan can facilitate a rational allocation of pension costs among taxpayers and enhance the security of benefits. That is true because the process of funding a pension plan affects the fiscal decisions that determine the overall financial condition of the government.

To fund a pension plan is to recognize the cost of benefits in the budget as those benefits are being earned. This recognition takes place as the sponsoring government makes periodic payments to the plan. If they are included in the budget, those payments must be financed. Policymakers and citizens are forced by the arithmetic of the budget to acknowledge that pensions are consuming fiscal resources.

Recognition of costs in the budget does not necessarily mean that the burden rests on current taxpayers. Financing retirement costs with higher deficits would shift some of the burden to the future. But without budget recognition and full disclosure, policymakers have little opportunity to weigh the appropriate division of costs among present and future generations. Failure to recognize all future net costs increases the chances that amounts shifted to the future will be greater than intended,

that the shifted burden will be intolerable, and that current policies will be unsustainable over the long term.

Effects of the President's Proposal on Beneficiary Security

Earned benefits provided under the District pension plan are currently at substantial risk. More than half are unfunded. Although the District has paid the plan for all benefits earned since 1979 and made additional payments for the unfunded liability, the District's current fiscal policies cannot be sustained.

The Administration's proposal for transferring the District's plan to the federal government would use current assets to pay pension benefits. That policy change would not affect the security of annuity payments for the next 10 years or so, because accumulated plan assets provide sufficient financing to pay all obligations coming due over that period even if the District retained responsibility. After the plan's assets have been consumed, the superior financial condition of the federal government compared with that of the District could enhance the longer-term security of District plan benefits.

In order to determine the effect of the Administration's proposal on the longer-term security of benefits, the Congressional Budget Office (CBO) looked first

at the long-term projected cash outlays to federal annuitants (see Table 1). That projection showed federal disbursements to be manageable under current policy. Federal pension payments to annuitants will constitute a declining share of national income after 2015 because of downsizing in the federal workforce and armed services. Also contributing to this downward trend is the shift from defined benefits to Social Security and defined contributions enacted with the Federal Employees' Retirement System (FERS) in 1983. Although the projection does not include outlays for District annuitants under the Administration's proposal, this share of the District's pension payments (about $800 million in 2010) is too small in relation to federal pension outlays ($126 billion) to affect significantly the conclusion that federal outlays for pensions are unlikely to impose a heavy burden in the future. From this perspective, projections suggest that federalizing District pension obligations could increase the long-term security of benefits to annuitants.

The next step in the assessment is to consider the entire burden being shifted to the future by current federal policies. CBO projects that government spending under current policy will rise significantly after 2010 (see Table 2). The retirement of the baby-boom generation and continued expansion in the use of federally financed health care services will drive up outlays for Social Security, Medicare, and Medicaid. If policies are not changed, that surge in spending, unless accompanied by a corresponding increase in tax receipts, will cause federal borrowing to rise to unsustainable levels. The projected fiscal stress confronting the federal government

TABLE 1. LONG-RANGE PROJECTIONS OF FEDERAL CIVILIAN AND MILITARY RETIREMENT PAYMENTS (In billions of current dollars)

	1996	2000	2005	2010	2015	2020	2030	2040	2050
Civilian	40	48	62	81	103	124	171	225	296
Military	29	33	39	45	51	57	74	104	151
Total	69	81	101	126	153	181	245	329	447
Memorandum:									
Percentage of GDP	0.9	0.9	0.9	0.9	0.9	0.8	0.7	0.6	0.6

SOURCE: Congressional Budget Office estimates based on projections by the Office of Personnel Management and the Department of Defense.

NOTES: Projections do not include spending for retiree health care. They assume that discretionary spending grows with the economy after 2007.

GDP = gross domestic product.

TABLE 2. LONG-RANGE PROJECTIONS OF FEDERAL RECEIPTS AND EXPENDITURES, CALENDAR YEARS 1996-2050 (As a percentage of GDP)

	1996	2000	2005	2010	2015	2020	2025	2030	2035	2040	2050
NIPA Receipts	21	20	20	20	20	20	20	20	20	20	20
NIPA Expenditures											
Federal consumption expenditures	6	5	5	5	5	5	5	5	5	5	5
Transfers, grants, and subsidies											
Social Security	5	5	5	5	5	6	6	6	6	6	6
Medicare	2	3	4	4	5	6	7	7	8	8	8
Medicaid	1	1	2	2	2	2	2	3	3	3	3
Other[a]	5	5	4	4	4	4	4	4	4	4	4
Net interest	3	3	3	3	3	4	5	6	8	9	12
Total	22	22	22	23	25	27	29	31	33	35	39
NIPA Deficit	2	2	2	3	5	7	9	11	13	15	18
Debt Held by the Public	50	48	48	50	59	75	97	125	158	193	267
Memorandum:											
Gross Domestic Product (Trillions of dollars)	7.6	9.1	11.4	14.4	18.0	22.4	27.7	34.3	42.6	52.8	80.5

SOURCE: Congressional Budget Office.

NOTES: Simulations without economic feedbacks assume that deficits do not affect either interest rates or economic growth. Discretionary spending is assumed to grow with the economy after 2007.

GDP = gross domestic product; NIPA = national income and product accounts.

a. Includes federal retirement spending.

leaves retired government employees exposed to the risk that their earned benefits will not be paid in full in the face of unrelenting downward pressures on all federal spending.

Over the longer term, the Administration's proposal would expose District annuitants to the same fiscal risks that federal employees are facing. Those beneficiaries face risk now, however, and the net effect on their well-being is probably improved.

Effects of the President's Proposal on Tax Burdens

The Administration's proposal would shift the burden of most of the accumulated shortfall in the District plan to future federal taxpayers and provide immediate relief to District citizens. Inasmuch as the entire unfunded liability in the District's pension plan is attributable to the failure of the federal government to fund retirement benefits before home rule, this shift may be appropriate. However, the proposal avoids burdening federal taxpayers for the next 10 years or so. Use of accumulated assets to pay benefits for that period enables the federal government to avoid making payments from its own revenues. The President's proposal requires no net increase in federal outlays or the deficit except in years that are outside the 10-year budget planning outlook.

ALTERNATIVE APPROACHES TO THE DISTRICT PENSION PLAN

The President's proposal would provide immediate financial relief to the District of Columbia. A federal takeover of the pension plan would initially reduce the District's pension contributions by $176 million a year. Relieving the District of the obligation to make up the plan's unfunded liability could also raise the credit quality of the city's bonds and reduce its financing costs. The primary disadvantages of the Administration's proposal are that it terminates the District's independent plan for funding earned benefits and delays budgetary recognition of the cost that is shifted to federal taxpayers. As you suggested in your letter of invitation, Mr. Chairman, alternative approaches to resolving the District's unfunded liability could preserve the current plan structure, result in earlier recognition of the cost of federal assistance in the budget, and do so without increasing total federal cost.

Preserving the District Plan

Retaining the current plan, with its independent board and its policies of funding liabilities with first-quality, marketable financial assets could have several advantages. It would avoid the cost of setting up a new retirement plan to fund future earned benefits for District employees. More important, the current system—if fully

funded now—might afford District beneficiaries more long-term security than they could obtain under a federal plan. That security might result from the ability of the autonomous pension board to defend earned benefits from cuts. A fully funded District plan might also insulate District annuitants from fiscal pressures that may threaten earned benefits under the federal system.

Two options—a lump-sum payment and 30-year amortization—would preserve the District's plan (see Table 3). Those plans, which cost the federal government the same amount in present value, differ only in the rate that federal funds are paid into the District pension plan. Under the lump-sum approach, the federal government would make a single payment to the District in 1998 to cover the estimated unfunded termination liability of $3.9 billion. Operationally, this is the simplest way of providing immediate relief to the city while preserving the current plan. The lump-sum option would require an immediate budget outlay for the full amount of the federal contribution.

The hole in the District pension plan does not have to be filled immediately, however. The sustainablility of the existing plan could be restored by increasing the current federal annual payment to the District plan of $52 million through 2004 to the District plan to $318 million a year for the next 30 years. That is the general approach recommended by Delegate Eleanor Holmes Norton. The 30-year amortization plan would add up to $1.6 billion in federal outlays over the 1998-2002 period

TABLE 3. FEDERAL BUDGETARY COSTS OF ALTERNATIVE PLANS TO ASSUME MOST OF THE DISTRICT'S UNFUNDED PENSION LIABILITY
(In millions of dollars)

	1998	1999	2000	2001	2002	Five-Year Total	Present Value[a]
Administration's Proposal	0	0	0	0	0	0	3,856
Lump-Sum Payment	3,856	0	0	0	0	3,856	3,856
30-Year Amortization[a]	318	318	318	318	318	1,593	3,856
Pro-Rata Federalization[b]	208	220	233	247	261	1,169	3,856

SOURCE: Congressional Budget Office estimates based on data from Milliman & Robertson, Inc., *District of Columbia Retirement Board Valuation as of October 1, 1996 for Fiscal Year 1998* (Washington, D.C., February 1997).

NOTE: "Unfunded pension liability" refers to the "unfunded present value of accrued benefits" or the unfunded termination liability. The Administration proposed that the federal government assume responsibility for the unfunded termination liability.

a. The present value expresses the flow of current and future payments in terms of an equivalent lump sum paid today. The calculation assumes a 7.25 percent interest rate, as do the other calculations in this table.

b. Assumes that 49.3 percent (the current funding ratio of the termination liability) of benefit payments are made by drawing down trust fund assets and that 50.7 percent of benefit payments come from general federal revenues.

(see Table 3). From the District's perspective, one disadvantage of amortizing the unfunded liability over 30 years is that receipt of future payments would not be certain, especially as the federal government begins to come to terms with the unsustainability of its own current fiscal policies.

The last option, the pro-rata approach, would terminate the District's plan but disclose federal acceptance of the cost of the District pension plan more prominently. Under this alternative, the federal government would use plan assets to pay benefits, but only in proportion to the ratio of current assets to current liabilities. Because plan assets constitute about one-half the termination value of accrued federal liabilities, the federal government would pay one-half the annual cost of annuities from liquidating plan assets and pay the rest from general federal revenues. The estimated five-year cost of this approach would be about $1.2 billion.

Reporting Federal Costs

Recognizing the full federal cost of taking over the District's pension plan in the budget when it is enacted is consistent with several objectives of budgeting, including accountability, fiscal control, and the provision of full information. Accountability requires that costs be matched in time and place with the actions that give rise to those costs. Recognizing the full cost of a decision also supports the

objective of fiscal control. Furthermore, decisions are not fully informed unless all information about cost is available.

The District plan's unfunded liability is attributable to the failure of the federal government to fund retirement benefits before the plan was turned over to the District under home rule. Under any option that returns the District plan to the federal government, the cost of earned benefits is "sunk" or possibly fixed beyond the ability of the federal government to control. Inasmuch as the federal government incurred but did not recognize that cost in the past, the timing of its recognition appears to be arbitrary. However, a broader, governmentwide perspective suggests a decisive basis for preferring earlier to later recognition of pension costs—even those that are sunk. The essential fact about the financial condition of the federal government is that its current policies cannot be sustained over the long term. Current long-term commitments cannot be honored indefinitely with current tax rates.

Significant policy changes will be required to restore long-term balance, and those changes will considerably affect the ability of citizens to realize their long-term financial plans for economic security. The unavoidable increases in taxes or cuts in spending will require adjustments in personal behavior and plans. Policy changes will be more manageable and less disruptive if they happen gradually rather than suddenly. That is especially true for changes in retirement programs, on the

basis of which citizens are making plans and taking action over a lifetime. To wait until beneficiaries are nearing retirement to change policy is to leave annuitants without opportunities to minimize their losses by adjusting long-term consumption and savings. The sooner the necessary changes in policy and expectations are adopted, the more gradual they can be and the lower their social cost. The need to ease the adjustment to a sustainable set of policies argues for recognizing all costs sooner rather than later.

IMPLICATIONS FOR FEDERAL PENSIONS

The disadvantages of the President's proposal to convert a District pension fund into a federal plan highlight some weaknesses of the federal pension system. One weakness is that the security of earned federal retirement benefits is not assured. Another is that in a cash-basis budget, cost recognition for federal pensions is deferred until benefits are paid out. The Congress has a variety of options for addressing these shortcomings. Of course, each remedy has its own disadvantages.

The Security of Earned Federal Benefits

Few observers feel that a doomsday scenario, which is inherent in the unsustainability of current federal policy, is a realistic forecast. The government is expected to modify current policy to avoid that outcome. The process of adjusting current policy to a sustainable path, however, will expose all federal spending programs to intense downward pressure. Spending for federal retirement benefits is unlikely to escape those pressures entirely.

The insecurity of benefits is obviously a disadvantage to beneficiaries. But it may also be inconsistent with the interests of taxpayers and the public at large. The uncertainty of benefits can reduce the value that current employees assign to future benefits. That discounting for risk raises the total compensation that must be offered to attract employees to government. Thus, taxpayers would benefit from increasing the certainty of retirement benefits in terms of a lower cost of total compensation for federal employees.

Recognizing the Deferred Cost of Federal Retirement Benefits

The federal government gives only incomplete recognition to the cost of employee retirement benefits as they are earned. Current costs are recognized through internal

bookkeeping entries rather than cash payments, which are the unit of account for most other activities. In addition, the accounting entries understate the costs of earned benefits for many employees.

Trust funds for defined benefit pension plans for civilian and military personnel have been established on the books of the government in order to tally and report those costs. Employee contributions to defined benefit plans are credited to the trust fund. Similarly, intragovernmental transfers from employing agencies are credited to the trust funds as benefits are earned. For employees covered by FERS or the Military Retirement System, agency transfers of credits cover the present value of the normal cost of earned benefits. For civilian employees covered by the older Civil Service Retirement System (CSRS), agency transfers cover about one-third of the present value of the government's expected outlays for pensions. Agencies make no transfers to the trust funds for the cost of retiree health care benefits. Those costs are paid out of the general fund of the Treasury.

The excess of employee and agency contributions over benefits paid in any period is "invested" in special-issue Treasury debt, on which the Treasury pays interest. But because of the underfunding of CSRS benefits and an inherited deficit in the Military Retirement System, the trust funds have a gap between Treasury promissory notes and pension liabilities (health care costs are not booked) of about $1 trillion. Consequently, Treasury's interest payments to the trust funds are only

about one-third of the amount required to convert the present value of earned pension benefits into the amounts to be paid. That underpayment increases the gap between Treasury IOUs and pension obligations, despite a series of Treasury payments intended to amortize the trust fund deficit. Therefore, the funds' reported unfunded liability tends to grow.

Options for Improving Federal Pension Security

Alternative structures for federal pension plans could accelerate recognition of pension costs in the federal budget and contribute to an increase in the security of earned benefits. Options that inform legislators and citizens more quickly of the fiscal consequences of current policies could facilitate the adjustment to a sustainable policy path, reduce future financial stress, and add to the security of earned benefits. Those alternatives would require some trade-off of other objectives, however. Two options are outlined here: a fully funded, defined benefit plan and a pure defined contribution plan.

Funding the Federal Defined Benefit Plans. The federal government could adopt a fully funded version of the District of Columbia's defined benefit pension plan. Doing so would mean creating an independent board of trustees charged with the fiduciary responsibility of overseeing the operation of each plan for the sole benefit

of plan participants. An autonomous board might provide some protection of earned benefits by monitoring and reporting periodically the financial condition of the plan and actions of the federal government that could threaten benefits.

That option would also require the government to acquire a large portfolio of high-grade investments. Purchasing those assets would accelerate the recognition of federal pension costs by raising budget outlays and the deficit now. One way in which funding the plan would increase the security of federal pension promises is through an improvement in the general, long-term financial condition of the government. The short-term increase in the deficit is the key to obtaining that improvement. If the size of the current budget deficit affects the willingness of the Congress to spend or tax now, raising the deficit now rather than later will cause some cuts in spending or increases in taxes now. Depending on the specific policies, that adjustment could shift some of the burden slated to be borne by future taxpayers to the current generation and guide fiscal policy toward a more sustainable course. If policymakers do not adjust current policy in response to higher current deficits, all the assets acquired to fund pension liabilities will be matched by an equal increase in federal debt and the future tax consequences of current policy will remain unchanged.

Because the critical link between the funding of pension benefits and increased pension security occurs through the effect on the budget deficit, it is worth

noting that the advantages of funding could also be obtained through changes in the federal budgetary treatment of pension benefits. For example, by simply filling the shortfall in the federal trust funds with Treasury IOUs, requiring agencies to pay the full cost of CSRS benefits, and designating the trust funds as nonbudgetary, the annual federal deficit would be increased by the annual change in the value of earned pension benefits. Funding the cost of retiree health benefits in the same way would add further to the deficit. Fully funding federal defined benefits with either Treasury IOUs or private securities would also require that projected increases in the federal debt ceiling take place now rather than later.

Funding a federal defined benefit plan with a portfolio of securities would also raise some potential difficulties. First, the trustees might be subject to political pressure to invest the retirement funds according to the objectives of the sponsoring government and to exercise some control over the firms in which it invested. That is the same issue that arises in proposals to invest the Social Security trust funds in private securities. Second, a funded defined benefit plan might provide new opportunities for budget gimmickry. It is not a simple matter to evaluate the assets and liabilities of such a plan to determine its actual funding level. Where there is room for doubt, there is room to fudge. Indeed, many private, state, and local sponsors do not fully fund their defined benefit plans.

Defined Contribution Plan. The difficulties inherent in a defined benefit pension plan have prompted a number of private and public employers to move to defined contribution plans, such as the federal Thrift Savings Plan (TSP). Defined contribution plans have all the cost recognition features of a fully funded defined benefit plan combined with the further advantages of greater ease of administration, security and portability of earned benefits, and limited scope for budgetary sleights of hand.

Under a defined contribution plan, an employer pays benefits as earned to a pension fund in which accounts are maintained for individual beneficiaries, who exercise some control over fund investments. The government's cost of providing pensions is recognized as outlays as the benefits are earned and paid. Once paid into employee accounts, contributions belong to employees. For public employees in particular, there is less risk that the government will succumb to future budget pressures and renege on earned benefit promises. Moreover, defined contribution plans are always fully funded by definition. If the employer defaults on the agreement to make contributions, that breach is immediately apparent, rather than being discovered when retirement benefits are due for payment.

Experience to date with the Thrift Savings Plan suggests that a possible win-win situation might exist—savings for the government and higher-valued retirement benefits for federal employees—if the government were to switch to the defined

contribution approach. Because of the potential for high returns on TSP investments and the plan's other positive attributes, the average employee might be better off if the government made the switch away from defined benefit plans. For example, employees might find a $90 contribution to the TSP more attractive than a $100 contribution to the defined benefit plan.

Defined contribution plans have some disadvantages, however. First, the value of the benefit at retirement depends on the financial performance of plan investments. Although employees can reap rewards from holding marketable securities, they also bear the risk of fluctuations in value. Inevitably, some employees will be unlucky or make poor investment choices and will end up with a lower benefit at retirement than expected. Second, a defined contribution plan does not penalize employees who change employers, as a defined benefit plan does. Some employees and employers may regard that as an advantage, but for other employers it may mean reduced worker loyalty and greater employee turnover. As a result, the employer may have a weaker incentive to invest in employee training. Third, defined contribution plans do not include a disability benefit that is often rolled into a defined benefit plan. To fill that gap, disability insurance has to be added to the compensation package.

CONCLUSION

The President's proposal for addressing the unfunded liability in the District's pension plan exploits federal budgetary accounting practices to prevent any of the cost from appearing in the budget outlook for the next 10 years. That delayed cost recognition sends policymakers and the public the wrong signals about the commitment of scarce resources and shifts fiscal burdens to the future. Alternatives to the Administration's proposal could increase the chances that a larger share of the cost would be borne now and increase the long-term security of benefits.

Although the cost of federal pensions is projected to decline as a share of national income, overall federal fiscal policies are unsustainable over the long run. Federal pension benefits, which are backed solely by the ability of the federal government to finance payments when they come due in the future, are thus subject to some risk that they will not be paid in full. Improving the federal government's long-run fiscal condition would increase the security of the current system of federal employee benefits. Fully funding current plans could contribute to the difficult process of improving the fiscal condition of the federal government if doing so affected Congressional behavior to act sooner to reduce other spending or increase taxes. Alternatively, the Congress could switch federal retirement benefits to a defined contribution basis, but such a change would increase the vulnerability of beneficiaries to investment risks at the same time as it reduced political risks.