APPENDIX

THE EFFECT OF THE MILITARY SERVICE OBLIGATION ON THE BUDGET SCORING OF H.R. 22

I. INTRODUCTION

This paper examines three issues relating to the effect on the unified budget of H.R. 22's changes to the treatment of military service pension credits of USPS employees: (1) CBO's 2005 scoring of H.R. 22 reflecting the transfer of the military service pensions obligation from the Postal Service to Treasury; (2) an alternative approach prepared by some Administration officials for discussion purposes,[1] which achieves budget neutrality but does not transfer the military service obligation to Treasury; and (3) a proposed compromise that transfers the military service obligation to Treasury, achieves budget neutrality, and provides both short-term rate relief to mailers and long-term relief to the Postal Service.

II. SUMMARY

The Congressional Budget Office's 2005 Cost Estimate found that the Senate version of H.R. 22, which transfers the military service obligation to Treasury, would increase the unified budget deficit by $3.9 billion from 2006-2015 ("Option 1"). An alternative approach suggested by Administration officials for discussion purposes ("Option 2"), which does not contemplate such a transfer, sets the amortization payments for the unfunded liabilities of the PSRHBF[2] at whatever amount would result in a zero budget effect. Using the assumptions and payment approach of Option 2, we have attempted to develop a viable proposal to return the military service obligation to Treasury and, at the same time, achieve budget neutrality ("Compromise Proposal"):

1. The CSRS[3] overpayment that results from transferring military service costs to Treasury would be deposited into the PSRHBF (approximately $20.5 billion).[4] CBO's analysis seems to indicate that this does not affect the budget score.

2. The future "CSRS" payments, which would no longer be necessary because of the transfer of the military service obligation, would continue to be paid by the Postal Service, but not into the CSRS Fund. Instead, the funds would be deposited into the

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[1] Because H.R. 22 is moving to conference shortly, and we are unaware of any other scoring analysis by the Administration, we are using this discussion paper as a starting point. In particular, in an attempt to limit controversy, we have developed the Compromise Proposal using assumptions adopted in this discussion paper rather than those adopted by CBO.

[2] PSRHBF is the acronym for the "Postal Services Retiree Health Benefits Fund."

[3] CSRS is the acronym for the "Civil Service Retirement System."

[4] This Compromise Proposal assumes that under H.R. 22 the escrow would also be eliminated, with escrow funds deposited into the PSRHBF, and that the PSRHBF, instead of the Postal Service, would be responsible for paying the health care premiums for current retirees.

PSRHBF as payments of principal of the unfunded health care liabilities. This is necessary to ensure a zero effect on the budget score.

3. To protect mailers, the Postal Service would not be allowed to recover the "CSRS" payment amounts (in Paragraph 2 above) in its rates, but it could borrow these amounts from Treasury. Generally, borrowing (except for the costs of the loan) is not reflected in the budget score, and year-to-year variations in rates do not change the score over the long run.

4. For the first ten years, the Postal Service would make payments to the PSRHBF under the formula in Option 2, modified to include "CSRS" payment amounts. That formula sets the amortization payments at whatever amount ensures a zero budget score in each of the ten years.

5. After ten years, the Postal Service would start to pay the balance of unfunded liability in the PSRHBF according to a 30-year amortization schedule (as done in Option 2), but the remaining liability would be substantially reduced by earlier deposits made into the PSRHBF and the accrued interest. The savings resulting from the difference between the reduced amortization payments and Option 2's proposed amortization payments would benefit the Postal Service over the long term and enable it to pay off its loan.

There may be other ways to modify H.R. 22 to achieve budget neutrality, but we believe that this approach is a politically viable compromise.

III. BACKGROUND

Prior to 2002, many believed that the Postal Service's deferred liabilities for its CSRS pension payments and its retiree health care costs[5] threatened its long-term viability.[6] However, in November 2002, in response to a request by GAO, OPM determined that the Postal Service's future payments to the CSRS Fund under the statutorily-mandated schedule would result in overfunding the Service's liability by at least $71 billion. Subsequently, GAO reported that before calculating the $71 billion, OPM had transferred an additional $27 billion obligation to the Postal Service for pensions of USPS employees with military service credits. The law at that time did not require the Postal Service to pay these military service pension costs. Without the transfer, the Postal Service's portion of the CSRS Fund would have had a projected overpayment of approximately $100 billion.

Since the Postal Service's payments into the CSRS Fund were statutorily mandated and could only be changed by an act of Congress, P.L. 108-18 was passed on April 23, 2003, to authorize the Postal Service to reduce its annual CSRS payments by $3.5 billion in FY 2003, $2.7 billion in FY 2004, and $2.9 billion in FY 2005. After FY 2005, P.L. 108-18 required the Postal Service to continue to collect the statutorily-mandated (over)payment through rates and

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[5] For a detailed exposition of the CSRS and retiree health care deferred liabilities problems, see the Comments to the President's Commission of the EMA Foundation's Institute of Postal Studies, February 12, 2003.

[6] *See* United States Postal Service: Information on Retirement Plans, GAO-02-170, December 31, 2001.

place these funds in escrow until future legislation directed the Postal Service on their use. P.L. 108-18 also mandated that the savings from the first three years be used to pay off the Postal Service's debts to Treasury and to defer rate increases until FY 2006. Over some objection, P.L. 108-18 transferred the military service obligation from Treasury to the Postal Service. Thus, although P.L. 108-18 provided mailers short-term rate relief, it shifted the "baseline" for budget scoring purposes so that, as explained below, reversion of the military service obligation to Treasury may now have the effect of increasing the deficit of the unified budget.

On January 9, 2006, the Postal Service began collecting a 5.4% across-the-board rate increase to fund the $3.1 billion 2006 escrow payment mandated by P.L. 108-18.

On July 26, 2005, the House passed H.R. 22 by a vote of 410-20. On February 9, 2006, the Senate passed S. 662, its version of H.R. 22, by unanimous consent. The Conference Committee is expected to meet in May.

The Administration and certain fiscally conservative members of the House and Senate objected to both S. 662 and H.R. 22 on the grounds that since both bills return the military service obligation to the Treasury, the bills have the effect of increasing the deficit of the unified budget (measured by the baseline set by P.L. 108-18). Although not explicitly stated, the Administration appears to measure budget neutrality over a ten-year time frame, from 2006-2015. Despite the fact that making ratepayers instead of taxpayers pay the costs of military service is generally viewed as inequitable, Treasury officials have predicted that if the postal reform bill is not "budget neutral," it will be vetoed.[7]

Separately, at the time of passage of the Senate bill, Senator First added a requirement that there be no "net increase in on-or off-budget direct spending [*i.e.*, in the unified budget] in excess of $5 billion in any of the four 10-year periods beginning in 2016 to 2055, as estimated by the [CBO]."[8]

Although the military service provisions of H.R. 22 are only one part of a comprehensive postal reform scheme, because the Administration has advocated budget neutrality as a prerequisite to Presidential approval of H.R. 22, parties seeking to achieve postal reform must first ensure that budget issues are satisfactorily resolved in order for the bill to become law.

IV. CBO'S 2005 ANALYSIS OF THE EFFECT OF H.R. 22 ON THE UNIFIED BUDGET (OPTION 1)

This section lays out basic scoring guidelines and explains Option 1, CBO's cost estimate[9] of H.R. 22 (Senate version).[10] Specifically, it analyzes the four main payment streams

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[7] The Administration has stated that the final bill "must have zero score – all escrow funds must go toward unfunded liabilities."

[8] U.S. Senate Comments, Postal Accountability and Enhancement Act, S. 662 (H.R. 22), Daily Digest, Feb. 9, 2006.

[9] Congressional Budget Office Cost Estimate of S. 662, July 1, 2005.

[10] The House and Senate versions of H.R. 22 differ in the details of how escrow payments and military service costs are handled. However, these differences do not materially affect our general analysis. For simplicity's sake, we use the Senate version of H.R. 22 (previously S. 662) as our basis for comparison.

which affect the budget score. Section V contrasts Option 2, an approach for achieving budget neutrality, which was previously raised for discussion by the Administration.

A. H.R. 22 Provisions

Both the Senate and House versions of H.R. 22 transfer to Treasury responsibility for paying pension costs associated with military service credits. Under the Senate version of H.R. 22, this transfer results in the Postal Service no longer being obligated to make either an agency contribution or any further annual amortization payments for CSRS (although employee contributions continue).

Both bills also eliminate the requirement that savings from reduced pension contributions be placed in escrow. Instead, in the Senate bill, the savings are to be deposited into a new Postal Services Retiree Health Benefits Fund (PSRHBF). Moreover, any overfunding of CSRS liabilities (after the military service obligation reverts to Treasury) would be transferred from the CSRS Fund to the PSRHBF (estimated by CBO to be approximately $20.5 billion) .

Previously, the Postal Service paid retiree health care costs on a pay-as-you-go basis (as a multi-employer) by paying health care premiums for current retirees out of its operating expenses.[11] The Senate bill would require the Postal Service to pay into the PSRHBF the estimated costs of retiree health care as such costs are accrued by employees (part of the so-called "pre-funding").[12] The PSRHBF would in turn pay the Postal Service's share of health care premiums for current retirees. Although under H.R. 22 some of the costs of pre-funding in the first decade are defrayed by the payment of funds which would have otherwise gone into the escrow account, after those payments are phased down, the required pre-funding amounts continue to grow. Thus, the legislation's mandate to move from pay-as-you-go accounting to accrual accounting for retiree health care liabilities imposes serious long-term financial consequences that stretch far beyond the current CSRS overfunding situation.

In addition, the bill requires the Postal Service to make annual amortization payments toward the unfunded liabilities of health care costs of both current and future retirees. This amount is set at the difference between the assets held in the PSRHBF and the net present value of accrued liabilities projected for retiree health care. CBO estimates that the net present value of the unfunded liability for the health care costs of retirees is $49 billion as of 2006 (assuming the military service obligation reverts to Treasury and CSRS overfunding is credited to the PSRHBF).

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[11] *See* USPS 2005 Annual Report at 49.

[12] Amounts to be included in pre-funding would also reflect changes in such factors as the cost of living, number of participants, and interest rates.

Finally, the Postal Regulatory Commission and the USPS Office of Inspector General would no longer be funded from the Postal Service Fund. The Senate bill authorizes the appropriation of funds for these offices (approximately $140 million per year).[13]

B. Basic Guidelines for Scoring

Although Postal Service operations, like Social Security, are considered "off-budget," both "off-budget" and "on-budget" effects are combined to determine the "unified budget." Analysts use the unified budget to assess how the federal government's activities will affect the economy and capital markets, and thus it is the unified budget that concerns Congress and the Administration. The financial operations of the Postal Service are shown on a net basis – that is, the difference between its collections (mainly from postage) and its expenditures is an "outlay" (or "spend") if expenditures exceed collections, or a "negative outlay" if collections exceed expenditures.

Transfers between two government funds are considered intragovernmental payments and have no net impact on the unified budget. Moving funds from the governmental escrow account to the intragovernmental PSRHBF has no effect on the unified budget.

The impact of the Postal Service's actions on the unified budget is entirely a function of its transactions with the public, *i.e.*, whether money flows into or out of the government from or to the public (here, postal ratepayers). The determining factor is how the Postal Service uses its savings from CSRS payments that are no longer necessary because of the CSRS overfunding. While redeeming federal debt or placing the savings in an intragovernmental fund for future retiree health care costs would not affect the unified budget, using the "savings" to fund capital investments or to postpone a rate increase would affect the budget. The latter two actions would result in either more money spent outside the government by the Postal Service or less money received by it, and would thus increase the unified budget deficit.

C. Four Payment Streams that Affect Scoring[14]

CBO has analyzed the ten-year "on-budget" effect of H.R. 22 (Senate version) as follows:

1. **Elimination of CSRS Payments:** Because the bill returns the military service obligation to Treasury, the Postal Service's payments into CSRS are discontinued. On-budget receipts are thus reduced by $11.7 billion for the ten-year period 2006-2015.

2. **Payments into the PSRHBF:** The bill requires that the Postal Service make pre-funding payments into the PSRHBF consisting of normal payments (accrual and other

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[13] The Senate bill would also lower workers' compensation payments made by the Postal Service, resulting in savings of roughly $50 million over the 2006-2015 period. Because this effect is relatively minor, it is not factored into any of the analyses.

[14] The CBO budget figures used here are from July 2005. In the past week, they were updated (with resulting decreases in the budget effects) based on revised assumptions (e.g., interest rate) but without any significant change in methodology. As noted in the following section, the Administration usually has its own cost estimate figures, which may differ in part because they are based on different assumptions.

adjustments) and amortization payments. The PSRHBF will pay the premiums for current retirees' health care, removing this obligation from the Postal Service. The Postal Service's payments into the PSRHBF, net of the soon-to-be discontinued USPS payment of current retirees' premiums, will increase on-budget receipts by $49.4 billion for 2006-2015.

The total "on-budget" effect over the first ten years is $49.4 billion - $11.7 billion = $37.7 billion increase in receipts.

The ten-year "off-budget" effects of H.R. 22 (Senate version) are:

3. **Elimination of Escrow:** The elimination of escrow account for "savings" would result in a decrease in off-budget receipts of $43.2 billion for 2006-2015.[15]

4. **PRC and OIG Funding:** Because funding for the Postal Rate Commission (PRC) and the Office of Inspector General (OIG) would be subject to appropriation rather than paid by the Postal Service Fund, the Postal Service's spending would be reduced by $1.6 billion for 2006-2015.

The total off-budget effect over the first ten years is $43.2 billion - $1.6 billion = $41.6 decrease in off-budget offsetting receipts.

The total effect on the unified budget is thus $37.7 billion (on-budget) - $41.6 billion (off-budget) or

$3.9 billion increase in the deficit of the unified budget from 2006-2015.

CBO has indicated that the estimated deficit for the ten year period of 2016-2025 exceeds $5 billion, the limit set by Senator Frist for any ten-year period. However, we are unable to analyze that projection because CBO has not provided supporting data for that decade.

In reaching its projection of $3.9 billion, CBO necessarily adopts certain assumptions that materially affect its scoring. For example, CBO uses a 5.75% interest rate. It also assumes a specific rate of increase in health care costs and a certain number of participants in the health care plan over 40 years. Although CBO has not defined all of its assumptions in its cost analysis, it is likely that they differ from the assumptions of the Administration officials. For example, Option 2 uses a 6.25% interest rate and assumes that health care costs will increase 7% each year for the next 40 years and that the number of participants will remain the same in each of the next 40 years.

[15] That is, the Postal Service will no longer be required to pay this money into the escrow account, and, since CBO assumes that USPS revenues will equal costs, it also assumes that the Postal Service will earn $43.2 billion less in revenues over this period.

V. ADMINISTRATION'S DISCUSSION MODEL FOR ACHIEVING BUDGET NEUTRALITY WITHOUT TRANSFERRING THE MILITARY SERVICE OBLIGATION (OPTION 2)

The Administration is, of course, not bound by CBO's cost analysis or its underlying assumptions. In fact, the discussion paper prepared by Administration officials, which we have labeled "Option 2"), addresses only two main payments streams: escrow payments and payments into and out of the PSRHBF (consisting of normal payments, amortization payments for the unfunded liability portion, and premium payments). It does not address either the costs for funding the PRC and the OIG, or the elimination of CSRS payments. The former is presumably considered relatively insignificant; the latter is non-existent because the Administration's position is that the Postal Service should continue to be responsible for military service costs.

The effect of retaining the requirement that the Postal Service pay military service costs is twofold: First, there is no concern that eliminated CSRS payments will increase the unified budget deficit. Second, the principal balance of unfunded liability in the PSRHBF remains at $64 billion, instead of being paid down by $20.5 billion (the amount of CSRS overfunding which would otherwise have resulted and would have been moved from the CSRS Fund into the PSRHBF as a "downpayment"). Option 2 achieves "budget neutrality," *i.e.*, a zero effect on the budget, for the first ten years, by setting the amortization payment for the retiree health care unfunded liability at:

Amortization payment = *Escrow payment* + *Premium payment (amount avoided by USPS to be paid from PSRHBF)* - *Normal Payment*

This formula guarantees that the net effect on the unified budget for the first ten years will be zero because:

"Sources" *less* *"Uses"* = *0*

(Escrow payment + Premium payment) less (Normal Payment + Amortization payment) = 0

After ten years, the remaining liability is amortized over 30 years as flat payments. Although Option 2 achieves budget neutrality for 2006-2015, it does not attempt to conform to Senator Frist's requirement that no subsequent ten-year period will increase the budget deficit by more than $5 billion: At least one decade would likely exceed the $5 billion ceiling.

As mentioned earlier, two key assumptions underlying Option 2's normal payments schedule is (1) that health care costs will increase by 7 percent per year over the next 40 years, and (2) that the number of participants (current employees) will remain the same over the next 40 years. Accurately estimating health care costs twenty to thirty years from now is a close to impossible task. Even more dubious is the assumption that with internet diversion and dropping mail volumes, the Postal Service will continue to employ the same number of people in twenty or thirty years. It would be equally valid to assume a decrease in the number of participants and to choose a 5% - 6% increase in health care costs.

Even a minor adjustment in one of these assumptions can have a significant impact in the amount the Postal Service must pay. For example, if a 5% health care cost increase were adopted, even assuming the number of participants remained the same, the total normal payments due over 40 years would decrease $254 billion from $629 billion to $374 billion. Since normal payments will be calculated annually based on up-to-date costs and projections, the assumptions in Option 2 will not necessarily result in the Postal Service actually paying more in normal payments; the (misestimated) normal payments are relevant only in the current scoring exercise to determine the projected effect on the budget because each year's amount of amortization payment is in part dependent upon the amount of the normal payment. As long as the amortization payments are set by a formula and not set as fixed amounts by law, the amounts eventually paid will reflect actual normal payments.

In sum, Option 2 does not allow for the transfer of military service costs to Treasury. It achieves a zero budget effect for the first ten years by postponing amortization payments until later years. It also uses its own assumptions as to the percentage increase in health care costs and the number of participants over 40 years.

VI. A COMPROMISE TO TRANSFER MILITARY SERVICE COSTS TO TREASURY *AND* ACHIEVE BUDGET NEUTRALITY (COMPROMISE PROPOSAL)

The Administration argues that returning the military service obligation to Treasury would result in an unacceptable increase in the deficit of the unified budget. Under Option 1, in 2005, CBO scored the increased deficit at $3.9 billion for 2006-2015, using its own set of assumptions and a different approach. However, even if the assumptions and approach of Option 2 are followed, it is possible to transfer the entire military service obligation to Treasury and achieve budget neutrality during the first few decades.

If the $27 billion military service obligation were returned to Treasury, approximately $20.5 billion of overfunding would be deposited into the PSRHBF (as a kind of downpayment) and the annual CSRS payments (totaling $11.7 billion over ten years) would become unnecessary. In order to remove the negative budgetary effect of eliminating these CSRS payments, the Postal Service must continue to pay those amounts into an on-budget fund. The amounts that would have been paid into the CSRS Fund (referred to as "CSRS" payments") could instead be deposited into the PSRHBF.

This proposal would follow H.R. 22's approach of eliminating the escrow and depositing funds that would have been deposited into escrow into the PSRHBF. The PSRHBF, instead of the Postal Service, would be responsible for paying premiums for current retirees' health care.

Amortization payments for the unfunded liability would follow the formula of Option 2 with two modifications:

a. The total amount to be amortized would be $47.5 billion, reflecting the "downpayment" of $20.5 billion from the reversion of the military service obligation; and

b. The Amortization Payment would be set at an amount that ensures budget neutrality for the first ten years:

Increased amortization payment into PSRHBF =

Escrow payment + *Premium payment* – *Normal payment*
PLUS "CSRS" payment

While the proposal thus far would meet the Administration's budget neutrality requirement and decrease USPS' unfunded liabilities, the ratepayer would receive no immediate rate relief from the return of the military service obligation to Treasury.

To protect mailers, Congress should place some kind of limit on recovery of the "CSRS" payments in rates. That limit could take the form of an explicit disallowance of the Postal Service's recovery of "CSRS" payments in mailers' rates. This would provide mailers immediate rate relief. The Postal Service could avail itself of its ability to borrow the necessary funds to make the "CSRS" payments. That borrowing would not affect the budget score. Budget analysts generally assume that although rates may fluctuate, in the long run, rates will be set so that the Postal Service breaks even.

Limiting recovery of the "CSRS" payments from ratepayers and encouraging the Postal Service to borrow may appear to place financial pressures on the Postal Service over the long term. However, after ten years, the "CSRS" payments made into the PSRHBF and the initial downpayment from CSRS overfunding already deposited into the PSRHBF, together with the interest earned, would have the effect of dramatically decreasing the principal balance of unfunded liabilities. Following the formula of Option 2, this reduced amount would be amortized over 30 years. The savings from these reduced amortization payments compared to the amortization payments of Option 2 would be so significant that the Postal Service should be able to pay off the loan and pay the increasing health care costs.

VII. CONCLUSION

Building upon the Administration's requirement of "budget neutrality" and assumptions in Option 2, we propose returning the $27 billion military service obligation to Treasury and achieving budget neutrality through the following steps:

1. Deposit the CSRS overpayment amounts (approximately $20.5 billion) into the PSRHBF.

2. Continue to pay the now-unnecessary "CSRS" payments but deposit the funds not into the CSRS Fund but into the PSRHBF as principal payments.

3. Limit the Postal Service from recovering these "CSRS" payment amounts in rates and encourage it to borrow these amounts from Treasury if necessary.

4. For the first ten years, make pre-funding payments into the PSRHBF under the formula of Option 2, modified to include "CSRS" payment amounts.

5. After ten years, amortize at a flat rate over 30 years the balance of unfunded liability in the PSRHBF, which will have been significantly reduced by earlier deposits and interest.