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MID-SESSION HEARINGS ON THE BUDGET FOR FISCAL YEAR 2006

HEARINGS

BEFORE THE

COMMITTEE ON THE BUDGET UNITED STATES SENATE

ONE HUNDRED NINTH CONGRESS

FIRST SESSION

April 21, 2005—STRUCTURAL DEFICITS AND BUDGET PROCESS REFORM

June 15, 2005—SOLVENCY OF THE PENSION BENEFIT GUARANTY CORPORATION—CURRENT FINANCIAL CONDITION AND POTENTIAL RISKS

July 20, 2005—HEALTH INFORMATION TECHNOLOGY: THE FEDERAL ROLE AND BUDGET IMPLICATIONS

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STRUCTURAL DEFICITS AND BUDGET PROCESS REFORM

THURSDAY, APRIL 21, 2005

U.S. SENATE,
COMMITTEE ON THE BUDGET,
Washington, DC.

The committee met, pursuant to notice, at 10:01 a.m., in room SH–216, Hart Senate Office Building, Hon. Judd Gregg, chairman of the committee, presiding.

Present: Senators Gregg, Domenici, Allard, Bunning, Crapo, Alexander, Graham, Conrad, Sarbanes, Nelson, Stabenow, and Corzine.

Staff present: Scott B. Gudes, Majority Staff Director; and Dan Brandt.

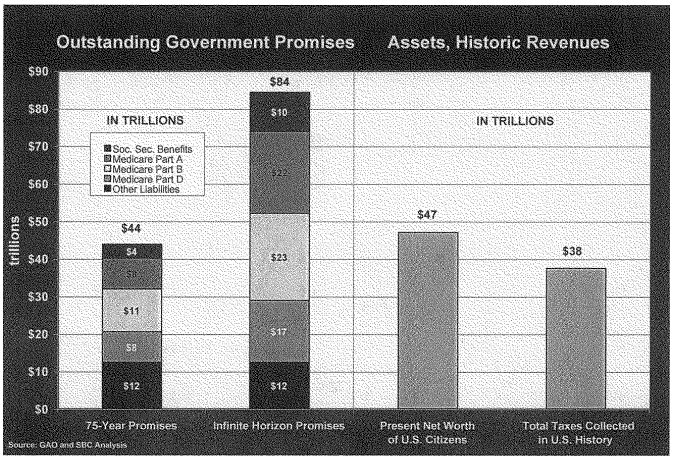
Staff present: Mary Ann Naylor, Staff Director; and Jim Klumpner.

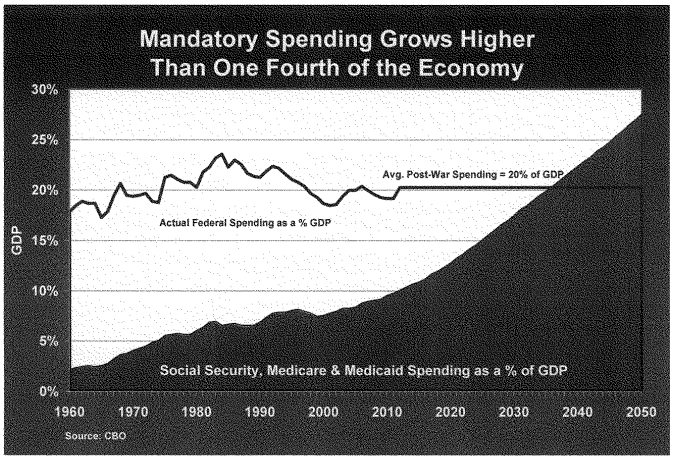
OPENING STATEMENT OF CHAIRMAN JUDD GREGG

Chairman GREGG. It is a pleasure to convene this hearing and to have with us today the Chairman of the Federal Reserve, who has been such a force for fiscal responsibility not only in the United States but around the world, and who has had such a massive impact throughout his career in allowing for the proper and effective growth of the markets and making sure that capitalism moves forward in a positive and constructive way across the United States and across the globe. And so it is a great pleasure to have the Chairman here.

I wanted to make a couple of opening comments just to try to put in context what I see as the concerns which this committee confronts, and then I will yield to my ranking member, and then we look forward to hearing from the Chairman.

Because charts are the tradition in this committee as set by the ranking member, I have brought my charts. The problem which we have as a Nation was defined for us rather starkly by the Comptroller General of the country, who testified before this committee. He made the point—and this is a point which is rather startling but is accurate—that the unfunded liabilities which the Federal Government presently has on its books represent $44 trillion, which is this line on the left—$44 trillion, that is with a "t"—of unfunded liabilities using the actuarial life of these programs that we have put on the books already.


Outstanding Government Promises
Assets, Historic Revenues
IN TRILLIONS
Soc. Sec. Benefits
Medicare Part A
Medicare Part B
Medicare Part D
Other Liabilities
trillions
$90
$80
$70
$60
$50
$40
$30
$20
$10
$0
$44
$4
$11
$8
$12
$84
$10
$22
$23
$17
$12
IN TRILLIONS
$47
$38
75-Year Promises
Infinite Horizon Promises
Present Net Worth of U.S. Citizens
Total Taxes Collected in U.S. History
Source: GAO and SBC Analysis



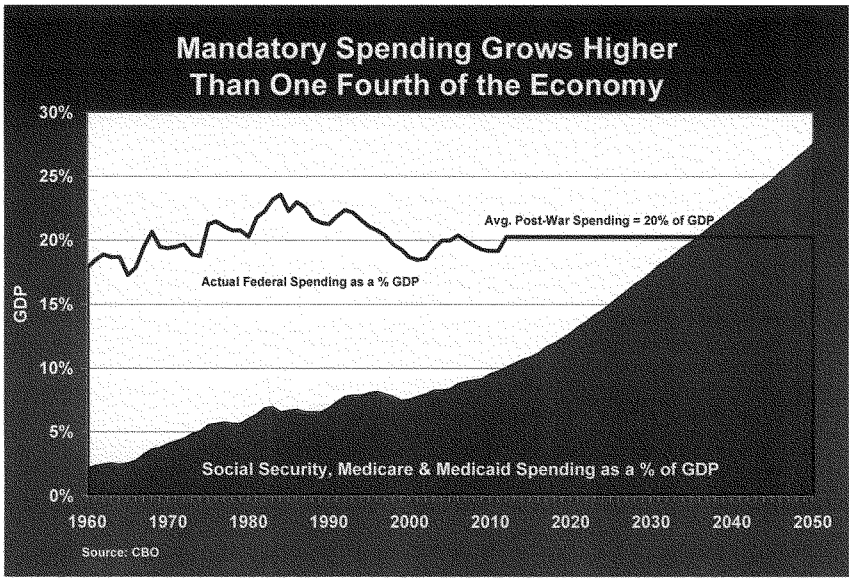
To try to put that in context, the total amount of taxes paid into the Federal Government since the Revolution, since we created ourselves as a Nation, are $38 trillion. That is the line on the right. And the total net worth, if you take everybody's assets in this country—your cars, your houses, your stocks, your bonds—the total net worth of our Nation is $47 trillion. So we actually have on the books today a liability which we as a Government have put in place which essentially equals the net worth of the Nation.

This liability is primarily driven by the fact that we have this massive generation known as the baby-boom generation, which is a demographic bubble of enormous impact, and has impacted our

culture every time it has hit a generational event, whether it is adding schools in the 1950's or changing the culture in the 1960's. And it will have a massive impact when our generation, the baby-boom generation, retires beginning in 2008, peaking around 2030. And the primary driver of this unfunded liability is the health care costs which this generation will burden our children with in supporting us.

In fact, the Comptroller General mentioned or cited a figure of $26 trillion of the $44 trillion as being health care-driven costs. And the question becomes: How do we address that as a Government?

Some have suggested, well, you can raise taxes to alleviate the Social Security issue or the health care issue, but I want to show one last chart here which reflects the fact that you really cannot tax your way out of this problem.


Mandatory Spending Grows Higher
Than One Fourth of the Economy
30%
25%
20%
15%
10%
5%
0%
GDP
Avg. Post-War Spending = 20% of GDP
Actual Federal Spending as a % GDP
Social Security, Medicare & Medicaid Spending as a % of GDP
1960
1970
1980
1990
2000
2010
2020
2030
2040
2050
Source: CBO

Traditionally, the spending of the Federal Government has been about 20 percent of the gross national product. By about the year 2030, three items of the Federal Government—Social Security, Medicare, and Medicaid—will absorb 20 percent of gross national product, if they are continued to be allowed to grow at their present growth rates. And we know this is going to occur because the people who are born, who exist, the baby-boom generation, will drive these costs. And that number goes up.

So no matter how much you raise taxes, you cannot tax your way out of this issue unless you are willing to absorb massive amounts of the economy in supporting and addressing this fundamental question and you are willing to burden our children and our children's children with huge tax increases.

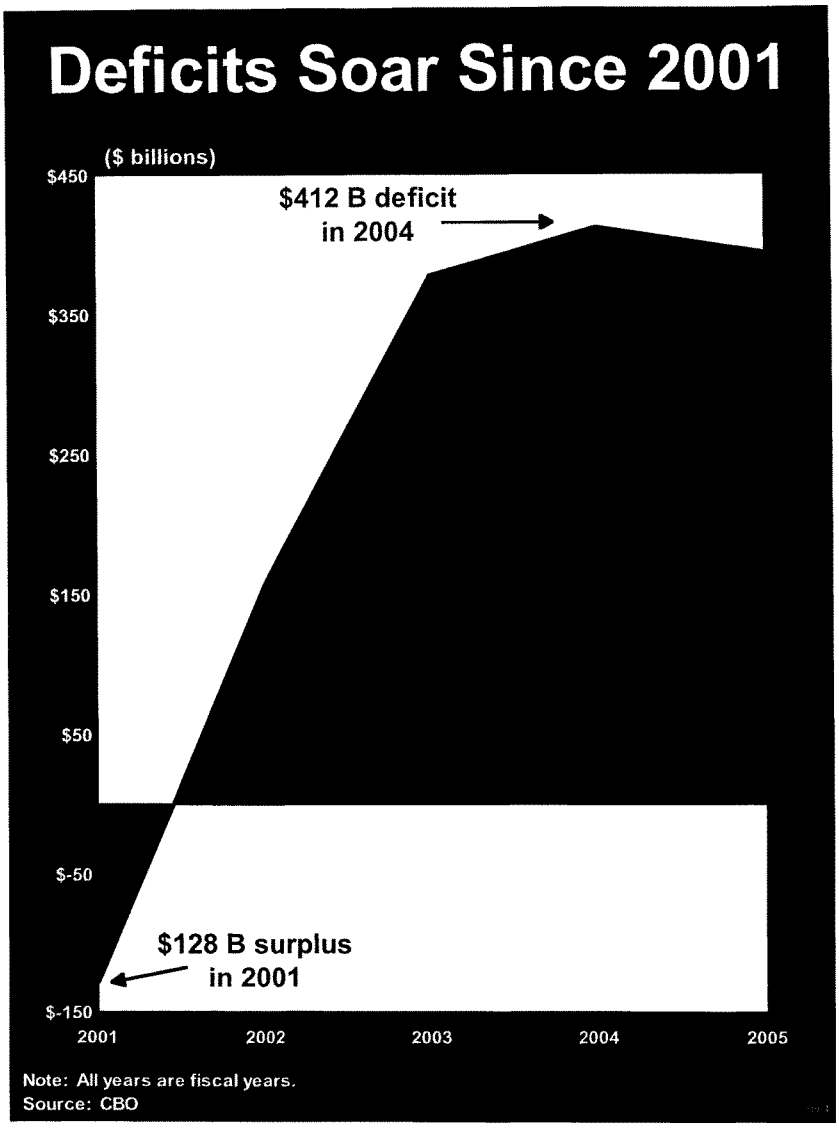
So we have to address these issues through policy that somehow manages better these entitlement programs. And I know that the Chairman has thought about this a lot and has given us counsel on this, and I hope that in today's testimony he will give us further counsel and direction on this. And it does come down to a large degree of incremental steps, in my opinion, and the first incremental step is to pass a budget which actually starts to put some controls on entitlement spending, which is why it is so important that the budget which we passed in this committee—regrettably, it did not pass the floor of the Senate—which began the effort of addressing one of the two major health care accounts, specifically Medicaid, be reinstituted and passed by the Congress so that at least one of the elements that are driving out-year fiscal costs, Medicaid—the other two elements being Medicare and Social Security—will begin to be addressed.

And with that, I will yield to the Senator from North Dakota.

OPENING STATEMENT OF RANKING MEMBER KENT CONRAD

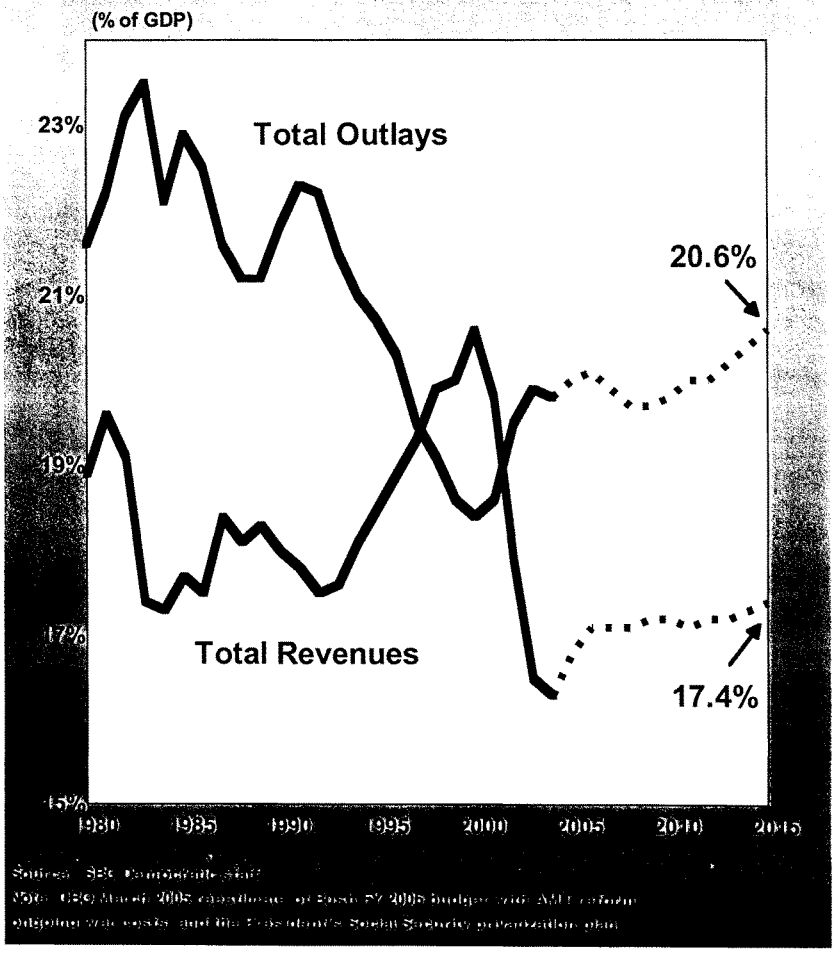
Senator CONRAD. I thank the chairman, and I thank the witness, Chairman Greenspan, for being with us as well today.

I thought I would just go through a brief review of where I see our fiscal situation and where I see it headed. Let me just go to this. This is the history of the budget deficit since 2001, and we can see now we are at a record $412 billion deficit in 2004. This graph shows some slight improvement. I wish it were so, but I do not believe it will actually occur.


Deficits Soar Since 2001
($ billions)
$450
$350
$250
$150
$50
$-50
$-150
$412 B deficit
in 2004
$128 B surplus
in 2001
2001
2002
2003
2004
2005
Note: All years are fiscal years.
Source: CBO

Let's go to the next. If we look back to 1980 and look at the relationship between spending and revenue as a share of gross domestic product, which I think most economists, Mr. Chairman, would tell us is the right to compare over extended periods of time.

Deficits Primarily Caused by Drop in Revenues, Not Increase in Spending



The red line is the spending line of the United States from 1980 to today and then the dotted line projected going forward. The green line is the revenue line of the United States. We can see the spending as a share of gross domestic product has come down quite substantially from the levels of the 1980's and early 1990's, and, in fact, we got below 19 percent of GDP. We have had a tick-up now as a result almost exclusively of increases in defense and homeland security and aid for New York. And we see going forward basic stability with some increase, some slight further increase in spending as we go forward.

The revenue line, we can see when President Bush came in revenue was a historic high as a share of GDP, but look at what has happened. The revenue side of the equation collapsed. And last year, revenue as a share of GDP was the lowest it has been since 1959.

We see some slight improvement, but the projection going forward still leaves us at a revenue line that is far short of the traditional 20 percent that the chairman outlined in his opening remarks, leaving us with this substantial gap, very substantial gap between spending and revenue going forward.

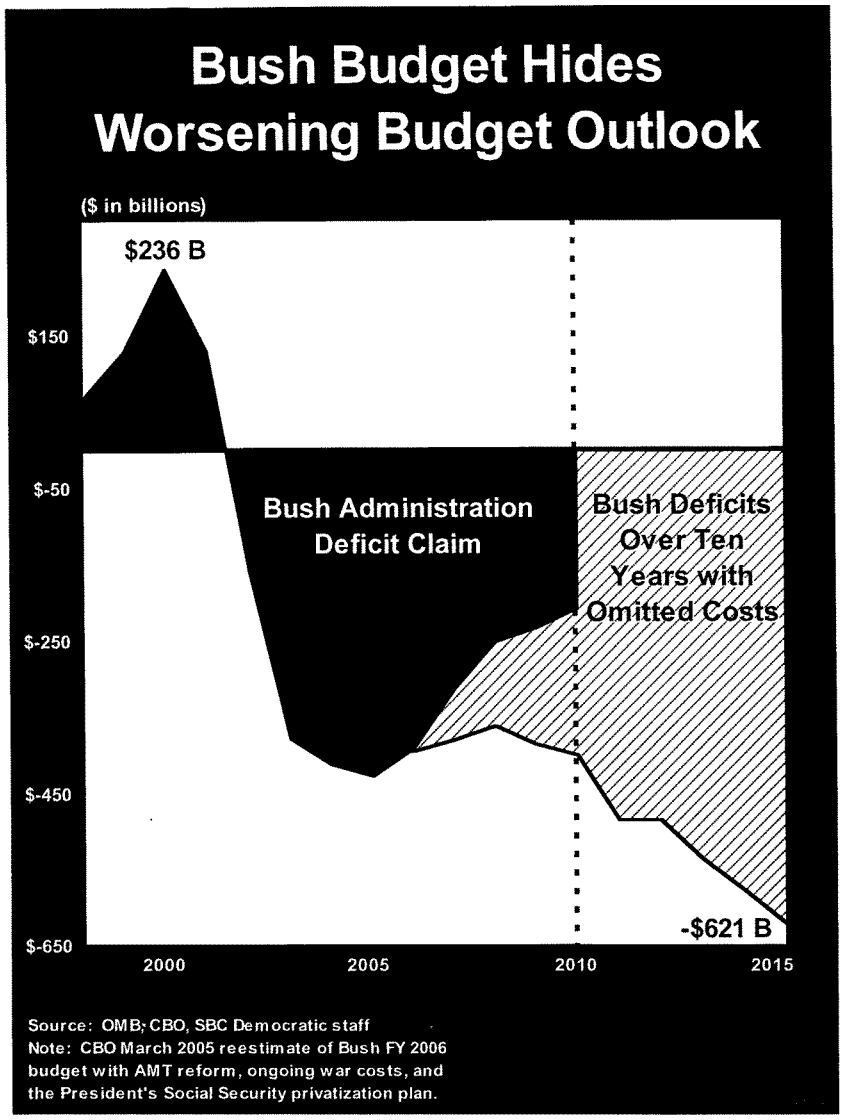
Let's go to the next. That gap is of special concern now because this is before the baby boomers retire. This is the Comptroller General of the United States in a speech that he made to the National Press Club in February: "The simple truth is that our Nation's financial condition is much worse than advertised." I believe that. I think he has got it exactly right. I think the accounting system of the Federal Government misleads us. I think the language that we use about our financial condition misleads us, misleads the American people. I think it probably misleads our colleagues. Perhaps we even mislead ourselves.

Comptroller General Walker Warns That Fiscal Outlook is Worse Than Claimed

"The simple truth is that our nation's financial condition is much worse than advertised."

–GAO Comptroller General David M. Walker
Speech to National Press Club
February 2, 2005

Let's go to the next. When the Comptroller General talks about the situation being worse than advertised, the President and his administration tell us that the deficit is going to get cut in half over the next 5 years. But the only way it gets there is he leaves out things. He leaves out war costs past September 30th. He leaves out the need to fix the alternative minimum tax, which is rapidly becoming a middle-class tax trap. He leaves out the cost of his Social Security proposal.


Bush Budget Hides
Worsening Budget Outlook
($ in billions)
$236 B
$150
$-50
$-250
$-450
$-650
Bush Administration
Deficit Claim
Bush Deficits
Over Ten
Years with
Omitted Costs
-$621 B
2000
2005
2010
2015
Source: OMB; CBO, SBC Democratic staff
Note: CBO March 2005 reestimate of Bush FY 2006
budget with AMT reform, ongoing war costs, and
the President's Social Security privatization plan.

When you add these things back in, the hashed red line is what we see happening going forward. He also only has the first 5 years of making the tax cuts permanent when we all know that the second 5 years, the cost of that proposal explodes.

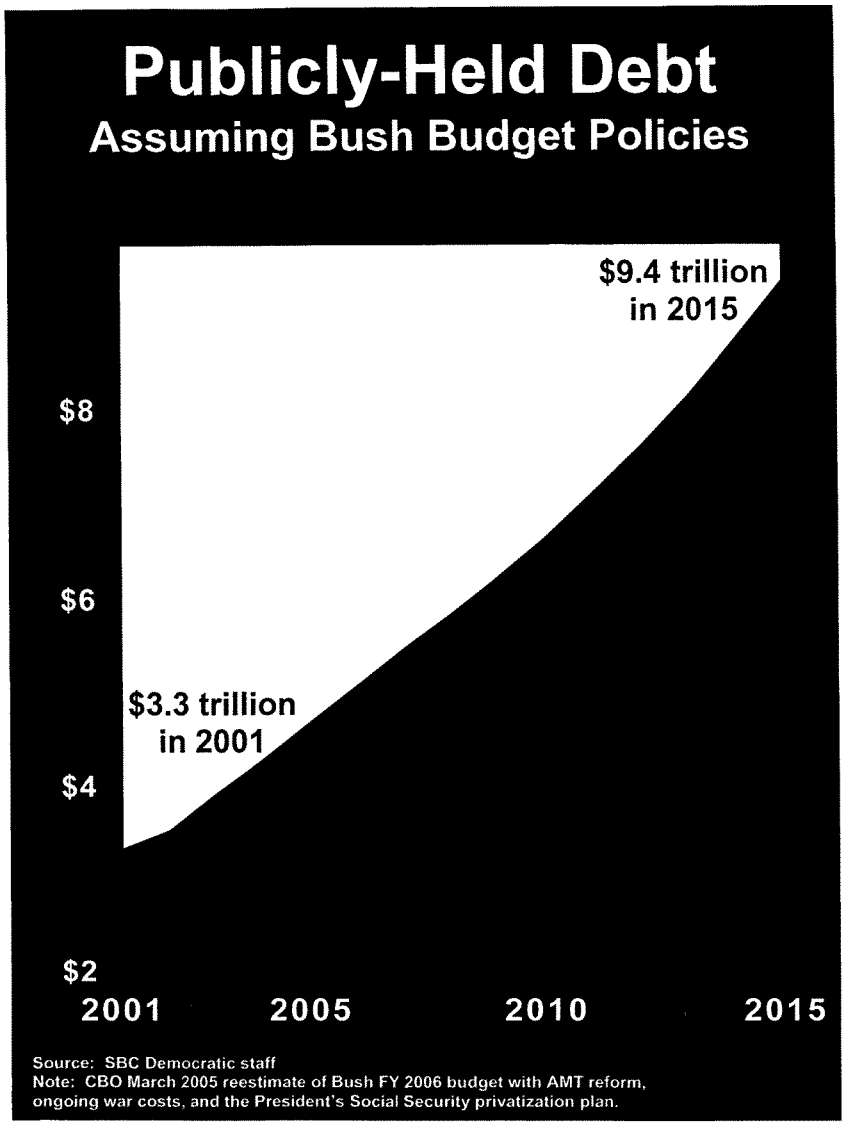
Let's go to the next. So the harsh reality here is that our fiscal condition is not improving. The President told us back in 2001 that, "My budget pays down a record amount of national debt. We will pay off $2 trillion of debt over the next decade. That will be the largest debt reduction of any country ever. Future generations shouldn't be forced to pay back money that we have borrowed. We owe this kind of responsibility to our children and grandchildren." And I agreed with that sentiment. I did not believe that he was right that his budget would actually wind up paying down debt to that degree.

Bush Administration on Importance of Paying Down Debt

"...(M)y budget pays down a record amount of national debt. We will pay off $2 trillion of debt over the next decade. That will be the largest debt reduction of any country, ever. Future generations shouldn't be forced to pay back money that we have borrowed. We owe this kind of responsibility to our children and grandchildren."

–President George W. Bush
Radio Address
March 3, 2001

Let's go to the next and just match that prediction with what has actually happened, because instead of paying down debt, the debt is exploding. The debt was $3.3 trillion in 2001, and we now anticipate a publicly held debt of over $9 trillion by 2015. So debt is not being paid down. Debt is increasing dramatically, $9 trillion by 2015.


Publicly-Held Debt
Assuming Bush Budget Policies
$9.4 trillion
in 2015
$8
$6
$3.3 trillion
in 2001
$4
$2
2001
2005
2010
2015
Source: SBC Democratic staff
Note: CBO March 2005 reestimate of Bush FY 2006 budget with AMT reform, ongoing war costs, and the President's Social Security privatization plan.

Let's go to the next. When we look at the budget that is before us and we look at what it would do—this is the budget that was passed in the U.S. Senate, and these are the calculations of what it would do to the debt in each of the next 5 years. Debt goes up $675 billion in 2005, $651 billion in 2006, $643 billion in 2007, $644 billion in 2008, $635 billion in 2009. This is not a budget that is improving our fiscal situation. The debt is going up each and every year under this budget by over $600 billion.

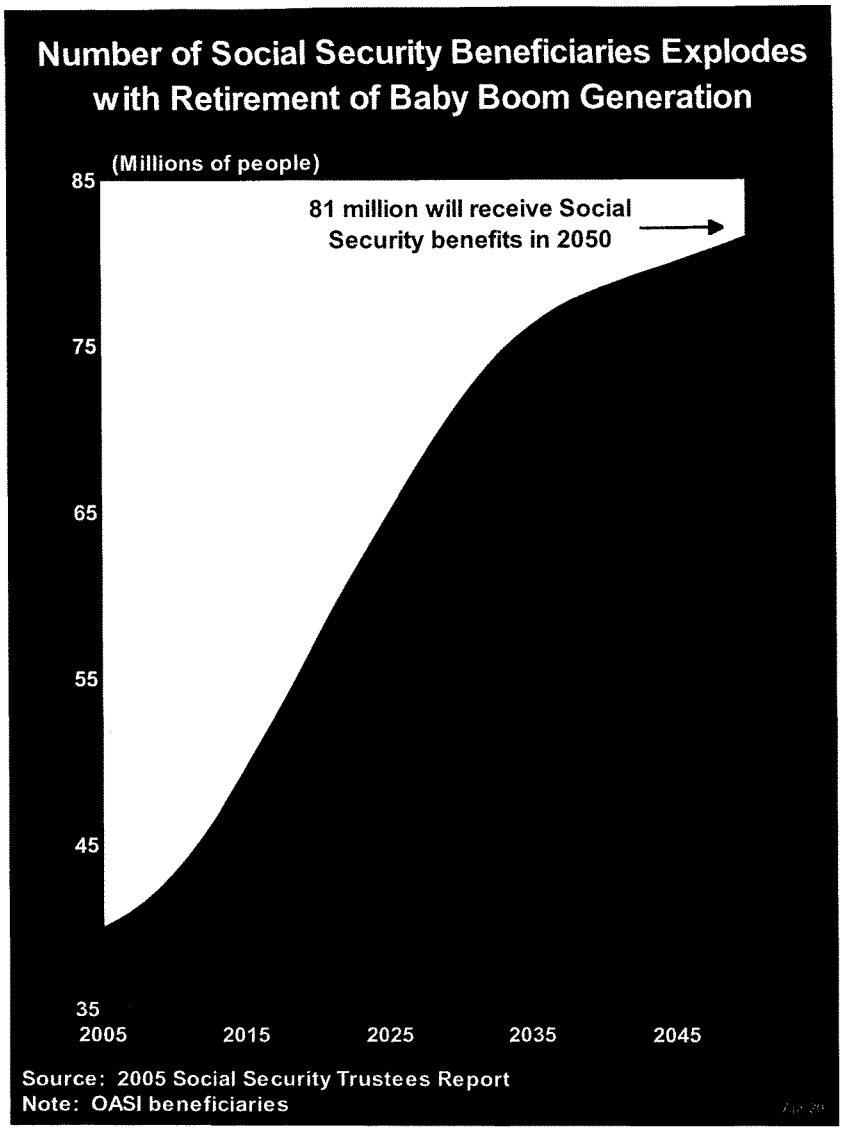
Senate-Passed GOP Budget Increases Debt Every Year Over Five-Year Period

(In billions of dollars)

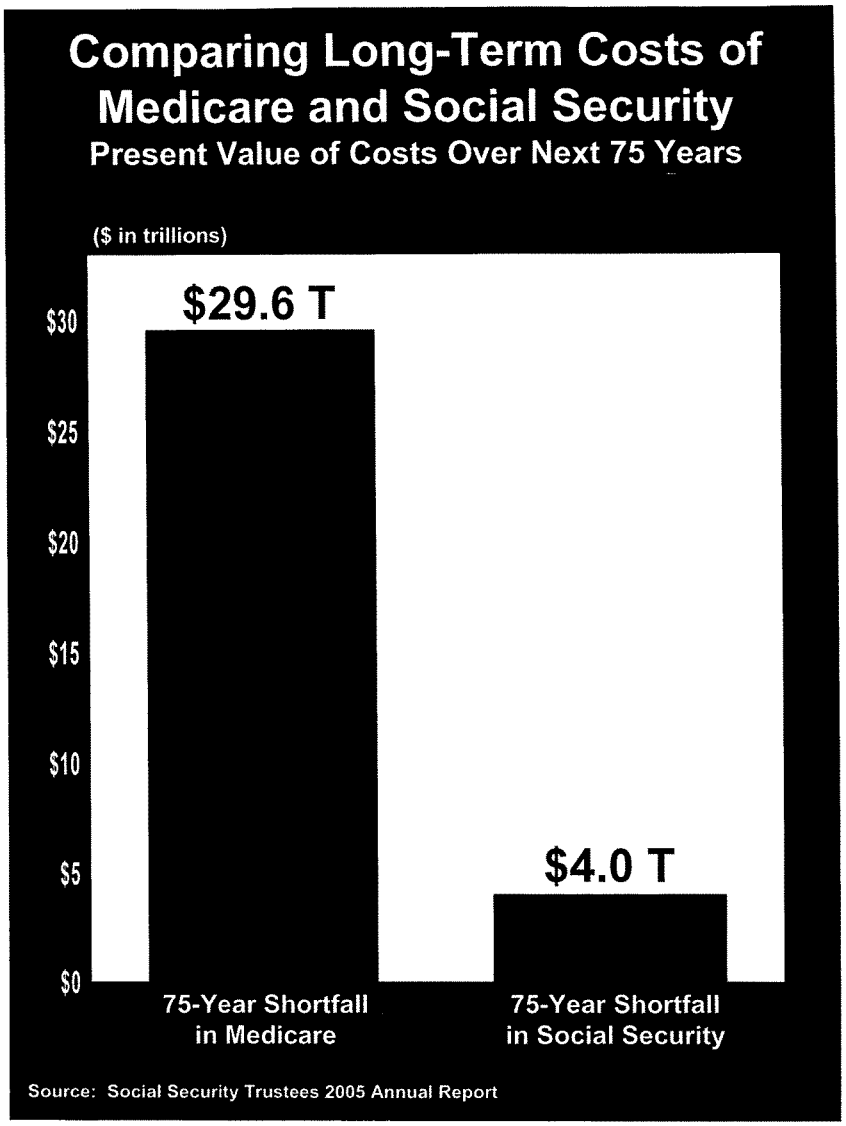
Fiscal year	2005	2006	2007	2008	2009	2010
	Summary					
Debt Held by the Public (end of year)	4,689	5,067	5,395	5,686	5,956	6,199
Debt Subject to Limit (end of year)	7,962	8,637	9,289	9,931	10,575	11,210
	675	651	643	644	635	

Note: SBC calculations based on Senate GOP budget and subsequent floor action.

Let's go to the next. The place where the chairman and I agree is that we face a demographic tsunami because here is what is going to happen to us. This is the people eligible for Medicare and Social Security, and it is going to go from about $40 million to $80 million. And it is going to fundamentally change everything.


Number of Social Security Beneficiaries Explodes with Retirement of Baby Boom Generation
(Millions of people)
85
75
65
55
45
35
2005
2015
2025
2035
2045
81 million will receive Social Security benefits in 2050
Source: 2005 Social Security Trustees Report
Note: OASI beneficiaries

Let me just go to the next one, and then I will finish on that score. Comparing the long-term costs of Medicare and Social Security, the Comptroller General's report shows us that the 75-year shortfall in Social Security is $4 trillion; the 75-year shortfall in Medicare, $29.6 trillion—more than 7 times as much.


Comparing Long-Term Costs of Medicare and Social Security
Present Value of Costs Over Next 75 Years
($ in trillions)
$30
$25
$20
$15
$10
$5
$0
$29.6 T
$4.0 T
75-Year Shortfall in Medicare
75-Year Shortfall in Social Security
Source: Social Security Trustees 2005 Annual Report

You know, the sooner we get at dealing with these long-term fiscal imbalances, the better off our country will be. My own judgment is I have serious doubts about these forecasts, by the way. I think the notion that over 75 years the economy is only going to grow 1.9 percent a year, highly questionable to me. Over the previous 75 years, the economy grew at 3.4 percent. If the economy grew in the same way it has in the past going forward, 90 percent of the Social Security shortfall would go away.

That does not mean we do not have a problem. And I think that is what is so hard to get across to people, because even if the projections are wrong, we have a serious budget problem. And we have a serious budget problem because those Social Security bonds have to be redeemed out of current income. And this demographic change is going to lead to enormous pressure on the budget, made much worse by the shortfall in Medicare and the size of the current deficits.

So we have, even if these projections are wrong, which I believe they are overly pessimistic—but if we all just look back at the last 10 years, Social Security actuaries told us 10 years ago we are going to run out of money in 35 years. Ten years later, they tell us we are going to run out of money in 35 years. They underestimated economic growth. But even with that said, we have a serious problem, and the sooner we deal with it, the better.

I thank the chairman.

Chairman GREGG. Thank you. We do not call this the "Dark Cloud Committee" for nothing.

[Laughter.]

Chairman GREGG. Having heard those thoughts of optimism, we look forward to the Chairman shedding some more light on this situation, and we appreciate the Chairman taking the time to be here and to testify and give us his thoughts.

STATEMENT OF HON. ALAN GREENSPAN, CHAIRMAN, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Mr. GREENSPAN. Thank you very much, Mr. Chairman, Senator Conrad, members of the committee. I am pleased to be here to offer my views on the Federal budget and related issues. In this regard, I want to emphasize that I speak for myself and not necessarily for the Federal Reserve.

The U.S. economy delivered a solid performance in 2004, and thus far this year, activity appears to be expanding at a reasonably good pace. However, the positive short-term economic outlook is playing out against a backdrop of concern about the prospects for the Federal budget, especially over the longer run. Indeed, the unified budget ran a deficit equal to about 3.5 percent of gross domestic product in fiscal year 2004, and Federal debt held by the public as a percent of GDP has risen noticeably since it bottomed out in 2001. To be sure, the cyclical components of the deficit should narrow as the economy expands and proceeds forward and incomes rise. And the recent pace of the ramp-up in spending on defense and homeland security is not expected to continue indefinitely. But as the latest projections from the administration and the Congressional Budget Office suggest, our budget position is unlikely to im-

prove substantially in the coming years unless major deficit-reducing actions are taken.

In my judgment, the necessary choices will be especially difficult to implement without the restoration of a set of procedural restraints on the budget-making process. For about a decade, the rules laid out in the Budget Enforcement Act of 1990 and in the later modifications and extensions of the act provided a framework that helped the Congress establish a better fiscal balance. However, the brief emergence of surpluses in the late 1990's eroded the will to adhere to these rules, which were aimed specifically at promoting deficit reduction rather than at the broader goal of setting out a commonly agreed-upon standard for determining whether the Nation was living within its fiscal means. Many of the provisions that helped restrain budgetary decisionmaking in the 1990's—in particular, the limits on discretionary spending and PAYGO requirements—were violated ever more frequently; finally, in 2002, they were allowed to expire.

Reinstating a structure like the one provided by the Budget Enforcement Act would signal a renewed commitment to fiscal restraint and help restore discipline to the annual budgeting process. Such a step would be even more meaningful if it were coupled with the adoption of a set of provisions for dealing with unanticipated budgetary outcomes over time. As you are well aware, budget outcomes in the past have deviated from projections—in some cases, significantly—and they will continue to do so. Accordingly, a well-designed set of mechanisms that facilitate mid-course corrections would ease the task of bringing the budget back into line when it goes off track. In particular, you might want to require that existing programs be assessed regularly to verify that they continue to meet their stated purposes and cost projections. Measures that automatically take effect when costs for a particular spending program or tax provision exceed a specified threshold may prove useful as well. The original design of the Budget Enforcement Act could also be enhanced by addressing how the strictures might evolve if and when reasonable fiscal balance came into view.

I do not mean to suggest that the Nation's budget problems will be solved simply by adopting a new set of rules. The fundamental fiscal issue is the need to make difficult choices among budget priorities, and this need is becoming ever more pressing in light of the unprecedented number of individuals approaching retirement age. For example, future Congresses and Presidents will, over time, have to weigh the benefits of continued access, on current terms, to advances in medical technology against other spending priorities as well as against tax initiatives that foster increases in economic growth and the revenue base.

Because the baby boomers have not yet started to retire in force, we have been in a demographic lull. But this state of relative stability will soon end. In 2008—just 3 years from now—the leading edge of the baby-boom generation will reach 62, the earliest age at which Social Security retirement benefits can be drawn and the age at which about half of those eligible to claim benefits have been doing so in recent years. Just 3 years after that, in 2011, the oldest baby boomers will reach 65 and will thus be eligible for Medicare. Currently 3–1/4 workers contribute to the Social Security system

for each beneficiary. Under the intermediate assumptions of the program's trustees, the number of beneficiaries will have roughly doubled by 2030, and the ratio of covered workers to beneficiaries will be down to about two. The pressures on the budget from this dramatic demographic change will be exacerbated by those stemming from the anticipated steep upward trend in spending per Medicare beneficiary.

The combination of an aging population and the soaring costs of its medical care is certain to place enormous demands on our Nation's resources and to exert pressure on the budget that economic growth alone is unlikely to eliminate. To be sure, favorable productivity developments would help to alleviate the impending budgetary strains. But unless productivity growth far outstrips that embodied in current budget forecasts, it is unlikely to represent more than part of the answer. Higher productivity does, of course, buoy revenues. But because initial Social Security benefits are influenced heavily by economy-wide wages, faster productivity growth, with a lag, also raises benefits under current law. Moreover, because the long-range budget assumptions already make reasonable allowance for future productivity growth, one cannot rule out the possibility that productivity growth will fall short of projected future averages.

In fiscal year 2004, Federal outlays for Social Security, Medicare, and Medicaid totaled about 8 percent of GDP. The long-run projections from the Office of Management and Budget suggest that the share will rise to approximately 13 percent by 2030. So long as health care costs continue to grow faster than the economy as a whole, the additional resources needed for these programs will exert intense pressure on the Federal budget. Indeed, under existing tax rates and reasonable assumptions about other spending, these projections make clear that the Federal budget is on an unsustainable path in which large deficits result in rising interest rates and ever-growing interest payments that augment deficits in future years. But most important, deficits as a percentage of GDP in these simulations rise without limit. Unless that trend is reversed, at some point these deficits would cause the economy to stagnate or worse.

The broad contours of the challenges ahead are clear. But considerable uncertainty remains about the precise dimensions of the problem and about the extent to which future resources will fall short of our current statutory obligations to the coming generations of retirees. We already know a good deal about the size of the adult population in, say, 2030. Almost all have already been born. Thus, forecasting the number of Social Security and Medicare beneficiaries is fairly straightforward. So too is projecting future Social Security benefits, which are tied to the wage histories of retirees. However, the uncertainty about future medical spending is daunting. We know very little about how rapidly medical technology will continue to advance and how those innovations will translate into future spending. Consequently, the range of possible outcomes for spending per Medicare beneficiary expands dramatically as we move into the next decade and beyond. Technological innovations can greatly improve the quality of medical care and can, in some instances, reduce the costs of existing treatments. But

because technology expands the set of treatment possibilities, it also has the potential to add to overall spending—in some cases, by a great deal. Other sources of uncertainty—for example, the extent to which longer life expectancies among the elderly will affect medical spending—may also turn out to be important. As a result, the range of future possible outlays per recipient is extremely wide. The actuaries' projections of Medicare costs are, perforce, highly provisional.

These uncertainties—especially our inability to identify the upper bound of future demands for medical care—counsel significant prudence in policymaking. The critical reason to proceed cautiously is that new programs quickly develop constituencies willing to fiercely resist any curtailment of spending or tax benefits. As a consequence, our ability to rein in deficit-expanding initiatives, should they later prove to have been excessive or misguided, is quite limited. Thus, policymakers need to err on the side of prudence when considering new budget initiatives. Programs can always be expanded in the future should the resources for them become available, but they cannot be easily curtailed if resources later fall short of commitments.

I fear that we may have already committed more physical resources to the baby-boom generation in its retirement years than our economy has the capacity to deliver. If existing promises need to be changed, those changes should be made sooner rather than later. We owe future retirees as much time as possible to adjust their plans for work, saving, and retirement spending. They need to ensure that their personal resources, along with what they expect to receive from the Government, will be sufficient to meet their retirement goals.

Crafting a budget strategy that meets the Nation's longer-term needs will become ever more difficult the more we delay. The one certainty is that the resolution of the Nation's unprecedented demographic challenge will require hard choices and that the future performance of the economy will depend on those choices. No changes will be easy. All programs in our budget exist because a majority of the Congress and the President considered them of value to our society. Adjustments will thus involve making tradeoffs among valued alternatives. The Congress must choose which alternatives are the most valued in the context of limited resources. In doing so, you will need to consider not only the distributional effects of policy changes but also the broader economic effects on labor supply, retirement behavior, and national savings. The benefits to taking sound, timely action could extend many decades into the future.

Thank you very much. I look forward to your questions.

Chairman GREGG. Thank you, Mr. Chairman, and you have certainly outlined a challenge to us, which is, I think, very appropriate. But the question is: How do we convert your challenge to action? And in a democracy, how do we actually get a Congress to act to be fiscally restrained when, as you have highlighted, the emphasis and the momentum is always toward expanding programmatic activity?

You have mentioned one way to do it is to set up procedural mechanisms and reauthorizing the Budget Enforcement Act. The

budget which we passed out of this committee had a large number of procedural mechanisms in it. They obviously were not by law because it was a resolution, not an act. But I guess my question to you is: This concept that you put forward of a mechanism that would review programmatic activity on a regular basis to see if it was affordable and appropriate, how would we do that relative to the entitlement programs, which are the drivers right now of Federal spending, representing 59 percent of Federal spending? I mean, I can see how we can do it to discretionary programs. Basically it is easy. But on the entitlement side, specifically Medicare and Medicaid, how do we do that?

Mr. GREENSPAN. Well, I think that it would be difficult and probably unnecessary in Social Security because the elements that make up that particular program are very well defined, and we can calculate within very narrow ranges what the actual costs are. In that regard, it is, in fact, self-policing. The fact that we periodically go through evaluations—such as we did in 1993 and again most recently—suggests that, in fact, we do that for Social Security.

Medicare and Medicaid are quite different. The actual numbers that are involved in the forecast, unlike the defined benefit structure of Social Security, are just plain economist forecasts. While there is some dispute on this question, the particular forecast which the trustees make of a gain in outlays per Medicare beneficiary moving faster by 1 percentage point of growth relative to per capita GDP growth is not a programmatic structure. Indeed, in my judgment, and I think in most people's judgment, to get to 1 percent probably requires significant actions which the Congress has not as yet taken.

But in items such as that, what you need to define is a certain level of outlays or certain commitments of real resources which are effectively available to open-ended programs such as Medicare.

Chairman GREGG. So you are essentially saying take any entitlement program and make it a hybrid, which is basically partially discretionary?

Mr. GREENSPAN. In effect, that is what it comes down to.

Chairman GREGG. Well, how would you deal with the fact that you would inherently be knocking people—under entitlement, a person has a right to it. You would inherently be knocking people out of the benefit if you set it up as a discretionary, hybrid discretionary.

Mr. GREENSPAN. Well, this is the fundamental difficulty that you are confronted with. This is why I say that we have committed more than our economy can provide.

Chairman GREGG. I agree.

Mr. GREENSPAN. And so if you are going to restrain Medicare to some level the economy can afford, of necessity it means that there will be less medical care available than is projectable under current law, and even I suspect that it is very difficult to know what that particular figure is. But this is what law-making is all about. You have in front of you an economic outlook which throws off real resources within a relatively narrow range. And we have essentially said we are going to give out more than what we have. Unless the laws of arithmetic are somehow altered—or hopefully in this respect completely eliminated—you have no choice.

Chairman GREGG. Well, unfortunately, there is another law, which is called the law of majority rules, which usually tends to give out more than it has got, which is a problem.

Mr. GREENSPAN. Well, what this country has been able to do over the generations is confront issues like this, and our democracy has struggled. It has tried to get around the issues. Eventually, we seem to work it out.

Chairman GREGG. And I hope we can.

Senator Conrad.

Senator CONRAD. I thank the chairman. I thank Chairman Greenspan for being here as well.

I think part of the frustration of many of us on this committee is convincing our colleagues that there really is a problem. And they are probably not going to be convinced unless the American people are convinced. And it is very hard to convince people there is a real threat to our collective economic security when the economy seems to be doing reasonably well.

What would you say to the American people to convince them that there is a problem that requires action and that that action requires tough choices?

Mr. GREENSPAN. I would first point out that the American economy is doing well, as you point out. We are in effect, as I said in my prepared remarks, in a demographic lull.

Senator CONRAD. A demographic lull.

Mr. GREENSPAN. Yes. Everybody knows there is a very large blocK of people currently employed in the work force, producing goods and services for the whole community. With the inexorable turn of the calendar, they will retire and we will have an utterly unprecedented change in the society where a huge number of people will be retired, and be retired for a long period of time, as longevity continues to increase.

Because of the very substantial shift out of the labor force into retirement and because of the fact that the generations subsequent to the baby boomers are much smaller, the number of people who will be working, producing goods and services for not only themselves and their families but for retirees as well will be much smaller. Remember, when we talk in terms of dollar amounts of Medicare or Social Security, we are talking about dollars and claims to real resources. But in real time, all of those real resources are being produced by that work force, which is growing very slowly. Unless productivity accelerates at a pace far in excess of what we are currently projecting, there are going to be fewer goods and services to be distributed over a larger population.

Senator CONRAD. Can I ask you—what you are saying is people's way of life is going to be affected negatively.

Mr. GREENSPAN. Correct.

Senator CONRAD. Can I try to connect another dot here? Because you made reference in your testimony about a pressure on rising interest rates as a result of these collective deficits, buildup of debt, I assume you are including our trade deficit circumstance as well.

Mr. GREENSPAN. No, I am just talking strictly in terms of the Federal budget deficit.

Senator CONRAD. Just in terms of the Federal budget deficit, that this is going to put upward pressure on interest rates.

Mr. GREENSPAN. Yes.

Senator CONRAD. Can you help people understand what the effect of rising interest rates might be on the strength of our economy, on what it would mean for, for example, the housing market? I heard the other day, Mr. Chairman—the chairman of the committee—that a rise in interest rates, a relatively modest rise, might lead to a rather significant reduction in home values in parts of the country because there has been such a run-up in those values.

Mr. GREENSPAN. Well, a rise in interest rates per se need not do that. What history tells us is that a rise in interest rates will, one, curtail new construction because the moneys that are borrowed from long-term assets—and homes tend to be long-term assets—are very sensitive to what long-term interest rates are. It is also the case that the turnover of existing homes is itself a function of interest rates.

One would presume that to the extent that the turnover and construction falls—because demand is falling—prices will certainly slow from their very significant rate of increase. But it does not necessarily follow that they go down. They may but that is not clear from the data. However, clearly, if you talk about an extraordinarily large rise in long-term interest rates, then, of course, one would have to envisage such an event.

Senator CONRAD. I thank the chairman.

Chairman GREGG. Senator Alexander.

Senator ALEXANDER. Thank you, Mr. Chairman.

Mr. Greenspan, I want to thank you for your advice. I want to ask you a general question about structure of the budget, and I want to compare it to the experience I had when I was a Governor.

What I felt then and what I still feel today is that there is an air of unreality about spending here, as we make spending decisions, as compared with the decisions I had to make as a Governor. For example, here we are about to increase spending in the Federal budget by about $100 billion. That is about a 4-percent increase.

In my experience, that is a big increase. Everybody here is gnashing their teeth and wailing about that. We tried to restrain the growth of Medicaid spending from 41 percent growth over 5 years to 39 percent over 5 years in growth. Everyone here is calling that a cut. I used to call that a big increase. And I was wondering why, when I get on the plane and fly from Nashville or Knoxville to Washington, suddenly it all changes. And why in correcting that attitude or environment in which in State capitals around the country, States are able to every year balance their budgets as one way of restraining things. The current Governor of Tennessee is trying to cut 323,000 people off our Medicaid rolls, which is a big number out of a total of 1.4 million, because he does not have the money to provide Medicaid to that optional population and to provide for K–12 education. He would have already done it, the legislature would have already overwhelmingly approved it—he is a Democrat, by the way—except for the fact that he has to get permission from us in Washington and two Federal judges.

So there seems to be in the State capitals a different attitude, and there are three parts of budget structure I wanted to ask you about that are different there than here. One is the requirement for a balanced budget. Two is the division of budgets into a capital

budget and operating budget, and if you are going to do it here, you would add Social Security to that. The argument could be that if we did that here, instead of having this unified budget, we might more clearly see what we were doing. In other words, in a State government, you know you are going to borrow money for capital projects, so you go ahead and borrow it. But you limit your borrowing from the operating budget.

So if everyone can see that here in Washington we have a Social Security budget, what goes in comes out of that; we have an operating budget, in and out; and then we have a capital budget, in and out. That would be more like the way States do it.

And then the third would be something that I will let Senator Domenici talk more about, because he is the primary exponent of it, the idea of a 2-year budget, which about 40 States used to have, about 20 States still do, and which, arguably, would provide more time for us to do authorization and oversight and more time to maybe be back home where people expect you to not spend very much more than comes in.

I suppose one last thing—which would be a fourth thing, and it might be small—is this odd October 1 fiscal year we have. That is a bigger problem for most people, I think, than we think about. Nothing else in the world I know operates on such a year. It is confusing to me even to know what fiscal year we are in. And just that uncertainty and irregularity, it seems to me, creates the kind of confusion that permits all this extra spending to go on.

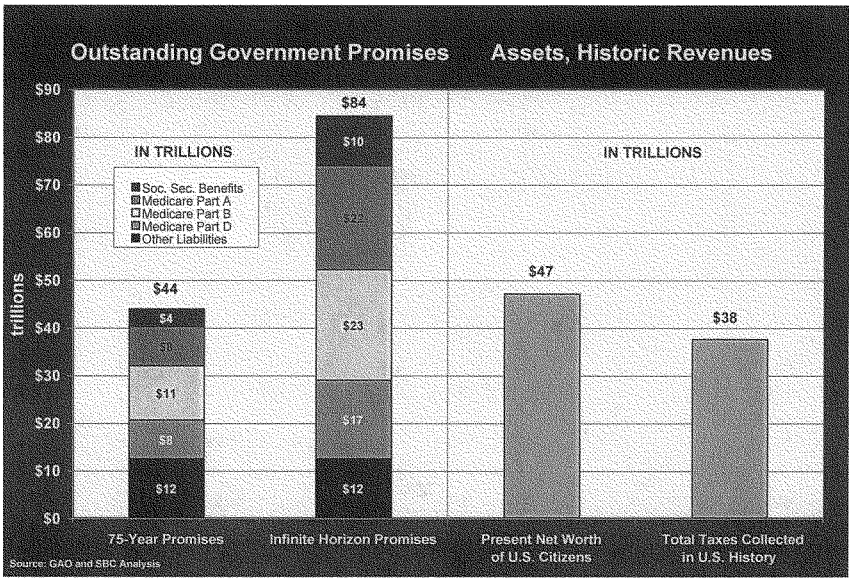
So my question is: Balanced budget, or dividing the budget into capital, operating, and Social Security, 2-year budget, or maybe even the October 1 fiscal year—would any of those things help create an environment that would limit the air of unreality we seem to have here about excessive spending?

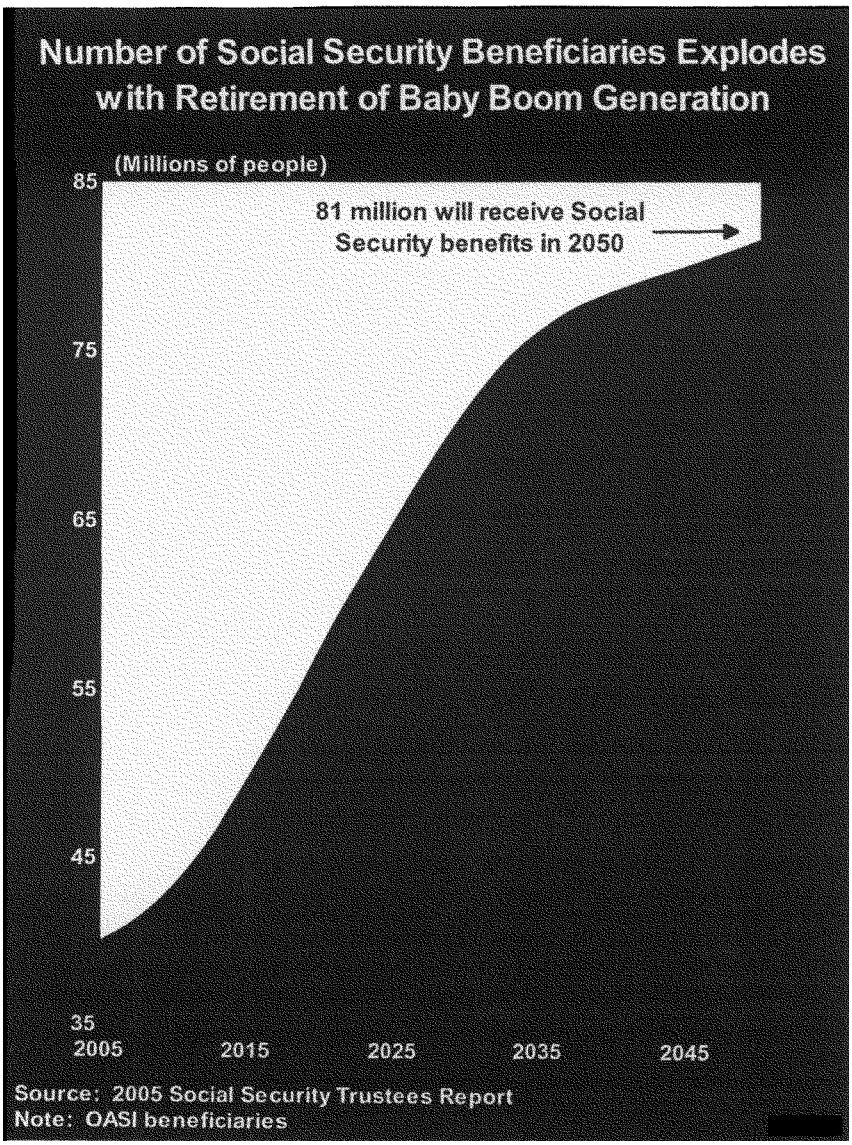
Mr. GREENSPAN. Well, Senator, as you may recall, before we had the October 1st date, we had July 1st, and that was there largely because July 1st was the beginning of the crop year and where most revenues and outlays really mattered. So when you are looking at a fiscal year different from calendar year, it is wholly a historical accident, and one can very readily change it. We did, remember, change it not all that long ago from July 1st to October 1st.

The basic issue of a balanced budget, of course, is which budget is being balanced, and we have several. In the context of what Senator Conrad was raising previously about broader budgets, the real interesting issue is how would the Federal Government look if we went to an accrual basis, which is essentially what private business does. We would know very rapidly the level of the commitments that we are making for the future because it shows up in current outlays. And, indeed, in that context, we would have a significantly larger deficit since it would be accruing a backlog of outlays for a number of entitlement programs. The surpluses that we had in the unified budget would not exist in the accrued budget. The unified budget is an excellent portrayal of the direct impact of the Federal Government on the private economy and the savings, or surplus, and deficit, or dissavings, in the unified budget corresponds to the savings flows in the private economy and, hence, is a very useful

vehicle to understand the short-term immediate impact of Government in the economy.

But more and more of our outlays are entitlements—or as we used to call them, "uncontrollables"—they were very small back then when we called them that. The notion of the short-term impact as the critical issue has gradually faded, and we are finding that the real critical impact of the Federal Government is the commitment to the future. If we were to go to an accrued budget, we would know what that was. Indeed, it is reflected in the chart which Senator Conrad showed previously, and specifically the chart which the chairman showed with respect to the $44 trillion, as I recall, of the aggregate amount of unfunded liabilities.


Outstanding Government Promises
Assets, Historic Revenues
IN TRILLIONS
Soc. Sec. Benefits
Medicare Part A
Medicare Part B
Medicare Part D
Other Liabilities
IN TRILLIONS
trillions
$90
$80
$70
$60
$50
$40
$30
$20
$10
$0
$44
$4
$0
$11
$8
$12
$84
$10
$22
$23
$17
$12
$47
$38
75-Year Promises
Infinite Horizon Promises
Present Net Worth of U.S. Citizens
Total Taxes Collected in U.S. History
Source: GAO and SBC Analysis


Number of Social Security Beneficiaries Explodes with Retirement of Baby Boom Generation
(Millions of people)
85
75
65
55
45
35
81 million will receive Social Security benefits in 2050
2005
2015
2025
2035
2045
Source: 2005 Social Security Trustees Report
Note: OASI beneficiaries

That is merely what the accrual system throws off, and instead of having that as a contingent liability, which is really what we call it, it would be part of the actual debt, and we would learn a great deal about what we are doing when we are committing to the future, which I don't think we have a full understanding of at this particular stage.

I have always advocated that we take Social Security off the budget as the only way to take the law seriously. If we do take the law seriously, we would actually create new savings, which we need to finance the real investments that are required to turn out the real goods and services which retirees will need in retirement.

So that is a useful tool, but the critical issue gets to an accrued budget or one which is basically a private sector accounting system.

The capital budget is a very tricky issue. The capital budget is something that the private sector uses because there are revenues that come from capital investments. Where revenues do come from capital investments in the Federal sector, there is a good argument for leaving them in a special category. Whether you call it on or off budget is not very important. But to take all of what we now consider investments, which include the military, is a very interesting and very debatable issue. I think I would prefer that we stay with the far more limited capital budget notion equivalent to what is basically in the private sector.

With respect to the 2-year budget issue, I think there is a great deal of merit in it. It is more of a technical issue of how the Congress operates, and Senator Domenici is far more knowledgeable on that issue than I, and I would clearly defer to him on that question.

Chairman GREGG. Senator Stabenow.

Senator STABENOW. Thank you, Mr. Chairman. And welcome again, Mr. Chairman.

As I listened to your thoughtful statement, which I appreciate very much, it appears to me the bottom line is we have more money going out than coming in, and there is a question on both ends, on whether it be spending as well as revenue. And when we look at where we are, I mean, the 2004 budget deficit, $412 billion, which about equals everything we are spending this year that is nondefense. I mean, defense is about half the budget. Everything else, whether it be education, the environment, veterans' affairs, homeland security—everything else we do is about half the budget. So we could eliminate half the Federal budget, discretionary budget, to eliminate the deficit.

And so it appears to me that it is more than just about spending even though spending obviously is a critical thing, and I supported the balanced budget agreement in 1997 when I was in the House, to limit that. But it is more than that. We obviously have to look at the revenue side in terms of the tax policy decisions we are making.

When I look at your thoughtful comments about medical technology, I am drawn to the fact that this year we will spend less on the National Institute of Health to create new technologies, whether it is Alzheimer's or Parkinson's or juvenile diabetes, whatever those issues are that directly relate to people's quality of life for themselves and their families, we will spend less on NIH this year than those earning over $1 million will receive in tax cuts, $32

billion in tax cuts. Not to beat up on our wealthiest Americans, but it is just a values question in terms of what is most important.

My first question to you relates to how we get this back in control, and back when we were doing the original tax cut, the determination was made to basically take all of the surplus in 2001, rather than dividing it up among investments and strategic tax cuts and paying down the deficit, all of it went into basically the tax cuts, the majority.

But Senator Bayh and Senator Snowe and I worked on an issue called a trigger, which I think is indirectly what you are speaking of, it appears, within the context of future decisions. And I wonder if you might speak to that. If we had, in fact, passed that trigger that we had spoken about in terms of not proceeding with each tax cut, each phase of it unless we could pay for it, or new spending unless we could pay for it, we would not be where we are right now. We would have had some balance there. And I wonder if you might speak to the notion of a budget mechanism, a trigger for the future.

Mr. GREENSPAN. Well, Senator, if you go back to 2001, when we were all looking at these huge surpluses, everybody had an idea of how much we should cut taxes—and there were differences, but everybody was in favor of cutting taxes and increasing spending essentially—to get rid of the surplus.

What was fascinating about that period is that even though there were a number of people who just looked at the size of the long-term surpluses and said this is extraordinary, it has never happened before, it probably will not happen now, the people who knew most about the projection—CBO, OMB, the Federal Reserve—who really went into the details, you would prod them and they would still say it is very difficult to come up with a forecast that does not have a chronic long-term surplus.

But what a number of people were suggesting at that time was, why don't we have a contingency plan that in the event it isn't the case so that we could review it. In the testimony in which I was advocating significant tax cuts, there is also the notion of however we may be wrong, let's put a trigger in. It never passed. It never got any real interest. And as you point out, that is unfortunate because we would have found that a number of things would have occurred differently.

But one of the real problems we have had was allowing PAYGO to lapse in September 2002.

Senator STABENOW. I agree.

Mr. GREENSPAN. Were we still under a PAYGO regime, which I thought worked very well, I think we would have fewer problems now. We would still have the longer-term problems. It is obviously not going to affect the trend of Medicare. But procedures and process do matter. They do not override an overwhelming desire on the part of the Congress to go in a certain direction. Congress will do what it perceives it should be doing. But it has been my experience that how you set up procedures does alter the rhetoric and does influence the ultimate outcomes.

I did not believe that a budget act which passed in 1990 with 51 percent of the vote could tie the Congress' hands as it did in subsequent years. You did not have what I thought would occur very

readily, that as soon as you ran into pressure, 51 percent of the Congress would say let's throw this out. You did not. The fact that you did not actually constrained what went on in the early part of the 1990's and through a goodly part of that decade. I think we would be far better off if we got back to that type of structure sooner rather than later.

Senator STABENOW. Thank you, Mr. Chairman.

Chairman GREGG. Senator Allard.

Senator ALLARD. Mr. Chairman, I yield my time to Senator Domenici. He has got a very important meeting, and my understanding is that he would be next after me, anyhow. I would just trade places with him, if that is OK with you.

Chairman GREGG. Sure.

Senator DOMENICI. Thank you very much.

Doctor, first, on the biennial budget and the biennial appropriation, I thank you for your comments regarding my understanding of it. And I might just say it is being introduced today, bipartisan, and has a much broader base of support. And whether it achieves what we are looking for here today or not, it seems to me to make an inordinate amount of sense from the standpoint of letting both the Executive and Congress have more time to do something other than just appropriating and budgeting.

Having said that, Mr. Chairman, I look out there, and, you know, we do not have to do a whole lot of studying as to what is the long-term problem in terms of getting our fiscal house in order. Clearly, we have overpromised both in Social Security and in health care commitments, and both, depending upon time, both cannot be sustained in their current form indefinitely. The one that will bring about a breakdown sooner will be health commitments.

I have been asking the question in my own mind: Will we be able to solve the problem, that is, make the policy decisions, in a timely manner? Or will we in America await a failure, a major failure in the health delivery system before we do anything?

I will ask you two questions. One, am I correct in my assessment of the major components of fiscal—of current policy that we cannot fulfill that will, if we try to fulfill it, cause fiscal policy decay? And, second, how do you think we could solve the health care problem policy-wise without waiting for a crash?

Mr. GREENSPAN. There is no question that the overwhelming problem confronting the fiscal situation in the years ahead is health care. Social Security is a problem, and it will have to be solved—even though nobody wants to solve it because it does require either an increase in taxes or a reduction in benefits, it is the only way it is going to happen to bring the actual system into balance. But it is a small issue compared to Medicare, largely because of the huge uncertainty about what the overall outlook is.

Here I think there are several strains currently in play which I trust will work to our benefit. One is the fairly dramatic increase in information technology which is moving into the health care area. It is remarkable that physicians are like everybody else: They resist this type of thing. I may even say it is true of economists as well; A lot of us resist these newer technologies. Younger economists do not; younger physicians do not. But until you get a global system where you have encrypted records for each individual re-

cipient, for example, of Medicare and Medicaid and have a full history, you will not truly be able to cut through one of the very critical issues of uncertain cost. When surveys are taken, we find that medical practice in the United States differs region by region and that the actual procedures employed and their outcomes are very different.

If we were to get the information technology fully in play, it would readily become apparent which are the clinical best practices with respect to a variety of different ailments. That, of course, would improve medical care per se. But it is also likely to show the way to lower costs without cutting benefits. But at the end of the day, I do not see how we can avoid significant curtailment of benefits currently promised on a per beneficiary basis, especially as we multiply that number by essentially doubling the numbers of retirees over the next generation.

Senator DOMENICI. So are you suggesting we might have to means test it? Is that what you are suggesting?

Mr. GREENSPAN. I suspect that is clearly one of the critical issues that will be before the Congress because you are going to certainly want to protect those with lower income and lesser resources. You probably are going to want to have some form of catastrophic insurance. But at the end of the day, numbers of people are going to have very large copayments—and probably should.

Senator DOMENICI. Doctor, on Social Security, you said it is a smaller problem. The fact that it is a smaller problem does not mean we ought not fix it. It seems to me if it is a smaller problem, we ought to fix it now.

Mr. GREENSPAN. I thought that it was a smaller problem, could be fixed now, and could be fixed quickly. I was mistaken.

Senator DOMENICI. Thank you.

Chairman GREGG. Senator Corzine.

Senator CORZINE. Thank you, Mr. Chairman. And welcome, Chairman Greenspan.

I thought I had heard some suggestions toward the Social Security discussion that we are having. First of all, I think I heard you say that you think it ought to be taken off budget in your remarks that you——

Mr. GREENSPAN. Well, it is legally off budget, but we do not behave that way.

Senator CORZINE. But we ought to manage it as if it is off budget on a stand-alone basis so that the trust fund resources would stand on their own and not be mixed, OK. And then I thought I heard you say it will have to be solved in one of two ways or a combination: increase in taxes or reduction of benefits. Is that correct?

Mr. GREENSPAN. That is correct, Senator.

Senator CORZINE. I will leave the unmentioned portion to whatever one wants to draw their conclusion on.

Let me ask, you said accruals would have given us a greater ability to analyze and understand where we stood. In 2001, if we were using accrual accounting, would have we believed that we were in such an ongoing surplus situation that we could have committed to such long-term tax programs, setting aside the issue of triggers, which I think is an important concept, but would we have drawn the same conclusion if we had used accrual accounting, since we

had all these contingent liabilities we knew existed, just did not bother to factor them into what we were doing.

Mr. GREENSPAN. In 2001, on an accrued basis, the Federal budget would have been in deficit. Indeed, projecting it forward in the years from 2001, it would have remained in deficit. Indeed, at certain points it would be enlarging the deficit, as indeed we see in observing the path of so-called contingent liabilities, which are rising, which is another way of saying what the difference is between the outlays and the aggregate accrued requirements.

Senator CORZINE. Might have led to a different framing of the debate than what we had, or at least brought more caution to the debate.

Mr. GREENSPAN. I suspect so.

Senator CORZINE. I actually agree that procedures and process have a lot to do with outcomes. Triggers, which I am not particularly keen on—and I will admit that—I think actually would have been a good thing. But PAYGO rules clearly worked to some large degree in the 1990's to their expiration.

Do you think PAYGO rules should include both tax and spending decisions?

Mr. GREENSPAN. I do, Senator.

Senator CORZINE. It is extremely difficult, at least where I come from, when you look at budgets where you do not talk about revenues and expenditures. And so I hope that if we are serious about PAYGO rules we are dealing both with spending and revenues as we go forward. I think I heard you support that.

If we had had a trigger included in 2001, which you advocated, have you done any of the playing out of what those triggers would have done in the current environment with regard to the change in circumstances, and they are quite substantial, obviously. September 11th occurred, and lots of other things happen in life that are unpredictable.

What kinds of policy changes would have occurred if we had had those triggers in place, as you had contemplated and recommended?

Mr. GREENSPAN. Well, actually, in the period since then, perhaps the more important issue of altering policy was PAYGO, because even before PAYGO was allowed to lapse in 2002, we had extraordinarily large numbers of endeavors to get around it, and there were more unusual emergencies declared by Government than I ever thought existed.

So PAYGO was effectively lost a couple of years earlier, but prior to then it was quite effective. Had it been in place and adhered to throughout that period, I think we would be in much better shape now.

The trigger issue gets to the longer term and to the question of programmatic analysis of budget programs going forward. It is very clear that the record of forecast implicit in the preambles of most acts is notoriously poor, and that the biases invariably are on the up side, both with respect to taxes and spending. The result is that because of that bias, one has to presume that the trigger should have taken effect after a while in the adjustment process of what the actual expected costs were, and one presumably would get different results.

So that the issue here is if you have a trigger, even if you do not do that, there is a certain whistle-blowing process. Essentially, it says that to the extent that Senators and Members of the House of Representatives voted for a bill on the basis or the presumption of certain costs going forward and that turned out to be wrong, then one might well presume that a number of people would like to change their votes or, if it is a generation later in the equivalent state, would look differently upon the particular program.

We have no mechanism to do that, and because of the implicit bias in the system of evaluation of program costs——

Senator CORZINE. Program and tax.

Mr. GREENSPAN. Yes.

Senator CORZINE. Tax programs as well spending programs.

Mr. GREENSPAN. Correct, yes. Because of that particular bias, we are biasing the long-term outlook, and one should basically ask—I know you cannot do this in a vote, but say you vote in the Senate for a bill—you should ask the Senators, Is your vote contingent on the projection of the cost of what this program is? And if you want it to have a full exam, you could ask, What are your tolerable limits as to how you would look at it.

Senator CORZINE. Sunsets are a way to do that as well.

Thank you.

Chairman GREGG. Senator Allard.

Senator ALLARD. Thank you, Mr. Chairman, and welcome, Chairman Greenspan. I value your expertise and your comments.

I support the chairman of this committee in trying to put in some budget enforcement provisions. I think one of the potentially most effective budget enforcement provision we could have is a balanced budget amendment. Personally, I have supported a balanced budget amendment with the exception of war. And I think perhaps in today's environment we need to look at that. I am thinking that perhaps maybe we could have a balanced budget amendment except in cases of a major international conflict.

I would like to hear your comments on the balanced budget amendment as to whether its time has come and gone, and what your views might be on what would be appropriate exception language in a balanced budget amendment.

Mr. GREENSPAN. Well, Senator Alexander was raising the issue of what the States are involved with the obvious impact of what a balanced budget does. The real issue you are going to have to confront is what you do with entitlements. Let's take, for example, the commitments that are currently made, and assume at the moment we have a budget balance. If you project forward with the demographic changes that we are envisaging, you are going to run into a very significant widening of the deficit. The question is: What is the enforcement mechanism which then requires you to go back to the application of the balanced budget statute?

It is one of many ways to come at the fact that we have, in fact, committed more than we have promised and committed more than we almost surely can deliver in the future. It is another way of saying that the budget deficit is going to open up inexorably. Having a balanced budget amendment without specifying how you get back to that—in other words, what budgetary procedures—risks a very serious breach in how Congress would behave. It is conceivable to

me that you could have on the books a balanced budget amendment and an inability of both Houses to come to a conclusion on which programs they would change in order to restore balance as it moves away.

So I am strongly in favor of any mechanism which will enforce this type of operation. But the mere passage of a balanced budget amendment in itself will not solve this particular problem unless it has elements which suggest how that particular balance will be achieved if you go off. In other words, if it is a balanced budget amendment to the Constitution, that is all it would say. But you would have to have specific ways in which the Congress is directed under statute to confront particular problems as they arose and adjust them.

Senator ALLARD. Thank you for your comment. I want to move on to the value of the dollar. Milt Friedman, a well-known economist, I think, to both of us, always felt that—if I remember correctly, his position was that you do not mess with the value of the dollar. It is a commodity out there. It floats in the international market. It is beyond our borders and very difficult to control. And that if you start messing with the dollar value, then you start leading to policies that lead to trade restriction, and that is not good for our economy.

And we now have a situation where China has apparently tied the value of its currency to the value of the dollar. Would you comment a little bit on the value of the dollar? I know it has helped our manufacturing sector in ways in which now because it is lower, goods are less expensive overseas, but yet I know there is some concern about the value of the dollar and the impact on the economy. I wonder if you could comment on that.

Mr. GREENSPAN. Well, I think the first issue is that fixing the RMB to the dollar is beginning to significantly work to the detriment of the Chinese economy. There is no question that two things are happening. One is in order to sustain the value of the RMB relative to the dollar, the Chinese have been purchasing, as you know, very significant amounts of U.S. Treasury issues. In so doing, in order to prevent an inflationary money supply increase, they sterilize the purchase of foreign reserves, which are a reserve base for the expansion of the money supply. They do that by selling bank issues, bank liabilities, denominated in their domestic currency. So long as they do that, that tends to prevent purchases of foreign reserves from expanding the money supply.

However, because there are interest rate caps in China, they are finding some difficulty in selling an adequate amount of domestic currency-denominated debt to absorb the excess, and that is creating imbalances, which suggests sooner rather than later that they are going to have to, for stability purposes, move their currency.

Second, they are also, by holding their exchange rate down, creating a misallocation of resources in China by subsidizing the capital stock associated with very large numbers of workers. Because their concern is very clearly stability—that they are worried about large levels of unemployment—they are emphasizing the capital stock which is of lower technological state and, therefore, employs larger numbers of workers on average. But it also prevents stand-

ards of living from rising because their intellectual technical capabilities are rising. If the exchange rate began to rise, they would start to move capital into more efficient types of uses, which essentially would mean that output per hour would rise, which is what you would expect when you get an increase in the amount of capital stock per worker. Holding their exchange rate where they are is preventing the growth in the terms that will be most valuable for China in the decades ahead.

As far as I am concerned, it is very much in their interest to move, and as you can well imagine, we in the U.S. Government have been in conversations with them to indicate that, in our judgment and in our experience, they should be moving sooner rather than later. There is also debate going on within China on this issue. I have no way of projecting when they will move. That they will move I am reasonably certain.

Senator ALLARD. And so your bottom line is that you think they are headed for trouble with their current policies and they will pay the price in the future.

Mr. GREENSPAN. The sooner they move off this fix, the better off for China's economy.

Chairman GREGG. Senator Nelson.

Senator NELSON. Welcome, Chairman Greenspan. I agree with you that the balanced budget amendment might be one component for us to address the problem, and it has been frustrating that the budget has been employed as a tool more than a fiscal document, a political document, even to the point that major things are left out. We are, as we speak, dealing with an emergency supplemental, and those all have their effects because it is billions and billions of dollars. The likelihood that we will address fixing the alternate minimum tax problem is not even a part of the budget.

And so to enforce this discipline, you said that the balanced budget amendment might be one component that we could employ. But you said we need to specify elements in it of how Congress would address the imbalance.

Can you elaborate, please?

Mr. GREENSPAN. Well, as I said before, Senator, if we put in the Constitution a balanced budget amendment and left it at that, then the question is up to the Congress to adhere to that. Since the demographics going forward almost certainly indicate that we will be moving toward deficits, there is the danger that there will not be majorities in both Houses of the Congress to come up with a contraction in the deficit as required by the Constitution. That would be a very, very difficult political issue for this country.

Therefore, if you move in the direction of a balanced budget amendment, you have to have in place default mechanisms that will actually do what is required to adhere to the law. It is by no means certain that in all cases you are going to get actions by both Houses of the Congress, including the signature by the President, which will adhere to the Constitution. Therefore, a balanced budget amendment to the Constitution will not in and of itself solve the problem.

If it is part of a much broader program which comes to grips with the chronic movement toward increasing deficits, then I think you obviously look at it as you do other things. But it may very well

turn out that if you do all the things that are required to adhere to the balanced budget amendment, you do not need the balanced budget amendment.

Senator NELSON. Is part of that broader program that we ought to rethink the entire Budget Act? It started out in the 1970's as a means of fiscal discipline to lower deficits. And then it was employed a few years ago as a means by which to lower taxes, which contributed to the huge deficits that we have now. What is your thinking there?

Mr. GREENSPAN. Well, if PAYGO were in place all through this period, you would not have had the types of problems to which you are referring. I cannot say whether going back to the Budget Enforcement Act and revising it is going to solve a great deal. But I do think it is crucial for the Senate, and specifically this committee, to think through what has to be done, and it is hard to find a group more knowledgeable about how the American system works than this committee. After you have reached a conclusion, then you can define what statute is required to implement the policy. But just putting the Budget Act on the table and starting to play with it is not going to get you there. You have to decide how you are going to come to grips with the fundamental issue which was raised in this hearing. If you have promised more than we have, you are going to have to take back some of the things you have promised, and there is no way of getting around that conclusion.

Senator NELSON. I see the red light is on, Mr. Chairman. I was just curious to find out what in the world are you going to do about rates. You raise the rates, you cause the economy to start slowing down. Are we headed to stagflation again?

Mr. GREENSPAN. It certainly does not seem that way, Senator.

Chairman GREGG. Senator Crapo.

Senator CRAPO. Thank you very much, Mr. Chairman, and, Chairman Greenspan, I appreciate your attendance yet again at one of these important hearings where we discuss these issues.

I want to go first to the question of balancing the budget, and it seems to me that it is pretty obvious that there are two broad solutions: one is we can reduce spending; the other is we can increase revenue. And there are different ways to increase revenue. You can try to stimulate the economy, or you can just raise taxes.

There are some who argue very strongly around here that we do not need to control the size of Government as much as we need to just try to increase revenue by increasing taxes to match the level of our spending. And many of them attribute the deficit or large portions of the deficit to the President's tax cuts of a few years ago and argue that we should allow those tax cuts to expire.

The CBO has done a long-term projection in that context, and based on their projections, assuming that the growth in Medicare and Medicaid continues at its past rates and that the real bracket creep in the AMT continues and if we allow the tax cuts to expire, which would cause total revenues to reach 24.7 percent of GDP in 2050, assuming that we just allow the tax cuts to expire but did not address the entitlement spending and the other aspects of the growth of Government, we are still unable to balance the budget. And the reason, as I understand it, is that we are not in that sce-

nario getting a handle on entitlement reform, which we have discussed a lot here today.

Would you agree that unless Congress begins to reduce entitlement spending, the financial future of our Nation is in jeopardy?

Mr. GREENSPAN. I have testified that we are currently committed to making outlays in the next decade, which is on a slope of advance, much larger than we can afford.

We can raise taxes, and I don't deny we probably at the end of the day will do that in order to get an ultimate resolution of this. But as I have said many times before this committee, as you raise taxes you reduce the rate of growth in the economy and, hence, the revenue base itself. As a consequence, you do not get a one-to-one revenue increase. At the end of the day, if you raise taxes high enough, you will find you have not increased revenues at all. And the deficit is still there because the spending is still there.

Senator CRAPO. Well, you may have already answered my follow-on question here by what you just said, then, because CBO's analysis indicates that under the scenario that they were analyzing, the effective marginal tax rate would rise from 32 percent to 40 percent. And the question I need to ask you is: What impact would that have on our economy and on our ability to generate the revenue necessary to balance the budget?

Mr. GREENSPAN. Well, as you raise taxes, especially at the margin, you very likely curtail capital investment and the underlying economic structure that is required to increase productivity and standards of living. So there is a significant dilemma here, namely, that in raising revenues, you can create a lower deficit as a consequence of that, but only up to a point; and so I conclude that there is no way you can bring tax rates up to the level that would be required to generate the revenues which would effectively solve the fiscal problem that we now have. From that I conclude that one of the significant parts, probably the largest part, of the adjustment is scaling back the promised benefits, say, from the year 2010 forward. Unless we have a huge increase in immigration, which I do not anticipate, we are locked into the arithmetic of what the population changes that we are about to experience are going to mean.

Senator CRAPO. Thank you.

Chairman GREGG. Senator Graham.

Senator GRAHAM. Thank you, Mr. Chairman.

Mr. Chairman, thank you for coming. I have some specific questions about Social Security reform efforts, and I will try to be concise and get as much of it in as I can.

There is a big debate—well, one, we have chosen to talk about Social Security because the President has chosen to talk about Social Security. I applaud his efforts to put it on the table. Maybe we should do Medicare first, but we are certainly going to do Medicare at some point. But when you talk about entitlement reform, whether it is Medicare or Social Security, people mention different time periods, whether it is 2017 when we pay out more in benefits than we collect in taxes, the estimate by certain people that we will have a benefit cut coming in 2041, others 2050. You said something to me privately that sort of struck me.

Your belief—and I do not want to put words in your mouth—is that if we do not start the reform process before the baby boomers slip into the retirement systems, it is too late. Could you expound on that.

Mr. GREENSPAN. Well, I do not know whether I said it was too late, but if you wait you are going to have to start to adjust benefits to groups of people who are already retired, and that is not fair. And it is, in fact, extremely difficult to do politically, obviously.

Since we are going to have a significant number of people starting to retire in 2008——

Senator GRAHAM. Right.

Mr. GREENSPAN. Remember, half the people eligible to retire at age 62, and once you have started down the road, it is very difficult to start to change. So, in my judgment, it is far easier to come to grips with these issues before the baby-boom generation starts to retire in large numbers.

Senator GRAHAM. And that process begins in 2008. Is that correct?

Mr. GREENSPAN. Yes, sir.

Senator GRAHAM. Now, solvency. We have talked a lot about personal accounts, but I would like to talk with you a moment about the solvency aspect of Social Security. In present dollars, it is about $3.7 trillion underfunded, short of the money to meet the promises. There is a concept floating around called index changes that if you went away from wage growth in terms of calculating your basic benefit to inflation, that that change alone with substantially bring about solvency.

Do you agree with that? Would you like to comment on that?

Mr. GREENSPAN. Well, actually it does. Current law takes the average of approximately a 40-percent replacement rate of Social Security, meaning the level of retirement benefits as a ratio to the wage income that one experienced just before retirement.

Shifting from wage indexing, which is currently in law, to price indexing will bring the replacement rate down quite significantly in the process.

I should add, however, that that replacement rate is going to come down in any event. It almost is built into the demographics that we are now looking at, so it is not as though we have the possibility of maintaining the 40-percent replacement rate. We can do so only by raising taxes at an inordinate level, as I was discussing with Senator Crapo.

So the issue is, yes, that action in and of itself removes the $3.7 trillion, which is the present cost of the shortfall through the year 2075.

Senator GRAHAM. And if I may go a step further—and if you do not want to answer this, I totally understand.

Mr. GREENSPAN. I am sorry, 2080.

Senator GRAHAM. Would you recommend such a change?

Mr. GREENSPAN. I think that some such structure, if you are going to come to grips with this issue, is obviously on the table. But it is up to the Congress to decide which particular variation of a whole series of potential ways of solving this problem should be employed.

Senator GRAHAM. Are you familiar with longevity indexing?

Mr. GREENSPAN. In the sense of making eligibility a function of longevity, life expectancy after age 65?

Senator GRAHAM. Yes, sir.

Mr. GREENSPAN. I am.

Senator GRAHAM. Would you recommend that change? Do you think that would be helpful?

Mr. GREENSPAN. I have always advocated that on the grounds that to have a stable system like Social Security, you are going to need to have the number of years in retirement as a ratio to the number of years working stable.

Senator GRAHAM. Mr. Chairman, have I used my time?

Chairman GREGG. You sure have.

Senator GRAHAM. OK. Well, I apologize.

[Laughter.]

Chairman GREGG. But brilliantly, brilliantly.

Senator GRAHAM. OK. Well, I had a few more questions, but we will do it next time.

Chairman GREGG. Senator Bunning.

Senator BUNNING. Thank you, Mr. Chairman. Thank you for being here, Chairman Greenspan.

The report the Fed released yesterday indicated that energy prices were having an impact on inflation. How important is it to our economy that our country develop a strong energy policy?

Mr. GREENSPAN. Well, Senator, it is a fact that the significant rise in the prices of gasoline and home heating oil as a consequence of the big rise in crude oil prices are significant components in the Consumer Price Index. Indeed, just looking at the level of prices, you can see the mirror image of these prices going up.

The problem that we have is we do not produce enough energy ourselves. We actually produce more than most countries in the world, but we still import, as you know, well over half, close to two-thirds, of our petroleum requirements.

Unless we find a means to consume very significantly less or produce significantly more, we are going to remain dependent on others to ship oil to this country to meet the demands that are part of our infrastructure.

Senator BUNNING. Well, we also are in a world economy now that other countries are competing and driving up the price of crude oil not only from the Middle East but other area. China's consumption of crude oil now has exploded. Ours has exploded from when we had our first oil boycott until the present time where 60 percent of all our crude is not domestically produced.

But an overall energy policy would give us some guidance if we had an overall energy policy. By that I mean there has got to be alternatives to the current use of just crude oil to produce power, energy, drive cars, do everything that we use energy for.

Mr. GREENSPAN. Well, there certainly is, Senator. Clearly, we could run electric power from nuclear plants, which, are still a fraction of the aggregate electric power we employ.

There are a number of technologies out there—hydrogen fuel cells and a number of so-called exotic technologies. There may, however, be more in the way of exploiting natural gas possibilities in the sense that there is an awful lot of what we call natural gas

hydrates out there. We have in the United States huge reserves, which is sort of a methane that is encased in ice crystals, and which we are now only beginning to look at.

If we are capable of creating a significant increase in output from that source and the so-called newer technology of what they call gas-to-oil conversion, which is actually taking gas and putting it into a liquid form, it is conceivable we may find many years down the road significant alternate sources of types of fuel which we use today.

Senator BUNNING. But you are not disagreeing with me that we need an overall energy policy?

Mr. GREENSPAN. I think that we better have one, because it is something which is integrated not only into our economic system, but into our national security systems as well.

Senator BUNNING. I agree. The last question. As an economist, can you comment on dynamic scoring? Do you agree with the President's Council of Economic Advisers that using dynamic scoring shows the true cost of a capital gain tax cut to be about half of the costs reflected by static models?

Mr. GREENSPAN. Well, in principle, Senator, there is no question about the value of having full-blown models that evaluate not only the initial impact of a spending or tax program, but the secondary impacts as well. These impacts create, for example, changes in economic activity, revenues, and the net effect at the end of the day is different from static scoring, which, by definition, only endeavors to capture the initial effect.

The trouble is that the nature of the dynamic scoring process rests very considerably on the specific structure of the model that is employed.

We economists build models and explicitly indicate they are a very large abstraction of the real world with which we deal. If we all agreed on a single model, then dynamic scoring would unquestionably be the right way to evaluate all sorts of programs. But we have been unable to do that, and so we have all fallen back to static scoring, which is admittedly second best. Unless we can find agreement on which types of models to employ, you cannot get the staffs of these committees here and in the House and elsewhere to agree on what the results are. So that is the problem. It is not the issue of whether dynamic scoring is better than static scoring. It clearly is.

Senator BUNNING. Thank you, Mr. Chairman. Thank you.

Chairman GREGG. Mr. Chairman, you have been very generous with your time. I know Senator Conrad had an additional question and Senator Graham had an additional question. I appreciate your generosity with your time. Do you need to head off?

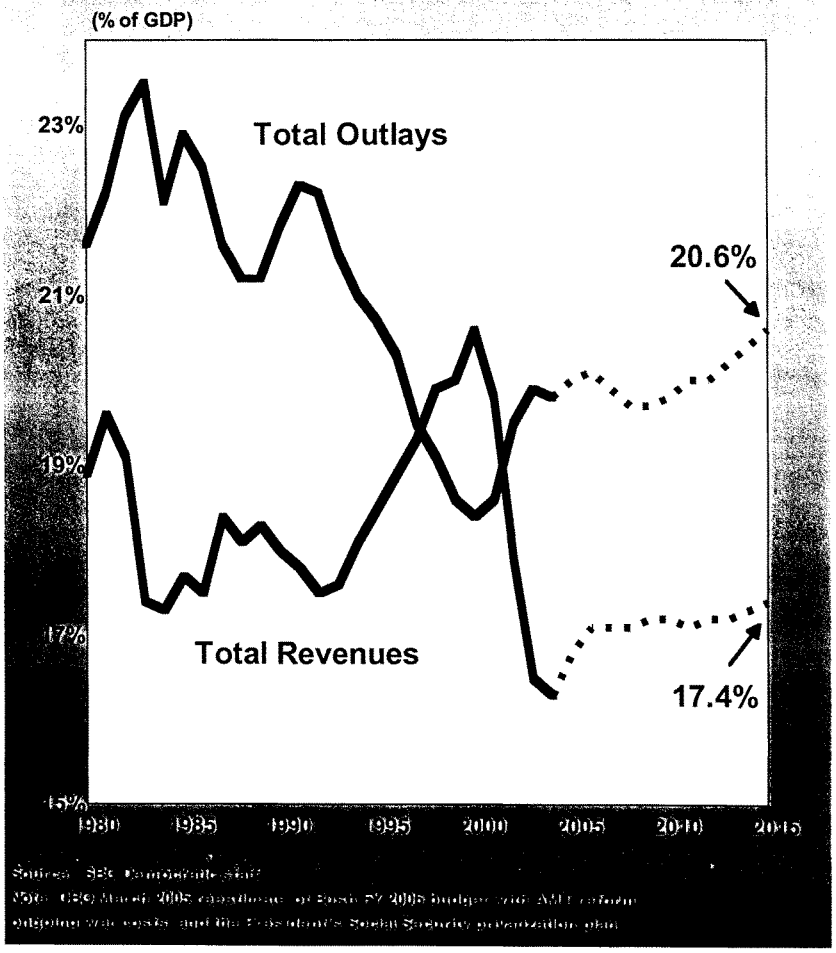
Mr. GREENSPAN. No. I can stay for a short while longer if you would like me to.

Chairman GREGG. Well, why don't we go with one question from Senator Conrad, one question from Senator Graham, and I just have a simple question, which is: Why have we lost comparative advantage as a concept of why we are working as a Nation? But we will start with Senator Conrad.

Senator CONRAD. Thank you, Mr. Chairman.

I go back to this chart that shows for a very long period of time the relationship between spending and revenue. And spending now is lower than it was through the 1980's as a share of GDP, through a good chunk of the 1990's as well. It is the revenue side of the equation that has really fallen out on us, and although we see some uptick, the projections going forward still leave us with this enormous gap.

Deficits Primarily Caused by Drop in Revenues, Not Increase in Spending



And I agree with you, longer term the entitlements have to be dealt with. I do not see it happening without a mix of spending and revenue. This revenue last year is the lowest since 1959 as a share of GDP.

When we look at revenue, I have been saying to my colleagues, before we talk about any tax increase to get additional revenue, we ought to focus like a laser on the tax gap. The tax gap, the Revenue Service now tells us, is over $330 billion for 2001. I believe, based on my experience, that that tax gap is very significantly understated.

Mr. GREENSPAN. I am sorry. Are you referring to the fact of what we do not collect?

Senator CONRAD. Yes.

Mr. GREENSPAN. OK.

Senator CONRAD. The difference, the tax gap being the difference between what is owed and what is being paid. And while the vast majority of Americans pay what they owe, the vast majority of companies pay what they owe, there are some who do not. And that amount of money has grown very significantly. And you know well the schemes that are out there across America to dodge taxes. Every kind of aggressive accounting move that people have conjured up over the years is in play. I have friends that are in major accounting firms. They tell me the culture has changed. And the Revenue Service's numbers show that this tax gap has grown significantly.

This is not going to happen just on the spending side of the equation. It is just not. I personally believe that most of the adjustment or a very significant part is going to have to occur on the spending side because the numbers do not lie. The number of people eligible for Social Security and Medicare is going to grow dramatically, and it would not be good for the economy to do this all on the revenue side of the equation. I do not think it could be done all on the revenue side. That argues, as you have argued here this morning very clearly, much of this must be done on the spending side.

But I also believe there are not going to be any agreements around here unless the revenue side of the equation is also addressed. And I believe the first place we ought to look is this tax gap.

Would you comment on that basic notion?

Mr. GREENSPAN. Senator, I have a firm belief that all legal obligations need to be paid, and enforcement is required to sustain the law. Part of the problem, obviously, is there is sometimes lack of clarity in what the legal obligations are, and this is where you get this sort of vague notion between tax avoidance and tax evasion. That legal line is not drawn as sharply as it should be.

But there is no question in my mind that if it is a legal obligation, the law needs to be enforced.

Chairman GREGG. Senator Graham for one question.

Senator GRAHAM. Thank you. It goes to the personal account debate about Social Security. It is my understanding that you support the concept of personal accounts for a portion of FICA taxes for younger workers. Is that correct?

Mr. GREENSPAN. I do, Senator.

Senator GRAHAM. I have been told that people born after 1980 as a group receive about a 1.4-percent rate of return on their FICA taxes. Is that fairly accurate, do you think?

Mr. GREENSPAN. I do not have the specific numbers, but I have no reason to doubt your numbers.

Senator GRAHAM. So is it your firm belief that as a Nation we could take, let's say, a $1,000 account, structure it correctly, get a better rate of return than 1.4 percent? You feel like that is a very—is that doable?

Mr. GREENSPAN. Well, it is a tricky question as to what rates of return are because you can very clearly increase the rate of return on Social Security or, by carve-outs, the rate of return on a private account. But you have to be careful that in the process you do not also reduce the rates of return on other private sources of retirement. So there is a tricky question here which often gets pushed aside.

Senator GRAHAM. Well, I will be glad to talk to you about how to accommodate that. One of the down sides of the account, in my opinion, is the effect that setting the accounts up would have on the deficit. I have asked the following question, that if you made the tax cuts permanent with AMT relief, and if you borrowed the transition cost of a personal account plan like I have proposed, $1,300, the deficits in 2014 would be about $650 billion; that if you made the tax cuts permanent that we propose to do, and if you borrowed the money to set up an account of $1,300, the deficit in 2014 would be $650 billion.

If that is true, what effect do you think that would have on the economy?

Mr. GREENSPAN. The problem here is that most unified budget analysis is pretty clear-cut. When you have an appropriation and spend money or cut taxes, you borrow and you spend. So it is fairly clear what the change in resources are in the United States.

When you essentially borrow for a carve-out, you have effectively a forced saving account, which essentially says that the amount of debt that is issued by the Treasury is offset by a demand of an equivalent amount—and one would think that that should be a wash in the marketplace. So in an accounting sense and saving sense, it does not affect national savings. But what we are not clear on is whether the financial markets read the increase in marketable debt by the Federal Government as a wash and, hence, not an issue of concern.

If I were convinced that the financial markets would look at those increased elements of the Federal debt as being essentially offset by private savings and, hence, not respond in driving interest rates up, then I would be very comfortable with the issue.

My problem is I really do not know how they are going to behave. One of the reasons I have argued to do this type of account very gradually and in very small amounts is you would be able to judge whether, in fact, there is a market effect here from a system which does not effectively change national savings.

Senator GRAHAM. One last question——

Chairman GREGG. I thank the Senator. No, I am afraid we are going to have to move.

Senator GRAHAM. OK.

Chairman GREGG. Senator Sarbanes, I think you have the last 5 minutes here.

Senator SARBANES. Well, thank you. Thank you very much, Chairman Gregg, and, Chairman Greenspan, I am pleased to welcome you to the committee.

In a somewhat lighthearted fashion, I sometimes read editorial cartoons that appear in the newspaper. Sometimes they seem to make a point and make it very well, and this morning I am going to cite the one by Tom Toles in the Washington Post that appeared last month. It shows you reading a book entitled "The Independent Fed" by G.W. Bush. And then the quote from the book says, "...but then without warning, after the tax cuts solved the surplus problem, massive deficits somehow appeared. We must address these, I've concluded, by reforming Social Security right now, with private accounts, as it happens...".

Now, I don't know what the book went on to say from there, but I use that to set the context for the question I want to put to you. You say in your statement this morning, "Our ability to rein in deficit-expanding initiatives, should they later prove to have been excessive or misguided, is quite limited. Thus, policymakers need to err on the side of prudence when considering new budget initiatives. Programs can always be expanded in the future should the resources for them become available, but they cannot be easily curtailed if resources later fall short of commitments."

And I take it when you make reference to budget initiatives, you are talking about tax cut initiatives as well as spending program initiatives. Would that be correct?

Mr. GREENSPAN. That is correct, Senator.

Senator SARBANES. Now, that, of course, raises the question about how prudent the advice was that we were given in January of 2001 when the prime issue before us was the Bush tax cuts. You said then, "The time has come, in my judgment, to consider a budgetary strategy that is consistent with a preemptive smoothing of the glide path to zero Federal debt or, more realistically, to the level of Federal debt that is an effective, irreducible minimum."

And I said to you at the time that it would not be far off the mark for the press to carry the story on the basis of your testimony that morning, "Greenspan takes lid off of punch bowl," because your position in the past has consistently been that the surpluses should be devoted to reducing the debt. When drawn into, the question of wheteher we should have tax cuts or spending increases, you have generally remained out of that debate, although you have indicated a preference for tax cuts ahead of spending increases. But that was not really relevant because your first line was always to reduce the deficits.

And so the question I put to you is: Didn't the Bush tax cuts of 2001 and 2003 fail the test of prudence that you set out this morning in your statement when considering new budget initiatives?

Mr. GREENSPAN. Well, Senator, let me answer you by expounding on what else I said in 2001 at the same hearing. Everybody at that particular point in time was forecasting very significant surpluses as far as the eye could see. Indeed, all of the technicians who knew most about the issue of revenue estimation and budget estimation were coming up with significant surpluses.

If you literally believed what they were saying—and I checked very closely with all of the technicians in our operations and elsewhere—there is no way you can get around this question unless you make several different assumptions.

If that is indeed the case and we run policy on the basis of information, then what we would be looking at there was a very dramatic decline in the level of debt, which would have come to effectively zero. This would have required, in order not to reverse fiscal policy dramatically, a huge increase in private assets held by the Federal Government, which for reasons I outlined at the time, I thought was a very undesirable policy.

So I advocated tax cuts, but I also advocated triggers in the same testimony. The testimony essentially indicated that if indeed, despite all of the optimism with respect to the levels of surplus, it did not turn out that way, we needed a mechanism to reverse course. And the failure to reverse course has not only been the result of an issue of the trigger, it has also been the result of allowing PAYGO to dissipate and finally be eliminated in September 2002.

So it is the case that I did believe that the forecasts of surpluses were real and, indeed, the Federal Reserve embarked upon a very extensive program to determine how we would operate Federal open market policy, the policy of purchases and sales of U.S. Government securities, when the level was disappearing. So it was not an issue of just the forecast that did not mean anything. We took action on the basis of that forecast, and all I am saying is we were wrong on that forecast. But I did say that were we wrong—and this is in the same testimony which you are citing—we should have a mechanism to deal with it.

Senator SARBANES. I recall it was at the end.

Mr. GREENSPAN. That is correct.

Senator SARBANES. But it came at the end, once the punch bowl lid was off. Paul O'Neill——

Mr. GREENSPAN. But let me say, the question is: Is the statement about the punch bowl accurate? In other words, reading the flow of testimony, there is a question not only of whether somebody said the punch bowl lidwas being taken off. The issue is: Is that an appropriate evaluation of the full testimony? Unless you say that people only heard half of what I said.

Senator SARBANES. Well, given the dynamic of the process in the Congress, which, after all, you are quite familiar with——

Mr. GREENSPAN. Partly.

Senator SARBANES [continuing]. It seems to me that giving any sort of green light to tax cuts—or spending increases, for that matter, if you are concerned about the deficit problem and the reduction of the debt—is a very tricky proposition.

Mr. GREENSPAN. Senator, the same——

Senator SARBANES. And the consequence, of course, is that we have now gone deeply into deficit and deeply into debt with no prospect of working out of it.

Mr. GREENSPAN. Yes, but, Senator——

Senator SARBANES. As one looks ahead.

Mr. GREENSPAN. As you remember certainly as well as I, first of all, I did not support a specific tax cut. People assumed that I did, but you will not find anywhere in the public record that I sup-

ported a specific tax cut. Indeed, the Democratic leadership tax cut would have solved the problem that I was raising with respect to reducing the level of the debt outstanding too quickly. If you look at the combination of both the President's program and the Democratic leadership program, including spending, you would be hard pressed to find really significant differences about the reduction in the issue of debt outstanding.

So there is a question of context back there, and I will admit that I was wrong, like everybody else, on the issue of surpluses. But I think it is, frankly, unfair to read half of my testimony and discard the remainder.

Chairman GREGG. Well, with that bit of——

Senator SARBANES. I think what is fair——

Chairman GREGG. Senator, Senator.

Senator SARBANES. I will just close with this observation, Mr. Chairman. I think what is fair is to consider how your message would be taken, and it clearly was taken the way I have suggested in terms of providing a green light. I can put together——

Mr. GREENSPAN. I plead guilty to that. If indeed that is the way it was interpreted, I missed it. In other words, I did not intend it that way, and that certainly, if that was indeed the case, was not my intention.

Chairman GREGG. I would just submit for the record there are those of us who think that moving forward with the tax cuts was good policy, and we think we can defend that policy with the economic recovery that has occurred and the shallowness of the recession which resulted as a result of those tax cuts.

But that is history. We are trying to look forward here. And we appreciate your advice as to how we should look forward at what are the big issues coming out, which specifically are the entitlement accounts and health care. And the advice and guidance you have given us today I am hopeful we can convert to some specific legislative language. So thank you, Mr. Chairman, for your time.

Mr. GREENSPAN. Thank you very much, Mr. Chairman.

[The prepared statement of Mr. Greenspan follows:]

For release on delivery
10:00 a.m. EDT
April 21, 2005

Statement of

Alan Greenspan

Chairman

Board of Governors of the Federal Reserve System

before the

Committee on the Budget

United States Senate

April 21, 2005

Mr. Chairman, Senator Conrad, and members of the Committee, I am pleased to be here today to offer my views on the federal budget and related issues. I want to emphasize that I speak for myself and not necessarily for the Federal Reserve.

The U.S. economy delivered a solid performance in 2004, and thus far this year, activity appears to be expanding at a reasonably good pace. However, the positive short-term economic outlook is playing out against a backdrop of concern about the prospects for the federal budget, especially over the longer run. Indeed, the unified budget ran a deficit equal to about 3-1/2 percent of gross domestic product in fiscal 2004, and federal debt held by the public as a percent of GDP has risen noticeably since it bottomed out in 2001. To be sure, the cyclical component of the deficit should narrow as the economic expansion proceeds and incomes rise. And the recent pace of the ramp-up in spending on defense and homeland security is not expected to continue indefinitely. But, as the latest projections from the Administration and the Congressional Budget Office suggest, our budget position is unlikely to improve substantially in the coming years unless major deficit-reducing actions are taken.

In my judgment, the necessary choices will be especially difficult to implement without the restoration of a set of procedural restraints on the budget-making process. For about a decade, the rules laid out in the Budget Enforcement Act of 1990 and in the later modifications and extensions of the act provided a framework that helped the Congress establish a better fiscal balance. However, the brief emergence of surpluses in the late 1990s eroded the will to adhere to these rules, which were aimed specifically at promoting deficit reduction rather than at the broader goal of setting out a commonly agreed-upon standard for determining whether the nation was living within its fiscal means. Many of the provisions that helped restrain budgetary decisionmaking in the 1990s--in particular, the

limits on discretionary spending and the PAYGO requirements--were violated ever more frequently; finally, in 2002, they were allowed to expire.

Reinstating a structure like the one provided by the Budget Enforcement Act would signal a renewed commitment to fiscal restraint and help restore discipline to the annual budgeting process. Such a step would be even more meaningful if it were coupled with the adoption of a set of provisions for dealing with unanticipated budgetary outcomes over time. As you are well aware, budget outcomes in the past have deviated from projections--in some cases, significantly--and they will continue to do so. Accordingly, a well-designed set of mechanisms that facilitate midcourse corrections would ease the task of bringing the budget back into line when it goes off track. In particular, you might want to require that existing programs be assessed regularly to verify that they continue to meet their stated purposes and cost projections. Measures that automatically take effect when costs for a particular spending program or tax provision exceed a specified threshold may prove useful as well. The original design of the Budget Enforcement Act could also be enhanced by addressing how the strictures might evolve if and when reasonable fiscal balance came into view.

I do not mean to suggest that the nation's budget problems will be solved simply by adopting a new set of rules. The fundamental fiscal issue is the need to make difficult choices among budget priorities, and this need is becoming ever more pressing in light of the unprecedented number of individuals approaching retirement age. For example, future Congresses and Presidents will, over time, have to weigh the benefits of continued access, on current terms, to advances in medical technology against other spending priorities as well as against tax initiatives that foster increases in economic growth and the revenue base.

Because the baby boomers have not yet started to retire in force, we have been in a demographic lull. But this state of relative stability will soon end. In 2008--just three years from now--the leading edge of the baby-boom generation will reach 62, the earliest age at which Social Security retirement benefits can be drawn and the age at which about half of those eligible to claim benefits have been doing so in recent years. Just three years after that, in 2011, the oldest baby boomers will reach 65 and will thus be eligible for Medicare. Currently, 3-1/4 workers contribute to the Social Security system for each beneficiary. Under the intermediate assumptions of the program's trustees, the number of beneficiaries will have roughly doubled by 2030, and the ratio of covered workers to beneficiaries will be down to about 2. The pressures on the budget from this dramatic demographic change will be exacerbated by those stemming from the anticipated steep upward trend in spending per Medicare beneficiary.

The combination of an aging population and the soaring costs of its medical care is certain to place enormous demands on our nation's resources and to exert pressure on the budget that economic growth alone is unlikely to eliminate. To be sure, favorable productivity developments would help to alleviate the impending budgetary strains. But unless productivity growth far outstrips that embodied in current budget forecasts, it is unlikely to represent more than part of the answer. Higher productivity does, of course, buoy revenues. But because initial Social Security benefits are influenced heavily by economywide wages, faster productivity growth, with a lag, also raises benefits under current law. Moreover, because the long-range budget assumptions already make reasonable allowance for future productivity growth, one cannot rule out the possibility that productivity growth will fall *short* of projected future averages.

In fiscal year 2004, federal outlays for Social Security, Medicare, and Medicaid totaled about 8 percent of GDP. The long-run projections from the Office of Management and Budget suggest that the share will rise to approximately 13 percent by 2030. So long as health-care costs continue to grow faster than the economy as a whole, the additional resources needed for these programs will exert intense pressure on the federal budget. Indeed, under existing tax rates and reasonable assumptions about other spending, these projections make clear that the federal budget is on an unsustainable path, in which large deficits result in rising interest rates and ever-growing interest payments that augment deficits in future years. But most important, deficits as a percentage of GDP in these simulations rise without limit. Unless that trend is reversed, at some point these deficits would cause the economy to stagnate or worse.

The broad contours of the challenges ahead are clear. But considerable uncertainty remains about the precise dimensions of the problem and about the extent to which future resources will fall short of our current statutory obligations to the coming generations of retirees. We already know a good deal about the size of the adult population in, say, 2030. Almost all have already been born. Thus, forecasting the number of Social Security and Medicare beneficiaries is fairly straightforward. So too is projecting future Social Security benefits, which are tied to the wage histories of retirees. However, the uncertainty about future medical spending is daunting. We know very little about how rapidly medical technology will continue to advance and how those innovations will translate into future spending. Consequently, the range of possible outcomes for spending per Medicare beneficiary expands dramatically as we move into the next decade and beyond. Technological innovations can greatly improve the quality of medical care and can, in some instances, reduce the costs of existing

treatments. But because technology expands the set of treatment possibilities, it also has the potential to add to overall spending--in some cases, by a great deal. Other sources of uncertainty--for example, the extent to which longer life expectancies among the elderly will affect medical spending--may also turn out to be important. As a result, the range of future possible outlays per recipient is extremely wide. The actuaries' projections of Medicare costs are, perforce, highly provisional.

These uncertainties--especially our inability to identify the upper bound of future demands for medical care--counsel significant prudence in policymaking. The critical reason to proceed cautiously is that new programs quickly develop constituencies willing to fiercely resist any curtailment of spending or tax benefits. As a consequence, our ability to rein in deficit-expanding initiatives, should they later prove to have been excessive or misguided, is quite limited. Thus, policymakers need to err on the side of prudence when considering new budget initiatives. Programs can always be expanded in the future should the resources for them become available, but they cannot be easily curtailed if resources later fall short of commitments.

I fear that we may have already committed more physical resources to the baby-boom generation in its retirement years than our economy has the capacity to deliver. If existing promises need to be changed, those changes should be made sooner rather than later. We owe future retirees as much time as possible to adjust their plans for work, saving, and retirement spending. They need to ensure that their personal resources, along with what they expect to receive from the government, will be sufficient to meet their retirement goals.

Crafting a budget strategy that meets the nation's longer-run needs will become ever more difficult the more we delay. The one certainty is that the resolution of the nation's unprecedented

demographic challenge will require hard choices and that the future performance of the economy will depend on those choices. No changes will be easy. All programs in our budget exist because a majority of the Congress and the President considered them of value to our society. Adjustments will thus involve making tradeoffs among valued alternatives. The Congress must choose which alternatives are the most valued in the context of limited resources. In doing so, you will need to consider not only the distributional effects of policy changes but also the broader economic effects on labor supply, retirement behavior, and national saving. The benefits to taking sound, timely action could extend many decades into the future.

Chairman GREGG. The hearing is adjourned.
[Whereupon, at 12:05 p.m., the committee was adjourned.]

Statement by Senator Russ Feingold
Senate Budget Committee
April 21, 2005

Thank you, Mr. Chairman, for calling this hearing. I am delighted that the committee is holding a hearing on budget process reform, and I hope there will be further opportunities this year for the committee to consider specific proposals in this area.

I am also pleased that the committee will hear from Chairman Greenspan today. He has consistently supported the full reinstatement of the old PAYGO rule for both mandatory spending and revenues, and that perspective has never been timelier.

Mr. Chairman, reducing the federal deficit was the central issue of my campaign for the U.S. Senate in 1992. That issue dominated the presidential campaign as well, thanks in great part to the candidacy of Ross Perot. The result was that fiscal responsibility became an overriding concern. The legislative environment changed, and the goal of deficit reduction infused nearly every policy debate in Congress. The question "is it paid for?" was asked of virtually every bill or amendment, and the PAYGO statute and later the PAYGO rule in the Senate became ingrained into the thinking of both Congress and the White House.

Sadly, that budget discipline disappeared when it became inconvenient for the new administration in 2001, and it was allowed to expire. As has happened in too many other areas, the advancement of a narrow policy agenda has taken precedence over the rules under which we have operated. In this instance, the cost of this expedience will be borne principally by our children and grandchildren. They will pay the consequences for our mistake, and the price tag will be enormous. In the past four years we have seen a projected 10-year surplus of $5 trillion become a projected 10-year deficit of nearly that same amount under any reasonable set of assumptions.

Reinstating some tough budget discipline will not, by itself, pay off the massive debt that our children and grandchildren will face. That will require a significant change of priority around here. As we saw during the 1990s, climbing out of the deficit ditch requires making some tough decisions. But while budget rules are not a substitute for those tough decisions, they can help sustain them, and ensure that we don't slip back into the ditch.

The PAYGO rule is central to that effort. Last year, a bipartisan majority in the Senate insisted that the PAYGO rule be included in the budget resolution. Because the House and Senate Leadership refused to accept the Senate's position on PAYGO, we were left with no budget resolution. This year, we again garnered bipartisan support for a return to the PAYGO rule, but failed on a tie vote.

Mr. Chairman, I am convinced that if Members of the House and Senate had voted their conscience on PAYGO we would have a real PAYGO rule in place. There was tremendous pressure brought to bear by the White House and Congressional Leadership again on this issue. PAYGO is clearly an impediment to the policies of the current Administration. Given the fiscal record of this White House, there may be no better endorsement of PAYGO as a tool of fiscal responsibility than that very fact.

If we are ever going to get back on track to balancing the federal books, we will need PAYGO. I very much hope Chairman Greenspan's endorsement of this proven instrument of fiscal responsibility will help us get it back in place.

SOLVENCY OF THE PENSION BENEFIT GUARANTY CORPORATION - CURRENT FINANCIAL CONDITION AND POTENTIAL RISKS

WEDNESDAY, JUNE 15, 2005

UNITED STATES SENATE,
COMMITTEE ON THE BUDGET,
Washington, D.C.

The committee met, pursuant to notice, at 9:52 a.m., in Room SD–608, Dirksen Senate Office Building, Hon. Judd Gregg, chairman of the committee, presiding.

Present: Senators Gregg, Allard, Enzi, Bunning, Conrad, Murray, Byrd, and Stabenow.

Staff Present: Scott B. Gudes, Majority Staff Director; and Mary Ann Naylor, Staff Director.

OPENING STATEMENT OF CHAIRMAN JUDD GREGG

Chairman GREGG. Since we have our witnesses and myself and Senator Conrad here, I thought we might just as well get started because we do have a vote at 10 o'clock, and this way Senator Conrad and I can make our statements, go vote, come back, and then start with your testimony, if that is agreeable to you folks, even though it is a little early by our own standards. But that is good. Congress should be early. We are usually late. It is about time we were early.

You will note that we have these big screens. This is an attempt to move our committee into the 20th century. We do not expect to catch up with the 21st century on technology in this committee. But we have felt great solace and concern for the staff of Senator Conrad and their need to hold posters and billboards and charts all the time. So in order to try to relieve that stress on his staff, we have put in these fancy screens and we are going to go electronic.

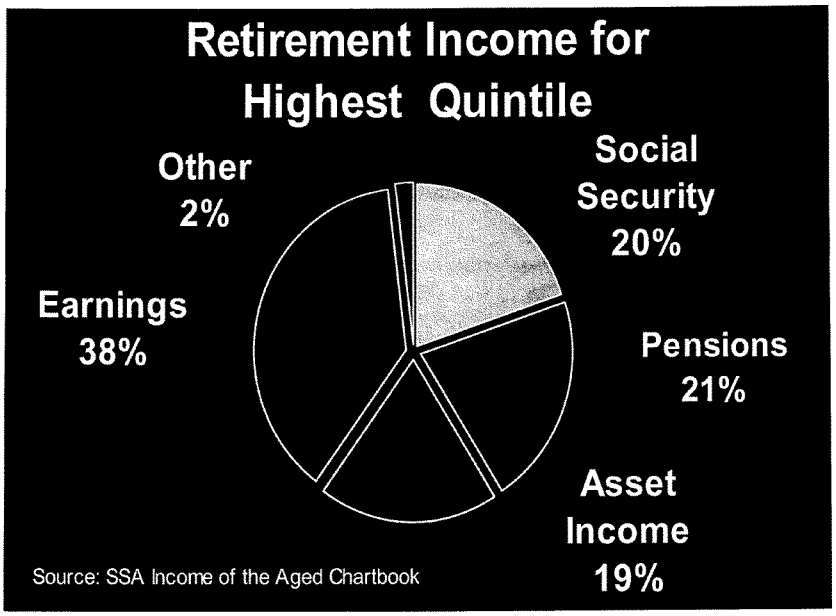
My hope actually had been to have these screens like the House has. They have quite spectacular video capability in their hearing rooms. However, the Senate does not move with such alacrity, and so we have this structure here, which hopefully will work. It is going to be a test, and I suspect there will be some glitches. But Dave is down there working for us, and Senator Conrad has his folks down there. So hopefully this will all work out, and we can put our charts up in an electronic way. If that does not work, I am sure there is some back-up system.

The hearing today deals with the Pension Benefit Guaranty Corporation, and we are fortunate to have the Executive Director, Brad Belt, and the Director of the Congressional Budget Office, Dr.

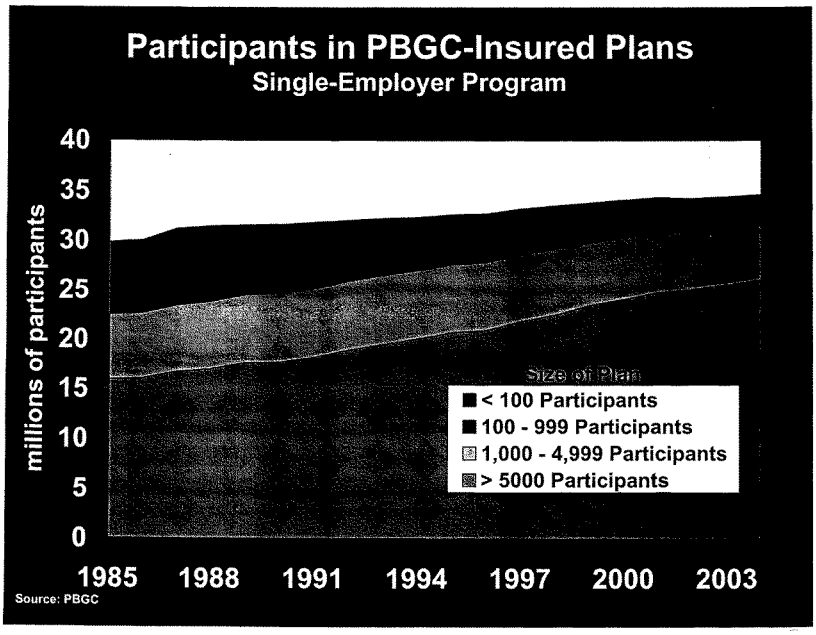
Holtz–Eakin, with us today in order to talk about the issues which are confronting us in this area.

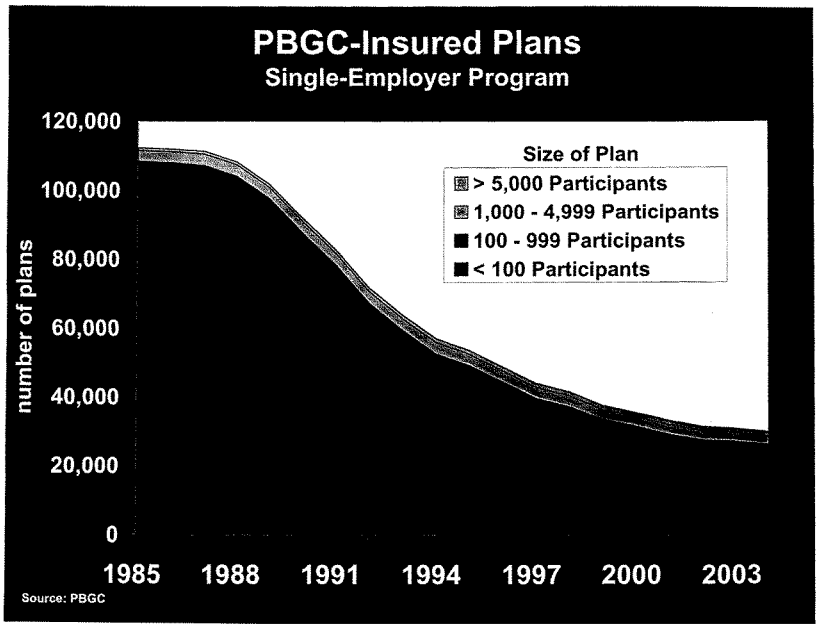
In my opinion, if we look out into the out-years of what our Government is confronting in the area of fiscal issues, we have a major crisis looming. We have talked about a lot on this committee, both myself and Senator Conrad. The crisis is driven in large part by demographics and the entitlement programs which we have created within the Government to assist people and to benefit people who are retired—obviously, Social Security, Medicare, and Medicaid being three of the largest ones. But if we are looking at contingent liabilities that are out there, potential liabilities, the PBGC is the fourth largest concern for us as a Government after those three major entitlements. And that is a function of the fact that we face a huge unfunded liability within defined benefit pension funds and the PBGC fund, and that is what we are going to talk about today.

The pension incomes of Americans are dependent on two basic sources. One is obviously the public pension system, which is Social Security, and for people who are in the lower-income brackets, that makes up about 83 percent of their income. You can track Chart 1 and Chart 2 here. We will see if we can get those up. And the second is for people in the middle- and higher-income brackets, private pension benefits—and that would be Chart 2—of which defined benefit plans make up a large amount.

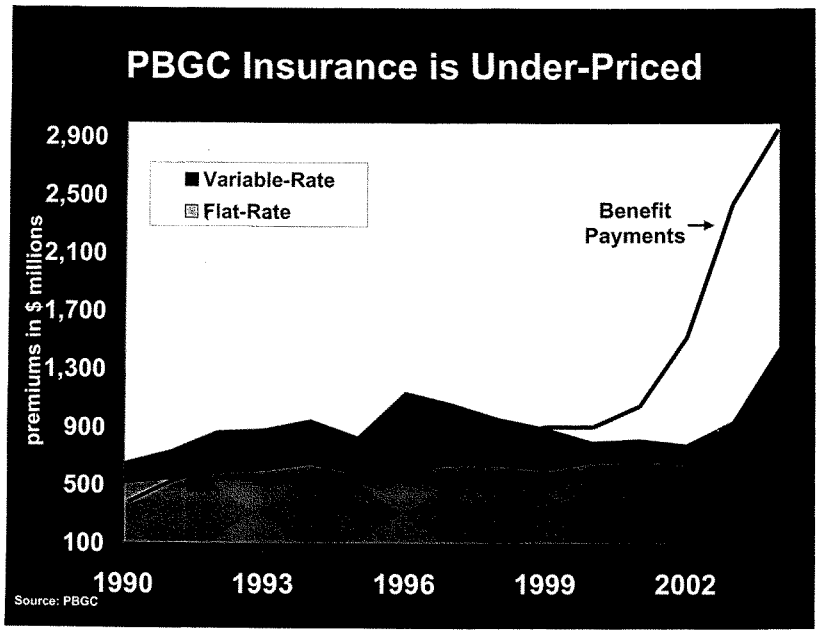

Retirement Income for
Highest Quintile
Other
2%
Social
Security
20%
Earnings
38%
Pensions
21%
Asset
Income
19%
Source: SSA Income of the Aged Chartbook

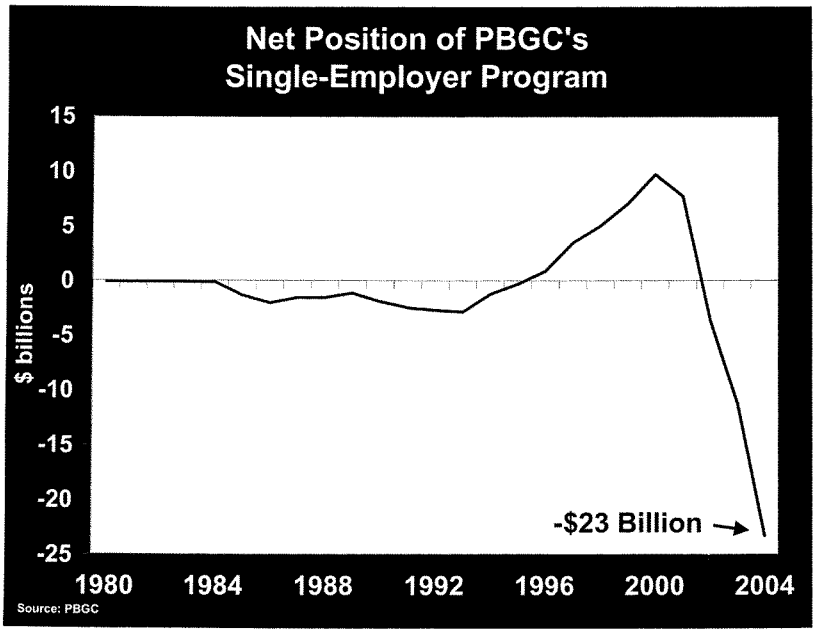
The number of participants in these programs, which would be the next chart, has been rising in the defined benefit plans, which are PBGC approved. But the number of plans have actually been dropping, which is an interesting fact and something which reflects, I think, the fact that most people, many employers, are moving towards contribution plans versus defined benefit plans. And the PBGC is finding that it now has fewer plans to participate in their system, which has an impact on their solvency to a significant degree.


Participants in PBGC-Insured Plans
Single-Employer Program
millions of participants
40
35
30
25
20
15
10
5
0
1985
1988
1991
1994
1997
2000
2003
Size of Plan
< 100 Participants
100 - 999 Participants
1,000 - 4,999 Participants
> 5000 Participants
Source: PBGC

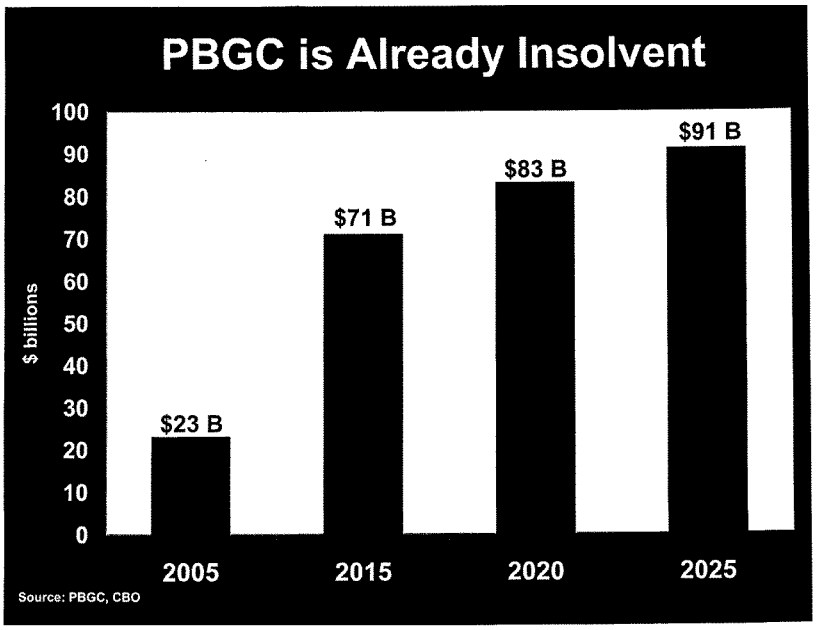

PBGC-Insured Plans
Single-Employer Program
120,000
100,000
80,000
60,000
40,000
20,000
0
number of plans
1985
1988
1991
1994
1997
2000
2003
Size of Plan
> 5,000 Participants
1,000 - 4,999 Participants
100 - 999 Participants
< 100 Participants
Source: PBGC

The defined benefit insurance program as set up by Congress 30 years ago is, regrettably, grossly underpriced right now and broken, and that would be the next chart, which is a rather dramatic reflection of the fact that we basically do not have enough money coming in and we have got a lot of money going out, or potential money going out. And the next two charts also reflect this, and so let's move on to those.


PBGC Insurance is Under-Priced
premiums in $ millions
2,900
2,500
2,100
1,700
1,300
900
500
100
Variable-Rate
Flat-Rate
Benefit Payments
1990
1993
1996
1999
2002
Source: PBGC


Net Position of PBGC's
Single-Employer Program
15
10
5
0
-5
-10
-15
-20
-25
$ billions
1980
1984
1988
1992
1996
2000
2004
-$23 Billion
Source: PBGC

The plans basically are giving people a false sense of security as to what they are going to receive in pension benefits because essentially the promises exceed the assets. And as we start to draw down assets in these plans, especially if we look at the projected drawdown of assets, we see that the insolvency accelerates significantly, and that would be the next chart, so that by 2025 we are projecting insolvency of $91 billion in the PBGC.


PBGC is Already Insolvent
$ billions
100
90
80
70
60
50
40
30
20
10
0
$23 B
$71 B
$83 B
$91 B
2005
2015
2020
2025
Source: PBGC, CBO

This is a huge number, and the problem here is that it is almost faster than Social Security, as we understand it. We actually have an insolvency right now of $23 billion, and because of the way the system works, as we start to draw down assets in the plan to pay current liabilities, we end up basically eating the seed corn which would theoretically grow the benefits for people in plans trustd by the PBGC who are going to retire in later years, which is why this accelerates so dramatically, leaving us with a huge out-year problem.

I would compare it to the savings and loan problem that we had in the late 1980s, early 1990s, which brought down the banking industry, especially in the Southwest and in the New England States. It is that type of an issue in that, theoretically, at least, the Federal Government is on the line for a whole lot of this. But that is only theory, I think. We have to acknowledge the fact that if we have this type of a meltdown in our defined benefit structure, clearly the Federal Government is going to be drawn into this. People would expect that.

So what do we do? What do we do? Well, I think there are a number of suggestions which we should pursue, and let me just read a few of them.

First, we have to require that we have valid information about the security of these benefit plans. We cannot keep misleading people. We really actually have to have more transparency and more accuracy as to what these plans' benefits are, and participants need to know that. They need to know if their plan is in jeopardy and to what extent it is in jeopardy so that they have that information.

Workers must be assured that the law does not allow and even encourage hollow promises, that we do not have a system where employers and union leaders are making and offering rank-and-file members benefit increases that cannot possibly be paid for. And this has been a huge issue. Promises have been made here in order to settle negotiations, which clearly people should have understood were not going to be able to be fulfilled, and that continues and it should not continue and we should change the law so it cannot happen.

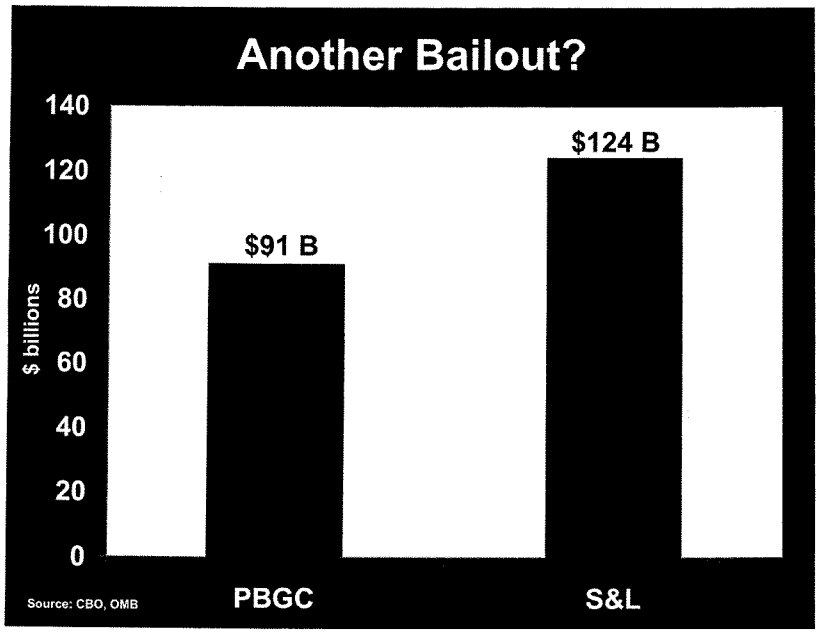
The law must place a tangible price on all defined benefit plans' underfunding to limit the moral hazard of shifting risks to the beneficiaries, to PBGC, and other companies paying premiums. Accounting schemes that paper over massive funding shortfalls must be outlawed. Interest rate policies and funding targets must be straightforward to administer and be consistent with each plan's liability payouts.

These are just a few of the things which need to be changed, but what we do know is that the PBGC already has a serious deficit and a cash crisis looming with a clock that will toll within 20 or 30 years sooner than when the Social Security problem hits us. And so we need to get on this issue. In fact, our window of opportunity is even narrower, in my opinion, than it is with Social Security because of the way this system works and the fact that we will be using up assets to pay liabilities, which assets really are not coordinated with those liabilities.

Under the current law, the remedies for this broken system do not include the full faith and credit of the United States Govern-

ment. I think this is an important point. The PBGC is only authorized to borrow up to $100 million from the U.S. Treasury. This amount pales in comparison to the projected shortfalls in the amount that would be needed to pay out the current projected levels of insured benefits. If we do nothing, employers left standing will pay even higher premiums than we have proposed in the Budget Resolution which we passed, and workers and retirees will be faced with significant reductions in insured benefits.

We have got to learn from the history, especially the history of the savings and loan crisis, that you cannot wait to act on something like this. The most important thing we should all have to learn is that the longer we wait, the costs of the remedy will become higher, and there is another chart that shows the comparison—number 8, I think it is—of this problem to the S&L crisis.


Another Bailout?
140
120
100
80
60
40
20
0
$ billions
$91 B
$124 B
PBGC
S&L
Source: CBO, OMB

We are going to hear today that the PBGC deficit is projected to be $23 billion. Fortunately, PBGC payments are generally not made on a lump-sum basis, unlike withdrawals from a savings and loan. Nevertheless, the pension insurance fund will first run short on cash in just 5 years, and it will take roughly another 15 years to liquidate all remaining assets in the fund, which at that point there is nothing left and it is over. There are no more pension benefits. People who have pensions at 15 years out, we will have nothing to pay them if they are in the PBGC system. So that is the crisis we confront.

But we have the opportunity to get it right, and the Budget Resolution attempted to try to start that process, and what this hearing is about today is whether or not the Budget Resolution went far enough or went too far and what needs to be done in the area of raising premium and in the area of making the increases in premium responsible enough so that we do not force companies to tip over into bankruptcy and draw more people into the PBGC. This is the conundrum we face, which is that as we try to make the system solvent, we do not want to make more companies insolvent, which in the end makes the system less solvent.

So we appreciate the fact that we have got two expert witnesses with us today to talk about this, and at this point I would yield to the ranking member, Senator Conrad.

OPENING STATEMENT OF RANKING MEMBER KENT CONRAD

Senator CONRAD. Thank you very much, Mr. Chairman, and thank you very much for holding this hearing. We have seen an outpouring of concern on this issue since the United default. Let's go to that first slide, if we can.

The Washington Post ran this story on the human toll of a pension default, and they told the story of the family of a young United pilot who died in the disaster of September 11th. And that young pilot's widow now faces a cutting in half of her pension benefits because of the United default.

The Washington Post
MONDAY, JUNE 13, 2005

Human Toll of a Pension Default

By Dale Russakoff
Washington Post Staff Writer

Ellen Saracini lost her husband, United Airlines Capt. Victor J. Saracini, when his Flight 175 crashed into the World Trade Center on Sept. 11, 2001. Now she stands to lose more than half of her widow's pension in a very different kind of crash — United's default of its $9 billion pension obligations.

The scale of the default, the largest in U.S. history, has received more attention than the toll on the lives of the bankrupt airline's 120,000 employees and pensioners. Saracini discussed its impact on her and her two daughters in an interview yesterday, saying she hopes her story will help shift the focus to the laws and policies that allow such defaults.

"My own situation is not a crisis — I have my husband's life insurance to keep us secure in our house," she said from her home in Yardley, Pa. "But a lot of other people have real hardship — medical costs they won't be able to afford, houses they won't be able to keep. If I can help draw attention to them, I'll do it in a heartbeat."

Saracini was among about 2,000 United pensioners and employees who e-mailed their stories to Rep. George Miller (D-Calif.) in recent days for what he called an online hearing on the human impact of the default. "We have been overwhelmed — both numerically and emotionally — by the response," said Miller, one of several politicians in both parties warning that a wider crisis will loom if the nation's pension security laws are not revised.

More than 20 other companies have defaulted on pension funds of more than $100 million in the past three years, and last week, executives of troubled Delta and Northwest airlines said they may be next. Miller has proposed a six-month moratorium on defaults, as Congress debates how to fix what many lawmakers call "broken" pension protection laws.

"Like Enron, workers' lives and retirements have been ruined," Sen. Charles E. Grassley (R-Iowa) said last week. "But unfortunately, this time it's perfectly legal."

In e-mails to Miller that his staff is posting online, and in interviews, United retirees recounted stories of job-hunting in their sixties and seventies, facing medical costs they no longer can afford, uprooting families to move to lower-cost communities, selling dream retirement homes and losing money they had counted on to support elderly parents.

The Pension Benefit Guarantee Corp. (PBGC), the federal insurance program that faces its own solvency crisis and is to take over the United pensions, ensures a maximum of $45,000 a year in benefits for those who retired at 65, but considerably less for those who retired younger — much as Social Security pays less to early retirees. This particularly hurts pilots, whom the law requires to retire from major airlines at 60 and who now collect as much as $125,000 a year in pensions, depending on length of service. The PBGC's maximum coverage for those who retire at 60 is $28,000 — a cut of 50 to 75 percent for pilots. Saracini will receive even less because her husband was 51 when he was killed.

United Airlines pilot Victor J. Saracini was killed during the attacks on Sept. 11, 2001.

The PBGC limits cover full pensions for most United retirees, but those still working will have their pensions frozen, meaning they will accrue no more benefits and will have less money for retirement than they had counted on — in some cases, much less.

Dale Casaudy, a flight attendant for 32 years who lives in Arlington, wrote to Miller that she exhausted most of her savings putting her daughter through college and now will have to take in a boarder to be able to pay her mortgage and property taxes. Floyd Channell, 72, a retired United ramp worker at Dulles International Airport, said he worries how today's workers will fare in old age with even smaller pensions than his. Although PBGC probably will protect his full benefit, he said he needs one-third of it just to pay medical costs — beyond what Medicare covers — for his wife, who has disabling back pain. He has taken a part-time job at a church, "but when you're 72, you can't get much," he said.

For pilots, the six-figure drop in pension benefits follows losses of tens and even hundreds of thousands of dollars in United stock they received in the 1990s in exchange for major pay and benefit concessions — and were required to hold until retirement, as the stock plummeted in value. Other employees lost stock as well, but had less to lose.

"I call it legalized crime," said United pilot Klaus Meyer, 47, of Bethlehem, Pa. "I lost almost all my United stock value in the bankruptcy, and here's another part of the retirement I was promised that is gone. And now my Social Security is at risk. Where does it all end? You feel brutalized by the system."

Meyer agreed to be interviewed despite warnings from the pilots' union that United may penalize employees who talk to reporters. "What are they going to do to me — cut my pension in half?" he said.

Retired pilots nationwide who spent their work lives expecting six-figure pensions told of scrambling to downsize as fast as possible. "The last thing I thought was that I would depend on Social Security as the cornerstone of my retirement," John J. Pinto, 60, of Annapolis, wrote to Miller. Pinto said he is job-hunting, and has found that he and his wife, a schoolteacher, probably will earn together less

In the late 1990s, United pilot Gerald Innella had $500,000 in United stock and a promised $110,000 pension for life. His children grown, he and his wife built a "dream home" on a golf course in Somerset County, N.J. His stock sold at $10,000 in the bankruptcy, and his pension stands to drop almost $80,000 a year. Innella, now 60, and his wife recently sold the dream home, moving in first with their son and now a niece. Interviewed at his niece's home in Glen Gardner, N.J., Innella was preparing for a pre-dawn flight to Antigua; he is back at work as a full-time charter pilot at one-third of his former salary.

Last week, United Chief Executive Officer Glenn Tilton testified to the Senate Finance Committee about $4.5 million he is receiving from United to replace benefits he had accrued over a 32-year career at Texaco, his previous employer. Tilton said that the default will not affect the payment, and that he has $1.5 million left to collect. He said this does not represent a double standard because United promised him the money in his contract.

"He is saying, 'United guaranteed that to me,' " said retired pilot John D. Clark of Charlottesville, who flew United planes for 36 years out of Dulles and whose $125,000 annual pension is to be reduced by more than 70 percent. "Why is the promise made to him understandable, and the one made to me can go by the wayside?"

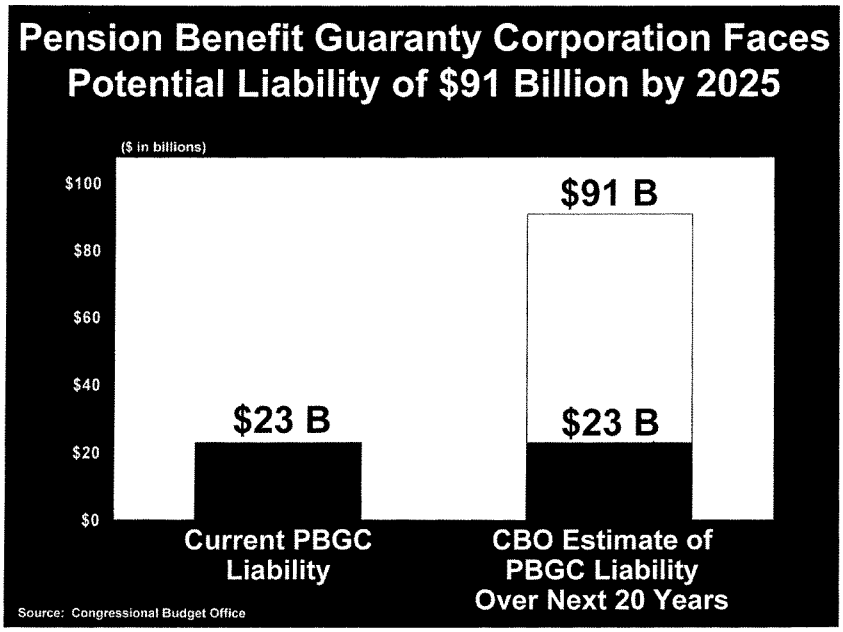
Clark said he is more enraged at the injustice of the pension default than at his own situation. "The

See PENSIONS, A4

We know that some 120,000 employees of United are going to absorb the $3.2 billion of that default not covered by the PBGC. These are people earning pensions over $45,000 a year, and I know myself, I grew up with a young guy in North Dakota, a very dear friend who wound up becoming a United pilot after a distinguished career in the military. And he was in town just recently and told us he has lost a significant majority of his pension benefits.

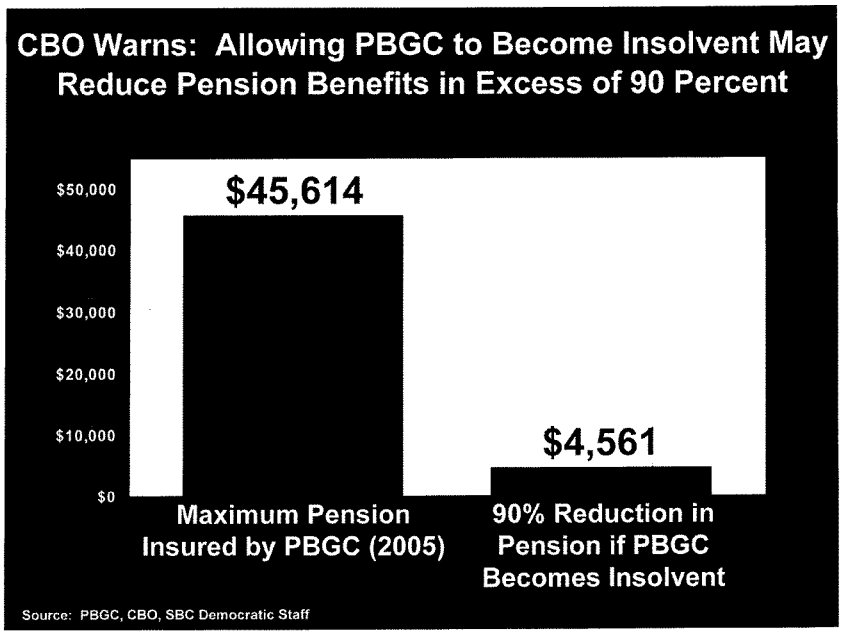
That story is repeated over and over in this story that was in the Washington Post. Those who were counting on a retirement that they thought was assured, certainly one that was promised to them, now find the rug pulled out from under them.

Let's go to the next slide. We know that PBGC has experienced a dramatic reversal of fortunes in recent years. In 2001, PBGC reported a cumulative surplus of $7.7 billion—a surplus. Now we see a current PBGC liability of $23 billion, as the chairman indicated, growing to an estimated PBGC liability of $91 billion in 20 years. That is an incredibly serious matter for all of those who are in danger of having their pension benefits reduced from what they thought was assured.


Pension Benefit Guaranty Corporation Faces Potential Liability of $91 Billion by 2025
($ in billions)
$100
$80
$60
$40
$20
$0
$23 B
$91 B
$23 B
Current PBGC Liability
CBO Estimate of PBGC Liability Over Next 20 Years
Source: Congressional Budget Office

At that rate, assets in the PBGC fund will have been exhausted, and without serious reform PBGC may pay only pennies on the dollar each year to beneficiaries. Director Holtz–Eakin, you have warned of the risk to beneficiaries, stating that an insolvent PBGC would necessitate a drastic reduction in benefits, perhaps in excess of 90 percent.

Let's go to the next slide, if we could. The maximum pension insured by the Pension Benefit Guaranty Corporation now is $45,614. If that has to be reduced by 90 percent, that would be only coverage of $4,561. Can you imagine the extraordinary hardship that would impose on people who, once again, are counting on these pension benefits? And, you know, when you have reached retirement age, what are you going to do to catch up? What are you going to do to make this all work? That is the very serious threat facing people.


CBO Warns: Allowing PBGC to Become Insolvent May Reduce Pension Benefits in Excess of 90 Percent
$50,000
$40,000
$30,000
$20,000
$10,000
$0
$45,614
$4,561
Maximum Pension Insured by PBGC (2005)
90% Reduction in Pension if PBGC Becomes Insolvent
Source: PBGC, CBO, SBC Democratic Staff

The chairman asked the question: What do we do? That is precisely the question we ought to ask and try to answer.

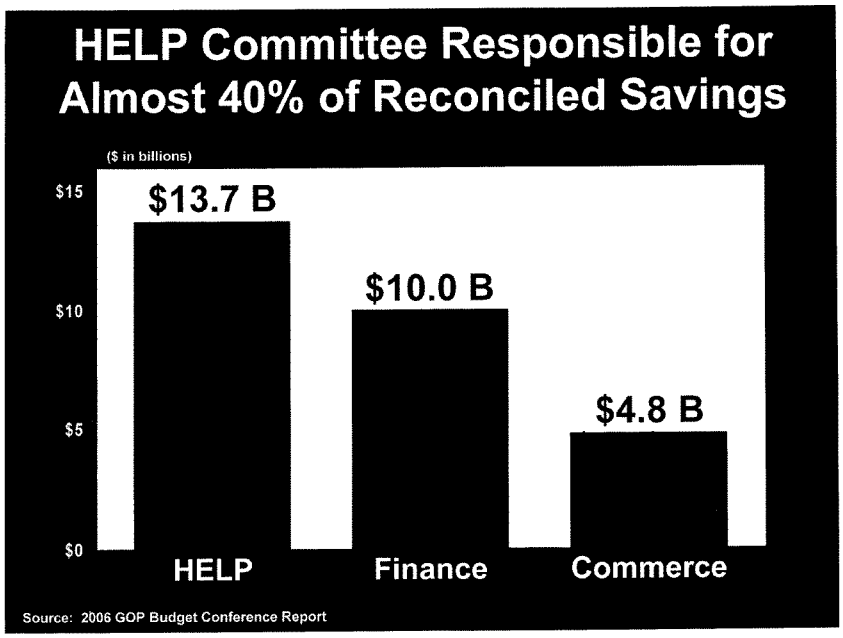
One thing we know is that there are things that could be done here that make the situation worse. Again, Director Holtz–Eakin, you warned the Finance Committee that changes in policy that require augmented pension funding would impose new costs on sponsors, probably increasing the chances for further bankruptcy filings. So the first thing we have got to do is make sure we do no harm, that we do not dig this hole deeper.

CBO Director Holtz-Eakin Warns of Potential Risks to Firms and Beneficiaries in Reforming PBGC

"Changes in policy that require augmented pension funding would impose new costs on sponsors ... probably increasing the chances of further bankruptcy filings ...."

– Douglas Holtz-Eakin, CBO Director
Before Senate Finance Committee
June 7, 2005

As part of this year's budget resolution—let's go to the next slide—the HELP Committee, which oversees the Pension Benefit Guaranty Corporation, must approve savings proposals of $13.7 billion over 5 years, some of which is assumed to come from PBGC. The HELP Committee has the largest instruction of any Senate committee, higher than even the Finance Committee, and equal to just under 40 percent of the $34.7 billion of projected savings. There you can see the HELP Committee has by far the biggest instruction in terms of savings, and they have got responsibility for PBGC.


HELP Committee Responsible for Almost 40% of Reconciled Savings
($ in billions)
$15
$10
$5
$0
$13.7 B
$10.0 B
$4.8 B
HELP
Finance
Commerce
Source: 2006 GOP Budget Conference Report

Congress clearly needs to act, whether as part of reconciliation or in some stand-alone legislation. I am interested in hearing more from Mr. Belt about the administration's proposals.

Let's go to the next slide. As I see it, there are really four components to the administration's proposal. Number one, increase premium income, and these are really two elements to that: increase fixed premium from $19 to $30 per plan participant, and, second, apply variable premiums to every dollar of plan underfunding.

Administration's Pension Reform Proposal

- Increase Premium Income
  - Increase Fixed Premium from $19 to $30 Per Plan Participant
  - Apply Variable Premium to Every Dollar of Plan Underfunding
- Reform Minimum Funding Levels
- Prevent Companies with Underfunded Plans from Increasing Pension Benefits
- Enhance Transparency of Pension Plans

The second major element of the administration's proposal is to reform minimum funding levels, to reform how companies calculate the minimum funding levels that are needed for their pension plans.

Third, prevent companies that have underfunded plans from worsening the situation by further increasing pension benefits.

And, fourth, improving the transparency of the financial status of pension plans for employees, pensioners, and investors, and other stakeholders.

This is at least my attempt to summarize, Mr. Belt, the proposals that you are making.

My own conviction is we need to provide a practical path for employers who have established defined benefit plans, to maintain those valuable plans for their employees and retirees. Termination should be an extraordinary step for a plan sponsor, not merely another financial option. Employees and retirees are relying on these promises, and we should not let them down.

It is also clear to me that some of the requirements that we have had in the past really do not make much sense. We have, in fact, restricted companies on what they could put in in the good times to their pension plans. And then, of course, when the bad times come, the downturn occurs, they are in no position to catch up. So I think that is one of the things that require our review as well.

Senator Gregg has notified me that there is a vote now on an amendment in 10 minutes. He has asked me to recess the committee, and we will then return to hear the testimony of our witnesses. Senator Gregg had another committee responsibility. That is why he is not here at the moment. He had to go, I think to provide a quorum perhaps there. And then we have this vote scheduled very shortly on the floor, and he feels the best way to conduct our business would be to recess the committee at this moment, for us both to go and vote, and then return and hear the testimony of the witnesses.

I apologize to the witnesses for this. This vote was perhaps as you know, only scheduled late yesterday, so we did not know of it when we had scheduled this hearing. So I apologize for that, and I apologize to those who are here to listen to the testimony as well. We will attempt to reconvene in approximately 10 or 15 minutes.

With that, we will recess the committee.

[Recess.]

Chairman GREGG. I apologize for the break. I appreciate Senator Conrad taking over. I appreciate Senator Byrd being here. But we did have a vote. And so we shall proceed to testimony.

Mr. Belt, I guess we will start with you.

STATEMENT OF BRADLEY D. BELT, EXECUTIVE DIRECTOR, PENSION BENEFIT GUARANTY CORPORATION

Mr. BELT. Thank you, Mr. Chairman.

Chairman GREGG. Try to bring that microphone a little bit closer.

Mr. BELT. I will certainly do so. Chairman Gregg, Senator Byrd, thank you for the opportunity to testify on the financial condition of and risks facing the Federal pension insurance program. Let me begin by making a few general observations that I hope will help frame the policy choices facing this committee and Congress.

First, the key issue facing policymakers is not really the solvency of the PBGC per se. When underfunded pension plans terminate, it is not the PBGC that loses. We are merely a passthrough for the very stakeholders in the defined benefit system. In reality, there are three important constituencies who stand to lose when underfunded pension plans terminate. First, workers and retirees may lose promised benefits because of statutory limits on PBGC's insurance coverage. Second, other companies that have responsibly met their pension obligations may be required to pay higher PBGC premiums. And, third, U.S. taxpayers may ultimate be called upon to bail out the insurance fund if it cannot honor its commitments.

Nevertheless, we continue to hear the criticism that the administration's comprehensive pension reform proposal is focused on saving the PBGC. These criticisms seem intended to obfuscate the real issues at stake in this debate. The administration's pension reform proposal has three goals: to protect the pension benefits that workers and retirees have earned; to protect responsible companies from paying for the broken promises of their corporate brethren; and to protect taxpayers from a costly bailout of the pension insurance fund.

There is no question that the administration's reform proposal is the strongest measure put forward to get pension plans funded and to put the insurance program on a stable footing. In fact, I would suggest that the administration's proposal should be the benchmark against which all such proposals are measured. Simply put, stronger funding rules mean better protection for workers, responsible companies, and taxpayers. Weaker funding rules mean less protection for these three constituencies.

Consider a real-world example of what happens when underfunded pension plans terminate. United Airlines is defaulting on nearly $10 billion of unfunded benefit promises. The pension insurance program will cover roughly $6.6 billion of the shortfall. That means the workers and retirees stand to lose more than $3 billion in benefits they have earned that were promised to them but never funded by United Airlines. It also means responsible companies are on the hook for $6 billion that under current law will have to be covered with higher premium dollars. And, finally, further large losses increase the chances that the pension insurance fund will need a costly Federal rescue at some point in time.

Indeed, with about $40 billion in assets but more than $60 billion in liabilities, the pension insurance program is already in a deep hole. And without needed changes in law, as recommended by the administration, the hole could get much deeper.

Last year, we reported that the universe of PBGC-insured pension plans was underfunded by more than $450 billion, with almost $100 billion of that shortfall in plans sponsored by financially weaker companies. Further losses will depend on numerous variables that are inherently uncertain and difficult to predict, such as changes in equity prices, interest rates, raw material prices, inflation, and general economic conditions.

But without needed changes in law, large losses are likely. And there are several useful methodologies for analyzing and pricing the risk to the pension insurance program. One tool used by PBGC is a stochastic model that provides a range of possible outcomes,

depending on different economic scenarios. The options pricing model used by CBO which adjusts for market risk is another useful analytical tool, and an independent think tank has published a deterministic cash flow model that provides policymakers with yet another way to assess the scope and magnitude of the potential cost of providing Federal pension insurance under current law.

Each of these approaches shows that losses will grow substantially under current law, and there are several indicators that the risks to the pension insurance program are growing rather than abating. The most recent source of information on the financial status of pension plans comes from the reports filed with the PBGC by companies with pension plans underfunded by more than $50 million. The latest reports show that pension underfunding has grown by 27 percent compared to a year ago, from $279 billion to $354 billion. And the average funded ratio of the plans was just 69 percent.

In addition to greater levels of underfunding, market indicators show that the risk of default on the part of several companies sponsoring large pension plans has risen appreciably in recent months. Meanwhile, PBGC's premium revenues are not keeping pace with the growing losses and exposure. PBGC's flat rate premium of $19 per participant brings in only about $600 million each year. The variable rate premium has averaged only about $300 million per year over the past decade. At current levels, premiums are clearly inadequate to close the pension insurance program's $23 billion accrued deficit, let alone cover future expected claims.

The administration has put forward a comprehensive pension reform proposal that accomplishes three critical objectives.

First, it strengthens the pension funding rules so that companies set aside enough money to fill their pension promises while using real measures of assets and liabilities, not measures of liabilities and assets based upon years past.

Second, it fixes the premium structure to better enable the PBGC to meets its commitments to more than 1 million Americans in failed pension plans.

And, third, it opens up the non-public pension underfunding reports filed with the PBGC so that workers and retirees can know if their benefits are at risk.

This is the right approach, and it is a balanced approach. Under current law, the PBGC receives no taxpayer money, as you noted, Mr. Chairman, and its obligations are not backed by the full faith and credit of the United States Government. In other words, premium payers are responsible for the obligations PBGC has assumed from terminated plans. If premiums are not sufficient to cover past or future losses, then Congress will have to address the question of who pays. When the PBGC runs out of money, should participants in terminated pension plans expect to stop receiving their benefit checks or will pressure build to ask the taxpayer to restore the insurance program to solvency?

The administration believes there is a better approach: fix the funding rules now to require companies to fully fund the promises they have made to their workers. That is the best insurance policy for plan participants, premium payers, and ultimately taxpayers.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Belt follows:]

TESTIMONY OF BRADLEY D. BELT

Executive Director

PENSION BENEFIT GUARANTY CORPORATION

Before the Committee on Budget

United States Senate

June 15, 2005

Chairman Gregg, Ranking Member Conrad, and Members of the Committee: I appreciate the opportunity to discuss the current financial condition of the PBGC and the risks the pension insurance program is facing. My testimony also describes in more detail the current status of the defined benefit system, the flaws in the current statutory framework that result in lost pension benefits for workers and retirees, and the comprehensive reforms proposed by the Administration that provide a sensible and equitable way of addressing these issues.

Before addressing these and related issues in more detail, a few general observations will help frame the policy choices facing Congress. The first point is that the issue is not the solvency of the federal pension insurance program, but rather the costs imposed on workers and retirees, companies that have acted responsibly in honoring their pension promises, and, potentially, taxpayers. The second point is that incurred and likely losses to the federal pension insurance program are substantial, and they appear to be growing. The final point is really a question - who should be responsible for paying the promises companies make to their workers and retirees?

Some critics argue that the Administration's single-employer defined benefit plan proposal is focused on "saving the PBGC" at the expense of the defined benefit system itself. But, the PBGC does not have its "own" financial interests as does a private sector company representing the economic interests of its shareholders. PBGC represents the interests of all the stakeholders in the defined benefit system - the participants in plans for which PBGC has assumed responsibility, all of the participants in single-employer and multiemployer plans covered by the federal pension insurance program, and the companies sponsoring pension plans that pay premiums to cover losses. In addition, because the PBGC is supposed to be self-financing, we have an obligation to not incur avoidable losses that may require taxpayer monies to restore the insurance funds to solvency.

The PBGC insures pension benefits worth $2 trillion covering 44 million participants in single-employer and multiemployer defined benefit plans and is responsible for paying current and future benefits to more than 1 million workers in more than 3,400 terminated defined benefit pension plans. While the PBGC steps in to pay benefits to participants in terminated pension plans, because of limits on guarantees established in law by Congress, some workers and retirees may lose benefits they were counting on to provide economic security in retirement. Fortunately, most participants receive all of their accrued benefits, but this isn't always the case. And losses can be staggering in the aggregate and life-altering for many individuals. For example, workers at United Airlines, in the aggregate, should receive about 80 percent of their accrued benefits. But the United workers and retirees still stand to lose more than $3 billion in promised benefits. And, some participants, or their survivors, may see benefits reduced by half or more because of statutory limits.

In addition to the losses by workers and retirees from terminations of underfunded pension plans, the single-employer insurance program is itself now in jeopardy. With more than $40 billion in assets, PBGC can continue paying benefits for a number of years. But with more than $60 billion in liabilities, PBGC will be unable to meet its long-term commitments without additional revenues beyond those mandated by current law.

The PBGC reported a $23.3 billion deficit in the single-employer insurance program at the end of the past fiscal year, and without needed changes in law as recommended by the Administration, the hole could get much deeper. Last year, we reported that the universe of PBGC-insured single-employer pension plans is underfunded by more than $450 billion, with almost $100 billion of that shortfall in plans sponsored by financially weak companies. Future losses in the system will depend on numerous variables which are inherently uncertain, e.g., ups and downs in the business cycle, changes in law, volatility of raw material prices,

changes in equity prices, and changes in interest rates. But there are several useful methodologies for analyzing and pricing the risks to the pension insurance program. As discussed more fully later in my testimony, one tool used by PBGC is a stochastic model that provides a range of possible outcomes depending on different economic scenarios. The options pricing model used by the Congressional Budget Office, which adjusts for market risk, yields an expected total cost of $71 billion to PBGC over the next ten years. Finally, an independent think tank uses a deterministic cash flow model to project that with no changes to current law, a capital infusion of $78 billion in today's dollars would be necessary to ensure PBGC can make all required benefit payments.

Regardless of the methodology used, there are indications that the risks to the pension insurance program are growing. The most recent source of information on the financial status of pension plans comes from "4010 reports" that are required to be filed by companies with pension plans underfunded by more than $50 million. The filing deadline for most companies is April 15, and PBGC has now aggregated the information from those reports. While the number of companies required to file such reports grew only modestly, the amount of underfunding reported by the 4010 filers grew by 27 percent as compared to a year ago - from $279 billion to $354 billion. These 1,108 plans covering 15 million workers and retirees had $787 billion in assets to cover over $1.14 trillion in liabilities, for an average funded ratio of 69 percent.

Moreover, PBGC currently has approximately 350 active bankruptcy cases, a record for the agency, 36 of which have been opened in the past four months. Of the open cases, 37 have underfunding claims of $100 million or more, including six in excess of $500 million.

The growing financial challenges facing certain companies and industry sectors are a subject of almost daily coverage in the nation's newspapers. In addition to the $10 billion in recorded claims against the insurance program from United and US Airways, the other carriers in the airline industry could present further claims of billions of dollars. Delta has publicly warned that the company may have to consider bankruptcy. If it does, it may follow United and US Airways and seek to terminate its defined benefit pension plans.

The pension insurance program also faces substantial exposure from other industries, the largest of which is the automotive sector. Assets of pension plans sponsored by this industry fall short of pension promises by $55-$60 billion. Credit rating agencies in May downgraded the debt of General Motors and Ford to below investment-grade status. While the manufacturers have substantial liquidity, their financial problems may cascade down to other companies in the automotive industry. For example, some auto supply firms have had their credit

lines restricted because of the downgrades in the debt ratings of General Motors and Ford. At least a dozen auto suppliers' credit ratings have been downgraded to below investment-grade status. More significantly, half a dozen automotive parts suppliers have filed for bankruptcy in recent months. These bankrupt companies sponsor defined benefit plans with more than $800 million in unfunded pension obligations that would become a loss to the pension insurance system should those companies' plans terminate during their bankruptcies.

Meanwhile, PBGC's premium revenues are not keeping pace with the exposure to the single-employer insurance program. PBGC's flat-rate premium of $19 per participant brings in only about $600 million each year. The variable-rate premium (VRP) of $9 per $1,000 of unfunded vested benefits has averaged only about $300 million per year over the past decade. In 2004, because of increased underfunding, revenue from the VRP grew to about $900 million, bringing PBGC's total premium revenues to almost $1.5 billion. Not only do premiums not cover expected claims, they provide nothing toward eliminating the existing $23 billion deficit.

Comprehensive reform is needed, and it is needed promptly. The Administration's reform package includes the changes needed. It would revise minimum funding rules to ensure that companies pay for the benefits they promise. It would redesign premiums to eliminate the $23 billion deficit over time, cover future expected claims, and allocate premium costs more equitably. It would also improve disclosure to workers, investors, and regulators about the funding status of plans.

To reiterate, the PBGC receives no taxpayer monies and its obligations are not backed by the full faith and credit of the United States government. Under current law, premium payers are responsible for providing the revenues to the insurance programs sufficient to cover the obligations that PBGC has assumed from terminated plans. If premiums are not sufficient to cover past or future losses, then Congress will have to address the question of who pays. When PBGC runs out of money, should participants in terminated plans expect to stop receiving benefit checks? Or, will pressure build to ask the taxpayer to restore the insurance program to solvency?

The remainder of my testimony addresses in detail:

- the state of the defined benefit system,
- the flaws in current law, and
- the Administration's reform proposal.

State of the Defined Benefit System

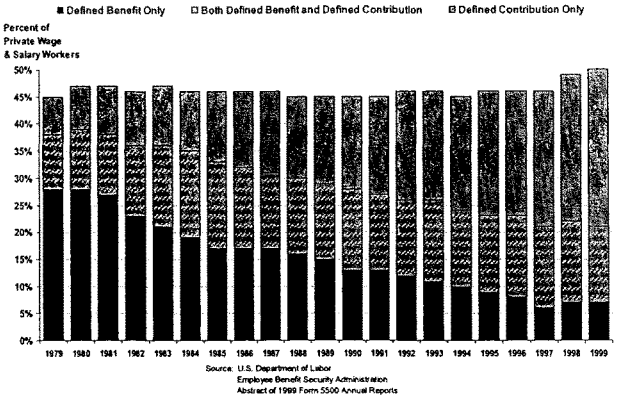
Private-sector defined benefit plans have been and are intended to be a source of stable retirement income for more than 44 million American workers and retirees. Unfortunately, as I discuss more fully below, the defined benefit system is under severe stress - the number of defined benefit plans has fallen precipitously over the past two decades, the percentage of the workforce covered by such plans has dropped by half, and, in many cases, benefits are being frozen or the plans are being closed to new participants.

More ominously, there have been a growing number of instances in which plans have been terminated by their sponsors with assets far insufficient to pay the promised benefits. This results in lost benefits for a number of participants in those plans, threatens the long term financial solvency of the insurance program, requires sponsors that have acted responsibly to pay higher premiums, and potentially could lead to a call for a rescue of the program with taxpayer funds. I would emphasize that this has occurred under the current statutory and regulatory framework. In order to stop the hemorrhaging in the system, to put the insurance program on a sound financial footing, and to best protect the benefits of millions of workers and retirees, the Administration believes that comprehensive pension reform is critically needed. If we do nothing or merely tinker at the margins the inevitable outcome will be a continued erosion of this important component of retirement security and continued large losses for participants, premium payers and potentially taxpayers.

Fortunately, not all of that underfunding is in plans sponsored by weak companies. Still, PBGC estimates that non-investment grade companies sponsored pension plans with combined underfunding of $96 billion, almost three times as large as the amount recorded at the end of fiscal year 2002. We anticipate that this number will increase significantly by the end of fiscal year 2005 due to growing underfunding in financially weak companies.

Traditional defined benefit pension plans, based on years of service and either final salary or a flat-dollar benefit formula, provide a stable source of retirement income to supplement Social Security. The number of private sector defined benefit plans reached a peak of 112,000 in the mid-1980s. At that time, about one-third of American workers were covered by defined benefit plans.

Pension Participation Rates 1979 - 1999



In recent years, many employers have chosen not to adopt defined benefit plans, and others have chosen to terminate or freeze their existing defined benefit plans. From 1986 to 2004, 101,000 single-employer plans with about 7.5 million participants terminated. In about 99,000 of these terminations the plans had enough assets to purchase annuities in the private sector to cover all benefits earned by workers and retirees. In the remaining 2,000 cases, companies with underfunded plans shifted their pension liabilities to the PBGC.

Of the roughly 30,000 defined benefit plans that exist today, many are in our oldest, most mature industries. These industries face growing benefit costs due to an increasing number of retired workers. Some of these sponsors also face challenges due to structural changes in their industries and growing competition from both domestic and foreign companies.

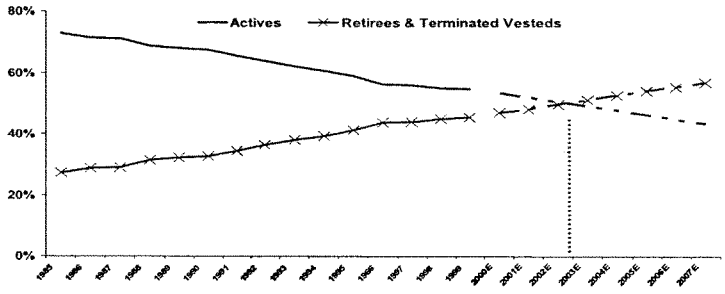
In contrast to the dramatic reduction in the total number of plans, the total number of participants in PBGC-insured single-employer plans has increased. In 1980, there were about 28 million covered participants, and by 2004 this number had increased to about 35 million. But these numbers mask the downward trend in the defined benefit system because they include not only active workers but also retirees, surviving spouses, and separated vested participants.

The latter three categories reflect past coverage patterns in defined benefit plans. A better forward-looking measure is the trend in the number of active participants, who continue to accrue benefits. That trend is moving downward.

In 1985, there were about 22 million active participants in single-employer defined benefit plans. By 2002, the number had declined to 17 million. At the same time, the number of inactive participants has been growing. In 1985, inactive participants accounted for only 28 percent of total participants in single-employer defined benefit plans, a number that has grown to about 50 percent today.

In a fully advance-funded pension system, demographics wouldn't matter. But when $450 billion of underfunding must be spread over a declining base of active workers, the challenges become apparent.

Participants in Defined Benefit Pension Plans
[1985 - 2007est.]



Source: U.S. Department of Labor
Pension and Welfare Benefits Administration
Abstract of 1999 Form 5500 Annual Reports Spring 2004

The decline in the number of plans offered and workers covered doesn't tell the whole story of how changes in the defined benefit system are impacting retirement income security. There are other significant factors that can undermine the goal of a stable income stream for aging workers.

For example, in lieu of outright termination, companies are increasingly "freezing" their plans. Surveys by pension consulting firms show that a significant number of their clients have frozen their plans or are considering instituting some form of plan freeze.[1] Freezes not only eliminate workers' ability

[1] See, e.g., Aon Consulting, *More Than 20% of Surveyed Plan Sponsors Froze Plan Benefits or Will Do So*, Oct. 2003; Hewitt Associates, *Survey Findings: Current Retirement Plan Challenges: Employer Perspectives* (Dec. 2003).

to earn additional pension benefits but often serve as a precursor to plan termination, which further erodes the premium base of the pension insurance program. [2]

Given the increasing mobility of the labor force, and the desire of workers to have portable pension benefits that do not lock them into a single employer, many companies have developed alternative benefit structures, such as cash balance or pension equity plans that are designed to meet these interests. The PBGC estimates that these types of hybrid structures now cover 25 percent of participants in defined benefit plans.[3] Unfortunately, the legal status of these types of plans is in question, further threatening the retirement security of millions of workers and retirees.[4]

The Roll of the PBGC

The Pension Benefit Guaranty Corporation (PBGC) was established by the Employee Retirement Income Security Act of 1974 (ERISA) to guarantee private-sector, defined benefit pension plans. Indeed, the Corporation's two separate insurance programs—for single-employer plans and multiemployer plans—are the lone backstop for hundreds of billions of dollars in promised but unfunded pension benefits. The PBGC is also the trustee of nearly 3,500 defined benefit plans that have failed since 1974. In this role, it is a vital source of retirement income and security for more than 1 million Americans who would have lost benefits without PBGC's protection, but who currently are receiving or are promised benefits from the Corporation.

PBGC is one of the three so-called "ERISA agencies" with jurisdiction over private pension plans. The other two agencies are the Department of the Treasury (including the Internal Revenue Service) and the Department of Labor's Employee Benefits Security Administration (EBSA). Treasury and EBSA deal with both defined benefit plans and defined contribution benefit plans, including 401(k) plans. PBGC guarantees benefits of defined benefit plans only and serves as trustee for underfunded defined benefit plans that terminate. PBGC is also charged with administering and enforcing compliance with the provisions of

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[2] Some of the trends in the defined benefit system are captured in a PBGC publication issued less than two weeks ago, the *Pension Insurance Data Book* 2004 (available at www.pbgc.gov). The *Data Book* shows that since PBGC's inception in 1974, 68 percent of its losses were incurred in the five years from 2000 through 2004. As a result of all these recent terminations, PBGC's annual benefit payments have almost tripled, from a little over $1 billion in 2001 to $3 billion in 2004.

[3] Table S-35, PBGC Pension Insurance Data Book 2004 (April 2005).

[4] *Cooper v. IBM Personal Pension Plan*, 274 F. Supp. 2d 1010 (S.D. Ill. 2003) (holding that cash balance plans violate age discrimination provisions of ERISA). Other courts, however, have disagreed. *Tootle v. ARINC, Inc.*, 222 F.R.D. 88 (D. Md. 2004); *Eaton v. Onan Corp.*, 117 F. Supp. 2d 812 (S.D. Ind. 2000).

Title IV of ERISA, including monitoring of standard terminations of fully funded plans.

PBGC is a wholly-owned federal government corporation with a three-member Board of Directors – the Secretary of Labor, who is the Chair, and the Secretaries of Commerce and Treasury.

Although PBGC is a government corporation, it receives no funds from general tax revenues and its obligations are not backed by the full faith and credit of the U.S. government. Operations are financed by insurance premiums, assets from pension plans trusteed by PBGC, investment income, and recoveries from the companies formerly responsible for the trusteed plans (generally only pennies on the dollar). The annual insurance premium for single-employer plans has two parts: a flat-rate charge of $19 per participant, and a variable-rate premium of 0.9 percent of the amount of a plan's unfunded vested benefits, measured on a "current liability"[5] basis.

The PBGC's statutory mandates are: (1) to encourage the continuation and maintenance of voluntary private pension plans for the benefit of participants; (2) to provide for the timely and uninterrupted payment of pension benefits to participants; and (3) to maintain premiums at the lowest level consistent with carrying out the agency's statutory obligations. In addition, implicit in these duties and in the structure of the insurance program is the duty to be self-financing. *See, e.g.*, ERISA § 4002(g)(2) (the United States is not liable for PBGC's debts).

These mandates are not always easy to reconcile. For example, the PBGC is instructed to keep premiums as low as possible to encourage the continuation of pension plans, but also to remain self-financing with no recourse to general tax revenue. Similarly, the program should be administered to protect plan participants, but without letting the insurance fund suffer unreasonable increases in liability, which can pit the interests of participants in a particular plan against the interests of those in all plans the PBGC must insure. The PBGC strives to achieve the appropriate balance among these competing considerations, but it is inevitably the case that one set of stakeholder interests is adversely affected whenever the PBGC takes action. This conflict is most apparent when PBGC determines that it must involuntarily terminate a pension plan to protect the interests of the insurance program as a whole and the 44 million participants we cover, even though such an action may adversely impact participants in the plan being terminated.

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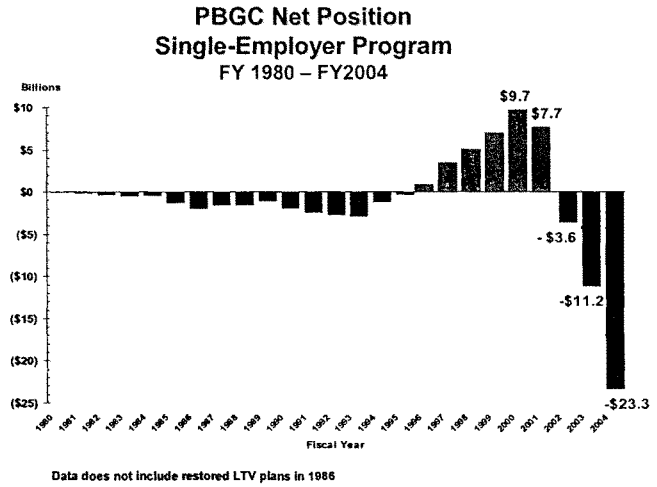
[5] Current liability is a measure with no obvious relationship to the amount of money needed to pay all benefit liabilities if a plan terminates.

The pension insurance programs administered by the PBGC have come under severe pressure in recent years due to an unprecedented wave of pension plan terminations with substantial levels of underfunding. This was starkly evident in 2004, as the PBGC's single-employer insurance program posted its largest year-end shortfall in the agency's 30-year history. Losses from completed and probable pension plan terminations totaled $14.7 billion for the year, and the program ended the year with a deficit of $23.3 billion. That is why the Government Accountability Office has once again placed the PBGC's single employer insurance program on its list of "high risk" government programs in need of urgent attention.



Notwithstanding our record deficit, I want to make clear that the PBGC has sufficient assets on hand to continue paying benefits for a number of years. However, with $62 billion in liabilities and only $39 billion in assets as of the end of the past fiscal year, the single-employer program lacks the resources to fully satisfy its benefit obligations.

The most recent snapshot taken by the PBGC finds that corporate America's single-employer pension promises are underfunded by more than $450 billion. Almost $100 billion of this underfunding is in pension plans sponsored by companies that face their own financial difficulties, and where there is a heightened risk of plan termination.

Of course, when the PBGC is forced to take over underfunded pension plans, we will provide the pension benefits earned by workers and retirees up to the maximum amounts established by Congress. Unfortunately, notwithstanding the guarantee provided by the PBGC, when plans terminate many workers and retirees are confronted with the fact that they may not receive all the benefits they have been promised by their employer, and upon which they have staked their retirement security.

Three statutory limitations constrain the level of PBGC's guaranteed benefits: the maximum insurance limitation, the phase-in limitation, and the accrued-at-normal limitation. The first limitation places a dollar limit on the size of the monthly benefit PBGC will guarantee. The second limits the amount of recent benefit enhancements PBGC will pay. The third ensures that the monthly benefit that PBGC pays will be no greater that the monthly single life annuity benefit payable at the plan's normal retirement age.

For example, the maximum benefit payable for plans that terminate in 2005 is $45,614 annually payable as a single life annuity beginning at age 65, and benefit increases arising from plan amendments in the five years immediately preceding plan termination are phased in at the rate of 20 percent per year. The amount guaranteed is actuarially adjusted for the participant's age and for a survivor benefit. Generally, PBGC guarantees early retirement benefits and supplemental benefits to the extent that total benefits do not exceed the single life annuity benefit at normal retirement age.

The PBGC pays most people all of their promised benefits, but some people lose benefits that are not guaranteed. In an increasing number of cases, participants lose benefits that were earned but not guaranteed because of these legal limits on what the pension insurance program can pay. It is not unheard of for participants to lose two-thirds of their promised monthly benefit.

For example, a steelworker in the Bethlehem Steel plan, like many other steelworkers, started working just before his 20th birthday. He worked until he was 50 years old and retired, like many other steelworkers, under his plan's 30-and-out provision with a $3,600 per month pension. About 6 months later, the PBGC trusteed the Bethlehem Steel plan. Although the maximum monthly benefit for plans terminating in 2003 was about $3,600, we are required by law to reduce the maximum benefit for workers who start receiving their pension benefits before age 65. As a result, this worker's benefits were cut by two-thirds to about $1,200 per month.

Other companies that sponsor defined benefit plans also pay a price when underfunded plans terminate. Because the PBGC receives no federal tax dollars and its obligations are not backed by the full faith and credit of the United States, losses suffered by the insurance fund must ultimately be covered by higher premiums. Not only will healthy companies that are responsibly meeting their benefit obligations end up making transfer payments to weak companies with chronically underfunded pension plans, they may also face the prospect of having to compete against a rival firm that has shifted a significant portion of its labor costs onto the government.

In the worst case, PBGC's deficit could grow so large that the premium increase necessary to close the gap would be unbearable to responsible premium payers.[6] If this were to occur, there undoubtedly would be pressure on Congress to call upon U.S. taxpayers to pay the guaranteed benefits of retirees and workers whose plans have failed.

If we want to protect participants, premium payers and taxpayers, we must ensure that pension plans are adequately funded over a reasonable period of time. As I will discuss in more detail, the status quo statutory regime is inadequate to accomplish that goal. We need comprehensive reform of the rules governing defined benefit plans to protect the system's stakeholders.

Mounting Pressures on the Pension Safety Net

These broad defined benefit trends, and financial market and business cycles, combined with flawed funding rules, have translated into severe financial pressures on the pension insurance program. In addition to the $23 billion shortfall already reflected on the PBGC's balance sheet, the insurance program remains exposed to record levels of underfunding in covered defined benefit plans. As recently as December 31, 2000, total underfunding in the single-employer defined benefit system came to less than $50 billion. Two years later, as a result of a combination of factors, including declining interest rates and equity values, ongoing benefit payment obligations and accrual of liabilities, and minimal cash contributions into plans, total underfunding exceeded $400 billion.[7] As of September 30, 2004, we estimate that total underfunding exceeds $450 billion, the largest number ever recorded.

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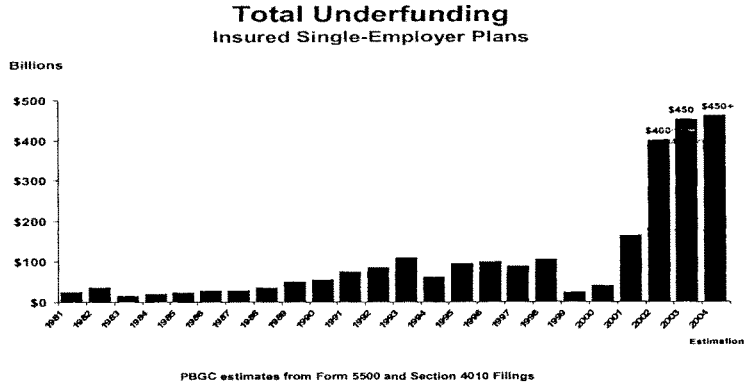
[6] See page 3, *Pension Tension*, Morgan Stanley, Aug. 27, 2004. "[I]n today's environment healthy sponsors may well decide that they don't want to foot the bill for weak plans' mistakes through increased pension insurance premiums."

[7] See page 14, *The Magic of Pension Accounting, Part III*, David Zion and Bill Carcache, Credit Suisse First Boston (Feb. 4, 2005). "[F]rom 1999 to 2003 the pension plan assets grew by $10 billion, a compound annual growth rate of less than 1%, while the pension obligations grew by $430 billion, a compound annual growth rate of roughly 10%." See also page 2, *Pension Tension*, Morgan Stanley (Aug. 27, 2004). "DB sponsors were lulled into complacency by inappropriate



Not all of this underfunding poses a major risk to participants and the pension insurance program. Indeed, the vast majority of companies that sponsor defined benefit plans are financially healthy and should be capable of meeting their pension obligations to their workers. At the same time, the amount of underfunding in pension plans sponsored by financially weaker employers has never been higher. As of the end of fiscal year 2004, the PBGC estimated that non-investment-grade companies sponsored pension plans with $96 billion in underfunding, almost three times as large as the amount recorded at the end of fiscal year 2002.

The losses incurred by the pension insurance program to date have been heavily concentrated in the steel and airline industries. These two industries, however, have not been the only source of claims, nor are they the only industries posing future risk of losses to the program.

The PBGC's best estimate of the total underfunding in plans sponsored by companies with below-investment-grade credit ratings and classified by the PBGC as "reasonably possible" of termination is $96 billion at the end of fiscal 2004, up from $35 billion just two years earlier. The current exposure spans a range of industries, from manufacturing, transportation and communications to utilities and wholesale and retail trade. Some of the largest claims in the history of the pension insurance program involved companies in supposedly safe industries such as insurance ($529 million claim for the parent of Kemper Insurance) and technology ($324 million claim for Polaroid).

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and opaque accounting rules, misleading advice from their actuaries causing unrealistic return and mortality assumptions, and mismatched funding of the liabilities, and the two decades of bull equity markets through the 1990s veiled true funding needs."

Reasonably Possible Exposure

(Dollars in Billions)

Principal Industry Categories	FY 2003	FY 2004
Manufacturing	$ 39.5	$ 48.4
Transportation, Communication & Utilities	32.9	30.5
Services & Other	2.5	7.9
Wholesale and Retail Trade	4.3	5.8
Agriculture, Mining & Construction	1.8	1.9
Finance, Insurance & Real Estate	1.1	1.2
Total	$82.1	$95.7

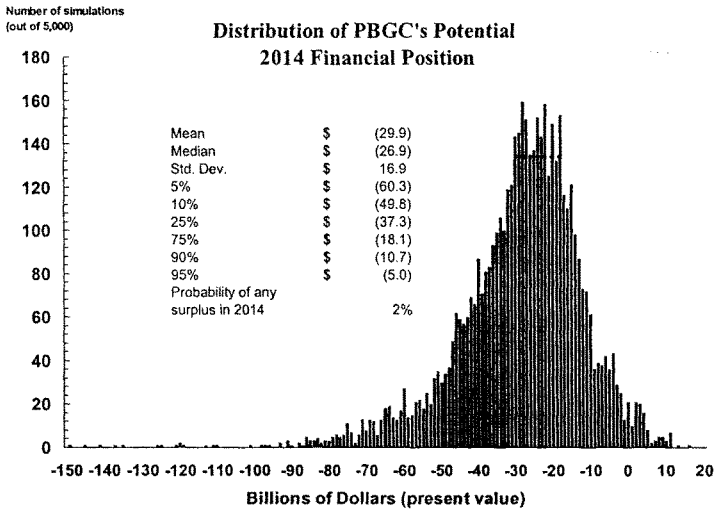
No single underfunding number or range of numbers is sufficient to evaluate PBGC's exposure and expected claims over the next 10 years. There is too much uncertainty about the future, both with respect to the performance of the economy and the performance of the companies that sponsor insured pension plans. PBGC uses a stochastic model – the Pension Insurance Modeling System (PIMS) – to evaluate its exposure and expected claims.

PIMS portrays future underfunding under current funding rules as a function of a variety of economic parameters. The model simulates the flows of claims that could develop under thousands of combinations of economic parameters and bankruptcy rates.

Under the model, median claims over the next 10 years will be about $1.7 billion per year (expressed in today's dollars); that is, half of the simulations show claims above $1.7 billion per year and half below. The mean level of claims (that is, the average claim) is higher, about $2.0 billion per year. The mean is higher because there is a chance under some simulations that claims could reach very high levels.

PIMS then projects PBGC's potential financial position by combining simulated claims with simulated premiums, expenses, and investment returns. The mean outcome in present value terms is a $29.9 billion deficit in 2014.

The graph below illustrates the wide range of outcomes that are possible for PBGC over the next 10 years. For example, the model shows a 10 percent chance that the deficit could be as large as $49.8 billion and a 10 percent chance that PBGC could have a deficit of $10.7 billion or less. The probability of a surplus of any amount in 2014 is 2 percent. However, it should be noted that this model may understate possible losses to the system given that it doesn't capture behavioral catalysts - such as the competitive pressures on the legacy airlines to terminate their pension plans to respond to the United Airlines and US Airways actions.



Some have argued that current pension problems are cyclical and will disappear once equity returns and interest rates revert to historical norms. Perhaps this will happen, perhaps not. The simple truth is that we cannot predict the future path of either equity values or interest rates. It is not reasonable public policy to base pension funding on the expectation that the unprecedented stock market gains of the 1990s will repeat themselves. Similarly, it is not reasonable public policy to base pension funding on the expectation that interest rates will increase dramatically.[8] The consensus forecast predicted that long-term interest rates

[8] See page 1, *Pension Update: Treading Water Against Currents of Change*, James F. Moore, PIMCO (Feb. 2005). "Unfortunately things are likely to get worse before they get better. . . As of the

would have risen sharply by now, yet they remain near 40-year lows.[9] And a recent analysis by the investment management firm PIMCO finds that the interest-rate exposure of defined benefit plans is at an all-time high, with more than 90 percent of the exposure unhedged.[10]

More important, while rising equity values and interest rates would certainly reduce the amount of current underfunding, this would not address the underlying structural flaws in the pension insurance system.

Flaws In Current Law

Unfortunately, the current problems in the system are not transitory, nor can they be dismissed as simply the result of restructuring in a few industries. They are the result of fundamental flaws in the statutory and regulatory framework governing defined benefit plans and the pension insurance program. If we want to retain defined benefit plans as a viable option for employers and employees and avoid insolvency of the insurance program, fundamental changes are needed.

The defined benefit pension system is beset with structural flaws that undermine benefit security for workers and retirees and leave premium payers and taxpayers at risk of inheriting the unfunded pension promises of failed companies.

The first structural flaw is a set of funding rules that are needlessly complex and fail to ensure that pension plans are adequately funded. Some companies that have complied with all of the statutory funding requirements have still ended up with plans that are less than 50 percent funded when they terminated.

A second structural flaw is what economists refer to as "moral hazard." Unlike most private insurers, the PBGC cannot apply traditional risk-based insurance and premium methods.

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beginning of February, the Moody's AA long term corporate index was below 5.50% and 30-year Treasuries were below 4.5%."

[9] Long-term rates have declined in Japan and Europe – to 2.5 percent and 4.0 percent, respectively – two economies facing the same structural and demographic challenges as the United States. See page 1, *Pension Update: Treading Water Against Currents of Change*, James F. Moore, PIMCO (Feb. 2005).

[10] See page 1, *Defined Benefit Pension Plans' Interest Rate Exposure at Record High*, Seth Ruthen, PIMCO (Feb. 2005).

A third flaw is the lack of information available to stakeholders in the system. The funding and disclosure rules seem intended to obfuscate economic reality. The PBGC's record deficit and the historic levels of pension underfunding underscore these structural defects - flaws that must be corrected to better protect workers' benefits, responsible plan sponsors from further premium increases, and taxpayers from being called upon to rescue the pension insurance program.

Weaknesses in Current Funding Rules

The current defined benefit pension funding rules, which micromanage annual cash flows to the pension fund, are in need of a complete overhaul. Current rules are needlessly complex, don't reflect economic reality, and don't ensure that plans become well funded. Some of the pressing problems with the funding rules are described below.

- Current measures of liabilities and assets are not accurate and meaningful.

  - The original ERISA funding targets were set too low and can be manipulated. Under current funding rules, there is no uniformity in liability measures. In addition, a plan actuary has substantial discretion in selecting actuarial assumptions that are used to determine liabilities. For example, the actuary must assume an interest rate that reflects future investment earnings on plan assets; an actuary will commonly assume the high rate of return that is anticipated from investments in equities. As a result, companies can report that their pension plans are fully funded when in fact they are substantially underfunded using a more meaningful and accurate measure of liability. In a study released last week, GAO found that from 1995 to 2002, because of this actuarial discretion, underfunding may actually have been more severe and widespread than reported. [11]

  - The later deficit reduction contribution rules are also ineffective. The deficit reduction contribution rules, adopted in 1987, override the minimum funding requirements for many underfunded plans and require accelerated contributions to plans. These rules are based on "current liability," which is a somewhat more standardized measure of liability. It is a measure with no obvious relationship to the amount of money needed to pay all benefit liabilities if the plan terminates. Employers can avoid having to make deficit reduction contributions by maintaining plan funding at 90 percent of current liability.

[11] United States General Accountability Office, "Recent Experiences of Large Defined Benefit Plans Illustrate Weaknesses in Funding Rules" GAO-05-294, p. 15 (May 2005).

The interest rate used in determining current liability can be selected from a corridor that is based on an average of interest rates over the prior 48 months, and thus can be significantly out-of-date during periods of rapidly changing interest rates. In addition, the current liability is measured using a long-term interest rate that does not take into account the actual timing of when benefit payments will be due under the plan, which often is considerably sooner.

- Risk of plan termination is not recognized in funding. The same funding rules apply regardless of a company's financial health. PBGC studied 41 of its largest claims that represented 67 percent of total gross claims. Over 90 percent of these largest claims against the insurance system were from plans sponsored by companies that had junk-bond credit ratings for 10 years prior to termination. Yet current funding targets do not reflect the substantial risk of termination and losses to plan participants and the pension insurance system posed by financially weak employers. As the recent GAO report notes, speculatively rated sponsors represent greater risks to the PBGC. Plan sponsors that are in financial distress may have a more limited time horizon and place other financial priorities above funding their pension plans. [12]

- Asset values are smoothed. Current funding rules permit the use of an actuarial value of plan assets, which is determined under a formula that "smooths" fluctuations in the market value of assets by averaging the value over a number of years. These smoothing mechanisms were created in an attempt to reduce the year-to-year fluctuations of plan contribution requirements. Masking current market conditions is an imprudent and unnecessary way to avoid volatility in funding contributions, it obscures the funded status of a plan, and it distorts the risks posed to participants and shareholders. The recent GAO report notes that, by smoothing annual contributions and liabilities, a plan's reported level of funding may be distorted. [13]

- Underfunded plans have too long to make up shortfalls and employers can take funding holidays without regard to a plan's funding level.

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[12] United States General Accountability Office, "Recent Experiences of Large Defined Benefit Plans Illustrate Weaknesses in Funding Rules" GAO-05-294, p. 4 (May 2005).

[13] United States General Accountability Office, "Recent Experiences of Large Defined Benefit Plans Illustrate Weaknesses in Funding Rules" GAO-05-294, p.22 (May 2005).

- Amortization periods are long. The current law 30-year amortization period for plan amendments is too long given the default risk for many plan sponsors. Furthermore, collectively bargained plans often increase benefits every few years and as a result are perennially underfunded. The deficit reduction contribution override - with amortization periods from four to seven years - was designed to address this problem, but its effectiveness has been limited.

- Funding rules allow companies with unfunded pension liabilities to take funding holidays or reduce their required contributions. Under current law, companies can build up a "credit balance," for example, by contributing more than the minimum required amount or by favorable investment performance of pension assets. They can then treat the credit balance as an offset to the minimum funding requirement for the current year. This allows a plan to take a contribution holiday without regard to whether the additional contributions have earned the assumed rate of interest or have instead lost money in a down market, and regardless of the current funded status of the plan.

- The result is that some sponsors are able to avoid making any contributions to plans that may be hundreds of millions or even billions of dollars underfunded. According to the recent GAO study, from 1995 to 2002 on average 62 percent of the 100 largest plans each year received no cash contributions, including 41 percent of plans that were underfunded. [14] Bethlehem Steel made no contributions to its plan for the three years immediately preceding plan termination. US Airways made no contributions for the four years immediately before terminating.

- Maximum deductible contributions are set too low.

  The current funding rules prohibit tax-deductible contributions whenever the plan's assets exceed the greater of the plan's accrued liability and the plan's current liability. In some cases, a plan sponsor may be in the position of being unable to make deductible contributions in one year and then being subject to accelerated deficit reduction contributions in a subsequent year. As a result, a sponsor's

[14] United States General Accountability Office, "Recent Experiences of Large Defined Benefit Plans Illustrate Weaknesses in Funding Rules" GAO-05-294, p. 11 (May 2005).

ability to build up an adequate surplus in good economic times to provide a cushion for bad times is constrained.

- Underfunded plans are allowed to increase benefits.

  Under current funding rules, sponsors of badly underfunded plans can continue to provide for additional accruals and, in many situations, even make benefit improvements. Restrictions apply only if the actuarial value of a plan's assets would be less than 60 percent of current liability after a plan amendment increasing benefits; in that case, the employer is required to post security in the amount by which the assets are less than 60 percent, but only to the extent this amount exceeds $10 million. Plan sponsors in financial trouble have an incentive to promise generous pension benefits, rather than increase current wages, and employees may go along because of the PBGC guarantee. This increases the likelihood of losses for participants and the PBGC. Plan assets are depleted when seriously underfunded plans allow retiring employees to elect lump sums and similar accelerated benefits.

Several failed pension plans provide cases in point for the structural defects in the current funding rules. Bethlehem Steel's plan was 84 percent funded on a current liability basis, but turned out to be only 45 percent funded on a termination basis, with a total shortfall of $4.3 billion. Despite these funding levels, for a number of years prior to termination, Bethlehem Steel was not required to make a deficit reduction contribution, and for the three years immediately preceding termination it relied on credit balances to avoid making contributions.

Bethlehem Steel

Termination Benefit Liability Funded Ratio 45%

Unfunded Benefit Liabilities $4.3 billion

	1996	1997	1998	1999	2000	2001	2002
Current Liability Ratio	78%	91%	99%	96%	86%	84%	NR
Was the company required to make a deficit reduction contribution?	Y	N	N	N	N	NR	NR
Was the company obligated to send out a participant notice?	Y	Y	N	N	N	N	N
Did the company pay a Variable Rate Premium?	$15 million	$17 million	N	N	N	N	N
Actual Contributions	$354 million	$32.3 million	$30.9 million	$ 8.1 million	$0	$0	$0
Debt Rating	B+	B+	BB-	BB-	B+	D	Withdrawn

US Airways' pilots' plan was 94% funded on a current liability basis, but the plan was only 33 percent funded on a termination basis, with a $2.5 billion shortfall. Similarly, US Airways was not subject to a deficit reduction contribution for six years leading up to the year of termination and relied on credit balances to avoid making any contributions for the four years immediately before terminating.

Moral Hazard

A second structural weakness in the current defined benefit system is that there is little to prevent financially weak employers from creating unfunded pension costs that they can shift to the insurance system if the company fails. This is what economists call "moral hazard."

A fundamental principle of insurance design is to eliminate or minimize moral hazard. That is why banks have risk-based capital standards, drivers with poor driving records face higher premiums, smokers pay more for life insurance than non-smokers, and homeowners with smoke detectors get lower rates than those without.

The current insurance program is replete with moral hazards. Benefits can be increased as long as the plan is at least 60 percent funded, regardless of the financial capacity of the company. Management and workers in financially troubled companies may agree to increase pensions in lieu of wage increases. For a company, the cost of wage increases is immediate, while the cost of new pension benefits is spread out over 30 years. In addition, labor may choose to bargain for wages or other benefits rather than for full funding of a plan because

of the federal backstop.[15] If the company recovers, it may be able to afford the increased benefits. If not, the costs of the insured portion of the increased benefits are shifted to other companies through the insurance fund.

Similarly, a company with an underfunded plan may increase asset risk to try to make up the gap, with much of the upside gain benefiting shareholders (but not necessarily participants) and much of the downside risk being shifted to other premium payers. In the recent report, GAO notes that moral hazard from the presence of PBGC insurance may cause financially troubled sponsors to alter their funding behavior, which would increase PBGC's exposure. [16]

The standard insurance industry safeguards against moral hazard are risk-based underwriting and risk-based premiums. These safeguards are absent from the pension insurance program. Unlike most private insurers, the PBGC cannot apply traditional risk-based insurance underwriting methods. It cannot turn away bad risks and it cannot charge more for them. As a result, there has been a tremendous amount of cost shifting from financially troubled companies with underfunded plans to healthy companies with well-funded plans.

Consider: Bethlehem Steel presented a claim of $3.7 billion after having paid only $60 million in premiums over the 10-year period 1994 to 2003, despite the fact that the company was a deteriorating credit risk and its plans were substantially underfunded for several years prior to the time the PBGC had to step in. Similarly, while United Air Line's credit rating has been junk bond status and its pensions underfunded by more than $5 billion on a termination basis since at least 2000, it has paid just $75 million in premiums to the insurance program over the 10-year period 1995 to 2004. Yet the termination of United's plans would result in a claim on the fund of roughly $6.6 billion.

Lack of Transparency

A third structural weakness is that the current funding and disclosure rules shield relevant information regarding the funding status of plans from participants, investors and even regulators. This results from the combination of stale, contradictory, and often misleading information required under ERISA. For example, the principal governmental source of information about the 30,000 private-sector single-employer defined benefit plans is the Form 5500. Because ERISA provides for a significant lapse of time between the end of a plan year and the time when the Form 5500 must be filed, when PBGC

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[15] See page 3, *The Most Glorious Story of Failure in the Business*, James A. Wooten, 49 Buffalo Law Rev. 683 (Spring/Summer 2001). "Termination insurance would shift default risk away from union members and make it unnecessary for the UAW to bargain for full funding."

[16] United States General Accountability Office, "Recent Experiences of Large Defined Benefit Plans Illustrate Weaknesses in Funding Rules" GAO-05-294, p. 34 (May 2005).

receives the complete documents the information is typically two-and-a- half years old. It is exceedingly difficult to make informed business and policy decisions based on such dated information, given the dynamic and volatile nature of markets.

The PBGC receives more timely and relevant information regarding a limited number of underfunded plans that pose the greatest threat to the system, but the statute requires that this information not be made publicly available. This makes no sense. Basic data regarding the funded status of a pension plan, changes in assets and liabilities, and the amount that participants would stand to lose if an underfunded plan was terminated are vitally important to participants. Investors in companies that sponsor the plans also need relevant and timely information about the funded status of company pensions. More can and should be done to provide better information to regulatory bodies and the other stakeholders in the defined benefit system.

Congress added new requirements in 1994 expanding disclosure to participants in certain limited circumstances, but our experience tells us that these disclosures are not adequate. The notices to participants do not provide sufficient funding information to inform workers of the consequences of plan termination. Currently, only participants in plans below a certain funding threshold receive annual notices of the funding status of their plans, and the information provided does not reflect what the underfunding likely would be if the plan terminated. Workers in many of the plans we trustee are surprised when they learn that their plans are underfunded. They are also surprised to find that PBGC's guarantee does not cover certain benefits, including certain early retirement benefits.

The Administration's Reform Proposal

The Administration believes that comprehensive pension reform is needed to address the problems and challenges noted above. We have proposed several reforms to the single-employer defined benefit system that are intended to improve pension security for workers and retirees, stabilize the defined benefit system, and put the federal pension insurance program on a solid financial footing. The President's proposal has three primary elements:

- First, the funding rules must be reformed to ensure that plan sponsors adequately fund their plans and keep their pension promises.

- Second, premiums must be increased and made more risk-related, and protections must be provided against unreasonable losses due to sponsor bankruptcy and shutdown.

- Third, disclosure to workers, investors and regulators about pension plan status must be improved.

The Administration's Proposed Changes in Funding Rules
The President's solution to today's systemic pension underfunding begins with fundamental reform of the rules governing plan funding. The Administration proposal is designed both to simplify funding rules and to enhance pension plan participants' retirement security. The federal government has an interest in defining and enforcing minimum prudent funding levels, but many other funding, investment, and plan design decisions are best left to plan sponsors. Under this proposal, pension plans would be required to fund towards an economically meaningful funding target – a measure of the currently accrued pension obligations. Plans that fall below the minimum funding target would be required to fund up to the target within a reasonable period of time. Plans that fall significantly below the minimum acceptable funding level would also be subject to benefit restrictions.

(1) Meaningful and Accurate Measures of Liabilities and Assets
In order to encourage plan sponsors to manage volatility and to pre-fund benefits in good times, the Administration's proposal will use more accurate measures of plan assets and liabilities and base funding targets on the plan sponsor's financial health. Liabilities will be measured on an accrual basis using a single standard liability measurement concept. Within this single measure, a plan's accrued liability will reflect whether the plan is likely to remain ongoing or poses a risk of termination. "Ongoing liability" will be measured using assumptions that are appropriate for a financially healthy plan sponsor (investment-grade rated) while "at-risk liability" will be measured using assumptions that are appropriate for a less healthy plan sponsor (below-investment-grade rated) that is more likely to default on pension obligations in the short to medium term.

Ongoing liability is defined as the present value on the valuation date of all benefits that the sponsor is obligated to pay (salary projections are not taken into account in determining the level of accrued benefits). Expected benefit payments will be discounted using a corporate bond spot yield curve that will be published by the Treasury Department. Retirement assumptions will be developed using reasonable methodologies, based on the plan's or other relevant recent historical experience. Finally, unlike the current liability measure under current law, plans will be required to recognize expected lump sum payments in computing their liabilities.

At-risk liability measures liabilities that accrue as a plan heads towards termination because of the deteriorating financial health of the plan sponsor. At-risk liability includes the present value of accrued benefits under an ongoing plan, plus additional costs that arise when a plan terminates. These costs include acceleration in early retirements, increases in lump sum elections when available, and the administrative costs associated with terminating a plan.

Accuracy requires that the discount rates used in calculating the present value of a plan's benefit obligations satisfy two criteria: (i) they should reflect the timing of future payments, and (ii) they should be based on current market-determined interest rates for similar obligations. The corporate bond yield curve will reflect the timing of future payments by matching appropriate market interest rates to the time structure of a pension plan's projected cash flows. The Department of the Treasury will derive discount rates from a spot yield curve based on high grade (AA) corporate bond rates averaged over 90 business days. It recently published a white paper[17] detailing its methodology that is available on the Treasury Department web site.

Under the Administration's proposal, asset values used in determining minimum required and maximum allowable contributions will be based on market prices on the valuation date. No smoothed actuarial values of assets will be used, as they mask the true financial status of the pension plan.

(2) Funding Targets and Credit Ratings

Under the Administration's proposal, accrued liability (appropriately measured as described above) serves as a plan's funding target. Plans sponsored by financially healthy firms (investment-grade rated) will use 100 percent of ongoing liability as their funding target. Less healthy plan sponsors (below-investment-grade rated) will use 100 percent of at-risk liability as their funding target.

A sponsor is considered financially weak if the plan sponsor OR any significant member of the sponsor's controlled group has NO senior unsecured debt that is classified as investment grade by at least one of the nationally recognized rating agencies.

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[17] Creating a Corporate Bond Spot Yield Curve for Pension Discounting Department of the Treasury, Office of Economic Policy, White Paper, February 7, 2005.

(3) Funding Accrued Benefits

Under the proposal, if the market value of plan assets is less than the funding target for the year, the minimum required contribution for the year will equal the sum of the applicable normal cost for the year and the amortization payments for the shortfall. Amortization payments will be required in amounts that amortize the funding shortfall over a seven-year period. This will extend the amortization periods for many underfunded plans from as little as four years under the deficit reduction contribution, which will counteract the effect of other funding changes that may increase costs under the proposal.

The initial amortization base is established as of the valuation date for the first plan year and is equal to the excess, if any, of the funding target over the market value of assets as of the valuation date. The shortfall is amortized in seven annual level payments. For each subsequent plan year, if the sum of the market value of assets and the present value of the future amortization payments is less than the funding target, that shortfall is amortized over the following seven years. If the sum of the market value of assets and the present value of future amortization payments exceeds the funding target, no new amortization base is established for that year and the total amortization payment for the next year is the same as in the prior year. When, on a valuation date, the market value of the plan's assets equals or exceeds the funding target, the amortization charges will cease and all existing amortization bases will be eliminated.

(4) Increased Deductibility

The Administration-proposed reforms provide real and meaningful incentives for plans to adequately fund their accrued pension obligations. These new funding requirements are matched with new opportunities to pre-fund obligations on a tax-preferred basis. Pension sponsors believe that their inability, under current rules, to build sufficiently large funding surpluses during good financial times has contributed to current underfunding in the pension system. The Administration proposal addresses this problem directly by creating two funding cushions that, when added to the appropriate funding target, would determine the upper funding limit for tax-deductible contributions.

The first cushion allows funding to 130 percent of the funding target and is designed to allow firms to build a sufficient surplus so that plans do not become underfunded solely as a result of asset and liability value fluctuations that occur over a business cycle. A second funding cushion allows plan sponsors to pre-fund for salary and benefit increases. In addition, plans will always be able to deduct contributions that bring a plan's funding level up to at-risk liability.

(5) Credit Balances
The Administration proposal eliminates credit balances. Because credit balances currently are not marked to market and can be used by underfunded plan sponsors, they have in many cases resulted in plans having lengthy funding holidays, while becoming increasingly underfunded. Some companies have avoided making cash contributions for years through the use of credit balances, heedlessly ignoring the substantial contributions that may be required when the credit balances are used up.

(6) Benefit Restrictions
The Administration believes that companies should make only benefit promises they can afford, and keep the promises already made by appropriately funding their pension plans. When companies are unable to keep their pension promises, the losses are shifted to the pension insurance system and to workers. It is these hollow promises that harm workers by putting their retirement security at risk.

Under the reform proposal, plans with financially weak sponsors that are funded at a level less than or equal to 80 percent of their targets will be restricted from offering lump sums or increasing benefits. If funding is less than or equal to 60 percent of target liabilities, accruals will also stop and there will be no preferential funding of executive compensation. Plans with healthy sponsors will be restricted from increasing benefits if they are funded at a level less than or equal to 80 percent of their funding target and from offering lump sums if they are at a level less than or equal to 60 percent of their funding target. Underfunded plans with sponsors in bankruptcy will also be subject to benefit limits.

These proposals will create a strong incentive for employers to adequately fund their plans - making it more likely that workers' retirement expectations will be met.

The Administration's Proposed Changes to Restore PBGC to Financial Health

Reforming PBGC's Premium Structure
The Administration proposes a more rational premium structure that will meet the program's long-term revenue needs, provide incentives for full funding of covered plans, and better reflect the different levels of risk posed by plans of strong and weak companies.

There are two fundamental problems with the PBGC premiums. First, the premium structure does not adequately reflect risk. Second, the current premium structure does not raise sufficient revenue to eliminate the existing deficit or to cover expected future losses.

By law, the principal funding source for the insurance program is the premiums paid to PBGC by covered plans. Premium rates are prescribed by law. While claims against the program have skyrocketed, premium revenue has not kept pace. The $19 per participant flat-rate premium has not been increased in 14 years, not even to reflect wage growth over that period. Because the number of participants has remained relatively stable, the flat-rate premium has not been a source of additional premium revenue.

Premium revenue growth in recent years has come only from the variable-rate premium (VRP). While the VRP charge of $9 per $1,000 of unfunded vested current liability appears reasonable, the VRP does not raise the amount of revenue it should for two reasons. First, the "full funding limit" exemption generally relieves plans that are funded for 90 percent of current liability, from paying a VRP. As a result, less than 20 percent of participants are in plans that pay a VRP. The full funding limit exemption is also why some of the companies that saddled the insurance fund with its largest claims ever paid no VRP for years prior to termination. In addition, VRP revenue is artificially low because current liability understates liabilities at plan termination, often dramatically so. In the last several years, premium revenue has not even been sufficient to pay monthly benefits in trusteed plans, let alone pay the underfunding in new terminations.

Under the Administration proposal, the flat per-participant premium will be immediately adjusted to $30 initially to reflect the growth in worker wages since 1991, when the current $19 figure was set in law. This recognizes the fact that the benefit guarantee continued to grow with wages during this period, even as the premium was frozen. Going forward, the flat rate premium will be indexed for wage growth.

In addition to the flat-rate premium, a more risk-based premium would be charged based on the gap between a plan's funding target under the proposed funding reforms and its assets. As noted earlier, the funding target is a more accurate measure of liability than current liability, capturing the sponsor's financial condition. Moreover, the current "full funding limit" exemption would be eliminated, so that all underfunded plans would pay the risk-based premium. The PBGC Board – which consists of the Secretaries of Labor, Treasury and Commerce – would be given the ability to adjust the risk-based premium rate periodically so that premium revenue is sufficient to cover expected losses and improve PBGC's financial condition. Charging underfunded plans more gives employers an additional incentive to fully fund their pension promises.

Protections Against Unreasonable Losses
The proposal also provides the PBGC with better tools to carry out its statutory responsibilities in an effective way and to protect its ability to pay benefits by shielding itself from unreasonable costs.

1. Protections in Bankruptcy
The Corporation faces special problems when a plan sponsor enters bankruptcy. Guarantees continue to grow even though plan sponsors may no longer be making contributions. A lien automatically arises against the assets of a plan sponsor and members of its controlled group if required pension contributions of $1 million or more are missed. However, because the automatic stay and avoidance provisions of the Bankruptcy Code prevent PBGC from perfecting liens for missed required contributions in bankruptcy, companies are able to avoid making contributions to the plan as otherwise required by federal law, and can do so without consequence. As a result, plan participants and the PBGC insurance program both may suffer greater losses if an underfunded plan later terminates while the plan sponsor or members of its controlled group are in a bankruptcy proceeding.

The PBGC guarantee limit would be frozen when a company enters bankruptcy, and PBGC would be allowed to perfect liens for missed required pension contributions against companies in bankruptcy.

2. Contingent Liability Benefits
There are also inadequate protections for the insurance program against accrual of potentially large, and unfunded, contingent liability benefits. One example is when a plan sponsor provides plant shutdown benefits -- benefits triggered by a plant closing or other similar condition. The Administration believes that shutdown benefits are severance benefits that should not be paid by pension plans. These benefits generally are not funded until the shutdown occurs, by which time it is often too late, and no PBGC premiums are paid for them. However, despite the lack of funding, shutdown benefits may be guaranteed if the shutdown occurs before the plan termination date, often imposing large losses on the insurance program.

The Administration proposal would prospectively eliminate the guarantee of certain unfunded contingent liability benefits and prohibit such benefits under pension plans. These severance benefits generally are not funded and no PBGC premiums are paid for them. Such benefits could continue to be provided outside the pension plan.

The Administration's Proposed Improvements in Disclosure
The financial health of defined benefit plans must be transparent and fully disclosed to workers and their families who rely on promised benefits for a secure and dignified retirement, as well as to investors and shareholders who need this information because the funded status of a pension plan affects a company's earnings and creditworthiness.

While ERISA includes a number of reporting and disclosure requirements that provide workers with information about their employee benefits, the timeliness and usefulness of that information must be improved.

Provide broader dissemination of plan information
Under the Administration's proposal, the Section 4010 information filed with the PBGC would be made public, subject to existing Freedom of Information Act protections for corporate financial information, including confidential "trade secrets and commercial or financial information."

Broadening the dissemination of information on pension plans with unfunded liabilities, currently restricted to the PBGC, is critical to workers, financial markets, and the public at large. Disclosing this information will both improve market efficiency and help encourage employers to appropriately fund their plans.

Provide more meaningful and timely information
The President's proposal would change the information required to be disclosed on the Form 5500 and summary annual report (SAR). Plans would be required to disclose their ongoing liability and at-risk liability in the Form 5500, whether or not the plan sponsor is financially weak. The Schedule B actuarial statement would show the market value of the plan's assets, its ongoing liability, and its at-risk liability.

The information provided to workers and retirees in the SAR would be more meaningful and timely. It would include a presentation of the funding status of the plan for each of the last three years. The funding status would be shown as a percentage based on the ratio of the plan's assets to its funding target. In addition, the SAR would include information on the company's financial health and on the PBGC guarantee. The due date for furnishing the SAR for all plans would be accelerated from two months to 15 days after the filing date for the Form 5500.

The proposal also would provide for more timely disclosure of Schedule B information for plans that cover more than 100 participants and that are subject to the requirement to make quarterly contributions for a plan year (i.e., a plan that had assets less than the funding target as of the prior valuation date). The deadline for the Schedule B report of the actuarial statement would be shortened for those plans to the 15th day of the second month following the close of the plan

year -- February 15 for a calendar year plan.[18] If any contribution is subsequently made for the plan year, the additional contribution would be reflected in an amended Schedule B that would be filed with the Form 5500.

Responses to Concerns Raised about the Administration's Proposals
Several questions have been raised regarding the impact of the Administration's proposals on defined benefit plans and their sponsors. Many of the questions posed and issues raised have merit and warrant careful consideration and a delicate balancing of interests. Some of these objections, however, do not withstand scrutiny.

Will Employers Exit the System?
The most frequent general complaint we have heard is that the Administration's proposal does not provide enough incentives for plan sponsors to remain in the defined benefit system.

The Administration believes that defined benefit plans should remain a viable option for companies that want to provide guaranteed retirement benefits to their employees. Unfortunately, in our view, the current funding system is not sustainable in the long run. Defined benefit sponsors are aware that the complexities of the current system and the funding rules allow some sponsors to transfer the risks of their funding and investment decisions to the insurance system. We want to eliminate artificial impediments that unnecessarily and avoidably raise the costs of offering DB plans. And, we believe that the Administration's proposal would revitalize the system by placing both the insurance program and individual pension plans on a solid financial footing.

Numerous meetings have been held with stakeholders over the past two years to gain a better understanding of the issues of concern to them, and, as a result, have incorporated many of the key elements sought by plan sponsors and others. For example, there have long been complaints about regulatory complexity and excessive costs associated with compliance with overly burdensome rules and regulations. We agree with this assessment, and the Administration's proposal greatly simplifies and streamlines the pension funding rules. Sponsors said they wanted to be able to use a corporate bond rate, rather than the risk-free Treasury rate, to discount liabilities.

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[18] Under current law, defined benefit plans subject to minimum funding standards are required to file a Schedule B with the Form 5500, which is generally due 7 months after the end of the plan year (July 31 for calendar year plans), with a 2 ½ month extension available (October 15 for calendar year plans).

The Administration believes that the measure of pension liabilities should be based on market rates of interest for quality corporate bond issuers and this view is reflected in the Administration's proposal. They said they want greater flexibility to fund up their plans in good economic times, to provide a cushion during more lean times. The Administration's proposal significantly increases the ability of sponsors to make tax deductible contributions to their plans. Some sponsors have complained about the cliff effect of the deficit reduction contribution rules, which in some cases requires funding deficits to be made up in as few as three years. The Administration proposal provides seven years to amortize funding deficits.

Risk and Volatility

There are a few more specific issues that have been raised about the Administration's proposal. One is that it would increase volatility and make contributions more unpredictable. The fact is that the risk and volatility associated with defined benefit plans stems from the investment and business decisions made by plan sponsors, along with changes in longevity and retirement patterns, none of which are changed by the Administration's proposal. Companies have the means under current law to manage these risks in accordance with their own risk tolerances. And, the Administration's proposal provides additional tools to manage volatility, including amortization over seven years and the enhanced ability to prefund benefits in good economic times.

What is not acceptable is to mask risk or pretend that it doesn't exist by artificially smoothing asset and liability values and distorting current economic reality. That is precisely what has allowed the funding gaps we've experienced. Ultimately, it is participants, shareholders, other companies, and potentially taxpayers, that stand to lose. Companies should be free to take risks and make business decisions that they believe to be in the best interests of their stakeholders, so long as the impact of those risks and decisions is transparent and the costs cannot be readily transferred to participants or other third parties.

Yield Curve

Another issue relates to the use of a yield curve in discounting liabilities. Some commenters support the use of a corporate bond rate, but object to applying those bond rates against a yield curve. They argue that it is unnecessarily complex and will create unpredictable funding obligations.

The Administration believes that discounting future benefit cash flows using the rates from the spot yield curve is the most accurate way to measure a plan's liability because it recognizes the real costs of operating defined benefit pension plans. Accurate measurement of liabilities does not advantage one type of plan sponsor over another, as is the case under current law with a single rate. The pension benefit obligations that make up plan liabilities are not changed in any way by use of the yield curve.

The yield curve simply recognizes that older plans must make a relatively high proportion of benefit payments in the near future. Conversely, use of the yield curve also recognizes that younger plans will make a high proportion of benefit payments in the more distant future. Current law, by using a single long-term bond rate to discount all future payments, largely ignores this fact and therefore measures liabilities inaccurately.

Yield curves are regularly used in valuing other financial instruments, including mortgages and certificates of deposit, and therefore will not pose a difficult technical challenge for actuaries. There is no evidence that implementation of the yield curve will cause significant increases in pension plan expenses, but to avoid any sudden changes in cash flow demand, the Administration's proposal includes a three-year transition period to the yield curve.

Credit Ratings

Some have objected to the use of credit ratings to determine funding and premium levels. It is not clear whether the principal concern is with the use of the ratings agencies themselves, or with the concept of incorporating credit risk into the funding and premium requirements.

As to the former point, it should be noted that a company's cost of capital is, to a significant degree, derived from the rating agencies' calculation of creditworthiness. That leads to the second point - the concept of credit risk itself. As discussed more fully above, it is both reasonable and fair to require higher plan contributions and premium payments from companies that pose a higher risk of underfunded terminations. At-risk funding targets are likely to be higher than ongoing targets, so the Administration provides a five-year phase-in period to the higher target for any plan whose sponsor becomes financially weak. The funding target during the phase-in period will be a weighted average of the ongoing and at-risk targets. Other provisions designed to reduce the effects of the proposal on financially weak firms include a three-year transition period to the yield curve and an extension of the amortization periods for many underfunded plans from as little as four years (under the deficit reduction contribution) to seven years.

Credit Balances
Another criticism that has been leveled against the Administration proposal is that sponsors will have no incentive to make more than the minimum required contributions if they can't take advantage of credit balances. First, I want to reiterate that the credit balance feature of current law allowed companies like Bethlehem Steel, US Airways, and United (PBGC's largest claims) to avoid making contributions to their plans for several years prior to their termination - notwithstanding the fact that they were already substantially underfunded and the amount of grew significantly during the run-up to termination. Allowing companies to take "funding holidays" when they are underfunded (other than through the waiver process) does not make business or policy sense and runs counter to the whole notion of steadily improving the funding status of underfunded plans.

Moreover, we believe that sponsors would have ample incentive under the Administration's proposal to make more than the minimum required contribution without the use of credit balances. First, they would be able to generate a larger tax deduction. Second, they would shorten the relevant amortization period. And, third, their risk-based premiums would be lowered.

PBGC Premiums
A number of issues have been raised about the Administration's proposed changes to the structure and level of premiums that finance the pension insurance program. The argument has been made that the increase in and indexing of the flat per-participant premium puts an inappropriate burden on employers with well-funded plans; that the provision to adjust the risk-based premium may result in greater volatility and burden on financially stressed companies; and that the solution should be limited to improved funding rules, not increased premiums.

Understandably, plan sponsors would rather not pay greater premiums or subsidize underfunded plans of financially weak sponsors. However, the deficit in the pension insurance single-employer fund is already substantial and likely will grow, which imperils the ability of the PBGC to meet its long run commitments to participants in terminated plans. The fact is that under current law, the PBGC is supposed to be self-financing; the agency does not receive any taxpayer monies and its obligations are not backed by the full-faith-and-credit of the United States. At the same time, PBGC has very little control over its primary revenues and expenses. Congress sets PBGC premiums, ERISA mandates coverage for all defined benefit plans whether they are adequately funded or not, and companies sponsoring insured plans can transfer their unfunded liability to the PBGC as long as they meet the statutory distress criteria.

Plan funding reforms, by themselves, will not eliminate PBGC's deficit. The Congressional Budget Office scored the Administration's premium proposal as raising $18 billion of revenue over five years. This was based on the assumption that the risk-based premium is assessed against all underfunding, that the flat-rate reforms are enacted, and that total premium revenue will cover expected future claims and amortize the PBGC's $23 billion deficit over 10 years.

The issue ultimately is who pays for past and future claims. The Administration believes that companies that make the promises to their workers should pay for them, which is why we have put so much emphasis on strengthening the funding rules. But, changes to premiums are still necessary to compensate for the losses that have and inevitably will occur. The Administration believes that the proposed balance between the flat per-participant premium and the risk-based premium for plan underfunding is reasonable. The proposed increase in the flat per-participant premium is only to reflect wage growth since the last increase in 1991 and in the future.

The risk-based premium rate would be established by the PBGC's Board on a periodic basis. This is similar to the approach taken in the federal bank insurance program. Since 1993, the Board of Directors of the Federal Deposit Insurance Corporation has reviewed and adjusted semiannually the premium rates that it assesses each insured bank and thrift. Moreover, the FDIC uses a risk-based premium system that assesses higher rates on those institutions that pose greater risk to the insurance funds.

Premiums also need to be viewed in context - relative to contributions that sponsors will have to make to their plans. The fact is that premiums are and would continue to be a very small percentage of pension costs for most employers. Total premiums collected by the PBGC have averaged about a billion dollars a year. Plan contributions have averaged more than $20 billion per year (constant dollars) - twenty times higher than premiums. Estimates are that companies contributed more than $70 billion to their plans in 2003.

Conclusion

Companies that sponsor pension plans have a responsibility to live up to the promises they have made to their workers and retirees. Yet under current law, financially troubled companies have shortchanged their pension promises by nearly $100 billion, putting workers, responsible companies and taxpayers at risk. As United Airlines noted in a recent bankruptcy court filing, "the Company has done everything required by law"[19] to fund its pension plans, which are underfunded by nearly $10 billion.

It is difficult to imagine that healthy companies would want to continue in a retirement system, or that prospective employers would want to become part of a retirement system, in which the sponsor-financed insurance fund is running a substantial deficit. By eliminating unfair exemptions from risk-based premiums and restoring the PBGC to financial health, the Administration's proposal will revitalize the defined benefit system.

That, Mr. Chairman, is precisely why the rules governing defined benefit plans are in need of reform. At stake is the viability of one of the principal means of predictable retirement income for millions of Americans. The time to act is now. Thank you for inviting me to testify. I will be pleased to answer any questions.

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[19] Page 26, United Air Lines' Informational Brief Regarding Its Pension Plans, in the US Bankruptcy Court for the Northern District of Illinois, Eastern Division (Sept. 23, 2004).

Chairman GREGG. Thank you, Mr. Belt.
Dr. Holtz-Eakin?

STATEMENT OF DOUGLAS HOLTZ–EAKIN, DIRECTOR, CONGRESSIONAL BUDGET OFFICE

Mr. HOLTZ-EAKIN. Chairman Gregg, Senators, thank you for the chance to be here today to talk about this important and timely issue.

In our written testimony we walk through all of the comments that I am going to make, but I thought I would focus my oral remarks on four key points, the first being, how large is the commitment represented by pension insurance for defined benefit pension plans? How much of that commitment will be picked up by the U.S. taxpayer? What are effective ways to improve the conveyance of information to this committee and to other members of Congress so as to more carefully monitor the financial condition of the PBGC, and what would be the impacts of policy options, particularly those relevant to the reconciliation process on the economic and budgetary challenge that is pension insurance?

Beginning with the size of the pension problem, the caveat I would like to put at the outset is that the numbers I am about to discuss are a work in progress. They represent ongoing work at CBO to more accurately measure the economic cost of insurance provided on the Federal budget. The goal of this particular exercise is to essentially estimate the size of the check that one would have to write to modern financial markets in order to have them provide such pension insurance, and as a result, the CBO exercise is really a three-step process which is the same process that any financial market analyst would undertake to look at the PBGC and the insurance it provides.

Step one would be to estimate the probability that any pension plan sponsor might enter bankruptcy, and to examine the assets and liabilities and ongoing business operations for that probability.

Step two is to estimate the potential range of underfunding for any plan that might arrive at the PBGC as a result of a bankruptcy, and at that termination estimate the check that will have to be covered.

And then Step three is to value this underfunding at market prices. Markets are especially conscious of the time at which money has to be paid out. Money paid out at bad times is more expensive than money during good times. And unfortunately, volatility is a key aspect of providing insurance, and pensions tend to arrive at an insurance agency at the same time the economy dips and thus cash flows are weak, at a time when the stock market is down and thus asset values are reduced, and at a time when interest rates are lower, and as a result, valuations of liabilities increase.

So at the same time that the insurance is most likely to arrive, it is at a time when markets will place the greatest price tag on it, and as a result, incorporating this market risk as an ongoing part of valuing the insurance is an important aspect of what we do.

If we go to the first slide, you can see that undertaking this exercise reveals some magnitudes of the market valuation of the insurance provided to defined benefit pension plans, and there are really two kinds of costs displayed on the slide. The first and the one that

is segregated at the bottom is what is labeled the "sunk costs." These are the costs for those plans that are in actuality or in effect already under water and have arrived at the PBGC or are quite likely to do so.

There, as Mr. Belt mentioned, the real issue is who will pick up the tab? Will it be workers and retirees? Will it be firms and their shareholders, or will in fact some of this cost be picked up by the American taxpayer?

The remaining costs are prospective costs, likely insurance that would be paid out over different horizons, rising from 48 billion over the next 10 years to 68 billion over a 20-year horizon, and it is those costs that can be changed by policy and that the deliberations of the Congress are most important in thinking about.

Step two is to ask what is the current taxpayer exposure to these costs? And there the answer is quite simple. As the chairman noted, under current law the explicit liability is zero. I think you refer to this as a theoretical zero, but there is going to be clear pressure on a cash flow basis as the PBGC shows annual deficits and ultimately exhausts its on-budget and off-budget assets. There will be pressure for the Congress to contemplate providing more of the taxpayers' resources to this problem, and there the question is, how much, and how will this decision be made? Is it the case that there should be an ongoing subsidy to provide low-cost insurance to defined benefit pensions as a matter of policy, and in doing so, how will the Congress recognize those costs on both the outlay side as well as on the revenue side, where the implications of all pension reforms will affect tax liabilities of firms?

The next step, if we go to the next slide, is trying to provide information to this committee and to the Congress so as to better monitor the current and any changed condition in the insurance for defined benefit pension plans.

There are really two vehicles for this, the annual budget statements, and also the financial statement of the United States Government, and under current law the budget shows a very incomplete and partial snapshot of the PBGC's financial condition, showing only the on-budget aspects of the operations, and the cash flows, premiums coming in, benefit payments going out, and this has permitted the budget to reflect the PBGC as a profit center, when in fact in any economic measure it has been losing money for a sustained time.

The financial statement currently shows the $23 billion in the liability which includes probable terminations, but also has broader measures in the note disclosure about possible terminations that could get as large as an additional $96 billion.

Now, possible alternatives going forward would be to leave the current statements unchanged, or to move both the budget or the financial statement toward presentations that are more reflective of the economic cost. One could imagine putting on the budget the accrual cost of additional exposure including the market value of the risk. Those would be numbers quite similar to the type that I presented at the outset, or you could take a more limited approach and simply identify the annual equivalent subsidy, the pricing below market of the pension insurance provided to firms, and place that on the budget to reflect the Government's subsidy to this en-

terprise. And on the financial statement one could imagine moving to a full accrual cost using market values as a way to inform the Congress better about the ongoing financial condition of the system.

Let me close with a few thoughts about policy options that appear to be under consideration at the moment, broadly broken into two categories, those which would affect premiums and those which would affect funding rules and reporting requirements.

Under premiums, it is clear that there are aspects to improve policy on pension insurance fund. The first would be to overall raise premiums so as to lower the subsidy present in the insurance system and to have as a result firms more accurately reflecting their decisions to provide compensation, the true cost of making sure that that compensation, which is promised at one point in time, will actually be paid at a later point in time regardless of what economic circumstances might transpire in between it, the firm or the industry or even the economy-wide level.

It would be desirable to move the premiums toward ones that reflected risk in a more comprehensive fashion. This would provide better incentives and also lead to lower subsidies from low risk to high risk sponsors in these kinds of plans, and one could do that by linking the risks to the plan's assets or by linking it to a sponsor's financial status at investment grade or below investment grade, for example, or a variety of other methods that we outline in the testimony.

Now, overall, to change the economic problem, the $48 billion of the likely cost that we identified at the outset, would require a five-fold increase in premiums as currently charged. At the moment we are collecting about $1 billion in premiums per year to meet the reconciliation kind of instruction that has been debated on the order of 6 to 7 billion dollars over the budget window, would require only doubling those premiums between 2006 and 2010. The five-fold increase would eliminate the economic cost. Merely doubling would reduce it.

If it was done via strictly the flat rate premium, that would require raising it to about $60 from $19 at the moment, and that would have an economic impact of reducing the cost by only $7 billion to $41 billion. If one chose instead to focus exclusively on the variable rate premium, the $9 per $1,000 of underfunding, that would require an increase to about $27 from $9. This would have much more dramatic incentive effects, and lower that prospective cost by $18 billion. However, it would most likely provide incentives for some sponsors to terminate or freeze their plans at the same time.

The second broad category of changes are those in funding rules and reporting, where it would be desirable to more closely price assets and liabilities to their market value. The essence of insurance is to capture the volatility so that when bad times arrive it is recognized that they are present. Market values are most reflective of those situations. In doing so it would be desirable to match more closely the characteristics of assets and liabilities, provide, as a result, hedges, so that when liabilities go up, assets go up at the same time, and vice versa. This is a substitute and a complement

to providing greater funding overall to make sure that the net positions move in the same way.

Finally, it would be desirable to consider all the costs in measuring liabilities. As has been made vivid by several recent examples, it is often the case that what appears to be a funded plan arrives in bankruptcy severely underfunded because of shut-down benefits, lump sum cash payouts in the pension plans, having liabilities more reflective of all those costs so that we get—better funding would be desirable. In doing so, it would improve the transparency of the pension system. This would allow both workers and markets to more carefully monitor it and provide incentives to either fully fund, and thus bring the resources to the future on the part of the firm, or to purchase appropriately priced insurance from the PBGC and provide the resources in that fashion.

In all cases, I just remind the committee that in moving either funding rules or moving premiums, there will be not only outlay consequences but also potential revenue consequences which are important in thinking about the net impact of these changes on the exposure of the taxpayer and the overall budget process.

The CBO thanks you for the chance to be here today and we look forward to your questions.

[The prepared statement of Mr. Holtz–Eakin follows:]

CBO TESTIMONY

Statement of
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The Pension Benefit Guaranty Corporation: Financial Condition, Potential Risks, and Policy Options

before the
Committee on the Budget
United States Senate

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Chairman Gregg, Senator Conrad, and Members of the Committee, I welcome this opportunity to discuss with you the important issues of pension insurance and pension plan funding. Those issues are important to workers and firms that participate in defined-benefit pension plans as well as to U.S. taxpayers.

I will focus my remarks on four themes:

- PBGC's costs can be usefully divided into prospective and so-called sunk costs. Changes in policy can reduce or avoid losses that have not yet occurred, whereas the losses from plans that are already terminated or are in the process of terminating can only be paid.

- Recent experience shows that lack of clarity in financial information about an insurance program can effectively obscure rising costs and delay policy responses.

- Premiums and funding rules that reflected the risks and costs that various plans imposed on PBGC could match costs with behavior and provide incentives for firms to reduce those costs.

- Policies that reduced costs to PBGC could also reduce federal revenues. Those two effects should be taken into account in assessing policy changes to avoid simply transferring PBGC's costs to the revenue side of the budget.

Accrual Accounting and Exposure to Underfunding

At present, the underfunding of defined-benefit pension plans is a pervasive and sizable phenomenon. PBGC estimates that the vast majority of plans are currently underfunded to some degree. The agency's best estimate of total underfunding (on a termination basis) among all insured plans is $600 billion—$450 billion for single-employer plans and $150 billion for multiemployer plans.[1]

Fortunately, most underfunded plans are not likely to be terminated because they are sponsored by financially healthy firms. Therefore, PBGC assesses the amount of underfunding among plans for which the agency considers default "reasonably

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1. By law, the funding rules and insurance system treat pension plans sponsored by a single employer differently from those sponsored by more than one firm, which are referred to as multiemployer plans. Although both types of plans are experiencing similar problems, PBGC underwrites much more liability for single-employer plans, and as a result, most efforts at pension reform concentrate on them.

possible." In fiscal year 2004, PBGC estimated its exposure to claims from such plans at $96 billion.[2]

Even without taking those prospective costs into account, PBGC is already in a deep fiscal hole. At the end of 2004, the agency was reporting a negative net financial position of $23.5 billion. PBGC's net financial position essentially measures how the resources available to the agency at a given point in time compare with the pension obligations from plans that have already been terminated as well as claims from plans whose termination in the near future PBGC considers "probable."

Of course, all estimates of underfunding are just that: estimates. As such, they are sensitive to projections about interest rates, future returns on assets, retirement ages, and life expectancies. A shift in those factors could have a substantial effect on projections of underfunding.

Economic Costs

Under the Employee Retirement Income Security Act of 1974 (ERISA), PBGC is not backed by the full faith and credit of the U.S. government and has no authority to change the premium structure or call on general revenues to pay benefits. The resources at its disposal are premiums, the assets from terminated plans, and investment income from its accrued assets. Therefore, if PBGC exhausted all of its holdings, as is projected to occur under current law, it would have to rely almost entirely on its ongoing stream of premiums to cover its expenses. That circumstance would in turn necessitate a drastic reduction in benefits—perhaps in excess of 90 percent.

As a practical matter, however, the public probably views the pension insurance system as carrying an implicit federal guarantee. Consequently, many observers expect that if PBGC became insolvent, the Congress would feel compelled to provide direct assistance from general revenues.

How extensive is that implicit guarantee? Over the past 18 months, the Congressional Budget Office (CBO) has been analyzing the economic costs that PBGC's insurance represents for taxpayers if the implicit guarantee is honored. That work is still in progress; currently, however, CBO estimates that the economic costs to the public of PBGC's insurance for single-employer plans

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2. That "reasonably possible" termination category includes primarily plans sponsored by firms that the financial markets consider to be experiencing some financial distress—indicated by credit ratings below investment-grade—but that are not already included among plans whose termination PBGC rates as "probable."

(including "sunk" as well as prospective costs and subtracting premium collections) total $71 billion for the upcoming decade and $91 billion over the next 20 years. Those figures describe the estimated net present value of the financial resources that PBGC will be transferring to sponsors of and participants in defined-benefit pensions. They are also the estimated prices that the government will have to pay to private insurers bidding in competitive markets to take on the obligations that PBGC will assume during those periods under the current premium structure and funding rules. Thus, they reflect both the costs that are likely to be incurred in coming years and the risk that those costs could be even greater than anticipated.

In considering how to address the economic costs that PBGC's insurance represents, it is critical to distinguish between costs that have already been incurred and costs that are likely to be incurred in the future. At the end of 2004, PBGC had accumulated losses in the single-employer program of $23.3 billion for plans that had been terminated or plans whose termination the agency regarded as probable. Those sunk costs cannot be avoided, and policy decisions can determine only who will bear them. But changes in policy can reduce prospective economic costs, which, according to CBO's current estimates, are $48 billion for the next 10 years and $68 billion for the next 20 years.

PBGC's Cash Resources

Increased pressure to provide additional resources to PBGC may arise once the shortfall between liabilities and assets from terminated plans begins to register as a deficit in the agency's annual bottom-line measurement of its cash flow. Under PBGC's current premium structure and funding rules and the assumptions of CBO's current economic forecast, the agency will soon start running cash deficits, which will continue for the foreseeable future. In CBO's projections, the combination of growing obligations for benefits and level income from premiums causes the agency's on-budget fund to be exhausted in about 2013.[3]

No precedent exists for how PBGC would proceed if its on-budget fund became insolvent. However, CBO's expectation is that the agency would cover its costs by increasing the percentage of benefits and other expenses being paid out of its nonbudgetary trust fund. (By doing so, PBGC would essentially be providing less insurance protection to future recipients in terminated plans than it provides to current recipients.) CBO does not formally estimate the value of the assets held by

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3. The resources available to pay for PBGC's costs are divided between two funds: an on-budget fund for receipts of premiums and outlays for benefits and administrative costs, whose transactions since 1980 have been included in federal budget totals; and a nonbudgetary trust fund, in which the assets of terminated plans are held until used to help pay benefits.

the trust fund. There is a significant likelihood, however, that all of PBGC's assets will be exhausted within the next 20 years.

Alternative Budgetary Treatments

The potential liability that pension insurance represents for taxpayers might be made more visible by changing PBGC's budgetary treatment. Today, that treatment focuses on the cash inflows (primarily from premiums, interest income, and transfers from the nonbudgetary trust fund) to the agency's on-budget account, which are then subtracted from the federal government's outlays for the pension benefits that PBGC pays and for its administrative expenses. That treatment delays, often for decades, the budget's recognition of PBGC's insurance claims from when they are realized at a plan's termination to when benefits are paid. As a consequence—and despite large losses—PBGC's budgetary position has helped reduce the federal deficit in every year except 2003. That kind of budgetary treatment is neither designed to indicate nor suited to describe the expected risk and magnitude of losses in the pension insurance system.

A budgetary treatment that better indicated the full costs of pension insurance would have the following attributes:

- *Timeliness of Recognition.* The budget should reflect costs when the government incurs the obligation to pay them.[4] Although sunk costs must be recorded and paid, it is the costs that are being incurred during a budget period that are the focus of policymakers' decisions. One possibility would be to include the losses that PBGC incurs on pension plans when those plans are terminated rather than when the benefit payments are actually made. Of course, under current law, the extent of the government's commitment to pay benefits is restricted to the resources available to PBGC from premiums, the assets of terminated plans, and whatever it can recover from plans' sponsors.

- *Market-Value Basis.* The best way to assess the cost of an insurance program is by using market prices to value the risk associated with it. For PBGC, the market price of risk is significant because the events that are most likely to precipitate a transfer of pension liabilities to the agency (including low investment returns, high rates of financial distress, and low interest rates) generally occur when the market value of all assets has dropped.

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4. President's Commission on Budget Concepts, *Report of the President's Commission on Budget Concepts* (October 1967), p. 36.

The current budgetary treatment of PBGC recognizes the inflow of premium collections and the outflow of benefit payments during the budget period, but it does not take into account the value of the claims arising under the insurance and thus does not manifest the attributes outlined above. CBO is currently exploring budgetary alternatives that might better reflect those qualities.

For example, if policymakers wanted the federal budget to reflect PBGC's prospective economic costs rather than its current cash flows, one possibility would be to treat those net prospective costs as the agency's baseline costs. Future year budgets could then recognize alterations in the value of the insurance as a result of changes in law, regulations, or such variables as insured liabilities and interest rates. Similar to the way that loan programs are treated under credit reform accounting, those changes in costs might be considered either reestimates (the result of unexpected economic changes) or modifications (the result of policy changes). That treatment would capture the magnitude of future claims from unfunded insured pensions, but it would also depart from standard budgetary treatments by including costs for which the government is not currently liable. In addition, unlike credit reform accounting, the values presented could include the cost of market risk.

Another possibility would be to recognize as budgetary costs the unpaid fair-market value of premiums for PBGC's insurance—that is, estimates of the annual premiums required to reduce to zero the net economic costs of the insurance that PBGC provides. Such unpaid premiums could be compared with the premiums that are expected to be paid by plans' sponsors, and the difference could be shown as the budgetary costs of PBGC. (As with the option above, this treatment would also depart from standard budget presentations by displaying costs for which the government was not currently liable and by including the cost of market risk.)

An alternative approach would be to transfer PBGC to private owners. That step would probably accelerate the recognition of sunk costs in the budget because PBGC's current deficit would have to be covered, presumably through appropriated funds, before a private entity would be willing to assume the agency's obligations. In addition, a private owner might require either an annual or lump-sum payment from the federal government to continue to operate the insurance program under its current premiums and funding rules. Because PBGC's insurance is mandatory for defined-benefit pension plans, the government would probably remain involved in regulating the terms of the insurance—which raises the question of how much risk and responsibility the government could effectively transfer to private owners. Nevertheless, the risk to taxpayers would most probably be less under such an arrangement than it is under current policy.

Policy Proposals Under Consideration

Defined-benefit pensions are a form of employee compensation. The objective of policies directed toward improving pension insurance is to provide a framework to support payment of that compensation despite the potential for adverse economic events affecting the sponsoring firm, particular industries, or the economy as a whole between the time when the compensation is earned and the time when the pension benefits are paid. In addition, it would be desirable for such policies to support—or at least not impede—any economic restructuring that changes in competitive pressures might induce.

Two broad policy avenues are available: sponsoring firms could be required to accumulate more resources to pay promised benefits, or they could pay the full cost of purchasing insurance from PBGC to provide the necessary resources. Under both types of policies, it would be important for firms to face the full cost of their decisions about compensation—through rules that enforced adequate funding and insurance that was appropriately priced to reflect the risk of losses particular firms posed—and for there to be sufficient transparency for markets to enforce those incentives.

Alter the Premium Structure

The underpricing of PBGC's insurance—that is, the current premium structure—is a key factor in the agency's present financial difficulties. Premium revenue is the only source of income available to PBGC to cover the shortfall between the liabilities of terminated plans and the value of their assets. CBO expects that under current law, premium income will remain relatively flat—at around $1 billion annually—whereas benefit payments resulting from both past and future claims will rise from about $3.5 billion this year to more than $10 billion in 2015.

A contributing factor to that pattern is that the premium rate paid by sponsors of multiemployer plans has remained constant since 1988, and rates for the two types of premiums charged for single-employer plans have not changed in more than a decade. (One of those premiums is an amount levied per plan participant; the other is calculated on the basis of a plan's underfunding.)[5] The rates for the premiums are set by statute, and PBGC cannot adjust them, as most insurance providers can, for the losses that past events lead it to expect.

Raising premiums would require sponsors to pay a larger share of PBGC's economic costs. To cut federal costs to zero through higher premiums alone would require a fivefold increase in the agency's receipts from premiums. Those higher premiums might be manageable for well-funded plans, which currently pay

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5. The premium levied on underfunding does not always work as intended. Because of loopholes in the premium rules, many plans that are underfunded are not actually required to pay premiums on their underfunding.

only a flat charge of $19 per year per participant for insurance. Firms whose plans are significantly underfunded, however, pay not only the flat rate per participant but also a charge of $9 per $1,000 of underfunding. (A hypothetical firm with 1,000 participants and $50 million in underfunding pays premiums of $469,000 per year, of which $450,000 is the charge for underfunding.) Therefore, for some firms, an increase in premiums could be significant—perhaps to the point of causing them to adjust the form and amount of compensation that they offer.

An alternative to a proportionate increase in premiums for all plans' sponsors would be to make premiums more sensitive to the risk that various plans pose for PBGC. Although the extra charge for underfunding currently provides some adjustment based on risk, varying premiums on the basis of risk could reduce the current cross-subsidies from low-risk sponsors and plans to high-risk ones. Some risk-adjusted premiums could also strengthen incentives for firms to reduce risk—which could lower the premium rate required to achieve any given level of net costs.

Under a risk-based approach, premiums would be higher for sponsors that were more likely to encounter financial distress and whose plans tended to be more deeply underfunded at termination. For example, premiums could vary with the volatility of the market value of a firm and its pension assets, the ratio of the firm's liabilities to its equity (leverage), or the firm's credit rating. The resulting range of premiums would be substantially wider than it is under current policy because risk varies significantly among plans.

Another important correlate of plans' risk that could provide a basis for adjusting premiums is the ratio of a pension plan's assets in stocks to its total assets. Plans' sponsors appear to prefer to hold a large proportion of their assets as equities because, historically, stocks have yielded higher average returns (but at greater risk) than have bonds. If those higher returns are realized, the risk premium that they represent serves to reduce the cash contributions that a sponsor must make to its plan to fund the pension benefits it has promised. Of course, investments in equities entail the risk that the stock market will do poorly and the plan will become underfunded. Indeed, plans that hold a large proportion of common stocks, rather than high-quality bonds or other fixed-income securities, exhibit more volatility in the value of their assets than do plans that hold more debt securities. Plans with a large share of stocks are thus at greater risk of underfunding when their sponsors encounter financial distress.

Because PBGC's costs vary more closely with plans' liabilities than they do with the number of participants in plans, the current premium structure does not reflect the chances that PBGC will take on particular claims. The current per-participant charge tends to result in lower premiums per dollar of insured liabilities for firms with a higher proportion of older or high-wage employees compared with firms

whose workforce is predominantly younger or lower paid and therefore has few accumulated pension benefits. At the current rate of $19 per participant, those effects may be small, but if rates were raised to be fair, on average, the effects on firms' behavior could be significant.

Another issue relevant to the pricing of pension insurance is how premiums should be changed to reflect past versus future claims against PBGC. The estimated shortfall for past claims as well as some imminent losses is $23.5 billion. CBO has estimated that the value of PBGC's insurance over the next two decades will be $68 billion. That is, the agency may soon be taking on billions of dollars more in claims. If premiums were set so as to lessen or eliminate the agency's accumulated deficit as well as to accurately reflect its exposure to future claims, ongoing sponsors of plans would be charged more than actuarially fair rates. That kind of a system might lead some sponsors of well-funded plans to freeze or terminate their plans—which would actually worsen PBGC's finances by reducing its premium collections. In considering how to finance pension insurance in coming years, it would be useful to address the following as separate issues: (1) how to price pension insurance to cover future risks and provide the proper economic incentives to firms in managing their pension plans and (2) how to pay for losses that have already been incurred.

Change Funding Rules and Reporting

The current rules governing pension funding were intended to ensure that firms contributed adequate resources to pay promised benefits by the time the benefits came due and to provide firms with some flexibility as to when and how they made those contributions. However, certain features of those rules may have led to systematic underfunding among a number of defined-benefit plans. Many firms whose pension plans were recently taken over by PBGC used those features to make small or no contributions in the years leading up to the plans' termination—at which point they presented PBGC with billions of dollars in claims.

A number of options are available for strengthening pension funding rules, and all involve trade-offs that might make them more or less attractive to a particular stakeholder in the pension system. Instead of attempting to enumerate them all, the discussion that follows broadly describes several approaches and spells out some general principles that might guide reform.

Price to the Market. Under the current set of funding rules, plans' liabilities are assessed not according to market values but on the basis of a four-year weighted average of interest rates, a practice known as smoothing. The current actuarial valuation of assets relies on a smoothing technique as well. (Another example in which assets and liabilities are not priced to market involves credit balances from previous-year contributions that exceeded the minimum funding requirement,

which are calculated without regard to changes in market values.) When markets (and rates) are changing rapidly, the funding ratios (assets to liabilities) that plans report under the current funding rules may be markedly different from the ones that would result from calculations that used current market values. In recent years, such discrepancies have led plans to appear better funded than they actually are. (Of course, in a different economic environment, the reverse could be true.) Valuations of pension assets and liabilities that were more closely linked to current economic conditions would provide a more accurate picture of plans' funding status and provide a better base on which to set funding requirements. Some observers have also suggested that using current market values for liabilities and assets would encourage plans to invest their assets in a way that better matched the duration of their liabilities with the projected income from those assets. That approach would help insulate plans from financial fluctuations and thus moderate the volatility of required contributions.

Match Characteristics of Assets to the Nature of Liabilities. Plans are required to pay for most pension benefits as those benefits are accrued, but they have great leeway in deciding how to invest their accumulated pension assets. As noted earlier, most plans attempt to take advantage of the opportunity to realize an equity premium by investing in stocks rather than bonds. (On average, about 70 percent of the pension assets of publicly traded companies are invested in equities, and most of the rest is invested in bonds or held as cash.) Although, historically, stocks have yielded higher average returns than bonds over the long run, they are also more volatile, which makes them unsuited to financing pension benefits that will come due in the short term. The combination of low stock values and low interest rates over the past several years helped create a large amount of underfunding, which sponsors are now being required to make up. Investment behavior by sponsors that more closely matched the characteristics of investments with the expected duration of liabilities would have enabled plans to avoid much of the underfunding they now face. Creating incentives in the funding rules to encourage plans to more closely match the type of assets they hold to the duration of their liabilities would lead to fewer large swings in funding levels and put PBGC at less of risk of having to absorb sudden increases in pension shortfalls.

Consider All Relevant Costs. The current funding rules do not take full account of all costs that a pension plan may represent. For instance, some plans provide lump-sum payments to participants if a particular facility shuts down. In addition, plans that are nearing termination often experience a sudden increase in costs as many employees take early retirement. Although not every plan will experience the surge in costs associated with shutdown benefits or a sudden flurry of early retirements, those events can substantially increase PBGC's costs if a plan is terminated. Therefore, considering ways to measure liabilities that included all relevant contingent liabilities along with the likelihood of incurring those costs would be prudent.

Make Risk Part of the Equation. Just as with premiums, it would be possible to link certain funding requirements with the risk that a plan will terminate. Data about plan terminations suggest that so-called distress terminations are strongly linked to the credit ratings of plans' sponsors. According to the Government Accountability Office, of the largest 41 claims in PBGC's history for which a credit rating was known, 39 plans were sponsored by firms whose credit was rated as speculative at least three years prior to their plans' termination. Those data suggest that one way to help prevent large claims for PBGC would be to structure the funding rules to minimize underfunding in plans sponsored by less credit-worthy firms. The difficulty with that approach, however, is that firms with lower credit ratings often exhibit weaker cash flows than firms with higher ratings and have limited access to capital in the credit and equity markets.

Improve Transparency. Markets work best when full information is available to participants. The current pension system does not do a very good job of providing the kind of information that is helpful to investors and plans' participants as well as to policymakers and taxpayers. Funding levels are measured in different ways for different purposes, and information about potential underfunding that is filed with PBGC and other government agencies (such as the Internal Revenue Service) often lags years behind. The lack of transparency can cause investment markets to undervalue sponsors' costs for providing pension benefits; it may also lead workers to underestimate the likelihood that their promised pensions will not be delivered in full. Regulatory changes that led to greater transparency would help stakeholders (including plans' participants and investors) to evaluate whether sponsors were meeting their obligations. Although the effect would be difficult to quantify, that increased level of scrutiny could discourage sponsors from underfunding their plans or committing their firms to obligations that could not be kept.

Improve Flexibility. At various times in ERISA's history, the law has limited the ability of sponsors to effectively overfund their plans. Those restrictions have been reduced over time, mostly in an effort to limit the losses of federal revenue that those contributions may represent. (Contributions to the plans are tax-deductible to the sponsoring companies—to the extent that they are profitable enough to owe taxes.) The evidence is mixed as to whether plans will actually contribute more than is required, even during good economic times. However, the argument is often made that allowing sponsors to effectively overfund their plans can provide them with a buffer in the event of an economic downturn.

The Administration's Proposal

The Bush Administration has proposed several changes in the defined-benefit pension system to reduce its financial shortfall and increase transparency.[6] In

6. Details are available at www.dol.gov/ebsa/pdf/seppproposal2.pdf.

general, the Administration would raise premiums and permit further adjustment of them for risk, change the measure of plans' liabilities and funding requirements, and increase public disclosure of plans' funding status. The sponsors of plans would also be permitted to fund the plans' liabilities at higher levels during good economic times (without the loss of tax benefits) as a buffer against underfunding during less prosperous periods and to use a higher discount rate to calculate plans' liabilities.[7] Most of those changes are consistent with the objective of reducing the federal costs of pension insurance.

Reconciliation and PBGC's Deficit

The reconciliation instructions associated with the Concurrent Budget Resolution for Fiscal Year 2006 directed that the Senate Committee on Health, Education, Labor, and Pensions reduce outlays for mandatory programs within its jurisdiction by $13.6 billion over the 2006-2010 period. The resolution does not specify the amounts that must come from each program of mandatory spending within the committee's jurisdiction, but the bulk of that spending covers higher education programs and PBGC. It has been widely reported that roughly $6 billion to $7 billion of the savings is expected to come from PBGC. To put that target in perspective, under current law, PBGC's gross outlays will total $34 billion over the five-year period, in CBO's estimation, and premiums will bring in $7 billion.

One option for meeting the reconciliation bill's target would be to roughly double total premium income—to around $14 billion—over the 2006-2010 period. Such an increase would be enough to erase PBGC's on-budget cash deficit over that period and avoid exhaustion of the assets in its on-budget fund during the 2006-2015 budget window. However, the increase in premiums would not be sufficient to cover the $48 billion in economic costs that CBO estimates the agency is likely to incur over the next 10 years. Reconciliation targets are a measure of the agency's annual cash flows, whereas PBGC's economic costs are the net present value of its insurance claims (that is, net of premiums) over the next decade.

Achieving the reconciliation target from an increase in flat-rate premiums alone would require that the current per-participant charge be more than tripled, from $19 to nearly $60. Such a policy could generate the needed $7 billion in additional cash receipts over five years and about $14 billion over 10 years, but the premium increase would reduce the economic cost of providing insurance by less than $7 billion over the same 10 years, to $41 billion.

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7. The present value is a single number that expresses a flow of current and future income (or payments) in terms of an equivalent lump sum received (or paid) today. Market interest rates are the basis of the discount rate used to calculate the net present value of plans' liabilities.

Another approach would be to increase the variable-rate premium, which is charged on the amount of underfunding in each plan. Tripling the variable-rate premium would generate about $6 billion in additional cash receipts over the five-year period. It would also reduce PBGC's economic costs by nearly $18 billion, but it could cause some sponsors to terminate or freeze their plans.[8] (Meeting a five-year target through the variable-rate premium is further complicated by a lag in the collections.)

Changes to the funding rules that reduced PBGC's future benefit payments by reducing the size of the claims it was likely to take on could significantly reduce the agency's long-term economic costs but would do little to help meet the reconciliation targets. That circumstance results because any reduction in underfunding among active plans would occur over a number of years and its effect on claims in the short run would be relatively small. The effect of reduced underfunding on PBGC's outlays over the five-year period would be even smaller.

Implications for Revenues

Changes to the pension funding rules that affected the mandatory spending covered by the reconciliation instructions to the Senate Committee on Health, Education, Labor, and Pensions would also have an impact on federal revenues. Changes that required sponsors to increase contributions to their plans, which are tax-deductible, would result in firms' redirecting some resources slated for other purposes. Presumably, many of those resources would be directed away from taxable forms of spending.

Thus, efforts to limit PBGC's future claims by reducing underfunding within the pension system would also tend to reduce federal revenues. However, because defined-benefit pensions are a form of tax-deferred compensation, some tax revenue would eventually be realized from the additional contributions (although far outside the 10-year budget window) when those contributions were paid out as benefits that otherwise would not have been paid in full.

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8. Neither the estimated receipts nor the estimated economic costs currently reflect any response on the part of affected sponsors.

How Big Is the Prospective Problem?

Economic Costs Under Current Law

10 Years:	$48 Billion
15 Years:	$60 Billion
20 Years:	$68 Billion
Sunk Costs:	$23 Billion

What Is the Taxpayers' Liability?

Under Current Law

Zero

Under Policy Changes

Depends on the types of reforms (and may involve both direct expenditures and revenue effects)

How Is Policy-Relevant Cost Information Presented?

Under Current Law

Budget:
- Cash Flows of On-Budget Fund

Financial Statement:
- Probable Claims
- Contingent Liabilities/ Reasonably Possible Claims (Disclosed in footnotes)

Reporting Options

Budget:
- No Change
- Accrual of Economic Costs Incorporating Market Risk
- Annualized Premium Subsidy

Financial Statement:
- Market Value of Insurance

Policy Options: Effects of Raising Premiums

- Reduces Overall Subsidy and Prospective Net Costs
- Reduces Cross-Subsidies If Premiums Are Risk Adjusted
  - Link Premiums to Credit Quality of Sponsors
  - Link Premiums to Risk of Plans' Assets
  - Link Premiums to Plans' Underfunding
- Addresses Reconciliation Instructions

Policy Options: Changes in Funding Rules

- Price Assets and Liabilities to Market
- Match Duration and Risk of Assets with Duration and Risk of Liabilities
- Consider All Costs
- Link Funding Rules to Risk
- Improve Transparency

Chairman GREGG. Thank you, doctor. Would you send us a memo as to how we should change the budget accounting rules so that we more accurately reflect this, so we could maybe incorporate that in our rules next year?

Mr. HOLTZ-EAKIN. We would be happy to work with you on that.

Chairman GREGG. We did in the reconciliation instructions direct Finance and the HELP Committee, the HELP Committee having primary jurisdiction here, to do $6.6 billion of premium increases in this area. I guess my initial question to Mr. Belt and to you, doctor, if you wish to comment on it, is what effect does this have on the PBGC if we were to pursue the reconciliation instructions?

Mr. BELT. As Doug noted, the size of the accrued deficit is $23 billion. We can also expect significant future claims. Those claims will be large or smaller depending on how strong the funding rules are that are finally implemented. Clearly, the $6.6 billion is well insufficient to fill the current hole, let alone cover future expected claims, so that does then raise the question, if it is not going to be the premium payers that either the hole for the sunk costs or are not fully covering expected future claims, then who does do that?

Ultimately, from PBGC's perspective, you either have to end up, as you noted, Mr. Chairman, assets drained down, and at some point in time we would not be able to honor the commitments we have taken on to a million plus participants, and that number is growing and growing unfortunately for all the wrong reasons, or the resources would have to come from somewhere else, general revenues, which under current law are not available to us, and the taxpayer would be called upon to rescue the program. There is no magic number. We know what the size of the current hole is. We can project, using various methodologies, as CBO has done, what the future expected costs are, and then it is a question of who covers those costs.

Chairman GREGG. The current hole of $23 billion is over what period of time do you expect to have to pay that down, I mean you would cover that?

Mr. BELT. That is the size of the current deficit. That is, we have taken—

Chairman GREGG. Assuming you were to cover it.

Mr. BELT. We have assets of a little over $40 billion now. We have taken on pension promises that have a net present value in excess of $23 billion more than that, in excess of $60 billion. As you noted, in contrast to the S&L crisis, we are not facing a liquidity problem right now. Currently we are paying out about $3–1/2 billion, or this year we will pay out about $3–1/2 billion in benefit payments, and that number is going to steadily increase. But we have sufficient resources on a cash basis to cut benefit checks, subject to the maximum guarantee limit, for a number of years yet, but it is not a sustainable business model.

The hole is deep, and every day it gets deeper. When we take on United Airline pension plan, we take on $7 billion in assets in that pension plan. That is two years worth of benefit payments. The problem is we have also taken on $17 billion of promises associated with that, and ultimately the question is, how do we make up that gap?

Chairman GREGG. Let me phrase my question another way. We know that 15 years from now you are not going to have any assets under the present projection to pay any benefits. So anybody that ends up in your fund is going to get zero on their pension. With these reconciliation instructions, does that take it out to 17 years, to 20 years?

Mr. BELT. I believe our modeling shows—and of course it is dependent on a host of factors looking forward—that it actually does not improve our position. It lessens the deterioration of our financial position, but it does not improve our financial position.

Chairman GREGG. So how much more would we have to do? And when is the tipping point? In other words, if we go to 12 billion do we put more people in your fund than we actually protect the fund with assets?

Mr. BELT. Perhaps I can approach that in a slightly different way. Ultimately, behavioral changes are difficult to model, but I think we can put the premiums in perspective that will be helpful in framing the policy debate. The total premium revenue collected under the flat rate premium now is about $600 million a year, and the total premiums we have collected are a billion a year. We are talking about, under the Budget Act reconciliation instructions, an additional $6 billion. The amount of money that companies would have to put in the plan to close the gap and exit the system, if they chose to do so, would be $450 billion, substantially more than that extra $300 million proposed under the flat rate or the extra, the little over a billion dollars a year relative to current law, in the reconciliation instructions.

So it is really a drop in the bucket. Take the example of the largest pension plan out there, General Motors, which I think has about 700,000 participants. The proposed increase in the flat rate premium from $19 to $30 would mean their pension insurance cost would go up with respect to that component about $8 million a year, certainly significant, but the company has revenues of excess of $150 billion a year. Its health care costs are $5 billion a year. The premiums need to be put in perspective. It is a cost. There is no question about that, but it has been underpriced, as Dr. Holtz–Eakin noted, for a substantial period of time.

I do not know what the tipping point is. It is going to vary from company to company. From a systemic standpoint premiums are very, very small, even under the Budget Act and even if you substantially increase those relative to the needed cash contributions to the pension plan to make up the funding gaps.

Chairman GREGG. Thank you.

Senator CONRAD.

Senator CONRAD. Thank you, Mr. Chairman.

Mr. Belt, as I understand it, under the administration's plan, if an employer's bonds go to junk bond status, that would then trigger a requirement for new pension contributions and additional premiums. Does that not further threaten the viability of the enterprise?

Mr. BELT. What the administration's proposal is trying to do, first and foremost, is make sure that we begin in a very measured way to fill the gap. We have an extraordinary amount of underfunding, chronic underfunding on the part of pension plans, that

when plans terminate it results in workers and retirees losing their hard-earned benefits. As noted with respect to the case of Ms. Sarasini, potentially half or more. It is a tragic situation. There is a very human toll. What we are saying is "Let us make sure that there are sufficient assets on the pension plan to cover the promises made, and then also, as the chairman noted earlier, to not make new hollow promises when they cannot afford to pay the old promises."

We are also trying to reflect the fact that there is risk in the system, and as in any properly designed insurance system, you want to encourage appropriate behavior and discourage risky behavior. That is not the way the current system is constructed. We want to start moving in that direction.

With respect to credit ratings, I would note—and we just pulled up the Standard & Poor's data, looking at average default rates—the default risk for non-investment grade companies is 20 times higher than that for investment-grade companies over a 5-year period, not 20 percent higher, 20 times higher.

Senator CONRAD. 20 times higher. Let me ask you this question. I do not see anywhere in this proposal a changing of the limitation that we currently have on companies' contributions when things are going well. Is that not part of the problem? I mean I have had so many companies tell me, "Gee, we have been frustrated because there is a limitation on what we can put into the fund when things are going well." Then as the system, as it has been described to me, when things get tough, when the economy falters, when it becomes clear that they are underfunded, then the requirements increase. It is almost like we have got it upside down and backwards.

Mr. BELT. Actually, Senator, the administration proposal does propose that companies be given additional flexibility beyond current law to increase the amount of tax-deductible contributions into the plan in any given year.

Senator CONRAD. How do you do that? I am glad that you have got that as part of the plan. I did not see it as I went through the—

Mr. BELT. It is a core element to actually provide them to be able to make tax-deductible contributions up to 130 percent of their funding target. So that is a substantial increase relative to current law. Obviously, that has revenue consequences, and it is usually anathema to tax policy to allow people to control the timing of their losses—

Senator CONRAD. I understand. I understand. That has got an effect on the Federal revenue, right?

Mr. BELT. Yes.

Senator CONRAD. That is going to reduce Federal revenue to have them be able to make further contributions.

Mr. BELT. The administration is supporting and providing that additional flexibility. Having said that, the argument that the maximum contribution limit has materially contributed to the current level of underfunding is unfortunately not wholly correct.

Senator CONRAD. And why not?

Mr. BELT. We analyzed that. We looked at the data. And in some years 80 percent of the companies could have contributed more during the good times and did not do so. That is, they did not bump up against the maximum contribution.

Senator CONRAD. They could have done more even under current law, but did not.

Mr. BELT. Yes, even under as I said, the worst of years, more than half the companies could have contributed more, that is, they would not have bumped up against the maximum contribution limit, but they did not. It has not been a material contributing factor to the current funding gap.

Senator CONRAD. I am running out of time. I want to get this question in to you. You know, in business school, we often talked about the 80/20 rule. 20 percent of your clients do 80 percent of your business. The 80/20 rule just seems to follow in many, many applications. That is, a small percentage of the entities out there are the biggest part of your problem, and the biggest part of your opportunity.

If we would be looking for the element that is contributing most of the problem, what would that be?

Mr. BELT. Well, there is a combination of factors. Companies have been taking on substantial investment risk in their pension plans, and the consequences of taking on that risk were borne out beginning in 2000 when—

Senator CONRAD. In what way were they taking on—

Mr. BELT. They have a mismatch, a fundamental mismatch between their assets and liabilities. Their liabilities are very bond-like in nature. The assets were disconnected from the bond-like nature of those liabilities. So they had exposure both to changes in equity prices as well as interest rates.

Senator CONRAD. So they were taking out-sized risks?

Mr. BELT. I do not want to characterize it as out-size. They were taking risk. And there was—

Senator CONRAD. Well, it did not turn out.

Mr. BELT. There was substantial duration risk. And what you saw then is the asset prices were falling, the liabilities were increasing in value because of lower interest rates at the same time, and in some cases companies were making new pension promises, and liabilities were accruing ordinarily in any event. In addition, because of smoothing mechanisms built into current law and which the administration proposed to eliminate, this was hidden from view. In addition, because of another mechanism under current law called credit balances, companies were able to avoid putting cash in during these years, notwithstanding the fact that the gap was widening during this period of time.

We would also propose to eliminate credit balances, again, making sure that we have meaningful asset and liability measures, and a meaningful funding target.

Senator CONRAD. My time has expired.

Chairman GREGG. Thank you.

Senator ALLARD.

Senator ALLARD. You mentioned the 450 billion total liability on the companies and I was not clear as to over what time period that was, Mr. Belt.

Mr. BELT. That is the current size of the hole when you look at measuring those assets on a market basis, the entire assets in the system relative to the current market price of those liabilities dis-

counted back, the net present value of the promises they have made. So that is the current size of the hole.

Senator ALLARD. I see. Now, in your view is this problem something that can be solved now without putting an undue burden on the participants on the guaranty fund?

Mr. BELT. That is certainly the objective of the administration's proposals, to address the problem now so that we avoid having situations like United Airlines in the future, where not only do the participants—the workers and retirees—lose a substantial amount of the benefits that were promised to them, but companies that have acted responsibly then are called upon to pay higher premiums, whether it is $6.6 billion or some other number, or if Congress decides not to put it all ont premium payers, then where else are the monies going to come from? Are we going to stop cutting checks to the participants or are we going to ask the American taxpayer to step in?

Senator ALLARD. There was some discussion that other airlines might follow, since you mentioned United, there was some discussion that other airlines may follow up and do what United had done. What do you view as the likelihood of that happening?

Mr. BELT. Ultimately that depends on market conditions and their own unique business needs. The situation with respect to the legacy carriers that are now in Chapter 11 is different, each one is different from another.

Senator ALLARD. Let me put it this way. Is there a concern of the administration that other airlines will likely follow United?

Mr. BELT. There is certainly a concern that, given the fact that the CEOs of each of the other legacy carriers have indicated publicly that they would feel competitive pressure to at some point potentially enter Chapter 11 and seek to terminate their pension plans. Given the fact that those pension plans are substantially underfunded by an excess of $20 billion, there is no question we are concerned about that.

Senator ALLARD. With the administration's plan that you have now, when do you think that you could get the pension fund back on solid footing financially?

Mr. BELT. The administration's proposal is to require companies to fully fund their pension plans over a 7-year period.

Senator ALLARD. So you think in 7 years we could be—

Mr. BELT. You are always moving towards 7 years. There is a new amortization schedule established each and every year, and as long as you are still taking investment risks, the assets or liabilities may be greater or lesser during that period of time.

But I also want to note that that 7-year time frame that the administration proposed is trying to be fairly measured and responsible when it is compared to current law. Current law has multiple time periods for funding deficits—as little as 3 years if you are captured by the Deficit Reduction Contribution Rule. So under current law, you may have to make up that funding gap in as little as 3 years, which is the case for the airlines.

Chairman GREGG. Senator Allard, may I?

Senator ALLARD. Follow up, Mr. Chairman.

Chairman GREGG. Just so we are all on the same page here, you are talking of the administration plan, which is $12 billion more than what the reconciliation instructions in the budget were, right?

Mr. BELT. Well, I was not talking specifically about—

Chairman GREGG. You are talking the—

Mr. BELT. —specifically about the premium aspect of it. I was talking more about the funding rules portion of it. Again, the emphasis in the administration proposal is not to have monies coming into the PBGC, although clearly we need to figure out how to fill the hole. The emphasis of the administration's proposal is making sure there are sufficient assets in the pension plan to cover the promises that are made so we do not have to worry about losses occurring to a pension plan down the road.

The weaker the funding rules are, the more we are going to have claims, and that is going to necessitate higher premiums. There is a direct connection between the two.

Senator ALLARD. Thank you, Mr. Chairman.

Chairman GREGG. Senator Byrd.

Senator BYRD. Thank you, Mr. Chairman. Thank you, Mr. Conrad.

Dr. Holtz-Eakin and Director Belt, we remember in West Virginia a great union leader, John L. Lewis. He spoke of those who supped at labor's table and who are sheltered in labor's house. Many of the workers in my State sacrificed their wages to ensure higher pensions in retirement. And they view those pensions as much their entitlement for a day of labor, as their Friday paycheck. These workers are outraged that companies can escape their pension and health care obligations through escape clauses. They escape their pension and health care obligations through bankruptcy.

In West Virginia it has happened in the coal industry, it has happened in the steel industry, it has happened in the aluminum industry and in the special metals industries. Businesses, rightly or wrongly, file for bankruptcy, and workers, through no fault of their own, find themselves stranded, too young to collect Social Security, too old to find a new job.

Congress, Director Belt, recently passed legislation cracking down on individuals who abusively shed their debts in bankruptcy. What further reforms are necessary to ensure that companies do not abusively shed their pension obligations in bankruptcy? And what changes to the corporate bankruptcy laws, as they relate to pensions, should the Congress consider?

Mr. BELT. Senator, I would be delighted to take the first crack at that. There is no question that under current law the interaction of ERISA, the Employee Retirement Income Security Act, and the bankruptcy code leads to bad outcomes, and multiple losers. All the stakeholders lose, workers and retirees. You have companies, responsible companies, and they would be on the hook for higher premiums. Not only that, but they may face the prospect of having to compete against a rival that now has the Federal Government subsidizing its labor cost on an ongoing basis.

In addition, it exposes the taxpayer to risk down the road. That is current law. Current law does allow companies a method, a mechanism for filing Chapter 11 and seeking to have their pension plans terminated under so-called distress termination.

PBGC has a very limited role in that process. That is ultimately a determination made by a bankruptcy judge under the Bankruptcy Code, if they find that the company would be unable to emerge from Chapter 11 successfully if it had to maintain one of more of its pension plans. Certainly, we have seen that happen, we have seen it happen in too many instances.

What was particularly troubling to us—and the administration has a specific proposal to address this—is a situation that arose with respect to United Airlines last summer, when it had a legally required contribution that it had to make under ERISA of $70 million last summer. It said it elected to defer that contribution even though there is no concept of election or deferral under the law. And there was ultimately no consequence to their not only missing that legally required contribution or other subsequent contributions because of the operation of bankruptcy code.

If they had not been in Chapter 11, a lien arises automatically under the operation of law, and PBGC would have the ability to enforce that lien. In bankruptcy, however, although the lien arises, the automatic stay provisions of the bankruptcy code kick in and we can not take any action. So as a result there was no practical consequence to United of simply not making a legally—

Senator BYRD. But what reforms are necessary to ensure that companies do not abusively shed their pension obligations in bankruptcy? What changes to the corporate bankruptcy laws as they relate to pensions should the Congress consider?

Mr. BELT. The only other—perhaps Dr. Holtz–Eakin has some thoughts on that. I would note that part of the administration's proposal is to address the issue that arose last year, is to make sure that PBGC would have the authority to enforce a lien in bankruptcy, which we think is one critically important change.

Senator BYRD. Dr. Holtz–Eakin?

Mr. HOLTZ-EAKIN. A different way to think about this is that pensions are just like wages. They are compensation that is given to workers, and it is earned at the time the work is done. That is over once the work is finished. And it should not be affected by any reorganization in bankruptcy or outside of it as a result of competitive pressures. And so the challenge is to make sure that the compensation that has been earned is carried forward in time and paid to the workers upon retirement. That can be done either internally with better funding rules to make sure the resources are actually there, or externally by paying an appropriate price to someone like the PBGC to deliver those resources at the time the worker retires.

But it is not necessarily a bankruptcy problem. Bankruptcy is about economic reorganizations. It is about making sure that firms make adequate preparation internally or externally to provide that compensation that has already been earned.

Senator BYRD. My time is up, but is what you say—I say to both—is what you say enough to prevent companies from abusively discharging in bankruptcy their pension obligation to workers?

Mr. HOLTZ-EAKIN. Director Belt is more familiar with the rules than I am, but to my knowledge, no one is accused of abusing rules. They are following the rules. So the key will be to write rules which strengthen both the internal and the external funding for these pensions.

Mr. BELT. The only other point I would note, Senator, in that regard, is that bankruptcy is at the end of the process—and PBGC historically—once we are in bankruptcy as a general unsecured creditor, receives about 5 to 7 cents on the dollar in claims recovery.

The focus really should be on the front end. There is nothing that we can, in my view from a governmental perspective, do to change the business cycle. Companies are occasionally going to go out of business. What we can and should do something about is, if they sponsor a defined benefit plan, making sure that there are sufficient assets in that pension plan to cover those promises, so everybody is getting 100 cents on the dollar. We are not at the very end of the process, worrying about getting a nickel on the dollar.

Senator BYRD. Thank you very much.

Thank you, Mr. Chairman.

Chairman GREGG. Senator Bunning.

Senator BUNNING. Thank you, Mr. Chairman.

I want to go back and get some figures corrected. $450 billion was mentioned. Is that the overall number of all pensions that all companies have, whether it be a defined pension program? In other words, is that whole world we are looking at?

Mr. BELT. It is defined benefit plans. It is the amount—

Senator BUNNING. That has nothing to do with 401(k)s, it is just the defined benefit plans?

Mr. BELT. Correct, Senator.

Senator BUNNING. One of the—

Mr. BELT. I am sorry. Just one clarification about the private sector defined benefit plans. That does not include public sector defined benefit plans. That is a whole other issue and an even bigger gap.

Senator BUNNING. One of the solutions would be to freeze, until made whole. In other words, I ask this question because there is usually a 30-year rule that if you start a defined benefit plan and you have promised your employees X amount of dollars, and you are the corporation, you have 30 years to fund that pension. Is that incorrect or correct?

Mr. BELT. That is one of the funding elements, yes. There are 30-year amortization periods under current law.

Senator BUNNING. Obviously, business cycles and many other things take hold, particularly those who were funding their pensions with their own securities. I know we made some changes there, but for a while the only thing that went into a pension program, if you were a Procter and Gamble, was Procter & Gamble stock, and if the stock went down the company's assets went down. The defined benefit program went down, so it was not good if you had a down cycle.

I do not know what United and Delta and Northwest and all of these legacy airlines are doing, but I think they started out with pension programs that invested in their own stock, or that was part of. Would that be a good rule, that you should not be able to put your own stock? I mean we have it to a certain point now.

Mr. BELT. There are severe restrictions under current law, Senator, on non-cash contributions.

Senator BUNNING. But that is just recent.

Mr. BELT. It has been in place for a while now. There is a process that one can go through, and it is under Title I, and the Employee Benefit Security Administration administers that, not PBGC, where a company if it wanted to put something other than cash into the pension plan, would have to get a prohibited transactions exemption from the—

Senator BUNNING. It sure would stop management from over promising if there was a shorter period of time for funding. In other words, if you had a 7-year window to fund a benefit plan, you surely could not go out and promise 50 percent of wages for a 20-year, 25-year employee, because you could not possibly fund that kind of benefit in a shorter window of 7 years, say, rather than 30 years. So there are a lot of little things that can be done—and I do not think the administration has covered all of them in their proposal—to make whole the employee in the future. And for God's sake, we have to change the escape clause that the corporations now have of dumping their employees on the PBGC in bankruptcy. This Pension Guaranty Trust Fund was not ever set up to do what it has been asked to do.

CBO's, the number $450 billion, there is no way, there is absolutely no way we will ever get there unless taxpayers foot the bill. And with the restrictions on PBGC as far as return, maximum return to those people who deserve and have earned those benefits, because that was part of their compensation package, we are not going to get to that number unless we get taxpayers' money involved. Is there any other suggestions that we can stop the hemorrhaging? I am asking.

Mr. HOLTZ-EAKIN. I think a couple of thoughts on it. Number one, 450 billion is unlikely to be the number that would show up at the PBGC. Our estimates suggest that something more modest, $100 billion over the right horizon would be the cost. But your general point is well taken.

Number two, some of that you cannot change. It is a matter of picking up the bill one way or another. That is the $23 billion number for sure. The remainder is—

Senator BUNNING. 23 billion is not going to break the Federal Government. 450 billion added on to what we already owe just piles debt onto debt.

Mr. HOLTZ-EAKIN. And the remainder is about improving incentives, either for better funding, the funding rule changes, or by paying if you do not fund, which is higher premiums too, and insure like the PBGC. And your point that sometimes you are going to have to fund this and make clear the cost of a promise you made to workers, if that is clearer, if the transparency is improved, shareholders are going to see the nature of that promise as well, and they are going to know that that money is going into the pension, not coming back as dividends. That will improve incentives as well, so it all fits together. There are a variety of things that Congress can do.

Senator BUNNING. Thank you, Mr. Chairman.

Chairman GREGG. Thank you, Senator.

Senator STABENOW.

Senator STABENOW. Thank you, Mr. Chairman. I want to thank you for holding this meeting. I think this is one of the most critical

issues confronting all of the families that we represent, and appreciate both of you being here today.

I want to first just indicate that I think it is important to stress what has been said by colleagues, and also with you, that we are talking about pensions that are part of wages that people have earned throughout their lives. This is about creating the American dream, and really creating the middle class of America that has been the economic engine for us. You work hard, you pay into a pension. You may not take the pay increase that you would otherwise. But you are paying into a pension, and you are also getting health care. We have a whole generation of families now that are counting on this and have worked hard for this all their lives. So this is pretty serious business, pretty serious discussion we are having—but I think we all are interested in knowing how best to address this right now.

I think it is also safe to say, and looking at this CRS report, that we are really talking about something that has happened just in recent years. In 1996 the PBGC showed a surplus for single-employer programs for the first time in its history, and it peaked in 2000, and is now, as a result of the economy, and this is now saying particularly steel and airline industries, we have large deficits. And multi-employers had surpluses for 20 years and are now looking at deficits.

I wish, frankly—hindsight is always 20/20, but I sure wish we had been having this discussion three or four years ago, frankly. Every year we wait on this has caused deep, deep problems for American families and American workers.

But my question really relates to how we move forward now in a way that does not unduly hurt those businesses that are already in serious trouble, being pressured on many different angles, obviously General Motors in Michigan, and what is happening in terms of the auto manufacturers and other manufacturers is critical. They did the right thing. They have paid their employees well. They provided pensions. They provided health care. They have done all that they were asked to do in terms of doing the right thing in corporate America.

And now my concern is that we see, just as they are being pressured with high health care costs, exploding health care costs, issues of illegal trade practices, both of which I would hope we will address together in a bipartisan way because I think these are the larger, long-term issues that are pressing these companies. But now we are seeing a proposal for a five-fold increase in premiums, and I understand why.

But my concern is—and Mr. Belt, I would first ask you. I mean how do we shore up the pensions without driving the less healthy companies right now into bankruptcy, which I think is a serious, serious issue for us right now. Putting the majority of the costs, majority of the increases onto those that are already struggling with legacy costs, already struggling at the ends, seems to me to be placing them in an even more dangerous situation for employees, as well as the business.

Mr. BELT. It is a very good question, Senator. I would make a couple of observations in that regard. First, the last thing we want to do as a policy matter and the last thing I want to do wearing

my business hat, I think, as the PBGC, is exacerbate the problem or drive the good actors out of the system. The defined benefit plans are good things for employees, for workers and retirees. We want those to be maintained. If we drive people out of the system, that means my revenue base from a business standpoint is eroded and that is the last thing we want to have happen.

I think we need to recognize that there is a steady erosion under the current law from the defined benefit system. We have got to figure out how to stabilize that system and hopefully turn the corner. We also have to recognize under current law that there are these huge risks, losses have already occurred and risks of future losses, and we have not yet solved the problem of who pays for those. Under current law it is the premium payers. It is the GM and everybody else that sponsors a pension plan that are on the hook for the losses of United Airlines, US Airways, Wheeling Pitt, LTV, Weirton, PanAm, Eastern, et cetera, et cetera. I do not believe that—we had this discussion a little bit earlier—that an increase in premiums in and of itself is going to require or necessitate a systemic exit from the system. Again, relative to the funding gaps in the pension plans, that $450 billion in single-employer plans, plus another $150 billion in the multi-employer program, and the $100 plus billion of exposure we have to companies that are non-investment grade, at higher risk of default, that $6.6 billion of premium increases proposed under the Budget Act is fairly modest, as would the $18 billion proposed under the administration's budget submission. That was over 5 years.

Also, even though it is a voluntary system, companies do not have the unilateral ability to freeze or exit the system if they are covered by a collective bargaining agreement, as you well know. That has to be negotiated.

The consequences of leaving in the status quo flexibility—some would characterize this as flexibility, I would characterize it as loopholes—is that we are going to continue to end up with terminated pension plans that are substantially underfunded and everybody loses. So we have got to do something to address that.

We believe the administration proposal provides ample incentive for companies not only to maintain their pension plans, but hopefully create a dynamic such that they can make an economically viable decision to start new pension plans. We greatly simplify the rules. Plan sponsors have long complained about the complexity of the rules, and they are absolutely right. They have asked for a permanent corporate bond rate to discount their liabilities, rather than the old Treasury rate. We are proposing that.

The earlier point, giving them greater flexibility to fund up during good times, they have not really used that much in the past. We hope that they will do so in the future, and will give them that greater flexibility.

We also support resolving the issues with respect to cash balance plans. Congress needs to address that because if there is a future to defined benefit plans it is in hybrid structures. There have been issues with respect to conversion that need to be addressed, but that type of plan is critically important. We believe we have to stop the hemorrhaging, have to stop the hole from getting deeper, and the only way to do that is through stronger funding rules imple-

mented in a responsible, measured way over time. We have proposed 7 years, which is in contrast to the 3 to 5 years that some companies have to face under current law.

Senator STABENOW. I appreciate that, and I certainly, as you raise the issue of bankruptcy, as well support what you are talking about in terms of getting around the ability to move into bankruptcy and to be able to move your pension plan into the PBGC.

Just quickly if I might, Mr. Chairman, just one other quick question. I am wondering at this point in terms of employees and economic impact of employees, when a system moves into the PBGC, what is the typical percentage right now of the promised pension payment that can be expected by an employee?

Mr. BELT. The average pension benefit I believe—I am not sure we have this data. It is in our data book and I may be wrong on this. It is less than $10,000 a year is the average pension received under a DB plan by—

Senator STABENOW. But what percentage now—when you are talking about dollar for dollar, how much for every dollar that somebody has paid in their pension plan would they expect to be able to receive?

Mr. BELT. It totally depends on the individual and the construct of their plan and the benefits that are promised. The guarantee covers up to a limit established by Congress, an annual benefit of more than $45,000 a year for somebody taking an annuity at age 65. So historically the vast majority of participants in the system have not been hit by the maximum guarantee limit. They have gotten all the benefits that were promised under the plan, the basic benefits. That does not mean they are not losers when pension plans terminate because they are no longer accruing future benefits, and they may lose some early retirement subsidies. But in terms of that basic benefit, the vast majority of participants have not been impacted by that, but there certainly are too many cases in which they have.

Senator STABENOW. Thank you.

Thank you, Mr. Chairman.

Chairman GREGG. Now we turn to the man with the magic wand—

[Laughter.]

Chairman GREGG. —the Chairman of the HELP Committee, Senator Enzi, going to straighten all this out.

Senator ENZI. Thank you, Mr. Chairman. Thank you for holding this hearing.

Director Holtz–Eakin, two months ago, my staff directed a fundamental scoring request to CBO, and that was what are the savings if we repeal the full funding exemption as it applies to the PBGC's variable rate premium? Now, the answer to that one question affects all the other decisions that the HELP Committee makes in reaching its budget reconciliation instruction. Now, I know that dozens of other scoring estimates related to pensions have been issued from your office, some of them to my staff, many more to other committees. For my purposes none of them are as important as the one question that we asked 8 weeks ago.

You do not need to explain why it has taken so long. I only want to know when the HELP Committee will get this critical question answered?

Mr. HOLTZ-EAKIN. Knowing it is the most important thing you need to know, sir, as fast as we can. Thank you for letting me know.

Senator ENZI. Okay. Thank you. Another question. In your testimony you speak of implied Federal guarantees that underlay the Federal insurance program of PBGC. You talked of the costs of pension failures being borne potentially by taxpayers. We can all imagine the scenario where your prophecy would be self-fulfilling it is mentioned enough.

I join Senator DeWine, who is the Retirement Security Subcommittee Chairman, in asserting that a taxpayer bailout is not an option. I know that Chairman Boehnert in the House, and I feel certain that Chairman Grassley on the Finance Committee, shares that view that a taxpayer bailout is not an option.

That being said, my question is this: Are you willing to assert here today that your prophecy of a taxpayer bailout is a certainty based on the budget numbers you have seen and considering all other options that are available to us, or are you just trying to get people's attention?

Mr. HOLTZ-EAKIN. Well, certainly not. It is a matter of the Congress's decisions. What is certain is that there exists large scaled underfunding in defined pension system as a whole, that the current rules are such that many of those claims which show up at the door of Mr. Belt, and that in the future some of those claims will arrive at a door which has no resources behind it. And the question then will be: Who pays? Will it be the case that it will be the workers and retirees, or will it be some other mechanism? But that much we know.

Senator ENZI. And if Congress takes some action, some decisive action, it is possible to avert all of those prophesies?

Mr. HOLTZ-EAKIN. Yes.

Senator ENZI. Some people are kind of confused with the savings & loan bailout that we had before, compared to PBGC. And I hope that people are helping to emphasize the fact that that was cash that people lost at that point, that that loss that they got immediately, as opposed to a pension which is over a number, a period of years, as they are supposed to earn it. There can still be some similar problems, but it is a much longer cash flow problem than the others, and I hope everybody will—I will have some questions in writing dealing with that one.

We are working on a fix, and I think it is almost historical that the Finance Committee and the HELP Committee are working together to come up with a solution. There are kind of two ways that we can go. We can start fresh, which some people would say would be throwing out the baby with the bath water, or we can tinker around the edges. Now, hopefully there is a third way that will be a little bit more comprehensive than that, but the approach that—this is for Brad Belt—the approach that you propose and the administration has proposed kind of falls in that first camp, throwing out the existing rules and trying something new.

what are the likely consequences if you are wrong, and the dictates of mark to market asset valuations and a near spot rate yield curve causes such volatility and unpredictability, that the strong plans terminate and the weak plans collapse? What happens then?

Mr. BELT. A couple points in that regard, Senator Enzi. First, it is not the administration's proposal that is causing any volatility. That risk and volatility is inherent in the pension plan itself. It is wholly a function of the business and investment decisions made by the company. They are taking on that risk and volatility through their decisions. What they are asking us to do is pretend it is not there and hide it from view. We are simply saying: "Let us expose that". Companies have full ability under current law, and they would have full ability under the administration's proposal, including some additional incentives, to lower that risk and volatility should they choose to do so. If they want to volitionally bear that risk and volatility, that is up to them, but let us make sure those risks are understood and transparent and priced.

To the point about whether we would drive them out of the system, I have heard that argument made. There are a couple of issues in that regard, and I pointed this out in response to Senator Stabenow's question. The cost to exit the system for all the system stakeholders would be $450 billion. Whether they have those resources to be able to do that, to go out and buy annuities on behalf of all the participants is another question all together, but that is what the cost would be relative to what we are saying, which is some additional premiums, a measured way to fund up to get to fully funded, and numerous incentives, tax-based incentives and otherwise, to be able to contribute to their pension plan.

Senator ENZI. Your argument suggests that all the companies ought to just invest in bonds to avoid volatility and I do not think that is going to be the answer to it too.

Could I have just another minute?

Chairman GREGG. Sure.

Senator ENZI. I know that there have been some reference before to consider smoothing rules to be lies. Are they frauds on the American people? I ask these questions because some of the rhetoric we are hearing is that unless we throw out the current law, try something completely different, that we will be attacked as liars and do-nothings. If we do what you are asking, we will be attacked as dead set on killing the defined benefit system.

So just so we know where you stand, do you believe that tightening the smoothing rules, as we have done in the Boehnert–Thomas bill in the House, is tantamount to lying to the American people?

Mr. BELT. We believe, Mr. Chairman, that you need accurate measures of assets and liabilities at a point in time, market-based measures of assets and liabilities. Smoothing is not market-based. That is not accurate as of a point in time. That is saying what happened three or four years ago is relevant to today, but that is not the way that markets work.

We believe that in order to best protect the benefits earned by workers and retirees, as well as best protect the American taxpayer, you need to have accurate measures of assets and liabilities,

market-based measures of assets and liabilities, and a meaningful funding target.

Chairman GREGG. Senator Murray.

Senator MURRAY. Thank you very much, Mr. Chairman, for holding this really critical hearing. I do have an opening statement I would like to submit for the record.

Chairman GREGG. Of course.

[The prepared statement of Senator Murray follows:]

Senator Murray's Opening Statement for Budget Committee Hearing
Pension Benefit Guaranty Corporation

June 15, 2005

Mr. Chairman, thank you for calling this hearing to explore ways to help shore up the Pension Benefit Guaranty Corporation (PBGC). We need to better protect defined benefit pension plans for millions of workers across our great nation.

It is clear to anyone reading the newspaper these days that our current set of pension laws and rules do not adequately protect the retirement savings of our workers. I believe that to protect defined benefit pension plans we need a stronger commitment to greater regulatory oversight of the investment services community and those responsible for the administration of pension plans across the U.S. It is simply unrealistic to expect that workers can adequately protect against these reductions in benefits for themselves and their families given the lack of timely information about their pensions that is currently provided to them.

I believe the current system is stacked against workers and too heavily skewed to allow corporations to play fast and lose with the inadequate rules and regulations currently on the books. The federal government should not condone poor management decisions and pass the costs of corporate missteps onto loyal workers and American taxpayers.

It is critical that the Congress moves quickly to shore up defined pension plans, while also including reforms to stabilize multi-employer and cash balance plans. As we have seen from the recent case with the United pension terminations, those who have worked hard and played by the rules are not necessarily guaranteed the retirement savings they are relying on in their golden years.

I have talked to many United workers in my state of Washington who will be severely affected by these cutbacks. I know it will be very difficult for a 50 year old flight attendant based in Seattle to recoup the nearly 40% lost in future retirement benefits because of the PBGC takeover of United's pension plan. I am also very worried that Delta, Northwest and other legacy industries may not be far behind United in seeking to terminate their defined benefit pension plans.

These reductions are devastating to workers, especially when coupled with our low national rate of savings and possible reductions in Social Security benefits. The three-legged retirement stool is very wobbly right now, and workers are rightfully worried that they will not be able to retire as planned.

I am committed to working on a bipartisan basis in the HELP Committee, along with our friends in the Finance Committee, to produce a solution that will first and foremost protect future workers' pensions. We must also ensure greater transparency, disclosure, and a realistic financing mechanism to allow employers to continue to provide a realistic level of defined pension plan benefits to their workers.

Senator MURRAY. And let me just say off the top that it is pretty clear to anybody who reads the newspapers today knows that our current set of pension laws and rules do not adequately protect the retirement savings of our workers, and I believe to protect defined benefit pension plans we do need a stronger commitment to greater regulatory oversight of the investment service community and those responsible for the administration of pension plans across the country.

I think it is just unrealistic to expect workers to adequately be able to protect themselves against reductions in benefits for themselves and their families because of the lack of timely information about their pensions that is currently provided to them, and it just appears to me that the current system is sort of stacked against workers and heavily skewed to corporations that can play fast and loose with inadequate rules and regulations, and I do not think the Federal Government ought to condone poor management decisions and pass the costs of corporate missteps onto loyal workers and the taxpayers.

But having said that, I am hearing the numbers that you are giving us today and looking at the pension insurance data book that was recently released. A serious decline in numbers over the last four years, and I am kind of mystified by the fact that when you look at this, $38 billion in PBGC losses over the last 3 years alone. Why did this agency not face those kinds of deficits in the past? You know, from 1985 to 2002 the PBGC had a cumulative surplus of over $25 billion. Why was the agency able to remain in surplus during those times even when there were economic recessions during those times?

Mr. BELT. I would have to check the records, look at the data book. I do not believe we have ever had a surplus of that size. I believe our record cumulative surplus was, in about 2000, a little over $9.7 billion.

But to the broader point, I think what has happened is that we have had pension plans grow substantially in size over the last 30 years. Simply the size of the pension plans, both the assets and liabilities, is much, much greater than it was. And then what you had was, coming into 2000, companies had been taking advantage of very robust market returns to avoid putting any cash into the pension plans for several years. They were able to ride asset gains. That all changed beginning in 2000. Asset prices fell by 25 to 30 percent over a 3-year period. Interest rates also fell at that point in time, which increased the value of the liabilities.

At the same time, companies were taking advantage of the rules—not breaking the rules, simply taking advantage of the loopholes in the rules—to in some cases make new benefit promises, notwithstanding the fact that they may have been in financial difficulty and the funding gap in the pension plan was increasing, to take advantage of things like smoothing, referred to by Senator Enzi, that hid from view the fact—hid from the workers and retirees as well as the markets—the fact that this gap was there and growing. And they were also able to use mechanisms like credit balances, which pretended that the previous value of assets was still there even though these were long eroded to avoid making any cash contributions into the pension plans. And it was the combina-

tion of those factors over a 3- or 4-year period that caused not only PBGC's deficit to go from $3.6 billion to $23 billion, but the underfunding gap to grow so precipitously to $450 billion, and the amount of reasonably possible claims to increase from $10 billion to $100 billion.

It has just been a fairly dramatic change in a fairly short period of time, and what this has really done is disclose the problems, the structural problems in the pension rules.

Senator MURRAY. The $25 billion that I referred to was cumulative over those years, 1985 to 2002. But having listened to what you just said, has Congress failed to provide adequate oversight during the last 3 years?

Mr. BELT. The administration proposed and my predecessor and then Under Secretary of Treasury as well as the Assistant Secretary of Labor proposed in the summer of 2003 many of these reforms that we have before us now. We have gone much further, and Congress has not yet acted on those. We would hope that the Congress would move forward as soon as possible to enact these reforms so that the problem does not get even deeper in the intervening time.

Senator MURRAY. Do you think that Congress should provide the PBGC with a stronger enforcement model, maybe something like the new and expanded authority that the SEC was given under Sarbanes–Oxley?

Mr. BELT. I am not sure that the Sarbanes–Oxley model dealing with governance issues is quite appropriate for the PBGC, but there is no question—and we have talked about this before—that the PBGC has a limited set of tools available to it to enforce the provisions of Title IV. I would just simply contrast some of the tools available to the Federal Deposit Insurance Corporation, another Federal insurance entity.

We have used the tool set that we have as aggressively as possible and as responsibly as possible to avoid losses and to enhance recoveries. But there certainly are limitations, and as we noted earlier, we have bumped up against the fact that—the positions we take consistent with ERISA are often trumped by what happens in the bankruptcy court.

Senator MURRAY. Mr. Chairman, if I could ask just one really quick question, I have heard from a lot of United workers who live in my State who are obviously very, very upset about what is happening to their pensions system, especially the older flight attendants. Some of them are now saying, "We are going to have to fly until we die." They do not believe they are ever going to have a pension. I think that is a serious concern for all of us.

But I would like to ask you: Should the PBGC provide stronger financial protections for low-wage earners or those wage earners who are close to retirement, so if you are 50 and you expect to retire in a few years, you have, a much shorter amount of time to be able to recover from impacts like this?

Mr. BELT. That is obviously a policy decision for the Congress to make. That is not anything we have current authority to do. The only point I would make is that if you raise the maximum guarantee limit or you somehow provide a mechanism providing additional benefits beyond those contemplated by current law, it simply

raises the price tag of the insurance program. And then the question we have been discussing this morning is ultimately who pays for that.

Senator MURRAY. Thank you very much, Mr. Chairman. I appreciate the hearing.

Chairman GREGG. Thank you.

I would like to try to put in context the way I see this problem, and tell me where I am wrong. Defined benefit programs guarantee a return. They say you are going to get X amount, and that is the difference between other programs. A 401(k) you invest, and if your investment does well, you get what the investment return is; if it does poorly, you get less. A defined benefit plan says you are going to get a certain amount back. And, therefore, the assets should match to generate that return, and it is totally predictable from the standpoint of actuarial accounting. And if it were an insurance fund which was being monitored by a State and the assets did not match the risk of the insurance, which was actuarially predictable, the State government would step in and say you, insurance company, must correct your fund to match.

So I sort of look at this issue in that context, and looking at it in that context, it seems to me that what we need are rules that say, A, that the companies that make promises to their employees and the employees who seek those promises through collective bargaining negotiations have to be honest that the assets are going to match the promises that are going to be put into the fund; and that you as the PBGC and the Government should have rules which require companies and the unions which support the contracts to put those assets in, and that the assets should be predictable. And it gets to the point that Senator Enzi was making, which is: Is it equities or is it bonds? But whatever it is, it should not be speculative and it should not be risk based. It should be predictable return on assets to match the benefit.

Where we disconnected was that in the 1990s with the market doing so well, many defined benefit plans decided to move into the risk business and position themselves like contribution plans where because they were getting such a good return on their investment and they thought that they could basically pursue it that way, rather than effectively matching with predictable returns assets which had long-haul return rates which would match their benefit structure.

And so my sense is that as we try to correct this, we have got a two-level problem: first, we have to fix what we know is the issue, the $23 billion; and, secondly, we have to restructure the way companies fund the defined benefit plans for the future so that there is transparency, so that people know what the benefit is they are going to get, and so that we know that there are assets behind those benefits to support them which are predictable and have long-term returns.

Is that an incorrect way to see this issue?

Mr. BELT. I think it is a very thoughtful and thorough analysis, Mr. Chairman, and it is actually a point that Federal Reserve Chairman Greenspan made just the other day as well in his testimony before the Joint Economic Committee.

Chairman GREGG. Well, I did not hear that testimony. I wish I had. I would not have understood it, anyway.

[Laughter.]

Mr. BELT. Congress can decide what limitations it wants to put on. I think the important point to note is that there is risk. And how is that risk reflected and how is it priced? Whether you want to have assets matched against liabilities or allow companies the flexibility to take additional risk, as long as that risk is understood, transparent, and priced, may be the appropriate policy tradeoff. You can dictate or you can allow flexibility, but understand that if you are 100 percent funded but you are taking a lot of risk, there is risk there. You may not be 100 percent funded the next day. Unless you adopt—

Chairman GREGG. The employee needs to understand that. I mean, they need to understand if that is the type of defined benefit plan they have negotiated or joined, they may get nothing at the end of the day if that is going to be a risk-based plan as versus a traditional defined benefit plan, which gives them a guaranteed return with guaranteed assets underneath it that support that, right?

Mr. HOLTZ-EAKIN. And the mirror side of that is the employer needs to appropriately reflect that risk in their decisionmaking. And you can either hedge the risk internally, your strategy, or you could pay for that risk, either internally by overfunding the plan so that if things go bad, it is there, and the shareholders have given up those dividends and they are in the pension plan; or you can pay Mr. Belt more for the insurance, but you reflect the price of that risk somewhere in the decisionmaking.

Chairman GREGG. What we need is a set of rules that accomplish that, and we do not have them right now.

Mr. BELT. It is interesting how, if you talk to any CFO of any industrial company, they are making these kinds of decisions every day with respect to raw materials, prices, currencies, and other things. They are making a decision: Do I want to stay exposed to price changes next year, 2 years down the road, or do I want to hedge those risks today? That is an issue that the airlines are facing with respect to fuel cost. Southwest, the reason it is doing relatively better than its brethren, is it hedged its fuel price cost. It decided it did not want to see what prices were going to be down the road. It said, "I want to lock those in today."

You have the ability to do the same thing with respect to pensions.

Chairman GREGG. Thank you.

Senator Conrad, did you have any further questions?

Senator CONRAD. I do. Just briefly, if I can, Mr. Chairman.

Chairman GREGG. Yes.

Senator CONRAD. I want to go back to this credit balance problem because it really is stunning when I look at what has happened. Mr. Belt, you said in your testimony, "Funding rules allow companies with unfunded pension liabilities to take funding holidays or reduce their required contributions. Under current law, companies can build up a credit balance by contributing more than the minimum required or by favorable investment performance of pension assets. They can then treat the credit balance as an offset to the

funding requirement for the current year. This allows a plan to take a contribution holiday without regard to whether the additional contributions have earned the assumed rate of interest or have instead lost money in a down market, and regardless of the current funded status of the plan."

You go on to say, "The result is some sponsors are able to avoid making any contributions to plans that may be hundreds of millions or even billions of dollars underfunded." And you then cite a GAO study: "On average, 62 percent of the 100 largest plans each year received no cash contributions, including 41 percent of plans that were underfunded."

Why, you talk about an absolutely bizarre system, this is it. You talk about a system designed to fail, this is it.

Bethlehem Steel made no contributions to its plan for the 3 years immediately preceding plan termination. US Airways made no contributions for the 4 years immediately before termination.

First of all, Mr. Belt, thank you for providing this in your testimony. Second, what do we do to stop this charade? What an absolutely bizarre system that allows people to not make contributions when they are substantially underfunded based on some notion of a credit balance that has no connection to reality. What is your sense of how we stop that?

Mr. BELT. Enact the administration's proposal, which would do away with credit balances. But if I may make one additional point in that regard, the critics of the administration's proposal to eliminate credit balances will argue that if you do not allow credit balances, they have no incentive to put in more than the minimum.

Senator CONRAD. And that was the notion of credit balances to begin with, that this was going to incentivize companies to make additional contributions.

Mr. BELT. That is correct.

Senator CONRAD. What went wrong?

Mr. BELT. Well, multiple problems, but they took advantage of the situation to avoid putting in cash when it was most needed. We believe there are ample incentives under the administration's proposal to put in more than the minimum. Number one, you shorten that 7-year amortization period. Just like when you make an extra contribution when you are paying your mortgage, the mortgage lender does not allow you to skip next month's payment. It shortens the 30 years.

Secondly, dollar for dollar under the administration's proposal, you would reduce the amount of variable rate premium you would have to pay since it is tied to underfunding. The more you fund up, the lower the funding gap, the less you would pay in premiums.

And, third, we provide, again, as we talked about before, a substantial additional tax incentive relative to current law to fund up your pension plan beyond the minimum because you get to shelter current income.

So we believe that there are substantial incentives in place, apart from the question of whether any incentive should be needed to prudently fund the pension plan.

Senator CONRAD. Dr. Holtz–Eakin, Director Holtz–Eakin—both apply—what is your reaction to what you have just heard here with respect to this credit balance circumstance, the administra-

tion's recommendation, anything that CBO can add to this discussion or understanding?

Mr. HOLTZ-EAKIN. This is one of a whole series of issues that comes under what we hope to cover under pricing things to market. Revealing the market value of the assets and the liabilities is very important. I know there is concern about volatility when one does that, but I think it is important to distinguish between the volatility in those assets and the volatility that any premium payments might have as a result.

In a homeowner's policy, there is a lot of volatility. The house is either there or burned down. That does not mean the premiums are $100,000 or zero. So what you want to do is reflect the value of the assets and show the status of the plan, and then have a premium stream that reflects the risks associated with that. And there could be quite stable. But this is part of really reflecting the valuation in the assets.

Senator CONRAD. Thank you.

Chairman GREGG. Senator Enzi, did you have any follow-up questions?

Senator ENZI. Thank you, Mr. Chairman. I really appreciate the brief summary that you gave on how all this works.

Chairman GREGG. I did not understand it.

[Laughter.]

Senator ENZI. Oh, I think you did. One of the things that happens with investments, yes, executives do make decisions on a daily basis on what is going to happen in all of the markets that they deal in. Some of the markets are more predictable than the investment market. And if they go into just a system of bonds, they know that that is a very limited return. And the market has been extremely good in other investments, and everybody changed to other investments instead of bonds and were considered pretty stupid if they stayed just with bonds. Now, bonds are predictable, but I think they made normal business decisions based on those investments, and those investments paid off for a long time. They were generating enough revenue in additional value that kept the fund solvent. That is why people did not make additional contributions to the plans. They were showing, at least on paper, a sufficient return that they were funding their plans well and were pleased that they were able to do that, and that also allows them to put some of their other assets into productive things within the business so that the business can continue to expand and grow and pay the kind of dividends that will make people want to invest in their business.

I asked about the smoothing earlier, and I am still concerned about the fact that if we eliminate all of the smoothing, the strong plans will terminate and the weak plans will collapse. And I think it is a lot of weak plans that make up that $450 billion that we are talking about. Not all, but a lot of that.

So can't smoothing also provide a transition between two asset values as we go from one system to virtually a brand-new system, Mr. Belt?

Mr. BELT. Senator Enzi, I would distinguish between what I characterize as the inputs, understanding the value of assets and liabilities, versus your contribution requirements, the outputs. If

the concern is about contributions maybe bouncing around because of what is happening on the asset and liability side and you do not want to impose any strictures on how you invest assets, let's just understand what the risks are. Let's understand what the value, the market-based value, of assets and liabilities is at any given point in time. If you want to put some Governors on the contribution side, that is, the contributions requirements may not spike by 100 or 200 percent in a given year, I think that is a reasonable discussion or conversation to have.

What I would find troubling is to look back in time and say that the market and economic conditions that existed 2, 3, or 4 years ago are at all relevant to where we are today in the decisions that need to be made in the future. So that is why we feel very strongly that you need to price assets and liabilities on a current market basis; otherwise, you are just simply not going to have an understanding of what the risks are in the system and how to deal with those appropriately on a go-forward basis.

Senator ENZI. Thank you. I will shift gears here pretty quickly. Dr. Holtz–Eakin, could you discuss how CBO scores premium increases? Your previous testimony indicates that the administration's proposal to raise the fixed-rate premium per participant from $19 to $30 per year within indexing would reduce 10-year economic costs by $3 billion. However, preliminary scores from various policy options my staff have requested from CBO saves money over 5 years, but actually reflect a cost in years 5 through 10. Can you give a little explanation?

Mr. HOLTZ-EAKIN. There are two different conceptual bases for those calculations. One are the scores that you receive from the CBO for purposes of marking up legislation. They are done on a traditional cash flow budget basis, and those are distinct from the economic valuations that we presented today for the kinds of pricing of overall markets risks and exposure to pension underfunding that are really underneath our financial market writing a check for pension insurance. Those are conceptually different, and they are numerically different as a result. And everything that you will get for your committee will be traditional budget scoring, absent market risk, done on a cash flow basis.

Senator ENZI. Thank you. My time is up.

Chairman GREGG. Senator Byrd, you have been very patient.

Senator BYRD. Well, thank you, Mr. Chairman. I want to thank you for conducting this hearing. It is obvious from the questions that have been asked there are great concerns here, and I want to thank our two witnesses for their very helpful responses.

If I may very briefly ask a question, I think about the 50-year-old steelworker who has earned a pension that was supposed to pay $3,600 a month, and when his company filed for bankruptcy, that worker was forced to accept a $1,200-per-month pension, one-third of what that worker had expected. And these workers—we have plenty of them who are in this kind of situation—as well as their families and communities, pay a terrible price when their companies shed their pension obligations.

What additional protections should the Congress consider to further protect those workers whose pensions are assumed by the

PBGC? And, furthermore, what happens if those reforms do not work?

Mr. BELT. Senator Byrd, the administration believes that promises made to workers should be promises kept, so we want to make sure that we have a funding and premium and transparency regime in place that makes sure that there are sufficient assets in the pension plan to cover the liabilities so you do not get to the point where there is this risk of losing hard-earned benefits. That is not acceptable.

And if there are issues with respect to the health of the financial sponsor or the pension plans, it is important that workers and retirees, that investors in the company, and regulators have information, relevant, timely information on a market basis so we understand those risks. Ultimately it is a question of tradeoffs. And I think Dr. Holtz–Eakin has outlined extraordinarily well the policy tradeoffs, the choices facing Congress. Who pays for the promises when these promises are not kept? We believe that the starting point is let's strengthen the funding rules, let's make sure that there are sufficient assets in there to cover the liabilities so we do not have these problems because, otherwise, you have workers and retirees losing benefits. Responsible companies that have honored their promises are on the hook, and the taxpayer may be on the hook. We do not want that to happen. As I indicated in my oral statement, we think that is the best insurance policy for everybody.

Senator BYRD. What happens if your reforms do not work? What happens if the company leaves the system? What is the safety mechanism for workers?

Mr. BELT. Hopefully the company will honor its pension promises to workers and maintain its pension plan, in which case if they maintain the pension plan, then workers are receiving all the benefits that were promised to them. When PBGC assumes responsibility for a pension plan, under current law we are required, as established by Congress, to impose a maximum limit on guaranteed benefits, and that is $45,000 a year for somebody retiring at age 65, just like in Social Security; if you retire earlier than then, your benefits are actuarially adjusted downward, if you are still under 65 when the plan terminates.

So there is no question that in some cases workers in the steel industry, in particular, have retired at an earlier point in time, and that actuarial reduction downward from age 65 down to age 50 is dramatic. That is the law that is currently in place.

If it were otherwise, if you paid them all the benefits they had accrued and did not have the actuarial cutback, which would be a policy change Congress could put in place, it should be noted that the $23 billion hole would not be $23 billion. It would be much, much greater than that, and ultimately it does come back to the question who pays for that.

Senator BYRD. What safety measures should the Congress consider to further protect workers' pensions in such circumstances—circumstances in which the companies are forced to contribute more to their pensions and businesses as a result decide to shed their pension obligations in bankruptcy or through other means?

Mr. BELT. Senator, I can only go back to the earlier point, which is let's make sure that we have strong, robust funding rules in

place. Let's make sure we have transparency throughout the system so everybody understands what the costs and risks are at any point in time, and let's have a premium structure in place that encourages good behavior, discourages risky behavior. And we believe that adopting those core principles, we will get to where we need to be, that is, protecting the benefits that have been earned by workers and retirees.

Senator BYRD. Thank you, Mr. Belt. I think you have been a very fine witness. And thank you, Dr. Holtz–Eakin.

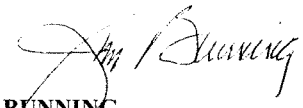
Thank you again, Mr. Chairman.

Chairman GREGG. Thank you, Senator.

We thank you very much, gentlemen. I found this extremely informative, and I know that Senator Enzi intends to aggressively pursue reform in this area, and I certainly appreciate the Chairman's participation in this hearing. And we look forward to working with you to try to make sure the reform accomplishes the goals that you have outlined, which is that fewer pension funds end up in your account, Mr. Belt, and that workers who have worked hard get their pensions.

Thank you, and the committee is adjourned.

[Whereupon, at 11:58 a.m., the committee was adjourned.]



STATEMENT FOR SENATOR BUNNING
SENATE BUDGET COMMITTEE
Solvency of the Pension Benefit Guaranty Corporation
15 June 2005

THANK YOU, MR. CHAIRMAN.

MR. BELT AND MR. HOLTZ-EAKIN,

WELCOME. YOU AND I ARE SPENDING A LOT OF TIME TOGETHER RECENTLY.

IT IS UNFORTUNATE THAT THIS TIME TOGETHER IS NECESSARY TO DISCUSS SUCH A WORRISOME SITUATION.

LAST WEEK, IN FINANCE COMMITTEE, WE DISCUSSED THE SITUATION WE ARE FACING WITH AIRLINE PENSION PLANS.

TODAY, WE ARE LOOKING AT THE HEALTH OF THE P.B.G.C.

AS I'M SURE WAS EVIDENT AT THE FINANCE COMMITTEE HEARING LAST WEEK, I AM GRAVELY CONCERNED ABOUT WHERE WE FIND OURSELVES TODAY.

WE HAVE THE P.B.G.C., THE SAFETY NET OF OUR PRIVATE PENSION SYSTEM, FACING A DEFICIT THAT THE C.B.O. IS NOW TELLING US COULD BE ALMOST $100 BILLION DOLLARS OVER THE NEXT 20 YEARS.

I HAVE ONE OF THE LARGEST EMPLOYERS IN MY STATE TELLING ME THAT, WITHOUT SOME HELP, THEY MAY BE FORCED TO DEFAULT ON THEIR PENSION PLAN WHICH WILL AFFECT 80,000 RETIREES AND EMPLOYEES.

I WANT TO DO ALL THAT I CAN TO STOP THAT FROM HAPPENING.

WE NEED SOME SOLUTIONS AND WE NEED THEM SOONER RATHER THAN LATER.

I WANT TO COMMEND THE P.B.G.C. AND THE CURRENT ADMINISTRATION FOR BEING PRO-ACTIVE ON THIS MATTER.

WHILE I AM STILL REVIEWING ALL OF THE DETAILS OF THE LONG LIST OF REFORMS PROPOSED BY THE ADMINISTRATION, I AM HEARTENED THAT THE ISSUE OBVIOUSLY HAS THE ATTENTION OF MANY SMART FOLKS.

WE HERE IN CONGRESS ARE COUNTING ON THOSE SMART FOLKS, LIKE THE WITNESSES BEFORE US TODAY, TO HELP US AVOID THE LOOMING DISASTER.

I LOOK FORWARD TO A MEANINGFUL DISCUSSION TODAY AND I THANK THE CHAIRMAN FOR HAVING THIS IMPORTANT HEARING.

THANK YOU.

Senate Budget Committee
Solvency of the Pension Benefit Guaranty Corporation—
Current Financial Condition and Potential Risks
June 15, 2005

Statement of Senator Mike Enzi

The solvency of the Pension Benefit Guaranty Corporation has become front-page news this year, and is receiving even more attention since United Airlines plans were terminated last month. The news is indeed bad, and that is why this hearing and numerous other hearings of late are timely.

But the news is not always accurate. Despite the drumbeat of the national media, taxpayers are NOT on the hook for the PBGC or its deficit. The only way the American taxpayer would be faced with paying the debts of underfunded pension plans or the debts of the agency would be if Congress passed a new law to make that happen. The media and the PBGC may promote a taxpayer bailout as the only solution to this problem, but there simply is no support for such a proposal – either in Congress or among the general public.

Our guiding principle here is that a taxpayer bailout is not an option.

Who is on the hook to pay the PBGC's deficit? The companies that remain in the defined benefit pension plan system. They and their employees ultimately will bear the costs of mismanagement or underfunding of other plans in the system – and it is certain that they do not like it one bit.

In developing pension legislation, Congress needs to be mindful of the tipping point between therapeutic and excessive funding requirements, as well as the delicate balance between tolerable pension insurance premium levels that protect retirees and burdensome levels that drive sponsors out of the system.

Allow me to draw on health care analogies that are all too familiar to the Chairman of the Budget Committee, Senator Gregg, from his work on the HELP Committee. Risky therapies, such as mega-doses of radiation, are never advisable for weakened patients, especially when other cures are available. Likewise, we cannot accept the argument that some patients are going to die anyway, so one remedy should be applied to all without regard to the consequences. It was suggested earlier this year that pension premiums should be radically increased in order to quickly pay down the deficit in the pension insurance system. Senator Gregg and I rejected that approach because of the obvious impact on the unhealthy pension plans.

I think the best way to shore up PBGC's financial health is by comprehensive reforms to the defined benefit system. I am working with the Finance Committee and hope to accomplish that this summer. The Budget Resolution conference report passed in April directs the HELP Committee to find approximately $6.6 billion over 5 years in

savings from PBGC premium increases. So if comprehensive reform isn't achieved quickly, the HELP Committee will need to approve premium increases in a reconciliation bill this September.

As Chairman of the HELP Committee, I am considering a host of proposals that would help reduce PBGC's current deficit of $23 billion. I want to focus on writing legislation that responsibly reforms our pension system, while also reducing prospective deficits. I want to ensure that our Nation's *voluntary* pension system is strengthened.

Statement by Senator Debbie Stabenow
Senate Budget Committee
Pensions
June 15, 2005

Mr. Chairman, thank you for calling this hearing.

We should always remember that a pension is something you collect after a lifetime of work. It is something you pay into, day after day, paycheck after paycheck.

After you have worked 20, 30, or 40 years, you then have earned a pension that will allow you to retire in dignity.

This pension issue is very important to Michigan since there are 1.3 million such workers and pensioners in my state -- about one out of every six adults.

Many companies set up so-called “defined benefit pensions” many years ago. These pensions were guaranteed – so you knew exactly what you would get when you retire.

They have allowed generations of workers the ability to plan for a secure retirement and not be a burden to their children and grandchildren.

Most of these pension plans were established with support from company executives and union workers. They both should be commended for these agreements.

Now, our system of defined benefit pensions seems to be crumbling. Unlike the 1990s, many of our major companies are in financial trouble. There are many reasons for this – like unfair trade, large number of retirees, and skyrocketing health care costs.

And we need to fix these problems. But the worst thing would be to kick these companies while they are down.

Illegal trade practices, which our government has not prosecuted, and cheap labor overseas have decimated our manufacturing base. And the President and Congress' inability to do anything to slow the growth of health care has made its plight worse.

Now some are calling for major tax hikes on companies with defined benefit pension plans, in the form of higher premiums and contributions, just at a time when these companies are losing money and laying off workers.

Indeed, we should do something to make defined pensions more secure and I think we will need some small increases in company payments. However, we must be careful we do not force them out of businesses at the same time.

We must remember that these companies have done the right thing. They have given their workers guaranteed pensions and health care in retirement.

Today, many companies do none of this. They not only don't provide pensions but they don't even provide health care.

Our goal in pension reform should not be to transform good companies with pensions and health care to companies who don't provide either. That is a race to the bottom in which we are all losers.

Many of my colleagues have often said that we should never increase taxes when we are in an economic downturn because that will only make it worse.

We should keep this in mind as we approach the issue of pensions.

We also need to get to the root cause of our economic woes. We must do more to help our companies cope with the spiraling cost of health care and illegal foreign competition.

We should do more to help these companies and their workers – they should be supported in these tough times for doing the right thing.

Thank you.

Responses to Senator Bunning's Written Questions for Douglas Holtz-Eakin

Question 1.
With the recent upswing in the economy, the markets have been recovering to some degree. How will this recovery affect plan underfunding levels?

Answer. Given the heavy investment in equities by many pension plans, a rising stock market will reduce underfunding. However, the substantial allocation of fund assets to stocks also means increased underfunding when the markets fall.

Question 2.
One proposal of the Administration and the PBGC is an increase in premium payments. Has anyone tried to determine if, and if so, how many, companies might drop their pension plans altogether if those premium increases go into effect?

Answer. Although it is extremely difficult to predict how sponsors might react to changes in premiums, the proposed change in the fixed premium from $19 to $30 per participant per year would increase pension labor costs by less than 1 cent per hour worked. Changes of that magnitude seem unlikely to affect the decision to retain or drop a pension plan. Increases in the variable-rate premium, however, could be quite costly for plans that are underfunded.

Question 3.
The current budget resolution calls for approximately $6 to $7 billion in savings from the PBGC. What mix of policy proposals do you think can be implemented and that the market can absorb in the next five years to meet this target?

Answer. CBO estimates that higher premiums, a limit on the share of pension plan investments allocated to equities (rather than bonds), accelerated correction of underfunding, and a reduction in the discount rate used to calculate pension liabilities could produce that level of savings.

Question. While $7 billion is not enough to meet the PBGC deficit, do you believe it will buy more time for the Congress to act? Or, have we already reached the tipping point where much more dramatic changes are required?

Answer. PBGC's shortfall consists of an accumulated deficit (about $23 billion) and prospective net costs over the next 10 years that are more than double that amount. Prospective net costs are potentially avoidable through changes in the terms of the insurance. Thus, urgency is more likely warranted on the basis of avoiding losses rather than the threat of a collapse of the defined-benefit insurance system.

Question 4.
To what extent do you believe underfunded pensions are product of the weak stock market of the past few years?

Answer. The decline in the stock market played a significant role in the rise of underfunding in defined-benefit pension plans. However, so long as pensions plans are heabily invested in equities, the system will continue to be vulnerable to market disturbances. Stock market declines and bankruptcies by sponsors tend to occur at the same time in response to the same economic changes. Thus, PBGC is likely to see an increase in plan termination precisely when underfunding is most prevalent.

Question. Do you think that as the stock market continues to recover, we will see a decrease in the number of underfunded pensions insured by PBGC?

Answer. Yes. But future declines in the stock market are also likely. A continuously rising stock market is not a reliable solution to the financial difficulties of the defined-benefit pension system.

Question 5
I understand that the CBO recently made projections about the possible deficit of the PBGC in 10 and 20 years.

Answer. To clarify, CBO's projections of the net costs of federal pension insurance are not projections of PBGC's deficit. Rather they are measures of the estimated market price to insure all covered benefits of currently operating plans under current premium and funding rules over a specified period. The estimates do not correspond to a projected deficit for PBGC because the agency does not purchase insurance at market prices.

Question. Can you tell us what assumptions went into that estimate of a $71 billion deficit over the next 10 years?

Answer. CBO's projections require numerous technical and economic assumptions. Most of those are described in detail in the CBO paper *The Risk Exposure of the Pension Benefit Guaranty Corporation* (September 2005).

Question. How did you determine which plans you thought the PBGC might take over?

Answer. CBO projects the bankruptcy probabilities of sponsors of defined-benefit pension plans. CBO assumed that PBGC would take over all plans of bankrupt sponsors.

Question. How can you make accurate predication with so many unknowns?

Answer. CBO attempts to project the most likely direction of change in costs under current policy rather than a precisely accurate prediction. Nonetheless, CBO has subjected the estimates to a variety of checks for robustness. For example, the agency's projections of bankruptcies by sponsors are consistent with historical failure rates for firms of each major credit rating.

Responses to Senator Bunning's Written Questions for Bradley D. Belt

1. MR. BELT, COULD YOU ADDRESS INDUSTRY CONCERNS ABOUT THE TREASURY PROPOSAL ON THE TREATMENT OF "CREDIT BALANCES" AND HOW THAT COULD AFFECT A COMPANY'S WILLINGNESS TO ENGAGE IN PRE-FUNDING?

Some industry groups have complained that elimination of credit balances would create a disincentive to companies to contribute to their plans.[1] They assert that companies will be less likely to make contributions in excess of the minimum required amount if they are not allowed to use the excess to offset a funding obligation in future years.

The Administration strongly disagrees with this assertion. Under the Administration's proposal there are ample incentives for plan sponsors to contribute more than the minimum required amount. The Administration proposal would allow companies to contribute more on a tax-deductible basis than under current law. By contributing more than required, the plan's funding target will be reached sooner. When the funding target is reached, amortization charges cease and the sponsor need contribute only the normal cost (cost of benefits accruing in that year). Excess contributions above the funding target are used, dollar for dollar, to offset the normal cost. And, additional contributions above the minimum directly lower the amount of premiums that would be paid.

The fact is that underfunding is partly due to the use of credit balances - they are part of the problem, not the solution. Credit balances allow a plan to have a contribution holiday without regard to whether the additional contributions have earned the assumed rate of interest or have instead lost money in a down market - and, more importantly, regardless of the actual funded status of the plan. According to a GAO study released in May 2005, for the 1995 to 2002 period, the sponsors of the 100 largest plans each year on average made relatively small cash contributions to their plans; their reliance on credit balances to meet minimum funding obligations distorted plan funding levels and contributed to deteriorating plan conditions. [2]

Many of PBGC's largest claims have come from plans whose sponsors took extended funding holidays prior to termination. For example, neither Bethlehem Steel nor US Airways was required to make cash contributions in the years leading up to the termination of their plans. And remarkably, notwithstanding the fact that the United pilots' plan is underfunded by almost $3 billion, the company was not required to

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[1] Under the minimum funding rules, plan sponsors accumulate charges and credits to a funding standard account. If in any year the cumulative employer contributions or actuarial gains ("credits") exceed the cost required to provide a plan's schedule of benefits and to amortize increases in unfunded actuarial liabilities and actuarial losses ("charges"), the account will show a positive "credit balance."

[2] United States General Accountability Office, "Recent Experiences of Large Defined Benefit Plans Illustrate Weaknesses in Funding Rules," GAO-05-294, pp. 16, 22 (May 2005).

make a cash contribution to that plan for the years 1996 through 2004. In fact, during that time period, the pilots' plan credit balance was used in lieu of cash to satisfy over $350 million in funding requirements. In all of these situations, the plans were severely underfunded upon plan termination, and as a result participants lost (or will lose) a significant portion of their promised benefits. Allowing companies to stop making contributions when their plans are underfunded does not make business or policy sense and runs counter to the whole notion of steadily improving the funded status of underfunded plans.

2. MR. BELT, COULD YOU ADDRESS THE STANDING OF THE P.B.G.C. IN THE BANKRUPTCY COURTS? DO YOU THINK CHANGES NEED TO BE MADE IN THIS RESPECT, AND IF SO, WHAT CHANGES?

When a pension plan covered by Title IV of ERISA terminates, PBGC becomes responsible for collecting from the sponsoring employer all unfunded benefit liabilities, including the value of shutdown benefits. If the employer is a debtor in bankruptcy, PBGC files its claim as a general unsecured creditor for the plan underfunding. PBGC divides its recovery on the claim (usually only pennies on the dollar) between itself (to help pay for unfunded guaranteed benefits) and participants (to help pay their non-guaranteed benefits). Any amount of the claim that goes unpaid in the bankruptcy proceeding is then discharged.

As an unsecured creditor, PBGC is last in priority (after secured creditors) for a claim against any remaining assets of the company. Although a lien automatically arises against the assets of a plan sponsor and members of its controlled group if required pension contributions of $1 million or more are missed, PBGC cannot perfect these liens to provide the plan with a secured claim for missed contributions, unless there is a controlled group member that is operating outside of bankruptcy.

Because of the automatic stay and avoidance provisions of the Bankruptcy Code, once a petition for bankruptcy has been filed, companies are able to avoid making contributions to the plan as otherwise required by federal law, and can do so without consequence. As a result, plan participants and the insurance program may suffer greater losses if an underfunded plan terminates while the plan sponsor or members of its controlled group are in a bankruptcy proceeding.

The Administration's proposal addresses a number of these problems. The automatic lien provisions of ERISA and the Internal Revenue Code are intended to ensure that unpaid contributions are not treated the same way as normal loans, and this special lien should not be made ineffective by entering bankruptcy. To correct this problem, the Administration's proposal would amend the Bankruptcy Code to allow PBGC to perfect liens for missed required pension contributions against companies in bankruptcy. In addition, under the Administration's proposal, the maximum

guarantee limit and the phase in of the guarantee of benefit increases would be frozen when a company enters bankruptcy.

There are other instances in which ERISA provisions may be ignored by bankruptcy courts, with the result of substantially greater losses to the insurance program. One is the ERISA requirement that the distress termination test be met on a plan-by-plan basis (the debtor's ability to continue to support one or more - though not all - of its plans often is overlooked). Another is the method for calculating the amount of PBGC's claim. Title IV provides that the amount of the claim is to be determined in accordance with regulations issued by PBGC. Notwithstanding this ERISA requirement, some bankruptcy courts have used different valuation methods, always to the benefit of other creditors and detriment of the insurance program.

3. **MR. BELT, HOW CAN P.B.G.C. ADDRESS THE PROBLEMS ASSOCIATED WITH "ADVERSE SELECTION" AND KEEP STRONG COMPANIES WITH WELL-FUNDED PLANS IN THE SYSTEM?**

WHAT INCENTIVES DOES A STRONG COMPANY HAVE TO STAY IN A SYSTEM IN WHICH THEY BASICALLY BEAR THE BURDEN OF COMPANIES WITH UNDERFUNDED PENSION PLANS?

These questions correctly identify one of the major problems with existing law, and why it is urgent that Congress change the law. Under the current system, there has been a tremendous amount of cost-shifting from financially-troubled companies with underfunded plans to healthy companies with well-funded plans. Companies with well-funded pension plans may have to shoulder higher premiums as a result of companies with underfunded pension plans terminating. This can create a financial incentive for companies with well-funded plans to leave the system while the worse risks stay ("adverse selection"). The Administration's reform proposal addresses this problem in several ways, principally through plan funding reforms and risk-related premiums, both of which should be welcome by strong companies that responsibly fund their plans.

First, the Administration's proposal posits that companies that responsibly fund their plans would benefit from robust funding rules because increased funding across-the-board reduces the risk that these companies would have to shoulder higher premiums in the future and reduces the financial incentive to leave the system. The proposal improves plan funding by measuring pension liabilities and assets more accurately using a yield curve to value liabilities and eliminating the calculation of liabilities and assets based on average values over time ("smoothing") rather than current market rates; by requiring plan sponsors to amortize their pension shortfalls over a reasonable seven-year period; and by requiring plans of financially troubled companies to fund to a higher target, reflecting the increased costs of a plan that is more likely to terminate.

Second, the Administration's proposal improves the fairness of the PBGC premium structure by spreading the cost of premiums among all underfunded plans, establishing funding targets that reflect a plan's risk of termination, and encouraging companies to fully fund their plans. A risk-based premium on all underfunding would apply by eliminating the current "full funding limit" exemption, which relieves certain plans (generally, those that are funded for 90% of current liability) from paying a variable-rate premium. Because of this exemption, fewer than 20 percent of participants are in plans that pay a variable-rate premium. This exemption is also why some of the companies that saddled the insurance fund with its largest claims paid no variable-rate premium for years prior to termination.

Third, the Administration's proposal would tighten limits on benefit increases, to ensure that companies with underfunded plans do not add to the risks being shouldered by other companies. Under current law, benefits can be increased as long as the plan is at least 60 percent funded, regardless of the financial capacity of the company. The Administration's proposal restricts plans with financially weak sponsors that are 80 percent or less funded from offering lump sums or increasing benefits. If funding is 60 percent or less of target liabilities, accruals also stop and there can be no preferential funding of executive compensation. Plans with healthy sponsors are restricted from increasing benefits if they are funded at 80 percent or less of their funding target and from offering lump sums if they are 60 percent or less of their funding target. Underfunded plans with sponsors in bankruptcy would also be subject to benefit limits.

Fourth, the Administration's proposal corrects problems that arise when a plan sponsor enters bankruptcy. Under current law, the PBGC's guarantees continue to grow even though the plan sponsor may no longer be making contributions. Although a lien automatically arises against the assets of a plan sponsors and members of its controlled group if required pension contributions of $1 million or more are missed, the automatic stay and avoidance provisions of the Bankruptcy Code prevent PBGC from perfecting liens for missed required contributions in bankruptcy. Under the Administration's proposal, the PBGC guarantee limit would be frozen when a company enters bankruptcy, and PBGC would be allowed to perfect liens for missed required pension contributions against companies in bankruptcy.

Finally, there have long been complaints that complex and burdensome rules and regulations unnecessarily raise the costs of offering defined benefit plans. Under the Administration's proposal, the pension funding rules will be greatly simplified and streamlined. In addition, the Administration believes that the legal uncertainties raised by cash balance plans and other hybrid plans must be addressed in order to eliminate the obstacles to offering these plans and allow employers to adopt new plan designs that address changing business needs.

In sum, the Administration's reform proposal would revitalize the system by placing both the insurance program and individual pension plans on a solid financial footing. This will give stronger companies the assurance that, if they stay in the defined benefit system, they will not be unfairly burdened with paying for the unkept pension promises of other companies.

4. MR. BELT, WHEN YOU DETERMINE THE DEFICIT AND POTENTIAL LIABILITIES OF THE P.B.G.C., YOU LOOK AT PLANS THAT MAY BE "REASONABLY POSSIBLE" TO FAIL AND AT PLANS FOR WHICH TERMINATION IS "PROBABLE".

CAN YOU TELL US HOW YOU MAKE THESE DETERMINATIONS AND WHAT IS THE DIFFERENCE BETWEEN "REASONABLY POSSIBLE TO FAIL" AND "PROBABLE TO FAIL"?

PBGC's financial statements are prepared in accordance with Generally Accepted Accounting Principles (GAAP) - the same standards used by all publicly traded U.S. companies. Our financial statements are reviewed by the Inspector General and audited by outside accounting firms. For fiscal year 2004, PBGC's financial statements received their 12th consecutive clean (*i.e.*, unqualified) audit opinion from its independent auditors. A clean audit opinion requires consistent and accurate valuations and estimates.

Pursuant to GAAP, PBGC is required to include "probable" terminations as liabilities on its balance sheet. In accordance with the Financial Accounting Standards Board Statement No. 5, *Accounting for Contingencies* (FAS 5), a plan is classified as a "probable" termination if it is likely the plan will terminate and be trusteed by PBGC. The bases for a plan to be classified as probable include: the employer is in liquidation and there are no related companies that could fund the plan; the employer has filed for a distress termination; or the PBGC is seeking involuntary plan termination. Other criteria, such as a bankruptcy filing or the sponsor's default on a credit agreement, often also are used to classify a plan as a "probable" termination.[3] Historically, the vast majority of plans booked as "probable" losses subsequently terminate.

FAS 5 also requires disclosure of exposure to losses from plans that are "reasonably possible" to terminate in footnotes to the PBGC's financial statements. Unlike losses from completed and probable terminations, these potential losses are not included in the PBGC's balance sheet. Generally, plans are classified as "reasonably possible" of termination if they are sponsored by companies with a higher default risk, *e.g.*, companies whose bonds are rated below investment grade.

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[3] Pension Benefit Guaranty Corporation 2004 Annual Report, Note 2- Significant Accounting Policies, pp. 26-27.

Most of the claims the PBGC has received were sponsored by companies that were in bankruptcy or otherwise rated as below investment grade for a number of years before plan termination. According to a recent GAO report, of PBGC's 41 largest claims since 1975 in which the sponsor's credit rating was known, 39 have involved plan sponsors that were rated as below-investment-grade at least three years prior to termination. About 80% of the sponsors involved in these claims were rates as below-investment-grade 10 years prior to plan termination.[4]

5. MR. BELT, UNITED IS IN THE PROCESS OF TRANSFERRING ABOUT $6.6 BILLION TO THE P.B.G.C. OTHER AIRLINES TOLD US LAST WEEK IN THE FINANCE COMMITTEE THAT THEY ARE AT RISK OF DEFAULTING.

THE P.B.G.C. ALSO RECENTLY TOOK OVER A NUMBER OF STEEL COMPANY PLANS.

ARE WE SEEING A DOMINO EFFECT IN CERTAIN "OLD GUARD" INDUSTRIES?

The growing financial challenges facing certain companies and industry sectors are a subject of almost daily coverage in the nation's newspapers. In addition to the $10 billion in recorded claims against the insurance program from United and US Airways, the other carriers in the airline industry could present further claims of billions of dollars. Delta has publicly warned that the company may have to enter bankruptcy. If it does, it may follow United and US Airways and seek to terminate its defined benefit pension plans, with billions of dollars of additional loss exposure to the insurance program.

Taken in historical context, the current concentration of claims is merely a continuation of a pattern. Historically, the majority of net claims against the single-employer insurance program have been concentrated in only a few industries – manufacturing (primarily steel) and transportation (primarily air transportation, reflecting the large airline claims in recent years). However, the PBGC has recently taken on large losses from plans in other industries as well, such as a $529 million claim for the parent of Kemper Insurance and a $324 million claim for Polaroid.

The pension insurance program also faces substantial continuing exposure from a variety of industries, the largest of which is the automotive sector. Assets of pension plans sponsored by this industry fall short of pension promises by $55-$60 billion. Half a dozen automotive parts suppliers have filed for bankruptcy in recent months. These bankrupt companies sponsor defined benefit plans with more than $800 million in

[4] United States General Accountability Office, "Recent Experiences of Large Defined Benefit Plans Illustrate Weaknesses in Funding Rules," GAO-05-294, pp. 30-36 (May 2005).

unfunded pension obligations. And, the rating agencies have down-graded the debt of some of the large manufacturers to below investment-grade status.

6. **MR. BELT AND MR. HOLTZ-EAKIN, ONE PROPOSAL OF THE ADMINISTRATION AND THE P.B.G.C. IS AN INCREASE IN PREMIUM PAYMENTS.**

HAS ANYONE TRIED TO DETERMINE IF, AND IF SO, HOW MANY, COMPANIES MIGHT DROP THEIR PENSION PLANS ALTOGETHER IF THOSE PREMIUM INCREASES GO INTO EFFECT?

There are many factors that a company will consider in determining whether to establish or maintain a pension plan, including a defined benefit plan. Costs, of which premiums are a part, are certainly a factor. However, premiums are a fairly small component of those costs, particularly compared to contribution requirements and benefit payments. To put it into better perspective, total premiums collected by the PBGC have averaged about $1 billion a year. In 2003, companies contributed $83 billion to their pension plans. According to industry data, annual benefit payments are about $120 billion.

Moreover, PBGC's premium revenues are not keeping pace with the losses accruing to the single-employer insurance program and future expected claims. PBGC's flat-rate premium brings in only about $600 million each year. The variable-rate premium has averaged only about $300 million per year over the past decade. In 2004, because of increased underfunding, revenue from the variable-rate premium grew to about $900 million, bringing PBGC's total premium revenues to almost $1.5 billion.

The annual insurance premium for single-employer plans, which is set by law, has two parts: a flat-rate charge of $19 per participant, and a variable-rate premium of $9 per $1,000 of unfunded vested benefits - measured on a current liability basis. The $19 per participant charge has not been increased in 14 years. In addition, as long as plans are at the "full funding limit," generally 90 percent of current liability, they do not have to pay the variable-rate premium. This is why Bethlehem Steel, the largest single claim in the history of the PBGC, paid no variable-rate premium for five years prior to termination, despite being drastically underfunded on a termination basis.

The Administration's pension proposal would implement a rational premium structure that will gradually restore the PBGC to fiscal balance. The flat-rate premium would be increased to $30 per participant to reflect wage growth and would be indexed for future wage growth. All underfunded plans (based on at-risk or ongoing liability, depending of the financial status of the sponsor) would pay a variable-rate premium. The new structure would meet the program's long-term revenue needs, provide

incentives to fully fund covered plans, and appropriately reflect the risks faced by the program.

But the proposed premium reforms must be coupled with stronger funding rules. There is a direct connection between the two. Weaker funding rules will lead to greater losses, and thus necessitate higher premiums. Stronger funding rules will lessen the need for higher premiums over time.

7. **MR. BELT, IS THE P.B.G.C. IN A BETTER POSITION AS A RESULT OF THE AGREEMENT WITH UNITED THAN IT MIGHT HAVE BEEN OTHERWISE? IS IT CORRECT THAT THESE PLANS WERE ALREADY ASSUMED IN THE DEFICIT NUMBERS THAT WE HAVE SEEN IN RECENT MONTHS?**

We believe that the agreement between the PBGC and United Airlines, under the circumstances, is in the best interests of the pension insurance program and its stakeholders. The PBGC has an obligation to minimize its losses, for the protection of workers and retirees and other companies that pay insurance premiums. The settlement furthers that goal.

Given the continuing rise in fuel prices, the deteriorating financial condition of UAL (it lost $1 billion in the first quarter of 2003), continued losses in the industry as a whole, and adverse court rulings, among other factors, PBGC concluded that UAL would have prevailed in bankruptcy court, that is, the bankruptcy judge would find that the company would be not be able to emerge from Chapter 11 while maintaining any of its pension plans. Indeed, in approving the settlement, the bankruptcy judge noted that "the relief requested is essential to the continued operation of the Debtors' businesses." The judge also stated that ERISA encouraged the consensual resolution of claims between debtors and the PBGC, and that Congress had given the PBGC the power to effect a termination with the consent of the plan sponsor without a prior court ruling, in order to protect the pension insurance system.

As a result, PBGC sought to obtain the highest recovery possible for the insurance program in settling its claims against United. Based upon the analysis of outside financial advisers, PBGC believes that the recovery obtained under the settlement is superior to the recovery that would have been obtained as an unsecured creditor in bankruptcy. PBGC also avoided litigation over several unresolved issues, including the value of its claims, which could have dragged on for months.

PBGC's $23.3 billion deficit in its single-employer program as of September 30, 2004 included an estimate of the net claims from the United Airlines plans.

8. MR. BELT, I UNDERSTAND THAT SENATOR AKAKA HAS INTRODUCED A BILL THAT WOULD ALTER THE MAXIMUM PENSION GUARANTEE AGE FOR PILOTS FROM 65 TO 60. COULD YOU COMMENT ON WHAT IMPACT THAT LEGISLATION, IF ENACTED, COULD HAVE ON THE COST TO THE P.B.G.C. OF THE UNITED PENSION PLAN, IF IT WERE TO APPLY TO THAT PLAN?

The maximum pension guaranteeable by PBGC under the Employee Retirement Income Security Act of 1974 is expressed as a straight life annuity commencing at age 65. The amount is indexed to the Social Security wage and contribution base and is actuarially adjusted for other ages and benefit forms. For plans terminating in 2005, the maximum annual guaranteeable single-life annuity is $45,613.68 at age 65 and $29,648.88 at age 60. The age reduction applies to any benefit recipient who is younger than age 65 at plan termination or at retirement, if later. The age reduction reflects the longer payout period for a retiree who receives benefits from PBGC before age 65. This age reduction applies to any retiree who receives benefits before age 65, not just to pilots. Many retirees in the steel and other industries commonly retire before age 65, and the same reduced maximum guarantee applies to them as to pilots. PBGC can pay more than the guaranteed amount only if the plan has money from plan assets or recoveries from employers.

The Pension Benefit Guaranty Corporation Pilots Equitable Treatment Act (S. 685) was introduced by Senator Akaka on March 17, 2005. The bill would not apply the age reduction to the maximum guaranteeable benefit amount in a terminating plan for individuals who are participants in the plan by reason of service as a commercial airline pilot if, at the time of the plan termination, regulations of the Federal Aviation Administration require separation from service as a commercial airline pilot before age 65. PBGC estimates that if this provision were applied just to the United pilots' plan, the unfunded guaranteed benefits in that plan would increase by more than $400 million. If applied in all situations, the losses to the insurance program would be much higher. The issue, as in all instances of enhancing benefits, is who pays for the increased program losses.

HEALTH INFORMATION TECHNOLOGY: THE FEDERAL ROLE AND BUDGET IMPLICATIONS

WEDNESDAY, JULY 20, 2005

U.S. SENATE,
COMMITTEE ON THE BUDGET,
Washington, DC.

The committee met, pursuant to notice, at 10 a.m., in room SD–628, Dirksen Senate Office Building, Hon. Judd Gregg, chairman of the committee, presiding.

Present: Senators Gregg, Allard, Enzi, Ensign, Conrad, Murray, and Stabenow.

Staff present: Scott B. Gudes, Majority Staff Director; and Mary Ann Naylor, Staff Director.

OPENING STATEMENT OF CHAIRMAN JUDD GREGG

Chairman GREGG. We will convene the hearing of the Senate Budget Committee.

We are honored today to have joining us the Secretary of Health and Human Services. The Secretary has a long and extraordinary career of public service, as we all know, and has focused the Department on a lot of critical issues to our Nation, but none more critical than delivering better health care, and as part of that exercise, of course, the issue of how the health care delivery system of our country uses its information is critical, and especially information technology.

Information technology has been discussed at a variety of different hearings that we have held, and has been discussed at considerable length in a number of different arenas, received a lot of attention from the President of the United States, and also during the Presidential campaign. It is I think generally admitted, agreed to, that if we do a better job of developing and managing information, using technology, that we can significantly reduce the overhead cost of the health care community and delivery of health care.

There have been representations that up to 20 percent of the overhead of the health care community could be dramatically reduced if we were able to get better technology in place. We know that during the campaign Senator Kerry was fond of using the example of how he would go to have his car fixed, and be able to go to any number of dealerships and have the dealerships call up the history of his car and what the problems were and have an instant response, and yet when he went in to get health care he had to fill out a bunch of paper forms and nobody knew what his history was. In other words, it would have been much easier to have people carry around a credit card with their information on it. That is just

one example of how technology could significantly impact health care.

So we are looking forward to hearing from the Secretary today as to the advances that the Department has been making in the area of bringing the health delivery system into the 21st century relative to technology and the application of technology, and we appreciate he has taken the time to come testify.

I would turn to the ranking member of the committee, Senator Conrad.

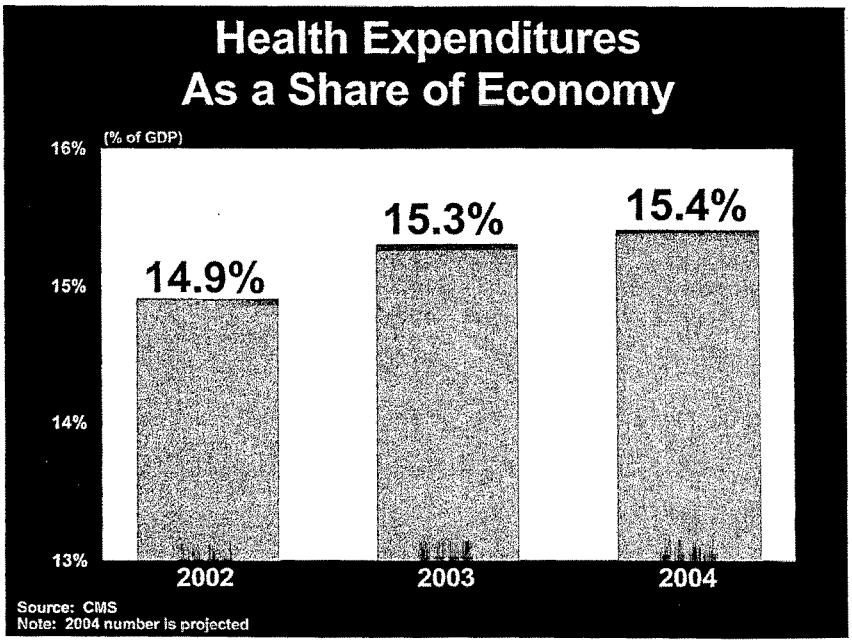
OPENING STATEMENT OF RANKING MEMBER KENT CONRAD

Senator CONRAD. Thank you, Mr. Chairman.

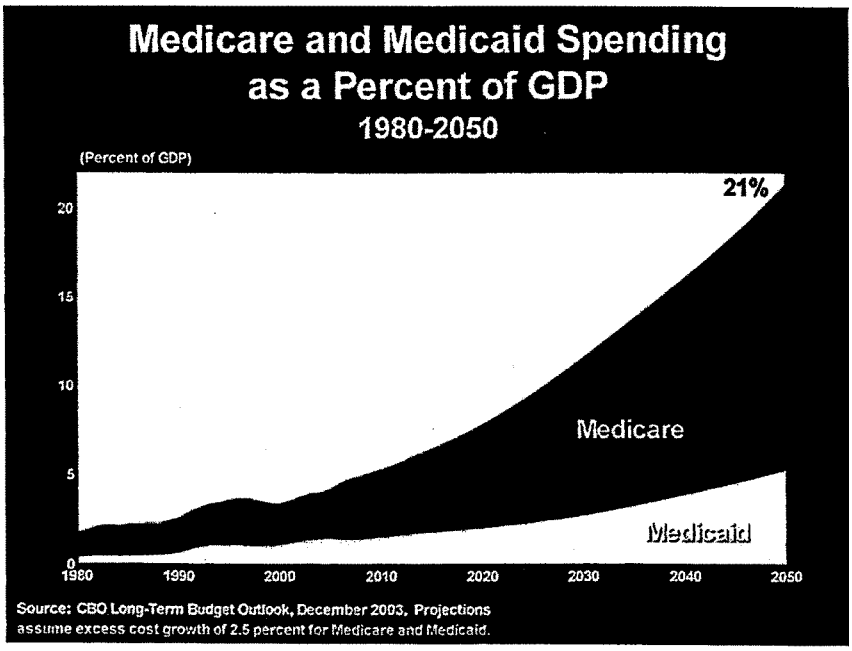
Thank the Secretary very much for being here. This is a critically important subject.

Back in the 1990's I co-founded the Telehealth Caucus here in the Senate. We have been very active ever since, and we have also focused on the whole question of information technology and the opportunities that presents.

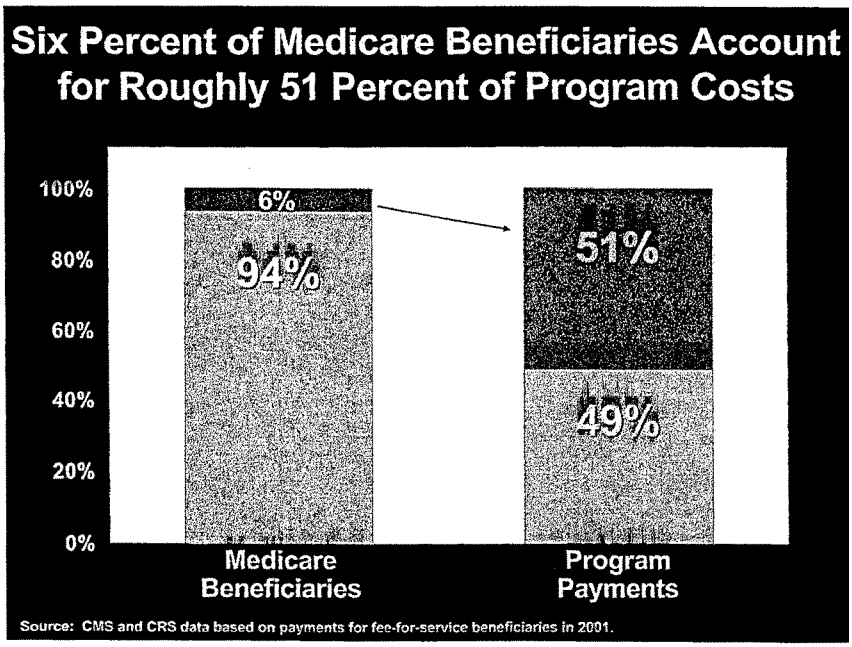
I would like to just go through a couple of slides quickly, kind of setting the context for this discussion if we can, and then have a chance to hear from the Secretary.


Health Expenditures
As a Share of Economy
(% of GDP)
16%
15%
14%
13%
14.9%
15.3%
15.4%
2002
2003
2004
Source: CMS
Note: 2004 number is projected

This is what is happening to health care expenditures in the United States. They continue to rise. We are now, last year, 15.4 percent of gross domestic product, by far the biggest percentage of our national income going to health care of any of the industrialized countries.


Medicare and Medicaid Spending
as a Percent of GDP
1980-2050
(Percent of GDP)
21%
20
15
10
5
0
Medicare
Medicaid
1980
1990
2000
2010
2020
2030
2040
2050
Source: CBO Long-Term Budget Outlook, December 2003. Projections
assume excess cost growth of 2.5 percent for Medicare and Medicaid.

This is what the chairman and I are, I think it is fair to say, most concerned about, and that is the trend line for Medicare and Medicaid expenditures. As we see going forward—we are looking out to 2050—and the long-term outlook according to the head of the Congressional Budget Office, according to the head of the General Accounting Office, we are headed for a circumstance, if current tend lines continue—and I want to emphasize that—we would be spending 21 percent of GDP just on two programs. That is more now than we spend on the total of the Federal Government. This is the enormous challenge that we face.


Six Percent of Medicare Beneficiaries Account for Roughly 51 Percent of Program Costs
100%
80%
60%
40%
20%
0%
6%
94%
51%
49%
Medicare Beneficiaries
Program Payments
Source: CMS and CRS data based on payments for fee-for-service beneficiaries in 2001.

This to me is one of the things that requires us to focus like a laser. 6 percent of beneficiaries are using 51 percent of the money. At times it has been 5 percent using 50 percent of the money. And who are they? They are the chronically ill. They are people who have multiple conditions, and that is what presents us, I believe, with our biggest opportunity. This is where we can get the biggest bang for the buck in terms of savings for Medicare and Medicaid. It is also the place where we can most dramatically improve health care outcomes. So I think we really need to rivet our attention on this statistic and the reality of people's lives behind those statistics, chronically ill, people who have multiple conditions. Their care is not being well coordinated now. As a result, they are subjected to multiple tests. They are also taking many too many prescription drugs, many times actually making them less healthy rather than more healthy.

Bush Administration Framework for National Health IT Infrastructure

- Electronic health records
- Computerized treatment options and best practices easily accessed by doctors
- Computerized health assessment and treatment recommendations from doctors
- Electronic health information/patient data exchange

The administration's framework for IT infrastructure emphasizes electronic health records, computerized treatment options and best practices easily accessed by doctors, computerized health assessment and treatment recommendations from doctors, electronic health information, patient data exchange. I think the administration has been quite right to focus on those areas of opportunity.

As I have talked to health care providers around the country, as I have talked to people running major health care companies, they tell me they think there is an enormous cost multiplier here, cost savings multiplier, by using best practices, and it is simply not happening. There are huge management opportunities, places where we can save substantial sums of money and improve the efficiency of health care.

What are the Benefits of Health IT?

- Reduction in medical errors
- Improvement in access to health care
- Improvement in coordination of care

What are the benefits of information technology and health? Reduction in medical errors. We have just seen a national survey on medical errors, really quite stunning, the number of errors that are occurring in some of our very best facilities. And we all know how it happens, you know, charts that cannot be read, charts that are not available at the key location at the right time.

Improvement in access to health care, improvement in coordination of care. And I want to emphasize the last one if I can, improvement in coordination of care. I have said this to my colleagues many times. I will say it again. I truly believe one of the biggest opportunities we have is with the small percentage of those who are eligible for Medicare and Medicaid, roughly over time 5 percent who use 50 percent of the money. We need to better coordinate their care.

We did a pilot with some 21,000 patients, and we found out, when we put a nurse practitioner in every one of their cases, first thing they did was go into their homes, lay out all the prescription drugs they were taking. All too often they found they were taking 16 or 17 prescription drugs, and half of them they should not have been taking.

It happened with my own father-in-law. I went into his house, laid out all the prescriptions he was taking. He was taking 16. I got on the phone to the doctor. I went down the list. About the third drug I mentioned, he said, "My God, Kent, he should not be taking that. He should not have been taking that the last 3 years." I went further down the list, and with two drugs he was taking, he said, "He should never take those drugs together." I said, "Well, doctor, how does this happen?" He said, "It is very easy how it happens. He has a lung specialist, a heart specialist, he has an orthopedic doctor. He has me as his family practice doctor. He is getting medications at the hospital pharmacy, at the corner pharmacy, at the pharmacy down at the beach, mail order several pharmacies. Nobody is coordinating it."

Chairman GREGG. He was probably buying in Canada.

Senator CONRAD. He probably was. The problem was nobody is coordinating. He was sick and confused. His wife was sick and confused, and that is how it happens. We have to do a better job of making certain that this care gets coordinated because we will get better health care outcomes and we will save money.

With that, I thank the Chair.

Chairman GREGG. Thank you, and your points are absolutely well taken, and we look forward to the Secretary telling us how we are going to make some progress in this area.

We turn to the Secretary for a statement.

STATEMENT OF HON. MICHAEL O. LEAVITT, SECRETARY, DEPARTMENT OF HEALTH AND HUMAN SERVICES

Secretary LEAVITT. Thank you, Mr. Chairman, and also, Mr. Conrad, thank you members of the committee.

My prepared opening statement is somewhat redundant to what has been said, and so I would just like to submit it for the record and just reemphasize a couple of points if that would be permissible.

Chairman GREGG. Whatever was you want to approach it.

Secretary LEAVITT. That is what I would like to do.

What I have heard you say basically between the two of you is that this is really about lower cost, it is about fewer medical mistakes, it is about better care, it is about patients having less hassle in addition to it.

I would just add one more to the list, and that would be it is about having a more secure Nation as well. There are quite profound implications with respect to our preparation for bioterrorism events as well as pandemic events that we are now working to prepare ourselves for as a country.

Senator Conrad mentioned the need for laser focus. I would like to suggest that the place for our laser focus is on interoperability of systems. We do have to deal with the issue of how we provide access of adoption among the broad medical community. That is clearly part of the discussion. But until we have developed a means of being able to allow our systems to speak together, to talk, to be interconnected, we will not get the profound benefit that is available.

Another point I would make is that we have now in place a very clear strategy to achieve interoperability. We have deployed recently the American Health Information Community. I would like to describe for you what our strategy is in simple terms. The national Government agencies, the programs that you referenced, as well as some others, if you take Medicare, Medicaid, the Veterans Administration, DOD, the Indian Health Service and, if you add the Medicaid component in the States, among that group, we fund publicly about 46 percent of all health care in this country.

Our strategy is very simple. Let us bring together all of the Federal agencies and have them begin operating with a set of common standards, recognizing that we will move the market when we do that. We have gone to the private sector and said, "We need you to help us develop these standards." Over the course of the next several months we will develop the standards, and believe at that point in time, once the standards are in place for interoperability, we will begin to see quite profound progress and some specific breakthrough projects.

I can see a time where the medical clipboard will be a thing of the past. When you walk into a clinic, the first thing they hand you is a clipboard, and over and over and over again, you fill out the same information. The whole idea of medical mistakes—we have all had experiences with this—we can eliminate them.

I would also like to just add that many of the other issues that we deal with together will be affected by this. The profound growth of Medicaid and Medicare will not ultimately be stemmed until we are able to get controlled health care costs, and information costs are a major part of it. The whole idea of physicians' reimbursement is an issue that we will, I am sure, talk about today, one that is of great concern to the medical community. A big part of that, in my judgment, is the capacity to begin paying physicians and providers on the basis of their performance and their outcomes as opposed to just treatment. All of this is about a major shift from treatment to health.

One of the concerns I mentioned earlier—I will just highlight it—is bioterrorism. Currently, as we exercise on bioterrorism events, it

becomes quite evident that a significant problem in the early part of any incident is determining if an incident has occurred, how broadly it has occurred, and what it is.

One of the early benefits of an interoperable health IT system will be linking together emergency rooms so that we have information very early in those incidents to determine where they are. The same will be true for pandemics.

If I could make one direct appeal to you today, it would be, as this committee deals with this issue, that we recognize that the important laser focus has to be on achieving interoperability. Yes, we need to deal with adoption, and we will, but until we have achieved those standards, dramatic expenditures on health information technology will not achieve, in and of itself, the vision that I have heard many of you espouse.

[The prepared statement of Secretary Leavitt follows:]

STATEMENT

OF

MICHAEL O. LEAVITT
SECRETARY

DEPARTMENT OF
HEALTH AND HUMAN SERVICES

BEFORE THE

COMMITTEE ON THE BUDGET
UNITED STATES SENATE

JULY 20, 2005

Introduction

Chairman Gregg and members of Committee, I am honored to be with you today to discuss a key element of the President's health care agenda-- health information technology (IT). The President and I are committed to promote health information technology and we believe that it will yield lower health care costs, reduction in medical errors, and enhanced quality of care. Today, I will provide a brief overview of our Department's health information strategy and the activities underway at this time.

Setting the Context

When President Bush asked me to become Secretary of the Department of Health and Human Services (HHS), he charged me with helping Americans live longer, healthier lives and with doing so in a way that will maintain our economic health as a nation. While the U.S. offers world-class health care, it also spends nearly 16% of its GDP on health care or $1.8 trillion. In 1960, 5.1% of our GDP was spent on health care. Estimates are that it could be close to 19% of GDP by 2014. This is almost twice the average among European Union countries, with a growing portion attributable to Medicare spending.

While other industries like shipping, retail, and banking have successfully transformed the way they do business through the use of information technology, the health care industry's use of information technology has lagged. Furthermore, the productivity of the health care sector in the U.S. has failed to keep pace with its spending.

While much of this spending is unavoidable, the current system is saturated with inefficiency. In fact, economists believe that up to a third of health care spending – more than half a trillion dollars a year – is wasted because of poor or redundant care or other problems.

And it's not just a matter of dollars – it's a matter of human lives. The Institute of Medicine has estimated that medical errors are responsible for the deaths of 44,000 to 98,000 Americans every year in hospitals. The information necessary for clinicians to treat their patients is often missing

at the point of care. Our nation is facing an economic and humanitarian imperative in health care– we must become more efficient or face losing our economic prosperity and precious human lives.

Nothing short of transformation of our health care system will do. What are the big gears of health care transformation? I think there are three.

Perhaps the biggest gear is a change in the way we think about health care. When I was Administrator of EPA, I learned that it is much easier and less costly to prevent pollution than to clean it up. The same principle can be applied to health care. We need to become a society who thinks of staying healthy rather than simply being treated after we're sick. That is the reason the President fought so hard for a prescription drug benefit and other preventive benefits for seniors. That is the reason he is pressing hard for progress on obesity and emphasizing the importance of exercise and eating healthy. These lifestyle changes help prevent the onset of chronic diseases, such as Type 2 diabetes and heart disease. An increasing amount of our total health care costs as a nation are from preventable and manageable chronic diseases.

The second big gear is realigning health care incentives. The incentives in our health care system are just wrong - wrong for providers, wrong for payers, wrong for patients. Providers get paid on the basis of the quantity of the care they provide, not the quality of outcomes. Until this changes, we cannot transform health care. I am determined to see pay-for-performance become part of the way we compensate health care providers. We are already starting to implement these changes in the Medicare program. For example, the Medicare Care Management Performance Demonstration (MMA section 649) is a three-year pay-for-performance demonstration involving physicians to promote the adoption and use of health information technology to improve the quality of patient care for chronically ill Medicare patients. Doctors who meet or exceed performance standards established by CMS in clinical delivery systems and patient outcomes will receive bonus payments for managing the care of eligible Medicare beneficiaries. This demonstration, which is currently under development, is focused on small and medium-sized physician practices. It will be implemented in four states: Arkansas, California, Massachusetts, and Utah, with the support of the Quality Improvement Organizations in those states.

Likewise, current consumer incentives are counterproductive. If a person is sent into a store and told they can buy all they want and the price doesn't matter, the outcome is predictable. Too often, that's how our health care system works. Transformation will not occur until we change these incentives. That is why the President feels so passionately about tax-free health savings accounts [HSAs]. Owners of HSAs have an incentive to become more cost-conscious consumers of health care.

The third big gear is the widespread adoption of interoperable health information technology. Health information technology is a tool which holds much promise for improving the quality of care Americans receive by preventing medical errors, providing clinicians with better clinical decision-making tools, sharing information with other clinicians involved with the treatment of their patients, tracking health outcomes and coordinating public health activities. While improving the quality of care Americans receive is important, health information technology can also lead to cost savings, through better coordination of care, information sharing, reducing redundancies, and preventing errors.

Last year, the President made the use of health information technology a key principle of his health care agenda. On April 27, 2004, the President signed Executive Order 13335 (EO) announcing his commitment to the promotion of health information technology to lower costs, reduce medical errors, improve quality of care, and provide better information for patients and physicians. In particular, the President called for widespread adoption of interoperable electronic health records (EHRs) within 10 years so that health information will follow patients throughout their care in a seamless and secure manner. This means that their medical information is available to the right people at the right time, while remaining protected and secure. The President has tasked HHS with making this vision a reality by 2014. The goal can be met, but there are major challenges to be faced, and the path forward requires a concentrated nationwide effort to achieve widespread adoption of interoperable EHRs.

This Administration's commitment is clear. HHS will spend $85 million on health IT in FY05, and President Bush has requested another $125 million for health IT in FY06. This commitment

will support the foundational work of the Office of the National Coordinator for Health Information Technology and the Agency for Healthcare Research and Quality that is required to achieve the President's goals in 10 years.

Key Challenges

There has been great progress in the past year, and I am optimistic about the future of health IT. However, there is much more to be done, and we have to work to address real issues and barriers that will halt the remarkable progress that is being made.

The Adoption Gap:

The first challenge is an adoption gap. Although low EHR adoption overall is a concern, there is a bigger concern with the varying rates of EHR adoption. Some clinicians adopt EHRs more readily than others – creating an adoption gap based, in large part, on the size of practice. This could prevent market forces and competition from improving healthcare. According to a study by the Commonwealth Fund, 57% of large group practices of 50 or more physicians are using an EHR, but only 13% of solo practitioners are doing so. Larger practices have more resources, more ability to acquire information technology and more capacity to implement technology well. These early adopters should be commended for their leadership, and they should not be faulted for their inventiveness. But, we need to develop solutions that assist EHR adoption up and down the spectrum of care delivery organizations. Effective adoption of health IT can preserve what is unique and valuable about small practices, where approximately 70 percent of physicians practice. We are particularly focused on the needs of these clinicians in their IT programs.

Interoperability:

A second challenge is achieving interoperability and minimizing the limitations of proprietary data that cannot be exchanged between different systems. The U.S. health care system is complex, fragmented, and uses multiple standards for the use of technology. It is analogous to the railroad system that existed in America in the 1850's. Several railroad companies began laying tracks and competing for business, but the rail gauges (or, width of the tracks) varied, so that most trains couldn't switch from one network to another. The continent had multiple,

incompatible networks instead of one interoperable network. We solved our rail problem long ago, but now we face a similar hurdle with health IT. I have seen this first hand through a recent visit to a major U.S. city where an academic medical center, county hospital, and a children's hospital existed within blocks of each other. Each had made substantial investments in health IT, but each invested in different IT systems from different vendors. In the end, these hospitals have a common geographical service area and share many physicians on their medical staffs, but the information systems at these hospitals were incompatible with each other. This is a story repeated across the U.S. The rail gauges don't line up. We cannot let this continue in our health care system. As a result, patient information exchange is limited at best; it cannot be transferred electronically from one setting to another. If we are not able to address the challenge of interoperability, the health IT systems today will further set in concrete the silos of information existing today on paper. More importantly, the chance for true transformation of our healthcare system will have been lost – along with many promising potential benefits.

The spirit of the transcontinental railroad is alive in health IT. People want to build it, and there is a sense of urgency. We are spending lots of time building elaborate railcars, but not enough in lining up the tracks. It is the power of a competitive free market that will make this happen, and we are blessed to have innovators and entrepreneurs that are capable of making miracles happen. But the promise of health IT will only be realized when all this power is channeled into creating a standardized system that is open, adaptable, interoperable, and predictable.

HHS is taking advantage of the current low adoption rate for EHRs, and putting the goal of interoperability forward first. When interoperability is in place, EHR adoption will follow.

The Path Forward

I'm persuaded there are only three possible ways that interoperability will emerge.

- The federal government can choose a standard and mandate it. That sounds easy, but it almost never works because it ignores a lot of good ideas in the private sector, and people instinctively fight it.

- The second way is to let vendors fight it out. I call that method the "last vendor standing." It works for some things, but not railroads or national frameworks for health information interoperability. The inevitable result is multiple standards and incompatibility.
- The third method and the only real alternative is a guided collaboration. Let's face it: collaboration is hard, and private sector technology competitors are not hard wired to do it; but it's also absolutely indispensable, and it works.

It has become clear that the challenge of health IT interoperability is a compelling national problem and that it will require an extraordinary measure to achieve it. It requires a sustained effort that goes beyond a private effort—and, beyond a federal effort. This requires a nationwide effort, harnessing the best of every sector.

In an effort to channel this momentum and continue toward meeting the President's goal, I am forming a national collaboration to dramatically intensify the pace of progress in health information technology. On July 14, 2005 I published a notice in the Federal Register to create the American Health Information Community (the Community). This body will be tasked with helping the nation transition to electronic health records – including common standards and interoperability – in a smooth, market-led way. The President intends the Community to be the place where major government players and private sector interests unify behind a common framework achieving interoperability. The Community will be an open, transparent and inclusive collaboration involving the critical mass necessary to get things done.

The Community, which will be formed using the procedures of the Federal Advisory Committee Act, will provide input and recommendations to HHS on how to make health records digital and interoperable, while assuring the privacy and security of those records remain protected. The Community is being chartered for two years, with the option to renew for a duration of no more than five years. It is my intention that the Community be succeeded within five years by a private-sector health information community initiative that, among other things, would set additional needed standards, certify new health information technology, and provide long-term governance for health care transformation.

The Committee will not exceed 17 voting members, including the chairperson. It will consist of nine members from the public sector and eight members from the private sector. Public Sector members will be drawn from Department of Health and Human Services (including the Office of the Secretary, the Centers for Medicare and Medicaid Services, and the Public Health Service), Department of Veterans Affairs, Department of Defense, Department of Commerce, Department of the Treasury, Office of Personnel Management, and a State government. The private sector membership will be drawn from purchasers, third-party payers, hospitals, physicians, nurses, ancillary services (e.g., lab or pharmacy), consumer and privacy interests, and health information technology. This is of such importance to the transformation of health care in America that I have concluded that, as Secretary of Health and Human Services, I should serve as the Community's first chairman. Nominations for the Community are due August 5, 2005.

The Community will start by building on the vast amount of standardization already achieved inside and outside the healthcare industry. Specifically, the Community will:

1) Make recommendations on how to maintain appropriate and effective privacy and security protections.
2) Identify and make recommendations for prioritizing health information technology achievements that will provide immediate benefits to consumers of health care (e.g., drug safety, lab results, bio-terrorism surveillance, etc.).
3) Make recommendations regarding the ongoing harmonization of industry-wide health IT standards and a separate product certification and inspection process.
4) Make recommendations for a nationwide architecture that uses the Internet to share health information in a secure and timely manner.
5) Make recommendations on how the AHIC can be succeeded by a private-sector health information community initiative within five years. (The sunset of the AHIC, after no more than five years, will be written into the charter.)

Furthermore, I have also issued four requests for proposals (RFPs). The products of these contracts will, in part, serve as inputs for the AHIC's consideration. We expect to award

contracts for these RFPs in September 2005. Specifically, the RFPs will focus on four major areas:

1. ***Standards harmonization:*** Harmonization of standards is fundamental to the success of widespread interoperability. Today, we have many standards for information exchange, clinical vocabulary and coding, but we have not harmonized them. These variations may hinder interoperability and the widespread adoption of health IT. There are also gaps in standards. The contractor selected will be asked to develop, prototype, and evaluate a harmonization process for achieving a widely accepted and useful set of standards. These standards would be designed to enable and support widespread interoperability among health care software applications, particularly EHRs.

2. ***Compliance certification:*** There are more then 200 EHR products on the market today, but there are no criteria to evaluate product functionality and interoperability. The variability and lack of criteria limit physicians' and hospitals' ability to make informed buying decisions. Agreement on product capabilities and compatibilities would reduce the risk of poor IT investment by healthcare providers. The contractor selected will be asked to develop criteria for the functional requirements for health IT products, as well as the infrastructure components through which EHRs interoperate.

3. ***Nationwide Health Information Network (NHIN) Architecture:*** Today, there is no consensus regarding how to utilize the Internet infrastructure to support interoperable health information exchange. As a result, information is often fragmented and incomplete at the point of care. The contractors selected will develop models for an NHIN architecture that would maximize the use of existing resources, such as the Internet, to achieve widespread health care interoperability.

4. ***Security and privacy:*** Currently, privacy and security practices vary by state and health care organization and this variation poses a challenge to widespread health care information exchange. The contractor selected for this RFP will define workable mechanisms and policies to address these variations, while maintaining the levels of security and privacy that consumers expect.

Other Health IT Initiatives Underway

In addition to the Community and four RFPs, there is other significant work underway at the Department which I would like to mention. I would like to highlight two initiatives here.

E-Prescribing

Shortly after being appointed Secretary, I announced proposed regulations to establish a foundation set of standards to support electronic prescriptions for Medicare. E-prescribing can improve patient safety and reduce avoidable health care costs by reducing prescription errors due to hard-to-read physician handwriting and by automating the process for checking for drug interactions and allergies. E-prescribing can also help ensure patients and health professionals have the best and latest medical information at hand when they make important decisions about medicines, helping patients get the most benefits at the lowest cost. The electronic drug prescribing initiative will accelerate the nationwide adoption of e-prescribing in Medicare, which is expected to accelerate e-prescribing throughout the nation's health care system. The regulations implementing the Part D benefit under the Medicare Prescription Drug, Improvement and Modernization Act of 2003 (MMA) provide that e-prescribing based on national standards be mandatory for drug plans participating in the new Medicare Part D program.

A critical piece in nationwide adoption of e-prescribing is the promulgation of the MMA mandated exception to the physician self-referral statute [the Stark provision] and the safe harbor to the anti-kickback statute, which would enable hospitals, group practices, Prescription Drug Plan sponsors and Medicare Advantage organizations to donate software to physicians and other providers for use in e-prescribing. We plan to issue proposed regulations for the physician self-referral exception and for the safe harbor to the anti-kickback statute very soon.

Efforts at the Agency for Health Research and Quality (AHRQ)

In FY 2004, AHRQ awarded 108 grants and contracts to advance the use of health IT across the nation. These awards will provide insight into how best to use health information technologies to improve patient safety by reducing medication errors; increasing the use of shared health information between providers, laboratories, pharmacies and patients; helping to insure safer patient transitions between health care settings, including hospitals, doctors' offices, and nursing homes; and reducing duplicative and unnecessary testing. Specifically, we awarded grants and contracts for three specific purposes:

1. Planning, implementation and research grants: The grants are to build the knowledge base for how to do health IT well, and to seed essential partnerships. The grants are for three years and were awarded to 38 different states, with a special focus on small and rural hospitals and communities. These programs are anticipated to have a positive impact on 40 million Americans.
2. Develop statewide and regional networks: Contracts were awarded for five years to five states who have taken a leadership role in advancing health IT (Colorado, Indiana, Rhode Island, Tennessee and Utah) to help them develop secure, statewide networks.
3. Encourage adoption of Health IT by sharing knowledge: This five-year contract was provided for the creation of the National Health Information Technology Resource Center to provide technical assistance and promote best practices to grantees and contractors to aid them in their Health IT adoption efforts. The Resource Center is also being made available to community health centers and rural health programs across the country.

Reflecting a commitment of $139 million over five years, these awards were truly nationwide in scope. They spanned 43 states, with over half of the projects based in rural and small hospitals and clinics. In combination, these community-based health care institutions provide health care to more than 40 million Americans.

Conclusion

HHS will continue to lead the nation along the path toward interoperability as a convener and an early adopter. The path will be difficult, and it will be painful at times. But, with the right commitment and the right leadership, we will create a transformation in our healthcare delivery system that is meaningful and that is lasting. In doing so, we can transform our health care system so that we achieve fewer medical mistakes, lower costs, better care, and less hassle. We all agree transformation must take place; now let's all agree to work together to do it. Abraham Lincoln transformed transportation in America. George Bush is resolved to do the same thing for health care. And, I am committed to seeing the President's goal become reality.

That concludes my opening statement, Mr. Chairman.

Chairman GREGG. Thank you very much, Mr. Secretary. We have this issue of interoperability at a lot of different levels in the area of homeland security. We cannot get the State police to talk to the local city police in most of our States in this country. So I guess my question is, how do you get over this? I was talking to the head of my largest hospital, not my largest, but one of my larger hospitals, just so he is not designated. And they do a lot of things. They have a long-term care facility. They have a heart center. They have a cancer center. They have a center for battered women. And he was saying that one of his biggest problems is that his computer systems within his own hospital cannot communicate with each other.

So how do you ever—when we cannot even get the police to agree on a bandwidth to deal with spectrum, how do we get the health community, which is a matrix of incredible complexity, to come up with simple protocols to allow, for example, a single way to develop pharmaceutical requests or a single way to present the basic health care information that everybody has such as blood type? How do we do that?

Secretary LEAVITT. Senator, let me just indicate I have experienced the difficulty that you reference with respect to bandwidth. While I was Governor of Utah, we were preparing for the Olympics. We had 7 years to prepare to get our radio communications to all be on the same system. It took us all 7 years to get there. World War II was fought in half that time. We can do better, and we have to do better on this subject.

Here is our strategy. We recognize that it is going to require—we recognize this is a place for some Federal leadership. Between Medicare, Medicaid, Indian Health Service, VA, DOD, we pay for about 35 percent of all health care in the country. If you add State Medicaid and other Government programs, we are 46 percent of the market. So the strategy is, step one, to in essence bring all of the Federal programs together and say we are going to adopt standards of interoperability.

Chairman GREGG. Can I interrupt? For example, are you going to have a standard that every doctor who executes a prescription under Medicare or in the veterans facilities or in an Indian health facility, that prescription has to be typed out as versus being handwritten?

Secretary LEAVITT. We are moving toward an e-prescribing standard. We are not going so far as to say every one of them has to be handled that way. We are using it in a more voluntary adoption basis, but very shortly, we will put forward e-prescribing standards that will allow the systems of various medical providers to integrate so that there is a tremendous advantage.

Over time it will I am sure create lots of incentives for people to do that. So the answer is that is precisely the direction we are following, and it is a good example.

If we can bring together the VA, the DOD, Medicaid, Medicare, and say, "Here are the standards we are going to adopt, and in time we are going to expect all who do business with us to adopt the same interoperable standards." We know we will move the market.

We want to do it in the proper way, so we have invited the vendors, the medical providers, the entire private sector by saying, "Help us develop these standards." We are moving in a rapid way now to develop standards that will ultimately be deployed both in public but also then in private settings.

Chairman GREGG. A secondary issue here is that as you move to these standards you get into questions of sharing patient information, and error information within hospitals, and physician delivery systems. Now, we, last year, passed something called the Patient Safety Act. It has passed Senator Enzi's committee already, and the House, I understand is actually going to mark it up this year—they stopped it last year. But do we not have to have some sort of an understanding of protocol, an understanding so that this information, when we create these data bases that are going to try to be universal and address issues like errors, are protected from being abused or used overly aggressively so that there is a chilling effect on them by the trial bar.

Secretary LEAVITT. Confidentiality, privacy, and security need to be first principles of this effort. Those are problems we are dealing with in many aspects of our society, but in no place is it more sensitive than it is with information, with health information technology.

HIPAA was an important step forward with respect to health information. The Congress provided that States could have more stringent standards. We now have more than 30 States who have adopted different standards. So one of the elements of creating interoperability is not just the technical aspect of being able to get the computers to talk together, it is getting the people to work together too by harmonizing the standards and having ways in which we can accommodate all of those different standards of privacy. So you are absolutely correct.

And, we have recently put out an RFP, inviting the States to help us find the differences so we can harmonize in that effort. It is a first priority.

Chairman GREGG. Senator Conrad?

Senator CONRAD. In this area you want us to focus like a laser on, interoperability, I have had legislation that would create what we would call a National Emergency Telemedical Communications Act, and it would provide $150 million for three State consortia to set up networks that could connect CDC in an interoperable way with major hospitals and major clinics, and law enforcement. So that if we, God forbid, had a bioterrorism event, we would have a communications network that has been tested and vetted and was interoperable.

I would hope very much that the administration would support that legislation, or comparable legislation. The important thing here is that we really go down this trail and go down it quickly.

One of the things we learned on September 11th, if you go back and look at the analysis of what happened at the Pentagon, the No. 1 problem was the lack of interoperability of communications. So the first responders—and the Chairman had it just right—they could not talk to each other. You had police, you had medical, you had those who were to deal with hazardous toxic situations, all re-

sponding, fire as well. They could not talk to each other. It created a massive confusion.

It seems to me the way to address this is to begin with manageable sized groups and link them, and put the money into running tests. The reason we came up with the idea of having three different consortia was to test different methods, put them in competition. I think that is what we ought to do with all these things, test and compete. And that was the idea here. Let three groups go out there and test systems and compete against each other, and see which one works best before we try to lay it out nationally.

I think every time we have gone and tried to lay something out nationally without testing it, we have wasted a lot of money. So I hope very much that we will pursue that.

I also wanted to ask you very specifically, as we try to focus on this question, do you have some other idea of how to actually create networks that are interoperable, that test the theory?

Secretary LEAVITT. Senator, we are currently engaged in a project we call BioSense. We have identified the 36 most sensitive cities from a bioterrorism standpoint, where we believe the risks are the highest. We are beginning to work, I might add, aggressively to link up what I believe are 421 emergency rooms, starting with development of standards of interoperability. One of the dilemmas of interoperability is not just, as I indicated, finding ways to hook up the wires. We have to learn to define things in the same way. The glossary of terms that we use to describe things has to be similar. We will have a number of hospitals linked this year for trial. We expect to have dramatically more the next year, and it is our ambition, in a relatively short timeframe, to have all 36 major cities and all 400 plus emergency rooms operating on an interoperable basis.

This not only has value in terms of our near-term bioterrorism needs, it is also driving the decisions that need to be made that can be used in e-prescribing and could be used in an electronic medical record. Once we have established the basic decisions on the standard we are adopting, this will begin to grow in its proportion rapidly.

Senator CONRAD. Let me just very quickly turn to another subject, because we are about to face the roll-out of Medicare prescription drug plans, and I tell you, it is very much on the minds of people in my State. People have already approached me, very concerned that there is going to be confusion, and if there is confusion, that will reduce sign-up and that will reduce participation. Can you give us some insight on what you are doing to roll this plan out in a way that people understand it and are not confused by it, and that we do not have so many plans circulating out there that people cannot reach a decision?

Secretary LEAVITT. Senator, yes. I am spending at least 2 days a week—I will be leaving again tonight to go out to visit local communities throughout the country. We are in the first phase of our roll-out. The first phase of our roll-out is to meet with local community groups. I must tell you, I am quite heartened by what I am feeling and seeing. We will see roll-out over the course of the next 10 months, a national conversation, a national conversation that will include literally tens of millions of different venues.

It will be as simple as a daughter sitting down with her aging parents to say to them, "Mom, Dad, I need to help you assure that you have made a decision on this prescription drug plan." It may be a pastor who organizes a committee at his or her church to help the members. It will be a pharmacist at a store counter dealing with a customer, who has a trusted relationship. It may be a doctor dealing with a patient, or a nurse at a community health center or a senior center. And we are seeing groups, seniors organizations, community groups, mayors, county commissioners, State Departments of Health, all who are rallying to help a common constituency of seniors to make this decision.

I feel a sense of real optimism, that while it will not be perfect in its execution, and while it will not be without complexity, at the end of the period of time we will see between 28 and 30 million people who will have enrolled in this remarkable new health benefit. It is in fact among the most significant events in health care in a half century.

Senator CONRAD. Can I invite you to North Dakota?

Secretary LEAVITT. I would love to come to North Dakota.

Senator CONRAD. We are asking the churches across our State to get involved in a very meaningful way, and we would love to have you come.

Secretary LEAVITT. I have been in little Havana at a senior center, I have been at a Southern Baptist church in South Carolina, I have been at an arboretum in Alabama. It is actually very heartening to see these groups come together. The partisanship is gone now. This is out in the community. People are rallying for a particular cause. This is a moment, I believe, in our history where people are going to unify to deliver it.

Now, I do not want to create an expectation that there is not going to be a decision to make for people. There is. We will have multiple plans that they can choose from in a way that will allow them to pick a plan that is best for them, and seniors are going to want to hear this over and over and over again, as we all would.

Senator CONRAD. Can I just say to you, you have not lived until you have gone to a Lutheran Church basement lunch.

[Laughter.]

Secretary LEAVITT. Senator, I have lived, on that basis I have lived.

Senator CONRAD. We will have the Jello there for you and the bars and——

[Laughter.]

Chairman GREGG. Senator Ensign.

Senator ENSIGN. I have not lived yet.

Chairman GREGG. Maybe he is going to go to Las Vegas.

Secretary LEAVITT. We are coming to Las Vegas.

[Laughter.]

Senator ENSIGN. People always make fun of my town, and I always tell them that those are your people acting crazy in my town.

[Laughter.]

Senator ENSIGN. Secretary Leavitt, thank you for being here today. We just held a markup in the HELP Committee, thanks to Senator Enzi's leadership on the issue of health information technology. As you know, I held at the Commerce Subcommittee on

Technolgy, Innovation and Competitiveness on this issue. I really believe that health information technology is one of the more important issues that we are dealing with in health care today. Health information technology does provoke careful thought and discussion. It is difficult to determine for the electronic exchange of health information.

We have a lot of experience with individual information systems and how bad they can be, how they over promise, and how they under deliver. For example, I remember when I was first running for Congress in Nevada and I spoke with the person who oversees all the welfare programs. The person had developed proprietary software with the assistance of outside help. This software was going to completely computerize their whole system, and make it much more efficient. They finally got it online in late 2000 at about three times the cost of what it was originally supposed to be.

A lot of us have had negative experiences with information technology. As a veterinary practitioner, we were always over promised and under delivered on what software was going to do. A lot of individual physicians have experienced some of the same things. Consequently, there is some trepidation in the health care community, especially for those people on the front lines. And, as we learned in our Commerce Subcommittee hearing, a lot of the information technology related benefits of improved efficiency and quality of care accrue to the payer and patients, but not to the providers who bear most of the implementation costs.

I think interoperability is a critical aspect in our discussions on health information technology. There is no question about it. If you think you are buying a system that is not going to work with other systems, you are not going to invest in a system and put your capital at risk. It is critical that we facilitate the widespread adoption of interoperable health information technology.

The Internet has worked because standards are in place that enable communication, commerce, and information to flow freely. I am glad that you are focusing on the issue of interoperability. Could you please address the front line physician or health care provider who says, "Why should I invest in health information technology when I would receive very little of the benefit?"

Secretary LEAVITT. Senator, thank you for your question, and I am delighted about the markup. I want to express, as you did, a compliment to Senator Enzi and the remarkable leadership he has shown in his committee.

There is little question that one of the dilemmas we face is that oftentimes the benefit, the economic benefit, does not flow to the same party to whom the investment is required and that there will be a transition as we help people work through this adoption process.

There are a number of ways in which I believe that can and will occur. One I mentioned earlier, and that is the pay for performance, being able to identify methods of responding to payment that are not simply on the basis of how much treatment is given, but the quality of treatment that is provided. If we are able to say to a physician—if you can demonstrate that a number of different—or if you can demonstrate that a high enough percentage of your patients have been treated in a particular way, we know we will

save money; and as a result, we will share that with you and help you with your adoption costs through some kind of pay for performance. That is one way.

There have been a lot of discussions about exemption to the Stark amendment that would in the proper context, when we have achieved interoperability, allow systems of health to begin developing networks.

Over time it has been my observation that it is rarely the technology that limits us. It is almost always the sociology that limits us. And, I believe this is just such a circumstance. If we can begin to work together, we can create the interoperability, and I believe the economic model will follow.

Senator ENSIGN. Thank you for your response. What you have just expressed is what came out of our Commerce Subcommittee hearing. I appreciate your comments regarding pay for performance initiatives and the idea of best practices. Driving best practices down to the lowest level is absolutely critical. BY encouraging the use of best practices, you can achieve better outcomes that we are all talking about.

Thank you, Mr. Chairman, for holding this hearing.

Chairman GREGG. Thank you.

Senator Murray?

Senator MURRAY. Thank you very much, Mr. Chairman, and thank you, Mr. Secretary. And while I have the opportunity, let me just thank you for working with us on the nomination of Dr. Crawford to head FDA. I was, as you know, very frustrated on the planned BOTC application and the fact that, despite the overwhelming scientific and clinical data, there wasn't a decision made and PDUFA deadlines have been missed, and I really appreciate your July 13th letter and working with us to assure that FDA is going to finally act on this application. And I wanted to just take this opportunity to publicly thank you for that.

Secretary LEAVITT. Thank you, Senator.

Senator MURRAY. This is a very important issue, and I think it is critical for us, looking at cost savings and numerous other things. But you raised in your testimony when you spoke an issue that I think this has direct impact on, and that is the Medicare reimbursement. It is an issue I have been long frustrated at, that Medicare rewards inefficiency, basically, and overutilization. It hurts States like Washington that are very efficient. We have one of the lowest per beneficiary cost in the country, and so we are very much at a disadvantage in a system that does not reward doctors' being more efficient. And I wanted you to comment on your written testimony where you talk about the Medicare management performance demonstration and how we can make sure that when we structure this new health IT effort in Medicare, we do it without providing more disincentives in reimbursement rates that could just cause more problems and more costs in the future.

Secretary LEAVITT. The subject of Medicare reimbursement rates is one that I am constantly having conversations with Members of Congress about, particular conversations relative to their area, whether they feel that the reimbursement levels in their area are fair or not fair. And we are working to respond to those on a situation-by-situation basis to do our best to be fair and responsive.

The subject on a global basis or macro basis is very complex and one, frankly, that we are going to be dealing with very shortly as you deal with the budget. We are under obligation statutorily to continue to move forward with what will be a 4.3-percent reduction in Medicare reimbursement rates. There have been many who believe that is not reasonable. Nevertheless, it is the statute, and we are moving toward implementation of it.

That is one of the reasons that the topic of pay for performance is so integral to the conversation we are having on health information technology. We will never achieve a more rational way of paying and incenting providers without being able to accomplish interoperability and a national system that will allow us to gather information and measure outcomes and then compensate, at least in part, on that basis.

So having these two conversations linked is a very appropriate response.

Senator MURRAY. I agree, and I think we all want to work with you toward that goal.

I had the opportunity a short while ago to visit a hospital in Spokane, Washington, with the Inland Northwest Health System that was doing something very innovative in IT, and that was providing pharmaceutical and pharmacy access to rural hospitals through their technology at that hospital linking up with rural communities in eastern Washington and doing the pharmaceutical prescriptions for patients there. And I think there is a lot of really exciting opportunities.

But as I hear all this talk about technology, I hear a lot about how it helps doctors, how it helps hospitals. I want to make sure it helps patients, and I think patients' having access to their own records will provide tremendous savings for us as well.

Senator Conrad talked about his own father and all the medications he took. Sometimes I think patients can be the best savers if they actually have records and their own information. People too often go and get a diabetes test or an osteoporosis test, never go back and ask what the results were, so they do not know what they can be doing for their own health and actually cost savings.

How can we make sure that in this effort we make sure that patients have access to their own records through IT?

Secretary LEAVITT. Patients do need to both own and control their own records. Most of all, we need to have a way in which they can access them.

I have experienced recently this dilemma on a very personal basis. I went to the hospital to have one of those over–50 tests that we all look forward to so much. And I was handed a medical clipboard as I walked in the door, a ritual in American medicine. I spent the next hour filling out my name and my address and my insurance information over and over and over again.

Finally, I got to the point of the test, and the physician sat down with me one more time to say, "Now, let's ask you some questions. Have you had a reaction to prescription drugs?" I mean, we have all been through these questions before. And then he said, "Do you have any serious medical problems?" I said, "No, I have no serious medical problems."

Well, just by coincidence, I guess, or at least I was prompted to say, "Well, I do have sleep apnea." He said, "I need to know that because I am going to put you under an anesthetic for this, and that is a very important piece of medical information." That was a medical mistake. It was my mistake. He asked me the questions. I did not answer them. Had I had an electronic medical record, that would have very clearly been there. It would have saved me the hour that I took filling out my name and my address and my phone number and a health history that I could not properly remember. That is the way it will benefit patients.

There are many ways. I have a colleague who indicated she needed to take a half a day off work. I asked her the next day, "How did it go?" She was going to the doctor. She said, "I spent most of the day being a medical courier. I went from doctor's office to doctor's office picking up brown envelopes to deliver them to a doctor's office." That could have and should have been done with the click of a mouse. Think of the half-day of unproductivity that it cost her—and, I might add, her employer.

This is about lower costs. It is about less hassle. It is about fewer medical mistakes. This is about transforming medicine as we know it today. It is about being able to deal with Medicare, Medicaid, national defense. This is a very significant undertaking that we are about.

Senator MURRAY. I agree, but I just think we cannot lose sight, as we work through this issue, that the patient having access to their own medical records is an important part of technology and that patients will actually make better decisions. I know there is this fear in this country that, you know, doctors have to keep the information and we should not maybe know everything we should know about ourselves. But I think we will actually find that if patients know themselves what their tests show and what they are taking, they can do a better job of preventive medicine.

And, Mr. Chairman, preventive medicine is what we all need to be focused on to save dollars in the long run in the health care system.

Chairman GREGG. We will next hear from the man who is going to straighten all this out, the Chairman of the HELP Committee, Senator Enzi. I apologize for the duplication of this hearing with your markup, but the Secretary asked that we set it up.

Senator ENZI. I think it is outstanding that we are having this hearing. I am just so excited today. I love numbers and I love technology, and bring it all together at one time. I want to congratulate the chairman for the extensive work that he has done on this. I remember being on a task force that he led a year and a half ago when we talked about ways to solve medical crises in the United States. And I am doing 18 bills that you brought up at that time, and this is one of them.

Chairman GREGG. That is why I left.

[Laughter.]

Senator ENZI. It is keeping us busy, I want you to know. This is probably the key one to all of the rest because everything builds on information, patient information and their access to it and what can be done to follow chronic illnesses. There are just so many pos-

sibilities with it that we need to tap and we need to tap right away. And I want to thank you for getting that started last year.

I want to thank the Secretary for being here. He and I have had numerous meetings. In fact, we have had numerous meetings for several years, because he has been deeply involved in technology, in computers, and, in fact, was key in starting the Western Governors University, which I think was the first online degree-granting university probably in the world, and he put that together. So I have seen his capability of being able to understand technology and to work with technology and, probably even more importantly, to bring other people along in understanding it. He has a tremendous gift for making things very clear and simple enough that even I can understand them. That is a gift. He has a great example of train tracks that he did not get to use this morning, but he has been using it across America as he puts all this together.

Now, I share your concerns and those of Chairman Gregg and Senator Ensign about spending wisely on IT. I am certain that we will work to make sure that we are filling the financing gaps. And I am pleased that we were able to pass the bill this morning in markup, and what it does is give express authorization to Health and Human Services to do the work that Health and Human Services has been involved in for a couple of years, but is now coming to a head and I am sure will get on track and completed in a very short period of time under your leadership.

We wanted to make sure those specific areas of authorization were there, and I do want to commend you for taking the helm at HHS and moving quickly to implement the President's vision that everyone in America have electronic health records by the middle of the next decade. And I think under your leadership we can exceed that.

Senator Grassley and Senator Baucus intend to move their legislation through the Finance Committee to build the pay-for-performance measures into the Medicare program. What else do you think Congress can do to assist you to make this shared vision a reality?

Secretary LEAVITT. That is an appealing question. Thank you. May I just respond that I have now been serving as Secretary of Health and Human Services for almost 5 months, and it was very clear to me quickly that this subject was right at the heart of nearly every aspect of my mission. Medicare, Medicaid, in order to get costs contained where they are sustainable, this is at the heart of it. The responsibilities I have for drug safety, right at the heart of it. The responsibility I have for bioterrorism, this is right at the heart of it. So this was an easy decision for me to put as much time as I am on it because it is so critical to every element of the way we deal with cost containment in our country.

And may I just answer directly your question. The most important thing from my standpoint is that we are using what Senator Conrad referred to as a laser focus and that we use it on interoperability. If the Congress wrote a $1 trillion check today for health information technology and everyone went out and bought systems, we would probably get some good systems. But we would not have achieved the vision that you have spoken of where we are able to reduce costs because of better practices to be able to have lower costs, fewer medical mistakes, better care, and less hassle. We

would not achieve that even if we wrote a check for $1 trillion today. We have to get interoperability and then begin to work very deliberately on solving the problem referred to before by Senator Ensign with respect to adoption.

Both are significant problems. Interoperability is the first one we have to solve, and then we have to deal with the adoption issue.

Senator ENZI. I particularly want to thank you for page 9 of your testimony. It shows how you focus in on and prepare and do a project, and that is where it lists the four RFPs that you have already arranged for, and I think it is pretty remarkable, since you have only been on the job for 5 months, that you already have this underway and have taken it to the Nation.

I see that my time is about to expire.

Chairman GREGG. Thank you, Senator Enzi.

Senator Stabenow has some views on interoperability.

Senator STABENOW. Well, thank you, Mr. Chairman.

I first want to thank you, Mr. Secretary, for your work with your other hats, with the EPA and the work that we did on the Great Lakes. I appreciate your leadership there. Positive things are happening as a result of bringing people together.

Secretary LEAVITT. I am optimistic about that.

Senator STABENOW. And we thank you for your leadership and look forward to the same kind of bringing people together and moving forward on this issue.

I could not agree more with the comments that have been made about this being at the heart of our ability to move forward, both for cost savings not only for the Federal Government but for private businesses as well. And also we save lives by doing this. So I cannot think of anything more positive than to be focusing on this.

I do want to speak, though, because I have a slightly different view in terms of how we need to move forward or the extent to which we focus on interoperability alone or making sure that hospitals and physicians and so on are beginning to purchase equipment, do training, move along so that they are ready for interoperability, they are ready for the efforts that are so important.

When I think about the U.S. Senate—in fact, when I was in the U.S. House, we did not wait for interoperability before everybody got PCs, before we trained people. Right now we still are not totally interoperable in the U.S. Senate. And yet we have certainly benefited from e-mail, even when it was our own individual e-mail system. And look how long it has taken to be able to do that. And if we had waited for interoperability, we still would not be on a system. People would not be able to talk to us. We would not be able to do our work.

So I tend—and I just want to share with you, the Center for Information Technology Leadership has estimated $44 billion annually in savings from the use of health IT in independent settings. And that does not in any way negate what you are saying. I totally agree with what you are saying about interoperability. But we also, according to them, are told that we would reduce medical errors by 50 percent by the use of stand-alone electronic prescribing systems—50 percent. So the question that I have for all of us is: Why wouldn't we want to be working on that at the same time?

I congratulate Senator Enzi for his leadership, and I was pleased to testify with Senator Enzi before Senator Ensign's subcommittee. But I think Senator Ensign really has a very important point that I agree with, and this is what I hear from hospitals and physicians and so on. We cannot wait to begin to get them online, to get the equipment and so on. And so I would urge you—and I will be working with colleagues on this—to look at not only pay for performance, which I agree with, but pay for use as an important part of that in terms of incentives. And Senator Snowe and I have introduced a bill that goes right to heart of that would allow expensing, accelerated depreciation, like we do for many, many other things, for private physicians and so on to be able to buy the equipment, to be able to get going on this.

We have in other areas allowed dollars to be spent from Medicare, MRIs, other things, where we knew it would save money by allowing purchases of equipment. Our legislation would allow that for hospitals and nonprofits to be able to begin to purchase.

I think it is absolutely critical that we move, Mr. Chairman, on a several-track front if we want to meet the goals that you are talking about. And then I would just add that if we really want to be able to have the performance standards that we all want, in order for clinicians to be able—for us to accurately measure their performance or outcomes, they have to have systems in place. So we cannot do that, any of that, all of which we want to do, if they do not have systems in place, people are not trained, and so on.

Also, we have to be able to look at whether we are paying them fairly or unfairly, rewarding them, disincentives, and so on. And as Senator Ensign said earlier, unfortunately in this process the payer, meaning us, gains the savings, and it may not be—where the cost is incurred by the physician or the other health care provider, the hospital and so on. And we have to, I believe, provide incentives in grants in order to be able to do that.

So I hope, Mr. Chairman, that—because I think this is a wonderful bipartisan effort. We have people all across the Senate and the House and the administration that want to do the right thing. I am very hopeful that we will not just talk about interoperability when there is so much more that has to be done in order to get this done.

Again, I will just close by saying that, again, if we can save $44 billion a year through health IT in independent settings and have 50 percent fewer medical errors now, while we are doing the important work that you are doing, I hope that we will not underestimate that. And I honestly believe that we can move ahead on the legislation, and I am hopeful we can add legislation that will allow us to be able to provide those incentives so that they are ready for the interoperability and that we are not in the end doing the good work you are doing and then waiting another 10 years while they get themselves up to speed in terms of equipment.

Thank you.

Secretary LEAVITT. Senator, let me just reinforce the fact that I subscribe to what you have suggested with respect to the adoption of health IT being an important continuing priority. We are seeing substantial investment on health information technology within the health sector. It tends to be concentrated more in the large practice and large hospitals.

One of the worries I have, I was in a major city recently and attended a meeting at an academic health center, a medical school. Across the street there was a large county-owned hospital. And just down the street there was another hospital that was a children's hospital. All three of them were major medical centers. They shared faculty at the medical school, a lot of the same patients. Each of them had purchased a different system. Each of them had spent nearly $100 million in bringing their hospital IT system up. And I am sure they are doing great things within those hospitals and that they are making progress. But none of the three could talk to each other.

We are moving with some dispatch, for example, to develop a new e-prescribing rule that will have an exception to the Stark amendment, which will allow hospitals, for example, to begin sharing technology with smaller providers. That will begin immediately to deal with adoption issues.

We are working aggressively with pay for performance. We would like to be able to say-let's create funds and created savings and use part of that savings to help small providers with adoption of technology.

You are absolutely correct when you say we need to move down a parallel track here. My advocacy for the "laser focus" on interoperability is to acknowledge the fact that until we solve that problem, our investment should be focused there because many of the benefits that you have alluded to will come only when that has occurred.

Senator STABENOW. I would only add one thing, and that is, we are facing the same thing in Homeland Security. I have been working on issues of interoperability for communications, and police and firefighters have not stopped creating their own systems while we are trying to get interoperability. And so it does need to be done together, and there are now new kinds of technology, software that is being created in Michigan. We have a company in Michigan that is able to bring together through a common software all of these different communications systems to be interoperable for much less cost.

So I think it is just very important that—if our police and fire were waiting, you know, they would not be talking to each other even in their own communities. So there is a benefit to moving on a parallel track.

Chairman GREGG. Senator Allard?

Senator ALLARD. Thank you, Mr. Chairman. I feel honored to be here with a lot of expertise as far as health care and what-not and a lot of brain power, and a lot of thought has been going into all these ideas.

But I do have a hospital in Colorado that is trying to bring everybody online with the same technology as far as communications is concerned. And they are trying to communicate with the Health Department, communicate with individual doctors' offices that use their hospital, and to communicate within the hospital, and any other agency that might be there that would have some health records. And they are having a hard time doing it because there are a lot of issues involved.

My question to you is: Are you looking at individual circumstances like that and visiting with them to see how these theories get applied in sort of a practical way? I would like to hear your comment on that.

Secretary LEAVITT. Yes, in fact, I think this adds to the last answer I gave. We are actually funding a lot of adoption to help people——

Senator ALLARD. I think this hospital may be getting some of your funding.

Secretary LEAVITT. Yes, and we are working with many different models around the country where we are working with different hospital groups and working with them to see what can be learned. And, the combination of establishing national standards plus being able to deal with what we are learning from those individual situations is the key.

Senator ALLARD. Now, the Veterans Administration, I know that they are developing some systems where there is a lot of communication within the system. And so you are going to have the Veterans system. Then you have each hospital with their doctors and everything else. I can see a problem when you go and try and—now you have these entities that have sort of—they have formed kind of a cluster built around the technology of that hospital, or maybe built around the technology of an agency. It seems to me like the real challenge will be to take the next step and get the technology of the Veterans Administration to begin to merge into maybe the technology around some hospital. Because for either one of those entities, now these clusters, to change—they have built around a certain amount of technology. Then to get each one of them to come, the cost even gets horrendous if they have to make changes to their system, and they are going to resist that, it seems to me.

Have you thought a little bit about where the second and third step might carry you?

Secretary LEAVITT. I have thought a lot about this because that is the dilemma and really the reason we have to achieve interoperability. The Veterans Administration has a brilliant system. If you are in a Veterans hospital system, you have an electronic health record that will include virtually every aspect of your medical involvement.

The problem is if you go to a doctor outside that system, it is not populated with that information. And the same is true that the doctor outside does not have access to the information. So we have to be able to create this sense of interchange in information.

If you go to Kaiser Permanente in California, you see brilliant electronic health records. If you go to the Cleveland Clinic, you see brilliant use of electronic technology. If you go to the Montefiore Hospital in New York or InterMountain Health Care within our region, you see all kinds of brilliance that is being created in individual regional areas. The problem is none of them can talk to each other.

Senator Enzi referenced a favorite story of mine. I have become fond of studying railroads. As we built the railroad network in this country, we had one major dilemma, and that is that the rail gauges did not line up. They had some that were 4-foot–8, some

that were 5 feet, and some that were 5-foot–3. And through some good leadership, they standardized that.

I told a friend of mine about this. He said, "Well, I had an uncle in 1960 that went to Australia to help them solve that problem." I was intrigued by that, and I put into a search engine "Australian railroad gauge." And up popped a whole series of articles about this dilemma they have in Australia today. They are trying to solve the fact that they have three different rail gauges. And if you want to go from Point A to Point C, at Point B you get off the railroad and get on a different railroad.

Well, we are doing the same thing in health care in the United States. We have these pockets of brilliance, but we have rail gauges that do not line up. And so when I emphasize the need for interoperability along with adoption, the reason is because in order to get the long-term vision that we are talking about and the serious benefits, we need both.

Senator ALLARD. Well, I appreciate your railroad analogy, but to get back to the medical side of it, when we standardize everything, we are going to—and on the cost, I have my doubts. I am a little skeptical about that. On the patient care, I am really optimistic about that because I think there will be a lot of medical mistakes that will not happen. But, on the other hand, if a medical mistake does happen, it is going to be big, you know, because it is going to be built into the system, and it could impact a lot.

So we have to give some thought about that, and the other thing is on, as we move forward with this technology, we need to have sort of some latitude in there, which I never expect to happen through a bureaucracy, and we are going to have more bureaucracy. I do not see any way around it. It is for innovation. There will be some doctors that will have different ideas, some different approaches on treatment and what-not, which probably in the long run will be better, and they are going to have to work themselves through a bureaucracy that will not want to change because it is built into the system. And I hope somehow or the other we can keep that needed flexibility as we move forward in trying to standardize treatments and standardize information protocols.

Chairman GREGG. Those are excellent points. You are obviously the big elephant in the room, and you can set the gauge. And so we look forward to working with you. If you need legislative authority to help you on this, you have the man right here. And we want to work with you to make sure this is successful.

I know that Senator Conrad had one followup request relative to a report he would like to try to get, which I think is a good idea.

Senator CONRAD. Let me ask, if I could, could you help us get a report on CDC's ability to communicate in real time with major health care providers around the country? Let me tell you what my concern is.

The group that I mentioned before, the Telehealth Caucus, we have previously done a lot of analysis on bioterrorism. What would happen if, God forbid, there were an event somewhere in the country? What is our ability to respond in real time? What is the ability to analyze what it is and communicate with those who would be the first to confront the victims and confront providing care to victims?

Our assessment is we are not in good shape there, and what I would request directly is that—and we can talk about what is a reasonable amount of time. I would hope in 30 days that we could get a report on what is the ability of CDC to communicate in real time with major health facilities across the country in the case of a bioterrorism event, in the case of a pandemic. Those two I think are the great potential threats that are out there, and we should know with great certainty how well prepared we are to have our major institution that can deal with analysis and diagnosis communicate in real time with the major health care institutions across the country. That may be an absolutely critical matter. We know certainly with the case of a pandemic being able to respond quickly and in the right way can make a massive difference in the outcome.

And so that is a request I would make. Would 30 days be reasonable?

Congressional Response
Real-time communications capabilities at CDC

Communication is a CDC core public health function. CDC is committed to maintaining the highest degree of excellence in the dissemination of scientific information, including emergency communication, to help providers, policy makers, scientists, people, families and communities protect their health and safety. CDC has begun a strategic approach to build our public/private partnership to expand timely access to needed CDC health and safety information and urgent public health information using innovative and rigorous strategies for reaching these partners based on audience, communication, channel, and market research. This document provides a summary of CDC's current real-time communications capabilities and a listing of projects that are nearing completion or are under development.

Current Capabilities

Health Alert Network

The Health Alert Network (HAN) is intended to ensure that each community has rapid and timely access to emergent health information, highly-trained professional personnel, and evidence-based practices and procedures for effective public health preparedness, ~~response, and service on a 24/7 basis. Through continuous, high-speed internet~~ connectivity and broadcast capacity to support emergency communication, HAN provides the national public health system with a network of public health officials and other first-responders who are continuously connected to information vital to emergency and non-emergency public health practice.

In addition to state and local health departments, HAN maintains distribution lists that include national public/private health organizations such as the American Medical Association. Many of these organizations have the capacity to automatically relay urgent health information to their constituency and membership.

CDC has worked collaboratively with state health departments to create the state and local infrastructure/capabilities necessary to ensure real-time access to emergency health information. This includes state and local health authority capability to modify and/or re-transmit urgent health information from CDC to local organizations (county/city medical societies, local hospitals, etc.) on a 24/7 basis.

If real-time infrastructure dependent telecommunications capability should be interrupted, many state and local health departments have incorporated radio and satellite technologies for redundancy capability. These redundant systems allow for the immediate transmission and receipt of urgent health information among federal, state, local public/private health officials and various emergency responders.

The Epidemic Information Exchange (Epi-X)

Epi-X is a secure communication network utilized by public health departments and CDC. While it includes a notification system and forum capacity that can function in real-time, these mechanisms are not open to clinicians outside the system. This is due to the secure nature of the system, which requires pre-authorization and authentication.

Clinician Information Line

The Clinician Information Line is a toll-free phone resource clinicians may use 24 hours a day, 7 days a week, to obtain up-to-date clinical information in real-time. Calls are answered by clinical staff trained in phone hotline execution that use resources vetted by the CDC to answer clinical inquiries. There is a mechanism in place for critical calls to be immediately transferred to the CDC Director's Emergency Operations Center (DEOC), as in the case of a real or suspected outbreak or bioterrorism event. In instances of clinical urgency, the DEOC staff can connect the clinician caller with an appropriate CDC subject matter expert via phone and provide support material via fax, email and other means. Questions of a less urgent manner, which the CIL staff are unable to answer, are forwarded to the appropriate CDC subject matter expert for their review and response, typically via email to the inquirer.

The CDC Clinician Registry

The CDC Clinician Registry is an e-mail based list-serve that has 40,000 clinician members. Updates or new information regarding terrorism and emergency preparedness are sent to members weekly, and more frequently if needed. Our research indicates that e-mail is useful for information dissemination, but not in a timely manner, since many clinicians do not check e-mail regularly. Thus, this mechanism currently has limited applicability to real-time communication efforts but has potential for improvement in this regard.

Additionally, email inquires can be submitted, by both subscribed clinician members and non-clinician members of the lay public, to the Clinician Registry requesting information on a number of CDC-oriented topics. These questions are answered through a combination of extant, mostly web-based text, and when appropriate, by presentation to the appropriate scientific subject matter expert. An extra benefit of this inquiry process is that it may have a sentinel effect and alert the CDC to an occurrence of disease outbreak or bioterroism.

Morbidity and Mortality Weekly Report (MMWR)

MMWR Series of publications (*MMWR* weekly report, including Dispatches, CDC Recommendations and Reports, Surveillance Summaries, and Supplements) provide timely, accurate, critical CDC scientific public health information and recommendations to a world wide audience of professional partners and consumers that represent CDC strategic public health priorities, urgent public health concerns, CDC policy, and recommendations for immediate action.

Since 2002, *MMWR* has published urgent, important public health information related to terrorism and other public health emergencies in the form of *MMWR* Dispatch. *MMWR* Dispatches are published electronically as often as necessary to provide the latest and most accurate information regarding public health investigations, surveillance, prevention and treatment guidelines, and other clinical information. These dispatches are distributed to over 60,000 electronic subscribers and to 30,000 in print through CDC and partners. The website generates over 500,000 website hits per day with a 50% increase during national crises such as SARS. For example, during bioterrorist attacks in 2001, CDC developed guidelines for anthrax treatment, prophylaxis, and exposure management that required immediate dissemination to all health care professionals. To expand distribution, *MMWR* initiated the partners' distribution network in 2001. Participants electronically distribute *MMWR* to their members and subscribers to reach health care professionals with critical public health information within hours of release by CDC. In addition, *MMWR* is distributed to the media and are often highlighted on major television networks, cable newscasts, national radio broadcasts, and national print publications. The National Library of Medicine database includes *MMWR* citations and *MMWR* is also available through webMD.

Since 2002, we have published 30 dispatches including eight in 2003 (e.g., Smallpox vaccination and adverse reactions, preliminary clinical description of SARS, multi-state outbreak of monkey pox); 13 in 2004 (e.g., multi-state investigation of measles among adoptees from China, investigation of rabies infection in organ donor and transplant recipients) and five to date in 2005 (e.g., Clostridium sordelli Toxic Shock Syndrome, Lymphocytic Chroriomeningitis virus infection in organ transplant recipients, and outbreak of Marburg virus hemorrhagic fever). In addition, reports published electronically are included in the following week's printed issue of *MMWR*. The quick publication of these reports helped to avert additional public health emergencies.

Since 2002, *MMWR* has been equipped to publish remotely from any site in the United States in the event of a local or national emergency. Personnel are on call 24 hours a day, seven days a week and are required to test the capability of this operation by working on a remote site at least one day per month.

BioSense

BioSense is a program to improve the Nation's capabilities for disease detection, monitoring and situation awareness by using data from health care information systems. The program focuses on early event detection and situational awareness (location, size, rate of spread, and effectiveness of response for an event) by connecting electronic health data from hospitals, clinics, and other health-related sources to public health. These data are analyzed using spatial and temporal detection algorithms to assist with early outbreak detection as well as to provide situational awareness for an event. Through the BioSense software application, state and local public health partners have access to real-time views of their community's health status at the zip code level.

The BioSense Program received its first appropriation this year, and the application is operational with views for major cities and all states and is accessed by over 400 state and local users nationally. Data received into BioSense are monitored daily by analysts in the CDC BioIntelligence Center (BIC) for population disease trends and to support situational awareness for managing and responding to bioterrorism and naturally occurring health emergencies. A major target for the BioSense Program is to receive real-time data from private health care providers.

Real-Time Clinical Connections Initiative, a component of the BioSense Program, will connect public health to the clinical community through the delivery of real-time, clinically-telling data from emergency rooms/hospitals in all BioWatch cities. The project will stream real-time data to BioSense to provide federal, state and local officials with up-to-the-minute views of suspect illness trends and probable disease cases. These views will also support situational awareness during possible health events. It should be noted that while this system is being designed for real-time exchange of data to monitor health in the field, it is not currently designed to provide the real-time communication of emergency information to the healthcare community.

In 2005, acute care centers in ten BioWatch cities will be selected to share relevant clinical data with BioSense and appropriate public health jurisdictions for biosurveillance situational awareness.

Clinician Outreach and Communication Activity (COCA)

COCA is a network of 108 national clinician organizations such as the American Medical Association (AMA), the American Hospital Association (AHA) and several physician specialty organizations. Monthly COCA conference calls are held on terrorism and emergency response topics and additional calls can be held if needed. These calls allow two-way communication between representatives of these organizations and CDC scientists. Although there is a small amount of lead-time needed to set up these calls, once COCA is alerted, calls could be held as needed.

Another method for clinician communication involves web or video conferencing – similar in content to the scheduled COCA calls, they could reach a much broader audience. These conferences allow subject matter experts to present the latest clinical and scientific information, using audiovisual aides, and answer questions in real-time. Additionally, as in the case of the Clinician Registry, COCA members and/or the web-conference audience may query CDC subject matter experts via email and request educational and informational material.

CDC Website

The CDC Internet and Event-Specific Websites provide widely available access to audience specific information and publications for public health partners, policy makers,

clinicians, media and the general public. The CDC website contains information on numerous health and safety topics, links to professional journals including *Emerging Infectious Diseases*, *Morbidity and Mortality Weekly Report (MMWR)*, and *Preventing Chronic Disease,* and access to statistical information that can be utilized guide actions and policies to improve the health of the Nation

Under Development

State Medical Board Pilot Program

CDC awarded a contract to the Federation of State Medical Boards (FSMB) to conduct a pilot program that evaluates the feasibility of developing a repository of physician contact information via the state medical boards. Such contact information can be used to augment the alerting capabilities of health agencies during a public health emergency. The primary intent of this pilot has been the identification of obstacles to gathering the data and the development of approaches to mitigate them. CDC and FSMB are in the process of assessing specific data utilizing agreed upon data formats and data sharing mechanisms for five pilot state medical boards.

Partner Database

CDC is currently compiling a comprehensive database of contact information for key professional organizations which includes professional associations/organizations, pharmacist organizations, health plans and others. The database currently contains over 350 organizations. CDC is in the process of compiling the names, phone numbers, and email addresses of executive leadership and those responsible for quality improvement and preparedness in these organizations.

This database was used to facilitate conference calls with multiple professional groups during the influenza vaccine shortage to disseminate messages, to get real-time feedback, to answer critical questions, and to help redirect efforts to meet the needs of these external stakeholders.

Secretary LEAVITT. Senator, we will be responsive. Perhaps we could talk offline about the timeframe. Thirty days does not seem unreasonable to me as I speak, but I should confer with my colleagues.

I will tell you that we are exercising constantly on this exact point. Our capacity does not meet our aspirations. We have to improve here. We have project that I referred to earlier called BioSense. It is an active, aggressive effort on our part to take information technology and to use this project to move our capacity forward rapidly. We have identified 36 cities that contain, I believe, 400-plus emergency rooms. Our intent is to have them interoperable and able to deliver the information you have talked about in a relatively short timeframe. We are not there now.

Senator CONRAD. OK. I think it is just very important that we know here exactly where we are today, where we are headed. Are there steps that we need to take that would help? Because, you know, I think this is a major vulnerability for the country, and we need to make very, very certain that we are focused on this as well.

One other point I would like to make, and this is my concluding point, Mr. Chairman. I have become absolutely convinced, after 19 years here, that anytime we are doing these kinds of major efforts that we test and compete. And what I mean by that is that we do not just go down one road, that we go out there and we try variations and we get different groups to try different approaches and that we put them in competition.

I am very, very worried in Homeland Security, for example, that we are going to roll out a big program on border security without having tested it and without having competed it. And we have had this conversation with the Homeland Security Director. The same thing applies here. Let's not do something that we have not tested and competed because that is what helps prevent major, major malfunctions and major wastes of money.

Secretary LEAVITT. Our effort is to develop an architecture upon which many innovations can be found and lots of testing and competing can be conducted. I subscribe to the philosophy you have articulated.

Chairman GREGG. I want to join Senator Conrad. In fact, when we did Project BioShield 2–1/2 years ago, we had extensive discussions with Dr. Gerberding about her concerns that she did not have real-time capability to communicate. I know efforts have been made in this area, and I think it is appropriate that we get an update as to how successful those efforts have been, because it is a critical issue. I know she is very concerned about it—or I am sure she is still very concerned about it. She was then.

Senator Enzi had a followup question and then Senator Stabenow.

Senator ENZI. Just briefly, to end on a very positive note. I feel compelled to mention three Wyoming inventions that answer some of the questions here, but there is this problem of information in the United States. There is technology out there that we do not even know about that we are going to find out about from this project. For instance, a fellow at the University of Wyoming has invented a little thing that looks like a little speed gun. It is a little bit smaller than that. You point it at any substance, pull the trig-

ger on it, and in the PalmPilot you can find out what that is in a matter of seconds.

Not only that, the PalmPilot then tells you what to do about the incident. You know, right now we collect samples around this building. We haul it out to huge vans that we put this stuff in. There is a handgun that would make that technologically faster. And there is a PalmPilot that was used in 9/11 events that told them what to do with the different kinds of chemicals and things that they came across. That was also a little Wyoming invention.

And then, third, there is one for doctors that is used by our submarines that, again, is a PalmPilot technology, that kind of a computer that they put in symptoms of a sailor and they can come up with a confirmation of their diagnosis. Without that, they used to have to surface the submarine. Some of those are under the polar ice cap. The Federal Government anticipates that saves $600,000 a year. And rural doctors can use that same sort of thing to confirm their diagnosis.

So there are some very positive things out there. I do remember, though, that I am still trying to get permission to take my laptop on the floor of the Senate. So this is not the best place to talk about technology.

[Laughter.]

Chairman GREGG. Submarine technology in Wyoming, that is creative.

Senator ENZI. Yes. We have a Powder River Navy.

But we are going to have to be more positive on this interoperability or, as I prefer it, the standards harmonization. Regardless of what computer you have, what software you have, you can now e-mail anybody in the United States that also has a computer. And you do not have to know how it got there or much about how to do it. And you can also search the Web from virtually any computer, and you do not have to know much about that either. That is interoperability of information, and that is what we are talking about now for health care. What we have to throw in, of course, is the privacy and the security so that the data for the person just goes to the people that person authorizes. But I still see the day when a person walks into the doctor's clinic, takes a little fob off of their key chain, waves that by their computer, and then releases whatever level of data they want to whatever health care provider that is. And it will reduce mistakes.

So I thank you for holding this hearing, and I thank you for your efforts on this. You are doing tremendous work on it, and I have confidence that we will get it done.

Chairman GREGG. Senator Stabenow?

Senator STABENOW. Thank you, Mr. Chairman.

Speaking of technology, I want to brag about Michigan. I cannot let Senator Enzi brag only about Wyoming. Talking about those fobs, my new vehicle, which Senator Conrad has seen, which is a Cadillac STS, made in Lansing, Michigan, does not have a key. It has what is called a fob. You just get within 3 feet of the automobile. You can turn it on. I never take that out of my purse. There is no key. We would be happy to have that fob become the health IT fob for the kind of thing that Senator Enzi is talking about.

I share Senator Enzi's enthusiasm and excitement about the opportunities. I have one comment and one question.

The comment would be that the kinds of things we are talking about today, those individual items that Senator Enzi talks about, they cost money. And it is separate from interoperability. It is about whether or not the hospital or the doctor can afford to do those things at a time when we are cutting Medicaid, we cut back on their resources.

If we do not take seriously providing tax incentives and resources, even though it saves money, it is going to be tough for a lot of folks to do that.

And I would also say on your railroad connection that they were, in fact, using those railroads across States even though they did not connect all the way across the country and probably benefited from using that.

And so, again, there is a lot of mysticism around all this stuff, and I certainly am not an expert. But I do know it is just about software in order to be able to make these connections, and that right now every vendor is including in their contract something called backward compatibility so, in fact, they can become interoperable. So this is not that they cannot use the equipment. It is not that the people who are trained cannot—you know, this is about software. And so I welcome the fact that you are doing that, but it does not take away from the other things that have to happen in order to make it happen.

A question. I know there has been a lot of progress regarding standards, and I know that the Consolidated Health Informatics initiative that was begun by your predecessor has made a lot of standards available. They have been adopted for 3 years now. And I am wondering if you can tell me which Federal agencies or programs are currently using those standards internally and what their relationship is with health care providers.

Secretary LEAVITT. We did adopt a group of standards, and the next logical step is full Federal implementation. That is one of the reasons we have set up this American health information community to be able to achieve full adoption by Federal agencies.

Senator STABENOW. Do we know at this point how many——

Secretary LEAVITT. I am not able to give you off the top of my head which agencies have adopted which standards. They have been adopted, for example, at HHS, and we are beginning to roll them out. But adoption of the standards is going to be a critical part of it, there is no question.

Senator STABENOW. Absolutely. Thank you.

Thank you, Mr. Chairman.

Chairman GREGG. Senator Conrad for the last thought.

Senator CONRAD. Let me just say, not to be outdone, in North Dakota——

[Laughter.]

Senator STABENOW. I move to adjourn.

[Laughter.]

Chairman GREGG. In North Dakota, they are doing aircraft carrier technology.

Senator CONRAD. In North Dakota, we are working on a fob that would start your car and give you your health care records.

[Laughter.]

Chairman GREGG. Thank you, Mr. Secretary. We appreciate your time and your courtesy.

[Whereupon, at 11:15 a.m., the committee was adjourned.]

Senate Budget Committee
Health IT Hearing – July 20, 2005
Questions for the Record

1. Question from Senator Conrad:
Why did you specifically request one open source proposal? Is such a request at odds with the OMB guidance? By asking for at least one open source proposal, isn't HHS signaling a preference for a type of software.

Answer:
HHS invited many options for proposals through the Request for Proposal (RFP) for a Nationwide Health Information Network (NHIN) Architecture, including options for open source proposals. The Department of Health and Human Services (HHS) intends to award one open source contract out of the six contracts that can be awarded, provided that there is an open source proposal that meets the technical requirements. HHS is not signaling any preference for a type of technology. Rather, HHS is encouraging responses from a wider range of respondents than might otherwise be expected for a project of this nature.

The OMB guidance (OMB Memorandum M-04-16) applies to acquisitions of software, whether it is proprietary or open source software. HHS believes that the set-aside for an open source solution is one that is "technology and vendor neutral" and does not unduly restrict competition. Furthermore, HHS does not view acquisitions for "open source" software as technology specific. Rather, "open source" software merely describes the Government's (or other users') license rights in software provided under the contract. Therefore, we do not read the OMB guidance as prohibiting agencies from including certain license terms as part of an agency's contract requirements. Moreover, the Government's intent through this procurement is to support proof-of-concept demonstrations rather than an acquisition of software to be deployed and used by the Government.

All proposals submitted for the NHIN architecture will be evaluated against the technical requirements of the solicitation. Technical criteria include categories such as: organizational description, management approach, technical understanding and approach, personnel qualifications, and performance standards. Contract awards will be determined based on four factors: technical merit, past performance of the offeror, small disadvantaged business participation and cost/price. This RFP solicitation is designed to be technology-neutral and to encourage a broad response rate for this important prototype and evaluation for the NHIN architecture.

2. Question from Senator Stabenow:
Do you agree there are any financial savings or clinical benefits to be had from the use of health IT in independent settings? Is there any reason we shouldn't start saving lives, improving the efficiency of our health care system, and reducing healthcare costs for our businesses and taxpayers today?

Answer:

There are some financial savings and clinical improvements from the use of non-interoperable health IT in an isolated health care setting, but lack of interoperability limits the benefits from such investments. Our healthcare system today is fragmented, and most people get their care from multiple settings – different physicians, hospitals, long-term care facilities, labs, pharmacies, and many others. When health IT draws upon information that is limited to any single setting, the benefits are limited. If decision support – which includes such functions as clinical alerts, reminders, drug-drug interaction checks, allergy interaction checks, etc. – is supported only by the patient information in any single setting, critical information from other settings may be missing. This means, for example, that the best ePrescribing system, with state-of-the-art drug-drug interaction checking, can only check a prescription against the drugs that a provider knows the patient takes, and not against all of the other medications given by other physicians. Real transformation occurs when health IT is applied to the longitudinal medical record that incorporates clinical information from a patient's many different providers.

Not only is interoperability required to derive truly transformational benefits; interoperability will help drive adoption of EHRs more quickly. With the advent of certified, interoperable EHRs and an interoperable NHIN, EHR adoption will be stimulated without subsidies by lowering the cost of technology and reducing risk to buyers. Clinicians will have greater price transparency, and health IT products will be more plug-and-play (i.e., requiring much less customization and integration work to get these systems up and running).

HHS is placing its primary efforts on interoperability in order to ensure that health information can seamlessly follow patients as they desire. Interoperability was a nearly unanimous recommendation from the recent Request for Information on the Nationwide Health Information Network architecture that had more than 500 respondents. Right now, we have a one-time chance before large-scale health IT adoption occurs to overcome fragmentation of health care. With interoperability, the benefits will be greater, and the adoption rate for EHRs will rise much more quickly.

3. Question from Senator Stabenow:
Which federal agencies or programs are currently using those standards internally and in their relationships with health care providers? Are providers able to submit data using the standards that have been adopted?

Answer:
The Consolidated Health Informatics (CHI) initiative continues to establish a portfolio of existing and commonly used clinical vocabularies and messaging standards enabling federal agencies to build interoperable federal health data systems. On March 21, 2003, the Departments of Health and Human Services, Defense, and Veterans Affairs announced the first set of uniform standards for the electronic exchange of clinical health information to be adopted across the federal government. On May 6, 2004, the Departments of Health and Human Services, Defense, and Veterans Affairs announced the adoption of additional standards agreed to by the CHI initiative to allow for electronic exchange of clinical information across the federal government.

Adoption of these standards is only the first step toward achieving common standards with interoperability. These agencies are now integrating these standards into requirements for new information technology systems, and these agencies are looking for ways to implement these standards consistently. In Phase II of CHI, these Federal partners will develop implementation guides that will support consistent implementations and therefore interoperability. These implementation guides are an important next step for interoperability – not just across Federal systems, but also for providers looking to submit data to the Federal government.

4.Question from Senator Stabenow:

Do you believe we can move to a pay for performance system without first ensuring we are both able to accurately measure performance and outcomes, and that clinicians have the tools needed to access clinical decision support and other critical information? If you believe we are able to compensate providers using a "pay for performance" system without first providing financial incentives to address large start-up and ongoing costs, please explain to me how you envision such a system working, and how you would phase it in?

Answer:
In order to pay providers on the basis of their performance, we have to be able to measure that performance adequately. We have considered several different types of measures -- measures of provider structure, measures of the processes of care providers use, and measures of the outcomes of their activities -- each of which have advantages and drawbacks.

Based on the experience of the Hospital Quality Alliance, reporting quality measures has been demonstrated to improve the quality of hospital care. The structure of pay-for-performance initiatives for providers in ambulatory care settings could include the utilization of claims data to obtain data for quality measures that have been agreed upon by the physician and payer communities. This would enable reporting of quality measures without imposing an undue burden on physician offices. As this initiative matures and EHRs become interoperable (i.e., can share data and report measures), physician offices will be in a better position to adopt health information technology (HIT) and EHRs to automate the reporting of quality measures. CMS is evaluating options for incentives for physician adoption of EHRs and has an ongoing initiative to support adoption and effective use of HIT through the Medicare Quality Improvement Organizations. As with other private sector initiatives, pay-for-performance can be successfully implemented in parallel with ongoing adoption and use of HIT. It is important to achieve interoperability and certification of EHRs prior to realizing widespread adoption of EHRs.

5. Question from Senator Stabenow:
Given that vendors are able to make their software "backwards compatible" and can do and adjust to additional standards as they are approved, what would be the downside to moving forward aggressively on interoperability and adoption simultaneously?

Answer:
The adoption of EHRs by large physician groups and hospitals is already occurring, outside of any specific policies to promote this behavior. HHS is not proposing to stop or slow current adoption as part of an "interoperability only" strategy; rather, HHS is pursuing an "interoperability forward" strategy, in which adoption promotion policies will be linked to interoperability. HHS published a Request for Proposal in June 2005, and HHS plans to issue a contract to develop and evaluate a certification process for health IT. This will quickly move to develop a first generation of criteria for the minimum requirements for functionality and interoperability. These will be tested in the market and will evolve through real-life use and evaluation. HHS will focus first on criteria for ambulatory EHRs. This means that by Spring 2006, physicians and hospitals will be able to purchase EHRs that, if certified, will be able to interoperate with forthcoming network infrastructure in the future.

Certification will have a significant impact on the adoption rate, but certification alone may not be enough. HHS will consider appropriate incentives that focus on putting the right technologies into the hands of clinicians at the point of care. But, the HHS strategy will link these incentives to the capacity to interoperate and securely share health information.

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