Insight

# Pension Smoothing, Ephemeral Revenue, and Budget Gimmicks

GORDON GRAY | AUGUST 5, 2021

## Executive Summary


- The proposed bipartisan infrastructure bill includes a provision allowing for "pension smoothing," which allows pension plan sponsors to defer pension contributions, thereby raising federal revenues.
- Pension smoothing insulates firms from interest rate volatility, but Congress has repeatedly modified how these rates are calculated – most recently in the American Rescue Plan – to bias toward reducing pension plan contributions over the near term.
- These deferrals generate temporary increases in tax revenue to fund new spending, but any revenues are ephemeral as firms must make up the deferrals later.


## Introduction

Only Congress could devise a policy that allows firms to underfund pension plans and somehow count that policy as a tax increase to fund new spending. That is exactly what Congress is considering (again) as part of the bipartisan infrastructure bill currently under consideration in the Senate. The policy in question is known as "pension smoothing," and it essentially allows employers to defer pension contributions they would otherwise be required to make. Because pension contributions are tax deductible, to the extent firms don't make them, their tax bill increases accordingly. But those forgone pension contributions remain tax deductible and must eventually be made on top of existing contribution obligations. Whatever additional tax revenue that is realized over the period in which those contributions are forgone evaporates when those tax-deductible contributions are eventually made.

Pension smoothing is a timing shift that *looks* like a tax increase over the 10-year budget window Congress uses to evaluate the costs of policies, but it fundamentally does not raise any real new money. It is therefore quite popular, having already been deployed once this year as paper offset in the American Rescue Plan enacted in March.

## Pension Contributions

There are over 23,000 single-employer defined benefit pension plans in the United States covering over 24 million Americans. After over a decade and a half of serial underfunding, this system of pension plans is, on net, funded. This average, however, belies the individual funding ratios of any given plan – indeed annual plan terminations have averaged over 1,000 per year for the last two decades. Firms are required to contribute to these plans in amounts sufficient to cover future benefit claims as set forth under federal law.

The value of these benefits, and thus employer pension contributions, are in part determined by interest rates. In general, the higher the interest rate is, the lower the value of the future pension obligations and, in turn, contributions. But interest rates can be volatile, so federal law provides some ability for pension plans to use

rates based on long-term averages. Congress has also established minimum and maximum thresholds for how these rates are calculated. As a matter of pension funding policy, this design is sensible, as it provides some cushion from rate volatility. These policies have the effect of smoothing out interest rates used to calculate benefit valuations. The policies that set forth these parameters are referred to as pension "smoothing." Where Congress has gone awry is in setting the thresholds to indulge in budget gimmicks rather than pension funding. In general, the thresholds established by Congress bias the rates higher in the near term – reducing plan sponsors' required contributions.[1]

**Budget Gimmickry**

Setting interest rates that, all else equal, reduce pension contributions in the near term would seem like potentially poor pension policy. And it is, as the Congressional Budget Office observed that this bias could increase plan terminations and exposure to the Pension Benefit Guaranty Corporation, the federally chartered pension insurer. Congress "discovered," however, that this policy would generate, at least for a time, tax revenue that could be used to offset new spending. Pension contributions are tax deductible, which means that when firms forgo pension contributions, taxable income increases, generating higher tax revenue. Yet this revenue is ephemeral: Over the longer term, firms face higher contribution requirement than otherwise, which reduces tax revenue.

Congress has used pension smoothing to offset new spending on numerous occasions over the last decade, most recently in the American Rescue Plan (ARP). According to reports, the bipartisan infrastructure bill would stretch out the pension-smoothing provisions in the ARP for another 5 years and generate about $2.8 billion in offsets for proposed new spending. Few policies have united the policy research community quite like pension smoothing. Indeed, analysts from the Center for a Responsible Federal Budget, the Bipartisan Policy Center, the Heritage Foundation, the American Enterprise Institute, Tax Policy Center, and the Center on Budget and Policy Priorities have all identified pension smoothing as a gimmick. It is perhaps no surprise that Congress has become so enamored of this policy.

**Conclusion**

Congress is particularly innovative in avoiding hard decisions. Nowhere is that more evident than in fiscal policy, where congressional innovation in irresponsibility has been perfected to a near art form. Pension smoothing policy is a masterwork in budget gimmickry. It underfunds pensions while generating ephemeral tax revenue that can be spent on new pet projects. For Congress, it's close to ideal. As a matter of public policy, it's somewhat less inspiring.

[1] For an analysis of how these rate thresholds interact with valuation rates and pension contributions see: https://www.soa.org/globalassets/assets/Files/Research/Projects/Proposed-Pension-Funding-Stabilization–How-Does-It-Affect-the-Single-Employer-Defined-Benefit-System–Report.pdf