A CBO STUDY

The Railroad Retirement System: Benefits and Financing

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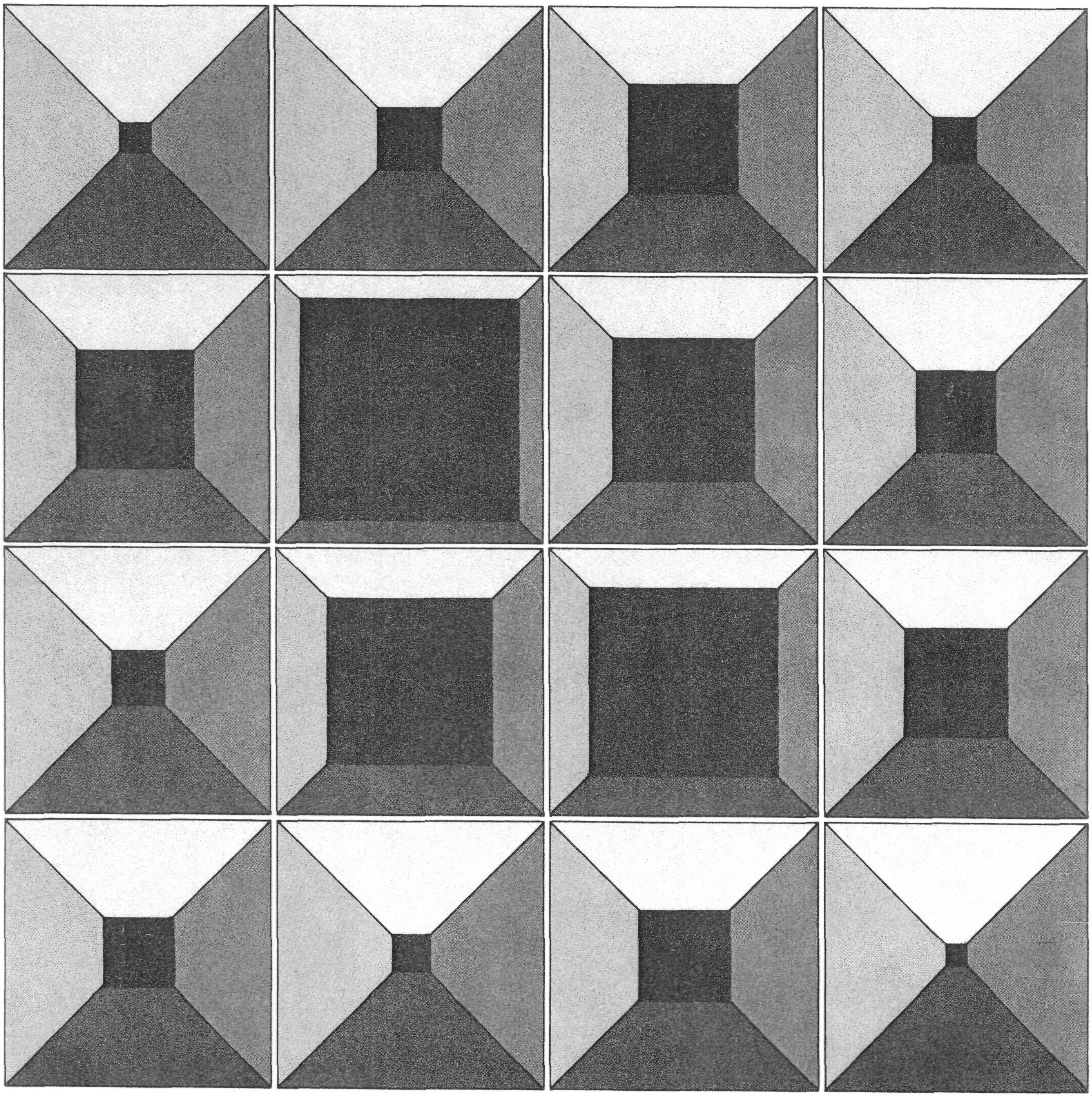
Congress of the United States
Congressional Budget Office



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NOTES

For estimating purposes, annual appropriations for "windfall" railroad retirement benefits (see page 7) are assumed to remain constant at $350 million. A continuing resolution, enacted on December 15, 1981, provided federal funding through March 31, 1982 and increased the 1982 appropriation to the Railroad Retirement System from $350 million to $379 million.

Unless otherwise specified, all dates in this paper refer to fiscal years.

In some tables, details may not add to totals because of rounding.

PREFACE

This paper, undertaken at the request of the Senate Committee on Labor and Human Resources, examines the benefits and finances of the Railroad Retirement System. Particular attention has been given to the differences between railroad retirement annuities and those typically available other private-sector employees. In keeping with CBO's mandate to provide objective and nonpartisan analysis, the study makes no recommendations.

The paper was prepared by David DelQuadro of the General Government Management staff of CBO's Office of Intergovernmental Relations, under the supervision of Stanley L. Greigg and Earl A. Armbrust. The author gratefully acknowledges the special assistance given by Sherri Kaplan, Edgar A. Peden, and staff of the Railroad Retirement Board. Johanna Zacharias edited the paper and suggested several improvements; Norma Leake typed the various drafts and prepared the paper for publication.

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SUMMARY

The Railroad Retirement System (RRS), unlike any other pension plan covering private-sector employees, has provisions set by federal statute and is administered by the U.S. government. Thus, changes in RRS benefits or finances affect the federal budget. The RRS, which currently provides mandatory pension coverage for employees of approximately 1,000 railroad companies, requires annual outlays of some $5.7 billion. At present, about 500,000 railroad workers and their employers support nearly one million beneficiaries, of whom something over half are spouses and survivors.

Since the inception of the system in 1935 (that is, before the establishment of Social Security), the Congress has repeatedly revised RRS benefits and financial provisions. The most recent statutory amendments, enacted in the summer of 1981, raised the total RRS taxes that partially finance the system from about 19 percent to some 22 percent of total payroll; they also modified benefits and authorized the RRS to borrow from the general fund of the U.S. Treasury. Without the 1981 legislation, the RRS program would have become insolvent by 1985. But as amended, the system should maintain a positive financial condition through 1990 provided employment in the industry does not decline precipitously.

HOW THE SYSTEM WORKS

Today, RRS remains independent of the Social Security program, although the two systems now have many common features and do coordinate coverage. In 1975, the RRS was restructured to resemble the two-part retirement available to most private-sector employees: a Tier I component that not only substitutes for Social Security but also provides extra benefits; and a corporate-type component, Tier II, which in some instances may be augmented by a longevity supplement and a "windfall," or dual, payment earned by nonrailroad employment prior to 1975.

About 62 percent of RRS revenues come from the payroll taxes that railroad employees and employers pay, and about 28 percent

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come from a transfer payment from Social Security. (The intent of the transfer payment was to assure that neither the RRS nor the Social Security program is better or worse off financially because of their independence. The transfer currently works to the advantage of RRS, because past declines in railroad employment have resulted in smaller payroll tax revenues to suppport Social Security-type benefits now being paid by RRS.) The remaining RRS revenue comes mainly from interest and federal appropriations, which finance windfall payments.

FINANCIAL CONDITION AND CONTINGENCY MEASURES

The solvency of the RRS remains the subject of some concern because, even with the 1981 amendments, RRS reserves will drop from $1.94 billion to $1.88 billion during 1982. Uncertainties limit the accuracy of any projections, but the future condition of the RRS will depend generally on the revenues collected from payroll taxes and in turn, on the level of railroad employment. Statistical analysis indicates that, during the past 20 years, railroad employment has been directly correlated with changes in real Gross National Product (GNP). Most current economic projections predict some annual growth in the real GNP.

The Congressional Budget Office currently assumes (somewhat optimistically) that the economy will grow at an average annual rate of 3.5 percent through 1987. If this growth materializes, RRS reserves will accumulate in 1983 and subsequent years, reaching an estimated $2.4 billion in 1987, or 33 percent of the year's RRS outlays. Under less optimistic economic assumptions, projected levels of railroad employment would be lower and would thus generate less tax receipts. According to actuarial projections prepared by the Railroad Retirement Board, the RRS could face funding problems if, in 1984, employment fell below 450,000. But a drop of this magnitude is not likely, assuming future growth in the nation's economy and a continuation of historical relationships between real GNP and railroad employment. The RRS, however, remains subject to other forces that could reduce program revenues, including technological changes in the transportation industry, amendments to Social Security, labor disruptions, and future declines in the demand for transporting coal.

COMPARISON WITH OTHER PRIVATE-SECTOR RETIREMENT

Railroad retirement includes several benefit provisions that are superior to those commonly available in the rest of the private sector--including:

- o No benefit reduction for career employees retiring as early as age 60;
- o Spouse payments that include a corporate-type benefit component;
- o Tax-exempt status for virtually all RRS benefits; and
- o Guaranteed cost-of-living adjustments.

Considerations of RRS benefit advantages should not overlook the quite high and recently raised payroll withholdings railroad companies and employees pay toward the corporate benefit component. Tier II payroll withholdings have just been raised from 9.5 to 13.75 percent (the employee pays 2 percentage points) of the first $24,300 of earnings in calendar year 1982.

Taken together, the comparative advantages of RRS help provide married career employees highly attractive income security at relatively early ages of retirement. The initial RRS income for such new annuitants, who represent more than half of those now retiring directly from the railroads, could easily exceed the net annual salary received just before retirement. Largely because of early-retirement provisions and Tier II spouse payments, railroad retirement offers benefits to married annuitants that appear among the highest in private industry. This point becomes particularly clear when expressed in terms of after-tax wage replacement. For a married worker retiring with an annual salary of $22,000, RRS provides a net wage replacement of 129 percent; the RRS wage replacement of a $30,000 salary is 105 percent. These rates exceed those available under retirement plans, reviewed by CBO, in the utilities and other transportation industries.

ALTERNATIVE BENEFIT PROVISIONS

The Congress may want to consider modifying RRS as a means to fortify further the program's financial condition, to reduce federal budgetary costs, or to align the RRS better with typical private-sector practices. Because of the increased RRS tax burden already imposed and the link to future scheduled increases in Social Security taxes, any modifications to the current system would most likely entail benefit reductions rather than additional tax increases.

The arguments for and against maintaining the current system and three possible modifications are outlined below. (The alternatives are based on the assumption that the federal role in RRS will not change radically, although some proposals to withdraw most or some of the government's involvement in RRS have been advanced.) Options II and IV go beyond the adoption of private-sector practices in order to demonstrate the maximum budgetary effect possible. For estimating purposes, all of the options are assumed to have an October 1982 effective date. As a practical matter, the timing and duration could differ, and the Congress could mix or adapt the measures to fulfill specific reduction objectives. The three alternatives could generate five-year savings ranging from $0.1 billion to $1.9 billion (see Summary Table).

Option I: Continue the Current System

Advocates of the current system point out that the Congress recently enacted changes to assure adequate finances for the RRS. Opponents argue that the system's payroll taxes, already representing 22 percent of payroll, support a program that provides excessive benefits to many new annuitants.

Option II: Reduce Benefits for Early Retirement

Under this option, career employees who spent 30 or more years with the railroads could still retire as early as age 60, but primary and spouse benefits would be reduced by the same age factors that apply to Social Security. As a result, some 10,000 employees per year would either receive lower benefits or delay retirement. Cumulative savings during the first five years would total $0.7 billion. (Such an early-retirement reduction proposal would probably carry certain retroactive provisions; otherwise, RRS costs would rise sharply as employees accelerated retirement plans to avoid scheduled benefit cuts.)

In light of proposals to increase Social Security's early-retirement reductions, some observers might view Option II as not going far enough. Others would criticize it because many railroad workers have already made plans for early retirement. In some cases, however, early-retirement annuities available under Option II would continue to exceed after-tax income from active railroad employment.

Option III: Reduce Tier II Spouse Benefits

Option III would automatically achieve savings by suspending the annual cost-of-living increases in Tier II spouse payments, excluding survivor benefits. This would recognize the unique benefit advantage available to married RRS retirees and avoid reductions both in the initial annuities awarded new retirees and in present payments to current annuitants. Option III would also bring Tier II survivor provisions into closer alignment with retirement practices in the rest of the private sector. Cumulative savings through 1987 could reach $120 million.

In order to provide spouse survivor protection, most private-sector retirees must accept an actuarial reduction in their initial annuities. Option III would apply the more modest offset currently in effect for federal civilian retirees (2 1/2 percent of the first $3,600 plus 10 percent of the remaining annual annuity).

Opponents of Option III would point out that spouse and survivor benefits were revised as part of the 1981 railroad amendments and that further revisions would breach standing agreements between labor and management. Single and widowed employee annuitants could argue, however, that an individual's marital status should not influence the size of a corporate pension. From their perspective, Option III should further limit spouse benefits as a means to increase the railroad employee's annuity.

Option IV: Tax Railroad Retirement Benefits

This alternative would reduce federal costs for RRS by increasing income tax receipts at the expense of railroad annuitants. First-year savings would equal some $360 million and would accumulate to about $1.9 billion over five years.

Railroad annuitants would object to Option IV because the typical private-sector retiree receives tax-exempt Social Security benefits. But this approach would allocate the financial loss according to total taxable income. Railroad annuitants most able to accommodate the reduction would likely bear the greatest burden, and low-income annuitants would be liable for little if any of the new tax.

The Congress could continue the tax exemption for half of the RRS benefits as an approximation of the Social Security tax exclusion available to other private-sector annuitants. This more limited action could be viewed as sound public policy, regardless of RRS financial considerations.

SUMMARY TABLE. SAVINGS UNDER ALTERNATIVE MODIFICATIONS TO RAILROAD RETIREMENT: DOLLARS IN BILLIONS

	First-Year Savings	Cumulative Five-Year Savings
Reduce Benefits for Early Retirement (Option II)	0.11	0.71
Reduce Tier II Spouse Benefits (Option III)	0.02	0.12
Tax Railroad Retirement Benefits (Option III)	0.36	1.90

SOURCE: Congressional Budget Office.

NOTE: For estimating purposes, the options are assumed to take effect October 1, 1982.

CHAPTER I. INTRODUCTION

Several features distinguish the Railroad Retirement System (RRS) as unique. First, RRS is the only pension plan for private-sector workers in the United States that is managed by the federal government. Second, it is the only pension system that offers annuitants retirement incomes that are essentially tax free. Third, it treats all workers in a given industry, regardless of what specific firms employ them, as a single body; common practice in other private industries is that pension plans are negotiated by labor and management on a firm-by-firm or regional basis. Partly because of these peculiarities, RRS is a subject of widespread interest and specifically, of governmental concern for both the Executive and the Legislative branches.

The industry-wide RRS now covers the employees of some 1,000 railroad companies and awards age and disability pensions for retired employees, payments for their spouses, and survivor benefits. At present, the RRS provides mandatory pension coverage for about 500,000 active workers and nearly one million annuitants. Fewer than half of the RRS annuitants are in fact former railroad employees--55 percent being spouses or survivors. During the next 10 years, the number of railroad employees added to the retirement rolls will decline, averaging about 21,700 a year through 1986 and averaging about 17,000 each year thereafter. The total number of annuitants will also decline because new RRS beneficiaries will not offset the deaths of present retirees and survivors.

Direct costs for railroad retirement have been rising steadily. For instance, annual RRS outlays have grown from $1.6 billion in 1970 to $5.4 billion in 1981. This year, the program will disburse some $5.7 billion in annuity benefits and related costs. By 1987, outlays will reach $7.4 billion. 1/ Nearly all of that projected increase will result from cost-of-living provisions, which automatically adjust RRS benefits for inflation.

1/ Outlay projections were developed by the Railroad Retirement Board at the request of the Congressional Budget Office.

From its inception during the Depression, the RRS has faced one financial crisis after another. On the basis of recommendations from labor and management, the Congress has revised the program again and again. The most recent statutory amendments, enacted in the summer of 1981, were necessary to avert RRS' insolvency. The Economic Recovery Tax Act of 1981 significantly increased RRS payroll withholding tax rates, and the Omnibus Reconciliation Act of 1981 modified several railroad retirement benefit provisions and authorized borrowing by RRS from the general fund of the U.S. Treasury. (Appendix A summarizes the changes in railroad benefits resulting from the 1981 amendments.) The 1981 reconciliation legislation also requires the President, by October 1, 1982, to submit to the Congress a report that analyzes the long-run financial condition of the RRS and options for assuring its actuarial soundness.

The RRS program's past financial difficulties and recent cost trends have given rise to three particular concerns: the adequacy of current RRS financing; the cost impact on the federal government; and whether or not RRS benefits and costs should be reduced. In response to these concerns, this paper provides background information for examining the current railroad retirement program as revised by the 1981 legislation. (The relationship of RRS to unemployment insurance and RRS disability benefits are not discussed because neither has much impact on RRS's long-range fiscal requirements.) In particular, this study addresses the following questions:

- Do current financing provisions ensure adequate income for the program?
- To what extent could changes in RRS reduce the federal budget?
- Are existing benefits excessive, in view of retirement practices in the rest of the private sector?

The remainder of this chapter presents an overview of the current system--its mechanics, the benefits it provides, its sources of revenue, and contingency measures to safeguard it against future financial difficulties. Chapter II analyzes RRS financing and cost issues; and Chapter III describes possible modifications to the current system that would reduce the federal budget by adjustments in RRS benefits.

HOW THE BENEFIT PROVISIONS WORK

The Congress enacted the Railroad Retirement System in 1935--before the introduction of Social Security--to substitute for the failing pension plans of railroad companies, to encourage older workers to retire, and thereby, to provide jobs for younger workers. Social Security and RRS remain independent today, although the two systems now have many common features, and they do coordinate coverage and financing.

In 1951, the Congress established a funding mechanism whereby neither the Social Security program nor the RRS would be better or worse off because of their independence. Since that time, an annual calculation has determined the payroll taxes that would have been collected and the benefits that would have been paid if railroad employment were covered by Social Security. The first calculation was retrospective, encompassing railroad employment between 1937 and 1951. Now the estimated annual difference between the prior fiscal years' tax receipts and benefit payments is transferred, each June, from Social Security to RRS. 2/

The Two-Tier Benefit System

Since 1975, railroad retirement has been structured after the two-part retirement income available to other employees in the private sector: an annuity component--Tier I--that both substitutes for Social Security coverage and provides certain extra benefits; and a corporate-type component, Tier II. The Tier I component accounts for about 64 percent of the total amount of RRS outlays, and Tier II accounts for roughly 27 percent. Most of the remaining costs cover two relatively small, special RRS benefits: longevity supplements for particularly long careers of service, and so-called "windfall," or dual, payments for annuitants with prior service in nonrailroad work covered by Social Security (discussed below). Table 1 presents the various benefit components of RRS.

The sum total of these benefit components can amount to a distinctly generous pension. For the typical male railroad worker

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2/ See General Accounting Office, Keeping the Railroad Retirement Program on Track--Government and Railroads Should Clarify Roles and Responsibilities (March 9, 1981) pp. 8-13.

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TABLE 1. BREAKDOWN OF RAILROAD RETIREMENT BENEFITS AND OUTLAYS: FISCAL YEAR 1982, DOLLARS IN BILLIONS

Benefit Component	Source of Financing	Cost As Percent of Total	Cost in Billions of Dollars
Tier I			
Social Security substitute	Employer and employee withholdings on payroll (10.8 percent) a/ plus transfer payments from Social Security	59	3.33
Extra benefits for career employees and their dependents	Derived from Tier II taxes	5	0.28
Tier II	Employer and employee withholdings on payroll (13.75 percent) a/	27	1.54
Longevity Supplement	Employer contribution for each employee hour worked	2	0.12
Windfall Payment	Federal appropriations b/	6	0.35
Total c/		100	5.68

SOURCE: Congressional Budget Office.

a/ Beginning in January 1982, RRS taxes will be levied on the first $32,400 of railroad earnings for Tier I withholdings and on the first $24,300 for Tier II withholdings.

b/ Recent action on the 1982 appropriation for RRS will increase windfall funding somewhat above the $350 million estimate.

c/ Details do not add to totals because administrative expenses are excluded.

retiring in January 1983 (see Example), the two-tier RRS pension may significantly exceed his after-tax wage income just before railroad retirement. In fact, his retirement income can be as much as 29 percent again as large as his highest net earnings during his working life.

To help finance these benefits, the combined employer and employee withholdings, in 1982, will total nearly 22 percent of total payroll. The individual RRS benefit provisions and sources of financing are described in more detail in the following sections.

Tier I Benefits. These benefits are based on combined railroad and Social Security covered wages and then reduced for any Social Security benefit received. Besides substituting for Social Security coverage, Tier I has another feature that enhances RRS pensions. Specifically, employees with the equivalent of 30 or more years of railroad service may retire as early as age 60 with no reduction in employee or spouse benefits. This is distinct from Social Security benefits, which are reduced by 1/180 for each month the retiree is under age 65, by 1/144 for each month the spouse is under 65, and which are not available at all until age 62.

Tier II Benefits. Benefits for this component are now determined by the highest average monthly salary received over any five-year period and by total length of railroad service, which includes credit for certain military duty. 3/ The percentage of average salary received as a pension rises by 0.7 percentage points for each year of service. This amount is increased if the annuitant is married (Tier II spouse benefits), but it is decreased if the annuitant receives a windfall benefit.

Longevity Supplements. Beginning in 1966, the RRS provided a supplemental annuity to employees with the equivalent of 25 or more years of railroad service. If an annuitant has 30 or more years of service, he may receive the longevity supplement immediately upon retirement; otherwise, he receives it upon reaching age 65. Roughly 75 percent of employees now retiring directly from the railroad industry receive a longevity supplement.

For employees who retired before 1974, the monthly supplemental payment could reach a maximum of $70 ($840 per year) but

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3/ Military service occurring during war or national emergency and immediately preceded by railroad employment applies toward the calculation of railroad retirement benefits.

EXAMPLE OF TWO RRS RETIREES' PENSIONS (January 1983)

To illustrate the composition and possible sizes of RRS pensions, CBO has constructed two hypothetical railroad retirees and their RRS benefit packages. Retiree A, a widower, elects to begin collecting RRS benefits at age 62 and at a final gross salary of $30,000; he has 23 years of railroad service as well as other employment covered by Social Security. Retiree B, whose wife is still living, retires at age 62, after 36 years of railroad service; his final gross salary was also $30,000.

	Retiree A	Retiree B
Tier I Social Security substitute	$ 6,110	$ 8,970
Tier I extra benefit for early retirement	--	3,630
Tier II corporate-type benefit	3,030	7,410
Tier II longevity supplement	none	510
Windfall payment	$ 1,210	$ 610 a/
Total RRS pension	$10,350	$21,130
RRS pension as a percent of final gross salary	(34%)	(70%)
RRS pension as a percent of final salary after taxes	(60%)	(105%)

a/ Less than half of new railroad annuitants with more than 30 years of service receive windfall benefits. Excluding the $610 payment would reduce this retiree's after-tax replacement rate from 105 percent to 103 percent.

required a reduction in the regular railroad annuity. For more recent retirees, the monthly maximum was reduced to $43 ($516 per year) and the annuity offset was discontinued. 4/ The 1981 amendments eliminated the supplemental annuity for all workers first hired by the railroads after October 1, 1981.

Windfall or Dual Benefits. Before 1975, railroad retirement and Social Security were not coordinated, and employees who had worked under both systems could gain an extra benefit advantage. (Social Security benefit calculations assured higher wage replacement for low-income annuitants but did not distinguish noncareer workers with 10 years of coverage from career workers with long years of service at low wages.) The coordination of RRS and Social Security coverage in 1974 corrected this anomaly for subsequent employment, but the provision was not retroactive in that it did not eliminate any extra benefit advantage already acquired. Thus, railroad employees with the equivalent of 10 years' coverage under both Social Security and the RRS prior to 1975 may receive the special windfall (or dual) payment. 5/

In 1974, the Congress agreed to subsidize windfall benefits through annual appropriations to the RRS. But the 1981 Omnibus Reconciliation Act requires the Railroad Retirement Board to reduce windfall benefits if the estimated aggregate payments exceed the total amount appropriated. Because the estimated payments for 1982 exceed the federal funds currently available, the board has cut individual windfall benefits. 6/

4/ The calculation of longevity supplementals for employees hired since 1974 includes a minimum of $23 per month plus $4 per month for each year of service over 25 up to a maximum of $43 per month.

5/ Windfall payments represent the benefits acquired prior to 1975 under both Social Security and railroad retirement, minus the smaller benefit that would have been earned if railroad earnings were integrated with Social Security earnings. For a detailed discussion of windfall benefits, see General Accounting Office, Keeping Railroad Retirement on Track, pp. 25-37.

6/ The Congress has enacted three resolutions that continue federal appropriations for 1982. The current resolution, in effect from December 15, 1981 through March 31, 1982, provides $379 million for windfall benefits and thus requires an average benefit reduction of some 14 percent.

RRS PENSIONS AS WAGE REPLACEMENT

As stated above, the combination of current RRS features can, under certain circumstances, offer attractive retirement income, especially to married employees who spend a major part of their working years with the railroad industry. Such employees, representing more than half of workers who become eligible to retire directly from the railroads on the basis of age and length of service, could receive monthly benefits that greatly exceed after-tax wages just before retirement.

Calculating the portion of after-tax earnings continued at retirement--referred to as wage replacement--serves as a way to assess the combined impact of RRS benefits. To illustrate the income redistribution aspects of benefits and taxes, the Congressional Budget Office has calculated wage replacement rates at two different gross final salary levels: $22,000 and $30,000. 7/ Under current law, RRS replaces, respectively, 129 percent and 105 percent of railroad wages before retirement and after taxes. 8/

The RRS wage replacement rates would be much less attractive were it not for three particular provisions: that RRS makes no reduction in Tier I benefits for retirement as early as age 60, that it offers additional payments to retirees with living spouses (Tier II spouse payments), and that nearly all RRS benefits are tax free. The effects of these three provisions are illustrated on the following page:

7/ These income levels were selected after analyzing age and wage data on railroad employees with 29 or more years of service.

8/ Unless otherwise stated, the wage replacement calculations for RRS and other plans, which appear in Chapter II, assume retirement in January 1983 at age 62 (the earliest age at which a retiree may receive Social Security); 36 years of service (consistent with RRS experience); wage history based on 5 percent annual growth; and RRS taxes and benefits that will be in effect on December 31, 1981. The calculations for RRS benefits further assume that the annuitant receives both a longevity supplement and a windfall payment. The calculations reflect the reduced federal income tax rates enacted by the Congress in 1981 and state income tax rates of Colorado.

	Percent of Net Wages Replaced by RRS	
	Final Gross Salary of $22,000	Final Gross Salary of $30,000
With all existing benefits	129	105
Without early retirement benefits	110	87
Without Tier II spouse payments	115	93
Without income tax exclusions	119	96
With the three omissions above	93	73

With any one of the provisions eliminated, RRS benefits for married employees would drop significantly. But they would still compare favorably with after-tax income available from other private-sector plans (see Chapter II, page 26). Without all three provisions, RRS benefits for married annuitants would drop substantially. As the examples above demonstrate, the wage replacement rates would decline from 129 percent to 93 percent for the $22,000 gross salary level, and from 105 percent to 73 percent for the $30,000 level.

SOURCES OF RRS REVENUES

The RRS currently receives about 62 percent of its program revenues from payroll taxes paid by railroad employees and employers and about 28 percent from the transfer payment from the Social Security system. During the next 10 years, the relative value of employer and employee contributions will gain importance over the Social Security transfer (see Table 2). The remaining income derives mainly from interest and the appropriation of federal funds for windfall (or dual) benefits. The federal government further supports the RRS program in two ways: through new authority, enacted in 1981, to borrow from the general fund of the U.S. Treasury, and by exempting benefits from federal income taxes (the latter provision is described in greater detail in Chapter II).

TABLE 2. SOURCES OF RAILROAD RETIREMENT FINANCING: 1982 AND 1990

	Dollar Amounts (in billions)		Percent of Total Revenue	
	1982	1990	1982	1990
Employer Contributions				
Social Security-Type Tier I Taxes	0.88	1.71	15.7	19.4
Corporate-Type Tier II Taxes	1.33	2.36	23.8	26.8
Special Length-of-Service Supplement	0.16	0.17	2.8	1.9
Subtotal	(2.37)	(4.24)	(42.3)	(48.2)
Employee Contributions				
Social Security-Type Tier I Taxes	0.88	1.71	15.7	19.4
Corporate-Type Tier II Taxes	0.21	0.40	3.8	4.5
Subtotal	(1.09)	(2.11)	(19.5)	(24.0)
Transfer Payments from Social Security	1.59	1.92	28.4	21.8
Federal Appropriations a/	0.35	0.35	6.2	4.0
Interest & Other	0.20	0.18	3.6	2.0
TOTAL	5.60	8.80	100.0	100.0

SOURCE: Derived from estimates prepared by the Railroad Retirement Board's Bureau of Research, according to economic assumptions of the Congressional Budget Office.

NOTE: Details may not add to totals because of rounding.

a/ For estimating purposes, annual appropriations for windfall benefits are assumed to remain constant at $350 million.

Payroll Taxes

Railroad retirement payroll taxes are structured after the RRS's two-part benefit program, although the revenues are not earmarked by benefit component. For railroad employees as a group, the combined employer and employee withholdings for RRS, in 1982, will total 21.8 percent of total payroll, of which 15.3 percent of total payroll is paid by the employer (see Table 3).

The RRS payroll taxes for Tier I are linked to those levied for Social Security. 9/ Thus, increases in both the Social Security tax rates and the maximum income subject to taxation will cause equivalent adjustments in RRS Tier I taxes. 10/ In January 1982, employers and employees will each pay 5.4 percent (if the portion for Medicare coverage is excluded) on earnings up to a maximum annual amount of $32,400.

For the Tier II component, RRS payroll taxes are now independent of Social Security and will apply, in calendar year 1982, to earnings up to the annual equivalent of $24,300. 11/ In October 1981, Tier II taxes rose from 9.5 percent to 13.75 percent of covered payroll. In particular, the Tier II taxes levied on the railroad companies (that is, the employers' share) increased from 9.5 percent to 11.75 percent, and employees began contributing 2.0 percent of pay. An additional tax, equivalent to $0.17 for each employee hour worked in calendar year 1982 and maintained in a separate account, is also paid by employers to finance the special length-of-service supplement.

9/ The difference is that RRS Tier I payroll taxes are calculated on monthly rather than annual earnings. The General Accounting Office has recommended that the RRS calculation conform to the annual method used for Social Security taxes; see Keeping Railroad Retirement on Track, p. 17.

10/ The withholding tax rates and the taxable earnings bases for Social Security are scheduled to rise each year, in accordance with the Social Security Amendments of 1977. These changes will be reflected in the RRS Tier I rates as well.

11/ From 1974 through 1978, Tier II taxes applied to the same monthly income used for calculating taxes for Social Security (Tier I) taxes. Annual increases in the Tier II tax maximum still reflect increases in private sector wage rates.

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TABLE 3. SUMMARY OF RRS PAYROLL TAXES IN 1982

	Tier I Social Security Substitute	Tier II	Length-of-Service Supplement	Total
		(in dollars)		
Maximum Earnings Subject to Taxation as of January 1982	32,400	24,300	a/	n/a
Tax Rates as a Percent of Covered Payroll				
Employer	5.40	11.75	1.11	18.26 b/
Employee	5.40	2.00	--	7.40 b/
Total	10.80	13.75	1.11	25.66 b/
Taxes as a Percent of Total Payroll				
Employer	4.96	9.26	1.11	15.33
Employee	4.96	1.47	--	6.43
Total	9.92	10.73	1.11	21.76

SOURCE: Congressional Budget Office.

a/ Taxes based on $0.17 for each hour worked by employees.

b/ Totals represent the sum of withholding rates for separate RRS components, which each use a different basis for calculating taxable earnings.

Transfer Payments. Annual transfers between the Social Security trust funds and railroad retirement have become an important source of revenue for the RRS. Through 1990, the RRS will receive an annual payment from Social Security averaging $1.8 billion; after that, the size of the payment will gradually decline. Some time around the year 2005, Tier I tax revenues are projected to exceed Social Security-type benefits for the first time. In that year, the direction of the transfers should reverse, with RRS making payments to Social Security.

Federal Borrowing. The 1981 amendments authorize the RRS to borrow from the general fund of the U.S. Treasury in anticipation of the annual Social Security transfer. Without such borrowing authority, the RRS could find itself with insufficient cash to pay benefits during the months preceding the June transfers. Under the present provisions, loans to RRS must be repaid, with interest, as soon as RRS funds are available; the outstanding loan may not exceed the next transfer payment from Social Security. 11/

Federal Appropriations. Each year, the federal government appropriates funds for the windfall (or dual) benefits described above for employees who had previously received an advantage from railroad's independence from Social Security. In recent years, federal appropriations have covered less than the amount needed. For example, the 1981 appropriation of $350 million fell nearly $100 million short of the total needed for windfall benefit payments; thus, funds had to be diverted from Tier I and Tier II tax collections. The authorization for windfall appropriations does not specify a particular level of funding; but the 1981 amendments limit aggregate windfall disbursements to the level of federal funds available.

FINANCIAL CONTINGENCY ACTIONS

In addition to the Presidential report on RRS required next year, the 1981 amendments include several contingency provisions designed to safeguard the system against future financial failure and to assure payment of benefits at least equivalent to the Social Security portion of Tier I payments. The Congress stipulated that such minimum RRS benefits shall be provided even if paid directly from the Social Security trust fund, although further legislative action might be necessitated.

11/ Social Security's annual payments to RRS are drawn from both the Old Age and Survivors Insurance and the Disability Insurance trust funds. RRS borrowing has no direct impact on federal budget outlays, because the loans and repayments represent internal budgetary transactions between the general fund of the U.S. Treasury and the Railroad Retirement Trust Fund.

The contingency measures are triggered whenever the Railroad Retirement Board projects that half of a given year's federal borrowing authority will be used up. When this happens, the board must report to the President and the Congress the status of borrowing, recommended funding changes, and the year in which, without remedial funding, benefits would need to be reduced. Within 180 days after submission of the board's report, three separate steps must be taken: labor and management must report their joint or separate recommendations to the President and the Congress; the President must submit recommendations to Congress to insure payments equivalent to Social Security benefits; and the Railroad Retirement Board must issue regulations to implement benefit reductions. The Congress could either develop legislation based on the recommendations submitted or allow the issued regulations to go into effect.

CHAPTER II. RRS ISSUES--SOLVENCY, BUDGETARY COSTS, AND BENEFIT ALIGNMENT

Modifying the railroad retirement system could be considered primarily for two purposes:

- o To reduce federal expenditures, and
- o To bring the benefit structure into closer alignment with other private-sector retirement.

In addition, the solvency of the system remains a subject of concern despite the legislative amendments recently enacted to assure a sound financial base for the program. The first portion of this chapter assesses the adequacy of RRS financing.

THE FINANCIAL CONDITION OF THE RRS TRUST FUND

Without the new legislation enacted in 1981, the railroad retirement program would have been destined to suffer cash flow problems in the spring of 1982 and to become insolvent by 1985. But a series of measures--the increase of withholding rates from 18.6 percent to 21.8 percent of total payroll, the authorization of limited borrowing from the U.S. Treasury, and certain benefit reductions agreed to by both labor and management--was taken to put RRS on a sound financial footing. Nonetheless, the system's financial prospects are still subject to changing conditions in the economy and the transportation industry. In fact, RRS is currently operating at a deficit.

The Railroad Retirement System could face funding problems in the 1980s if a sharp drop in railroad employment occurs. According to RRS actuaries, the financial contingency provisions included in the 1981 legislation could be triggered if railroad employment fell below 450,000 in 1984. 1/ In 1981, railroad

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1/ Letter of July 16, 1981 from the Acting Chief Actuary and Director of Research to the Chairman of the Railroad Retirement Board.

employment averaged 513,000 and the RRS received some $4.7 billion in revenue--including $2.7 billion from payroll taxes and a $1.3 billion transfer from Social Security. Because these revenues were short of the $5.4 billion paid out for benefits and related expenses, RRS reserves--in one year--fell from $2.7 billion to $1.9 billion. Even with the legislated benefit cutbacks and increases in payroll taxes, reserves will drop another $60 million during 1982. In later years, though, CBO projects (somewhat optimistically) that railroad employment will decline only slightly. Thus, RRS funds will begin to accumulate and could reach 32 percent of annual outlays by the end of 1984 and about 41 percent by the end of 1990. Although more job reductions in the railroad industry would occur under less optimistic economic assumptions, employment is not likely to fall below 450,000 in 1984. Therefore, measures that would enhance long-term solvency through changes in benefit levels or financing do not appear necessary at this time.

Financial Projections. Although railroad employment has steadily declined since World War II--dropping from a peak of 3.0 million in 1945 to 0.5 million in 1980, many analysts believe that major cutbacks in rail service have now run their course. Factors cited as stabilizing influences on the railroad industry include deregulation, mergers among railroad companies, energy efficiency of trains, and transportation of grain and coal. 2/ But drops in the demand for hauling coal, as well as protracted labor disputes, have forced railroads to reduce employment in the past and could do so again in future years. In the longer term, technological changes such as the development of a coal slurry could have severe impacts on the railroad industry. Such uncertainties limit the accuracy of future projections based on CBO's or any other economic assumptions. Nevertheless, statistical analysis suggests that the key to a healthy railroad industry is continued growth in the nation's economy. 3/

2/ See, for example, Gus Welty, "Outlook for 1981: The Stage Is Set For Recovery, But When?" Railway Age (January 26, 1981).

3/ Through a regression analysis by the Congressional Budget Office, the annual levels of railroad employment were shown to be closely correlated with changes in real Gross National Product for the 21-year period 1960-1981.

Estimates of the RRS's financial status mainly reflect the brightness or gloominess of the economic assumptions underlying projections of railroad employment. At this time, most economic assumptions (including CBO's) foresee future growth in the real Gross National Product (GNP) and declining rates of inflation. Differences among economic scenarios generally center about the assumed rate at which the economy will improve. For example, a three-year forecast constructed by Data Resources, Inc. (DRI) portrays a smaller annual growth in real GNP and a continuation of higher levels of interest rates than those currently assumed by CBO. Any set of economic assumptions, and thus estimates based on those assumptions, become more uncertain as the period of projection extends further into the future. With this caveat, the results and sensitivity of the CBO projections are discussed below and summarized in Table 4.

The CBO's estimate is based on an assuption that real GNP will grow at an average rate of 3.6 percent per year between 1982 and 1985 and 3.0 percent between 1986 and 1990. A lower growth rate would have a noticeable impact on railroad employment estimates but should not jeopardize RRS solvency so long as the nation's production of goods and services grows faster than the annual increase in prices. This conclusion is supported by comparing the RRS under CBO's and less optimistic economic assumptions.

Railroad employment, under the CBO economic assumptions, would decline gradually from a calendar year 1982 level of 495,000 to about 480,000 by the end of this decade. Because of higher RRS tax revenues and lower benefits, however, reserves for the program would increase by $526 million between 1982 and 1987 and accumulate to more than $3 billion by 1990. Annual projections consistent with the DRI economic forecast would assume an annual growth rate averaging 2.4 percent between 1982 and 1985--about 1.2 percentage points less than that projected by CBO. As a result of the smaller assumed rate of growth, estimated railroad employment for calendar year 1984 would fall by 16,000, or 3.2 percent. This suggests that in order for railroad employment to fall below 450,000 in 1984, the nation's economy could not expand (no real growth) for the next three years.

<u>Sensitivity to Changes in Social Security Provisions</u>. Most legislative changes--including some already enacted and others now contemplated--affecting Social Security tax rates, benefit levels, and eligibility criteria automatically modify RRS Tier I

TABLE 4. ACTUAL AND PROJECTED FINANCIAL CONDITION OF RRS UNDER TWO ECONOMIC SCENARIOS: 1980-1990, DOLLARS IN BILLIONS

	1980	1982	1984	1986	1988	1990
	Based on CBO Assumptions					
Real Gross National Product (Annual growth in percents)	0.3	2.7	4.0	3.4	2.9	2.7
Railroad Employment (In thousands by calendar year) a/	531	495	493	494	489	484
RRS Income	4.35	5.62	6.48	7.17	7.86	8.80
RRS Outlays	4.76	5.68	6.39	7.03	7.68	8.26
Surplus or Deficit (-)	(0.41)	(0.06)	0.09	0.14	0.18	0.54
Accumulated Reserves at end of year	2.69	1.88	2.03	2.31	2.59	3.37
(As percent of outlays)	56.5	33.1	31.8	32.8	33.7	40.8
	Based on Data Resources, Inc. Assumptions					
Real Gross National Product (Annual growth in percents)	0.3	1.3	2.2	3.0	2.9	2.7
Railroad Employment (In thousands by calendar year) a/	531	491	477	468	462	457
RRS Income	4.35	5.62	6.51	7.15	7.74	8.51
RRS Outlays	4.76	5.68	6.40	7.03	7.65	8.21
Surplus or Deficit (-)	(0.41)	(0.06)	0.11	0.12	0.09	0.30
Accumulated Reserve, end of year	2.69	1.89	2.12	2.42	2.55	2.92
(As percent of outlays)	56.5	33.2	33.1	34.4	33.3	35.6

SOURCE: Data provided by the Railroad Retirement Board; computations based on CBO and Data Resources, Inc. economic assumptions of September 1981.

a/ Projections incorporate CBO estimates of employment reductions for CONRAIL and AMTRAK.

benefits. 4/ The notable exception to this linkage is the early-retirement annuity available to railroad workers with 30 or more years' service. Because of this exception, certain changes in Social Security provisions for early retirement (prior to age 65) would decrease the size of future transfer payments and would thus weaken the RRS's finances. For example, increasing the Social Security benefit reduction for persons retiring before age 65 would not affect annuities for new RRS retirees with more than 30 years of railroad service. But the reimbursement for these retirees' benefits from the Social Security transfer payment would reflect the new benefit reduction, and the RRS would have to finance a larger part of the Tier I benefit. Such changes in Social Security, however, would probably require a lengthy phase-in period and, if enacted, could be applied by the Congress to all RRS participants.

FEDERAL BUDGETARY COSTS

The costs of RRS--the only corporate pension program administered by the federal government--directly affect federal outlays and revenues. The impact on government receipts equals the difference between revenue received from RRS payroll tax collections and revenue forgone because railroad pensions are virtually exempt from federal income taxes. In addition, expenditures for RRS benefit payments and associated administrative expenses (regardless of financing sources) represent federal budgetary outlays. Put another way, the combined annual impact of railroad retirement on the federal budget represents a year's expenditures plus the loss of federal income taxes, less receipts from RRS payroll withholding taxes. 5/

The RRS's budgetary impact has increased from some $0.7 billion in 1970 to an estimated $2.6 billion in 1982 and is

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4/ The link of RRS withholding and taxable earnings rates to rises already legislated for Social Security will bring about one of the most predictable of these effects.

5/ Because RRS is a part of the federal budget, the transfer payments from Social Security, the interest paid by the U.S. Treasury, and the federal appropriations for windfall benefits represent internal budgetary transactions, not outlays.

projected to remain around $2.6 billion for each year between 1983 and 1987 (see Table 5). Within the present structure, the federal budgetary impact of RRS would be reduced by measures that increase RRS reserves--either through further payroll tax increases or through benefit limitations. Federal costs could also be reduced by withdrawing all or part of the tax-free status of RRS benefits. (The budgetary implications of changing the present federal role are discussed at the end of Chapter III.)

TABLE 5. PROJECTED IMPACT OF RRS ON THE FEDERAL BUDGET: 1983-1987, DOLLARS IN BILLIONS

	1983	1984	1985	1986	1987
Outlays (-)	-6.0	-6.4	-6.7	-7.0	-7.4
Revenues	3.4	3.7	4.0	4.4	4.8
Net negative budget impact	-2.6	-2.7	-2.7	-2.6	-2.6
Detail for Revenue Changes					
Revenue gained from RRS tax collections	3.8	4.0	4.4	4.8	5.2
Revenue forgone because of tax-exempt status of benefits a/ (-)	-0.4	-0.4	-0.4	-0.4	-0.4
Net revenue	3.4	3.7	4.0	4.4	4.8

SOURCE: Congressional Budget Office.

a/ These estimates represent the revenue impact of taxing all RRS benefits at rates consistent with the Economic Recovery Tax Act of 1981.

RRS COMPARED WITH OTHER PRIVATE-SECTOR RETIREMENT

Because RRS taxes already equal about 22 percent of the industry's payroll, any changes to safeguard further the future solvency of RRS would probably reduce benefits rather than increase payroll taxes. The Congress might also consider limiting RRS benefits in the context of government-wide budget reductions, even though the program now appears financially sound. For either reason, limitations on certain RRS provisions could help align the system more closely with other private-sector pension plans.

The rest of this chapter contrasts RRS with retirement practices in other parts of the private sector and concludes with an illustration of the so-called "disposable" portion of preretirement income replaced by RRS in comparison to that replaced by other retirement plans.

Benefit Differences

The RRS includes several benefit provisions that are more generous than most pensions in the private sector. Four features in particular account for the relative advantage of RRS over the pensions available to other private-sector workers:

- Early-retirement provisions,
- Spouse benefits,
- Annual cost-of-living adjustments, and
- Tax-exempt status.

In considering these RRS benefit advantages, however, one key counterpoint should not be overlooked: the 2 percent payroll tax railroad employees contribute toward Tier II benefits (discussed later in this chapter).

Age of Retirement. An RRS pension is available to a worker as early as age 60 and without any reduction in earned benefits for Tier I and Tier II so long as he has the equivalent of 30 years of railroad service. Prior to 1974, RRS benefits for all male retirees and for females with less than 30 years' service were reduced according to the Social Security formula.

The early-retirement provisions for career railroad employees contrasts sharply with those under Social Security (benefit reductions before age 65 and a minimum age of 62), which some critics regard as permitting retirement at too early an age. Because Social Security represents a large part of most retirees' income, few workers can afford earlier retirement even under plans that allow retirement before age 62. Most corporate pension plans--counterparts of RRS Tier II--only require a reduction in the earned annuity if retirement is elected before age 62 or, in some instances, age 55. 6/

In calculating length of railroad service, years of employment may either be consecutive or interrupted. This feature bridges changes from one company to another so long as all work is within the railroad industry. Such bridging over breaks in service and between firms is another superior feature.

More than 90 percent of the RRS employees retiring in 1980 were men, and more than half of them were younger than 62 years of age. On the other hand, male annuitants first receiving a Social Security retirement pension are, of course, much older--primarily because of age requirements and financial considerations. The striking difference in the ages at which retirees draw RRS and Social Security retirement benefits is illustrated by the following compilations of data for men 60 years of age and older: 7/

6/ About one-fourth of the 666 corporate pension plans surveyed by an independent actuarial firm permit retirement as early as age 62 without a reduction in earned benefits. See Hay-Huggins, Noncash Compensation Comparison, 1981, pp. V25-V27. A CBO review of eight selected plans in the transportation and utility industries found the larger plans not reducing benefits unless the retiree is under age 55.

7/ The RRS figures are calculated from data on males retiring under the system during 1980; retirees who were disabled or receiving deferred pensions are excluded. Social Security data cover men first awarded such benefits in 1977 (see Social Security Administration, Office of Research and Statistics, Annual Supplement 1977-1979, Table 65, p. 117). Data for both groups are the most recent available.

	Percent of New Enrollees	
Age at Retirement	Railroad Retirement	Social Security
60 and 61	57	None
62-63	21	41
64-65	18	51
66 and Over	4	8

Spouse Payments and Survivor Coverage. Unlike most corporate plans, the RRS includes a payment--generally equal to 45 percent of the Tier II benefit--to a nonworking spouse; this payment is in addition to the amount provided by the Social Security-type Tier I benefit. 8/ If the employee had at least 30 years of service, the payments may be received by the spouse at age 60 without any reduction. But if the railroad employee had less than 30 years of service, the spouse may not receive benefits until age 62 and such benefits are subject to the age reduction used by Social Security (1/144 for each month the spouse is younger than age 65). In addition, the RRS automatically provides for continuation of Tier II spouse benefits whenever the retired employee pre-deceases the spouse. This survivor coverage is a clear advantage over most private plans, which commonly extend such protection only if the employee elects a reduction in his corporate pension at retirement. (Like Social Security, RRS Tier I provides survivor coverage without a benefit reduction.)

Cost-of-Living Adjustments. Both portions of RRS pensions are automatically adjusted once a year for increases in the cost of living as measured by the Consumer Price Index (CPI). For Tier I, the cost-of-living adjustment (COLA) reflects the full CPI increase; for Tier II benefits, the COLA is calculated at just under one-third of the CPI increase.

8/ The spouse of a railroad retiree may resume work without losing either the Tier I or Tier II spouse payment if employment is neither with the railroad industry nor with anyone who employed the spouse just before the spouse payment was first received. The Tier I spouse payment is reduced, however, if the spouse receives Social Security benefits.

The limit on the size of the Tier II COLAs appears consistent with recent experience of private-pension retirees, but the RRS guarantee of an automatic adjustment each year is superior. Relatively few (4 to 8 percent) private-sector pension plans have an explicit COLA provision, and approximately 40 percent grant no COLA of any kind. Most private companies' plans adjust benefits on an unscheduled, ad hoc basis. 9/

Exemption From Federal Taxation. Virtually all RRS benefits are tax free. 10/ This provides a pecuniary advantage for RRS annuitants, because only the Social Security portion of retirement income received by other private-sector annuitants is tax free. For example, in calendar year 1983, married railroad annuitants--with RRS pension benefits ranging between $20,000 and $22,000--will receive an annual federal income tax advantage averaging some $1,200 per couple. After a railroad annuitant and his spouse both reach age 65, the tax advantage on the same income shrinks to about $900 because of the extra tax exemptions available to older persons. 11/ Because of graduated federal income tax rates, the advantage of a tax-free RRS pension increases to the extent that a railroad annuitant has taxable income from other sources.

Employee Contributions. Because of Tier II taxes, railroad employees pay some 2.0 percent of covered payroll more toward their retirement than do most other private-sector workers covered by Social Security and a corporate pension plan. In January 1982, railroad employees will pay a 5.4 percent tax on earnings up to $32,400 per year for Tier I benefits (excluding health-care

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9/ Appendix B summarizes recent surveys that have collected data on COLAs available to private-sector retirees.

10/ The longevity supplement is the only RRS benefit subject to federal income taxation, but because of the small size of this benefit, no taxes would be collected unless the average annuitant under age 65 reported taxable income exceeding $3,300 if single and $5,400 if married and filing a joint return.

11/ The estimates reflect implementation of the tax reductions the Congress enacted in 1981. In addition, the hypothetical employee considered here is assumed to retire at age 62 with 36 years of service.

coverage) and an additional 2.0 percent tax on earnings up to $24,300 per year for Tier II benefits. 12/ Because most corporate plans are fully paid by the employer, most employees in the private sector pay only the equivalent of the 5.4 percent Tier I/Social Security tax.

Wage Replacement

Taken together, the RRS provisions offer attractive income security at relatively early ages for employees who spend all or most of their careers with the railroad and who have nonworking spouses. For these people, accounting for more than half of those retiring directly from the railroad each year, RRS provides a retirement package that seemingly ranks among the highest in private industry.

This conclusion is supported by comparing the replacement of wages--just before retirement and after taxes--under RRS and under other private-sector retirement plans. The private-sector retirement examples combine Social Security with either a hypothetical company plan (a composite constructed by CBO) for blue-collar workers in all industries, or with selected plans in the transportation service and utility industries (see Table 6). 13/ The RRS replacement rates for married annuitants exceed the highest of the selected other plans reviewed in the transportation service and utilities industries. The rate of disposable income replacement for single RRS annuitants appears close to average private-sector practice.

12/ Estimated average earnings per railroad job will increase from $27,400 in 1981 to about $29,600 in 1982.

13/ For a detailed description of the composite plan see CBO Alternative Approaches to Adjusting Compensation for Federal Blue-Collar Employees (November 1980), pp. 38-40. The selected plan descriptions (covering 1.7 million employees in the utilities and transportation service industries) include two provided by the Bureau of Labor Statistics and six provided by the Bankers Trust Company in Corporate Pension Plan Study (1980), pp. 242-263.

TABLE 6: EXAMPLES OF WAGE REPLACEMENT RATES UNDER RRS AND OTHER PRIVATE SECTOR RETIREMENT: WAGE REPLACEMENT AS A PERCENT OF FINAL SALARY AFTER TAXES

	Final Gross Salary	
	$22,000	$30,000
	(For Married Retirees a/)	
Railroad Industry	129	105
All Industries b/	97	76
Select Transportation and Utility Company Plans c/	104	89
High benefits	(118)	(99)
Low benefits	(92)	(73)
	(For Single Retirees)	
Railroad Industry	96	79
All Industries b/	83	66
Selected Transportation and Utility Company Plans c/	90	80
High benefits	(105)	(90)
Low benefits	(77)	(63)

SOURCE: Congressional Budget Office.

NOTE: Workers assumed to retire at age 62 after 36 years of service. See Chapter I, footnote 8.

a/ Spouse assumed to be age 62 to reflect Social Security spouse benefits.

b/ Combines Social Security and composite company benefits for blue-collar workers. See CBO, Alternative Approaches to Adjusting Compensation, pp. 38-40.

c/ Estimates represent the average retirement benefits covering a population of 1.7 million transportation and utility workers in eight selected plans. The sources for the selected plans are described in footnote 13 on the preceeding page.

CHAPTER III. ALTERNATIVE BENEFIT PROVISIONS

In considering what if any action to take with regard to RRS, the Congress will want to weigh several factors. Modifications in the system could be designed to align it more closely with other private-sector retirement practices, to lower federal budgetary costs, or to fortify further the program's financial condition. As Chapter II states, however, it is unlikely that the Congress will need to consider benefit reductions solely as a safeguard against future financial crisis for RRS or as contingency measures that could be invoked later. 1/ Alternatively, the Congress may want to assess a more radical course that would limit the federal role in RRS (discussed at the end of this chapter).

In order to illustrate the maximum impact of various possible modifications to the current RRS, two alternatives discussed in this chapter go beyond aligning railroad retirement with practices of other private-sector employers. The Congress could blend or scale these measures to fit particular requirements for RRS or the federal budget. Or as is always the case, the Congress could decide that the best course would be a continuation of the present system (Option I). Three possible changes, all dealing with RRS benefits because withholding rates were increased significantly in 1981, are examined below:

- Reducing benefits for early retirement (Option II);
- Reducing Tier II benefits for spouses (Option III); and
- Taxing benefits (Option IV).

1/ As noted in Chapter I, the President must send the Congress a report, within a year, on RRS financial condition along with recommendations for any needed long-term changes in benefits or funding. In addition, the Railroad Retirement Board is required to notify Congress by April 1 in any year that projections show half of the newly authorized borrowing authority will be depleted and, if necessary, to reduce benefits in a fair and equitable manner. The Board's actions must assure that each recipient's benefits would at least equal what would otherwise be received if railroad service had been covered by Social Security.

The cumulative five-year reductions generated by the three alternatives range from $0.1 billion under Option III to $1.9 billion under Option IV (see Table 7 later in this chapter). The savings would reduce the federal budget and at the same time, could increase the buildup of RRS reserves. (For estimating purposes, the assumed effective date of each option is October 1982. As a practical matter, the effective dates could differ as could scope, duration, and timing of particular measures.)

OPTION I. CONTINUE THE CURRENT SYSTEM

According to projections prepared for CBO by the Railroad Retirement Board, RRS reserves will continue to grow throughout the next five years, increasing from $1.9 billion at the end of 1983 to $2.4 billion in 1987. During this same period, the system's annual impact on the federal budget is projected to remain around $2.6 billion--a 25 percent greater burden on the budget than if, hypothetically, present benefits and employee withholdings were aligned with other private-sector retirement practices.

Opponents of the present system oppose it as too costly to the industry (the effective 22 percent payroll tax) and overgenerous to retirees, especially younger ones. In their view, it would be prudent to reduce RRS payroll taxes by scaling back the current benefit structure. Alternatively, certain particular benefit cutbacks could bring the RRS into closer alignment with other private-sector retirement, thus providing a larger cushion in RRS reserves and smaller federal budgetary costs.

Advocates of the current RRS program point out that the Congress just modified the system--expressing a degree of Congressional commitment--and believe that these changes assure adequate finances for the future. Even though certain benefits features are more liberal than those in other plans, they are mostly paid for by railroad companies and workers. Some would argue that any adverse impact the RRS may have on the federal budget represents a short-term accounting problem, not a permanent burden on taxpayers. A counter to this view is that it overlooks annual federal appropriations to the RRS and the federal tax exemption enjoyed by railroad annuitants.

OPTION II. REDUCE BENEFITS FOR EARLY RETIREMENT

Option II would reduce both primary and spouse RRS benefits currently available to retirees with 30 or more years of service. The initial annuity reductions would reflect the early retirement factors used by Social Security. This change would be a reversion to the pre-1974 RRS provisions, and it would be stricter than provisions generally found elsewhere in the private sector (see discussion in Chapter II).

For employees retiring at age 60 with at least 30 years railroad service, the Option II reduction would decrease earned benefits by one-third (60 months times 1/180). For a hypothetical married employee with a final salary of $30,000, RRS benefits would fall from 105 percent to 87 percent of net final salary before retirement and after taxes. (The calculations assume that the annuitant retires at age 62 after 36 years of rail service, and that RRS income remains tax exempt.)

Reinstatement of the monthly reduction, disregarding length of service, for all new RRS retirees would delay retirement or reduce benefits for approximately 10,000 persons per year. This would lighten the annual cost burden for RRS by about $110 million in the first year and $160 million four years later. An early-retirement reduction proposal, such as Option II, would probably require authorizing legislation that incorporates certain retroactive provisions. Otherwise, retirement rates and associated RRS costs would rise sharply as employees accelerated retirement plans to avoid impending benefit reductions.

In light of current proposals to increase early-retirement reductions for Social Security, some observers might view Option II as not going far enough. Others would critize the option because many railroad workers have undoubtedly already made plans to retire early 2/; questions would surely arise as to why present annuitants were spared any financial sacrifice. It should be noted, however, that in some cases early-retirement annuities available under Option II would continue to exceed after-tax income received just before retirement.

2/ Some 118,400 railroad employees have the equivalent of 29 or more years of service; 14 percent are age 62 or older, 15 percent are age 60 or 61, 35 percent are between age 55 and 60; and the remaining 36 percent are age 55 or younger.

OPTION III. REDUCE TIER II SPOUSE BENEFITS

Option III would bring RRS Tier II spouse payments into closer alignment with retirement practices in the rest of the private sector. Two changes would result: first, Tier II spouse payments would no longer be adjusted for increases in the cost-of-living; and second, the new plan would eliminate the automatic payment of Tier II survivor benefits for spouses of current and future retirees. The Tier II survivor protection (based on current benefit provisions) would continue only if a railroad retiree elected a modest reduction in his Tier II benefit. Taken together, the changes in Option III would reduce costs by some $120 million through 1987. (The option would not affect either present annuities for current survivors or prospective survivor payments to spouses of employees who die prior to retirement.)

According to information collected by the Bureau of Labor Statistics and by the actuarial firm of Hay Associates, company pensions do not include any payment for the spouses of living retirees. In most cases in which spouse survivor protection is available, the employee must have accepted an actuarial reduction in his initial annuity or waived coverage. An annuity reduction for elective survivor protection could, of course, be more modest than one based on actuarial factors. For example, federal retirees who elect to provide survivor protection to their wives or husbands have their initial annuities reduced by 2.5 percent of the first $3,600 of annual income, plus 10 percent of income over $3,600. Applying this formula to the RRS would reduce cumulative Tier II outlays by $80 million between 1983 and 1987.

Suspending the annual cost-of-living adjustments in Tier II spouse benefits would avoid reductions both in the initial annuity awarded new beneficiaries and in present spouse payments. It also would recognize the unique benefit advantage available to married railroad retirees, which, for obvious reasons, seems inequitable to some annuitants and taxpayers.

Proponents of Option III point out that, even with the proposed reductions in spouse payments, initial RRS benefits for married annuitants would still exceed their railroad wages just before retirement and after taxes. Opponents counter that the RRS spouse and survivor benefits were recently changed by the Congress (see Appendix B), and that further revisions would breach standing agreements between labor and management. The opposition would also point out that the reductions would affect the prospective survivor benefits of a group that would be hard pressed by an income cut. Single and widowed employee annuitants could argue, however, that a person's marital status should not influence the size of a corporate pension. From their perspective, Option III should further limit spouse benefits as a means to increase the railroad employee's annuity.

OPTION IV: TAX RAILROAD RETIREMENT BENEFITS

Option IV would withdraw the tax-free status of RRS benefits. This alternative, requiring amendment to the original RRS provisions of 1935, would reduce federal costs for RRS in the form of income tax receipts forgone under current law. The federal budgetary savings would begin at some $360 million in the first year and accumulate to about $1.9 billion over five years.

If, as an accompanying contingency measure, it were decided to augment RRS reserves, Option IV could be modified by authorizing new federal appropriations corresponding to the estimated increase in federal tax revenues. This approach would not increase costs to the federal government but would replace the indirect tax subsidies (revenues forgone) with additional direct appropriations. (The current federal appropriations to RRS for windfall benefits would not be affected by this modification.)

Discontinuing the RRS tax advantage would help federal budget-cutting efforts, but at an expense to railroad annuitants. For example, the portion of income (before retirement and after taxes) retained by a hypothetical retiree would decline from 105 percent to 96 percent under Option IV. 3/ But this approach would allocate the financial sacrifice among railroad annuitants according to their total taxable income. Individuals best able to accommodate the reduction would likely bear the greatest burden, and low-income annuitants would face little if any additional tax burden.

Option IV would represent a departure from typical private-sector practice inasmuch as Social Security income is exempt from federal taxation. If requirements to reduce the federal budget

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3/ The calculations assume that a new railroad retiree is married, has 36 years of rail service, retires at age 62 with a gross salary of $30,000, and is eligible for windfall benefits.

TABLE 7: ESTIMATED ANNUAL SAVINGS FROM RRS MODIFICATIONS: DOLLARS IN BILLIONS

	In First Year	In Fifth Year	Cumulative Five-Year Savings
Option I: Current System	--	--	--
Option II: Reduce Benefits for Early Retirement	0.11	0.16	0.71
Option III: Reduce Tier II Spouse Benefits	0.02	0.03	0.12
Option IV: Tax Railroad Retirement Benefits	0.36	0.41	1.90

SOURCE: Congressional Budget Office.

NOTE: For estimating purposes, options are assumed to take effect October 1, 1982.

called for a less far-reaching action, the Congress could continue the tax exclusion for half of RRS retirement income; this would approximate the Social Security tax exclusion. Such a more limited exemption might be viewed as sound public policy regardless of RRS financial considerations, but it would yield smaller savings--accumulating to some $0.9 billion in the first five years.

CHANGING THE FEDERAL ROLE--A BASIC DEPARTURE

Under each of the above alternatives for modifying RRS, programmatic and financial responsibility for railroad retirement would remain with the federal government. 4/ Some analysts have

4/ The Railroad Retirement Board administers RRS with a 1,580 federal workforce and an operating budget of some $60 million.

argued for a fundamental departure from this arrangement. For example, the current federal involvement could be scaled back by taking the corporate-type portion (RRS Tier II benefits) out of the federal budget. Proponents of such an approach believe that it would improve the financial accountability of the RRS, because rail management and labor would be directly responsible for the formulation and implementation of future financing or benefit changes.

Collective bargaining for RRS corporate-type benefits would be more consistent with labor-management relations in other industries. Such an approach would relieve the federal government of its existing statutory responsibility for these benefits. In principle, this represents an extension of provisions contained in the 1981 amendments that call for industry and labor to develop recommendations whenever the need for changes in the RRS becomes apparent. As a practical matter, however, changes in the federal government's present involvement could encounter several budgetary and administrative problems, including the prospect of duplicative organizations to administer separate RRS benefit components.

Although restructuring the RRS to reduce the role of the federal government could take many forms, the basic ingredient would be the off-budget administration of Tier II benefits. Because Tier II tax revenues, under current law, are projected to exceed benefit demands, the federal budget will enjoy a net gain. If the Tier II program were moved off budget, however, this advantage would disappear--the resulting net annual loss to the government would grow from $0.1 billion in 1983 to some $0.4 billion in 1987. In addition, large one-time increases in federal outlays could result from certain potential transition requirements concerning liquidation of the $1.9 billion held in RRS reserves and final reimbursement for some $3.6 billion in Social Security-type benefits already paid by RRS.

Several features might be designed to moderate or defer such effects, but they would be accompanied by continued federal involvement. To change the present RRS structure, the government would also need to address other complex decisions regarding funding for windfall benefits and whether provisions of the Employment Retirement Income Security Act (ERISA) should cover the new railroad program.

APPENDIX A. SUMMARY OF CHANGES IN RAILROAD RETIREMENT BENEFITS CONTAINED IN THE OMNIBUS BUDGET RECONCILIATION ACT OF 1981

Prior Law	Current Law as Amended
Calculations of Employee Tier II Benefits	
The calculation of employee Tier II annuities included three parts: a component for service prior to 1974; a component for post-1974 service, and a component for employees who worked both before and after 1974.	For new retirees, employee Tier II annuities calculated as 0.7 percent of the employee's average monthly compensation for the 60 highest months of earnings times each year of service. The amount is then reduced by 25 percent of any monthly amount received from RRS windfall/dual benefits.
Employee Tier II Cost-of-Living Adjustment	
Statutory authority for COLAs, tied to 32.5 percent of annual Social Security adjustments, expired in 1981.	Permanently continues annual Tier II COLAs.
Eligibility for Tier I Spouse and Survivor Benefits	
Divorced wives of railroad employees were not eligible for RRS payments.	Provides Tier I spouse payments for a divorced wife who is at least age 62, had been married to the employee for at least 10 years, and is currently unmarried. This change conforms RRS to Social Security.
Tier I survivor benefits were not available to divorced wives, remarried widows, and divorced mothers.	Provides Tier I survivor benefits to divorced wives, remarried widows, and divorced mothers so long as such persons would have qualified for Social Security benefits if the railroad service of the deceased employee or annuitant had been covered by Social Security. This change conforms RRS to Social Security.

(continued)

Prior Law	Current Law as Amended
Calculations of Tier I and II Spouse Payments	
The spouse's Tier II payment equaled 50 percent of the retired employee's Tier II annuity up to a maximum amount.	The spouse's Tier II payment for new awards equals 45 percent of the retiree's Tier II annuity without limit.
For employees with less than 30 years of service, the initial spouse payment was reduced by 1/180 per month before the spouse's 65th birthday.	Increases the reduction to 1/144 per month under age 65.
Calculation of Tier II Survivor Benefits	
A surviving widow or widower's Tier II benefit equaled 30 percent of the deceased employee's Tier I benefit. The survivor benefit was indexed at 100 percent of annual Social Security adjustments.	A surviving spouse's Tier II benefit equals 50 percent of the deceased employee's Tier II benefit. The change in survivor benefits is not effective until October 1, 1986 except for survivors of employees dying after October 1, 1981. Indexation for all survivors is immediately reduced to 32.5 percent of annual Social Security COLA.
Eligibility for Longevity Supplement	
Longevity supplements were available for annuitants who retire directly from the railroads with at least 25 years of service.	Employees first hired after October 1, 1981 are not eligible for longevity supplements, regardless of length of rail service.

(continued)

Prior Law	Current Law as Amended
Windfall/Dual Benefit	
Appropriations and outlays for windfall/dual benefits were paid out of the general Railroad Retirement account.	Creates a separate account for dual/windfall payments. If appropriated amounts are not adequate to cover estimated costs, windfall benefits are reduced accordingly.
The calculation of benefits recognized changes in the cost of living from 1974 to the date of retirement.	Discontinues further pre-retirement indexing of windfall benefits. Also applies the age reduction factor to all parts of the formula for calculating windfall benefits.
In determining eligibility for windfall benefits, married women were allowed to include their spouses' employment covered by Social Security. The courts had ruled that this provision should also be available to married male railroad retirees.	Eliminates spouse's employment under Social Secuity as a factor determining windfall benefit eligibility for both men and women. Also, eliminates future windfall awards to spouses and survivors.

Other Amendments

Credit is allowed for actual months of service instead of rounding to the next full year for six or more months of service.

Technical changes are made in calculating Tier I and Tier II cost-of-living adjustments for employees who retired before age 65 with less than 30 years of service.

APPENDIX B. INFORMATION ON COST-OF-LIVING ADJUSTMENTS IN THE PRIVATE SECTOR

Recent surveys have collected data on COLAs in private-sector pensions. Summaries of these surveys follow.

Bankers Trust Corporate Pension Plan Study 1980, Section 2, pp. 52-55.

The Bankers Trust Study of 325 pension plans covering more than 8 million employees found that only 4 percent (13 plans) provided cost-of-living adjustments based on changes in the Consumer Price Index. In nine of these plans, annual changes were made automatically, but increases were limited to 4 percent per year. Another 32 percent made pension adjustments, mostly unscheduled, on some basis other than changes in CPI.

For the plans that granted post-retirement increases of any kind during the six-year period 1975-1980, none granted increases every year: 45 percent of the plans gave one increase, 35 percent gave 2 increases, 5 percent gave 3 increases, 5 percent gave 4 increases, and 10 percent gave 5 increases.

Hay-Huggins Noncash Compensation Comparison, 1981, Section V, pp. V18-V21.

The spring 1981 survey of 666 corporate retirement plans, covering some 5.7 million participants, found that 42 percent (280 plans) do not grant COLAs and that only 8 percent (53 plans) have formal COLA provisions, but most with a limit on the size of the adjustment--ranging from 2 percent to 5 percent. The remaining 50 percent (333 plans) provide COLAs on an ad hoc basis. Of these, only 12 percent (41 plans) provided an adjustment in 1981; 35 percent (115 plans) provided the last COLA in 1980; and 53 percent (177 plans) provided the last COLA in 1979 or before.

Towers, Perrin, Foster and Crosby Analysis

From January 1, 1975 through December 31, 1979, annual COLA increases for 100 private-sector pension plans averaged one-third of the change in the CPI. Specifically, the average annual increase (weighted for plan size) was 2.7 percent, compared to an annual inflation rate of 8.1 percent. The TPF & C study, conducted for the U.S. Office of Personnel Management, analyzed the magnitude of COLAs for 100 private pension plans that covered over 2 million employees; frequency of adjustments was not identified.

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