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## Privatizing Railroad Retirement

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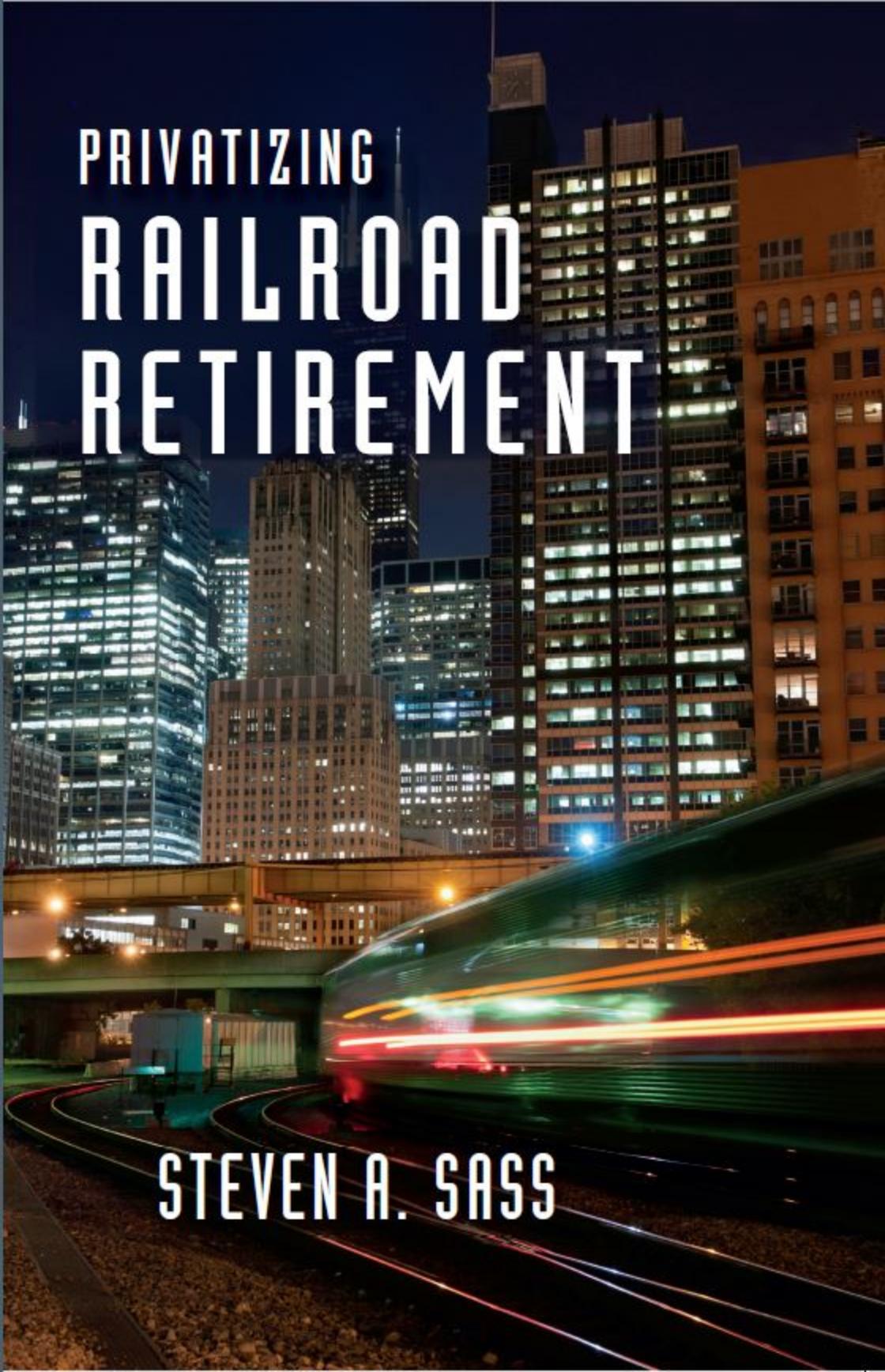
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A nighttime photograph of a city skyline with several illuminated skyscrapers. In the foreground, a train is captured in motion, creating long, horizontal light trails in shades of green, orange, and red. The train tracks curve through the lower part of the frame. The overall scene is a blend of urban architecture and dynamic transportation.

**PRIVATIZING  
RAILROAD  
RETIREMENT**

**STEVEN A. SASS**

# **Privatizing Railroad Retirement**

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# Privatizing Railroad Retirement

Steven A. Sass

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To Levi, Itai, and Ayelet, and others in the next generation.

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## Introduction

The history of railroad retirement begins in the private sector, at the end of the nineteenth century, when the railroads created the nation's earliest private sector employee pension programs. But since the Great Depression, when the government took over these employer plans, Railroad Retirement has been a government program. Like Social Security, also created in the Great Depression, Railroad Retirement is funded by a payroll tax on workers and employers, the benefits paid out are defined by an act of Congress, and its assets are government assets.

In 2001, however, a key component of the program was privatized. Railroad Retirement covers workers who are primarily employed by large rail corporations and represented by strong rail labor unions. In the late 1990s, these employers and unions developed a plan to privatize the investment of Railroad Retirement assets. These assets, until then, had only been invested in government bonds. The industry plan would invest Railroad Retirement assets like the assets held in private sector pension trusts—in equities and other private sector securities, which have much higher expected returns than the returns on government bonds.

Rail management and labor saw the higher expected returns on equities as allowing a cut in Railroad Retirement payroll taxes and/or an increase in Railroad Retirement benefits. These gains were not free. Equities are riskier than government bonds, as well as offering higher expected returns. The industry plan thus included a mechanism that automatically raised taxes, if necessary, to keep the program on track. The parties accepted this risk, and on balance saw investing Railroad Retirement assets in equities as beneficial.

Congress was generally inclined to enact the industry plan. The major concern was the precedent it set for Social Security, which was a much larger program and covered nearly the entire U.S. workforce. More to the point, the Social Security Trust Fund held about 100 times the assets as the Railroad Retirement program. If just 40 percent

of those assets were invested in equities, Social Security could soon own 5 percent of the U.S. stock market. To many, this crossed a critical line and opened the door to unwanted government involvement in the private economy.

Congress enacted the industry plan in 2001 with one major change: it allowed the investment of Railroad Retirement assets in equities, but it removed, as best it could, government involvement in the investment process. It created a private sector trust—the National Railroad Retirement Investment Trust (NRRIT)—to invest Railroad Retirement assets in equities. Private sector employer and union Trustees would oversee NRRIT’s operations. The government would receive periodic financial reports and could take legal action should NRRIT fail to meet its fiduciary obligations, but Congress otherwise excluded government employees from any participation in NRRIT’s operations.

The book analyzes this reform and its implications going forward. Chapter 1 reviews the history of railroad retirement programs to the late 1980s, from their origins in the private sector to the government takeover in the 1930s, to the expansion of Railroad Retirement in the postwar period, to the benefit cuts and tax increases needed in the 1980s to keep the program afloat. Chapter 2 discusses the growing appeal of equity investment as a way to reduce payroll taxes and restore lost benefits, and the difficult management-labor negotiations needed to develop a proposal that could capture these gains. Chapter 3 discusses the difficult negotiations needed to win congressional enactment, negotiations made especially difficult by the precedent it seemed to set for investing Social Security assets in equities. Chapter 4 reviews the experience of the reformed program to date and offers a case study of management-labor collaboration in overseeing pension investments. It also discusses the ability of the program’s unique automatic adjustment mechanism to negotiate the difficult financial markets in the first dozen years after the reform. Chapter 5 discusses the effect of the reform on rail workers and companies, with special attention given to the potential impact on employer tax rates. Chapter

6 discusses implications for Social Security. It finds no significant lessons on the issue that most concerned Congress in 2001—how to invest Social Security assets in equities without government involvement in the private economy—but an important example of the value of an automatic adjustment mechanism, such as that introduced in the reformed Railroad Retirement program.

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# Chapter 1

## A Brief History of Railroad Retirement Programs

The railroads were the first U.S. private sector industry to make pensions a standard feature in its personnel management systems. The first plans appeared in the late nineteenth century as part of corporate “industrial insurance” programs, which protect workers and their families against the loss of wages due to death, disability, or being too old to work. Management’s objective was to win the loyalty of employees and diminish the appeal of unions, which offered competitive benefit programs. After the turn of the century, rail management increasingly used pensions for a different purpose. As the rail labor force aged and an increasing number of elderly workers held jobs they could no longer effectively perform, management increasingly used pensions to help terminate employment relationships—as a sweetener in compulsory retirement programs (Sass 1997).

Company plans covered 1.5 million rail workers, 75 percent of the industry workforce, by 1919 and accounted for the bulk of all private sector workers covered by employer plans. Over the following decade, prefunding future obligations came to be recognized as “best practice” pension plan management. But the railroads had become a financially weak industry, due largely to the emergence of intercity truck competition. So they continued to operate their plans on a pay-as-you-go basis. Burdened with high fixed costs and a harshly competitive environment, the railroads entered the Depression strapped for cash, paying benefits to 56,000 pension beneficiaries in 1933 (Railroad Retirement Board 2010; Sass 1997).

### **NATIONALIZING RAILROAD RETIREMENT**

As the burdens of pension payments stressed the carriers’ fragile finances, a grassroots organization of rail workers—from retirees

seeking to secure their pensions to young workers seeking to keep their jobs by retiring their elders—turned to the federal government. Rail workers were politically influential, as they were numerous and dispersed throughout the nation; the railroads were already heavily regulated and seen as a critical national industry; the Depression was a national economic emergency; and Franklin Roosevelt’s coalition was busily fashioning a New Deal for America. So, in 1934, the rail workers succeeded in having Congress nationalize the carrier’s plans. Like the Social Security program enacted one year later, the federal Railroad Retirement program was funded on a pay-as-you go basis with equal employer and employee contributions. And because rail workers had this plan, they were excluded from the Social Security program enacted one year later.<sup>1</sup>

New Deal reforms also significantly enhanced the role of unions, and pensions were explicitly ruled an issue subject to collective bargaining in the early postwar period. While Railroad Retirement was now a government program, benefit changes were typically the result of labor-management negotiations, which Congress then enacted. In the postwar period, Congress expanded benefits to keep pace with benefits provided by Social Security (adding spousal and survivor benefits) and benefits negotiated in collectively bargained plans (adding early retirement on full benefits and “occupational” disability, which grants disability benefits if the worker can work but not in his or her current occupation). Funding nevertheless remained pay-as-you-go, and the railroads remained financially weak, with rapidly declining employment (Salmon 2013; Stover 1997; Winston 2006).

In 1974, the same year Congress “rationalized” employer plans with the Employee Retirement Income Security Act (ERISA), it rationalized Railroad Retirement. It divided the program into two tiers, with Tier I essentially replicating Social Security and Tier II clearly identified as the industry’s supplementary “employer” pension program. Tier I taxes and benefits would now be transferred to and from the Social Security Trust Fund: the Railroad Retirement Tier I program in essence was a Social Security “pass-through.” The legislation

also reduced the employee tax to the Social Security employee tax, with amounts needed for benefits above Social Security payments now borne by the carriers alone. Where each had paid 10.6 percent of covered earnings, employees now paid just the Social Security employee tax of 5.85 percent, and their employers paid 15.35 percent, with the Social Security employer tax of 5.85 percent sent to Social Security and 9.5 percent retained by Railroad Retirement (see Table 1.1) (Railroad Retirement Board 2009, 2010; Salmon 2013; Whitman 2008).

The Railroad Retirement Tier II program was responsible for paying retirees a monthly benefit equal to 0.7 percent of average earnings over their highest 60 months of earnings for each year of service. It also retained the obligation to pay certain sweetened Social Security benefits, known as “Excess Tier I” benefits. A key provision in the 1974 legislation was the introduction of “60/30”—a provision allowing workers aged 60 with 30 years of service to retire on unreduced benefits—unreduced Tier I Social Security benefits as well as unreduced Tier II benefits. The legislation did eliminate future windfall “dual” benefit entitlements, which had allowed rail workers who qualified for Social Security benefits based on nonrailroad work to get unusually high Social Security benefits, paid for by Railroad Retirement.<sup>2</sup> Despite the elimination of future dual entitlements, the addition of 60/30 increased the program’s obligations. Unless otherwise stated, all further references to Railroad Retirement taxes and benefits refer only to Tier II taxes and benefits, including Excess Tier I benefits.

**Table 1.1 The 1974 Division of Railroad Retirement Benefits and Tax Revenues (%)**

	Benefit	Payroll tax		
		Employee	Employer	Total
Tier 1	Social Security	5.85	5.85	11.70
Tier 2	Railroad Retirement + excess Tier I benefits		9.50	9.50
Total		5.85	15.35	21.20

SOURCE: Commission on Railroad Reform (1990).

The shift in the payroll tax from workers to employers exacerbated the serious financial pressures on U.S. railroads. Over 20 percent of the nation's rail mileage, including the iconic Penn Central, would enter bankruptcy in the 1970s. Assets in the Railroad Retirement Account at the U.S. Treasury also fell sharply, from three times annual benefit payments in 1970 to barely an eight-month cushion in 1979. Both the industry and its retirement program thus ended the decade financially distressed (Stover 1997; Winston 2006).

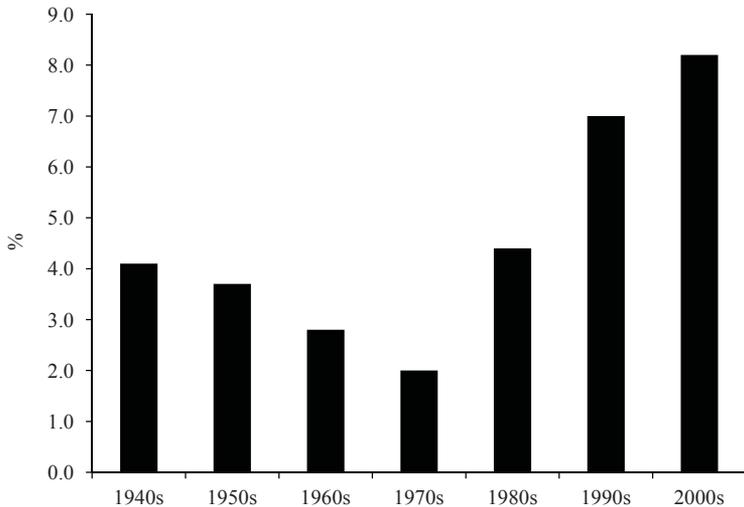
### **BACKGROUND FOR REFORM: THE 1980s WATERSHED**

The 1980s marked a watershed in the finances of the railroad industry, setting the stage for initiatives that would result in the 2001 reform of the Railroad Retirement program. The key events were the Staggers Rail Act of 1980; the shoring up of Railroad Retirement finances, primarily in legislation enacted in 1983; and a management proposal to privatize railroad retirement, which would evolve into an initiative to invest Railroad Retirement assets in a manner similar to the way assets are invested in private plans.

The Staggers Act was part of a broader initiative that loosened federal regulation of the nation's major transportation systems—the Airline Deregulation Act of 1978, the Motor Carrier Act of 1980, and the Staggers Rail Act for railroads. Deregulation ushered in a dramatic decline in railroad rates—rates on average were cut in half—and a dramatic rise in railroad profits (Figure 1.1). The explanation was a dramatic rise in productivity due to industry consolidation, the abandonment of uneconomic lines, the growth of long-haul coal and intermodal traffic, and a far more intensive use of a “right-sized” railroad system (Caves, Christensen, and Swanson 2010–2011; Martland 2012; Stover 1997).

While the Staggers Act rejuvenated the railroads, it inadvertently undermined the fragile finances of the industry's retirement program. Railroad Retirement was a pay-as-you-go plan, with benefits financed by a tax on current payroll. The ratio of beneficiaries to workers is

**Figure 1.1 Rail Industry Return on Investment: Before and After the 1980 Staggers Act**



SOURCE: Association of American Railroads (2011).

critical to the health of such programs, and by 1980 the ratio had become decidedly worrisome. The number of beneficiaries had more than doubled since 1950, while the number of workers had declined by well over half. So taxes on each active worker in 1980 funded the benefits of two beneficiaries, up from just 0.3 in 1950. The decline in railroad employment had nevertheless slowed in the 1970s, while the number of beneficiaries, which is relatively predictable, would slowly plateau and then trend down. But the efficiencies that the Staggers Act introduced accelerated the decline in railroad employment. By the end of the 1980s, taxes on each active worker would need to pay the benefits of 3.2 beneficiaries (Figures 1.2a and 1.2b).

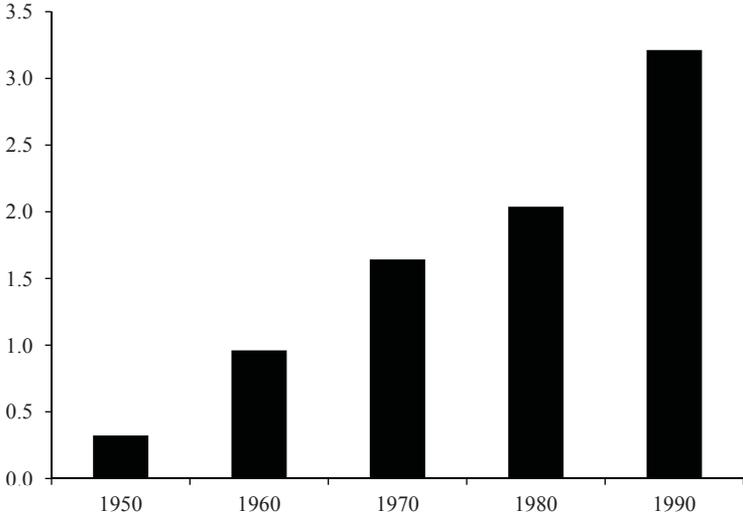
Congress responded to the rising ratio of beneficiaries to workers in 1981, raising the Railroad Retirement payroll tax on employers from 9.5 to 11.75 percent of payroll and initiating a 2 percent tax on

**Figure 1.2a Railroad Retirement Beneficiaries and Active Railroad Employment, 1950–1990 (000s)**



SOURCE: Railroad Retirement Board *Annual Reports*, various years.

**Figure 1.2b Ratio of Railroad Retirement Beneficiaries to Active Employees, 1950–1990**



SOURCE: Railroad Retirement Board *Annual Reports*, various years.

workers, in addition to the “Social Security” payroll tax employers and workers paid.

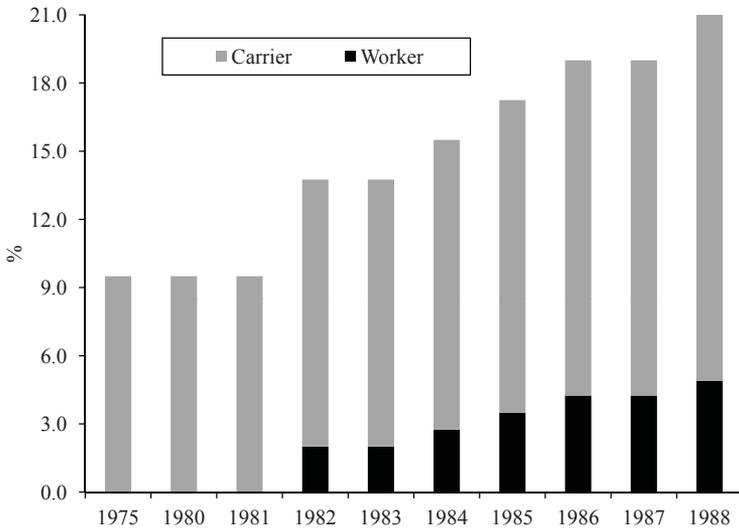
The accelerated decline in railroad employment would in time require higher Railroad Retirement taxes or lower Railroad Retirement benefits. But the sharp recession of 1980–1982 brought the crisis on much sooner. Rail employment fell below 400,000 in 1983, a 25 percent decline from its level in 1980, and the Railroad Retirement Board, the government agency responsible for managing the program, was considering a 40 percent cut in benefits (Commission on Railroad Retirement Reform 1990, p. 275).<sup>3</sup>

As it turned out, 1983 was the year Congress enacted a major reform of the Social Security program, significantly raising taxes and cutting benefits to address a large funding shortfall. Immediately after completing work on Social Security, the House Committee on Ways and Means turned to Railroad Retirement. Seeing parallels with Social Security, Ways and Means drafted a bill that significantly raised Railroad Retirement taxes and cut Railroad Retirement benefits. The legislation increased the payroll tax nearly 40 percent over three years, from 13.75 to 19 percent of payroll, raising the tax on workers to 4.25 percent and the tax on carriers to 14.75 percent (Figure 1.3). It also cut benefits. It eliminated 60/30—retirement at age 60 on unreduced Tier I benefits for workers with 30 years of service—requiring workers with 30 years of service to be at least age 62 to retire on unreduced Tier I benefits. It also eliminated Tier II survivor benefits, providing widow(er)s just a continuation of much lower spousal benefits.<sup>4</sup> Further bolstering the program, and also similar to the 1983 Social Security reform, the legislation subjected Railroad Retirement benefits to income taxation and returned the proceeds to the Railroad Retirement Account.<sup>5</sup> Section 502 of the legislation also called for the Railroad Retirement Actuary to submit an annual report on the program’s finances. Unlike most prior and subsequent reforms of the system, the 1983 changes were not the result of a labor-management joint initiative, but proposals imposed by Congress to address the severe financial crisis.

While U.S. employment recovered strongly from the sharp recessions of the early 1980s, continued declines in railroad employment renewed concerns over the finances of the Railroad Retirement program. The Office of Management and Budget (OMB) proposed another large tax increase. Rail management and labor resisted and responded by negotiating a compromise, which Congress accepted. It raised the payroll tax another 10 percent, to 21 percent of payroll, with the tax on workers rising to 4.9 percent and the tax on carriers to 16.1 percent (Figure 1.3). Congress also created a commission to examine the long-run financing of the program, including a review of other funding options.

In less than a decade, the Railroad Retirement payroll tax had gone from 9.5 percent of payroll, paid entirely by the carriers, to 21 percent of payroll, with the carriers paying 16.1 and workers 4.9 percent. It had gone from an annoyance to what Drew Lewis, Chair-

**Figure 1.3 Railroad Retirement Tier II Tax Rate, 1975–1988**



SOURCE: Railroad Retirement Board *Annual Reports*, various years.

man of the Union Pacific, called the industry’s “foremost legislative concern”—a concern that would result in a major reform of the Railroad Retirement program (Salmon 2013).

### Notes

1. While the 1934 legislation was declared unconstitutional by the Supreme Court, revised legislation passed muster (Sass 1997; Whitman 2008; Railroad Retirement Board 2010).
2. The windfall dual benefit had been an inadvertent result of Social Security’s procedure of basing benefits on the average of a worker’s indexed earnings over all years since 1950 (or their highest 35 years of indexed earnings after 1985). Workers needed 10 years of employment covered by Social Security to qualify for benefits. But earnings from 10 or more years of nonrailroad work would be averaged over the lesser of 35 years or all years since 1950, making a rail worker appear like a lower earner. As Social Security replaced a much larger share of a low earner’s wages, this procedure provided rail workers a benefit that replaced a high percentage of those average earnings, and a very generous benefit for relatively few years of covered employment.
3. Legislation enacted in 1981 had mandated a cut in benefits should the program have insufficient revenues (Railroad Retirement Board 2009, p. 7).
4. Spouses had been entitled to “spousal benefits” when the worker was alive and “survivor benefits” upon widowhood. Tier II spousal benefits were 45 percent of the worker’s Tier II benefit, and the survivor benefit was the worker’s actual Tier II benefit. Tier II benefits were partially indexed to inflation—increased by 32.5 percent of the increase in prices—and thus also lost significant value by the time most spouses became widows.
5. Prior to the 1983 acts, neither Social Security nor Railroad Retirement benefits were taxed (Commission on Railroad Retirement Reform 1990, p. 120ff.).

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## Chapter 2

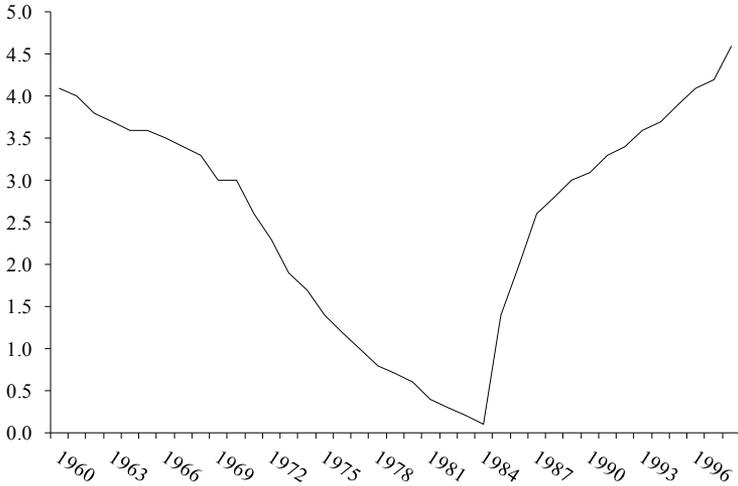
# The Appeal of Equity Investment

The government-run Railroad Retirement program is a clear anomaly in the U.S. economic landscape. In the late 1980s, many government officials would have gladly returned the program, with its financial, administrative, and political burdens, back to the private sector. The OMB even drafted a bill in 1988 to do just that. As the fortunes of the railroads revived in the 1980s, and as the Railroad Retirement payroll tax exploded and Railroad Retirement assets rebounded (Figure 2.1), officials in Lewis's Union Pacific also grew interested in reform. They saw investing in equities as a way to reduce the cost of the program and viewed privatization as the only way that this could be done. By the late 1980s, officials in the Union Pacific tax department had sketched out a plan.<sup>1</sup>

### THE APPEAL OF PRIVATIZATION

Privatization was complicated. Would existing workers and beneficiaries be transferred to the new private program? Would a privatized program retain unique “government” features, specifically the return of income taxes on benefits? Could the industry extract a price for assuming this federal government liability, especially liabilities it viewed as unfair impositions, such as windfall dual benefits, and for having been forced to invest assets in the Railroad Retirement Account in low-yielding government bonds? How would the program be managed? And how would the transition occur?<sup>2</sup>

The Union Pacific plan of the late 1980s was hardly fully developed. But the outlines were clear. It would establish a standard, industrywide, collectively bargained, multiemployer plan for new hires while existing workers and beneficiaries would remain in a “legacy Tier II” program. The assets of the new plan would be invested as the assets in any private plan; the assets of the legacy program would

**Figure 2.1 Railroad Retirement Accounts-Benefits Ratio**

SOURCE: Railroad Retirement Board *Annual Reports*, various years.

continue to be invested in government bonds. The plan, not surprisingly, also called for the continued return of income taxes on Railroad Retirement benefits and government “restitution” payments for the unfair burdens it had imposed on the program in the past. The plan would also continue current tax/contribution rates, on both new and existing workers, with amounts in excess of ERISA funding requirements for the plan for new hires “taxed” and transferred to the legacy Tier II program. When the legacy program was “fully funded”—when assets in the legacy Railroad Retirement Account equaled the present value of legacy Tier II obligations—the transition to a privatized Railroad Retirement would be complete.

Key elements of the Union Pacific design won the endorsement of the Commission on Railroad Retirement Reform, which the compromise 1987 legislation had established to examine the program’s long-run financing options. The commission’s 1990 report, however, also included recommendations opposed by the carriers (a change

in the way payroll taxes were calculated) and labor (cuts in early retirement benefits and a more stringent disability program). As neither management nor labor supported the commission's package of reforms, the industry did not approach Congress urging enactment of its recommendations. The commission report also declared Railroad Retirement financially healthy, so there was no need for action. The commission's recommendations thus were never considered by Congress.<sup>3</sup>

The appeal of privatization nevertheless persisted in the tax department of the Union Pacific and with senior tax professionals at other railroads. The focus at Union Pacific was to lower the cost of the program. Others in the industry saw the program producing large future surpluses as the large number of legacy pensioners died off and the tax rate remained unchanged, which would be costly and invite demands from labor for increased benefits.<sup>4</sup>

However, senior rail management and the staff in the industry trade association, the Association of American Railroads (AAR), were cautious. Going to Congress was risky. Industry leaders, moreover, were primarily concerned with the mergers then consolidating the nation's major freight carriers into four giant roads, and with the resulting complications in relations with unions and government regulators. By reducing the number of major players in the industry, the mergers in time would simplify the task of forming a carrier consensus on reforming Railroad Retirement. But launching a major initiative to privatize the pension program while the mergers were under way would only complicate these high-stakes maneuvers, especially with labor (Salmon 2013, pp. 19–20).

In 1995, a path forward opened. The Social Security Advisory Council was then considering major reforms to close Social Security's long-term financing shortfall, including "privatization" measures such as the creation of individual accounts and the investment of Social Security Trust Fund assets in equities. Any such reform would likely affect government policy on Railroad Retirement. So rail industry tax officials used this development to pressure the AAR

to review the carriers' positions on the industry's pension program. Like most industry trade associations, the AAR was risk adverse and reticent to take on controversial initiatives without broad support. But given the attention on Social Security reform, it authorized the development of an updated industry position on Railroad Retirement in January 1995 (Salmon 2013, p. 12).

Responsibility for developing the industry position fell to the AAR Tax Policy Committee, led by Jim Hixon of Norfolk Southern. Hixon in turn created a Tax Working Group (TWG) to develop a plan. The group's key members included Hixon, Union Pacific's Bernie Gutschewski, Jim Peter of CSX, Dan Westerbeck of what would become BNSF, and two key contributors to the Union Pacific's work on Railroad Retirement, lawyer John Salmon of Dewey Ballantine and economist Randy Weiss of Deloitte & Touche.

The TWG essentially adopted the Union Pacific plan, adjusted to function as the opening position in a negotiation. For example, the proposal it developed would transfer to the government the program's "excess Tier I" benefits—benefits based on the Social Security benefit formula but far more generous than what Social Security provides. Excess Tier I benefits were expensive. They included items such as retirement on full benefits at age 62 with 30 years of service, as opposed to full benefits only available at Social Security's "Full Retirement Age" of 65; and "occupational" disability, which granted benefits to workers unable to perform their occupational tasks, even if capable of working in some other occupation. The working group knew the government would likely balk at the transfer, but it wanted to remove these issues in any initial negotiations with labor, which would inevitably come before any negotiation with the government, to clear the decks to discuss privatizing the Tier II program. And there was always the outside chance that the government might accept a portion of these benefit obligations (Salmon 2013, pp. 12–18).

## COURTING LABOR

The path forward again opened in 1997. As part of an interim compromise in a contentious dispute over occupational disability benefits, the rail unions had agreed to meet with management to discuss Railroad Retirement issues. The meeting took place during a break in the scheduled program at rail labor's winter meetings. At that meeting, Hixon and Salmon from the TWG highlighted threats to the status quo—initiatives to reform Social Security, the shift from traditional employer pensions to 401(k)s, and the high cost of the Railroad Retirement program. Then they explained the virtues of privatization—how the higher returns on assets could lower the program's cost and the taxes paid by labor and management. The assembled union officials sat through the presentation and, by prior agreement among themselves, made no comments and left the room without asking any questions (Salmon 2013, pp. 21–23; TWG 1995).

Labor had little interest in management's proposal. The carriers' primary interest in Railroad Retirement was cost, and the primary argument for privatization in the TWG presentation was a reduction in cost. Labor's primary interest was benefit security. Railroad Retirement benefits were statutory, defined in an act of Congress. The law stipulated that benefits would be cut if revenues were insufficient, but the program was financially sound; the carriers paid most of the bill; and labor was confident that Congress would shore up the program if need be. Labor was also concerned that going to Congress with such a radical proposal risked a review of the existing benefit package, specifically, excess Tier I benefits that the 1990 Commission on Railroad Retirement Reform had recommended be eliminated. Thus, labor saw no reason to accept a modest tax cut in exchange for the far less certain benefits of a private plan and risk revisions in the legacy program (TWG 1995).<sup>5</sup>

The one element in management's presentation that did intrigue some in labor was the investment of Railroad Retirement assets in equities. Most union pension funds invested in equities. Equities had

been stellar performers over the past two decades, with annual returns averaging over 13 percent above inflation (Figure 2.2). So while “past performance is no guarantee of future performance,” many union officials were quite comfortable with investing the program’s assets in equities.<sup>6</sup>

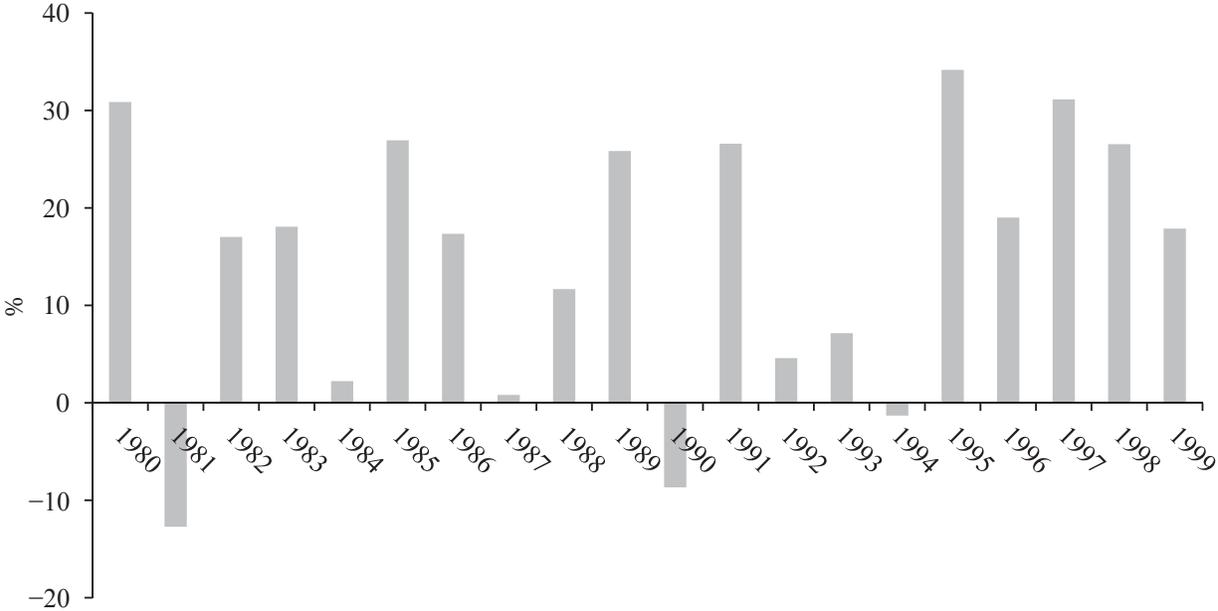
The turning point came when labor saw the “gain” from investing in equities as increased benefits, not lower taxes. Labor specifically targeted a restoration of two key benefits lost in the 1983 reform: retirement on full benefits at aged 60 with 30 years of service and, secondarily, more ample survivor benefits for widow(er)s.

A catalyst that brought the two sides together was a September 17, 1998, congressional hearing on a resolution that urged rail labor and management to negotiate improved benefits for the 250,000 widow(er)s that the program supported—30 percent of program beneficiaries (U.S. Department of Health and Human Services 1994).<sup>7</sup> While the hearing focused on an expansion of benefits, a union representative was explicitly asked whether he could “support a change in Tier II investment policies to allow for equity investment to increase the rate of return on fund assets” (Salmon 2013, pp. 23–25).

With both sides seeing the value of investing in Railroad Retirement assets in equities, the negotiations began. What followed was the standard labor-management kabuki dance, with each side sending out highly stylized messages, wary of giving too much and getting too little. Thus C. V. Monin, International President of the Brotherhood of Locomotive Engineers, wrote the Subcommittee on October 1,

The carriers indicated they wanted to discuss survivor benefits only as part of Labor/Management dialogue on all aspects of railroad retirement. My experience is that we can succeed in reaching a quick agreement to improve survivor benefits only if we stay focused on that issue and not muddy the waters by including all other issues. However, Rail Labor stands ready to discuss any and all aspects of the railroad retirement system so long as those discussions are aimed at preserving and protecting the solvency and stability of our retirement program.

**Figure 2.2 Real Return on Equities, 1980–1999: Large Company Stocks**



SOURCE: Morningstar (2013).

If the railroads truly want to open all aspects of the railroad retirement system to new Labor/Management dialogue, they should be aware that Rail Labor has a number of items to include on the discussion agenda. (Quoted in Salmon [2013], pp. 25–27.)

To which Edward R. Hamberger, President and Chief Executive Officer of the Association of American Railroads, responded on October 30,

As I stated in my testimony on September 17, AAR stands ready to discuss opportunities for improving our legislated retirement plan with rail labor and has made several overtures over the past two years to initiate such discussions ...

AAR and its member companies believe that out of such discussions might grow opportunities to lower the substantial payroll tax burden now carried by all railroad taxpayers, both employers and employees, while at the same time maintaining the value of the total package of benefits provided to covered participants. Only within the context of general discussions is this desirable outcome a real possibility. The importance of a broad consideration is heightened by the potential for major legislative changes in the Social Security system, which would inevitably affect Railroad Retirement. (Quoted in Salmon [2013], pp. 25–27.)

## **NEGOTIATING REFORM**

On December 9, 1998, the two sides met, and labor, for the first time, was now actively engaged in the negotiating process. Labor emphasized that benefit security was its paramount concern, expressed clear opposition to privatization, and put its benefit demands on the table. Labor also indicated its seriousness by asking for details about management's projections, informing management that it would be securing its own financial advisor, and asking that the actuary at the Railroad Retirement Board be available as an impartial resource (Salmon 2013).

The basic outline of a deal soon emerged, and it was dramatically different from management's original proposal. There would be no new private plan. Labor insisted that Railroad Retirement remain a government program with "statutory" benefits. But there would be equity investment, with Railroad Retirement assets invested much like the assets in private employer plans. The assets would be managed by a nine-person board composed of three management, three labor, and three public trustees from the Railroad Retirement Board. And the expected gains from the higher return on equities would provide tax cuts for management and enhanced benefits for labor.

While the outline was clear, closing the deal was hardly straightforward. Labor and management had to agree on the size of the gain, how to divide it, and how to divide the risks that equity investment entailed. These issues were complex and interconnected. There was no guarantee that a deal could be struck that gave each side enough of what it needed. For the negotiations to proceed, each also had to separate the other side's opening gambits from their basic demands, give up their own gambits and bargain in "good faith," and trust the other side to respond in kind. The negotiations began with management proposing and labor reacting. A tactically aggressive management proposal, put forward by management at a June collective bargaining session, nearly derailed the process, as labor felt a lack of "good faith" reciprocity. But labor regrouped, responded with counter-proposals, and the negotiations went forward (Salmon 2013).

Assessing the size and timing of the gain shifted fundamentally when privatization was taken off the table. The gain was no longer a reduction in the cost of the program at some point in the future. It would now be immediate or near-term tax reductions and benefit enhancements, consistent with maintaining an "adequate" balance in the Railroad Retirement Account. By the mid-1990s, assets in the Railroad Retirement Account had risen above four times annual benefit outlays for the first time since 1961 (see Figure 2.1). The negotiators thus defined an "adequate" balance as assets at least equal to four

times annual benefits. The ratio of assets to outlays was projected to rise over the next decade; turn down in the 2010s and 2020s, with railroad employment and payroll tax revenues falling faster than benefit outlays; and then rise sharply as current beneficiaries died off. So the key question in determining the size of the “gain” became how much taxes could be cut or benefits increased and still have assets equal to four times benefit outlays in the 2010s and 2020s as the “watermelon passed through the snake”—as the gap between outlays and tax receipts widened and had to be filled with transfers from the Railroad Retirement Account.

The next question was how to divide the gain. Each side made reasonable claims. Management, noting it paid over 75 percent of the program’s cost, sought a comparable share of the gain. Labor viewed the payroll taxes paid by the carriers as part of “labor compensation” and claimed the entire gain to avoid a cut in compensation. But before push came to shove, each side settled for a 50-50 split (Salmon 2013).

The negotiators then had to agree on the cost of the desired benefit enhancements, and whether the gain would be large enough so that half the gain would be enough to pay for these enhancements. Most troublesome was the restoration of 60/30, labor’s key demand. It was by far the most expensive benefit enhancement, and by far the most difficult to price.<sup>8</sup> The cost, in terms of benefits paid and revenues lost, depended on how many workers would in fact retire early. The cost estimates were necessarily rough, and predictable differences of opinion on the assumptions used in these estimates complicated the negotiations. Labor also demanded a parallel extension of retiree health coverage, a benefit not provided by Railroad Retirement but included in the collectively bargained labor contract. Moreover, two unions insisted on 55/30—retirement on full benefits at age 55 with 30 years of service—an extremely expensive proposition. The carriers rejected 55/30 out of hand because of concerns about disruptive skill shortages as well as its cost. The remaining 11 unions wanted 55/30. But they recognized that the funds available were simply too small to afford it, without risking the stability of the system. They focused

instead on restoring 60/30, which the actuary's analysis demonstrated was an achievable goal without putting long-term solvency at risk.

Then there was risk. Along with their higher expected returns, equities were riskier investments than government bonds. The "tax adjustment mechanism," which had been a key element in management's privatization designs, emerged as the program's critical risk-management tool. The tax adjustment mechanism, or "ratchet," had been the device in the privatization proposals that reduced the 21 percent payroll tax in the transition to a private plan. In the initial Union Pacific design of the late 1980s, it merely eliminated the existing 21 percent payroll tax when the legacy Tier II program was "fully funded," leaving just the required ERISA contribution for the new privatized plan.<sup>9</sup> The 1995 TWG design modified the ratchet to kick in sooner and provide a more gradual transition to privatization. It would establish a target "account benefits ratio"—the ratio of assets in the Railroad Retirement Account to annual benefit outlays—and cut the payroll tax when the ratio exceeded that target (TWG 1994, 1995). Now that Railroad Retirement would not be privatized, the ratchet became the mechanism for keeping the account benefits ratio within a target band. Taxes would still be cut should Railroad Retirement Account assets exceed the band's upper bound, which would be set at six times annual outlays. But taxes would rise should assets fall below a lower bound—the four times annual outlays the negotiators had agreed would be the minimum "adequate" Railroad Retirement Account balance.<sup>10</sup>

The negotiators then had to decide how this risk would be shared. Labor's position was simple: it insisted on the "division" of risk found in collectively bargained private plans, with management bearing all the risk and workers none. Labor, in other words, was unwilling to see benefits cut or the tax on workers raised should the account benefits ratio fall below four times annual outlays. Management's position was also simple: it saw a direct connection between risk and reward as a basic principle of finance. So if the carriers took all the risk, they claimed they should get all the reward. Management thus responded

to labor's "no risk" demand with an offer in which they took all the risk and got nearly all the gain.<sup>11</sup>

The ratchet would also be the mechanism for reducing taxes after the watermelon had passed through the snake, when the account benefits ratio was expected to rise above six times benefit outlays. To split the gains of reform 50-50, the unions insisted that those tax reductions also be split 50-50.<sup>12</sup> Should the ratio subsequently fall, the unions agreed that the tax on workers could increase up to the current 4.9 percent rate. But they insisted that reductions for the carriers cease should the tax on workers fall to 0, setting a floor of 8.2 percent on management's payroll tax.

Recognizing that this conflict over risk sharing was the key impediment to reaching a deal, the carriers ultimately agreed to labor's demands. But they insisted on a cap: that the ratchet could not push their tax above a specified level, which would be set at 22.1 percent of payroll. So there would be a limit on how high or low the ratchet could set taxes—from a low of 8.2 percent, with the carriers paying the entire amount, to a high of 27 percent, with the workers paying 4.9 percent and the carriers the rest. On either side of these limits, should a 27 percent payroll tax be "too low" or a 8.2 percent tax be "too high," risk management and the financing of Railroad Retirement would no longer be automatic but would require a renegotiation of the program and a change in the law by Congress.

Estimating the size of the gain, the cost of benefits, the risks to the program's finances, and the risks each party would bear, using a variety of reasonable assumptions, presented the negotiators with an exceedingly confusing "Rubik's cube" of options.<sup>13</sup> They would need to decide on various technical details, such as when the new program with its lower taxes and higher benefits would start, how the account benefits ratio would be measured, and how the ratchet would raise and lower taxes when that ratio strayed beyond the target band of assets to outlays. The later the program would start, the greater the program's initial level of projected assets and asset income. To avoid controversies and to avoid sharp changes in the payroll tax,

the negotiators agreed to measure the account benefits ratio as the average ratio over a number of trailing years. The finances of pension plans are typically guided by forward-looking actuarial projections, not backward-looking trailing ratios. But trailing ratios are objective data, whereas actuarial projections involved judgments that could invite disputes. Basing tax rates on actuarial projections could also raise constitutional issues, as tax rates would be effectively set by actuaries in the executive branch, not by Congress, as constitutionally required.<sup>14</sup> The ratchet also based tax rates on multiyear averages to dampen volatility: neither management nor labor wanted a system in which taxes could change each year. Both saw averaging as affecting the timing of taxes paid to fund the program—primarily taxes on the carriers, which bore the primary burden for funding Railroad Retirement—but not affecting obligations to fund the system.

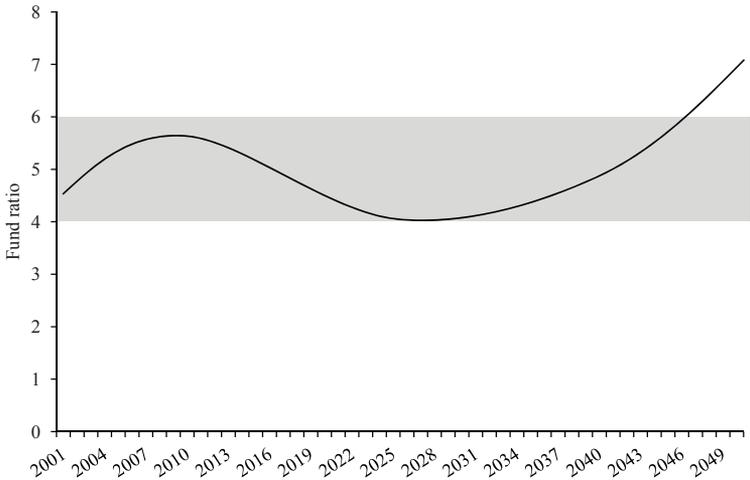
The availability of the Railroad Retirement Actuary as an impartial resource was a critical contributor to success of the negotiations. The actuary ran projections of different Rubik's cube combinations that both sides could accept, assuming both accepted the assumptions the actuary used. The negotiations were also greatly simplified with the announcement, in the actuary's August 1999 annual Section 502 report to the Railroad Retirement Board, that railroad employment was, and would likely be, higher than previously projected. Rail employment was hard to predict, with projections ranging from a mild to a dramatic decline over time. With payroll taxes as the dominant source of Railroad Retirement revenues, assessments of the size of the gain and the risks to the program were critically dependent on the actuary's employment projections. The updated August 1999 projections now indicated that a deal could be reached.

The actuary's projections had never shown that a 50-50 split of the gain could support 55/30—retirement on full benefits at age 55 with 30 years of service—except assuming very low rates of early retirement. Projections based on the August 1999 data did not change that assessment. They did, however, indicate that the program could support 60/30 in most scenarios if the transition were delayed just

a few years. Labor could then get its benefit enhancements and the carriers a 3 percent reduction in their payroll tax. Stress tests showed these reforms to be capable of negotiating the “watermelon in the snake” using the actuary’s optimistic projection of railroad employment (Figure 2.3) and likely able to produce enough revenue to pay promised benefits using the intermediate employment projection. As actual rail employment had tended to conform to the actuary’s optimistic projections, the negotiators were generally comfortable with these results. While 2 unions continued to hold out for 55/30, the other 11 decided to go forward without the two holdouts.

The actuary, however, was not so sanguine. Actuaries by training tend to be very cautious, and estimates using the pessimistic employ-

**Figure 2.3 Projected Account Balances under the Industry Reform Proposal, Optimistic Employment Projection**

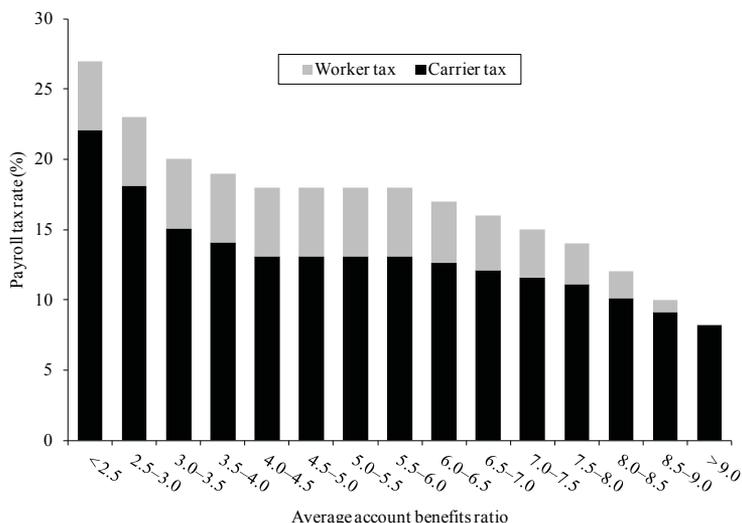


NOTE: Assumes return on investment of 2 percentage points higher than current RRB actuarial assumption of 6 percent. Assumes initial benefit increases and employer tax reductions per agreement. 20th valuation, Assumption 1. Average fund balance for 1960–1998 is 2.6 years. The number of years 1960–1998 with balance of 4 or more is 4.

SOURCE: Salmon (2013).

ment projection did not do well. That projection had rail employment falling nearly two-thirds by the middle of the century, to a seemingly implausible level well below 100,000. Neither Congress nor the unions, however, would sign off on a deal that the actuary thought too risky, so an urgent negotiation ensued. To avoid sharp changes in tax rates, the negotiators had designed a ratchet that measured the account benefits ratio as the average ratio over the previous 10 years. This backward-looking average slowed the ratio’s decline as the current ratio of assets to outlays fell below the target lower bound of four times annual outlays. To make the mechanism more responsive, in the event of potential adverse shocks, a revised proposal increased the size of the tax increments to the schedule shown in Figure 2.4. The ratchet still failed to produce sufficient revenues in stress tests using the “pessimistic” employment projection, but it gave management,

**Figure 2.4 The Tax Adjustment Ratchet**



NOTE: Railroad retirement payroll tax is based on a 10-year average ratio of assets to annual outlays.

SOURCE: Railroad Retirement and Survivor’s Improvement Act (2001 Section 204).

labor, and Congress more time to respond to shortfalls identified in the required annual five-year projections of the program's finances, which was enough for the actuary to allow the plan to proceed.

So the deal on the table was set. The carriers would get a three-percentage-point reduction in their payroll taxes. Labor would get early retirement on full benefits with 30 years of service, enhanced health insurance for early retirees, enhanced survivor benefits, and five-year vesting.

Labor, for the most part, accepted the deal. The two unions that insisted on 55/30—the Brotherhood of Maintenance and Way Employees and the Brotherhood of Locomotive Engineers and Trainmen—did not, but the rest were satisfied with their portion of the gain.

The management negotiators reviewed the deal with senior management, outlining the benefits and risks in a reformed Railroad Retirement program. If the projections illustrated in Figure 2.3 prove accurate, the cut in the carriers' payroll tax from 16.1 to 13.1 percent would generally remain in place even in the challenging years in the near future. The carriers' tax rate could rise—not above 22.1 percent—but tax rates should fall, possibly below 10 percent by the end of the twenty-first century, after the near-term demographic costs of the current retiree imbalance are resolved. These tax rates would also change automatically, without contentious negotiations with labor or the troublesome involvement of Congress. The carriers would bear all the risk of funding shortfalls. The most likely cause of a shortfall, however, was a sharper than expected employment decline. Such a decline could offset much or all of the increase in the payroll tax rate, so that the carriers' total tax (employment  $\times$  average earnings  $\times$  the payroll tax rate) might not increase much, or at all. To the degree that employment declines reflect increased efficiency and profitability, the ratchet in fact reduced the carriers' risk: it adjusted the tax rate in line with the carriers' ability to pay. For some or all of these reasons, the carriers also agreed to go forward.

In January 2000, rail management and a majority of rail unions reached an agreement in principle and agreed to go to Congress and

jointly support these negotiated increases in Railroad Retirement benefits, cuts in Railroad Retirement taxes, and the investment of Railroad Retirement assets in equities (National Railroad Retirement Investment Trust [NRRIT] 2002; Salmon 2013).

### Notes

1. For a description of the OMB plan, see Commission on Railroad Retirement Reform (1990, pp. 186–188); interview with Randy Weiss, April 10, 2013; a version of the Union Pacific plan was also presented to the commission by the “Regional Railroads of America.”
2. For a discussion of these complications, see Commission on Railroad Retirement Reform (1990, pp. 184–200).
3. For the commission’s recommendations, see Commission on Railroad Retirement Reform (1990, pp. 2–15). Also see Salmon (2013, pp. 12–13).
4. James Hixon, interview with the author, January 6, 2012.
5. Joel Parker, interview with the author, January 29, 2012.
6. Joel Parker, interview with the author, January 29, 2012.
7. In 1993, retired and disabled workers accounted for 45 percent and spouses 55 percent of program beneficiaries.
8. Labor also sought enhanced Tier II survivor benefits, but far less vigorously than sweetened early retirement benefits. Survivors at the time just received a continuation of their spousal benefit, based on half of the worker’s benefit. The labor negotiators would settle for a survivor benefit equal to the higher of the worker’s benefit—not indexed to inflation—or the existing spousal benefit, which was indexed to inflation. In part because the survivors’ alternative benefit was not indexed to inflation, this benefit change was much less expensive than sweetened early retirement benefits. Labor also demanded five-year vesting, which was now required of all private plans. But the additional cost of vesting workers with rights to pension benefits after 5 years of service, over the existing requirement of 10 years of service, was small.
9. What tax or contribution would replace the 21 percent payroll tax to cover the “normal cost” of any remaining active legacy employees or to respond to adverse shocks to the funded status of the legacy program was not worked out in the early Union Pacific design.
10. By setting a four-year reserve as the lower bound, the system was designed to have significantly higher reserves than found in national pay-as-you-go social security programs.

11. This was the proposal, cited above, that the unions viewed as a sign of “bad faith.”
12. There was some interest on labor’s side to convert tax reductions the ratchet produced into higher benefits. But consensus opted for tax cuts, at least initially, to avoid introducing benefits the program might not be able to maintain. All parties agreed that this was something labor and management could renegotiate at a later date.
13. John Salmon’s apt description.
14. Randy Weiss, interview with the author, April 10, 2013.

## Chapter 3

# The Railroad Retirement and Survivors' Improvement Act of 2001

Railroad Retirement is a unique institution, and reforming the program typically follows a unique process. Railroad Retirement is the employer pension program of rail workers, who are largely private sector workers, and the program is funded by taxes paid solely by these workers and their employers. It is also a federal government program, and reforms are thus typically initiated by the private sector parties, in negotiations between rail management and labor, who then bring their proposals to Congress for enactment (Szymendera 2011). The 2001 reform largely followed this script.

### INSIDE THE BELTWAY

After negotiating their agreement, in January 2000 rail labor and management went to Congress, but getting their deal enacted was hardly straightforward. There was concern that the proposed bill lowered the age that rail workers could claim full benefits while Social Security's full benefit age was rising, and many reformers were urging an even higher age. The government's accounting authorities also wanted to score the exchange of the government bonds in the Railroad Retirement Account for private securities as a deficit-widening government expenditure, which almost killed the reform. The major resistance, however, came from Republican lawmakers and pundits who characterized the reform as a dangerous and ill-advised political boondoggle.<sup>1</sup>

Viewing Railroad Retirement as a private plan, these critics saw raising benefits and cutting taxes as a crazy response to "a \$40 billion unfunded liability" (Novak 2001a,b). Viewing Railroad Retirement as a government program, they saw these higher benefits and lower

taxes as busting the budget, adding \$7 billion to the federal deficit over the next 10 years.

The sharpest complaints, however, focused on the investment of Railroad Retirement assets in equities. The policy, critics claimed, exposed the program to two types of risk: the financial risk in equity investment, and the risk of political influence on investment decisions. The critics claimed the proposal used the high expected returns on equity investment to “make up for lost revenue [and increased benefits]” but ignored the increased risk (John 2000, p. 1). They viewed this arbitrage—selling bonds to buy stocks, effectively “borrowing money from the public and then getting a higher rate of return through private investment”—as a pointless shell game. More serious, they viewed the investment of government assets in equities as crossing a critical redline in the government’s involvement in the private economy. They feared it would allow “political appointees and government bureaucrats” to advance their political and social agendas, which would degrade investment performance and, much worse, distort the democratic political process (John 2000, p. 2; Novak 2001a,b). The record of state and local pension plans, and the plans of other nations, were full of examples of such adverse political influence (see Brown, Pollet, and Weisbenner [2009]; Munnell and Sundén [1983]; Palacios [2002]; Sass [1992]).

Given the relatively modest importance of Railroad Retirement in the larger scheme of things, the attack was far more intense than one might expect. The real political and policy issue, however, was Social Security, not Railroad Retirement. Reforming Social Security was a major initiative of the new Bush Administration, whose key proposal was to allow workers to direct a portion of their payroll taxes to personal retirement savings accounts in exchange for a reduction in their future Social Security retirement benefits (President’s Commission to Strengthen Social Security 2001). This would shift the assets financing future Social Security–equivalent retirement income from the government bonds in the Social Security Trust Fund to equities and other securities in these personal accounts. Proponents argued

that this would increase national saving and raise the return on "Social Security" assets, which, of course, was precisely what the proposed shift in Railroad Retirement assets would do. So the problem was not so much arbitrage and shell games but how retirement assets and their investment in equities would be managed.

The Democrats under President Clinton had proposed investing a portion of Social Security's \$2 trillion Trust Fund, perhaps 40 percent, in stocks (Clinton 1999). The Democrats were confident they could eliminate political influence on the Trust Fund's investment decisions; the Republicans were just as confident they could not. It would be "almost impossible," according to Alan Greenspan, "to insulate investment decisions from political interference" (quoted in John [2000]). And the specter of political influence over the Social Security Trust Fund, 100 times larger than the Railroad Retirement Account, made the investment of Railroad Retirement assets in equities abhorrent. "Giving bureaucrats the power to invest huge amounts of [Railroad Retirement] money in the stock market would create a fundamental conflict of interest between the long-term needs of future retirees and short-term political goals. If this model were extended to Social Security's trust funds, the door would open for government ownership of a significant portion of the economy" (John 2000, p. 2).

## **MEETING THE CHALLENGE: BUDGETARY ACCOUNTING**

Accounting should not influence policy, but it does. When the industry went to Congress, the initial judgment of the government's budgetary authorities, the Congressional Budget Office (CBO) and the OMB, was that the proposed sale of government bonds and purchase of private securities by the Railroad Retirement program should be scored as current government expenditure. Initial CBO estimates projected the size of the expenditure, and thereby the increase of the size of the federal deficit, at \$15.3 billion (CBO 2001). Because this almost killed the proposal, the Railroad Retirement reformers had to devise a workable alternative.

Selling Treasuries and buying private securities of equal value would not be considered expenditure in “normal” accounting—the transaction would affect neither the income statement nor the balance sheet—but government accounting is not normal. It is *cash* not *accrual* accounting. It does not distinguish between the purchase of *consumption* items that will be used within a year, such as copy paper or a welfare payment, and the purchase of *investment* items, such as a battleship with a 50-year life expectancy. Expenditures on copy paper and expenditures on battleships are both recorded as current expenses. Normal accrual accounting, by contrast, would depreciate the cost of the battleship over its 50-year life expectancy and consider only a portion (say, 1/50th) as a current expense. This is considered good practice, as it records an expense when a purchased good or service makes an economic contribution. But, for a variety of reasons, among them the difficulty of determining the useful life of many government purchases, government accountants have adopted the simple cash accounting framework.

Consistent with cash accounting, OMB Circular A-11 instructs government accountants to “treat an investment in non-U.S. securities (equity or debt securities) as a purchase of an asset, recording an obligation and an outlay in an amount equal to the purchase price in the year of the purchase” (OMB 2012, p. 2 of Section 113). According to this procedure, the purchase of private securities for the Railroad Retirement program would be booked as current government expenditure.

Government accounting also would not offset this outlay with the sale of Treasuries of equivalent value. OMB Circular A-11 instructs government agencies to treat Treasuries as equivalent to cash, and the purchase or sale of Treasuries “as a change in the mix of asset holdings rather than as a purchase or sale of assets” (OMB 2012, p. 3 of Section 113). Buying private securities is an expenditure; selling Treasuries is a nonevent. Assuming the Railroad Retirement Trust would retain about 20 percent of its assets in Treasuries and use the

proceeds from the sale of the remainder to purchase private securities, the CBO came up with its \$15.3 billion expenditure figure.

Whatever the rationale for cash-basis accounting for general government operations, it made little sense for a pension plan. Government accounting prior to 1969 had in fact separated the accounts of Social Security from the rest of the budget. The finances of Social Security are still addressed independently of the accounts of general government operations in the annual Social Security Trustees Report. Since 1969, however, government accounting included Social Security in the federal unified budget and reported its operations, as part of the government's unified operations, on a cash accounting basis. For decades government accounting thus reported Social Security running surpluses—while the actuarial projections in the trustees' reports showed increasingly serious financial trouble.

The railroad team negotiating with Congress recognized the political impediment this accounting treatment created. As it turned out, cash accounting was not universally applied in government accounting. In the Credit Reform Act of 1990, Congress specified by statute that direct student and home loans be treated as a means of financing, so extending such loans (i.e., buying such loans) would not be recognized as a current budgetary outlay. The railroad team succeeded in getting similar treatment for Railroad Retirement investments in private securities. To prevent the sale of Treasuries and purchase of private securities from creating a budgetary deficit—an accounting illusion that disguised what in effect was an exchange of assets of equal value—the 2001 legislation specified that purchases of private securities by the Railroad Retirement program be scored as a neutral “means of financing” (Salmon 2013).<sup>2</sup>

With the treatment of securities purchases settled by statute, the CBO and OMB specified the reporting of annual investment income. The budgetary offices required interest, dividends, rents, and realized and unrealized capital gains be recorded as government revenue—or a government outlay should capital losses exceed interest, dividend,

and rental income. These amounts, however, were not expected to significantly affect the government's reported deficit (or surplus).

### **MEETING THE CHALLENGE: FINANCIAL AND POLITICAL RISKS IN EQUITY INVESTMENT**

The primary concerns of Congress were the financial and political risks in equity investment. Because stocks are far riskier than bonds, investing Railroad Retirement assets in equities raised the prospect of large, unexpected changes in the program's finances. The proposal that the reformers brought to Congress, however, included the automatic adjustment ratchet that raised and lowered payroll taxes in response to such shocks. The inclusion of this automatic adjustment mechanism was critical in easing concerns about investing Railroad Retirement assets in equities. It also allowed Congress to distance itself from resetting Railroad Retirement taxes and benefits in response to future shocks, which had been a poor use of congressional time and resources.

The major concern of Congress, however, was the risk of political influence on investment decisions. The major changes it made to the industry plan thus addressed that risk. To minimize the risk of political influence, Congress removed the government as much as possible from the management of Railroad Retirement assets. Thus the industry had proposed a nine-person board of trustees to manage those assets, with three trustees selected by the carriers, three by labor, and the other three being the three members of the Railroad Retirement Board. Congress removed the three Railroad Retirement Board representatives, as the Board was a government agency. The final statute specifically stated that "no member of the Railroad Retirement Board shall be eligible to be a member of the Board of Trustees." The organizations representing labor and management, as specified in the Railway Labor Act, would select the six private sector trustees. Then they, not the government, would select a single "independent" (not "public") trustee.<sup>3</sup>

Congress also created a new entity to hold and manage Railroad Retirement assets—the National Railroad Retirement Investment Trust (NRRIT)—and moved it out of the government. The statute clearly stated that the NRRIT “is not a department, agency, or instrumentality of the Government of the United States.” Congress also named the NRRIT a “trust” to more closely track the structure of private sector pension trusts and “make the investment aspects of the proposal sufficiently ‘less governmental.’”<sup>4</sup>

Private sector pension trusts themselves had problems with “political influence” on investment decisions—with the plan’s company or union sponsors, or executives within those entities, investing pension assets in ways that advanced their interests, not the interests of the plan participants. A major contribution of ERISA was to impose strict new fiduciary standards on the sponsors and managers of private pension plans. Congress now borrowed freely from ERISA to impose similar requirements on the NRRIT. The Railroad Retirement and Survivors’ Improvement Act (RRSIA) required the new Investment Trust to act “solely in the interest of the Railroad Retirement Board and through it, the participants and beneficiaries of the programs funded under this Act.” This language specifically forbade any other objective, such as advancing the interests of the carriers or unions—interests ERISA sought to exclude. It also prohibited the advancement of other social or economic goals, as often found in the mandates of other “public” pension programs (ERISA 1974, Section 404(a); Mercer 2011; RRSIA 2001, Section 105(a); Sass 1997; U.S. House of Appropriations Committee 2007, pp. 9–10.)

Also borrowing from ERISA, Congress required competent investment management. It couldn’t mandate investment success. But it did require trustees with professional qualifications—with “experience and expertise in the management of financial investments and pension plans”—to invest Railroad Retirement assets with “care, skill, prudence, and diligence” (the ERISA “prudent man” standard), and to diversify asset holdings “so as to minimize risk of large losses” and “avoid disproportionate influence over a particular industry or

firm”—a potentially politically problematic influence (RRSIA 2001, Sections 105(j) 3(B); 105(j)(5)(A)(ii); and 105(j)(5)(A)(iii)).

While Congress created the NRRIT as much as it could in the image of a private pension trust, Railroad Retirement remained a government program and its assets government assets. So Congress also constructed a system of government oversight. The statute required an annual audit by an independent auditor. It also required an annual report, sent to Congress, the president, the Railroad Retirement Board, and the OMB, on the Trust’s financial position, cash flows, internal accounting and control systems, and “any other comments and information necessary to inform Congress about the operations and financial condition of the Trust.” A memorandum of understanding between the Trust and the Railroad Retirement Board, the Treasury, and the OMB would also require monthly reports of gains and losses, sales and purchases, receipts and disbursements, and administrative expenses. If something was amiss, Congress authorized the Railroad Retirement Board to go to court “to enjoin any act or practice by the Trust, its Board of Trustees, or its employees or agents that violates any provision of this Act” or “(ii) to obtain other appropriate relief to redress such violations, or to enforce any provisions of this Act.” This oversight of the Investment Trust supplemented the existing reports on the financial status of the Railroad Retirement program produced by the Railroad Retirement Actuary—the annual “Section 502” report providing five-year projections of the program’s finances and the triennial actuarial valuations that provided projections over a 75-year horizon (RRSIA 2001, Section 105(j)(5)(E); Section 105(j)(5)(F); Section 108(b)).<sup>5</sup>

## **ENACTMENT**

Despite these refinements, key Republican leaders remained opposed to the investment of Railroad Retirement assets in equities. With an eye on Social Security, they saw the stakes as enormously high. Others in Congress, in both parties, were more attuned to the

unified support for reform from rail labor and management. Union and carrier representatives made joint visits to key congressmen and senators. According to Joel Parker, a lead labor negotiator, the unions organized “one of the biggest lobbying efforts by the rank and file in labor history,” with members receiving a steady stream of communications promoting the virtues of reform, with mailers they could send to their congressmen and senators. Given the popularity of 60/30 and enhanced widow(er)’s benefits, it did not take much to motivate the rank and file.<sup>6</sup>

The House passed legislation in September 2000 for what would become the RRSIA in 2001. But the Republican leadership, which controlled the Senate, was able to block the bill. The House passed essentially the same legislation in 2001 by a vote of 384 for and 33 against, and the Senate leadership again blocked the bill.

What broke the logjam was the decision by Senator James Jeffords of Vermont to quit the Republican Party, become an independent, and caucus with the Democrats. That gave Democrats control of the Senate and its schedule, which allowed the bill to come to the floor for a vote. The key vote was the vote to end a filibuster by Republican leaders, widely understood as a vote on the legislation itself. Voting yes was politically expedient, as it made rail workers, retirees, and rail management happy. Once passage seemed assured, even many Republican senators voted to end the filibuster. Reform was then enacted with overwhelming support: 90 votes for and 9 against. President Bush, unwilling to veto this clear “will of Congress,” signed the RRSIA into law on December 21, 2001 (NRRIT 2002 *Annual Report*; see Salmon [2013, Note 60], for an insightful narration of the enactment process).

## Notes

1. It should be noted that not all Republicans opposed the legislation. Bud Shuster (R-PA) and Don Young (R-AK), two senior House Republicans, supported the bill on pragmatic grounds, believing the reforms would improve the system. Without their support, the bill would not have been passed by the House of Representatives in 2000 or 2001.
2. The CBO (2003, p. 12) called this treatment “a significant departure” from traditional government accounting.
3. In 2000, the House of Representatives modified the original labor-management proposal to remove the three members of the Railroad Retirement Board as Trustees but left the Railroad Retirement Board with the responsibility to appoint all seven trustees (*Congressional Record* 2000). In 2001, the House of Representatives went further to address continuing concerns about the government retaining any role in the investment activities of the NRRIT, particularly within the Bush Administration, and transferred the power to appoint all seven Trustees from the Railroad Retirement Board to the industry. Section 105(j) (3) thus specified that organizations employing and representing at least two-thirds of all active workers covered by the Railway Labor Act select the NRRIT’s management and labor trustees (RRSIA 2001, Section 105(j)(3)).
4. Section 105(a); Salmon (2013, pp. 65, 71); Congress reaffirmed the Trust’s status as a nongovernmental entity when the Railroad Retirement Board’s Inspector General wanted to audit the Trust’s operational procedures, considered “best practice” in government audits. In rejecting that request, Congress cited its desire that “the Trust functions independently from the Railroad Retirement Board.”
5. The memorandum of understanding also outlined procedures for transferring assets between the Treasury and the Trust.
6. Interview with Joel Parker, January 29, 2012; Salmon (2013, pp. 62ff).

## Chapter 4

# An Assessment to Date of the Reformed Railroad Retirement Program

The Railroad Retirement and Survivors' Improvement Act of 2001 made four key changes in the Railroad Retirement program: it raised benefits, cut taxes, and introduced two major institutional innovations. The first such institutional innovation was the creation of the NRRIT to invest Railroad Retirement assets in equities and other private-sector securities. The second was the creation of an automatic tax adjustment mechanism, the Railroad Retirement ratchet, to keep the program's finances on track. This chapter will assess the performance of these two institutional innovations over their first dozen years in existence. The next chapter will assess the effect on rail workers and carriers of the increase in benefits, cut in taxes, and prospect of higher taxes down the road.

When enacting the RRSIA, Congress was primarily concerned with the governance of Railroad Retirement assets and risk of political influence on investment decisions. This chapter will thus begin with a review of the creation of the NRRIT and its governance of Railroad Retirement assets. It will then review the ability of the tax adjustment ratchet to keep the program on track—an unusually challenging task given the increase in benefits, reduction in taxes, and financial turbulence over the first dozen years of reform.

### CREATING THE GOVERNANCE STRUCTURE

Congress charged the rail industry to set up and run the NRRIT much like a standard private sector pension trust, which the industry was well equipped to do. Creating the governance structure of a modern pension trust is no simple task. It would take eight months to get

the Trust up and running and several more years to fully staff up and define and execute the Trust's investment program, but the roadmap was understood.

Congress had set February 1, 2002, as the date the Trust could be created. So between December 21, when President Bush signed the RRSIA into law, and February 1, the rail management and labor organizations selected their trustees. The three carrier trustees were Thomas N. Hund, James A. Hixon, and Bernie Gutschewski; the three from labor were Joel Parker, Daniel E. Johnson III, and George J. Francisco, Jr.<sup>1</sup> When they met on February 1, the six trustees adopted a set of bylaws; secured the necessary insurances and bonding; selected Parker as chair; set up investment, administration, and audit committees; and selected Dewey Ballantine LLP (outside counsel to the Union Pacific) and Guerrieri, Edmond, and Clayman PC (a firm close to labor) as Trust co-counsels. Hixon, Gutschewski, Parker, and John Salmon, of Dewey Ballantine, were leading players in the negotiations creating the industry reform proposal and in the lobbying effort to win congressional passage.

The trustees then went to work to create a modern "institutional" investment organization. They met with senior investment managers in major corporate and multiemployer pension trusts for guidance and advice. They conducted nationwide searches that resulted in the selection of John W. MacMurray, a seasoned pension executive, as the NRRIT's "independent" trustee, Northern Trust as Trust Custodian, and Enos T. Throop as chief investment officer.<sup>2</sup> Following directives in the statute, the trustees developed compensation packages for Throop and other Trust employees "necessary for the proper administration" of the Trust's activities. Congress explicitly included this requirement because the terms and conditions of employment in the investment management industry were quite different from those offered to public sector workers, and the Trust needed to offer competitive terms and conditions to attract and retain effective investment managers. Also following the RRSIA directives, the trustees retained "independent advisers to assist it in the formulation and adoption of

its investment guidelines,” commissioning an asset-liability study from Watson Wyatt that was finalized in August. They then retained independent investment managers to invest the assets of the Trust in a manner consistent with such investment guidelines, selecting Barclays Global Investors in September as the Trust’s first investment manager. Barclays managed passive stock and bond index funds, which is where the trustees placed their first investments. As the Trust staffed up and developed greater managerial capacity, it would move the bulk of its assets to active external investment managers. But the Trust was now ready—eight months after its creation—to manage the assets of the Railroad Retirement program (RRSIA 2001, Section 105(j)(4); Section 105(j)(6); NRRIT 2002).

Consistent with the intent of Congress, the trustees created added safeguards against political influences on investment decisions. ERISA allowed pension trusts to invest up to 10 percent of their assets in the sponsor’s securities. As the language in the RRSIA seemed to frown on such investments, the trustees agreed not to invest any Railroad Retirement assets in securities issued by North American railroads. The pension fund would not be, and would not be seen, as a captive source of credit for the industry, or any firm in the industry. The trustees also decided to restrict active investment managers to oversee at most 10 percent of Trust assets. While the primary purpose was to promote diversification, the policy would also limit any perceived influence on the broader U.S. economy. Finally, the trustees adopted institutional investor best practice for voting proxies. It delegated proxy voting to the Trust’s external investment managers with the mandate that “all proxies shall be voted solely in the interest of plan participants and beneficiaries” (NRRIT 2002).<sup>3</sup>

The board politics were also conducive to effective trust fund management. Unlike standard multiemployer pension plans, which had one dominant union and many small employer representatives, the NRRIT board had a much more balanced power structure, with the four large Class I Railroads that dominated the industry after the mergers of the 1990s essentially naming the three management trust-

ees and 12 unions, represented by the Cooperating Railway Labor Organizations, naming the three labor trustees. Various trustees report a high degree of comity, with essentially no disagreements between management and labor, and the trustees making decisions in an efficient, businesslike manner. A contributing factor could be joint management-labor effort in winning congressional approval of the 2001 reform. Another could be the distribution of risk. The carriers bore all the downside risk. The tax adjustment mechanism that the RRSIA introduced would raise the carriers' payroll tax, not the workers' payroll tax, if the finances of the program weakened beyond specified benchmarks. As the carriers were also far more willing and able than labor to bear that downside risk, this removed a potential area of conflict between management and labor trustees. Whatever the reason, the board, by all reports, was generally united in reaching its investment and managerial decisions.

## **INVESTMENT GOVERNANCE TO DATE**

The Trust began receiving Railroad Retirement assets in September 2002, once its basic investment infrastructure was in place. By the end of March 2003, the transfer was largely complete. As it turned out, this was a remarkably fortuitous time for the Railroad Retirement program to sell bonds and buy stock (NRRIT 2006).

The shift in Railroad Retirement investments from government bonds to private sector securities came just after the 2001 recession had ended. The market interest rate on intermediate-term Treasuries, which the Railroad Retirement program held, had fallen precipitously (Figure 4.1). The program's bonds thus had an above-market yield and produced a substantial capital gain when sold. The funds were transferred to the NRRIT—\$21.3 billion by the end of the first quarter of 2003—and invested in Barclay stock and bond index funds. Stock prices had also fallen sharply, then increased smartly: by the end of the 2003 fiscal year, NRRIT assets produced annualized returns of nearly 20 percent (NRRIT 2002).

**Figure 4.1 Market Interest Rate, Intermediate-Term Government Bonds**



SOURCE: Morningstar (2013).

The RRSIA had established the “account benefits ratio”—the ratio of the market value of Railroad Retirement assets to annual benefit outlays—as the basic yardstick for measuring the financial health of the program, with the trailing 10-year average of that ratio determining Railroad Retirement tax rates. Despite the sweetened benefits and lower taxes the 2001 reform introduced, the capital gains on the sale of the program’s bonds and the returns achieved on trust fund investments pushed the account benefits ratio, which had been about 4.5 times annual outlays in 1999, to 6.6 times annual outlays by the end of the 2003 fiscal year (NRRIT 2003).

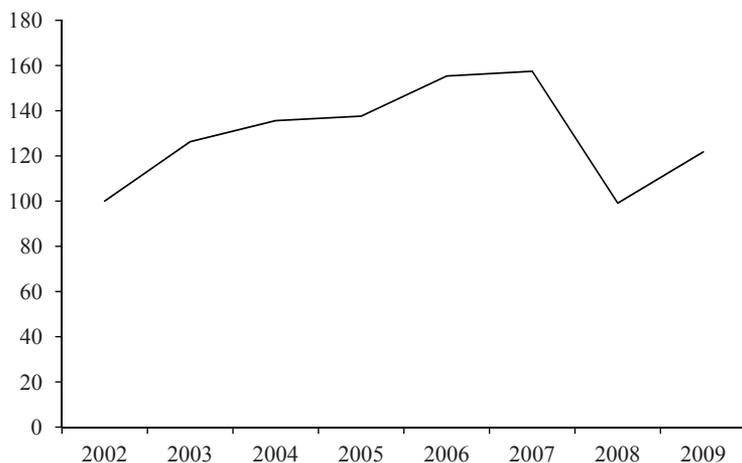
The interest rate decline that produced the capital gain on Railroad Retirement bonds and boosted the program’s account benefits ratio—the yardstick used to measure the health of the program—had a very different effect on the “funded ratio” of private defined benefit pension plans—the yardstick used to measure the health of such plans. The funded ratio is the ratio of trust fund assets to the present

value of plan obligations. It reports whether the plan has sufficient assets in hand to meet those obligations. The obligations of a pension plan stretch far into the future and by statute must be valued using current interest rates on high-quality corporate bonds. Just as the decline in interest rates raised the value of Treasuries held by the Railroad Retirement system, it raised the present value of private pension obligations. The interest rate decline was in fact the main contributor to the dramatic fall in the funded ratios of private plans in the early 2000s. Congress, concerned that plan sponsors and their plans could go bust and transfer large unfunded obligations to the government's Pension Benefit Guaranty Corporation, had over time required sponsors to rapidly eliminate shortfalls when the shortfalls grew beyond specified levels. These rules resulted in contributions tripling in the recession at the turn of the century and were a major factor in sponsor decisions to terminate, freeze, or otherwise abandon their defined benefit pension programs (Munnell and Sass 2006).

Government-run social insurance programs do not have the same bankruptcy risks as private defined benefit plans. Thus the funded ratio, which uses the present value of plan obligations as the yardstick for assessing the adequacy of pension plan assets, is far less useful for assessing the health of such programs. Railroad Retirement, however anomalous, is a government-run social insurance program. It might be argued that the interest rate decline should trigger a reduction in the expected return on Trust assets, which could require an offsetting increase in Railroad Retirement payroll taxes. But no such relationship was present in the RRSIA's tax adjustment ratchet, which based payroll taxes solely on the ratio of assets to annual benefit payments.

Whatever the implications of the decline in interest rates on expected returns, the returns on stocks the Trust bought in 2002–2003 were remarkably good. The promise of higher returns on equities had been the primary factor driving management and labor to reform the Railroad Retirement program. And the gains from investing in stocks—up until the Crash of 2008—exceeded all expectations (Figure 4.2).

**Figure 4.2 Real Value of a Portfolio of Large Company Stocks Index, 2012 = 100**



SOURCE: Author's calculations using data from Morningstar (2013).

Determining the share of trust fund assets to invest in stocks, and which type of stocks; how much to invest in bonds, and which type of bonds; and how much to invest in other types of assets, such as real estate and private equity, is a difficult issue. The fundamental objective of any pension trust is to provide the cash the plan needs, when it needs it, to pay promised benefits. The gain that the 2001 reform divided between management and labor—like the gain that management and labor divide in private pension plans—involved investments in equities and taking on risk. So the trustees, “in accordance with statutory directives,” defined its two “principal objectives: 1) to ensure the timely and certain payments of benefits to eligible railroad retirement plan participants and beneficiaries, and 2) to achieve a long term rate-of-return on assets sufficient to enhance the financial strength of the Railroad Retirement System.” The prudence and diversification the RRSIA required could enhance the certainty of benefit payments and reduce other financial risks—but only so far

without also reducing expected returns. So setting the Trust’s “Investment Guidelines”—its mix of assets and how much and what type of risks to take on—was the fundamental decision the Trustees had to make (NRRIT 2002).

The RRSIA clearly stated that the Trustees “shall . . . retain independent advisers to assist it in the formulation and adoption of its investment guidelines,” which had to be approved by “a unanimous vote of the entire Board of Trustees” (Section 105(j)(4)(A); Section 105(j)(7)). The Board retained Watson Wyatt to produce an asset-liability study that recommended a strategy, which the trustees unanimously adopted (Table 4.1).

The guidelines gave the trustees some flexibility to alter asset allocations in response to market conditions, but they limited the range of deviation. As changes in the price of stocks and bonds shift the value of assets invested in each class, the Trust rebalances on a quarterly basis: It sells assets above their target allocation to provide any additional cash the plan needed to pay benefits, or to buy assets below their allocation target.

The Watson Wyatt guidelines were relatively aggressive. High-yield bonds have relatively high expected returns and risk—a financial profile much like equities. So the guidelines allocated 70 percent of trust fund assets to investments with high expected returns and risk and 30 percent to investment grade bonds, securities with relatively low expected returns and risk. International and private equity

**Table 4.1 Target Asset Allocation Strategy**

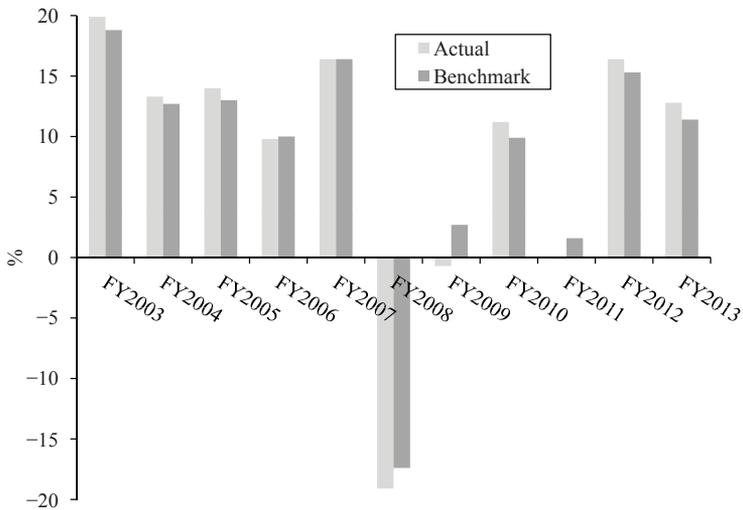
Asset class	Policy target (%)	Target range (%)
Equity	65	60–70
Domestic (U.S.) equities	40	34–46
International equities	20	17–23
Private equity	5	3–7
Fixed income (including cash)	35	30–40
Investment grade bonds	30	25–35
High-yield bonds	5	3–7

SOURCE: NRRIT *Annual Report* (2003).

and high-yield bonds have different risks than domestic equities, the primary risk asset held by the Trust. So the allocation dampened the expected volatility of trust fund returns. The trustees would add new asset classes, such as overseas bonds, real estate, commodities, “opportunistic” hedge funds, and cash; they would also set allocations and performance benchmarks for finer classifications within these asset classes. But the allocation remained relatively aggressive.

As shown in Figure 4.3, the NRRIT achieved returns that “generally compared favorably” to its benchmarks—indexes used to evaluate the performance of investment managers. But as the figure shows, the Trust’s strategic investment allocation and the performance of the financial markets have been far more important than its own tactical performance vis-à-vis its benchmarks. The Trust’s investment strategy produced returns well above expectations through fiscal 2007, but returns over the next four years, through the crash of 2008 and the Great Recession that followed, were far worse than anyone could

**Figure 4.3 NRRIT Returns vis-à-vis Policy Benchmarks**



SOURCE: Szymendera (2011) using data from NRRIT *Annual Reports*.

have expected.

The crash also sparked a scramble for liquidity as the financial markets froze. The Railroad Retirement program was quite dependent on transfers from the NRRIT to pay benefits. The 2001 benefit increases and tax cuts, and further cuts produced by the tax adjustment ratchet in response to the dramatic rise in trust fund assets and the program's account benefits ratio, had created a substantial gap between annual benefit outlays and incoming tax receipts. The payroll tax and income taxes on benefits, which were returned to the Railroad Retirement program, covered just 70 percent of outlays in 2008. Transfers from the NRRIT were needed to cover the remaining 30 percent. The experience of the 2008 financial crisis and the Railroad Retirement program's dependence on transfers from the Trust led the NRRIT to bulk up in cash until the markets returned to more normal conditions. It also created additional liquidity by eliminating securities lending, which trimmed returns by a negligible few basis points. But investment policy was otherwise little changed. The 2011 guidelines of major asset classes, with the performance benchmarks for each, are presented in Table 4.2. The allocation remained relatively aggressive, with increased diversification somewhat dampening the expected volatility of trust fund returns.<sup>4</sup>

Investment returns through the end of fiscal 2011, though below expectations at the beginning of the decade, were nonetheless sufficient to help produce an account benefits ratio of 4.75 times annual outlays for 2012, somewhat above the 4.62 ratio for 2012 projected at the beginning of reform (Railroad Retirement Board 2003, 2014, using employment projection 1). By this measure, the creation of the NRRIT has thus far proved a success.

## **THE PERFORMANCE OF RAILROAD RETIREMENT RATCHET**

The 2001 reform raised benefits, cut taxes, created the NRRIT to invest Railroad Retirement assets in equities, and introduced the tax

**Table 4.2 NRRIT 2011 Investment Guidelines**

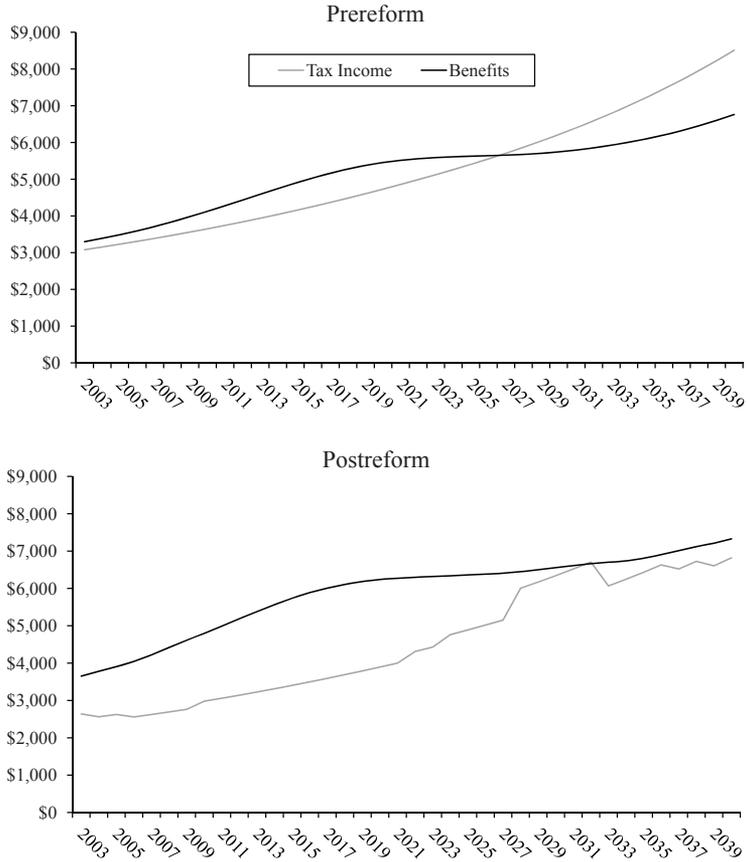
Asset class	Policy benchmark	Target allocation (%)	Policy range (%)
U.S. equity	Russell 3000	23.0	18–28
Non-U.S. equity	MSCI ACWI Ex-US IMI-\$Net	21.0	16–26
Private equity	2/3 Russell 3000 + MSCI ACWI Ex-US IMI-\$Net + 300 bp	10.0	2–15
Global equity		54.0	45–61
U.S. fixed income	Barclays U.S. Universal	13.5	9–18
Non-U.S. fixed income	Barclays Global Aggregate ex-USD	8.5	5–15
Global fixed income		22.0	18–28
Real estate	80% NCREIF Property Index + 20% Custom REIT <sup>a</sup>	10.0	2–15
Commodities	DJ-UBS Total Return	5.0	2–8
Global real assets		15.0	10–20
Absolute return	NRRIT Public Markets Composite	8.0	2–10
Cash	BofA ML 3-Month T-Bill	1.0	0–3
Other		9.0	2–12
Total fund		100.0	

<sup>a</sup>NRRIT's Custom REIT benchmark is 2/3 "FTSE NAREIT index" and 1/3 "FTSE EPR/NAREIT Global Real Estate Index – Net Return to U.S. Investors."

adjustment ratchet to keep the program's finances on track. The tax cuts, benefit increases, and early retirements financed by the benefit increases, which reduced payroll tax revenues, all weakened the system's finances. These effects were expected (Figure 4.4). The CBO estimated the cost of these changes at \$7 billion over the first 10 years following the enactment of reform. The higher expected returns on trust fund assets and the tax adjustment ratchet were designed to see that Railroad Retirement benefits were nonetheless paid.

The tax adjustment ratchet set the payroll tax rate based on a 10-year trailing average of the ratio of assets to annual outlays (Figure

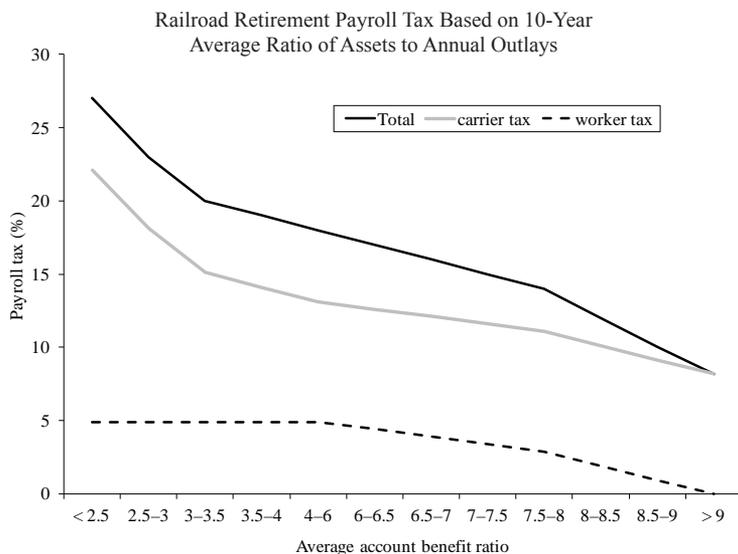
**Figure 4.4 Projected Tax Income and Benefit Outlays, Pre- and Postreform (\$ billions)**



SOURCE: 21st and 22nd valuations, using employment projection I.

4.5). It cut taxes when that ratio rose above six and raised taxes when it fell below four. The ratchet went into effect as the unexpectedly strong returns on trust fund assets, through 2007, pushed the value of Railroad Retirement assets to just below eight times annual outlays, and the trailing 10-year average ratio to just below seven times annual

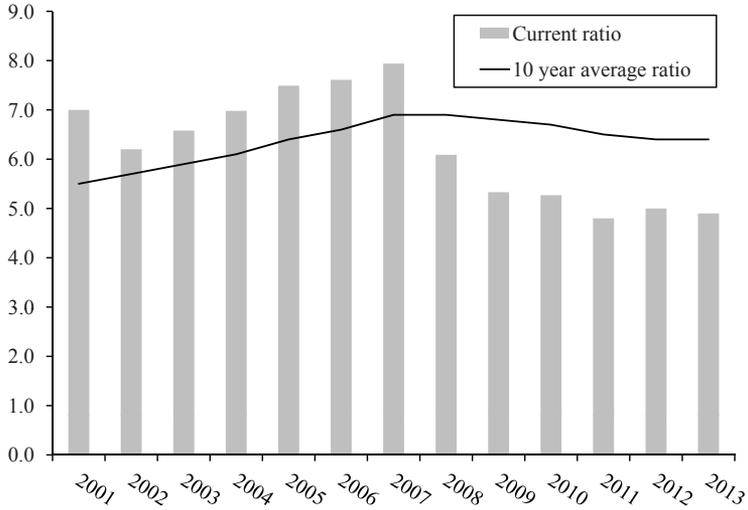
**Figure 4.5 The Railroad Retirement Tax Adjustment Ratchet**



outlays (Figure 4.6). As the 10-year average ratio rose above the target band of four-to-six-times outlays, it triggered tax reductions that cut the payroll tax from 18 to 16 percent of covered earnings (Figure 4.7)—an 11 percent reduction.

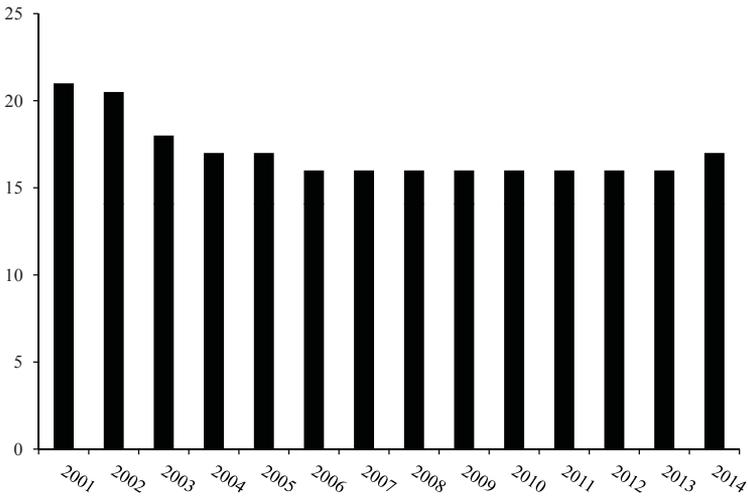
The unexpected tax cuts arrived as the “watermelon entered the snake”—as the gap between benefit outlays and tax receipts widened and had to be filled with large transfers from Trust assets. The system needed \$1.3 billion from the Trust to pay promised benefits in fiscal 2008—31 percent of that year’s benefit outlays. This was 4 percent of Trust assets of \$32.7 billion at the beginning of the fiscal year. But then the market crashed, and the value of Trust assets fell 19 percent in fiscal 2008 (Table 4.3). After transferring the \$1.3 billion, the value of assets in the Trust assets fell 23 percent, from \$32.7 to \$25.3 billion—from 7.9 to 6.1 times annual benefit outlays—by the end of fiscal 2008 (Figure 4.8).

**Figure 4.6 Railroad Retirement Account Benefits Ratios, 2011–2013**



SOURCE: NRRIT *Annual Reports*, various years.

**Figure 4.7 Railroad Retirement Payroll Tax Rates, 2001–2014**



SOURCE: NRRIT *Annual Reports*, various years.

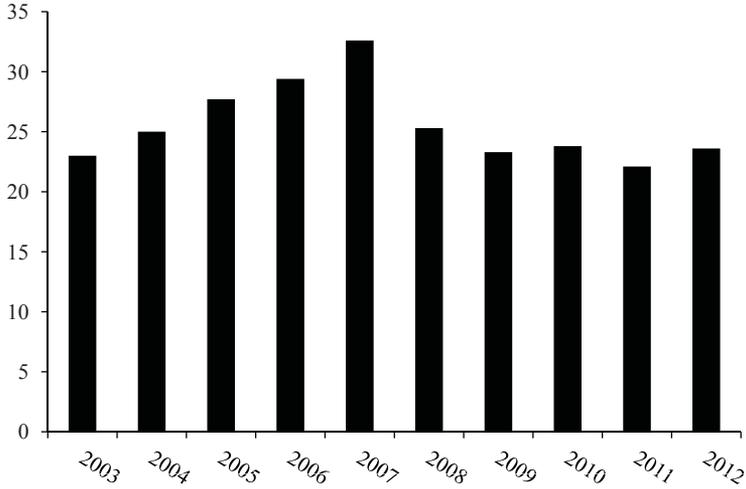
**Table 4.3 Railroad Retirement Asset Returns, Transfers to Pay Benefits, and Returns-Transfers**

	Investment	Transfers		Returns-
	returns	Transfers		transfers
	As % of	As % of	As % of	As % of
	initial assets	benefits	initial assets	initial assets
2004	13.0	43	7.0	6.9
2005	14.0	22	3.2	10.8
2006	9.8	25	3.2	6.6
2007	16.4	34	4.8	11.6
2008	-19.1	31	4.0	-23.1
2009	-0.7	36	6.3	-7.0
2010	11.2	44	8.6	2.6
2011	-0.1	38	7.1	-7.2
2012	16.4	42	8.6	7.8

SOURCE: NRRIT *Annual Reports*. 25th actuarial valuation. Table A2.—Status of the Railroad Retirement accounts and trust funds, by fiscal year, 2003–2012; Author’s calculations.

From 2009 through 2012, assets in the National Railroad Retirement Investment Trust earned, on average, 6.7 percent.<sup>5</sup> But because of rising benefit costs and the payroll tax remaining 2 percentage points below its benchmark 18 percent rate, the trust fund had to provide between 36 and 44 percent of Railroad Retirement outlays. Transfers over these four years, on average, were 7.7 percent of Railroad Retirement assets. Because transfers exceeded investment earnings, the value of Railroad Retirement assets declined nearly 7 percent from 2008 to 2012 (Table 4.3). And because annual outlays continued to rise, the ratio of assets to outlays slipped from 6.1 in 2008 to 4.9 in 2012.

Despite this weakening in the system’s finances since the crash of 2008, payroll tax rates remained unchanged at 16 percent of covered earnings. The Railroad Retirement ratchet adjusts tax rates based on the average account-benefits ratio over the preceding 10 years.<sup>6</sup> As shown in Figure 4.7, that average trended down slowly and only crossed the 6.5 threshold at the end of fiscal year 2012, triggering a 6 percent increase in the payroll tax to 17 percent of covered earnings

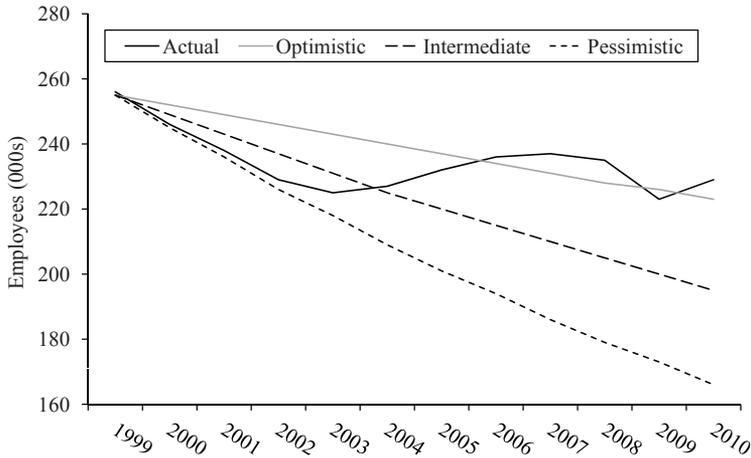
**Figure 4.8 Railroad Retirement Assets, 2003–2012 (\$ billions)**

SOURCE: Railroad Retirement Board (2014, Table A2).

in calendar year 2013. The tax will likely rise another 6 percent, to 18 percent of covered earnings, in calendar year 2015. Only then, seven years after the crash of 2008, will the tax return to its benchmark 18 percent rate.

What strengthened the system during this period was the unexpected stability of railroad employment. Rail employment had declined dramatically over the entire post–World War II era, and falling employment is the worst of all possible environments for pay-as-you-go retirement programs. Rail employment is expected to continue to decline, with the debate in projecting the finances of the Railroad Retirement program on how steep the decline would be. Despite the increased retirements that came in response to the 2001 reform—which allowed workers with 30 years of service to retire on full benefits at age 60, not 62—rail employment remained remarkably strong. Rail employment at the end of 2010 was even greater than the optimistic projection of the prereform Actuarial Valuation

**Figure 4.9 Actual Railroad Employment Compared to Various Assumptions of 21st Actuarial Valuation**



NOTE: Actual employment figure represents average from January to November 2010.  
 SOURCE: John Salmon, using data from Railroad Retirement Board actuarial valuations and Financial, Actuarial, and Statistical Data (D-1).

(Figure 4.9). This stronger than anticipated employment performance produced unexpectedly strong payroll tax receipts and reduced the need for Trust transfers to pay benefits; it also helped offset the lack-luster performance of the financial markets after the 2008 crash and the delayed response of the ratchet to the program’s falling ratio of assets to outlays.

**AN ASSESSMENT TO DATE**

The primary concern of Congress in enacting the reform was the risk of political influence on the investment decisions. A secondary concern was the financial performance of the redesigned program.

In terms of the governance of Railroad Retirement assets, a leading observer identified a set of good practices not commonly observed in public fund management:

(i) explicit funding targets and mechanisms to trigger action in the case of deviation from this objective; (ii) commercial investment policies flowing from these targets and explicitly aimed at maximizing risk-adjusted returns for members; (iii) professional boards selected through a process that maintains an “arms-length” relationship with government officials; (iv) prohibition on social investment criteria or ETIs [economically targeted investments]; (v) significant share of investment done through external managers selected and retained by explicit and objective criteria; (vi) avoidance of strict portfolio limits, especially on foreign investments and (vii) high standards of reporting and disclosure including annual, independent audits, performance reviews, and codes of conduct for Board members available to the public. (Palacios 2002, p. 40)

By these criteria, the NRRIT is an exemplary manager of public pension assets.

A recent review of the NRRIT governance structure likewise concluded that thus far “the NRRIT appears to have achieved the political independence Congress desired” (Whitman 2011, p. 81). That review cited five contributing factors: 1) the Trust’s legal status as an independent nongovernment entity; 2) the ERISA-based “mandate” to invest Railroad Retirement assets prudently and solely in the interest of the plan and plan participants; 3) the “professional” character of NRRIT trustees, who represent both management and labor; 4) the professional development of investment guidelines and benchmarks, primarily carried out by external investment managers; and 5) an effective system of financial reporting and oversight (also see GAO 2014).

The basic explanation of this success is that all parties—Congress, carriers, and unions—wanted NRRIT to function like a modern private pension trust. The governance of such trusts has been well developed under ERISA mandates and decades of experience to act as Congress intended—solely in the interests of the plan and its participants, using transparent and sophisticated investment management practices.

Of more concern is the financial design of the reformed Railroad Retirement program. The reformers had far less precedent upon which to build the new design and selected key parameters in a somewhat ad hoc manner. The ratchet raised taxes above the benchmark 18 percent rate when assets fell below four times benefit outlays because that was the ratio of assets to outlays when they designed the reform, and having assets equal to four times benefit outlays was historically high in the program's experience. The decision to use a 10-year average ratio of assets to outlays as the basis for setting the tax rate was chosen to dampen shocks on carrier cash flows and reduce the volatility of employee tax rates. The performance of the financial markets in the first decade of reform—admittedly a historically volatile period—illustrates the limits of the ratchet's ability to stabilize the program's finances. Were it not for the unexpected strength in railroad employment, the program's finances would have been in much worse shape.

### Notes

1. Thomas N. Hund was executive vice president and chief financial officer of Burlington Northern-Santa Fe; James A. Hixon was senior vice president—administration of Norfolk Southern; and Bernie Gutschewski was vice president—taxes, for Union Pacific. Joel Parker was international vice president, Transportation Communications Union; Daniel E. Johnson, III, was secretary—treasurer of the United Transportation Union; and George J. Francisco, Jr., was president of the National Conference of Firemen and Oilers.
2. When hired, Throop was the director of investments of the UMWA Funds and had more than 25 years of investment management experience working for plan sponsors.
3. The trustees drew up a list of 10 North American railroad companies, later expanded, whose securities the Trust would not purchase. Their securities could only be held indirectly within of a passive index fund.
4. The 2008 *Annual Report* of the NRRIT characterized the allocation as “a structure which is more fully diversified across geography, capitalization size, style, credit quality and many other characteristics” (p. 16) and “addresses asset allocation across a spectrum of active risk levels and degrees of liquidity” (p. 17).
5. The arithmetic average. The geometric average was 6.2 percent.
6. Rounded up to the nearest tenth.

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## Chapter 5

# The Reform's Effect on Workers and Carriers

The 2001 reform of the Railroad Retirement program had a significant effect on the lives of rail workers and the finances of their employers. The labor and management negotiators had agreed to divide the gains of reform 50-50, with the workers getting higher benefits and the carriers a payroll tax cut. The carriers also agreed that they would pay higher taxes down the road, up to 22.1 percent of payroll, should the program's finances unwind as the watermelon passed through the snake. The negotiators also agreed that should financial pressures on the program thereafter subside, the carriers' tax could fall sharply, and the tax on workers could even vanish.

### **WORKERS AND THE 2001 REFORM**

Labor took their portion of the gains of reform by increasing benefits in three different ways. Beginning January 1, 2002, the program 1) vested workers with rights to benefits after fewer years of service, 2) increased benefits paid to survivors, and 3) allowed workers with 30 years of service to retire on full benefits at 60 rather than 62.

Prior to the 2001 reform, rail workers earned a vested right to Railroad Retirement benefits after 10 years of service—only after 10 years of service would they receive any benefits from the program. Ten-year vesting was one of three minimum vesting rules ERISA required in private sector plans, and it became the vesting rule most private plans had adopted. Congress changed that rule to require vesting after 5 years of service in 1986. So to keep abreast of private-sector practice, union negotiators included five-year vesting in their package of benefit enhancements.

Five-year vesting affected very few workers. The great majority of rail workers either have fewer than 5 years of service or more than

10. In 2012, the Railroad Retirement program granted pensions to only 100 workers with 5–10 years of service (Railroad Retirement Board 2014, Table B10). Their pensions were also quite small. The Railroad Retirement benefit formula sets pensions at  $(\text{years of service}) \times (0.7 \text{ percent of average covered earnings over the last five years of rail employment})$ . Thus, the pensions of those 100 workers were 3.5–7.0 percent of their average earnings over their last five years of service. Many of these workers had left rail employment a quarter century or more prior to retirement, and the benefit formula did not adjust their earnings to reflect the subsequent rise in prices or wages. Inflation and wage growth thus cut the value of their Railroad Retirement pensions roughly in half, to about 3 percent or less of their preretirement earnings.<sup>1</sup>

The 2001 increase in survivor benefits was more significant. Survivors had formerly received a continuation of their Railroad Retirement spousal benefit, equal to about half their spouse's benefit. Survivors now got their deceased spouse's benefit. This increment, however, was reduced dollar for dollar by the cost-of-living increases in *both* the survivor Railroad Retirement spousal benefit and typically much larger Social Security survivor benefit—until the increment disappeared. While all new widow(er)s and many existing widow(er)s got an increase in benefits, that increase would wither away, depending on the rate of inflation, in 10–15 years.

By far the most significant increase in benefits introduced by the 2001 reform was the ability of workers with 30 years of service to retire on full benefits at age 60 rather than 62. About 75 percent of rail workers aged 60 had 30 years of service, and the reform gave those who chose to retire an additional two years of “full” Social Security–equivalent Tier I and Railroad Retirement Tier II benefits. If married—and about 70 percent of rail workers that age were—the couple was also entitled to a spousal benefit equal to half the worker's “full” Tier I and Tier II benefits (Railroad Retirement Board 2014, Table S-43).

The reform created a powerful incentive for workers aged 60 with 30 or more years of service to retire. Railroad Retirement pro-

vided essentially all, or nearly all, of the income they would need. A standard rule of thumb says retirees need about 80 percent of their preretirement earnings to maintain their standard of living—and less if they have paid off the mortgage or have children they no longer support (Palmer 2008).<sup>2</sup> A “full” Railroad Retirement benefit replaced about 80 percent of the preretirement earnings of a married worker and about 55 percent for a single worker.<sup>3</sup> So a “full” benefit provided a sufficient retirement income for workers with a nonworking spouse or a spouse with relatively low earnings, and an income close to sufficient for those without a spouse. Also encouraging the retirement of workers aged 60 with 30 years of service, their pensions would only increase modestly, only about 2–3 percent, for each year they delayed retirement.<sup>4</sup>

Workers with 30 years of service who retired at 60 thus got pensions about 4–6 percent smaller than what they would get at 62. This was less than the additional cost to the Railroad Retirement program of providing these somewhat smaller benefits earlier and for a longer period of time, and for forgoing two years’ employer and employee payroll taxes. This additional cost for 60/30 was the primary way that labor took its portion of the gains of reform. And the availability of “full” pension benefits at age 60, albeit somewhat smaller than the “full” benefits available at older ages, proved hard to resist. Among rail workers with 30 or more years of service in 2004–2006, 62 percent of those aged 60 and 49 percent of those aged 61 retired. The retirement rates for such workers in 1998–2001, just prior to the 2001 reform, were 11 percent for those aged 60 and 10 percent for those aged 61 (Railroad Retirement Board 2001; 2007, Table S-30).

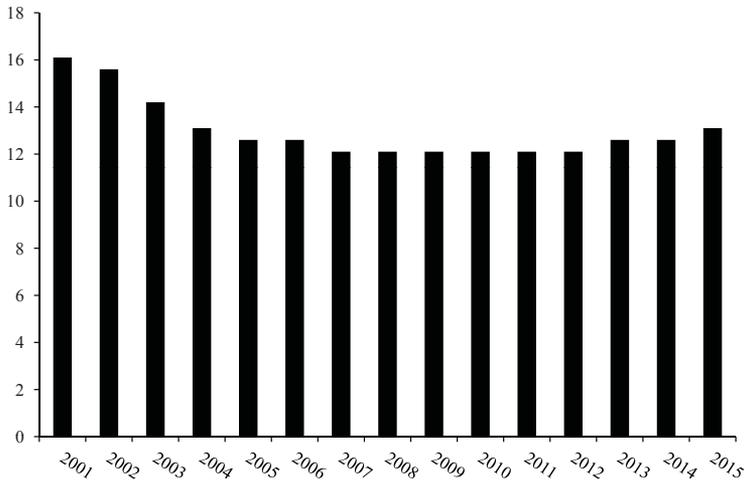
## **THE CARRIERS AND THE 2001 REFORM**

The 2001 reforms had two immediate effects on the carriers: the stepped-up retirements cut railroad employment, and the payroll tax cut reduced pension expenditures. The tax cut by far had the greater effect.

The 2001 reforms cut railroad employment by about 4,000 workers.<sup>5</sup> Workforce reductions had been major contributors to carrier profitability since the end of the Second World War. Key drivers of carrier profitability continued to economize on labor, such as the use of larger cars and longer trains and the shift to intermodal freight traffic (Martland 2012). Railroad employment fell by 9,000 workers from 2001 to 2002, when 60/30 was introduced—more than the increase in retirements attributable to the 2001 reform—and by another 4,000 in 2003. Railroad employment, however, then slowly began to rise. Even after a sharp decline in the Great Recession, the carriers employed 2,000 more workers in 2011 than they had in 2004. This suggests that the employment reduction attributable to the 2001 reform at best had just a minor effect on profitability.

The employment reduction attributable to the 2001 reform was a reduction in the number of older workers, aged 60 and 61, that the carriers employed. The carriers had introduced mandatory retirement on pension at the turn of the twentieth century precisely to terminate the employment of older workers whose productivity had declined. They initially set the mandatory retirement age at 70, which was often lowered to 65. But given the dramatic gains in worker health and education, and reductions in many of the physical demands of railroad work, it is far from clear that workers aged 60 and 61 are much less productive, if less productive at all, than younger workers. This again suggests that the retirements attributable to the 2001 reform at best had a minor effect on profitability.

The cut in the carriers' payroll tax, by contrast, had a significant effect. The 2001 legislation and the ratchet cut the carrier's payroll tax from the prereform 16.1 percent of payroll in 2001, down in steps to 12.1 percent by 2007. The ratchet then kept the carriers' tax that low to 2013, when it pushed it up to 12.6 percent. The carriers' tax rate is expected to return to 13.1 percent of payroll in 2015. It would then be at the carriers' benchmark rate in the 2001 legislation, 3 percentage points below their prereform 16.1 percent levy (Figure 5.1).

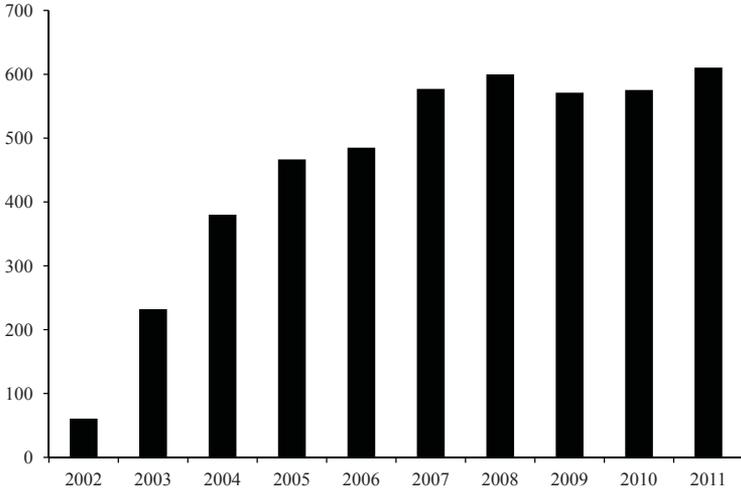
**Figure 5.1 Carriers' Railroad Retirement Tax Rate, 2001–2015**

SOURCE: Railroad Retirement Board *Annual Reports*, various years.

Over the 10 years from 2002, when the reform began to cut their tax rate, to 2011, the carriers paid \$17.5 billion in Railroad Retirement payroll taxes. Assuming no change in payrolls, they would have paid an additional \$4.5 billion had their tax rate remained 16.1 percent—and over the last 5 of those years, about an additional \$600 million a year (Figure 5.2). Assuming a 35 percent marginal tax rate, the 2001 reforms added \$3 billion to the carriers' after-tax earnings over this 10-year period, and about \$400 million a year over the last 5 of those years.

These tax savings made a reasonably significant contribution to carrier profits. From 1996 through 2004, U.S. Class I Railroads, which earn the bulk of industry profits, earned about \$4 billion a year or less. Class I profits then increased rapidly, reaching \$12.1 billion in 2012. Figure 5.3 shows the estimated contribution of tax savings to the profits of Class I Railroads. The contribution to profits at all railroads is probably quite similar.

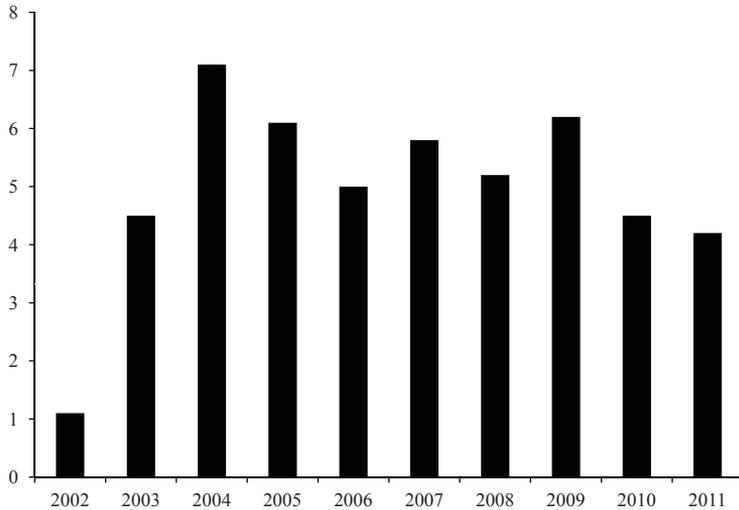
**Figure 5.2 Estimated Contribution of Payroll Tax Cut to Carrier Profits, 2002–2011 (\$ millions)**



SOURCE: Author's calculations, based on data from Railroad Retirement Board (2014, Statistical Table D1).

The continuation of carrier tax cuts through the Great Recession, including the reductions produced by the ratchet in 2005 and 2006, stand in stark contrast to the spike in mandatory employer defined benefit pension contributions when the economy turns down. Economic downturns reduce the value of pension fund assets, and the value of assets in the NRRIT fell nearly 20 percent in 2008 because of the decline in equity prices. Employer defined benefit plans typically measure the adequacy of their assets against the present value of future obligations, a yardstick highly sensitive to current interest rates. As interest rates fell sharply in the Great Recession, the present value of Railroad Retirement obligations jumped dramatically, producing a significant drop in the program's funded ratio—the ratio of assets to the present value of plan obligations. Had Railroad Retirement tax rates been pegged to this funded ratio, carrier taxes would have moved sharply higher. But Railroad Retirement measures the

**Figure 5.3 Estimated Contribution of Payroll Tax Cut to Carrier Profits (%), 2004–2012**



SOURCE: Author's calculations. Tax saving based on data from Railroad Retirement Board (2014, Table D1), assuming the share of Class I railroads in Tier II compensation is the same as their share of Tier I compensation; profit estimates based on data from Surface Transportation Board (2014).

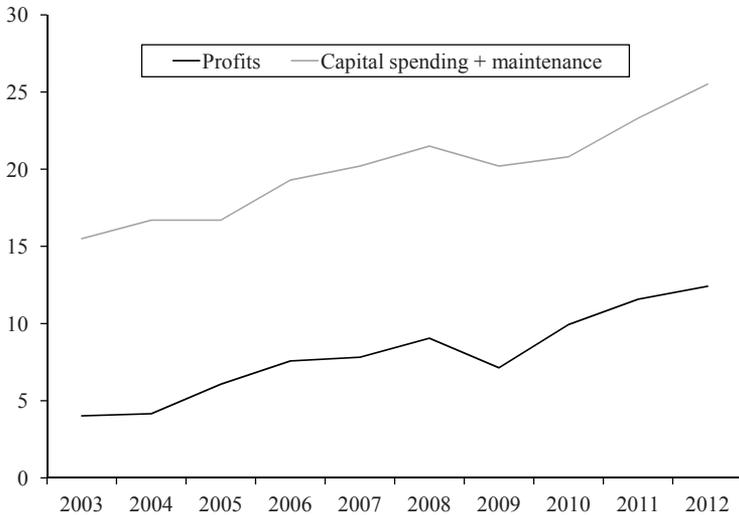
adequacy of trust fund assets against the far more stable yardstick of annual benefit outlays and sets its tax rate based on the trailing 10-year average of that ratio. After the crash of 2008, the ratio of Railroad Retirement assets to outlays did fall, though not nearly as far as the ratio of assets to the present value of future Railroad Retirement obligations. As the trailing 10-year average fell slowly, carrier tax rates were stable and below the program's benchmark 13.1 percent rate throughout the Great Recession.

When downturns depress the funded ratios of employer defined benefit pension plans, the government requires employers to increase their contributions to quickly restore the plans' ability to pay promised benefits. To the extent the carriers retained and invested their payroll tax savings, those tax cuts also shored up Railroad Retirement, as the

program has a contingent claim on the carriers. Should the Railroad Retirement’s finances weaken, as indicated by a decline in the trailing 10-year average ratio of assets to outlays, the ratchet increases the carriers’ tax rate. Although not legally specified, it was also generally understood that the carriers would be required to increase their contributions beyond what the ratchet demanded, if need be, to keep the program afloat.

It is impossible to say with any precision how much of the tax savings the carriers retained and invested, as opposed to paying out as dividends. This is especially so as the tax savings became a relatively small contributor to railroad earnings. Nevertheless, the carriers made increasingly large investments as their earnings rose, with their investments rising roughly dollar for dollar with the increase in earnings (Figure 5.4). The carriers have internal hurdle rates—expected rates of return on investment projects—well above the expected

**Figure 5.4 Class I Railroad Profits and Investments, 2003–2012**  
(\$ billions)



SOURCE: Association of American Railroads (2013a,b).

return on financial assets. The Great Recession had also cut the cost of capital and investment goods and services, increasing the attractiveness of long-term infrastructure investments in expanding businesses such as intermodal traffic and Western coal. The portion of the tax savings that the carriers retained and invested thus probably earned much higher returns than had it been invested in financial assets by the NRRIT. There is no guarantee that the value this investment created will be there when needed by the Railroad Retirement program. But it is fair to say that in addition to strengthening the carriers, the tax savings to some degree also strengthened Railroad Retirement. The tax cuts were not simply value lost by the program.

## **THE CARRIERS AND THE 2001 REFORM GOING FORWARD**

The carriers' tax is rising back to 13.1 percent of payroll, the benchmark set in the 2001 reform, and is projected to rise still further. The carriers' taxes, and gains from the 2001 reform, thus depend on how well the program negotiates the upcoming demographic transition.

The Railroad Retirement program was initially designed as a pay-as-you-go plan, with a trust fund to cushion transient shocks. The ratchet was designed to raise taxes and beef up the trust fund when the cushion got too thin. In any pay-as-you-go plan, the program's finances largely depend on the ratio of retirees receiving benefits to tax-paying workers. That ratio currently stands at 2.5 beneficiaries for each active worker, a legacy from the days when the railroads employed many more workers than they currently do. The ratio of assets to outlays is unlikely to rise, and tax rates are unlikely to fall, until that ratio of beneficiaries to workers falls below two.

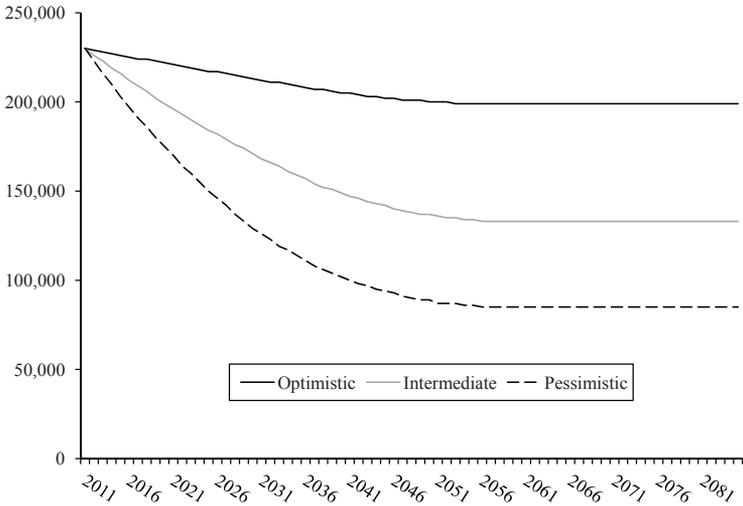
The number of Railroad Retirement beneficiaries going forward is reasonably predictable. The future course of railroad employment, on the other hand, has historically been hard to predict. The triennial actuarial valuations of the Railroad Retirement program thus project the program's finances using three different employment trajec-

ories. The trajectories in the most recent 25th Actuarial Valuation, released in June 2012, were a mild decline, a steeper decline, and a much steeper decline over the first half of the century, with railroad employment stabilizing thereafter (Figure 5.5).

The valuation’s optimistic projection, based on a mild decline in railroad employment, projects the account benefits ratio declining to about three times annual outlays by 2025 but then rising steadily over the next three decades, as the ratio of beneficiaries to workers falls below 2, and stabilizing at about eight times annual outlays a bit after midcentury (Figure 5.6, Panel A).

The valuation’s intermediate projection, based on a steeper decline in railroad employment, has the account benefits ratio falling below three in 2020, to about two times annual outlays from 2026 to 2029, then rising above three times outlays through midcentury. The decline in railroad employment is then projected to end and ratio of

**Figure 5.5 Railroad Employment Projections, 25th Actuarial Valuation**



SOURCE: Railroad Retirement Board (2014).

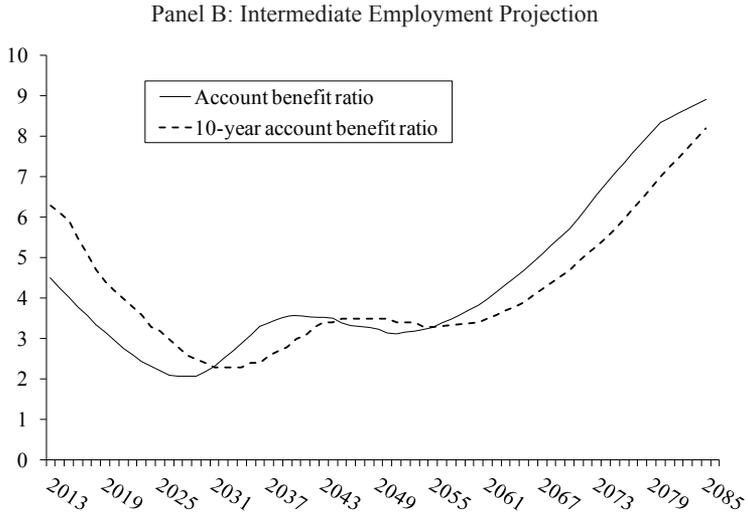
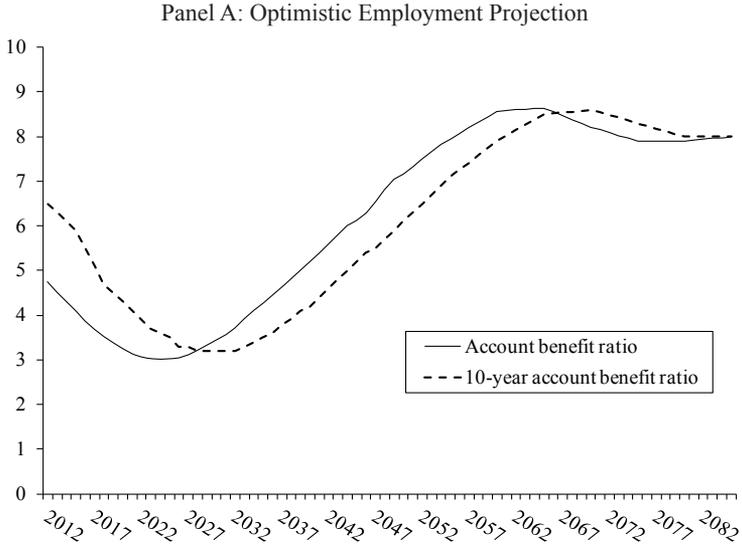
beneficiaries to workers falls below 2. The ratio of assets to outlays again rises steadily over the next three decades and stabilizes at a bit more than eight times annual outlays toward the end of the century (Figure 5.6, Panel B).

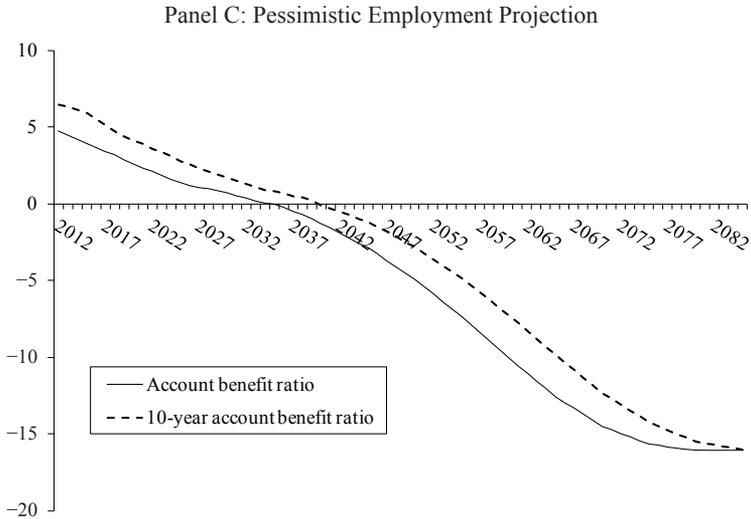
The valuation's pessimistic projection, based on much steeper employment decline that was widely viewed as highly unlikely, shows a negative account benefits ratio in 2035 and every year thereafter: it shows the trust fund exhausted in 2035 and the program incurring ever-mounting debts to pay promised benefits (Figure 5.6, Panel C). The report thus cautiously concludes that "barring a sudden, unanticipated, large drop in railroad employment or substantial investment losses, the railroad retirement system will experience no cash flow problems during the next 23 years"—to 2035 (25th Actuarial Valuation, p. 2).

The system was not expected to experience cash flow problems over those 23 years because the ratchet would raise carriers' tax rates in response to declines in the trailing 10-year average of the ratio of assets to outlays. Should the optimistic projection prove accurate, the ratchet would push the carriers' tax rate above the 2001 benchmark, 13.1 percent, from 2022 to 2038, as that average ratio fell below four times benefit outlays. But the carriers' tax rate would never top the prereform 16.1 percent. The 2001 reform thus would continue to have a positive effect on carrier earnings as the watermelon passed through the snake (Railroad Retirement Board 2014, p. 16).

Should the intermediate projection prove accurate, the ratchet would push carriers' taxes above the prereform 16.1 percent rate from 2027 to 2039, as the 10-year average ratio fell below three times annual outlays. The carriers' tax rates over that 13-year period would be 4.2 percentage points higher, on average, than their prereform rate. But over the 25 years from 2002 to 2026, when the carriers employed many more workers, their tax rates would, on average, be 3.6 percentage points less. So, even should railroad employment follow the intermediate trajectory, reform would still leave the carriers better off. To the extent they retained and invested their tax savings over the first

**Figure 5.6 Projected Current and Trailing 10-Year Average Ratio of Railroad Retirement Assets to Outlays**



**Figure 5.6 (continued)**

SOURCE: Railroad Retirement Board 25th Actuarial Valuation.

25 years of reform, and the returns on those investments equaled or exceeded their internal investment hurdle rates, the carriers would be much better off and be in a stronger position to pay the higher tax rates projected from 2027 to 2039 (Railroad Retirement Board 2014, p. 17).

Should the pessimistic projection prove accurate, the ratchet would push the carriers' tax rate above the prereform 16.1 percent in 2025, and to the maximum 22.1 percent 2 years later. But these increases would not keep the system afloat. If nothing else were done, the trust fund would be empty in 2035, 23 years after the projection was released. The carriers would then be expected to shore up the program, or at least be the primary contributor. Such a sharp decline in railroad employment, however, would also overwhelm the pre-reform system. In the 22nd Actuarial Valuation, the last conducted prior to the 2001 reform, the pessimistic projection depleted the trust

fund even more quickly—in 21 years after the report was released. The carriers could be worse off as a result of the 2001 reform, especially if the program retained 60/30. But as workers would probably not retain 60/30, the carriers would probably not be significantly worse off (Railroad Retirement Board 2003, p. 20; 2014, p. 18).

The future trajectory of railroad employment is the only risk factor addressed in Railroad Retirement's triennial actuarial valuations. But the 2001 reform also exposed the program to new risk factors. By cutting taxes and increasing benefits, it made the program dependent, for at least a quarter century, on large cash transfers from the NRRIT. By allowing the investment of Railroad Retirement assets in equities, it then exposed the trust fund and its ability to make transfers to significant financial market risks.

A key financial risk is that the return on trust fund assets will be less than expected. The most recent actuarial valuation assumes a reasonable 7 percent nominal return—4.2 percent above its assumed 2.8 percent inflation rate. More troublesome is the risk of sharp fluctuations in asset values. The ratchet was designed to respond slowly to financial shocks. The market crash of 2008, admittedly a highly unusual event, illustrates how quickly the program's finances could sour without any tax response. The program's finances benefited during the post-crash period from unexpectedly strong railroad employment, which maintained payroll tax receipts and reduced demands for trust fund transfers. As economic downturns typically reduce both employment and asset values, it seems reasonable to expect employment shocks to amplify, not dampen, future financial shocks.

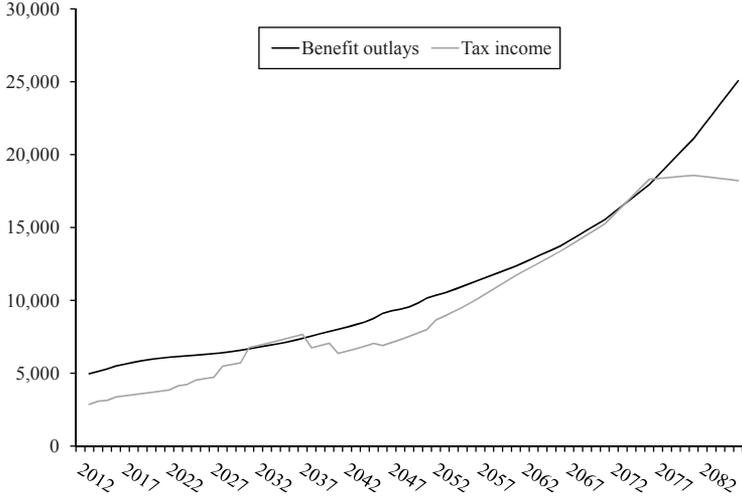
Projections in the most recent actuarial valuation based on the intermediate employment trajectory had trust fund assets at two to three times annual outlays from 2020 to 2035, and only rising above four times annual outlays after 2060. Assets equal to two to four times outlays is a very comfortable cushion for a national pay-as-you-go Social Security program, with assets invested in Treasuries and benefits covered by payroll tax receipts. It is not such a comfortable cushion for the far less stable Railroad Retirement program, with a trust

fund invested in risky assets, tax rates at or close to the maximum defined by the ratchet, and large trust fund transfers needed to pay benefits (Railroad Retirement Board 2014, p. 17).

The program's vulnerability to sharp declines in asset values in the intermediate projection peaked early on. In 2020, when the ratio of assets to outlays was projected to fall below three, tax receipts were projected to cover less than 70 percent of benefit payments. But the ratchet raised the carriers' tax rate in response to the declining ratio of assets to outlays, and the need for trust fund transfers subsided. Tax receipts were actually projected to exceed benefit outlays from 2030 to 2036, eliminating the need for trust fund transfers and raising the value of trust fund assets above three times annual outlays. The ratchet then reduced the carriers' tax rate, and tax receipts again fell below benefit outlays. The program would need trust fund transfers to cover about 20 percent of benefit payments, and assets would remain below three and a half times annual outlays. As illustrated by the effects of the 2008 crash, Railroad Retirement remained vulnerable to a sharp decline in asset values. This vulnerability continued until the decline in payroll employment slowed. When the employment decline ceased and the ratio of beneficiaries to workers fell below two, the program's finances rapidly improved. Assets in the trust fund rose quickly, even though the ratchet was reducing payroll tax rates and trust fund transfers had to cover an increasingly large share of benefit payments. With trust fund assets rising above eight times outlays after 2080, Railroad Retirement's ability to pay benefits should no longer be vulnerable to sharp but transient declines in asset values (Figure 5.7).

The ability of the Railroad Retirement program to pay promised benefits does not depend solely on the ratchet's ability to keep the program on track. It depends on the ratchet's ability to give Congress (and the industry) enough time to respond to shocks that overwhelm the ability of its sluggish tax adjustments to assure benefit payments. Should trust fund assets fall below three times annual outlays while the program requires significant transfers to pay benefits, Congress

**Figure 5.7 Projected Railroad Retirement Outlays and Tax Receipts, Intermediate Employment Trajectory, 2012–2086 (\$ millions)**



SOURCE: Railroad Retirement Board (2014).

(and the industry) would likely develop contingency plans to shore up the program.

The 2001 reform was largely developed assuming railroad employment would follow the optimistic trajectory, as that trajectory had been the most accurate projection of industry employment. Since the most recent actuarial valuation, railroad employment has in fact been stronger, and the program’s ratio of assets to outlays higher than that valuation’s optimistic projections. Railroad employment in March 2012 was 234,000—5,000 more than the optimistic projection’s 229,000. Assets in the Railroad Retirement Trust Fund were 4.96 times annual outlays at year-end 2012, significantly higher than the 4.75 times annual outlays in the optimistic projection (Railroad Retirement Board 2014; NRRIT 2012). Railroad Retirement has a long way to go before the watermelon has passed through the snake.

But these early indications are encouraging, and they support the view that the current program will survive the watermelon with its current design intact, providing workers enhanced benefits and the carriers lower tax rates.

## **THE FUTURE**

Railroad Retirement seems likely to negotiate the upcoming demographic transition with its current design intact. The program's finances should then significantly improve, either by the middle of the century under the optimistic projection or toward the end of the century under the intermediate projection. Both projections have trust fund assets then stabilizing at a bit more than eight times benefit outlays and taxes falling to 12 percent of payroll. The carriers would then be subject to a 10.1 percent payroll tax and the workers a 1.9 percent tax. These taxes would cover about 75 percent of benefit outlays, and transfers from the trust fund, now between 8 and 8.5 times annual outlays, would cover the remaining 25 percent.

The program's finances would then seem reasonably stable. It would have an adequate trust fund balance to cushion shocks, with the ratchet having enough time, range, and responsiveness to adjust tax rates to keep the program on track. Should the trailing 10-year average ratio of assets to outlays fall below 8, the ratchet would raise the payroll tax from 12 to 14 percent. With taxes covering 75 percent of benefit outlays, a 2-percentage-point change in the payroll tax rate—a 17 percent swing—would have a dramatic effect on the need for trust fund transfers. Assuming 90 percent of tax receipts come from the payroll tax, with the remainder from income taxes on benefits returned to the program, a 2-percentage-point increase in the payroll tax would cut the required trust fund transfer over 40 percent. The required trust fund transfer would then be less than 2 percent of a trust fund balance equal to just 7 time benefit outlays. This in time should be sufficient to raise the value of trust fund assets above 8 times annual outlays and lower the payroll tax back to 12 percent.

Nor should there be strong pressures to raise benefits or lower taxes. The carriers' 10.1 percent tax would be somewhat higher than the employers' traditional 7–8 percent of payroll cost for a defined benefit pension plan, so labor could expect the carriers to resist demands for further benefit enhancements. The tax, however, would not be so high that the carriers could expect labor to accept benefit reductions to lower the carriers' 10.1 percent levy.

There could be pressure, however, to move Railroad Retirement from a pay-as-you-go to a prefunded program. With trust fund assets exceeding eight time annual outlays, responsible for providing a quarter of annual benefit outlays, the program in fact would no longer be funded on a pay-as-you go basis. Shifting to prefunding, with program rules adjusting taxes and/or benefits to assure sufficient assets in the trust fund to pay promised pensions, would probably not require major tax increases or benefit cuts. Railroad Retirement at some point will need to make this transition. While the railroads will probably be a viable industry for another 100 years, it probably will not for 1,000 years. Unless the program shifts to a prefunded design, at some point it could fail and Railroad Retirement pensions would not be paid.

The long history of railroad pensions is full of change as well as continuity. Pension programs are inherently long-term arrangements, with future obligations dependent on events in the past. They hold claims created during an employee's working years for income many decades in the future. Those claims have rarely been fulfilled in the same institutional setup in which they were granted. The 2001 reforms thus will probably not be the last restructuring of the Railroad Retirement program.

### Notes

1. If prices on average rise 2 percent a year and wages 1 percent above inflation, the value of a benefit earned 25 years in the past, as a replacement of preretirement earnings, would be cut over 50 percent.
2. Rail workers also received retiree medical benefits, which reduced the retirement income needed to maintain their standard of living and also covered the risk of needing to pay for rising medical expenses as they aged.
3. In 2012, the average monthly pension for workers retiring early on “full” benefits was about \$3,600 a month: sum of Tier I and Tier II benefits for workers retiring before their “Full Retirement Age” (Railroad Retirement Board 2014, Table B9). Workers with 30 or more years of service then earned an estimated \$6,600 a month: average Tier I covered compensation in 2010 was \$6,150 (Railroad Retirement Board 2010, Table S-41); assuming nominal wage growth of 3.5 percent per annum, average Tier I covered compensation in 2012 would be \$6,600 a month (while Tier I covered compensation excludes compensation above the Social Security wage cap, the great majority of rail workers earned less than the Social Security wage cap). Assuming a spousal benefit equal to half the worker’s benefit, or \$1,800, couples would get \$5,400 a month, over 80 percent of the worker’s preretirement earnings (\$5,400/\$6,600); and single workers would get 55 percent (\$3,600/\$6,600).
4. Tier I Social Security–equivalent benefits are based on the average of the worker’s highest 35 years of covered earnings—earnings on which the worker paid either Railroad Retirement or Social Security payroll taxes—with earnings prior to age 60 indexed by the growth of national average wages. For workers with 35 years of covered earnings, the additional year of earnings would have a negligible effect on that average. For workers with less than 35 years of covered earnings, it could increase that 35-year average perhaps 3 percent. But due to Social Security’s progressive benefit formula, even a 3 percent increase in average earnings would raise the benefit of a relatively high-paid rail worker less than 1.5 percent.

Tier II benefits would increase more, about 4–5 percent. Tier II benefits are 0.7 percent of final 5-year average earnings for each year of service. The additional year would increase the pensions of workers with 30 years of service 3.3 percent ( $1/30$ ), and 2.9 percent for a worker with 35 years of service ( $1/35$ ); as Railroad Retirement pensions are indexed to inflation, benefits would also rise by the increase in final 5-year average earnings above inflation, typically 1–2 percent.

For workers with 30 years of service who retire early, Tier I benefits are about 50 percent greater than Tier II benefits: the average Tier I benefit for such workers in 2012 was \$2,160 a month, and the average Tier II benefit was \$1,455 (Railroad Retirement Board 2014, Table B9). Delaying retirement would thus increase the pensions of such workers about 2–3 percent.

5. In 2012, 5,213 workers aged 60 or 61 retired on full benefits (Railroad Retirement Board 2014, Table B10). Of workers aged 60–61 who retired on full benefits over the three-year period 2004–2006, 74 percent were aged 60 and 26 percent were aged 61 (Railroad Retirement Board 2009, Table S-30). Applying those percentages gives an estimated 3,834 workers aged 60 and 1,379 workers aged 61 retiring on full benefits in 2012. Dividing those figures by the retirement rates derived from Table S-30 in the 2012 25th Actuarial Valuation (which are essentially the same as those reported in the text derived from Railroad Retirement Board [2009]) gives 6,280 workers aged 60 and 2,865 workers aged 61 with 30 years of service in 2012. Applying the pre-reform retirement rates of 10 percent and 11 percent, respectively, for workers aged 60 and 61 with 30 years of service, gives an estimated 691 retirements by workers aged 60 and 286 by workers aged 61, or an estimated total of 977 retirements by workers aged 60 or 61 with 30 years of service had the 2001 reforms not been enacted. This is 4,236 less than the 5,213 such workers who retired in 2012.

## Chapter 6

# Lessons for Social Security

The histories of the federal Railroad Retirement program and Social Security have long been closely connected. Railroad Retirement was created one year before Social Security, when the government took over the tottering pension plans of the nation's railroad industry. The new federal program had the same pay-as-you-go social insurance structure that Congress would use for Social Security. Both programs would add ancillary social welfare benefits, for spouses and other dependents. The finances of both were significantly shored up in 1983, by the same Congressional committees, responding to similar financial issues. And the use of equities became central to proposals to reform each program in the 1990s.

From the creation of the Railroad Retirement and Social Security programs in the 1930s through the end of the 1990s, the trust funds of each program held only U.S. Treasury bonds. A well-established principle of finance nevertheless held that equities offered higher expected returns than Treasuries, at the price of higher expected risk. The long bull market in stocks, running from the early 1980s through the end of the 1990s, provided a powerful object lesson on higher returns on equities, and barely any lesson at all on higher risk. As described above, the appeal of higher returns on Railroad Retirement assets, if those assets were invested in equities, was the driving force behind the 2001 reform. When the 1994–1996 Social Security Advisory Council (1997) addressed in earnest Social Security's long-term financing shortfall, all three proposals the Council members presented included the use of equities. While none of these Social Security proposals has been enacted in the United States, other nations, such as Canada, Ireland, Japan, New Zealand, and Sweden, adopted a policy of investing Social Security Trust Fund assets in equities in the years between 1995 and 2001 (Palacios 2002).

The 2001 Railroad Retirement reform introduced equities, and the higher expected returns they offered, to cut taxes and raise benefits. The Advisory Council proposals embraced equities as an alternative to closing Social Security's financing shortfall the "old-fashioned" way—by raising taxes or cutting benefits. There was real resistance to raising Social Security payroll taxes. The payroll tax had become by far the largest tax most workers paid, at 15.3 percent of covered earnings (10.2 percent for Old Age and Survivors' Insurance, 1.8 percent for Disability Insurance, and 2.9 percent for Medicare. While the payroll tax is formally "split evenly" between employers and workers, the employer portion is part of labor compensation and generally viewed by economists as reducing employee earnings nearly dollar for dollar, and thus largely borne by workers.)

There was also real resistance to cutting benefits. Social Security was already scheduled to replace a significantly smaller share of household preretirement earnings for retirement at any given age, owing to the increase in the Full Retirement Age from 65 to 67 between 2000 and 2017. Combined with projected increases in the taxation of benefits and in Medicare Part B premiums, which are deducted from Social Security checks, benefits are expected to replace less than 30 percent of the "average worker's" preretirement earnings by 2030, significantly less than the 40 percent of the mid-1990s (Munnell and Sass 2006, p. 12).<sup>1</sup>

The three Advisory Council proposals, which remain the primary options for introducing equities into the Social Security program, were to

- 1) invest a portion of the Social Security Trust Fund assets in equities;
- 2) continue to invest Social Security Trust Fund assets in Treasuries and reduce benefits to what the program could finance, but add mandatory contributions to an individual retirement savings account that could be invested in equities; and

- 3) allow workers to divert a portion of their Social Security payroll tax to an individual account, which could be invested in equities, in exchange for a reduction in future Social Security benefits.

The Democrats under President Clinton had proposed adopting the first option—to invest a portion of the Social Security Trust Fund assets in stocks (Clinton 1999). The Republicans under President Bush had proposed the third option: allowing workers to carve out a portion of their Social Security payroll tax to fund individual accounts in which the funds could be invested in stocks. (See, for example, Greenspan [2001].) And each side vehemently opposed the other's proposal. The Democrats viewed carve-out accounts as gutting, and potentially killing, the social insurance safety net created by Franklin Roosevelt. The Republicans generally viewed the government investing the Social Security Trust Fund in equities as crossing a critical line in its involvement in the private economy. President Bush, in particular, made Social Security reform a major policy initiative, and he did so just as the railroad industry brought its proposal to Congress (Bush 2001).

The industry proposed that the Railroad Retirement program invest in equities and other private securities—like a private employer defined benefit plan. The rub, however, was that Railroad Retirement was a government program and its assets are government assets. Investing the program's assets in equities was widely seen as creating a precedent for doing the same with Social Security. This was an unwanted complication for the industry, as it generated stiff opposition that nearly scuttled the proposed reform—especially from proponents of President Bush's individual account alternative.

Some lawmakers suggested that the industry consider converting Railroad Retirement into a 401(k)-type individual account program, but that was a total nonstarter—the unions would never accept the transition, nor was management interested. If equities were to be introduced into the Railroad Retirement program, it would have to be done using the assets in the Railroad Retirement Account.

Congress in the end enacted a reform of the Railroad Retirement program that included investment in equities. As discussed above, Congress did what it could to distance the investment process as much as possible from government. The experience of the reformed Railroad Retirement program nevertheless has implications for the investment of Social Security Trust Fund assets in equities. The most important implications, in increasing order of importance, are in budgetary accounting, the governance of trust fund investment, and dealing with risk.

## **GOVERNMENT ACCOUNTING**

Railroad Retirement assets are government assets, but the accounting treatment of the investment of Railroad Retirement assets in equities, in the words of the CBO, was “a significant departure from traditional federal transactions” (CBO 2003, p. 12.) This treatment, and its influence on policy decisions, would likely be extended to the investment of the Social Security Trust Fund assets in private securities.

Normal government accounting would book the trust fund’s purchase of private securities as a current government expenditure. It would also treat its sale of Treasuries to finance the purchase as a nonevent, which could increase in the government’s reported current deficit and long-term debt by well over \$1 trillion.

Normal pension accounting, however, would book the trust fund’s purchase of private securities as an investment, not a current expenditure, with the cost of that investment offset by the sale of the trust fund’s investment in Treasuries. The transaction would change the composition of government assets, but it would not affect the income statement (i.e., the federal deficit) or the size of the government’s liabilities (i.e., the federal debt).

The railroad team succeeded in winning similar treatment for NRRIT transactions; it did so by having Congress apply a new accounting treatment it had developed a decade earlier. In 1990, Con-

gress had specified that government student and home loans, financed by the sale of Treasuries, be booked as “a means of financing—a budgetary nonevent—rather than a current government outlay. In 2001, it specified that NRRIT transactions likewise be treated as “means of financing” budgetary nonevents.

Should Congress choose to invest Social Security assets in equities, the means of financing precedent established for NRRIT could be used to avoid recording an enormous—an illusory—expenditure and deficit when exchanging Treasuries for private sector securities. A conservative critic of the 2001 reform noted that this budgetary treatment created a bias in favor of using the Trust Fund, not carve-out individual accounts, for introducing equities into the Social Security program. Payroll taxes diverted to carve-out individual accounts would clearly reduce government revenues, with the reduction duly recorded on the government’s books. As government accounting is cash accounting, the reduction in *future* Social Security benefit obligations, resulting from the diversion of payroll taxes, would *not* be recorded.

While the means of financing treatment would avoid a major political impediment to investing the Social Security Trust Fund in equities, the treatment of the NRRIT’s annual income and loss does not. The interest, dividends, rents, and realized and unrealized capital gains on NRRIT assets are booked as government revenue—or as government outlays should NRRIT’s capital losses exceed the interest, dividend, and rental income it collects. With a Social Security Trust Fund now holding over \$2 trillion, the volatility of equity prices can be expected to regularly generate capital gains and losses of \$100 billion or more. In a unified budget context, these gains and losses flow directly to the budgetary bottom line. They would also tend to be strongly procyclical: large capital losses in downturns, reported as outlays, would widen budget deficits; large capital gains in upturns, reported as revenues, would shrink or eliminate budgetary deficits. Swings in the value of equities held in individual accounts—whether carve-out or add-on accounts—would sometimes trouble and some-

times please the account holder. But they would have no direct effect on the federal budget. If government accounting continues to report the operations of Social Security within the unified budget context, this treatment of annual income and loss would clearly create a bias against investing the Social Security Trust Fund in equities.<sup>2</sup>

## **GOVERNING THE INVESTMENT PROCESS**

The primary concern of Congress when it enacted the 2001 reform was the NRRIT's ability to manage the investment of government assets efficiently and without political influence. This, not accounting, was the primary substantive issue motivating resistance to the industry initiative. The Republican leadership was convinced that political pressures would inevitably affect how government assets were invested, which would undermine financial efficiency and—far more serious—the American democratic political system.

So Congress did what it could to make the investment of Railroad Retirement assets as much as possible a nongovernmental activity. It explicitly made the NRRIT a nongovernmental entity, with no government employees or agencies involved in its operations. It created the Trust by statute in the image of a private multiemployer pension trust—with the Trustees primarily selected by management and labor and the one “independent” (not “public”) trustee selected by these industry representatives. The statute also charged these Trustees, like trustees in a private pension trust, to make investment decisions solely in the interest of the plan participants. They were also charged to use industry “best practice” to develop and execute a formal investment plan.

Consistent with the intent of Congress, the NRRIT has managed the assets of the Railroad Retirement program like a private pension trust, free of political influence. But despite the fears of the Republicans, and hopes of the Democrats, the NRRIT experience does not provide much of a precedent for Social Security and the investment of Social Security Trust Fund assets.

The primary impediment in using the NRRIT as a model for Social Security is the lack of national private organizations that could legitimately select trustees of a nongovernment entity that could oversee the investment of Social Security assets. The railroad industry is highly organized, with the Association of American Railroads and the National Railway Labor Conference representing the carriers and the Cooperating Railway Labor Organizations representing labor. These organizations have an extensive history negotiating the terms and conditions of railroad employment and managing joint labor-management health and welfare plans. These organizations, implicitly recognized as representing rail management and labor by Section 2 of the Railway Labor Act and Section 105(3)(A)(ii) of the 2001 reform, selected the six management and labor NRRIT Trustees. If Railroad Retirement were a private multiemployer pension plan, these would be the organizations that would name the trustees of the plan's pension trust.

Many nations in continental Europe have national management and labor organizations that function as “social partners” and negotiate and oversee national social security programs and other employment institutions. The status of these organizations is often defined in law and their negotiated decisions enforced by law.<sup>3</sup> But there are no such organizations in the United States that could legitimately claim to represent all employers or employees and thus be in a position to oversee the investment of employer and employee contributions to the Social Security program. The U.S. Social Security system is purely a creation of the national government, with no formal “employer” or “employee” involvement. Unlike Railroad Retirement, there are no national organizations that could legitimately assume responsibility for managing the Social Security Trust Fund.

Canada provides an example of a nation without social partners that succeeded in developing a governance structure for investing social security trust fund assets in equities. Its Canada Pension Plan Investment Board (CPPIB), which manages the assets of the government's Canada Pension Plan, is a quasi-independent entity. Like

NRRIT, the CPPIB is subject to private-sector fiduciary mandates and periodic reporting requirements. To select the CPPIB directors, who oversee the investment process, Canada uses an elaborate decentralized process involving both provincial and federal governments. The process, which could be a model for the United States, is generally seen as successful: like the NRRIT, the CPPIB is seen as operating like a well-run private pension trust, free of political influence (Munnell and Sass 2006).

The most prominent proposals for investing Social Security assets in equities, however, take a different tack. They would have the assets managed by an entity modeled on the Thrift Savings Plan for federal employees, and they would have its investment board nominated by the president and confirmed by the Senate—the process used for selecting political appointees to government positions. Thus, the proposed Social Security investment board would not be well insulated from political influence. But its investment discretion would be sharply constrained: it would simply select a broad market index, such as the Russell 3000 or the Wilshire 5000, then competitively bid out and monitor the investment managers selected to follow that index. This approach to the problem of political influence on investment decisions is not to exclude political influence but to radically reduce investment discretion.<sup>4</sup> Given America's congenital suspicion of government and the enormous size of Social Security's potential investment in equities—estimated at 5–10 percent of the U.S. market with 40 percent of trust fund assets invested in stocks—this approach seems best.

## **DEALING WITH RISK**

The most important lessons for Social Security provided by the reformed Railroad Retirement program deal with the management of risk. Pension programs are extremely long-lived institutions, and their finances will always move in unexpected ways. The 2001 Railroad Retirement reform introduced a mechanism—the tax adjustment

ratchet—that automatically raised and lowered the payroll tax to offset changes in the program’s finances. Such automatic stabilizers strengthen the financial viability of long-term pension programs. The inclusion of the ratchet was also important in easing congressional concerns about the investment of Railroad Retirement assets in equities and other risky securities. Some type of automatic adjustment mechanism, similar to the Railroad Retirement ratchet, thus seems critically important, financially and politically, to any viable program of investing the Social Security Trust Fund in equities.

The tax adjustment mechanism was a key element in the initial designs for reforming Railroad Retirement developed by the carriers in the 1980s and early 1990s. The carriers had developed proposals for privatizing Railroad Retirement, and the ratchet was the device for reducing the payroll tax—then 21 percent of covered earnings—in the program’s transition to a normal private employer plan. When the carriers presented their proposal to labor, the unions saw the benefit of investing Railroad Retirement assets in equities. But they saw no gain in giving up their statutory benefits, granted by an act of Congress, and flatly rejected privatization. So the parties settled on a pay-as-you-go program, with Railroad Retirement assets invested as the assets in a private pension trust. In this new design, the tax adjustment ratchet became a device for keeping the program financially stable.

The ratchet enacted in the 2001 reform adjusted the Railroad Retirement payroll tax up or down, based on the trailing 10-year average of the ratio of trust fund assets to annual benefit outlays, and was designed to keep trust fund assets within a target band of 4–6 times annual outlays. As shown in Figure 2.4, the ratchet would automatically increase the payroll tax should that trailing 10-year average ratio fall below 4; and it would cut taxes should it rise above 6 (RRSIA 2001, Section 204, 26 USC Section 3241). In both cases, tax rates would rise or fall by increasing amounts as the trailing 10-year average ratio strayed beyond the target band of 4–6 times annual outlays.

The ratchet can thus make very large adjustments to payroll tax rates, pushing the rate up to 27 percent or pulling it down to 8.2

percent of covered payroll. This extremely broad range was due to the expectation that the tax needed to keep the program on track 1) could rise and fall quite dramatically over the course of the program's 75-year planning horizon, but 2) would likely fall significantly by the end of those 75 years.

The ratchet was not designed to provide a complete solution to the problem of risk. It could not push the payroll tax above 27 percent nor below 8.2 percent of covered payroll. By basing the tax on the average ratio of trust fund assets to annual benefit outlays over the previous 10 years, by design it responded quite slowly to changes in the program's finances.

Changes in Railroad Retirement finances that exceed the limits of the ratchet's automatic responses would require a political response. Should an 8.2 percent payroll tax produce an ever-rising ratio of assets to outlays, Congress (and the industry) would need to decide how to cut taxes or increase benefits. Congress (and the industry) would likewise need to decide what to do should a 27 percent payroll tax prove insufficient or should the ratchet respond too slowly to a sudden downturn in the program's finances. The critical measure of the ratchet's effectiveness in such cases is whether it gives Congress (and the industry) enough time to fashion an adequate response.

The enactment of the 2001 Railroad Retirement reform suggests that Congress would require some type of automatic adjustment mechanism should it allow the Social Security Trust Fund to invest in equities. It also suggests that any such mechanism cannot be expected to provide a complete solution to the problem of risk. The design of the mechanism would specify the size and speed of the automatic adjustments, setting limits on its ability to stabilize Social Security's finances. A sufficiently large or long-lasting shock, which exceeds the mechanism's ability to respond, would require Congress to act. On the other hand, automatic adjustments large enough and fast enough to respond to such shocks could generate reactions so strong that Congress would also be required to act. The mechanism's design could

only influence how and when Congress might intervene, not completely eliminate the need to intervene.

A Social Security program with a trust fund invested in equities should be far more stable and predictable than the current Railroad Retirement program. This is especially true for a program's employment base, payroll tax revenues, number of beneficiaries, and annual benefit outlays. The ratio of Social Security beneficiaries to workers will rapidly rise as the baby boom generation ages but then remain relatively stable. Nor will the Social Security Trust Fund likely be invested nearly as extensively in equities as the NRRIT. A Social Security program that invests in equities thus should not experience short-term shocks anywhere near as large, relative to the size of the program, as those seen in Railroad Retirement. The adjustment mechanism could thus be designed to respond rather slowly. The American political process, on the other hand, has convincingly demonstrated its inability to manage Social Security's finances. Despite knowing for decades that Social Security had a serious long-term financing shortfall, the nation for decades has failed to act.<sup>5</sup> This argues for allowing the automatic mechanism to make adjustments large enough to adequately address as many anticipated risks as possible, so Congress would only need to act should those adjustments generated substantial political resistance.

Several nations in recent years have introduced automatic adjustment mechanisms to make their social security programs more sustainable. The great majority, however, operate traditional pay-as-you-go programs with small trust funds designed to buffer short-term cash-flow shortfalls and hold only government bonds. They generally pay relatively high benefits, have relatively high tax rates, and anticipate revenue shortfalls in response to upcoming demographic shifts. Unlike the Railroad Retirement ratchet, nearly all of these automatic mechanisms only adjust benefits, not taxes—and are expected to adjust benefits downward.<sup>6</sup>

Canada is an exception. It has a social security program with a large trust fund that is invested much like the NRRIT, and an auto-

matic adjustment mechanism to keep the program's finances on track. The Canada Pension Plan (CPP)—the earnings-related component of the nation's social security program—is funded by a 9.9 percent tax on covered earnings, pays a benefit of 25 percent of average indexed earnings, and is projected to have a trust fund equal to 6.5 times annual outlays, responsible for providing 15 percent of annual benefit payments, by 2080. The CPP also has an automatic adjustment mechanism. The mechanism is not based on the ratio of assets to outlays, as in Railroad Retirement, but on projections by the Chief Actuary of Canada, conducted every three years, on the tax needed to sustain the program. If the projection indicates the 9.9 percent tax is too low, the politicians are given the opportunity to bring the program back into balance. If they don't, two things happen automatically: 1) retiree cost-of-living adjustments are eliminated until the next triennial review; and 2) taxes are raised, up to 0.2 percent of covered earnings per year, up to half the difference between the current tax and the minimum tax needed to restore sustainability in 75 years. Should the next triennial review again report a shortfall, the process is repeated.<sup>7</sup>

In one key respect, the CPP mechanism is more suited to Social Security's needs than the Railroad Retirement ratchet. The CPP makes adjustments based on a long-term, forward-looking assessment of the program's finances; Railroad Retirement makes adjustments based on much shorter-term retrospective performance. As the finances of Social Security and the CPP are far more stable and predictable than those of the Railroad Retirement program, it is both feasible and preferable to adjust Social Security taxes and benefits based on long-term projections.<sup>8</sup> It might also be advisable to include a trigger based on a shorter-term assessment; given the experience of the sharp financial shocks since 2008, it might be advisable to include a secondary adjustment mechanism that responds to risks of near-term cash-flow shortfalls that the 75-year projection might not flag. But adjustments based on long-term projections would seem to be the norm, with any based on shorter-term assessments as a safety measure.

The adjustments automatically made by the CPP, on the other hand, are decidedly not appropriate for Social Security. The burden of the CPP's tax and benefit adjustments by design falls most heavily on retirees. The three-year suspension of cost-of-living adjustments cuts the purchasing power of benefits 6 percent if inflation is running 2 percent a year, and 9 percent if inflation is running 3 percent a year. And these cuts are permanent—should cost-of-living adjustments resume, they resume from these post-freeze levels. The tax increases, by contrast, are unlikely to be anywhere near as large. And they could be reversed should conditions improve. Canada adopted these adjustments not because it viewed them as equitable, but as a political instrument: the threat of a benefit freeze is expected to mobilize retirees to “put a cannon” at the head of the politicians to get them to restore sustainability some other way. Given the U.S. track record in managing Social Security's finances, it seems advisable to adopt adjustments expected to be put in place, not to pressure politicians to act.<sup>9</sup>

That the Railroad Retirement ratchet automatically adjusts only taxes, that nearly all social security programs with automatic mechanisms adjust only benefits, and that the CPP adjusts both, is not especially significant for Social Security. The nations that introduced automatic adjustments to lower benefits generally had programs paying benefits that replaced a much higher share of preretirement earnings than the U.S. Social Security program. The Railroad Retirement program is modeled on standard employer-defined benefit pension plans, in which benefits are defined and the employer, typically, is responsible to pay what's needed. The CPP adjusts both taxes and benefits, but it placed the primary burden on benefits as a political device. So what to adjust, and how much to adjust, remain open questions. Social Security could adjust taxes and benefits; the adjustments could target those better equipped to bear risk, such as higher-income workers and beneficiaries or employers as opposed to workers; those who bear risk could also be compensated by lower expected tax rates

and higher expected benefits—from where their taxes and benefits would be should the program not invest in equities.<sup>10</sup>

One lesson Railroad Retirement offers, however, is how to respond to surpluses. The primary concern when reviewing automatic adjustment mechanisms is how they handle shortfalls—whether they raise taxes, cut benefits, delay eligibility, or make some other adjustment. But how do they handle surpluses? The Railroad Retirement ratchet lowers taxes. One could assume that rail workers would spend that tax reduction on current consumption. For the carriers, the reduction would increase earnings, which would be used either to increase dividends or be retained and invested. To the extent that tax reductions on the carriers are retained and invested, the tax reduction increased the carriers' financial strength. Should the Railroad Retirement program subsequently face a financial shortfall, the carriers would be in a better position to pay the higher taxes the ratchet would introduce. Something similar could be done in Social Security—say by directing tax reductions on workers into individual accounts, which could be accessed only 1) to pay future payroll taxes, should taxes subsequently need to rise above the statutory rate; or 2) should the worker retire, become disabled, or die, or the value of the account exceed some specified amount.<sup>11</sup>

Finally, it is important to note that an automatic adjustment mechanism presupposes a program in balance, or moving toward balance. If Congress would require an automatic adjustment mechanism for the Social Security Trust Fund to invest in equities, the investment in equities would need to be part of a package that produced a sustainable Social Security program. This would necessarily mean some combination of higher taxes or lower benefits. This would reduce the gap between tax revenues and benefit outlays, which income from the trust fund would need to fill, well below the currently projected shortfall of 25 to 30 percent scheduled benefits.

A critical benefit of any reform package that included the investment of trust fund assets in equities would thus be the automatic adjustment mechanism. Though included in response to political

demands for a mechanism to deal with risky equities, it would adjust the Social Security program in response to any shock, not just financial shocks. Had such a mechanism been in place, it would have introduced adjustments to Social Security, without the need for Congress to act, in response to the demographic shocks that have made the current program unsustainable, and it would keep the program sustainable for generations to come.

### Notes

1. The increased employment of married women, which raised a household's preretirement earnings far more than postretirement benefits, further diminished Social Security's role in providing an income to the nation's elderly (Munnell, Sanzenbacher, and Soto 2007).
2. One Social Security accounting issue that the Railroad Retirement experience did not address is how to treat the return on equities in financial projections. Both the Social Security and Railroad Retirement actuaries, like other actuaries, use the expected return on equities in making such projections. Government budgetary officials, like many financial analysts, use the risk-adjusted return that "costs" the risk in equities as the difference between the expected return and the return on riskless government securities. After deducting this "cost," they use the much lower return on government securities in their financial projections. This is a very thorny and contentious issue, which the Railroad Retirement experience did nothing to resolve or clarify.
3. For a discussion of the Dutch system, which does invest social security assets in equities, see Ponds and van Riel (2007).
4. The proposed board would need to choose the broad market index, which could include foreign securities. It would not be allowed take an active role in corporate governance: Social Security shares would not be voted (which tends to favor incumbent management), shares would be voted similarly to the other shareholders, or the investment managers would vote the shares "in the best interest of program participants," as is done in the Thrift Savings Plan. For a discussion of these and other issues, see Munnell, Balduzzi, and Gist (1998) and White (1996).
5. For some reasons why, see Diamond (1994).
6. For a review see OECD (2012).
7. The discussion of the CPP follows Monk and Sass (2009). Sweden also invests social security trust fund assets in equities, and investment performance is incorporated in program's automatic adjustment mechanism when setting benefits (Palacios 2002).

8. This assumes that there is no constitutional issue in changing tax rates based on actuarial projections provided by the executive branch of government, rather than an act of Congress.
9. As Monk and Sass (2009) write, “Concentrating the burden on current retirees is clearly at odds with general notions of social insurance objectives. The distribution of losses is also quite unfair: workers who will retire soon will pay the modestly higher contributions and then retire on unreduced benefits; workers just a few years older will have their CPP benefits substantially reduced. A small reduction in all benefits paid out over the next 76 years, a reduction akin to the increase in contributions, would be far more consistent with social insurance objectives” (p. 4).
10. For an innovative employer plan that shares risk, see Munnell and Sass (2013).
11. Congress might also allow workers to access this account should they have a hardship or need the funds for a “socially approved” use, such as paying for college or buying a house. A similar treatment could be used for employer contributions, though this could raise thorny legal issues, and passing the reduction to the employer is exactly analogous as the treatment used in Railroad Retirement.

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## **About the Institute**

The W.E. Upjohn Institute for Employment Research is a nonprofit research organization devoted to finding and promoting solutions to employment-related problems at the national, state, and local levels. It is an activity of the W.E. Upjohn Unemployment Trustee Corporation, which was established in 1932 to administer a fund set aside by Dr. W.E. Upjohn, founder of The Upjohn Company, to seek ways to counteract the loss of employment income during economic downturns.

The Institute is funded largely by income from the W.E. Upjohn Unemployment Trust, supplemented by outside grants, contracts, and sales of publications. Activities of the Institute comprise the following elements: 1) a research program conducted by a resident staff of professional social scientists; 2) a competitive grant program, which expands and complements the internal research program by providing financial support to researchers outside the Institute; 3) a publications program, which provides the major vehicle for disseminating the research of staff and grantees, as well as other selected works in the field; and 4) an Employment Management Services division, which manages most of the publicly funded employment and training programs in the local area.

The broad objectives of the Institute's research, grant, and publication programs are to 1) promote scholarship and experimentation on issues of public and private employment and unemployment policy and 2) make knowledge and scholarship relevant and useful to policymakers in their pursuit of solutions to employment and unemployment problems.

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