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United States General Accounting Office ~~34395~~

# GAO

Report to the Chairman
Committee on the Budget
United States Senate

May 1986

# RAILROAD RETIREMENT

# Federal Financial Involvement

130125



GAO/HRD-86-88

GAO

United States
General Accounting Office
Washington, D.C. 20548

Human Resources Division

B-222204

May 9, 1986

The Honorable Pete V. Domenici
Chairman, Committee on
the Budget
United States Senate

Dear Mr. Chairman:

This report is being provided in accordance with your December 17, 1985, request. On March 5, 1986, we furnished you with a fact sheet that briefly summarized the major points covered in more detail in this report.

In this report, we (1) present an inventory and description of past and present federal financial assistance to the rail industry's retirement and unemployment programs administered by the Railroad Retirement Board and (2) show how much assistance will be needed under current law to continue the federal government's unique relationship with these programs.

The financial data compiled for this report were obtained primarily from Board records. The sources of the data and the basis for estimates and projections are discussed in appendix I. We obtained official oral comments from the Railroad Retirement Board on the matters discussed in this report on April 11, 1986, and considered those comments in its preparation.

As arranged with your office, unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days from its issue date. At that time, we will send copies to other interested congressional committees and members; the Chairman, Railroad Retirement Board; the Director, Office of Management and Budget; and other interested parties. We will also make copies available to others upon request.

Sincerely yours,

Richard L. Fogel

Richard L. Fogel
Director

# Executive Summary

The Railroad Retirement Board administers two programs. One is a retirement program for rail workers and their dependents and survivors, which incorporates the protection provided by social security but also provides additional industry benefits. The other is an unemployment and sickness insurance program for rail workers.

The Congress and the rail industry originally intended that these programs be financed solely by the rail industry, but both programs later received federal financial assistance.

The Chairman, Senate Budget Committee, asked GAO to report on the nature and extent of federal financial involvement in these programs.

## Background

During fiscal year 1985, about $6 billion in railroad retirement benefits were paid to almost 1 million beneficiaries. Also, about 135,000 rail workers received about $175 million in unemployment and sickness benefits.

Railroad retirement beneficiaries are entitled to two basic types of benefits—a social security equivalent benefit comparable to what they would have received had rail employment been covered by social security, and a private rail industry pension benefit (currently averaging $317 a month for new retirees). About 35 percent of beneficiaries also receive a special windfall benefit (averaging $179 a month) payable to persons whose work history makes them eligible to receive benefits under both railroad retirement and social security. About 20 percent of beneficiaries also qualify for a special supplemental private pension benefit (averaging $42 a month) intended for those with at least 25 years of service who retire directly from rail employment.

Retirement benefits are financed by payroll taxes on rail employers and employees. Receipts from these taxes are credited to the railroad retirement trust funds. The windfall benefit for dual beneficiaries is financed by annual appropriations from general revenues.

Under the unemployment and sickness insurance program, workers receive up to $25 a day for periods of unemployment or sickness. These benefits are financed by payroll taxes on rail employers.

In its analysis, GAO characterized federal involvement in the railroad retirement programs as that which (1) affected general revenues and (2) involved other federal trust funds. GAO relied primarily on Board data and projections in developing the estimates contained in this report but did not independently verify their accuracy.

## Results in Brief

The railroad retirement programs and their beneficiaries have benefited from retirement and unemployment programs separate from social security and the state-administered unemployment insurance program. The retirement program has (1) established close ties with the social security program and received annual transfers of funds from the social security trust funds, (2) received general revenues to pay certain benefits, and (3) received special treatment regarding taxation of benefits, tax revenues, investment authority, and certain administrative expenses. The unemployment and sickness insurance program has also received general revenues.

Most of the federal involvement in these matters was initiated to address a financial need stemming, at least in part, from the separate nature and uniqueness of the Board programs.

## GAO Analysis

Federal financial involvement in the railroad retirement program has increased to where it now comprises almost half of annual revenues.

### Transfers From Social Security

Almost 85 percent of this involvement has come from an annual transfer of funds from social security, which, when combined with the payroll taxes paid by rail workers and employers at the social security rate, enables the Board to pay a social security equivalent benefit to railroad retirement beneficiaries. This transfer does not represent an additional cost to the federal government, but rather enables the Board to pay the social security equivalent benefit, a benefit that would be payable directly by social security if rail workers were covered under social security rather than railroad retirement.

### General Revenues

Other costs incurred by the government because of railroad retirement primarily involve direct payments from general revenues and the rail industry's avoidance of certain costs that are borne by general revenues.

General revenue payments are currently made directly to the railroad retirement programs principally to pay the windfall benefit to persons entitled to benefits under both social security and railroad retirement.

About $375 million is to be provided in fiscal year 1987 and another $3.3 billion through the year 2000 to continue this dual benefit payment.

General revenues have also been affected by special treatment afforded the taxation of railroad retirement benefits, tax revenues, and investments. From 1960 to 1985, an estimated $4.9 billion in potential revenues have been forgone by the U.S. Treasury because railroad retirement pensions were not taxed like other private pensions. Because of legislation enacted in 1983 and in April 1986, railroad retirement private pension benefits are now being taxed as other private pension benefits.

Special investment authority intended to enable the Board to maximize the interest earned on its government securities results in additional interest income earned by the Board programs at the expense of the general revenues.

## Future Involvement

Legislation enacted in 1983 restored the viability of the railroad retirement system, and current Board projections indicate that future benefits can be paid through the year 2000. However, lower than anticipated rail employment could again threaten the program's solvency by reducing the anticipated revenues from payroll taxes and increasing unemployment benefit costs. The unemployment and sickness insurance program owed the retirement program $803 million as of December 1985 because of past borrowing to pay benefits.

The retirement program's private pension funding is patterned after social security's pay-as-you-go system (current taxes pay current benefits with only a limited reserve maintained) rather than being patterned after multiemployer private pension plans under the Employee Retirement Income Security Act, where future liabilities are insured and payments are made toward fully funding the benefits over time. Consequently, an unfunded liability, estimated by the Board to be $33 billion as of December 1983, exists for the railroad retirement program's private pension.

## Recommendation

GAO makes no recommendations in this report.

## Agency Comments

Board officials, in orally commenting on the matters discussed in this report on April 11, 1986, presented technical clarifications, which have been incorporated in the final report.

# Contents

# Figures



**Abbreviations**

| | |
|---|---|
| GAO | General Accounting Office |
| HCFA | Health Care Financing Administration |

# Introduction

The Railroad Retirement Board administers a railroad retirement program, which provides benefits to retired or disabled rail workers, their spouses, and survivors, and an unemployment and sickness insurance program, which provides benefits to rail workers who become sick or unemployed. These programs have encountered financial problems in the past and have been and continue to be helped by federal financial assistance. This report describes the evolution and growth of the programs, the nature and extent of federal financial assistance received, the effect on general revenues of treatment afforded because of the programs' unique nature, and some implications for the future.

## Objectives, Scope, and Methodology

On December 17, 1985, the Chairman of the Senate Budget Committee requested us to report on the federal financial involvement in the railroad retirement programs. On March 5, 1986, we provided the Chairman a fact sheet (GAO/HRD-86-73FS) summarizing some of the major points covered in this report. Our objective in preparing this report was to describe the size and nature of the railroad retirement programs and present a comprehensive inventory of federal financial involvement to date as well as implications for future involvement. We considered such involvement to include general revenue appropriations, government trust fund transfers, and any of the programs' provisions or exemptions that could result in forgone revenues to the Treasury. Some of this financial involvement parallels that which exists in other federal programs and some is unique to the railroad retirement program.

Our work was conducted primarily at the Railroad Retirement Board headquarters in Chicago. During our work, however, we discussed the matters included in this report with officials from the Office of Management and Budget, the Office of Personnel Management, the Social Security Administration, the Department of the Treasury, and various rail industry management and labor organizations.

In compiling the cost of federal involvement in the Board programs, we used, where possible, actual cost data from the inception of the programs through 1985 and Board projections through the year 2000. Where data were not available and estimates could be developed, we did so. This was done, for example, to estimate income tax revenues forgone in the past because rail private pension benefits were not taxed and the amount of general revenues that had been used to pay for Board administrative costs associated with the private pension component.

Actual cost information used in this report was based on the Board's accounting records, actuarial valuations, and beneficiary data. These data were supplemented with information from our prior reviews, data from the Office of Management and Budget and Office of Personnel Management, and public documents. In computing estimated incurred and potential future financial projections, we used the services of the Board's Bureaus of Research and Analysis and the Chief Actuary. We did not, however, independently verify the accuracy of the data we obtained from the Board and other government agencies.

We obtained official oral comments on the matters discussed in this report from the Board on April 11, 1986, and considered those comments in its preparation. A detailed description of our scope and methodology and the assumptions we used is included in appendix I.

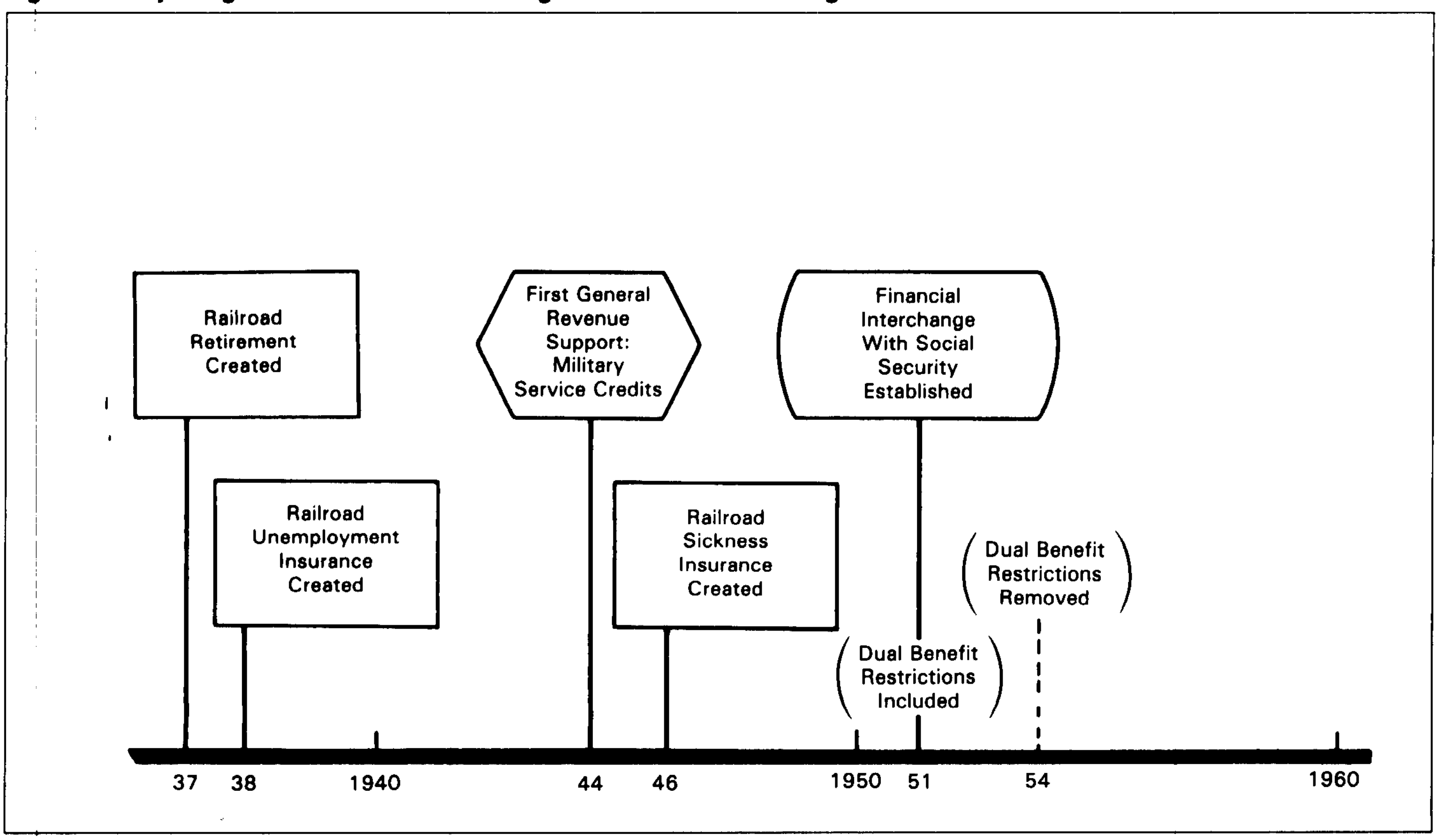
Except as noted above, we performed our work in accordance with generally accepted government audit standards.

# A Brief History of the Railroad Retirement Board Programs

Created by the Railroad Retirement Act of 1937 at the urging of rail labor, the railroad retirement program was to establish a staff retirement plan that would provide benefits to aged retired rail employees based on their rail earnings and service. The program was to be financed solely by payroll taxes on rail employers and employees.

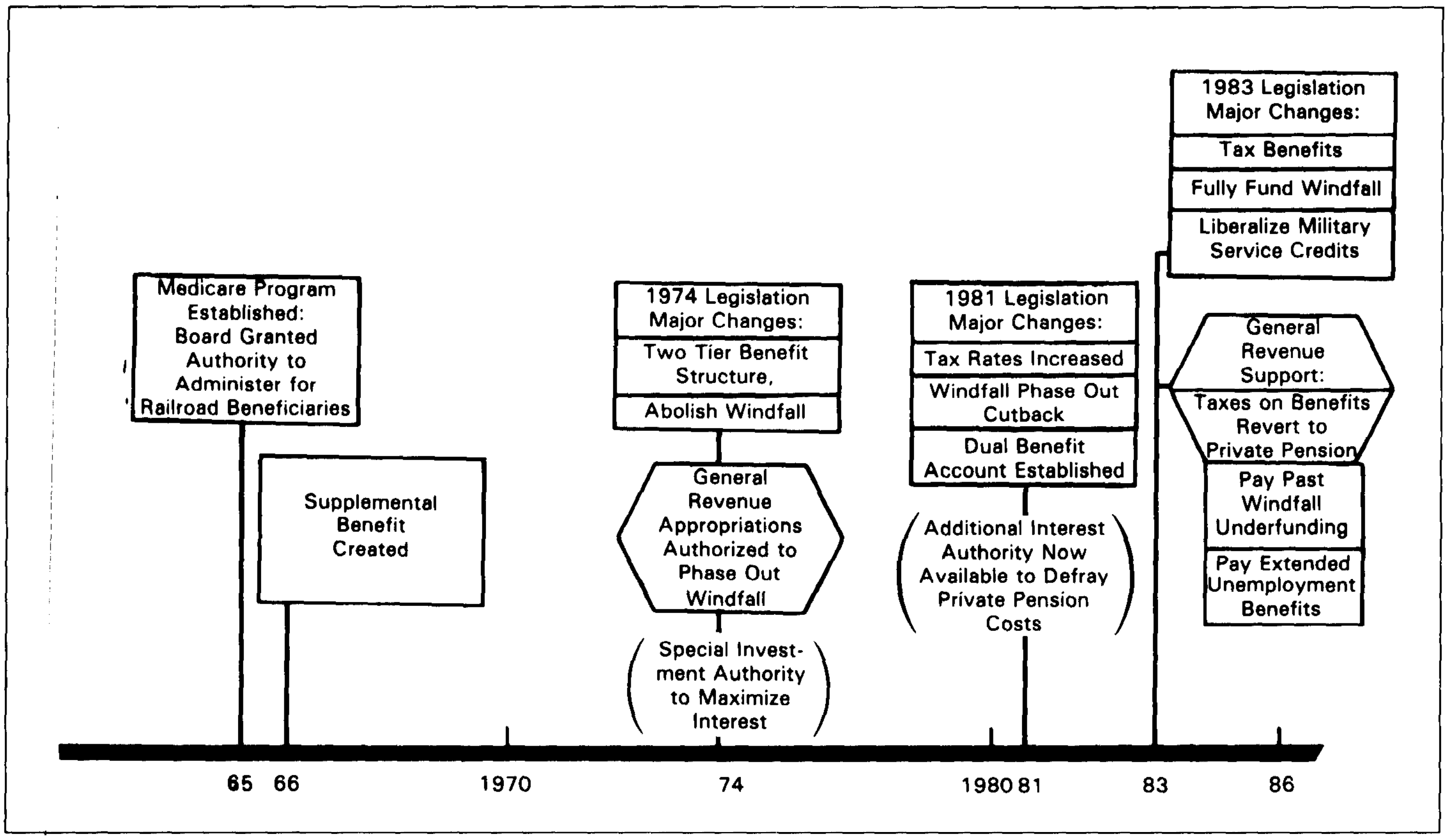
In the early 1930's, railroads with private rail pension plans had seen their plans defaulting. Although by the mid-30's a national social security program had been proposed, the rail industry decided to remain separate. The rail industry hoped that a separate program would permit rail workers and retirees to retain credit for pension benefits they earned under earlier private railroad pension plans. This, it was believed, would enable rail companies to retire senior workers, thereby making jobs available for others, especially during the depression years.

**Figure 2.1: Major Legislative Milestones Involving Railroad Retirement Programs**



Mandatory retirement with a pension for 65-year-olds was the stick. The carrot was making retirement benefits available immediately—instead of in 1942, as was planned for social security.

Numerous legislative changes after 1937 increased benefits and added social insurance features similar to those provided under social security. In 1938, the railroad unemployment insurance program was separated from the nationwide federal-state system. One argument for doing this was that rail workers working in the same jobs on the same railroad but living in different states were getting different treatment and benefit amounts under the federal-state unemployment insurance system. In 1946, a provision was added for the payment of sickness benefits. This program was to be financed solely through taxes on rail employers.



The following pages describe the major changes involving the federal government's involvement in the railroad retirement programs from the programs' inception through April 7, 1986.[1] Figure 2.1 shows the major legislative milestones through March 1986.

## Evolution of Legislated Federal Involvement in the Railroad Retirement Programs

1937. Because of the widespread occurrence of financially troubled private rail pension plans, a railroad retirement program—separate from social security—was established. The program was to be solely supported by employees and employers of the rail industry. Reasons offered for a separate program included (1) many older rail workers would be able to get credit for pre-1937 earnings and (2) rail pensions would be available earlier than under social security.

1938. A separate railroad unemployment program was created. The main reasons offered for a program separate from the federal-state one was that rail employees working in the same jobs would not get equal treatment because of the varying state unemployment insurance benefit structures.

1944. The railroad retirement program began receiving general revenues for retirement credits earned by rail employees who had served in the military (resulting from 1940 amendments to the act). Since 1964, general revenue contributions have been calculated on the basis of the additional benefits that will have to be paid out as a result of giving retirement credits for time spent in military service. Initially, they were calculated on the basis of the employer's (in this case the federal government) contribution for retirement taxes that should have been collected for individuals' wages while in the military.

1946. In the 1946 amendments to the Railroad Unemployment Insurance Act of 1938 a program of cash sickness benefits (including maternity) was established for railroad workers, paralleling unemployment benefits and financed from the same taxes.

1951. Amendments were enacted creating a financial interchange between the railroad retirement and social security programs. The amendments substantially increased railroad retirement benefits (to resemble the benefit increases granted persons under social security the preceding year), and the financial interchange was created as a method

[1]On April 7, 1986, while this report was being finalized, the Congress enacted legislation which is discussed on page 15.

of financing these benefit increases. A computation was to be made annually of what social security would have collected in taxes and what it would have paid in benefits had rail workers been included under social security. The net difference was to be transferred between the two programs. If tax receipts would be more than benefits paid, the railroad retirement program would transfer the amount to the social security program. If benefits paid exceed tax receipts, social security would transfer the amount to railroad retirement. Since 1958, social security has annually transferred funds to the railroad retirement program (essentially because the ratio of payroll tax income to social security equivalent benefit payments is lower in the railroad program than in the social security program), and this trend will continue into the foreseeable future.

Individuals with sufficient earnings under both the social security and railroad retirement programs were entitled to benefits under both programs. Because of the benefit provisions under each program, dual beneficiaries were entitled to a proportionately higher total benefit than those who might have the same lifetime earnings but who worked only in the rail industry or only in social security covered employment. The additional benefit amount was not reimbursed by social security through the financial interchange but would have to be absorbed by the railroad retirement trust fund. The 1951 amendments, however, included various dual benefit restrictions to reduce the additional burden on the railroad retirement trust fund. One restriction provided that railroad retirement benefits be decreased by the amount of social security benefits based on service before 1937. This restriction was repealed 3 years later (1954).

1966. The Railroad Retirement Board was given authority by the Department of Health, Education, and Welfare to select its own agent to administer Part B of medicare—rather than using the regional agents used by the Health Care Financing Administration (HCFA). In 1972 this authority was legislatively mandated. The rail industry argued that it needed this authority to better serve its beneficiaries. Since 1970, this has resulted in additional administrative costs, which have been borne by HCFA.

The railroad retirement supplemental benefit for retirees with at least 25 years of service was established as a benefit on a temporary basis. In 1970, the benefit was made permanent and was to be financed entirely by rail employers. Unlike the regular private pension component, the supplemental benefit has always been subject to federal income taxes, and the revenues from these taxes have gone to general revenues.

1970. Because of the retirement system's serious financial problems, the Congress established a Commission on Railroad Retirement to study the program's financing.

1974. Major amendments resulted in substantially new federal financial involvement in the railroad retirement programs. Although beneficiaries receive only one check, for computational purposes the basic railroad retirement pension was split into two separate benefits—the social security equivalent benefit and the private pension component.

Windfall payments to beneficiaries entitled to both railroad retirement and social security benefits (coupled with rising benefits) had been seriously eroding the financial viability of the railroad retirement trust fund for years. The amendments eliminated all future windfall benefits except for persons vested as of December 31, 1974. They also authorized general revenues to annually fund windfall payments (then estimated at $250 million annually).

The amendments also provided for a reduction in the private pension component equal to about 25 percent of individuals' windfall benefits (this had the effect of reducing rail industry taxes necessary to fund the private pension). They also gave the Board the authority to carry out its own investment policy regarding railroad retirement funds. The additional interest income made available through Board investment policies came from general revenues but had to be used to help offset the cost of windfall payments being financed by general revenues.

1981. The investment interest offset provision was repealed. The railroad retirement program could then keep the additional general revenue funds to pay private pension costs. A separate windfall account was established to ensure that there would be no further drain on the regular railroad retirement account.

1983. For the first time, general revenues were advanced to finance temporary extended unemployment benefits for unemployed workers. It was argued that the rail industry's separate unemployment program should be accorded the same treatment as was given the federal-state unemployment system that year. Major legislative changes pertaining to federal financial involvement in the railroad retirement programs were enacted. These measures included:

- The taxation of the private pension and windfall benefits for income tax purposes, but such revenues would be paid to the retirement program rather than general revenues.
- The taxation of certain other private pension-related benefits as social security benefits rather than private pension benefits and the receipt of the tax revenues by the railroad retirement program rather than general revenues.
- Revenues from the newly taxed pension benefits would go to the Railroad Retirement Account annually for up to 5 years, or until $877 million was received.
- Agreement by the federal government to fully fund all windfall payments out of general revenues.
- Agreement by the federal government to provide general revenues to reimburse the retirement program for past underfunding of windfall appropriations actually provided since 1976.
- Liberalized use of military service credits in determining eligibility and entitlement to benefits.

1986. Legislation was enacted that changed the tax treatment accorded to benefits of those who have reached 60 years of age and had more than 30 years of service and those with an occupational disability that prevented them from working at their former railroad jobs but did not necessarily preclude other gainful employment. These benefits would now be subject to the same tax treatment accorded to other private pension benefits rather than being subject to the tax provisions relating to social security benefits.

In addition to the above instances of legislative activity resulting in "direct" federal financial involvement, various other forms of "indirect" federal financial involvement have occurred. Some examples:

- Since the program's inception in 1937, railroad retirement benefits had not been subject to federal income taxes until the legislation was changed in 1983.
- Since 1969, the Treasury has been making annual appropriations to fund certain future retirement-related expenses of the civil service retirement system for current Board employees involved in railroad private pension activities.
- With the passage of the Employee Retirement Income Security Act of 1974, employers with private pension plans had to meet funding requirements for their plans and contribute insurance premiums to the Pension Benefit Guaranty Corporation to protect workers from future

plan default. The railroad retirement program was excluded from coverage under the act.

## Recurring Financial Crises and Growth of Federal Financial Involvement

World War II witnessed the resurgence of the U.S. rail industry. Employment reached almost 1.7 million in 1945. In that year there were only 171,000 beneficiaries for the railroad retirement program to support—a worker to beneficiary ratio of about 10 to 1. By 1985, rail employment had decreased to about 373,000, while beneficiaries had increased to 954,000. In that year, there were 2-1/2 beneficiaries collecting retirement benefits for every person working in the rail industry. (See figures 2.2 and 2.3)

**Figure 2.2: Railroad Employees and Beneficiaries (1937-2000)**

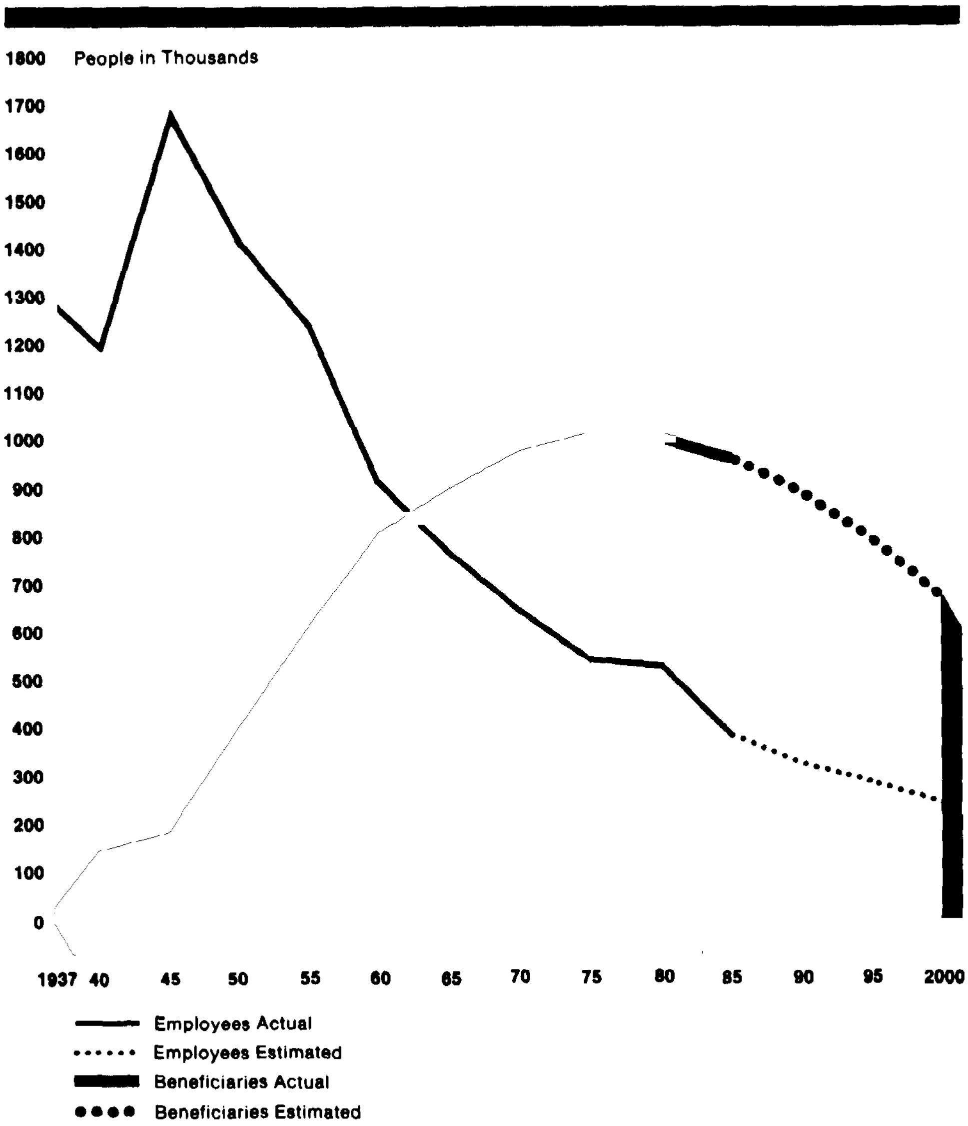
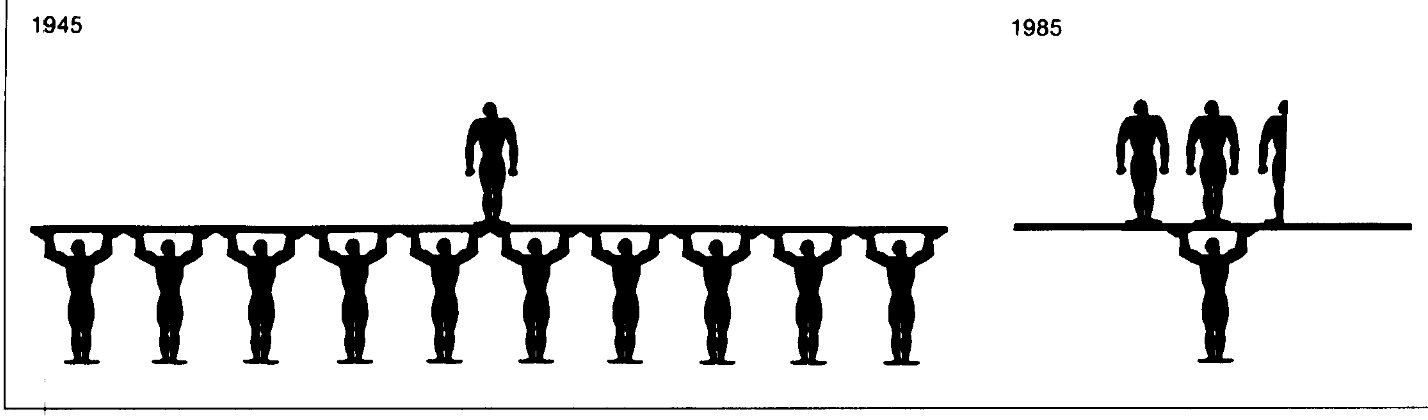


Figure 2.3: Ratio of Workers to Beneficiaries




The drain on the retirement program caused by the increased number of beneficiaries and more liberalized benefits was aggravated by the decline in revenue because of decreasing rail employment. By fiscal year 1982, reserves to pay retirement benefits had dropped to a little over $1 billion from a high of $4.8 billion in fiscal year 1970.

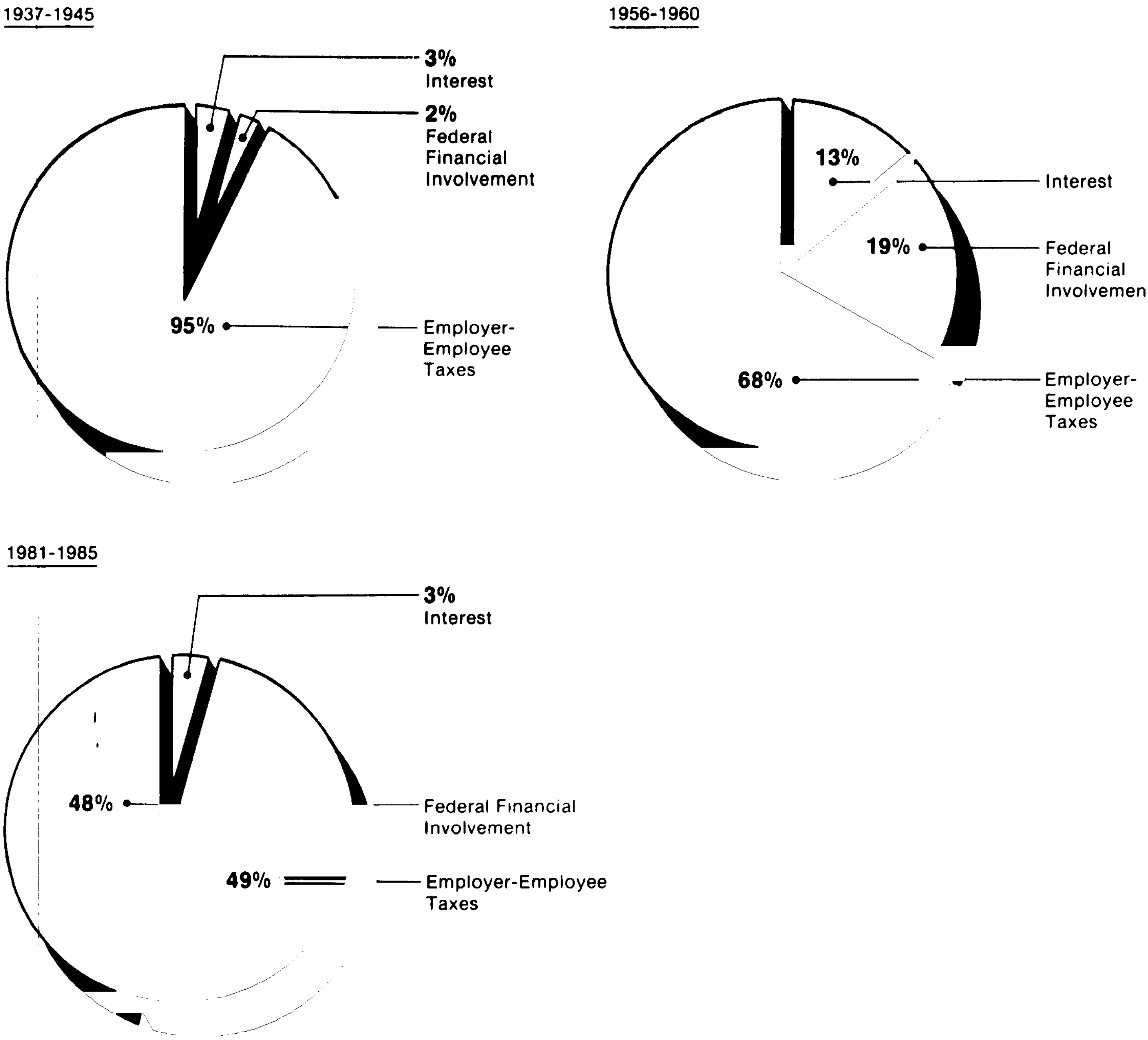
In a little more than a decade, the Congress enacted three pieces of legislation aimed at ensuring the financial solvency of the railroad retirement program. In 1974, the Railroad Retirement Act was amended to bring about long-term actuarial soundness. However, because of overly optimistic employment assumptions and unexpected increases in benefit costs, the act had to be modified again in 1981 to make the retirement program solvent through the 1980's. Two years later—with the industry experiencing a dramatic drop in employment and faced with the prospect of having to reduce the industry benefit—the act was again amended with a number of benefit and tax reforms. Although the 1983 legislation restored viability to the program, there are recent indications of potential future problems if employment continues to decline.

As stated, both the railroad retirement and unemployment programs were supposed to be financed entirely by rail industry employers and employees. Since the end of World War II, however, the sources of financing have changed dramatically. The most notable changes resulted from the large influx of social security trust funds into the railroad retirement program, which began in the 1950's, and the use of general revenue funds to support windfall payments to dual beneficiaries, which began in the late 1970's.

From inception through the end of World War II, taxes on employers and employees constituted about 95 percent of the railroad retirement program's revenues. Direct federal financial involvement represented less than 2 percent.[2] By the late 1950's, federal financial involvement—including transfers from social security trust funds—had increased to almost 20 percent. For the period 1981-85, direct federal financial involvement had escalated to where taxes on employers and employees represented less than half of the program's revenues. (See figure 2.4.) The increases in federal involvement consisted primarily of funds transferred from the Social Security Administration, which that agency would have paid directly to rail beneficiaries if they had been covered under social security. The nature of the federal involvement in the railroad retirement programs is discussed in chapter 4.

[2]This consisted solely of federal funds for military service credits, which represented the federal government's contribution as employer of rail employees who served in the Armed Forces.

Figure 2.4: Funding Sources



# Program Benefits and Funding

There are currently five trust funds paying benefits that are funded by four sources of revenue—taxes on employers and employees, transfers from social security trust funds, and general revenue appropriations from the federal government. A beneficiary receives a single check from the Railroad Retirement Board, which may include four different types of benefits.

1. Social security equivalent benefit (referred to as tier I)—an amount of money that is the same as or approximates what the beneficiary would have received had his or her combined railroad and nonrailroad earnings been covered by social security. Two special benefits awarded under tier I are really industry benefits. Benefits are available to those who reach 60 years of age and have 30 years of service and to those who are determined to have an occupational disability that prevents them from working at their former railroad job but does not necessarily preclude other gainful employment. The money for this benefit comes, in part, from payroll taxes paid by rail workers and employers. Most of the money, however, comes from annual transfers from social security. All beneficiaries are entitled to this benefit.

2. Industry benefit (referred to as tier II)—an amount of money based on rail employment only. The money for this benefit comes principally from payroll taxes levied on rail employers and employees. All retirees are eligible for this benefit.

3. Supplemental benefit—an amount of money awarded only to retirees who have 25 or more years of rail service and who were working for the rail industry when they retired. This is also an industry benefit. This benefit is financed solely by taxes on rail employers. During 1985, about 200,000 retirees received this benefit.

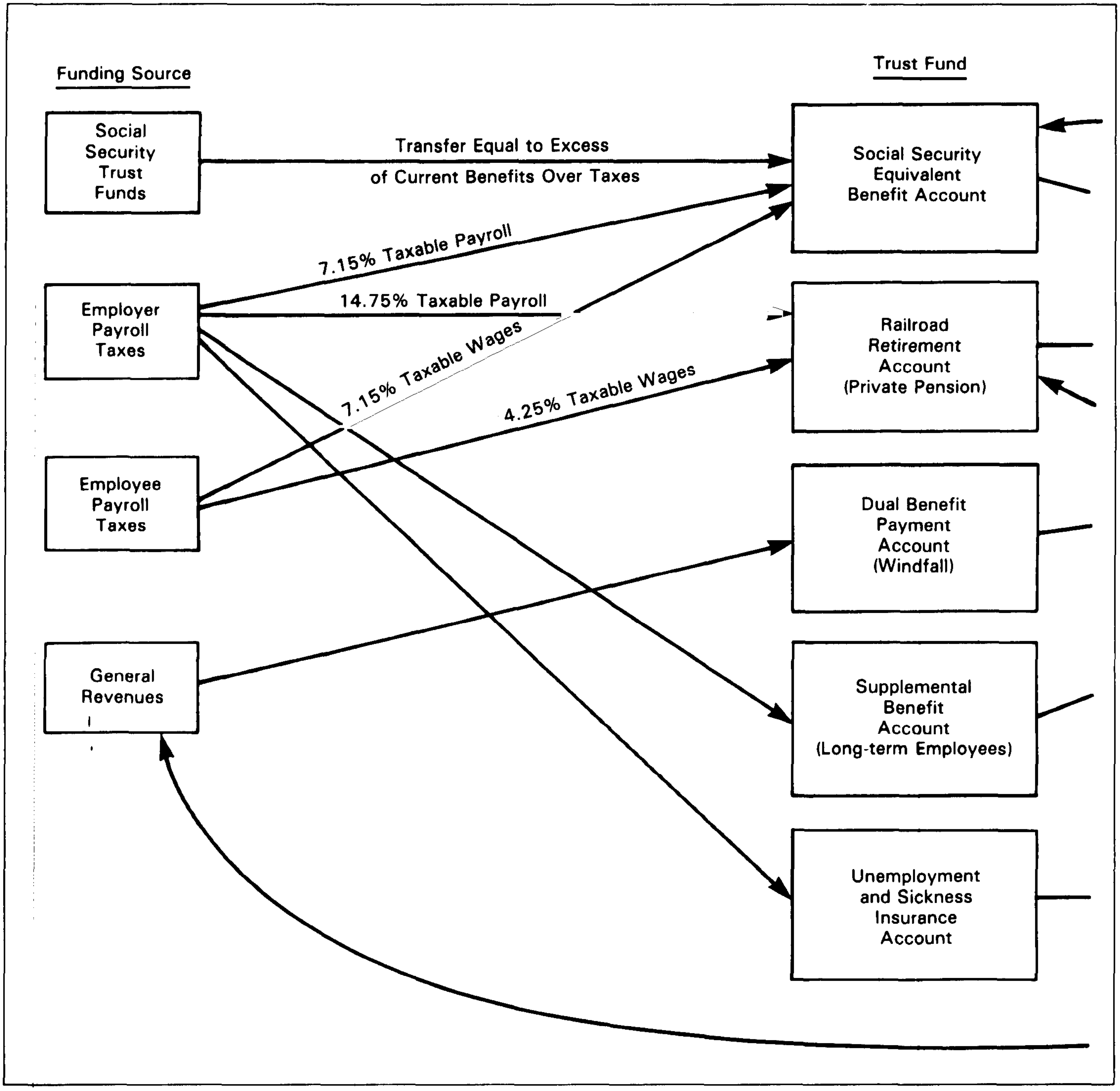
4. Windfall benefit—an amount of money available only to beneficiaries who worked for, or are spouses or widow(er)s of someone who worked for, the rail industry and a nonrail employer covered by social security.[1] The benefit currently is financed entirely through general revenues. During 1985, about 325,000 beneficiaries received windfall benefits.

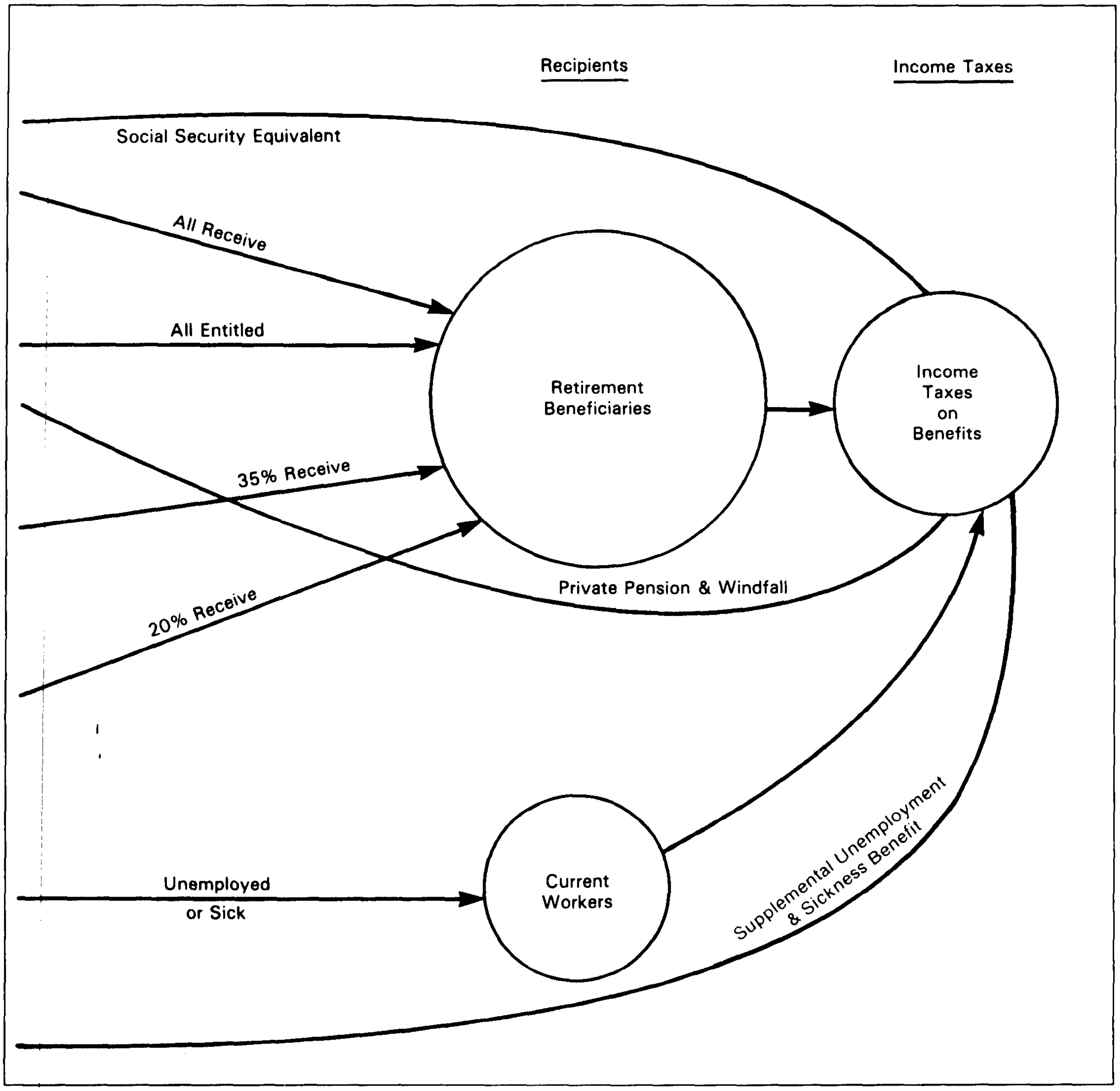
[1]The 1974 amendments to the Railroad Retirement Act eliminated these benefits for most future beneficiaries. It did "grandfather-in" those already receiving such benefits and those whose work history as of December 31, 1974, entitled them to benefits under both programs upon retirement. The 1981 amendments to the act eliminated the benefit for the spouses and widow(er)s of vested rail workers.

In calculating social security benefits and the social security equivalent benefit, the law allows a proportionately higher return for persons with lower lifetime earnings. This was intended to provide a higher benefit for persons who did not have significant lifetime earnings and might otherwise have received only a small retirement check. The "windfall" aspect occurs when a person has enough earnings in rail industry and in social security-covered work to be eligible for benefits from both. Both benefits are calculated separately based on the lifetime earnings under each program. The result is a total combined benefit which is larger than if the earnings had been combined and benefits calculated under one program only. This additional amount received is the "windfall."

Benefits are also available to current rail workers who are unemployed or sick. Figure 3.1 shows the flow of funding, benefit payments, and use of receipts from taxation of benefits.

**Figure 3.1: Flow of Funding, Benefit Payments, and Taxation Under Railroad Retirement Programs**




Recipients
Income Taxes
Social Security Equivalent
All Receive
All Entitled
Retirement Beneficiaries
Income Taxes on Benefits
35% Receive
20% Receive
Private Pension & Windfall
Unemployed or Sick
Current Workers
Supplemental Unemployment & Sickness Benefit

## What Taxes Do Rail Employers and Employees Pay to Finance Benefits?

Rail employers and employees pay the same payroll tax for the social security equivalent benefit (tier I) as those covered by social security (7.15 percent of the taxable wage base for 1986), but employers pay an additional 14.75 percent and employees 4.25 percent of wages to finance the private pension benefit (tier II). As shown in table 3.1, under current law, the payroll tax for the social security equivalent benefit will continue to increase through 1990 while the payroll tax for the rail private pension benefit will remain constant during that period.

**Table 3.1: Payroll Tax Rates** (1986-90)

(Percent of taxable wages and payroll)

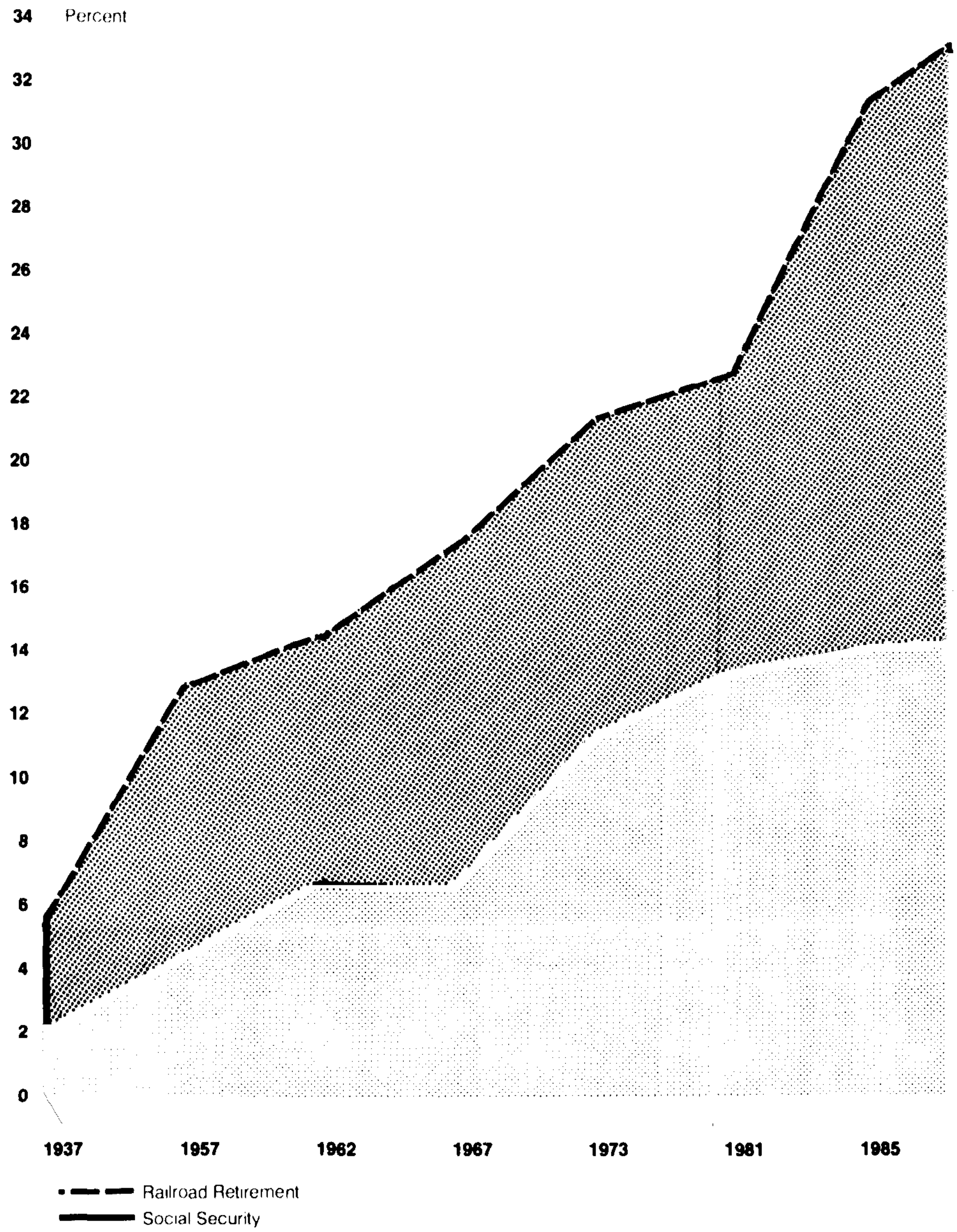
| | 1986 | 1987 | 1988 | 1989 | 1990 |
|---|---|---|---|---|---|
| Social security: | | | | | |
| Employees | 7.15 | 7.15 | 7.51 | 7.51 | 7.65 |
| Employers | 7.15 | 7.15 | 7.51 | 7.51 | 7.65 |
| **Total** | **14.30** | **14.30** | **15.02** | **15.02** | **15.30** |
| Private pension: | | | | | |
| Employees | 4.25 | 4.25 | 4.25 | 4.25 | 4.25 |
| Employers | 14.75 | 14.75 | 14.75 | 14.75 | 14.75 |
| **Total** | **19.00** | **19.00** | **19.00** | **19.00** | **19.00** |

Employers also presently pay a 22.5-cents-per-hour payroll tax to finance the private pension supplemental benefit.

Regarding tax contributions by employers and employees within the rail industry, we have two observations:

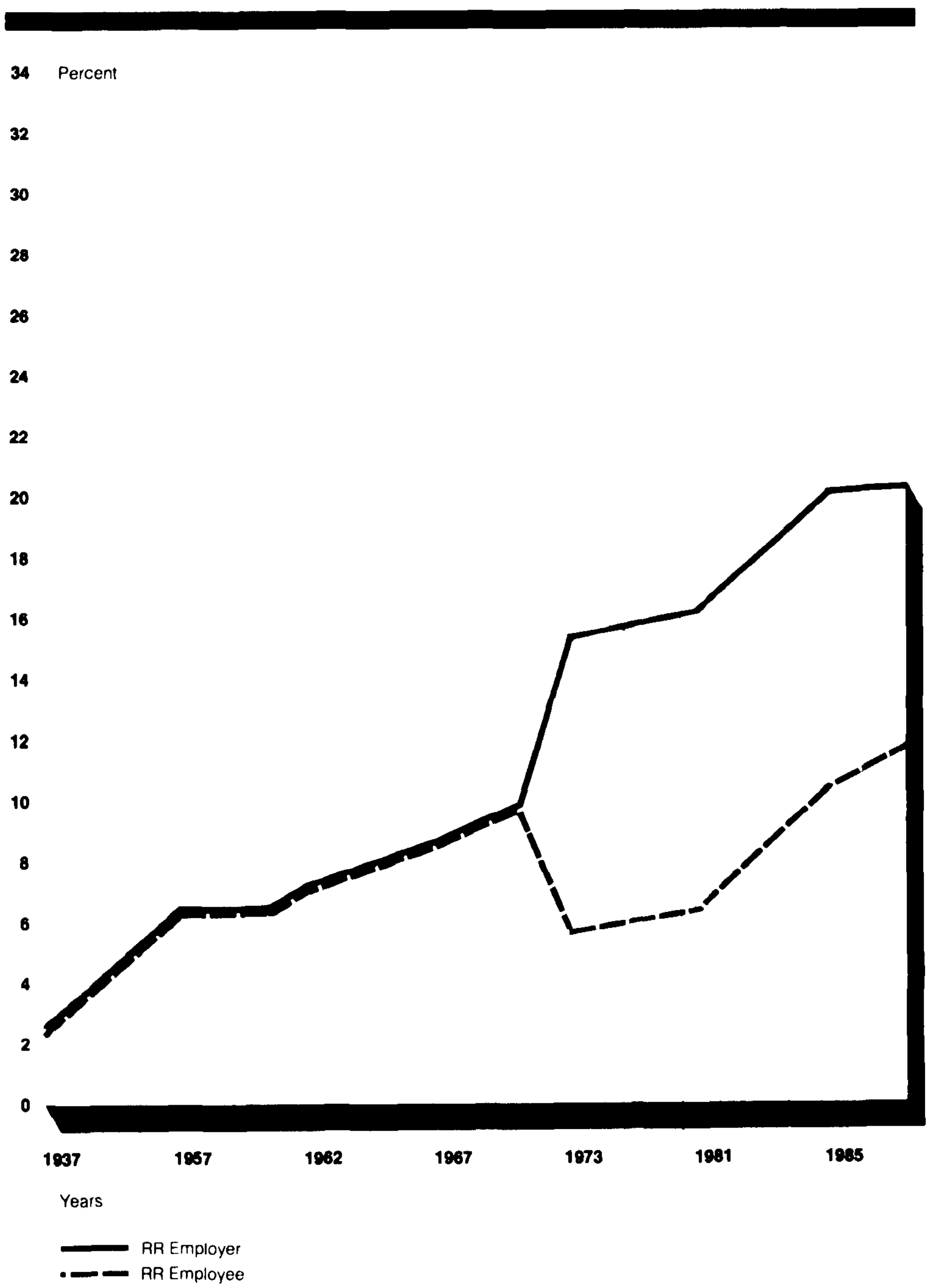
- The taxes paid under the railroad retirement program have always been higher than those paid under the social security program, as shown in figure 3.2.
- Although it was originally contemplated that the employers and employees would share the tax burden for retirement benefits equally, the situation has since changed.

**Figure 3.2: Change in Railroad Retirement and Social Security Tax Rate by Year**




From 1973 through 1985, the railroads have paid a larger portion of the taxes to finance benefits than rail employees have, as shown in figure 3.3. This situation more closely approximates that of other private employers who, other than for social security, generally bear most or all of the pension costs.

**Figure 3.3: Employer and Employee Share of Railroad Retirement Taxes by Year**



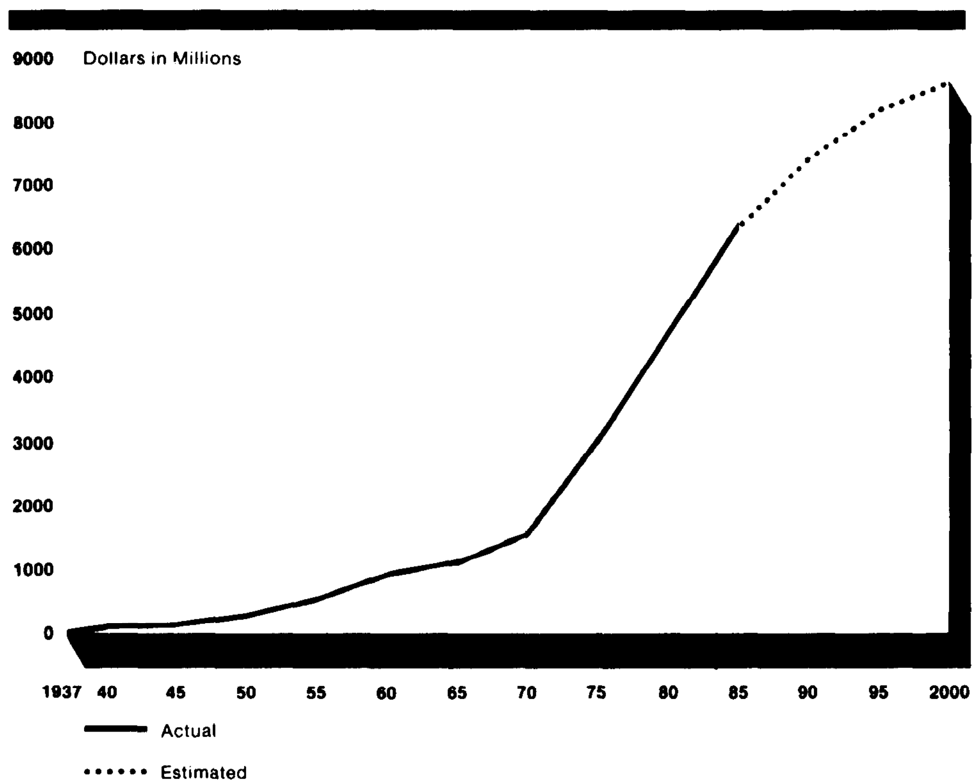
For the unemployment and sickness insurance program, only employers pay a variable rate up to 8 percent of each employee's monthly wages up to $600.

## Who Receives What?

### Retirement

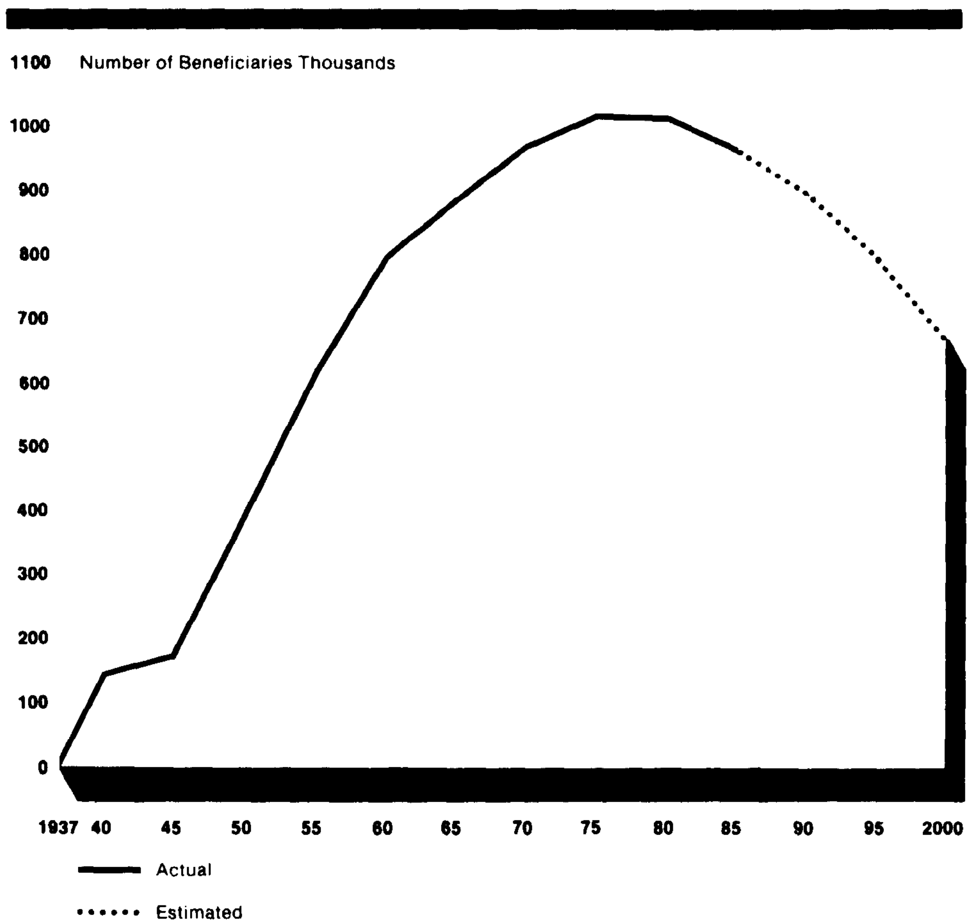
Since the inception of the program, total railroad retirement benefits have increased dramatically from $5 million in 1937 to over $6 billion in 1985. Figure 3.4 also shows the Board's projections of benefits to the year 2000.

**Figure 3.4: Benefit Payments Under the Railroad Retirement Act by Year**




As shown in figure 3.5, the number of beneficiaries increased from about 7,000 in 1937 to about 1,026,000 in 1977. The total number of beneficiaries has been gradually declining between 1978 and 1985 and is projected by the Board to further decline to about 673,000 by the year 2000.

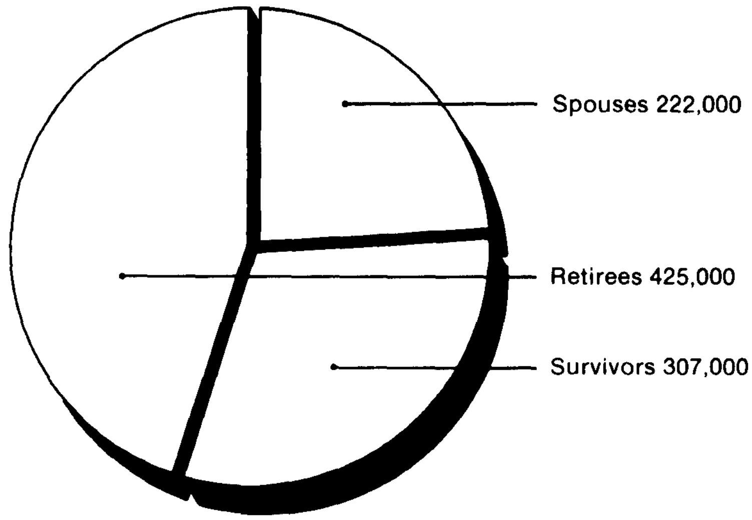
**Figure 3.5: Beneficiaries Paid Under the Railroad Retirement Act by Year**




In fiscal year 1985, about $6 billion in railroad retirement benefits were being paid to 954,000 beneficiaries. Most were retirees (425,000) and their spouses (222,000), and the rest were survivors (mostly widows and widowers). Figure 3.6 depicts the composition of total railroad retirement beneficiaries by category.

With four components, individual railroad retirement benefits will be significantly higher than what persons receive under social security

**Figure 3.6: Composition of Railroad Retirement Beneficiaries as of August 1985**




alone. Average railroad retirement benefits awarded in the last quarter of fiscal year 1985 were:

**Table 3.2: Average Benefits Awarded to Retirees**

| | Average monthly benefit | | |
|---|---|---|---|
| | **Retirees** | **Spouse** | **Survivor** |
| Social security | $543 | $259 | $437 |
| Private pension | 317 | 127 | 147 |
| Windfall | 179 | • | • |
| Supplemental | 42 | • | • |
| **Average total benefits[a]** | **$905** | **$293** | **$559** |

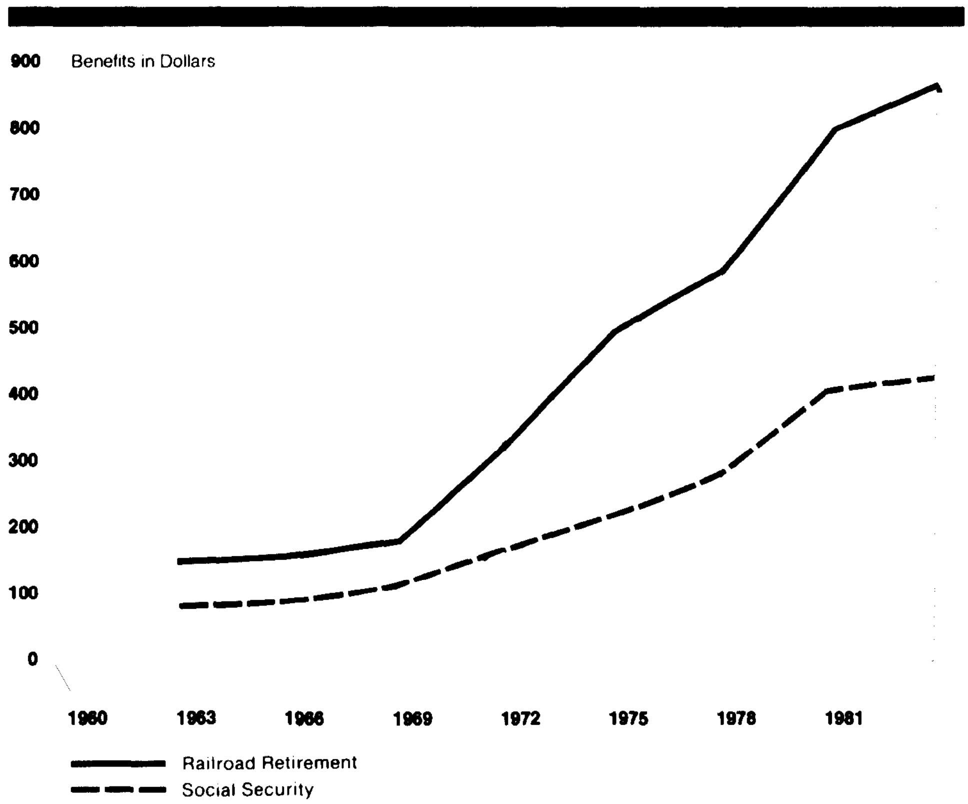
[a]Components do not equal "average total" because component averages are based on differing numbers of beneficiaries.

A comparison of average monthly awards of employee retirement benefits under both programs over the past 2 decades without including any private pension benefits that might be received by those covered under social security is shown in figure 3.7.

## Unemployment and Sickness

In addition to the above benefits—payable upon retirement, disability, or death—rail workers can also receive other benefits. Under the railroad unemployment and sickness insurance program, up to $25 per day

**Figure 3.7: Average Monthly Awards of Railroad Retirement and Social Security Benefits**




in benefits are paid to unemployed or sick rail workers who had sufficient earnings in a preceding period to qualify. The largest amount of unemployment and sickness insurance benefits paid in a given benefit year occurred in 1983, when about 242,000 beneficiaries received $378 million in unemployment benefits and $56 million in sickness benefits. Benefits have declined since 1983, however, with the Board paying $130 million for unemployment insurance and $45 million for sickness benefits in 1985.

These benefits are financed by payroll tax contributions by all rail employers. In recent years, however, tax revenues have been insufficient to pay benefits, and as of December 1985, this program had an outstanding debt of $803 million to the railroad retirement program for amounts borrowed, plus interest, to meet unemployment benefit costs.

# Federal Financial Involvement in the Railroad Retirement Programs

The railroad retirement program is unique in that it is the only private pension plan whose benefits are financed by a levy of federal payroll taxes. For years, rail labor has maintained that the benefits and structure of the program are justified because the program "pays its own way." Over time, however, the railroad retirement program has evolved from a private staff pension plan supported solely by rail employers' and rail employees' tax contributions to one that includes a social insurance component and depends on federal funding for about half of its annual revenues.

Federal financial involvement in railroad retirement and unemployment insurance programs has occurred in a number of forms over the years. This involvement has benefited— individually and collectively— retirees, current rail employees, and the railroads. It has resulted in costs to the social security trust fund and the Treasury.

This financial involvement has been in the form of direct assistance through trust fund transfers and general revenue disbursements. It has also taken the form of indirect assistance to beneficiaries and rail workers and employers through general treasury revenues forgone because of the special treatment accorded beneficiaries in regard to income taxes and other special allowances or exemptions.

One reason for this involvement is that the railroad retirement program strove to mirror the higher benefit amounts being paid by social security in the post-World War II period—despite the fact that the critical ratio between the active rail workforce and beneficiaries was declining and the industry was heavily saddled with payroll taxes to pay benefits. Another reason for this involvement is that over the years the Congress has seen fit to continue to give special consideration to the rail industry so as not to harm either beneficiaries or the financially troubled rail industry.

Issues raised concerning the government's involvement in the railroad retirement programs have generally centered on equity factors, beneficiary needs, or budgetary considerations expressed as follows:

Equity Factors—The rail industry and railroad retirement beneficiaries are being treated differently from other private industries and their retirees. The rail industry has not been required to systematically make payments toward funding its private pension costs over time, and until 1984, beneficiaries were exempt from federal income taxes.

Beneficiary Needs—Under the railroad retirement program, retirement is permitted as early as age 60, persons with occupational disabilities are eligible for benefits (unlike social security disability), and certain windfall benefits are paid to some who are also eligible for benefits under social security. Consequently, a question could be asked as to whether such benefit levels need to be maintained—especially with federal support.

Budgetary Considerations—With the growth of federal involvement and the increasing concern about federal budget deficits, this involvement with the railroad retirement programs has contributed to the rise in federal expenditures.

This chapter discusses currently legislated federal financial involvement in the railroad retirement programs and categorizes the involvement as that which (1) affects general revenues and (2) affects federal trust funds. Chapter 5 presents two other areas that could require additional future financial commitments by the federal government.

## Current Legislated Federal Financial Involvement

Legislated federal financial involvement with the railroad retirement and unemployment programs has affected the general revenues of the U.S. Treasury and authorized transfers from the trust funds of the Social Security Administration and HCFA for payments to be made by the Board that would have been made by those agencies if rail workers were covered under social security rather than railroad retirement. Table 4.1 summarizes selected legislative federal financial involvement through 1985 and projections through the year 2000 where data are available.

**Table 4.1: Areas of Federal Financial Involvement**

(Amounts in millions)

| Type of Involvement (and year started) | To 1985 | Future |
|---|---|---|
| Military Service Credits (1944) | $ 527[a] | [b] |
| Social Security Equivalent Payments (1958) | 26,806[c] | $42,368[d] |
| (Available for industry pensions) | (1,499) | (1,050) |
| Windfall Benefit Payments (1976) | 4,695[e] | 4,822[f] |
| (Used to reduce industry pension costs) | (948) | (1,007) |
| Forgone Income Tax Revenues (1937) | 4,862[g] | [b] |
| Separate Medicare Agent (1966) | 84[h] | [b] |
| Unfunded Administrative Costs (1937) | 47[i] | [b] |
| (Board employees' retirement) | (41) | [b] |
| (Board employees' health insurance) | (6) | [b] |
| Extended Unemployment Benefits (1983) | 53[j] | • |
| Special Investment Authority (1974) | 13[k] | [b] |
| Regional Rail Reorganization (1976) | 29[l] | [b] |

[a]Since 1944.

[b]Unknown.

[c]First actual transfer of funds from social security to railroad retirement trust fund did not occur until 1958.

[d]Through the year 2000.

[e]From fiscal year 1976.

[f]Future windfall payments through year 2000. Also includes $800 million in payments for past underfunding and associated interest.

[g]Since fiscal year 1960.

[h]Since 1970.

[i]Since 1979.

[j]For fiscal years 1983-84.

[k]Represents calendar year 1978, the only year for which an estimate was available from the Board. The Board continues to earn additional interest through this provision.

[l]Since fiscal year 1976.

## Factors Affecting General Revenues

The principal and largest form of federal involvement in terms of dollars that has affected general revenues is the appropriation of funds to finance windfall benefits. The next largest category involved the forgone income taxes to the Treasury due to the special tax treatment of railroad retirement benefits. Because of the unique structure of the railroad retirement and unemployment programs, additional costs have been incurred for certain Board retirement and health insurance costs, military service of rail workers, temporary extended unemployment benefits, and the special investment authority granted the program.

## General Revenues for Windfall Benefits

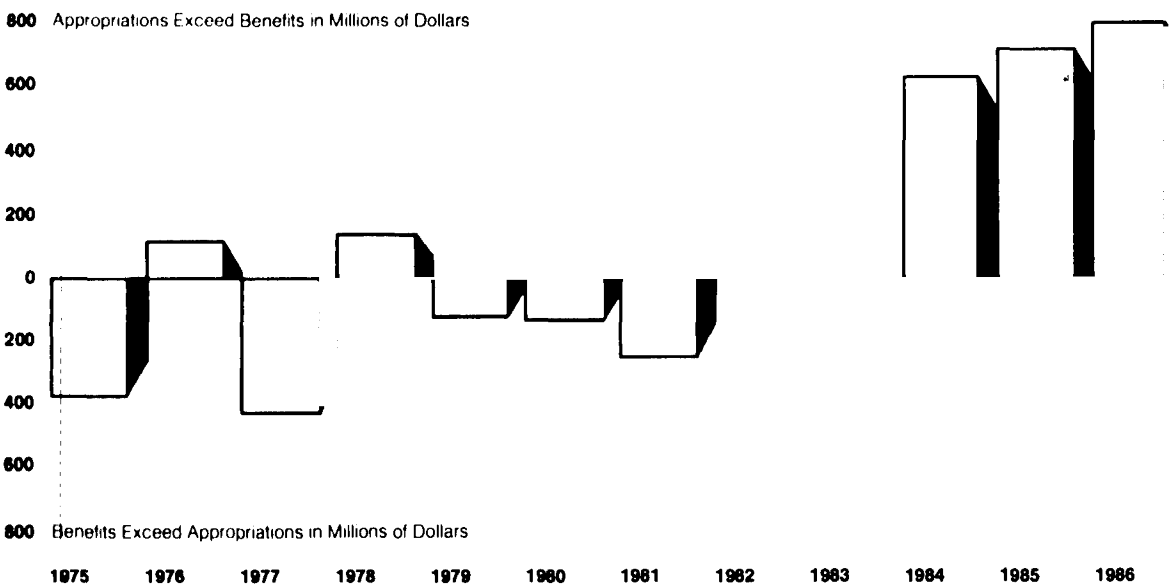
During the period 1976-85, payment of a windfall benefit to persons entitled to both railroad retirement and social security benefits resulted in the expenditure of about $4.7 billion in general revenues. Although 1974 legislation that authorized use of general revenues for windfall benefits also eliminated this benefit for rail workers not vested before 1975, windfall benefits will consume about $4.8 billion of general revenues through the year 2000.

The windfall benefit has had a significant financial impact on the railroad retirement program. Until the 1974 railroad retirement amendments, although the benefit had to be paid, no specific funding source or tax amount was designated, and the windfall benefits were paid from available revenues, primarily supported by the payroll tax on employers and employees collected for private pension benefits.

Because of its adverse effect on the financial solvency of the railroad retirement program, in 1974 the Congress not only abolished the windfall benefit for rail employees not vested before 1975, but also authorized funding windfall benefits from general revenues instead of continuing to finance them with tax contributions by rail employers and employees.

Between fiscal years 1976 and 1985, the Congress had appropriated $3.4 billion in general revenues to pay for windfall benefits. However, the $3.4 billion was insufficient to fully cover windfall costs and the difference was also paid from rail industry employer and employee retirement tax receipts. In August 1983, the Congress agreed to provide an additional $2 billion in future general revenues to make up for the shortfall (including interest) between past appropriations and the amounts actually paid for windfall between 1975 and 1981. (See figure 4.1.) The Board estimates that an additional $4 billion in general revenues will be needed to fully fund anticipated benefits through the year 2000.

**Figure 4.1: Net Annual Differences Between Windfall Benefits Paid and Appropriations Received (By Calendar Year)**




In two prior reports, we pointed out alternatives that could result in reduced federal expenditures for this benefit by having the rail industry pick up some of the cost or by reducing or eliminating the benefit for certain beneficiaries.

Specifically, in a 1981 report to the Congress,[1] we suggested a reevaluation of the issue of how to finance windfall benefits. We pointed out in that report that the windfall appropriations reduced private pension costs and thereby provided indirect federal assistance to the rail industry. This occurs because each windfall beneficiary's industry-pension component is reduced by about 25 percent of the windfall amount received and thus reduces the amount of rail industry payroll taxes needed to pay benefits by that amount. If this offset were not permitted and railroad payroll taxes were increased by enough to retain the retiree's industry pension benefit at its originally computed level, the annual windfall appropriation could be cut by 25 percent, with no effect on the retiree's total benefit check. This would result in budgetary savings of almost $1 billion through the year 2000 but increased costs to the rail industry of a similar amount.

[1]Keeping the Railroad Retirement Program on Track—Government and Railroads Should Clarify Roles and Responsibilities (HRD-81-27, Mar. 9, 1981).

In a 1982 report,[2] we pointed out that about 80 percent of windfall funds go to family units whose benefits exceed the average railroad retirement benefit. We identified several alternative approaches that could be used to reduce or eliminate windfall payments and still protect those most in need. These included (1) elimination of windfall benefits for all but the most needy, (2) elimination of windfall for specific groups regardless of economic status, and (3) reduction of windfall for family units who fall into the higher benefit ranges.

The report showed that savings could be realized by providing windfall benefits only to families whose present railroad retirement benefit level places them below the poverty level or the average railroad retirement pension. For fiscal year 1982, we estimate these savings would have ranged from $284 million to $423 million—depending on one's definition of need.

## Tax Revenues Forgone Because of Tax Treatment of Rail Private Pension Components

Another area where special treatment of railroad retirement programs significantly affects general revenues is the government's past and present tax policy regarding the rail private pension components. We estimate that from 1960 to 1985, about $4.9 billion (in current dollars) in potential revenues have been forgone by the Treasury because railroad retirement pension benefits were not taxed like other private pensions.

Nonrail private industry pension benefits generally have been subject to income taxes after the beneficiary has recovered his or her contributions. Until 1984, however, railroad retirees did not have to pay any income tax on most of their regular benefits. Only the railroad retirement supplemental annuity (a benefit introduced in 1966 and associated with the private pension portion of railroad retirement and funded solely by the employer) had been taxed as ordinary income.

Because of the 1983 amendments to the Railroad Retirement Act, the tier II industry pension and the windfall benefits are now taxable after the beneficiary recovers his or her contribution.

To aid the financially troubled retirement program, the Congress stipulated in the 1983 amendments that the tax revenues generated from taxing the tier II industry pension and windfall component benefits were to be provided to the railroad retirement account for a 5-year period or

[2] Relationship of Dual Benefit Windfall Payments to Total Railroad Retirement Benefits (GAO/HRD-82-97, July 12, 1982).

until $877 million was received to support the payment of industry benefits. After the 5 years, or sooner if the $877 million is received, the tax revenues will remain with the Treasury as general revenue receipts, as do taxes on other private pension benefits.

For income tax purposes, two other private-pension-associated benefits have been subject to the generally more favorable tax provisions applicable to social security rather than those applicable to private pension benefits. These benefits are for those who have reached 60 years or older with more than 30 years of service, and those with an occupational disability that prevents them from working at their former railroad job but does not necessarily preclude other gainful employment. On April 7, 1986, Public Law 99-272, the Consolidated Omnibus Budget Reconciliation Act of 1985, made these benefits subject to taxation like other private pension benefits beginning in 1986.

Neither the 1983 amendments nor the Consolidated Omnibus Budget Reconciliation Act of 1985 specified where the tax revenues from these private pension associated benefits (retirement at age 60 with 30 years of service and occupational disability) should go. The Board said that because these benefits are being taxed like the tier II benefit, the revenues will continue to go to the Railroad Retirement Account, with revenues from taxation of the tier II benefit, for the 5-year period or until the $877 million is received.

## General Revenues for Certain Board Employee Retirement and Health Insurance Costs

Rail industry payroll taxes are used to fund the Board's annual administrative costs, but such taxes do not cover the total retirement and health insurance costs incurred for Board employees. Besides Board employees' salaries, the budgeted administrative costs include the Board's contributions for civil service retirement and health insurance premiums for current Board employees. However, certain future retirement and health insurance costs are not budgeted and therefore not funded by rail industry payroll taxes. These costs represent the employer's contribution toward future civil service retirement costs and health insurance premiums of current Board civil service retirees. These costs are calculated on an annual basis and are borne by general revenue contributions of about $7 million annually.

The Congress specifies in law each year how much of the money derived from payroll taxes on railroads and rail employees will be used to administer the railroad retirement program. The Railroad Unemployment Insurance Act, as amended, states that 0.5 percent of taxable payroll will be set aside for the administration of the unemployment program.

Railroad Retirement Board employees are federal civil service employees and therefore eligible to receive civil service retirement and to retain their federal health insurance coverage upon retirement. To support civil service retirement, both the Board employees and the Board (like other federal agencies) each contribute 7 percent of gross payroll. Since the Board's 7 percent comes from the industry payroll taxes that are used to fund program administration, the combined contribution of 14 percent actually comes from the rail industry. However, the Office of Personnel Management estimated that for 1983, for example, the actual cost of civil service retirement was about 36 percent of gross payroll. Rail industry payroll taxes also support the Board's share of health insurance premiums for current Board employees.

Each year, however, the Treasury makes a transfer to the civil service trust fund on behalf of all federal agencies, including the Railroad Retirement Board. These transfers are made to cover the accrued interest on the unfunded civil service retirement liability and to amortize the cost of more recent benefit increases. Each year, the Treasury also makes a contribution for the employer's share of health insurance premiums for those civil service retirees who elect to maintain such coverage.

A certain portion of the general revenues used to pay for these costs would appear reasonable since they pertain to the performance of social security-related administrative functions and general revenues are used to pay for the government's share of civil service retirees' health insurance premiums and to fund certain accrued past civil service retirement costs of all federal employees. However, more than half of the Board's administrative costs are associated with administering the private pension components and the unemployment program. For fiscal years 1979-85, we estimate that about $47 million in general revenues was used for Board employee retirement-related costs associated with that portion of the employee's work that involved administering the private pension components and unemployment program.

## General Revenues for Military Service Credits

General revenue contributions are made to both the railroad retirement and social security programs to compensate for additional benefits arising because of social security and railroad retirement credit being given to persons for time spent in military service during certain periods in the past. Military service must have been preceded by railroad service in the same or preceding calendar year, and the employee must have entered the Armed Forces in wartime or periods of national emergency or have been drafted. Most of the revenues received by the railroad retirement program for military service credits has been for rail workers who served in the World War II period. From 1944 to 1985, these general revenue contributions, which were one of the earliest forms of direct federal financial involvement in the railroad retirement programs, amounted to $527 million.

Although both the social security and railroad retirement programs gave retirement credit for time spent in military service, they differed as to periods covered and basis for computing federal contributions as permitted under legislation enacted by the Congress. Noncontributing military service credits for social security covered the period September 1940 through December 1956. After 1956, members of the Armed Forces paid into the social security program. Military service credits for railroad retirement covered the World War I period and most of the period from September 1939 through September 1978.

Until 1957, the social security trust fund absorbed all the costs of additional benefit payments because of military service credits. In 1957, it was reimbursed through general revenues for its prior costs on an "additional" cost basis (i.e., the added cost to social security in higher benefit payments because of military service credits). From 1957 to 1985, social security has been reimbursed annually on a "prepaid tax" basis (i.e., it received from general revenues what the employer's tax contribution would have been on the basis of military base pay and/or wage credits).

The railroad retirement program, on the other hand, has received general revenues for military service credits since 1944. The general revenue contributions for the pre-1937 period were on an additional cost basis, from 1937 to June 1963 on a prepaid tax basis, and after June 1963 on an additional cost basis.

The railroad retirement program has not received additional general revenues for military service credits since 1975 because the Board decided that an additional request for general revenues would not be made until the amount becomes larger. For example, for the period 1973-77, only $63,000 was due because of additional benefit costs.

The 1983 amendments to the Railroad Retirement Act also permitted the use of military service credits in more than one federal program when individuals apply for benefits under more than one federal program. Board officials advised us this could result in additional numbers of beneficiaries using military service credits in the determination of eligibility for and the calculation of railroad retirement benefits, resulting in increased benefit payments. They estimated that an additional $600,000 in general revenues may be required annually to implement the 1983 amendments.

## General Revenues for Extended Unemployment Benefits

The benefits paid by the rail industry's unemployment and sickness insurance program were intended to be fully supported by the railroads. On two occasions, legislation required the Treasury to provide assistance.

Under the law, rail workers with more than 10 years of service can collect extended unemployment benefits (more than 26 weeks of regular benefits in a given year). However, rail workers with less than 10 years of service are generally not entitled to such benefits.

The solvency of the rail industry's unemployment and sickness program is substantially affected by major recessions or work stoppages causing industry-wide unemployment on a temporary basis. Thus, during the recession of the early 1960's when the federal government provided interest-free general revenue loans to the states for temporary extended unemployment benefits for nonrail workers, the rail industry sought and received the same. In 1961, the railroad unemployment program received and later repaid $30 million in interest-free general revenue loans for rail employees with less than 10 years of service.

The next, and more significant, instance of federal assistance to the railroad unemployment program occurred in 1983, when general revenues were appropriated for temporary extended benefits for unemployed rail workers as they were for the states providing benefits to nonrail workers. This assistance represented a major precedent in that the general revenues advanced did not have to be repaid. By the time the temporary extended unemployment assistance program had expired in 1984, about $53 million in general revenues were paid out in railroad unemployment benefits.

## Special Investment Authority Provides Additional Interest Income at General Revenue Expense

Another anomaly of the railroad retirement program is the special treatment that must be accorded to it by the Treasury. Legislatively, its trust fund moneys are permitted to earn a higher rate of interest on its investments in government securities than other government agencies—this interest is paid out of general revenues. These additional revenues may be used to support the private pension aspects of the railroad retirement program.

When the 1974 amendments legislated that windfall benefits would be paid from general revenue, it also gave the Board special privileges concerning its investments. Although the Board's investments are limited to government securities, the act took the management of the investments out of the hands of the Secretary of the Treasury and transferred them to the Board with the intent that the Board should be able to maximize interest income. The reason for this privilege—not available to the Social Security Administration—was that the program is primarily a private pension plan administered by the government and it should have the privilege of handling its investments as any other private pension plan.

However, there was a caveat placed on this privilege. Any increased interest income was to be used to reduce the annual general revenue appropriation to pay windfall. This offset provision was included in the 1974 amendments because of congressional concern with the possible revenues that might be needed for funding the annual windfall payments.

The 1981 amendments removed this offset requirement but not the privilege to maximize investment interest. Subsequently, the Railroad Retirement Solvency Act of 1983 provided for funding from general revenues all past windfall benefits financed by the rail industry and future windfall benefits. Although the federal government therefore will provide general revenues to pay all windfall benefits, the special investment authority remains.

The total amount of additional interest available to the Board under the special authority to manage its own investments has never been calculated. The extent of additional interest to be realized in the future is uncertain and would depend on the size of Board assets and the extent to which the interest rates the Board receives exceed what it would have realized without the authority. The Board's actuary did estimate the additional interest realized for calendar year 1978 when the social security and industry pension assets were combined into one trust fund.

This estimate totaled $13.3 million on assets of about $2.7 billion when interest rates were about 8 percent. On November 1, 1985, the Railroad Retirement Account and Social Security Equivalent Benefit Account had a combined balance of about $4 billion and were earning 9-3/4-percent interest.

### General Revenues for Regional Rail Reorganization Act Protective Payment Credits

The Regional Rail Reorganization Act of 1973 restructured many bankrupt railroads in the Northeast and Midwest into the Consolidated Rail Corporation (Conrail). This act provided for protection payments to employees adversely affected by this realignment. Payments were made to rail employees who became unemployed because of the restructuring, and larger payments were made to those who decided to relinquish all rights to future employment in the rail industry. The act was later repealed, but from fiscal years 1976 through 1983, $407.5 million was expended from general revenue appropriations administered by the Board.

The payments, however, were considered creditable service under the railroad retirement and unemployment insurance programs and were subject to employment taxes. Therefore, $27.3 million and $1.3 million ultimately flowed into the railroad retirement and unemployment insurance trust funds, respectively, from the general revenue appropriations to pay the employers' and employees' share of the payroll taxes.

## Factors Affecting Other Federal Trust Funds

The federal involvement in the railroad retirement programs that affects other federal trust funds results from the railroad retirement program being separate from social security but having a unique structure with ties to it. This has resulted in an annual transfer of funds from the Social Security Administration, and the Board administering a portion of the medicare program. These forms of involvement are discussed below.

### Support From Social Security

Probably the single most important event to influence the financial solvency of the railroad retirement program was the enactment of the 1951 amendments to the Railroad Retirement Act which created a special relationship with social security. This has resulted in $27 billion in social security funds being transferred to the railroad retirement program through fiscal year 1985—and the Board projects an additional $42 billion in transfers through the year 2000.

Because rail employers and employees pay the social security payroll taxes, they receive a benefit payable by the Board which is the equivalent of what they would have received under social security. The amount transferred by the Social Security Administration annually is the amount by which social security taxes paid by rail employees and employers that year fall short of the amount needed to pay the social security equivalent benefits for the same period.

The financial interchange was created by legislation in 1951 to place the social security trust fund in the same financial situation it would have been in had rail employment always been covered under social security. This legislation also made this arrangement retroactive to 1937.

The Board makes a determination annually, with the concurrence of the Social Security Administration, of what the latter would have collected in payroll taxes and what it would have paid out in social security benefits if rail workers had been covered under social security. If the estimated taxes are greater than the estimated benefits, the Board transfers the difference to the Social Security Administration. If the opposite holds true, the Social Security Administration transfers money to the Board.

Originally, the interchange favored social security. However, with the decline in the ratio of rail workers to beneficiaries, this situation was reversed, and since 1957 all transfers have been from social security to railroad retirement.

Without the annual transfer of funds from social security which began in 1958, the railroad retirement program would have incurred solvency problems sooner than it did and probably could not have emulated the benefit increases that occurred under social security during the 1960's.

Had rail industry employment initially been placed under social security, the social security trust funds would have paid directly to retired rail workers the same amount of benefits as has been transferred to date and will be transferred in the future. However, funds transferred from the social security trust fund would not have been available for use to help pay the private pension benefits. Such funds became available because the railroad retirement program's social security equivalent benefit does not provide benefits for dependent children although the amount the Social Security Administration transfers to railroad retirement is calculated as if such benefits had been paid.

In the past, funds transferred from the social security trust fund and taxes collected from the rail industry were commingled in one account and their separate identity was lost. Over the years, about $1.5 billion (on the basis of Board estimates) of these unspent social security trust fund moneys were not used for social security equivalent benefits but were available to pay for the private pension component—in effect lowering the taxes the rail industry would have needed to raise to pay benefits.

The Railroad Retirement Solvency Act of 1983 provided that, beginning in fiscal year 1985, the railroad retirement trust fund would be separated into two trust funds—the social security equivalent benefit account and the railroad retirement account. In 1981 we had made a similar proposal to the Congress to maintain the financial integrity of the social security funds and prevent use of excess social security funds to pay rail industry pension benefits. The social security equivalent account will receive the social security employment taxes paid by rail employers and employees and the net annual financial interchange transfer from the Social Security Administration. The social security equivalent benefit will be paid from these funds in the social security equivalent account. Therefore, beginning in fiscal year 1985 the interchange funds that are transferred but not paid out—an additional Board-estimated $1 billion through the year 2000—will no longer be commingled in one fund but will accumulate indefinitely as a reserve in the social security equivalent account.

Although the reserve will not be immediately available to pay industry pension benefits, under current law, the funds may be used for this purpose at some future date. If the industry pension account should run short of funds, funds may be transferred from the social security equivalent account—as long as the transfer does not jeopardize the tier I benefit—and such transfers need not be repaid.

## Board's Administration of Medicare Results in More Medicare Costs

Unlike the prevailing situation whereby HCFA administers the nationwide medicare system—including the selection of the regional agents to process medicare claims—the Board has been legislatively authorized to administer the supplemental Part B portion of medicare for eligible railroad beneficiaries. HCFA reimburses the Board for the associated costs incurred and transfers that amount from the medicare trust fund. We estimated that for fiscal years 1970-85, this practice resulted in an additional expense of $84 million to the trust fund.

The Board's role in administering the medicare program for rail employees and retirees includes providing outreach services to potential beneficiaries and collecting premiums for the supplemental portion (Part B) of medicare. Part B covers other than hospitalization costs, such as payments for doctors, laboratories, and other medical services.

We concluded in prior reports that it is more costly to the HCFA trust fund to permit the Board to use its own agent to process medicare claims rather than the regional agents used by HCFA nationwide. In a report in 1971[3] and another in 1979,[4] we recommended that this practice be discontinued. The additional cost is incurred because the Board's agent cannot achieve the economies of scale that can be realized by other HCFA medicare agents and many railroad retirement claims are initially misrouted to HCFA agents, thus incurring an additional expense for HCFA.

The Board's and rail industry's opposition to our recommendations has generally been based on the Board's contention that using a sole agent for the rail industry results in better service to rail beneficiaries. In a 1984 report,[5] we stated that continuation of this practice had resulted in additional annual costs of $6 million to the HCFA trust fund.

[3] Opportunity to Reduce Medicare Costs by Consolidating Claims Processing Activities (B-164031(4), Jan. 21, 1971).

[4] More Can Be Done to Achieve Greater Efficiency in Contracting for Medicare Claims Processing (HRD-79-76, June 29, 1979).

[5] Use of a Separate Carrier to Process Medicare Claims for Railroad Retirement Beneficiaries (GAO/HRD-84-54, Sept. 26, 1984).

# Potential Future Federal Financial Involvement

There are other aspects of the railroad retirement programs which—although not representing a legal obligation of the federal government at this time—could involve the need for additional federal government assistance to the railroad retirement and unemployment programs. Two such possibilities involve the unfunded actuarial liability for private pension benefits and the potential need for future general revenue loans and grants to the unemployment program. The solvency of both programs can be affected by economic recessions or competition that drastically reduces rail employment, periods of high inflation that escalate benefit payments, and nationwide work stoppages, such as strikes.

## Unfunded Actuarial Liability

The rail industry has not had to systematically make payments toward funding its private pension costs over time as other industries are required to do under the Employee Retirement Income Security Act. Thus, as of December 1983, unfunded actuarial liabilities totaled about $33 billion for the tier II industry pension and about $1 billion for the supplemental benefit. And, although the federal government has no legal obligation for this substantial unfunded liability, it could be argued that because the private pension was created by legislation and is federally administered, an implicit moral obligation exists and might have to be honored in the event the rail industry experiences a severe financial setback.

The initial enabling legislation established the railroad retirement program as a pay-as-you-go system—similar to social security. Placing any single industry (much less one that is economically declining and has a diminishing employment base) on a pay-as-you-go system financed solely by payroll taxes is almost certain to result in future funding problems if employment in that industry declines beyond anticipated levels.

The Employee Retirement Income Security Act, enacted in 1974, was to help protect workers against the loss of their pension should their private pension plan terminate. Two of the principal provisions of this act require that private pension programs be fully funded over a period of time and that the employers must pay insurance premiums to the Pension Benefit Guaranty Corporation. These premiums are to be used to pay benefits to vested employees in instances where employers default on programs that have not been fully funded. The act, however, excluded all government pension plans, including the railroad retirement program.

The tier II industry pension is funded by taxes on railroads and their employees and is on a pay-as-you-go basis, with current revenues being used to fund current benefits. There is no provision—as exists in other private pension plans—to amortize any liability for future benefit payments. The amount due for future benefits is not considered a liability by the Board but is reported in its actuarial valuations.

The supplemental benefit is financed solely by taxes on the railroad employers that must be adjusted quarterly to assure there are enough funds to pay current benefits. By law, this benefit is being phased out (new employees after Oct. 1, 1981, will not be eligible), but it will be well into the next century before the entitled employees receive their last benefit payments. Since the tax rates are continually adjusted to assure adequate revenues, little reserves are maintained with which to pay this benefit.

Unfunded actuarial liability is the net present value of the benefits due to vested workers, less assets available to pay them. In effect, this is the money that would be needed to pay off all entitlements if the program stopped receiving revenues or were terminated. The Board's actuary estimated that as of the end of calendar year 1983 (the last year an estimate was made), the unfunded actuarial liability for the tier II industry pension component was $33 billion. The Board's projected unfunded actuarial liability for the industry supplemental benefit through 1995 is about $1 billion.

The rail industry has taken the position that converting to a fully funded program would not be possible without raising taxes to an unreasonably high level or scaling back current benefits.

Demographics and economic conditions greatly affect the railroad retirement programs. While the 1983 Solvency Act restored viability to the railroad retirement system and the Board projected that benefits could be paid beyond the year 2000, lower than anticipated employment could again threaten the program's solvency. In fact, lower than anticipated employment is occurring now. Actual 1985 average rail employment and estimated 1986 employment is substantially below the most pessimistic employment projections used in the Board's most recent actuarial valuation. The valuation, made in 1985, estimated average rail employment for 1986 at 372,000. Actual employment declined to 347,000 in December 1985, and a current Board estimate for calendar year 1986 is 339,000.

The decline in rail employment has been attributed to several factors, including a decline in certain types of rail shipments, increased operational efficiency, and the selling of rail lines. For example, export grain sales, which affect rail shipments, have declined. Railroad productivity has also increased, particularly in switching operations, and some railroads are selling segments of their operations, which then become smaller railroads that negotiate labor contracts that require fewer personnel.

Because the current pay-as-you-go financing is federally mandated and is vulnerable to changes in the long-term health of the industry, it could require federal involvement should a financial crisis occur.

Because the tier II component and supplemental benefit are exempt from the provisions of the Employee Retirement Income Security Act, rail employers have not had to pay insurance premiums to the Pension Benefit Guaranty Corporation. The railroad industry has saved about $7.7 million in such premiums since passage of the act. We estimated that the industry can also expect to realize an additional savings of about $12.3 million through the year 2000 by not having to pay such premiums.

## Unemployment Program Assistance

The financial difficulties of the railroad unemployment program, caused in part by rising unemployment, portends other potential federal involvement in the future. The unemployment program owed the railroad retirement account $803 million as of December 1985 because the former had to borrow in the past from the retirement account in order to pay benefits. Proposals advanced by the Railroad Unemployment Compensation Committee[1] call for providing additional general revenue funds through outright grants and repayable loans.

The Railroad Unemployment Compensation Committee proposed in June 1984 that the railroad unemployment program be given between $135 million and $200 million in outright grants from general revenues because of past preferential treatment accorded the state unemployment programs—such as interest-free loans from general revenues before 1982.

[1]The Railroad Retirement Solvency Act of 1983 (Public Law 98-76, Aug. 12, 1983) established this committee to review all aspects of the unemployment and sickness insurance program, including benefit levels, loan repayments, and alternatives to the existing system, such as possible inclusion under the nationwide federal-state unemployment compensation system.

The committee also proposed in June 1984 that the railroad unemployment program be given the same consideration as state unemployment programs—that is, be allowed to borrow from general revenues. As of March 1986, the Congress had not acted on the committee's proposals.

# Detailed Approach and Methodology

The objective of our study was to bring together—in a single document—an inventory of the extent of the federal government's financial involvement in the railroad retirement and unemployment insurance programs.

Actuarial data released by the Board in May 1985 shows that no financing problems are anticipated for the railroad retirement program through the year 2000. This short-term projected financial solvency is due, in large part, to federal financial involvement.

We focused on clearly discernable areas of federal financial involvement, namely:

1. Expenditures by other federal trust funds for the payment of the railroad retirement program's social security equivalent benefit and medicare associated administrative costs.

2. Transfers of general revenues for windfall benefits, military service credits, Board administrative costs, and extended unemployment benefits.

3. Losses to general revenues because of preferential income tax treatment accorded railroad retirement beneficiaries and special investment authority granted the railroad retirement program.

We did not attempt to measure the possible financial impact on individual beneficiaries, current rail employees, or the railroads if any of the provisions were modified or eliminated.

In describing the federal financial involvement in the rail industry's programs, we identified past financial assistance, future assistance already legislated, and potential future involvement. The latter consisted primarily of the unfunded actuarial liability for the industry pension components of the railroad retirement benefit. We distinguished between direct financial assistance from general revenues and governmental trust funds and indirect assistance resulting from provisions that, in effect, financially benefited beneficiaries and rail employers and employees. Where possible, we used actual data from inception of the programs through the most recent year for which complete data were available and Board projections through the year 2000. Where data were not available, we made our own estimates and projections based on the best available data. The basis for the estimates contained in this study are described below.

The unfunded actuarial liability for the tier II industry pension component was taken from the Board's 16th triennial actuarial valuation as of December 31, 1983. The liability for the supplemental industry pension component is a calculation of the net present value of the Board's estimates of benefits through the year 1995, taken from the 15th actuarial valuation but based on interest rates proposed for the 16th actuarial valuation.

The amount of appropriations for past military service credits were available from the Board's accounting records. Possible estimated future outlays for military service credits were obtained from Board officials.

Past financial interchange information was available in published documents and at the Board's Bureau of Research. Future financial interchange estimates came from the Board's actuary and the 16th actuarial evaluation. The information on the use of a separate medicare agent for Part B of medicare was discussed in prior GAO reports shown in table I.1.

The amount of windfall benefits and the extent to which windfall benefits exceed appropriated general revenue funds are a matter of public record. The Board's actuary developed the estimates of future windfall benefits. We computed the gross versus net windfall based on the percentage reduction in the tier II industry pension component that beneficiaries experienced as a result of their entitlement to receipt of the windfall benefit. This reduction is currently legislated at 25 percent of the windfall amount.

Estimated revenues from income taxes on retirement benefits to be returned to the trust funds for tier II and windfall benefits were estimated by the Department of the Treasury based on benefit data supplied by the Board. The estimated tax revenues from the tier I component benefits which have no counterpart under social security were obtained from the Board's Bureau of Research and the Office of Management and Budget.

The past federal financial assistance to the unemployment insurance program as shown in this study is the actual appropriation to that program. We obtained the Regional Rail Reorganization Act protective payments from the Board's Bureau of Unemployment and Sickness Insurance records. We computed the taxes paid on this creditable service by applying employer and employee tax rates applicable to service for the period of the program.

We computed the exemption from the Pension Benefit Guaranty Corporation premiums on the basis of premium rates obtained from the Corporation applied to actual and projected employment in the rail industry. The projected employment is the high estimate used in the 16th actuarial evaluation.

The 1974 Railroad Retirement Act authorized the Board to maximize interest earnings. The Board's Actuary developed the calendar year 1978 estimate of the additional earnings resulting from this authorization in the 14th triennial actuarial valuation. A more recent estimate was not available.

To determine what portion of the annual general revenue contributions to the civil service retirement fund represented that portion of Board administrative costs attributable to private pension administration, we first obtained certain civil service retirement data from the Office of Personnel Management and used the following rationale. Since costs associated with the Board's administering the social security equivalent benefit would have been absorbed by social security, we determined that portion of the Board's administrative expenses that were not reimbursed by social security—essentially costs associated with the unemployment program and industry components of railroad retirement. We matched these costs against the Board's total federal payroll for a given year to determine what portion of total payroll represented Board personnel costs not reimbursed by social security. This factor was then applied against the total annual general revenue contribution to the civil service retirement fund for Board employees to determine the estimated costs attributable to administration of the private pension components of the Board's program. Data were readily available only for the period from fiscal years 1979 to 1985.

The Office of Personnel Management also supplied an estimate of the number of retired Board employees who had elected to continue their federal health insurance coverage after retirement and the average employer premium funded from general revenues. These data provided the estimate for the federal contribution for this coverage but were also limited to the period from 1979 to 1985. Office of Personnel Management officials said they could not provide an estimate of the number of future retirees who might elect to take this coverage; consequently, we were unable to project future costs.

Before 1984, the tier II private pension component of the railroad retirement benefit was not subject to income tax as other private pensions were. Estimating the financial advantage to railroad beneficiaries of this exemption was difficult because of the lack of data on each beneficiary's total income. The Board did not have available the total amount of industry pension benefits paid on which to estimate income taxes. This was also true of the tier I retirement benefits paid that had no counterpart under social security—the 60/30 and occupational disability benefit.

To arrive at an estimate of the past income taxes that would have been collected had the tier II industry component been subject to taxation, we obtained an average percentage of income that persons receiving pensions pay in taxes.

Data on the average percentage of pension income paid in taxes were not available. However, since 1960, the Internal Revenue Service has published data on income, including pension benefits, and taxes paid for families with at least one taxpayer over age 65. From this we computed on an annual basis what percentage of adjusted gross income was paid in taxes by taxpayers over age 65. This percentage may be somewhat overstated because a larger percentage of the over 65 population, as a whole, is in the higher income tax brackets than those under 65.

To compute the amount of industry pension benefits that might be subject to taxes, we obtained from the Board published data on the total benefits paid each year since 1960. We then deducted from this amount the gross benefit reimbursement from social security through the financial interchange. We also considered the small amount of the interchange that is not paid out in social security equivalent benefits and subtracted the supplemental industry benefit because this has always been taxed.

Staff of the Board's Bureau of Research did not completely agree with using this methodology to compute the industry pension benefits. They were concerned that the financial interchange amount in a particular year could contain rather significant prior period adjustments and lump-sum death benefits. On a limited basis, therefore, they computed their own estimates for us. Because the Board's accounting system cannot produce data on the total benefits paid out according to the various benefit components and categories, Board personnel had to manually calculate estimates of payments by benefit component and category. This estimate was based on the number of beneficiaries in current pay status in a representative month multiplied by the average benefit entitlement for a particular component and category.

Their estimates of total industry benefits were somewhat higher than ours. Because either approach is reasonable, we used our more conservative figures. Also, we did not believe financial interchange prior period adjustments in a particular year would significantly affect our estimate because we were developing a total figure for the period 1960-83.

There were two areas of indirect federal financial involvement in the rail industry's programs that we considered but did not include in our inventory. A number of other federal agencies incur costs because of the existence of the railroad retirement and unemployment insurance programs. The Social Security Administration must interface with the Board daily and is responsible for the financial interchange. Treasury must invest and account for Board funds. The Internal Revenue Service must collect taxes and reconcile tax collections. The Congress itself expends a great deal of resources to pass the legislation pertaining to the rail industry's programs. While agencies recognize they incur costs as a result of the existence of the Board, they do not record such costs separately as they are considered part of their overall operations. We did not attempt to estimate the costs other agencies incurred as a result of the Board's existence.

In addition, the federal government subsidizes various railroad operations that can affect the railroad retirement trust funds. Two examples are Conrail and Amtrak. There are also other subsidies made to commuter railroads. Any subsidies for operations would mean that a portion of the federal funds would reach the Board in the form of employment taxes. The time and effort required to assess this form of federal financial involvement were beyond the scope of this review.

Additional detailed information on some of the programs, provisions, and matters discussed in this report is contained in the GAO reports listed in table I.1.

**Table I.1: GAO Reports Since 1979 on Railroad Retirement Programs**

| Title | Issue date | Identification number |
|---|---|---|
| Railroad Retirement Board's Calculations of Annual Appropriation Necessary To Phase Out Dual Railroad Retirement and Social Security Benefits | Jan. 11, 1979 | B-114817 |
| Railroad Retirement Program— How Does It Compare To Other Selected Retirement Programs? | June 8, 1979 | HRD-79-41 |
| More Can Be Done to Achieve Greater Efficiency in Contracting for Medicare Claims Processing | June 29, 1979 | HRD-79-76 |
| Keeping the Railroad Retirement Program on Track—Government and Railroads Should Clarify Roles and Responsibilities | Mar. 9, 1981 | HRD-81-27 |
| Delays in Receiving and Investing Taxes Are Reducing Railroad Retirement Program Interest Income | Sept. 24, 1981 | HRD-81-112 |
| Relationship of Dual Benefit Windfall Payments to Total Railroad Retirement Benefits | July 12, 1982 | GAO/HRD-82-97 |
| Inaccurate Fund Transfers Between Social Security Administration and Railroad Retirement Board | Apr. 4, 1983 | GAO/HRD-83-2 |
| Railroad Employment Projections | July 15, 1983 | GAO/HRD-83-76 |
| Railroad Retirement Board Disability Determinations | July 20, 1984 | GAO/HRD-84-11 |
| Use of a Separate Carrier to Process Medicare Claims for Railroad Retirement Beneficiaries | Sept. 26, 1984 | GAO/HRD-84-54 |
| Need to Improve Internal Controls to Curtail Possible Fraud and Abuse in the Railroad Retirement Board's Unemployment and Sickness Insurance Program | Feb. 27, 1985 | GAO/HRD-85-37 |
| Redemption of Railroad Retirement Account Investments | Dec. 13, 1986 | GAO/HRD-86-53 |
| Discrepancies in Benefits Paid by the Railroad Retirement Board for SSA | Feb. 5, 1986 | GAO/HRD-86-3 |
| Railroad Retirement— Size, Nature and Funding Sources | Mar. 5, 1986 | GAO/HRD-86-73FS |

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