Chapter 3

FINANCING OF THE RAILROAD RETIREMENT SYSTEM

Railroad retirement and survivor benefits are financed by the following sources of income:

1. Payroll taxes on railroad earnings paid by covered employees and employers.
2. Earnings on investments.
3. Revenues from Federal income taxes on railroad retirement benefits.
4. Income from a financial interchange with the social security trust funds.
5. Borrowing from general revenues related to certain features of the financial interchange mentioned in (4).
6. Appropriations from general revenues.

Each of these income sources is described briefly on the following pages.

PAYROLL TAXES

The primary source of income to the railroad retirement system is payroll taxes levied on covered employers and their employees.

The tax rate equivalent to that which would be paid under social security is commonly called the tier I tax. The tier I tax rate of 7.65 percent is divided into 6.20 percent for railroad retirement and 1.45 percent for Medicare hospital insurance. Payroll taxes in excess of the tier I rate are called tier II taxes. Tier II taxes are 15.60 percent on employers in 2002 and 4.90 percent on employees.

The Railroad Retirement and Survivors' Improvement Act of 2001 significantly revised the financing of the railroad retirement system through provisions for the investment of railroad retirement funds in nongovernmental assets, adjustments in the payroll tax rates paid by employers and employees, and the repeal of a supplemental annuity work-hour tax. Supplemental annuities continue to be payable and are funded by the new National Railroad Retirement Investment Trust, effective January 1, 2002.

The tier II tax rate on rail employers was reduced from 16.10 percent to 15.60 percent in 2002 and to 14.20 percent in 2003. The tier II tax rate for rail employee representatives is 14.75 percent in calendar year 2002 and 14.20 percent in 2003. An employee representative is a labor official of a noncovered labor organization who represents employees covered under the Acts administered by the Railroad Retirement Board.

While there is no change in the tier II tax rate of 4.90 percent on employees in the years 2002 and 2003, beginning with the taxes payable for calendar year 2004, tier II taxes on both employers and employees will be based on an "average account benefits ratio." Depending on the average account benefits ratio, the tier II tax rate for employers will range between 8.20 percent and 22.10 percent, while the tier II tax rate for employees will be between 0 percent and 4.90 percent.

The "account benefits ratio" is, with respect to any fiscal year, the amount determined by the Railroad Retirement Board by dividing the fair market value of the assets in the Railroad Retirement Account and the National Railroad Retirement Investment Trust as described on pages 70-71 (and for years before 2002, the Social Security Equivalent Benefits Account) as of the close of such fiscal year by the total benefits and administrative expenses paid from the Railroad Retirement Account and the National Railroad Retirement Investment Trust during such fiscal year. If the ratio is not an exact multiple of 0.1, it is raised to the next highest multiple of 0.1.

Likewise, the term "average account benefits ratio" means, with respect to any calendar year, the average determined by the Secretary of the Treasury of the account benefits ratios for the 10 most recent fiscal years ending before such calendar year.

Tier I taxes are ultimately transferred to the social security and hospital insurance trust funds through the financial interchange. The tier II tax is used to finance tier II benefits, supplemental annuity benefits, and also the portion of tier I benefits not reimbursed through the financial interchange.

Earnings Base

The taxable amounts of an employee's earnings are subject to tier I and tier II maximums, which are both indexed to annual increases in national wage levels. The tier I maximum is the same as the social security wage base and is higher than the tier II base as a result of 1977 social security amendments, which provided for a series of yearly increases in the social security tax base that effected corresponding increases in the railroad retirement tier I tax base. The December 2001 legislation did not affect the tier I or tier II earnings bases.

INVESTMENTS

December 2001 legislation provided greater latitude in the investment of railroad retirement assets effective January 1, 2002. Under prior law, the investment of funds not needed immediately for benefit payments or administrative expenses had been limited to interest-bearing securities restricted to obligations of the U.S. Government, obligations guaranteed as to principal and interest by the U.S. Government, or other obligations that are lawful investments for trust funds of the United States.

The legislation provided for the transfer of railroad retirement funds from the Railroad Retirement Account and the Social Security Equivalent Benefit Account to a new National Railroad Retirement Investment Trust, whose Board of Trustees is empowered to invest Trust assets, other than assets transferred from the Social Security Equivalent Benefit Account, in nongovernmental assets, such as equities and debt, as well as in governmental securities. In addition, the Railroad Retirement Supplemental Account is being eliminated and the balance of the account will be transferred to the Trust.

The National Railroad Retirement Investment Trust is not treated as an agency or instrumentality of the Federal Government. Its Board of Trustees is comprised of seven members: three members selected by rail labor to represent the interests of labor; three members selected by rail management to represent the interests of management; and one independent member selected by a majority of the other six members. Trustees are appointed only from among persons who have experience and expertise in the management of financial investments and pension plans. The members are appointed for three-year terms. However, the initial labor and management members were divided into three groups, with one group appointed for a one-year term, one group for a two-year term, and one group for a three-year term.

The Trustees are authorized to retain independent advisors to assist in the formulation and adoption of investment guidelines; retain independent investment managers to invest the assets of the Trust in a manner consistent with such investment guidelines; and invest assets of the Trust, pursuant to such guidelines.

The Trustees are subject to reporting and fiduciary standards similar to Employee Retirement Income Security Act (ERISA) requirements with respect to fiduciaries of private employee pension benefit plans. However, no rules similar to the funding requirements of ERISA and related provisions apply to the Trustees, the Trust, or Trust assets.

INCOME TAXES ON RAILROAD RETIREMENT BENEFITS

Social security amendments in 1983 subjected railroad retirement tier I benefits to Federal income taxes on the same basis as social security benefits, and subsequent railroad retirement legislation subjected benefits over and above social security levels to Federal income tax on the same basis as private and public service pensions, beginning with taxable year 1984. Revenues from income taxes on tier I, tier II and vested dual benefits are used for benefit payments.

FINANCIAL INTERCHANGE

Purpose and History of Financial Interchange

The financial interchange between the railroad retirement and social security systems is intended to put the Social Security Old-Age, Survivors, and Disability Insurance (OASDI) and Hospital Insurance (HI) trust funds in the same position they would have been had railroad employment been covered under the Social Security and Federal Insurance Contributions Acts. It follows that all computations under the financial interchange are performed according to social security law. The amount of benefits payable under the Railroad Retirement Act has no effect on the results.

The financial interchange provision was introduced by the 1951 amendments to the Railroad Retirement Act and was made retroactive to January 1, 1937. The initial determination covered the period from January 1937 through June 1952 and indicated a balance of $488.2 million in favor of the social security system. Only interest was paid on that amount until the debt was liquidated by subsequent offsets in favor of the railroad retirement system.

Since the liquidation of the original balance, annual transfers reflecting the experience of the preceding fiscal year have always favored railroad retirement.

The experience under the financial interchange proved to be more favorable to the railroad retirement system than was originally anticipated. There were two primary causes for this. The first was a series of successive amendments to the Social Security Act which raised benefits immediately while tax increases were deferred. The second factor was the decline in railroad employment, which reduced the taxes payable to social security but had little immediate effect on the benefit reimbursements.

Financial Interchange Determinations

Placing the social security trust funds in the same position they would have been had railroad employment been covered under social security since its inception involves computing the amount of social security payroll and income taxes relating to railroad employment and computing the amount of additional benefits which social security would have paid to railroad retirement beneficiaries during the same fiscal year. In the computation of the latter amount, credit is given for any social security benefits actually paid to railroad retirement beneficiaries. When benefit reimbursements exceed payroll and income taxes, the difference, with an allowance for interest and administrative expenses, is transferred from the social security trust funds to the railroad retirement trust funds. If taxes exceed benefit reimbursements (this has not happened since 1951), a transfer would be made in favor of the social security trust funds.

BORROWING FROM GENERAL REVENUES RELATED TO THE FINANCIAL INTERCHANGE

Financial interchange transfers are made in a lump sum for a whole fiscal year in the June following the close of a fiscal year. At any time, therefore, there are between 9 and 21 months' worth of financial interchange transfers which in a sense are owed the

Board. The Board receives interest on this money, so this practice does no long-term harm to the financial condition of the railroad retirement trust funds. The lag in the transfers, however, periodically caused short-term cash-flow problems in past years.

In order to avoid any further cash-flow problems from this lag, the 1983 Solvency Act provided for monthly loans from U.S. Treasury general funds. Each loan is equal to an estimate of the transfer the Board would have received in the preceding month if the financial interchange with social security were on an up-to-date basis, with interest adjustments. The Board must repay these loans when it receives the transfer from social security against which the money was advanced.

APPROPRIATIONS FROM GENERAL REVENUES

Prior to the Railroad Retirement Act of 1974, concurrent social security benefits (dual benefits) payable to railroad retirement annuitants had a significant effect on the amount of the financial interchange. Consider the example of two hypothetical employees shown on the next page.

The size of the benefits is appropriate to the early 1970's. The employees are assumed to have identical dates of birth, dates of retirement, and histories of railroad earnings. One employee, however, is assumed to have had just enough covered employment under social security to qualify for a social security benefit. (The difference in railroad retirement benefits arises from minor reductions in the 1937 Act formula for receipt of a social security benefit.)

Two conclusions are apparent. First, the employee with benefits under both systems received an advantage over the career railroad worker, which many considered unfair. In the example, the employee who is eligible for social security collects $80 more than the employee who is not eligible (the difference in line C); while, under a completely integrated system, the social security earnings would have added only $20 (the difference in line D). Second, because social security subtracted the social security benefit in calculating the financial interchange transfer, railroad retirement

Table 5.--**Example of Effects of Dual Benefits on Financial Interchange**

Item	Employee eligible for social security	Employee not eligible for social security
(A) Railroad retirement benefit	$380	$400
(B) Social security benefit	100	-
(C) Total benefit, A + B	480	400
(D) Social security benefit on combined earnings (gross tier I)	240	220
(E) Financial interchange transfer from social security to railroad retirement, D - B	140	220
(F) Amount to be financed by excess of railroad retirement taxes over social security taxes, A - E	240	180

paid most of the cost of these benefits. In the example, this is represented by the $60 difference in line F.

This situation was a major cause of the poor financial condition of the railroad retirement system in the early 1970's. In order to improve the system's financial condition, the Railroad Retirement Act of 1974 provided that the tier I component of the railroad retirement annuity be reduced by any social security benefit. This essentially integrated the two systems and eliminated the advantage of qualifying for benefits under both systems.

However, it was generally considered unfair to eliminate this advantage entirely for those already retired or close to retirement when the 1974 Act became effective. The 1974 Act, therefore, provided for a restoration of social security benefits which were considered vested at the end of 1974. The restored amount is known as the "vested dual benefit." This benefit was initially available to qualifying spouses and survivors as well as to qualifying employees. The vested dual benefit was explained in the previous chapter on benefit provisions. Eventually, after a period of several decades, the vested dual benefit will be entirely phased out.

Under the 1974 Act, appropriations had been authorized from general revenues for the phase-out costs of vested dual benefits. The amounts were to be sufficient to fund (on a level payment basis over the years 1976-2000) the vested dual benefit for new accruals and for beneficiaries on the rolls. The yearly amount was to be reviewed every three years at the time of each actuarial valuation.

The costs of these vested dual benefit payments, which were intended to be funded solely from general revenues, were substantially more than the amount estimated at the time the 1974 Act was passed, and substantially more than the funds that were appropriated between 1974 and 1981. To stop the resulting drain on the Railroad Retirement Account, the 1981 amendments established a Dual Benefits Payments Account. This account is credited with the general revenue appropriations, and it is charged with vested dual benefit payments. The Board is required to adjust vested dual benefit payments from this account so that the amounts paid to annuitants do not exceed the amounts appropriated.

FINANCIAL POSITION OF THE RAILROAD RETIREMENT SYSTEM

The financial condition of the railroad retirement system is closely related to the size of the railroad work force. This is because, as mentioned previously, the primary source of income to the system is the payroll tax on covered employers and their employees. Clearly, a large labor force will generate more revenue for the system than a small labor force. Railroad employment has declined steeply over the years and the drop in employment necessitated the strong corrective action taken in the 1981 and 1983 amendments. In the absence of these amendments, substantial reductions in payments to current beneficiaries would have been required.

The omnibus budget legislation enacted December 22, 1987, increased railroad retirement payroll tax rates in January 1988 by a total of two percent, and it provided for revenues from Federal income taxes on certain railroad retirement benefits to be transferred to the railroad retirement system for an additional year, fiscal year 1989. Subsequent legislation extended these income tax transfers on a permanent basis.

The Board's recent railroad retirement financial reports to Congress have been generally favorable. The 2002 report, which addressed the 25-year period 2002-2026, contained generally favorable information concerning railroad retirement financing. It indicated that cash-flow problems arise only under a pessimistic employment assumption and then not until calendar year 2022. However, the 2002 report indicated that the long-term stability of the system, under its current financing structure, is still dependent on future railroad employment levels, and on investment returns. No railroad retirement financing changes were recommended by the Board.

Table 6.--**Railroad Retirement and Survivor Program Consolidated Financing Sources, Costs and Net Position (Millions)**[1/]

	For the fiscal year ended September 30,	
	2001	**2000 (Restated)**
Financing Sources:		
Payroll taxes	$4,693.9	$4,754.9
Financial interchange	3,407.3	2,717.8
Interest on investments	1,118.2	1,146.8
Net gain on sale of securities	198.8	22.8
Federal income taxes	337.0	476.0
General appropriations	146.1	154.4
Other	14.4	16.6
Total financing sources	9,915.7	9,289.3
Costs:		
Benefit payments	8,418.8	8,302.9
Interest expense	221.1	219.1
Salaries and expenses[2/]	97.2	97.3
Other	2.0	1.6
Total costs	8,739.1	8,620.9
Financing sources over costs	1,176.6	668.4
Net position - beginning of period	18,629.6	17,961.8
Non-operating adjustments	(1.4)	(0.6)
Net position - end of period	$19,804.8	$18,629.6

1/ Prepared on an accrual basis of accounting.

2/ Includes unemployment and sickness insurance salaries and expenses of approximately $14.1 million and $14.9 million for fiscal years 2001 and 2000, respectively.