CONGRESSIONAL BUDGET OFFICE
COST ESTIMATE

May 24, 2001

H.R. 1140
Railroad Retirement and Survivors' Improvement Act of 2001

As ordered reported by the House Transportation and Infrastructure Committee on May 16, 2001

SUMMARY

H.R. 1140 would make several changes to the Railroad Retirement program. The bill would expand benefits for certain participants in the program and reduce the number of years of covered railroad service needed before a worker (and qualified spouse) can be vested in the system. The legislation would also eliminate the Supplemental Annuity tax and lower the payroll tax rate on railroad employers. Finally, the bill would create a new Railroad Retirement Investment Trust and establish a board to manage this fund. That board would be authorized to invest the reserves of the Railroad Retirement System in private securities.

Assuming that investments in private securities are treated as budget outlays, as specified in OMB Circular A-11, CBO estimates that H.R. 1140 would increase direct spending by $13.8 billion during the 2002-2006 period and by $10.6 billion over the 2002-2011 period. It would reduce revenues by $1.7 billion from 2002 through 2006 and by $4.0 billion in the 10-year period. Because the bill would affect direct spending and receipts, pay-as-you-go procedures would apply. The net effect of H.R. 1140 would be to decrease the budget surplus by $15.5 billion from 2002 through 2006 and by $14.6 billion over the 2002-2011 period. Because there is little precedent for the purchase of private securities by the federal government, alternative budgetary treatments are possible that could substantially alter the budgetary impact.

The legislation contains no intergovernmental or private-sector mandates as defined in the Unfunded Mandates Reform Act (UMRA) and would impose no costs on state, local, or tribal governments.

ESTIMATED COST TO THE FEDERAL GOVERNMENT

The estimated budgetary impact of H.R. 1140 is summarized in Table 1. The costs of this legislation fall within budget function 600 (income security).

TABLE 1. ESTIMATED BUDGETARY EFFECTS OF H.R. 1140

	By Fiscal Year, in Millions of Dollars										
	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
CHANGES IN DIRECT SPENDING											
Benefit Changes											
Expansion of Widow/er Benefits	0	83	92	94	95	97	100	102	104	106	108
Reduction in Retirement Age	0	37	121	192	228	259	305	359	397	420	443
Reduction in Vesting Requirements	0	*	*	*	*	*	1	1	1	1	2
Repeal of Ceiling on Railroad Retirement Benefits	0	11	14	15	16	18	19	20	22	24	26
Subtotal	0	131	227	301	339	374	425	481	523	550	578
Investment in non-Treasury Securities [a]	0	15,320	-460	-660	-830	-920	-990	-1,060	-1,140	-1,250	-1,340
Total	0	15,451	-233	-359	-491	-546	-565	-579	-617	-700	-762
CHANGES IN REVENUES											
Repeal of Supplemental Annuity Tax [b]	0	-59	-79	-81	-79	-77	-76	-75	-75	-74	-74
Adjustment in Tier II Tax Rate [b]	0	-59	-198	-329	-362	-366	-374	-379	-383	-384	-386
Total	0	-118	-277	-410	-441	-443	-450	-454	-458	-458	-460
TOTAL CHANGES IN THE BUDGET SURPLUS											
Increase or Decrease (-) in the Surplus	0	-15,569	-44	-51	50	103	115	125	159	242	302

NOTES: Components may not sum to totals because of rounding.

* = Less than $500,000.

a. The budgetary treatment of this provision follows the instructions in OMB Circular A-11. CBO assumes that the investment board will maintain 20 percent of the portfolio in U.S. Treasury securities, 20 percent in corporate securities, and 60 percent in private equities.

b. Assumes that 20 percent of employer-paid payroll tax reductions are offset by additional income and employee-paid tax collections.

BASIS OF ESTIMATE

The Railroad Retirement system has two main components. Tier I of the system is financed by taxes on employers and employees equal to the Social Security payroll tax and provides qualified railroad retirees (and their qualified spouses, dependents, widows, or widowers) with benefits that are roughly equal to Social Security. Covered railroad workers and their employers pay the Tier I tax instead of the Social Security payroll tax, and most railroad retirees collect Tier I benefits instead of Social Security. Tier II of the system operates much like traditional multi-employer pension systems, with employers and employees contributing a certain percentage of pay toward the system to finance defined benefits to eligible railroad retirees (and qualified spouses, dependents, widows, or widowers) upon retirement. But while most multi-employer plans are run by a group of cooperating employers in the same industry, the federal government collects the Tier II payroll contributions and pays out the benefits.

H.R. 1140 would make fundamental changes to the Railroad Retirement system by expanding certain retirement benefits, reducing payroll taxes, and authorizing a new government organization to invest funds credited to the Railroad Retirement Account in the private securities market. In addition, the bill would eliminate the separate account for supplemental benefits and pay those benefits directly from the Railroad Retirement Investment Trust.

CBO assumes an enactment date of September 30, 2001.

Direct Spending

H.R. 1140 would make several changes in Railroad Retirement benefits, including:

- Expanding benefits for qualified widows and widowers;
- Reducing the normal retirement age for Tier I benefits to 60;
- Reducing the system's vesting requirements; and
- Repealing the cap on the Railroad Retirement benefits.

The bill also would establish a new entity called the Railroad Retirement Investment Trust, which would be responsible for investing the reserves of the Railroad Retirement System in private securities, as well as in U.S. Treasury Securities. Without changes in law, CBO estimates that outlays for the Railroad Retirement benefits will be $8.5 billion in fiscal year 2002 and will grow to $10.5 billion by 2011.

Benefit Changes. The four changes in Railroad Retirement benefits (described below) would increase spending by $0.1 billion in 2002 and by $3.9 billion over the 2002-2011 period. A fifth change, which would have no budgetary effects, would shift the payment of the Supplemental Annuity from its separate account to the Railroad Retirement Investment Trust.

Expansion of Widows' and Widowers' Benefits. Section 101 of the legislation would increase Railroad Retirement annuities payable to certain widows and widowers of railroad employees. Under current law, the Tier II component of a widow(er)'s Railroad Retirement annuity is generally equal to 50 percent of the Tier II benefit that was payable to the retired employee at the time of his or her death. Section 101 would provide a guaranteed minium benefit for widow(er)s based on 100 percent of the employee's Tier II annuity. This provision would generally provide widow(er)s with the same Tier II benefits that were previously being paid to the now deceased railroad retiree.

Section 101 would apply to benefits paid in months beginning 30 days after the bill is enacted. For widow(er)s whose benefits begin before that date, the guaranteed minimum would be based on the amount of the original annuity without adjustments for inflation.

According to the Railroad Retirement Board, this provision would initially affect approximately 50,000 widow(er)s currently collecting benefits. CBO estimates this provision would increase direct spending by $83 million in 2002 and by $979 million during the 2002-2011 period.

Reduction in Retirement Age. Section 102 of the legislation would provide for full retirement benefits at age 60 for railroad workers (and qualified spouses) who have at least 30 years of covered service. Under current law, retirees with 30 years of service may begin collecting full Tier II benefits at age 60, but Tier I benefits are reduced if they file before the age of 62. This legislation would eliminate that reduction in Tier I benefits, which was enacted in the Railroad Solvency Act of 1983. Based on data provided by the Railroad Retirement Board, CBO estimates this provision would initially affect about 2,500 workers and would increase direct spending by $37 million in 2002 and by $2.8 billion over the 2002-2011 period.

Reduction in Vesting Requirements. Section 103 would reduce the number of years of covered service needed before workers (and qualified spouses) become vested in the Railroad Retirement System from 10 years to five years. The reduced vesting requirement would only apply to qualified service performed after 1995. Employees who had fewer than 10 years of qualified railroad employment before 1996 would either have to meet the current 10-year vesting requirement or have five years of covered service after 1995 in order to be vested. Section 103 would correspondingly reduce the vesting requirements for disability and survivor benefits.

Based on information provided by the Railroad Retirement Board, CBO estimates this proposal would have a negligible effect on direct spending through 2006, but would increase direct spending by $6 million during the 2007-2011 period.

Repeal of the Ceiling on Railroad Retirement Benefits. Current law caps the total monthly benefits payable to a retiree and spouse under the Railroad Retirement system. This cap is calculated based on the employee's average monthly salary during the two years prior to retirement, or the worker's monthly Social Security earnings in the 10-year period prior to retirement. The maximum cannot be more than the final average monthly compensation and cannot be less than $1,200. Section 104 would repeal this limit, effective January 1, 2002. The Railroad Retirement Board indicates that about 2,000 employee annuitants and 12,000 spouse annuitants currently collect reduced benefits because of the cap. CBO estimates that eliminating the Railroad Retirement maximum would increase direct spending by $11 million in 2002 and by $182 million from 2002 through 2011.

Investment in Non-Treasury Securities. Section 105 of H.R. 1140 would establish a new entity, the Railroad Retirement Investment Trust, which would be allowed to invest in non-Treasury securities, such as publicly traded stocks in private companies. By law, the fund's assets, which CBO estimates will total about $19.2 billion in December 2001, now consist solely of U.S. government securities. Because those securities are the safest possible investment, they generally earn a lower rate of return than riskier instruments like corporate stocks and bonds. Similar restrictions apply to the investment policies of every major federal trust fund—Social Security, Medicare, Civil Service Retirement, Military Retirement, the Highway Trust Fund, and others. H.R. 1140 would make Railroad Retirement an exception to that rule.

Estimate Under Current Budgetary Treatment. The current budgetary treatment of federal investments in non-Treasury financial instruments is specified in the Office of Management and Budget (OMB) Circular A-11, which states that the purchases of such securities should be displayed as outlays and the sales of such securities and returns such as dividends and interest payments should be treated as offsetting receipts or collections. Under this budgetary treatment, this bill's authorization for such investment practices would increase outlays by $15.3 billion in 2002. Beginning in 2003, however, most proceeds from stock dividends and sales would be used to pay benefits because tax revenues would not be sufficient to fund all benefits payments. Thus, the new investment practices result in decreased outlays beginning in 2003, and net spending of $6.7 billion over the 10-year period.

As required by the bill, funds currently held in the Railroad Retirement Account and the Social Security Equivalent Benefit Account that are not currently needed to pay benefits would be transferred to the newly created Railroad Retirement Investment Trust. CBO assumes that about $19.2 billion in those accounts would be transferred on December 31, 2001, and would promptly be invested in various financial instruments. Based on the practices of other multi-employer pension plans, CBO further assumes the managers of the fund would keep 20 percent of the investments in U.S. Treasury securities, 20 percent in high-grade corporate bonds, and the remaining 60 percent in equities. Because purchases of Treasury securities are not considered outlays, only 80 percent of the initial investments of the fund would be shown as federal outlays. The estimates assume that Treasury securities yield about a 6 percent return, high-grade corporate bonds a 7 percent return, and equities a 9 percent return. The assumption of returns on Treasury securities is based on CBO's January 2001 economic projections, while the assumed returns on corporate bonds and equities are consistent with the 1999 report of the Technical Panel on Assumptions and Methods to the Social Security Advisory Board.

Current Budgetary Treatment vs. Possible Alternatives. For most federal programs, accounting for outlays is straightforward. The federal government buys goods and services—such as defense and medical care—and makes transfer payments like Social Security and payments for Food Stamps by issuing a check or its equivalent. Those payments are counted as outlays when they are issued. The A-11 treats the purchases of assets—financial or physical—in the same way. The purchase price simply appears as a federal outlay. Specifically, the A-11 states:

> "[w]e treat an investment in non-U.S. securities (equity or debt securities) as a purchase of an asset. You must record an obligation and an outlay for the purchase in an amount equal to the purchase price... You record interest received on such investments as a collection when you receive it and in the amount that you receive... You record the proceeds from the sale or redemption of a non-U.S. security as a collection when received and in the amount received."

In contrast, the A-11 directs that U.S. securities be treated as equivalent to cash, and tells agencies to count transactions involving such securities as a change in the mix of asset holdings rather than as a purchase or sale of assets. Thus, purchases of non-Treasury securities are deemed to be outlays under the A-11 guidelines, but purchases of Treasury securities are not. In practice, this difference has been of little consequence because the government has only rarely acquired non-Treasury securities.

Some budget experts think that this long-standing practice is ill-suited to purchases of financial assets that the government acquires as a way of preserving (or enhancing) the value of cash balances. (For example, the current treatment would dictate that if current or future budget surpluses were entirely invested in non-Treasury securities, the budget would record government expenditures equal to receipts, which might not be a useful indicator of the government's financial condition.) It can also be argued that purchases of financial assets in order to preserve or enhance the value of cash balances are very different in nature, and should be treated differently in the budget, than purchases of goods and services, entitlement benefits, grants, employees' salaries, and other programmatic or operational activities of the government. Consequently, some analysts have argued that these purchases should not be treated as outlays, but rather as a means of financing the activities of the federal government. In this estimate, CBO has followed the instructions of the A-11, but we may consider a different budgetary treatment in the future.

Revenues

H.R. 1140 would make several changes to the payroll tax specified in the Railroad Retirement Act, and would result in estimated net revenue losses of $0.1 billion in 2002 and $4.0 billion over the 10-year period. Because reductions in employer-paid employment taxes are assumed to be passed through to workers as higher compensation, mostly in the form of wages, increased income and employee-paid payroll tax collections are assumed to offset 20 percent of the lost payroll tax revenues.

Supplemental Annuity Tax. Section 203 of the bill would repeal the Supplemental Annuity tax, which is currently levied on employers to pay for a third layer of benefits on top of Tier I and Tier II. Instead of being paid from a separate account, supplemental benefits would be paid directly from the Railroad Retirement Account. Based on information provided by the Railroad Retirement Board, CBO estimates that this provision would reduce net revenue by $375 million over the 2002-2006 period and by $749 million over the 2002-2011 period.

Tier II Payroll Tax Rates. The bill would also lower the Tier II tax rate on employers from its current level of 16.1 percent to 14.75 percent in calendar year 2002 and 14.2 percent in calendar year 2003. Thereafter, H.R. 1140 would link future Tier II tax rates to the financial condition of the Railroad Retirement Investment Trust (see Table 2). Specifically, the bill would require the Railroad Retirement Board to calculate the ratio of assets held in the trust fund (using the average balance in the fund over the previous 10 years) to the total Railroad Retirement benefits paid out in a given year (the account benefit or trust fund ratio). In 2004, CBO expects the account benefit ratio would be about 5.6, which would cause payroll tax rates to be set at 13.1 for employers and 4.9 for employees (which is the current rate for employees). CBO estimates that the Tier II tax rates will remain at that level through at least 2011 and that the changes in the tax rate would reduce revenue by $1.3 billion over the 2002-2006 period and $3.2 billion from 2002 through 2011. (Under current law, CBO estimates that Tier II tax revenues will total about $31 billion over the 2002-2011 period.)

If, however, the account benefit ratio rises or falls below expectations, a change in payroll tax rates could be triggered by the bill. For instance, if the board determined that this ratio had gone above 6.0, then the Tier II payroll tax rate for both employers and employees would be reduced. Conversely, if the board determined that the ratio had fallen below 4.0, then the payroll tax for railroad employers would increase.

Under reasonable assumptions about railroad employment and investment income to the trust fund, CBO estimates that neither outcome would occur during the next 10 years. For example, if the new trust fund held only Treasury securities, the account benefit ratio would fall from 6.0 today to 5.1 by 2011. If the trust fund were invested in a wider variety of securities, and the rates of return matched CBO's assumptions, the ratio would be roughly 5.8 in 2011.

Although that conclusion represents CBO's best judgment, the unexpected could happen. For example, rapid growth in the railroad industry's payroll or spectacular returns in the stock market could trigger tax cuts by 2011. On the other hand, employment that is significantly lower than expected or a drop in stock values could lead to automatic tax increases.

TABLE 2. DETERMINATION OF TIER II TAX RATE

If the account benefit ratio is:		The Tier II tax rates would be:	
At least	But less than	For employers	For employees
0	2.5	22.1	4.9
2.5	3.0	18.1	4.9
3.0	3.5	15.1	4.9
3.5	4.0	14.1	4.9
4.0	6.1	13.1	4.9
6.1	6.5	12.6	4.4
6.5	7.0	12.1	3.9
7.0	8.5	11.6	3.4
7.5	8.0	11.1	2.9
8.0	8.5	10.1	1.9
8.5	9.0	9.1	0.9
9.0	NA	8.2	0

NOTES: The account benefit ratio is calculated by dividing average trust fund assets over the previous 10 years by the total Railroad Retirement benefits benefits paid in a given year.

NA = Not applicable.

PAY-AS-YOU-GO CONSIDERATIONS

The Balanced Budget and Emergency Deficit Control Act sets up pay-as-you-go procedures for legislation affecting direct spending and receipts. The net changes in outlays and governmental receipts that are subject to pay-as-you-go procedures are shown in Table 3. For the purposes of enforcing pay-as-you-go procedures, only the effects in the current year, the budget year, and the succeeding four years are counted.

TABLE 3. ESTIMATED EFFECTS OF H.R. 1140 ON DIRECT SPENDING AND RECEIPTS

	By Fiscal Year, in Millions of Dollars										
	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Changes in outlays	0	15,451	-233	-359	-491	-546	-565	-579	-617	-700	-762
Changes in receipts	0	-118	-277	-410	-441	-443	-450	-454	-458	-458	-460

INTERGOVERNMENTAL AND PRIVATE-SECTOR IMPACT

H.R. 1140 contains no intergovernmental or private-sector mandates as defined by UMRA and would impose no costs on state, local, or tribal governments.

COMPARISON WITH OTHER ESTIMATES

The Railroad Retirement Board has prepared an estimate of the individual benefit increases and projected trust fund holdings under H.R. 1140. The board's estimate contains trust fund projections using three different assumptions about employment levels in the railroad industry.

Using the middle employment assumption, which CBO believes is the most realistic, the Railroad Retirement Board estimates that the cost of benefits under H.R. 1140 would increase by $1.4 billion from 2002 through 2006 and by $3.9 billion during the 2002-2011 period, slightly more than CBO estimates. In addition, the board estimates that revenues from Tier II payroll taxes would decrease by $1.5 billion from 2002 through 2006 and $3.6 billion over the 2002-2011 period. The board's estimates do not include any impact the lower employer-paid payroll taxes might have on income and employee-paid payroll tax receipts. On a comparable basis, excluding impacts on income and employee-paid payroll tax receipts, CBO estimates Tier II revenue losses of $1.6 billion over five years and $4.0 billion over 10 years. Both the board and CBO estimate that balances in the new trust fund would rise steadily over time, but would not be high enough to trigger a reduction in the payroll tax during the next 10 years.

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