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Railroad Retirement: Forfeitures of Benefits and Contributions by Workers Leaving the Industry

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Railroad Retirement: Forfeitures of Benefits and Contributions by Workers Leaving the Industry

SUMMARY

Railroad workers, through coordination between Railroad Retirement and Social Security, earn old-age retirement income through the same social insurance structure as other commercial and industrial workers. Railroad workers also participate in a separate industry pension. However, railroad workers who leave their jobs with less than 10 years of railroad service forfeit their pension benefits and all contributions they made to help finance those benefits, a more severe loss of rights than federal law permits for any other pension covering workers in the private sector.

Private pension plans are governed by the Employee Retirement Income Security Act (ERISA). In 1996, amendments to ERISA required multiemployer plans to provide a nonforfeitable, contractual right, called a "vested" right, to benefits for workers completing 5 years of covered service. ERISA also requires that workers are always vested for any benefits attributable to their own contributions.

Railroad workers are not protected by ERISA, and separating railroad workers forfeit significant amounts in benefits and contributions by not meeting the more stringent Railroad Retirement vesting requirements. According to data from the last actuarial valuation of the program, an average worker leaving the industry with more than 5, but less than 10 years service was leaving behind about $7,000 in employee contributions; maximum forfeitures are above $15,000 and rising. A typical worker with 8 years of service at separation could also lose more than $10,000 in benefit rights.

Because railroad employment is declining, incoming workers have diminished opportunities to retain their jobs until vesting, or to return to rail service after a period outside the industry. According to the Railroad Retirement Board, about two-thirds of new railroad workers leave the industry with less than 10 years service. Almost 10,000 workers left railroad employment in 1993 before satisfying the vesting requirement. Some former rail workers whose pension rights have been forfeited have asked Congress to amend the rail program to provide vesting rights similar to ones found in other private industry pensions.

Congress usually increases program benefits only in response to rail industry proposals supported by a labor/management agreement. Although some 5-year vesting rules could be adopted without endangering projected funding, any added costs would be borne by the rail industry, and substantial bargaining between management and labor could be required before agreement was reached on any necessary trade-offs. Neither management nor labor is likely to initiate vesting changes on its own because neither represents separated workers: management seeks better returns for industry stockholders; labor bargains to improve compensation for current workers. If Congress decided to change the railroad pension vesting rules, retroactive application of the new rules would be an important issue.

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Railroad Retirement: Forfeitures of Benefits and Contributions by Workers Leaving the Industry

Introduction and Background

In addition to any income from savings and investments, the conventional model for retirement income planning assumes income from two other sources: Social Security and pensions. Social Security computes benefits based on earnings in nearly all jobs (96%); required employee payroll taxes are social insurance "premiums" and are used to pay current benefits. Pensions are compensation deferred from the period in which it is earned until retirement. Benefits are based on the specific jobs through which the compensation was earned; any employee contributions are normally treated as belonging to the employee.

In many ways, Railroad Retirement resembles the combination of Social Security and employer-sponsored pensions available to workers in other industries. At retirement, eligible railroad workers receive a Social Security component (Tier I), based on all wages covered by either Railroad Retirement or Social Security. In addition, railroad workers earn rights to a separate pension component (Tier II), based only on railroad industry employment.

When a worker with 10 years of railroad service retires, any wage credits earned by the worker under Social Security are transferred to the Railroad Retirement Board (RRB) for use in the computation of a Tier I benefit. The benefit is calculated using the same formula as is used by Social Security, and spouse, survivor, or dependent benefits based on that worker's wage history are also treated similarly under both programs. Tier II benefits are calculated by a separate formula, and are based only on railroad service.

When a worker becomes eligible for Social Security benefits and does not have 10 years railroad service, the RRB transfers Tier I wage credits to the Social Security Administration (SSA) for use in the computation of a Social Security benefit. Thus, for Social Security purposes, all wage credits earned in jobs covered either by Railroad Retirement or Social Security are treated the same under both programs, and are not lost to workers who move from one job to another, whether in or out of the railroad industry.[1]

Tier II retirement credits, on the other hand, are meaningful only for railroad workers meeting the 10-year "vesting" requirement. A vested right is one that becomes nonforfeitable and contractual. Upon completing 10 years service (or service in 120 months), railroad workers are vested for Tier II retirement benefits, and

[1] There are minor differences in Tier I and Social Security that have no effect on benefit or contribution forfeitures.

for additional spouse, dependent, and survivor benefits. Workers not meeting vesting requirements receive no Tier II benefits, and forfeit any contributions they made toward the financing of Tier II.

Such rules contrast with vesting for pensions covering workers in other industries. While other workers have similar Social Security protection, federal regulation of private pensions through the Employee Retirement Income Security Act (ERISA), provides greater pension protection for those workers when they separate before retirement. Recent amendments to ERISA require 5-year vesting for workers in multi-employer plans, bringing vesting under those plans in line with vesting requirements for single-employer plans. Furthermore, even before ERISA, other laws gave workers immediate and full vested rights to their own pension contributions.

Lost Retirement Rights for Separating Railroad Workers

There are three primary causes of the forfeitures.

- Declines in railroad employment means many rail workers lose jobs before vesting, and have fewer opportunities to reenter railroad service and add to past service credits.

- Railroad Retirement vesting rules are more restrictive than similar federal laws governing vesting in other private pensions.

- Expanding railroad pension vesting would add costs usually bargained within the context of total compensation, and neither management nor labor represents the interests of former employees.

The RRB[2] estimates that new entrants have only a one in three chance of reaching 10 years service. Table 1 shows estimates of employees separating with less than 10 years service from 1982, the first full year after Tier II employee contributions were required, through 1993, the last year for which data are currently available.

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[2] U.S. Railroad Retirement Board. Bureau of the Actuary. *Nineteenth Actuarial Valuation of the Assets and Liabilities Under the Railroad Retirement Acts of December 31, 1992.* August, 1994. The data show that 57% of incoming employees leave within 5 years.

TABLE 1. Workers Leaving Railroad Employment Without Vesting

Year	Number[1]	As a % of total separations[2]	0-5 years	More than 5 and less than 10
1982	27,302	38	21,207	6,095
1983	15,924	33	10,872	5,052
1984	12,661	32	8,971	3,690
1985	17,901	41	13,152	4,749
1986	15,604	37	9,082	6,522
1987	16,680	36	9,076	7,604
1988	13,262	34	8,730	4,532
1989	11,429	34	8,500	2,929
1990	9,885	36	7,862	2,023
1991	8,842	38	7,180	1,644
1992	7,835	32	6,234	1,601
1993	9,464	39	7,834	1,630

[1]Separating employees who did not reenter rail employment at any time before 1994.
[2]Percentage of employees separating in that year, some of whom subsequently reentered rail employment.

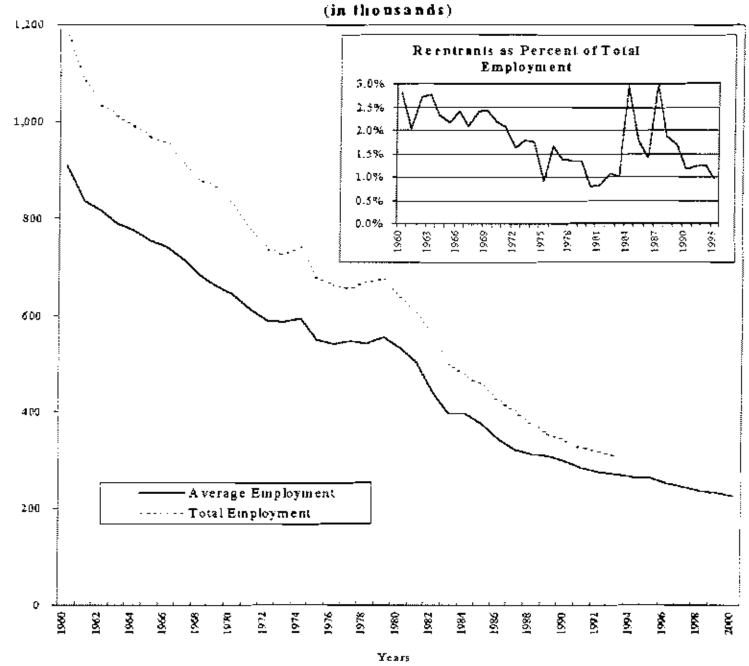
Source: Estimates developed for this report by the Bureau of Actuary, Railroad Retirement Board

Declining Opportunities in Rail Industry Employment. The difference between the total and average number of railroad workers each year is an indication of how much sporadic railroad employment exists, and whether workers who do not have sufficient seniority to successfully bid for regular, scheduled work can still periodically acquire wage credits toward meeting the vesting requirement.

Chart 1 shows the decline in the difference between total and average railroad employment over the period from 1960-2000, coinciding roughly with the work careers of workers currently reaching retirement age. During the early years of the period, the total number of jobs exceeded the average number by almost 200,000. By 1993, the difference between the total and average number of jobs dropped to less than the number of new entrants that year, thereby providing fewer opportunities for workers to reach the vesting criterion through sporadic employment.

Diminishing Opportunities for a Return to Railroad Work. The inset in chart 1 shows the number of employees who returned to railroad employment after at least 1 year without a railroad job as a percentage of total employees. As the inset shows, declining employment leads to a decreasing percentage of workers able to subsequently reenter, because workers with increasing seniority are competing for a decreasing number of jobs. In 1984 and 1987, temporary increases in railroad employment raised the percentage of total workers who reentered, but that apparent rise in opportunities did not last. As the total numbers or railroad workers declines, the reentrant percentage also becomes more volatile, as smaller changes to the number of reentrants has a larger effect. In 1993, about 3,000 former railroad workers reentered a railroad job.

Chart 1. Employment in the Railroad Industry 1960-2000 (in thousands)



Vesting Rules Under the Employee Retirement Income Security Act of 1974 (ERISA). On the premise that workers own their compensation when their service is performed, ERISA regulates pensions as deferred compensation. Upon becoming vested, employees have nonforfeitable, contractual rights to any benefits earned at that point, and all subsequent benefit gains from additional covered service are fully vested as they are earned. When ERISA was enacted, pensions were prohibited from requiring more than 10 years before workers became fully vested for plan benefits. Subsequent amendments to vesting rules lowered benefit requirements to 5 years, first for single-employer plans in 1986, followed by multiemployer plans in 1996. The new rules were applied prospectively, with a phase-in period for plans governed by collective-bargaining agreements. All plans must be in compliance with the new vesting rules by January 1, 1999.

ERISA also requires that workers are always immediately vested for any benefits or refunds attributable to their own contributions. ERISA provides strict guidelines for determining the portion of any benefit that is attributable to employee contributions. In the first few years of an employee's service, the value of any accrued benefit is often less than the sum of that employee's contributions, and an amount equal to the contributions is refunded if the employee separates before becoming vested for plan benefits. Any refund of employee contributions must include interest, and reentering employees have the right to repay past withdrawals to purchase their past service credits.

Why Railroad Retirement Was Exempted from ERISA. The same year (1974) that it enacted ERISA, Congress ended any future right for workers to qualify for separate entitlement to Railroad Retirement and Social Security. The two-tier benefit structure was established, with Tier II a clearly defined rail industry pension. Nevertheless, Congress did not consider covering Railroad Retirement by ERISA. The exclusion was in part based on ERISA funding standards, which that Act made central to retirement benefit security. ERISA generally requires pensions to set aside sufficient funds to pay vested benefits at the time the service earning such rights is performed. Unfunded pension liabilities (which usually reflect credit given for past service) are required to be amortized, or paid-off over a fairly limited period. Instead of a fund sufficient to finance all vested benefits, Railroad Retirement is backed by the power of Congress to require the industry to meet its pension obligations, and funding is largely drawn from current industry revenues. If Railroad Retirement was required to meet ERISA funding standards, additional industry revenue to fund past service credits would be unavailable for other current uses, either corporate investment returns or employee compensation. Thus, the industry favored exempting Railroad Retirement from ERISA.

Forfeiture Amounts

Contribution Forfeiture. From 1937 through 1974, railroad employees paid one payroll tax to Railroad Retirement. In most years, that tax rate exceeded the tax rate they would have paid had their jobs been covered by Social Security rather than Railroad Retirement. With the advent of the two-tier structure in 1975, workers paid a tax rate to Railroad Retirement to help fund Tier I benefits equal to the tax rate they would have paid if they were directly covered by Social Security. By inference, the equivalent Social Security portion of the taxes paid by railroad employees before 1975, equals the taxes that employees would have paid to Social Security had they been covered by that program; industry pension contributions equal the remainder of the payroll taxes the workers actually paid. According to the RRB, since 1950, about 2.8 million former railroad workers have left railroad employment without vesting in almost $700 million in past contributions they made to support the rail industry pension.

In 1981, an enacted agreement reintroduced payroll taxes on employees to reinforce Tier II financing, a departure from the agreement of 1974, in which management accepted sole financing responsibility for Tier II. Labor agreed to assessments on their members as a trade-off during bargaining over compensation. Subsequent rate increases raised the level on employees from 2.0% in 1981, to the current level of 4.9%. The rate is assessed on wages up to a maximum annual amount (wage base). The Tier II wage base is about 25% lower than the Social Security wage base. Both the Tier II and Social Security wage bases are adjusted annually for economy-wide increases in wages. In 1997, the Tier II wage base is $48,600 (the Social Security/Tier I wage base is $65,400, with a tax rate of 6.2%).

Maximum and Average Contributions. The magnitude of contribution forfeitures is illustrated in table 2. Table 2 shows the amount of Tier II taxes paid by a worker with wages at the taxable maximum, for the years between 1982 and 1993. Table 2 also shows average lifetime contributions toward the industry pension made by workers who left the industry in those years without vesting.

By 1997, the annual maximum Tier II payroll tax on railroad employees has risen to nearly $2,400. Data from the RRB show that in 1993, about 22% of railroad employees had less than 10 years service; about 36% of those workers paid the maximum Tier II tax that year. About 80% of all railroad workers had service during 12 months, at average wages near the maximum taxable wage.

TABLE 2. Maximum Annual Employee Tier II Contributions and Average Lifetime Tier II Contributions for Separating Employees with Less than 10 Years Service, 1982-1993

Year	Maximum contributions each year	Average lifetime contributions by employees separating each year: 0-5 years	Average lifetime contributions by employees separating each year: More than 5 and less than 10 years
1982	$486	$130	$399
1983	534	298	579
1984	776	388	985
1985	1,040	368	1,563
1986	1,339	759	2,310
1987	1,391	787	2,400
1988	1,646	820	3,578
1989	1,749	864	4,208
1990	1,867	952	5,082
1991	1,940	1,005	5,301
1992	2,029	1,444	6,460
1993	2,102	1,406	7,004

Source: Estimates developed for this report by the Bureau of the Actuary, Railroad Retirement Board.

Benefits Forfeiture. To illustrate benefit forfeitures on an individual, the present value of deferred benefits at separation was calculated for a hypothetical worker making $50,000[3] who separated from rail service in 1996 at age 40 after 8 years of railroad employment. In this illustration, the worker is assumed to be married to a spouse 3 years younger. If Railroad Retirement followed ERISA vesting standards, this railroad worker would be eligible for a deferred benefit of $2,800 per year beginning at age 62.

Tier II also pays spouse benefits based on a worker's benefit amount. The spouse's benefit is financed from the combination of employer and employee payroll taxes to Tier II. ERISA would prohibit a spouse's benefits from being forfeited from the point at which the right to them became fully vested. Thus, in this example, the

[3] The actual formula provides a benefit to a retired railroad worker of 0.7% of pay, for each year of completed service, times the average of the highest 60 months of employment. Thus, in the example, the worker is eligible for 5.6% (0.7 X 8 years) of $50,000 (assuming that as a 5-year average), or $2,800 per year if the worker was eligible for the benefit. The spouse's benefit is equal to 45% of the worker's benefit and surviving spouses are eligible for 50% of the worker's benefit. There are additional dependents benefits potentially payable under Tier II that were ignored for this illustration.

Tier II spouse benefit of $1,260 per year is included as a component of the rights earned through this hypothetical employee's service.

ERISA also governs the vesting of survivor benefits. ERISA requires that plans provide Joint and Survivor Coverage, which means that the primary benefit is generally reduced by an amount sufficient to fund a survivor benefit equal to 50% of the primary benefit, payable to the survivor if the retiring worker dies first. For this example, the Tier II spouse benefit of $1,260 per year payable during the worker's retired life, becomes a survivor benefit of $1,400 per year if the retired worker died leaving the spouse surviving.

ERISA permits plans to cash-out a separating worker's vested rights if the present value of the deferred benefit is $3,500 or less. In remaining cases, the workers can choose a lump-sum payment or leave the money in the pension and draw a deferred benefit at retirement. The present value at separation of this worker's accrued benefit rights would be $10,400. Workers separating with more service (up to 10 years), at older ages, at higher income levels, or with more dependents would experience losses of greater amounts; workers leaving with less service (but more than 5 years), at younger ages, lower incomes, or with fewer dependents would have smaller losses.

Issues to be Considered

From time-to-time, congressional offices receive inquiries from constituents whose separation from a job covered by Railroad Retirement has prompted them to seek a return of their contributions. Changing the vesting rules to provide for refunds would require an amendment to the Railroad Retirement Act. Several issues would arise if Congress considered liberalizing Tier II vesting.

- Should Congress await an industry proposal, or should it initiate its own?
- Could Tier II vesting be modeled along similar rules in ERISA?
- Should retroactive application be considered?
- What administrative issues would need to be addressed?
- How would additional costs affect Tier II funds?

Should Congress Address Tier II Vesting? Congress rarely acts to increase Railroad Retirement benefits without the railroad industry first reaching a bargained agreement to do so. Benefits are mostly paid from funds drawn from current rail industry revenue, and bargaining between railroad companies and their workers over shares of that revenue is accorded the same general independence as other transactions between private parties. Even if it was determined that Congress should intervene, Congress is not a party to all negotiations that effect the respective shares. Industry negotiators bargain salary, work rules, and job guarantees with very little congressional input, and trade-offs in these areas can spill over into negotiations affecting retirement benefits and contributions.

Furthermore, improvements to vesting rules are grounded in equity considerations, and if Congress sought to involve itself in equity issues in Railroad Retirement, it may well find other areas in the program in which it finds similar equity questions. Congress may decide that such intrusion into industry compensation is no more warranted in this case than in others.

Nevertheless, Congress has sometimes acted on its own initiative in Railroad Retirement. In most such cases, Congress has acted so that railroad workers and their compensation are treated similarly to other workers under federal tax policy. Congress has also acted so that railroad workers are treated similarly to all other workers covered by Social Security. In other instances, such as the treatment of divorced spouses, Congress has forced the industry to accept changes in the context of broader industry proposals to amend Railroad Retirement.

Could ERISA Vesting Rules Be Applied to Railroad Retirement? Some constituents contacting congressional offices have advocated covering Railroad Retirement by ERISA so that they would be protected by ERISA vesting rules. However, vesting rules are only one facet of the relationship between private pension funding and the distribution of fund assets to eligible beneficiaries. Applying all ERISA rules to Railroad Retirement could create problems. ERISA was designed to improve the security of retirement benefits, but it also regulates the distribution of pension funds among plan participants so that the funds are not created simply for the purpose of avoiding taxes.

ERISA vesting rules are relatively simple, and similar rules could be used to govern Tier II vesting. If such vesting rules were extended to Tier II, at 5 years service, employees would have rights to Tier II benefits. Under ERISA, workers separating with less than 5 years service are eligible for refunds of their contributions upon separation, plus interest, and vested separating workers are given the choice between a lump-sum at separation or benefit rights deferred until retirement age.

Should Vesting Apply Retroactively? Former railroad workers who press Congress for changes to Tier II vesting would expect that the change would give them some additional rights they do not now have. Yet, establishing limitations to retroactive application of liberalized vesting rules would probably be required. Unless a restriction were placed on retroactive claims, previously separated workers with 5 years railroad service could substantially increase the benefit caseload. Unless a limit were placed on retroactive rights to contributions for unvested, separated workers, all such former employees could claim refunds. If these contributions were refunded with earned interest, costs could be substantial.

What Administrative Issues Might Need to Be Addressed? Under a 5-year vesting rule, the RRB would administer benefits for a larger number of retirees. Furthermore, ERISA rules permit employees to withdraw vested rights, and repay the withdrawn money if they subsequently reenter that employment. If employees could withdraw funds on each separation, and submit payments to recapture past service, the RRB would have added administrative responsibilities.

Also, Tier II and Tier I claims are currently administered together by RRB. Under a 5-year vesting rule, the two tiers would require separate administration, because some workers would qualify for Tier II benefits who were ineligible for either Tier I or Social Security. Workers become permanently insured under Social Security after 40 quarters of coverage through either Social Security or Tier I coverage;

railroad workers currently eligible for Tier II also meet that requirement. Under a 5-year rule, workers would establish rights to Tier II independently from meeting eligibility rules for Tier I/Social Security benefits.

What Would Be the Effect of 5-year Vesting on the Tier II Fund? Liberalized vesting would add to costs. Currently, Tier II is projected to be able to pay benefits for the next 25 years without increasing the current payroll tax rate. If additional costs of vesting changes could not be successfully absorbed within existing Tier II funding, then either the tax rate would need to be increased, or other benefits cut. Both of these alternatives could entail difficult negotiations, because they could adversely effect investment returns or current employee compensation.

However, there are ways to limit the cost of vesting changes. In addition to restrictions on retroactive application, all payments could be deferred until retirement age, thereby diminishing the effect on short-term payment demands and long-term fund investment interest. At the age of deferred benefits, an employee not meeting the vesting requirements could have contributions returned, without interest. This approach would be consistent with the view that deferred compensation is for the purpose of providing retirement income, and that restricting plan distributions until former workers reach retirement age is appropriate.

For illustrative purposes, the Bureau of the Actuary of the RRB prepared projections[4] for this report, of the effect on the Tier II trust fund of one 5-year vesting scenario. For these projections, the following assumptions were used:

- The effective date was assumed to be January 1, 1995. This date was chosen so that previously developed data could be used in the projections.

- All benefits and contributions are assumed to be retained until retirement age, at which time participants would be given benefits based on salary and service at the point of their separation.

- Retroactive payments would be limited to employees with 5 years service after December 31, 1989. For these projections, contributions are forfeited for employees who do not vest.

- Certain benefits would be payable only if the worker would also be eligible for Social Security. Under these projections, no Tier I benefits would be paid to workers who did not have sufficient service to qualify for benefits from Social Security.

- Survivors of workers who die before retirement with more than 5, but less than 10 years service after 1989 would receive Tier II benefits. (Under current law, these participants must have 10 years service for survivors to be eligible for payments.)

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[4] These projections are based on data from the 19th Valuation, updated to include projections for the 1996 *Section 502 Report*, a report to Congress on the health of the Railroad Retirement system.

Results of the Projections. With the above assumptions, this 5-year vesting scenario is projected over the next 25 years to make very little difference in the Tier II trust fund balance, payouts, or income. At present, the fund is considered in sound financial health for the next 25 years. At the end of FY1996, the Tier II trust fund had a balance of $12.1 billion. Under both current law and this scenario, the fund balance would grow to a high of $14.9 billion in 2008, and then decline. Under the 5-year vesting scenario, the fund balance would be about $146 million less in 2020, or about 2-3% lower than under current law. Annual outlays would be about 12 million higher (about 1/4 of 1% by 2020). The scenario would have almost no effect on Tier II tax revenue;[5] annual income from interest would be about $8 million less.

As a percentage of benefits, tax revenue to the Tier II fund is projected to decline from 85% to 65% between 1996 and 2020 under both projections. A declining ratio of benefits financed from concurrent revenues with the difference paid from fund assets does not indicate a probable funding crisis at some future point. On the contrary, a declining fund balance would be expected as the total number of participants in the fund (workers and retirees) nears stability. In the long-term, a declining number of railroad workers means a fewer number of workers earning credits toward future benefits, and smaller demands on the Tier II fund. crsphpgw

[5] Tier II benefits are subject to income taxes, and proceeds from that tax are transferred to the Tier II fund; the effect on those proceeds would be insignificant.