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SOCIAL SECURITY AND EQUITIES: LESSONS FROM RAILROAD RETIREMENT

BY STEVEN A. SASS*

Introduction

Investing Social Security Trust Fund assets in equities has long been a controversial proposal. Equities have higher expected returns than government bonds, which are the only asset the Trust Fund currently holds. So investing a portion of these assets in stocks could reduce the program's long-term financing shortfall. But critics see this step as crossing a red line in the government's involvement in the private economy. They also see the greater risk inherent in equity investments as offsetting the higher expected returns.

The experience of the government's Railroad Retirement program, which now invests in equities, provides lessons that address these concerns. Railroad Retirement and Social Security have long been closely connected. Congress created the Railroad Retirement program in 1934, one year before the enactment of Social Security, when it took over the rail industry's tottering pension plans in the midst of the Great Depression. The two programs have the same pay-as-you-go social insurance structure, funded by a payroll tax on workers and employers. Both had relatively

modest Trust Funds, with the assets invested solely in government bonds. In the 1990s, however, the use of equities became central to proposals to reform each program. Nothing was done in Social Security. But in 2001, Congress enacted legislation that introduced equities into the Railroad Retirement program. This *brief*, based on a recent study, reviews the experience of Railroad Retirement for lessons it might provide on the use of equities in Social Security.¹

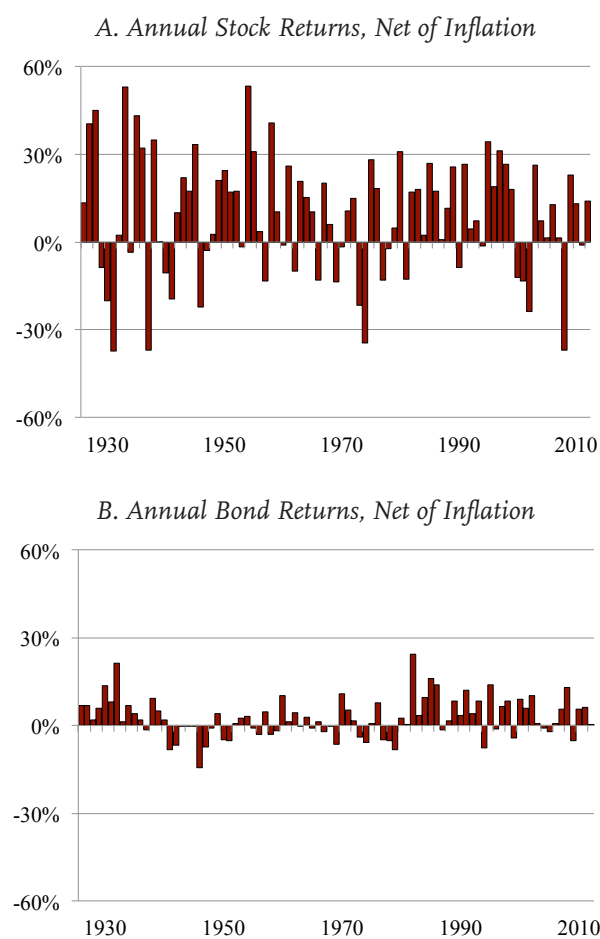
The discussion proceeds as follows. The first section describes the development of the proposal to invest Railroad Retirement assets in equities. The second section discusses how the 2001 reform addressed the risk of political influence on investment decisions. The third section discusses how the reform addressed the financial risk in equity investment. The final section concludes that investing Social Security assets in equities would require managing the risk of political influence, by limiting investment discretion, and managing financial risk, by creating an automatic way to respond to major financial shocks.

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The Investment of Railroad Retirement Assets in Equities

Equities have higher expected returns than government bonds, but also greater risk (see Figure 1). The long bull market in equities running from the early 1980s through the end of the 1990s provided a powerful lesson on the higher returns, and barely any lesson at all on the greater risk. Thus, the allure of higher returns then became a powerful force for introducing equities into the Social Security and Railroad Retirement programs.²

FIGURE 1. STOCK AND BOND RETURNS, 1926-2012



Source: Morningstar, Inc. (2013).

When the 1994-96 Social Security Advisory Council addressed the program's long-term financing shortfall, all three proposals its members advanced included the use of equities.³ One proposal would invest Social Security Trust Fund assets in stocks. The other two would create individual accounts that would invest in stocks. Despite the common embrace of equities, a fierce debate erupted over the best way forward. President Clinton backed the investment of Trust Fund assets in equities. President Bush backed individual accounts. In the end, nothing was done.⁴

As the debate over Social Security proceeded, negotiations between rail management and labor developed a proposal for investing Railroad Retirement assets in equities, much like the assets in private defined benefit pension plans. Assets in the program's Trust Fund had grown to four times annual outlays, a historically high level, and could grow even more should the use of equities increase investment returns. The railroad carriers saw the higher returns allowing a cut in the Railroad Retirement payroll tax, then 21 percent of earnings, with the carriers paying 16.1 percent and workers 4.9 percent. The unions saw the promise of more generous benefits. By the end of 1999, the two parties had developed a plan that split the gain 50-50. It cut the payroll tax 3 percentage points, to 18 percent – reducing the carriers' tax to 13.1 percent and leaving the workers' tax unchanged – allowed workers with 30 years of service to retire on full benefits at age 60, instead of 62, and increased survivor benefits.

Railroad Retirement is a government program. So rail management and labor had to convince Congress to enact their plan. They had no desire to influence the debate over Social Security. But as the debate had risen to the top of the nation's political agenda, investing Railroad Retirement assets in equities was seen as creating a precedent for doing the same in Social Security. To win enactment, they thus had to address two key challenges to the investment of assets in equities that were relevant to the Social Security debate: the risk of political influence on investment decisions and the financial risk inherent in equity investment.

Addressing the Risk of Political Influence

Congress's primary concern was the risk of political influence on investment decisions. As one pundit observed, "Giving bureaucrats the power to invest huge amounts of [Railroad Retirement] money in the stock market would create a fundamental conflict of interest between the long-term needs of future retirees and short-term political goals. If this model were extended to Social Security's trust funds, the door would open for government ownership of a significant portion of the economy."⁵

Unlike Social Security, Railroad Retirement is the "employer pension" program for the largely private sector rail industry. So to limit political influence on the investment of Railroad Retirement assets, Congress created an entity to manage these assets in the image of a private sector pension trust. It made this entity, the National Railroad Retirement Investment Trust (NRRIT) a non-governmental organization; it excluded government employees and agencies from participating in its operations, and required just periodic reports to government oversight agencies.

Emulating the governance structure of private multi-employer pension plans, Congress had industry-wide labor and management organizations each select three Trustees,⁶ who would then select a seventh independent Trustee. Congress also imposed "private sector" fiduciary mandates on these Trustees, requiring them to invest Railroad Retirement's government assets solely in the interest of plan participants using industry "best practice."⁷ By all accounts, the NRRIT has managed the government's Railroad Retirement assets like a well-run private pension trust, free of political influence.⁸

Proponents of investing Social Security Trust Fund assets in equities took a different tack. Their approach to the problem of political influence was not to reduce the risk of such influence, but to reduce investment discretion. They would specify the share of Social Security assets to be invested in equities, say 40 percent, and then direct those assets to be invested in a broad market index, such as the Russell 3000 or the Wilshire 5000.⁹ Given America's congenital suspicion of government and the size of the Social Security Trust Fund – currently \$2.7 trillion, with Social Security potentially owning 5 to 10 percent of the U.S. equity market – this approach to the risk of political influence seems best.

Addressing the Financial Risk

The 2001 reform of the Railroad Retirement program highlights the risk in equity investments as a second issue that must be addressed. As stocks are far riskier than bonds, investing Social Security assets in equities raises the prospect of large unexpected changes in the program's finances. The proposal that rail management and labor brought to Congress included an automatic adjustment mechanism that raised and lowered payroll taxes in response to such changes. The inclusion of this tax adjustment "ratchet" was critical in easing concerns and winning Congressional approval for investing Railroad Retirement assets in equities.¹⁰

An automatic adjustment mechanism must specify a financial indicator to trigger program changes and how large and how quickly those changes would be made. The Railroad Retirement ratchet adjusts tax rates based on the ratio of Trust Fund assets to annual benefit outlays, averaged over the previous 10 years. The adjustments are designed to keep that ratio

within a target band of four to six times outlays. The ratchet raises taxes should the ratio fall below four, and cuts taxes should

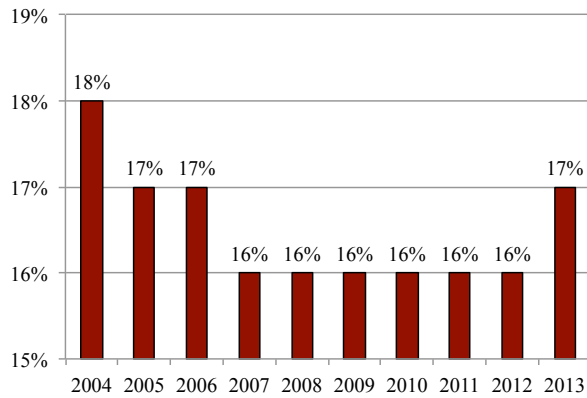
it rise above six. These adjustments are based on the slow-moving 10-year average of the ratio of assets to outlays because both management and labor sought to avoid sharp year-to-year changes in tax rates.

The turbulent financial markets in recent years offer a valuable test of the ratchet's design. Railroad Retirement assets were largely transferred to NRRIT in 2002-2003, after the financial downturn at the turn of the century had reduced both interest rates and stock prices. The interest rate decline had increased the value of the bonds in the Railroad Retirement Trust Fund, and thus the value of assets transferred to NRRIT. The Trustees then allocated 65 percent of NRRIT assets to stocks, and the value of these assets quickly shot up. As this increase pushed the 10-year average ratio of assets to outlays above the target band of 4 to 6 times annual outlays, the ratchet cut the payroll tax from 18 to 16 percent of earnings.

Then, in 2008, the market crashed. The value of Railroad Retirement assets fell sharply. But the 10-year average ratio of assets to outlays fell slowly and still remains above the target band. The ratchet only this year raised the payroll tax to 17 percent of earn-

Reform involves addressing the political and financial risks of equity investing.

FIGURE 2. RAILROAD RETIREMENT PAYROLL TAX RATE, 2004-2013



Source: National Railroad Retirement Investment Trust Annual Reports (various years); and U.S. Railroad Retirement Board (2012).

ings (see Figure 2). Only in 2015, seven years after the crash, is it expected to return to its benchmark 18-percent rate.

The ratchet's slow response to the 2008 crash is worrisome. Should the program experience another financial shock, it might not be able to raise taxes fast enough to prevent the depletion of the Railroad Trust Fund. The ratchet, however, was not designed to provide a complete solution to the problem of risk. It was designed to provide Congress sufficient time to respond should a shock exceed its ability to get the program back on track. And in that regard, the design seems reasonably successful.

If the Social Security program were to invest in equities, it should experience financial shocks nowhere near as large. Social Security's tax revenues and outlays are far more stable and predictable. Nor would Social Security invest nearly as large a share of its assets in equities, nor be nearly as dependent on Trust Fund transfers for benefit payments. Adjustments could thus be smaller and slower than those in the Railroad Retirement ratchet. Congress, however, has convincingly demonstrated its failure to respond to Social Security shortfalls. The automatic adjustments thus should be large enough to get the program back on track in the great majority of cases.¹¹

Conclusion

The Railroad Retirement experience illustrates two key issues that must be addressed for Congress to allow the investment of Social Security assets in equities, and how these issues might be handled.

The first is the risk of political influence on investment decisions. The Railroad Retirement reform created the NRRIT, modeled on a private pension trust, and it has successfully invested the program's assets free of political influence. But NRRIT Trustees are named by industry-wide organizations representing employers and workers, an option not available for Social Security. Given the size of the Social Security Trust Fund and the nation's suspicion of government, a highly circumscribed investment program using index funds seems the best way to address the risk of political influence.

The second issue is financial risk in equity investment. The 2001 reform indicates that Congress would require an automatic adjustment mechanism, similar to the Railroad Retirement ratchet, to deal with financial risk. But such a mechanism presupposes a program in balance or moving toward balance. Thus, the investment of Trust Fund assets in equities would need to be part of a larger reform that produced a sustainable Social Security program.

Endnotes

- 1 Sass (2013a, 2013b, and 2013c).
- 2 Canada, Ireland, Japan, New Zealand, and Sweden all decided to invest their Social Security Trust Fund assets in equities in the years between 1995 and 2001. See Palacios (2002).
- 3 1994-1996 Social Security Advisory Council (1997).
- 4 Clinton (1999); President's Commission to Strengthen Social Security (2001).
- 5 John (2000); also see Novak (2001a, 2001b).
- 6 The National Railway Labor Conference represents management and the Cooperating Railway Labor Organizations represent labor.
- 7 Congress authorized the government Railroad Retirement Board to take legal action to assure compliance with the mandates defined in the 2001 legislation.
- 8 See Whitman (2011).
- 9 The most prominent proposals would create a Social Security investment board that would choose the broad market index, and then bid out and monitor the investment managers selected to follow that index. To further limit potential political influence on the U.S. economy, this board would not be allowed take an active role in corporate governance: Social Security shares either would not be voted (a practice which tends to favor incumbent management); would be voted similarly to the other shareholders; or the investment managers would vote the shares "in the best interest of program participants." For a discussion of these and other issues, see Munnell, Balduzzi, and Gist (1998) and White (1996).
- 10 Salmon (2013).
- 11 The Canadian system, which also has an automatic adjustment mechanism, offers a different response to the problem of political inaction in the face of shortfalls: it concentrates the pain on current retirees – not to bring the program back into balance but to generate pressure for a political solution. For further discussion, see Munnell and Sass (2006).

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