Chapter 6
Lessons for Social Security

The histories of the federal Railroad Retirement program and Social Security have long been closely connected. Railroad Retirement was created one year before Social Security, when the government took over the tottering pension plans of the nation’s railroad industry. The new federal program had the same pay-as-you-go social insurance structure that Congress would use for Social Security. Both programs would add ancillary social welfare benefits, for spouses and other dependents. The finances of both were significantly shored up in 1983, by the same Congressional committees, responding to similar financial issues. And the use of equities became central to proposals to reform each program in the 1990s.

From the creation of the Railroad Retirement and Social Security programs in the 1930s through the end of the 1990s, the trust funds of each program held only U.S. Treasury bonds. A well-established principle of finance nevertheless held that equities offered higher expected returns than Treasuries, at the price of higher expected risk. The long bull market in stocks, running from the early 1980s through the end of the 1990s, provided a powerful object lesson on higher returns on equities, and barely any lesson at all on higher risk. As described above, the appeal of higher returns on Railroad Retirement assets, if those assets were invested in equities, was the driving force behind the 2001 reform. When the 1994–1996 Social Security Advisory Council (1997) addressed in earnest Social Security’s long-term financing shortfall, all three proposals the Council members presented included the use of equities. While none of these Social Security proposals has been enacted in the United States, other nations, such as Canada, Ireland, Japan, New Zealand, and Sweden, adopted a policy of investing Social Security Trust Fund assets in equities in the years between 1995 and 2001 (Palacios 2002).
The 2001 Railroad Retirement reform introduced equities, and the higher expected returns they offered, to cut taxes and raise benefits. The Advisory Council proposals embraced equities as an alternative to closing Social Security’s financing shortfall the “old-fashioned” way—by raising taxes or cutting benefits. There was real resistance to raising Social Security payroll taxes. The payroll tax had become by far the largest tax most workers paid, at 15.3 percent of covered earnings (10.2 percent for Old Age and Survivors’ Insurance, 1.8 percent for Disability Insurance, and 2.9 percent for Medicare. While the payroll tax is formally “split evenly” between employers and workers, the employer portion is part of labor compensation and generally viewed by economists as reducing employee earnings nearly dollar for dollar, and thus largely borne by workers.)

There was also real resistance to cutting benefits. Social Security was already scheduled to replace a significantly smaller share of household preretirement earnings for retirement at any given age, owing to the increase in the Full Retirement Age from 65 to 67 between 2000 and 2017. Combined with projected increases in the taxation of benefits and in Medicare Part B premiums, which are deducted from Social Security checks, benefits are expected to replace less than 30 percent of the “average worker’s” preretirement earnings by 2030, significantly less than the 40 percent of the mid-1990s (Munnell and Sass 2006, p. 12).

The three Advisory Council proposals, which remain the primary options for introducing equities into the Social Security program, were to

1) invest a portion of the Social Security Trust Fund assets in equities;

2) continue to invest Social Security Trust Fund assets in Treasuries and reduce benefits to what the program could finance, but add mandatory contributions to an individual retirement savings account that could be invested in equities; and
3) allow workers to divert a portion of their Social Security payroll tax to an individual account, which could be invested in equities, in exchange for a reduction in future Social Security benefits.

The Democrats under President Clinton had proposed adopting the first option—to invest a portion of the Social Security Trust Fund assets in stocks (Clinton 1999). The Republicans under President Bush had proposed the third option: allowing workers to carve out a portion of their Social Security payroll tax to fund individual accounts in which the funds could be invested in stocks. (See, for example, Greenspan [2001].) And each side vehemently opposed the other’s proposal. The Democrats viewed carve-out accounts as gutting, and potentially killing, the social insurance safety net created by Franklin Roosevelt. The Republicans generally viewed the government investing the Social Security Trust Fund in equities as crossing a critical line in its involvement in the private economy. President Bush, in particular, made Social Security reform a major policy initiative, and he did so just as the railroad industry brought its proposal to Congress (Bush 2001).

The industry proposed that the Railroad Retirement program invest in equities and other private securities—like a private employer defined benefit plan. The rub, however, was that Railroad Retirement was a government program and its assets are government assets. Investing the program’s assets in equities was widely seen as creating a precedent for doing the same with Social Security. This was an unwanted complication for the industry, as it generated stiff opposition that nearly scuttled the proposed reform—especially from proponents of President Bush’s individual account alternative.

Some lawmakers suggested that the industry consider converting Railroad Retirement into a 401(k)-type individual account program, but that was a total nonstarter—the unions would never accept the transition, nor was management interested. If equities were to be introduced into the Railroad Retirement program, it would have to be done using the assets in the Railroad Retirement Account.
Congress in the end enacted a reform of the Railroad Retirement program that included investment in equities. As discussed above, Congress did what it could to distance the investment process as much as possible from government. The experience of the reformed Railroad Retirement program nevertheless has implications for the investment of Social Security Trust Fund assets in equities. The most important implications, in increasing order of importance, are in budgetary accounting, the governance of trust fund investment, and dealing with risk.

GOVERNMENT ACCOUNTING

Railroad Retirement assets are government assets, but the accounting treatment of the investment of Railroad Retirement assets in equities, in the words of the CBO, was “a significant departure from traditional federal transactions” (CBO 2003, p. 12.) This treatment, and its influence on policy decisions, would likely be extended to the investment of the Social Security Trust Fund assets in private securities.

Normal government accounting would book the trust fund’s purchase of private securities as a current government expenditure. It would also treat its sale of Treasuries to finance the purchase as a nonevent, which could increase in the government’s reported current deficit and long-term debt by well over $1 trillion.

Normal pension accounting, however, would book the trust fund’s purchase of private securities as an investment, not a current expenditure, with the cost of that investment offset by the sale of the trust fund’s investment in Treasuries. The transaction would change the composition of government assets, but it would not affect the income statement (i.e., the federal deficit) or the size of the government’s liabilities (i.e., the federal debt).

The railroad team succeeded in winning similar treatment for NRRIT transactions; it did so by having Congress apply a new accounting treatment it had developed a decade earlier. In 1990, Con-
gress had specified that government student and home loans, financed by the sale of Treasuries, be booked as “a means of financing—a budgetary nonevent—rather than a current government outlay. In 2001, it specified that NRRIT transactions likewise be treated as “means of financing” budgetary nonevents.

Should Congress choose to invest Social Security assets in equities, the means of financing precedent established for NRRIT could be used to avoid recording an enormous—an illusory—expenditure and deficit when exchanging Treasuries for private sector securities. A conservative critic of the 2001 reform noted that this budgetary treatment created a bias in favor of using the Trust Fund, not carve-out individual accounts, for introducing equities into the Social Security program. Payroll taxes diverted to carve-out individual accounts would clearly reduce government revenues, with the reduction duly recorded on the government’s books. As government accounting is cash accounting, the reduction in future Social Security benefit obligations, resulting from the diversion of payroll taxes, would not be recorded.

While the means of financing treatment would avoid a major political impediment to investing the Social Security Trust Fund in equities, the treatment of the NRRIT’s annual income and loss does not. The interest, dividends, rents, and realized and unrealized capital gains on NRRIT assets are booked as government revenue—or as government outlays should NRRIT’s capital losses exceed the interest, dividend, and rental income it collects. With a Social Security Trust Fund now holding over $2 trillion, the volatility of equity prices can be expected to regularly generate capital gains and losses of $100 billion or more. In a unified budget context, these gains and losses flow directly to the budgetary bottom line. They would also tend to be strongly procyclical: large capital losses in downturns, reported as outlays, would widen budget deficits; large capital gains in upturns, reported as revenues, would shrink or eliminate budgetary deficits. Swings in the value of equities held in individual accounts—whether carve-out or add-on accounts—would sometimes trouble and some-
times please the account holder. But they would have no direct effect on the federal budget. If government accounting continues to report the operations of Social Security within the unified budget context, this treatment of annual income and loss would clearly create a bias against investing the Social Security Trust Fund in equities.²

GOVERNING THE INVESTMENT PROCESS

The primary concern of Congress when it enacted the 2001 reform was the NRRIT’s ability to manage the investment of government assets efficiently and without political influence. This, not accounting, was the primary substantive issue motivating resistance to the industry initiative. The Republican leadership was convinced that political pressures would inevitably affect how government assets were invested, which would undermine financial efficiency and—far more serious—the American democratic political system.

So Congress did what it could to make the investment of Railroad Retirement assets as much as possible a nongovernmental activity. It explicitly made the NRRIT a nongovernmental entity, with no government employees or agencies involved in its operations. It created the Trust by statute in the image of a private multiemployer pension trust—with the Trustees primarily selected by management and labor and the one “independent” (not “public”) trustee selected by these industry representatives. The statute also charged these Trustees, like trustees in a private pension trust, to make investment decisions solely in the interest of the plan participants. They were also charged to use industry “best practice” to develop and execute a formal investment plan.

Consistent with the intent of Congress, the NRRIT has managed the assets of the Railroad Retirement program like a private pension trust, free of political influence. But despite the fears of the Republicans, and hopes of the Democrats, the NRRIT experience does not provide much of a precedent for Social Security and the investment of Social Security Trust Fund assets.
The primary impediment in using the NRRIT as a model for Social Security is the lack of national private organizations that could legitimately select trustees of a nongovernment entity that could oversee the investment of Social Security assets. The railroad industry is highly organized, with the Association of American Railroads and the National Railway Labor Conference representing the carriers and the Cooperating Railway Labor Organizations representing labor. These organizations have an extensive history negotiating the terms and conditions of railroad employment and managing joint labor-management health and welfare plans. These organizations, implicitly recognized as representing rail management and labor by Section 2 of the Railway Labor Act and Section 105(3)(A)(ii) of the 2001 reform, selected the six management and labor NRRIT Trustees. If Railroad Retirement were a private multiemployer pension plan, these would be the organizations that would name the trustees of the plan’s pension trust.

Many nations in continental Europe have national management and labor organizations that function as “social partners” and negotiate and oversee national social security programs and other employment institutions. The status of these organizations is often defined in law and their negotiated decisions enforced by law. But there are no such organizations in the United States that could legitimately claim to represent all employers or employees and thus be in a position to oversee the investment of employer and employee contributions to the Social Security program. The U.S. Social Security system is purely a creation of the national government, with no formal “employer” or “employee” involvement. Unlike Railroad Retirement, there are no national organizations that could legitimately assume responsibility for managing the Social Security Trust Fund.

Canada provides an example of a nation without social partners that succeeded in developing a governance structure for investing social security trust fund assets in equities. Its Canada Pension Plan Investment Board (CPPIB), which manages the assets of the government’s Canada Pension Plan, is a quasi-independent entity. Like
NRRIT, the CPPIB is subject to private-sector fiduciary mandates and periodic reporting requirements. To select the CPPIB directors, who oversee the investment process, Canada uses an elaborate decentralized process involving both provincial and federal governments. The process, which could be a model for the United States, is generally seen as successful: like the NRRIT, the CPPIB is seen as operating like a well-run private pension trust, free of political influence (Munnell and Sass 2006).

The most prominent proposals for investing Social Security assets in equities, however, take a different tack. They would have the assets managed by an entity modeled on the Thrift Savings Plan for federal employees, and they would have its investment board nominated by the president and confirmed by the Senate—the process used for selecting political appointees to government positions. Thus, the proposed Social Security investment board would not be well insulated from political influence. But its investment discretion would be sharply constrained: it would simply select a broad market index, such as the Russell 3000 or the Wilshire 5000, then competitively bid out and monitor the investment managers selected to follow that index. This approach to the problem of political influence on investment decisions is not to exclude political influence but to radically reduce investment discretion. Given America’s congenital suspicion of government and the enormous size of Social Security’s potential investment in equities—estimated at 5–10 percent of the U.S. market with 40 percent of trust fund assets invested in stocks—this approach seems best.

DEALING WITH RISK

The most important lessons for Social Security provided by the reformed Railroad Retirement program deal with the management of risk. Pension programs are extremely long-lived institutions, and their finances will always move in unexpected ways. The 2001 Railroad Retirement reform introduced a mechanism—the tax adjustment
ratchet—that automatically raised and lowered the payroll tax to offset changes in the program’s finances. Such automatic stabilizers strengthen the financial viability of long-term pension programs. The inclusion of the ratchet was also important in easing congressional concerns about the investment of Railroad Retirement assets in equities and other risky securities. Some type of automatic adjustment mechanism, similar to the Railroad Retirement ratchet, thus seems critically important, financially and politically, to any viable program of investing the Social Security Trust Fund in equities.

The tax adjustment mechanism was a key element in the initial designs for reforming Railroad Retirement developed by the carriers in the 1980s and early 1990s. The carriers had developed proposals for privatizing Railroad Retirement, and the ratchet was the device for reducing the payroll tax—then 21 percent of covered earnings—in the program’s transition to a normal private employer plan. When the carriers presented their proposal to labor, the unions saw the benefit of investing Railroad Retirement assets in equities. But they saw no gain in giving up their statutory benefits, granted by an act of Congress, and flatly rejected privatization. So the parties settled on a pay-as-you-go program, with Railroad Retirement assets invested as the assets in a private pension trust. In this new design, the tax adjustment ratchet became a device for keeping the program financially stable.

The ratchet enacted in the 2001 reform adjusted the Railroad Retirement payroll tax up or down, based on the trailing 10-year average of the ratio of trust fund assets to annual benefit outlays, and was designed to keep trust fund assets within a target band of 4–6 times annual outlays. As shown in Figure 2.4, the ratchet would automatically increase the payroll tax should that trailing 10-year average ratio fall below 4; and it would cut taxes should it rise above 6 (RRSIA 2001, Section 204, 26 USC Section 3241). In both cases, tax rates would rise or fall by increasing amounts as the trailing 10-year average ratio strayed beyond the target band of 4–6 times annual outlays.

The ratchet can thus make very large adjustments to payroll tax rates, pushing the rate up to 27 percent or pulling it down to 8.2
percent of covered payroll. This extremely broad range was due to the expectation that the tax needed to keep the program on track 1) could rise and fall quite dramatically over the course of the program’s 75-year planning horizon, but 2) would likely fall significantly by the end of those 75 years.

The ratchet was not designed to provide a complete solution to the problem of risk. It could not push the payroll tax above 27 percent nor below 8.2 percent of covered payroll. By basing the tax on the average ratio of trust fund assets to annual benefit outlays over the previous 10 years, by design it responded quite slowly to changes in the program’s finances.

Changes in Railroad Retirement finances that exceed the limits of the ratchet’s automatic responses would require a political response. Should an 8.2 percent payroll tax produce an ever-rising ratio of assets to outlays, Congress (and the industry) would need to decide how to cut taxes or increase benefits. Congress (and the industry) would likewise need to decide what to do should a 27 percent payroll tax prove insufficient or should the ratchet respond too slowly to a sudden downturn in the program’s finances. The critical measure of the ratchet’s effectiveness in such cases is whether it gives Congress (and the industry) enough time to fashion an adequate response.

The enactment of the 2001 Railroad Retirement reform suggests that Congress would require some type of automatic adjustment mechanism should it allow the Social Security Trust Fund to invest in equities. It also suggests that any such mechanism cannot be expected to provide a complete solution to the problem of risk. The design of the mechanism would specify the size and speed of the automatic adjustments, setting limits on its ability to stabilize Social Security’s finances. A sufficiently large or long-lasting shock, which exceeds the mechanism’s ability to respond, would require Congress to act. On the other hand, automatic adjustments large enough and fast enough to respond to such shocks could generate reactions so strong that Congress would also be required to act. The mechanism’s design could
only influence how and when Congress might intervene, not completely eliminate the need to intervene.

A Social Security program with a trust fund invested in equities should be far more stable and predictable than the current Railroad Retirement program. This is especially true for a program’s employment base, payroll tax revenues, number of beneficiaries, and annual benefit outlays. The ratio of Social Security beneficiaries to workers will rapidly rise as the baby boom generation ages but then remain relatively stable. Nor will the Social Security Trust Fund likely be invested nearly as extensively in equities as the NRRIT. A Social Security program that invests in equities thus should not experience short-term shocks anywhere near as large, relative to the size of the program, as those seen in Railroad Retirement. The adjustment mechanism could thus be designed to respond rather slowly. The American political process, on the other hand, has convincingly demonstrated its inability to manage Social Security’s finances. Despite knowing for decades that Social Security had a serious long-term financing shortfall, the nation for decades has failed to act. This argues for allowing the automatic mechanism to make adjustments large enough to adequately address as many anticipated risks as possible, so Congress would only need to act should those adjustments generated substantial political resistance.

Several nations in recent years have introduced automatic adjustment mechanisms to make their social security programs more sustainable. The great majority, however, operate traditional pay-as-you-go programs with small trust funds designed to buffer short-term cash-flow shortfalls and hold only government bonds. They generally pay relatively high benefits, have relatively high tax rates, and anticipate revenue shortfalls in response to upcoming demographic shifts. Unlike the Railroad Retirement ratchet, nearly all of these automatic mechanisms only adjust benefits, not taxes—and are expected to adjust benefits downward.

Canada is an exception. It has a social security program with a large trust fund that is invested much like the NRRIT, and an auto-
matic adjustment mechanism to keep the program’s finances on track. The Canada Pension Plan (CPP)—the earnings-related component of the nation’s social security program—is funded by a 9.9 percent tax on covered earnings, pays a benefit of 25 percent of average indexed earnings, and is projected to have a trust fund equal to 6.5 times annual outlays, responsible for providing 15 percent of annual benefit payments, by 2080. The CPP also has an automatic adjustment mechanism. The mechanism is not based on the ratio of assets to outlays, as in Railroad Retirement, but on projections by the Chief Actuary of Canada, conducted every three years, on the tax needed to sustain the program. If the projection indicates the 9.9 percent tax is too low, the politicians are given the opportunity to bring the program back into balance. If they don’t, two things happen automatically: 1) retiree cost-of-living adjustments are eliminated until the next triennial review; and 2) taxes are raised, up to 0.2 percent of covered earnings per year, up to half the difference between the current tax and the minimum tax needed to restore sustainability in 75 years. Should the next triennial review again report a shortfall, the process is repeated.

In one key respect, the CPP mechanism is more suited to Social Security’s needs than the Railroad Retirement ratchet. The CPP makes adjustments based on a long-term, forward-looking assessment of the program’s finances; Railroad Retirement makes adjustments based on much shorter-term retrospective performance. As the finances of Social Security and the CPP are far more stable and predictable than those of the Railroad Retirement program, it is both feasible and preferable to adjust Social Security taxes and benefits based on long-term projections. It might also be advisable to include a trigger based on a shorter-term assessment; given the experience of the sharp financial shocks since 2008, it might be advisable to include a secondary adjustment mechanism that responds to risks of near-term cash-flow shortfalls that the 75-year projection might not flag. But adjustments based on long-term projections would seem to be the norm, with any based on shorter-term assessments as a safety measure.
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The adjustments automatically made by the CPP, on the other hand, are decidedly not appropriate for Social Security. The burden of the CPP’s tax and benefit adjustments by design falls most heavily on retirees. The three-year suspension of cost-of-living adjustments cuts the purchasing power of benefits 6 percent if inflation is running 2 percent a year, and 9 percent if inflation is running 3 percent a year. And these cuts are permanent—should cost-of-living adjustments resume, they resume from these post-freeze levels. The tax increases, by contrast, are unlikely to be anywhere near as large. And they could be reversed should conditions improve. Canada adopted these adjustments not because it viewed them as equitable, but as a political instrument: the threat of a benefit freeze is expected to mobilize retirees to “put a cannon” at the head of the politicians to get them to restore sustainability some other way. Given the U.S. track record in managing Social Security’s finances, it seems advisable to adopt adjustments expected to be put in place, not to pressure politicians to act.9

That the Railroad Retirement ratchet automatically adjusts only taxes, that nearly all social security programs with automatic mechanisms adjust only benefits, and that the CPP adjusts both, is not especially significant for Social Security. The nations that introduced automatic adjustments to lower benefits generally had programs paying benefits that replaced a much higher share of preretirement earnings than the U.S. Social Security program. The Railroad Retirement program is modeled on standard employer-defined benefit pension plans, in which benefits are defined and the employer, typically, is responsible to pay what’s needed. The CPP adjusts both taxes and benefits, but it placed the primary burden on benefits as a political device. So what to adjust, and how much to adjust, remain open questions. Social Security could adjust taxes and benefits; the adjustments could target those better equipped to bear risk, such as higher-income workers and beneficiaries or employers as opposed to workers; those who bear risk could also be compensated by lower expected tax rates.
and higher expected benefits—from where their taxes and benefits would be should the program not invest in equities.  

One lesson Railroad Retirement offers, however, is how to respond to surpluses. The primary concern when reviewing automatic adjustment mechanisms is how they handle shortfalls—whether they raise taxes, cut benefits, delay eligibility, or make some other adjustment. But how do they handle surpluses? The Railroad Retirement ratchet lowers taxes. One could assume that rail workers would spend that tax reduction on current consumption. For the carriers, the reduction would increase earnings, which would be used either to increase dividends or be retained and invested. To the extent that tax reductions on the carriers are retained and invested, the tax reduction increased the carriers’ financial strength. Should the Railroad Retirement program subsequently face a financial shortfall, the carriers would be in a better position to pay the higher taxes the ratchet would introduce. Something similar could be done in Social Security—say by directing tax reductions on workers into individual accounts, which could be accessed only 1) to pay future payroll taxes, should taxes subsequently need to rise above the statutory rate; or 2) should the worker retire, become disabled, or die, or the value of the account exceed some specified amount.  

Finally, it is important to note that an automatic adjustment mechanism presupposes a program in balance, or moving toward balance. If Congress would require an automatic adjustment mechanism for the Social Security Trust Fund to invest in equities, the investment in equities would need to be part of a package that produced a sustainable Social Security program. This would necessarily mean some combination of higher taxes or lower benefits. This would reduce the gap between tax revenues and benefit outlays, which income from the trust fund would need to fill, well below the currently projected shortfall of 25 to 30 percent scheduled benefits.  

A critical benefit of any reform package that included the investment of trust fund assets in equities would thus be the automatic adjustment mechanism. Though included in response to political
demands for a mechanism to deal with risky equities, it would adjust the Social Security program in response to any shock, not just financial shocks. Had such a mechanism been in place, it would have introduced adjustments to Social Security, without the need for Congress to act, in response to the demographic shocks that have made the current program unsustainable, and it would keep the program sustainable for generations to come.

Notes

1. The increased employment of married women, which raised a household’s preretirement earnings far more than postretirement benefits, further diminished Social Security’s role in providing an income to the nation’s elderly (Munnell, Sanzenbacher, and Soto 2007).

2. One Social Security accounting issue that the Railroad Retirement experience did not address is how to treat the return on equities in financial projections. Both the Social Security and Railroad Retirement actuaries, like other actuaries, use the expected return on equities in making such projections. Government budgetary officials, like many financial analysts, use the risk-adjusted return that “costs” the risk in equities as the difference between the expected return and the return on riskless government securities. After deducting this “cost,” they use the much lower return on government securities in their financial projections. This is a very thorny and contentious issue, which the Railroad Retirement experience did nothing to resolve or clarify.

3. For a discussion of the Dutch system, which does invest social security assets in equities, see Ponds and van Riel (2007).

4. The proposed board would need to choose the broad market index, which could include foreign securities. It would not be allowed take an active role in corporate governance: Social Security shares would not be voted (which tends to favor incumbent management), shares would be voted similarly to the other shareholders, or the investment managers would vote the shares “in the best interest of program participants,” as is done in the Thrift Savings Plan. For a discussion of these and other issues, see Munnell, Balduzzi, and Gist (1998) and White (1996).

5. For some reasons why, see Diamond (1994).

6. For a review see OECD (2012).

7. The discussion of the CPP follows Monk and Sass (2009). Sweden also invests social security trust fund assets in equities, and investment performance is incorporated in program’s automatic adjustment mechanism when setting benefits (Palacios 2002).
8. This assumes that there is no constitutional issue in changing tax rates based on actuarial projections provided by the executive branch of government, rather than an act of Congress.

9. As Monk and Sass (2009) write, “Concentrating the burden on current retirees is clearly at odds with general notions of social insurance objectives. The distribution of losses is also quite unfair: workers who will retire soon will pay the modestly higher contributions and then retire on unreduced benefits; workers just a few years older will have their CPP benefits substantially reduced. A small reduction in all benefits paid out over the next 76 years, a reduction akin to the increase in contributions, would be far more consistent with social insurance objectives” (p. 4).

10. For an innovative employer plan that shares risk, see Munnell and Sass (2013).

11. Congress might also allow workers to access this account should they have a hardship or need the funds for a “socially approved” use, such as paying for college or buying a house. A similar treatment could be used for employer contributions, though this could raise thorny legal issues, and passing the reduction to the employer is exactly analogous as the treatment used in Railroad Retirement.