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Instituting PLOP to Help Shore Up the RSA

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Public pension plans have existed since the dawn of the Roman Republic. In 13 BC, Augustus formalized a state-sponsored retirement plan for veterans who served in Roman military campaigns. In 1775, the United States of America began guaranteeing retirement income for its Army and Naval forces, and after the Civil War, Congress passed a series of laws organizing the modern pension program for veterans—a fixed percentage of base income after a set number of years.[1]

It was not until the Progressive movement at the turn of the twentieth century that states expanded access to public pensions from military to civilian employees. And by 1930, the federal government was providing pension plans to all federal employees, with many state and local municipalities following suit. Yet the popularity of defined-benefit pensions did not spread to the private market, where fewer than 15% of employees had guaranteed pensions.[2]

Today, over 80% of state and local full-time employees have a defined-benefit contribution plan, compared to less than one-third of private employees.[3] According to the Hoover Institution, the total unfunded public pension liability in the United States is $3.846 trillion, over $2 trillion more than governments recognize in actuarial reports.[4] In Alabama, the Retirement Systems of Alabama (RSA) held assets of $29.4 billion and liabilities of $44.6 billion as of 2013, equating to an unfunded liability of $15.2 billion and a funded ratio of 66 %[5]; yet, under a more accurate accounting of market value, the unfunded liabilities jumps to $46 billion and the funded ratio drops to 40%—the eleventh worst-funded ratio in the country. Moreover, Alabama's current unfunded liability is five times the value of its 2015 tax revenues. To simply prevent a rise in its unfunded liability, Alabama would have to more than double its yearly contribution from 4.1% of revenue to 9.5% of revenue.[6] Among Alabama's deeply conservative populace and legislature, the prospect of raising taxes to fund pension obligations is dead on arrival, while meeting those obligations through current revenues is unlikely as the state can barely fund basic services such as indigent defense, much less capital investments.

While there are no easy solutions or silver bullets to Alabama's pension problem, there are small steps legislators can take to ease the burden of state obligations. One of them is the institution of a Partial Lump-Sum Options Payment (PLOP) financed by a one-time bond issuance at historically low rates.

At the present, Alabama state employees and retirees may pick from a handful of retirement options: lifetime monthly pension, return of contributions plus interest, lifetime annuity, and lifetime annuity with survivor benefits. The PLOP would add another option to this bouquet: a one-time lump-sum payment equal to the total or partial actuarial value of a worker's lifetime annuity or some portion of that annuity. In simpler terms, employees would receive a single retirement check today instead of a stream of smaller checks later.

Per most the recent publicly-available financial statements, the RSA has 420,512 total members with 218,164 of those who are current employees.[7] To properly fund the pension obligations of its members, the RSA assumes an investment return of roughly 7.75%. When this goal is not met, the state is required to fund the shortfall out of state general revenues. With $29.4 billion in assets, even a 1% shortfall costs the state $300 million per year, and in 2016 Alabama altogether contributed over $900 million to the RSA. Considering the State General Fund (SGF), the discretionary budget controlled by the legislature, is less than $2 billion, the RSA's failure to meet its investment target represents a weighty albatross around the state's financial neck.

The financial value of the PLOP is that it would replace the state's pension obligations with long-term bond debt obligations. While pension obligations assume a yearly return of 7.75%, a thirty-year bond deal could be financed at ~4.5% per year. In essence, this creates a "reverse arbitrage" play in which 7.75% liability is replaced with 4.5% liability, saving 3.25% per year on every dollar withdrawn from the RSA and replaced with a bond. For example, if the total value of the PLOP were $100 million, the state would save 3.25% times $100 million, which equals $3.25 million per year.

To accomplish this, the state would issue a one-time bond payment to finance the PLOP. Immediately, the unfunded actuarially-accrued liability of the state lowers by the value of the bond issuance—lowering the state's annual required contribution to the RSA. The state then pays its debt service on its bond and can redirect savings to the SGF or back into the RSA.

The states net savings from the PLOP would be determined by the total size of the bond deal, which would be determined by the rate of participation among retirees and the present day value of their retirement plans. At present, there are an estimated 113,000 current retirees, 6,000 unretired former employees, and 23,000 retirement-age current employees eligible to receive PLOP; a total of 142,000.[8] The participation rate of individual retirees is hard to predict, but we can develop a theoretical framework for why a person might opt for PLOP. A retiree may have a present liquidity or debt crisis in their personal finances, such as high-interest credit card debt or an underwater mortgage. A retiree might have other streams of long-term, predictable retirement income and a desire to make a large, one-time purchase or investment (home, car, education for children, etc.). Or, a retiree may just enjoy the freedom of managing his or her own retirement portfolio.

Next, we need to determine the average pension values of potential PLOP participants. Unfortunately, the RSA's financial reporting makes that hard to do, as they do not report the average value of pensions as a function of years worked or benefits previously withdrawn. So, we must do our best to estimate these values using available information. As of September 30, 2014, the RSA has 420,512 total participants and $44.6 billion in liabilities. (For the sake of this analysis, we use the state actuarial numbers, not the amounts calculated by Rauh 2017.) That equates to an average liability of $106,061 per RSA member. While this number is a

rough estimate and does not adjust for the potential uniqueness of the PLOP-eligible population, it can be informative as a tool for estimating the potential value of PLOP. With 142,000 retirees eligible, that gives an estimated potential PLOP value of $15.1 billion. Table 1 calculates the value of the PLOP as a function of participation percentage. For every 1% increase in participation, the state saves $4.9 million per year. Meaning, even if only 5% of eligible retirement benefits are cashed out via PLOP, the state would save nearly $25 million per year—totaling almost $750 million over the course of the bond.

Since PLOP is a purely financial policy proposal, it's efficacy is a question of mathematics, not broader market forces and incentive structures. If properly implemented, it cannot fail to save the state money. At its root, PLOP is like refinancing a home mortgage—exchanging a high interest rate for a low one and ensuring that the transactional costs do not exceed the potential savings. With that in mind, it is worth considering how a PLOP might be implemented.

Similar to other governmental initiatives, the state would have a three-month long registration period where eligible participants can sign up to receive the PLOP. During that time period, the state would send out informational guides and retirement overviews to employees and retirees. These retirement forms would include the individual's current retirement situation (expected yearly payment, etc.) as well as the potential PLOP value of their retirement account. Moreover, potential participants would be granted access to financial advising through either an online tutorial or an RSA advisor. Participants would then register online or by mail, and the state would calculate the total PLOP amount at the end of the registration period. At the close the registration period, the state officials would have three months to negotiate and secure a thirty-year bond deal at the value of the PLOP, and at the end of that three-month period, the state would send PLOP payments to individual retirees.

From a tax perspective, PLOP payments would not be subject to state income tax but would be subject to the federal income tax, though retirees would be able to rollover their PLOP tax-free into an IRA or other tax-sheltered retirement account.

In many ways, this policy seems like a no-brainer for legislators. It gives employees greater choice in deciding how to manage their hard-earned retirement, while also taking advantage of the unique financial climate to deflate the state's ballooning pension obligations and/or fund necessary state agencies. Moreover, it provides an effective talking point on the campaign trail for legislators concerned with re-election. Lastly, a bond-financed PLOP would allow greater flexibility in the event that the state goes into bankruptcy. As Detroit, Michigan and Jefferson County, Alabama illustrate, municipalities tend to be more successful reneging on bond obligations than guaranteed pensions.[9]

Yet, state pension funds and their managers have incredible political clout and would potentially be opposed to any bill that shrinks their balance sheets. Not only do they have sizable financial resources, but they also have the means to organize

current and former state employees to persuade lawmakers against supporting the bill. This is a very real challenge, but it can be overcome by a consistent, determined adherence to the facts and reason.

While policy mechanisms like PLOP will not single handedly turn the tides of increasing unfunded pension liabilities, they are small steps in the right direction and can provide policy makers with increased flexibility to shore up the RSA and fund necessary state functions.

Senator Everett Dirksen was once famously misquoted as saying, "A billion here, a billion there, and pretty soon you're talking real money." Lawmakers often seem to forget that the numbers in the budget *are* real money and that the billions of dollars they spend each year come from the pockets of some hardworking Alabamian. It is their unique responsibility to preserve and spend that money wisely, and any move that better allows them to do so is worth the effort.

Tables & Figures

Table 1

A. % Participating	1%	5%	10%	15%	20%	25%
B. Bond Size (A*$15.1B)	$151M	$755M	$1.51B	$2.26B	$3.02B	$3.77B
C. Yearly Savings (B*.0325)	$4.9M	$24.5M	$49.1M	$73.6M	$98.2M	$122.7M

[1] Lee A. Craig, "Public Sector Pensions in the United States," in *EH.Net Encyclopedia*, ed. Robert Whaples, March 16, 2003.

[2] Robert L. Clark, Lee A. Craig, and Jack W. Wilson, *A History of Public Sector Pensions in the United States* (Philadelphia: University of Pennsylvania Press, 2003).

[3] Employee Benefit Research Institute, *EBRI Databook on Employee Benefits* (Washington, DC: EBRI, 2015).

[4] Joshua Rauh, "Hidden Debt, Hidden Deficits: 2017 Edition," Hoover Institution, 2017.

[5] James Barth and John Jahera, "Alabama's Public Pensions: Building a Stable Financial Foundation for the Years Ahead," Alabama Policy Institution, 2015.

[6] Rauh, "Hidden Debt."

[7] Barth and Jahera, "Alabama's Public Pensions."

[8] Barth and Jahera, "Alabama's Public Pensions."

[9] Lester Graham, "Detroit Bankruptcy Lesson: Underfunded Pension Funds Could Trip Up Other Municipalities," Michigan Radio, December 1, 2015.