Principles for Pension Reform in Alabama:

Rethinking the Defined Benefit in Alabama’s Retirement System
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Principles for Pension Reform in Alabama: 
*Rethinking the Defined Benefit in Alabama's Retirement System*

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EXECUTIVE SUMMARY

The promise of a fully funded retirement for the nation’s state employees is becoming harder and harder to keep. Of the 149 state plans reporting their funding ratios for 2010, 93 were less than 80% funded. (Funding ratios are the difference between asset values and future liabilities, which are the promises made to current and future retirees.) And, since 2008, the number of states failing to make full annual contributions to their state pension funds rose from 23 to 30 in 2010. In response to these declining ratios, most states have reduced retiree benefits, increased employee contribution requirements, or pursued a combination of benefit cuts and contribution increases, some more than once.

Several factors have created the current crisis in pension funding including: a dramatic decline in the number of workers per retirees; overly optimistic returns on investments by pension funds; the continued effects of the 2008 financial crisis; and the use of defined benefit (DB) plans by almost all state pension programs. Unlike defined contribution (DC) plans, DB plans guarantee an uninterrupted stream of revenue for retirees, and are usually based on formulas including years of service and salary at retirement.

The fiscal crises facing Alabama’s Retirement Systems of Alabama (RSA) are no different than the rest of the nation. In addition to being in the 12th percentile for public pension performance for the past 10 years, the RSA’s teachers’ retirement fund (TRS) and employees’ retirement fund (ERS) have gone from being fully funded in 2001 to only 71% and 67% funded, respectively. Moreover, the RSA was the worst performing public pension fund in the nation in 2008 and among the worst performers for the 2008–2009 period, with losses of approximately $8.6 billion.

Much of the RSA’s funding problem can be attributed to the use of an overly optimistic 8% rate of return on its investments. While the national average assumed return rate is also around 8%, a rate of 3.1%, based on 30-year Treasury bonds, is probably more realistic. Using the current rate of 8%, the RSA has unfunded liabilities totaling about $10 billion over the next 30 years. If the 3.1% rate is used, this number becomes more than $40 billion. To help cover these gaps, the required contributions of state employees have been raised from 5% to 7.25% and eventually 7.5%, but these increases will not keep the RSA financially stable.

Since 2003, employer costs to the RSA have risen from $296 million to $999 million per year. These skyrocketing costs are largely the result of three causes: (1) RSA employees can retire with full benefits at any age with only 25 years of service, or at age 60 with at least 10 years of service; (2) current retirees have received generous cost of living (COLA) adjustments that have often exceeded inflation rates; and (3) the introduction of the (now-repealed) Deferred Retirement Option Plan (DROP) in 2002, which cost the RSA almost $60 million per year.

Unless these problems are addressed soon, state employees face an eventual reduction in benefits, an increase in their contributions, and a later retirement than they originally planned. Alabama must implement long-term reforms that protect taxpayers from the RSA’s unfunded liabilities. This paper recommends that the RSA commit itself to five core principles:

1. Alabama lawmakers should adopt a conservative accounting approach where “worst case” scenarios are assumed and liabilities are properly counted. This will involve more than targeting future employees with reduced benefits and higher costs: to meet its current shortfall in funding, rosy assumptions about expected returns must be abandoned in favor of conservative ones that take into account the worst that can happen.

2. Legislators should move the risk of retirement plans from the taxpayer to the individual employee by moving away from the DB pension model. The state should implement DC plans, which are more flexible, portable, and less risky to the RSA because they are more protected from political decisions.

3. The “transition costs” of reform can be handled through buyouts and one-time government borrowing. By buying out its current employees and
closing the state’s DB plan, the state could transition to a DC plan immediately.

4. Radical reform will be unpleasant and met with resistance from employees and their representatives, but the long-term pain of further program modifications and benefit erosion will be far worse.

5. Alabama underestimates the ability of its employees to manage their own money. Risk-averse employees could safely park their assets in low-yield accounts, financial planners could help them make good portfolio selections, or a limited selection of higher-yield, lower-risk options could be offered.

INTRODUCTION

Public pensions across the United States are in crisis. Of the 149 state plans reporting their funding ratios for 2010, 93 were less than 80% funded. (Funding ratios are the difference between asset values and future liabilities, which are the promises made to current and future retirees.) In fiscal year 2010, 30 states did not make their annual required contribution, compared to 26 states in fiscal 2009 and 23 in fiscal 2008.¹ And, of course, 2011 was another year of modest financial market performance and weakening pension stability.

Weakened public pension plans have prompted much needed and long overdue reform. According to a Pew Center on the States project,² 26 states reduced retiree benefits, increased employee contribution requirements, or engaged in some combination of benefit cuts and contribution increases between 2008 and 2010; in fact, in some states like New Jersey and Iowa, programs were reformed more than once in the three-year period mentioned above. In 2011, at least 24 states—including some of the same reformers from the 2008 to 2010 period—engaged in additional reform.³ The year 2012 promises more of the same: contribution rates will have to be increased and benefits will have to be cut for many plans across the United States to remain solvent.

Many factors have fueled the crisis in public pension plans across the states. Fluctuating demographics have played an important role. As Chart 1 indicates, workers per retiree in the United States and around the world will continue to decline into the future. This trajectory means there will be fewer workers contributing funds used to support current DB plan benefits.

Flawed accounting techniques have also played a role. On average, pension funds across the United States value liabilities with a 7.25% rate of return assumption (Alabama uses an 8% assumption). By relying on optimistic valuation techniques, the true health of programs becomes misrepresented. Weak market returns and the financial crisis of 2008 also played an important role in the dire condition of pension plans facing the states.

Possibly the greatest contributor to failing pension systems is the defined benefit (DB) model used by many retirement systems to provide retirement benefits to workers in the public sector. Contrary to the private sector, where most employer-sponsored retirement plans are defined contribution (DC), almost every state and local government in the United States covers employees under a DB system.⁴

DB plans guarantee employees a stream of lifetime payments based on a benefit formula. Formulas vary by state and program health, but they normally account for years of service and salary. While there has been some legal wrangling related to cost of living adjustments (COLAs) in recent months, the stream of payments received in retirement—when pension plans are enjoying stability—tend to be indexed for inflation. In addition to adding some protection against inflation, the plans provide employees with survivor and disability benefits.

The most appealing aspect of DB plans for plan participants is that the risk of investment decisions is assumed by the plan provider rather than the individual. In the case of public employee DB plans, the risk of retirement planning is born by the taxpayer, the ultimate guarantor of state pensions. Rather than have individuals make investment decisions for themselves, DB plans turn decisions over to a group of experts and pool assets of thousands of workers together. In theory, pooling of assets reduces risks, lowers overall administrative costs per member, and gives members—through the investments by the pension fund—access to more aggressive financial instruments, such as options, derivatives, and initial public offerings (IPOs). Employees are typically required to make...
contributions from their salaries into the investment pool, but they do not “own” any particular share of funds, and their payouts in retirement are not directly tied to the amount they contributed. When DB plans experience significantly lower funding ratios, some combination of benefit cuts and increased contributions are necessary to shore up the plans.

Like all public pension plans, the Retirement Systems of Alabama (RSA) has been faced with the very real challenges that come with changing demographics and rising life expectancy. These problems alone make pension reforms a virtual requirement. However, the RSA has not done its members any favors: Over the last 10 years, the RSA has been in the 12th percentile overall for public pension investment performance. To put the RSA’s weak performance in perspective, their losses in 2008 and 2009 could almost cover the official unfunded liabilities the RSA currently faces. When compared to other pension funds facing many of the same economic realities, the RSA’s poor management record and abysmal returns over a long period of time play a primary role in Alabama’s current pension shortfalls.

This paper surveys the current pension situation in Alabama and explores alternatives available to policymakers. After summarizing the costs and risks—both for taxpayers and for public employees—the paper concludes with the recommendation that the state close its DB plan to new workers, give state employees early in their tenure the option of switching, and begin the phase out of the DB plan for workers with many years of service. This shift is consistent with retirement practices currently employed in the private sector; it provides clarity for lawmakers and taxpayers; and it creates a sense of ownership for people with DC accounts.

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**THE DOWNFALL OF ALABAMA’S DEFINED BENEFIT PROGRAM**

State employees classified as full-time in Alabama are required to participate in the Retirement Systems of Alabama’s DB pension plan. As plan administrators like to point out, RSA assets have grown and have fueled a number of Alabama development initiatives, such as the Robert Trent Jones Golf Trail and the PCH Hotels. Despite a large, visible output, the plan places a significant financial burden on public employees and taxpayers. As Chart 2 indicates, in fiscal year 2010 the RSA’s teachers’ retirement fund (TRS) was 71% funded and the employees’ retirement fund (ERS) was 67% funded. Since 2001, these funds have gone from being fully-funded to weak funding ratios near 70%.

The decline in funding ratios reflects investment losses and weak portfolio performance over the last decade, and the numbers would appear much worse if the RSA were to adopt a more conservative discount rate than the 8% rate currently being employed. Current public sector accounting methods allow state pension administrators to assume their pension plans will earn long-run returns at or near the historical average in stock markets. In Alabama, RSA administrators have determined that an 8% return assumption is appropriate; the assumed rate for all pension funds in the United States currently averages near 8%.

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8 Brian Lawson, Alabama House Speaker Wants Changes to State Retirement Systems, The Huntsville Times (Jan. 15, 2012, 7:25 AM), http://blog.al.com/breaking/2012/01/alabama_house_speaker_wants_ch.html. The RSA has a third fund, the Judicial Retirement Fund, which is smaller in size but nonetheless faces the same funding challenges as TRS and ERS.


Such accounting techniques leave public sector pensions out of step with private sector pension valuations, which estimate liabilities based on the likelihood of repayment rather than expected return. If lower discount rates are employed consistent with private sector methods, Alabama’s unfunded liabilities are much larger than reported. At an 8% discount rate, the state of Alabama admits to having unfunded liabilities around $10 billion over the next 30 years. However, if a more reasonable discount rate were to be employed— for example, the 3.1% rate on 30-year Treasury bonds—RSA’s unfunded liabilities increase to more than $40 billion.11 (Using other discounting techniques, Joshua Rauh says the RSA’s true

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11 Author’s calculations.
liabilities are in excess of $55 billion.)\textsuperscript{12} Forty billion dollars in liabilities is equal to 21\% of Alabama’s gross state product for 2012 and nearly 150\% of its current state and local debt.\textsuperscript{13} The wide potential variations on the RSA’s asset valuation are themselves evidence of yet another structural defect in the state’s current pension system.

Recent increases in required employee contributions from 5\% to 7.25\% and 7.5\% after October 2012 will help Alabama’s funding gap, but these measures do not guarantee long-term stability in the RSA. With Alabama’s pension program in crisis and with state leaders looking to put Alabama on a firmer long-term fiscal trajectory, the time is right to consider alternatives to the current DB plan structure.

The RSA is supported by employee contributions, employer contributions, and investment returns. For the teachers’ retirement system, combined employee and employer contributions are approximately 17\% of every dollar earned. With the exception of state police employees, who pay a combined rate of more than 40\%, combined rates for employees’ retirement system workers are similar to teachers’ retirement system rates of 17\%. Payments made out of the RSA are to cover operating expenses and pay benefits.

Since the employee contribution rate is set by statute and less flexible, the employer contribution rate is calculated by actuaries, and it is based on assumptions about retiree life expectancy, investment returns, new retirees, and other factors. In years when funding ratios for the plan were closer to 100\%, employer contribution rates were brought down to rates less than 5\%. With declining funding ratios, however, employer contribution rates have risen steadily over the past 10 years, and they now exceed more than 10\% of every dollar earned by public employees.\textsuperscript{14}

The overall cost of RSA plans has increased in recent years, and it will continue to rise in the future. The evidence in support of rising costs can be found in the state of Alabama’s budget fact booklet: between 2003 and 2012, employer costs to support the RSA have risen rapidly from $296 million per year to $999 million per year.\textsuperscript{15} The rising pension costs are paid for by taxpayers who support state institutions and others, such as students, who support the RSA indirectly with their tuition dollars. The rapidly rising costs of the RSA are due, in part, to the following causes:

(1) RSA employees can retire at young ages. Anyone with 25 years of service credit can retire from RSA at any age. The retiree with 25 years of service credit is entitled to full retirement benefits which amount to approximately 50\% of the average three highest years’ salary over the last 10 years. In addition, anyone with 10 or more years of service credit who has attained the age of 60 is eligible for retirement benefits as well. With the current life expectancy in the United States averaging 78.1 years, a large fraction of Alabama state workers will be paid benefits for a longer period of time than they worked.\textsuperscript{16}

(2) Excessive benefits during periods of above average investment returns. During periods of strong investment performance, Alabama politicians provided excessive cost of living (COLA) adjustments to current retirees. While COLAs were, without a doubt, politically popular, the payouts compromised the RSA’s long-term funding ratio. In 2006 and 2007, for example, retirees were given

\textsuperscript{14} Legislative Fiscal Office, STATE OF ALABAMA, BUDGET FACT BOOK (Nov. 2010), www.lfo.state.al.us/pdfs/FY%202011%20Budget%20Fact%20Book.pdf.
\textsuperscript{15} Id.
\textsuperscript{16} For example, suppose an employee joins the RSA at age 22 after finishing his or her undergraduate degree. He or she puts in 25 years of service and can retire with full benefits at age 47. The retiree will still enjoy 31 statistical years of life after work, all of which he or she is drawing 50\% of his or her highest three years’ salary from RSA. For life expectancy information, see Catharine Paddock, American Life Expectancy Hits Record High, MEDICAL NEWS TODAY, June 13, 2008, www.medicalnewstoday.com/articles/111095.php.
4% and 7% cost of living adjustments. The payouts exceeded inflation rates and came just in advance of the 2008 financial crisis.

(3) The introduction of the Deferred Retirement Option Plan (DROP) in 2002 can be thought of as another excessive benefit extension. The program, which was intended to keep Alabama public employees in the state and help address teacher shortages, has had the unintended effect of raising RSA costs, and the biggest beneficiaries of the program have been Alabama’s highest-earning public employees. Although the program was terminated in March 2011, plenty of damage has been done to an already weak RSA balance sheet. Prior to its elimination, estimates put the annual cost of DROP at approximately $58 million per year.

The financial condition of RSA plans has been weakening since the early 2000s. As stated earlier, the RSA claims that unfunded liabilities as of December 31, 2011 are in excess of $10 billion. If more conservative discounting techniques are applied, liabilities rise to more than $40 billion. But, even using RSA’s funding ratios of 67% and 71% for the two main funds, the funding status is a serious concern and could have an effect on the state’s credit rating going forward. Credit rating organizations, such as Moody’s and S&P, have announced they will take unfunded pension liabilities into account when evaluating state credit ratings, and Alabama’s rising liabilities could eventaully lead to a credit downgrade from its current Aa rating. (Credit downgrades lead to higher borrowing costs and higher taxes for Alabama citizens.) In fact, in August 2011, the credit rating agency, Fitch, downgraded New Jersey’s credit rating and cited the state’s significant unfunded liabilities in its rationale.

While there is no imminent threat of a credit rating downgrade for state bonds, Alabama’s plan is well below ideal funding ratios and future costs to taxpayers and public employees are expected to rise. If the true costs of Alabama’s unfunded liabilities are discovered and costs continue to rise more rapidly in the future, downgrades by credit rating agencies may occur.

A possible cut to the state’s credit rating should be the least of its concerns. A cut in the benefit rate for future retirees, an increase in employee and taxpayer contributions, and a hike in age and eligibility requirements all seem likely, if not necessary, in the years to come. While these reforms aim to improve the overall financial health of the RSA, they will be met with significant push-back and place significant burdens on taxpayers and public employees. States like Illinois are ahead of Alabama when it comes to addressing state pension problems directly, and all indications from Illinois suggest that mishandling state pensions has the potential to encourage businesses to leave and destroy the morale of state workers.

The significant unfunded liabilities, the unpredictability of future taxes to pay for liabilities, and the general lack of clarity regarding RSA’s solvency going forward are serious concerns for political leadership in Alabama and should be for taxpayers as well. The severity of Alabama’s pension problems warrants an honest assessment of how deep the fiscal hole is and what possible alternatives are available to move in a better direction.

19 Mary Williams Walsh, Moody’s to Factor Pension Gaps in States’ Ratings, N.Y. Times, Jan. 27, 2011.
**PRINCIPLES FOR PENSION REFORM**

The Alabama State Legislature introduced a number of reforms in the 2011 session and more reforms may pass in the 2012 session. The 2011 reforms sought to improve the long-term balance sheet of the RSA by requiring employees to contribute an increased percentage to their retirement plans. The most significant change involved raising the required employee contribution from 5% to 7.25% (and ultimately to 7.5% in October 2012). Regrettably, these steps neither make RSA a fully-funded system, nor do they relieve the state of Alabama from the repeated volatile swings in funding ratios and contribution requirements.

Any successful long-term reform of RSA must address two crucial points: (1) How will the reform reduce the excessive costs of the program going forward? (2) How will the reform decrease volatility and risk to taxpayers? Reforms geared towards short-term funding make retirement plans less attractive to new employees, encourage many people to retire immediately, and cause otherwise productive workers to leave the state for other employment opportunities. Instead of relying on Band-Aid reforms, legislators should seek more meaningful long-term reforms which permanently protect taxpayers against the RSA’s unfunded liabilities.

Long-term reforms involve charting a different course for the RSA. They require creative thinking and a commitment to the following fundamental reform principles:

**Core Principle 1:** Alabama lawmakers should adopt a conservative accounting approach where “worst case” scenarios are assumed and liabilities are properly counted.

As mentioned, RSA’s liabilities are likely well in excess of those currently stated. When the funding gap is properly accounted for, many of the small changes being proposed to employee contribution rates, benefit factors, etc. are insufficient panaceas. More sweeping reform—reforms targeted at new employees and current employees—will need to be entertained once the magnitude of Alabama’s funding shortfall is taken into account.

Up until now, legislators have been doing too little and the reforms have been coming too late to stabilize RSA for the long-term. Legislation proposed in the 2012 session calls for changes in the benefit factor, a minimum retirement age increase, and a number of other cost-saving measures, but does little to improve the short-term prospects for Alabama’s pensions and will not protect taxpayers and public employees from the need for further reforms. The reforms, while commendable, are Band-Aid reforms being applied to a gaping financial wound. Moreover, many of the small changes made in recent sessions, such as raising the employee contribution rate to 7.25%, were offset by many state institutions raising pay by an amount equal or greater than the 2.25% contribution rate increase on current employees. At Troy University, a 3% pay increase was announced shortly after the news broke about the employee contribution hike from 5 to 7.25%. The same was true for Auburn University and for many public agencies around the state. Thus, the burden falls on future employees, and future employees are far less of a political threat to legislators than current employees and retirees. Making future employees pay more into the retirement system and promising them less in retirement benefits will, indeed, save money in the long-term. But there is a problem with targeting cuts on future employees: The cuts are insufficient to put the RSA on firm long-term footing, and they do almost nothing in the short-term to improve the health and funding of the system.

Take Illinois, for example. Of all state pension plans across the United States, Illinois’ public pension plans are among the worst. Their pension program has already needed bailouts from Illinois’s general fund, and reform efforts have largely focused on how future employees will be treated. According to the Chicago Tribune:

*The most significant of those changes was a 2010 plan, known as Tier 2 and sponsored by Madigan and Cullerton, that cut costs over the long term by lowering benefits for those hired after Jan. 1, 2011. During the next three decades, the move is projected to lower the state’s contributions by more*
than $70 billion and cut the total pension liabilities nearly in half, by $256 billion.\textsuperscript{22}

Unfortunately for Illinois taxpayers and public employees, the savings from targeted cuts on new employees will take years to materialize and the state of Illinois has already counted the savings from their reforms in current financial projections:

\textit{Although the bulk of the savings from Tier 2 won’t begin for a number of years, the state began counting them right away and, in the process, lowered the amount it had to contribute into the funds.}\textsuperscript{23}

Illinois is just one example of a state not doing enough to stem its pension crisis. It and many other states with significant funding shortfalls, including Alabama, must cut benefits to both future workers and current employees. (Targeting retirees is far more difficult and should be considered an option of last resort for reformers because (1) it is an attack on benefits already accrued; and (2) it would be met with reasonable legal challenges.\textsuperscript{24}) Alabama legislators deserve praise for asking current employees to contribute more to their retirement going forward. But for the state to gain sound fiscal footing under the DB system, more changes to the future benefits of current employees—reductions in the benefit formula, for example—are still needed.

Rather than continue to rely on overly optimistic assumptions about the RSA’s future liabilities, it should adopt a conservative accounting approach that assumes the worst about its future liabilities. In the current environment, an assumption that the RSA faces $55 billion in future liabilities should be treated as the starting point when discussing reform and making reform recommendations.

\textbf{Core Principle 2: Legislators should shift the risk of retirement plans from the taxpayer to the individual employee by moving away from the DB pension model.}

The DB pension structure itself is the ultimate source of Alabama’s public pension problems. It has proven to be a flawed form of retirement compensation, and the private sector has been experiencing a significant shift away from DB towards DC since 1970. The private sector is not alone in its shift away from DB: three states—Alaska, Michigan, and Utah—have made the transition to DC. Several, such as Georgia, Virginia, and West Virginia, have given employees greater choice or introduced hybrid models. Others, such as New Hampshire, are entertaining a shift to DC.

DC plans have a number of desirable features for both employees and employers. For employees, they give members a great degree of flexibility and mobility. The plans are portable and go with the employee when he or she leaves a job. For many young professionals in Alabama’s state government, this is a particularly attractive option. The mandatory RSA contribution and longer vesting period is a deterrent to individuals wishing to serve their state with a mind to more mobile modern career paths. Another advantage is that the risks of investment decisions are borne by the individual plan member rather than the state. Under a DC plan, state contributions are determined by a simple formula and not subject to wild swings in investment performance, demographics, and increased retirements.

Of the states already mentioned, Michigan was one of the first to shift from DB to DC in 1997. Since 1997, Michigan’s pension reforms have helped the state save more than $4 billion, and more savings will continue to accumulate as the ratio of DC members to DB members increases in the future.\textsuperscript{25}


\textsuperscript{23} \textit{Id.}

\textsuperscript{24} As stated earlier, though, cost of living adjustments (COLAs) for retirees have been called into question and have been considered by some state judges as not part of a retiree’s guaranteed benefits. See Walsh, \textit{supra} note 7.

Most states, Alabama included, are not as entrepreneurial about reform as Michigan and Utah. Alabama’s politicians tend to pursue piecemeal reforms, which adjust benefits and contributions and provide a patch for the state’s problems. Unfortunately, these patchwork fixes all operate within the framework of the flawed DB model rather than challenging the model altogether. The tweaks and patches may temporarily improve funding ratios of the DB plan, but they do nothing to insulate taxpayers from the inherent uncertainty resulting from promised benefits and other people investing taxpayer money.

Even the advertised savings projections for current changes to Alabama’s DB plan should be met with skepticism. Savings projections over more than 30 years rely on a multitude of assumptions about future economies and the state workforce. In contrast, the budget experts at the non-partisan Congressional Budget Office typically operate in a ten-year budget window, and even their projections are subject to wild inaccuracies in the out years.

Additionally, the political games associated with DB plans are significant and potentially devastating to a state. In 2006 and 2007, for example, Alabama legislators thought the RSA was funded sufficiently to justify cost of living adjustments of 4% and 7% for members of the ERS and TRS, respectively. The COLAs handed out to retirees in 2006 and 2007 exceeded inflation rates in those years, and smacked of an attempt to politically influence state retirees. While the handouts were, no doubt, popular to current retirees, they compromised RSA funding, which was then greatly weakened by the financial crisis of 2008.

Even if lawmakers “fall on the sword” by pushing for meaningful benefit reductions and higher contribution requirements in the current legislative session, their efforts to fix the system are not permanent and can be undone as soon as market returns improve, lawmakers become interested in handing out more benefits to current retirees, or a different group of lawmakers seizes control of state government. In sum, the benefits and costs DB plans—as long as they exist—are far from certain, and they will move in fits and starts based on the whims of politicians and movements in financial markets.

DC programs provide the better long-term retirement option for Alabama. They are far more transparent when it comes to forecasting individual retirement benefits. They are still subject to market movements, but they are better protected from politics. They give their members a sense of ownership that should be part of a broader vision for Alabama—a vision that holds individual autonomy over investment decisions as a fundamental good. And, DC programs are far better for anyone with a preference for moving out of the public sector or out of the state of Alabama. A public workforce filled with employees calculating the hit they will take to their retirement if they dare leave the state or leave the public sector is not an ideal or healthy public workforce; Alabama’s public sector employees should be given greater freedom to choose, freedom to move, and freedom to control their own futures. Only a DC system can give them the flexibility and sense of ownership described above.

**Core Principle 3: The “transition costs” of reform may be handled through buyouts and one-time government borrowing.**

If reformers accurately account for the costs of their DB plans and share a commitment to DC reform, the following question arises: What should Alabama do with public employees currently covered under the RSA’s DB program? As Alabama looks to reform, other states could serve as a guide. Michigan, for example, offered employees the option of continuing with their DB plan or switching. Some new, young employees switched to DC, but many stuck with DB. Thanks to being fully funded at the time of the switch, Michigan was able to offer the option of switching from DB to DC plans to all eligible public employees. Michigan has not missed a payment to employee DC accounts, and employees now benefit from having individualized accounts that they control and can take with them whenever they decide to leave the state or their public sector jobs. In an ideal scenario, Alabama could transition to a DC program during a period where the existing DB plan is fully funded.

For states with funding shortfalls, more radical reform options may be entertained. One scenario would involve states borrowing to fully fund their systems and then
using the borrowed funds (plus existing assets) to buy out current employees. Borrowing to buy out pensioners and close the RSA’s DB program would be one-time borrowing, and all future retirement contributions would be to DC accounts. While the idea of taking on debt to close out the state’s pension program might be met with ire by some lawmakers, it would help transition from the DB model to a DC system right away.\textsuperscript{26} Of course, closing out the DB plan and replacing it with a DC program would involve significant “front loaded” costs, but these costs could be covered through the initial borrowing and future program savings. Alabama lawmakers borrow for all kinds of programs to support schools, hospitals, roads, and prisons. Some of this borrowing makes sense; some of it is problematic and involves questionable returns on investment. Few things could be better for the state’s long-term fiscal health than borrowing, closing the fund, and shifting to a DC pension plan.

In the absence of a complete and immediate closure of the DB program and conversion to DC, a hybrid model that phases out the DB program over time and phases in DC accounts would provide a compromise option going forward. Such programs have worked well in other states, and reform in this direction is consistent with Core Principle 2 listed above.

One model that lawmakers should consider if a complete switch to DC is not an option is the Federal Employees Retirement System (FERS) model, which became effective in 1987. FERS maintains elements of a DB program, but it also gives workers some DC benefits that are portable and can be allocated to a range of investments. This innovative retirement program at the federal level has helped reduce the future burden taxpayers will face from the FERS DB portion, and it has led to increased efficiency gains.

Core Principle 4: Radical reform will be unpleasant and met with resistance, but the long-term pain of further program modifications and benefits erosions will be far worse.

The time is ripe for comprehensive pension reform in the state of Alabama. When it comes to these programs, many lawmakers understand the dire situation facing taxpayers and future generations. In fact, many are familiar with the arguments in favor of shifting to DC and have some sympathy for the idea. Sadly, the momentum for these changes has been thwarted by interest groups opposed to reform. While the Alabama Education Association is opposed to radical pension reform, they are not the most ardent opponents of reform. In fact, the largest roadblock to moving towards a DC retirement system may be the RSA itself.

In its newsletters (which, by the way, are an overhead cost being paid for by public contributions), the RSA presents a very one-sided, skewed account of the fund’s performance. They focus on the obvious, visible projects RSA funds have supported and downplay the abysmal market returns of RSA investments and flawed state projects. They scare their members by playing up the risks related to DC plans and paint a rosy picture of life as a RSA member.

Of course, most people do not and should not believe the RSA’s spin. The RSA has supported a number of questionable investment projects, such as their large ownership stake in US Airways and the steel rail car plant in the Shoals. These investments in the state—while helping to create jobs—have come at a cost to retirees. The long-term goal of the RSA should not be to create jobs and golf courses in Alabama, but, rather, to secure the highest returns for its members. Anything less than securing maximum rates of return is a breach of the organization’s fiduciary responsibility.

Any efforts to shift away from DB plans to DC plans for the sake of Alabama’s long-term fiscal health, should recognize the RSA as the most difficult political entity to overcome. Embracing DC plans requires the RSA to surrender control over significant financial resources, a means of tremendous political power. A shift to DC plans would undermine the RSA’s ability to influence Alabama’s economy and pursue projects like the Robert Trent Jones

\textsuperscript{26} In earlier policy work, I suggest borrowing to overcome transition costs. See Scott Beaulier, \textit{From Defined Benefit to Defined Contribution} (Mercatus Center Working Paper No. 11-37, 2011), http://mercatus.org/sites/default/files/publication/Defined_contribution_Beaulier_WP1137_0.pdf
Golf Trail. Instead, individuals would be the owners of their own retirement accounts and would be free to choose for themselves where to invest their retirement dollars. Under a DC framework, there would be fewer visible state projects like the ones supported by the RSA in recent years. However, limited state projects would mean greater savings for taxpayers and greater freedom of investment choice for retirees.

Of all the reforms mentioned, breaking through the institutional obstacles presented by RSA may be the greatest challenge. Alabama’s state pension program is in dangerous financial shape, and the RSA is rather unwilling to even acknowledge the seriousness of its health. Admitting Alabama’s pensions have a problem is the first step to recovery, and a major part of reform requires the RSA to do just that.

Core Principle 5: People are smarter than expected when it comes to managing their money.

Even if lawmakers accept the idea that individuals—instead of taxpayers—should bear the risk for their retirements, and even if they develop a successful plan for the transition, another concern remains: Some worry that lay people will not manage their individualized retirement accounts effectively.

This is a reasonable concern that has been dealt with a number of different ways. The first option is simply give retirees the freedom to choose their own investment strategy and to trust that they can protect their own interests. For those who are not comfortable making financial decisions, there are financial advisers, basic on-line tools, and numerous financial literacy programs throughout the state that can assist them as they make good portfolio selections.

Another option is to provide some oversight on the range of financial management options people have, with respect to their retirement accounts. University of Chicago finance professor Richard Thaler has found that people often stick with defined contribution default settings when the default is a “life cycle” fund that focuses on maximizing return while reducing risk over one’s life cycle. Beyond tweaking the default, the state could limit individuals to a selection of diversified mutual funds that provide some security against risk but also help them focus on maximizing long-term value. Even though people can sometimes make mistakes when investing, the possibility of mistakes does not, in and of itself, imply that all retirement decisions should be handled by experts (who, if the RSA is any indication, are also susceptible to plenty of mistakes when making investment decisions).

CONCLUSION

Alabama legislators should consider the core principles listed above as a guide when evaluating the merits of different pension reform ideas. Adherence to each of the principles will put the state of Alabama on more solid footing going forward and will pull taxpayers and public employees away from the financial abyss.

The first step towards meaningful, long-term reform will involve lawmakers investigating the true costs of RSA’s unfunded liabilities. An honest discussion of liabilities should include actuaries and experts from the RSA, but should also include outside data on the state’s unfunded liabilities. Additional independent economists and accountants should also be called to offer differing perspectives on the RSA’s accounting methods, and alternative estimates, such as the $40-$55 billion estimates mentioned above, should be put on the table as a more realistic estimate of the RSA’s true funding shortfall.

Once the RSA-employed actuaries and independent experts have established an accurate estimate of the funding shortfall, a discussion about how to guarantee a long-term balancing of assets and liabilities can begin. If the RSA’s true liabilities are in the $40+ billion range, then lawmakers will have to take a hard look at the scale and scope of benefit cuts and contribution increases necessary to assure long-term solvency. By continuing to base reform on the RSA’s far more optimistic projection of future liabilities, reforms cannot do enough and will fail to anticipate the upcoming financial storms facing the RSA and many other public pension plans across the country.
If lawmakers and the RSA can agree on a more realistic estimate of Alabama’s pension liabilities, they must embrace a more conservative accounting method permanently. By relying on a more conservative estimate going forward, taxpayers and lawmakers will be able to plan and avoid the never-ending tweaks common under the current model.

State legislators could play an important role in reforming the RSA’s accounting practices by calling on them to adopt the same accounting practices as the standard accounting practices used in the private sector. A more honest accounting method will help lawmakers and taxpayers better prepare for future changes. More conservative accounting will also signal Alabama’s full transparency commitment to credit agencies when it comes to unfunded liabilities; in fact, an embrace of tougher accounting standards here in Alabama could prompt other states to follow the state’s lead when it comes to pension accounting.

Once the RSA’s liabilities are properly estimated, the challenge then becomes how to implement reform. A phasing out of Alabama’s DB program will lead to a slow, steady decline in unfunded liabilities going forward. For current employees, an option to convert from DB to DC should be offered; people with less than 10 years of experience may find the DC alternative attractive and others with concerns about the long-term DB funding situation might also switch.

For the remaining people who are unwilling to switch to DC, lawmakers have at least two choices: they can either move forward with a much smaller DB program and let time lead to a gradual phase out of DB liabilities or they can shut the program down by paying out the benefits earned by members (and not the benefits promised to them in the future). The group of members hoping to retain the DB plan will, no doubt, be the most difficult group to persuade, but the possibility of getting pennies on each dollar contributed may motivate many more to convert.

Pension funds running out of money without serious reform is not a problem limited to Greece or Italy: states like Illinois, New Jersey, and Rhode Island are facing it here and now. Municipalities like Harrisburg, PA and Prichard, AL have also confronted the harsh reality of bankruptcy. The fact that many pensions are broke should help clarify the pressing need for radical reform.

With state and federal governments facing a number of seemingly irresolvable fiscal crises, money to bail out public pensions across the states may not be available. States must find ways to fix their public pensions without turning to over-burdened taxpayers for help. To do so, they will have to implement benefit cuts in the short-term. To avoid any future pension crises and provide greater predictability going forward, they must consider a shift from DB pension plans to DC plans.
