



The Alabama Deferred Retirement Option Program (DROP) Executive Summary

The Problem

DROP, which stands for “Deferred Retirement Option Program” (or “Plan” in some states), was first designed to allow retiring employees who would be difficult or expensive to replace an option to work beyond their retirement age in return for some sort of cash payout, the size of which would depend upon the length of time between retirement and the actual end of their employment.

Employees who participate in Alabama’s DROP must be age 55 or older (or age 52 or older for state police) and have at least 25 years of credited service with the Retirement Services of Alabama (RSA), the Teachers’ Retirement System (TRS), or the State and County Officers and Employees’ Retirement System (ERS). During this period, the participant retains his status as a full-time employee, and his pension, based on average salary and years of service, is deposited into the DROP account while he remains on the payroll and receives a salary. Since Alabama’s defined benefit formula is about two percent per year once an employee works at least 25 years, they would already have a pension that is equivalent to 50 percent of their final pay. If an employee who meets these criteria participates in the DROP (with their pension accruing in an account until their DROP service is completed), this would be the same as the employee receiving a 50 percent increase in total compensation for their years worked in DROP. The employee’s pension fund also earns interest (4 percent compounded monthly at the time of this report). This, in effect, provides the employee with a pay increase of about 50 percent during the DROP period.

Unlike some other states, employees in Alabama are not required to end their employment at the end of their DROP period. Rather, their accounts continue to accrue interest until their employment ends. At that point, the state allows them to take either a lump-sum payment (less a required 20 percent federal income tax withholding) or roll over the full amount into a tax-qualified plan, such as an IRA, 401(k), 403(b), or 457(b) of a governmental employer.

In September 2009, the actuarial valuations of the Teachers’ Retirement System of Alabama (TRS) and the Employees’ Retirement System of Alabama (ERS) show 5,307 education employees and 2,357 state employees enrolled in the DROP plan. The cost to fund prior-service costs for TRS and ERS is \$22 million a year for 10 years (TRS) and 20 years (ERS), with an estimated \$5 million per year in normal-service costs (yearly costs).

DROP plans are controversial for several reasons:

- They are misunderstood by the public and even state employees, who may not be aware of the potential downsides of participation. Consequently, DROPs have become easy media targets, particularly when it is discovered that high-profile public employees, such as sheriffs, county commissioners, and judges, have received large DROP payoffs, in addition to their pensions. Some Alabama press reports have referred to the DROP as a retirement “nest egg,” a “pension bonus,” and a “perk adopted in lieu of pay raises”—in essence, a way to turn highly-paid, long-term state and education employees into millionaires prior to their retirement. Such “double dipping” has also been characterized as gaming the system.
- Some DROPs have created giant liabilities their providers did not anticipate. In Houston, Texas, for example, the city offered a guaranteed rate of at least 8.5 percent interest on DROP balances. Not only did this payout rate allow a hypothetical employee earning \$40,000 per year and retiring at age 65 to create an annuity worth more than \$2.5 million, it threatened to seriously stress the city’s retirement system before the guarantee was defeated in 2005 by a 3-1 margin.
- In periods of financial distress, DROP hamstring the state because it encourages longer-term, higher-paid employees to continue working, even when the employer might want them to retire in order to replace them with younger employees or terminate/combine positions. In Alabama, the merit system requires layoffs to be decided by seniority, and those who have entered the DROP program cannot voluntarily terminate without losing their DROP benefits.
- For employees, a primary disadvantage of the DROP is uncertainty over future pay increases. The defined benefit pension annuity is “frozen” at the DROP date and based on that salary to date unless the DROP allows for cost-of-living increases (few do).

Our Solutions

There are at least three ways Alabama can deal with its DROP program:

- Terminate the program in its entirety. The advantages of terminating the program are the cost savings from increased employer payroll contributions to fund the program and the ability to downsize positions that can be combined or eliminated altogether.
- Restructure DROP so that it would be more of a management tool for departments rather than an entitlement for thousands of public employees. Any employee meeting the age criteria would be eligible to be invited if, in fact, his services were needed. The employer or a committee, using a strict set of criteria, would determine whether the employee was needed for a deferred retirement. The employee would

retire without knowing whether he/she would be invited to join the DROP (thus solving the problem of employees entering DROP to trade the cash bonus for the defined-benefit formula).

- Increase the retirement age for entry into DROP. If the retirement age were increased from 60 to 62, this would solve the problem of losing employees to early retirement and save the state the cost of healthcare premiums for early retirees (the two reasons given for the DROP program initially). Because state and education employees contribute 5 percent toward their defined benefit funding, they would be paying into the RSA longer, thus alleviating some of the problems created when employees work 25 years but live another 40 years or longer after retirement.