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Gold Standard in Public Retirement System Design Series—No. 3

BEST PRACTICES FOR COST-OF-LIVING ADJUSTMENT (COLA) DESIGNS IN PUBLIC PENSION SYSTEMS

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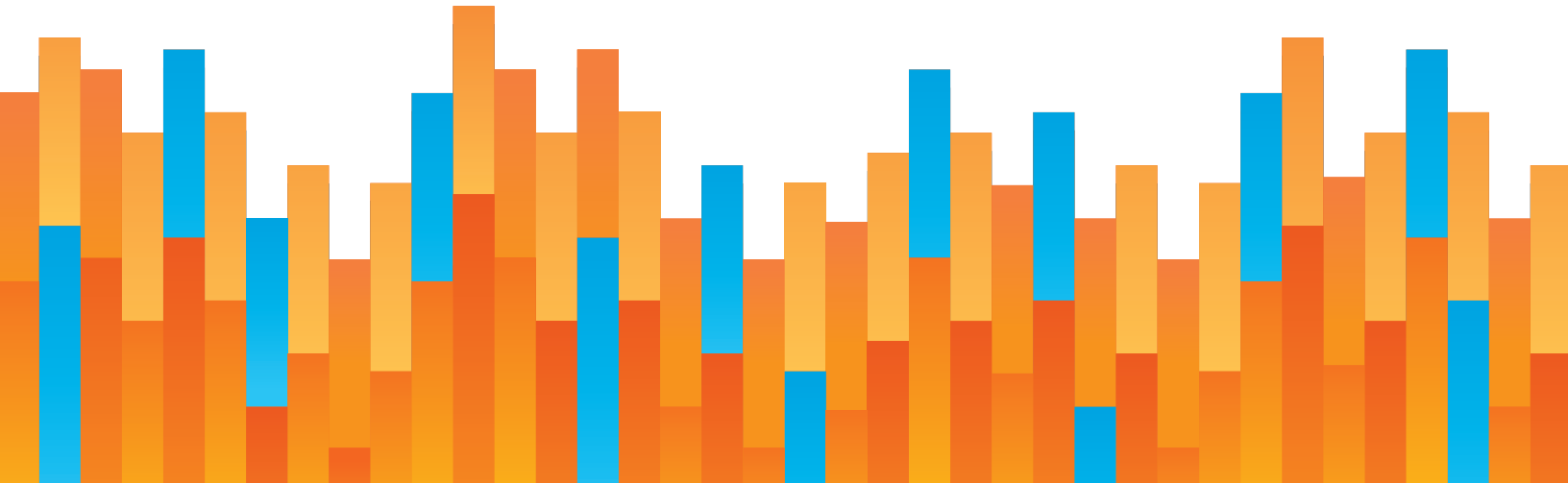

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The "Gold Standard in Public Retirement System Design Series" reviews the best practices of state-level public pensions and provides a design framework for states that are struggling under a burden of post-employment benefit debt. This third entry in the Gold Standard series looks at best practices for integrating cost-of-living adjustments (COLAs) into public pensions. This analysis examines how public plan sponsors can best design and implement COLAs in public pension plans.

Gold Standard Brief #1: Best Practices in Incorporating Risk Sharing into Public Sector Defined Benefit Pension System Design

Gold Standard Brief #2: Best Practices in the Design and Utilization of Public Sector Defined Contribution Plans

Gold Standard Brief #3: Best Practices in Cost-of-Living Adjustment Designs in Public Pension Systems

Gold Standard Brief #4 Best Practices in Hybrid Retirement Plan Design

EXECUTIVE SUMMARY

Cost-of-living-adjustment (COLA) benefits are a common feature of many public employee retirement systems used to provide a level of protection against loss of purchasing power in retirement resulting from inflation. Public defined benefit (DB) pension plans use a wide variety of COLA benefit designs and funding methods that have led to a mixed bag of outcomes for retirees and have often exacerbated existing underfunding problems.

The principal problem with most COLA benefit provisions is failing to treat it as one of the plan's core benefit objectives and to prefund it the same way as the primary retirement benefit. Instead, too many plan sponsors apply ad hoc COLAs unevenly. In addition, there is an issue of inconsistent timing. Moreover, not enough thought is given to how actual inflation impacts those who receive the increase. And, finally, little consideration how the increase impacts the total program's long-term funding.

This brief identifies several proposed best practices to guide public plan sponsors to a more coherent and financially sustainable COLA benefit design and funding for their pension systems. The best practices include:

- *Best Practice #1 – Plan sponsors should create a formal COLA benefit policy that is an integral part of the overall retirement plan objectives*. This provides clarity for the retirees, sets expectations properly, and provides guardrails for future policymakers when faced with changing circumstances.

- *Best Practice #2 - The COLA benefit design should clearly identify 1) who is eligible for the COLA, 2) what benefit the COLA applies to, and 3) when it is payable*. This is necessary to force recognition of the reality that the plan cannot and should not provide unlimited inflation protection for all participants.
- *Best Practice #3 - The COLA amount should reflect an objective inflation benchmark*. This helps provide a more predictable amount of inflation protection and more equitable distribution of benefits for similarly situated retirees.
- *Best Practice #4 –The COLA Benefit amount should be consistent, predictable and clearly communicated to the retirees*. Retirees need to have a firm understanding of what COLA benefits will or will not be provided to set expectations and to allow them to manage their retirement assets and income more effectively.
- *Best Practice #5 - The COLA benefit amount should be limited*. This recognizes that inflation varies over time and that the COLA benefit design distinguishes between "normal" inflation and periods of high inflation that are more difficult to predict. Establishing limits or caps on the COLA benefit are needed to allow more sustainable funding approaches.
- *Best Practice #6 - COLA costs should be pre-funded as part of the overall normal cost of the retirement plan*. Pre-funding of COLA benefits is essential to ensure the consistent delivery of inflation protection to retirees and to avoid the creation of unfunded liabilities. It also avoids the creation of complicated and unpredictable COLA funding schemes, such as investment gain sharing or actuarial funding margin reserve allocations.
- *Best Practice #7 - COLA benefits should be subject to change for future accruals and new employees*. COLA benefits should be subject to adjustment for future accruals for current active employees and for new hires to create benefit design and funding flexibility under changing circumstances.
- *Best Practice #8 – Plan sponsors must stop making the same mistakes*. This recognizes that it is important to break the cycle of suboptimal COLA practices.
- *Best Practice #9 – New practices must refrain from trying to fix all past inflation* - Not all past inflation has to be fixed. This recognizes that there are limited public funding resources, and a prioritization among competing demands for the public treasury is necessary.

TABLE OF CONTENTS

PART 1 INTRODUCTION 1

PART 2 THE CASE FOR COST-OF-LIVING ADJUSTMENT (COLA) PROTECTION FOR PUBLIC PENSION PLANS 2

PART 3 UNDERSTANDING INFLATION 5

3.1 MEASURING INFLATION 6
3.2 WHICH INFLATION INDEX IS THE BEST? 7
3.3 THE SOCIAL SECURITY COLA 8

PART 4 COLA PRACTICES OF PUBLIC PENSION PLANS AND RECENT DESIGN CHANGES 10

4.1 RECENT PUBLIC PENSION COLA DESIGN CHANGES 12

PART 5 BEST PRACTICES FOR PUBLIC PENSION COLA DESIGN AND FUNDING 14

5.1 BEST PRACTICE #1. CREATE A FORMAL STATEMENT OF POLICY AND OBJECTIVES 14
5.2 BEST PRACTICE #2. PROVIDE A CLEAR COLA BENEFIT ELIGIBILITY STATEMENT—WHO, WHAT, AND WHEN 15
5.3 BEST PRACTICE #3. THE COLA AMOUNT SHOULD BE RELATED TO AN OBJECTIVE INFLATION BENCHMARK 16
5.4 BEST PRACTICE #4. THE COLA BENEFIT AMOUNT SHOULD BE CONSISTENT, PREDICTABLE, AND CLEARLY COMMUNICATED TO THE RETIREES. 16
5.5 BEST PRACTICE #5. THE COLA BENEFIT AMOUNT SHOULD BE LIMITED. 17
5.6 BEST PRACTICE #6. COLA COSTS SHOULD BE PRE-FUNDED AS PART OF THE OVERALL RETIREMENT PLAN NORMAL COST 18
5.7 BEST PRACTICE #7. COLA BENEFITS SHOULD BE SUBJECT TO CHANGE FOR FUTURE ACCRUALS AND NEW EMPLOYEES. 18
5.8 BEST PRACTICE #8. PLAN SPONSORS SHOULD REFRAIN FROM MAKING THE SAME MISTAKES. 19
5.9 BEST PRACTICE #9. PLAN SPONSORS SHOULD NOT TRY TO FIX ALL PAST INFLATION 20

PART 6 BEST PRACTICES VERSUS COMMON COLA DESIGNS 20

PART 7 PRACTICAL CONSIDERATIONS 22

PART 8 CONCLUSION 24

ABOUT THE AUTHOR 25

PART 1

INTRODUCTION

Inflation's impact on the purchasing power of retirement benefits and savings needs to be managed when designing and funding effective retirement plans. Periods of high inflation show how important properly designing inflation protection measures is in public sector defined benefit (DB) pension plans. These plans have addressed this dilemma in different ways over the years with varying degrees of effectiveness. More recently, public sector pension reform efforts have often significantly changed in how cost-of-living adjustment (COLA) and post-retirement benefit increase (PBI) features are designed and funded.

"Periods of high inflation show how important properly designing inflation protection measures is in public sector defined benefit (DB) pension plans."

This brief focuses on how state and local government DB public employee retirement systems have used COLA benefit features to address inflation's risk to retirement security and provides a set of best practices to help guide policymakers and stakeholders in designing and funding inflation protection design elements for their DB plans.

PART 2

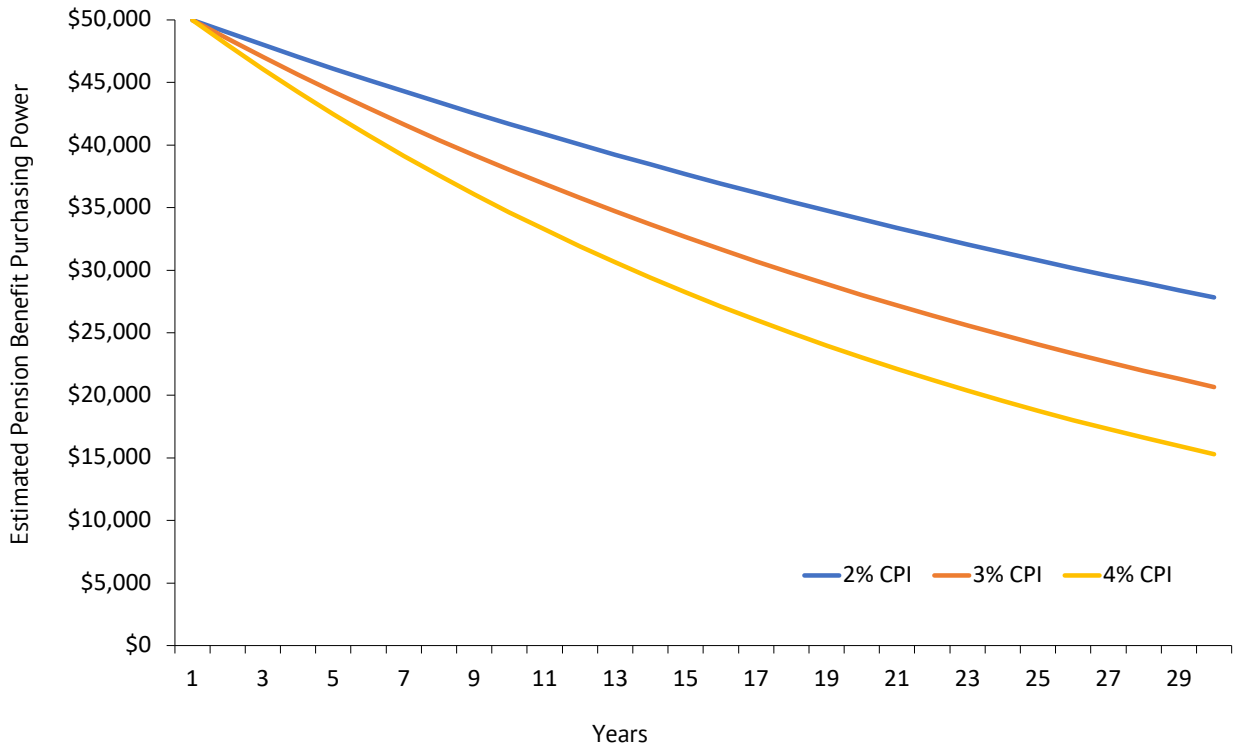
THE CASE FOR COST-OF-LIVING ADJUSTMENT (COLA) PROTECTION FOR PUBLIC PENSION PLANS

Inflation is a serious concern for all retirees, including retired public workers covered by DB plans. For these individuals, when the growth in personal income from pensions, Social Security, and personal retirement savings is less than the rate of inflation, they experience a real reduction in the purchasing power of the guaranteed portion of their retirement benefits. Social Security benefits include inflation protection, as these payments are adjusted in response to increases in consumer prices each year. Retirees with investments in defined contribution plans, IRAs, brokerage, and other similar arrangements can offset inflation's negative impacts with investment gains. Fixed annuity payments, however, from DB plans can lose value over time unless a mechanism is provided to increase payments in response to price increases due to inflation.

DB plans are typically designed to provide a monthly amount for the life of the participant and any continuing survivor beneficiaries. These annuity benefits can extend 20-40 years or more depending on the participant's age at retirement and the recipient's longevity. Over time the purchasing power of the initial pension amount decreases because of the impact

of price inflation. Figure 1 illustrates the degradation of the purchasing power of an initial DB plan annuity because of general CPI inflation at various levels. It shows that, even with modest 2% CPI inflation per year, the initial $50,000 benefit value per year is worth less than an adjusted $35,000 20 years into retirement—a more than 30% reduction. The negative impact is more acute with higher inflation rates and greater longevity.

FIGURE 1: IMPACT OF INFLATION ON PURCHASING POWER OF PENSION BENEFITS ABSENT COLA: THREE CONSUMER PRICE INDEX SCENARIOS



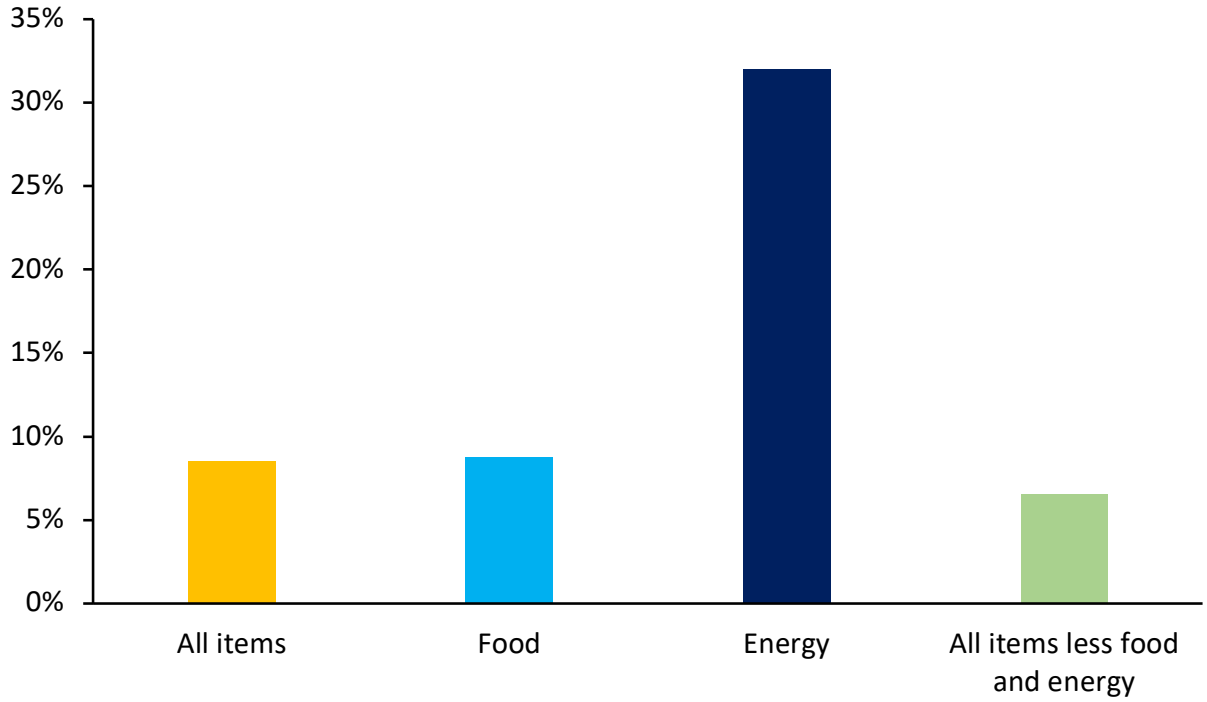
An individual's exposure to inflation will vary by the basket of goods and services each consumes. For example, a retiree owning a home in a hot housing market can experience increased property taxes that eat directly into their available budget for other expenses. A report by ATTOM in April 2021 shows that property taxes on single family homes were up by 5.4% in 2020.[1] In contrast, retirees who rent can be impacted even more by rental prices with median rent spiking 17.6% year over year.[2] Similarly, individuals with health problems generally will consume more health care goods and services than someone who is

1 "Property Taxes Levied on Single Family Homes Up By 5.4% In 2020, To More Than $323 Billion," Attom, 2021, https://www.attomdata.com/news/market-trends/home-sales-prices/attom-data-solutions-2020-property-tax-analysis/ (May 11, 2022)

2 "Apartment List National Rent Report," Apartment List, 2022, https://www.apartmentlist.com/research/national-rent-data, (May 11, 2022)

healthier. Those who consume more energy goods and services may also experience more inflation impacts as illustrated by the recent 25%+ change in energy prices shown below (Figure 2).

FIGURE 2: CHANGE IN CONSUMER PRICE INDEX RECORDED MARCH 2021 TO MARCH 2022



Source: Bureau of Labor Statistics, March 2022

Public employees' exposure to inflation can also vary depending on whether they have earned a Social Security benefit. About 25%–30% of state and local government employees are not covered by Social Security.[3] Unless these employees earn a Social Security benefit through other covered employment, they are not eligible for the COLA inflation protection features of that federal system, which adjusts for CPI increases without a cap. This means the retirement systems covering employees that do not participate in Social Security may have a greater interest in including some sort of inflation protection for the benefits they provide.

[3] "Social Security: Mandatory Coverage of New State and Local Government Employees," Congressional Research Service, 2011, https://www.everycrsreport.com/reports/R41936.html#_Toc299368668 (May 11, 2022)

PART 3

UNDERSTANDING INFLATION

Inflation means prices rise and the underlying currency can buy fewer goods and services than before. The Federal Reserve defines and explains inflation as follows:

> *Inflation is the increase in the prices of goods and services over time. Inflation cannot be measured by an increase in the cost of one product or service, or even several products or services. Rather, inflation is a general increase in the overall price level of the goods and services in the economy.*[4]

The technical causes of inflation are a subject of much debate, but the primary root cause is when the money supply increases faster than increases in the availability of goods and services (e.g., more money chasing fewer goods and services). A variety of factors can cause this, including increases in government spending or low interest federal reserve monetary policy. It can also be related to an increase in demand for a limited supply good or service or an increase production cost of a good or service for any reason, including natural disasters, energy supply disruptions because of geopolitical factors and reduced supply of natural resources.

[4] "*What Is Inflation and How Does the Federal Reserve Evaluate Changes in the Rate of Inflation?* Board of Governors *of the* Federal Reserve System," Board of Governors of the Federal Reserve System, https://www.federalreserve.gov/faqs/economy_14419.Htm (May 11, 2022)

Inflation tends to be somewhat volatile over the short run but has historically evened out over longer time periods. Inflation as measured by the Bureau of Labor Statistics CPI – W index for the period 1980-2021 shows a range from a 14.3% high in 1980 to a –7% low in 2009 and an average of about 3.2% per year. [5]

The Federal Reserve has taken the formal position that "inflation at the rate of 2 percent, as measured by the annual change in the price index for personal consumption expenditures, is most consistent over the longer run with the Federal Reserve's statutory mandate."[6]

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3.1 MEASURING INFLATION

The Bureau of Labor Statistics (BLS) uses the Consumer Price Index (CPI) in various forms to measure price changes of food, clothing, shelter, fuels, transportation, doctors' and dentists' services, drugs, and other goods and services that people buy for day-to-day living. The major CPI indices are as follows:

- *CPI for all Urban Consumers (CPI-U)* is the inflation metric for all urban consumers including hourly wage earners, clerical workers, and professionals. It covers about 93% of the United States' population.[7]

5 Calculated from Bureau of Labor Statistics Databases, Tables & Calculators at https://data.bls.gov/timeseries/CUSR0000SA0&Output_View=Pct_1mth

6 "Statement on Longer-Run Goals and Monetary Policy Strategy," Adopted Effective January 24, 2012; As Reaffirmed Effective January 25, 2022, Board of Governors of the Federal Reserve System, https://www.federalreserve.gov/monetarypolicy/files/FOMC_LongerRunGoals.pdf (May 12, 2022)

7 "Consumer Price Indexes Overview," U.S. Bureau of Labor Statistics, 2020, https://www.bls.gov/cpi/overview.htm (May 12, 2022)

- *CPI for Urban Wage Earners and Clerical Workers (CPI-W)* is the inflation metric for a subset of the CPI-U population. It focuses on about 29% of the United States' population and is a subset of the CPI-U index.[8]
- *Consumer Price Index for the Elderly (CPI-E)* is an experimental index that focuses on persons 62 years of age or older but is not yet in general use for COLA purposes. [9]
- *Chained Consumer Price Index for all Urban Consumers (C-CPI-U)* is an inflation metric for all urban consumers that uses a formula to account for the "substitution effects" of how consumption behaviors change when the price of one commodity (e.g., beef versus pork) results in consumers purchasing more of one over the other.

Inflation and its impact on retirees' cost of living is a complex subject, and defining what kind and how much of inflation a retirement plan COLA benefit should reasonably address is an important first step.

3.2 WHICH INFLATION INDEX IS THE BEST?

Much like market returns, forecasting inflation is difficult, but price inflation clearly has a negative impact on retirees' financial security. It is appropriate for public sector DB plans to consider how to best include inflation protections in their design and funding policy.

"Much like market returns, forecasting inflation is difficult, but price inflation clearly has a negative impact on retirees' financial security."

Myriad studies address which inflation index most accurately measures the actual change in cost of living. The BLS acknowledges the CPI indices do not completely measure cost-of-living changes. A more complete CPI measurement would use additional variables to provide a closer measurement of changes in cost of living and would take longer to calculate and publish. That said, *the BLS considers the CPI-U and CPI-W to represent an "upper*

[8] Ibid at 6.

[9] "R-Cpi-E Homepage," U.S. Bureau of Labor Statistics, 2022, https://www.bls.gov/cpi/research-series/r-cpi-e-home.htm, (May 12, 2022)

bound" of changes in actual cost of living, while it sees the Chained CPI-U (C-CPI-U) as a closer measurement of actual changes in the cost of living.[10]

Other sources assert that a better cost-of-living measure is needed for retirees because of the different basket of goods retirees consume. This brief does not delve into which measure of inflation is the most suitable for determining pension plan COLA benefits. All the current CPI indices track each other relatively closely and are reasonable estimates of cost-of-living changes in the broad sense. The use of the CPI-W arguably has the advantage of being consistent with how Social Security COLA benefits are determined and avoids added confusion and complexity for retirees that can occur when different indices are used for COLAs. A regional CPI index can also be considered, particularly for plans where the retirees tend to stay within the state.

3.3 THE SOCIAL SECURITY COLA

Social Security provides a COLA to ensure that the purchasing power of Social Security benefits is not eroded by inflation. It is based on the percentage increase in the Consumer Price Index for Urban Wage Earners and Clerical Workers (CPI-W) from the third quarter of the last year to the third quarter of the current year. If there is no increase, there is no COLA for that year. A negative CPI does not result in a reduced Social Security benefit. These Social Security COLA benefits are compounded from the original benefit amount, and there is no limit or cap to the annual increase.

The following table shows the COLA adjustments made by Social Security for the period 1975 through 2021. The average for the 47-year period is about 3.68%/year. More recently, the average over the last 25 years has been about 2.24%/year (Table 1).[11]

TABLE 1: SOCIAL SECURITY COLA, YEARS 1975–2021

10 "Frequently Asked Questions About the Chained Consumer Price Index For All Urban Consumers (C-Cpi-U)," U.S. Bureau Of Labor Statistics, 2022, https://www.bls.gov/cpi/additional-resources/chained-cpi-questions-and-answers.htm (May 12, 2022)

11 Author Calculations Using U.S. Bureau of Labor Statistics Data.

Year	COLA
1975	8
1976	6.4
1977	5.9
1978	6.5
1979	9.9
1980	14.3
1981	11.2
1982	7.4
1983	3.5
1984	3.5
1985	3.1
1986	1.3
1987	4.2
1988	4
1989	4.7
1990	5.4
1991	3.7
1992	3
1993	2.6
1994	2.8
1995	2.6
1996	2.9
1997	2.1
1998	1.3
1999*	2.5
2000	3.5
2001	2.6
2002	1.4
2003	2.1
2004	2.7
2005	4.1
2006	3.3
2007	2.3
2008	5.8
2009	0
2010	0
2011	3.6
2012	1.7
2013	1.5
2014	1.7
2015	0
2016	0.3
2017	2
2018	2.8
2019	1.6
2020	1.3
2021	5.9

*** The COLA for December 1999 was originally determined as 2.4% based on CPIs published by the Bureau of Labor Statistics. Pursuant to Public Law 106-554, however, this COLA is effectively now 2.5%.**

PART 4

COLA PRACTICES OF PUBLIC PENSION PLANS AND RECENT DESIGN CHANGES

Inflation protection features and related funding policies of public sector DB plans at the state level vary widely according to a 2021 Issue Brief from NASRA.[12] The analysis provides the following descriptions of COLA benefit design features:

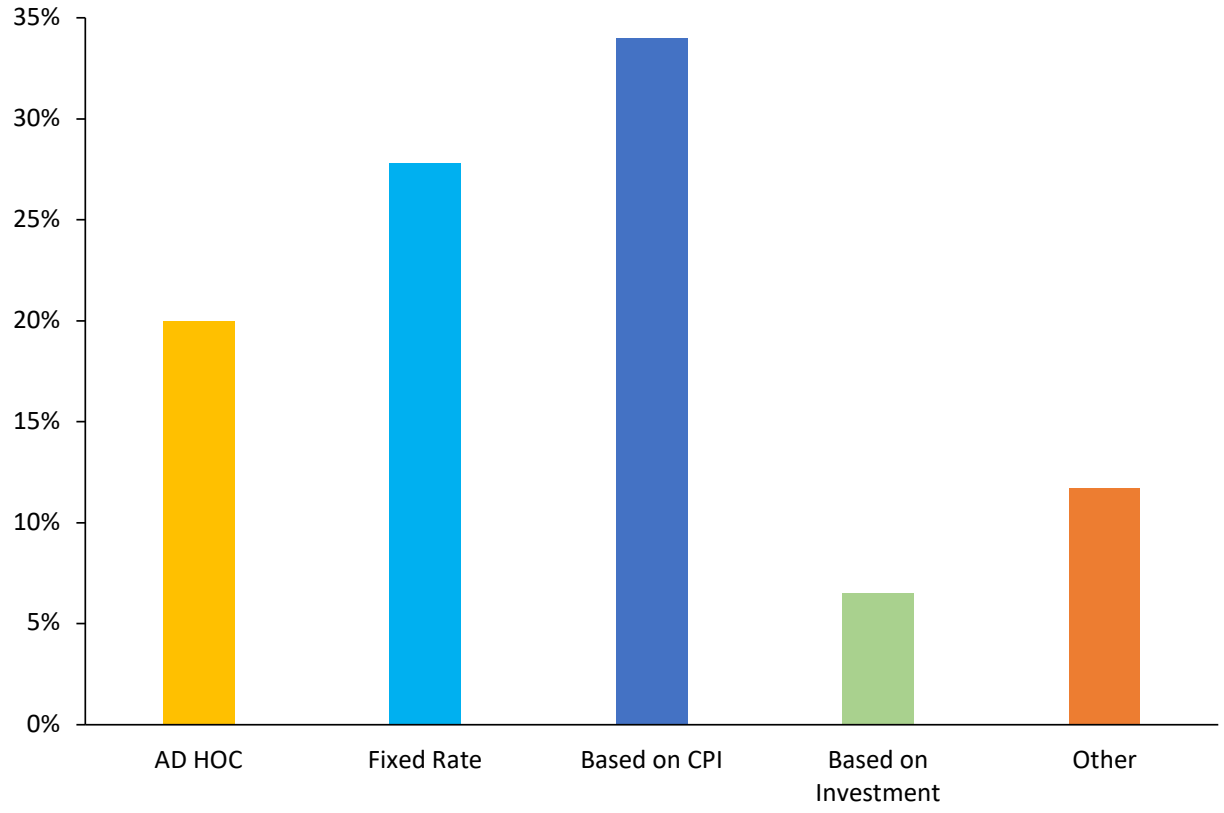
- *Automatic vs. Ad Hoc* – The COLA is provided automatically if conditions are met vs. requiring a governing body to actively approve the increase.
- *Simple vs. Compound* – Simple COLA provides an increase only on the original benefit amount at retirement vs. having the increase apply to the original amount plus any prior increases.
- *Inflation-Based* – The COLA is based on some benchmark of inflation such as the Bureau of Labor Statistics Consumer Price Index (CPI) vs. a fixed percentage or dollar amount.

12 "Nasra Issue Brief: Cost-of-Living Adjustments," June 2021, https://www.nasra.org/files/issue%20briefs/nasracola%20brief.pdf (May 12, 2022)

- *Performance-Based* – The COLA is conditioned on the plan meeting some pre-established level of actuarial funding or investment return target.
- *Delayed Onset or Minimum Age* – The eligibility for the COLA is delayed for a fixed period of time or attainment of a minimum age.
- *Limited Benefit Basis* – The COLA is applied to only a base portion of covered compensation, e.g., the first 50% of compensation or a flat dollar amount.
- *Self-Funded Annuity Option* – The COLA is based on the retiree taking a reduced annual benefit to purchase some form of COLA protection.
- *Reserve Account* – The retirement system funds the COLA through a separate reserve account established for that purpose, which determines the amount of any increase based on the funding level and/or performance of that fund.

A 2011 analysis by an actuarial firm summarized the COLA design approaches used by 100 large public plans in the NASRA and NCTR Public Fund Survey in the following chart:

FIGURE 3: COLA APPROACHES USED BY LARGE PUBLIC PENSION PLANS



Source: GRS Insight, Postemployment Cost-of Living Adjustments: Concepts and Recent Trends, April 2011

Another recurring method plan sponsors[13] use to provide some form inflation protection is through the so-called "13th check," which simply gives retirees an extra payment. There are many variations of the 13th check approach, ranging from the simple, one-time additional monthly pension payment to more-permanent amounts for the life of the retiree.

4.1 RECENT PUBLIC PENSION COLA DESIGN CHANGES

State and local government DB plans' chronic underfunding has led to several pension reform efforts over recent years, and COLAs have frequently been a focus in these reforms. NASRA reports that, since 2009, 18 states have changed (reduced) COLAs affecting current retirees and six states have changed COLA benefits only for future retirees.[14] The changes included eliminating COLAs entirely or until a target funding level is achieved, lowering annual COLA maximums, and moving to CPI-linked approaches.[15] Most of these changes have withstood legal challenges, not receiving the same level of contract protection as the base retirement benefit.[16] This lower threshold of benefit protection has provided government policymakers one of the few areas to legally change current pension designs to address funding shortfalls, and these reforms at times remove valuable inflation protection from retirees, making it detrimental to proper COLA design.[17]

The COLA design changes made in 2016 for the Arizona Public Safety Personal Retirement System (PSPRS) illustrate some of the major issues. The PSPRS had a Pension Benefit Increase (PBI) feature that allocated 50% of investment returns over 9% in a year. The PBI benefits were not directly linked to inflation and are not distributed equitably among retirees, making it a poor method of adjusting retiree benefit levels to keep up with actual changes in the costs of living. The PBI was calculated as up to 4% of the average pension

13 A plan sponsor here is a generalization that refers to a company or employer that offers a retirement plan as a benefit to employees. In the context of public pensions, these are, in most cases, employers and administrative bodies that manage the plans finances.

14 Ibid at 11.

15 Alicia Munnell et al., "COLA Cuts in State/local Pensions," May 2014, Center for Retirement Research at Boston College, https://crr.bc.edu/briefs/cola-cuts-in-statelocal-pensions/ (May 12, 2022)

16 Ibid

17 While not a focus of this paper, the author believes the Super ERISA vesting rights that exist in many states for public pension benefits (i.e., the benefit structure is contractually guaranteed even for future years of service) has created even more barriers to designing effective retirement plans for the future and has resulted in COLA benefit changes that would not meet best practices recommended in this paper. Public sector plan sponsors without the flexibility to impact future benefit accruals are left with fewer levers to pull to address pension funding problems, which can mean making future COLA benefits reductions larger than would occur if other plan design elements could be modified.

benefit in PSPRS, then distributed in a level dollar amount, regardless of the retiree's actual pension benefit level. The PBI design was a significant factor in the declining funded status of the plan. The legislature crafted a new COLA design based on regional CPI for the Phoenix–Mesa-Scottsdale area with a 2% annual maximum. The new COLA is conditioned on the system having attained minimum funding levels. The changes moved the Arizona PSPRS away from the flawed PBI, which was neither tied to actual inflation nor properly funded to a CPI-based inflation benchmark with appropriate funding and cost controls.

> *State and local government DB plans' chronic underfunding has led to several pension reform efforts over recent years, and COLAs have frequently been a focus in these reforms.*

PART 5

BEST PRACTICES FOR PUBLIC PENSION COLA DESIGN AND FUNDING

Public pension plan sponsors face a daunting challenge when trying to rationalize existing inflation protection features of their public DB plans and when they consider how to implement future COLA benefit and funding policy. They often see a history of COLA benefits being applied inconsistently over the years. For example, sometimes COLA benefits are fully funded when granted, but in other cases they have inadequate or no designated funding source. The stories of retirees with no benefit increases for many years create a desire and urgency to act. But knowing what to do and how best to do it is difficult to ascertain. Unsurprisingly, expediency becomes the deciding factor—for good or ill. To help guide plan sponsors in this complex area, this brief recommends the following best practices to the design and fund COLA benefits.

5.1 BEST PRACTICE #1: CREATE A FORMAL STATEMENT OF POLICY AND OBJECTIVES

COLA benefits should be viewed as an integral part of the plan sponsor's overall retirement benefit objective to provide public employees with financial security throughout their retirement. How and whether to provide COLA benefits is best articulated in a formal

statement of benefits policy that explains the rationale for providing or not providing the benefit.

The COLA benefit policy statement is the place to consider how a COLA benefit is prioritized versus other retirement plan objectives. COLA benefits, as desirable as they may be, are not free and need to be prioritized against other retirement and plan funding objectives. For example, a plan sponsor may decide that delivering the primary retirement benefit amount at retirement age is more important than the COLA.

Developing a formal COLA policy statement helps create transparency and benefit predictability. It better sets expectations for public employees in advance, allowing them to plan for their financial security with full knowledge of what to expect and not expect from their retirement system. It also reduces the occurrence of "squeaky wheel" politically based decision-making on COLA benefit grants.

5.2 BEST PRACTICE #2: PROVIDE A CLEAR COLA BENEFIT ELIGIBILITY STATEMENT—WHO, WHAT, AND WHEN

The COLA benefit design should clearly identify 1) who is eligible for the COLA, 2) what benefit the COLA applies to, and 3) when it is payable.

- *Who is eligible?* The COLA benefit needs to be clear about defining the eligible retiree group. COLA benefit design must address the fact that not all retirees are equal in the level and amount of lost purchasing power. Depending on when a person retired, they will have experienced more or fewer years of inflation. COLA designs such as 13th checks or flat percentage or flat dollar grants that don't recognize actual exposure to inflation create windfalls or shortfalls for those who have not been retired very long versus those retired longer.
- *What benefit is eligible for the COLA?* At the broadest level, retirees in pay status with a normal, early, or disability benefit would typically be in the eligible class of benefits for a COLA. Survivor benefit recipients in pay status would normally be included as well. Excluded classes would typically be those not in pay status, such as deferred, vested, inactive members.

  When designing benefits features of a pension plan, plan sponsors should separate COLA benefit eligibility from unique features such as a Deferred Retirement Option Program, (DROP) benefits, partial lump sum benefits, or benefits earned or suspended during a return to work. Partial retirement benefits (e.g., when an individual is allowed

to take part of their pension annuity payment and keep working part-time) is a unique situation and should be examined separately for COLA benefit eligibility. If such partial retirement payments can be increased because of the additional employment, then it should be excluded from COLA eligibility to avoid "double dipping." All these situations should be identified and classified as eligible or ineligible for the COLA benefit.

- *When is the COLA payable?* The COLA should have a defined period after retirement before it is granted. Inflation impacts on purchasing power start low and grow over time, so it is appropriate to only apply COLA benefits after a stated period in retirement. A one-year waiting period would mean some individuals may have up to nearly a two-year period for their first COLA benefit. For example, a person retiring on January first of a year would not receive a COLA until the end of the following year. This should be viewed as an acceptable practice for administration ease. Longer waiting periods may also be justified for early retirees that are expected to be able to continue to earn income from other work prior to normal retirement age.

5.3 BEST PRACTICE #3: THE COLA AMOUNT SHOULD BE RELATED TO AN OBJECTIVE INFLATION BENCHMARK

Instead of fixed or sporadic adjustment rates, COLA benefits should simply be determined based on some objective external measure of actual inflation as it impacts those eligible for the benefit. Picking one of the BLS CPI indices would meet this best practice. The CPI-W used to adjust Social Security benefits has the advantage of being more commonly understood. There are pro and con arguments for using other CPI indices—including the CPI-U, CPI-E or C-CPI-W—previously discussed in Section 3.2.

5.4 BEST PRACTICE #4: THE COLA BENEFIT AMOUNT SHOULD BE CONSISTENT, PREDICTABLE, AND CLEARLY COMMUNICATED TO THE RETIREES

The COLA benefit amount should be well-defined and clearly communicated to allow retirees a firm understanding of what to expect. COLAs should be predictable and automatically granted when clearly articulated conditions are met—e.g., once a year in the amount calculated based on an actual CPI benchmark. Even if the plan provides no COLA benefit or when there are caps or limits to the COLA, retirees are better off than not knowing what to expect. Setting clear expectations from the outset lets retirees and future retirees manage their retirement assets to mitigate inflation impacts more effectively.

Ad hoc COLA approaches are not consistent, predictable, or easily communicated. The opaque nature of these policies makes it difficult for employees and retirees to evaluate the levels of inflation-related risk they face.

5.5 BEST PRACTICE #5: THE COLA BENEFIT AMOUNT SHOULD BE LIMITED

Inflation tends to be somewhat volatile over the short run but has historically evened out over longer time periods. Inflation as measured by the Bureau of Labor Statistics CPI – W index for the period 1980-2021 shows a range from a high of 14.3% in 1980 to a low of -.7% in 2009, and about a 3.2% average per year.[18]

Not all inflation should be treated as equal for designing a COLA. The Federal Reserve considers 2% as a normal desirable rate of inflation that guides its monetary policy.[19] Obviously, actual annual inflation rates vary from this 2% expectation constantly—sometimes higher and sometimes lower. Sometimes inflation can become "unanchored" from the long-term objectives of the central banking system because of a variety of factors, including geopolitical, supply chain, and other reasons that are not easily controlled by pure monetary policy alone. In short, retirement systems have a baseline assumption for inflation, but they should be prepared for periods of unpredictability and rates that go well beyond long-term expectations.

The question public pension plans face is whether retirees should be protected from all inflation regardless of the cause or the cost. The COLA for Social Security does not have a cap, so expenditures will follow inflation as it occurs regardless of how much it costs and regardless of the funded status of the Social Security trust funds. Most public DB plan COLA benefits have caps on the amount that can be provided each year.[20]

Fiscal prudence and budget requirements of state and local government plan sponsors do not permit the granting of unlimited inflation protection. Reasonable caps on annual COLA

18 Author's calculations using Bureau of Labor statistics databases, tables and calculators at https://data.bls.gov/timeseries/CUSR0000SA0&output_view=pct_1mth

19 "Review of Monetary Policy Strategy, Tools, and Communications," U.S. Bureau of Labor Statistics, 2020, https://www.federalreserve.gov/monetarypolicy/review-of-monetary-policy-strategy-tools-and-communications-statement-on-longer-run-goals-monetary-policy-strategy.htm (May 12, 2022)

20 Marc Joffe, "Inflation Could Significantly Raise Costs For Some Public Pension Systems," Reason Foundation, April 2022, https://reason.org/commentary/inflation-could-significantly-raise-costs-for-some-public-pension-systems/

benefits should be in place and tied to long-term "normal" inflation expectations. Using the long-term Federal Reserve 2% target or the 3% long-term inflation average based on the CPI-W are reasonable cost control features that should be adopted. This will mean there will be periods where plan COLA does not fully protect retirees from reduced purchasing power. It should not be the plan sponsor's responsibility to protect against non-normal inflationary effects that cannot be funded in advance on a predictable basis.

5.6 BEST PRACTICE #6: COLA COSTS SHOULD BE PRE-FUNDED AS PART OF THE OVERALL RETIREMENT PLAN NORMAL COST

Best Practice #1 makes the case that COLA benefits should be viewed as an integral part of the plan sponsor's overall retirement benefit policy. A corollary to that best practice is that, like the core retirement benefit, COLA benefits should be pre-funded as part of the entire retirement plan's normal cost. Advance funding helps avoid creating unfunded liabilities being passed on to future generations of employees, employers, and taxpayers.

Prefunding is only possible if the cost of the COLA benefit being promised can be readily determined and predictable on an actuarial basis. The COLA design must have guardrails and limits to reduce the risk of creating large unfunded liabilities because of investment and other negative actuarial economic and demographic experience losses. This is to ensure that existing promises are fulfilled before any additional promises are made.

Prefunding COLA benefits as part of normal cost of the pension plan helps avoid short-term political decision-making around the issue. It also avoids complicated funding schemes such as separate COLA reserve funds that can be subject to different actuarial funding methods and assumptions that need to be managed apart from the core retirement benefits.

5.7 BEST PRACTICE #7: COLA BENEFITS SHOULD BE SUBJECT TO CHANGE FOR FUTURE ACCRUALS AND NEW EMPLOYEES

A corollary to Best Practice #1 is that plan sponsors should retain the flexibility to change the COLA promise for the future if circumstances require. Specific provisions should be incorporated into the COLA to ensure this is not a "permanent" contract or property right benefit that can't be modified for future accruals for current employees and for new hires. Balancing the interests of the plan participants and those of the employers and taxpayers is

extremely challenging, but it is crucial to ensure the long-term sustainability of both pension and inflation protection benefits. The flexibility to adjust COLA benefits for future employees and accruals allows policymakers to optimize this balance in a way that best works for both sides of the arrangement. It also reduces the chances of lawmakers simply dropping COLA benefits altogether when there are more compromises available at their disposal.

5.8 BEST PRACTICE #8: PLAN SPONSORS SHOULD REFRAIN FROM MAKING THE SAME MISTAKES

COLA grants of the past that don't meet the suggested best practices should not be repeated, but perhaps the most important rule is to not create new unfunded liabilities. Any new COLA grant should meet the "do no harm" principle. In practice, this means public plan sponsors should pre-fund all COLA benefits. Any new COLA grant that does not have an accompanying *new* funding source to come with it violates this best practice standard. For example, an ad hoc COLA grant for existing retirees that adds to the unfunded liability without new funding to pay for it is problematic because it adds to the burden and risk of future taxpayers and potentially active retirees.

An argument can be made that allowing plan sponsors to change COLA benefits is inconsistent with the objective to have a predictable level of inflation protection built into the plan design. The recommended best practice strikes a balancing of interests with accrued benefits being protected but future COLA promises for existing and new employees subject to change as circumstances warrant.

5.9 BEST PRACTICE #9: PLAN SPONSORS SHOULD NOT TRY TO FIX ALL PAST INFLATION

Not all past inflation has to be fixed. This can be a controversial and unpopular position to take, but public retirees of the past do not have a priority claim against the limited resources of current and future government budgets or against the needs of other members of the citizenry. Doing the best you can is the privilege and burden of current plan sponsors, and adhering to these best practices can help make more-prudent COLA benefit decisions for the future.

PART 6

BEST PRACTICES VERSUS COMMON COLA DESIGNS

The following provides an analysis of some common COLA practices compared to the Best Practice standards just discussed.

TABLE 2: ANALYSIS OF COMMON COLA FEATURES FOR BEST PRACTICES

Common COLA Practices	Best Practice Analysis
Ad Hoc COLAs	Ad hoc COLAs lack predictability, consistency and can result in uneven purchasing power protection based on when a person retired.
Flat Dollar COLAs PBIs and 13th checks	Flat dollar COLAs and PBIs are not tied to an actual CPI benchmark and benefit retirees unevenly regardless of their initial benefit amount or time in retirement.
Flat Rate COLAs	Flat rate COLAs (e.g., 3% for everyone each year) generally will not meet best practice standards because the increase is not tied to an actual inflation benchmark.
COLA Based on Gain Sharing	COLAs based on achieving some predetermined excess investment return amount on the assets of the pension fund are a way to

Common COLA Practices	Best Practice Analysis
(Excess Investment Return)	provide some inflation protection. However, it can result in uneven inflation protection for retirees. In addition, it can become a burden on the fiscal health of the pension plan resulting in systemic problems. This approach diverts investment returns away from other funding needs of the pension and may result in the need to reduce the long-term investment rate for the main plan as years of excess return diversion reduce the ability to cope with down markets. Additionally, it can also negatively impact the ability to meet the amortization schedule of unfunded liabilities.

PART 7

PRACTICAL CONSIDERATIONS

Public plan sponsors are rarely faced with the simple question of designing a COLA feature for their DB pension plans for the first time. Almost invariably there has been a history of actions that make simple decisions more complicated. They may be facing:

- *Generational Inequities:* The previous COLA features and grants create an uneven playing field of those retirees who received COLAs and those who didn't and in varying amounts and at various times. Maintaining equity between generations of retirees can be a Gordian Knot of epic proportions. For example, assume a state legislature provides a one-time 3% COLA for retirees in 2022 regardless of when a person retired. A person who had been retired since 2010 would have experienced about 25% in compounded inflation but a retiree retired since 2015 would have experienced about 15% in compounded inflation.[21] The one-time 3% COLA would be viewed as inequitable by the 2010 retiree because of their longer exposure to inflationary impacts. The plan sponsor is faced with the problem of trying to address inflation but has done so in a way that treats more-recent retirees better than longer-term retirees.
- *Pension unfunded liabilities:* If the pension system is underfunded (as most are), then it is harder to justify granting a new COLA that adds to costs or creates greater risk of underfunding down the road. This is why fully funding pensions should be an upmost

[21] Author calculations based on Social Security COLA adjustments for the periods noted.

priority for all plan sponsors and should be a concern for members of these plans. Fulfilling pension promises is, in most cases, a constitutional obligation, therefore the primary retirement vehicles—the main defined benefit plan—must take priority in budgets and funding over offerings for inflation protection. Long-term policies of public retirement systems usually reflect this hierarchy, so it is usually a best practice to pair new COLA promises with reforms to improve the costs and funding of the pension plan.

Some public plan sponsors have adopted "conditional" COLA benefits as a best practice compromise.[22] For example, the Arizona Public Safety Retirement System (PSPRS)—through a state constitutional amendment process (Proposition 124)—replaced the previously existing "permanent benefit increase" COLA with a CPI-based COLA with a 2% annual cap. It further allows the restriction of the COLA if overall plan funding falls below 90% and no COLA if funding falls below 70%.

Providing conditional COLAs can result in lower inflation protection because it creates the possibility of uneven COLA grants over time.[23] The subordinate nature of COLA benefits to the plan's overall financial integrity allows this to happen when plans are not adequately funded.

[22] Leonard Gilroy et. al., "Arizona Voters Overwhelmingly Approve Public Safety Pension Reform," May 2016, https://reason.org/commentary/arizona-pension-reform-safety/ (May 12, 2022)

[23] "Public Pension Risk-Sharing Policies, A Policymaker's Guidebook," The State And Local Government Finance Project, The Center For Policy Research, January 2021, https://livealbany.sharepoint.com/sites/web_rockefeller/shared%20documents/forms/allitems.aspx?id=%2fsites%2fweb%5frockefeller%2fshared%20documents%2fslgf%20public%20pension%20risk%2dsharing%20guidebook%2frisk%2dsharing%20guidebook%2epdf&parent=%2fsites%2fweb%5frockefeller%2fshared%20documents%2fslgf%20public%20pension%20risk%2dsharing%20guidebook&p=true, (May 12, 2022)

PART 8

CONCLUSION

COLA design and funding is complicated at many levels. The need for some inflation protection for public pension retirees is clear, but resources to provide protection are limited. This means public plan sponsors should carefully craft COLA benefit and funding policies that help maintain financial security for retirees but do so in a financially prudent and risk-managed basis. Following the eight best practices outlined in this paper should provide some important guardrails for designing effective COLA benefits, which will help plan sponsors as they strive to strike the proper balance between cost, risk, and benefit in a way that works for both employees and employers.

ABOUT THE AUTHOR

Roderick B. Crane is an authority on public sector retirement benefit programs with expertise in the design, administration, and governance of defined benefit, defined contribution, deferred compensation, and retiree health plans sponsored by states, local governments, public higher education, local governments, and special districts.

During his 32 years of experience, Crane has worked as legal counsel to a state legislative retirement oversight committee, a retirement benefits and fiduciary consultant for two national retirement consulting and actuarial firms, and directed the public sector market strategy for one of the largest defined contribution financial services firms in this country. Crane has been an active participant in the public retirement industry through his participation and leadership in national public sector retirement associations. He has written extensively on the proper design and funding of public pension, defined contribution, and retiree health benefit programs.

Crane also has expertise regarding federal tax and workplace laws as they apply to public and private sector 401(a), 401(k), 457, and 403(b) arrangements, prefunded retiree105(h) health reimbursement accounts (HRA), as well as fiduciary and governance requirements that apply to plan sponsors and boards of trustees.