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COLA CUTS IN STATE/LOCAL PENSIONS

By Alicia H. Munnell, Jean-Pierre Aubry, and Mark Cafarelli*

INTRODUCTION

One of the more surprising responses of public plan sponsors to the financial crisis and the ensuing recession was their reduction, suspension, or elimination of cost-of-living adjustments (COLA) for current workers and, in a number of cases, current retirees. The response was surprising because it has often been assumed that public plan participants have greater benefit protections than their private sector counterparts. The Employee Retirement Income Security Act of 1974 (ERISA), which governs private pensions, protects accrued benefits, but it allows employers to change the terms going forward. In contrast, most states have legal provisions that constrain sponsors' ability to make changes to *future* benefits for current workers. Yet they were able to change the COLA for current workers and often for people already receiving it. This *brief* provides an overview of the COLA changes made to date, discusses the impact of eliminating COLAs on benefits, and explores the extent to which the courts view COLAs differently from 'core' benefits.

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COLAs IN 2009

The defined benefit plans in the public sector generally calculate the initial benefit as a product of three elements: the plan's benefit factor, the number of years of employee service, and the employee's average earnings. In order to mitigate the effect of inflation on retirement income, most public plans provide retirees with a post-retirement COLA.

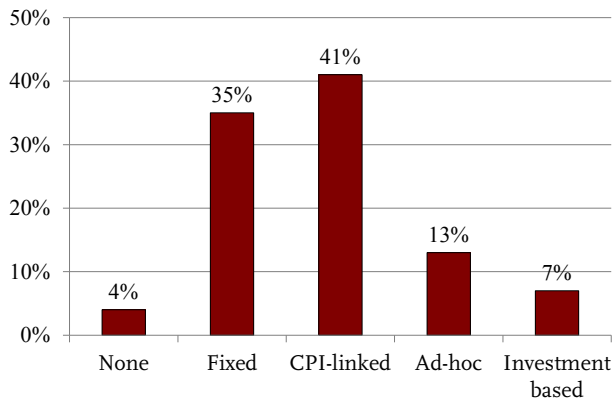
COLAs come in four main forms: 1) fixed rate – the increase is a constant percentage or dollar amount that is not tied to the Consumer Price Index (CPI); 2) CPI-linked – the increase is tied to the CPI; 3) ad-hoc – the increase is set by the legislature and revised on an ad-hoc basis; and 4) investment-based – the increase is tied to some financial metric, generally the plan's overall funded level or the level of assets in a special COLA fund. As of 2009, about 75 percent of public plans provided automatic increases – either fixed rate or CPI-linked (see Figure 1, on the next page). Roughly half of these were linked to the CPI, and these increases were generally capped at 3 percent; the other half applied automatic adjustments

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at a fixed rate specified by the plan. The remaining plans provided increases either on an ad hoc basis or linked to investment returns.

FIGURE 1. DISTRIBUTION OF STATE AND LOCAL PLANS, BY COLA TYPE, 2009



Source: *Public Plans Database* (2009).

These COLAs warrant some comment. First, trying to maintain the real purchasing power of benefits in retirement is a laudable goal. It makes little sense to leave the well-being of retirees to the vagaries of the economy. Second, inflation protection is particularly important to the 25-30 percent of state and local workers who are not covered by Social Security, which provides full inflation protection. Third, providing full inflation protection is a risky undertaking for state and local governments because few states have economies that can ensure the revenues to cover this type of commitment. Thus, it is not surprising that many CPI-linked COLAs are capped. Finally, and importantly when thinking about the legal ramifications of cutting or eliminating COLAs, these arrangements do not exist in private sector defined benefit plans, where sponsors virtually never provide regular post-retirement adjustments.

CHANGES TO COLAs, 2010-2013

Between 2010 and 2013, 17 states (with a total of 30 plans) enacted legislation that reduced, suspended, or eliminated COLAs for current workers and often for current retirees (see Figure 2).¹

Cutting COLAs is an extremely attractive option to plan sponsors, because it is virtually the only way to make large reductions in a plan's unfunded liabil-

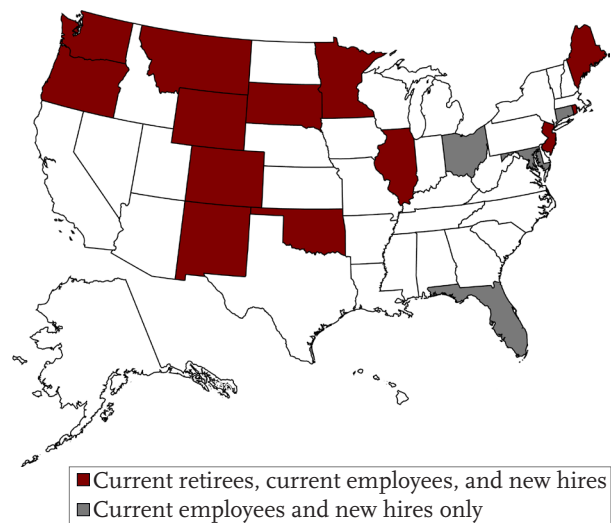
ity. Reducing benefits for new hires or even future benefits for current employees – if legally possible – lowers future pension costs but has no effect on the existing liability. The existing liability represents benefits already earned, including promised COLAs. To the extent that the cost of future COLA payments is embedded in the liability estimate, cutting COLAs reduces the unfunded liability.

All the COLA changes represent a cut in benefits, but the magnitude of the cuts varies. They essentially fall into three groups: 1) virtually eliminating the COLA for the foreseeable future; 2) reducing guaranteed fixed amounts; and 3) reducing caps for CPI-linked COLAs.

ELIMINATED COLAs FOR FORESEEABLE FUTURE

Three states with seriously underfunded plans – New Jersey, Rhode Island, and Oklahoma – essentially eliminated the COLA for the foreseeable future. New Jersey terminated all post-retirement COLAs for current and future retirees until the plans are 80 percent funded, at which point a committee will be formed to determine whether COLAs will be reactivated. Since the state has allowed funding to decline since the legislation, the prospect of 80 percent funding is very unlikely. In 2011, Rhode Island also suspended the

FIGURE 2. STATES ELIMINATING, SUSPENDING, OR REDUCING COLAs FOR CURRENT WORKERS AND/OR RETIREES



Note: Washington state closed its plan.

Sources: National Association of State Retirement Administrators (2014); and National Conference of State Legislatures (1999-2014).

COLA until the plan is 80 percent funded and tied the COLA to the investment performance of the fund thereafter. Under a mediation agreement reached in February 2014, the COLA would have been linked to the CPI as well as investment performance. However, in April 2014, the mediation agreement was rejected by police union members, so the parties are headed back to court.² Oklahoma required that any COLA must be prefunded at the time of enactment, making future COLAs very unlikely.

REDUCED GUARANTEES

Interestingly, the vast majority of states that changed their COLA had a fixed guarantee of 2.5-3.5 percent compounded annually, regardless of what was happening to inflation. These states include Colorado, Florida, Illinois, Minnesota, Montana, New Mexico, Ohio, and South Dakota. In the current low-inflation environment, such guaranteed adjustments more than compensate for increasing prices and therefore produce increasing real benefits after retirement. Three states (Colorado, Ohio, and South Dakota) abandoned the guarantee and linked future COLAs to changes in the CPI, with both Colorado and South Dakota including provisions that link the COLA to funded status as well. Two states (Minnesota, and Montana) reduced the guarantee and linked future increases to the funded status of the plan. Illinois and New Mexico simply reduced the amount of the guarantee. Florida suspended the COLA for several years, but plans to reinstate a 3-percent guaranteed increase in 2016.

LOWERED CAPS ON CPI-LINKED COLAS

Six states with CPI-linked COLAs cut their COLAs. Maine and Maryland reduced the cap on the CPI adjustment, with Maryland linking the cap to investment returns. Oregon moved away from CPI-linking

entirely, providing instead fixed COLA guarantees that vary inversely with benefit levels.³ Washington suspended the COLA indefinitely for PERS 1 (a closed plan), and Wyoming suspended the COLA until the plan is 100 percent funded. Since the plan is currently 84.5 percent funded, 100 percent is a feasible target. Connecticut lowered its minimum COLA from 2.5 percent to 2 percent.

MAGNITUDE OF COLA CUTS

A simple model suggests that eliminating a 2-percent compounded COLA reduces lifetime benefits by 15-17 percent (see Table 1). Eliminating a 3-percent COLA on the same initial benefit reduces lifetime benefits by 22-25 percent. The ranges reflect the impact of the assumed discount rate on the magnitude of the cut. With high discount rates, COLAs scheduled in the out years are not very valuable when discounted to the present; with low interest rates they are more valuable and the loss greater. Reductions in guarantees or lowered caps on CPI-linked COLAs have a lesser impact.

The seriousness of the effect on retirees depends critically on whether state and local workers are covered by Social Security. Social Security benefits are fully adjusted for price increases, so those with coverage are assured that at least their basic retirement income is inflation protected.

Four states that cut their COLA – Colorado, Illinois, Maine, and Ohio – have plans where workers are not covered by Social Security. It is worth taking a closer look at the cuts in these states.

- Colorado lowered the COLA from 3.5 percent to a modified 2 percent for those hired prior to 2007, and shifted to a CPI-linked COLA with a 2 percent cap for those hired during or after 2007.⁴
- Illinois, where participants in SURS and TRS are not covered by Social Security, reduced the COLA for those hired before 2010 from a guaranteed

TABLE 1. COLAS AS A PERCENT OF TOTAL LIFETIME BENEFITS BY DISCOUNT RATE ASSUMPTION

COLA	Discount rate				
	7.75%	7.00%	6.00%	5.00%	4.00%
2.0 percent	14.7%	15.2%	15.9%	16.7%	17.4%
2.5 percent	18.2	18.9	19.7	20.6	21.5
3.0 percent	21.7	22.4	23.4	24.4	25.4

Note: Estimates assume a retirement age of 60 and an initial benefit of \$35,000.

Source: Authors' calculations.

3 percent to 3 percent of the lesser of: 1) their current benefit; or 2) \$1,000 multiplied by years of service.⁵ Those who retire during or after July 2014 will receive COLAs only every other year for the next 10 years.⁶

- Maine froze its CPI-linked COLA for three years (2011-2013) and reduced the cap from 4 percent to 3 percent of the first \$20,000 thereafter.
- Ohio changed its three major plans, all of which rely on a simple – rather than a compounded – COLA. Ohio PERS and Ohio Police and Fire moved from a 3-percent guarantee to a CPI-linked, with a 3-percent cap. Ohio STRS simply reduced the guarantee from 3 to 2 percent, but also suspended COLAs for existing retirees from July 1, 2013 to June 30, 2014.

If inflation remains low (less than 2 percent), most public employees in the four states will not be seriously hurt by the changes in the COLA. Even at low inflation rates, however, those with higher benefits in Illinois and Maine will be affected, as these states have targeted their COLAs to retirees with benefits below \$30,000 and \$20,000, respectively. If inflation rises to 3 or 4 percent, participants in all four states at all benefit levels will see the real value of their entire retirement income erode.

HOW DID THE COURTS REACT?

Before looking at how the courts reacted to lawsuits seeking to prevent the COLA cuts, it is useful to have a little background on the legal protections afforded benefits provided by state and local pension plans. Generally public pensions appear to be better protected than pensions provided in the private sector. In the private sector, ERISA protects benefits earned to date but permits the sponsor to adjust *future* benefits.

In contrast, many states face legal constraints on the ability to change future benefits for current workers.

Most states protect pensions under a contracts-based approach. The federal Constitution's Contract Clause and similar provisions in state constitutions prohibit a state from passing any law that impairs existing public or private contracts.⁷ A handful of states that protect pensions under the contract theory have state constitutional provisions that expressly prevent the state from amending the plan in any way that would produce benefits lower than participants expected at the time of employment. Illinois and New York have such a provision. Alaska has language that specifically applies only to accrued benefits, but the courts have interpreted the provision to protect all benefits from the time participants enroll.⁸

Table 2, which is based on an earlier study of legal protections, categorizes the states as of 2012 by the extent to which benefit accruals are protected and the legal basis for that protection.⁹ States that appear in bold have cut their COLA. Interestingly, these states are not concentrated among those with the least protection, but rather are distributed evenly across all three groups.

Of the 17 states that changed their COLA, 12 have been challenged in court. The courts have ruled in nine states and in all but one case have upheld the cut. The Rhode Island proposals to cut the COLA withstood the mediation process with only minor changes but, as noted, police union members subsequently rejected the mediation agreement. Table 3 (on the next page) summarizes the status of these suits. Suits have been filed in Illinois and Oregon, but no decisions have been reached.

The main rationale for allowing the COLA cut is that COLAs are not considered to be a contractual right. For example, in Colorado, where the decision

TABLE 2. LEGAL BASIS FOR PROTECTION OF PUBLIC PENSION RIGHTS UNDER STATE LAWS

Legal basis	Accruals protected			
	Past and future	Past and maybe future	Past only	None
State constitution	AK, IL , NY	AZ	HI, LA, MI	
Contract	AL, CA, GA, KS, MA, NE, NV, NH, ND, OR , PA, TN, VT, WA , WV	CO , ID, MD , MS, NJ, RI, SC	AR, DE, FL , IA, KY, MO, MT NC, OK , SD, UT, VA	
Property	ME , WY	CT , NM, OH	WI	
Promissory estoppel ^a	MN			
Gratuity				IN, TX

^a Promissory estoppel is the protection of a promise even where no contract has been explicitly stated. Source: Munnell and Quinby (2012).

is currently under appeal, the judge found that the plaintiffs had no vested contract right to a specific COLA amount for life without change and that the plaintiffs could have no reasonable expectation of a specific COLA amount for life given that the General Assembly has changed the COLA formula numerous times over the past 40 years. In Minnesota, the judge ruled both that the COLA was not a protected core benefit and that the COLA modification was necessary to prevent the long-term fiscal deterioration of the pension plan.¹⁰ The courts clearly view COLAs very differently than core benefits. At this point, the legal hurdles to cutting COLAs appear to be quite low.

CONCLUSION

How state and local defined benefit promises have actually played out in the public sector in the wake of the financial crisis is an interesting story. Public plan participants were thought to have a higher degree of protection than their private sector counterparts. Whereas ERISA protects benefits earned to date, participants may end up with less than expected if their employer closes down the plan for reasons of economy or bankruptcy and the benefit formula is applied to today's earnings rather than to the higher earnings at retirement. In contrast, in many states the constitution prescribes, or the courts have ruled,

that the public employer is prohibited from modifying the plan. This prohibition means that employees hired under a public retirement plan have the right to earn benefits as long as their employment continues. Thus if the employer wants to reduce the future accruals of benefits, such a change usually applies only to new hires.

On the other hand, in the wake of the financial crisis, in many instances the "pension wealth" of both current employees and retirees has been reduced through reductions in the COLA. Courts apparently do not view COLAs as a core benefit protected under the laws of the state. One wonders how COLAs would be treated under ERISA in the private sector. Of course, almost no private sector defined benefit plans have COLAs, so a direct comparison is not possible.

The key point is that defined benefit promises in the public sector are not as secure as one would have thought before the financial crisis. It was the belief that they were guaranteed that led economists to argue that the liabilities should be discounted by the riskless rate for valuation purposes. But when the stock market collapsed, benefit promises were in many cases reduced.

TABLE 3. RESPONSES TO COLA CUTS, 2010-14

State	COLA cut upheld	Rationale	Court/ process	Date	On appeal
CO	Yes	COLA not a contractual right	State District	2011	Yes
FL	Yes	COLA not protected under applicable state law	State Supreme	2013	
ME	Yes	COLA not a contractual right	US District	2013	
MN	Yes	COLA not a contractual right	State District	2011	
MT	Yes	Complaint dismissed*	State District	2013	
NJ	NA	Complaint dismissed for lack of jurisdiction	US District	2012	
	Yes	Complaint dismissed**	State Superior	2012	Yes
NM	Yes	COLA not a contractual right	State Supreme	2013	
RI	Yes	NA	Mediation	2014	Mediation rejected
SD	Yes	COLA not a contractual right	State Circuit	2012	
WA	No	Illegal impairment of contract	State Superior	2011	Yes

*The court refused to issue a preliminary injunction, finding it was not clear that plaintiffs would be successful in proving that the COLA was protected as a contractual right.

** No written opinion.

Sources: National Association of State Retirement Administrators (2014); National Conference of State Legislatures (1999-2014); Buck (2011 and 2013); and various court cases.

ENDNOTES

- 1 Arizona and South Carolina have also been involved in COLA changes in recent years. Arizona, in 2011, revised the COLA structure for members of three of its smaller state-administered plans covering public safety personnel, corrections officers and elected officials. Previously, the plans granted COLAs on an ad-hoc basis funded by investment returns in excess of 9 percent, with the COLAs not to exceed 4 percent annually. The 2011 law increased the excess return threshold from 9 to 10.5 percent and linked the allowable COLA increase to the funded ratio of the plan. But these changes were soon challenged and ultimately overturned in 2012 by the Superior Court of Arizona, returning COLA provisions to their pre-2011 levels. A subsequent appeal by the State of Arizona in 2014 failed. South Carolina passed legislation in 2012 to change its COLA, but the goal was to increase, not reduce, the COLA.
- 2 As part of the mediation process, the agreement had to be approved by six groups representing state and local employees. Of the six groups, the Police MERS bargaining unit was the only one to reject the agreement.
- 3 The COLA for those who have earned an annual benefit under \$20,000 is 2 percent; between \$20,001 and \$40,000 is \$400 plus 1.5 percent; between \$40,001 and \$60,000 is \$700 plus 1 percent; and over \$60,000 is \$900 plus 0.25 percent.
- 4 Both the modified COLA and the COLA cap increase by 0.25 percent if the funded status reaches more than 103 percent, but decrease by 0.25 percent if the fund reaches at least 103 percent funded and then drops below 90 percent funded. If the plan experiences negative investment returns in any year, all COLAs become CPI-linked for the next three years. At no point can the COLA be less than 0 percent.
- 5 For example, for a retiree with 30 years of service and a benefit of \$40,000, the COLA will be the lesser of: 1) 3 percent of \$40,000 or \$1,200; or 2) 3 percent of \$30,000 (30 years of service x \$1,000) or \$900. The alternative formulation serves as a cap.
- 6 The period of intermittent COLA payments is phased in based upon a member's age as of June 1, 2014. The younger the employee, the longer the period. For those age 50 or over, COLA payments will be skipped in the second year of retirement only. For those age 47-50, no COLAs will be paid in the 4th and 6th years of retirement. For those age 44-47, no COLAs will be paid in the 2nd, 4th, 6th, and 8th years of retirement. And finally, for those age 43 and under, no COLAs will be paid in the 2nd, 4th, 6th, 8th, and 10th years of retirement.
- 7 To determine whether a state action is unconstitutional under the Contract Clause, the courts undertake a three-part test. First, they determine whether a contract exists. This part of the test involves determining when the contract is formed and what the contract protects. Second, the courts determine whether the state action constitutes a substantial impairment. If the impairment is substantial, then the court must determine whether the action is justified by an important public purpose and if the action taken in the public interest is reasonable and necessary. This approach sets a high bar for changing future benefits.
- 8 Arizona's language is less clear, but prior court rulings suggest that the protection extends to future as well as accrued benefits. In these states, changing benefits for existing employees is virtually impossible. The only real option is to amend the state constitution. In contrast, Hawaii, Louisiana, and Michigan have constitutional provisions that have been interpreted as protecting only benefits earned to date.
- 9 Munnell and Quinby (2012).
- 10 The judge deciding the case made an additional point about Minnesota TRS, which not only reduced COLAs but cut other benefits for actives and raised contributions for both active teachers and school districts: "In exercising its authority here, the legislative change to the statutory adjustment formula was a comprehensive package of amendments that spread the burden and sacrifice of stabilizing the Plans across all members, the State, and the taxpayers..."

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