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# Commentary

The Public Affairs Research Council of Louisiana

## Fix the COLA System

### The Louisiana way of retiree cost-of-living adjustments kicks the can down the road and is given at too early an age

Five years have passed since the last cost-of-living increase for retirees under Louisiana's major state retirement programs. As decision-makers consider a boost in payments for those drawing state retirement income, PAR recommends that new benefits, if granted, be funded in a fiscally responsible manner. That is far from the case for how cost-of-living adjustments, or COLAs, are funded under the current method. A better system would implement COLAs with predictable, advance funding and would set a higher age than 60 for beneficiaries to qualify.

COLAs, broadly speaking, are permanent retirement benefit increases designed to combat the effect of inflation on a retiree's check. The Legislature has the authority to grant them with a two-thirds vote. These adjustments are being sought for each of the state's four retirement systems: Teachers, State Employees (LASERS), School Employees and State Police. COLAs often enjoy support among lawmakers who want to ensure that retirees are able to pay for basic goods and services as their fixed retirement benefit loses purchasing power over the years. LASERS, for example, has had 10 COLAs in the past 22 years and none since 2009.

### How it works

The current method of funding COLAs is through a mechanism created in 1992 known as the Experience Account. When the retirement systems have particularly good returns on their investments, some of those investment earnings (or the "experience") is credited to a separate account. When these funds build up to a certain level in the Experience Account, a COLA may be given. Thus it is often claimed that COLAs are funded through the positive investment returns of the retirement system portfolios.

The workings of the Experience Account warrant critical examination. Currently, the assumed actuarial rate of return on investments for both LASERS and Teachers is 8% per year. That is not to say that every year those systems believe they will make an 8% gain on their investments. Rather, the assumption is that over a very long period their investments will average an annual 8% return.

For money to move into the Experience Account, the actuarial investment return for the year has to surpass a threshold. For LASERS, the trigger is pulled when the investment gain exceeds the 8% mark by \$100 million. Fifty cents of every dollar over that threshold pours into the Experience Account. The threshold for Teachers is 8% plus \$200 million. This flow of money is called "excess investment income," a somewhat misleading term because there is no such thing as an excess of income for retirement systems deeply in debt. Once the

funds in the Experience Account are sufficient to cover the long-range expense of a cost-of-living raise, the Legislature may grant one. Once a COLA is given, current retirees get the raise for the rest of their lives.

For example, in fiscal year 2013, Teachers and LASERS had a very good year. LASERS had a 14% investment yield that resulted in \$195 million being credited to the Experience Account while Teachers had a 13.4% return with \$219 million credited to the account.<sup>i</sup> These returns were greater than the amounts needed to pay for retiree benefit increases of 1.5%, which is the target figure used in most of the current proposed COLA legislation.<sup>ii</sup>

## The myth of funded COLAs

So while the Experience Account grows during good years, what happens if the systems earn less than what they assumed? Each time a return is less than 8%, the shortfall adds to the unfunded accrued liability (UAL) of the system. The UAL is the difference between how much employees are owed in future pension benefits and the retirement systems' ability to pay those benefits based on existing assets. The UAL can be viewed as the "debt" of the retirement systems. Combined, the four state systems have an unfunded accrued liability of more than \$19 billion. Teachers has a UAL of \$11.3 billion and LASERS' is \$6.4 billion.

There are many reasons for the UAL. One is the original debt of the system at the time of Louisiana's 1989 constitutional amendment requiring the systems be funded on an actuarial basis. A 40-year payment schedule was devised that cost the state comparatively little in the early years but ballooned in later years. That escalated payment schedule is now a major annual expense for the state. Agencies this year will pay about \$2 billion toward unfunded liabilities in the state retirement systems, a huge drain on state finances.

The largest recurring source of UAL is poor investment returns. For example, in fiscal year 2009 LASERS had a 7.6% loss, resulting in an additional UAL of \$1.4 billion. Even if a system has investment gains, those gains must be large enough to meet the system's assumed rate of return or they can create retirement debt as well. This happened in 2010, when LASERS had a 2.2% return on investments but still created almost \$500 million in UAL.

The systems do not need an 8% return every year to reach the goal of an 8% long-term average. When a system earns less than 8%, it needs a corresponding year that earns more than expected to cover the difference. As long as the good years offset the bad years, the system can function soundly.

However, the existence of the Experience Account throws a wrench in that equation. Because market gains are siphoned off in good years to pay for future cost-of-living adjustments, losses from bad years are not completely offset. The investment gains and losses of the system will not balance out, but instead there will be an increasing accumulation of debt over time. In short, the Experience Account does not add a dollar of additional funding to the retirement systems to help pay for COLAs.

The state has made improvements to the Experience Account since its creation. The account can no longer have a negative balance, retirees must now be at least 60 to get a COLA and thresholds were established to trigger credits to the account. However, the core problem remains. The Experience Account takes funds that otherwise would be used to reduce the debt of the retirement system and applies them toward permanent benefit increases. This method is particularly troublesome for Louisiana's systems that have only about 60% of the funds needed to meet their liabilities, one of the most severe liability shortfalls in the nation.

## Inconsistent benefits for retirees

From the perspective of the state as the employer, the Experience Account is a broken system that will lead to ever higher amounts of funds diverted to paying for retirement debt. However, the current system is not an ideal one for retirees either. COLAs are granted only when there is enough money in the Experience Account. The timing is completely dependent on market fluctuations. Retirees might go years without a COLA and at other times they might receive several increases in a row.

Recent history serves as an example. Increases in benefits were given to retirees in 2006, 2007, 2008 and 2009; but retirees have not received anything since then.<sup>iii</sup> If COLAs are to be given, they should have a consistent rational funding mechanism, and they should provide at least some predictability to retirees.

## Solutions

PAR's recommendations on COLAs in 2005 are still relevant today:

"The State should develop a realistic, affordable, predictable and carefully defined COLA policy for its state retirement systems. COLAs should only be provided to retirees who have reached age 65.

The existing experience accounts should be eliminated, and planned COLAs for existing retirees should be funded through employer contributions, while planned COLAs for active employees should be funded by both employer and employee contributions."<sup>iv</sup>

A predictable, reasonable system for COLAs would allow them to be funded in advance. If COLAs are going to be given anyway, a set schedule should be developed. The cost of those COLAs can then be recognized by the system and the contribution rates can be adjusted accordingly. By funding them ahead of when they are given, the retirement systems would be able to invest the funds. This approach reduces the long-term cost of providing COLAs.

Raising the eligibility age for COLAs from the current level of 60 to 65 would help reduce the cost to the state (excluding disability or death benefits). This change is fair compared with Social Security or many private pension systems. Under the current age qualification, beneficiaries in state systems might receive multiple COLAs before those in the private sector would even be eligible to retire.

If COLAs are changed to fit PAR's recommendations, policy makers should construct a program to avoid potential legal pitfalls. Future retirees might sue if COLAs were not paid in accordance to a schedule set in legislation. Therefore, care should be taken to allow the Legislature under some circumstances to modify or suspend scheduled COLAs.

The current efforts under way in the legislature to grant a 1.5% COLA for the retirees of the statewide systems should not miss the opportunity to make larger and needed changes that will provide greater sustainability. It is understandable that legislators want to provide for retirees who have not received a COLA in several years. However, if those legislators approve a COLA without fixing the system, they will be doing the same thing as the legislators before them: kicking the expense of the retirement can down the road.

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*Cost-of-Living Adjustments and Permanent Benefit Increases for Teachers and LASERS*

<b>Year</b>	<b>Teachers COLA Amount</b>	<b>LASERS COLA Amount</b>
1992	None	None
1993	None	None
1994	None	None
1995	\$1 for each year worked; \$1 for each year retired; \$1 for each year of service credit over 30 years	None
1996	None	\$.50 for every yr of service credit \$1 for every yr of service credit over 30 \$1 for every yr retired
1997	None	None
1998	\$1/year since retirement to 6/30/97; \$1/year since retirement to 6/30/97 for years in excess of 10; \$1/year of service; \$1/ year of service for years in excess of 25; \$10/month for all eligible recipients	\$1 for each yr of service credit \$1 for each yr of service credit over 30 \$1 for every yr retired \$1 for every yr retired over 10
1999	1.6% of gross benefit	1.6% of gross benefit
2000	2.0% of gross benefit	2.0% of gross benefit
2001	2.0% of gross benefit	2.0% of gross benefit
12/1/2001	Act 1172 (2001) Minimum Benefit; up to \$200, not to exceed \$1,000	None
3/1/2002	Act 1172 (2001) Survivor Benefit Increase (includes 2002 and 2003 adjustments)	None
2002	1.6% of gross benefit	1.6% of gross benefit
2003	None	None
2004	None	None
2005	None	None
2006	None	2.4% of gross benefit
2007	3.0% of gross benefit	3.0% of gross benefit
2008	3.0% of gross benefit	3.0% of gross benefit
2009	The lesser of \$300 per month or the amount necessary to increase his monthly benefit to \$1,200.	The lesser of \$300 per month or the amount necessary to increase his monthly benefit to \$1,200.
2010	None	None
2011	None	None
2012	None	None
2013	None	None

The terms COLA and Permanent Benefit Increase (PBI) are often used interchangeably. Both refer to increases in benefits after retirement to combat the effects of inflation. Minimum benefit increases affect only the retirees who receive benefits under a certain amount, such as in 2009. In the 1990s COLAs were given as increases in dollars per month based on an individual's years of service or various other criteria.

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Footnotes

<sup>i</sup> These investment returns refer to the actuarial investment return instead of the market return on assets. The actuarial return is a sort of moving average of market returns. For purposes of determining the amount in the Experience Account, the actuarial investment return is the appropriate figure.

<sup>ii</sup> Benefit increases are limited to the lesser of 3% or the increase in the Consumer Price Index, the most commonly used measure of inflation. Benefit increases are also limited to those 60 and over (unless it is a disability retirement) and to those who have been retired for at least one year.

<sup>iii</sup> Some of these increases were minimum benefit increases aimed at those receiving the lowest benefit amounts rather than across the board COLAs. The benefits also varied by system. For example, in 2006 LASERS retirees received a 2.4% COLA while Teachers retirees did not receive any adjustment. See chart on page 4 for additional detail on the history of COLAs in Teachers and LASERS.

<sup>iv</sup> PAR Research Brief [Public Employee Retirement: A Time for Change](#), March 2005. Whether a constitutional change would be necessary for some system reforms is a subject for a separate discussion.