

The Cost of Cost-of-Living Adjustments in Massachusetts Public Retirement Systems

No. 106
October
2013

A Pioneer Institute White Paper

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PIONEER INSTITUTE
PUBLIC POLICY RESEARCH

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■ **The Cost of Cost-of-Living Adjustments in Massachusetts Public Retirement Systems**

Introduction

Public employee retirement systems in Massachusetts had over 500,000 members – current employees and retirees – at the end of 2011. Public employees in Massachusetts do not participate in Social Security, meaning that for many of them their pensions will provide an extremely important source of retirement income.

Payments from the state and local governments into the pension system have been one of the largest and fastest-growing components of state and local budgets over the past decade.¹ Because pensions represent such a large expenditure and because the complex system has been subject to abuse and manipulation, the legislature and governors have repeatedly attempted to reform pension law. Since 2009, statutory changes have restricted the calculation of benefits to reduce the potential for abuse, and extended the funding schedule to postpone required employer payments – thereby taking pressure off state and local budgets.

While the recent pension reforms focused primarily on reducing the cost to the government, one component of the changes had the opposite effect: the legislation allowed local retirement boards the option of offering retirees a larger annual cost-of-living adjustment, or COLA. While Massachusetts has made its COLAs more generous, many retirement systems around the country have been reducing COLAs to save money.²

COLAs are usually meant to ensure that retirees' purchasing power does not decline. To achieve this goal, simple COLAs increase payments by the rate of inflation to keep the real value of benefits constant.³ However, the COLAs in the Massachusetts public pension

system are not simple and do not maintain retirees' standard of living. Instead, the system provides COLAs that are not directly tied to inflation and apply only to a portion of benefits.

The legislature changed state law governing COLAs in 2010 and 2011 to allow local retirement boards and governments to increase COLAs. Since then, 46 local retirement boards and the cities and towns they serve have increased their COLAs. The convoluted nature of the system makes it difficult to recognize the financial implications of raising the COLA, and some local policy makers may not understand the impact of their actions. While increasing the COLA may or may not be good policy, or fair to retirees and taxpayers, cities and towns should have clear information when they make their decisions. This report describes the somewhat unusual COLA in Massachusetts and explores the justification for and the costs of increasing the COLA. The report also investigates why some local boards have raised the COLA while others have not.

COLAs in Massachusetts

Pension COLAs are usually very simple – the annual benefit amount is increased each year to adjust for inflation. For example, Social Security payments are raised each year based on the prior-year increase in the Consumer Price Index for Urban Wage Earners and Clerical Workers, published by the Bureau of Labor Statistics. If the COLA accurately adjusts the entire pension amount for inflation, then the real value of benefits stays about the same.

The legislation governing COLAs in Massachusetts is somewhat unusual for two reasons. First, the adjustment only applies

Table 1: Impact of 3% COLA with \$12,000 COLA Base on Benefits, with Inflation of 1.5%, 2.5%, and 3.5%

	Inflation Rate	Low Pension \$10,000	Medium Pension \$25,000	High Pension \$50,000
Real value after 10 years (% change)	1.5%	\$11,580 (+16%)	\$24,860 (-0.6%)	\$46,400 (-7.2%)
	2.5%	\$10,500 (+5.0%)	\$22,680 (-9.3%)	\$42,210 (-16%)
	3.5%	\$9,530 (-4.7%)	\$20,720 (-17%)	\$38,440 (-23%)
Real value after 20 years (% change)	1.5%	\$13,280 (+33%)	\$24,860 (-1.0%)	\$43,300 (13%)
	2.5%	\$11,020 (+10%)	\$20,870 (17%)	\$36,130 (-28%)
	3.5%	\$9,080 (-9.2%)	\$17,680 (-29%)	\$30,245 (-40%)

to a portion of benefits, known as the COLA base. Through 2011, the COLA base was restricted to the first \$12,000 of benefits. The second unusual feature is that the percentage increase in benefits is not directly tied to any measure of inflation – instead it is chosen at the discretion of each retirement board up to a maximum of 3%, subject to approval by the legislative body of the corresponding governmental unit.

This legal framework has a number of implications for retirees in Massachusetts. One is that the COLAs depend on which of the retirement systems provides the pension. Retirees who had a similar work history but worked for different cities or towns (or if one of them worked for the state) would begin with the same pension, but could receive different COLAs. Until recently the disparities would have been small because most retirement boards chose the maximum 3% COLA every year and all boards were restricted to the \$12,000 COLA base. However, in the past few years the differences between boards have grown so that retirees will not be treated equally in the future.

A more significant consequence of the unusual legal structure is that the overall COLAs are not directly tied to inflation, so that the real value of benefits could increase or decrease. Retirees who receive very small pensions (because they had short careers or had very low annual earnings) could receive COLAs that are larger than inflation. However, because the maximum COLA was only \$360 (3% of \$12,000), the majority of retirees could see the purchasing power of their pensions eroded over time as the COLAs fail to keep up with inflation.

Table 1 illustrates the impact of inflation over a decade on the real value of pensions, assuming that the retirees receive a 3% COLA on a \$12,000 COLA base. It examines three retirees with low, medium, and large pensions of \$10,000, \$25,000, and \$50,000 respectively, and considers scenarios with annual inflation of 1.5%, 2.5%, or 3.5%. By reference, in the decade prior to the pension reforms, inflation averaged about 2.5% per year.

When inflation is subdued, low-income retirees are better off after 10 years because

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the 3% COLA is higher than inflation. Middle-income retirees see little impact, but high-income retirees are worse off because the COLA only applies to the first \$12,000 of income. As more time passes, these changes are magnified and the higher-income retirees continue to see their real income fall.

Massachusetts COLAs are not directly tied to inflation, so that the real value of benefits could increase or decrease.

Not surprisingly, a higher inflation rate hurts retirees. With inflation of 2.5%, which more closely corresponds to the actual rate from 2000 to 2010, low-income retirees would still be protected from inflation and see their real benefits rise. However, the middle- and higher-income retirees face relatively large declines in their purchasing power and a standard of living that deteriorates over time.

In the highest-inflation scenario, even the low-income retirees begin to fall behind the rising cost of living. The middle- and higher-income retirees see dramatic declines in their purchasing power – as much as 40% for a higher-income retiree after 20 years in retirement.

Are Restrictions on the COLA Fair?

Any discussion of fairness is obviously subjective. However, it is useful to explore who would benefit and who would be hurt by moving towards a system that maintained the real value of pension benefits.

The Public Employees Retirement Administration Commission (PERAC), the agency that oversees Massachusetts public employee retirement systems, voted in 2005 to recommend an increase of the COLA base to \$16,000. A PERAC report published

that year offers three reasons to increase the base: “the base has not kept up with inflation, the current base disadvantages the longer service employees, and it is not competitive with most other state and teacher systems.”²⁴ Each of these statements is worth reviewing briefly before exploring whether they provide justification to change the system.

Table 1 clearly illustrated that the COLA does not keep up with inflation; many retirees see the real value of their benefits fall, and the problem worsens as more time passes or inflation rises. Under very plausible scenarios, some retirees could easily see the value of their benefits fall by 50% during their lifetimes.

Table 1 also demonstrated that the current system disadvantages higher-income retirees. Some might argue that offering more protection to retirees with smaller pensions is a desirable feature of the system. However, retirees with very small pensions probably worked as public employees for a short time or in part-time jobs and may have other sources of retirement income. In contrast, employees who spent their entire careers in state or local government jobs probably depend on their pensions for a large portion of their retirement income. Under the current system, these retirees will see their real benefits erode over time and may have little recourse to maintain their standard of living.

PERAC’s final point was that the limited COLAs might make Massachusetts a less attractive place to work than other states. While the COLA in Massachusetts may be less generous than COLAs in other states, it is unlikely that this difference has any impact on recruitment or retention. The differences in retirement systems are so large and the systems are so complex that the limits on the

COLA are insignificant or extremely difficult to quantify. Public employees in different states face different wages, benefits and cost of living, and the retirement systems have different rules for vesting, contribution rates, eligibility for Social Security, retirement ages, early retirement, the calculation of benefits, survivor benefits, health care, and many other factors, as well as different COLAs. It is hard to believe that the COLA restriction would be the determining factor that influences prospective employees' choice of a job. Massachusetts has had the unusual COLA limitations for many years, but there is no evidence that it has prevented state or local employers from hiring qualified employees.

Although the current system allows many retirees to lose ground to inflation, it is not clear if this is ample justification to make changes. One could argue that employees understood the system when they accepted jobs, and that the state is not responsible for increasing pensions beyond what was promised when employees were hired. As an editorial in the Boston Globe stated when the legislature was considering an increase in the COLA base, “[I]awmakers have generally maintained that benefits for current employees must never be diminished – not by a penny – but have been willing to increase them time and time again.”⁵ As noted at the beginning of this section, fairness is a matter of subjective criteria.

Increasing the COLA Base

In recent years the state legislature has made two changes to allow higher COLAs. The first one, Chapter 188 of the Acts of 2010, allowed local retirement boards to raise the COLA base in increments of \$1,000 up to a maximum of \$18,000, subject to local approval. One year later, in Chapter 176

of the Acts of 2011, the state increased the COLA base for state employees and teachers to \$13,000.

There is no clear answer about whether the COLA system is unfair to employees and retirees and whether the COLA base should be increased to shelter retirees from the impact of inflation. However, it is clear that changing the COLA to track inflation more closely would cost state and local governments, and ultimately taxpayers, in the form of higher required payments into the system. Therefore even if one believes that the current system does not adequately protect employees and retirees, it would be helpful to have an accurate estimate of the cost of increasing the COLA.

Unfortunately, it is easy to misunderstand the impact of a higher COLA. When the legislature was considering allowing boards to increase their COLAs, cost estimates ranging from \$230 million to \$2.2 billion were published in local media.⁶ The huge range of the estimates was due mostly to different assumptions about what counted as a cost and whether to include the potential cost to local systems, as well as when the costs would ultimately be paid.

The COLA base for the state and teachers' retirement systems is \$13,000, while the other systems can raise their base up to \$18,000.

Even ignoring potentially partisan reports, the estimates still varied widely. PERAC reported that the system's liability would increase by less than \$300 million, while the Executive Office of Administration and Finance indicated that the cost would be \$1.5 billion over 30 years.⁷ The primary

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reason for the wildly different estimates is that PERAC evaluated what the state would have to appropriate immediately to cover all future costs, while A&F considered the total appropriations over 30 years because the payments would likely be spread out.

Unfortunately, the competing estimates made it somewhat difficult for legislators to evaluate the impact of their votes and make an informed decision, but at least the estimates were available. When local boards make decisions, they may have little or no information about the total cost of the change, and in other cases they may even face misleading information.

Evaluating the impact of raising the COLA is not intuitive; even financial professionals used to dealing with municipal budgets may not recognize the true cost of increasing the COLA. The following sections of this report focus on estimating the cost of COLA increases to local governments, both those already made and prospective changes, and also examine why some boards have raised the COLA while others have not.

Why Is It Difficult to Recognize the Cost of Increasing the COLA?

With a COLA base of \$12,000, a retiree receiving a pension of at least \$12,000 would be eligible for an additional COLA of \$360 each year, assuming that the retirement board grants the full 3% COLA. Increasing the base to \$13,000 would mean that the annual COLA rises to \$390 for everyone with a pension of at least \$13,000 – an increase of only \$30, which is often cited when discussing changes to the COLA base.⁸ For any individual retiree, the increase appears very small, and it seems logical that the total cost to a retirement system would also be small; unfortunately, this intuitive feeling is wrong.

There are two reasons why this intuition leads people to misunderstand the cost of changing the COLA base. The most important is that the benefits compound over time, as illustrated in Table 2.

A retiree would only get an extra \$30 the first year – an insignificant amount. But during the second year she would receive the slightly larger increase again (\$390 vs. \$360), which would mean that her total pension would be \$60 higher than it would have been had the

Table 2: Impact of \$1,000 Increase in COLA Base on a Retiree with a \$25,000 Pension

Year	Base=\$12,000	Base=\$13,000	Difference
0	\$25,000	\$25,000	\$0
1	\$25,360	\$25,390	\$30
2	\$25,720	\$25,780	\$60
3	\$26,080	\$26,170	\$90
...
25	\$34,000	\$34,750	\$750
Total	\$767,000	\$776,750	\$9,750
Present Value⁹	\$320,598	\$323,459	\$2,861

COLA base not been raised. This difference jumps to \$90 during the third year, and so on. If the employee lived for 25 years in retirement, by the end she would be receiving \$750 more with the higher COLA base, and over her lifetime she would receive an extra \$9,750.¹⁰

In other words, a retirement board that increases the COLA to \$13,000 has effectively promised this retiree almost \$10,000 – quite a bit larger than the \$30 that is evident during the first year. Stating that the change would only increase a retiree’s benefits by \$30 per year is not wrong, but it could be misleading.

A \$1,000 increase in the COLA base adds about \$10,000 in payments over the lifetime of an employee with a \$25,000 pension.

While the change in the COLA would lead to \$10,000 in additional payments, this is not the way that PERAC or most financial professionals would measure the cost. Instead, they would evaluate how much money the retirement board would have to invest today to cover the additional payments. In this example, the retirement board would have to have \$2,860 invested and earning 8.25% interest to cover the higher payments – i.e., the “unfunded liability” would increase by this amount.¹¹ This \$2,860, along with the investment return it generates, would amount to enough money to make the \$10,000 in payments.

Neither of these methods measures the actual impact higher COLAs have on annual appropriations. The government would typically not appropriate the entire \$2,860 immediately, nor would it simply appropriate the \$10,000 in higher pension payments.

Instead, the liability would probably lead to higher payments spread out over the next decade or more. If the payments ran for 20 years and included 4% annual growth in appropriations (parameters that are broadly in line with funding schedules used by many retirement systems), increasing the COLA for this single retiree would require additional appropriations of about \$6,600 spread over the next 20 years.¹²

These alternative ways of looking at the cost (extra benefit payments, impact on current liability, or increased future appropriations) help explain why the publicly quoted figures vary so widely. None of the methods are necessarily wrong – they simply represent different ways of looking at the cost. As stated earlier, the more conventional way to evaluate the impact is to use the change in liability, with the knowledge that the actual budgetary impact will be larger and spread out over many years.

Regardless of how we measure the impact, the figures above represent the cost for a single employee. If a system has hundreds or thousands of retirees, the financial impact of the extra \$30 per year can grow quite large.

Another factor that leads people to underestimate the cost of changing the COLA is that the decision affects not only current retirees, but every future retiree as well. Even if a system only had one current retiree, the cost would not end when that person passed away. Instead, every retiree in the future would also receive larger benefits, which contributes to the overall cost.

Under current Massachusetts law, COLA base increases are irreversible and apply to all future retirees.

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Table 3: Local Boards by COLA Base for 2014

COLA Base	\$12,000	>\$12,000	\$13,000	\$14,000	>\$14,000
Number of Boards	56	47	18	17	12
Number of Retirees	31,600	56,000	27,800	16,400	11,900
% of Retirees ¹³	36%	64%	32%	19%	14%

Who Has Already Raised the COLA Base?

In 2010, the legislature changed the law to allow local retirement boards to increase the COLA base, and one year later they increased the COLA base for the 110,000 retired state workers and teachers to \$13,000. As of 2013, forty-seven of the 103 local retirement boards, or 45%, had already raised the COLA base (see Table 3 and Appendix 2). These boards serve 64% of the retirees in the state covered by the local systems. Most of the boards that have made a change have increased the base by more than \$1,000 – twenty-eight have a COLA base of \$14,000 or higher, and two have increased the base up to the statutory maximum of \$18,000. At least five of these boards will increase their COLA bases further in 2014.

It would be interesting to understand why some local boards have increased the COLA base and others have not. According to the revised pension law, a majority of the retirement board must vote to raise the COLA base, and the vote is subject to approval by the local legislative body. Retirement boards are often sympathetic to the needs of retirees and are probably likely to support increasing the COLA. However, the legislative bodies that must approve the increase could be influenced by political or financial factors. For example, a municipality's income, financial condition, or governing structure could determine whether it would support an increase, as might the political views of voters or their representatives.

A factor that seems associated with increases of the COLA base is whether the board is a regional or county board. While only 31 out of the 85 city and town boards have increased the COLA base, 14 out of 15 county or regional boards have done so. Furthermore, nine of the 15 have already raised the base above \$13,000.

The greater tendency of county and regional boards to approve COLA base increases may be because the approval process is further removed from taxpayers than it is in the municipal boards. While in cities and towns the city council or town meeting must approve an increase, in a regional board the increase must be approved by a retirement board advisory council. The additional bureaucratic layer could reduce the weight given to costs when the decision is made.

In addition to the municipal and regional boards, there are also three boards serving state authorities: those of the Massachusetts Port Authority (MassPort), the Massachusetts Housing Finance Agency (MassHousing), and the Massachusetts Water Resources Authority (MWRA). Two of these three boards, MassPort and MassHousing, have increased the COLA base. It is difficult to generalize from only three cases, but MWRA may be more sensitive to costs because the board is controlled by appointees from local communities and the costs are passed on directly to member communities, while MassPort and MassHousing have little accountability to taxpayers.

Regional and agency retirement boards are more likely to raise the COLA base, perhaps because they are less accountable to communities and taxpayers.

Beyond the distinction between municipal and regional or county boards, there are no other identifiable characteristics that could explain why some boards have raised the COLA base and others have not. For example, the governing structure does not seem to have a noticeable impact; cities and towns are approximately equally likely to have raised the COLA. Similarly, the percentages of local voters registered as Democrats or Republicans, which could capture their views on fiscal matters or support for unions, also show little correlation with the decision on the COLA base.

The relationship between the size of the board and the decision on the COLA base is not clear. While eight of the ten largest boards have raised the COLA, five of the eight are county boards. If county boards are excluded, only four out of the ten largest retirement systems have raised the COLA. Similarly, five out of ten of the smallest municipal boards have raised the COLA.

We also explored whether financial variables might help explain the decision. One possible consideration was that the municipality's ability to pay for the expanded benefits might affect the decision. To test this, we examined the average income in a community and the recent growth in local government revenue, but neither was strongly correlated with the choice. In addition to the resources, we also looked into whether the current financial condition of the pension system influences

the decision – i.e., perhaps systems with smaller unfunded liabilities might feel more comfortable with an increase in the COLA. However, the funding condition does not appear to impact the decision; boards that have raised the COLA base had similar pension funding ratios to those that had not raised the COLA base.

Cost Estimates

The purpose of this report is not to argue whether the COLA base should be raised, but to explore the financial impact of the choice. The cost of increasing the COLA depends on many factors. The most important is the number of retirees with pensions greater than \$12,000. Of course a system with more retirees eligible for the COLA will have higher costs, as will a system where retirees are likely to continue to collect COLAs for many years. Because an increase in the COLA will apply to all future retirees as well as current retirees, a detailed model would also include data on current employees: their numbers, their ages, the number of years they are likely to continue to work, and their predicted wages until retirement.

Local retirement boards and their actuarial advisors are in the best position to model the impact of a change in the COLA. However, we have enough information to produce some rough estimates for every retirement system in the state. To generate cost estimates for each local board, we began with PERAC's estimate of the cost of the 2011 legislation that raised the COLA base for state workers. PERAC's figures indicate that for every retiree receiving over \$12,000 in benefits, the increase in the COLA cost is approximately \$3,400.

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We then applied this per-retiree cost to the number of retirees receiving more than \$12,000 in each local retirement system. The actual headcounts of retirees with more than \$12,000 in benefits were available for 48 of the local systems that responded to our requests for data, and for the remaining systems we estimated the number. The estimated headcounts were based on the positive relationship between the average retirement benefit and the percentage of retirees receiving more than \$12,000 per year – systems with higher average benefits have a higher percentage of retirees earning at least \$12,000. We estimated the relationship between these variables and used it to predict the percentage of retirees earning above \$12,000 in the systems for which we did not have actual data (see Appendix 1).

Appendix 2 provides cost estimates of raising the COLA to \$13,000 for every retirement board in the state. The figures for each local board are approximate – more accurate figures would require more detailed data about current retirees and employees. For the most part our estimates should be reasonably accurate, but if a retirement system has an unusual number of retirees receiving more than \$12,000 in benefits or atypical demographics, then the corresponding estimate will have a greater error. The estimates indicate that if every local system in the state raised the COLA base by \$1,000 the total impact on liabilities would be \$203 million, or \$2,300 per retiree.

As a point of comparison, when the state raised the COLA base for state workers and teachers, PERAC estimated that the impact on liabilities was \$286 million or \$2,600 per retiree.¹⁴ For local retirement boards the per-retiree figure is lower because a larger number of local retirees receive less than \$12,000 per

year in benefits and are not affected by an increase in the COLA base.

If every local system in Massachusetts increased the COLA base by \$1,000, pension liabilities would increase by \$2,300 per retiree for a total of about \$203 million.

As explained previously, these figures represent the impact on current actuarial liabilities. Because retirement boards do not have this money invested, a plausible funding schedule that spread the payments out over 20 years would require much larger appropriations – \$470 million if every local board had raised the COLA (see Appendix 3).¹⁵ The figures also represent only the impact of decisions by *local* retirement boards (including the state authorities); the \$286 million cost of raising the COLA for retired state employees and teachers is not included.

State law allows local retirement boards to raise the COLA base not only to \$13,000, but all the way to \$18,000. If every system in the state raised the COLA to the maximum amount currently allowed by law, the total increase in liability would be more than \$1 billion and cities and towns would have to appropriate an additional \$2.5 billion over the next 20 years.

The figures above illustrate the hypothetical total cost if every system were to raise the COLA from \$12,000 to \$13,000. However, many systems have already acted and incurred a cost. As shown previously in Table 3, approximately 64% of retirees have already had their COLA base increased – in most cases beyond \$13,000. The COLA base changes that have already been approved have

increased unfunded liabilities by roughly \$214 million and will require some \$500 million in additional appropriations over the next 20 years. These retirement systems had an unfunded liability of more than \$6 billion and were only 58% funded before the increases in the COLA base.

Do Lawmakers Understand the Cost of Increasing the COLA?

When legislators and the governor were debating increases of the COLA, advocacy groups and government agencies published a wide range of competing estimates of the cost of the proposal. Most of the differences were due to different assumptions or methodologies, and if these differences are reconciled the range of cost estimates narrows considerably.¹⁶ Presumably the legislature was aware of the approximate cost of the provision when they voted to increase the COLA base.

Local retirement boards and legislative bodies may have adequate staff to calculate the cost accurately, or outside organizations may evaluate the proposals and provide cost estimates, but this does not mean that the costs will be reported fully or in a consistent manner. For example, in 2012 Boston considered proposals to increase its COLA base. At the time, policymakers, the media, and the public had access to estimates of the cost of the proposals, but both the estimates and the methods used to arrive at them varied widely (some estimates evaluated the impact on the unfunded liability, others looked at the additional annual spending by the pension system over many years).¹⁷

While state and Boston officials had at least rough estimates of the cost of changing the COLA base, the financial impact of

policy decisions may not be clear to other local policymakers. Because the cost is not simple to evaluate, smaller cities and towns may not have the expertise to get a more comprehensive estimate and may rely instead on misleading statements such as “the \$1,000 boost would increase retiree pensions **by just \$30 a year**” (emphasis added).¹⁸

A presentation by the Franklin Regional Retirement System on the impact of increasing the COLA base provides a good example of the type of confusing information presented to local policymakers.¹⁹ The presentation states that its purpose “is to report the impact of raising the COLA base” and lists the main benefit of raising the COLA as helping retirees, which is of course accurate. However, rather than arguing that helping retirees would be fair and is worth the additional cost, the bulk of the presentation contains misleading, unclear, or inaccurate statements. The muddled analysis leads to a questionable conclusion that raising the base “provides a large benefit to the entire region even after subtracting the costs.”

The report states that “[t]he second beneficial impact would be the sizeable increase in the inflow of dollars to the region” – i.e., that the higher pension benefits would help the economy. The presentation overestimates this inflow over the next 20 years by overstating the life expectancy and therefore the amount of extra income that retirees will receive, but more importantly it assumes that every dollar paid to a retiree will be spent within the local communities. In reality, the benefit to the local economy would be small because the majority of any increase in spending leaks out to manufacturers and other businesses outside the region.

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The presentation also treats the source of funding in a misleading way. In a section titled “Costs” the presentation states that:

The second benefit is achieved by investing some money. The employer units will collectively invest to address the increased actuarial liability of \$700,000 over 20 years through an increase in the annual assessments. This \$700,000 is one quarter of the \$2.8 million that will return to the region, which will mostly be from investments.

This statement may be somewhat hard to follow, but it seems to argue that any funding required from local governments will be invested and the local economies will benefit because of the investment return on their contributions. In other words, the cost is actually a benefit. By this logic, the more money local communities appropriate, the greater the benefit to the local economy.

This argument is wildly inaccurate for several reasons. First, the \$2.8 million is an overestimate and, even if accurate, most of it would not benefit the local economy. It also implies that the \$700,000 will be appropriated over 20 years, which is not correct. This cost represents the amount needed at that time to cover the increased expenses; the actual budgetary cost in required appropriations over the next decades would be much larger. Finally, the presentation ignores the question of where the municipalities will find the \$700,000 and how this drain on local resources will affect the local economy.

The presentation goes on to state:

The board is being presented with options that will allow the board to mitigate to zero the increase to the FY2012 assessment attributable to the increased COLA benefit to retirees... These options are also available to the board when it is working to accommodate an increase to the COLA base, allowing the

board to minimize the cost impact while providing beneficial impacts.

To a reader without in-depth knowledge of how the retirement system works, the implications of this statement may not be clear. In plain English it means that payments are being postponed and that future taxpayers will have to pay significantly more, and it neglects to point out that by delaying payments the liability will increase by 8% per year. The options do not minimize the cost, they shift it onto future taxpayers.

Increasing the COLA may be the right choice for a community to make to help protect retirees from inflation, but it is quite a stretch to imply that it will help the local economy. Given the unclear language of the presentation, it is hard to believe that a citizen or representative in one of the affected communities would have understood the true cost to his or her town and been able to make an informed decision. Perhaps not surprisingly, Franklin Regional was one of the first retirement boards in the state to approve an increase in the COLA base.

Conclusion

The COLA system for public employees in Massachusetts is very unusual. The annual COLA is not tied to any inflation measure and only applies to a portion of benefits. In most years, the COLA offers retirees only partial protection from inflation to retirees, and it is not clear whether those protected are most deserving or in need.

The very limited COLA has reduced the cost of benefits for both state and local pension systems relative to more widely accepted COLA practices – completely protecting all employees from inflation would increase liabilities by more than \$5 billion²⁰ and

require massive annual appropriations at both the state and local level.

While the limitations on the COLA reduce the cost to taxpayers, advocates for retirees have questioned the fairness of the limited protection. Depending on future inflation rates, some retirees could see the real value of their pension decline by as much as 50% over their lifetimes.

In 2010, the legislature changed the law to allow local boards to increase the generosity of the COLA to protect retirees better. Since that time, local retirement boards representing roughly 53,000 retirees have decided to increase COLAs. Regional or county retirement systems were much more likely to increase the COLA base than other local boards, but beyond that it is difficult to explain why some systems acted and others did not. The increases in the COLA base have had large costs that local policymakers and voters may not fully appreciate; this report attempts to provide better information for future discussions about raising the COLA.

About the Authors

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Appendix 1: Estimating the Number of Retirees with a Pension Greater than \$12,000

The cost of raising the COLA base depends on the number of retirees who receive benefits above \$12,000 per year, because they are the ones who would be affected by the increase. We contacted the local retirement boards to ask for this figure, and 48 of the boards responded. For those boards, we use the reported number of retirees who earn more than \$12,000.

For the remaining boards we estimate the number of retirees who would be affected by an increase in the COLA base. The estimates are based on a linear regression of the percentage of retirees receiving more than \$12,000 on (a) the average benefit level and (b) the average benefit level squared – the regression results are shown below.

Adjusted R-Squared	0.53	
Variable	Estimated Coefficient	T-Statistic
Constant	-0.11	-0.7
Average Benefit (\$000s)	0.064	4.1
Average Benefit Squared	-0.0013	-3.2

In four communities (Amesbury, Arlington, Concord and Dedham), the reported number of retirees receiving more than \$12,000 per year does not appear compatible with PERAC data on the average benefit levels. These four communities were therefore excluded from the regression.

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Appendix 2: COLA Base and Costs Estimates by Board

Retirement Board	FY12 Retirees	Number with Pension of More than \$12,000 ²¹	2014 COLA Base ²²	Cost to Raise COLA to 13,000	Cost Already Incurred
Adams	132	54	\$14,000	\$185,000	\$361,000
Amesbury	223	218*	\$12,000	\$748,000	\$0
Andover	396	255	\$12,000	\$875,000	\$0
Arlington	635	212*	\$15,000	\$727,000	\$2,108,000
Athol	148		\$12,000	\$281,000	\$0
Attleboro	390	278	\$12,000	\$954,000	\$0
Barnstable County	2,556		\$14,000	\$5,750,000	\$11,213,000
Belmont	343		\$12,000	\$832,000	\$0
Berkshire County	679	342	\$14,000	\$1,173,000	\$2,287,000
Beverly	429		\$12,000	\$1,022,000	\$0
Blue Hills Regional School	54		\$16,000	\$101,000	\$389,000
Boston	14,189	10,478	\$13,000	\$35,940,000	\$35,940,000
Braintree	496	375	\$12,000	\$1,286,000	\$0
Bristol County	2,239		\$15,000	\$4,900,000	\$14,210,000
Brockton	1,278	922	\$12,000	\$3,162,000	\$0
Brookline	875		\$13,000	\$2,126,000	\$2,126,000
Cambridge	1,893		\$14,000	\$4,601,000	\$8,972,000
Chelsea	384		\$12,000	\$910,000	\$0
Chicopee	809		\$12,000	\$1,877,000	\$0
Clinton	103		\$14,000	\$228,000	\$445,000
Concord	260	254*	\$12,000	\$871,000	\$0
Danvers	386	263	\$12,000	\$902,000	\$0
Dedham	297	299*	\$12,000	\$1,019,000	\$0
Dukes County	236	159	\$13,000	\$545,000	\$545,000
Easthampton	143		\$12,000	\$296,000	\$0
Essex Regional	1,624	970	\$13,000	\$3,327,000	\$3,327,000
Everett	544		\$14,000	\$1,238,000	\$2,414,000
Fairhaven	175		\$12,000	\$366,000	\$0
Fall River	1,513	1,047	\$12,000	\$3,591,000	\$0
Falmouth	343		\$12,000	\$804,000	\$0
Fitchburg	540	401	\$12,000	\$1,375,000	\$0
Framingham	809		\$12,000	\$1,887,000	\$0
Franklin Regional	476	247	\$14,000	\$847,000	\$1,652,000
Gardner	239	158	\$13,000	\$542,000	\$542,000
Gloucester	433	296	\$14,000	\$1,015,000	\$1,979,000
Greater Lawrence Sanitary District	22		\$12,000	\$47,000	\$0
Greenfield	230		\$14,000	\$513,000	\$1,000,000

* Data for these communities does not appear to be compatible with data on average benefit levels from PERAC. If the number of retirees earning more than \$12,000 is incorrect, the estimated costs will also be incorrect.

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Retirement Board	FY12 Retirees	Number with Pension of More than \$12,000	2014 COLA Base	Cost to Raise COLA to 13,000	Cost Already Incurred
Hampden County Regional	1,538	800	\$18,000	\$2,744,000	\$15,788,000
Hampshire County	1,111	592	\$13,000	\$2,031,000	\$2,031,000
Haverhill	1,067		\$12,000	\$2,046,000	\$0
Hingham	285		\$12,000	\$670,000	\$0
Holyoke	922	687	\$12,000	\$2,356,000	\$0
Hull	130		\$12,000	\$310,000	\$0
Lawrence	885		\$12,000	\$2,088,000	\$0
Leominster	384		\$12,000	\$866,000	\$0
Lexington	382	265	\$12,000	\$909,000	\$0
Lowell	1,157	720	\$14,000	\$2,470,000	\$4,817,000
Lynn	1,198	720	\$14,000	\$2,470,000	\$0
Malden	669		\$13,000	\$1,549,000	\$1,549,000
Marblehead	332	230	\$12,000	\$789,000	\$0
Marlborough	352	258	\$12,000	\$885,000	\$0
MassHousing	98		\$13,000	\$227,000	\$227,000
MassPort	630		\$13,000	\$1,426,000	\$1,426,000
MWRA	341		\$12,000	\$829,000	\$0
Maynard	90		\$15,000	\$213,000	\$618,000
Medford	602		\$15,000	\$1,451,000	\$4,208,000
Melrose	368	250	\$12,000	\$858,000	\$0
Methuen	421		\$13,000	\$1,004,000	\$1,004,000
Middlesex County	4,886	3,039	\$14,000	\$10,424,000	\$20,327,000
Milford	274		\$12,000	\$607,000	\$0
Milton	277		\$15,000	\$673,000	\$1,952,000
Minuteman Regional School District	37		\$13,000	\$86,000	\$86,000
Montague	114	64	\$18,000	\$220,000	\$1,265,000
Natick	360		\$12,000	\$862,000	\$0
Needham	473		\$12,000	\$1,064,000	\$0
New Bedford	1,774		\$12,000	\$4,029,000	\$0
Newburyport	217		\$12,000	\$510,000	\$0
Newton	1,319	1,005	\$12,000	\$3,447,000	\$0
Norfolk County	2,870		\$15,000	\$6,577,000	\$19,073,000
North Adams	211		\$13,000	\$455,000	\$455,000
North Attleboro	215	135	\$12,000	\$463,000	\$0
Northampton	363	286	\$13,000	\$981,000	\$981,000
Northbridge	108	64	\$14,000	\$220,000	\$429,000
Norwood	343	253	\$14,000	\$868,000	\$1,693,000
Peabody	766		\$12,000	\$1,691,000	\$0

■ The Cost of Cost-of-Living Adjustments in Massachusetts Public Retirement Systems

Retirement Board	FY12 Retirees	Number with Pension of More than \$12,000	2014 COLA Base	Cost to Raise COLA to 13,000	Cost Already Incurred
Pittsfield	749		\$14,000	\$1,609,000	\$3,138,000
Plymouth	562		\$14,000	\$1,320,000	\$2,574,000
Plymouth County	3,422		\$13,000	\$7,871,000	\$7,871,000
Quincy	1,561		\$12,000	\$3,744,000	\$0
Reading	329	235	\$12,000	\$806,000	\$0
Revere	544		\$12,000	\$1,308,000	\$0
Salem	581		\$12,000	\$1,334,000	\$0
Saugus	282	173	\$12,000	\$593,000	\$0
Shrewsbury	237		\$12,000	\$557,000	\$0
Somerville	897		\$12,000	\$2,161,000	\$0
Southbridge	166	104	\$12,000	\$357,000	\$0
Springfield	2,688	1,924	\$12,000	\$6,599,000	\$0
Stoneham	287	187	\$13,000	\$641,000	\$641,000
Swampscott	213	112	\$13,000	\$384,000	\$384,000
Taunton	742	455	\$14,000	\$1,561,000	\$3,044,000
Wakefield	365	248	\$12,000	\$851,000	\$0
Waltham	785		\$14,000	\$1,908,000	\$3,721,000
Watertown	416		\$12,000	\$1,009,000	\$0
Webster	132		\$16,000	\$283,000	\$1,090,000
Wellesley	406		\$15,000	\$958,000	\$2,778,000
West Springfield	375	229	\$13,000	\$785,000	\$785,000
Westfield	553	380	\$12,000	\$1,303,000	\$0
Weymouth	628	451	\$12,000	\$1,547,000	\$0
Winchester	286	198	\$12,000	\$679,000	\$0
Winthrop	169		\$12,000	\$374,000	\$0
Woburn	402	278	\$12,000	\$954,000	\$0
Worcester	2,777		\$13,000	\$6,615,000	\$6,615,000
Worcester Regional	2,975		\$15,000	\$5,839,000	\$16,933,000

Appendix 3: Sample 20-Year Funding Schedule

Increasing the COLA base causes an increase in liabilities. PERAC and most other analysts calculate the impact in present value – i.e., the amount that a board would have to invest immediately to cover the higher costs in the future. Because local retirement boards are unlikely to have the funding available, the liability will probably be funded over the next 20-30 years.

The table below illustrates a plausible schedule to fund the \$203 million liability that would have been incurred if every board in the state had raised the COLA base to \$13,000. The estimates are based on appropriations that increase by 4% per year and an 8% discount rate – assumptions that are similar to those used in currently existing funding schedules.

Year	Appropriation	Remaining Liability
2015	\$14,800	\$204,000
2016	\$15,400	\$204,900
2017	\$16,000	\$205,300
2018	\$16,700	\$205,100
2019	\$17,300	\$204,200
2020	\$18,000	\$202,500
2021	\$18,700	\$199,900
2022	\$19,500	\$196,400
2023	\$20,300	\$191,900
2024	\$21,100	\$186,200
2025	\$21,900	\$179,100
2026	\$22,800	\$170,700
2027	\$23,700	\$160,600
2028	\$24,700	\$148,800
2029	\$25,600	\$135,100
2030	\$26,700	\$119,200
2031	\$27,700	\$101,000
2032	\$28,800	\$80,300
2033	\$30,000	\$56,700
2034	\$31,200	\$30,000
2035	\$32,400	\$0

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Endnotes

1. For a more detailed explanation of the pension system, see “Demystifying the State Pension System” at http://www.massbudget.org/report_window.php?loc=Pension_3_11.html.
2. For example, see <http://www.pionline.com/article/20120611/PRINTSUB/306119977>.
3. This paper will not consider the contentious question of whether general measures of inflation appropriately measure the cost of living for retirees.
4. Public Employees Retirement Administration Commission. “PERAC Report on Impact of COLA Base Increase.” September 2005, accessed 2013.10.10 at <http://www.mass.gov/perac/report/colabase.pdf>.
5. Editorial. “Don’t add to pension problem by upping cost-of-living raises.” *Boston Globe*, September 19, 2011, accessed 2013.10.10 at http://www.boston.com/bostonglobe/editorial_opinion/editorials/articles/2011/09/19/dont_add_to_pension_problem_by_upping_cost_of_living_raises/.
6. For example, see <http://www.massretirees.com/article/issues/cola/cola-proposal-brutally-attacked>.
7. Retired State, County and Municipal Employees Association of Massachusetts. “House Passes Pension Reform 3.” November 4, 2011, accessed 2013.10.10 at <http://www.massretirees.com/article/issues/cola/house-passespension-reform-3>.
8. For example, see http://www.wvlp.com/dpp/news/politics/state_politics/unions-oppose-senate-pension-bill.
9. This figure assumes that the pension fund earns 8.25% on investments, as is used to calculate the unfunded liability for the state retirement system. Local boards generally assume a rate of return between 7.75% and 8.25%.
10. Of course, an older retiree would be unlikely to live for 25 years and would receive much less money – these figures are meant only to illustrate the potential impact. More accurate estimates based on actual life expectancy require more detailed.
11. The very important question of whether it is reasonable to assume an 8.25% return on investment is not explored in this paper. For a discussion of the impact of lower investment returns, see “Fiscal Implications of Massachusetts’ Retirement Boards’ Investment Returns,” Pioneer Institute White Paper 90, October 24, 2012, <http://pioneerinstitute.org/download/fiscal-implications-of-massachusetts-retirement-boards-investment-returns/>.
12. This figure is based on the following assumptions: the initial liability is \$2,860; appropriations begin 1 year after the increase in liability, grow 4% per year, and last for 20 years; the discount rate and assumed rate of return is 8%.
13. Percentages may not add up exactly because of rounding.
14. PERAC 2005.
15. This figure assumes that payments to fully fund the \$203 million increased liability would be spread over 20 years and grow at 4% per year.

16. PERAC has a sophisticated model of pension costs and was probably in the best position to offer an accurate estimate of the cost of any policy change. In 2011, after the legislation passed, PERAC estimated the increased liability at \$286 million.
17. “On pensions, Boston should avoid extra annual hike.” *Boston Globe* editorial. June 24, 2012, accessed 2013.10.10 at <http://www.bostonglobe.com/opinion/editorials/2012/06/23/higher-cost-living-benefits-for-city-workers-should-non-starter/LINmYnq0ZWCdzk2ISF2RNI/story.html?event=event12>, and “City considers hike in retirees’ pensions.” Boston.com, 2012, accessed 2013.10.10 at http://www.boston.com/news/local/massachusetts/articles/2012/06/18/boston_pushes_to_increase_pensions_for_retired_city_workers_bucking_national_trend/
18. Letter to Massachusetts Senate as quoted in “Unions Oppose Senate Bill,” September 15, 2011, accessed 2013.10.10 at http://www.wwlp.com/dpp/news/politics/state_politics/unions-oppose-senate-pension-bill.
19. Accessed 2013.10.10 at <http://www.frmsa.com/wp-content/uploads/2010/04/COLA-Base-Increase-Sept-2010-Presentation-Report-Plus.pdf>.
20. This is a very rough approximation of the cost to add a complete COLA, based on the likely distribution of benefits. We cannot calculate an exact value because detailed data on benefit levels are not available publicly.
21. Source: Local boards that responded to requests for information. Numbers estimated for other boards as explained in Appendix 1.
22. Source: PERAC website, communications with local boards, and MassRetirees.com.

