LOCAL COST OF LIVING ADJUSTMENT (COLA)

ISSUE:
Current statutes place restrictions on the amount and funding sources of COLAs that the LGERS Board may award. Under the Department of State Treasurer (DST) interpretation of statute (GS 128-27(k), see appendix), COLAs are limited to the percentage increase in the Consumer Price Index up to a maximum increase of four percent. The statute also states that COLAs "shall be contingent upon the total fund providing sufficient investment gains". Given these limitations, The Board of Trustees may wish to consider whether it should request additional flexibility on awarding COLAs.

BACKGROUND:
The state has had statutory provisions covering COLAs since at least 1971. Until 2006, LGERS COLAs were provided by the General Assembly in budget legislation. In 2006-2010, the General Assembly chose not to set the LGERS COLA and the Board established the COLA within the framework of the existing legislative restrictions.

During 2008, the system suffered significant investment losses. These losses are recognized in actuarial calculations over five years. Thus, the LGERS actuarial valuations are unlikely to show investment returns in excess of assumptions in the near future. At the same time, COLAs in recent years have fallen short of inflation by almost 8% and the threat of higher inflation could make this gap worse in the future. These factors could create the desire for the Board to have more flexible COLA funding regulations that might allow it to approve COLAs in excess of the one-year CPI increase or COLAs in years where investments do not create undistributed gains.

The 2008 investment losses will also cause the local government employer contributions to grow rapidly at a time when revenues are flat or down. The base contribution is projected to approach 10% of pay by 2015, up from 4.8% in FY2010. However, after that point, the valuation methodology and/or investment gains may generate undistributed gains in the valuation that could be used to provide COLAs. Some local governments have suggested that these gains should first be used to bring the contributions closer to historical levels. The current statute would require that the gains be used for COLAs, assuming the CPI is increasing.

ANALYSIS:
Providing the Board with increased flexibility would enable it to find alternative methods for funding COLAs, such as increasing employer contributions beyond those required. At the same time, providing the Board with increased flexibility would be granting additional power to an appointed body to make decisions that have a large impact on local government budgets across the state. The DST interpretation of current statute would not prevent COLAs outside of the current legislative limits from being granted in the next few years. It would, however, require that any COLAs outside the traditional parameters be approved by the General Assembly. Furthermore, the lack of excess investment returns is not permanent. RSD actuarial models project that within several years, funding for COLAs within the traditional restrictions may become available again, although it may be appropriate to also reduce the employer contribution at that time.

OPTIONS:

1. Do not change current policy. Any COLAs larger than CPI or COLAs funded through money outside of excess investment returns can be approved by the Legislature. If gains appear at a later point, they will be used to fund COLAs equal to CPI.
2. Repeal the restriction that all COLAs are limited by the CPI increase and perhaps also the 4% limit. This would more clearly allow the Board to enact a COLA consistent with need within the funding constraints.
3. Repeal the requirement that all COLAs be funded by investment gains. This would more clearly allow the Board to enact a COLA and use all available sources to fund it.
4. Repeal both the restriction on COLA size and the funding requirement. This would more clearly allow the Board to enact COLAs based on need and use all available sources to fund.
5. Suspend the requirement that COLAs be granted equal to CPI, until the Annual Required Contribution drops below some threshold. This would require than any gains arising in future years first be used to reduce employer contributions.

EXAMPLE:

Year	CPI	Available[1]	Option 1	Option 2	Option 3	Option 4	Option 5
1	4%	2%	2%	2%	4% [2]	Unknown[3]	0% [4]
2	1%	3%	1%	3%	1%	Unknown	0%
3	3%	0%	0%	0%	3%	Unknown	0%
Total	8%		3%	5%	8%	Unknown	0%

Note that this example is not representative of what is likely to occur over the next 5 years. During that time, the available COLA is very likely to be 0% every year. Therefore, COLAs are likely to be 0% every year under both options 1 and 2.

In addition, this example is a little simplified because the COLA granted one year will affect the amount available in the following years. Therefore the amount available will not be the same across all options.

[1] COLA that could be granted without increasing contribution. For example, if the contribution one year was 4.8% and then the next valuation determined that the required contribution was only 4.4% and that each 1% COLA increases the contribution by 0.2%, then a 2% COLA would increase the required contribution to 4.4% + 0.2% * 2 = 4.8%, keeping the contribution the same as the prior year. The most common reason that the required contribution would drop is investment gains (returns greater than 7.25%).

[2] This COLA would require an increase in the employer contribution rate, since only 2% was available and 4% was granted. Local governments would be forced by statute to pay the higher contribution.

[3] Under this option the Board could set any COLA it wished to set, regardless of CPI or contribution level. For example, the Board might wish to make up for past shortfalls between COLAs and CPI or grant increases to offset changes in Social Security or retiree medical benefits.

[4] Assumes that the contribution rate is currently above the threshold. For example, if the contribution rate is 9% and the threshold is 4.8%, the gains would be used to reduce the contribution rate instead of granting a COLA.

APPENDICES
GS 128-27(k):
"As of December 31, 1971, an increase in retirement allowances shall be calculated and made effective July 1, 1972, in the manner described in the preceding paragraph. As of December 31 of each year after 1971, the ratio (R) of the Consumer Price Index to such index one year earlier shall be determined, and each beneficiary on the retirement rolls as of July 1 of the year of determination shall be entitled to have his allowance increased effective on July 1 of the year following the year of determination by the same percentage of increase indicated by the ratio (R) calculated to the nearest tenth of one per centum (1/10 of 1%), but not more than four per centum (4%); provided that any such increase in allowances shall be contingent upon the total fund providing sufficient investment gains to cover the additional actuarial liabilities on account of such increase."