NRTA PENSION EDUCATION TOOLKIT

Cost of Living Adjustments (COLAs)

A cost of living adjustment (COLA) is a change in one's monthly retirement benefit to account for increasing prices or inflation.

When it comes to COLAs...

- Rising prices can quickly erode the value of your retirement income. Even a low inflation rate can significantly impact your purchasing power over time, if your benefit does not include a COLA.
- COLAs are very important, because they help to ensure that retirees' purchasing power is maintained, no matter how quickly prices might rise.
- COLAs may be even more important to retirees who do not receive Social Security, because without their pension COLA they may have no other retirement income that increases with inflation.
- While COLAs provide important protections, they do cost money. Any COLA benefits that are promised should be pre-funded or paid for in the year that they are given.

You may have heard some talk recently about the COLA in your pension plan. You may have wondered: What is a COLA? How much do COLAs matter? If the COLA changes, will I be impacted? You may have wondered—what do these trends mean for my retirement? How have these trends impacted my pension plan? This fact sheet provides some basic information that might help.

Understanding COLAs

A cost of living adjustment (COLA) is a change in one's monthly retirement benefit to account for increasing prices. COLAs help to ensure that your purchasing power remains the same no matter how long you may live, and how quickly prices might rise.

For example, if your retirement benefit is $1,000 per month, you can purchase a certain amount of goods or services with that income—groceries, prescriptions, utilities, gas, etc. However, if the prices of those goods and services increase by, say, 3% in a single year, you can purchase fewer goods with that $1,000 benefit—your "purchasing power" has declined.

If you receive a COLA based on this increase in prices, however, then this year's benefit would increase to $1,030 per month. Thanks to your COLA, you will have the same purchasing power—or the same ability to purchase those same goods—that you did last year with your $1,000 benefit.

NRTA
AARP's Educator Community

NATIONAL INSTITUTE ON
Retirement Security
Reliable Research. Sensible Solutions.

Even Modest Inflation can Significantly Erode Purchasing Power

When looked at this way, COLAs may not seem so significant—you may wonder, how important is just $30 per month? Yet rising prices and inflation can very quickly erode your retirement income, even to the point that a retirement benefit that was perfectly adequate to pay your monthly expenses when you retired can become inadequate over time. Like water cutting though a rock, even a modest rate of inflation can significantly erode your purchasing power over time.[1]

Figure 1. **Annual Inflation Rate, 1989-2009**

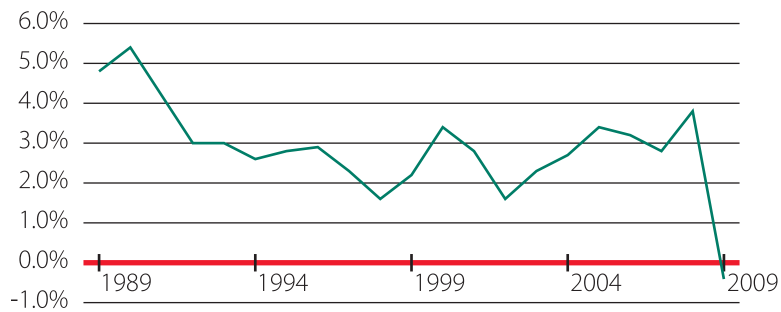
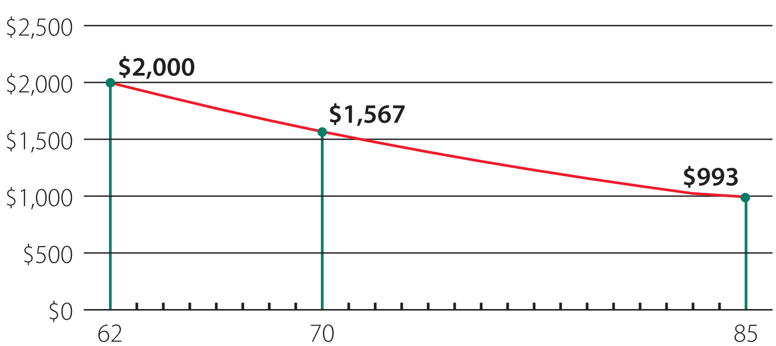


Figure 1 shows the rate of inflation in the U.S. for every year since 1989. The graph clearly shows that inflation has been positive in every year, except 2009. The average rate of inflation in this 20 year period has been nearly 3% annually (2.9% to be exact).[2]

Again, an increase in prices of 2.9% per year may not seem so significant at first. But your purchasing power can be eroded quite substantially over time due to even relatively small levels of inflation, if you do not have a COLA.

Figure 2. **The Effect of 3% Inflation on a $2,000 Benefit**



For example, let's say that a woman retires at age 62, with a benefit of $2,000 per month. And let's say that inflation averages about 3% per year after she retires. Figure 2 below shows the impact that this 3% annual inflation rate has on her purchasing power.

Without any type of COLA, this woman's purchasing power will fall to about $1,500—**a 22% drop!**—by age 70. By the time she reaches age 85—which happens to be her average life expectancy—her purchasing power will fall to just $993—less than half the value of her initial benefit. Again, this means that she will be able to purchase only half the amount of goods that she was able to buy when she retired. And if she were to live past 85, she would experience even greater reductions in purchasing power.

Luckily, the damaging effects of inflation are well understood, and most state and local retirement systems do offer COLAs, although they can vary in how they are designed.[3]

In some cases, the COLA is prescribed—for example, a fixed 3% per year, or an amount tied to increases in the Consumer Price Index (a measure of the average price of a fixed basket of consumer goods). This type of COLA provides retirees with the security that no matter how much inflation may go up, their benefits will keep the same value. In other words, they will always have the same purchasing power.

COLAs can also be ad-hoc in nature, which means that they are granted at the discretion of the state each year. This gives state employers a bit more flexibility, as they can provide COLAs when revenues are growing and withhold them if tax revenues are fixed or declining.

Social Security and COLAs

Since the 1970s, Social Security benefits have been indexed for inflation, so that retirees can keep their purchasing power. In the public sector, however, as many as 30% of employees are not covered by the Social Security system.[4]

COLAs are an especially important part of the pension benefit for those employees who do not participate in Social Security, because they are likely to have no other retirement income that increases with inflation. Without a COLA, their purchasing power will steadily decline as they get older. This means that a middle-class retiree may find themselves struggling to afford even the basics—food, healthcare, housing, and transportation—in their advanced years.

COLAs Should be Properly Financed

While COLAs provide important protections for retirees, they do cost money. One current concern about COLAs that has arisen recently is the extent to which state and local retirement systems fully account and pay for their COLA obligations in advance (also called "prefunding" a COLA).

One example of the negative consequences that can result when a plan's COLA benefit is not properly prefunded has occurred in the Texas Municipal Retirement System. From the 1940s through 2007, when this system calculated how much it needed employers to contribute to the pension fund in each year, this calculation did not account for the regular COLA the plan provided. As a result, contribution rates were set too low, and the plan did not fully prefund its COLA benefits.

Eventually, the system changed its calculation method in order to fully account for these benefits. In doing so, the plan's measured benefit obligations grew and its funded status dropped. Employers had to increase their annual contributions to the pension substantially in order to keep the plan on track toward full funding.[5] This is a good example of how delaying the funding of promised benefits only results in increased costs in the future.

In other words, any benefits that are promised—including COLAs—should be pre-funded or they must be paid for in the year that they are given.

---

[1] National Institute on Retirement Security. 2010. *Public Pension Resource Guide: Strong Public Pensions for Today and Tomorrow.* Washington, DC: National Institute on Retirement Security.

[2] U.S. Bureau of Labor Statistics. *Consumer Price Index Summary.* Washington, DC: U.S. Department of Labor.

[3] Schmidt, D. 2009. *2008 Comparative Study of Major Public Employee Retirement Systems.* Madison, WI: Wisconsin Legislative Council.

[4] U.S. Government Accountability Office. 2007. *State and Local Government Retiree Benefits: Current Status of Benefit Structures, Protections, and Fiscal Outlook for Funding Future Costs.* Washington, DC: U.S. Government Accountability Office.

[5] National Institute on Retirement Security. 2010. *Public Pension Resource Guide: Strong Public Pensions for Today and Tomorrow.* Washington, DC: National Institute on Retirement Security.