

“COLA Cuts in State-Local Pensions”

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Abstract

One surprising response of public plan sponsors to the financial crisis and recession was their reduction of cost-of-living adjustments (COLA) for current workers and retirees. The response was surprising because it has often been assumed that public workers have greater benefit protections than their private sector counterparts. The Employees Retirement Income Security Act of 1974, which governs private pensions, protects accrued benefits, but allows changes to benefits going forward. In contrast, most states have legal provisions that limit changes to future benefits for current workers. Yet they were able to change COLAs for current workers and, often, for retirees.

Introduction

This paper provides an overview of the COLA changes made to date, discusses the impact of eliminating COLAs on benefits, explores the extent to which the courts view COLAs differently from ‘core’ benefits, and assesses the factors related to enacting COLA cuts. It is organized as follows. The first section describes the prevalence and characteristics of COLAs in effect in 2009 at the worst of the financial crisis. The second section discusses the proposed changes to COLAs for the period 2010-14. The third section discusses the magnitude of the COLA cuts. The fourth section describes how the courts reacted to proposed changes to the COLAs, in most – but not all – cases upholding the cuts. The fifth section uses regression analysis to summarize the factors associated with enacting a cut to COLAs – being a state-administered plan, offering a fixed rate COLA (not linked to the Consumer Price Index), residing in a state with weaker legal protections, having a large unfunded liability relative to payroll, and sponsor having a high ratio of debt to revenues. The final section concludes the COLA cuts suggest that the defined benefit promises in the public sector are not as secure as one would have thought, that, while the pace has slowed, COLA cuts are likely to reappear if plans come under renewed financial pressures, and that the court ruling in Illinois will influence the likelihood of other states with strong protections enacting cuts to their COLAs.

The Prevalence of the COLA in State and Local Plans, 2009

The defined benefit plans in the state/local 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.

The data for COLAs come from the Public Plans Database (PPD), which contains extensive information for 150 state and local plans – 114 state and 36 local. Overall, the sample accounts for 91 percent of assets and workers relative to the totals reported by the U.S. Census Bureau. The coverage, however, varies by level of government (see Figure 1). At the state level, the PPD covers about 97 percent of assets and members, while at the local level the PPD (which includes some major cities such as New York, Los Angeles, and Chicago) represents only about 60 percent of local plan assets and 49 percent of local plan members. This outcome is to be

expected given that state-administered plans are few and large, while locally administered plans are many and often small.¹

The PPD data show that 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, recent investment returns, or the level of assets in a special COLA fund. As of 2009, about 70 percent of the plans provided automatic increases – either a fixed rate or CPI-linked COLA (see Figure 2). Roughly half of these were linked to the CPI, and these increases were generally capped at 3 percent; the other half applied automatic adjustments at a fixed rate specified by the plan. The remaining plans provided increases either on an ad hoc basis or linked to plan finances.

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 to 30 percent of state-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 2010-2014

Between 2010 and 2014, 17 states (with a total of 32 plans) and three localities (Chicago, Denver, and Duluth) in the PPD enacted legislation that reduced, suspended, or eliminated COLAs for current workers and often for current retirees (see Figure 3).²

¹ In total, the Census identifies 227 state-administered and 3,771 locally administered systems, compared to 114 and 36 in our samples, respectively (see United States Census Bureau, 2012a).

² We also identified four other localities outside of the PPD that enacted COLA legislation: 1) The General Retirement System of the City of Detroit; 2) The Police and Fire Retirement System of the City of Detroit; 3) Chicago Laborer's Retirement Board Employees Annuity Benefit Fund; and 4) Employees Retirement System of the City of Cincinnati. South Carolina also passed legislation to change its COLA, but the goal was to increase, not

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 liability. 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 cost-of-living adjustments. 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. Under legislation enacted in 2011 New Jersey terminated all post-retirement COLAs for current and future retirees, until the plans are 80 percent funded – an unlikely event given the plans' current funded ratios of about 60 percent and the state's unwillingness to fund – at which point a committee will be formed to determine whether COLAs will be reactivated. [As will be discussed later, the Appellate Division of the New Jersey Superior Court ultimately reversed the cuts, although they remain in place.] In 2011, Rhode Island also suspended the 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, a group of police union members rejected the mediation agreement, so the parties are headed back to court.³ Oklahoma required that any COLA must be prefunded at the time of enactment, making future COLAs very unlikely.

reduce, the magnitude of the adjustment.

³ 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.

Reduced Guarantees

Interestingly, the vast majority of states that changed their COLA had a fixed guarantee of 2.5 to 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. [As will be discussed later, a State Circuit Court in Illinois rejected the cuts.] 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 the participants' benefit levels.⁴ Washington suspended the COLA indefinitely for its 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.

Impact of the COLA Cuts

A simple model suggests that eliminating a 2-percent compounded COLA reduces benefits by 15-18 percent (see Table 1). Eliminating a 3-percent COLA on the same initial benefit reduces lifetime benefits by 22-26 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

⁴ The COLA for those who have earned an annual benefit under \$20,000 is 2.0 percent; between \$20,001 and \$40,000 is \$400 plus a 1.5 percent; between \$40,001 and \$60,000 is \$700 plus a 1 percent; and over \$60,000 \$900 plus 0.25 percent.

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-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 2007.⁵
- Illinois, where participants in SURS and TRS are not covered by Social Security, reduced the COLA for those hired before 2010 from a guaranteed 3 percent to 3 percent of the lesser of: 1) their current benefit; or 2) \$1,000 multiplied by years of service.⁶ Those who retire on or after July 2014 will receive COLAs only every other year for the next ten years.⁷ [The Illinois cuts are still working their way through the courts.]
- Maine froze its CPI-linked COLA for three years (2011, 2012, and 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 percent to 2 percent, but also suspended COLAs for existing retirees from July 1, 2013 to June 30, 2014.

⁵ 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.

⁶ 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.

⁷ 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 aged 43 and under, no COLAs will be paid in the 2nd, 4th, 6th, 8th, and 10th years of retirement.

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 employees.

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.⁸ 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.⁹

Six states have adopted a property-based approach for protecting pensions. To the extent that pension benefits are considered property, they cannot be taken away without due process according to the Fifth and Fourteenth Amendments to the Constitution. Due process has both a

⁸ 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.

⁹ 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.

procedural and a substantive component. Most of the challenges to state action are made on substantive due process and have not been successful. Courts have generally found amendments to public pension plans to be ‘an adjustment to the benefits and burdens of economic life’ rather than the taking of private property without just compensation.¹⁰ Thus, state officials have much more freedom to adjust pensions in states that have taken the property-based approach to pension rights.

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.¹¹ States that appear in bold have cut their COLA. The pattern looks like what one would have expected. Those states where benefits are not well protected or protected only under a property-based approach have seen a large number of COLA cuts. Those where past and future accruals are protected either under the constitution or under the contract clause have seen much fewer.

Of the 17 states that changed their COLA, 12 have been challenged in court. The courts have ruled in ten states and in all but two cases have upheld the cut (New Jersey and Illinois did not uphold COLA cuts). In New Jersey, the Appellate Division of the Superior Court has ruled that the workers have a contractual right to their COLAs but has sent the case back to the lower court to determine whether the impairment of the contractual right is responsible and necessary. In Illinois, the Circuit Court ruled in 2014 that COLA cuts (and other changes) were unconstitutional; the State is currently appealing this ruling to the Illinois Supreme Court, with a decision expected in March of 2015.¹² The Rhode Island proposals to cut the COLA were initially challenged in court but ended up in mediation instead. The proposals withstood the mediation process with only minor changes but, as noted, police union members subsequently rejected the mediation agreement and the case is headed back to court. Table 3 summarizes the status of these suits. Suits have been filed in Oregon, but no decisions have been reached.

The main rationale for allowing the COLA cut is a judicial determination that COLAs are not considered to be a contractual right. For example, in Colorado a lower 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 to a specific COLA amount for life given

¹⁰ Pineman v. Fallon, 842 F.2d 598 (2nd Cir. 1988).

¹¹ Munnell and Quinby (2012).

¹² Pierog (2015).

that the General Assembly changed the COLA formula numerous times over the past 40 years. This decision was upheld upon appeal. 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.¹³ The courts clearly view COLAs very differently than core benefits. At this point, the legal hurdles to cutting COLAs appear to be quite low.

Who Cut and Why: Regression Analysis

The final section attempts to bring together the story that emerged above and estimates a probit regression to see if a systematic relationship exists between the probability of enacting COLA legislation and factors identified in the narrative. The dependent variable is equal to 1 if the pension plan cut its COLA between 2009 and 2014, for either current retirees or current employees of the plan. The explanatory variables are as follows:

- **State flag:** COLA cutting appears to be a state-level phenomenon: 34 of 114 state-administered plans in the PPD had their COLA cut compared to 3 of the 36 locally-administered plans. This dummy variable is equal to one if the plan is administered by a state.
- **Fixed COLA:** A much higher share of plans with a fixed COLA, which provides an automatic increase unlinked to annual changes in inflation, appears to have had COLA cuts than plans with a CPI-linked COLA, an ad hoc COLA, or an investment-based COLA. This dummy variable is equal to 1 if the plan has a fixed COLA.
- **Legal Constraints:** As discussed, states provide varying levels of legal protection for the benefits of public sector employees and retirees. The assumption is that plans in states where past and future accruals are protected under the state's constitution or contract laws would have a tougher time cutting their COLAs. So, the relationship between cutting COLAs and legal constraints is expected to be negative.
- **UAAL/payroll:** Not discussed so far are the financial pressures to cut. The assumption regarding the plan finances is that a higher UAAL to payroll would be

¹³ The judge deciding the case made an additional point about the 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...'

positively related to COLA cuts, as cutting retiree COLAs is one of the few ways that plans can lower their existing unfunded liability.

- Debt/revenue: In terms of the financial pressure on the plan sponsor, the assumption is that the larger the debt relative to own-source revenue, the more likely a plan is to cut the COLA in an effort to decrease its liabilities. This variable is the ratio of state or locality's annual debt service to their annual own-source revenue.

The results of the regression are shown in Figure 4 and Table 4 (summary statistics are contained in Table 5). Four of the variables are statistically significant at the 99-percent level, and the unfunded liability measure at the 90 percent level. The three factors that emerged from the discussion – state-administered plan, fixed COLA, and legal constraints – all affect the probability of a COLA cut by about 20 percent, with state-administered and fixed COLA associated with a 20-percent increase and legal constraints with a 20-percent decrease. The marginal effects of the financial pressure variables are measured in terms of a one-standard deviation change. A one standard deviation higher ratio of unfunded liability to payroll is associated with a 10-percent increase in the probability of a COLA cut and a one standard deviation higher ratio of debt-to-revenue with a 5-percent. Together the variables explain about 30 percent of the variance.

Conclusion

How state-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 COLA cut initiative seems to have played itself out for this round. However, if the stock market should plummet again and plans and their sponsors feel under substantial pressure, we may see a new round of COLA cuts. Which plans undertake these cuts may well be influenced by the outcome of the Illinois appeal expected this spring. If the state with the strongest constitutional benefit protections allows the cuts, then more states may be tempted to cut their COLAs.

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Table 1. COLAs as a Percent of Total Benefits by Discount Rate Assumption

| Retirement age | 60 | | | | | |
|-----------------|--|-------|-------|-------|-------|-------|
| Initial benefit | \$35,000 | | | | | |
| Discount rate | 7.75% | 7.00% | 6.00% | 5.00% | 4.00% | 3.00% |
| COLA | Percent decrease in liability from removing COLA | | | | | |
| 2.0% | 14.7% | 15.2% | 15.9% | 16.7% | 17.4% | 18.2% |
| 2.5% | 18.2 | 18.9 | 19.7 | 20.6 | 21.5 | 22.4 |
| 3.0% | 21.7 | 22.4 | 23.4 | 24.4 | 25.4 | 26.4 |

Source: Authors' calculations.

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).

Table 3. *Responses to COLA Cuts, 2010-15*

| State | COLA cut upheld | Rationale | Court/process | Date | Current status |
|-------|-----------------|--|--------------------------------------|------|-----------------------------------|
| CO | Yes | COLA not a contractual right | State Supreme Court | 2014 | |
| FL | Yes | COLA not protected under applicable State law | State Supreme | 2013 | |
| IL | No | Violation of pension protection clause of Illinois Constitution | State Circuit Court | 2014 | On appeal |
| ME | Yes | COLA not a contractual right | US Circuit Court of Appeals | 2014 | |
| MN | Yes | COLA not a contractual right | State District | 2011 | |
| MT | Yes | Complaint dismissed* | State District | 2013 | |
| NJ | N/A | Complaint dismissed for lack of jurisdiction | US District | 2012 | |
| | No | 1997 State Statute created contractual rights protected by Contract Clause | Appellate Division of Superior Court | 2014 | Remanded for further findings** |
| NM | Yes | COLA not a contractual right | State Supreme | 2013 | |
| RI | N/A | N/A | Mediation Settlement | 2014 | Mediation rejected; back to court |
| SD | Yes | COLA not a contractual right | State Circuit | 2012 | |
| WA | Yes | Not an impairment of a contractual right | State Supreme Court | 2014 | |

*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.

**Remanded back to the lower court to determine whether the impairment of rights is reasonable and necessary to serve an important public purpose.

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

Table 4. *Regression Results for Introducing a COLA Cut for Retirees/Employees*

| Variables | Marginal effects |
|------------------------|----------------------|
| State flag | 0.244*** (0.786) |
| Fixed COLA | 0.197*** (0.290) |
| Legal constraints | -0.182*** (0.351) |
| UAAL/payroll | 0.049* (0.139) |
| Debt/revenue | 3.164*** (5.981) |
| Pseudo R-squared | 0.290 |
| Number of Observations | 145 |

Note: Robust standard errors are in parentheses. The coefficients report marginal effects from a probit estimation and are significant at the 90 percent (*) level or 99 percent (***) level. The dependent variable is 1 for pension plans that cut their COLAs for current retirees or current employees, and 0 otherwise. Five defined benefit plans that are closed to new members were dropped from the regression. These include: Alaska Public Employees Retirement System, Alaska Teachers' Retirement System, Michigan State Employees Retirement System, Minneapolis Employees Retirement Fund, and West Virginia Teachers' Retirement System.

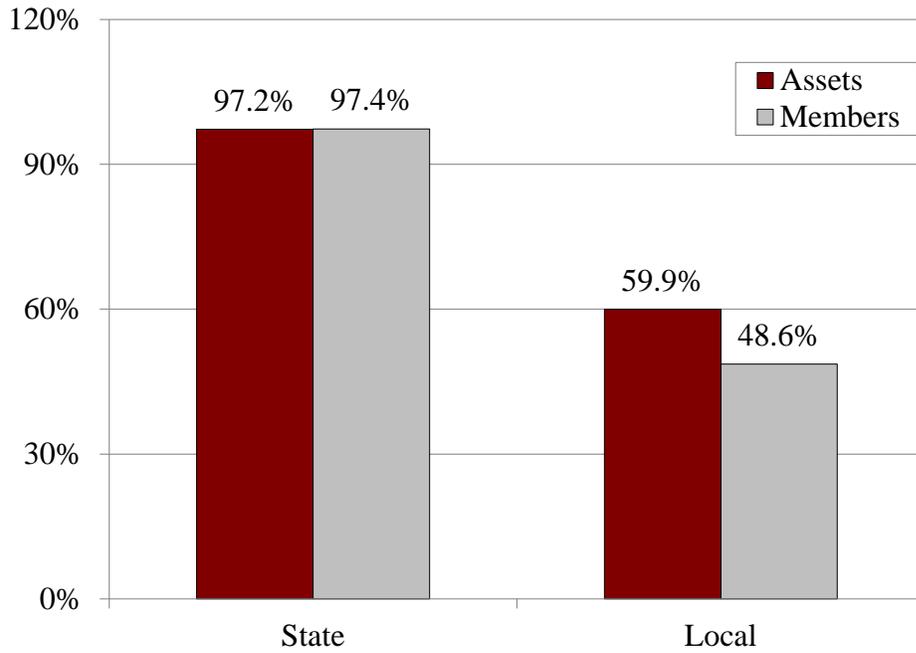
Source: Authors' calculations from U.S. Census Bureau (2012a); U.S. Census Bureau (2012b); U.S. Census Bureau (2011); and *Public Plans Database* (2015).

Table 5. *Summary Statistics for Regression on Probability of Introducing a COLA Cut for Retirees/Employees*

| Variables | Number of observations | Mean | Standard deviation | Minimum | Maximum |
|-------------------|------------------------|------|--------------------|---------|---------|
| State flag | 145 | 0.77 | 0.43 | 0 | 1 |
| Fixed COLA | 145 | 0.34 | 0.48 | 0 | 1 |
| Legal constraints | 145 | 0.40 | 0.49 | 0 | 1 |
| UAAL/payroll | 145 | 1.35 | 1.12 | -0.98 | 5.15 |
| Debt/revenue | 145 | 0.05 | 0.03 | 0.02 | 0.20 |

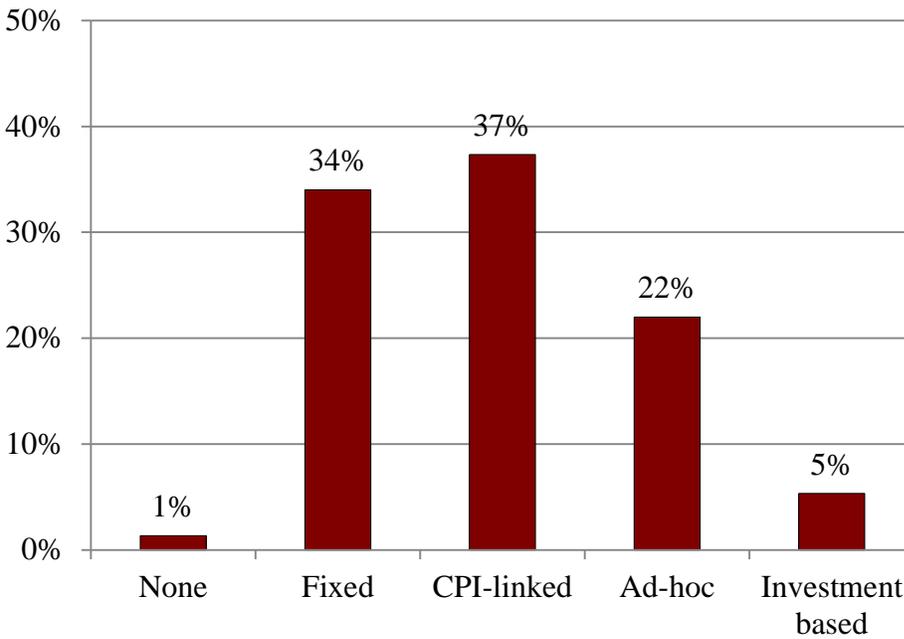
Source: Authors' calculations from U.S. Census Bureau (2012a); U.S. Census Bureau (2012b); U.S. Census Bureau (2011); and *Public Plans Database* (2015).

Figure 1. PPD Plans as a Percent of Total Assets and Active Members, by Level of Government.



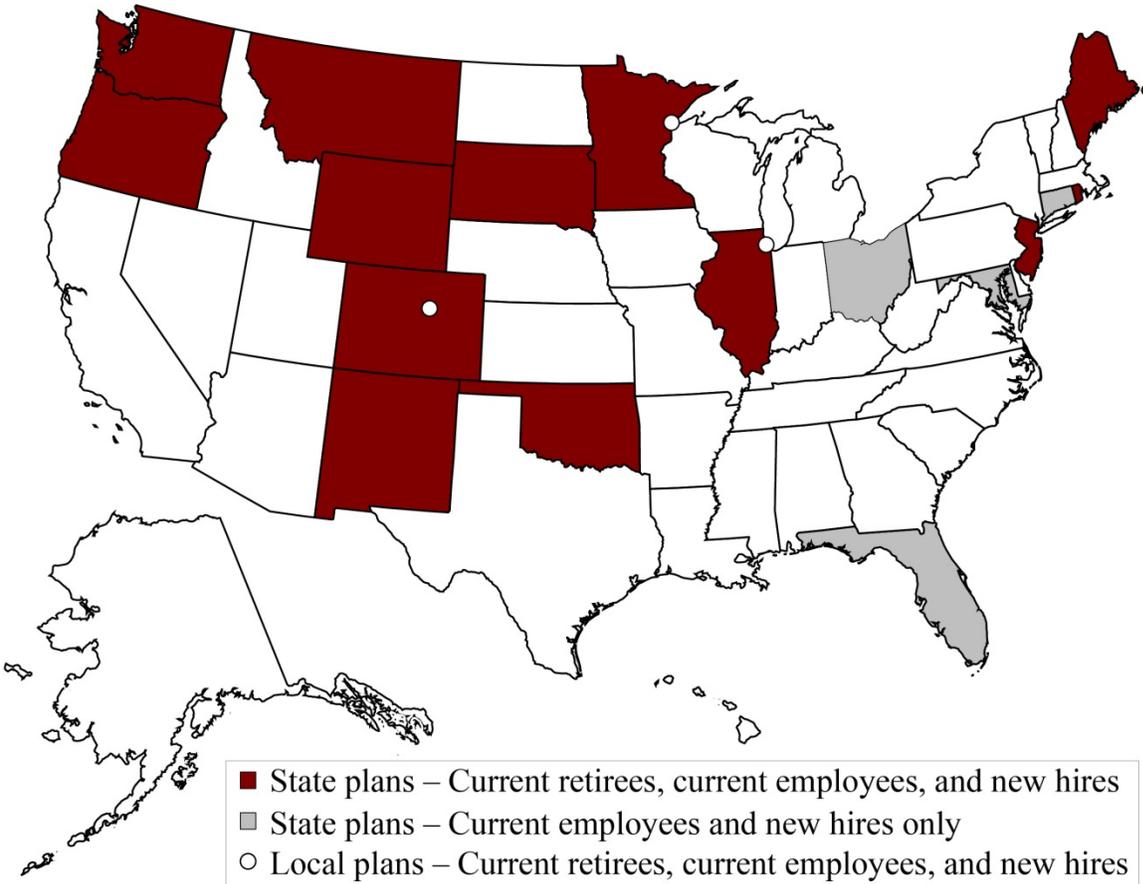
Sources: Authors' calculations from U.S. Census Bureau (2012a); and *Public Plans Database* (2012).

Figure 2. Distribution of State and Local Plans in PPD, by COLA Type, 2009



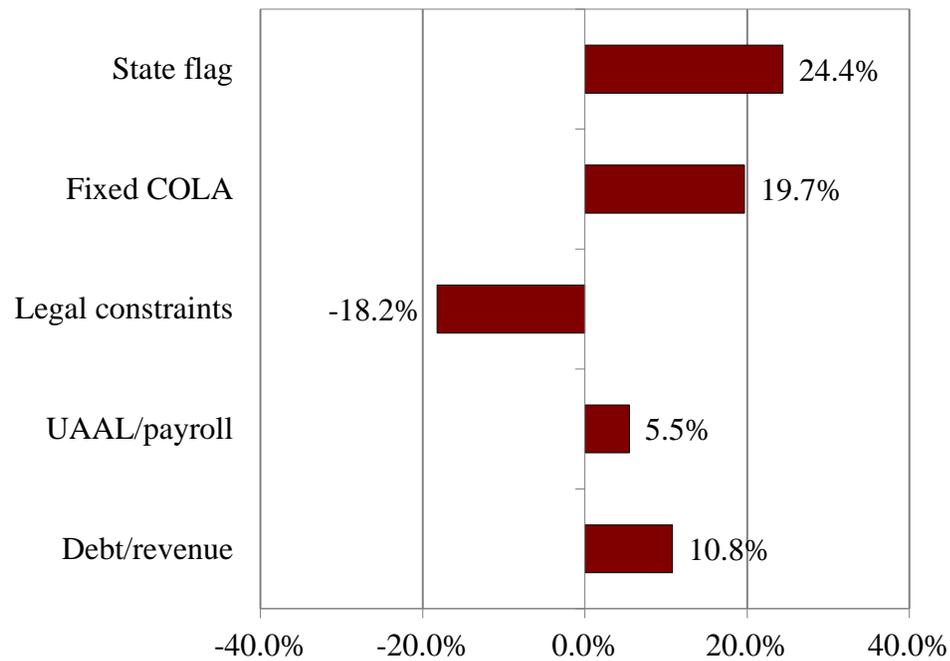
Source: *Public Plans Database* (2015).

Figure 3. *State and Local Plans Eliminating, Suspending, or Reducing COLAs for Current Workers and/or Retirees, 2010-14*



Note: Washington State closed its plan. Local plans include: Denver Public Schools Retirement System, Duluth Teachers' Retirement Fund, and Chicago Municipal Employees Annuity Benefit Fund.
Sources: National Association of State Retirement Administrators (2014); and National Conference of State Legislatures (1999-2015).

Figure 4. *Impact on the Probability of Introducing a COLA Cut for Retirees/Employees, 2009-2013.*



Note: Changes are one-standard deviation for continuous variables and 0/1 for dichotomous variables. All results are statistically significant at least at the 90-percent level.

Source: Authors' calculations from U.S. Census Bureau (2012a); U.S. Census Bureau (2012b); U.S. Census Bureau (2011); and *Public Plans Database* (2015).

Appendix: States and Localities Enacting COLA Legislation

(* Identifies four plans not included in *Public Plans Database*.)

*Cincinnati, OH (Employees Retirement System of the City of Cincinnati)

On December 31, 2014, Cincinnati and city workers reached a deal to stabilize the city's pension after 10 months of negotiations. The city will contribute \$38 million to the pension system next year by borrowing against future revenue and will contribute \$200 million in 2016 from the financially stable retiree healthcare trust fund to the pension system. It will also make larger contributions to the pension (16.25% of the annual operating budget contribution, versus 14% in recent years) and these higher contributions will continue for 30 years. Employees and retirees have agreed to forgo their COLA adjustments for three years and, after that, the COLA will be based on 3-percent simple interest (current COLA for retirees is 3 percent *compounded*).¹⁴ There are no known lawsuits challenging this COLA cut at this time.

Chicago, IL (Municipal Employees Annuity Benefit Fund, *Chicago Laborer's Retirement Board)

In 2014, Illinois lawmakers passed SB1922, which cut COLAs for current retirees, current employees, and new hires for Chicago's Municipal Employees Annuity Benefit Fund and Chicago's Laborer's Retirement Board. Previously, the COLA was 3.0 percent compounded annually. The new legislation cut the COLA to the lesser of 3 percent or half of the inflation rate (not compounded) and suspended all COLAs for certain years (2017, 2019, and 2025). A lawsuit was filed (*Mary J. Jones, et al. v. Municipal Employees' Annuity and Benefit Fund of Chicago*) in 2014 in the Illinois Circuit Court. The plaintiffs argue that SB1922, which cuts retiree benefits as well as COLAs, violates the Pension Protection Clause of the Illinois Constitution. No decision has been made as of this report. However, the decision is likely to wait until the outcome of the appeal in the Illinois state pension lawsuit (see '*We Are One Illinois Coalition*' vs. *Patrick Quinn in capacity as Governor of Illinois*).¹⁵

Colorado (Public Employees Retirement Association: Municipal Employees Retirement System, School Employees Retirement System, State Employees Retirement System)

On February 23, 2010, Colorado legislators passed SB 10-001, which changed its COLA structure for current retirees, current employees, and new hires who participate in Colorado PERA. Previously, all three state pension plans (MERS, School Employees, and SERS) provided an automatic 3.5 percent COLA. After the law was signed, COLAs for each of the state plans became tied to the funded ratio of the plan. The law established an automatic 2.0 percent COLA baseline with a 0.25-percent increase if the plan is more than 103 percent funded, and a 0.25-percent decrease if the plan is less than 99 percent funded. This COLA cut was challenged in court (*Justus v. Colorado*) in 2011. The plaintiffs' principal argument was that both the base pension and a specific COLA are constitutionally protected by the Contract

¹⁴ Coolidge (2014).

¹⁵ Pierog (2015).

Clauses of the Colorado and US Constitutions. The court found that the Colorado legislation never included language making any particular COLA adjustment a contractual commitment for life without change. It noted that many legislative changes have been made in Colorado COLA provisions over the years and found that the plaintiffs could have no reasonable expectation that the COLA formula that happened to be in place at the date of their retirement would be unchangeable for the rest of their lives. This decision was appealed to the State Supreme Court in 2012, which ruled in 2014 that the cuts were constitutional.

Connecticut (State Employees Retirement System)

In 2011, Connecticut changed its COLA formula for current state employees and new hires retiring after October 2, 2011. The new COLA formula is a CPI-linked COLA with a minimum guarantee of 2.0 percent. Before the law took effect, those retiring after October 2, 2011 would have received 60 percent of the CPI, up to 6 percent and 75 percent of the CPI over 6 percent, with a minimum COLA of 2.5 percent and a maximum of 6.0 percent. There are no known lawsuits challenging this COLA change.

*Detroit, MI (Employees Retirement System, Police and Fire Retirement System)

In 2013, Detroit filed for the largest municipal bankruptcy in US history. After a nine-day trial on eligibility, the US Bankruptcy Court ruled that Detroit was eligible for Chapter 9 bankruptcy protection due to its \$18.5 billion debt, and in 2014 the Michigan Legislature passed a package of bills (the city's legislative Plan of Adjustment) to help Detroit avoid further bankruptcy proceedings. Retirees of the Detroit Employees Retirement System (ERS) will have a 4.5-percent cut to their core pension benefit and lose their COLAs indefinitely.¹⁶ Retirees of the Detroit Police and Fire Retirement System (PFRS) will retain 100 percent of their core pension benefit, but will receive only 45 percent of their COLAs.¹⁷ These cuts were approved overwhelmingly by retirees who feared far greater cuts if these measures did not pass.¹⁸ Prior to the bankruptcy proceedings, retirees of both ERS and PFRS were given an automatic 2.25-percent COLA.

Denver, CO (Denver Public Schools Retirement System)

On February 23, 2010, Colorado lawmakers passed SB 10-001, which changed its COLA structure for current retirees, current employees and new hires in the Denver schools.¹⁹ Previously, the Denver Public Schools Retirement System provided an automatic 3.25-percent compounded COLA, and, for those hired after July 1st, 2005, the lesser of 3 percent per year or the increase in the CPI. After the law was signed, however, the COLAs were fully suspended in 2010 with an automatic 2.0 percent COLA issued thereafter. This COLA cut was challenged in

¹⁶ Tompor (2014).

¹⁷ Retired Detroit Police and Fire Fighters Association (2015).

¹⁸ Associated Press (2014).

¹⁹ Senate Bill 09-282 merged Denver Public Schools into Colorado PERA, effective January 1, 2010.

court (*Justus v. Colorado*) in 2011. The State Supreme Court ruled in 2014 that the cuts were constitutional.²⁰

Duluth, MN (Teachers' Retirement Fund Association)²¹

Minnesota lawmakers passed an Omnibus Pension Bill in 2010 that directly impacted COLAs for members of Duluth Teachers' Retirement Fund Association (as well as members of Minnesota's three state-sponsored pension plans). Previously, an automatic 2.0-percent COLA was awarded. The new law provides for COLA payments if the funded ratio of the plan exceeds either an actuarial funded ratio of 90 percent or a market value funded ratio of 80 percent.²² Since neither of these thresholds was met in 2010, 2011, or 2012, COLAs were effectively suspended for those years. These cuts were challenged in court (*Swanson et al v. State of Minnesota et al.*) in 2011 in the District Court of Minnesota. The plaintiffs claimed that the legislation in the Omnibus Bill constituted a violation of the contract and takings clauses of the US and Minnesota Constitutions. The court ruled that the relevant statutory language did not constitute a contract to provide COLAs, thereby allowing the COLA cuts to remain in effect. No known appeals have been filed at this time.

Florida (Retirement System)

In 2011, Florida legislators passed SB 2100, which suspended the automatic 3.0 percent COLA for current employees and new hires until June 2016, after which it will be reinstated. The COLA suspension was ultimately challenged in the Florida courts (*Scott et al. v. Williams et al.*) in 2013. Initially, the Circuit Court found that the suspension violated the Contract Clause of the Florida Constitution and ruled the legislation invalid on this and other grounds. On appeal, the Florida Supreme Court reversed the judgment of the Circuit Court and ruled that the legislation did not violate the Florida Constitution, concluding that while retirement benefits that have already been earned are protected as vested contract rights, future benefits for future service are not contractual rights protected against changes. There is no known further appeal at this time.

Illinois (State Employees' Retirement System, State Universities Retirement System, Teachers' Retirement System)

In 2013, Illinois lawmakers passed Public Act 98-599, which cut COLAs for current retirees and current employees for three of its state plans. Previously the COLA award was 3.0 percent compounded for each of these plans. Public Act 98-599 cut this COLA by introducing a new

²⁰ See Colorado section for detailed explanation of lawsuit.

²¹ The 2014 Omnibus Pensions and Retirement Bill authorized the merger of the Duluth Teachers' Retirement Fund Association into the Teachers Retirement Association of Minnesota, effective July 1, 2015.

²² The law provides for a post-retirement benefit adjustment of CPI-U (up to 5 percent) when the funding ratio using the actuarial value of assets equals or exceeds 90 percent. Until that 90 percent threshold is met, the post-retirement adjustment will operate under a transition schedule, which provides for an adjustment based on the funding ratio using the market value of assets (2 percent when greater than 90%, 1 percent when greater than 80 percent, and 0 percent otherwise)

formula to determine the COLA, which will be the minimum of: 3 percent of the current benefit payment or 3 percent multiplied by the number of years of service multiplied by \$1,000.²³ A lawsuit was filed that challenged the legality of this bill (*We Are One Illinois Coalition* vs. *Patrick Quinn in capacity as Governor of Illinois*) in 2014 in the Illinois Circuit Court. The court ruled in 2014 that because Public Act 98-599 diminishes and impairs pension benefits, the Act violates the Pension Protection Clause of the Illinois Constitution.²⁴ Thus, the COLA cuts were deemed to be unconstitutional. The state of Illinois is currently appealing this ruling to the State's Supreme Court, with a decision expected in March of 2015.²⁵

Maine (Public Employees Retirement System Consolidated Plan for Participating Local Districts, State Employee and Teacher Retirement System)

In 2011, legislators in Maine passed L.D. 1043 (their biennial budget for 2012 and 2013). This budget eliminated COLAs for retirees and current employees from September 2011 to September 2013, after which COLAs will be CPI-linked up to 3.0 percent (previously, the CPI-linked COLA maximum was 4.0 percent). This COLA cut was challenged in US District Court of Maine (*Maine Association of Retirees et al v. Board of Trustees of the Maine Public Employees Retirement System*) in June of 2013. The plaintiffs claimed that the legislation violated the Contract Clause of the US Constitution. The court concluded that COLAs are not a contractual obligation. The plaintiffs appealed, but in 2014 the US Circuit Court of Appeals upheld the COLA cuts, stating the COLAs in question are not a contractual right.

Maryland (State Retirement and Pension System)

In 2011, Maryland legislators passed HB72, which decreased the COLAs for current state employees and new hires. Previously, the COLA was CPI-linked, with a 3.0-percent cap. HB72 lowered the cap to 2.5 percent if the investment performance exceeded expectations, or up to a 1.0-percent cap if the investment performance was worse than expectations. There are no known lawsuits challenging this law at this time.

Minnesota (General Employees Retirement Fund, State Employees Retirement Fund, Teachers' Retirement Fund)

In 2010, Minnesota lawmakers passed the Omnibus Pension Bill, which cut COLAs uniquely for each of its state retirement plans. Previously, the State provided an automatic 2.5-percent COLA for members of its General Employees, State Employees and Teachers' state retirement plans. Under the new bill, COLAs for current retirees, current employees, and new hires were tied to

²³ For example, a retiree with 30 years of service and a base benefit of \$50,000 will earn a COLA of the lesser of (i) the base benefit of \$50,000 times 3 percent for a COLA of \$1,500, or (ii) the number of years of service times 1,000 times 3 percent for a COLA of \$900.

²⁴ The Wall Street Journal (2014).

²⁵ Pierog (2015).

the funded ratio of each individual plan.²⁶ These cuts were challenged in District Court of Minnesota (*Swanson et al v. State of Minnesota et al.*) in 2011. The Plaintiffs claimed that the legislation in the Omnibus Bill constituted a violation of the contract and takings clauses of the US and Minnesota Constitutions. The court ruled that the relevant statutory language did not constitute a contract to provide COLAs, thereby allowing the COLA cuts to remain in effect. No known appeals have been filed at this time.

Montana (Public Employees Retirement Administration, Teachers' Retirement System)

In 2013, Montana lawmakers passed HB 377, which cut COLAs for current retirees, current employees, and new hires. Previously, an automatic 1.5-percent COLA was awarded. Under the new law, the COLA became tied to the funded ratio of each plan.²⁷ These COLA cuts were challenged in 2013 in the First Judicial District Court of Montana (*Association of Retired Montana Public Employees et al v. State of Montana et al.*). The court refused to issue a preliminary injunction, finding that it was not clear that the plaintiffs would be successful in proving that the COLA was protected as a contractual right. Consequently, the COLA cut was upheld. No known appeals have been filed at this time.

New Jersey (Public Employees Retirement System, Police and Firemen's Retirement System, Teachers' Pensions and Annuity Fund)

In 2011, New Jersey Senate Bill 2937 (Chapter 78, 2011) 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. As a result of this bill, various unions and union members sued in the US District Court (*New Jersey Education Association vs. State of New Jersey*), claiming that enactment of SB 2937, which suspended COLAs, was unconstitutional. The court did not reach a decision on the merits of the case but dismissed the complaint on the basis that the US District Court lacked jurisdiction over the claim. The plaintiffs subsequently brought the same claims in a New Jersey State court, where they were dismissed via an oral opinion, thereby allowing the cuts to stand. The plaintiffs filed an appeal, and in 2014 the Appellate Division of the New Jersey Superior Court (an intermediate appellate court) ruled that retired public workers have a contractual right to yearly increases in their pension benefits and that right cannot be impaired unless the legislation is reasonable and necessary to serve an important public purpose. The cuts, however, remain in effect while the case is being sent back to a lower court to determine if the decision to suspend the COLAs was reasonable and necessary to serve an important public purpose.

²⁶ For the General Employees plan, the COLA is 2.5 percent if the funding ratio is greater than 90 percent and 1.0 percent otherwise. For the State Employees plan, the COLA is 2.5 percent if the funding ratio is greater than 90 percent and 2.0 percent otherwise. For the Teacher's Retirement plan, the COLA is 2.5 percent if the funding ratio is greater than 90 percent and 2.0 percent otherwise; COLAs are also suspended in 2011 and 2012.

²⁷ 1.5 percent if funded ratio is greater than 90 percent and 0.5 percent if funded ratio if less than 90 percent.

New Mexico (Public Employees Retirement Association, Educational Retirement Board)

In 2013, New Mexico lawmakers passed SB 115, which impacted COLAs for current retirees, current employees, and new hires. For the New Mexico Public Employees Retirement Association, the COLA was reduced from a 3-percent to a 2-percent automatic COLA for existing retirees and was suspended indefinitely for future retirees.²⁸ For the New Mexico Educational Retirement Board, the COLA awarded previously was 50 percent of the CPI, with a minimum of 2 percent and a maximum of 4 percent. After the law was passed, COLAs were immediately reduced and linked to the benefit level and the funded level (until the plan reaches a 100-percent funded level).²⁹ This law was challenged in the New Mexico courts (*Bartlett et al v. Board of Trustees of the New Mexico Education Retirement Board et al.*) in 2013. The plaintiffs claimed that the legislation was unconstitutional. The New Mexico Supreme Court rejected the plaintiffs' claims, ruling that the COLA was not part of the contractually protected retirement benefit provided by public employee retirement legislation. There are no known appeals at this time.

Ohio (Public Employees Retirement System, State Teachers' Retirement System, Police and Fire Pension Fund)

In 2012, Ohio legislators passed SB 343, 342, and 340 covering the Ohio Public Employees Retirement System (PERS), the State Teachers Retirement System (STRS), and the Police and Fire Retirement System (PFRS), respectively; each law covered both current employees and new hires. Before the new laws, all of these plans issued an automatic 3.0-percent COLA. However, each plan introduced a unique COLA cut. PERS introduced a CPI-linked COLA with a 3.0-percent cap (in effect five years from the bill's passage). STRS suspended COLAs in 2012 and 2013, after which it provides an automatic 2.0-percent COLA. PFRS introduced a CPI-linked COLA with a 3.0-percent cap. There are no known lawsuits at this time.

Oklahoma (Public Employees Retirement System, Teachers' Retirement System)

In 2011, lawmakers in Oklahoma passed HB 2132, which decreased COLAs for retirees, current employees, and new hires. Previously a 2.0-percent COLA was awarded on an ad-hoc basis. The new law requires that any COLA must be prefunded at the time of enactment, making future COLAs very unlikely. There are no known lawsuits at this time.

²⁸ Retirees earning less than \$20,000 receive a 2.5-percent COLA.

²⁹ The COLA reduction is based on the median retirement benefit of all retirees, excluding disability retirements. Retirees with benefits at or below the median and with 25 or more years of service credit will have a 10 percent COLA reduction; their average COLA will be 1.8 percent. All other retirees will have a 20 percent COLA reduction; their average COLA will be 1.6 percent. Once plan funding is greater than 90 percent, the COLA reductions will decrease. The retirees with benefits at or below the median and with 25 or more years of service credit will have a 5-percent COLA reduction; their average COLA will be 1.9 percent. All other retirees will have a 10 percent COLA reduction; their average will be 1.8 percent.

Oregon (Public Employees Retirement System)

In 2013, Oregon legislators passed SB 822, which cut COLAs for the state's current retirees, current employees, and new hires. Previously, COLAs were CPI-linked, with a 2-percent cap. Under the new law, a 1.5-percent COLA was awarded in 2013, with all post-2013 COLAs being linked to the level of the core pension benefit.³⁰ A lawsuit was filed in the state Supreme Court challenging the legality of these cuts (*Moro vs. State of Oregon*) in 2014. As of 2015, no decision has been made.

Rhode Island (Employees Retirement System, Municipal Employees Retirement System)

In 2011, Rhode Island suspended the COLA for retirees, current employees and new hires until the state retirement plans are 80-percent funded. This change was challenged in court, but ended up in a mediation process. Under a mediation agreement reached in February 2014, the COLA would have been linked to the CPI and to the investment performance of the fund. However, in April 2014, some police union members rejected the mediation agreement, so the parties are headed back to court with a trial expected to start in April of 2015.³¹

South Dakota (Retirement System)

In 2010, South Dakota lawmakers passed SB 20, which changed the COLA formula for current retirees, current employees, and new hires in the state retirement plan. Previously, the COLA awarded was an automatic 3.1 percent. SB 20 immediately lowered the COLA to 2.1 percent in 2010 and then tied all future COLAs to the funded ratio.³² COLAs were also eliminated for first-year retirees. These COLA cuts were challenged in the Circuit Court of South Dakota (*Tice v. State of South Dakota et al.*) in 2012. The plaintiffs claimed that the legislation was unconstitutional and violated the Contract Clauses of the US and South Dakota Constitutions. The court rejected plaintiffs' claims, stating that the COLA was not a contractual right. No appeal has been filed at this time.

Washington (Department Retirement System-Public Employees Retirement System Plan I)

In 2011, legislators in Washington passed HB2021, which suspended all COLAs indefinitely for current retirees and current employees of its PERS Plan I (this plan is currently closed to new employees). The COLA previously awarded to retirees was CPI-linked, with a 2.0-percent cap. This COLA suspension was challenged in the Washington courts (*RPEC vs. The State of*

³⁰ If annual benefit is less than \$20,000, COLA will be 2.0 percent. If annual benefit is between \$20,001 and 40,000, COLA will be \$400 plus 1.5 percent. If annual benefit is between \$40,001 and 60,000, COLA will be \$700 plus 1 percent. If annual benefit is greater than \$60,000, COLA will be \$900 plus 0.25 percent.

³¹ Russ (2014).

³² After 2010, COLA rate based on funded ratio. If 100 percent funded, COLA will be 3.1%. If greater than 90 percent funded, COLA is CPI-linked with 2.1 percent minimum and a 2.8 percent maximum. If greater than 80 percent funded, it is CPI-linked with a 2.1 percent minimum and a 2.4 percent maximum. If less than 80 percent funded, the COLA is 2.1 percent.

Washington) in 2011. The lawsuit contends that the new law violates the state constitution and due process rights and is a breach of contractual pension obligations. The judge agreed with the union that the legislature's repeal of the COLA amounted to an illegal impairment of contract. The State of Washington appealed the court's decision. In 2014, the Supreme Court of Washington ruled that the COLA cuts were permissible, effectively reversing the lower court's decision. No further appeal has been filed at this time.

Wyoming (Retirement System)

In 2012, Wyoming lawmakers passed SB 59, which suspended all COLAs for current retirees, current workers, and new hires until the state retirement plan is 100-percent funded. Previous COLAs were CPI-linked up to 3.0 percent. There are no known lawsuits at this time.