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The Honorable Sam Gibbons
Ranking Minority Member
Committee on Ways and Means
House of Representatives

The Honorable Barbara B. Kennelly
House of Representatives

This letter responds to your inquiry about cost-of-living adjustments (COLA) to the benefits retirees receive from public and private pension plans. Two types of adjustments affect retirees' pensions: (1) cost-of-living adjustments, or COLAs, which are automatic, annual adjustments that primarily affect public sector pensions; and (2) postretirement benefit increases, which are COLAs provided at the employer's discretion. Both types of COLAs are used to increase benefit payments to offset inflation. Because inflation can severely reduce the purchasing power of retirees' pensions, COLAs are an important attribute of retirement benefits. For example, if inflation averages 5 percent each year, the purchasing power of a dollar falls by one-half in about 14 years.

To help you in better understanding how COLAs are used, you specifically asked us for information on the frequency of use and characteristics of COLAs that federal pensions and Social Security, state and local governments, and private pension plans have paid retirees in recent years. To develop our information, we reviewed the available information on COLAs in public and private sector pension plans. Although many types of pension plans are available to retirees, we focused our work on defined benefit pension plans rather than on the other main category of pension plans--defined contribution plans--because defined contribution plans do not pay COLAs.[1] We obtained the most

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[1]A defined contribution plan, such as a 401(k) plan, generally specifies the level of employer and employee contributions to each employee's account. Benefits paid by the fund are determined by the amount of earnings in the fund at retirement. Distributions can occur in a lump sum or as an annuity.

recent data available from surveys of pension sponsors by government agencies and benefits consulting firms.

In summary, the Social Security System and pension plans for federal workers incorporate automatic, annual COLAs. Further, over half the states reporting information to the Bureau of Labor Statistics in 1992 indicated that they provide automatic COLAs annually. These COLAs are generally capped at between 3 and 5 percent. Most of the remaining states reported that they traditionally provided ad hoc COLAs. However, because of lower inflation since the 1980s, the number of states granting ad hoc COLAs has gradually decreased since 1987.

Ad hoc COLAs in private pension plans occur less frequently than automatic COLAs in the public sector--sometimes only once in several years--and the plans often specify a maximum increase. Although a number of factors, such as union negotiations, affect an employer's decision to provide a cost-of-living increase, many employers provide COLAs to address the cumulative effect of inflation. Further, provision of COLAs varies widely among industries, from 3 percent of pension plans in the retail sector to over 60 percent of pensions in the transportation industry. However, similar to state and local plans with ad hoc adjustments, ad hoc adjustments to private sector pension benefits have declined overall in recent years--from over 50 percent to under 10 percent of plans.

BACKGROUND

The number of people receiving pensions continues to increase. In 1992, over 11 million people were receiving pensions either as a result of their own or their spouses' employment. Retirees generally collect their pensions as a monthly annuity, in fixed dollar amounts, for their lifetime (and their spouse's lifetime, if the annuity is paid as a survivor benefit).

Although there are many types of pension plans available to retirees, only defined benefit plans pay COLAs. A defined benefit plan provides retirement benefits calculated by a formula specified in the plan that is based on salary, years of service, or both. The employer is responsible for funding benefits and usually for any COLAs paid by the plan, unlike defined contribution plans, where no COLAs are paid. Many public sector defined benefit plans also require employee contributions.

Over half the states (28) sponsor pension plans that automatically grant an inflation adjustment (see app. I). A majority of states with COLAs also cap any benefit increase (27). Some local government plans also pay automatic COLAs and usually cap them. Some plans, particularly in the private sector, make constant dollar or percentage ad hoc adjustments to monthly benefit checks that compensate for past inflation, although these changes are not specifically tied to the Consumer Price Index (CPI). For example, the Hewitt report[2] cited several types of formulas used to calculate COLAs in private employers' defined benefit pension plans. They include flat dollar increases, percentage increases, average return on pension assets, and minimum and maximum dollar amounts.

The CPI is generally cited as a measure of inflation in the economy. Inflation, measured by the CPI, began to decline in the early 1980s, reached a low of 1.9 percent in 1986, and has ranged between 2.6 percent and 5.4 percent since. The rate of inflation has averaged about 4 percent during the years 1983 to 1994 (see fig. 1).[3]

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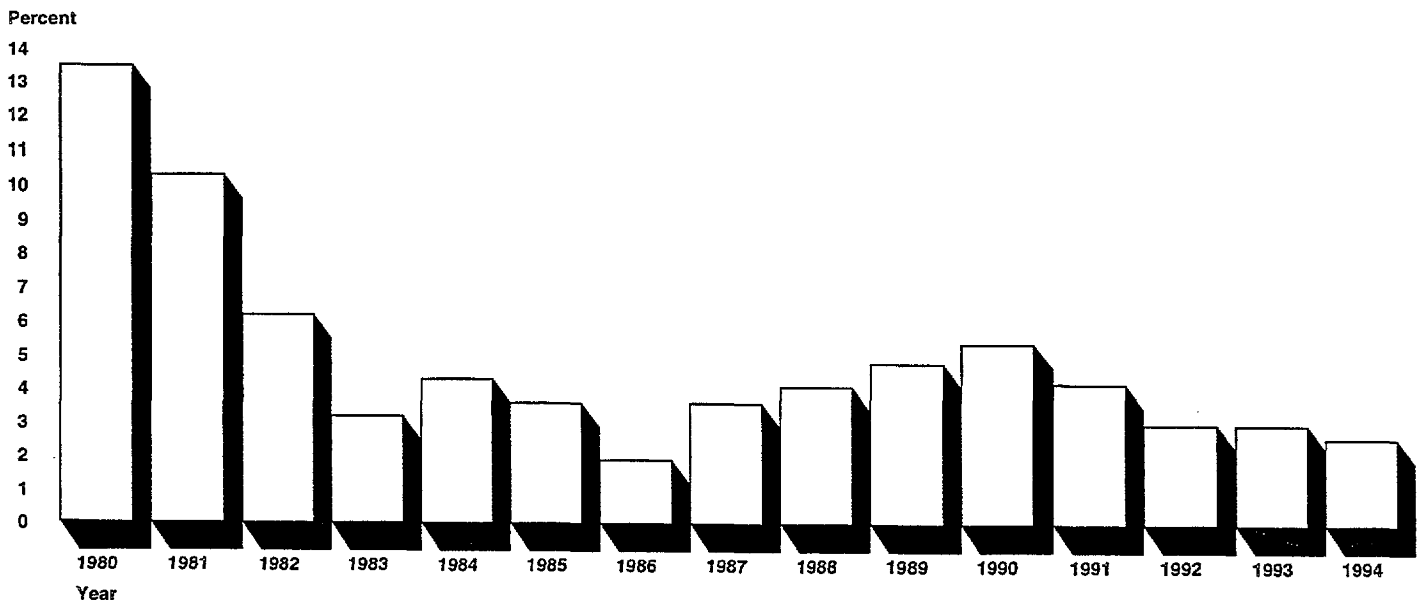
[2] Early Retirement Windows, Lump Sum Options, and Postretirement Increases in Pension Plans, Hewitt Associates (Lincolnshire, Illinois: 1992). In 1992, Hewitt Associates surveyed a cross section of companies about their postretirement pension increases. The survey received responses from 697 companies, with over one-third granting a COLA from 1988 through 1992.

[3] Economic Report of the President (Washington, D.C.: U.S. Government Printing Office, 1995).

Figure 1: Annual Changes in Rates of Inflation, 1980-94



Source: Economic Report of the President (1995).

FEDERAL PENSIONS

The Congress first enacted automatic inflation adjustments for the Civil Service Retirement System (CSRS) in 1962; for the military in 1963; and for Social Security in 1972 (first paid in 1975).[4] The previous system of legislating ad hoc increases was criticized as unrelated to price increases and overly subject to political manipulation.

Under section 201 of the Omnibus Budget Reconciliation Act of 1983 (P.L. 98-270), COLAs for CSRS annuitants are made effective December 1 of each year to be paid the following January. The adjustment is equal to the percentage change in the CPI for the third quarter of the current year over the CPI for the third quarter of the preceding year. Scheduled CSRS COLAs have often been reduced, delayed, or

[4] Federal Retirement Systems: Background and Design Concepts, Congressional Research Service (Washington, D.C.: 1994).

skipped in recent years as part of budget reduction efforts.[5]

The Federal Employees' Retirement System (FERS) Act of 1986 (P.L. 99-335) established a new retirement system for those federal employees covered under Social Security. Annuities provided under this system are adjusted annually to reflect increases in the CPI. However, as part of the overall redesign of federal pensions, annuities of retirees under age 62 are not adjusted; (2) if the increase in the CPI exceeds 2 percent but is less than 3 percent, annuities are adjusted by 2 percent; and (3) if the increase in the CPI is 3 percent or greater, annuities are adjusted by the amount of the increase less 1 percent.

Federal pensions pay benefits to civilian and military retirees. The largest retirement program, Social Security, covers nearly all workers, and paid benefits to over 90 percent of the elderly in 1993. These 42 million individuals received benefits from Social Security either as a result of their retirement or disability, or the death of a wage earner. These benefits, like federal pensions, also have automatic annual COLAs equal to the prior-year change in the CPI.

STATE AND LOCAL GOVERNMENT PENSIONS

Nearly all state and many local government retirement plans provide COLAs to retirees. In about half the states reporting to the Bureau of Labor Statistics (BLS), these adjustments are automatic and are usually based on the CPI-in most cases, with a cap (see enc. I). The remaining states provide COLAs on an ad hoc basis, as do many local plans. One survey of state and local government employer retirement systems found that, in 1991, 59 percent of plans provided COLAs, while 54 percent provided COLAs in 1992.[6] The average annual COLA in these plans for both years was over 3 percent.

The frequency of ad hoc COLAs in state and local government plans declined from 30 percent in 1987 to 9 percent in

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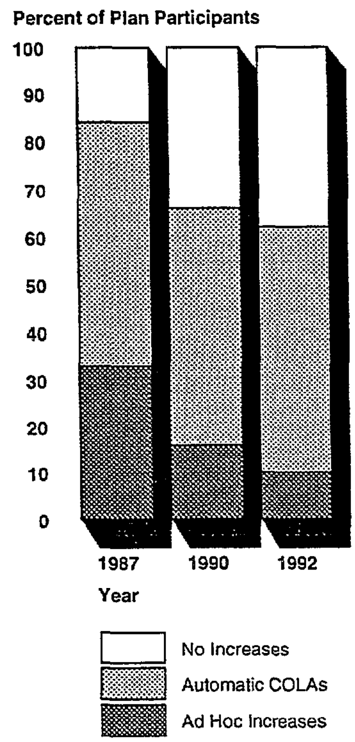
[5] Overview of Federal Retirement Programs (GAO/T-GGD-95-172, May 22, 1995).

[6] Paul Zorn, Survey of State and Local Government Employee Retirement Systems (Washington, D.C.: Public Pension Coordinating Council, 1994).

1992.[7] For those states and local governments where COLAs are automatic, the COLAs continued even though inflation had moderated (see fig. 2).

Figure 2: Postretirement Pension Increases for State and Local Governments, 1987-92



Source: BLS.

PRIVATE SECTOR PENSIONS

In 1991, over 77 million people were participating in about 700,000 private pension plans.[8] In the private sector,

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[7] Employee Benefits in State and Local Governments, 1992, U.S. Department of Labor, BLS (1994). The report represents the results of a 1992 survey on the incidence of selected employee benefit plans in state and local governments. BLS conducted two previous surveys in 1987 and 1990.

[8] Private Pension Plan Bulletin, Abstract of 1991 Form 5500 Annual Reports, Private Pension Plan Bulletin, U.S. Department of Labor Pension and Welfare Benefits

relatively few pension plans--less than 10 percent--explicitly provide for automatic COLAs. However, most private plans grant periodic ad hoc increases at the discretion of plan sponsors. Employers say that this method allows more control over costs and frees them to consider resources available when increasing benefits.

A recent survey revealed that of 228 companies surveyed, 39 percent provided COLAs for retirees at least once during the period 1989 through 1993.[9] Automatic COLAs, such as those in government pensions, were found in even fewer companies (4 percent). In cases in which a private plan did provide automatic increases, the plan benefit was generally capped at a predetermined level. Another study reported that, of 630 firms with defined benefit pension plans, about the same proportion, 44 percent, provided COLAs to their retirees at least once in the past 10 years.[10] A study of 50 large companies reported that 70 percent increased benefits to retirees during the period 1984 to 1993.[11] Nine of these companies gave at least three increases during this 10-year period.

Administration (Winter 1995).

[9]Retiree Issues "FAX FACTS" Survey Results, William M. Mercer, Inc. (1994). "FAX FACTS" is a series of surveys on human resources topics that obtained information on how 228 companies are handling various human resource issues. A recent survey on retiree issues included information on COLAs.

[10]Hay/Huggins Benefits Report, Hay/Huggins Company, Inc. (1994). The 1994 Benefits Report displays data received from 1,020 responses from organizations including a representative portion of large and medium-sized employers nationwide. The sample spanned most industries--including public, private, and not-for-profit organizations.

[11]Top 50: A Survey of Retiree Benefits Provided by Plans Covering Salaried Employees of 50 Large U.S. Companies as of January 1994, the Wyatt Company (1994). This report examines the retirement benefit plans provided for salaried employees of 50 of the largest U.S. companies included in Fortune magazine's list of top companies published in 1994. Among the many activities cited in the report, one area was noted for its lack of activity--namely, the number of postretirement benefit increases offered was lower than the average over the past 10 years.

The frequency with which employers grant COLAs varies widely from industry to industry. A 1994 study showed that the percentage of employers who provided automatic COLAs in their defined benefit plans ranged from 1 percent in the retail trade to 61 percent among state and local governments.[12] Some employers had given ad hoc COLAs at least once during the prior 10 years, ranging from 2 percent of employers in the retail trade to 56 percent in transportation. Overall, the number of employers giving either automatic or ad hoc COLAs ranged from 3 percent in the retail trade to 77 percent in government plans. Figure 3 shows the percentages of employers in various industries that provided COLAs, according to the study.

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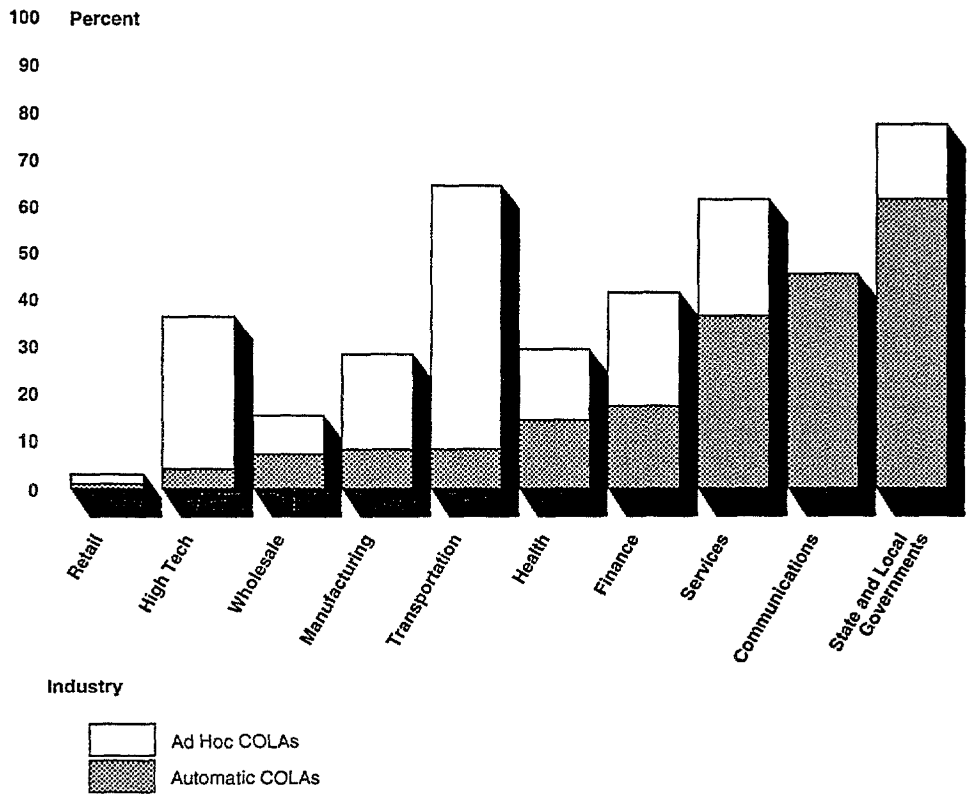
[12]KPMG's Retirement Benefits in the 1990s: 1994 Survey Data (Washington, D.C.: KPMG Peat Marwick LLP, 1994). This is a second nationwide retirement benefits survey of employers with 200 or more employees. The survey includes information on COLAs and ad hoc postretirement increases among defined benefit plan sponsors. The survey participant base was drawn randomly from a Dun and Bradstreet list of the nation's private and public employers.

Figure 3: Percentage of Employers Granting COLAs, by Industry, 1994



Source: KPMG's Retirement Benefits in the 1990s: 1994 Survey Data.

As inflation has slowed, more and more private employers are cutting back on the frequency of ad hoc COLAs. According to BLS,[13] retirees in private pension plans sponsored by medium and large firms who received COLAs declined from 54 percent of participants in 1983 to 10 percent in 1993 (see fig. 4).

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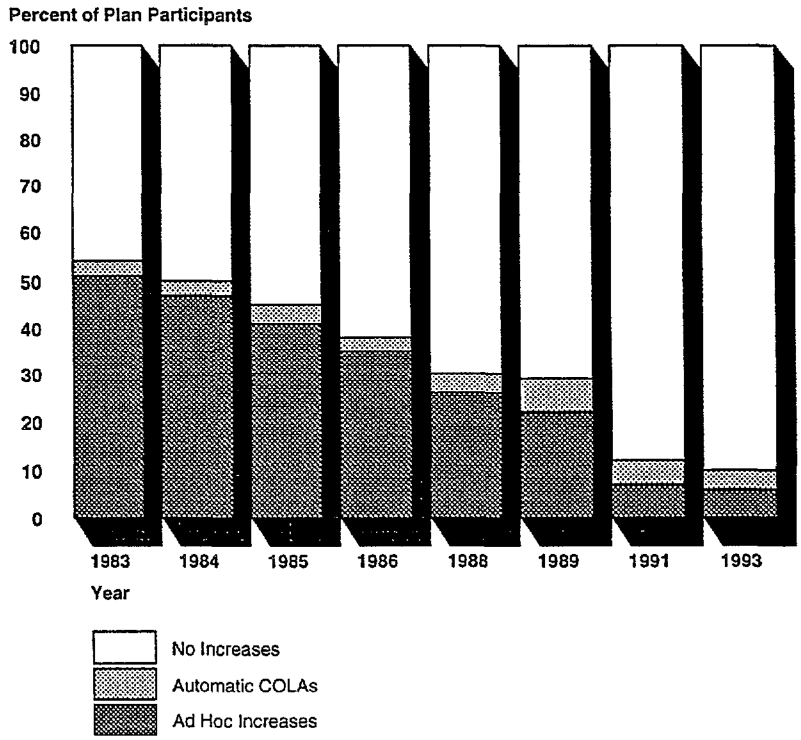
[13]Employee Benefits in Medium and Large Private Establishments, 1993, U.S. Department of Labor, BLS (1994). The report represents the results of a 1993 BLS survey of a sample of employee benefits in medium and large private firms. The survey provides data for 34 million employees in the nation's nonagricultural industries. BLS has surveyed medium and large firms since 1983. Each percentage in figures 2, 4, and 5 represents data from an annual report of that year.

Figure 4: Postretirement Pension Increases for Large and Medium Firms, 1983-93

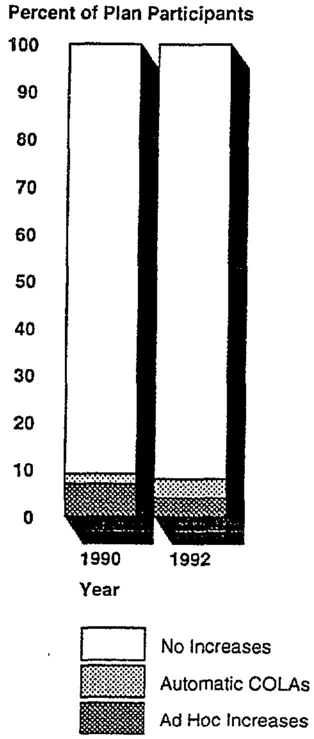


Source: BLS.

BLS also found a low prevalence of COLAs in small companies in 1990 and 1992, the only years of the survey, as shown in figure 5.[14]

[14]Employee Benefits in Small, Private Establishments, 1992, U.S. Department of Labor, BLS (1994). The report provides data on companies representing 44 million employees in the nation's nonagricultural, small, private firms with fewer than 100 employees. An earlier report was issued in 1990.

Figure 5: Postretirement Pension Increases for Small Firms, 1990-92



Source: BLS.

The BLS data reports on the percentage of participants in employer-sponsored plans that gave COLAs in a year. Since most private employers provide COLAs on an ad hoc basis, the percentage of employers in any year underrepresents the proportion giving COLAs to retirees over a 3- to 5-year period as described earlier. For example, some COLAs are tied to labor negotiations that occur every 3 years.

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If you have any questions concerning this information, please call me on (202) 512-7215. Other contributors to this correspondence are Donald Snyder, Assistant Director, and Benjamin Ross, Evaluator-in-Charge.

Jane L. Ross

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STATE COST-OF-LIVING ADJUSTMENTS

All states provide their retired employees with cost-of-living adjustments--either automatic or ad hoc. This appendix summarizes information, from a study by Foster Higgins,[15] on how each state provides COLAs. The various methods public employers use to adjust pension benefits, listed in table I.1, show the diversity of COLA calculations.

Table I.1: COLA Provisions in State Pension Plans, 1994

State	COLA provisions
Alabama	COLAs are ad hoc.
Alaska	COLAs are automatic and tied to the CPI and the financial condition of the plan.
Arizona	COLAs are ad hoc.
Arkansas	COLAs are annual and based on CPI.
California	COLAs are generally automatic, based on CPI, and between 2% and 5% plus supplemental payments.
Colorado	COLAs are automatic and annual at up to 3%.
Connecticut	COLAs are not automatic.
Delaware	COLAs are only for the state police pension plan.
Florida	COLAs are automatic at 3% annually.
Georgia	COLAs are 3% semiannually, with ad hoc increases.
Hawaii	COLAs are automatic at 2.5% of initial retirement benefit.
Idaho	COLAs are partially automatic, based on CPI, and at 1% floor and 6% cap.
Illinois	No information provided--other sources show some systems have a capped, annual COLA.

[15] Report on State Pension Systems, Foster Higgins (New York: A. Foster Higgins & Co., 1994).

Indiana	COLAs are ad hoc, usually annual, and between 2% and 4%.
Iowa	COLAs are ad hoc.
Kansas	COLAs are ad hoc.
Kentucky	COLAs are ad hoc.
Louisiana	COLAs are ad hoc.
Maine	COLAs are automatic, based on CPI, and at a 4% cap.
Maryland	State's old retirement system has an unlimited automatic COLA. The new system is also automatic but is limited to 3% of a participant's initial retirement benefit.
Massachusetts	COLAs are ad hoc.
Michigan	COLAs are only for judges and police officers.
Minnesota	COLAs are mostly automatic and based on plans' excess investment earnings.
Mississippi	COLAs are 100% of increase in CPI, not to exceed 2.5% of annual retirement allowance.
Missouri	COLAs vary but are CPI-indexed, mostly automatic, and capped at 4%.
Montana	COLAs are automatic.
Nebraska	COLAs are ad hoc.
Nevada	COLAs are automatic and prefunded but limited by CPI.
New Hampshire	COLAs are ad hoc.
New Jersey	COLAs are annual at 60% of CPI difference from year of retirement, not compounded.
New Mexico	COLAs are 3%, compounded annually.
New York	COLAs are ad hoc as legislated.
North Carolina	COLAs are ad hoc, based on CPI, and capped at 4%.
North Dakota	COLAs are ad hoc, based on periodic increases.

Ohio	COLAs are automatic, annual, and capped at 3%.
Oklahoma	COLAs are ad hoc.
Oregon	COLAs are automatic with step increments, CPI-based, and capped at 2%, with some periodic ad hoc increases.
Pennsylvania	COLAs are ad hoc, usually every 4 to 5 years.
Rhode Island	COLAs are automatic and annual, at 3% compounded.
South Carolina	COLAs are annual and automatic, CPI-based, and capped at 4%.
South Dakota	COLAs are annual and automatic at 3%.
Tennessee	COLAs are annual and automatic, CPI-based, and capped at 3%.
Texas	COLAs are ad hoc.
Utah	COLAs are based on the CPI and capped at 4%.
Vermont	COLAs are annual and automatic, CPI-based, and capped at 5%.
Virginia	COLAs are limited to the first 3% of CPI increase plus half of each percent increase from 3% to 7% for employees retired at least 2 years.
Washington	COLAs are automatic, based on CPI, and capped at 3%.
Washington, D.C.	COLAs are automatic, semiannual, and CPI-based.
West Virginia	COLAs are ad hoc except for public safety and judges' plans.
Wisconsin	COLAs are automatic, annual, and based on formula.
Wyoming	COLAs are automatic at 1% beginning 2 years after retirement.

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