MTRS
MASSACHUSETTS TEACHERS' RETIREMENT SYSTEM

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MEMORANDUM

To: William Keefe, Chair, Special Commission on State & Teacher COLA

From: Erika M. Glaster, MTRS Executive Director

Date: December 19, 2024

RE: COLA Reform Discussion

At the February 2024 meeting of the Massachusetts Teachers' Retirement Board, Sean Neilon and I prepared the following information in anticipation of the passage of Governor Maura Healey's FY25 state budget proposal to establish a "Special Commission for State and Teacher COLA."

Now that the Commission has begun its work, I hope the material will be helpful as background for our discussions.

In addition, we have recently learned the details of a supplemental COLA program in the Ohio State Teachers' Retirement System that may be of interest to the Commission, copy attached.

I. **Background Information**

As described in the 2023 *NASRA Issue Brief: Cost-of-Living Adjustments*, attached, the purpose of a cost-of-living adjustment (COLA) is to offset or reduce the effects of inflation on retirement benefits. Over time, the value of the dollar decreases, which can erode retirees' purchasing power and have a negative impact on their retirement security. The impact is most severe for retirees from non-Social Security states who receive little or no Social Security benefit due to the WEP and GPO, and those whose public pension accounts for the majority of their income.

Most public pension systems provide COLA benefits to their retirees, but there are many variations[1]:

[1] NASRA Issue Brief: Cost-of-Living Adjustments, June 2023

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Automatic vs. Ad hoc

An ad hoc COLA requires a governing body to actively approve a postretirement benefit increase. By contrast, an automatic COLA occurs without action, and is typically predetermined by a set rate or formula.

Simple vs. Compound

Under a simple COLA arrangement, each year's benefit increase is calculated based upon the employee's original benefit at the time of his or her retirement. Under a compound COLA arrangement, the annual benefit increase is calculated based upon the original benefit plus any prior benefit increases. Some COLAs contain both features, i.e., they may be "simple" until the retiree reaches a certain age or year retired, at which point COLA benefits are calculated using a compound method. A simple COLA produces a smaller benefit over time, and at a lower cost.

Inflation-based

These are COLAs based on a consumer price index (CPI), typically either the CPI-U or CPI-W, which is a measure of inflation. Most provisions like this restrict the size of the adjustment, such as by "one-half of the CPI" and/or "not to exceed three percent."

Performance-based

Some plans tie their COLA to their funding level or investment performance. In one statewide system, for example, the COLA falls within a percentage range specified in statute and tied to CPI, based on the funding level of the plan. Annuitants with another state system receive a permanent benefit increase tied to their length of service when the fund's actuarial investment return exceeds the assumed rate of investment return.

Delayed-onset or Minimum Age

Some automatic COLAs delay the onset, either by a given number of years or until attainment of a designated age.

Limited Benefit Basis

Some retirement systems award a COLA calculated on a portion of a retiree's annual benefit, rather than the entire amount.

II. The Massachusetts Landscape

The public pension systems in Massachusetts follow a combination of the *Ad-hoc*, *Inflation-based* and *Limited Benefit Basis* methods for awarding COLAs. As the Board is aware, the COLA for MTRS retirees is not guaranteed, but rather is subject to annual approval by the Governor and Legislature. The percentage increase, which is only on the first

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$13,000 of the benefit, is also determined annually by the Governor and the Legislature. Generally, the increases have been 3% a year.
Since the passage of M.G.L. c. 32, § 103(j)[2], many local Massachusetts public retirement systems have increased the COLA base for their retirees.

The following table illustrates the number of systems at each COLA base and the range of **COLA Base as a Percentage of the Average Benefit** in those systems:

COLA Base Amount (as of 2023)	# of Systems	% of Systems	Range of COLA Base as % of Average Benefit *(outliers)*
$12,000	5	4.8%	36%-42% *(Athol 76.9%)*
$13,000	19	18.3%	**27%**-55%
$14,000	25	24.0%	32%-69%
$15,000	16	15.4%	28%-61%
$16,000	17	16.3%	39%-78%
$17,000	4	3.8%	37%-50% *(Franklin Regional 93%)*
$18,000	17	16.3%	34%-79%
$22,000	1	0.96%	62%
TOTAL	**104**	**100%**	**Overall Average = 49%**

At 27%, the MTRS COLA Base as a Percentage of Average Benefit is the **lowest** of all Massachusetts systems. The overall average COLA base as a percentage of the average benefit for all systems is 49%. If the MTRS COLA base were 49% of the average benefit, the base would have to increase to $23,711[3].
The average salary for MTRS members is the 7th highest in the state, but all six systems whose average salaries are higher have higher COLA

[2] M.G.L. c. 32, § 103(j) states, in part, "Notwithstanding paragraph (a), the board of any system that establishes a schedule pursuant to section 22D or 22F, may increase the maximum base amount on which the cost-of-living adjustment is calculated, in multiples of $1,000. Each increase in the maximum base amount shall be accepted by a majority vote of the board of such system, subject to the approval of the legislative body."
[3] Based on the 2023 MTRS Actuarial Valuation.

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bases, with an average of $16,000. It is also notable that the retired educators of the Boston retirement system have a COLA base of $15,000.

The impact of inflation on MTRS retirees' purchasing power is illustrated in the **Benefit by Age Distribution Table** in our 2023 actuarial valuation:

Present Age	**# of Retirees**	**Average Benefit**
Under 50	108	$14,555
50-54	229	$23,916
55-59	1,497	$43,783
60-64	5,793	$50,773
65-69	13,612	$51,946
70-74	20,537	$52,128
75-79	14,156	$49,298
80-84	*7,134*	*$44,082*
85-89	*3,988*	*$37,980*
90+	*2,627*	***$30,176***
Totals	**69,727**	**$48,390**

Because the MTRS COLAs are not on the full benefit, the retirees who have been retired the longest – those age 80 or over – have lost the most purchasing power. It is especially concerning to see the average benefit for our oldest retirees. At $30,176, it is only 36.5% of the current average teacher salary[4], about two times the federal poverty level[5], and equal to the current Massachusetts "extremely low income" designation for subsidized housing in greater Boston[6].

III. COLA Reform Ideas

There are many questions and details to consider when crafting COLA reforms.

[4] The average salary for active members of the MTRS is $82,652, MTRS Actuarial Valuation, January 2023
[5] The federal poverty level for a single person is $15,060.
[6] The "extremely low income" amount is 30% of the Area Median Income (AMI), HUD Regional Housing Services

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For example:

- What is the appropriate COLA base? An amount? A percentage of the active member salary, or average benefit?
- Should it be indexed to grow over time? If so, what index is most appropriate?
- What percentage of the retirees' benefits should be protected?
- Should all retirees be treated the same (i.e., regular retirement, R+, termination retirement, minimum pension, ERI recipients, survivors, etc)?
- Does the member's length of service matter?
- Who should pay for the associated actuarial liabilities?
- Should the funding schedule be extended, or a layered funding schedule be adopted, to pay for COLA improvements?
- Should COLAs be automatic rather than subject to annual legislative approval?

While we do not have answers to all of these questions, the following are some ideas for COLA reforms for the Board's consideration:

1. **Increase the COLA Base**

   The most easily understood, and easily implemented, COLA reform would be an increase in the base on which the COLAs are paid.

   The history of COLA base increases for state and teacher retirees is as follows:

YEARS	COLA BASE
1971-1980	$ 6,000
1981-1984	$ 7,000
1985	$ 8,000
1986-1997*	$ 9,000
1998-2011	$12,000
2012-present	$13,000

***No COLAs were paid in 1989-91, 1993, 1995 and 1997**

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Based on the CPI measure of inflation, the $6,000 base of 1971 would equal $45,444 in today's dollars. However, the 1970s were the highest inflation years in U.S. history since 1947. By comparison, the $7,000 base in 1981 would equal $23,621 in today's dollars, and the $13,000 base established in 2012 would be $17,328 in today's dollars.

In 2009, the Legislature established a Special Commission on Pensions to study every aspect of the Chapter 32 plan, including COLAs. At that time, the Commission, which was led by Alicia Munnell of the Boston College Center for Retirement Research and Peter Diamond, an MIT economics professor and Nobel Prize recipient, recommended that the COLA base for Massachusetts public retirees should be raised to $18,000 in annual $1,000 increments. Thus, the base would have reached $18,000 in 2015. In 2015, the average MTRS retirement benefit was $42,138, so the COLA Base as a Percentage of the Average Benefit would have been 43%. As noted above, at 27%, the current COLA Base as a Percentage of the Average Benefit is far below this target.

In the current legislative session, the Mass Retirees recommended moving the COLA base to $16,000 and also providing a supplementary COLA benefit based on years of service, between $100 and $200 annually. The MTA supports moving the COLA base to $18,000 and indexing it upward to get to the maximum Social Security benefit (currently $43K).

All that being said, increases to the COLA base are the most expensive option, with an estimated increase in actuarial liability of $500 million for each $1,000 increase in the base for state and teacher retirees. This will be discussed further under Funding Options below.

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2. **Provide supplementary COLAs**

   As noted above many retirees are struggling right now due to the systemic loss of purchasing power through their retirement, especially in light of the recent spike in inflation. In the short-term, a possible option to consider is to pay a supplemental COLA benefit to a subset of the state and teacher retirees. For each $1,000 increase in the COLA base, the increase in a retiree's benefit is only $2.50/month. Even if the base were increased to $18,000, that would only provide an additional $12.50/month. A possible alternative would be to provide a more meaningful increase, perhaps $50/month, to retirees who were career educators, but whose pensions are below the current average benefit, or below a target % of the current average teacher salary. The Mass Retirees Association filed a bill along these lines in the last legislative session.

   At $50/month, this supplemental COLA for the MTRS retirees over age 80 identified above would cost less than $10 million in the first year. Future additional payments could be tied to funding availability or PRIT fund performance.

3. **Offer a lower initial benefit in exchange for a more generous COLA**

   As an alternative to raising the COLA base, the 2009 Special Commission on Pensions suggested that "some current employees may be concerned about the extent to which their future benefits might be eroded by inflation and be willing to trade off a lower initial benefit for more inflation protection. Offering an actuarially equivalent option would not increase system costs but could increase the well-being of some members. To limit gaming based on the latest inflation forecast, this option could be available only to workers at least 5 years from eligibility for retirement. The optional COLA might have a higher initial base or might have a base that is indexed for inflation or some combination."

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Alternatively, for new employees, a more generous COLA could be included along with a package of offsetting benefit reductions or higher contributions.

4. **Provide different COLA benefits for members in different Tiers or with different benefit types**
   Consideration could be given to whether COLA benefits should be the same for all types of benefits. The members in Tier 2 (those hired on or after 4/2/2012) have less generous benefits than those under Tier 1, but at 30 years of service, their contribution rate decreases by 3%. Rather than reducing their contribution rate by 3%, those funds could instead be used to improve their COLA benefit.

   Similarly, there are a number of benefit types that enhance benefits beyond the normal superannuation formula, such as the termination retirement allowance, the minimum pension, the 1993-94 early retirement incentive, and accidental disability benefits. If a supplemental COLA is considered, should all benefit types be included?

5. **Tie COLA increases to years of service**

   Another option is to restructure COLA increases to be based on a retirees' years of service in the system, with larger COLAs payable for career-long educators versus those with shorter service who may have Social Security or benefits from other employment.

IV. Funding Options

As fiduciaries, the Board and executive staff have long advocated for full-funding of the system. Under the current schedule, with the current benefit and COLA structure, the Commonwealth is poised to reach full funding in 2036. The funding schedule payment in FY2025 is $4.5 billion and is projected to increase to $8.2 billion in FY2036.

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In FY2037, the Commonwealth will have paid off the unfunded actuarial liability and, thereafter, only be required to pay the ongoing Normal Cost[7], which is projected at $1.66 billion in FY2037. This represents a savings of $6.5 billion twelve years from now. Those funds could be allotted to pay for COLA improvements, but can our retirees be expected to wait twelve years for meaningful reform?

Perhaps we should consider some alternatives to the current funding schedule to pay for equitable benefit improvements, leveraging those future savings.

The state actuary has estimated that for every $1,000 increase in the COLA base, the Commonwealth's actuarial liability will increase by about $500 million, which would increase the annual pension appropriation by approximately $50 million based on the current funding schedule. Thus, if the COLA base were increased to $16,000, the liability would presumably increase by $1.5 billion and the annual appropriation would increase by $150 million. Likewise, if the base were raised to $18,000, the liability would increase by $2.5 billion and the annual appropriation would need to increase by $250 million.
We should also ask the PERAC Actuary to project the system's savings in normal cost and reduction in plan liabilities due to the increasing number of Tier 2 members.

As the Board is aware, state revenues for the current fiscal year, are significantly below projections, and may cast a shadow on a permanent increase to the COLA base without in-kind savings. However, there may be other options, that we will explore below.

1. **Extend the funding schedule**
   In order to pay improved COLA benefits today, the Commonwealth could adopt a funding schedule that reaches full funding at the statutory deadline of 2040 rather than 2036, but still make the same payments using the excess to pay for the COLA improvements.

[7] The Normal Cost is the value of future benefits allocated to the current plan year.

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Similarly, the Commonwealth could adopt a supplementary funding schedule specifically for the increased COLA benefits that would go to 2040, or even later.

We would need the state actuary to determine the amounts for said schedules to know if the funds would be sufficient for desired COLA base increases and/or supplemental COLAs for a target population of retirees.

2. **Approve Temporary COLA increases**
   Rather than making COLA improvements permanent, which carries a hefty actuarial liability, one option is to establish a sunset clause whereby the COLA improvements would be approved only through 2036 when the Commonwealth will pay off the unfunded liability. At that time, the $6.5 billion savings could be leveraged to make the COLA improvements permanent.

3. **Secure other sources of pension funding**
   Pursuant to M.G.L. c. 29, § 5G, 5% of any excess capital gains revenue is allotted to the Commonwealth Pension Liability Fund (CPLF), 5% to the OPEB fund, and 90% to the Stabilization Fund. That distribution could be restructured so that a larger percentage could be earmarked for the CPLF and used to pay a supplemental COLA benefit.

   Another idea is to use a portion of the Stabilization Fund interest to fund COLA improvements.

4. **Close plan loopholes**
   The MTRS has filed three bills that would help close current loopholes, thereby freeing up funds for potential COLA improvements. The first is a technical correction that would treat all refund buybacks the same, charging interest through the date of payment rather than through the date of reinstatement to active

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service currently allowed for members who return to service within two years of taking a refund.

The second bill is the non-public school service purchase bill that would close the current loophole where members are only charged 5% of the salary they earned while working in a non-public school, as compared to every other service purchase that charges the rate in effect when the service was rendered or a flat 10%.

The third bill is our proposed creditable service study, which would normalize the cost of all service purchases including consideration of the value of the future benefit attributable to the additional service credit.

5. **Delay the start of COLA benefits**

   Presently, COLA benefits begin after one full fiscal year of retirement. Savings realized by delaying the onset of the COLA could be used to increase COLA benefits later.

6. **Increase the investment rate of return**

   As the Board is aware, on PERAC's recommendation, the administration has been decreasing the assumed rate of return on the PRIT fund assets over the past several years. The MTRS has not objected to these decreases in the assumed rate of return as they followed a national trend supported by objective data, and led to more aggressive funding of the system. However, those decreases increased the Commonwealth's unfunded actuarial liabilities (UAL), which may have impacted the administration's and Legislature's willingness to support COLA improvements.

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The following table shows the increases in the UAL attributable to each change in the assumed rate of return for the past several years:

Valuation year	Investment Rate of return change	Change in UAL Commonwealth	Change in UAL MTRS only
2013	From 8.25 to 8%	$1.670B	$889M
2015	From 8 to 7.75%	$1.947B	$1.045B
2016	From 7.75 to 7.5%	$2.218B	$1.190B
2018	From 7.5 to 7.35%	$1.520B	$845M
2019	From 7.35 to 7.25%	$1.053B	$577M
2021	From 7.25 to 7%	$2.846B	$1.570B
	Total	$11.254B	$6.116B

Most recently, in 2021, when the investment rate of return was decreased from 7.25% to 7.0%, it added $2.846 billion to Commonwealth's UAL[8]. As noted previously, the estimated increase in liability associated with raising the COLA base to $18,000 is approximately $2.5 billion, so a question for the actuary is if the administration had not decreased the assumed rate of return from 7.25%, but stayed on the same funding path, would the COLA base increase to $18,000 have been funded?

Alternatively, if the administration would consider a moderate increase in the assumed rate of return based on current market predictions, say 7.15%, and stay on the same funding path, would that be sufficient to fund an increase in the base, perhaps to $16,000?

This is not an exhaustive list of COLA reform proposals or funding options, but we hope that it helps to frame this issue for the Board 's consideration. We will walk through the material at the February Board meeting for discussion and to determine if there any other ideas the Board would like us to pursue as we prepare for participation in the Special Commission.

[8] Source: PERAC 2023 Commonwealth Actuarial Valuation

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