REPORT OF THE PUBLIC EMPLOYEE RETIREMENT STUDY COMMISSION ON POST RETIREMENT ADJUSTMENTS

Public Employee Retirement Study Commission

Commonwealth of Pennsylvania

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COMMONWEALTH OF PENNSYLVANIA

PUBLIC EMPLOYEE RETIREMENT STUDY COMMISSION

HARRISBURG

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Members of the Pennsylvania General Assembly,
Governor Dick Thornburgh,
Officials of Pennsylvania Municipalities and Municipal Pension Plans, and
Other Interested Persons

The law establishing the Public Employee Retirement Study Commission, Act 66 of 1981, as amended, placed on the Commission the duty to study the topic of public employee retirement and to formulate principles applicable to public employee retirement.

In response to that duty, the Commission has undertaken consideration of the topic of post retirement adjustments for public employees. This report of the Commission represents the result of that undertaking.

It is the view of the Commission that careful consideration of numerous policy issues must accompany any proposal for, or grant of, a post retirement adjustment. This report summarizes these policy issues. In that way, the Commission hopes to assist the process of policy making on pension issues applicable to all public employee pension plans in the Commonwealth.

Of particular concern to the Commission is the issue of funding the cost of post retirement adjustments. As with any public employee pension plan benefit, the cost attributable to post retirement adjustments should be funded in a responsible fashion. The Commission admonishes all parties proposing or considering post retirement adjustments to obtain complete information on the total cost of any post retirement adjustment proposal and to carefully consider the question of the affordability of undertaking that cost. If sufficient financing exists equal to the actuarial cost of the adjustment, funding should be provided immediately. If it is necessary to fund this actuarial cost over a period of years, that period should not exceed 10 years and should never be less than the pay-as-you-go or current disbursements funding requirement.

On behalf of the members of the Commission, I express our hope that this report will be of assistance to you in any future consideration of this significant and complex issue.

Sincerely,

Gilmore B. Seavers
Chairman

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INTRODUCTION

For many public employee pension plans, consideration of the provision of post retirement adjustments is one of the most significant pension benefit changes which can be contemplated. This report of the Public Employee Retirement Study Commission attempts to help clarify issues in this consideration.

A post retirement adjustment is a special type of retirement benefit. It is an increase in the amount of the retirement benefit which was initially payable at retirement. The increase is made at some point in time after the retirement benefit commenced. The decision to pay a post retirement adjustment is made either by the governing body of the pension plan or by the governing body of the governmental entity which established and maintains the public employee pension plan.

The actual granting of a post retirement adjustment is a decision for the appropriate policy making entity. This report is not designed to suggest that the granting of a post retirement adjustment is appropriate in any particular setting. It also is not intended to suggest what type of post retirement adjustment might be granted in any particular situation or the amount of any post retirement adjustment. Instead, this report will provide information to reduce or eliminate the confusion in the consideration of a post retirement adjustment proposal. It is hoped that it will allow persons proposing a post retirement adjustment, persons considering a post retirement adjustment proposal or persons concerned about the affairs of a public employee pension plan to better engage in the consideration process and to make informed decisions.

This report was prepared by the Pennsylvania Public Employee Retirement Study Commission as part of its duty pursuant to Act 66 of 1981 to study retirement subjects and formulate principles and objectives applicable to retirement subjects.

SUMMARY OF REPORT

Post retirement adjustments are a frequent occurrence in public employee pension plans. A post retirement adjustment is a complicated and a potentially very costly issue. Post retirement adjustments are granted through a formal process which contains numerous potential policy pitfalls. Focusing on the various elements of a post retirement adjustment will help avoid these potential policy pitfalls.

A. A chief consideration in granting a post retirement adjustment is the joint question of funding and affordability. The total actuarial cost of a post retirement adjustment, as well as the annual cost, must be determined so that an informed decision on the affordability can be made. Ten years is the maximum appropriate period over which the total actuarial cost for post retirement adjustments should be funded.

B. The appropriateness of providing a post retirement adjustment must be determined in relation to affordability and the intended purpose for the post retirement adjustment. Adjustments are requested and granted for varying purposes, which are frequently contradictory.

C. Post retirement adjustments are of two types, ad hoc adjustments and automatic adjustments. They differ on the presence or absence of a promise that additional adjustments will be granted in the future. Each type has numerous advantages and disadvantages, which should be reviewed in terms of the situation of the public employee pension plan.

D. The benefit recipients who can be included in a post retirement adjustment can be broad or narrow. The question of inclusion of recipients in an adjustment must be determined based on several factors. Additional qualifications or entitlement requirements can be utilized to insure that the intended purpose for the adjustment is achieved and that the potential cost of the adjustment is affordable.

E. The size of the adjustment is a function of the method of calculation and any applicable limits or maximums. Some methods of calculation are better suited to certain post retirement adjustment purposes.

F. Cost-of-living post retirement adjustments raise special policy issues and merit special consideration. Of particular concern is the measure of the cost-of-living to be selected and its function in the calculation of the size of the adjustment.

G. Post retirement adjustments do not occur in a vacuum. Other employment related benefits, including the current retirement benefit coverage, Social Security coverage and health insurance coverage, can function to reduce or eliminate the need for an adjustment.

The report stresses careful deliberation in undertaking the consideration of a post retirement adjustment, the use of available expertise in the process and attention to sound funding principles.

PART ONE

How a Post Retirement Adjustment is Granted

Suppose the public employee pension plan in question is being requested to provide a post retirement adjustment to those who receive benefits from that plan. In the normal course of events, that request would be presented to the policy making body (state legislature, municipal council or plan governing board) which has the discretion to adopt or reject the proposal. The exact provisions of the post retirement adjustment proposal would be detailed in the formal document for adoption or enactment. The proposal would be presented on behalf of the interested party or parties. These interested persons could range from one benefit recipient or a small segment of the benefit recipients through the total number of the benefit recipients and the active membership of the public employee pension plan.

The post retirement adjustment proposal would be discussed at one or more hearings or meetings of the policy making body. The proponents of the adjustment would set forth the merits of their proposal. The opponents of the proposal would similarly set forth their views. Consultants and other technical advisors may be contacted. These may include the person in charge of administering the pension plan concerning any administrative feasibility problems, a legal counsel on drafting and other legal issues, an actuary or financial officer with respect to the expected cost and perhaps a benefit consultant or similar person regarding any other public policy issues.

When the question of the post retirement adjustment proposal would have been addressed to the satisfaction of the policy making body, including any deliberations by a committee or committees of the body prior to consideration by the full body, action to adopt or reject the proposal would be taken. If the proposal is adopted, implementation of the adjustment would occur. One payment or several payments of the adjustment would be made to some or all of the benefit recipients and sufficient financing to cover the cost of the adjustment would be provided to the public employee pension plan.

Pitfalls in the Process

The process described above has numerous opportunities for ill-advised or undesirable policy making. This is due to the unique and complex nature of public employee pensions, the different purposes for which post retirement adjustments can be sought and granted, the intermixing of personal, social and technical issues contained in a post retirement adjustment proposal and the extent of unfamiliarity on the part of the policy making body with the subject. Examples of these pitfalls can include:

1) Improper drafting of the formal document granting the post retirement adjustment, unrecognized until after the wrong group was included, the wrong adjustment amount was paid or the wrong financing requirements were specified;

2) Misunderstanding by the parties to the process of the financial obligation associated with a post retirement adjustment, where the initial monthly or annual cost was assumed to be the total cost of a permanent adjustment;

3) Supporting or granting the post retirement adjustment proposal for the reasons of past or future expected political or policy support rather than for reasons related to the purpose or purposes which the post retirement adjustment was intended to fulfill, as in a case where an adjustment is granted to more politically active recent retirees to the partial or total exclusion of less politically vocal older retirees; and

4) Premising the funding of a post retirement adjustment on a future source of financial support which is either overly optimistic in its estimate or is already scheduled to be utilized by another aspect of the public pension program, like the situation where an adjustment is proposed based on future investment earnings where the future improvement in investment performance has already been included in the actuarial cost calculations of the plan.

The granting of public employee pension benefits frequently involves undertaking the functional equivalent of long term debt. The financial burden of a public pension benefit, including a post retirement adjustment, will be borne by current and future taxpayers. Depending on the amount of deferral utilized in financing the public employee pension plan, the financial burden will not be shared equally or evenly over time. Consequently, an ill-advised or undesirable decision on a post retirement adjustment proposal should be avoided.

PART TWO

Funding Post Retirement Adjustments

Funding for post retirement adjustments is a very important aspect of formulating or considering a post retirement adjustment proposal.

Liability to be Funded. When a post retirement adjustment is granted, the public employee pension fund will incur a liability to pay that adjustment for the period involved. The period can range from a single payment for a limited ad hoc post retirement adjustment to ever increasing payments for the remaining lifetimes of the applicable benefit recipients for an automatic post retirement adjustment.

Inappropriate Funding Choice. The funding for a post retirement adjustment should never be less than the current disbursements (or "pay-as-you-go") financing requirement. Under this funding procedure, as the payments of the adjustment come due and are paid, equal additional financing is provided to the fund. The goal is for the additional financing to equal the increase in the disbursements month to month and year to year. Numerous funding problems are associated with the use of a current disbursements (or "pay-as-you-go") method by pension plans historically. The practice is not acceptable for private sector pension plans regulated by the federal Employee Retirement Income Security Act of 1974 (ERISA). The practice is not viewed as optimal for public employee pension plans by most experts in this field, but is not precluded by any federal or Commonwealth enactment as of the time that this report was prepared. Even as a poor funding choice, current disbursements (or "pay-as-you-go") funding remains the minimum funding requirement to be met when determining the financial ability to adopt a post retirement increase.

Most Appropriate Funding Choice. The most appropriate funding for a post retirement adjustment is actuarial funding. Under this method, the liability for a post retirement adjustment is paid off like a long term debt over a period of years. The liability for a post retirement adjustment can be determined by the actuary for the pension plan. The actuary is a specialist in evaluating the cost of all aspects of the retirement plan. The maximum period for payment of the liability for the post retirement adjustment should be determined by looking at the expected remaining lifetime of the currently affected benefit recipients. The plan actuary can supply this estimate. A shorter period than this maximum period is desirable, but should be fixed with reference to the financial ability of the plan sponsor.

Most Desirable Funding Period. The Commission is convinced that as a matter of sound pension policy, the period for payment of the liability for a post retirement adjustment for benefit recipients should not exceed ten years. The Commission recommends the use by all public pension plans of a ten year period for the payment of the liability for a post retirement adjustment for benefit recipients.

PART THREE

The Appropriateness of Providing a Post Retirement Adjustment

Post retirement adjustments are more common among public sector pension plans in Pennsylvania and across the nation than they are in private sector pension plans. This is undoubtedly a result of several factors, including differing perceptions concerning the obligations of government and the obligations of the private sector, the different practice between governmental employers and private sector employers in providing Social Security (federal Old Age, Survivors, Disability and Health Insurance program) which currently provides substantial automatic post retirement adjustment coverage, and the different practice in requiring member contributions to support the pension plan coverage between governmental pension plans and private sector pension plans.

General Notion of Appropriateness. The appropriateness of providing a post retirement adjustment is dependent generally on the ultimate policy maker's view of the suitability of providing this type of retirement benefit and more specifically on the purpose for the post retirement adjustment. While the Commission does not necessarily endorse any of the following post retirement adjustment purposes as an appropriate purpose for seeking or granting a post retirement adjustment, it believes that identification of the primary purpose of a post retirement adjustment is a useful starting point.

Affordability. Common to all purposes is the question of affordability of the financial or actuarial cost of the post retirement adjustment. After a determination of the question of affordability is made, additional considerations based on the specific identified purpose may follow.

Specific Question of Appropriateness. The purposes for which a post retirement adjustment can be granted can be divided into four categories, with each post retirement adjustment purpose having its own measure of appropriateness. The question of the appropriateness of granting a post retirement adjustment can be outlined in general, but the specific question of appropriateness must be determined by the ultimate policy maker with reference to a specific post retirement adjustment proposal based on its identified purpose.

Purpose	Goal	Affected Benefit Recipients	Measure of Appropriateness
1. Individual Need	Ease financial need of individual retirees with very limited retirement income insufficient to purchase subsistence goods and services	Eldest benefit recipients, very short service benefit recipients	Factual question on sufficiency of total retirement income; pension policy question whether or not length of service and other criteria support recipient's expectation of provision of greater benefit by public pension plan; social welfare question of whether or not public pension plan is best source for this type of assistance
2. Benefit Parity	Bring parity between retirement benefits of one class of benefit recipients and retirement benefits of another class of benefit recipients	Group of benefit recipients omitted from benefit provision applicable to another group of benefit recipients	Factual question of omission from benefit provision applicable to another group; pension policy question whether or not length of service and other criteria support recipient's contention that equivalent benefits to remedy perceived injury from omission is due; pension policy question whether or not benefit recipient's perception of injury has merit
3. Inadequacy Correction	Correct, subsequent to retirement, the situation of retirement benefits which were inadequate at retirement	Group of benefit recipients who retired from restrictively designed retirement plan providing small percentage replacement of pre-retirement final salary	Factual question of replacement of pre-retirement final salary provided by plan; pension policy question whether or not length of service and other criteria support recipient's contention that fully adequate benefit should be provided by this pension plan; pension policy question whether or not applicable retirement benefit plan provided inadequate benefits at the time of their retirement to long service employees who are now retired

Purpose	Goal	Affected Benefit Recipients	Measure of Appropriateness
4. Post Retirement Adequacy	Replace erosion in purchasing power of retirement benefits since retirement resulting from inflation to retain adequacy of benefit over time	Recent benefit recipients, long standing benefit recipients with substantial retirement benefits and current active members	Factual question of erosion of retirement benefit through inflation in applicable goods and services; pension policy question whether or not maintenance of pension benefit adequacy is a duty to be met by public pension plan; pension policy question whether or not length of service and other criteria support recipient's expectation that adequacy be maintained

Types of Post Retirement Adjustments

In considering the formulation of a post retirement adjustment or in considering enactment of a proposed post retirement adjustment, the next question is that of the type of post retirement adjustment.

Advantages and Disadvantages. In the most basic classification, post retirement adjustments can be analyzed based on their frequency and separated broadly into two types. The two types, with their particular characteristics, and their respective policy advantages and disadvantages, are as follows:

AD HOC ADJUSTMENT	AUTOMATIC ADJUSTMENT
Characteristics	Characteristics
Adjustment which is granted on a single occasion without being accompanied by a promise of the occurrence of any further adjustments	Adjustment which is granted on a regular or recurring basis and is accompanied by at least an implicit promise of one or more further adjustments
Examples of Adjustment	Examples of Adjustment
Extra (thirteenth) monthly benefit payment, one time bonus amount or single permanent percentage or dollar amount increase in benefit	Scheduled series of percentage or dollar amount increases in benefit amount, percentage or dollar amount increase conditioned on occurrence of specific event (e.g. salary increase to active members) or increase with percentage or dollar amount of increase and occurrence of the increase conditioned on occurrence of change in specified economic indicator (e.g. 50 percent of increase in Consumer Price Index)

AD HOC ADJUSTMENT (Cont'd)

Policy Advantages and Disadvantages of Type

Advantages:	Disadvantages:
- can be designed to meet every type of post retirement purpose to some extent	- can only meet post retirement adequacy purpose if considered and granted frequently
- desirable from plan sponsor point of view because of potential for limited duration or lack of ongoing commitment	- less desirable from plan active and retired membership point of view because of potential for limited duration or lack of ongoing commitment
- over time, more flexible in design to target adjustments to groups with specific needs	- over time, not guaranteed to meet post retirement adequacy purpose and more subject to whim, caprice or political influence over timing, conditions for receipt and related items
- over time, cost of post retirement adjustment potentially can be tailored to financing available to plan sponsor	- cost of post retirement adjustment is always financed after post retirement adjustment is granted and runs risk that financing will extend over period longer than remaining average lifetime of benefit recipients

AUTOMATIC ADJUSTMENT (Cont'd)

Policy Advantages and Disadvantages of Type

Advantages:	Disadvantages:
- best designed to meet post retirement adequacy purpose	- least well designed to meet purposes other than post retirement adequacy purpose
- desirable from plan active and retired membership point of view because of extended duration and recurring commitment	- less desirable from plan sponsor point of view because of extended duration and recurring commitment
- over time, guaranteed to meet post retirement adequacy purpose and less subject to whim, caprice or political influence over timing, conditions for receipt and related items.	- over time, difficult or impossible to design in such a way so as to target adjustments to groups with specific needs
- over time, cost of post retirement adjustments past, present and future will be identified through regular actuarial valuation process and will be financed over the average working lifetime of active members	- over time, cost of post retirement adjustment potentially can exceed available financing and no readjustment of the benefit and resulting cost can be effected over the short term

AD HOC ADJUSTMENT (Cont'd)

Policy Advantages and Disadvantages of Type

Advantages:

- cost of ad hoc post retirement adjustment when granted will be largely known quantity, affected only by interest and mortality assumptions
- from active and retired membership point of view, may form a precedent or a moral or equitable commitment for future ad hoc adjustments

Disadvantages:

- cost of post retirement adjustment will be added to unfunded accrued liability and will be borne either totally by plan sponsor or by plan sponsor and current active members on behalf of current benefit recipients, which cost can be sizeable financing requirement
- from plan sponsor point of view, may form a precedent or a moral or equitable commitment for future ad hoc adjustments

AUTOMATIC ADJUSTMENT (Cont'd)

Policy Advantages and Disadvantages of Type

Advantages:

- cost of post retirement adjustment will be in whole or in part a portion of normal cost and can be jointly financed by plan sponsor and active employees who will be covered by post retirement adjustments at the time of retirement
- from active and retired membership point of view, may form a precedent or a moral or equitable commitment for the extension of adjustment to other recipients or to other benefits

Disadvantages:

- cost of automatic post retirement adjustment when instituted will be subject to all potential difficulties with actuarial assumptions and potential future increases in recognized liabilities and financing requirements
- from plan sponsor point of view, may form a precedent or a moral or equitable commitment for the extension of adjustment to other recipients or to other benefits

Coverage of Post Retirement Adjustments

Public employee pension plans generally provide a number of types of benefits with variations in the qualification for those benefits. In requesting a post retirement adjustment or granting a post retirement adjustment, a decision has to be made about the types of benefit recipients to be included in the coverage of the adjustment.

Range of Recipients. The benefit recipients potentially included in a post retirement adjustment include:

Retirement benefit

Normal retirement benefit recipients with long service.
Normal retirement benefit recipients with short service.
Early retirement benefit recipients.
Persons with vested rights to a deferred retirement benefit.

Disability benefit

Duty related permanent disability benefit recipients.
Duty related temporary disability benefit recipients.
Nonduty related permanent disability benefit recipients.
Nonduty related temporary disability benefit recipients.

Survivor benefit

Surviving spouse benefit recipients.
Surviving child benefit recipients.
Recipients of second half of joint and survivor optional annuity form of retirement benefit.

General Criteria for Inclusion. The decision of whether or not to include a particular benefit recipient in a post retirement adjustment will depend, first, on the purpose for the post retirement adjustment. Secondly, it will also depend on the extent of the connection between the benefit recipient and the pension plan. Some benefits are payable only after long service. Others are payable after only a short period of service. Some benefits (disability or survivorship) are heavily employment connected and others are connected with employment only incidentally.

Specific Criteria for Inclusion. Anyone requesting or granting a post retirement adjustment should sort the list of potential recipients of the post retirement adjustment into those deemed appropriate for inclusion and those deemed not. The consideration should take into account the following:

1. The purpose for the post retirement adjustment.

2. The connection of the potential recipient to the pension plan.

3. The connection between the potential recipient and the purpose for the post retirement adjustment.

4. The cost of including the potential recipient in the post retirement adjustment.

Legal Constraint on Inclusion. A potential contraint on those groups of benefit recipients which may be included in a post retirement adjustment is a provision of the Pennsylvania Constitution, specifically Article III (Legislation), Section 26. That provision is as follows:

> Extra Compensation Prohibited; Claims Against the Commonwealth; Pensions
>
> Section 26. No bill shall be passed giving any extra compensation to any public officer, servant, employee, agent or contractor, after services shall have been rendered or contract made, nor providing for the payment of any claim against the Commonwealth without previous authority of the law: Provided, however, that nothing in this Constitution shall be construed to prohibit the General Assembly from authorizing the increase of retirement allowances or pensions of members of a retirement or pension system now in effect or hereafter legally constituted by the Commonwealth, its political subdivisions, agencies or instrumentalities, after the termination of the services of said member.

The prohibition on extra compensation portion of the provision was adopted in 1874, and the portion of the provision authorizing increases in retirement allowance and pensions was adopted in 1955. Prior to the 1955 adoption, the prohibition on extra compensation caused a number of provisions of various municipal codes and governing laws which authorized post retirement adjustments to be invalidated.

While the provision is not clear on the point and no reported case or opinion of the Attorney General clearly stands for the proposition, the conventional interpretation of this section has been to exclude survivor benefit recipients from the group of benefit recipients to whom a post retirement adjustment may be granted.

Minimum Qualification Requirements

Minimum qualification requirements insure that the post retirement adjustment is targeted only to those persons who match the purpose for the post retirement adjustment. It also serves to limit the potential cost of any post retirement adjustment proposed or granted.

Potential Qualification Requirements. There are a number of potential minimum qualification requirements which could be imposed. These include the following:

1. Time interval elapsing since retirement
   - most appropriate for post retirement adequacy purpose
   - insures that there has been lost purchasing power resulting from inflation

2. Attained age
   - most appropriate for post retirement adequacy purpose and individual need purpose
   - insures that need for adjustment is not result of retirement at too early an age

3. Accrued service prior to retirement
   - most appropriate for post retirement adequacy purpose, benefit parity purpose and inadequacy correction purpose
   - insures that adjustment is directed to longer service public employees

4. Benefit amount
   - appropriate for any purpose
   - avoids administrative problems connected with adjustment for small pension benefit amounts, where processing cost exceeds adjustment

5. Salary level prior to retirement
   - appropriate for any purpose
   - differentiates between full time and part time employees

6. Residence
   - most appropriate for individual need purpose and post retirement adequacy purpose
   - insures that any public welfare cost savings accrues to jurisdiction, or that the replacement for inflation measured has been experienced

7. Non-dependency status
   - most appropriate for individual need purpose
   - insures that potential recipients have no alternative support

8. Post retirement income
   - most appropriate for post retirement adequacy purpose or individual need purpose
   - insures that potential recipients rely on pension benefit rather than non-retirement benefit earnings for their primary financial support

Size of and Limits to Adjustments

Some methods of calculating the amount of post retirement adjustments are better suited to a post retirement adjustment purpose than others. Some methods are more costly than others. Care should be used in selecting the method of calculation.

Method of Calculations. Post retirement adjustments can be classified on the basis of their method of calculation and separated broadly into the following groups:

1. Proportional post retirement adjustments, where the amount of the adjustment is determined as a percentage of the benefit, and which can either include any previously granted post retirement adjustments (known as compounded adjustments) or be based solely on the original pension benefit granted without any prior post retirement adjustments (known as linear adjustments); or

2. Nonproportional post retirement adjustments, where the amount of the adjustment is set in one of a number of ways, including as an additional flat dollar amount which is then uniformly applied to all appropriate pension benefits, as a guarantee of a minimum pension benefit level where any deficient benefits are increased up to the level of the guarantee, or as a recalculation of pension benefits on the basis of the provisions of a previously granted benefit improvement.

Specific Considerations. The purpose or purposes for which each method of calculation is most suitable and any additional considerations in determining a calculation method are as follows:

Calculation	Most Suitable Post Retirement Adjustment Purpose	Additional Considerations
Proportional Method	Post Retirement Adequacy, because inflation has proportional effect	1. The measure of the change in the cost-of-living for benefit recipients; 2. The formula for determining the amount of the change in the cost-of-living which will be replaced by the adjustment; 3. The benefit base to which the formula will be applied; and 4. The adjustment or lack of adjustment resulting from any declines in the measure of the change in the cost-of-living
Nonproportional Method	Individual Need Purpose, because need is seldom proportional to current benefit amount	Determination of dollar amount increase or guaranteed benefit amount which would approach subsistence income
	Benefit Parity Purpose, because parity is rarely proportional to current benefit amount	Determination of dollar amount increase which would bring benefit parity
	Inadequacy Correction, because relative benefit inadequacy is seldom proportional on average	On whatever basis of benefit adequacy is applicable to the public pension plan, determination of dollar amount increase which would result in adequacy

Special Note on Size of and Limits to Cost-of-Living Post Retirement Adjustments

Cost-of-living post retirement adjustments are adjustments granted for the purpose of post retirement adequacy. As such, they are the most frequently requested and considered type of post retirement adjustment and merit additional discussion.

<u>Measure of Cost-of-Living</u>. The most widely used measure of the change in the cost-of-living for benefit recipients is the Consumer Price Index, issued monthly by the Bureau of Labor Statistics of the United States Department of Labor. It is one of a number of potential measures of the change in the cost-of-living. Other potential measures include the gross national product (GNP) deflator, the employer cost index covering compensation rates in the civilian nonfarm economy, the average increase in compensation paid to all active employees of the applicable employer or the increase in compensation paid to a particular employment position.

<u>Deficiencies in Consumer Price Index</u>. The Consumer Price Index is a measure of the relative cost over time of a number of consumer goods, services and expenses. It has been criticized generally for a variety of reasons. These include the mix and weighting of the included items, the failure to include federal and state income taxes, the failure to consider changes in the quality of goods and services over time, and the failure to adequately respond to changing consumer consumption patterns. It has been criticized specifically because its range, mix and weighting of items does not reflect the cost-of-living realized by retirees.

<u>Function of Consumer Price Index</u>. While these problems are recognized and there is a general belief that it overstates the effects of inflation, the Consumer Price Index remains the most viable average measure of the effects of increases in the cost-of-living. Since any measure of the increase in the cost-of-living will not apply perfectly to particular retirees who feel the impact of inflation in a variety of ways, an average measure is the best available. The Consumer Price Index thus functions initially as a trigger for the granting of a cost-of-living post retirement increase, and secondly as a basis for the formula for determining the amount of any adjustment.

<u>Alternative Approach</u>. An alternative is to utilize an automatic proportional annual increase. This will remove some of the uncertainty in the amount and timing of cost-of-living post retirement adjustments. It does, however, implicitly assume future inflation at some level and runs the risk of providing adjustments during periods of no inflation or even deflation.

<u>Cost-of-Living Formula Generally</u>. In setting the formula for determining the amount of the change in the cost-of-living which will be replaced by an adjustment, the following questions should be answered:

1) whether the full increase in the measure or only a portion of the increase in the measure will be replaced;

2) whether the adjustment will or will not be subject to any caps or limits; and

3) whether the adjustment will or will not include any minimum adjustment.

<u>Partial Replacement or Maximums</u>. To replace only a portion of the increase in the inflation measure would reflect a belief that the measure of inflation overstates the effect of inflation on benefit recipients or a desire

to protect the funding stability of the applicable retirement system. To impose caps on any adjustment similarly reflects a policy of protecting the funding stability of the affected retirement system. To utilize a minimum adjustment in the event of inflation would reflect a desire to err on the question of the measure on the side of the benefit recipient if a minimum percentage is used or to provide a meaningful increase irrespective of the magnitude of the base benefit if a minimum dollar amount is used.

Base for Adjustment. The benefit base to which any adjustment formula will be applied is also an important consideration for a person requesting or reviewing a post retirement adjustment proposal. The benefit base may be the amount of the original benefit received, without taking into account any prior post retirement adjustments. In lieu of this linear adjustment, a compound adjustment could be used. This is the situation where the benefit base is the amount of the pension benefit then payable. The following demonstrates the long term impact of a linear adjustment and a compound adjustment each of five percent (benefit including increase in each year as a percentage of the benefit in the first year):

Year	Linear Adjustment	Compound Adjustment
1	1.0000	1.0000
2	1.0500	1.0500
3	1.1000	1.1025
4	1.1500	1.1576
5	1.2000	1.2155
10	1.4500	1.5513
15	1.7000	1.9799

Maximum Benefit Base. The benefit base for adjustment may also be limited to an amount which does not exceed a specific dollar amount. This will reduce the cost of providing a post retirement adjustment mechanism for post retirement adequacy purposes and will assist in moderating any negative public perception of the adjustment mechanism. However, a single annual benefit amount limit has the general effect of placing a limit on the adjustment for long term employees, while leaving the adjustment of shorter term employees with other benefit coverage unaffected.

Symmetry in Adjustment. The question of symmetry in any post retirement adjustment mechanism also needs consideration. During periods of deflation (a decline in the measure of the cost-of-living), the measure of inflation will indicate a negative number. If there is symmetry, the adjustment in this case will similarly be negative. Without symmetry, no adjustment downward would occur.

Modifying a Post Retirement Adjustment for Other Employment Benefit Coverage.

A number of benefits gained by virtue of employment can function to reduce or eliminate the need for post retirement adjustments, especially in the case of post retirement adjustments sought for purposes of post retirement adequacy.

Modification for Overadequate Retirement Coverage. Chief among these employment benefits which can modify the amount of any post retirement adjustment or adjustment mechanism is the retirement benefit coverage itself. The retirement benefit coverage may be overadequate at the time of retirement. This overadequacy in the amount of the retirement benefit at retirement is an existing accommodation for the lack of any regular post retirement adjustment for post retirement adequacy. During the period when the retirement benefit is overadequate, there will not be any real adverse effect from inflation.

Modification for Social Security Coverage. Another major employment benefit which could modify or eliminate the need for post retirement adjustments or a post retirement adjustment mechanism is the benefit coverage provided by the federal Old Age, Survivors, Disability and Health Insurance program (OASDHI, or Social Security). In addition to the primary insurance amount, Social Security provides the following:

1) an automatic, immediately payable, 50 percent survivor benefit;

2) post retirement adjustments equal to the cost-of-living as measured by the Consumer Price Index (although delayed for six months by recent Congressional enactment); and

3) broad medical coverage through the Health Insurance program (Medicare).

If a significant portion of a benefit recipient's total benefit is comprised of Social Security benefits, with substantial medical care coverage provided through Medicare, a careful assessment of the extent of this existing coverage when considering an adjustment for the purpose of post retirement adequacy should be made.

Modification for Other Benefit Coverage. A final major employment benefit which should be factored into any decision on a post retirement adjustment is any health and related medical coverage provided to benefit recipients. A major cost-of-living item experienced by benefit recipients is the cost of health and medical insurance coverage and deductibles. If all or a substantial portion of this coverage is provided by the employer to benefit recipients, and if that employment benefit increases with premium increases as a measure of inflation, then it can be argued that some modification in the post retirement adjustment should be made to account for it.

Reservation of Power to Alter Adjustment. Because of the difficulty in estimating the ultimate cost of post retirement adjustments or of predicting future revenues, the policymaker may wish to retain rights to tailor subsequent payments of the adjustment to the available financing. In the event that full funding of the cost of an ad hoc post retirement adjustment is not appropriated at the time the adjustment is enacted, the public employer may wish to include in the enacting legislation a provision for the partial or total suspension of the adjustment by operation of law in the event that appropriations in subsequent years do not meet the funding requirements of the adjustment.

CONCLUSION

Proposing or granting post retirement adjustments is a very complex subject. The topic should be handled with care since the adverse consequences of an ill-designed or an ill-financed post retirement adjustment can be substantial for all parties concerned.

In preparing a post retirement adjustment proposal or in considering a post retirement adjustment proposal, it would be sound policy to use whatever technical consultants may be available. These include the plan actuary, the plan accountant, the plan lawyer or solicitor and the plan administrator or comparable experts. An attempt to address the broad policy questions examined briefly in this report should be made. Most especially, the question of funding for the post retirement adjustment should be addressed. In particular the total amount of the resulting funding requirement caused by the post retirement adjustment, the source of that funding and the period over which that funding requirement will be spread should be addressed.