Retirement News Highlights

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Public Employers and the COLA Conundrum

With government workers' pay raises lagging the private sector's, state and local officials will need to navigate through different measures of inflation to fairly calibrate wage and pension increases.

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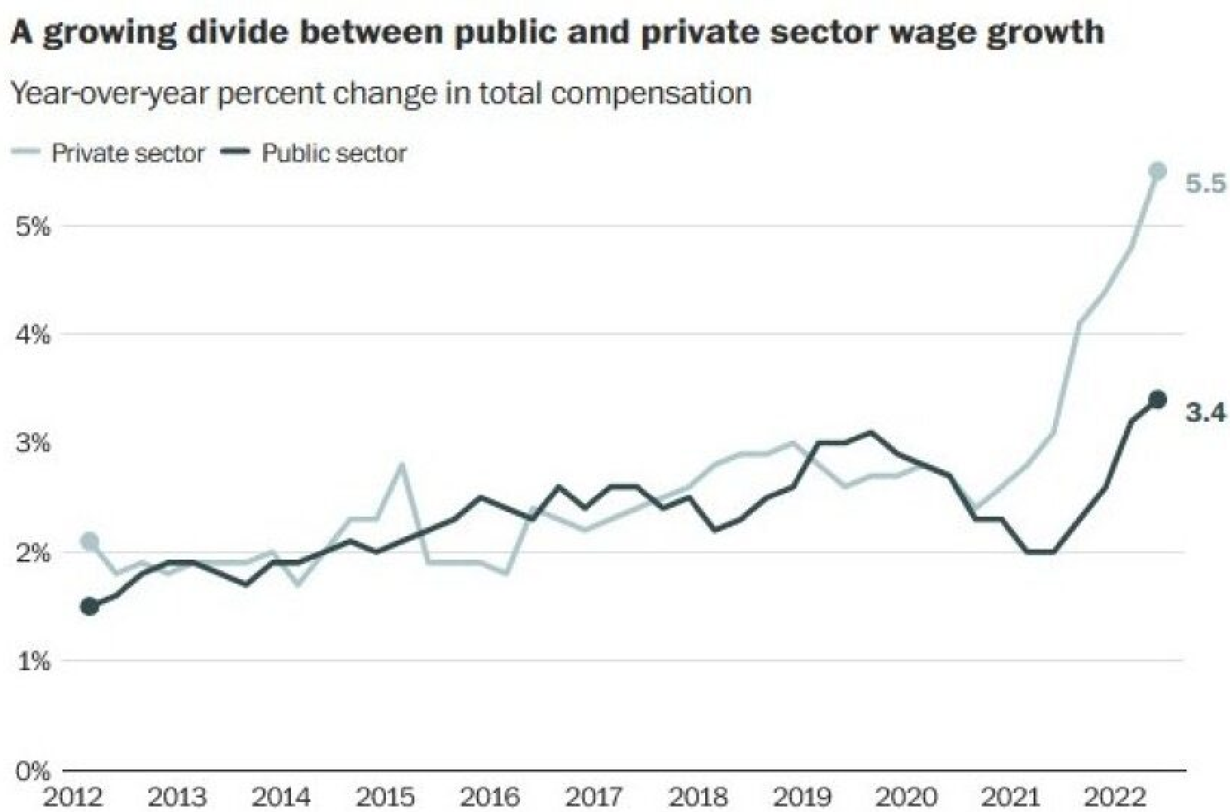
Government employees have drawn the short straw lately when it comes to inflation adjustments to their pay. The gap in pay increases could be closed in the coming year if cost-of-living adjustments (COLAs) are awarded by formula to public employees, but that's a big if. And don't be surprised if there are debates about which inflation index to use and how.



(**Source: The Washington Post, from Bureau of Labor Statistics data)**

The latest inflation report that is watched closely by the Federal Reserve showed "personal consumption expenditure" (PCE) inflation at 6.3 percent for May, lately far lower than the Consumer Price Index (CPI) of year-over-year inflation that's commonly used for labor agreements and pension adjustments. The comparable CPI rate for the same period was 9 percent, and came in at 8.5 percent for July.

That disparity illustrates the complexity of calibrating inflation at the state and local government level. It's not surprising that parties with competing viewpoints will cherry-pick their data, as well as which time windows in the past or the future are most relevant in making compensation adjustments.

Cost-of-living adjustments have been around for decades, and became commonplace in the "stagflationary" 1970s. Social Security began paying out COLAs in 1975 (the three-month average of urban wage earners' CPI increases it uses is projected to invoke a 9-plus percent COLA increase for recipients in 2023).

COLA indexing became popular in public-sector labor agreements around that time. Many public pension funds first tried to make unsystematic, ad hoc inflation adjustments, but that became a political and actuarial nightmare because those one-off, emotion-influenced adjustments were unfunded, which made a mess of the pensions' financial structures. As a result, the Labor Department's CPI became the common standard used in the public sector for COLA adjustments.

The CPI weighs housing costs more heavily (at roughly one-third of the index) than the Commerce Department's PCE, while placing a lower weighting on medical expenses that are often covered by public employer-subsidized health insurance. Those housing and medical-cost factors alone would seem to make the CPI more relevant to public workers' pay rates, although some could argue that younger and older workers have varying housing inflation pressures depending on renter vs. ownership status, when the latter's mortgage rates were set, and who has what kind of property tax protection.

To set monetary policy, it is likely that the Federal Reserve board will keep paying closer attention to the PCE to guide it in raising interest rates. Nonetheless, governmental salary and pension policy decisions and labor agreements will be driven by the CPI. Because housing prices have rocketed by double-digit rates in the last two years, it is possible that the CPI measure will keep running hotter than the PCE for months to come. Explaining these nuances to policymakers, workers and retirees will be a continuous challenge for public-sector managers, pension officers, labor representatives and budget staffers.

Rearview Mirror or Foggy Windshield?

Putting aside the CPI-PCE measurement gaps for now, and expecting that the CPI will continue to be the index of choice among states and local governments, the challenge for policymakers, labor negotiators and pension officials will be how to best make COLA adjustments when the underlying inflation rate has spiked. Although CPI escalation is expected to subside in 2023, it's unlikely to swoon to the idyllic 2 percent level that most central bankers deem optimal. So what's the fair solution to adjusting pay and pension benefit rates? Should we focus on past, present or likely future inflation rates?

For those who think the economy is about to head into a real recession with widespread layoffs and a hard contraction of economic activity and tax revenues, along with other ugly outcomes that crimp public employers' ability to pay, the problem is whether we should focus on the clear but cluttered rearview mirror or try to peer through a foggy windshield. But for those concerned about workers' purchasing power, the permanent pocketbook damage is already done and needs to be offset permanently. Arguably, even those who have locked in their housing costs with a fixed-rate mortgage and local property tax limitations are unlikely to stay put forever, so their purchasing power will eventually erode. That supports using the CPI index and making COLA adjustments based on price increases in the past year.

Where it gets complicated is the ability of public employers to finance inflationary salary and pension costs. As long as revenues keep escalating with inflation and the economy grows, there is no fiscal dilemma. But if a recession hits and we see reductions in tax revenues at the state and local level, the end result of hefty COLA payouts is that the budgets cannot afford them and layoffs and service reductions will be inevitable unless ample rainy-day money is set aside to weather that storm.

For employers and collective bargainers, the recession-risk scenario requires that thought be given to strategies to assure sufficient sustainable funding to keep paying the COLA-inflated salaries. One obvious solution is to focus labor negotiations and workers' attention on the necessity to properly finance a rainy-day fund for this contingency before making a generous COLA adjustment that might not be affordable in the next two years. That might mean that any permanent COLA salary adjustments should be lower than the CPI, with a provision for "catch up" payouts if the dreaded recession does not materialize. Or alternatively, the COLA adjustment could be bifurcated, with half added to salaries now and the other half paid out as a one-time COLA bonus payment that would be folded into future salaries at such time as revenue sufficiency is clearly established — when the storm of a revenue recession has passed, or if it never really arrives.

Seeing STARs

For pension funds, particularly those where public employers have volatile income tax revenues or operate under property tax limitations like California's Proposition 13 that hobble the revenue base well below the inflation rate, one approach is what some California pension systems have adopted: the Supplemental Targeted Adjustment for Retirees, acronymized as the "STAR COLA." Pension adjustments are capped at a fixed annual level, and future "make-up" payments — STAR COLAs — are provided if inflation subsides. In 2023, this means that these retirees will not receive an increase of more than 2 or 3 percent, depending on labor agreements, with the remainder of any CPI adjustment payable in future years if and when the inflation rate is lower than the STAR COLA's predetermined hurdle rate.

Besides employers' revenue constraints, part of the rationale for STAR COLAs is that retirees face lower inflation pain than active employees, having presumably stabilized their housing costs, so they are better able to accept a delay in COLA payments as long as they can eventually catch up. This arrangement also helps the pension actuaries make realistic forecasts of future pension cost inflation (now about 2.6 percent nationally) because the cap is there, and they can model in the accumulation of "STAR reserve" payments that will eventually work their way into the retiree liability calculation.

Although this formulation may seem odd to policymakers in other states, it's actually a fairly sensible solution to a complex problem that ought to be considered for pensions elsewhere — and perhaps also for salary adjustments where the employer's revenues are constrained or volatile.

Outlook: My crystal ball still sees inflation rates in 2023 registering above 4 or even 5 percent early in the year and above 3 percent for most of the rest, but nothing like the 8 to 9 percent year-over-year CPI increases we have seen lately. The most likely path of "sticky disinflation" will be a gradual downward stair step pattern of successively lower CPI reports as the Fed tries to thread the needle to bring the economy to a soft landing without delivering a hard recession. Having a game plan for both possible outcomes is a really smart strategy.

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