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Policy Design and Management Issues for State Retirement Saving Plans

Policy Brief

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Introduction

Many American workers do not have access to employer-sponsored payroll deduction plans for retirement saving. Groups with low rates of access include younger workers, members of minority groups, and those with low-to-moderate incomes.[1] Small business employees are especially at risk. Only about 14 percent of businesses with 100 or fewer employees offer their employees a retirement plan, leaving between 51 and 71 percent of the roughly 42 million people who work for a small business without access to an employer-administered plan (Government Accountability Office 2013).

Lack of access makes it difficult to build retirement wealth. A study by the Employee Benefit Research Institute (2014) shows that 62 percent of employees with access to an employer-sponsored plan held more than $25,000 in saving balances and 22 percent had $100,000 or more. In contrast, among those without access to a plan, 94 percent held less than $25,000 and only 3 percent hold $100,000 or more. Although workers without an employer-based plan can contribute to Individual Retirement Accounts (IRAs), very few do.[2] But employees at all income levels tend to participate at high rates in plans that are structured to provide guidance about the decisions they should make (Wu and Rutledge 2014).

With these considerations in mind, many experts and policy makers have advocated for increased retirement plan coverage. While a national approach would be desirable, there has been little legislative progress to date. States, however, are acting. Three states have already created state-sponsored retirement saving plans for small business employees, and 25 are in some stage of considering such a move (Pension Rights Center 2015).

This policy brief, based on John and Gale (2015), highlights a variety of issues that policymakers will need to address in creating and implementing an effective state-sponsored retirement saving plan.

Plan Design

State-sponsored plans can be either defined contribution (DC) plans or defined benefit (DB) plans, although to date, DC plans are more prevalent. A third option, marketplace models, could be used with either type of plan and would provide a way to connect firms and providers. Each option presents certain advantages and disadvantages. The optimal choice for a specific state will depend on its own political, historical, or economic factors. Because most workers hold a number of jobs during their working life, a key issue is that a state-sponsored plan should be compatible with those offered through private sector employers.

Defined Contribution Retirement Savings Plans

Although other options exist, states have mainly explored two types of DC plans – Automatic IRAs and Multiple Employer Plans (MEPs) – though sometimes they are called by different names.

Under an Automatic IRA, employers would automatically enroll workers into a payroll deduction IRA (Iwry and John 2009). Employees would have complete control and could choose to opt-out, save more or less than the default amount, and choose their investment option. Their contributions would be placed into one of only a few investment options, with those who do not choose otherwise contributing to a target date fund or similar investment. The Automatic IRA is a simple, easy-to-understand, low-cost retirement savings plan for small businesses and aims to replicate the benefits of automatic enrollment seen in 401(k) plans (Madrian and Shea 2001). The Automatic IRA would likely boost retirement plan participation substantially, but its effect on retirement saving balances depends on how old employees are when they start to save and how much they contribute (VanDerhei 2015). Proposed Department of Labor (DOL) proposed regulations clarify that state-sponsored Automatic IRAs are exempt from ERISA as long as employers are required to offer some form of retirement savings or pension plan.

Under a Multiple Employer Plan (MEP), several small businesses join together to offer a common type of account to each employer's workforce. In the state context, states would create a MEP for its small businesses. As Employee Retirement Income Security Act (ERISA)-regulated plans, MEPs can be 401(k) plans or accounts with features similar to 401(k)s. But MEPs are simpler: the common plan structure reduces the compliance burden and places most fiduciary responsibilities on the plan administrator. Recent DOL regulatory guidance would allow states to sponsor MEPs as long as the state plans meet certain requirements.

Traditionally, retirement savings plans have exempted contributions and accruals from taxation and taxed withdrawals as income. However, the deduction is worth less to those who face a lower marginal tax rate. A withdrawal before age 59 ½ generally imposes income tax, and in many cases, an additional 10 percent penalty.

Roth IRAs and 401(k)s embody an alternative tax

[1] John and Koenig (2014) estimate that 55 million U.S. wage and salary workers between the ages of 18 and 64 lack the ability to save for retirement through an employer-sponsored payroll deduction plan.
[2] Among such workers with wages between $30,000 and $50,000 only about one out of 20 contributes regularly to an IRA (Employee Benefit Research Institute 2006).

treatment, where the contribution is made from after-tax income and accrual and withdrawals (after age 59 1/2) are not taxed. Savers may withdraw all or part of their contributions at any time without having to pay additional taxes.

In a traditional retirement saving plan, workers are not enrolled unless they specifically sign up. However, in automatic enrollment plans, workers are automatically enrolled unless they opt-out. Automatic enrollment harnesses savers' tendencies towards not taking an action and makes it work to their retirement saving advantage. This method has been shown to raise participation rates among eligible workers of all ages, genders, racial and ethnic groups and income levels (Madrian and Shea 2001). If a state-sponsored plan uses automatic enrollment, employers merely have to offer automatic payroll deduction, sign the workers up for the plan, distribute information to employees, and collect forms from those who wish to opt-out.

Most state-sponsored plans under consideration include a default contribution level, while plans with automatic enrollment must specify a default contribution level.[3] Many plans use a contribution level of 3 percent of earnings, but this level is not high enough to create balances sufficient enough to replace much of one's pre-retirement earnings. Most state-sponsored plans will have a small number of investment choices, with one designated as the default fund. According to Federal law, sponsors can either choose a mix of investments that accounts for "the characteristics of the group of employees as a whole, rather than each individual," or the sponsor can consider each participant's age, retirement date, and life expectancy. These standards usually allow a choice of balanced funds, target date funds, and managed accounts.

Some states are considering guarantees that would protect individual savers from investment losses or ensure at least a certain level of return. Supporters believe that a guarantee would protect state-sponsored plan participants at a low cost. However, the benefits of a guarantee will depend on the overall share of wealth that is being guaranteed, the level of the guarantee, and the saver's risk aversion (Gale, John, and Kim 2015).

Most state-sponsored plans are currently only considering lump-sum withdrawals. In the future, however, their withdrawal options could include an immediate annuity upon retirement, a longevity annuity where payments begin a number of years after retirement, or a target date fund that begins to convert retirement balances into an annuity during workers' careers (Kahn and Strakosch 2015).

[3] In automatic enrollment plans, participation rates are not particularly sensitive to the initial contribution level (Chandler and Mottola 2014).

Defined Benefit Plans

A second model for state-sponsored plans is to offer small business employees the opportunity to join a DB plan. The program could be managed by the state's public employee pension plan, a subsidiary of those plans, or a private entity. A DB plan can provide workers who stay in the plan their whole careers with a predictable level of lifetime income, but it also has drawbacks. For example, using the same investment strategy for the state-sponsored small business plan and the state public employee pension plan may not make sense if the two work forces have different characteristics. Further, tying the state-sponsored plan to a state employee pension plan that may be underfunded or otherwise have political liabilities could undermine support for the small business plan.

Marketplace Models

A marketplace is a state-sponsored website that enables small businesses to find pre-screened retirement saving or pension plans. The marketplace might include a diverse array of plans, including payroll deduction IRAs, SIMPLE IRA plans, MEPs, the new federal MyRA, and perhaps even 401(k) plans and DB plans. Listed options would meet certain requirements such as low fees. The marketplace model would not require the state to have any involvement with ERISA because a marketplace just connects employers and providers. However, it is worth noting that a marketplace does nothing to simplify retirement saving or reduce regulatory burdens or fiduciary responsibilities of smaller employers.

Mandatory Coverage and Consumer Protections

Several policy design issues are common to all of the models described above. The first is whether coverage should be mandatory. Mandating that employers above a certain size offer some form of coverage if they don't already do so would boost the number of workers with retirement plans. Moreover, it would likely reduce the number of future retirees with little retirement income other than Social Security benefits, which, in turn, would lower the future demand for taxpayer-financed state services. Employees will benefit from a required offering, both because they will have the opportunity to save and because the accounts would be portable with respect to job changes. Nevertheless, in some states, business associations have remained neutral for a voluntary system, but have indicated strong opposition to any required coverage. Opposition also comes from groups and legislators who are against placing government requirements on businesses.

A second issue is consumer protection. Explicit consumer protections will help to build confidence in the state-sponsored plan and to encourage participation, especially for non-ERISA plans as the protections provided by that law would not be present.

Appropriately structured state consumer protections could provide the same or greater protection as ERISA. Friedman and Stein (2014) propose six consumer protections that parallel those in ERISA. These include creating a board of trustees charged with protecting the interests of savers and retirees, with representation from savers, retirees, employers and others, but not from providers or the financial industry.

Other consumer protections should include clear disclosures and a dispute resolution process with an independent ombudsman to resolve problems between savers and their employers or other aspects of the plan. Finally, a state-sponsored plan should have clear and explicit spousal protections including having spouses as default beneficiaries if savers die before retirement.

Management Issues

Government Responsibilities

An important, but understudied decision is where in the state government to place the responsible agency. Ideally, the agency would have prior experience in finance and investing, but would avoid conflict-of-interest with the financial industry.

A related issue is the extent to which services are performed in-house or contracted out. Contracting out specific services increases the responsibilities of the state entity using it. State employees must understand how the different pieces fit together, and they should structure the contracts so that different providers can mesh to create the whole. They must also have enough expertise to create contract specifications that clearly state which services are needed and set clear expectations about performance standards.

Private operation differs from contracting out in that the entire state-sponsored plan is handled by a private entity – either one company or a consortium of providers – with all decisions made by them. The state entity's function would be limited to oversight and branding. This structure is attractive to some states because private professionals who understand the industry handle the details of the plan instead of state employees who may not be as knowledgeable.

Another option is to allow a state entity such as the one which makes investment decisions for the state to operate the state-sponsored plan. Under this structure, the state might use existing tax collection or pension contribution structures to gather contributions, existing state or pension plan investment mechanisms to structure and handle plan investments, or existing state financial literacy experts to handle educating participants. By using existing state competencies for an expanded purpose, costs to plan participants could be lower and the plan could go into operation faster. However, if this structure is chosen, the state must be careful to avoid conflict of interest problems or the appearance that the plan is being used to benefit some other program or group.

Since retirement plans, fee structures, and the workforce are constantly evolving, a regular review of the state-sponsored plan and all of its elements will be important to ensure that it continues to meet the needs of the state's small business employers and their employees. As part of the review, the state can consider innovations and ensure that the plan's costs and fees are as low as possible and that it complies with any new federal laws and regulations. It will also ensure that the state is meeting its fiduciary duties and protect it from unnecessary controversy.

In addition to the reviews by financial professionals, states should consider establishing a review commission composed of representatives of employers, employees, financial professionals, and others. The commission could help to ensure that the plan continues to meet the needs of its savers and review the plan's progress in increasing coverage among small business employees.

In the case of a marketplace plan, the regular review should examine both the products that it offers to ensure that they continue to meet its standards and the standards themselves.

The Role of the Employee

Participation in a state-sponsored plan should be as simple and easy as possible. In states with automatic enrollment, employees do not need to take action in order to participate. However, they always have complete control over their participation and saving choices, including whether to stop. When state-sponsored plans do not offer automatic enrollment, employees will need to choose whether to participate, how much to contribute, how to invest the funds, and how to withdraw the funds. This includes situations where the state uses a required decision mechanism.

The Role of the Employer

Employer responsibilities depend on the structure of the state-sponsored plan and whether participation is required or just encouraged. In either case, states can keep the employer's duties at a minimum by keeping the plan as simple as possible. If the state chooses an Automatic IRA, employer responsibilities would be limited to four simple functions: enrolling employees or handling their paperwork to opt-out, setting up the payroll deduction, forwarding contributions to the plan, and dealing with an annual open enrollment period (Cowan 2015).

If the state chooses a marketplace model, the specific employer responsibilities will depend on which option

the employer chooses. It could be minimal if the employer chooses the MyRA, or more complex if it chooses a SIMPLE IRA or even a 401k. Other than arranging for a payroll deduction, the employer's most important duty is to ensure that an employee's contributions reach the plan in a timely manner. Employers with outside payroll processors need only to notify the processor of the deduction and provide routing information for the payment. Once this is done, the processor will handle the retirement contributions just like it handles other deductions and forward the money to the plan manager each pay period.

Companies doing their own payrolls without payroll processing software may find the process slightly more complex, but once the deduction is arranged, payment will become a routine part of the process. In no case will forwarding payments be any more difficult than handling income tax withholding.

Employer contributions depend on the structure of the state-sponsored plan or the specific choices allowed under the marketplace model. For example, if the state-sponsored plan's underlying account is a traditional or Roth IRA, employer contributions are prohibited. Alternatively, both the SIMPLE IRA and the SEP-IRA can receive contributions from the employer, and a SIMPLE IRA requires one.

Employer liability should be limited to their primary roles. States can reduce the potential liability of employers by adopting a simple plan design and assuming responsibilities that would otherwise fall to the employer (Toth 2014). By doing so, liability can be placed with those who are best able to handle it.

In addition, employers need clear disclosures stating what their responsibilities are and what standards they are expected to meet. Inevitably, employers or payroll providers working on their behalf will make a mistake such as using a wrong number, missing a deadline, etc. Fear that such an innocent error would result in a stiff punishment has been raised in several states as a reason for small business opposition to a state-sponsored plan. For this reason, states would be best served by making it clear that that they will treat innocent and occasional errors leniently as long as a correction is made quickly after the mistake is identified.

Conclusion

State-sponsored retirement savings plans for private sector small business employees have a real potential to improve the retirement security of its participants and improve the state's fiscal outlook. Additionally, these plans offer the best chance in the near term to increase the number of Americans with access to payroll deduction retirement savings plans. In the absence of a comprehensive federal program, they could be the most significant improvement in coverage for many decades. But there is still a great deal of work to be done before the plans reach their full potential. In order to make a difference, these plans must be carefully structured and implemented. The success of the plans in achieving their goals depends on the host of issues described above regarding plan design and management.

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