March 2016, Number 16-5

CENTER for RETIREMENT RESEARCH at BOSTON COLLEGE

STATE SAVINGS INITIATIVES: LESSONS FROM CALIFORNIA AND CONNECTICUT

By Anek Belbase, Alicia H. Munnell, Nari Rhee, and Geoffrey T. Sanzenbacher*

Introduction

At any given moment, about half of private sector workers are not covered by any employer-sponsored retirement plan. To close this coverage gap, 18 states are considering retirement savings initiatives.[1] These efforts have been spurred by the lack of action at the federal level – which would be preferable to a patchwork of state plans – and the apparent inability of existing employer-sponsored plans to solve the problem.

But the state initiatives are still at an early stage. To date, just two states – California and Connecticut – have completed "feasibility studies" to determine whether their initiatives can generate sufficient account balances and employer support to be successful. Both states propose a mandate on employers to either set up a retirement plan already available in the market or join a state program of individual retirement accounts with automatic enrollment ("auto-IRAs"). This *brief* focuses on lessons learned from these two states to inform other states considering similar efforts.

The discussion proceeds as follows. The first section describes the California and Connecticut initiatives. The second section presents three lessons learned from their feasibility studies: 1) high rates of employee participation can be expected; 2) employers are split in their support, but they will not discourage participation by employees; and 3) program design and implementation are critical. The final section concludes that while the work done by California and Connecticut suggests a promising outlook for auto-IRAs, success will depend on how well the programs are implemented.

Background on California and Connecticut

California was the first to pass a law expanding retirement coverage, when, in 2012, it established a state-sponsored auto-IRA program, the Secure Choice Retirement Savings Program.[2] Under the Secure Choice program, businesses in California with five or more employees that do not offer a retirement savings plan would be required to automatically enroll their workers in an IRA. The legislation established a trust to hold program assets and a board to study the feasibility of the program. To be considered feasible, the program must be exempt from the Employee Retire-

* Anek Belbase is senior research project manager at the Center for Retirement Research at Boston College (CRR). Alicia H. Munnell is director of the CRR and the Peter F. Drucker Professor of Management Sciences at Boston College's Carroll School of Management. Nari Rhee is the manager of the Retirement Security Program at the University of California at Berkeley Center for Labor Research and Education. Geoffrey T. Sanzenbacher is a research economist at the CRR. The authors wish to thank Genevieve Ballinger with the state of Connecticut and the retirement savings team at The Pew Charitable Trusts for helpful comments.

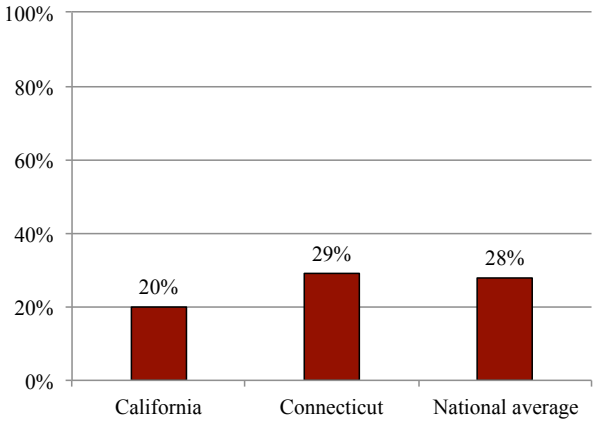
ment Income Security Act (ERISA) and cannot incur liability on behalf of the State. California's legislation allows the Secure Choice trust to set up a reserve account that could be used to smooth investment returns to minimize risk to participants. It also allows for guarantees that are backstopped by private insurance. The feasibility study for California's Secure Choice program was completed in February 2016, but legislative action is necessary before the program can be implemented.

In 2014, Connecticut established the Connecticut Retirement Security Board to study the feasibility of a State-sponsored auto-IRA program.[3] Connecticut and California's programs have many of the same provisions, including an employer mandate, automatic enrollment, and the provision of annuities upon retirement. Also like California, Connecticut is not allowed to incur any liability associated with the program, and the program cannot be treated as an employer plan under ERISA. However, unlike California's program, Connecticut's legislation does not set up a mechanism that would allow the program to smooth gains and losses and instead considers purchasing a guarantee to minimize risk. Connecticut's Retirement Security Board submitted its feasibility study to the legislature in January 2016 and needs legislative approval to implement the program.

Lessons Learned

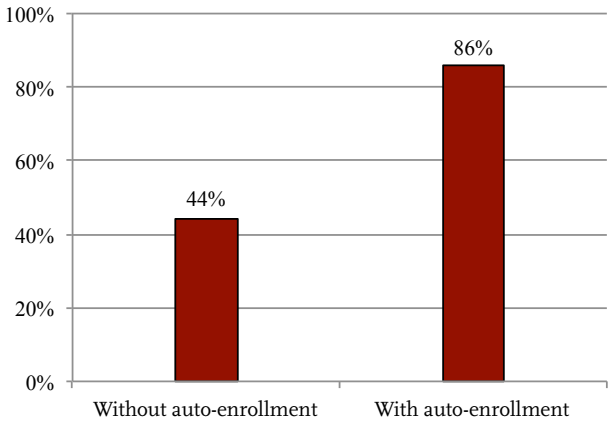
Both states recognized that the key to the success of their programs – both in terms of increasing retirement security and in terms of feasibility – is achieving a large pool of participating employees. Thus, both states took the auto-IRA approach, which requires firms to automatically enroll their employees. This approach is necessary because: 1) small employers are not likely to offer plans on their own initiative (see Figure 1a), as evidenced by the lack of interest in simple savings products designed to serve small businesses; and 2) employees are much more likely to participate with auto-enrollment as evidenced from the experience of 401(k)s (see Figure 1b).[4] Furthermore, the employer mandate combined with automatic enrollment greatly diminishes marketing costs for providers, while a large asset base allows the state to command lower fees through institutional rather than retail pricing on program investments. Of course, this approach only works if workers actually stay in the program, i.e., they do not "opt-out," and the California and Connecticut research offers valuable insights into this issue.

Figure 1a. Percentage of Workers at Small Firms Offered a Plan, 2014



Note: Small firms are those with fewer than 100 workers.
Source: U.S. Census Bureau (2015).

Figure 1b. 401(k) Participation Rates for Workers with Incomes Below $50,000, Without and With Auto-enrollment, 2014



Source: Authors' calculations from Vanguard (2015).

Lesson #1: High rates of participation can be achieved

As California and Connecticut select a default contribution rate, they must balance the benefit of producing more savings against the cost that more workers will opt out if they feel they need the money now. To study participation, California and Connecticut performed separate online benefit-enrollment experiments in which participants were randomly assigned to programs with different contribution rates and asked about their decisions to remain enrolled or opt out. For example, some respondents to Connecticut's program saw the program described in the Box.[5] A second group of workers saw a program with "3 percent of your pay" instead of the 6 percent highlighted in red in the Box, and a third group saw the contribution rate rise from 6 to 10 percent over four years. In California, workers saw a similar type of program description with either a 3-percent or 5-percent contribution rate. Changing the program descriptions slightly and seeing how workers respond shows how the level of the default contribution rate affects participation.

The results of both the California and Connecticut experiments are encouraging (see Figure 2). The participation rates range from 73 to 84 percent, depending on the state and the contribution rate being considered.[6] Further, the small difference in participation between 3 and 6 percent in the Connecticut experiment and 3 and 5 percent in the California experiment suggests that states can likely enroll workers at a higher contribution rate without risking low participation. Since workers tend to anchor to defaults, setting a high default is the best way to ensure the program produces retirement security for workers.[7] However, Connecticut's experiment does show that if contribution rates are automatically increased to 10 percent over four years, participation will be lower.

In addition to contribution rates, Connecticut's experiment also examined how uncovered workers respond to two other potential design features: annuitization and guarantees. On the annuitization front, the news from Connecticut is positive. When workers were told their account balances at retirement

Box. Example of Program Shown to Respondents in Connecticut's Experiment

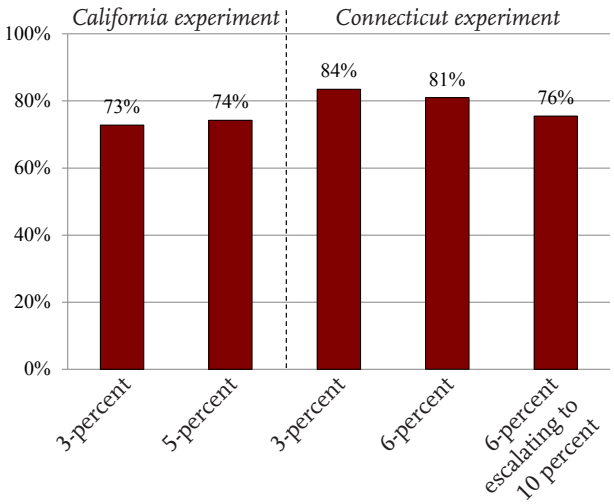
Imagine you're offered the chance to participate in a retirement program at work. Please read the information about the program offered (below) and select the choice you'd likely make if this program were offered to you in reality.

Your employer will automatically deduct a contribution each paycheck (just like it does for Social Security), and deposit the money into a retirement account in your name. Your savings will be invested and grow over time to provide you with income in retirement. Some important features of this program:

- 6 percent of your pay, or $60 per every $1,000 you earn, will be deducted and deposited into your account. You can change how much you contribute to your account once a year and can stop contributing at any time by opting out of the program.
- The money will be invested in a fund appropriate for someone your age, managed by a private company selected by the State of Connecticut.
- You can withdraw your contributions without penalty at any time; you pay taxes on your contributions up front.
- You can access all of your account balance (contributions plus investment earnings) without penalty or taxes when you retire.

Source: State of CT Retirement Security Board (2016).

Figure 2. Percentage of Workers Who Would Participate, by Contribution Rate



Sources: Overture Financial (2016); and State of CT Retirement Security Board (2016).

will be used to provide a monthly income "like Social Security," participation was higher than when they were told they could simply withdraw their account balances at retirement (as in the Box).[8] This result suggests that states can consider offering a default annuity without sacrificing participation.

However, the news on guarantees is not as positive, mostly because providing a guarantee can come at a steep cost. When workers were told they would be guaranteed a 1-percent real rate of return but that their return was unlikely to be higher than 1 percent (as in a money market fund), participation was a full 15 percentage points lower than when such a guarantee was not included. Similarly, workers in the California survey preferred their money invested in a balanced fund relative to a money market fund by a ratio of two to one. On the other hand, both the California focus groups and employee survey showed that Latino and low-income workers were more loss-averse and, thus, more willing to sacrifice returns for security than higher-income workers.

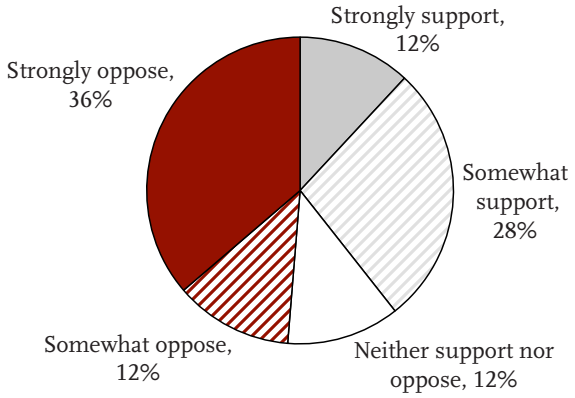
Given the high cost of private market guarantees, California policymakers are currently choosing between two default investment options that offer some safeguards without unduly sacrificing returns. One is to start new participants with two to three years in a stable value or Treasury fund to protect account balances as participants get used to saving, and then transition them into a riskier investment strategy. The other is a collective defined contribution plan design that uses a gain/loss reserve to smooth participant returns with no explicit guarantee.[9]

Ultimately, states considering offering a guarantee that limits long-term growth should be cautious about its effect on worker participation.

Lesson #2: Employer support is split, but they will not discourage participation

While employee participation is one key to the success of the program, employer reaction is also important. To understand how employers view the proposed programs, California interviewed employers and business associations in California, and Connecticut conducted focus groups of Connecticut employers. In addition, Connecticut worked with Nielsen, Inc. to conduct a phone survey of 199 small Connecticut employers that do not offer their employees a retirement plan and thus would be affected by the mandate. The results of this phone survey indicate that employers are split in their support of Connecticut's program with 48 percent opposing and 40 percent supporting (see Figure 3).

Figure 3. Percentage of Employers Supporting/ Opposing Connecticut's Proposed Program



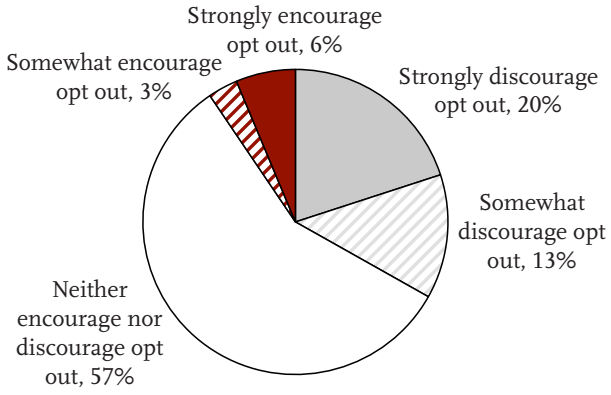
Source: State of CT Retirement Security Board (2016).

Three main concerns drove employer opposition to the proposed programs. In Connecticut, employers expressed concern that the state could not manage the program effectively, citing the state's struggles with its pension plans. Second, Connecticut employers did not like being "mandated" to offer a retirement plan and did not think that their employees should be "forced" to save for retirement. These concerns were echoed to some extent in California, though some business groups in the state saw the program as a beneficial employee recruitment and retention tool, leveling the playing field for small employers who often compete with larger employers. Finally, employers in both California and Connecticut worried about the administrative burden of enrolling employees and explaining the program to them.

This research suggests several ways to mitigate employer opposition. First, clarify that employees' money will be managed by a private sector provider and kept separate from the state's pension fund. Indeed, support in Connecticut was higher – at 61 percent – in an AARP survey that made it explicit that a private sector financial institution would manage employees' accounts with the state simply offering oversight.[10] Second, make it clear to employers that participation by employees is voluntary since they have the ability to opt out. Finally, minimize the administrative burden by, as suggested by California employers, including uniform eligibility requirements (i.e., no age or tenure requirements), limiting the frequency of employee contribution rate changes, having the recordkeeper rather than employers perform auto-escalation, and providing the employer with educational materials to give to employees.

Given the mixed support, an obvious concern is that employers might encourage workers not to participate. But the Connecticut phone survey suggests that this problem will not occur; just 9 percent indicated that they would encourage their workers to opt out (see Figure 4).

Figure 4. Percentage of Employers Who Would Encourage/Discourage Employees to Opt Out of Connecticut's Proposed Program



Source: State of CT Retirement Security Board (2016).

Lesson #3: Implementation is the next challenge

Implementation is a key remaining challenge for states to resolve. To ensure an efficient and effective program, states should generally rely on proven platforms and techniques, as well as foster consistency across states, employers, and service providers. Specifically, states should have four main goals: minimize the employer burden, create a recordkeeping platform, comply with federal security requirements, and develop an enforcement mechanism.

1. *Minimize employer burden*

Minimizing employers' administrative burden requires limiting their duties related to enrollment and payroll deduction to a bare minimum. The California study suggests a system in which the recordkeeper is responsible for almost all employee-level transactions and interactions including enrollment notices, opt-outs, employee contribution rate elections, communication, and auto-escalation. This approach would allow employers to simply upload employee data to the recordkeeping institution and implement payroll deduction under instructions from the recordkeeper. For employers that use full-service payroll processors, a national standard could be developed that allows recordkeepers for retirement plans to exchange this employee data with the payroll processors.

2. *Create a recordkeeping platform for auto-IRAs*

Recordkeeper platforms exist for auto-enrollment 401(k)s, but not auto-IRAs. Indeed, existing IRAs are designed for a retail audience, not institutional customers. Auto-IRAs require integration of some recordkeeping features used for IRAs and 401(k)s, while keeping the individual accountholder as the primary customer. Fortunately, the cost of developing this infrastructure is not a major barrier given the potential multi-billion dollar market. In addition, the California study recommends a phased roll-out starting with eligible large employers to work out any issues before enrolling a large number of smaller employers.

3. *Comply with Patriot Act without affecting participation*

While retail IRA providers normally meet Patriot Act "know-your-customer requirements" by obtaining signatures from accountholders, this task can pose a barrier to participation. The legal advisors to California's program have suggested that state auto-IRA programs and recordkeepers may develop alternative protocols that meet Patriot Act requirements for risk-based customer identification programs. These might include reliance on employer verification of employee identity through I-9s and standard cross-checks against consumer reporting and other databases, and steps to validate the identity of participating employers. This approach may be worth considering for other states.

4. *Develop an efficient enforcement mechanism*

Compliance enforcement – ensuring that employers are participating and duly enrolling eligible workers – will also be critical for the program's success. California is currently exploring, among other options, the state labor agency's workers compensation insurance audit system as a potential model. This system uses private vendor data and routine employer payroll data reporting to the state, combined with statistical sampling techniques, to efficiently identify employers who are likely to be under-insured. Each state needs to explore its own enforcement capacities early on in the program design process.

Conclusion

Both the California and Connecticut feasibility studies find that high levels of employee participation would result from an employer requirement to offer an auto-IRA, and therefore that account balances and total plan assets would be high enough to allow their programs to cover their costs at relatively low fees. While employers have some objections to state savings programs, they will not discourage participation and may view the program differently if their administrative burden is minimized.

While these findings are promising, much remains to be settled. Neither California nor Connecticut has actually implemented its program, so the extent of the burden on employees and employers is unclear. And an effective implementation is important to the overall success of the programs.

Still, other states considering these initiatives should benefit from what California and Connecticut have learned and should view the auto-IRA approach as an extremely promising way to close their retirement coverage gap.

Endnotes

1 Munnell, Belbase, and Sanzenbacher (2016).

2 State of California Legislature (2012).

3 State of Connecticut General Assembly (2014).

4 The most widely cited study (Madrian and Shea 2001) found that automatic enrollment increased 401(k) participation among new hires from 49 percent to 86 percent. Even after three years of service, participation with automatic enrollment was a third higher than before the feature was adopted.

5 California conducted a similar experiment. For more details on Connecticut's enrollment experiment, visit the Connecticut Retirement Security Board's website, http://www.osc.ct.gov/crsb, and view Appendix A to the Market Feasibility study. For more details on California's enrollment experiment, visit the California Secure Choice website, http://www.treasurer.ca.gov/scib and view the Overture Financial Final Report.

6 While Connecticut's experiment was given to individuals across the country and then re-weighted to represent Connecticut's uncovered workers, California's experiment was able to focus on just California workers because of its larger size. This focus on California workers has been proposed as one reason why participation rates in California's experiment are lower than Connecticut's, since workers in California indicated some distrust of the state government to run the program that may not have been present nationwide.

7 For more on the anchoring effect of defaults, see Beshears et al. (2009).

8 This finding was reversed and participation was lower when a deferred annuity was offered that used 15 percent of workers' account balances at retirement to purchase an annuity that began payments at age 82, perhaps because workers worried they would not live to get the benefit.

9 Called a "Pooled IRA with Reserve Fund," the collective defined contribution plan design is modeled after the SAFE Retirement Plan proposal described in Davis and Madland (2013).

10 AARP (2015).

References

AARP. 2015. "Giving Small Businesses a Competitive Edge: The 2015 Connecticut Retirement Savings Plan." Washington, DC.

Beshears, John, James J. Choi, David Laibson, and Brigitte C. Madrian. 2009. "The Importance of Default Options for Retirement Saving Outcomes: Evidence from the United States." In *Social Security Policy in a Changing Environment*, eds. Jeffrey Brown, Jeffrey Liebman and David A. Wise, 167-195. Chicago, IL: University of Chicago Press.

Davis, Rowland and David Madland. 2013. "American Retirement Savings Could be Much Better." Washington DC: Center for American Progress.

Madrian, Brigitte and Dennis Shea. 2001. "The Power of Suggestion: Inertia in 401(k) Participation and Savings Behavior." *Quarterly Journal of Economics* 116(4): 1149-1187.

Munnell, Alicia H., Anek Belbase, and Geoffrey Sanzenbacher. 2016. "State Initiatives to Cover Uncovered Private Sector Workers." *Issue in Brief* 16-4. Chestnut Hill, MA: Center for Retirement Research at Boston College.

Overture Financial. 2016. "Final Report to the California Secure Choice Retirement Savings Investment Board." New York, NY.

State of California Legislature. 2012. "California Secure Choice Retirement Savings Trust Act." S.B. 1234. Sacramento, CA.

State of Connecticut General Assembly. 2014. "An Act Promoting Retirement Savings." S.B. 249. Hartford, CT.

State of Connecticut Retirement Security Board. 2016. "Report to Legislature: Connecticut Retirement Security Board." Hartford, CA.

U.S. Census Bureau. 2015. *Current Population Survey March Supplement*. Washington, DC.

Vanguard. 2015. "How America Saves 2015." Valley Forge, PA: Vanguard Institutional Investor Group.

CENTER *for*
RETIREMENT
RESEARCH
at BOSTON COLLEGE

About the Center

The mission of the Center for Retirement Research at Boston College is to produce first-class research and educational tools and forge a strong link between the academic community and decision-makers in the public and private sectors around an issue of critical importance to the nation's future. To achieve this mission, the Center sponsors a wide variety of research projects, transmits new findings to a broad audience, trains new scholars, and broadens access to valuable data sources. Since its inception in 1998, the Center has established a reputation as an authoritative source of information on all major aspects of the retirement income debate.

Affiliated Institutions

The Brookings Institution
Massachusetts Institute of Technology
Syracuse University
Urban Institute

Contact Information

Center for Retirement Research
Boston College
Hovey House
140 Commonwealth Avenue
Chestnut Hill, MA 02467-3808
Phone: (617) 552-1762
Fax: (617) 552-0191
E-mail: crr@bc.edu
Website: http://crr.bc.edu

The research reported herein was performed pursuant to a grant from The Pew Charitable Trusts. The opinions and conclusions expressed are solely those of the authors and do not represent the opinions or policy of The Pew Charitable Trusts or the Center for Retirement Research at Boston College.