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Asset Building Program

The California Secure Choice Retirement Savings Program

An Innovative Response to the Coming Retirement Security Crisis

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Until recently, the "three-legged stool" was the reigning metaphor for achieving retirement security. Workers could anticipate being supported as they aged by a combination of Social Security benefits, private pension income, and personal savings. This model no longer holds. Traditional pensions have almost disappeared from the private workforce, personal savings are low, and Social Security benefits face political and actuarial threats. The new model relies on defined contribution ("DC") plans like the 401(k). Unlike yesterday's pensions, also known as defined benefit ("DB") plans, which based monthly benefits for life on earnings and time served, DC plans derive their value from employee and employer contributions, which are governed by a set of tax rules and limits.

Unfortunately, roughly half the private workforce does not have access to these DC plans because their employers choose not to offer one. Still, for many with access, their accumulated assets will not adequately replace their incomes. Without policy changes, the transition to a 401(k)-based system is on its way to becoming a "failed social experiment."[1]

The state of California has recently embarked on crafting a response. In September 2012, the state legislature passed Senate Bill 1234, which created the California Secure Choice Retirement Savings Program. California Secure Choice ("CSC") would establish automatic retirement accounts for all workers in the private sector who do not otherwise have access to a workplace retirement plan. The program is aimed at reducing disparities in retirement saving and shoring up the three-legged stool.

This issue brief will first, explore the inequities and shortcomings of the current retirement system; second, outline the effort in California to reduce these inequities through universal accounts; and third, offer additional policy considerations for both the California initiative and the national retirement savings framework.

[1] Ghilarducci (2008).

America's Retirement Savings Crisis

A growing number of workers are finding themselves approaching retirement with little— if any—savings to rely on. The statistics are sobering. In 2010, the median household retirement account balance for workers between the ages of 55 to 64 was a mere $120,000.[2] Converted to a monthly annuity, a worker who retires at 64 with this amount saved up will have access to only $625 per month in supplemental income if he or she lives to be 80. Three-quarters of near retirees (ages 50 to 64) have annual incomes below $52,201 and average total retirement savings of $26,395.[3] Compounding the problem further is the reality that many mid-career workers are not saving at all. A 2012 study found that a third of Americans between 45 and 54 had saved nothing specifically for retirement.[4] As many workers now spend twenty years or more in retirement due to increased longevity, and with workers with the most physically demanding jobs often forced to retire earlier, the financial security of older Americans is in serious jeopardy.

Without policy changes, the transition to a 401(k)-based system is on its way to becoming a "failed social experiment."

The marked shift over the past three decades from traditional pensions to DC plans like the 401(k) has been a significant driver of this trend. Whereas DC plans originated as a supplement to DB plans, today they predominate as the sole option for many covered workers. From 1980 to 2008, the percentage of private sector workers participating in a DB plan fell from 38% to 20%.[5] During this same period, the proportion of private employees participating exclusively in a DC plan (that is, not in both a DC plan and a DB plan) grew from 8% to 31%. The replacement of DB plans with DC plans reflects a changing conception of retirement security as an individual rather than collective responsibility.

Perhaps it should be unsurprising, then, that many workers find themselves without access to a workplace retirement plan whatsoever. The same proportion of workers guaranteed a traditional pension in 1960 is offered a plan of any kind today (with DC plans the far more likely option); indeed, only 58% of full-time, full-year private sector workers ages 25-64 work for an employer that sponsors a retirement plan of any sort (regardless of whether they are actually eligible to participate).[6] Particularly given the recent increase in part-time work, which is not even encompassed by this statistic, the low rate of access to a retirement plan in the private sector is troubling.[7]

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A key distinction between DB and DC plans is the allocation of risk. In DB plans, the employer makes all the investment decisions and is accountable for paying the worker's pension regardless of how these investments fare. Pension benefits are inaccessible until the worker reaches retirement, at which point they are generally distributed in equal monthly payments, thus guaranteeing that the worker will not outlive her savings. In contrast to DB plans, with 401(k)s, it is up to each worker to manage his investments and there is no recourse if they lose value. Though these workers can purchase annuities to receive consistent retirement funds for the remainder of their lives, this does not happen automatically and most opt to receive a lump sum. A recent survey, for example, found that only 6.5% of

[2] Munnell (2012). This figure represents the median 401(k)/ IRA balance for households in this age group.
[3] Saad-Lessler & Ghilarducci (2012).
[4] EBRI (2012).
[5] Butrica (2009).
[6] Ghilarducci (2008); Munnell et al. (2012).
[7] Rampell (2013).

workers nearing retirement having only a DC plan were expecting to receive any portion of their savings as an annuity.[8] By contrast, 92.5% of those with only a DB plan were anticipating a steady monthly payment. Even though annuities are not simple financial products, they do offer benefits in the form of predictable income during the post-work years.

DB plans are not without their problems. Firms can go bankrupt or run into serious financial distress and renege on their commitments. The federally-backed Pension Benefit Guaranty Corporation (PBGC), created in 1974, offers protection for DB plans by providing insurance and assuming the obligations of plans that fail, up to a guaranteed cap per worker. In the early 2000s, due to both macroeconomic factors and companies' underfunding, several large employers defaulted on their pensions and retirees received inadequate settlements, calling into question the terms of the PBGC insurance mechanism. Some argue that certain requirements established by the Pension Protection Act of 2006, while designed to strengthen pension stability in response to these defaults, are in fact deterring companies from maintaining DB plans. At the same time, the perception of plan instability triggered by a small number of high-profile bankruptcies may be prompting more retirees to take their benefits as a lump sum, an option that only became widely available in the late 1990s.[9] These trends in the administration of DB plans reflect an overall shifting of responsibility for ensuring retirement security from employers to individuals.

The risk shift also manifests itself in low DC participation rates, particularly among lower-income workers, which compounds the problems posed by vast numbers of employees not being offered a plan at all. The decision to participate in a DC plan, like all the accompanying investment decisions, is typically one that the worker must proactively make. Unlike with pensions, where workers who meet a minimum tenure requirement are assured the benefit without having to sign up, employees must generally take the initiative to enroll in a 401(k). If the default option is non-participation, many workers who feel unsure if they earn enough to save will be unlikely to commit. In March 2008, the take-up rate among workers whose employers offered a DB plan was 96%; for DC plans, only 77% participated.[10] Recent reforms that support automatic enrollment for DC plans (discussed in more detail below) have begun to address this imbalance.

Gaps in access and participation reveal significant disparities among workers based on race and income. Around 69% of white private sector employees have access to a workplace retirement plan, compared to 62% of black workers and 43% of Latinos.[11] Consequently, only 55% of white workers, 48% of black workers and 32% of Latino workers actually participate in a plan.[12] While some may save independently, many are not saving at all, greatly increasing the likelihood that they will experience economic insecurity during their years after they leave the workforce.

Furthermore, these disparities are often exacerbated rather than mitigated by Social Security benefits, despite the program's relatively progressive structure.[13] For decades, Social Security has been a critical lifeline for many older Americans. Currently, around 10% of seniors live below the poverty line; without Social Security, this figure would jump to almost half of retirees.[14] However, Social Security is not and was never intended to be an adequate income replacement on its own. The average benefit is just shy of $15,000 a year.[15] Because of lower lifetime earnings, black and Latino retirees receive 26 percent less in average annual Social Security benefits than do whites.[16] Yet over 30 percent of blacks and 26 percent of Latinos, compared to 22

[8] Watson Wyatt (2008).
[9] Ghilarducci (2008).

[10] Bureau of Labor Statistics (March 2008). `
[11] Rhee (February 2012).
[12] Rhee (February 2012).
[13] Favreault and Mermin (2008).
[14] Van de Water and Sherman (2012).
[15] Social Security Administration.
[16] Rhee (February 2012).

percent of whites, rely on Social Security for more than 90 percent of income in retirement.[17]

Finally, beyond low participation, a system that places the burden of managing retirement security entirely onto individual workers poses a variety of other barriers to the long-term financial security of the workforce. Research has shown that many people determining their own retirement contributions underestimate how much they need to save or how long they will live, and thus end up accumulating less than necessary.[18] Furthermore, in practice, workers with DB plans are likely to accumulate more than their counterparts with the same work history in DC plans, due in part to the high level of "leakage," or early withdrawals, from 401(k)s.[19] Lastly, due to their percentage-based match structures, DC plans inevitably provide much higher benefits to higher paid workers. A 5% match for an employee making $25,000, for example, is $1250; for a worker making $100,000, it's four times as much. This regressive benefit structure compounds inequitable plan access among workers who are otherwise similarly situated. Public policy and tax incentives have contributed to the creation of this system by establishing a regulatory environment more favorable to DC plans than traditional pensions. Now, policy must evolve further to address the looming retirement crisis.

Automation offers a potentially constructive response. Retirement plan features that draw upon principles of behavioral economics to make it easier to save have shown promise in reducing the current system's gaps and shortfalls. Perhaps the most successful of these is automatic enrollment, through which participating employers automatically sign up all of their workers for their retirement plan unless employees choose to opt out. By changing the default, auto-enrollment has been found to significantly increase participation in retirement plans.[20] Moreover, a recent study found that the policy can have a particularly meaningful impact for lower-income workers, who are less likely than higher earners to be "active savers" who alter their investment decisions in response to changes in retirement policy.[21]

Indeed, auto-enrollment has been shown to reduce both income and racial disparities.[22] For example, a 2012 study found that black workers who were not subject to auto-enrollment participated in plans at a rate of 64% in 2010, while Latinos participated at 59%; among whites, the participation rate was much higher, at 77%. However, employers who offered auto-enrollment reported both higher participation and a much narrower racial gap: their black employees participated at 82%, Latinos at 83%, and whites at 85%. The Pension Protection Act of 2006 made it easier for employers to adopt auto-enrollment, and recent studies show that an increasing number of workplaces are doing so.[23] The growing popularity of this policy could have a significant impact in promoting retirement savings equity.

Auto-enrollment has been shown to boost participation and to reduce both income and racial disparities.

However, while auto-enrollment has been highly effective in boosting participation, its effects on overall saving are mixed. Default contribution rates are often set as low as one or two percent, which makes it difficult for workers to save adequately for retirement even with an employer match. Many financial advisors recommend contributing no less than six percent of each paycheck to achieve sufficient income replacement by retirement. Boosting default

[17] Rhee (February 2012). Among all workers over 80, 76% rely exclusively on Social Security for their income. Center on Budget and Policy Priorities, Policy Basics: Top Ten Facts about Social Security.
[18] Ghilarducci (2008).
[19] Ghilarducci (2008), p. 77-79.

[20] GAO (2009) ; *see also* Madrian and Shea (2001).
[21] Chetty et al. (2012).
[22] GAO (2009); Choi et al. (2001); Ariel/Aon Hewitt (2012).
[23] Brown (2010).

contributions to these levels would increase the potential for workers to accumulate an adequate balance. Additionally, automatic escalation, which typically increases a worker's contribution automatically each year or with each pay raise, helps employees increase the amount they save without even thinking about it. These types of "nudge" policies can enable workers to overcome the inertia that often poses a barrier to saving, while simultaneously reducing the participation and savings gaps in the retirement system at large.

Retirement (In)security in California

As the most populous state in the nation, and with a particularly high proportion of low-wage workers, California faces some unique and critical retirement challenges. In California, 6.3 million private sector workers lack access to a workplace retirement plan, and in recent years coverage has been trending down. From 2008 to 2010, only 45% of California's private sector workers between 25 and 64 years old had access to a plan; this is a decrease from 50% from 1998 to 2000. Additionally, only 37% of the state's private workers actually participate in a plan, reflecting a persistent gap between those who are eligible for a plan and those who are enrolled.[24]

In California, 6.3 million private sector workers lack access to a workplace retirement plan.

In California, as in most states, the groups that are at the greatest risk of retirement insecurity are low-income workers, workers of color, women, and workers at small employers.[25] Members of these groups are typically far less likely to have access to a workplace retirement plan (and for women, far less likely to accumulate sufficient earnings due to the gender wage gap and fewer average years in the workforce). The median annual income of workers who do not have access to a plan is $26,000, which equates to half the earnings of those who do. Only 22.1% of the bottom income quartile has access to a plan, compared to 68.5% in the top quartile.

Similarly, just a third of Latino workers in the private sector have access to retirement plans, which is a far lower proportion than other racial groups.[26] This is explained in part by the fact that California's Latino workforce is disproportionately concentrated in low-wage sectors such as construction, food service, and accommodations. Finally, two-thirds of the private sector workers in California without access to a plan are at firms of 100 or fewer employees.

Retirees without personal savings are much more likely to rely on the social safety net or financial support from their adult children to meet basic needs and expenses.

Inadequate retirement savings can have a devastating impact on both individual households and the larger economy. Currently, 47% of California workers are expected to retire with incomes below 200% of the federal poverty level (FPL), or about $22,000 a year.[27] The outlook is even worse for younger workers; recent projections estimate that 55% of those between the ages of 25 and 44 will fall below the 200% FPL threshold. As traditional DB pensions disappear, retirees without personal savings are much more likely to rely on the social safety net or financial support from their adult children to meet basic needs and expenses. Widespread retirement insecurity thus imposes a cost on both families and society. Establishing broader and more equitable access to retirement savings opportunities can enable seniors to retire at a reasonable age, remain self-

[24] Rhee (June 2012).
[25] Rhee (June 2012).
[26] Rhee (February 2012).
[27] Rhee (June 2012).

sufficient, and maintain their quality of life when their time in the workforce is over.

The California Secure Choice Retirement Savings Program

California has taken a significant step in acknowledging its retirement crisis and striving to craft a response through the passage of SB 1234, a bill sponsored by Sen. Kevin de León and Sen. Darrell Steinberg that will create the California Secure Choice Retirement Savings Program. Signed into law in September 2012, the Act will create a retirement savings program administered by the state for private sector workers who do not have access to accounts through their employers. The program is intended to be a sustainable, self-funding path to retirement security for California's workers. Employees' payroll contributions will be pooled into a trust, which the nine-member California Secure Choice Retirement Saving Investment Board will administer.[28] The Board, with appointments from the Governor, the Senate Committee on Rules, and the Speaker of the Assembly, will select an investment manager to invest the funds to provide a stable and low-risk rate of return. These accounts are designed to act as a crucial supplement to Social Security benefits, with the goal of achieving a "minimum wage" of retirement income for Californians. While final authority on program rules and policies will be the responsibility of the board, the legislation identifies a number of key features of the program, which are described below.

Auto-Enrollment

One of the central features of the program is that it automatically enrolls all eligible employees, who are defined as private sector workers at firms of five or more employees that do not offer their own retirement accounts. Employees can opt out of the program if they choose and can withdraw any contributions without facing a penalty for the first ninety days. After that, withdrawing the contributions would incur a fee, but employees would always have the option of maintaining their account but stopping the payroll deduction. Prior to enrollment, employees will receive an information packet and disclosure forms specifying the risks and benefits of participation, instructions for opting out, and information about withdrawing funds.[29]

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At least every two years, employers will designate open enrollment periods during which employees who had previously opted out can sign up for the plan. Additionally, the bill stipulates that the Investment Board will have the authority to evaluate and establish a process whereby employees of non-participating employers can enroll in the program.[30] Given auto-enrollment's proven success at increasing retirement plan participation, this feature should enable the program to reach a broad swath of the target population in an effective and efficient manner. It is the mechanism by which California will extend participation in a savings plan to up to six million additional people, at essentially no cost to the public purse.

Contribution Structure

The CSC proposes a default employee contribution of 3% of income, which will flow to the trust through a payroll deduction. Workers can decide to adjust their contribution rates or withhold contributions at any time. The Investment Board has the authority to shift the default rate between 2%

[28] SB 1234 provided for a seven-member board, but the subsequent companion legislation, SB 923, will expand the board to nine when SB 1234 is enacted.

[29] The California Secure Choice Retirement Act, Title 21, Sec. 100014.

[30] The California Secure Choice Retirement Act, Title 21, Sec. 100012 (l).

and 4% and may elect to set different rates within this range for different employees, based on how long the worker has been participating in the program.[31] Because the accounts will be treated as tax-preferred Individual Retirement Accounts (IRAs), workers will be subject to the IRA contribution limits established by the Internal Revenue Service.[32]

Currently, the program does not provide for an employer match because so doing would cause the accounts to come under the purview of the Employee Retirement Income Security Act ("ERISA"), the federal statute governing employee benefits that preempts state laws. Nevertheless, the bill gives the Investment Board the authority to allow employer contributions should there become a way to do so without triggering ERISA and/or violating other rules in the current tax code.[33]

Portability

The lack of portability in a typical retirement plan (i.e., its connection to a single employer) poses a barrier to continuous saving and is a key driver of "leakage" in the retirement savings system.[34] Too often, workers leaving a particular job cash out their 401(k)s and end up starting from scratch in a new position; many plans actually require workers to withdraw their funds when they leave a position if their balance is below a designated minimum.[35] In other cases, retirement accounts get "lost" when a worker changes employers, resulting in millions in unclaimed benefits every year.

The CSC addresses these problems by linking the accounts to the worker rather than to the employer, and keeping accounts open as workers move from one job to the next with no need to roll over balances. Through centralized recordkeeping and investment management, the accounts are designed to be easier for workers to keep track of and maintain during a career move.

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Pooled Investments

The CSC relies on a pooled investment structure to leverage economies of scale, reduce insurance and management costs, and increase efficiency. The Investment Board will contract out investment management responsibilities through a bidding process, and the investment manager will be tasked with adhering to the plan investment policy of preserving the principle and providing a safe, stable rate of return.[36] The investment manager collectively invests workers' contributions in a conservative portfolio and individual account balances are determined by each worker's deposits and the annually determined interest rate. The pooled investment structure and professional management are a means to mitigate the risks inherent in individual retirement accounts, such as currently available IRAs and 401(k)s.

Guaranteed Benefits

A unique feature of the California program, which distinguishes it from both private plans and many other universal account proposals, is its provision of a guaranteed return. With a traditional 401(k) plan, a worker assumes all the risk for the vagaries of the market. Contributions to these saving plans can increase in value if the market goes up or they can drop in value if the market goes down. California's approach is committed to creating protections

[31] The California Secure Choice Retirement Act, Title 21, Sec 100032(i).
[32] The California Secure Choice Retirement Act, Title 21, Sec 100008(a); 100010(a)(11); 100043.
[33] The California Secure Choice Retirement Act, Title 21, Sec. 100012(k).
[34] Calabrese (2011).
[35] Rhee (June 2012).

[36] CalPERS, the California Public Employees' Retirement System, is therefore authorized to bid, and many have speculated that they will take on the investment management role.

against the declines while still offering the potential for market gains. The California statute sets in motion a process to protect and insure the value of workers' accounts. This may be accomplished through the purchase of secure investments, such as U.S. Treasuries, as well as private insurance. While private insurance makes the plans more expensive to administer (with a cost that rises steeply with the guaranteed rate of return), relying on private insurance is designed to alleviate fears that the state could be liable should the fund underperform due to economic conditions.

> The plan as envisioned should create no new costs for the state and should in fact strengthen overall economic security by providing millions of Californians with a critical supplement to their Social Security income.

Currently, the bill does not provide a specific rate of return, which is something that would be determined annually by the Investment Board for the following year. However, the law does stipulate that equities can account for no more than half of the overall asset allocation of the investment funds. Recent projections estimate that a hypothetical conservative portfolio (50% equities/50% bonds or treasuries) for a publicly sponsored retirement fund is likely to generate a 5% real rate of return over the long-term.[37] While the costs of private insurance will reduce this figure, economic models still predict that workers will see a modest return on their investments absent exceptionally poor economic circumstances, and that therefore a guarantee of a 2 to 3% real annual rate of return would be a reasonable expectation. In addition, the CSC trust has the authority to maintain a reserve account to which it may allocate excess earnings to protect against future losses.

Self-Financing

Finally, an important aspect of the CSC is that it is designed to be self-financing. The money that account holders contribute to the trust is divided into two accounts: an administrative fund and a program fund. Administrative expenditures derive entirely from workers' contributions, although the costs of administration cannot exceed 1% of the total fund each year.[38] According to recent estimates, a state-sponsored plan with a modest minimum return guarantee (3% nominal) would be fully funded or over-funded for the first forty years.[39] Additionally, the plan should impose no new costs on employers; their only obligations are: 1) the ministerial duty of providing employees with the information packet, and 2) adding a field to their payroll, similar to the existing fields for tax deductions, to enable employees to remit contributions to their account. Therefore, the plan as envisioned should create no new costs for the state and should in fact strengthen overall economic security by providing millions of Californians with a critical supplement to their Social Security income.

Next Steps for California Secure Choice

When Governor Jerry Brown signed SB 1234 into law, he initiated a process that could lead to the implementation of the first state-sponsored retirement plan for private sector workers. A number of steps need to be taken and key questions addressed concerning the default plan features, funding, and product design before the California Secure Choice Retirement Savings Program launches. Moreover, the dialogue surrounding the program presents an opportunity for discussion and enactment of broader structural reforms to address some of the barriers beyond account access that impede low-income workers' ability to save adequately for retirement. In this section, we explore

37 Stubbs and Rhee (2012).

38 The California Secure Choice Retirement Act, Title 21, Sec 10004(d).

39 Stubbs and Rhee(2012).

the next steps for implementing the California initiative; pose some additional questions regarding the design of the program and its savings products; and assess how the larger retirement savings landscape is (or is not) responding to the needs of low-income workers and their families.

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Forming the Board

Now that California has cleared the preliminary political hurdles to the implementation of SB 1234, it must turn to the mechanics and additional research essential to the program's launch and sustainable success. The first two necessary steps are to designate the members of the Investment Board and to raise funds from private and non-profit groups to conduct a market analysis.

As previously noted, the Investment Board will consist of nine members, including four gubernatorial appointees. In addition to the Treasurer, the Director of Finance, and the Controller, the Board will include a small business representative, an employee representative, and an individual with retirement savings and investment expertise, along with a member of the public and two additional members.[40] While the bill does not require that all Board members be permanent residents of California, all are expected to have at least a close connection with the state. The bill's sponsors anticipate that the composition of the Board will be finalized by late spring of 2013.

Conducting the Market Analysis

Once the Board is established, it will convene to determine the scope and parameters of the market analysis. Broadly speaking, the market analysis will evaluate likely participation rates, investment product design, contribution levels, and other variables that will affect the feasibility and mechanics of implementation. The results of this analysis, which is slated to be complete by mid-2014, will allow the Investment Board to determine whether the bill as written would indeed create a self-sustaining fund.

However, an initial obstacle to overcome is securing funding for this study. Cost estimates for the market analysis range from $500,000 to $1.5 million. All of these resources must come from private or non-profit entities. Ideally, from the perspective of the bill's sponsors, the funders of the study would represent a diverse spectrum of sectors and interests to signal broad support for the program.

Furthermore, before it can open for enrollment, the CSC must gain approval from the U.S. Department of Labor clarifying its relationship to ERISA, as well as a confirmation from the Treasury Department regarding the plan's tax-qualified status. Lastly, as established by the companion bill, SB 923, the program requires an authorizing statute from the legislature before workers can participate. Given the many details yet to be finalized by the Investment Board, the authorizing statute could contain some amendments to the original bill.

Program Design Considerations

The initiative in California has the potential to serve as a model for similar public retirement programs throughout the country. It is particularly important, therefore, that the market analysis and the ongoing policy development process address a range of considerations regarding defaults, account options, and distribution of benefits that will be key for making the program work most effectively for low-income workers.

[40] S.B. 923.

Default Contributions

As previously discussed, default enrollment and contribution policies have been found to have significant impacts on retirement plan access and participation. Because these policies have been so effective, however, it is important that the defaults are set at optimal levels. Two-thirds of employers with automatic enrollment set the default rate at 3%, as would the California plan, though there is growing evidence that this contribution level falls short of what many employees would choose for themselves.[41] Moreover, research suggests that these low defaults can make it more difficult for workers to save adequately. For example, a recent study found that automatic rates of 3% resulted in an average savings rate of 6.3%, while a 6% default yielded savings of 7.1%.[42] Additionally, employees in the 6% default group were twice as likely as those in the 3% group to attain an overall savings rate of 11%, which many financial planners recommend as the ideal retirement savings threshold.[43]

The same inertia that explains the success of automatic enrollment and contribution policies can render them counterproductive if the defaults are insufficient.

Furthermore, the same inertia that explains the success of such default policies can render them counterproductive if the defaults are insufficient. In particular, plans that do not include a mechanism such as automatic escalation for gradually increasing an employee's contributions can lull workers into making inadequate contributions over time. For example, younger workers could benefit from a "nudge" to increase their savings rate as their earnings increase. Two recent surveys found that workers generally support both automatic saving and pre-determined increases in savings amounts.[44] In the 2009 study, even 90% of those workers who had chosen to opt-out of the plan reported feeling satisfied with the automatic enrollment mechanism and procedure.[45]

A straightforward way to address this issue would be to increase the default contribution. However, this solution could place a significant burden on workers at the lower end of the income spectrum and potentially discourage initial participation. Another option would be to default employees into automatic escalation and require an opt-out, as with the overall plan.[46] Presuming most workers' earnings increase over time, this approach would allow workers to gradually save more without coping with a sudden or overly burdensome decrease in liquidity. Finally, regardless of the automatic contribution rate, participating employees could receive information regarding recommended levels of contributions as compared to the default, since they can elect to contribute in excess of the 2 to 4% automatic range. This information could include charts demonstrating how 3% contributions would grow over thirty years at a range of salaries compared to 6% contributions, for example. An assessment of these and other options, as well as the projected outcomes of various default mechanisms, would be a highly useful piece of the market analysis, both for California and for other states considering similar programs.

Employer Contributions

For many workers, an employer match or contribution is often a key motivating factor in the decision to participate in a retirement plan.[47] Employer contributions enable workers to accumulate significantly higher account balances and constitute an important part of a competitive compensation package. While many firms cut contributions

[41] Tergeson (2011).
[42] Principal Financial Group (2011).
[43] Principal Financial Group (2011); John Testimony (2011).
[44] John Testimony (2011). The surveys were: Prudential, The New Economic Reality and the Workplace
Retirement Plan, January 2010; and Retirement Made Simpler, How do employees feel about their auto 401(k) plan?, 2007.
[45] Prudential (2010).
[46] Calabrese (2011).
[47] Dworak-Fisher (2008).

to their employees' accounts during the most recent recession, the numbers have since bounced back, with approximately three-quarters of employers who offer plans also providing a match.[48] Establishing an employer contribution as a standard part of a retirement plan would help recalibrate retirement security as a shared rather than strictly individual responsibility, despite the rapid decline in traditional pensions.

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Since the CSC could potentially reach over six million households, facilitating employer contributions would be a powerful feature that would make the program much more impactful, and set a precedent for future state-sponsored retirement plans. The obstacle is that employers cannot make tax-deductible contributions to a pension or retirement saving plan unless it is a "qualified plan" under ERISA and subject to certain non-discrimination rules and other restrictions. Currently, as a program limited to facilitating employee saving, CSC appears to fall within ERISA's "safe harbor" provision, which excludes a plan from the ERISA definition as long as: 1) employers cannot contribute to the plan; 2) employers do not exercise control over the plan, but limit their role to collecting and forwarding payroll deductions to the IRA plan sponsor; and 3) employees' participation is voluntary.[49] If California instead structured the CSC to accept employer contributions on a tax-preferred basis, as qualified plans do, it would no longer qualify for the "safe harbor" exemption from ERISA rules and California would no longer have the authority to implement the program according to the terms of its own legislation.[50] While there are some concerns that the CSC not undermine the participation of employers currently sponsoring DC plans, the main reasons that the legislation opted for an ERISA-exempt approach was to avoid adding reporting requirements and fiduciary responsibilities to employers not offering plans.

As a growing number of states begin to explore the possibility of implementing a program like California's, this issue will become increasingly important. The market analysis process in California presents an opportunity to determine what sort of federal action, such as an amendment or a regulatory change by the Department of Labor, would be required to enable tax-deductible employer contributions to publicly introduced plans.

Product Design and Investment Allocation

The California program poses some important questions regarding the design of the accounts themselves and investment allocation. Many of these questions concern the manner in which the guaranteed rate of return is implemented, which is one of the most unique features of this policy effort. The guaranteed rate of return makes the CSC similar to a cash balance plan, which is a DB scheme in which employees' account balances are based on their contributions rather than their earnings and years of service, and in return workers are assured an annual credit equal to a specified percentage of the balance. However, the CSC's reliance on private insurance (rather than the federally-backed Pension Benefit Guaranty Corporation)

[48] Javis (2012).

[49] 29 C.F.R. 2510.3-2(d); *see* Department of Labor, Interpretive Bulletin 99-1, "Payroll Deduction Programs for Individual Retirement Accounts, 29 C.F.R. 2509, at p. 33001, which states: ". . . the Department has published a regulation at 29 CFR 2510.3-2(d), establishing a safe harbor under which an IRA established by employees and funded through payroll deductions will not be considered to be a "pension plan" within the meaning of section 3(2) of Title I when the conditions of the regulation are satisfied. The regulation specifies that an IRA will not be considered a "pension plan" when there are no contributions made by an employer; employees participate in the IRA on a completely voluntary basis; and the employer's activities with respect to the IRA must be limited solely to permitting, without endorsement, the IRA sponsor to publicize its program to employees; collecting contributions through payroll deductions or dues checkoffs; and remitting those contributions to the IRA sponsor.".

[50] The California Secure Choice Retirement Act, Title 21, Sec 100043.

and an independent investment manager (rather than the employers themselves) are important distinctions. Furthermore, true cash balance plans, because they are pension plans sponsored by employers, are subject to ERISA.

The private insurance component is closely linked to the guaranteed return. As the rate of return increases, the costs of insurance are likely to rise as well. On the one hand, the insurance mechanism all but eliminates any risk for employees participating in the program. At the same time, if it is too expensive, it may pose a barrier to helping workers accumulate significant savings.

One refinement might be to limit the insurance guarantee to workers who are close to retirement age (e.g., 55 and older) since market volatility poses the greatest risk to older workers whose asset balance may not recover from a steep downturn by the time they stop working. This is particularly relevant for a program, like the CSC, which may encourage annuitization as the preferred method of payment distribution. Since the worker's monthly payments for life are typically based on the account balance at retirement, without insurance a market downturn within the years immediately prior to retirement could lock in a permanent loss of lifetime income. In contrast, a younger worker may have decades to recover from what historically have been temporary market downturns (since, on average over ten-year periods, both U.S. stock and bond markets have historically had positive returns that revert to the mean given sufficient time).

Another idea to explore during the market analysis would be the possibility of providing multiple fund options while maintaining the guaranteed return option as the default. The Thrift Savings Program (TSP), the retirement savings program for federal employees, provides a useful point of comparison. Participants in the TSP can choose among a variety of funds, ranging from the "G" Fund, which invests solely in government securities and guarantees the principal, to the "I" Fund, which invests in a range of international stocks and carries the greatest degree of risk.[51] Average annual returns for the G Fund have been 3.6% over the previous ten years, compared to 8.4% in the I Fund. Adopting a similar structure in the California program or other public retirement plans would give workers the option of potentially increasing their returns or better matching their risk-reward profiles; however, the provision of these options would need to be accompanied by adequate information and education regarding the varying levels of risk that come from increased market exposure.

There are also questions about the distribution of the benefits. The California bill does not currently require annuitization, though there is flexibility to establish it as another default option that would go into effect as a recommended behavior unless the individual affirmatively opts out.[52] As discussed in the final section, however, mandatory annuitization carries its own risks at a time when a substantial proportion of American families have insufficient savings for shorter-term needs. An alternative approach would be to default some proportion of each worker's account into an annuity rather than the entire balance.[53]

Low Access Workers

Finally, although the California initiative and other state-sponsored retirement savings programs enable the vast majority of private employees to qualify for the plan, some are left out. In particular, workers employed by the smallest firms, as well as those who are self-employed, may have more difficulty accessing these programs because their workplaces are not required to participate.[54] Importantly, the group most likely to be self-employed is men aged 55-64, who are rapidly nearing retirement.[55]

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[51] Thrift Savings Plan, Fund Comparison Matrix.
[52] Calabrese (2011).
[53] Hamacher and Pozen (2011).
[54] *See* Calabrese (2011) for a discussion of how inadequate access by self-employed, part-time and small firm workers is a recurring issue in Auto-IRA proposals.
[55] Schultz (2012).

In California, automatic enrollment will be restricted to workers at employers of five or more, while similar plans emerging in other states set the minimum threshold at ten. The California bill provides the Investment Board with the authority to develop procedures for enrolling these workers.[56] Once these policies are in place, assessing how to educate these workers about their eligibility for the plan and the benefits of participation will be of particular importance, since they will not benefit from the same default enrollment mechanism as employees at larger firms.

Further Policy Considerations

California Secure Choice poses questions and considerations that reveal larger shortcomings in the retirement savings system. Indeed, savings policy experts have long criticized the current landscape of federal retirement policy for its "upside down" structure.[57] Current federal supports for retirement savings, which are delivered almost exclusively through the tax code, disproportionately benefit higher income families, in part because these families fall into higher tax brackets and have more to gain from the deduction. In 2011, for example, 80% of the tax benefits from 401(k)s and other qualified plans went to households in the top income quintile.[58]

Federal expenditures for other asset-building purposes also tend to accrue primarily to wealthier households.[59] Additionally, few low-income families have a sufficient savings cushion to cope with an emergency, job loss or unexpected expense. As a result, even those households with retirement accounts often dip into them to cover shorter-term costs, thus undermining the benefits of such policies as automatic enrollment. In this section, we briefly examine these larger structural issues and two potential policy responses: the Financial Security Credit and workplace savings accounts for purposes other than retirement.

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Financial Security Credit

The Financial Security Credit is a proposal to provide a match of up to $500 per year to families earning below around $58,000 (or 120% of the EITC income maximum) who make a deposit to qualifying saving instruments, including retirement accounts.[60] The Financial Security Credit would be a significant step toward disrupting the retirement system's "upside down" incentives and benefits. The Credit would also allow tax filers to make a deposit to a newly created account directly on their tax form.

The Financial Security Credit would complement proposals like the CSC both by promoting higher savings rates and providing the flexibility to save for other purposes.

The Financial Security Credit would complement proposals like the CSC both by promoting higher savings rates and providing the flexibility to save for other purposes. Unlike the existing Saver's Credit, the Financial Security Credit would be refundable, thus giving filers without sufficient income to incur tax liability an incentive to save. This incentive would trigger additional contributions and increase savings adequacy. At the same time, it would

[56] The California Secure Choice Retirement Act, Title 21, Sec 100012 (l).
[57] Assets Report 2012; Calabrese Testimony (2012).
[58] Toder and Smith (2011).
[59] Cramer et al. (2012).
[60] "The Financial Security Credit" (2012).

provide workers who are not receiving contributions from their employers the option to nevertheless earn a match to their own contributions. Moreover, the Financial Security Credit would allow families to choose from a range of different savings products that would best meet their needs, such as IRAs, college savings accounts, and savings bonds. As the debate regarding tax reform intensifies, initiatives like the Financial Security Credit present an opportunity for furthering equity in the tax code at a relatively minimal cost.[61]

Promoting Workplace Emergency Savings

One of the strengths of the Financial Security Credit is that it reflects the reality that families have multiple and varied savings needs and goals. Though putting aside money for retirement is crucial, it is but one component of the overall savings framework that can enable families to experience financial security both in the present and in the future. Because of its existing payroll structure, the workplace has potential to serve as a site for some of these savings opportunities that extend beyond retirement, which are worth exploring in tandem with programs like the CSC.

> An insufficient emergency fund "has the strongest association with the likelihood that workers will breach their retirement savings."

Recent research has shown that a high proportion of low and moderate income workers are cashing out their retirement plans to pay for everyday expenses.[62] In 2010, Americans took out $70 billion in early withdrawals from their retirement accounts, compared to $118 billion in worker contributions.[63] These early withdrawals are typically subject to both a federal tax penalty of 10% as well as the income tax, meaning that an unreasonably high proportion of workers who contribute to a 401(k) are ultimately losing money. Regardless of whether a given plan automatically enrolls workers or permits employer contributions, if workers are typically using them for short-term savings needs, access to these accounts will do little to bolster retirement security and reduce inequities.

One proposal that could reduce these so-called "breaches" of retirement accounts is increasing the availability of other workplace savings opportunities and workplace emergency loans. Indeed, an insufficient emergency fund "has the strongest association with the likelihood that workers will breach their retirement savings."[64] A workplace lending program could reduce this phenomenon and also provide an alternative to payday loans, which frequently have exorbitant interest rates that trap borrowers in a cycle of debt. Similarly, workplace programs that provide opportunities to save for emergencies or shorter-term goals could take advantage of the same payroll deduction infrastructure as retirement contributions while increasing the likelihood that workers' retirement savings are actually available at retirement. In the U.K., "corporate platform" accounts do just that, by automatically enrolling workers in a retirement savings program that also gives them the option to save for other purposes, with the added benefit of a financial education component.[65]

Alternatively, and as previously noted, one obvious solution to account "breaches" is to make accounts inaccessible to beneficiaries until retirement and to require annuitization, as with traditional pensions. Yet without access to liquid savings that can address more immediate needs and changes of circumstance, many workers may feel understandably reluctant to lock away their savings for the future at the cost of increasing their financial vulnerability in the present. Creating mechanisms for this type of saving, either as a fund option within a program like California's or as part of an independent initiative, would reflect an essential recognition that low-income families have a range

[61] "The Financial Security Credit" (2012).
[62] Fletcher (2013).
[63] Fletcher (2013).
[64] Fellowes and Willemin (2012).
[65] John (2012).

of savings needs and that incentivizing retirement savings alone can backfire.

A Model for Reform

It has become clear that the current retirement savings system is not working— especially for lower-income workers. The California Secure Choice Retirement Savings Program shows promise as an innovative effort to connect more workers with retirement savings opportunities, at a minimal cost to the public. Significant work remains for the initiative in determining the ideal program design features, including defaults and account options.

Nevertheless, the program has the potential to serve as a strong national model for a new approach to retirement security—and momentum for this effort is growing. Many states, including Illinois, Maryland, Connecticut, and Massachusetts, are already considering similar proposals. In order to continue to support retirement security as a shared rather than solely individual responsibility, these parallel efforts will need to engage with the issue of how to enable employer contributions. Furthermore, as this movement continues, it will be important for advocates and policymakers to keep in mind both the short- and long-term savings needs of low-income families.

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