

UC Berkeley

Recent Work

Title

Meeting California's Retirement Security Challenge through a State Sponsored Retirement Plan: Policy Design Challenges and Options

Permalink

<https://escholarship.org/uc/item/7kd488nn>

Author

Rhee, Nari

Publication Date

2012-02-06

**Meeting California's Retirement Security Challenge through a
State Sponsored Retirement Plan:
Policy Design Challenges and Options**

February 6, 2012

By Nari Rhee, Ph.D.
Associate Academic Specialist
UC Berkeley Center for Labor Research and Education

This paper outlines key choices in developing a state sponsored retirement system for private sector workers in California who lack access to a workplace pension. The first section briefly outlines the rationale for the creation of a publicly sponsored retirement plan. The remainder of the paper explores critical plan design choices that policymakers face within the constraints and opportunities afforded by two fundamentally different types of plan architecture: individual accounts such as 401(k)s and IRAs, and cash balance plans, a type of defined-benefit pension that limits employer risk and shares some of the characteristics of defined-contribution plans.

- Should participation in a state sponsored retirement savings program should be universal, or voluntary on a firm by firm basis?
- Who will contribute to the plan?
- Who will carry the risk?
- What types of risk protection should, and could, be provided to workers? This question is considered within the constraints and possibilities created by the above three factors and plan architecture, e.g., individual defined-contribution (DC) accounts such as a 401(k) or IRA, versus a modified cash balance plan that qualifies as a defined-benefit (DB) pension.
- Other plan design considerations include plan sponsorship and governance, regulatory requirements, and default contribution rates.

Workers face severe challenges in the current private sector retirement system that have eroded their retirement income security: One is the shift from DB pensions that provide guaranteed retirement income to DC plans, such as 401(k)s, in which workers bear all responsibility and risk for realizing investment returns, and which misguidedly emphasize wealth accumulation rather than income generation.ⁱ Among California workers who participate in a retirement plan, over 67 percent have only a 401(k) type plan.ⁱⁱ Another is declining access to workplace retirement plans, such that a large majority of small business employees and low wage workers do not participate in any kind of retirement plan, and/or only have access to an IRA. In California, 54 percent of private sector workers work in firms that do not sponsor any kind of retirement plan. Furthermore, in the absence of sufficient economies of scale and robust federal regulation, many 401(k)s and IRAs entail high costs, including hidden fees, that erode workers' retirement assets. As a result of these challenges, nearly half of California workers are headed for poverty or near-poverty when they retire.ⁱⁱⁱ

The State of California could overcome many of these problems and significantly improve worker retirement income security by sponsoring a retirement savings plan for private sector workers who do not have access to a workplace pension. Such a plan could take advantage of economies of scale to offer a retirement savings vehicle at a low cost; afford workers a measure of protection against market volatility through pooled risk and careful plan design; and offer portable benefits that would stay with each worker from job to job. It could also be a boon to employers who want to do the right thing but who lack the wherewithal to sponsor a plan of their own.

Broadly speaking, the goal of such a plan would be to improve retirement income security for private sector workers in California by:

1. Increasing retirement saving among workers, particularly those who lack access to a workplace retirement plan;
2. Creating a low-cost, professionally managed investment vehicle that shields workers' savings to some degree from investment risk during the accumulation phase; and
3. Providing a lifelong income stream that, combined with Social Security, will allow workers to maintain a decent standard of living throughout their retirement.

However, the design of such a plan is circumscribed by two key political constraints. While a state backstop would open the door for better benefits, there is currently no political appetite for even minimal financial risk to be absorbed by the state. Also, a policy that includes mandatory employer contributions is highly unlikely to pass the legislature; and even a voluntary program would have a difficult time attracting employers if it involved significant employer liability.

1. Should policy aim for universal coverage, or voluntary coverage on a firm by firm basis?

Short of compulsory savings, the best way to increase worker participation in retirement saving is for workers to be automatically enrolled in a plan, contributing funds via payroll deduction at a default percentage of pay.^{iv} (From the point of view of the plan, it is also far less costly to primarily receive funds through employer payroll deduction than through payments from individual workers.) Workers may choose to increase or decrease contributions or opt out entirely. The latter feature can lead to attrition, but this can be minimized by automatically re-enrolling non-participating workers after a specified period.

Because employer action is required to implement automatic enrollment, and because key retirement plan platforms entail employer sponsorship under current regulations, the real question is whether *employer* participation should be mandatory or voluntary.

- If the goal is universal pension coverage, the state should pass legislation requiring all firms that do not offer a retirement plan of their own to automatically enroll their employees into the state sponsored plan, except for those workers who individually opt out. Any such legislation must be carefully devised to address potential federal ERISA pre-emption challenges.

- In contrast, a voluntary model would involve marketing a plan to employers. The impact on worker pension coverage would probably be small, and administrative costs would be relatively higher than in a universal model. However, assuming that participating firms are willing to absorb modest costs and risks, such a voluntary plan could be crafted to offer better benefits than a universal plan in which neither the state nor the employer bears any cost or risk.

These pathways are not mutually exclusive. For instance, the state could pass legislation requiring all employees who are not offered a workplace pension to be automatically enrolled into a basic public plan, and also create a separate voluntary plan which requires some employer risk and funding and provides better benefits to workers.

2. Who Contributes? How much?

Who Contributes

Policymakers need to decide exactly who must contribute to the state sponsored plan—employees, employers, or both—and who may or may not be allowed to contribute on a voluntary basis. This depends in part on regulations tied to key platforms for pension and pre-tax retirement savings, outlined below. Tax-favored contributions are assumed.

- *Individual accounts – Traditional IRAs.* These are not workplace retirement plans; they are vehicles in which individuals can save for retirement on a tax-deferred basis, with an annual contribution limit of \$5,000. Deductibility of contributions for income tax purposes depends on income level and whether the individual or their spouse participates in an employer sponsored retirement plan.^v Most traditional IRAs are not qualified to receive employer contributions under current IRS rules. However, employers may set up a SIMPLE IRA or SEP on behalf of employees in order to make contributions to traditional IRA accounts on their behalf; these arrangements are covered by ERISA, albeit with minimal reporting and disclosure requirements. For the remainder of this paper, “IRA” refers to an individually established traditional IRA and not an employer-established SIMPLE IRAs or SEP.
- *Individual accounts – 401(k)s and other employer-sponsored DC plans.* These allow both employee and employer contributions. Most common is the 401(k), or 403(b) in the nonprofit sector, and a public plan in this category would most likely take the form of a multiple-employer 401(k). While 401(k) investment is individually directed and typically focused on stocks and bonds, an intriguing variation is a group retirement annuity contract with a private insurer, like that offered by TIAA-CREF, in which the primary investment vehicle guarantees the principle plus a minimum interest credit and offers the possibility of additional credits depending on fund performance. Contribution limits depend on plan type and are much higher than for traditional IRAs; in 2012, most employees can contribute a maximum of \$17,000 to their 401(k) and employers can match up to 6 percent of salary.^{vi}
- *Cash balance plan.* This is a type of DB plan in which individual workers accrue a hypothetical account balance based on a fixed percentage of yearly earnings plus

a guaranteed interest credit, generally tied to long-term Treasury rates.^{vii} In private sector cash balance plans, employers must contribute, and employees are generally not allowed to contribute under existing regulations. Investment is managed by the pension plan, not individual workers. The plan must offer a life annuity payout option, and may also offer lump sum withdrawal at retirement. Cash balance plans are regulated as a DB plan and must be funded accordingly; however cash balance plans entail significantly less volatility in required funding and less overall risk than does a traditional pension.

In light of the above, if only employee contributions are allowed, then the individual account model applies--either an auto-401(k), auto-IRA, or annuity contract.

If the plan is to be funded by both employees and employers, an ERISA-regulated DC plan applies, most likely a 401(k) although SIMPLE IRAs, and SEPs are also possibilities. If employer contributions are to be mandatory, policymakers need to decide whether this is predicated on employee contributions. Any mandate concerning contributions needs to be carefully vetted to pass legal muster.

Finally, employer-only contributions generally apply in the case of private sector cash balance plans. It may be worth exploring whether there may be exceptions to this rule. Nonetheless, because employers are ultimately liable for any shortfall in plan assets, such a plan would need to be voluntary at the firm level.

Contribution rate

Policymakers also need to determine the default contribution rate for workers and, if applicable, employers. This involves weighing the trade-offs between income replacement rates and worker participation rates.

Ideally, the rate would be set at a level that is sufficient, when combined with a conservative estimate of investment returns, to generate a meaningful income replacement rate at retirement when combined with Social Security. The following are some examples for illustrative purposes. Under Teresa Ghilarducci's Guaranteed Retirement Account (GRA) proposal, a 5 percent combined employee/employer contribution rate over 40 years with a guaranteed real rate of return of 3 percent—backstopped by the state—yields retirement income equal to 24 percent of final year earnings for a low wage worker in California, and about 68 percent when combined with Social Security.^{viii} Under the National Conference on Public Employee Retirement Systems (NCPERS) Secure Choice Pension proposal—a modified cash balance plan, further detailed below—a 6 percent employer contribution rate is estimated to yield about 30 percent income replacement for a middle wage worker, though with less certainty due to the flexibility of the plan's guarantees.^{ix} In the case of individual accounts, higher contribution rates would be necessary to achieve the same outcomes because of the limited availability of insurance against large market swings. It is also worth noting that the current draft of California Senator De Leon's bill proposing a state sponsored retirement trust for private sector workers, as of this writing, includes a default contribution employee contribution rate of 3 percent and a mandatory employer match that phases up to 2 percent.^x

These considerations will have to be weighed alongside political feasibility and likely worker behavior. The higher the default contribution rate, the more likely that workers—especially low wage workers who are most in need of a retirement plan—will opt out of the system. A lower initial default savings rate may ensure greater participation, and subsequent automatic increases may improve savings outcomes.

Furthermore, in the case of the cash balance plan, it would be best to require regular, consistent contributions across employers rather than to allow individual employers change contribution rates and benefits. This is because in a multiple-employer DB plan, all employers face increased risk even if only some employers increase benefits.

3. Who Bears the Risk?

In the current private sector system retirement system dominated by 401(k)s and IRAs, workers are exposed to a number of risks, including various kinds of investment risk during the accumulation phase and longevity risk during the payout phase. Potential strategies for managing and reducing these risks on behalf of workers are addressed in the next section.

But first, policymakers need to decide who will bear the risks entailed by any guarantee or insurance offered by the plan. For instance, any meaningful guarantee concerning rates of return on savings and investments, or monthly payments during the payout phase, requires someone other than the worker to backstop the guarantee, i.e., assume the risk of covering any shortfall in assets required to pay promised benefits. This is true even if the guarantee is designed to have negligible risk of the fund not having enough assets to pay for promised benefits.

- *The state?* In an ideal world, the state would back plan guarantees. This would allow policymakers to create a plan that combines the efficiencies of a pooled pension model with the scale of a universal publicly sponsored plan, greatly improving retirement income security for California workers. However, the State of California is highly unlikely to assume any such risk in the current political and fiscal climate.
- *Employers?* Firms may choose to back a modest guarantee in order to offer the benefit to their own workers, but this limits the plan to a DB pension model (in this case, a multiple-employer cash balance plan), and participation would have to be voluntary.
- *Private insurers?* Insurance companies could assume certain risks, depending on plan structure and the financial product in question, for a fee. But there are heavy trade-offs in control, costs, and efficiencies. For instance, it may make sense to outsource life annuities during the payout phase to a reputable insurance company, but it may be costly to privately insure a meaningful level of return on investment portfolios during the accumulation phase. The use of private insurers as a backstop for a program intended to serve several generations of Californians also introduces the risk that these firms will go out of business and fail to make good on their promises.

Ultimately, unless policymakers find a way to backstop meaningful guarantees in both the accumulation and payout phase, workers will continue to bear many of the risks that they now face in the private sector retirement system.

4. What Guarantees Are Feasible? Individual Account vs. Cash Balance Model

Access to a quality retirement plan is just one challenge faced by workers. The other is how to invest those savings and ultimately generate adequate retirement income. The key risks faced by workers in this process are:

- Idiosyncratic risk – the risk of making unwise or unlucky investments.
- Market risk – the risk of large market swings that, if poorly timed, could seriously erode the value of workers' retirement portfolio just before retirement when they have no time to recover.
- Longevity risk – the risk of outliving one's retirement savings.

The extent to which each of these risks can be mitigated depends heavily on plan architecture, particularly whether it is an individual account model such as an IRA or 401(k), or whether it is a group Defined Benefit plan, such as a cash balance plan. In both cases, public sponsorship can generate efficiencies and economies of scale that allow for lower costs and greater benefits than a similarly structured plan in the private sector. At the same time, individual accounts entail higher costs and are more constrained in the feasible level of risk protection—particularly in terms of protection from market risk and longevity risk—than a cash balance plan.

Idiosyncratic Risk

- In the individual account model, idiosyncratic risk can be minimized by defaulting contributions into a professionally managed, diversified investment vehicle with low expenses, and by creating an investment menu with limited, thoughtfully crafted choices.^{xi}
- In the cash balance model, as in traditional DB pensions, idiosyncratic risk is mitigated through professional, rather than individual, investment management. DB pensions, especially public pensions, are typically invested in a diversified portfolio with a wider variety of asset classes than are available to individual accounts.^{xii}

Market Risk^{xiii}

Protection against market risk, on the other hand, poses a complex set of trade-offs and regulatory and political constraints. The challenge is two-fold. First, any guarantee must be meaningful to workers; both the worst-case and probable outcomes in the level of retirement income generated by a given savings rate must be acceptable. This is especially important for lower-wage workers who are not in a position to substantially increase contributions in order to compensate for very low returns. Second, it must also be low enough to pose little or no risk to the sponsor. Available methods for insuring against market risk are outlined below by plan type.

Individual Accounts

In the individual account model, each worker's retirement benefit consists of accumulated contributions to their account, plus investment returns that depend heavily on financial market conditions. Account balances fluctuate with the market value of assets. A partial exception is the group retirement annuity contract, described later. Individual accounts are also self-directed; each participant is ultimately responsible for deciding how to invest their funds, faces an array of (usually extensive) investment choices, and individually shoulders all risk.

Nonetheless, there are several ways that a publicly sponsored system of individual accounts, whether IRAs or 401(k)s, can be structured to provide some insurance against large market swings.

- Default investment in a target fund, which offers a modest buffer against market risk by automatically and gradually rebalancing assets from equities to bonds as a worker nears retirement. This is the least robust model in terms of insurance against market risk. While target funds reduce older workers' exposure to stock market volatility, there is ultimately no guarantee that workers will achieve a particular long term rate of return or that they will not lose money.

The remaining options have stronger market risk protection, predicated on limited liquidity—that is, early withdrawal of funds is must be restricted in order to maximize the investment horizon.

- Default investment in a portfolio of long term Treasuries (bonds or TIPS, Treasury Inflation Protected Securities), in the reasonable hope that rates will rebound to their historical average 3 percent real return. This is risk-free in that the chance of default is minimal. The main risk is the possibility that real yields on Treasuries will not recover for many years, leading the fund to earn insufficient returns to provide adequate retirement income. In addition, because of the shorter investment horizons inherent in individual accounts, the fund would earn somewhat less than the 30-year treasury rate.^{xiv}
- Default investment in a Total Return Fund that includes a mixed bond/stock portfolio with a heavy hedge. Management fees are high (e.g., 1 percent before other expenses). The model also faces the problem of a shorter time horizon compared to DB pensions.
- It may be possible to purchase private insurance to backstop a minimum return at the time of retirement, based on portfolio composition. The guarantee could take various forms, for instance, a fixed rate of return—either nominal or real—over the entire accumulation phase, or perhaps a floating annual rate of return guarantee determined by calculating a rolling average of the returns on a hypothetical portfolio. Such an insurance policy could be combined with a target fund. Depending on benefit structure, it could help smooth asset returns across generations, although not to the same extent as a traditional DB pension. However, it is unclear what the highest minimum net return would be after accounting for insurance premiums.^{xv}
- Another option is a retirement annuity contract in which the default investment is a fixed annuity that earns guaranteed interest during the accumulation phase. For instance, TIAA-CREF offers to educational and nonprofit institutions a product called the TIAA Traditional Annuity, which guarantees a minimum annual interest credit closely tied to prevailing long term interest rates, and offers additional credits on an annual basis

depending on investment performance. The current minimum crediting rate (reflecting historically low interest rates) is 3 percent, and actual crediting rates have averaged roughly 2 percent above inflation over the last two decades. These rates apply to retirement annuity contracts with employers that restrict early withdrawal and require a minimum payout period of 10 years.^{xvi} TIAA Traditional is also available for IRAs, but with much lower guarantees. Importantly, TIAA Traditional entails regular contributions as a percentage of payroll.

Cash Balance Plan

In a typical private sector cash balance plan, workers' benefits are expressed as a hypothetical account balance made up of a defined percentage of each year's earnings plus an annual interest credit, usually tied to current Treasury bond interest rates. Plans sometimes credit additional benefits when fund investments perform better than expected. At retirement, workers can receive benefits in the form of an annuity or, if the option is provided, a lump sum payment. In pre-funded plans, the employer is required to make actuarially required contributions each year, and the contribution level depends on investment performance. Employees are generally not permitted to contribute to private sector cash balance plans.

A publicly sponsored cash balance plan would essentially be a multiple-employer Defined Benefit plan under ERISA, subject to private sector pension accounting and funding standards. Such a plan can potentially offer more substantial guarantees than individual accounts can, but in order to limit the possibility of employer liability for under-funding during bear markets, the guarantee must still be modest.

A critical question is the level of feasible guarantee under a cash balance plan that will not put employers at significant risk of unfunded liabilities and that will hold required contributions at a steady level. The National Conference on Public Employee Retirement Systems (NCPERS) Secure Choice Pension proposal provides an indication of what this level might be.^{xvii}

- The Secure Choice Pension proposal consists of a modified cash balance model for private sector employers, administered by large public pension funds. The fund would be invested similarly to a public pension fund in pursuit of higher returns, but the guarantee and funding formula are calibrated to ensure stable, regular contributions by employers and to minimize underfunding risk.
- The target benefit is 6 percent of a worker's earnings plus an annual interest credit equal to the yield on 10 year Treasury bills plus 2%. Since the real return on recent 10-year Treasury issues is close to zero, this amounts to a targeted real annual rate of return of 2 percent. However, unless the state decides to backstop this guarantee, the interest credit may be retroactively reduced to as low as 3 percent nominal if the plan becomes underfunded or if an employer withdraws from the plan. Thus the actual minimum guarantee is 3 percent nominal, on par with the TIAA Traditional Annuity.
- The funding formula is designed to keep the employer contribution rate relatively constant, near 6 percent of payroll. This would be achieved by using a conservative funding formula to keep the plan from being under-funded, and keeping excess investment earnings in reserve.

- If the pension plan is super-funded according to conservative calculations, then benefits may be increased.
- Finally, the default benefit at retirement is similar to a variable annuity, detailed later in this section.

Lifelong Income: Annuitization

Currently, outside of DB pensions and Social Security, workers have the option of purchasing life annuities from private insurers. Life annuities pool mortality risk and provide guaranteed lifetime income. Unfortunately, participation rates are low, even though research indicates that they would be better off annuitizing at least some of their retirement assets. This is due to a number of factors, including adverse selection; private market life annuities are priced unfavorably for workers who expect to live to population average life expectancy.^{xviii}

If a key goal of the plan is to protect retirees against the risk of outliving their savings, a publicly sponsored retirement plan for private sector workers should be designed to encourage or even require annuitization. With a large risk pool composed of low- and middle-earning workers, economies of scale, and reduced administration costs, the plan would be able to offer lower-cost/higher-return life annuities than the private market.^{xix} Paying out benefits through annuities rather than lump sum withdrawal will also extend the plan's investment horizon.

Ultimately, the rate of return on annuities that such a plan can offer depends on two factors: the size and makeup of the risk pool and the magnitude of adverse selection. Thus a key plan design choice is whether to encourage or require participants to annuitize:

- Mandatory annuitization to create the largest pool and enable the highest rates of return on annuities. However, depending on how the plan is funded and how its benefits are framed, a mandate may deter workers from participation in the retirement plan.
- Default annuitization with opt-out which will incur some degree of adverse selection.
- Voluntary annuitization, with strong encouragement and incentives to annuitize.

Notably, traditional DB pension benefits are structured as mandatory annuities, and workers generally value the lifetime income security that this provides. In addition, research shows that most households would be better off annuitizing at least some of its wealth upon retirement.^{xx} Nonetheless, many workers fear the worst case scenario in which they die soon after purchasing an annuity out of their own savings, and thereby forfeit much of their wealth. In addition to spousal survivor benefits, annuities can be structured to minimize the worst case scenario in other ways, for example by offering minimum payout periods; however, such options will increase the cost of annuities for everyone in the pool. Ultimately, framing the plan as a pension geared towards lifetime income security and maximizing the role played by employer funding may influence how plan participants evaluate the benefits and risks of annuitization.

Finally, annuities also entail certain risks for the carrier, including investment risk and aggregate longevity risk (the risk that the annuitant pool will live longer on average than expected).

Annuities can be designed to minimize such risks, but in the absence of a state backstop, they still have to be assumed by someone—either a private insurer or a willing group of employers.

Life Annuities and Individual Accounts

- In the individual account model—401(k) or IRA—a life annuity can only be offered as a product separate from the investment phase. Whether a state sponsored system under this model can stipulate life annuities as the default form of payout, or require annuitization of any portion of account balance upon retirement, requires further research.
- In a retirement annuity contract administered by a private insurance company, such as TIAA-CREF, the plan may give workers a choice between waiting until retirement to decide whether to annuitize, or committing to a life annuity in advance in return for increased benefits.
- In both cases, a private insurer carries financial and longevity risk. The plan would negotiate rates with the insurer.

Life Annuities and Cash Balance Plans

- Cash balance plans are required to offer payout in the form of an annuity. In practice, many plans also allow lump sum withdrawal at retirement, and most workers choose this option. Policymakers could choose to offer annuities as the default or exclusive form of payout.
- Investment risk and aggregate mortality risk can be handled in a number of ways.
 - As in individual accounts, the annuities could be contracted out to a private insurer who would take responsibility for paying promised benefits and bear the associated risks.
 - Alternatively, the plan could self-annuitize and decide how to structure benefits in order to minimize both investment and aggregate longevity risks for employers. For example, under the NCPERS Secure Choice Pension proposal, annuities are the default form of payout and each plan would self-annuitize. However, the annuity is not a traditional fixed annuity; a minimum income is guaranteed, with supplemental dividends paid during good times. Benefits are initially calculated by applying actuarial assumptions regarding life expectancy and nominal rate of return of 5 percent to each worker's hypothetical account balance at retirement. Annuitized assets are transferred to a separate fund and invested with the goal of capital preservation. Finally, required employer funding is calculated using conservative actuarial assumptions with generous provision for life expectancy growth.^{xxi}
 - Another way to handle aggregate mortality risk is proposed by Anthony Webb at the Center for Retirement Research: annuities could be structured so that participants, rather than the insurer (whether the plan or another provider), would bear aggregate mortality risk. That is, participants would receive lifetime payments, but could see their payments reduced by a small percentage if mortality rates in their cohort are lower than expected. In return, participants would receive slightly higher benefits at the beginning of their retirement.^{xxii}

5. Other Plan Design Issues

Plan sponsor

In the case of 401(k)s and multiple-employer cash balance plans, the entity established or by the state, e.g., a nonprofit retirement savings trust, would act as the plan sponsor in the meaning established by ERISA, in lieu of participating employers. Simple IRAs and SEPs—types of IRAs that are qualified to receive contributions from small employers—are regulated by ERISA but do not entail employer sponsorship. Traditional IRAs are not regulated by ERISA and do not involve employers except where contributions occur through payroll deduction.

Governance

Policymakers must decide how the Board of Trustees will be constituted, including its size and composition, and the manner in which Trustees are selected, whether through appointment or election.

Fiduciary responsibility

The Board would bear fiduciary responsibility, and its members would carry insurance against fiduciary liability. Employers would be exempt from fiduciary responsibility by virtue of the fact that key plan design, administration, and investment decisions would be made by plan trustees and staff. Some of these responsibilities may be transferred to third party contractors that assume financial responsibility and risk, such as private insurers in the case of annuities.

Plan administration and investment management

Regardless of plan architecture, plan administration and investment management could be contracted out or maintained in-house by an entity established or designated by the state to run the plan.

Employer reporting requirements and regulations

401(k)s and cash balance plans are subject to pension reporting requirements under ERISA. Assuming that the plan is established as a multi-employer plan, reports and audits—including Form 5500—would be filed at the level of the plan, not individual firms. However, individual firms may be required to submit an annual census to be used in plan level audits. In general, they must also comply with nondiscrimination standards regarding the level of benefit offered to highly compensated versus other employees.^{xxiii}

6. Questions for Further Research

This paper has outlined some key regulatory parameters that need to be considered in establishing a state sponsored retirement plan for private sector workers. Questions that warrant further research are listed below.

ERISA pre-emption.

- What are the conditions under which a state could legislate universal pension coverage, and what are the key restrictions under ERISA? For example, would a pay-or-play model—in which employers are required to either offer a retirement plan or contribute a payroll tax dedicated to a publicly sponsored plan—trigger ERISA pre-emption?
- Do the same preemption issues apply when employer participation in some kind of pension plan (their own or the public plan) is mandatory, but employer contributions are not?

Employer regulatory burden

- Assuming that they are not required to fill out form 5500, what are the remaining regulatory, reporting, and disclosure requirements that individual employers would have to meet under a multiple-employer 401(k) or cash balance plan?

Dual plans at the firm level.

- Assuming that a state mandate applies to certain classes of workers—for instance, part time workers—who do not qualify under an employer's existing employer plan, would that employer be able to enroll those workers in the state sponsored plan and keep their other workers in their existing plan?
- How would this be affected by non-discrimination requirements?

Mandatory annuitization of some or all of account balances at retirement.

- Is mandatory of default annuitization allowable for DC plans, and under what circumstances?
- What about under an IRA platform?

Employee funding of cash balance plans.

- What are the main regulatory obstacles against employee contributions to private sector DB plans?
- Are there any circumstances under which employee pre-tax contributions can be used to either solely or partially fund a cash balance plan?

Public pensions and private plan status.

- A large public pension fund could be an ideal institution to manage the publicly sponsored retirement program for private sector workers, or administer some of its functions as a contractor. How can this be implemented in a way that does not jeopardize the public pension's regulatory status as a governmental plan, even if the program and its funds are regulated as a private sector plan?

Endnotes

ⁱ Jacob Hacker, 2011, "The Coming Age of Retirement Insecurity," pp. 4-20 in Nari Rhee (ed.), *Meeting California's Retirement Security Challenge*, UC Berkeley Center for Labor Research and Education, October.

ⁱⁱ Sylvia A. Allegretto, Nari Rhee, Joelle Saad-Lessler, and Lauren Schmitz, 2011, "California Workers' Retirement Prospects," pp. 21-41 in Rhee (ed.), *op. cit.*

ⁱⁱⁱ *Ibid.*

^{iv} Jack VanDerhei and Lori Lucas, 2010, "The Impact of Auto-enrollment and Automatic Contribution Escalation on Retirement Income Adequacy," *Issue Brief* No. 349, Employee Benefit Research Institute, URL: http://www.ebri.org/pdf/briefspdf/EBRI_IB_011-2010_No349_EBRI-DCIIA.pdf.

^v IRS, "2012 IRA Contribution Limits," October 20, 2011. URL: <http://www.irs.gov/retirement/participant/article/0,,id=188232,00.html>. Retrieved February 5, 2012.

^{vi} IRS, "401(k) Resource Guide - Plan Participants - Limitation on Elective Deferrals," October 27, 2011. URL: <http://www.irs.gov/retirement/participant/article/0,,id=151786,00.html>. Retrieved February 5, 2012.

^{vii} Department of Labor, "FAQs about Cash Balance Pension Plans." URL: http://www.dol.gov/ebsa/faqs/faq_compliance_cashbalanceplans.html. Retrieved February 5, 2012.

^{viii} Teresa Ghilarducci, 2011, "High Performance Pensions for All Californians," pp. 94-112 in Rhee, *op. cit.*

^{ix} Hank Kim, 2011, "The Secure Choice Pension: A Way Forward for Retirement Security in the Private Sector," National Conference on Public Employee Retirement Systems. URL: http://www.sdccera.org/PDF/Secure_Choice.pdf.

^x Kevin De Leon, December 2, 2011 draft, "An act to Add Section 20139 to, and add Title 21 (commencing with Section 100000) to, the Government Code, relating to pensions, and making an appropriation therefor," RN 11 29395, Office of California State Senator Kevin De Leon, Sacramento, CA.

^{xi} Research in behavioral finance indicates that a limited investment menu is better than excessive investment choice. For instance, one study found that expanding a 401(k) investment menu to include an extensive array of choices actually *decreases* participation because workers become overwhelmed by "choice overload." Sheena Sethi-Iyengar, Gur Huberman, and Wei Jiang, 2004, "How Much Choice Is Too Much? Contributions to 401(k) Retirement Plans," pp. 83-96 in Olivia S. Mitchell and Stephen Peter Utkus (eds.), *Pension Design and Structure: New Lessons from Behavioral Finance*, Oxford & New York: Oxford University Press.

^{xii} Private sector DB funds are, on average, less diversified than public sector DB funds because the former tends to invest a significant amount in company stock issued by the sponsoring employer. It is also common for employer contributions to 401(k)s to take the form of company stock.

^{xiii} Thanks to Christian Weller for explaining many of the issues in this section for the author. However, any errors are solely attributable to the author.

^{xiv} While standard financial wisdom indicates that investing solely in Treasuries is too conservative an investment strategy for workers, particularly for younger workers who have several decades until they

retire, others such as Zvi Bodie have advocated investing primarily in TIPs. Zvi Bodie and Michael J. Clowes, 2003, *Worry-Free Investing: A Safe Approach to Achieving Your Lifetime Financial Goals*, Upper Saddle River, N.J.: Financial Times Prentice Hall.

^{xv} Researchers at the Center for Retirement Research at Boston College have calculated that the maximum feasible guarantee is the risk-free rate, without the possibility of higher returns. See A.H. Munnell, A. Golub-Sass, R.W. Kopcke, & A. Webb, 2009, "What does it cost to guarantee returns?," Center for Retirement Research Issue Brief No. 9-4. URL: http://crr.bc.edu/images/stories/Briefs/ib_9-4.pdf. Alternatively, Regina Jefferson proposed a form of DC plan insurance to encourage individual investors who might otherwise invest too conservatively to take on a more appropriate level of investment risk. Annual rate of return guarantees would be calculated through a five year rolling average on a hypothetical account meeting prescribed diversification standards. Individuals taking excessive risk would not be eligible for insurance. The program would protect workers against large market downturns near the time of retirement, effectively insuring a minimum benefit that reflects long-term average rates of return on contributions. Significantly, insurance benefits (the shortfall between actual account balances and hypothetical account balances, if any) would be payable as a life annuity, and steady contributions are assumed. Program scenarios assume rates of return that exceed the risk-free rate. Regina T. Jefferson, 2000, "Rethinking the Risk of Defined Contribution Plans," *Florida Tax Review*, vol. 4 no. 9, pp. 607-683.

^{xvi} Lump sum withdrawal from the TIAA Traditional Annuity after retirement must occur, at minimum, through ten payments over a period of nine years and one day. For more on the program, see John H. Biggs, 2010, "How TIAA-CREF Funded Plans Differ from a Typical 401(k) Plan," TIAA-CREF Institute Trends and Issues, February 2010, URL: http://www.tiaa-crefinstitute.org/ucm/groups/content/@ap_ucm_p_tcp_docs/documents/document/tiaa02029460.pdf.

^{xvii} Kim, op. cit.

^{xviii} Jeffrey R. Brown, 2007, "Rational and Behavioral Perspectives on the Role of Annuities in Retirement Planning," Working Paper No. 13537, Cambridge, MA: National Bureau of Economic Research.

^{xix} Anthony Webb, 2011, "Designing a More Attractive Annuitization Option: Problems and Solutions," pp. 76-93 in Rhee (ed.), op cit.

^{xx} Olivia Mitchell, James M. Poterba, Mark J. Warshawsky, and Jeffrey R. Brown, 1999, "New Evidence on the Money's Worth of Individual Annuities," *American Economic Review*, v. 89 no. 5, pp. 1299-1318.

^{xxi} Kim, op. cit., pp. 11-12, 14, 15

^{xxii} Webb, op cit.

^{xxiii} Simple IRAs and SEPs (another type of IRA) for small businesses, however, have fewer reporting and disclosure requirements than do 401(k)s.