Alternative Viewpoints on Employee Decision Making

The views expressed below are not necessarily the views of State Treasurer Janet Cowell or the Department of State Treasurer. We have provided these perspectives to give readers the full range of opinions on employee decision making with respect to retirement benefits. We have tried to make the best case for each viewpoint, using the arguments typically made by those who hold these views.

Note that view B is not entirely incompatible with views C and D. The employer could provide education and have default options. The employer could have a mandatory plan and educate employees about how it worked.

View A: Not the Employer's Responsibility

The role of the state and local governments as employers is simply to hire the right mix of employees to provide the best value in services to the public. It is not the employer's responsibility to prepare employees for retirement. The fact that some people will make bad decisions in their retirement planning does not change this. Some people will also make bad decisions in their marriages and how they raise their children, but no one is suggesting that the employer should step in and make these decisions for employees.[1]

The financial services industry is constantly innovating to provide the services that their customers demand. If employees want sound financial advice, there are reputable financial planners throughout the state. If they want to estimate how much they need to save, there are calculator tools on various internet sites. If they want low-cost, diversified investments, there are numerous firms that can provide this. If they want guaranteed lifetime income, there are multiple well-rated insurance companies that offer annuity products. If people do not use these services, it is probably because they do not really want them. If they want to spend money today and not worry about tomorrow, who is the employer to say that their preferences are wrong?

View B: Education and Guidance

Many employees have a low level of financial literacy, particularly when it comes to retirement planning.[2] The employer can provide a valuable service to its employees by educating them on retirement planning and providing them with professional financial advice. Not only are these services valuable to employees, they also pay off for employers because financial problems are a major distraction from work and cause for absenteeism[3]. In addition, by helping employees prepare for retirement, employers are better able to transition older employees out of the workforce and give opportunities for advancement to younger employees.

Employers should offer a combination of services to meet the needs of all employees. Some employees will want group seminars on retirement planning. Some will want to do online courses that allow users to develop a financial plan as they go through the course. Others will need to work

[1] State and local governments would obviously get involved in cases of severe abuse or neglect, but they would not be acting as an employer. If you prefer a financial example, no one is suggesting that employers should prevent employees from running a credit card balance or make sure they pay their mortgage.
[2] See for example http://www.soa.org/files/pdf/public_misperceptions.pdf and http://www.mrrc.isr.umich.edu/publications/papers/pdf/wp157.pdf
[3] http://www.personalfinancefoundation.org/features/Workers-financial-stress-may-hurt-productivity.html

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one-on-one with a financial advisor to tailor a plan for their particular situation. Because of the value of saving early, these services should be offered to the entire employee population. If we wait until people are nearing retirement, it is too late.

Through education, employees are able to learn financial skills that will help them throughout their lives. By working with an advisor, employees are able to tailor the benefits to the particular needs of themselves and their families. While default choices (view C) can have some impact, they only last as long as the employee is with that employer and they are not adaptable to situations that do not fit standard models.

Education and guidance are proven to work and increase employees' participation and savings rates.[4] There are a variety of reputable firms that provide these services and with the State's bargaining power, we can negotiate a good package of services at the best possible rate.

View C: Default Choices

The relatively new field of behavioral finance has shown how powerful default elections can be. The best example of this so far is auto-enrollment in 401(k) plans. In one example, auto-enrollment increased participation from 37% to 86%[5]. However, auto-enrollment alone is not enough. Employees face many other decisions where a default election would be useful:

- How much to save at first
- How to adjust their savings rate after a raise or investment gain/loss
- How to invest
- When to start taking withdrawals
- Whether or not to annuitize

By defaulting all these choices based on information available to the employer (e.g. age, income, current 401(k) balance, number of dependents), we can prepare the vast majority of employees for a financially secure retirement.

Some employees will still opt out of the defaults because they are experts at financial planning or have hired their own expert and have determined that the defaults are not right for their particular situation. By using default, rather than mandatory, choices, we have given these employees the freedom to do what is best for themselves. Some other employees will make unwise decisions to opt out of the defaults and, as a result, will not be financially prepared for retirement. However, as adults, they can take responsibility for their own bad decisions.

While financial education and guidance can be useful, they are expensive both in direct cost to the employer and in employees' time. Many employees choose not to participate in seminars or sign up for appointments with a planner, even when these are available for free. For example, the State Employees' Credit Union has a low usage rate for its free, unbiased, financial planning services.[6] Even when employees do participate, they may not change their behavior.[7] By using default elections, we can reach 100% of the employee population at little direct or indirect cost.

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[4] See for example http://www.businessweek.com/investor/content/jul2009/pi20090722_246198.htm

[5] http://www.ebri.org/publications/ib/index.cfm?fa=ibDisp&content_id=3778, the study is cited at the bottom of p.3, but this whole article is a useful reference on behavioral finance and retirement planning

[6] https://www.ncsecu.org/FinancialPlanning/FinancialPlanningOverview.html

[7] EBRI article, p. 14. Also, see http://www.cfo.com/article.cfm/14485672.

Many employees simply do not wish to spend their time on retirement planning. Even if they have some degree of financial literacy, they have more productive things to do at work or outside of work. Default choices allow them to spend very little time on retirement planning and yet still be ready for retirement. Employees appreciate this service and will factor that into their employment decisions.

Employers who follow the traditional hands-off approach in 401(k) plans, i.e. leaving all decisions up to the employee, are already providing default elections. The default election in this case is not to participate, to contribute 0% of your pay. Why not develop default elections that are likely to be closer to the optimal decision for most employees?

View D: Mandatory Benefits

As noted above, many people have a low level of financial literacy and are likely to make bad decisions when planning for events many years in the future. Many of the people who need financial education will simply not attend the class, forget what they learned, or fail to implement what they learned. If given default elections, many people will opt out of them without good reason or undo them later. For example, auto enrollment might get someone to participate in the 401(k) plan, but will not prevent that person from cashing out their account when they change jobs. Note in this case that the default election is already to leave the money in the 401(k) plan. The employee has to make an active election, i.e. submit a withdrawal form, in order to cash out their account, yet 46%[8] still do exactly that.

Therefore, the only approach that is proven to work for the majority of the population is simply not to give them a choice. Social Security is probably the ideal example of this in our society. As an employee, you do not have a choice about participating in Social Security. You do not choose how much to contribute. You are not allowed to cash out your Social Security when you change jobs. You do not make investment choices. You are not allowed to begin receiving benefits prior to age 62, unless you become disabled. You are required to take payment in the form of a lifetime, inflation-indexed annuity and your spouse automatically receives a benefit for his/her lifetime. The result has been a dramatic decrease in poverty among the elderly[9] and a benefit that will provide lifetime security even for the millions of people who repeatedly make bad financial decisions throughout their lifetimes. Social Security does have some funding issues, but these are not due to its mandatory nature and can be addressed by pre-funding benefits, as most employers do.

Both financial advice and default elections expose employers to legal liability. They may get sued if they choose incompetent or unethical advisors. They may get sued if they select bad default choices for employees. The Pension Protection Act of 2006 removed some of this liability for some specific offerings, but employers are still at risk.

Some people may say that this is not the employer's responsibility. That may be true for private employers, but if governments do not offer retirement benefits, they will end up paying for these people anyway in the form of other government assistance. The National Institute on Retirement Security has estimated that governments save $7.3 billion a year in public assistance due to providing retirement benefits to their employees.[10]

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[8] http://www.hewittassociates.com/Intl/NA/en-US/AboutHewitt/Newsroom/PressReleaseDetail.aspx?cid=7498, for other information on 401(k) average balances and participant behavior see http://www.ebri.org/publications/ib/index.cfm?fa=ibDisp&content_id=4378

[9] http://www.nber.org/aginghealth/summer04/w10466.html and http://www.cbpp.org/cms/index.cfm?fa=view&id=1111

[10] http://www.nirsonline.org/index.php?option=com_content&task=view&id=285&Itemid=48

Given that the employer is likely to contribute to the retirement plan, it should want those funds to be used in the most efficient possible way. It wants to guarantee that those funds are used for retirement, not squandered after being cashed out.

Conclusion

The Study Commission will need to decide which of these views (or combination of views) best expresses the philosophy it recommends for state and local governments in North Carolina. As noted at the top of the article, State Treasurer Janet Cowell and the Department of State Treasurer are not endorsing any of these views at this time.