PostPartisan

A Learning Pension System: Accumulating Evidence through Demonstrations

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It is difficult to understand how more Americans will achieve retirement security without innovation in the pension system. Innovation involves trying out new ideas and approaches, learning by trial and error. The federal government has a role to play in a learning pension system. First, it can be a catalyst for innovation. Second, it can create the regulatory space in which new approaches can be tried.

The role of innovation catalyst falls most naturally to the Secretary of Labor. This role could be formalized by adding to the Employee Retirement Income Security Act (ERISA) the responsibility to develop and from time to time revise a research plan. The research plan would identify innovations that seem promising. As time goes by, as innovations are tried, as evaluation results come in, conclusions can be drawn about whether what seemed promising truly is. Further, innovators should be able to reach beyond what seems to be possible within the confines of current law through a statutory demonstration authority that would allow an innovation to be implemented and evaluated.

Why we need a learning system

Current participation rates, both in terms of employers sponsoring plans and employees participating, fall short of the levels that will produce retirement security. How we get from here to there is not self-evident. The pension challenge has similarities to reducing smoking, increasing consumption of fruits and vegetables, and getting people to keep from texting while driving a car. The goal is clear. The path is not. No single policy change will yield success. Success, if it is attained, will likely be the result of many changes.

There are many ideas about innovations that hold promise to get more employers to offer plans, more employees to participate and employees who participate to save more. But without trying them out, without carefully evaluating them, we will not know if the promise of these innovations is real. We need to try out ideas, evaluate them, and use what we learn in the process of trying them to develop new ideas. Repeating this cycle will make for a learning pension system.

Recent innovation has been largely in defined contribution plans. Defined contribution plans have come to play a large role in retirement security and seem poised to be even more important in the future. These plans allow employees to defer current earnings and invest them to pay for consumption later. Getting it right requires workers to make a set of decisions that lead to retirement security. Getting it wrong means not having retirement security.

The decisions made by defined contribution plan participants often are at odds with the behavior predicted by standard economic models. In the lifecycle model of savings and consumption, individuals want to smooth consumption across their working and retirement years. To do this they accumulate savings during working years, do so at a rate that will allow them to have similar consumption levels in retirement years as in their working years, and use tools like annuities to realize a smooth path of consumption in their retirement years. Observed behaviors mock the models.

The life cycle model predicts how people will behave when they go to work for an employer who offers a defined contribution plan. The moment you become eligible to participate, you will sign up, and apart from such circumstances as being the beneficiary of a trust fund that provides generous payments late in life, you will put as much money into the plan as you are allowed. However, an abundance of evidence has shown that does not happen.[1]

Evidence from innovations in defined contribution plans has shown participants are strongly influenced by defaults. If the default says you must make an affirmative decision to enroll, many people wind up not enrolling. However, if the default says you are enrolled and must do something to disenroll, then a lot more people participate in the employer's plan. Rather than rational, calculating, and forward looking decisionmakers who do the same thing regardless of which way the default operates, plan participants and would be participants have proven to be influenced by institutional arrangements and how they frame decisions.

Having a set of policies in place that lead to better decisions requires answers to many empirical questions. Current institutional arrangements are not set up to frame or answer these questions.

The Pension Protection Act of 2006 (PPA 2006) set out the rules under which an employer could make automatic enrollment a feature of its plan. Those contributions had to go somewhere, and the PPA made clear that a default allocation of a default enrollment contribution would be treated as a participant exercising control and not a prohibited action by a fiduciary.

The evolution of this provision shows the limitations and difficulties in the current model of policy innovation. Automatic enrollment and default allocation could be seen as something that was inconsistent with the law. At a minimum, plan sponsors might be worried about the legal risk they faced if they implemented automatic enrollment. The pioneers managed that risk through a private letter ruling. The employer who sought the private letter ruling could implement innovations, but so could others who used the contours of the private letter ruling as a template for their own changes. Economists later worked with benefits consultants to obtain data about what happened as a result of the innovation. Their findings showed that more employees participated when the default shifted from employee action required to enroll to employee action required to disenroll. In time, the statutory framework caught up in the PPA of 2006.

The automatic enrollment and default allocation experience defines the current model for pension policy innovation and suggests one way future innovation might happen. First, an innovative employer wants to try out an idea. Second, the employer secures the regulatory approval required to move forward with the idea. Third, the results of the policy innovation become known. Fourth, the policy world responds.

The relative popularity of defined contribution plans does not mean that defined benefit plans are an evolutionary dead end. Instead it shows the challenges to new approaches in this area.

Through the "Conversation on Coverage" process many individuals with backgrounds that ranged from unions to large employers to financial institutions developed a set of mechanisms that could lead to an increase in pension coverage and retirement savings. One goal of the plans proposed in 2007 by conversation participants was to devise plans that were less complex, potentially interesting employers that currently do not offer plans. (The "Conversation on Coverage" process and the plans the conversation proposed are documented on its web site, http://www.conversationoncoverage.org/)

One of the plans that emerged in that process was a defined-benefit plan, a "plain old pension plan" or POPP. Government published tables would determine contribution amounts. Employers would have the ability to keep plan costs in line with how good a year they have. One was a hybrid of

[1] Another report in this series, Christian Weller's "Fun with Numbers: Disclosing Risk to Individual Investors," reviews this evidence. http://www.economicsecurityproject.org/documents/Weller_report.pdf

defined benefit and defined contribution, the Guaranteed Account Plan (GAP.) It would combine individual accounts with guarantees of investment performance. Like a defined benefit plan, it would lead to getting a monthly check in retirement.

In the case of both plans, the Conversation on Coverage group identified a list of provisions that were inconsistent with current law. Moving forward with either plan requires some regulatory space that current law may not allow. One way to move forward would be to change the underlying law, either to change the provision of law or to create an exception to the law for the type of plan envisioned by the Conversation on Coverage group.

However, moving immediately to change the law or provide exceptions that take care of the problems identified by the Conversation on Coverage participants pours concrete around a particular set of design features. What if it turns out that some of these features dampen employer or employee interest? Only by breaking the statutory concrete could the features be modified.

Whether it is overcoming the cognitive challenges of defined contribution plans or the hesitation of employers to begin defined benefit plans, the weaknesses in the current innovation model are similar. They include its reactivity, the statutory limits on the relief that a private letter ruling approach can allow, the lack of transparency in the process, a result that guides practitioners to hew to the result that arises from the set of facts addressed in the private letter ruling, and the necessity of getting Congress to change the law to allow some innovations to be tried.

The demonstration proposal

The Employee Retirement Income Security Act currently does not provide a mechanism for the Secretary of Labor to allow plan sponsors to try promising approaches without a ruling or rulemaking that would apply to all plan sponsors. A statutory provision that gives the Secretary of Labor the authority to approve demonstrations would allow approaches to be tried that a plan sponsor could not try or may be reluctant to try absent specific permission.

The potential for personal liability due to a violation of fiduciary standards creates a good case for any potential innovator to decide that the risk of innovation is too great. Compare employer efforts to advance workers' interests by reducing the health risk of tobacco to creating choice structures that seek to increase the potential for workers to enjoy a secure retirement. The ERISA fiduciary standard makes both the decision to be active in the two areas very different as well as make the consequences of getting it wrong much higher.

This proposal could be implemented in fairly simple statutory language. Forty years' experience with a similar provision in the Social Security Act suggests that a simple authority could work well. The real restriction on the use of the authority would not be the words of the statute but the eyes of all the interested parties who watch the Secretary use her authority.

The Social Security Act example (Section 1115 of the Social Security Act, 42 USC 1315) says: "In the case of any experimental, pilot, or demonstration project which, in the judgment of the Secretary, is likely to assist in promoting the objectives of [the programs administered under this Act], … the Secretary may waive compliance with any of the requirements …to the extent and for the period he finds necessary to enable such State or States to carry out such project…." Substitute "plan sponsors" for "State or States" and the Social Security Act provides a workable model.

The dualism of ERISA and the Internal Revenue Code for employee benefit plans would require that demonstrations be allowed to overcome impediments in both laws.

What a research and demonstration authority could do

The Pension Protection Act of 2006 provided the statutory space for employers to compensate for one form of inertia, failing to sign up for an employers plan, but did not address other forms of inertia, for example, getting employees to move beyond default investment choices. A demonstration authority could provide the potential for generating data that shows what happens when employers try something. Do employees respond? How much do they respond? What are the characteristics of employees who do and do not respond?

There are many possibilities for how employers and employees interact to produce retirement security for workers. More of them could be tried if the Secretary of Labor had the authority to allow demonstrations. The facts that would emerge from these demonstrations can provide the facts required to make defined contribution plans work better for employees.

The Conversation on Coverage proposals detailed several new types of plan that would have features inconsistent with current law that could be tried under a demonstration authority. Other promising innovations that could be tried under a demonstration authority include:

Benefits statements. There are many ideas for how information contained in benefits statements might encourage employee engagement with retirement planning. How do illustrations of future income feed back into employee decisions? Do employees respond to messages about where they stand relative either to what other employees are doing or representations of "ideal" behavior (and what should those representations be?)[2]

Turning 'defaulters' into active participants. Employees who begin their participation in employer plans by default and contribute to a default investment allocation are not well-served by staying in that position until they retire. What mechanisms can turn 'defaulters' into individuals who make investment decisions that make sense for them?

Other 'nudges' . Thanks to firms making decisions that created natural experiments for academic social scientists to evaluate, there is a strong empirical base for saying what happens when employers nudge employees to enroll in defined contribution plans. There are many other 'nudges' that could be imagined, but until they are implemented and generate evidence about their impact, one cannot say what the magnitude of their impact might be.

In each of these cases, demonstrations could generate the facts that will become the basis for "successful reform" in some future "Pension Protection Act of 20XX." (And the cold analytics of the evaluation process would likely leave some innovations behind as some ideas that seemed promising turn out to be less so.)

Issues a research and demonstration authority could address

While the Social Security Act authority has been an indispensable tool for carrying out demonstrations, it has no proactive features. Moving to a learning system requires some sense of where we are, where we want to go, and how we might get there. This desire could be expressed in a statutory provision that requires the Secretary of Labor to develop and publish a research agenda and revise it from time to time.

The agenda would identify areas where the Secretary believes information about potential worker and sponsor response to innovations could be gained by running a demonstration. While the research

[2] Christopher Spence's report in this series, "Practices for Retirement Plan Design from the Non-Profit Sector," shows how one organization structures this information for participants. http://www.economicsecurityproject.org/documents/Spence_report.pdf

agenda would not be a rule, the Secretary could be required to publish a proposed agenda in the *Federal Register* and solicit comment before adopting a final plan. The value of the agenda will be in its ability to distill what researchers and participants believe is important and inspire innovation.

Transparency in the Secretary's activity under the demonstration authority could include a requirement that the Secretary post on the Department's web site a summary of any demonstration project the Secretary is considering and the requirement that the summary be posted for at least 30 days before the Secretary approves a demonstration.

If you build it, will they come?

The research agenda would make the innovation process proactive by identifying ideas the Secretary believes worth trying. The real test of the research agenda is whether it inspires would-be innovators to step forward.

As in other domains, innovation in pensions requires entrepreneurs. Policy innovations are a form of public good. They benefit not only the innovator but also all who put the innovation to use. The costs in terms of the effort to move an innovation through the bureaucratic process fall on one plan sponsor but the benefits, should the innovation be more widely adopted, accrue to all those who adopt the innovation.

Benefits consultants serve the role of policy entrepreneurs in pensions. If a benefits consultancy pitches an innovation to a plan sponsor, sees it through the demonstration approval process and helps the plan sponsor to implement it, a demonstration will happen.

Other forms of entrepreneurship might bring about participation by employers below the size of those that use large benefits consultants. For example, an association of non-profits might take on the task of applying for a demonstration waiver to implement a plan like one of those proposed by the Conversation on Coverage participants.

Conclusion

There is much to be learned about how the features of plan design can lead to a more secure retirement for American workers. Demonstrations can provide the evidence about the impact innovations might have. By learning what makes a difference and what does not, American workers can benefit from a more nuanced regulatory regime that provides incentives that make a more secure retirement more likely.

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