Center for State & Local Government Excellence

Issue Brief

Using Automatic Escalation in Public Sector Retirement Plans to Increase Savings

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In 2014, states and localities across the country continue to modify their retirement packages in an effort to offer benefits that are fiscally sustainable and provide sufficient retirement income and health care security to retirees. Future retirees, as well as some current retirees, can expect their traditional, defined benefit pension to provide less income in real terms and may also be responsible for paying more of their health care expenses.

Because of these changes, the Center for State and Local Government Excellence has made it a priority to examine the expanding role of supplemental savings.

One way supplemental saving plans could be enhanced in the public sector is by automatically increasing how much a public employee saves as they progress through their career.

This issue brief, written by Paula Sanford of the Carl Vinson Institute of Government, University of Georgia, highlights the challenges and opportunities state and local governments may encounter as they consider automatic escalation policies.

Through interviews, case studies, and a review of academic and practitioner research, this brief provides recommendations on how governments might incorporate an automatic escalation policy into their defined contribution retirement plans.

Some of the key recommendations are:

- Ensure that employee groups are part of the process in working with elected and appointed leaders who support an automatic escalation policy.
- Acknowledge that there is not one uniform approach to automatic escalation. The policy should reflect a government's unique workforce preferences and policy environment.
- Reduce or eliminate as many barriers to plan enrollment as possible.
- Link communication and education about the feature with its adoption and consider implementing it in conjunction with other features, such as automatic enrollment.

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Using Automatic Escalation in Public Sector Retirement Plans to Increase Savings

By Paula Sanford*

Introduction

Public retirement plans have undergone significant reforms that require changes in how employees prepare for retirement. In particular, employees are increasingly assuming more responsibility for funding their retirements, including needing greater personal savings. Yet, research on how to accomplish this goal in public sector retirement systems is limited.

This report examines the use of automatic features in public sector retirement plans, focusing on automatic escalation to increase retirement plan contributions. While automatic escalation is widely used in the private sector, only a handful of governments have adopted it for their defined contribution plans. Obstacles to use of automatic escalation include perceptions about the need for it, legal constraints, concerns about what might be seen as government paternalism, and limited employee financial flexibility. Nevertheless, some governments have overcome these challenges and successfully introduced automatic escalation to help raise employee retirement savings. As defined contribution plans become more important to supplement other public sector employee retirement benefits, tools such as automatic enrollment and automatic escalation may become valuable in helping employees meet their retirement goals.

Methodology

This study is based on a review of written research and interviews with experts on public defined contribution plans. Academic literature on automatic escalation is scant, and what research exists is part of a larger analysis of automatic features.[1] In addition, most research and writing consider automatic escalation only in the context of private sector 401(k) plans. This is the first study to examine automatic escalation for public sector retirement plans and supplemental defined contribution plans. Because of the dearth of research on this topic, interviews with eight individuals who work for either government or organizations that assist public sector retirement plans were very valuable and provide the basis for the findings and conclusions in this report.[2]

Report Format

The purpose of this report is to increase understanding of how automatic escalation works as a tool for increasing retirement savings and to examine successful implementation strategies in public sector retirement systems. The report provides:

- background on the current public sector retirement environment and on the use of automatic escalation in both private and public sector defined contribution plans
- a discussion about the challenges of implementing automatic escalation in the public sector
- case studies on successful implementation of automatic escalation in supplemental defined contribution plans for some public employees in Missouri, Ohio, and Virginia
- a summary of lessons learned about how to implement automatic escalation in the public sector.

Automatic Escalation to Encourage Retirement Saving

Automatic escalation is a plan design feature within the larger component of automatic features used to promote savings. Defined contribution plans are expanding their use of automatic features to make saving easier and to improve retirement income outcomes for participants. Increased use of these tools is based on behavioral economics research, which has examined obstacles to saving for retirement, including knowing how much to save, how to invest, and how to develop the willpower to save.

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Two options that have proven successful in encouraging savings are automatic escalation and automatic enrollment. Under automatic escalation, a participant's contribution to a defined contribution plan is increased at regular intervals, typically annually, until a predetermined contribution level or cap is reached. The amount of the automatic increase can be either a percent of salary—most often 1 percent of salary—or a fixed dollar amount. Ideally, the increase in retirement contributions coincides with an annual raise so that the employee does not experience a net loss in take-home pay. The underlying assumption for automatic escalation is that slowly increasing retirement contributions reduces employee resistance to savings.

Under automatic enrollment, the plan has a default enrollment contribution rate, such as 3 percent and an opt-out provision. Research has found automatic enrollment to be extremely successful at encouraging employees to save for their retirement. For example, private sector employee participation rates in retirement plans have reached 90 percent with automatic enrollment.[3] In most cases, however, automatically enrolled employees remain at the initial default rate.[4]

Combining Features to Boost Savings

In order to boost the level of savings, some retirement plans incorporate automatic escalation with automatic enrollment, which has been shown to be very successful in helping employees achieve retirement readiness.[5] Automatic enrollment and escalation work well together because many employers are inclined to set the initial automatic enrollment contribution rate at a very conservative level. In the public sector, this is generally due to employers wanting to prevent employees from opting out of the retirement plan because the default contribution is too high, although research has shown that employees generally stay in plans, even with higher default contributions.[6] Private sector employers often set the automatic enrollment default rate at 3 percent and include a 50 percent match to produce a total pension contribution of 4.5 percent—still far below the generally recommended contribution rate of 10 to 15 percent.[7] The low default rates are due to private sector employers' concerns over employees opting out of the defined contribution plan and liability with employees' investments.[8] Automatic escalation can increase that contribution rate by several additional percentage points through annual increases.

Recent research has measured the impact of combining automatic enrollment and automatic escalation on retirement savings. VanDerhei and Lucas[9] conducted simulations that measured the likelihood that employees would achieve a level of retirement income that equaled at least 80 percent of their working income using savings from their 401(k) and Social Security benefits. The study focused on younger employees who would work 40 years. The probability that employees in the lowest income quartile would achieve that benchmark reached nearly 80 percent (79.2 percent), but only if the following four criteria were used:

1) The 401(k) plan adopted automatic enrollment with a 6 percent initial contribution rate.
2) The plan used automatic escalation that increased contributions by 2 percent annually.
3) The plan allowed employees to contribute up to 15 percent of their salaries.
4) Employees did not reduce contribution levels when changing jobs.

For employees in the highest income quartile, the probability of success was 64 percent with all four criteria. The reason the lower income quartile had a higher probability of reaching the 80 percent income replacement goal was that a higher percentage of their retirement income was expected to come from Social Security. The research also showed that changing any of the criteria to make the savings less robust, such as an automatic escalation rate of 1 percent annually or a 3 percent initial contribution rate, lowered the probability of reaching the 80 percent income replacement goal.

Behavioral Economics Research Guides Automatic Escalation Strategies

Automatic escalation as a tool for increasing employee contributions to retirement savings is founded on behavioral economics research. This field of research has improved appreciation for the fact that many decisions, particularly those with outcomes far into the future, are not based on a rational economic evaluation of choices.[10] In the case of retirement savings, individuals may delay saving for a variety of reasons, including having difficulty in making complex decisions, limited self-control, and inertia. Automatic escalation can overcome these obstacles by:

- helping people decide how much to save because contributions increase until a pre-determined savings cap or maximum has been reached
- overcoming a lack of self-control because the plan sponsor diverts savings on behalf of the participant before he or she has a chance to spend it, similar to tax withholding

- converting inertia into positive behavior because employees must take action to stop contribution increases.

Inertia offers employers and plan sponsors a special opportunity to help employees achieve a more financially secure retirement. Choi et al. commented on the passive nature of employees when it comes to retirement savings, noting that "for better or worse, plan administrators can manipulate the path of least resistance to powerfully influence the savings and investment choices of their employees."[11]

Private Sector Support for Automatic Features Outpaces Public Sector Use

Support for automatic enrollment and automatic escalation features in defined contribution plans has steadily increased in the private sector, due in large part to the Pension Protection Act, which provided a safe haven for employers who use the features. A 2012 survey by Lincoln Retirement Financial Group[12] found that 94 percent of employers recognize the success of the automatic enrollment feature in driving higher participation and deferral rates for employees in their retirement plans and helping their organizations reach plan-related goals. The study also found that plans with automatic escalation experienced deferral rates of 8 percent—double the average deferral rate of 4 percent or less for the majority of plans in the United States.

A survey by the Defined Contribution Institutional Investment Association (DCIIA) found that 56 percent of private sector defined contribution plans that responded offer automatic enrollment and approximately half of those plans (about 25 percent of all respondents) also offer automatic escalation.[13] The number of participants opting out of automatic escalation features is rather low as well. In the DCIIA survey, the median opt-out rate for automatic escalation was just 5 percent, with a majority of the plan sponsors describing the feature as favorable. Many in the private sector are calling for greater use of automatic escalation, including raising the annual contribution level to 2 percent of salary annually in order to increase the retirement income security of workers.[14]

In contrast, automatic features are still relatively rare in the public sector, with automatic enrollment being more widely adopted than automatic escalation. A March 2013 National Association of Government Defined Contribution Administrators (NAGDCA) survey[15] showed that of the 136 government defined contribution plans represented, 73 percent had elective plan participation and of these, only 8 percent used automatic enrollment. The primary reasons for not adopting automatic enrollment were anti-garnishment laws or the lack of any perceived need for the feature.

The following findings emerged from a January 2014 NAGDCA informal e-mail survey of its members about use of automatic escalation:

- Eight plan sponsors/governments reported offering the feature for their defined contribution plans, and three additional governments were considering it.
- Of the plans using automatic escalation, seven were statewide plans or state and local plans and one plan was only for a local jurisdiction.
- In all cases, the feature was used in a 457 defined contribution plan.

Three of the governments that reported using automatic escalation in the NAGDCA e-mail survey are highlighted as case studies in this report.

Current Public Sector Retirement Environment

Between 2009 and 2013, 48 states modified their retirement benefits, most often to increase plan financial stability and lower the plan sponsor's or employer's risk.[16] Other reasons for reforms include creating portable retirement benefits for today's more mobile employees and equalizing benefits between the public and private sectors. Many of the changes led to lower benefits for employees when they reach retirement age.

A 2014 study by the Center for State and Local Government Excellence and the National Association of State Retirement Administrators (NASRA) found that the average retirement income for employees is about 92 percent of pre-reform benefits for the 24 state pension plans in the study.[17] As a result, new employees will need to work longer or save more to have the same retirement income as their predecessors. In some cases, they will need to save an additional $100,000 to reach the pre-reform benefit level. Since 2009, 22 states have changed their cost-of-living (COLA) provisions in one or more plans.[18] Other changes to defined benefit plans have included increasing the number of years and months used to calculate the final average salary and raising the normal retirement age. Even though benefit multipliers, in most cases, have not decreased, these reforms still have a negative financial impact on retirement income. For example, increasing the final average salary calculation from three to five years results in a 2.4 percent reduction in the annual benefit.[19]

Hybrid Plans

One of the most significant trends in public sector retirement has been the rise of the hybrid plan. Sixteen states now offer hybrid plans as either a mandatory or optional retirement benefit.[20] One of the most important components of the hybrid plan is the greater sharing of risk between the employer and the employee over the traditional primary defined benefit plan. There are two types of hybrid plans, a "combination plan" and a "cash balance plan." The most common form combines a lower-level defined benefit plan coupled with an individual defined contribution plan to help employees save for retirement. Combination hybrid plans vary widely in the extent to which employees are required to participate in the defined contribution option. For example, Oregon, Rhode Island, and Washington require state employees to make some contribution to the savings plan, while Utah and Georgia make contributions optional. However, Georgia uses automatic enrollment to encourage savings and offers an employer match to employees who choose to contribute to the plan.

Because of the lower defined benefit associated with a combination hybrid plan, individual savings are very important to help employees reach retirement income goals. For a hybrid plan that provides a defined benefit with a 1 percent multiplier, after 30 years an employee will have 30 percent of his or her income replaced. If Social Security is added, approximately 60 percent of working income is replaced—still far below the commonly cited 80 percent income replacement goal.

Tables 1 and 2 provide two scenarios—one with and one without Social Security—for defined contribution rates required to achieve 80 percent of final salary after 35 years of employment for a combination hybrid plan with a 1 percent defined benefit formula.

Table 1 shows that employees need to save more as their salary increases, due to Social Security providing a smaller percentage of income. Table 2 shows that employees who will not receive Social Security need to contribute significantly more to a defined contribution plan in order to achieve a replacement income of 80 percent at retirement. Since many employees do not reach a 35-year career in government, savings will need to be even higher than shown in the tables. In cases where employee contributions need to be relatively robust to have an adequate retirement income, such as in most hybrid plans, automatic escalation may be a valuable tool.

In the second type of hybrid plan, the cash balance plan, employer and employee contributions are pooled, and the employer/plan sponsor manages the investments on behalf of employees. Employees are guaranteed a certain rate of return through the life of the plan. Upon retirement, an employee may "purchase" an annuity from the plan or receive a partial or total lump sum payment. Rules regarding guaranteed returns and payouts vary by plan. In public cash balance plans, employee contributions are mandated and set. However,

Table 1. *Defined contribution savings rate for a hybrid plan with Social Security*[21]

Entry salary	Defined benefit replacement (% of one-year final salary)	Estimated Social Security (% of final salary)	Target replacement income	Target defined contribution income	Required defined contribution rate
$40,000	35%	30%	80%	15%	**3%**
$60,000	35%	25%	80%	20%	**4%**
$80,000	35%	22%	80%	23%	**4.6%**

Table 2. *Defined contribution savings rate for a hybrid plan without Social Security*[22]

Entry salary	Defined benefit replacement (% of one-year final salary)	Estimated Social Security	Target replacement income	Target defined contribution income	Required defined contribution rate
$40,000	35%	0%	80%	45%	**9%**
$60,000	35%	0%	80%	45%	**9%**
$80,000	35%	0%	80%	45%	**9%**

in some cases, employer contributions vary by tenure of the employee.[23] If the guaranteed investment in the cash balance plan is anticipated to be higher than what the employee would earn from a conventional supplemental defined contribution plan, such as a 457 plan, perhaps employees could be given the opportunity to increase their contributions to the cash balance plan. If so, a voluntary automatic escalation feature may be a desirable option.

Shared Responsibility for Funding Retirement

One of the major results of pension reform has been a greater sharing of responsibility between the employee and employer for funding retirement benefits.[24] Reductions in retiree health care benefits and possible changes to Social Security add to employees' fiscal uncertainty. As a result, many public employees need to save far more for their retirement. Supplemental plans, like the 457 plan, provide fairly simple vehicles for public employees to save for their retirements—and behavioral economics research emphasizes that simplicity is crucial to encourage savings. Automatic features add further ease to enhance savings.

Public Sector Challenges with Automatic Escalation

Public sector plan sponsors have been hesitant to adopt automatic features, particularly automatic escalation, for their defined contribution plans. The following sections identify seven challenges to use of automatic escalation in the public sector that have emerged from research, practice, and interviews for this report.

Absence of Need

Overwhelmingly, public employees still have access to defined benefit pension plans. As of 2013, 83 percent of all state and local government workers had defined benefit plans, with 78 percent of employees participating.[25] Conventional thinking has been that income from a primary defined benefit plan and Social Security (where eligible) reduced the need for employees to accumulate large balances in supplemental defined contribution plans to fund their retirements. Instead, money saved in a defined contribution plan would be used to pay for unanticipated expenses such as medical costs or home repairs or lifestyle enhancements such

Types of Defined Contribution Plans

401(k) Plan

"A 401(k) Plan is a defined contribution plan where an employee can make contributions from his or her paycheck either before- or after-tax, depending on the options offered in the plan. The contributions go into a 401(k) account, with the employee often choosing the investments based on options provided under the plan. In some plans, the employer also makes contributions such as, matching the employee's contributions up to a certain percentage."

Source: http://www.irs.gov/Retirement-Plans/Plan-Participant,-Employee/Definitions

457(b) Plan

"Plans of deferred compensation described in [Internal Revenue Code] (IRC) section 457 are available for certain state and local governments and non-governmental entities tax exempt under IRC 501….Plans eligible under 457(b) allow employees of sponsoring organizations to defer income taxation on retirement savings into future years."

Source: http://www.irs.gov/Retirement-Plans/IRC-457(b)-Deferred-Compensation-Plans

401(a) Plan

"Generally, any public employer may set up a 401(a) plan. Under this plan: Employer contributions not made pursuant to a salary reduction agreement, but including employer "pick-up" contributions, are deferred from income tax until distribution, and exempt social security and Medicare tax. Employer contributions made under a salary reduction agreement are deferred from income tax, but are subject to FICA tax. Employee contributions pursuant to a salary reduction agreement are subject to income tax and FICA."

Source: http://www.irs.gov/Government-Entities/Federal,-State-&-Local-Governments/Government-Retirement-Plans-Toolkit

403(b) Plan

"Plans under [Internal Revenue Code] IRC section 403(b), also called tax-sheltered annuities, are available to certain employees of public schools, employees of certain tax-exempt organizations, and certain ministers. To maintain a section 403(b) plan, a governmental employer must be a public school of a state, political subdivision of a state, or an agency or instrumentality of one or more of these. Many public school employees are covered by 403(b) plans in addition to social security coverage under section 218. 403(b) plans resemble "qualified" (i.e., 401(k)) plans in many respects."

Source: http://www.irs.gov/Government-Entities/Federal,-State-&-Local-Governments/Government-Retirement-Plans-Toolkit

as travel. Absent the need for large account balances in supplemental plans, automatic escalation, which is designed to grow savings, could be considered excessive and unnecessary.

However, recent public pension reforms, uncertainty about the future of Social Security, and rising health care costs for retirees have altered the anticipated retirement outcomes for public employees, making defined contribution plans a more important source of retirement income than in the past.[26]

Impact of Mandatory Contributions

Even in instances when public employees' primary retirement plan is a defined contribution design more closely resembling the private sector benefit, automatic escalation is rarely used because governments typically establish mandatory employee contribution rates.[27] Of the eight states that offer primary defined contribution plans to broad employee groups (excluding elected officials and judges),[28] only Michigan allows employees to opt out of contributing to the plan. Many public universities provide faculty an option to participate in a defined contribution plan as well, but again, employee contributions are nearly always mandatory. Rather than give employees the opportunity to ratchet up contributions through automatic escalation, many financial experts support setting the initial contribution rate at an amount needed to achieve a reasonable retirement income.[29]

Risks of Overtaxing Employees

Because public employees typically help to pay for their defined benefits through payroll deduction, employers are often hesitant to withhold more income with a defined contribution plan even if the deductions benefit the employee. Since 2009, 28 states have increased the required employee contribution to their defined benefit plans.[30] Currently, the median defined benefit plan contribution for state and local employees is 6.4 percent.[31] These contributions are in addition to Social Security taxes (if applicable). Employees are also increasingly paying a greater share of health care costs through higher premiums, co-pays, or deductibles.[32] Concerns about overtaxing employees' ability to pay for benefits are compounded by limited pay raises over the past several years due to the recession. Fortunately, an improving national economy is leading to stronger state and local government budgets and the possibility of more regular salary increases and improved health care cost sharing.

Paternalism

Many policy makers are apprehensive about the perceived paternalism associated with automatic features in defined contribution plans. They believe employees are in the best position to know their capacity to save and how much savings they will need in the future. Two issues arise from this line of thinking:

- Behavioral economics and research on financial literacy clearly show that employees do not know how much they need to save and need help making good decisions about savings levels.
- The design of most defined benefit plans is to take the "guess work" out of retirement savings by mandating employee contributions[33] and providing a lifetime annuity, which could be seen as a paternal approach to retirement planning.

Increased Employer Costs

Automatic escalation has the potential to increase employer costs for plans with an employer match. Because the purpose of automatic escalation is to raise employee contributions, successful implementation means employer matching contributions will also increase. If an employer knows employees need to save more, yet the sponsoring government does not have the resources to fund a matching benefit for all employees, it would be better for the employer to amend the matching formula before implementing an automatic escalation feature. Employers should consider how design features—automatic escalation or employer match—can result in the best outcomes for employees.

Legal Barriers

In many states, there are legal barriers to adopting automatic escalation. Anti-garnishment laws prohibit employers, including governments, from withholding wages from an employee's pay without written consent. Only 10 states either do not have laws requiring written employee consent for payroll deductions or have specific exemptions regarding benefit plans. In five other states, the laws are unclear about employers' ability to make automatic deductions from employee paychecks without written consent. A few states have added specific exceptions to allow automatic enrollment in retirement plans, but have not done so for automatic escalation. In states with anti-garnishment laws, employees would need to voluntarily sign up for automatic escalation in their defined contribution plans. Simply getting employees to voluntarily enroll in a supplemental defined contribution plan can be challenging and adding automatic escalation may be even more difficult. However, the case studies for this research provide innovative strategies to encourage employees to adopt automatic escalation for their supplemental defined contribution accounts.

Not Having a Champion

Because of these challenges, often a champion for the adoption of automatic escalation does not exist. Yet, as with any policy change, one is needed, particularly if legislative changes are required. Rather than relying on elected officials to advance defined contribution plan changes, plan sponsors may want to fill that role. With so many defined benefit plan changes in recent years, it may be time for plan sponsors to evaluate the retirement income needs of employees. Some questions to consider are:

- To what extent has the defined benefit plan benefit decreased with reform?
- What is the status of the defined benefit plan's cost-of-living adjustment?
- Is the cost-of-living adjustment likely to change over the next 10 years?
- Have there been changes to retiree health benefits?
- How much more individual savings will employees need to achieve an adequate income in retirement?

Based on answers to these questions, plan sponsors may want to consider amending their defined contribution plan design to further encourage savings.

Case Studies

The following case studies demonstrate the variations possible in designing an automatic escalation feature for a defined contribution plan. The cases all have the same primary goal—increasing employee savings in a supplemental defined contribution plan. Their approaches differ, reflecting diverse retirement benefits, legal constraints, and organizational cultures within which they are operating. Here is a snapshot of the three cases:

- All three continue to provide a defined benefit, but their income multipliers vary.
- In two of the cases, employees participate in Social Security.
- The three states face different legal restrictions regarding wage garnishments, which affect how they structure automatic options.
- Two of the states have Democratic governors and one has a Republican governor.
- Two of the retirement systems actively advise elected officials in the policy formulation process to advance legislation; the third serves largely as a subject matter expert to legislators.

The applicability of automatic escalation across this environmental diversity is the most important lesson from the case studies.

Missouri State Employees' Retirement System

The Missouri State Employees' Retirement System (MOSERS) administers retirement, life insurance, and long-term disability benefits for state employees, including those working in public universities, with only a handful of exceptions. The system provides both a defined benefit and a supplemental plan. Approximately 32,000 employees actively contribute to the supplemental plan.[34]

Early in 2013, MOSERS adopted the automatic escalation feature in its supplemental 457 plan as part of a larger reform that also included adding automatic enrollment for all employees hired on or after July 1, 2012. MOSERS initiated the legislation that resulted in automatic enrollment in an effort to boost participation in the supplemental plan. In 2010, the legislature had passed pension reform, which required employees hired on or after January 1, 2011, to begin contributing 4 percent of pay to the defined benefit plan. Before the legislative action, employees did not contribute to the plan. The benefit multiplier of 1.7 percent of final average pay remained unchanged.[35] With the addition of a required contribution to the defined benefit plan, participation in the supplemental 457 plan dropped to 10 percent for new employees, compared with 40 to 50 percent for employees hired before the change.

In order to encourage employees to save enough to achieve an adequate retirement income, MOSERS trustees and staff supported legislation to change existing garnishment laws to allow automatic enrollment with an option to withdraw. Since Missouri is a right-to-work state, MOSERS staff did not face strong opposition from labor unions although executives met with employee groups to discuss the legislation. The default rate for automatic enrollment was set at 1 percent to minimize the likelihood of employees opting out of the plan and to reduce lawmakers' resistance to the reform.

With a low automatic enrollment rate, MOSERS staff decided to add a voluntary automatic escalation component to raise contribution rates. Since the automatic escalation is voluntary, no legislative changes were needed for implementation. The feature's design is purposely simple to encourage participation. Signing up for automatic escalation is done electronically. Employees can:

- choose the annual escalation amount in increments of a tenth of a percent
- select the month during which the increase will occur
- sign up or opt out of the feature at any time.

The plan's record keeper said administration of the automatic escalation feature is integrated with the other monthly plan changes. All 457 plan participants—not just those who were automatically enrolled—can participate in the automatic escalation feature. There are currently 160 participating employees.

Cindy Rehmeier, manager of MOSERS's defined contribution plans, said one of the biggest challenges in encouraging employees to sign up for automatic escalation has been inconsistency in pay raises, which are at the discretion of the legislature. Because of tight state budgets, raises have been sporadic and modest. As the economy continues to improve, pay raises may become more consistent, which could make employees more willing to start automatically escalating their contributions.

MOSERS uses a variety of outreach techniques, including social media, newsletters, videos, e-mail alerts, and web-based information, to encourage participation in the 457 plan and automatic escalation. Onsite education counselors provide both seminars and individual consultations. During seminars for new employees, the education counselors discuss automatic escalation, which appears to be the most effective means for reaching employees MOSERS most wants to target for the feature.

To increase the number of participants in automatic escalation, particularly those who joined the plan via automatic enrollment and continue to be at the 1 percent contribution rate, MOSERS is exploring changing the escalation feature from voluntary to automatic with an opt-out feature. That change would require state legislation. MOSERS leadership decided to exclude automatic escalation in its 2012 457 plan legislation in order not to over complicate the goal and have the legislation fail. MOSERS is fortunate to have a very good working relationship with legislators and a good board that will work to advance new, agreed upon polices. If MOSERS ultimately decides to support automatic escalation legislation, it should be in a good position to be successful.

Ohio Public Employees Deferred Compensation Program

The Ohio legislature established Ohio Public Employees Deferred Compensation Program(Ohio DC) in 1976 as a governmental organization separate from the state's public defined benefit plans. The sole purpose of Ohio DC is to manage supplemental retirement plans for the state and local governments and school districts. Ohio DC serves 1,800 different employers, the state of Ohio being the largest. Nearly 62 percent of Ohio state employees have an account with Ohio DC. The level of participation varies among local governments and school districts, particularly since some of these employers also offer deferred compensation plans from other entities. Membership in the 457 is particularly important for Ohio public employees because they do not participate in Social Security. [36]

Ohio public employees have access to a defined benefit plan. The Ohio Public Employees Retirement System (OPERS) is the largest of five statewide retirement plans and provides a defined benefit plan with an income multiplier of 2.2 percent. Employees contribute 10 percent of salary to the plan. OPERS does not match employee contributions to the 457 plan.[37]

Though state employee participation in the 457 plan is high, Ohio DC Executive Director Keith Overly believes savings rates are not high enough. For typical 457 plan participants, the defined benefit plan will replace approximately 56 percent of their pre-retirement income, and the supplemental 457 plan will add only 3.5 percent, for a total of 59.5 percent. This leaves a 20 percent savings gap to reach the recommended 80 percent replacement income retirement goal.

To address this income gap, Ohio DC has instituted innovative programs to boost savings rates, including automatic escalation. Ohio DC began offering automatic escalation more than six years ago. Ohio DC officials worked with Richard H. Thaler, a behavioral economist who developed one of the first automatic escalation plans, called Save More Tomorrow (SMarT). Thaler agreed to let Ohio DC brand its automatic escalation plan under the same name. Initially, about 1,000 employees signed up for the voluntary Ohio DC SMarT program. Today, the program has approximately 10,000 participants out of the 105,000 who are actively contributing into the plan. SMarT focuses on flexibility by letting employees choose both the dollar amount and month they want their annual increase to begin. Currently enrolled participants can sign up for automatic escalation by either checking a $20-per-year box or specifying a different amount.

Although automatic escalation membership has steadily increased, many early participants were already contributing the maximum allowable amounts. They used the automatic escalation feature for convenience, having their contributions automatically raised when permitted rather than changing it themselves. To reach those employees who needed to save more, Ohio DC developed three strategies:

1) **SMarT form with annual statements**: Ohio DC sends annual statements to all 457 participants. The statement includes a projection of the member's account balance at retirement, which is also converted to monthly income, using the participant's current contribution rate, and assumes a modest asset allocation. With this data, employees can better gauge whether they need to increase their savings amounts to meet retirement goals. By including the SMarT enrollment form with the annual statement, approximately 1,000 existing 457 plan members enroll in SMarT each year. Overly believes that providing good data about projected retirement income, coupled with minimizing effort by having the form immediately available, provides strong encouragement to enroll in automatic escalation.

2) **Voluntary enrollment with escalation opt out**: Ohio DC recently changed its EZ enrollment form so that new members will be automatically enrolled in the escalation program with an opt-out provision. Employees must check a box to elect **not** to begin automatic escalation. The default annual escalation amount is $10 per biweekly pay period. For example, an employee contributing $50 per pay period in year one would contribute $60 the following year. Ohio DC staff believe that since employees make an active choice to join the 457 plan, using an opt-out provision for automatic escalation does not garnish employee wages. Ohio governments are not bound by strict anti-garnishment statutes, which also provides Ohio DC greater flexibility in its 457 plan design. So far, the program has been successful, with few employees opting out or union objections to the escalation feature.

3) **Automatic enroll and escalate pilot program**: In 2013, Ohio DC began a pilot program with four agencies to automatically enroll new employees into a 457 plan with an automatic contribution escalation and opt-out provision. As of January 2014, 90 percent of the new employees have stayed in the plan. The default contribution amount for automatic enrollment was set very low—$15 per pay period/$30 per month—to discourage employees from leaving the plan and to increase support from the Ohio DC Board and participating employers. The automatic escalation is $10 per pay period annually, and the default fund is a target-date fund. Ohio DC has since spoken with participating employers and, based on the feedback, will determine how the program can be expanded.

Although Ohio DC Executive Director Overly is a proponent of automatic escalation, he concedes that plan design can be a challenge in a multi-employer system. One of the biggest challenges he faces in expanding the pilot program is reaching consensus among many different employers. For example, one major employer supports automatic enrollment but not with automatic escalation. Other employers are not comfortable with automatic enrollment because they feel it is too paternalistic.

Last, just as with MOSERS, non-existent or limited pay raises have made it difficult to increase participation in automatic escalation. With the economy improving, Overly hopes that more public employees will receive salary increases and sign up for the feature.

Virginia Retirement System

The Virginia Retirement System (VRS) manages defined benefit and defined contribution plans for state employees; public colleges and universities; local school divisions; local governments; and political subdivisions that include 598 non-state employers. VRS has 341,000 active members. Public employees in Virginia who are covered by VRS also participate in Social Security.[38]

Historically, the Commonwealth of Virginia and many local governments offered a defined benefit plan for employees called the VRS Plan 1. Pension reforms effective July 1, 2010, created a new plan (VRS Plan 2) for new employees or those who had not vested before January 1, 2013, that made several adjustments to the original plan:

- slightly reducing benefit multiplier
- increasing the number of months used to calculate final average salary
- raising the normal retirement age
- reducing the cost-of-living adjustment.

In addition, all VRS Plan 1 and VRS Plan 2 employees began contributing 5 percent of their salaries to their respective plans. Employers had been paying the 5 percent employee contribution since 1983 in lieu of pay raises.

About 85,000 VRS Plan 1 and VRS Plan 2 employees participate in a supplemental 457 plan that includes a legislature-enacted automatic enrollment feature. In addition to all members of VRS Plan 1 and VRS Plan 2, Virginia code permits political subdivisions to provide automatic enrollment in the VRS-administered 457 plan, but none of these employers has elected to exercise this option. The state's default enrollment amount is modest at $20 per semi-monthly pay period, and the default investment option is a target-date fund. Even with the newly required employee contributions to the defined benefit plans, the opt-out rate for automatic enrollment is only 6.8 percent. To further encourage savings, the state matches 50 percent of employee contributions up to $20 per semi-monthly pay period or $480 per year. Matching funds are deposited into a 401(a) plan. Twenty-four political subdivision employers provide some form of match in varying amounts. When the state began matching employee contributions, participation in the 457 plan increased substantially, leading VRS Deputy Director Patricia Bishop to conclude that the match provides a strong incentive for participation.

The state legislature continued to examine pension reform. The legislature commissioned the Joint Legislative Audit and Review Commission (JLARC) to assess current benefits and explore plan alternatives such as hybrid plans that have both defined benefit and defined contribution components and core defined contribution plans. The JLARC's report also discussed the value of automatic escalation to encourage increased savings.

In order to reduce plan costs and still provide some level of defined benefit, the legislature approved a hybrid design effective for new employees as of January 1, 2014. Existing employees were given the option of switching to the hybrid plan during the first four months of 2014. The reform plan was initiated and crafted by legislators. VRS serves as a subject matter expert when it comes to legislative retirement plan changes, but does not advocate for a particular type of retirement plan. Since Virginia is a right-to-work state, labor organizations did not lobby legislators particularly hard about their retirement preferences, but legislative sponsors met with employee associations and groups to discuss planned action.

The hybrid plan includes three components:

1) a defined benefit with a 1 percent multiplier, a 4 percent employee contribution, and a five-year vesting period.
2) a 401(a) plan for employee and employer mandatory contributions and employer matching contributions. Employees and employers are both required to contribute 1 percent of salary. In addition, employer matching contributions on employee voluntary contributions go into this plan. The default investment option is a target-date fund.
3) a new 457 plan for voluntary contributions, which is distinct from the existing supplemental 457 plan available to VRS Plan 1 and VRS Plan 2 members. All hybrid plan members have an account for their voluntary contributions in the new 457 plan, whether or not they choose to contribute anything. This approach avoids the need for an opt-out provision, giving employees the opportunity to contribute at some point if their finances permit. The new 457 plan includes an employer match that is 100 percent for the initial 1 percent employee contribution and 50 percent thereafter until the employee contributes 4 percent of salary. Employees cannot contribute more than 4 percent of salary[39] to this plan so the maximum employer contribution equals 2.5 percent. Employees are prohibited from taking loans or emergency withdrawals. Finally, the plan includes a mandated automatic escalation feature.

Achieving a sufficient retirement income for participants and overcoming inertia were primary considerations when developing the hybrid 457 plan's automatic escalation feature, which begins in January 2017. At that time, all plan members will have their contributions increase by 0.5 percent unless they are already contributing the maximum amount of 4 percent. The employer-matching formula continues with escalation. For example, if an employee is contributing nothing, he or she will begin contributing 0.5 percent in January 2017 and the employer will match it at 0.5 percent. If the employee is already contributing 2 percent, he or she will begin contributing 2.5 percent and the employer will contribute an additional 0.25 percent, for a total of 1.75 percent.

Automatic escalation will occur once every three years. Employees can opt out of the automatic feature during a limited time period between October 1 and December 15, preceding the automatic escalation installment date. Hybrid members can increase or decrease their voluntary contributions on a quarterly basis.

Because employees must contribute 4 percent to the defined benefit portion and 1 percent to the

401(a) portion of the hybrid retirement plan, policy makers debated whether employees would perceive the escalated contribution as too burdensome or the government as being as too paternalistic. The legislature ultimately chose a three-year rather than annual escalation period because many did not want to be too aggressive with the contribution escalation, particularly since employees may not receive regular pay increases. Likewise, the 0.5 percent escalation amount was chosen to limit financial hardship on employees, especially since average salaries for VRS covered employees are less than $49,000 a year. Those in the plan must also pay into the defined benefit plan, the 401(a) plan, and Social Security. With all three hybrid-plan components, an employee's contribution to his or her retirement ranges from 5 to 9 percent of salary.

Ultimately, the hybrid plan was designed from a pragmatic point of view to balance employees' and employers' ability to pay against the plan's objective of helping employees achieve a sufficient retirement income.

Lessons Learned and Implementation Advice

The case studies and interviews with experts demonstrate that automatic escalation can be successfully implemented in the public sector with or without automatic enrollment in a supplemental defined contribution plan. The experts offered several additional lessons learned and implementation advice, which are discussed below.

Assessing Employee Retirement Income

Deciding whether to explore automatic options should begin with an evaluation of anticipated employee retirement income from all potential sources—government pension, Social Security, and private savings. If the first two sources will be insufficient to secure an adequate retirement income, then it may be worthwhile to consider design features that increase participation in the government's supplemental retirement plan. Where a significant gap exists between income needed and income derived from the defined benefit and Social Security, adding automatic features to the supplemental defined contribution plan, such as automatic escalation, may be appropriate, particularly if other participation incentives such as an employer match are cost prohibitive.

An important factor to explore when assessing defined contribution incentives is the potential mobility of employees. If large segments of the workforce—such as information technology staff—are likely to move between the public and private sectors every few years, supplemental savings become especially important. More mobile employees will likely need to contribute more to the supplemental plan than employees who will secure greater retirement income through a defined plan. Automatic features can be particularly beneficial for mobile workers.

Implementing Automatic Options

Automatic escalation is possible under a variety of political and organizational cultures. For example, the Virginia Retirement System does not offer or promote retirement legislation but rather sees itself as a subject matter expert available to comment on legislation when asked. In contrast, both the Ohio Public Employees Deferred Compensation Program and Missouri State Employees' Retirement System are more engaged in launching new pilot programs and developing legislation to support pension reform. Yet all three systems successfully implement automatic options.

The following lessons emerged from the three case studies to improve the likelihood of successful implementation of automatic escalation.

1) **Find a champion or be the champion**. Every public policy change needs a leader—either appointed or elected—who supports implementation of automatic escalation and is willing to work for its adoption. In the case studies, automatic escalation had strong supporters, including the executive director of the retirement system and/or legislators who changed the law to make implementation possible.
2) **Work with labor groups**. In states and localities with active labor unions, direct and regular connections with labor leaders are essential, particularly if it is necessary to restructure existing contracts to implement automatic escalation. In the past, some labor organizations have resisted automatic features over concerns that their implementation would ultimately result in a shift toward greater reliance on defined contribution plans. However, if pension reform has already occurred, automatic escalation can be viewed as a response to defined benefit plan change, not a prelude to it. Even if choosing an opt-in approach to automatic

escalation, it may be worthwhile to talk with labor leaders to explain how the feature would be beneficial to employees and hear their feedback.

3) **Be pragmatic and creative**. Any innovation such as adding an automatic escalation component to a defined contribution plan requires high degrees of pragmatism and creativity. The first step in implementation is earning board approval. For example, to overcome concerns about employee resistance to an opt-out automatic escalation feature, Ohio DC agreed to a small default contribution amount. Similarly, MOSERS decided to make automatic escalation voluntary, shortly after advocating for legal authority to adopt automatic enrollment. In Virginia, pension officials and legislators agreed that a three-year escalation cycle was an appropriate middle ground. In all these cases, policy makers focused on the goal of getting automatic escalation started, and all succeeded. Another pragmatic and creative factor to consider is learning what flexibility exists under state statutes that could facilitate implementation. For example, Ohio DC's voluntary 457 plan sign-up with an automatic escalation opt-out provided a non-legislative approach to encourage participation. Finally, when developing an innovative plan design change, it is important to remember that creating a solution to the goal is as much art as science, requiring openness to new approaches and compromise if necessary.

4) **Focus on feature design to drive participation**. How enrollment is handled is a key decision when implementing automatic escalation. Research in the private sector has shown that automatically enrolling employees in an escalation feature dramatically increases participation. According to a 2011 survey by the Principal Financial Group, only about 6 percent of participants will sign up for automatic escalation in 401(k) plans, yet approximately 80 percent of employees will remain in the option if automatically enrolled into it as a plan default.[40] By requiring employees to opt out of the automatic escalation feature, Virginia created a very strong participation design. Likewise, MOSERS is evaluating whether to use automatic enrollment in the automatic escalation feature even though adding it will require legislative action. Despite its existing culture of high participation in its 457 plan, Ohio DC wanted to encourage higher employee contributions. By adding automatic escalation as a default, participation in the feature most likely will increase.

5) **Make enrollment easy**. The easier the plan sponsor makes participation, the higher participation will be. Employees participating in MOSERS's 457 plan just "point and click" twice to start automatic escalation, while Ohio DC's paper form asks employees to provide their name and employer only, then check a box. In addition, Ohio DC includes the SMarT enrollment form with annual statements sent to all contributing participants who are not already enrolled to encourage immediate action. Additionally, employees joining Ohio DC's 457 plan are now automatically enrolled in automatic escalation. Of course in VRS, employees in the hybrid plan will be automatically enrolled in the escalation feature. All three organizations do a good job highlighting the supplemental plans and the automatic escalation feature on their websites so employees know how to enroll.

6) **Make the feature flexible**. Pension plan officials stressed the importance of flexibility in plan design. In all three cases, employees are able to change the amount of escalation. For example, in Missouri employees can choose a contribution increase amount to a tenth of a percent, while Ohio DC lets employees choose any dollar amount. Both Missouri and Ohio let employees choose the month that the contribution increase will occur. The record keepers in these cases said flexibility in the automatic escalation design is relatively easy to implement as part of other regular updates to employee accounts.

7) **Focus on communication and education**. To further encourage participation and/or reduce employee confusion about automatic escalation, extensive information about the feature, including how it works and how it can help employees save for retirement, is essential. The organizations in the case studies highlight automatic escalation on their websites and have financial counselors available to explain the feature. Providing comprehensive information early in the enrollment process—particularly if automatic enrollment in the escalation feature is planned—is essential to ensure that employees know what to expect. Finally, showing employees data about their retirement readiness can be a very effective way to encourage participation in automatic escalation. For example, Ohio DC sends annual statements to 457 participants with account balance projections. This data, coupled with the accompanying escalation enrollment form, has led to 1,000 new participants in the feature each year.

8) **Consider automatic plan enrollment in conjunction with automatic escalation.** If, after careful evaluation, automatic escalation is deemed appropriate, it might be the right time to adopt automatic enrollment as well. Considering both options simultaneously may be particularly appropriate if their adoption will require legislation. In the private sector, automatic escalation typically does not exist without automatic enrollment. Study historical participation rates against enrollment goals. Where plan participation and contribution levels are both too low, combining automatic enrollment and escalation may be appropriate.

Summary of Key Findings

The new retirement environment provides an impetus to reflect on employees' future financial needs and how supplemental defined contribution plans can be better designed to assist employees in reaching their retirement goals. Because of extensive changes in defined benefit retirement plans, employees across the country will need to save more money than their predecessors in order to have an adequate retirement income. As such, the purpose of a supplemental defined contribution retirement plan has changed for many employees. Supplemental plans will not just pay for unanticipated expenses or lifestyle enhancements, but may be needed to fund health care costs, make up for lost buying power due to inflation, or even cover daily expenses. Yet, behavioral economics research has shown that getting people to save is very difficult, particularly in the case of the public employee who likely is already contributing to a defined benefit plan and Social Security while having, at best, small pay raises in recent years.

Automatic enrollment and automatic escalation have been successfully implemented in the private sector to boost employee retirement savings in 401(k) plans, yet only a few governments have done so for their supplemental plans. Several challenges have prevented the adoption of automatic escalation in public defined contribution plans, the foremost being a lack of perceived need for the feature. Where the defined benefit is still generous—a 2 percent or better benefit multiplier and automatic cost-of-living increases—and employees participate in Social Security, automatic escalation may not be necessary. However, where this is not the case, such as in hybrid plans with only a 1 percent multiplier, or the employee does not participate in Social Security, automatic escalation, even on a voluntary basis, may be appropriate.

Despite obstacles that have limited the use of automatic features in public sector contributory plans, MOSERS, Ohio DC, and VRS have successfully adopted automatic escalation programs. Their success emerged from a holistic review of the entire benefit package and the replacement income it will provide for majority of employees. This review, combined with an appreciation for behavioral economics, led MOSERS, Ohio DC, and VRS to support automatic escalation. As with any new plan design feature, communication with employees and policy leaders is critical to allay concerns and increase understanding of the potential benefits of automatic features. Because of wide differences among state and local governments and their retirement benefit packages, what works in one government may not work in another. Nevertheless it is important to understand and explore all available tools to improve employee retirement savings.

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33 In cases where employees do not contribute to the defined benefit plan, wage theory would argue that these employees receive a lower salary to compensate for the retirement benefit.

34 Information for this case study came from a phone interview with Cindy Rehmeier (MOSERS), Gregory Dyson (ICMA-RC), and Rosemary Roberts (ICMA-RC) on January 30, 2014, as well as the MOSERS website (www.mosers.org).

35 For more information about MOSERS pension reform, please see MOSERS Comprehensive Annual Financial Report, FY 2013, pp. 222–223, which compares plans for general state employees.

36 Information for this case study came from a phone interview with Keith Overly (Ohio DC) on January 7, 2014; information from the Ohio DC website (www.ohio457.org); and a presentation by Keith Overly at the Government Finance Officers Association annual conference on June 5, 2013, in San Francisco, CA.

37 Effective January 7, 2013, the final benefit is subject to anti-spiking rules so that if final average salary is not proportional to career contributions, payments may be reduced.

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