OPINION

CalSavers works on paper, but saddles workers with debt

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By TIMOTHY HARRIS, KENNETH TROSKE and AARON YELOWITZ |
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California is one of five states that has implemented automatic, state-run individual retirement accounts, known as “auto-IRAs,” in recent years. California’s workers—many of whom aren’t adequately preparing for retirement—should absolutely be saving more, and on paper, auto-IRAs move in that direction. But that doesn’t mean all of those workers are coming out ahead.

Here’s how it works: The CalSavers program automatically contributes a portion of a worker’s salary into a tax-preferred retirement plan when her company does not offer a retirement plan like a 401k. Although the worker has the freedom to opt-out of the IRA, the evidence shows that few take the active step to disenroll.

In a similar fashion, virtually all workers without employer retirement plans could easily contribute to an IRA without state involvement, but few take the active step to enroll. A Federal Reserve study shows that 40 percent of households have given little or no thought to retirement, and less than 30 percent have an IRA or Roth IRA.

The significant proportion of households without any retirement cushion besides Social Security is a serious long-run issue, but are state-run auto-IRAs like CalSavers the correct approach?

We explore this in a ew study published in The Journal of Retirement. Although default enrollment does succeed at increasing retirement savings in tax-preferred plans, there can be unintended, and damaging, consequences for

Primarily, workers with high-interest debt are nudged into contributing part of their paychecks to an IRA where it isn't used to reduce debt. If the interest on this debt—from credit cards, student loans, or auto loans, for example—exceeds the return of an IRA, than the auto-IRA results in a negative rate of return for the worker.

Think of it this way: In 2017, the typical interest rate on credit card plans was 13 percent while the risk-free investment return in an IRA was less than 2 percent. The guaranteed return from paying down high-interest debt first is certainly a smarter financial move.

If programs like CalSavers were implemented on a national scale, about 18 million individuals would contribute. One-third of those workers would have credit card debt with an average balance of nearly $5,500. Approximately one-fifth would have student loans or auto loans. And many experience difficulty paying bills such as rent or utilities, or affording balanced meals. Overall, millions of workers who struggle to make ends meet would have part of their paychecks redirected to state-run programs, which would put them in a more precarious financial position.

State-run auto-IRA programs blindly assume all workers without retirement plans would benefit from enrollment and exposure to the investment market. That may be true for some, but not for the millions who carry significant high-interest debt.

Some of the best policy alternatives involve "smart defaults" for consumers or workers who face complex financial decisions like choosing health insurance plans. In the world of health insurance, a smart default design analyzes health utilization patterns and auto-enrolls the person in the plan which yields the greatest expected financial benefit. Consumers have the freedom to switch to any health insurance plan they want, but—much like with retirement savings—very few end up doing so.

In the context of retirement saving, a smart default design could benefit millions of workers and their families. Those who carry substantial high-interest debt, face imminent financial distress from bankruptcy, eviction or foreclosure, or are behind on essential obligations like child support could be automatically opted-out of IRA participation. Workers could then more easily meet those immediate, pressing obligations. Our research shows this would drastically reduce the scope of the auto-IRA program and target only those most likely to benefit from its use.

Timothy Harris, Kenneth Troske and Aaron Yelowitz are economics professors at Illinois State University and University of Kentucky, and coauthors of the new study “How Will State-Run Auto-IRAs Affect Workers?”

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Timothy Harris

Kenneth Troske

Aaron Yelowitz