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# **Paradox of Choice in a Mandatory Pension Savings System: Challenges for Australian Retirement Income Policy**

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# **Paradox of Choice in a Mandatory Pension Savings System: Challenges for Australian Retirement Income Policy**

## ***Abstract***

As the Australian pension system has become increasingly privatized and less regulated, decisions about the quantum and nature of pension investments have progressively shifted to pension fund members. This choice environment provides members with the ability to control their own pensions, but it also creates challenges for ensuring pension assets are managed in way that will maximize returns and, ultimately, retirement benefits. Government initiatives to address these challenges have principally focussed on disclosure and education and not on the more pervasive behavioural constraints that limit the effectiveness of the existing policy. We advocate policy solutions consistent with libertarian paternalism where the government provides a competitive choice environment, but actively intervenes to set suitable pension savings and investment defaults.

## **Introduction**

Over the past few decades, the Australian retirement income system has become increasingly privatized and less regulated. The most significant step towards privatization occurred in the early 1990s, when the then Labor Government implemented a private-sector managed mandatory superannuation<sup>1</sup> system to reduce future reliance on a government-funded age pension. By mandating the rate of contributions needed to adequately provide for individual workers' retirement, the new policy continued to recognize the paternalistic role of government in the pension savings decision. However, in 1996 a change of government saw a shift in policy direction. In keeping with the libertarian philosophies of conservative governments, the Coalition Government adopted a less paternalistic approach by abandoning proposals to increase superannuation contribution rates above the present nine percent, and instituted policies and incentives designed to encourage individuals to take responsibility for their own retirement savings decisions. This more libertarian approach is reflected in the superannuation fund choice legislation enacted in 2004, mandating the offering of greater fund choice to superannuation fund members.

While this new choice-environment provides members with greater control over their own retirement savings, it also creates challenges for ensuring superannuation assets are managed in way that will maximize investment returns, and ultimately maximize retirement benefits.

In attempts to facilitate informed choice, the Government has principally focussed on improving disclosures by superannuation funds and on consumer education programs. A major hurdle is that, due to behavioural and financial literacy problems, only a small minority of superannuation fund members are likely to effectively exercise choice, even if optimal disclosure and education policies are successfully implemented. Policy makers and the superannuation industry in Australia appear to have largely ignored these important issues in their lengthy deliberations over choice.

In this paper we examine the current policy direction that emphasizes choice as a cornerstone to achieving adequate incomes in retirement. We analyse the limitations of the choice initiative and whether it is likely to achieve the expected policy outcome of adequate retirement savings for Australia's ageing population. Drawing on recent U.S. research on pension members' behaviour and the libertarian paternalism approach advocated by Thaler and Sunstein (2003),<sup>2</sup> we offer suggestions for addressing shortcomings of the choice initiative.

## **Incorporating mandatory private savings into retirement income policy**

The World Bank (1994) advocates a three-pillar approach to retirement income policy, with a government-provided age pension representing the first pillar, mandatory private retirement savings the second pillar, and voluntary retirement savings the third pillar. Australia is one of only a few countries that have implemented this three-pillar approach,<sup>3</sup> although it is only relatively recently that the second pillar – mandatory private savings – was added.

In the early 1980s, the newly-elected Labor Government identified a need to review the sustainability of publicly-funded pensions in the face of an ageing population. There were concerns that with rising aged dependency ratios, those in the workforce would become either unable or unwilling to pay pensions to an increasing proportion of aged individuals (EPAC, 1989). Responding to the challenges of these demographic changes, self-provision for retirement became a foundation of Australia's retirement income policy (Dawkins, 1992), and the Government pursued strategies for increasing worker participation in superannuation. The Superannuation Guarantee (SG) legislation was enacted in 1992 making it mandatory for employers to pay superannuation contributions for employees earning more than \$450 per month. The contribution rate started at four percent of an employee's salary, rising to nine percent by 2002.

With the addition of this ‘third pillar’ (mandatory retirement savings) to the Australian retirement income system, superannuation coverage expanded to 88 percent of all workers and, assets in superannuation funds grew from \$135 billion in 1991 to \$625 billion in June 2004 (APRA, 2004). The retirement income policy instituted by the Labor Government included plans to increase the superannuation contribution rate from nine to 15 percent,<sup>4</sup> but this proposal was abandoned in 1997 by the newly-elected Coalition Government (SSCSFS, 2001). Nevertheless, the superannuation industry and the union movement continue to push for increasing the contribution rate to 15 percent (see Clare, 1999 and SSCSFS, 2001).

Rather than increasing mandatory contributions, the Coalition Government’s strategy for bridging “the gap between retirement expectations and likely retirement incomes” is to place the onus on individuals to assess their circumstances and make changes if there is an ‘expectation gap’; such changes include making additional voluntary superannuation savings or deferring retirement (Australian Government, 2004: p.6). Thus the present Australian government is effectively leaving it to individuals to choose the extent to which they wish to increase retirement savings to ensure adequate retirement income levels are achieved. Evidence of declining voluntary superannuation savings (see Clare, 1999) suggests this voluntary approach will result in many Australians reaching retirement age with insufficient superannuation savings to fund an adequate retirement income. Their choice will then be to either defer retirement and continue working, or retire and rely on the tax-funded age pension. Hazards associated with the first choice include the risk of insufficient employment opportunities for older workers, and the risk of poor health in old age precluding continued employment. Reliance on the age pension presents the risk of future governments winding back access to the age pension as the tax burden of funding this benefit increases with an ageing population.

## **The move towards greater choice**

The government’s libertarian approach is also extended to giving individuals greater choice in the management of their mandatory superannuation savings. In a pre-1996 election promise, the Coalition Government announced that it would enact legislation requiring all awards and workplace agreements to offer individual workers a choice of up to five superannuation funds to which they could direct their employer contributions. The rationale for providing such choice was an expectation that it “will increase competition and efficiency in the superannuation industry, leading to improved returns on superannuation savings and placing downward pressure on fund administration charges” (SSCS, 2002: p. 2). Over a

period of eight years the government attempted to pass choice-of-superannuation-fund legislation three times. Protracted debates took place within and outside Parliament, including two Senate Committee inquiries (see SSCS, 1998 and 2002) and a roundtable discussion (see SSCSFS, 2000) involving wide-ranging consultation with superannuation industry leaders and other interested parties. Difficulties with reaching a consensus were not that there were objections to the choice of fund concept; on the contrary, superannuation choice is generally viewed as desirable by non-government political parties, the superannuation industry and consumer groups. Objections centred on a perceived lack of adequate consumer protection measures, principally relating to inadequate disclosure regulation and concerns about the adequacy of financial literacy skills that are necessary for informed decision-making (Gallery, Gallery and Brown, 2004). The Government addressed these concerns by allocating funding for consumer education and improving disclosure regulation. Sufficient support of the minority parties was eventually gained in the Senate and the *Superannuation Legislation Amendment (Choice of Superannuation Funds) Act 2004* was passed with effect from 1 July 2005.

Within the libertarian framework of the retirement income system that will be in place from the middle of 2005, Australians will face a hierarchy of three choices in relation to their retirement savings. First, individuals will need to evaluate whether their rate of retirement saving is adequate to fund their desired retirement income, and then choose whether to make additional voluntary contributions towards their superannuation. Second, individuals will have to choose into which superannuation fund their compulsory superannuation contributions are paid. Third, once a fund is chosen, an individual will need to make a further decision about which investment option to choose from a suite of investment options offered by their fund.

If an individual does not exercise choice at one or more of these levels, default options come into play. At the first level, the default is no additional voluntary savings, and if the superannuation savings are inadequate when the individual reaches retirement age, the individual will then have to face another choice of whether to retire and rely on the age pension (if available), or continue working. In relation to the second choice, the default fund for mandatory superannuation contributions savings is determined by the relevant industrial agreement applicable to the individual's workplace, or if no such agreement exists, the individual's employer must choose the default superannuation fund. In relation to within-fund choice of investment, the default investment portfolio must be selected by the fund trustee.

The default options in relation to each of these three decision levels have important policy implications. Similarly, the necessity for individuals to have the requisite knowledge and skills to make informed choices presents significant challenges for policy-makers. However, there has been virtually no debate about the even more critical issue of adequate default options. The focus has been on questionable consumer education and disclosure initiatives.

## **Consumer education and disclosure**

As part of the National Strategy for Consumer and Financial Literacy, the Government established a Consumer and Financial Literacy (CFL) Taskforce in early 2004. The Taskforce identified that “Australia is lacking both an effective framework for understanding consumer and financial literacy and an effective structure for improving information provision across sectors” (CFL Taskforce, 2004: p.67). It recommended the establishment of a central body which would promote and facilitate a coordinated approach to consumer and financial information across all sectors of the community, ranging from financial literacy education commencing in primary school, to strategies for targeting different groups among the adult population.

This strategic approach may redress financial literacy problems in the long-term, but does not offer any solutions for the immediate problem of large numbers of workers who are required to make superannuation choices but are ill-equipped to do so. Moreover, while many individuals will in the long-term benefit from financial literacy education campaigns to enable them to exercise informed choice, there will always be a large core of individuals who either do not have the capacity or are unwilling to acquire the necessary knowledge and skills to become informed investors (Brown et al, 2002). If an appropriate safety net is not established, these individuals will be exposed to the significant risks that their retirement savings will be mismanaged or misappropriated. In addition to the cost to the individual, a cost will also be borne by future generations of taxpayers if such individuals ultimately rely on a tax-funded age pension.

Those who potentially will not participate in superannuation choice can be categorised into three groups. First, there are those who have the capacity to become financially literate and willingly participate in education programs, but then do not actually exercise choice. U.S. research on the effect of financial investment seminars on pension savings behaviour highlights that while many participants indicated intentions to save more or rebalance their

investment portfolios, few subsequently followed through with specific action to do so (Choi et al, 2002a).

The second group comprises those who have the capacity to be educated in financial matters, but are simply not interested in making active and well-informed financial choices (MacFarland, Marconi and Utkus, 2004). A possible explanation for such unwillingness to become informed is the costs associated with the effort of acquiring financial knowledge and skills, and the further costs of having to continually update and maintain knowledge and skills, to enable ongoing monitoring and revisions of past choices (Brown et al, 2002). Such costs can be avoided by opting out of making a choice.

In the third group are those individuals who simply do not have the capacity to acquire and maintain the necessary knowledge and skills to make informed superannuation choices. Government statistics show that about 20 percent of Australians aged between 15 and 74 have very poor literacy skills, and up to six million Australians are likely to experience some difficulties with reading and understanding printed material encountered in daily life (SSCS, 2002: 21-22). Without first addressing the problems of basic literacy and numeracy there is no prospect that targeting the financial literacy of this group will have any benefit. There are also those individuals who have no general literacy problems, but struggle to deal with financial matters. Retirement savings and investment choices are complex, needing a good understanding of modern portfolio theory to be able to evaluate the relative risks and returns associated with alternative investment choices, and an ability to determine the level of income that will be needed at some distant date to meet consumption expectations in retirement (Arnone, 2004). Even well-educated individuals find superannuation matters difficult to understand and are not confident they have the necessary financial skills to choose among alternative investment strategies (Gallery, Gallery and Brown, 2000; Brown, Gallery, Gallery and Guest, 2004).

For these three groups of individuals who are unable or unwilling to exercise choice, the consequence of not making a choice is to default to no action or a choice made by an agent. At the top level of the hierarchy of choices, not exercising choice means no additional voluntary savings, the consequence of which is that the level of superannuation accumulated through mandatory contributions will not be adequate in retirement. At the next level, if no choice is exercised in relation to a superannuation fund, then the default fund that manages the retirement assets is nominated in a workplace agreement or selected by the employer. At



the third level, if an investment option is not selected, then the superannuation assets are invested in the default investment option selected by the fund trustee. Large numbers of individuals are likely to fail to exercise choice for all three of these retirement savings decisions, resulting in them being automatically assigned a default option that has been chosen by an agent.

It is clear that that Government sees its direct role in consumer education as minimal, and considers the superannuation industry and employers have the principal responsibility. Some superannuation funds have actively pursued strategies to educate their members in superannuation matters, but there is evidence of increasing concerns about fiduciary and legal liability associated with giving information and advice (see Towers Perrin, 2003). Unless employers and superannuation fund trustees have legislative protection against liability for losses associated with investment advice given to superannuation members, as exists in the U.S. (see Arnone, 2004), they are unlikely to actively pursue member education programs. On the other hand, leaving superannuation education to financial intermediaries in the superannuation industry could lead to commission-driven marketing campaigns being presented as ‘education’ in attempts to lure members into switching to what in the longer term may prove to be unsuitable funds (SSCS, 1998).

Consumer education is costly and brings with it responsibilities to ensure it is unbiased and meets the information needs of decision makers. Moreover, access to relevant and reliable information about alternatives in the choice decision is critical for achievement of informed choice. Despite recent efforts to improve certain disclosures, there are still widely-held concerns within and outside the superannuation industry that superannuation fund disclosure rules are inadequate for members to make informed decisions (see SSCS, 2002).<sup>5</sup> Even if individuals have the required skills and motivation to exercise choice, inadequate disclosure may lead to poor decisions.

## **Is increased choice the solution for inadequate retirement savings?**

### ***Behavioural implications of increased choice***

While issues of education and disclosure have been at the forefront of the choice debate, the behavioural implications of choice have received only scant attention. Yet, how individuals react when confronted with savings and investment choices is likely to have major long-term implications for the success of any private pension system. The underlying economic

assumption behind choice is that well-informed economic agents act rationally to optimize their consumption and savings patterns across their lifecycle (Modigliani and Brumberg, 1954). It is argued that as individuals age, they rationally forego current consumption and direct savings into optimal investment portfolios consistent with their risk-return preferences and planned retirement income needs. Government intervention in the form of unrestricted investment choice and taxation and other incentives provide the impetus for individuals to achieve their retirement income objectives. However, recent behavioural research has identified two major weaknesses in this traditional view. First, rational behaviour is limited by the ability of individuals to master complex issues (termed “bounded rationality” by Simon, 1955). Individuals may therefore fail to compute the correct savings rate given the available investment choices. Second, individuals may have the right savings and investment intentions but lack sufficient willpower and self-control necessary to implement their intentions (termed “bounded self-control” by Thaler and Shefrin, 1981). Left unchecked, behavioural traits arising from bounded rationality and bounded self-control represent serious threats to successful achievement of the savings and investment objectives that form the foundation of the Australian government’s retirement income policy.

### ***Behavioural issues associated with the savings decision***

Thaler and Benartzi (2004) argue that individuals may make inappropriate savings decisions for various reasons consistent with the concepts of bounded rationality and bounded self-control. First, determining the optimal savings rate is a difficult decision involving complex estimates about expected lifetime earnings, investment returns, tax rates, retirement age, and family and health status. Historically, most Australian retirees have relied on the age pension or a defined benefit superannuation plan and therefore, have had little need to determine a personal savings rate. Thus there has been no precedent or simple heuristic which individuals can use to determine an appropriate savings rate.

Second, even if individuals realize the necessity to increase savings, they often lack sufficient self-control to initiate savings programs. A recent survey of Australian pre-retirees shows that only 42 percent believe their current superannuation saving rate will provide the desired level of retirement income (ANOP, 2004). This relatively low percentage suggests that many Australians have failed to take control of their savings plans. The Australian experience is not unique. For example in a U.S. survey, Choi, Laibson, Madrian and Metrick (2002a) reveal that 68 percent of their sample of employees considered their saving rate in 401(k) plans<sup>6</sup> to be too low. Moreover, the findings of MacFarland, Marconi and Utkus (2004) show that

about a half of U.S. pension participants are uninterested in the financial and retirement planning activities thought necessary to plan successful retirement. That is, these participants are unable to impose the self-control needed to address the savings problem.

A third and related problem is the human tendency to procrastinate when faced with difficult decisions, often to the point of inertia. A contributing factor is the tendency for many individuals to incorrectly value future consumption. As a result, they naively place greater weight on current and near-term consumption at the expense of longer-term consumption.<sup>7</sup> A further contributing factor is likely to be the problem of loss aversion: the tendency to place greater weight on losses relative to gains (Kahneman and Tversky, 1979). Thaler and Benartzi (2004) argue that once households become accustomed to certain levels of income and consumption, they view reductions (including those in the form of savings) as losses. Hyperbolic discounting and loss aversion are likely to be more extreme for younger persons because of the longer period until retirement, and the tendency for these individuals to be dis-savers during earlier stages of their lifecycle.

Procrastination and inertia are commonly evident in surveys of saving intentions. While fewer than 50 percent of Australian pre-retirees believe that their current savings would be sufficient to cover their retirement needs (ANOP, 2004), only 20 percent of all employees make voluntary superannuation contributions (Australian Government, 2004). Similarly in the U.S., Choi et al (2002a) show that one third of those who declared their savings to be too low had intended to raise their savings in the next two months, but almost none actually did so. When employees are automatically enrolled in voluntary 401(k) pension plans with the ability to opt out, the number of new members dramatically increases compared to the relatively low rates of participation when employees must actively choose to participate (Choi et al, 2002a, 2002b; Madrian and Shea, 2001).

These findings suggest that although awareness has grown about the need to increase savings, problems of self control, procrastination and inertia impede the actual decision, despite the best intentions of many individuals and the availability of taxation and other savings incentives. The U.S. research on automatic enrolment demonstrates the importance of decision framing and default options in the design of voluntary pension saving systems; despite the importance of these factors, they have rarely featured in the retirement income policy debate in Australia (Gallery, Gallery and Brown, 2004).

***Behavioural issues associated with the investment decision***

In accordance with modern portfolio theory (MPT), rational investors should hold a diversified portfolio that includes the most efficient combinations of securities that optimize risk and return (a ‘mean-variance’ portfolio). Mean-variance efficient portfolios should be constructed to reflect investor utility preferences and time horizons. Notwithstanding this well-accepted theory, bounded rationality and bounded self-control lead to behaviour that appears to deviate from MPT. As in the savings decision, procrastination and inertia are severe impediments to optimal investment strategies in private pension systems. Additionally, a number of behavioural problems specific to a choice environment are likely to hinder the formation of mean-variance portfolios, including choice overload, unstable preferences, and default heuristics (Gallery et al, 2004; Mitchell and Utkus, 2004).

A basic principle of MPT is that expanding the investment choice can only lead to construction of more efficient portfolios. More efficient portfolios should lead to better investment returns for a given level of risk. However, as the number of investment options increases, the behavioural research shows that costs associated with sub-optimal investment choices also increase (Benartzi and Thaler, 2002). Iyengar and Lepper (2000) identify a demotivating effect from too much choice in relation to choice among consumer products. Sethi-Iyengar, Huberman and Jiang (2004) extend the choice experiments to retirement plans and find that consumers may in fact prefer fewer choices. Indeed, the Sethi-Iyengar et al (2004) results show that the demotivating effects of choice overload can lead to lower voluntary participation in pension plans.

Consistent with MPT, the success of Australia’s choice regime requires investors to have stable preferences in portfolio selection; however, research evidence suggests that many plan participants display relatively weak preferences. In an experiment involving choices among alternative portfolios, Benartzi and Thaler (2002) show that only 20 percent of participants preferred their own chosen portfolio to the median portfolio of all participants. When offered a portfolio selected by an investment manager (a portfolio option originally offered to all participants), 61 percent of participants indicated a preference for the manager’s portfolio over their own. These findings suggest that most plan participants do not have stable, well-defined preferences. That is, they “simply do not have the skills and/or information available to pick portfolios that line up with their risk attitudes” (Benartzi and Thaler, 2002: 1595) and thus gain little from choosing investment portfolios for themselves (Thaler and Sunstein, 2003).

The effects of bounded rationality extend to portfolio allocation decisions of investors. In results of experiments conducted by Benartzi and Thaler (2001), plan participants tended to allocate equal amounts across the portfolio of choices, regardless of the number of choices and asset types offered (i.e., they loaded up on equity funds if the plan was loaded up on equity funds, etc).<sup>8</sup> Benartzi and Thaler (2002) also show that menu-framing problems extend to ‘extremeness aversion’: an investor tendency to default to the middle portfolio in a menu of choice, regardless of the asset and risk characteristics of this portfolio and the alternatives. These tendencies to resort to simple heuristics suggest that plan sponsors may be implicitly and detrimentally influencing investment choices through the framing of investment menus they offer to members (Benartzi and Thaler, 2002).

As with the savings decision, problems of procrastination and inertia are commonly observed in the decisions of investors once they have elected to participate in a plan. A common observation is that many participants remain in default options and those that make active selections rarely rebalance their investment portfolios after joining plans. For example, Choi et al (2002b) find that over two-thirds of new plan participants invest exclusively in the default plan on commencement of employment, with this proportion declining by only a relatively small amount to 45 percent three years later. Similarly, Ameriks and Zeldes (2001) observe that over a 10-year period, 47 percent of their sample of TIAA-CREF pension plan participants made no changes to the asset allocation of new contributions, and 73 percent made no changes to the existing allocation of assets in their accounts.

The Australian evidence is consistent with the U.S. experience. While investment choices offered by Australian superannuation funds are generally limited (which should mitigate the choice overload problem), only about 10 percent exercise investment choice (Bowman 2003).<sup>9</sup> Thus a large proportion of superannuation fund participants simply choose to remain in their fund’s default investment option. Depending on the participant’s plan, this inertia can have significant negative consequences for retirement income. Gallery et al (2004) report a wide variation in medium-term performance rates of the default options of top ten funds. Among the ‘star-performing’ funds, recent five-year performance ranges from a low of 7.1 percent to a high of almost double that rate at 13.2 percent. This wide variation among just the top ten funds suggests a wide disparity when all funds are considered, and is likely to translate into even larger differences across longer time-horizons.

Like the behavioural problems encountered with the savings decision, the observed behaviour of individual pension plan participants with respect to their investing decisions challenges the notion that decisions are made in accordance with rational economic behaviour. The important implications are that pension plan design, together with procrastination and inertia, can lead to default behaviour that can have profound effects on retirement incomes.

## **The Way Forward – Some Suggested Policy Solutions**

Australia has adopted mandatory private retirement savings as a strategy to achieve the objective of adequacy in retirement incomes. However, with the mandatory contribution rate set at nine percent and the low level of participation in voluntary superannuation, there is growing concern within the superannuation industry that the government's retirement income policy will lead to inadequate funding of the retirement needs of a large number of Australians. Effective policy solutions are therefore needed to address the expected shortfall. Lessons from the behavioural research on pension saving and investment behaviour offer a number of useful insights that can guide more effective policy formulation in relation to increasing voluntary savings and achieving desirable investment outcomes.

One promising way forward is to exploit the behavioural problems of inertia and procrastination to increase voluntary retirement savings. Following Thaler and Sunstein's (2003) approach of libertarian paternalism, a possible strategy is to include automatic enrolment features in superannuation plans by requiring employers to automatically opt employees into voluntary retirement savings schemes. As shown in the U.S., automatic enrolment in pension plans significantly increases participation because once individuals are 'opted in' they are unlikely to 'opt out'. Such commitment devices will potentially be effective in increasing voluntary superannuation savings in Australia, provided they are supported by clear-cut regulatory guidelines. With respect to investments, guidelines are needed to encourage simplified menus of choices offered to superannuation participants to avoid problems associated with choice overload, while maintaining a sufficient range of choices to facilitate individuals choosing optimal investments.

Because the vast majority of superannuation fund members do not exercise choice in relation to how their mandatory superannuation savings are presently invested, and are unlikely to exercise choice when choice of fund legislation comes into effect, establishment of appropriate guidelines for default options is urgently needed. As demonstrated by Gallery et al (2004), the default investment options across Australian superannuation funds are similarly

labelled as ‘balanced’ options, but the five-year investment performance across those options varies considerably; this suggests they are very different in their asset composition and risk characteristics. As suggested by the SSCSFS (2000), there is a strong case for setting minimum standards for default options. In the absence of standardisation of default investment options, differences among the default options will inevitably result in significant differences in the end retirement benefits of the participants in the different funds. Trustees who select poor-performing default options or mislabel the default option (e.g. name a high-risk portfolio as ‘balanced’) may also be exposed to potentially costly litigation. Similar issues arise for employers in relation to the default superannuation fund.

An alternative to the requirement for a workplace-specific default superannuation fund or superannuation fund-specific default investment option is a government-run universal default fund (UDF) (Brown et al, 2002; Gallery et al, 2004). A central, professionally-managed UDF would provide an appropriate safety net for the superannuation savings of those who are unable or unwilling to exercise informed choice. The UDF could also serve as a benchmark for evaluating the performance and standards of workplace- and superannuation fund-specific default options (Brown et al, 2002).

With regard to education, it should be recognised that not all individuals have the capacity to be educated in financial matters, while others have the capacity but are not interested in making active and well-informed financial choices. To address differences in individuals’ motivations, MacFarland et al (2004) suggest new educational approaches are needed that emphasize simpler decisions and reduce complexities and range of choices.

The Australian retirement income system is increasingly relying on individuals to choose how much they save for their retirement, who manages those savings and how those savings are invested. While choice offers the ability to select efficient long-term investment portfolios that maximize retirement benefits, poor financial literacy, inadequate disclosure and behavioural problems present significant policy challenges. Failure to expediently and explicitly address these challenges will potentially result in the present policy approach leading to inadequate retirement incomes for many Australians.

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## Notes

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<sup>1</sup> ‘Superannuation’ is the term used in Australia to refer to employment-related retirement income; the term ‘pension’ is more commonly used in other countries.

<sup>2</sup> Libertarian paternalism preserves freedom of choice, but where choices may have harmful effects, it authorizes both private and public institutions to steer individuals towards decisions that maximize their welfare (Thaler and Sunstein, 2003).

<sup>3</sup> Sweden and Chile also have retirement income systems that incorporate all three pillars.

<sup>4</sup> The additional six percent comprised a requirement for employees to contribute three percent and the government making a co-contribution of three percent.

<sup>5</sup> Although the *Financial Services Reform Act 2001* expanded superannuation disclosures, there are still concerns that those disclosures are inadequate and do not permit comparisons between funds (SSCS, 2002), principally because the information is not standardised. The Ramsay (2002) report’s recommendations to standardise definitions of different types of fees and the calculation of management expense ratios would ensure disclosure of comparable information about superannuation fund fees and charges; these recommendations have not yet been adopted.

<sup>6</sup> In the U.S., 401(k) plans are employer-based retirement savings plans to which individuals voluntarily contribute from their pre-tax earnings; members generally have investment choice.

<sup>7</sup> This behavioural problem is commonly referred to as “hyperbolic discounting” (Thaler and Benartzi 2004).

<sup>8</sup> This behavioural response to portfolio selection is often referred to as the ‘1/n Rule’ (Benartzi and Thaler, 2001).

<sup>9</sup> Surveys show that 80 percent of superannuation fund members are in funds which allow members to choose the type of assets in which their superannuation is invested or offer members a choice of fund managers (Hely 2004).