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Soft Compulsion

Why Australia needs it

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EXECUTIVE SUMMARY

Soft compulsion in broad terms is requiring individuals to do something unless they opt out. In the Australian superannuation context, the term soft compulsion is applied to arrangements where individuals contribute over and above the rate of compulsory superannuation unless they make a formal decision not to.

Why soft compulsion?

- Soft compulsion actually works
- It does not cost the government much
- It is not hard or costly for employers to implement
- Employees and the community more generally think it is a good idea

How does soft compulsion work?

It basic terms it harnesses two of the most powerful savings forces, apathy or inaction of individuals, and the magic of compound interest.

In behavioural finance terms, soft compulsion:

- Stops people delaying decision making because of the complexity of the task.
- Gets around the human foible of putting off until tomorrow what you do not want to do today.
- Provides defaults which are seen as officially approved savings options.

International evidence on soft compulsion

Soft compulsion has been introduced by a range of employers in the United States. It has been very successful there in lifting the number of people saving for retirement and the amount that is saved.

In the United Kingdom soft compulsion will apply to all employees from 2012 onwards. This has followed a comprehensive public inquiry looking at all the arguments and evidence on the topic.

In New Zealand soft compulsion has applied since 1 July 2007. It has already had a significant impact on savings behaviour in that country.

Soft compulsion and Australia

The majority of Australians need and want higher standards of living in retirement. Governments are not willing to increase the rate of the Superannuation Guarantee or spend substantially more on the Age Pension. Soft compulsion would deliver better retirement living standards in Australia on a basis that is acceptable to governments and the community more generally. It would build on arrangements already in place in the public and private sectors in Australia.

What ASFA is proposing

ASFA has proposed that:

- Employers have default arrangements where an extra 1% of salary or wages is put into super each time an employee receives a wage increase or starts a new job
- Extra contributions would be capped at 3% of wages (bringing total contributions to 12%)
- The default would be salary sacrifice, with the option of after tax contributions for the lower paid

1. INTRODUCTION

Australia's retirement income system has achieved significant improvements to the living standards in retirement of current and prospective retirees. It has done this through the successful adoption of a 'three pillar' model of saving for and funding retirement.

This model consists of:

- **Age Pension –** Funded from government revenue (with income and asset tests applying).
- **Compulsory superannuation for most employees –** Funded by employer contributions of 9% of employee wages.
- **Voluntary superannuation –** Funded by contributions from some employers, employees and the self-employed.

However, while considerable progress has been made in bringing about greater adequacy of retirement incomes, many individuals and households will still have retirement living standards lower than they want and expect.

There appears to be only limited scope for increasing the level of the Age Pension due to the costs to government that would be involved. There also does not appear to be current Government, Opposition or community support for increasing the compulsory superannuation, the Superannuation Guarantee, above its current level of 9% of wages and salaries.

Tax concessions and the co-contribution lead to a substantial minority of the community making voluntary contributions. While enhancement of tax concessions and the co-contribution would lead to some further voluntary contributions being made, something else is needed in order to significantly lift retirement savings across the community.

This paper suggests that this "something else" should be a system of soft compulsion. Soft compulsion works through requiring individuals to do something unless they opt out. The softness of the compulsion comes from there being an opportunity to opt out.

2. FOUR GOOD REASONS FOR ADOPTING SOFT COMPULSION

There are four good reasons for adopting a system of soft compulsion for additional superannuation contributions over and above the 9% Superannuation Guarantee. These are:

- Soft compulsion actually works
- It does not cost the government much

- It is not hard or costly for employers to implement
- Employees and the community more generally think it is a good idea

The following sections will look at the theory behind soft compulsion, that is, individuals being required to make additional contributions to their retirement savings unless they opt out from doing so. The evidence from both overseas and Australia on how soft compulsion works in practice also will be reviewed and analysed.

3. THE BASIC THEORY BEHIND SOFT COMPULSION

Soft compulsion works in regard to retirement savings because it harnesses two of the most powerful forces in regard to financial behaviour. These are:

- Apathy
- Compound interest

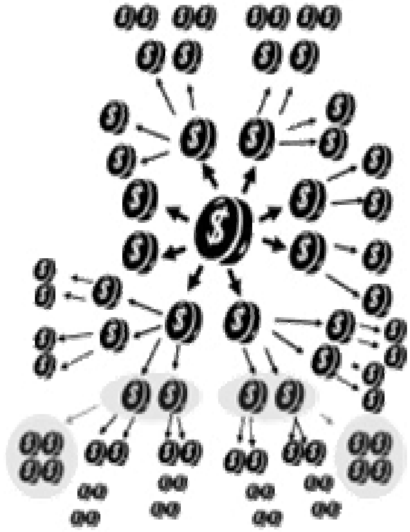
3.1 Apathy

In blunt terms, there is a lot of power (if it is properly harnessed) in the pent up apathy in individuals like the one whose image is on this page. This individual is particularly disinterested looking. However, there are many others like him with the same or even greater level of apathy in regard to financial decision making.

If a conscious decision is needed in order to not save more, then there is a relatively high probability that such individuals will go with the default. This probability is increased if the individual is required to fill in a form and/or raise the issue with their employer if they want to opt out.

The simple reality is that those who are most in need of saving more are those who will go with the flow and not take a decision or initiate an action. Soft compulsion works really well for them.

3.2 The magic of compound interest



The other powerful and basic force harnessed by soft compulsion is the magic of compound interest. The role and power of compound interest comes as no surprise to those who have attended any of Don Stammer's ASFA lunches on the Commonwealth Budget. As well Albert Einstein is also reported to have

said that compound interest is the most powerful force in the universe. While it is not clear exactly when or where he may have said this, the mathematics of compound interest certainly confirm the statement.

The earlier contributions are made the more they grow, both in nominal and today's dollars. Contributions which are left to be made voluntarily in the run-up to retirement do not benefit from this growth.

In terms of a numerical example, $20,000 invested for 20 years at a 7% nominal (4.5% real) return grows to $48,234 in today's dollars after 20 years, to $74,906 after 30 years and to a massive $116,327 after 40 years. In comparison, $20,000 invested five years before retirement would grow to only to $24,924.

Soft compulsion is so effective because it gets money into retirement savings many years before retirement. In contrast, only a minority make voluntary contributions, and then often only in the run-up to retirement.

4. BEHAVIOURAL FINANCE

Soft compulsion also has a sound basis in behavioural finance.

The behavioural finance has a number of dimensions. Soft compulsion:

- Stops people delaying decision making because of the complexity of the task
- Gets around the human foible of putting off until tomorrow what you do not want to do today
- Provides defaults which are seen as officially approved savings options

4.1 Complexity of the task

There are several sources of complexity in making decisions about an optimal savings plan. Individuals need to look at their current savings, the impact of compulsory superannuation on their final retirement savings, the role of the Age Pension, their prospective retirement date, and likely investment returns, amongst other things. Some individuals of course will either consult a financial planner or make use of a calculator on a fund or regulator website in order to make the necessary projections and decide on an appropriate contribution rate. A very few individuals might be able to do this without any assistance.

Soft compulsion with a default contribution rate greatly simplifies the task. Psychology literature has documented a clear tendency for individuals to put off decision making as the complexity of tasks increases. In contrast, soft compulsion decouples the retirement savings plan decision from the contribution rate and asset allocation decisions.

With soft compulsion the initial participation decision is reduced to a simple comparison of two alternatives:

- non-participation, or
- participating at a pre-determined contribution rate with a pre-determined asset allocation.

Soft compulsion also has its largest impact on those who generally have the least amount of financial sophistication – the young and low income earners.

4.2 Putting things off

Research in behavioural finance clearly indicates that individual problems with self control lead to poor retirement savings outcomes. As the adage goes, why do today what you can put off until tomorrow.

Soft compulsion gets around this by requiring people to save now unless they opt out. Soft compulsion will for most people deliver higher savings rates rather than leaving it to the individual to decide when and by how much to save on a voluntary basis.

4.3 Defaults as the approved savings option

Default options have a favourable impact on outcomes if individuals perceive the default as endorsement of a particular course of action. This impact is likely to persist even if numerous disclaimers are provided along with exhortations for individuals to obtain advice from a licensed professional if appropriate.

5. INTERNATIONAL EVIDENCE ON IMPACT OF SOFT COMPULSION

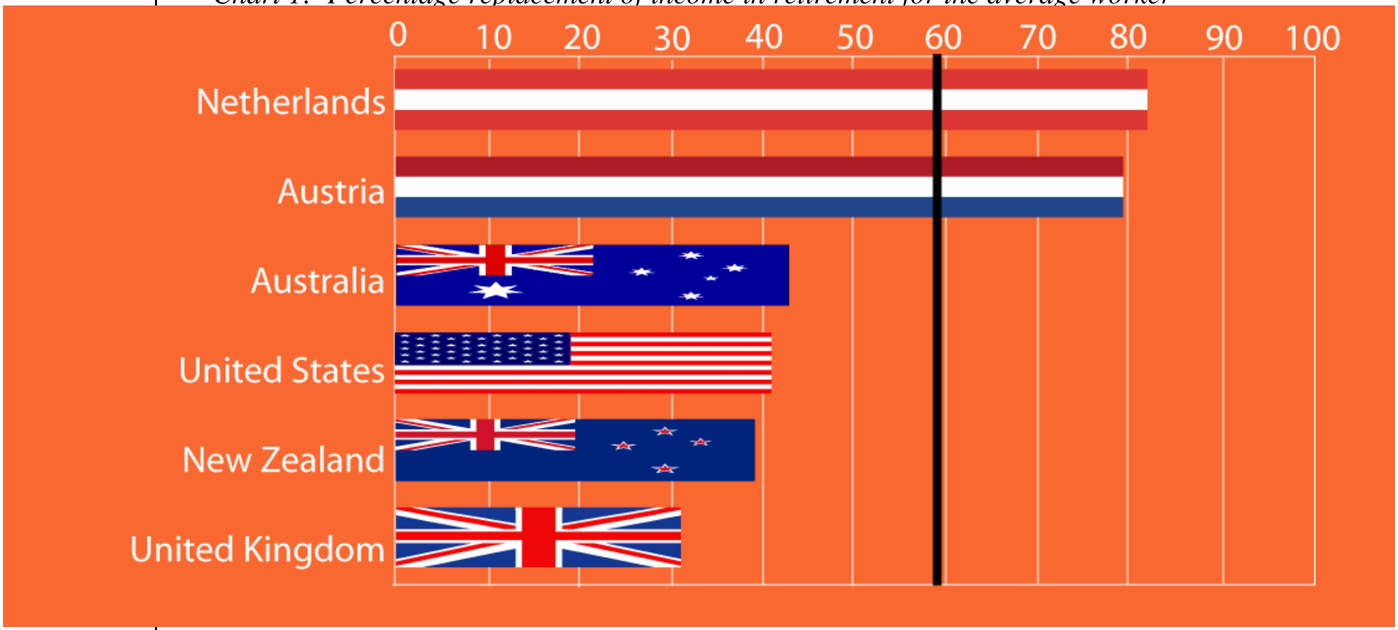
Soft compulsion is on the agenda of a number of countries and/or is being introduced in those countries. It is particular popular in Anglo countries. This is largely because of the level of prospective retirement incomes in those countries if no additional action is taken. The costs of alternative policy options, such as increasing social security benefits, also are a powerful motivating factor for adopting soft compulsion.

Soft compulsion has not been such an issue in continental European countries where retirement income adequacy is high, largely as a result of earnings related benefits paid by the State. The cost and sustainability of the retirement income arrangements in those countries is more the issue than adequacy.

The differences between countries in retirement income adequacy are illustrated in Chart 1. The continental European countries (with some typical cases in the Chart) get over the 60% replacement of income in retirement for the average worker goal line. The 60% benchmark is commonly used by the OECD, international analysts, and Australian financial planners. This benchmark is roughly comparable in dollar terms for the average wage earner to the Westpac ASFA comfortable living retirement standard for a single retiree.

The Anglo countries fall well short of the 60% target and it is in these countries there is the strongest interest in soft compulsion.

Chart 1: Percentage replacement of income in retirement for the average worker



Source: OECD, Pensions at a Glance

5.1 Soft compulsion in the United States of America

Soft compulsion in the United States has largely occurred as the result of decisions made by employers in implementing occupationally linked retirement savings plans. While government legislation and tax provisions have been supportive of occupationally linked retirement savings plans, there has been no mandating of soft compulsion. As a result perhaps only less than one per cent of the USA workforce are involved in such arrangements.

Another consequence of this is that there is an array of schemes and approaches adopted in the USA, as they are largely employer and fund promoter driven. Various marketing names are used, including "SMART Plan", "Escalator", and "Quick Enrolment". Along with differences in name, there are differences in terms and conditions.

Typically, default contribution rates involve a member contribution of 3% or 6% of salary, although higher and lower rates are also possible. Rates above 6% generally require a significant matching incentive from the employer to avoid substantial opting out from the default savings plan.

Given that soft compulsion in the United States generally involves a voluntary employer subsidy on top of any tax advantages, only the "good" employers get involved. Such employers often have substantial health insurance and other employee benefits as well.

5.2 Soft compulsion in the United Kingdom

The United Kingdom does not yet have any general system of soft compulsion, but it will from 2012 onwards.

This is a result of a comprehensive and well developed policy process. The UK Government gave a Pensions Commission the task of developing policy recommendations for the UK pensions system. The Commission conducted extensive studies and public consultations. This included a first and second report, and a final report delivered in 2006.

The broad thrust of the Commission's recommendations was adopted by the United Kingdom government. The soft compulsion recommendation was seen as one of the "sweeteners" in a package where other, tougher decisions were made. These included an increase in the eligibility age for the State Pension. The delay in implementation until 2012 has much to do with the need to work out how to integrate the new soft compulsion regime with existing company pension arrangements. Forward notice was also required for both employees and employers. What is proposed is a 4% contribution from employees, 3% from employers and the equivalent of 1% from government.

A key issue handed to the Pensions Commission at the time of its establishment was whether UK pension policy towards private funded pensions needed to "move beyond the current voluntarist approach". The conclusion reached was that voluntarism was not sufficient despite the tax concessions for voluntary contributions that were available. Equally, it was not seen as appropriate to introduce a system of fully compulsory retirement savings. Instead what was recommended was automatic enrolment (soft compulsion) to overcome the behavioural barriers to long term saving while leaving people ultimately free to make their own decisions.

Any public disagreement to soft compulsion came almost entirely (though only to a very limited extent) from those who would have preferred a fully compulsory approach.

The Commission came to the conclusion that soft compulsion is preferable to full compulsion because:

- The diversity of individual preferences and circumstances means that for some people at particular points in their life retirement saving is not essential or appropriate. For example, some people have or will have a large inheritance, and others might have large interest payment commitments. Soft compulsion allows such individuals to opt-out, while providing a strong encouragement to save when it is appropriate.
- Pure compulsion can be perceived by at least some as equivalent to further taxation.
- Focus group work in the United Kingdom and other opinion research indicates that soft compulsion is consistent with the grain of people's attitudes to the appropriate role of the state, and will command extensive support.
- These arguments and Commission findings also are very applicable to Australia in regard to contributions in excess of the Superannuation Guarantee.

5.3 Soft compulsion in New Zealand

New Zealand's experiences with retirement savings policies are very interesting. Between 1988 and 1990 New Zealand introduced tax neutrality for all savings, including savings for retirement. This together with a universal state pension, New Zealand Superannuation, was intended to provide a well-supported, cost-effective, adequate, secure and equitable approach to retirement income provision.

Unfortunately for New Zealand this approach in the end did not prove to be well-supported, cost-effective, adequate, secure or equitable, and it was brought to an abrupt end in 2007. Both individual retirement savings and national savings in New Zealand were too low and something had to be done. Box 1 sets out the basic parameters of what the NZ Government has introduced with effect from 1 July 2007.

Box 1: KiwiSaver (as at 1 July 2007)

- KiwiSaver is a voluntary, work-based savings scheme administered by the Inland Revenue Department using the existing PAYE tax system. Employees are automatically enrolled into KiwiSaver when they start a new job. They have from the second to eighth week of employment to opt out. After then withdrawal from the scheme can only occur on retirement or other very limited circumstances.
- Scheme enrolment is not automatic for those aged under 18 or for those employed for less than four weeks, or for existing employees. They may join if they wish, as can the self employed and social security beneficiaries.
- Employees' contributions are at a rate of 4% of gross salary or 8% if this is chosen. These contributions in effect come from the after tax salary. Matching contributions up to 4% by the employer are tax free. Investment earnings are taxed at a rate of either 19.5% or 33% depending on the employee's taxable income in the preceding two years.
- There is a matching tax subsidy of $20 a week for employees' contributions and a compulsory 4% contribution from employers to be phased in over four years from 2008, matched by a $20 a week flat rate tax subsidy paid to the employer.

Takeup of KiwiSaver has been relatively rapid. By 5 October 2007 there were 213,000 enrolments (out of a labour force of 2.2 million) into 45 funds made up of:

- 102,000 direct enrolments.
- 67,000 enrolments of existing employees through their employer.
- 44,000 new employees automatically enrolled.
- Half of those enrolled aged under 45, with 9% aged under 20.

The New Zealand experience has a number of interesting implications for Australia. It indicates that even in a country with a very high attachment to free markets and tax neutrality, soft compulsion is a viable policy option. It also indicates that relatively quick adoption of soft compulsion is possible if there is political commitment and leadership on the issue.

6. WHY AUSTRALIA NEEDS SOFT COMPULSION

The basic reason that soft compulsion is needed in Australia is that there is a gap between prospective outcomes and what Australians currently in the paid workforce need and want. While the Age Pension prevents individuals falling into poverty in retirement, it does not provide a living standard that in any way could be regarded as comfortable. Most individuals aspire to a retirement income in excess of $30,000 a year for a single person. The Age Pension is around $14,000 a year for a single person.

The Superannuation Guarantee and other occupational superannuation together with voluntary saving for retirement will lift retirement living standards for many individuals. However, for the foreseeable future the bulk of retirees will have retirement incomes of $25,000 a year or less.

For a single person and a couple, a lump sum of only around $100,000 is required to support expenditure in retirement consistent with a 'modest' lifestyle, namely $25,786 a year for a couple and $18,375 for a single person. The reason for this is that the Age Pension provides most of the necessary income.

For a 'comfortable' lifestyle, larger retirement savings are needed. For a single person the amount required is around $500,000 (assuming nominal investment returns of 7% per annum), while for a couple the amount is just over $500,000. Receipt of the Age Pension at the couple rate means the amount to be saved by a couple is not double the amount needed by a single person.

As shown in Table1, even a person on a salary of $100,000 a year would need to make contributions at the rate of 12% or more to achieve a 'comfortable' standard of living in retirement, assuming he or she was single or the only person with superannuation within a couple household.

For a person on $50,000 a year, contributions in the order of 20% per year over 30 years would be needed to support a 'comfortable' lifestyle in retirement.

Alternatively, if both members of a couple had incomes of $50,000 a year and each made total contributions (including the SG) of between 11% and 12% per year, they would be able to achieve a 'comfortable' lifestyle. Of course, some single persons and couples might be assisted in achieving their retirement savings from receipt of an inheritance or from savings outside the superannuation regime.

TABLE 1: Lump sum retirement benefits after 30 years in a taxed fund for a person aged 60 or over (a)

Tax treatment	Wage of $30,000	Wage of $50,000	Wage of $100,000
Contributions and investment earnings taxed at current rates	$110,000	$183,000	$366,000
Pre 1 July 2007 net amount after benefits tax on lump sum	$110,000	$174,214	$327,018
Improvement after 1 July 2007 with no benefits tax	Nil	$8,786 (5.0%)	$38,982 (11.9%)
Lump sum if contributions made at the rate of 12% of salary	$146,000	$244,000	$487,000

(a) All figures in today's dollars (using 3.75% AWE as a deflator), investment earning rate of 7% assumed.

Recent OECD research also indicates that an extra 4% contribution is needed for the average Australian wage earner to reach the 60% of pre-retirement income benchmark that the OECD sets for adequacy of retirement incomes.

While the precise amount of additional contributions needed will depend on individual circumstances, it is clear that generally an additional 3% to 6% is needed to achieve desired levels of adequacy.

As indicated earlier in this paper, there does not appear to be political or general community support for increasing the Superannuation Guarantee contributions rate to a figure in excess of 9%. While the tax concessions and the co-contribution encourage voluntary contributions, only a minority make such contributions. In addition, while many funds have found member education and encouragement effective in lifting contributions, again this applies to only a minority of members.

In contrast, soft compulsion offers the potential to lift contributions for the vast bulk of the paid labour force.

7. FIRST STEPS FOR SOFT COMPULSION ALREADY IN PLACE

Soft compulsion has already been put in place on a voluntary basis by a number of employers in Australia. This has occurred in both the public and private sectors.

7.1 Soft compulsion in the public sector

Public sector superannuation schemes often have either compulsory or default member contribution rates. This is particularly the case with defined benefit schemes (which are mostly closed to new members).

For instance, the Public Sector Superannuation Scheme has for its defined benefit division a default member contribution rate. Members can choose to contribute between 2% and 10% of salary. Member contributions attract additional employer support in terms of eventual benefit received, subject to overall caps on benefits received.

The Tasmanian public sector accumulation scheme, which was put in place in 1999 when the defined benefit scheme was closed to new members, has a default contribution rate of 5%. The legislation requires new employees to contribute at this rate in the form of after tax member contributions or opt out. Opting out can involve no contributions, or higher or lower contributions.

Simon Gillies, the Chief Executive Office of the Retirement Benefits Fund (RBF) in his presentation to this Conference has indicated that around one third of new members make the after tax contributions. Around 90% of those making contributions do so at the default rate of 5%. It is not clear exactly how employers present this form of soft compulsion to employees as its presentation to employees is not audited. The RBF considers that with the co-operation of employers and further member education the take-up rate could substantially improve. RBF is considering options in both of these areas.

7.2 Soft compulsion in the Australian private sector

A number of Australian employers have default member contributions either as a matter of scheme design or through the offering of default retirement savings plans.

Plum Financial Services has been an active promoter of default retirement savings plans to the various large employers that they service. Plum's Graeme Humphrys, in a paper presented to the 2007 Colloquium of Superannuation Researchers, outlined their experience with soft compulsion to date.

Since September 2006 when Plum first offered to employers its form of soft compulsion, called "Escalator", 12 clients have adopted this. Another 5 have implemented their own version. A further 24 clients have indicated that they are receptive to the proposal. In total this amounts to some 50% of Plum's clients.

One client had opt in for existing employees and opt out for new employees. The take-up rate for existing employees opting in was around 20%. For the opt out version the take-up rate was 90%. For other employers opt in rates have varied between 3% and 24%. Opt out rates are consistently around the 90% mark.

8. WHAT ASFA IS PROPOSING

While soft compulsion comes in a variety of forms, ASFA proposed in its last pre-Budget submission that:

- Employers have default arrangements where an extra 1% of salary or wages is put into super each time an employee receives a wage increase or starts a new job
- Extra contributions would be capped at 3% of wages (bringing total contributions to 12%)
- The default would be salary sacrifice, but option of after tax contributions for the lower paid

ASFA tested community reaction to such a proposal in its 2006 ANOP survey. Respondents were asked about the idea of putting "an extra 1% into super each time you receive a wage increase or start a new job, up to a maximum of 3%". It was also mentioned to those polled that this would be on top of the 9% compulsory superannuation but you could choose to opt out. The extra contribution would come from the employee's salary, and would not be an additional employer payment or cost.

The survey found very strong support for such a proposal, with 83% of respondents indicating that such a form of soft compulsion was a good idea. Support was even higher amongst those aged 25 to 39, with an 85% approval rating.

When respondents were asked for their unprompted reasons for their attitude to soft compulsion, the main reasons identified were:

- That it's a good boost to super.
- That you can opt out.
- That it's an acceptable means of lock-in at a time when you can afford it.
- That it's at a level that would not be missed.

These responses demonstrate both support and understanding of the proposal.

In the 2007 ANOP survey commissioned by ASFA this pattern of support continued, with 86% of respondents indicating that soft compulsion as proposed is a good idea.

While ASFA has not specifically surveyed employers on their attitude to soft compulsion, what is being proposed would involve minimal employer burden. The adjustment to contribution rates would occur when employees are hired or receive a salary increase. Wage payments and superannuation payments need to be set or adjusted at these times in any event. As well, given that around 90% of employees can be expected to go with the default, there would only be a limited number of employee elections to process. The calculations and administration of processing these elections by individual employees would also be very straightforward.

In terms of the implications for government, no significant additional direct expenditure is involved. There may be some modest additional expenditure on the co-contribution if lower income workers decide to make additional after tax contributions. The additional tax expenditures involved in the concessional tax treatment of the further salary sacrifice contributions that would be made would also be modest given that soft compulsion would apply across the entire labour force. Higher income earners who already have in place adequate retirement savings plans also would be more likely to opt out from soft compulsion compared to lower income earners.

9. CONCLUSIONS FOR BOTH THEORY AND PRACTICE

It is clear from both the theory of behavioural finance and from practice both overseas and in Australia that:

- Soft compulsion works.
- It is affordable for government.
- It is not a burden for employers.
- Will get support from employees.