

## DISCLAIMER

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### Paternalism in Pensions - how far should the law go in regulating pensions saving behaviour?

The great 1920s American film star Will Rogers once said that "the quickest way to double your money is to fold it in half and put it in your back pocket." In 2020 however, many people's back pockets are empty. Or maybe they contain items that are forgotten about until the washing machine is emptied and you are greeted with confetti of soggy tissue paper and some coins. Or perhaps modern trousers don't come with back pockets at all making it almost impossible to conveniently save loose change and tissues for a rainy day (or an unforgiving washing machine).

In the same way money rarely makes the short trip from one's hand to their back pocket, people often neglect to navigate the various forms, do the required research and seek the necessary advice in setting up a pension scheme that would undoubtedly benefit them later in life. This essay will consider how far the law should go in regulating pension saving behaviour and establish a pensions system which is predicated on paternalistic policy-making but is interwoven with freedom to choose. For the purpose of this essay, the proposed system will be called "*Back Pocket Savings*."

#### Human Factors

In order to best frame a system which encourages people to utilise and get the most out of pension saving schemes, it is pertinent to consider why people are not engaging effectively in such schemes under their current guise. Behavioural economists will say that there are various reasons why we are predisposed to put off such things as planning for retirement by virtue of the fact that we are human. *Back Pocket Savings* succeeds in mitigating these "human factors."

Firstly, people find it difficult to plan long-term as the ever available "future me" gets tasked with many things that our current selves are reluctant or unwilling to do. Psychologist George Ainslie has dubbed this "hyperbolic discounting" as humans consistently look for immediate rewards in favour of rewards in the future even if these future rewards are greater.<sup>1</sup> People tend to view their future and current selves as different people and this disconnect was demonstrated in a peculiar experiment by Princeton psychologist Emily Pronin where students were asked to drink a rancid liquid for "the good of science." Those who were signed up to drink it that day agreed to two tablespoons on average whereas those who could put it off until later in the semester agreed to four times as much on average.<sup>2</sup>

The same approach is seen in people's tendency to delay their enrolment in a pension plan as they are inclined to leave the unpleasantness of signing up to our future selves. Upon starting my own job, I was given several forms relating to the upcoming weeks' training which were swiftly hung on my wall and fastidiously studied. However, I was also given very helpful information on the firm's pension options which was rediscovered weeks later when tidying my workspace.

People also tend to be "loss averse." As Ryder Cup-winning (and Ryder Cup-losing) golfer Jim Furyk put it, "losing hurts worse than winning feels good."<sup>3</sup> This mind set is apparent both on and off the golf course. Economists Kahneman, Knetsch and Thaler conducted an experiment to demonstrate loss

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<sup>1</sup>George Ainslie, "Derivation of "Rational" Economic Behavior from Hyperbolic Discount Curves" (1991) The American Economic Review Vol. 81 No. 2 334-340.

<sup>2</sup>Susannah Locke, "Why Your Brain is so Bad at Planning for the Future" (2015).

< <https://www.vox.com/2014/12/18/7414105/procrastination-future-planning> > accessed 4 July 2020.

<sup>3</sup>"When Losing Hurts Worse than Winning Feels Good"

< <https://eu.usatoday.com/story/sports/golf/2014/09/23/when-losing-hurts-worse-than-winning-feels-good/16092293/> > accessed 4 July 2020.

aversion where half the students in a class are given mugs and the other half are tasked with examining the mugs and offering to buy them in accordance with a list of different prices to choose from. Similarly the sellers choose at which price they would be willing to sell in accordance with this list. Typically those who have mugs demand twice as much to part with their mugs as their classmates are willing to pay to get one.<sup>4</sup> In the same way, once people have earned money, losing it would “hurt worse” than getting that very same money (with interest) back at the age of 66 would “feel good.”

Loss aversion feeds into what William Samuelson and Richard Zeckhauser have termed “status quo bias” which is people’s tendency to stick with their current situation.<sup>5</sup> This aspect of human nature is well illustrated by the vast amount of “free trials” that companies offer in order to exploit your status quo bias. *Spotify Premium*, *Amazon Prime* and *YouTube Premium* offer a free 30 day free trial for signing up while *Audible* are keen to offer a free audiobook. Interestingly during the COVID-19 pandemic, more and more companies such as *Strava*, *Nike Training Club* and *Headspace* are now offering free trials for their premium services in the hope that with more free time people are more likely to sign up to new apps, but as unlikely as ever to cancel their subscription once the trial period has elapsed.<sup>6</sup>

American economists Thaler and Sunstein have noted that status quo bias can occur when the stakes are much higher than €5.99 per month for next day delivery. They observed that in a study conducted in the late 1980s, over half the US college professors who participated in the study failed to make any changes to the way their pension contributions were being allocated. In fact, many of them still had their mothers listed as their beneficiaries. This demonstrates the importance of a good default option in pension planning as even when people do sign up for a pension plan, just like with signing up to Amazon Prime, status quo bias kicks in but in this case a 30 day trial can be replaced by 40 years.<sup>7</sup>

Given these aspects of human nature, in the context of pension planning a degree of paternalism seems prudent. However, the optimum level of paternalism while maintaining people’s freedom to choose can be a tough balance to strike.

### Who Should Wear the Trousers?

In the realm of public policy, paternalism relates to any intervention in private decision-making by government or other authorities and it has been said to refer to “government as a benign parent”<sup>8</sup> as people’s personal liberty is restricted in situations where the government (like one’s parent) “knows best.” Such policies may be justifiable in situations where individuals are not best placed to make decisions for themselves and the government can steer people away from the pitfalls that they typically encounter. These policies have been apparent in Ireland before, notably in areas of public health as seen in the fluoridation of public water which sparked the seminal case of *Ryan v AG*<sup>9</sup> where the constitutionality of the State’s interference with people’s right to bodily integrity was challenged but

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<sup>4</sup> Daniel Kahneman, Jack L. Knetsch and Richard H. Thaler, “Experimental Tests of the Endowment Effect and the Coase Theorem” (1990) *Journal of Political Economy* Vol. 98, No 6 1325-1348.

<sup>5</sup> William Samuelson and Richard Zeckhauser, “Status Quo Bias in Decision Making” (1988) *Journal of Risk and Uncertainty* 1, 7-59.

<sup>6</sup> “3 Things to Consider Before Signing Up for a Free Trial,” (2020)

<<https://www.wired.com/story/things-to-consider-before-signing-up-for-free-trials/>> accessed 6 July 2020.

<sup>7</sup> Richard Thaler and Cass Sunstein, *Nudge: Improving Decisions about Health, Wealth, and Happiness*, Penguin Books 37-39.

<sup>8</sup> Matthew Thomas and Luke Buckmaster, “Paternalism in Social Policy When is it Justifiable?” (2011)

<[https://www.apf.gov.au/About\\_Parliament/Parliamentary\\_Departments/Parliamentary\\_Library/pubs/rp/rp1011/11rp08](https://www.apf.gov.au/About_Parliament/Parliamentary_Departments/Parliamentary_Library/pubs/rp/rp1011/11rp08)> accessed 7 July 2020.

<sup>9</sup> *Ryan v Attorney General* [1965] IR 294.

the paternalistic policy was ultimately upheld. Liberal commentators such as John Stuart Mill have stated that governmental regulation could only be required “to prevent harm to others.” What constitutes “harm” is up for debate however as it could be given a broader meaning to justify the regulation of people’s individual freedom.<sup>10</sup>

Paternalism can be demonstrated in many familial situations. Take for example a mother deciding what trousers would go best with her young son’s white shirt ahead of a formal event like a wedding. The son has no say and protests that the trousers are too baggy or too tight fall on deaf ears.

But what if the son could choose what to wear from a selection of different pairs that were still suitably formal for the event in question? What if they could be tailored by getting the legs taken up? What if he could change his mind the day before the ceremony? Here the son is afforded a freedom to choose within the parameters of the framework that his mother can set.

This is what Thaler and Sunstein call “libertarian paternalism” as though it is legitimate for policy makers to influence people’s lives for the better, it is important to respect the fact that people should be free to do what they like. <sup>11</sup> Mill might argue that the son need not wear trousers at all if he so wishes, although such a decision would undoubtedly be regarded as “harmful” to the bride and groom.

For *Back Pocket Savings* I would therefore apply a libertarian paternalistic approach which can be compared to the legal concept of proportionality as the basic principles in *Heaney v Ireland*<sup>12</sup> are applicable in the context of *Back Pocket Savings*. The policy must be “rationally connected to the objective” of increasing people’s savings through pension schemes and not be “arbitrary, unfair or based on irrational considerations.” Furthermore it must impair the right of people’s freedom to choose how they save money “as little as possible” and the scheme’s effects on people’s rights must be “proportionate to its objectives.”<sup>13</sup>

### **Back Pocket Savings**

A major paternalistic feature of *Back Pocket Savings* would be auto-enrolment into a retirement savings regime which people can actively opt out from. The Government had already committed to introduce an auto-enrolment system as part of the “Roadmap for Pension Reform 2018-2023” which would apply to all employees aged between 23 and 60 and earning more than €20,000 a year and are not already in a workplace pension scheme.<sup>14</sup> Given that roughly two-thirds of private sector employees in Ireland have no workplace pension, this assists in defeating the inertia associated with “status quo bias” as people under the Government’s plan would automatically start contributing 1.5% of their salary into the scheme and wouldn’t need to motivate themselves to actively sign up.<sup>15</sup>

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<sup>10</sup> Michael Rosenfeld, “The Jurisprudence of Fairness: Freedom Through Regulation in the Marketplace of Ideas” (1976) Fordham Law Review Vol. 44 Issue 5 878.

<sup>11</sup> Richard Thaler and Cass Sunstein, *Nudge: Improving Decisions about Health, Wealth, and Happiness*, Penguin Books 4-5.

<sup>12</sup> [1994] 3 I.R. 593.

<sup>13</sup> *Heaney v Ireland* [1994] 3 I.R. 593, at 607.

<sup>14</sup> “Automatic Enrolment Retirement Savings System” (2018)

< <https://www.gov.ie/en/consultation/1816502908-automatic-enrolment-retirement-savings-system/> > accessed 10 July 2020.

<sup>15</sup> Department of Employment Affairs and Social Protection, “Consultation Paper: A summary of the Automatic Enrolment (AE) proposal for employees into a retirement savings system” <

<https://www.gov.ie/pdf/?file=https://assets.gov.ie/69523/1c11a60e26d74631a748735cf4169937.pdf#page=1> > accessed 10 July 2020.

However, critics of paternalism may argue that auto-enrolment doesn't defeat the status quo bias but simply imposes a new status quo of the policy maker's choosing which people will be just as slow to extricate themselves from. This creates an opportunity for the policy maker to take advantage of the status quo bias à la *Spotify* and *Amazon Prime*.

It is therefore crucial that the default scheme that people are automatically enrolled in is well chosen. The Government's selection of 1.5% contributions rising to 6% after 10 years appears sufficiently conservative that it doesn't unduly impinge upon people's short term financial autonomy while being rationally connected to the objective of ensuring people are self-sufficient in their later years.

Wary of the default's power, Thaler and Sunstein submit that the best way to set a default is to ask what the "reflective employee" would want for themselves.<sup>16</sup> This is comparable to common law courts' recurring question of how the "reasonable man," "officious bystander" or "man on the Clapham omnibus"<sup>17</sup> among other hypothetical people would be perceived to act in given situations. They argue however that it is as irresponsible to nudge people towards investments that are too safe as it is to nudge them towards investments that are too risky.<sup>18</sup> *Back Pocket Savings* would therefore adopt further percentage increases that coincide with any increase in pay that the employee might enjoy. Thaler and Sunstein also discuss a mid-sized manufacturing firm which in 1998 saw 78% of its employees opt for a scheme which would increase contributions by 3% with every pay increase.<sup>19</sup> As we have seen it is important to ensure that the employee doesn't feel like they are losing money as that "hurts worse" than winning. Increasing the percentage of contributions in this manner would be designed to make it feel like the employee is still "winning" from the situation.

Another important method of tempering the paternalistic nature of *Back Pocket Savings* would be the provision of different options that the employee can choose from if they wish to deviate from the default. This puts the power back in the hands of employees while still being channelled in their choices by the policy maker who selects what these options would be. However it is important to avoid getting carried away with the idea of removing the shackles of paternalism and providing too many options. This issue surfaced in Sweden as though a carefully researched default option was available, people were actively encouraged to choose their own portfolios via various marketing campaigns from the government and from the funds themselves. Although this approach appears to liberate the individual as their freedom to choose is relatively unfettered, in the first ten years those who selected their own portfolios were on average 16.4% worse off than those who kept the default. *Back Pocket Savings* would therefore neither encourage nor discourage the selection of an alternative to the default as encouraging it would unduly limit people's freedom to choose whilst discouraging it would defeat its purpose and likely lead to poor returns for many people.

The ease or difficulty with which people can opt out of the scheme also has a bearing on the level of its paternalism. An unduly complex or lengthy process of opting out would appear "arbitrary" and "unfair" and the system would not be proportionate. *Back Pocket Savings* would therefore allow an individual to opt out with ease. We now live in a world where "one-click technology" pervades the

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<sup>16</sup> Richard Thaler and Cass Sunstein, *Nudge: Improving Decisions about Health, Wealth, and Happiness*, Penguin Books 13.

<sup>17</sup> John McCaughran, "Implied Terms: The Journey of the Man on the Clapham Omnibus" (2011) *Cambridge Law Journal* 607-622

<sup>18</sup> Richard Thaler and Cass Sunstein, *Nudge: Improving Decisions about Health, Wealth, and Happiness*, Penguin Books 136.

<sup>19</sup> Richard Thaler and Cass Sunstein, *Nudge: Improving Decisions about Health, Wealth, and Happiness*, Penguin Books 123.

many apps that people use on a daily basis as the hassle of filling out one's payment details is circumvented for the sake of convenience.

However, the stakes are higher when choosing to opt out of or select another pension scheme than accidentally clicking on an insipid e-book on *Kindle* which is paid for and downloaded instantly. *Back Pocket Savings* would therefore harness the convenience of one-click technology whilst balancing it against the duty to ensure that people are confident that their click is well-informed. *Back Pocket Savings* would have a mobile app which utilises finger print technology for security purposes and would allow people to opt in or out of different savings schemes with one-click technology. However, to avoid impetuous decision making, it would ask the person if they had discussed their decision with a professional and require the person to return to the app at least 36-48 hours later and make that same selection again. This cooling off period could be extended should the user wish to customise it in this way and encourage themselves to reflect before making such important decisions. The app could provide a variety of functions by allowing you, for example, to alter the percentage increase of contributions to correspond with pay increases similar to how "vault" features on apps like *Revolut* can be customised to change how much you want to save.

A government mobile app might appear fanciful and costly with various privacy and security concerns but a precedent has been set with the creation of the COVID Tracker Ireland app. Admittedly, in applying Mill's "harm principle" the protection of public health would more readily fall under his definition of the type of harm that could allow governmental interference with individual freedom.<sup>20</sup> However, people's future selves which we have seen can appear detached from their current selves may deserve protection from the harm of being without the means to live a comfortable life, something that their younger self unwittingly denied them.

## Conclusion

The question of how far the law should go in regulating pensions saving behaviour is complex. Finding a system which the reasonable man feels would respect people's liberty enough and is proportionate to the aim of saving people's money, is a lot more complicated than deciding what trousers should be worn to a wedding. *Back Pocket Savings* is one example of a system which could strike this balance. Perhaps if Will Rogers were with us today he would concede that the best way to double your money is no longer to fold it and put it in your back pocket but to "keep it in your *Back Pocket Savings*, track your contribution rates and opt out only if you have informed yourself of the consequences." This may not roll off the tongue in the same way but I am sure our future selves would agree with this sentiment.

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<sup>20</sup>Michael Rosenfeld, "The Jurisprudence of Fairness: Freedom Through Regulation in the Marketplace of Ideas" (1976) Fordham Law Review Vol. 44 Issue 5 878.