Individuals are taking on more financial responsibility, not least in providing for their old age. Maybe they should be better prepared

WHEN IBM announced an overhaul of its pension plan for employees in America last week, it joined a parade of employers that are shifting more responsibility for saving for retirement on to workers. For many Americans, of course, this is nothing new: millions of them have been managing their retirement assets in individual accounts for years (see chart 1). Nevertheless, in both America and Britain the closure of paternalistic corporate “defined benefit” programmes, in which pensions depend on earnings and years of service, is accelerating—even at healthy companies such as IBM (see article).

To the extent that this creates and encourages individual choice and responsibility, it is something to welcome rather than to fear. Many other countries, facing huge state-pension obligations, would also like to see their citizens assume a bigger role in providing for their own retirement. Even so, the trend raises an important question: how much do people due to take on these new responsibilities know about basic financial concepts?

The answer seems to be: not much, and less than they think they do. Studies show that many people overestimate their knowledge of everything from inflation to risk diversification and compound interest. One survey in Australia found that 37% of people who owned investments did not know that they could fluctuate in value. In America 31% did not know that the finance charge on a credit-card statement is what they pay to use credit. Britain’s Financial Services Authority will release the results of its own survey on financial literacy in the next month or two.
Even educated professionals may know the basics but see no need to keep up to date—having no idea of the interest rates on their credit cards, the fees on their mutual funds or how their investments are doing. But in both America and Britain low personal saving rates (negative in America, indeed) and record numbers of personal bankruptcies do not bode well. If people are to take charge of their pensions, shouldn't they know a little more?

In the end, ignorance could rebound on governments: if people save too little for old age, the state may have to provide for them willy-nilly. “Governments are taking this very seriously,” says Barbara Smith of the Organisation for Economic Co-operation and Development, which recently produced a report on global financial literacy. Just this week the British government launched an online debt calculator for overstretched consumers and a money-management course for teenagers that will be offered in schools across the country later this year. New Zealand is another country trying to catch its people young: one official financial-information website there (www.sorted.org.nz) includes an online game on “Money Island”.

The potential economic benefits of financial literacy extend beyond government budgets. More informed consumers—not just investors—would increase the efficiency of markets and help keep unscrupulous sellers at bay. If financial illiteracy leads to greater debt, then increased consumption today will be at the expense of less later, as interest payments weigh on household budgets.

Once people make financial decisions, they tend to stick to them even if a change might make more sense. Watson Wyatt, a consultancy, says that about half of Britons in defined-contribution pension plans (in which retirement benefits depend on investments' performance) never change the allocation of assets. One-third have not even reviewed them for several years. There is evidence that such inertia is a feature of other financial markets, including the one for mortgages (see article).

America has had a variety of financial-education programmes for some time, generally relying on the private sector. Most large companies and many smaller ones put on investment seminars for their employees, run by outside experts. Many of those who attend these seminars later increase their saving for retirement.

However, there is a fine line between education and advice. Although education and sales are meant to be strictly separated, many of those giving the seminars work for firms that sell financial products. Some employers have been hesitant to sponsor financial seminars for fear of being sued, notes Lynn Dudley of the American Benefits Council, a lobby group. Two bills now before Congress attempt to deal with this question. Meanwhile, a growing number of pension schemes offer “lifestyle” or “life-cycle” funds that skirt the question of advice by automatically shifting the mix of investments away from equities and towards bonds and cash as retirement nears (see chart 2).

Despite all the activity, experts caution against putting too much faith in financial education. “This is not the silver bullet that some people think it is,” says Ms Smith. No campaign can hope to reach everyone. In addition, although those with more knowledge of finance tend to save more and make higher returns on their long-term investments, the strength of the effect is not clear.

Annamaria Lusardi, an economist at Dartmouth College, and Olivia Mitchell, of the University of Pennsylvania’s Wharton School, have found that few employees attend financial seminars even when they are offered in the workplace. Scepticism about hidden sales pitches and slanted advice abounds, particularly in the wake of recent mutual-fund scandals. “Workers are entitled to believe this is not an objective voice,” says Ms Lusardi. Many who attend do not absorb what they hear, for want of understanding or interest.
In Europe they seem to be just as sceptical. In a report published this week, Forrester Research, a consulting firm, said that only one-third of Europeans trusted financial institutions to treat them fairly, and less than half trust the advice they get from their main bank. Only 20% think the information in promotional material will help them improve their financial decision-making.

Well-aimed information can make a difference, though. In Sweden, which started a new pension system in 1999, a mixture of financial education and a media campaign prompted more people to choose their mix of investment funds for themselves. The effect faded when the information programme was discontinued.

Some dismiss worries about low financial literacy. “Complaints that people are too stupid to manage their own money are dead wrong,” wrote James Glassman, a fellow at the American Enterprise Institute, recently. He points, for example, to America’s record levels of home-ownership.

There is good reason to believe that people will learn if they want to and if they must. It is not so long since the go-go 1990s, when millions started investing for the first time. Many then learned painful lessons about the risks of overenthusiasm for equities. Perhaps a strong message is needed to get people saving now for retirement a few decades away. Ms Lusardi offers a suggestion: “Tell them, ‘you're going to be poor, it's going to be tough'. The mutual-fund companies show pictures of cruises. You've got to show a nursing home and they'll give it some thought. Tell them poverty at retirement is hell.”

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