Peer Review in Social Protection and Social Inclusion 2008

Public information on pension systems and pension system changes

Poland 27 – 28.05.08

Synthesis Report

On behalf of the
European Commission
DG Employment, Social Affairs
and Equal Opportunities

Peer Review
in Social Protection
and Social Inclusion
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Public information on pension systems and pension system changes

Károly Mike — Ákos Szalai
TARKI Social Research Institute,
Corvinus University of Budapest

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Executive summary

Growing concerns about the sustainability of public pension systems have led to reforms which have tended to increase the degree of uncertainty over the amount of pension which individuals will receive when they retire. The changes in question include, in particular, linking contributions to benefits, building in annuity factors to take account of longevity, and introducing funded schemes to link pensions to the performance of the economy.

The assumption is that people will respond in a rational manner to the new financial incentives to work longer being built into the system. However, this is unlikely to happen if they lack detailed information or fail to understand the information they do have. Public authorities play an essential role in this regard.

This Peer Review, held in Warsaw (Poland) on 27–28 May 2008 and hosted by the Polish Ministry of Labour and Social Policy, therefore looks in detail at the action taken by various countries in this field. In particular, three main aspects are covered, including:

- Information on the introduction of changes to pension systems
- information on pension rights, and
- information on choices in pensions.

In addition to the host country, ten peer countries took part: Bulgaria, Estonia, Germany, Hungary, Lithuania, Malta, Portugal, the Slovak Republic, Sweden and the United Kingdom. Also participating was a stakeholder representative from the European Older People's Platform (AGE), together with representatives of the European Commission's DG Employment, Social Affairs and Equal Opportunities.

From the review, it emerged that the government responsibility as regards the provision of information is threefold: alerting people to choices and responsibilities; informing them about the choices on offer; advising them on new policies. However, these roles may conflict, leading to a potential

loss of credibility. To ensure the provision of politically unbiased information, therefore, governments should not be the only source of information on pensions. Third-party information sources can include NGOs, consumer groups, sectoral organisations and the social partners, including employers with fiduciary liability for their employees' pension choices. Pension rating companies also appear to be very successful in some countries, but, as regards independent advisers, some regulation of fees may be necessary to ensure truly unbiased advice. The government should also seek to assist market mechanisms that facilitate consumer choice, such as market concentration, corporate reputation and informative advertising.

There are no general best practice recommendations regarding the media used to reach people with information on pensions, other than that campaigns and information provision should focus on those communication methods that people tend to trust and use anyway. For example, the Polish experience suggests that information and awareness-raising campaigns should first and foremost focus on opinion leaders, who can subsequently provide independent information and advice to others.

In terms of information content, pension pay-out projections emerged as an important item, while the relative risks linked to different kinds of pension schemes and funds also need to be made clear. Indeed, while state pay-as-you-go (PAYG) systems may, for example, appear less risky than investment-based schemes at a first glance, they can also involve demographic and political uncertainty. Consumers also have to take other risk factors into account, such as unpredictable longevity, fluctuations in purchasing power and working profile changes, if they are to make sound choices. The type of pay-out may also influence risk and people therefore need more information about the relative merits of lump-sum payments and various types of programmed withdrawal.

The problem is that the complex financial nature of pensions often prevents people from understanding the information they have in their possession. This kind of financial illiteracy needs to be tackled but, in fact, high levels of regulatory uncertainty may reduce the incentive of people to improve their 'pension literacy' even further. Moreover, the tendency for people to be short-sighted about their situation after they retire suggests that even

knowledge and understanding may not be guarantee that they will make financially rational choices.

Nevertheless, it is clear that, to make rational decisions, people need a unified picture of their pension options. Public authorities should therefore coordinate their activities and standardise information provided by pension funds.

Finally, different groups may need different types of information. This may be the case for women and men, but also for groups with different economic, occupational and educational backgrounds.

A. Introduction

Across Europe, demographic change has been putting increasing pressure on pension systems. Reforms have already been implemented in a number of EU countries to make existing systems more sustainable, but public understanding and acceptance of these changes is rarely assured.

Detailed and intelligible information needs to be provided to citizens and this Peer Reviews looks in detail at the action taken by various countries in this field. In particular, three main aspects are covered:

- **Information on changes to pension systems**: Making pension systems more sustainable while maintaining adequate levels of allowances often increases the degree of uncertainty about the future value of pensions. People will need to take a bigger interest in their pensions and do so much earlier in life, as crucial decisions will, in future, have to be taken long before retirement. Without clear public information, such changes may not have the desired effect.

- **Information about pension rights**: As pension systems change, they become increasingly difficult to understand. The challenge is to inform people, in a relatively simple way, about what their pension will be when they retire.

- **Information on choices in pensions**: While there may be advantages to increased choice within pension systems of EU countries, the multitude of options can also give rise to uncertainty and anxiety. People need to be informed in such a way that they are happy about the choices they make.

The Peer Review was held in Warsaw (Poland) on 27–28 May 2008 and hosted by the Polish Ministry of Labour and Social Policy. In addition to the host country, ten peer countries took part: Bulgaria, Estonia, Germany, Hungary, Lithuania, Malta, Portugal, the Slovak Republic, Sweden and the United Kingdom. A stakeholder representative from the European Older People's Platform (AGE), together with representatives of the European Commission's DG Employment, Social Affairs and Equal Opportunities, also participated.

B. Theoretical background: the dilemmas of providing pension information

The high complexity of pension systems implies the need to make a great many decisions, including in particular, about:

(i) How much should people save for retirement (e.g. how large a fund to accumulate during their working life)?

(ii) What form of saving should they choose? Pension schemes versus other forms of savings, such as real property and bank accounts? Pay-as-you-go (PAYG) schemes versus defined-contribution funds? Conservative versus risky portfolios?

(iii) At what age should they retire?

(iv) Which payout form should they choose (e.g. lump sum versus annuity)?

Because decision-makers are incapable of predicting the future with certainty, they must take into consideration the degree of risk surrounding each of these decisions. This, however, is no easy task, particularly given that recent policy changes in most countries have tended to hand over more decision-making responsibility to beneficiaries, thereby multiplying the variety and the extent of risks they have to deal with.

From the beneficiary's viewpoint, a pension is a long-term, financial contract. However, in reality, many pension systems differ from typical long-term contracts because beneficiaries can choose to opt out of state PAYG schemes or to transfer the amounts they have accumulated between different private pension funds (this is called an 'exit option' in economics). Both these types of movements can be considered as re-contracting with a new insurer and, although reforms often assume that this kind of mobility will serve to correct previous 'wrong' choices, it remains unclear whether this is the case in practice. A key reason for this is that the complex financial nature of the pension contract often limits people's ability to understand the information they are provided with (so-called financial illiteracy).

All these increased individual responsibilities and risks imply that information policy should play a more and more important role in pension policy. In this Review, a distinction is made between two dimensions of information policies — on the content of information, or what beneficiaries should be informed about — and the sources of information. Two outstanding problems that information policy has to confront are financial illiteracy and myopia or short-sightedness. While the first pertains to a lack of comprehension of pension systems, the latter suggests that even knowing and understanding may not ensure sound consumer choice. The theoretical overview concludes by addressing these two thorny issues.

1. The content: informing on risks associated with pension contracts

Most governmental information programmes differentiate between three types of information relating to pension reforms. They attempt to provide beneficiaries with information on (i) changes in the pension system, (ii) the rights of beneficiaries in the standard system, and (iii) the choices they can make on pensions.

Pension system changes

Because pension reforms typically shift more of the responsibility and risk on to beneficiaries, they must be informed about the types of risk that are being transferred to them. In this respect, it is worth distinguishing between risks related to the contribution phase of a pension scheme and those related to the payout phase.

In the contribution phase, the biggest risks surround the accumulation of 'pension rights' (under a state PAYG scheme) or personal funds (under a funded scheme). In funded schemes, where contributions are used to purchase a pool of assets, there is an investment risk associated with the way in which portfolios of equities and bonds are managed. In unfunded (PAYG) schemes, the greatest risks stem from population ageing and political decisions — both of which may result in insufficient budgetary resources. Economic literature suggests it is possible to calculate an implicit rate of

return for the state PAYG system, based on the growth rate of the aggregate tax base. This measure can also serve as a benchmark for assessing the performance of the funded system (Samuelson [1958]).

Regarding the payout phase, beneficiaries have to consider longevity risks (i.e. the risk of living too long or dying too soon) as well as investment and demographic risks. The way these risks are shared between the beneficiary and the pension system will depend on the form of the payout — whether it is in annuities, lump-sum payments or programmed withdrawal. Lump-sum payments allocate the whole of both investment and longevity risks to the pensioner. Withdrawal, under which the pensioner receives part of the accumulated fund as a lump-sum payment at the time of retirement and the rest as an annuity, divides both investment and longevity risks between the fund and the pensioner. In non-funded schemes, the demographic risk comes into consideration once again as the government may have discretion in adjusting pension levels to match budgetary resources even after the beneficiary's retirement.

A major problem is that longevity risks are accentuated in the context of an ageing society. The mortality table, upon which the calculation of annuities is based, is likely to provide only uncertain estimates, notably because mortality can only be estimated from past experience and not predicted with any certainty. As a result, the fund may simply be unable to spread a significant part of the aggregate longevity risk.

Pension rights

Most pension systems have a default scheme that can serve to provide some information on the expected level of pension, for example based on the hypothesis that beneficiaries will accumulate funds (or pension rights) through a basic, mandatory scheme and retire at a defined retirement age.

The uncertainty of projections. A key difficulty under these default conditions is that calculations can only be based on rather unrealistic assumptions (e.g. the worker stays in his/her current job until the age when, according to existing regulation, he/she can retire). Yet, potential changes in the future earnings of the individual contributor will affect the size of the

accumulated fund at the time of retirement. More generally, payoffs are sensitive to changes in the working profile, including future wage levels (and corresponding contributions), possible gaps in contributions (due to unemployment, caring responsibilities etc.), the age at which contributions begin, the age of retirement, etc. In a PAYG system, calculations are also very sensitive to expectations about labour market participation and economic growth (i.e. the aggregate tax base and the dependency ratio). But demographic projections are inherently imprecise and frequent changes in forecasts over the past decades (see Whitehouse [2000]) mean there is no reason to think that current projections will be accurate, especially for young contributors. In funded schemes, it is, of course, the investment risk that plays a crucial role.

Regulatory risks. Although regulation is usually seen as a means of reducing risks, the uncertainty of pension regulation may, in fact, add significantly to inherent risks. Indeed, many countries have experienced regular reform of the pension system over past decades. As a result, people may regard the pension system as unpredictable and believe — probably correctly — that they cannot accurately predict the amount of pension they will receive when they retire as regulations may change before then.

Amid these uncertainties, providing extensive information on pension rights (under the standard scheme) may have the paradoxical side-effect of making contributors overly confident. In particular, people are unlikely to be aware of the uncertainty surrounding the assumptions on which calculations and forecasts are based. This may create a 'false sense of security', which may, for example, reduce their incentive to obtain information about the performance of pension funds.

Pension choices

In addition to information about the types of risk related to various pension schemes, beneficiaries also need information about the actual levels of risk associated with individual funds (e.g. the higher the share of more volatile (riskier) investment forms within the fund's portfolio, the higher the investment risk contributors face).

At least three mechanisms can help reduce the risks associated with pension choices: (i) market structure, (ii) reputation of pension markets and (iii) government regulation. In many ways, these mechanisms can complement one another to reduce the risks borne by beneficiaries substantially and their corresponding need for information.

Market concentration. The structure of the market affects the risk of choosing an inferior pension fund. The reason is that pension products can vary significantly in terms of quality but that the quality issue is so complex that consumers can only compare different offers at a very high cost. The higher the number of providers, the higher this cost and the lower the chances of consumers switching funds. Moreover, because the main 'quality issue' at stake relates to the riskiness of the financial instrument, costs of comparison can be even higher if account is taken consumers' often limited financial literacy. Market concentration is likely to reduce comparison costs in the pension market but, at the same time, it will also weaken the competitive pressure on insurers.

Credence and reputation. Pensions are rightly perceived as 'credence goods', i.e. goods for which consumers are typically unable to estimate the investment risk and for which even use may not enable them to determine whether the desired characteristics exist (Nelson [1970, 1974]). The credential nature of pension funds means reputation is of high importance in this market. This can also be inferred from the advertisement strategies typically adopted by pension funds, which, in many countries (e.g. Poland, see Chlon [2000]), are based on the existing market position of their parent companies. This corresponds to the most effective marketing strategy for credence goods suggested by economic analysis (Klein and Leffler [1981]; Landes and Posner [1987]).

Regulation. Regulations often serve to limit risk by forbidding particularly risky forms of investment or by requiring a certain portfolio composition. The guarantee of a minimum return by the state is an important means of reducing this type of risk. Typically, regulation also covers the types of charge that funds may levy. This is important because the advantages of the exit option can only be achieved if consumers respond to unfavourable changes in fees by moving to another insurer. However, this mechanism may not actually work if the fees charged by different funds are not readily comparable. [1]

Because risks relate not only to investment choices but also to forms of payout as well as career prospects and choices (health, family relations, gaps in employment, wage level, etc.), standardising and restricting the options with regard to forms of payout and establishing rules governing contributions in case of changes in the working profile may serve to mitigate the risks borne by beneficiaries. Obviously, economic and social policies (other than pension policy) can also strongly affect career paths and, therefore, pension choices.

Choosing when to retire. One of the most topical questions in pension policy is how to delay the age at which worker retire. Most pension systems attempt to create incentives for longer working lives — the most important measure being an increase in the pension payout if the contributor retires later. An additional incentive exists in those countries where the pension is calculated by the average wage during the last few years of employment. If the employees receive higher wages during the additional year(s), they will be entitled to an even higher pension. They must however consider that receiving a higher pension for a shorter period can in fact lead to a reduction in the net present value of the pension flow despite a longer working life. In fact, in most countries it does not pay to continue working for an additional year when people are in their s 60s.[2] This counter-incentive is present even

1 A special function of regulation is to protect clients from the possibly opportunistic behaviour of the fund's management. Governments can shape the management's incentives by regulating the governance structure of funds, the documents the pension fund must produce and publicize (The fund may also have to create specific internal functions such as a managing director, a manager responsible for investments, a senior accounting officer and an internal controller.)

2 For a Swedish example, see Palme and Swenson [2003].

if myopia (a heavy discounting of future payoffs) and the benefits of leisure are ignored.

Such an analysis of incentives is nevertheless based on the assumption that future pension policy is known with certainty at the time when the decision to retire is made (see Stock and Wise [1990]). However, this may well not be the case and the perceived uncertainty of pension policy may create an additional incentive to retire earlier. If the pension level is expected to decrease in the future (e.g. due to a lower replacement rate or a lower income level), contributors are encouraged to retire as soon as possible under the relatively favourable conditions available at present. In addition, if relatively low pensions are expected to increase more rapidly in the future, the incentive to delay retirement may be further weakened. The counter-incentives against later retirement point to a possibly unwanted consequence of information policy. If contributors are provided with detailed calculations about their future pensions and have similar expectations as policy-makers, they are likely to choose to retire earlier rather than later. Later retirement is likely only if (i) contributors have unrealistically high expectations about the effect of working longer on their pension, or (ii) they underestimate the replacement rate (i.e. they believe that their pension would be much lower than the wage they could obtain).[3]

2. Provision of information

Beneficiaries can be provided with the required information through three different channels. First, there are several non-governmental information sources, such as financial agents, employers, and advertisements. These are typically regulated by the government. The second source is the pension system itself (the state scheme or the pension funds). Here, regulation usually takes the form of mandatory disclosure. Third, governmental agencies can provide information.

3 The strength of the existing incentives for later retirement varies across different working groups. For example, if the wage increase in the additional years is more significant (and this has a positive effect on the level of pension) or an employee enjoys his job (i.e. work provides him more benefit than leisure), he will have a stronger incentive to remain in the labour market.

Non-governmental sources

Even in the absence of information provision by the government, beneficiaries can turn to several sources of information: advertisements (in the media, particularly on television, the written press and increasingly on the Internet), direct and voluntary information provision by pension funds (e.g. leaflets, brochures, call-centres), family and friends, tied and independent agents.

Agents. Agents are of two types: tied and independent. Tied agents are typically treated by consumers as biased advisors. By contrast, independent agents are considered to offer trustworthy information. Therefore, a key requirement is that agents must communicate their actual position to consumers. Tied agents must be penalised if they pretend independence. Moreover, non-tied agents are not necessarily truly independent. Differences in commissions may make them very partial — to the detriment of consumers. Agencies' incentives to sell may increase inequalities caused by differences in financial literacy among consumer groups. Low income groups that are least sophisticated and face the highest risk of wrong financial decisions rarely receive solicitations from agents (see Whitehouse [2000]).

Employers. Employers may be prohibited from influencing their employees' choices among pension funds (see Chlon [2000] on the example of Poland). By contrast, in many other countries, workplace access to pension insurance is not only allowed but positively encouraged. Arguably, there are two reasons for this: (i) lower marketing and administrative costs, and (ii) a higher intensity of market competition among funds. The latter is likely because employers are typically better educated in financial decisions than employees. They gather more relevant information and are able to compare funds in a more effective way.

A higher level of comparability forces funds to compete more vigorously. Moreover, employers may have greater bargaining power than employees and may be able to make better deals for them. It is debatable whether administrative costs are indeed lower. If an employee moves to a new job, his/her pension fund remains the same. So lower administration costs are only short-lived, especially in labour markets with high worker mobility.

Advertisements. The advertisement policies of pension funds are strongly regulated in many countries. For example, agents may not be allowed to promise higher investment returns than other funds. This may be consistent with the credence characteristics of pensions and the fear of chase after returns (see below). However, it contradicts the general finding of economics that advertising of truthful information should not be restricted by regulatory authorities (Rubin [2000]). The reason is that producers of products with quality levels above the minimum will have an incentive to advertise this fact, and the market will tend to provide complete information. Forbidding information disclosure may prevent movement towards an efficient market equilibrium and accommodation to consumer tastes.

Mandatory disclosure and provision of information by public agencies

Choosing among state and funded scheme. As noted above, the growth rate of the aggregate tax base can be used as a measure of the implicit return in a balanced PAYG system and is a useful benchmark for assessing the performance of a funded scheme. Its mandatory publication by the state pension scheme therefore facilitates choice between the two schemes. However, the unpredictability of demographic developments makes the estimates of average real wage growth highly unpredictable.

Choosing among funds. Regulations attempt to facilitate comparisons by prescribing specific accounting and publication rules for funds. Regulations may define indicators of costs (fees) and rates of return to be calculated and published in newspapers or leaflets sent out to clients. The indicators are either provided by the funds or calculated and published by the regulatory agency or private market firms (e.g. rating companies). Leaflets sent by the funds to all clients are a very cheap form of communication. They also provide a cheap opportunity to inform clients of the indicators of other funds. The regulator may well oblige funds to do this. For example, Impavido and Rocha [2006] recommend that the annual report sent by the fund to members

should contain not only information on the individual fund's performance but also simple tables comparing performance with the rest of the industry.

Information on rate of return versus fees. The chasing of returns is a well-known phenomenon in many countries: consumers move to funds that offer higher rates of return. However, information on fees should be considered as well. The problem is that information on the rate of return seems more obvious and is therefore used more readily than information on fees. However, the rate of return is volatile, and a high return is typically the consequence of riskier investments by the fund, which is often less obvious to clients. Moreover, consumers are more sensitive to information on return than information on fees because they do not realise that the return is calculated only on a fraction of their contribution: the funds that remain after operation costs. Another important aspect to be considered is that when funds follow more or less similar investment policies, differences in return between them are smaller than differences in fees. The discretion of funds with mixed fee structures to the detriment of uninformed clients can be constrained by a unified method of fee accounting: the obligatory calculation of a charge ratio (Impavido and Rocha [2006]).[4]

Mandatory calculations of accumulated contributions and projected payoffs. As noted above, individual calculations of future payoffs can only be based on rather unrealistic assumptions. This is true of both PAYG and funded schemes. Nevertheless, information regulations frequently require both PAYG schemes and funds to provide their clients with such calculations. This makes sense because even consumers who are aware of the size of their accumulated fund tend to overestimate their accrued pension benefits to a high degree (Ghilarducci [1992]). Several Member States nevertheless only provide information on the total accumulation of pension entitlements without projections. It is doubtful whether people can realistically assess such aggregate figures. For example, current figures on the funds accumulated may obscure the significance of a flexible retirement age. Moreover, these

4 The charge ratio is one minus the accumulation ratio, where the latter is the ratio of the final cash balance produced when fees are charged over the cash balance where fees are not charged. This regulation does not limit the types of fees levied by the funds. It merely obliges them to communicate information in a comparable form. Of course, the introduction of any obligatory indicator runs the risk that the regulated industry will look for new types of fee settings, which are not measured by the indicator.

figures tell nothing about the likely purchasing power of pension benefits. Projections, on the other hand, can help emphasise the consequences of future individual choices on pension benefits by including forecasts for different retirement ages.

Too much information? Even in the absence of prohibitive regulation, competing funds can produce a great deal of information. Mandatory disclosure might therefore worsen the situation, causing consumers to be flooded by information and making it harder for them to pick those pieces of information that are really relevant for them. They could even choose to ignore them all.

Crowding out of information produced by market participants can be another unintended negative consequence of government activity. Indeed, if public agencies provide information free of charge, both the funds and independent market institutions (e.g. rating agencies) will have fewer incentives to provide consumers with information. Furthermore, potential government failures could result in a situation where less reliable government-produced information crowds out more reliable market-produced information.

3. Financial literacy and myopia

Financial literacy regarding pension schemes and funds largely depends on a country's general financial culture. In most EU countries, including Poland and Hungary among others, the most widespread form of 'insurance' are the bank deposits, people attempting to accumulate a large fund in their bank accounts during their working lives to spend after retirement. Furthermore, surveys have revealed that many people plan to continue working after retirement or count on the support of their children. Poll respondents also refer to property or durables as investments for their retirement years. Complicated investments in financial markets typically play a minimal role in their planning (Chlon [2000]). In addition, among financial market instruments, consumers are least confident about picking a specific pension fund (see Whitehouse [2000]).

This situation is largely due to the fact that financial relationships require a thorough knowledge of financial issues, such as interest rates, fees, associated risks — as well as their weighting — that consumers are often unable to handle.

On top of this, frequent changes in regulations further weigh down on people's already limited knowledge of the details of pension systems. In fact, regulatory uncertainty can actually make ignorance of the details of the pension system appear as a rational consumer choice.

The low interest in and knowledge of pension systems in highly developed countries would appear to confirm this hypothesis, although the level of consumer interest changes over their life-cycle. Young people (and middle-aged) are, naturally, less interested in becoming informed about pensions so, even though their general financial literacy may be relatively high, their 'pension literacy' is likely to remain limited. Instead, other typical investment forms — repaying a student loan, buying a house, covering the costs of children's education, etc. — tend to remain their main focus.

Nevertheless, even under perfect information, people might find they have saved too little and regret their past decisions as they approach retirement. This is known as 'myopia' and generally results either from either a very high discount rate, time-inconsistency and/or excessive optimism about the future (i.e. about the pension they need).

Very high discount rates. As pensions represent a form of long-term saving, the contributor's "time preference" is a key determinant of his/ her behaviour. The higher the discount rate, the less a contributor will be interested in the future, meaning that any reduction in current consumption would only be compensated by the opportunity of very high consumption in the future. A very high return rate will therefore be demanded in exchange for giving up current funds and the contributor could end up neglecting his/her future needs.

Time inconsistency is a problem caused when a contributor has a declining discount rate (Diamond and Köszegi [2003], Laibson [1997], Loewenstein and Prelec [1992], Frederick et al. [2002]). This means that the discount rate is

higher for the years closer to the present than for later years, encouraging contributors to delay saving up until the last years before retirement. As a result, people keep postponing their decisions to save. This is also known as the 'weakness of will' problem. But the time-inconsistency problem could be dealt with by the presence of a rational, foresighted agent. A sophisticated consumer may then realise the potential threat and be ready to accept a saving scheme with increasing contributions as he/she ages. This could result in the widespread signing of long-term contracts of a 'hand-tying' nature by younger generations.

Excessive optimism. For insurance in general, optimism means that people taking out an insurance potentially underestimate the probability of an event that could reduce their income or worsen any of their other living conditions. For pension, this corresponds to underestimating the level of savings required to finance needs in old age, when people are no longer able to obtain sufficient income from the labour market. This is largely due to an underestimation of the length of the period of retirement. Empirical studies have found that people can on average predict their longevity well (Hamermesh [1985]; Hurd — McGarry [2002]). By contrast, based on a Hungarian household survey, Szalai [2006] estimated that the expected age of retirement in 2006 was on average five to six years higher than the average retirement age at the same time (55 and 56 years of age versus 60 and 62 years of age for women and men respectively). The gap cannot be explained by people predicting that retirement ages will rise, because expectations did not vary with the age of the respondent (the younger respondents should have expected a higher increase in their retirement age). This evidence suggests, therefore, that people will tend to save too little for their retirement.

C. Lessons from the peer countries

Turning to the experience of peer countries which have implemented pension reforms, in what follows, what is known about the behaviour of pension beneficiaries is first summarised and then a review is presented of the information people in different Member States actually had and used relating to (i) changes in the pension system, (ii) their pension rights, and (iii) their pension choices. The focus is on some common patterns that appear to emerge, based on a number of specific examples, and draw some general lessons about the usefulness of the information methods and policies used in the Peer Countries.

1. Pension beneficiaries' knowledge and behaviour

Pension system changes

What do people know about the systems which have been reformed? The empirical picture is somewhat ambiguous in all countries. People seem to be aware of the major driving forces behind pension reforms. For example, Germans correctly associate ageing and longevity with challenges to the long-term sustainability of the statutory pension scheme (especially people with higher education). However, the magnitude of the impact of ageing on pensions is limited. For example, average life expectancy is often underestimated, notably in the UK, where individuals are largely unaware of the extent of increases in average life expectancy and have a limited understanding of the way in which the system operates.

What's more, nearly all countries report that young people are usually not very interested in pension matters. By contrast, people approaching retirement age or who, for some reason, are afraid that they could become unemployed, generally seek information concerning eligibility conditions for retirement more often. Younger people are not only less interested in pension issues; some groups are actually against the state pension system itself. This is partly because the pension system constrains individual choice regarding expenditure priorities and alternative savings mechanisms. In the

UK, some younger groups also felt the state pension might well be phased out entirely by the time they retire anyway.

Another reason for the disinterest is that reform has simply become a permanent feature of every pension system. There are frequent changes in regulations (increases in retirement age, new calculations for payouts, new forms of savings, etc.), that make the prediction of future pensions very difficult. All countries reported recent changes or ongoing reform. For example, the Social Security Act in Malta guarantees that there will be a strategic review every five years.

Pension rights

Empirical results are very mixed as to whether people are inclined either to over- or underestimate their pension rights. Nevertheless, the belief that statutory pensions are inadequate for financing consumption during retirement is widespread in all countries. For example, 95% of Germans believe that the statutory pension "is not sufficient any more' and they will have to make up through private provision", while almost two-thirds of working-age people agree that 'there is a need to deal with the pension issues on a regular basis'. In the UK, 81% of those under state pension age think that a state pension will not provide them with the standard of living they hope for in retirement. Nevertheless, these expectations do not necessarily lead to high level of planning: many people at all income levels in the UK are not planning at all and only 37% have made any additional provision for retirement.

In the UK, this could be due to the fact that respondents often overestimate the level of state pension, further assuming that there is universal entitlement to it or that all those entitled receive the same amount. In Germany, on the other hand, the data shows that people tend to underestimate state schemes compared to occupational and private provision, with far more than half of Germans greatly underestimating potential resources available to them.

Pension choices

Financial risks: A pension fund's riskiness is an uncomfortable idea for many people, with, for example, the majority of people in the UK saying it is inappropriate to take risks with pension savings. 43% of respondents did not want to take any risk with their savings, while 64% believed that a pension fund linked to the stock market was too much of a risk. Yet a significant proportion of respondents did nevertheless have savings with an element of risk. This could result from the fact that, according to UK data on what people consider before choosing among financial products and services, 46% of people do not collect any information on products before taking a decision. In fact, 21% of households that made a purchase in the last five years took their decision without seeking any advice or information from anywhere. Instead, people appear to learn from experience, with selection patterns improving as the number of products held increases.

In many countries, pension funds offer a number of different investment portfolios. In Central Europe, regulations tend to define three types of portfolio with different risk levels. Contributors can typically choose between a conservative portfolio (with a low share of risky investment — in Hungary, this represents a maximum of 10% of equities), a balanced offer (10–40% of equities) and a progressive portfolio (35–65% of equities). In Hungary and Slovakia, regulation constrains individual choice among these forms of investment. In Slovakia, the saver is notably obliged to shift from the progressive portfolio after reaching the age of 47 and from the balanced portfolio at the age of 55. In Hungary, contributors above 57 years are not allowed to choose the riskiest portfolio. Also in Lithuania, people within 7 years of the pensionable age must be informed personally about the risks and their attention must be drawn to the option of a conservative portfolio.

Experience relating to consumer choice between investment portfolios is, however, very mixed. In Hungary, pension funds in the third pillar have had the right to offer different portfolio profiles to their members since 2001. However, by 2007, only about 10% of the funds actually introduced a multi-portfolio system and only 5–15% of fund members made a choice between these.

In addition, while all countries have adopted regulations reducing the cost of switching funds, statistics show that contributors to funds with low performance only rarely transfer their money to another fund. For example, in Estonia, it is well documented that people tend to be negligent about issues such as the fees levied by pension funds as well as their investment policies, especially in the first pillar. This confirms Impavido and Rocha's [2006] findings in Hungary.

On the other hand, statistics on switching in Estonia also show that people that do make choices generally make reasonable and beneficial decisions, with almost all younger contributors choosing aggressive (equity) pension funds, while older people tend to switch to balanced or conservative (no equity) funds.

According to AGE, the NGO representing older people, people may keep postponing pension choices because they think that they will have better information in the future. This means people must be given information about the impact that each option would have on them personally. One way of doing this is to provide several different scenarios for each case: optimistic, average and pessimistic.

Choosing the retirement age and payout options: The possibility of a deferred pension is an important option in every country's state pension scheme, allowing people to choose whether or not to continue working after reaching the statutory retirement age. If they choose to do so, they will tend to get a higher pension because the weight of the additional working year will be higher than the weight given to a working year within the obligatory contribution phase. In Lithuania, for example, the state pension can be deferred for up to 5 years with every full year of deferment increasing the pension by 8%. In the UK, the deferral has the form of a special lump sum payment. If people put off claiming for at least 12 consecutive months, they can claim a one-off taxable lump sum.

The British and German experience shows that more and more people are indeed working longer and postponing their retirement. This shift in attitudes seems to be propelled by an awareness of the inadequacy of pensions as well as improved health and vitality. Encouraging people to work longer

can however prove difficult, as seen in Sweden, where the retirement age is flexible but people continue thinking that the default age (65 years) is 'set in stone'.

Additional savings: Regarding the question of whether to sign up to additional voluntary forms of pension savings, this seems to depend mainly on the tax incentives attached. In fact, this may be the single most important piece of information people will consider. This is a significant problem since these are also risky financial instruments and people's use of them often simply represents a transfer from other forms of savings without tax incentives.

2. Information policies in the peer countries

After this brief review of what is known about beneficiaries' knowledge and behaviour, the following considers the experience of peer countries as regards information policies. Some important general remarks are followed by a discussion of policy measures relating to (i) pension system changes, (ii) pension rights, and (iii) pension choices.

General remarks

Information categories. Public information on pension reform falls into three distinct categories: alerting people to the possibility of choice and to the responsibilities this entails; advising people about new government policy and convincing them that it is the right one, and; informing people about the different choices on offer. Sometimes though, these roles may conflict, leading to a potential loss of credibility. It is particularly important to distinguish between information and advice. While providing information on pensions is a neutral, general function of governments, providing advice on pensions is a momentous step. In any case, it is important for the government not to be entirely negative about previous systems as otherwise people may opt to go into new mixed schemes even when it is not in their own best interests.

Rationality expectations. When it comes to deciding about concrete objectives for each type of information policy, policy-makers must examine

the ultimate question: what can they really expect from people and what would rational behaviour be? Unfortunately, there appears to be no coherent answer to this fundamental question, mainly due to the lack of any robust theory relating to long-term consumer behaviour under uncertainty. Three theoretical dilemmas seem especially important.

The first issue that arises is whether it is reasonable to expect young people to show an interest in pension issues. Surveys and experiments show that even perfectly informed and literate people tend to be short-sighted and may regret their past choices. And it remains far from clear whether this myopia can be changed and, if so, by what means and how quickly. Moreover, it may be argued that young people are quite rational in attending to their short-term consumption and saving needs while postponing saving for retirement until later in their career. Accumulation of wealth in the form of property and repaying loans may also be reasonable priorities. Such behaviour may be part of an entirely rational consumption/saving life-cycle.

The second issue is whether it is reasonable to assume that people will use pensions to insure themselves against low income in old age and longevity risks. It may well also be rational to turn to other forms of long-term saving and insurance, such as families, bank deposits, annuities from property, etc.

The third issue is whether the goal of making people feel well-informed on pension issues is reasonable. In any case, frequent changes in regulation are likely to create so much uncertainty that anyone who thinks he/she is well-informed on pension issues may well be mistaken.

To some extent, short-sightedness, inertia and ignorance may in fact appear as rational choices even to those relatively well-informed and financially literate people. It is therefore probably a mistake to try to establish the level of 'consumer sovereignty' exhibited in markets for less complex and uncertain goods.

Reaching target groups. Experience of how best to reach certain target groups differs across countries. Different social groups may need different types of information. To some extent, even those groups who are not affected

by one type of information should be informed in order to prevent confusion. This may, for example, be the case for women and men, but also for different income and occupational groups.

As a general rule, because people are unlikely to make much of an effort to obtain information, campaigns should focus on those communication methods people tend to trust and use anyway. Local culture, however, needs to must be taken into account. For example, call centres may be a success in one country but remain relatively unused in another. It is also important to note that trust does not always coincide with actual use. People may say that they trust information provided by public agencies most of all but, at the same time, actually rely, for example, on information transmitted by tied agents of pension funds.

The media, marketing activity and personal recommendations can all strongly influence investment decisions and it may be possible to use them more effectively to communicate risk issues. However, the British experience suggests that these channels can also easily create product misperceptions.

Information sources that are generally used in all countries include paper format (brochures, leaflets, etc) as well as cooperation with national TV and radio programmes. The Internet is also growing in importance (e.g. placing a pension calculator on the website of the government agency).But access to the Internet differs greatly in different countries, and it tends to be an adequate channel only for younger and/or sophisticated groups. For less sophisticated groups, the UK government in particular prefers face-to-face interaction.

More generally, UK policies are based on two approaches: (i) learning, and (ii) personal help in understanding information and reaching better decisions.

Education. Several Member States consider early education as important for financial learning. In Portugal, for example, two programmes designed for children — "From Mathematics to Financial Literacy", a successful scheme run by financial service providers, and "Financial education for youth: learning the basics", a game-style programme designed especially for children aged

11–13 — have been set up. Moreover, an ombudsman function with advisory tasks has been created to assist participants and beneficiaries of individual pension schemes.

From the different schemes, it emerged that while general financial education — preferably at secondary school — can play a major role in enabling people to engage in long-term planning, pension-specific education seems more appropriate around the time actual pension choices need to be made (i.e. when working careers start).

Paradoxically however, a successful information policy may make people feel less informed as they begin to understand the complexity and uncertainty of pensions. Nevertheless, this is only to be expected and it is certainly not desirable to make people believe, for example, that an official projection of their future monthly pension is all they should consider.

Evaluations. The impact of pension-related information should be evaluated regularly to check whether it helps people make the right choices. In the UK, for example, the government is sceptical as to the benefits of policy which consists only of providing information because of to the failure of many people to comprehend the information provided. This leads to many other policy measures besides simply providing information, including the pre-testing of publications. Customer information leaflets are comprehensively reviewed and rationalised before publication, with each leaflet undergoing rigorous customer testing to ensure the quality of the information provided meets with required standards.

Information policy concerning pension system changes

The main issues relating to state pension schemes — especially the questions of ageing and sustainability of the current pension system — are widely communicated in all countries.

Information campaigns by public authorities appear to have been successful in many countries in terms of alerting people to the choices they can make and the responsibilities they need to take on. In particular, campaigns can help to focus people's attention on the most important information. The Swedish

example (discussed in more detail below) is particularly enlightening, with the government effectively creating a brand for public information on pensions: the so-called 'orange envelope'.

But public campaigns seem much less suitable when it comes to providing people with information that they can use for making choices. One exception nevertheless relates to informing and educating opinion leaders (e.g. journalists), as this can enable them to later provide others with independent information and advice.

Information content. Generally, campaigns place a lot of emphasis on the investment risks associated with non-governmental funded schemes. However, people need to be made aware that pensions imply several other types of risks. Firstly, PAYG systems are characterised by demographic and political (budgetary) risks that are comparable to the investment risk in funded schemes. Secondly, longevity risks, as well as risks that can result from changes in people working profiles and from changes in the purchasing power of pension payouts also need to be taken into account. Thirdly, risks associated with forms of payout are often neglected. This is likely to become a serious policy problem in Central and Eastern Europe as contributors to funded schemes approach retirement age. People notably need more information about the relative merits of lump-sum payments and various types of scheduled withdrawal.

Information policy pertaining to pension rights

Most countries provide people with a tool that helps them to calculate the expected amount of their future pension. In Slovakia and Lithuania, for example, there is a pension calculator on the Internet (on the official website of the agency responsible for insurance regulation). In Lithuania, people can choose parameters (age, wage, gender, investment return, etc) and compare the predicted values of their future pension under funded schemes and the state social insurance system. In Portugal, people actually have access to the official website of the Social Security agency, by means of a password, so that they can view all the information on their career contributions and simulate the value of their pension.

In the UK, a number of specific forecasting tools have been created to provide information to people on State pension forecasts. Individual Pension Forecasts (IPF) are detailed and personalised forecasts that are provided "on demand", enabling the inclusion of information on how future changes in individual circumstances will impact on future State pension provision. Web-based forecasting services (so-called Real Time Pension Forecasts (RTPF) and voluntary services (Combined Pension Forecasts (CPF)) are also products designed to prompt people to consider their pension provision and review their plans if necessary.

In Sweden, the information needs that arose following the government's decision to switch to a defined contribution scheme were taken particularly seriously. The government created the so-called 'orange envelope', which is now mailed to people annually within a five-week period over February and March and which contains information on contributions over the past year — both to the PAYG and to the funded scheme. The envelope's design makes it easily recognisable from all the regular marketing mail. This has also helped it to attract special attention from the media, so that the orange envelope has basically become a trademark for the new pension system. Annual surveys show that 50% of recipients read at least part of the envelope and 70% say they trust it most among information sources. Interestingly, however, the percentage of people who feel well-informed (around 40%) is declining, though this figure relates to self-assessed knowledge so it could simply reflect the fact that people grow more self-critical as their knowledge increases. Another information tool is in the form of the '60-years' meetings', to which local pension offices invite all those reaching 60 for an information session. About 30% turn up.

Overall, experience in peer countries suggests that public provision of information should pay particular attention to the comparability of pension systems (e.g. PAYG versus funded schemes) as well as of different funds. People should certainly be provided with calculations of their future pension payoffs although such policy is not without dangers. This is, first, because people often find the calculations incomprehensible and, secondly, because payoffs are inherently very uncertain. If people do not realise this, they may rely too much on the estimates and make wrong decisions. One

possible conclusion from this is that public authorities should strive to make people understand that all estimates should be taken 'with a pinch of salt'. Alternatively, a few scenarios (pessimistic, average and optimistic) can be presented. However, doubts have also been raised as to whether governments should really emphasise the uncertainty of pension provision and information as, clearly, most people expect governments to have a duty of ensuring secure pensions.

Information policy on pension choices

The need for a unified picture. Individuals can only make sound choices about their pensions if they have a unified picture of the various elements of their pension. Public authorities should coordinate their activities and standardise information provided by pension funds in order to provide such a unified picture.

Public provision of information. In all countries, the performance of pension funds is heavily controlled by government agencies. These agencies also tend to issue a great deal of information on their websites. In some cases (e.g. Hungary), there may be too much information and much of it not really understandable by most people. But public agencies can also offer highly useful services such as tools for calculating future benefits in funded schemes. For example, in Lithuania, users can put their age, earnings and the assumed profitability of the relevant pension fund into a calculator on the internet and will receive an answer on that basis. Nevertheless, there is a clear danger that the user will ignore certain risks associated with the fund chosen.

There seems to be general agreement that too little emphasis is placed on information regarding the payout phase of pensions and about the effects that changes in a person's working profile can have on entitlements. The problem seems particularly severe in countries where the payout phase is not yet properly regulated — notably in Central Europe, where the payout phase has typically not even begun yet. There, legislation focuses almost exclusively on the accumulation of pensions. For example, in Lithuania the law does not set a time requirement for the beginning of the pay-out phase.

Information provided by funds. In all countries, funds are obliged to send annual personal reports to all clients regarding the pension they have accumulated. These must include information on the amount of contributions transferred to the account, charges levied, total funds accumulated on the account, etc. Information disclosure is also regulated in the contracting phase of the relationship and, in several countries, the pension fund also has to inform the client about risks and options.

But, because the perception of risk in general depends to a large extent on the way risk options are presented, policy should pay special attention to the way choice options are framed (e.g. how the riskiness of fund portfolios are advertised). A number of participants in the Peer Review meeting expressed their fears as regards unrestricted advertising by pension funds.

Some countries (e.g. Poland and Slovakia) have chosen to regulate the way that pension management companies advertise. Advertisements must contain warnings that the conclusion of an agreement with the pension management company bears risks and that the current or promoted yield of the pension fund portfolio is no guarantee of its future yield. However, it is also important to note that the prohibition of (certain forms of) advertising is likely to reduce the amount of information available to people and to limit — rather than enhance — consumer sovereignty. More importantly, such policies will probably not work anyway because private funds will find ways of circumventing the prohibitions. For example, governments will never be able to (and should probably not) supervise discussions between tied agents and prospective clients.

In any case, many of the problems of misleading advertising can be mitigated merely by standardising operational fees and calculations for published rates of return. Standardisation may also help ensure that comparative information is not misleading, although policymakers are often unwilling to allow comparative advertising.

Information from third parties. Public authorities and private pension funds should not be alone in informing people and assisting their choices. Indeed, governments may find it difficult to combine 'advertising' their pension policy to the electorate while informing them objectively at the same time. In this

context, consumer groups, sectoral organisations and the social partners may prove credible sources of information.

Employers can act as useful intermediaries between individual contributors and pension funds but they must be subject to some form of fiduciary liability for the pension choices they make on their employees' behalf. Otherwise, they may not have sufficient incentive to act in their best interests.

In most countries, independent agents seem to have a lesser role than economic theory would suggest. Nevertheless, some regulation of fees may be needed to ensure their advice is truly unbiased.

Rating companies can be particularly useful sources of information and advice. They can also play a vital role in ensuring that the reputation of pension funds corresponds to the true quality of their products, as highlighted by the German experience.

D. Conclusions

While pension reforms aim to make pension systems more sustainable by handing over more responsibility to beneficiaries and providing them with financial incentives to work longer, people are unlikely to respond in a rational manner if they lack information on the changes or fail to understand the information they do have.

A key problem is that the reforms introduced in many European countries tend to make schemes increasingly complicated and difficult to understand, meaning that public information on pensions and pension rights becomes very important. Also, as the range of pension schemes available grows, people need more information on their choices and assistance in selecting the options that best meet their needs. The challenge here is to inform people in relatively simple and unbiased terms.

From the review, it emerged that government responsibility in providing information is threefold: alerting people to choices and responsibilities; informing them about the choices on offer; and advising them on new policies. However, these roles may conflict, leading to a potential loss of credibility. Accordingly, to ensure the provision of politically unbiased information, government should not be the only source of information on pensions. Third-party information sources can include NGOs, consumer groups, sectoral organisations and the social partners, including employers with fiduciary liability for their employees' pension choices. Pension rating companies also appear to be very successful in some countries, but, as regards independent advisers, some regulation of fees may be necessary to ensure truly unbiased advice. The government should also seek to assist market mechanisms that facilitate consumer choice, such as market concentration, corporate reputation and informative advertising.

There are no general best practice recommendations regarding the media used to reach people with information on pensions, other than that campaigns and information provision should focus on those communication methods that people tend to trust and use anyway. For example, the Polish experience suggests that information and awareness-raising campaigns

should first and foremost focus on opinion leaders, who can subsequently provide independent information and advice to others.

In terms of information content, pension pay-out projections emerged as an important item, while the relative risks linked to different kinds of pension schemes and funds also need to be made clear. Indeed, while state pay-as-you-go (PAYG) systems may, for example, appear less risky than investment-based schemes at a first glance, they can also involve demographic and political uncertainty. Consumers, in addition, have to take other risk factors into account as well, such as unpredictable longevity, fluctuations in purchasing power and changes in working profile, if they are to make sound choices. The type of pay-out may also influence risk and people therefore need more information about the relative merits of lump-sum payments and various types of scheduled withdrawal.

The problem is that the complex financial nature of pensions often prevents people from actually understanding the information they have in their possession. This kind of financial illiteracy needs to be tackled but, in fact, high levels of regulatory uncertainty may reduce the incentive of people' to improve their 'pension literacy' even further. Moreover, the myopia or short-sightedness syndrome suggests that even knowledge and understanding may not guarantee that people make financially rational choices.

Nevertheless, what is clear is that, to make rational decisions, people need a unified picture of their pension options. Public authorities should therefore coordinate their activities and standardise information provided by pension funds.

Finally, different groups may need different types of information. This may be the case for women and men as well as for those with different economic, occupational and educational backgrounds.

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Public information on pension systems and pension system changes

Host country: **Poland**

Peer countries: **Finland, Ireland, Norway, Slovenia, Spain, United Kingdom**

Pension reforms have taken place in most Member States and have often become a continuous process. In this context, it is becoming increasingly difficult for the people concerned to understand how the changes introduced affect them and how they should respond. Moreover, for Member States where funded pensions are expected to have a growing role, more attention in public policies should be devoted to financial literacy. There is widespread recognition in Member States that the level of financial literacy among the general public is inadequate for people to be able to choose intelligently between the various options open to them.

Given the often complex nature of pension regulations, experience suggests that the provision of information per se is not enough for ordinary people to be able to understand the consequences for them of making different retirement choices. This is especially the case in a situation where private pensions are spreading, often encouraged by government to relieve financial pressure on public schemes. Accordingly, there is a greater element of individual choice than used to be the case.

The Peer Review is designed for Member States to exchange experience on how to ensure that people generally have enough information in a sufficiently clear form to enable them to make informed choices about their personal pension arrangements.