Optimal Illiquidity in the Retirement Savings System

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Key Findings and Policy Implications

This paper calculates the socially optimal level of illiquidity in a retirement savings system. It analyzes the trade-offs between commitment and flexibility, and assumes that people have access to two types of retirement accounts: a perfectly liquid account and an illiquid account with an early withdrawal penalty. The paper finds that:

- If people have the same present-biased preferences, the socially optimal retirement savings account should have a penalty that roughly offsets the present bias. That is, the penalty should be larger if there is a stronger present bias, indicating the potential for self-control problems.

- If people have varying preferences, however, and varying short-run discount rates, then the optimal policy design disproportionately addresses the needs of those with a stronger present bias. In an illustrative calibration for example, the optimal system is characterized by a retirement account that is essentially perfectly illiquid. In other words, our analysis with varying preferences suggests that savings should be divided between two accounts: one account that is completely liquid and one that is completely illiquid (like a defined benefit pension plan).

Retirement policies can be designed with more or less flexibility to withdraw funds, and more or less pre-commitment to save them. The findings are important in evaluating these policy alternatives, and particularly in demonstrating the potential costs of flexibility to people with a strong present bias. For example, if these theoretical results prove to be robust, it might be beneficial to create a new type of completely illiquid (defined contribution) savings account that is used in parallel with the existing low-or-no-penalty retirement savings account. On the other hand, Social Security might already provide a socially optimal level of such completely illiquid savings. More work is needed to quantitatively evaluate the adequacy of highly illiquid savings in the current U.S. retirement savings system.

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