Optimal Illiquidity

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<u>Key Findings and Policy Implications</u>

This paper develops the underlying theory for designing a socially optimal level of illiquidity in a retirement savings system. The paper finds that:

- The optimal retirement saving system is well-approximated with just two accounts, one that is completely liquid before retirement, and the other that is completely illiquid before retirement. Little welfare gain is obtained by moving beyond this simple two-account system.

- If a third account is added to the system, its optimized early-withdrawal penalty is between 6% and 13%. In equilibrium, the leakage rate from this (partially illiquid) third account ranges from 65% to 90%.

- These properties have analogs in the retirement savings systems in the US. The US has fully liquid accounts (i.e., a standard checking account), fully illiquid accounts (i.e., Social Security), and a partially illiquid defined contribution system with a 10% penalty for early withdrawals. This partially illiquid DC system has a leakage rate of 40%.

Private saving is an important complement to Social Security in providing for financial wellbeing in retirement. Social Security is essentially illiquid, as people's Social Security entitlements cannot be withdrawn prior to benefit eligibility at age 62. But what liquidity restrictions should be made on the deposits that people make to private retirement accounts? There are benefits to flexibility, allowing people to pay for unexpected pre-retirement expenses that may arise over time. But there are also benefits to restricting withdrawals to avoid the temptations of over-consuming too early. This paper develops the theoretical tools for evaluating these trade-offs.

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