



Countercyclical retirement accounts



David A. Love¹

Williams College, Williamstown, MA 01267, United States

ARTICLE INFO

Article history:

Received 20 August 2016

Accepted 13 June 2017

Available online 20 June 2017

JEL Classification:

G11

G22

D91

E21

Keywords:

Fiscal policy

Retirement accounts

Precautionary saving

ABSTRACT

This paper examines an unconventional, but potentially effective, new fiscal policy tool that can increase saving during good times and increase spending during bad times—a cyclical matching rate on contributions to retirement savings accounts. The combination of matching rates and matching limits on retirement savings plans creates sharp kinks in intertemporal budget sets that induce many households to save exactly at the matching limit, even when economic conditions might call for a fiscal policy to encourage spending, rather than saving. What if the matching rate instead disappeared during bad aggregate states? I model an economy with liquid and illiquid savings accounts in which matching is suspended during downturns. The economy features the usual sources of heterogeneity in education and earnings processes, and it allows for time-inconsistent preferences and heterogeneity in the discount rate. Although the theoretical effects of a countercyclical match are ambiguous due to income and substitution effects operating in different directions, the simulations of the model indicate that the policy delivers a large average increase in consumption from a set of households that look like the “wealthy hand to mouth” of Kaplan et al. (2014). And crucially, in contrast to conventional fiscal policy, the stimulus associated with countercyclical retirement actually improves the government’s financing.

© 2017 Elsevier B.V. All rights reserved.

1. Introduction

This is an unconventional paper about an unconventional form of fiscal policy. The paper is unorthodox in that it examines the impact of an automatic fiscal policy that has been neither proposed nor implemented anywhere in the world: a federal countercyclical retirement savings program that matches contributions only in non-recessionary periods. The fiscal policy, in turn, is unusual in that it has the potential to stimulate an economy during downturns while improving, rather than impairing, the government’s finances. It would also be consistent with a policy goal of increasing personal saving in the aggregate, as well as across a broader distribution of households. Despite the inchoate nature of the policy, its aggregate implications seem sufficiently interesting to warrant further investigation. If interest rates remain at their current low levels when advanced economies hit the next large crisis, policymakers are again likely to consider a fiscal stimulus, only this time with less fiscal space than before, due in part to the costs of previous interventions. It would be worth knowing whether a fiscal stimulus can be had without the costs of higher future taxes, reduced investment, and increased sovereign debt risk.

What would such a policy look like? In practice, it would mean introducing a government matching contribution to a savings vehicle similar the U.S.’s Individual Retirement Account (IRA). One could retain or alter different components of the

E-mail addresses: david.love@williams.edu, dlove@williams.edu

¹ I am grateful for the constructive comments of two anonymous referees and the editor.

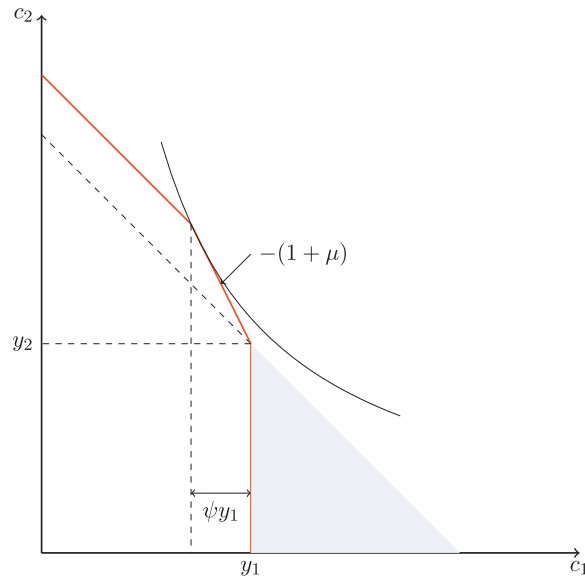


Fig. 1. Retirement account with matching.

IRA, such as the tax-preferred treatment of contributions and returns inside the plan,² but these would be inessential decisions from the perspective of the fiscal policy, which would entail offering a matching rate on contributions that would apply only during good aggregate states of the world. The logic of a cyclical matching rate is straightforward. The combination of a generous matching rate and a matching limit creates incentives that induce savers to bunch at exactly the matching limit during good times. Under typical employer-based defined contribution plans, this bunching at the kink can cause households to withhold consumption spending, even during bad aggregate states, when policymakers may want to encourage additional stimulus spending. What if the matching rate were instead reduced to zero when the economy fell sufficiently far below potential output?

Theoretically, the impact of such a policy on saving is ambiguous due to competing income and substitution effects. Consider, for example, how such a scheme might work in a standard two-period model of consumption and saving. To focus on the impact of the cyclical match, let us assume that the real interest rate is zero, there is no initial wealth, there are no taxes, and preferences are logarithmic with a discount rate of zero (so that the individual prefers equal consumption bundles). Fig. 1 shows how the matching scheme would affect decisions in the case where incomes are the same in each time period. As expected, the combination of a match rate of μ and a matching limit of ψ generates a strong kink in the budget constraint, making it attractive for the individual to consume less in the first period, despite the fact that incomes in the two periods are the same. What happens when the match disappears? As shown in Fig. 2, the disappearance of the matching rate would cause an immediate increase in consumption to the point where the liquidity constraint binds. Thus, for individuals who respond to the matching rate by saving more than they would otherwise, it seems clear that the countercyclical match would lead to increased consumption during recessionary times. But what about for people saving more than the matching limit, perhaps because their current income is high relative to their future income? In this case, the savers would experience only the income effect of the lost match, and consumption would unambiguously fall, as depicted in Fig. 3. Since the aggregate response to the program would be composed of the responses of both types of savers, the overall impact of the fiscal policy is ambiguous.

In a more realistic setting, which effect wins out—the substitution effect causing individuals at the kink to increase consumption or the income effect causing high savers to reduce consumption—depends on a combination of preferences, income processes, matching rates and limits, as well as heterogeneity across households. Showing how these real-world drivers of saving behavior affect the aggregate consumption response to the fiscal policy constitutes the main contribution of this paper. The modeling environment builds on the life-cycle framework of heterogeneous impatience in Carroll et al. (2015) by introducing three key features: a (partially) illiquid retirement account, as in Laibson et al. (1998) and Gomes et al. (2009), Epstein–Zin preferences (Epstein and Zin, 1989), and the possibility of quasi-hyperbolic discounting in the spirit of Laibson (1997) and Laibson et al. (1998), but modified for the case of Epstein–Zin preferences (Love and Phelan, 2015). The heterogeneous preference framework is important in this case, since the aggregate response to the fiscal policy likely depends on the distribution of households around the relevant kinks in the budget constraints. The inclusion of hyperbolic

² Gale et al. (2012) proposed a similar set of modifications to the 401(k) program, with the centerpiece being a federal matching contribution in the form of a flat refundable tax credit. In this proposal, the matching contribution would replace the current tax-favored treatment of contributions, but it is easy to imagine a match that is even more generous, but subject to a limit.

Download English Version:

<https://daneshyari.com/en/article/5066271>

Download Persian Version:

<https://daneshyari.com/article/5066271>

[Daneshyari.com](https://daneshyari.com)