Discussion of “Household Saving Behavior and Social Security Privatization” by Alisdair McKay

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The views expressed herein are those of the author and not necessarily those of the Federal Reserve Bank of Minneapolis or the Federal Reserve System.
This paper asks two questions

**Question 1:**
Why do households make imperfect financial decisions?
Example: some households buy high-expense index funds when seemingly identical but less-expensive funds are available. Idea: searching for best returns requires effort; distribution of returns in equilibrium (Burdett-Judd).

**Question 2:**
What is the welfare effect of privatizing Social Security?
Use calibrated model to calculate welfare before/after reform. Imperfect financial decisions reduce welfare after privatization.
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- And a big-picture comment on methodology.
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- Many potential applications to development economics.
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Many potential applications to development economics.

But are we persuaded that “search for low-cost intermediary” is best way to model imperfect decisions?
Mechanics of the model

- Finite-lived household faces a standard life-cycle problem:
  - Choose consumption, savings, work hours to maximize utility.
  - Need savings to cope with fluctuating wage and to finance retirement.

One catch: Return on savings depends on which intermediary the household saves with.

Intermediaries offer various fees (and pay a known aggregate return minus the fee).

Households spend time searching for offers.

More search time $\Rightarrow$ better chance of finding a good offer.

Result 1: distribution of offers is not degenerate in equilibrium.

Result 2: all else equal, households with more to invest will search more, get better returns $\Rightarrow$ adds skewness to the wealth distribution.
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Calibration

- Some fairly standard choices:
  - A period is 5 years.
  - Survival probabilities from life tables.
  - Labor productivity: AR(1).
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- Search efficiency: Calibrate $\Pr(j \text{ offers} | \text{time searching} = s)$ so that model equilibrium matches two moments from data:
  - Average time spent on “household financial management” and “banking and using financial services” (3 minutes/day).
  - Median fee on S&P 500 index funds (64 basis points/year).
Checking the calibration

- Compare model to data on:
  - Time spent managing finances over the life cycle.
  - Asset market participation over the life cycle.
  - Net worth over the life cycle.
  - Wealth distribution.
  - Distribution of intermediaries’ fees (counting households equally, and weighting by assets).
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- But is matching these moments enough to persuade us that “search for a low-cost intermediary” is the right way to model imperfect decisions?
Where I’m not convinced

- Time for “household financial management” and “banking and using financial services” is not mainly time looking for good returns.
  - Balancing checkbook, paying bills, getting $ from ATM.
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  - Choi/Laibson/Madrian (RFS 2010): investors inappropriately weight past returns.
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- Model is set up so it costs only 64 basis points (on average) to make rather lazy decisions (take the first offer).
  - Behavioral biases could be much more costly than that (e.g., investing mainly in employer stock).
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- De-emphasize index fund fees, look at other aspects of financial decisions.
Applying the model to Social Security privatization

Clean analysis, but the model is very stripped down. No aggregate shocks ⇒ no scope for intergenerational risk sharing. Geometric discounting ⇒ no need for forced savings. No contingent financial markets ⇒ Social Security is a very important source of insurance.

Model also rules out many aspects of imperfect decisions. Need a richer model to understand how important imperfect decisions are relative to other factors.
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- Policy experiment: What happens after an actual privatization?
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- How confident would we be in the results?
  - What if there are other reasons for suboptimal choices?
  - What does it mean to lower search costs?
My bottom line

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- The case for macro methods is stronger when GE effects are more important.
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