Discussion of Financially Fragile Households: Evidence and Implications
Paper by Lusardi, Schneider and Tufano

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Expense shocks happen. Lusardi, Schneider and Tufano study the ability of individuals to cope with such a shock, relating the results to the fragility of preparation. Vulnerability to shocks is a topic that development economists have long considered, but this paper is the first to make us (shockingly) aware that half of Americans (and many Europeans) may be unable to cope with a moderate expense shock of $2000. That innovation is sufficient to make this a great paper to read and remember.

I structure this discussion into two main parts. First, I offer thoughts on coping by re-classifying the survey responses of coping mechanisms in a slightly different clustering. In the process, hopefully I can bring to light some unanswered questions to which this paper opens the door. Second, I discuss the empirical specification beyond the tabulations of coping mechanism and suggest some alternatives.

Coping Tabulation

Beyond the finding that half of Americans cannot cope, the great innovation in the paper is in tabulating the way individuals cope, so let me begin with that tabulation. The most important coping methods found in the authors' survey are, in decreasing order of frequency cited: drawing from savings, borrowing from family, using credit cards, working more, and selling possessions. The second order mechanisms are liquidating retirement assets, pawning, borrowing from friends and taking out an unsecured loan. I would like to interpret these items using a slightly different classification scheme and discuss methods of coping in these buckets. My types of coping buckets would be (i) drawing savings, (ii) rebalancing, (iii) earning, (iv) bridge borrowing, and (v) leveraging assets.

First, what is savings? Savings is otherwise inefficiently invested wealth that provides liquidity. Savings is about consumption insurance. The authors begin their motivation citing theories such as Deaton (1992) and Carroll (1997) that risk-averse individuals will accumulate wealth to shield themselves against uninsurable risks. What are the relevant empirical findings from this literature? Precautionary savings behavior is observable in practice (Carroll and Samwick; 1998), but insufficiently so. The same is true using the consumption insurance frame. For example, Cochrane (1991)[1] documents failures of the consumption insurance hypothesis by looking at shocks of long-term illnesses and involuntary job losses. But the insurance measured is insurance against permanent shocks, and the shock queried by Lusardi, Schneider and Tufano is a transitory one. Cochrane (1991) is unable to reject insurance for temporary job interruptions. Likewise, Blundell, Pistaferri and Preston (2008) find a fair degree of consumption insurance to transitory shocks (less so to permanent shocks), except among the poor, who do not insure much at all.

How does Lusardi, Schneider and Tufano fit into this picture? Their survey captures fragility to a transitory expense shock. One might expect that the respondents' answers about savings would line up with Blundell, Pistaferri and Preston's (2008) distribution of who is insured to transitory income shocks. Instead, the authors find that Americans divide themselves almost equally into quarters in being very able, probably able, probably unable and definitely

[1] Attanasio and Davis (1996) also document a failure of consumption insurance by looking at shifts in cohort wage structures.

unable to come up with $2,000 within the next month. In other words, many more are unable to cope with a shock that would have been expected.

I would have liked to see the authors try to reconcile their finding to the macro literature, perhaps constructing proxies for fragility in the Survey of Consumer Finances over time. My instinct is that the short term nature of the respondents being able to come up with the cash “within the next month” matters. (When, by the way, in the month did the survey ask them and what date?) Or, perhaps there may be something special about the time period surveyed to why consumption insurance is so drastically rejected in the authors’ findings. Or maybe the difference is about coping to an expense shock versus an income shock, since short term safety nets exist for the latter. The authors could do much more to shed some light on this reconciliation. In addition, as I discuss later, I would have liked savings treated as a special category from the other coping mechanisms in an analysis of why precautionary savings levels cannot cover a $2000 shock.

The second bucket of coping mechanisms I would use is that of rebalancing. I would map pawning, the selling of things or one’s home, and also the liquidation of investments and retirement assets into a rebalancing bucket. If one adds up all of these items from Table 3, 22 percent of coping items (or 30 percent of non-savings coping items) cited are rebalancing. I was surprised by how large this is. Rebalancing retirement accounts is expensive because of penalties. Rebalancing home wealth is more important for large permanent shocks. Shore and Sinai (2010) find that when small shocks occur, consumption adjusts, but when large shocks occur, rebalancing occurs in housing consumption. That begs the question of what things people sell. Cars? Televisions and furniture? Depreciation on these items is extremely high immediately walking out of the showroom. I think this is an interesting finding of the paper, but leaves me wanting to know more.

The third bucket of coping is earning. Earning represents 12 percent of boxes checked, or 17 percent of non-savings boxes. Again, I would argue that this is hard to do in short term for a transitory shock. It begs the question of who has flexibility in wage potential. Not many can just increase the number of hours worked at the current job or find a short term supplemental income. Surely this margin is only available to certain professions. Maybe the authors could have offered some perspectives here from the labor literature.

In one sense, earning and rebalancing are related. Reading Lusardi, Schneider and Tufano gave me a new intuition that a quick transitory shock has the potential to disrupt household balance sheets in a different way from permanent job losses and the like. In particular, people may not be willing or able to undertake rebalancing or increasing income, and thus debt troubles could results from such frictions.

The fourth bucket is what I call bridge borrowing from family, friends or expensive loans. The authors may disagree with this classification of family and friends with expensive loans, but these are the stop-gap measures before worse outcomes occur, and by far the most important stop-gap is the family. I put bridge borrowing as the fourth bucket not because it carries little weight (it is second behind savings at 25 percent of items checked, or 35 percent of non-savings items checked), but because I wanted first to emphasize how costly the other non-savings buckets are for temporary shocks. Bridge borrowing is essential in a society where assets have sigmoidal depreciation, where rebalancing involves penalties, and where hours worked is often not a short term decision variable. It is also essential in situations in which individuals have no assets to rebalance. The authors are correct to point out that borrowing from family is under-considered in its societal role.

The fifth and final bucket is what I think of as leveraging assets. Two response categories fit into this bucket, home equity loans (or second mortgages) and credit cards. The household finance literature does not really do justice to the possibility that credit cards offer a leverage benefit to wealth; i.e., being able to tradeoff holding liquid savings with having credit card slack. We do know that people do value slack in credit cards (Agarwal, Skiba and Tobacman, 2010; Stango and Zinman, 2009). It is not hard to imagine a framework in which because shocks occur with only some probability, one might optimally use credit card slack, even with expensive interest rates, as precautionary savings. The quantity of slack might be considered a leveraging off assets, in the sense that the information credit cards us to calculate credit limits (income and outstanding debt) can easily be transformed into implied wealth. My point in reclassifying what the authors call mainstream finance into a leveraging of assets is that little has been written on the role of financial institutions in smoothing uninsured shocks, particularly if slack is considered an ex ante mechanism.[2]

At this point, I think it is worth drawing attention to the authors' data on European use of coping mechanisms. It would have been nice if the authors had used the differential frictions or policies across countries to identify how individuals make tradeoffs in planning for shocks and in reacting to them. I would like to know what it is about different income generation, savings,

[2] A few exceptions do exist. Krueger and Perri (2006) posit and offer evidence that financial markets have evolved to provide insurance where precautionary savings is incomplete. Athreya, Tam and Young (2009) contend that because income risk worsens credit prospects, those that need consumption insurance the most (the unlucky) are unable to access credit. Iacoviello (2008) shows that the standard deviation of income and the percent of debt scaled by disposable income move together at long frequencies and that income growth and debt growth move together well at annual frequencies.

borrowing or spending processes that feed into fragility and coping. Labor and pensions are perhaps obvious examples. In European countries where labor markets are less flexible, do we see less preparedness fragility? In countries where pensions are provided by the government such that the building of assets for retirement is less important, are the bridge mechanisms more important? Or is it that savings liquidity matters more since people cannot rebalance assets/ This paragraph is just intended to be provocative in suggesting that there is more work to be done at this micro-level, particularly if coping mechanisms and social safety net policies might want to be explored.

Analysis of Coping

The other points I would like to make concern the analysis in the paper. The abstract of the paper organizes the flow beautifully as follows: tabulate degree of self-reported ability to cope, tabulate the mechanisms of coping, and then understand what coping mechanism people use beyond savings by types of people. I think the paper could have added some additional analysis (or substituted) to speak more precisely to how people cope with shocks beyond savings.

The paper estimates probits for each of the coping types (saving, family/friends, mainstream credit, alternative credit, sell things, and work more) as a function of the rich set of demographics (income, wealth, change in wealth, education, age, gender, race, marital status, household structure and region). The paper then relates coping to the corporate finance “pecking order” concept of raising finance; i.e., savings comes first (cheapest form of finance), followed by family borrowing. I think this rationalizing the results with the pecking order is interesting, but I think it comes at the expense of more take-aways. I would have preferred that the authors provide an upfront frame of categorizing people into income categories (upper, middle, and lower classes) and provide evidence about coping for each. As it is the generalizations made in the introduction about the middle class being unable to cope are hard to get a handle on from the results.

The other analysis I found missing is a way to tie who is unable to cope in demographics to how they cope. (What really is not coping?) As a start, I would have liked to know the distribution of coping mechanisms once savings is removed, and then to understand the role of the coping mechanism when people say that they struggle coping. By showing the mechanisms use under different abilities to cope and then by relating these demographics to the mechanism, we would have better understood fragility.

To summarize, I learned two really important facts from Lusardi, Schneider and Tufano: that half of Americans are not positioned to cope with a quick expense shock of $2000 and that a coping mechanism tabulation includes many expected and unexpected mechanisms (credit cards, selling possessions, borrowing from family, earning more) and some missing ones (rebalancing everything else including home equity). My only strong wish-list for the paper is that it had re-focused its set of analyses on understanding the importance of different mechanisms for the lower class and the middle class, and how the extent to coping relies on mechanisms available. These authors are certainly well poised, not only in this work but also from their cumulative portfolios of work, to educate the reader a bit more about fragility.

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