Insurance versus Moral Hazard in Income-Contingent Student Loan Repayment

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MIT Sloan

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Government-Financed Higher Education

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This Paper: Insurance vs. Moral Hazard

This Paper

Conditional on borrowing, how does income-contingent repayment affect **labor supply** and welfare?

1. **Setting**: Australia's Higher Education Loan Program
   - **Variation**: discontinuities in repayment rates + policy change to these rates
   - **Identification**: limited room for selection and ex-ante responses
2. **Research design**: bunching at discontinuities before and after policy change
   - **Data**: universe of income tax returns + student debt balances

This Paper

Conditional on borrowing, how does income-contingent repayment affect labor supply and **welfare**?

1. Setting: Australia's Higher Education Loan Program
2. Research design: bunching at discontinuities before and after policy change
3. **Model**: life cycle model with endogenous labor supply + uninsurable wage risk
   - **Positive**: translate responses into preference parameters
   - **Normative**: characterize optimal amount of income-contingent repayment

Main Results

1. **Empirics**: borrowers adjust labor supply to $\downarrow$ income-contingent repayments
   - Larger responses in occupations with more hourly flexibility
   - Responses increase with liquidity constraints and decrease with **P**(repayment)

2. **Structural estimation**: labor supply elasticity of **0.11** $+$ adjustment frictions

3. **Contract design**: providing insurance with income-contingent loans $\Rightarrow \uparrow$ welfare
   - Moral hazard significantly reduces optimal amount of insurance
   - Fixed repayment $\rightarrow$ optimal income-contingent loan $\Rightarrow \uparrow$ **1.3%** lifetime consumption
   - Forbearance $+$ fixed repayment does worse because of slower repayment

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Takeaway: Income-contingent repayment creates moral hazard that affects contract design, but too small to justify fixed repayment

Related Literature & Contributions

1. Theories of human capital financing Lochner-Monge-Naranjo 2016, Stantcheva 2017

2. Empirical effects of student loans
   - $\uparrow$ Debt $\Rightarrow$ $\uparrow$ delinquencies, $\downarrow$ mobility, $\downarrow$ income Di Maggio et al. 2021, $\downarrow$ homeownership Mezza et al. 2020, Δ occupation Luo-Mongey 2019, Δ major Hampole 2022
   - Income-contingent loans $\Rightarrow$ $\downarrow$ delinquencies Herbst 2023, $\downarrow$ defaults Mueller-Yannelis 2019

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Contributions:

1. Empirical evidence of moral hazard from income-contingent repayment
   Britton-Gruber 2020, Herbst et al. 2023
2. Dynamic model of labor supply that replicates these responses
3. Quantification of how moral hazard affects optimal contract design

Related Literature & Contributions

3. Insurance vs. moral hazard in social insurance: UI Gruber 1997, Chetty 2008, Ganong-Noel 2019, HH bankruptcy Dobbie-Song 2015, Indarte 2023, health insurance Einav et al. 2015
4. State-contingent securities for households Shiller 2004, Caplin et al. 2007, Mian-Sufi 2014, Hartman-Glaser-Hébert 2020, Greenwald et al. 2021, Campbell et al. 2021, Benetton et al. 2022
5. Bunching at discontinuities in tax rates Saez 2010, Chetty et al. 2011, Kleven-Waseem 2013
6. Determinants of labor supply Blundell-MaCurdy 1999, Keane 2011, Chetty 2012, ...

Outline

1. Institutional Background and Data
2. Labor Supply Responses to Income-Contingent Repayment
3. Life Cycle Model with Endogenous Labor Supply
4. Welfare and Fiscal Impacts of Income-Contingent Repayment
5. Conclusion

Outline

Student Loans in Australia: HELP

- Australian citizens eligible for government-provided student loans through **HELP**
- **Initial debt** = tuition – upfront payment – govt. contribution (average $\approx$ \$20K USD)
- Debt grows at CPI net of **income-contingent repayments**:

$$\text{Repayment}_{it} = \text{HELP Rate}_t\left(\text{HELP Income}_{it}\right) \times \text{HELP Income}_{it}$$

$$\text{HELP Income}_{it} = \text{Labor Income}_{it} + \text{Capital Income}_{it} - \text{Deductions}_{it}$$

- Repayments continue until remaining debt balance equals zero or death
  - ✗ Cannot be cancelled or discharged in bankruptcy
  - Note: collection done from individual (not household) tax returns

▸ Variable Definitions

Why Study Income-Contingent Repayment in Australia?

- Benefit #1: only one government contract + no private market
  - Only choice is between borrowing and paying upfront, with former subsidized
  - ✓ Limited scope for **adverse selection** (or selection on moral hazard)
- Benefit #2: debt can only be used for tuition
  - Tuition is government-controlled at public universities (94% of enrollment)
  - ✓ Less room for **ex-ante** moral hazard from changes in borrowing
- Benefit #3: first nationwide provider of income-contingent loans in 1989
  - ✓ Borrowers likely **understand** structure of repayment

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▸ Differences from US

Data

1. Universe of individual tax returns from ATO ($\sim$ US Form 1040)
   - Income components to construct HELP Income and superannuation balances
2. Administrative HELP data: debt balances, repayments, and flag for new debt
3. 2016 Household Census: self-reported hours and mortgage $+$ rent payments
4. HILDA: survey data on hours worked and asset holdings

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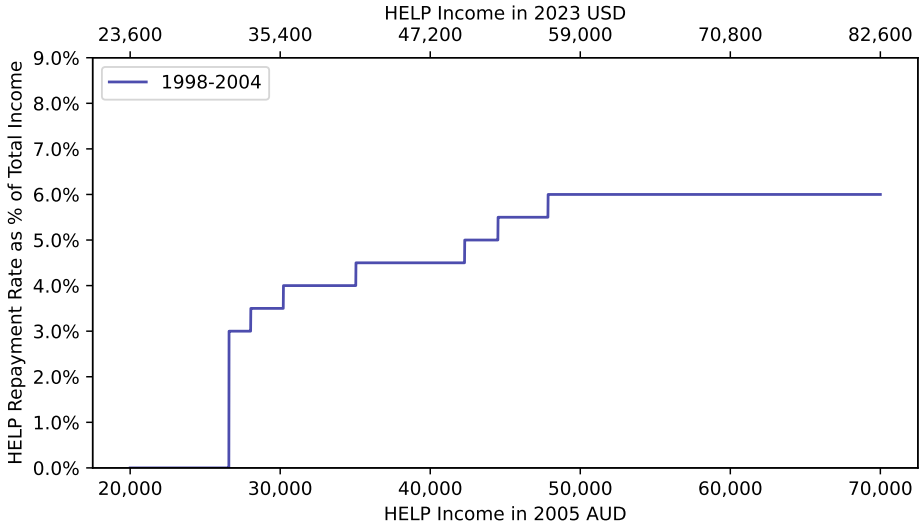
Sample: $\sim$ 4 million unique debtholders between ages 20-64 from 1991-2018

- At age 26, mean HELP Income = \$34K (98% labor income), mean debt = \$13K

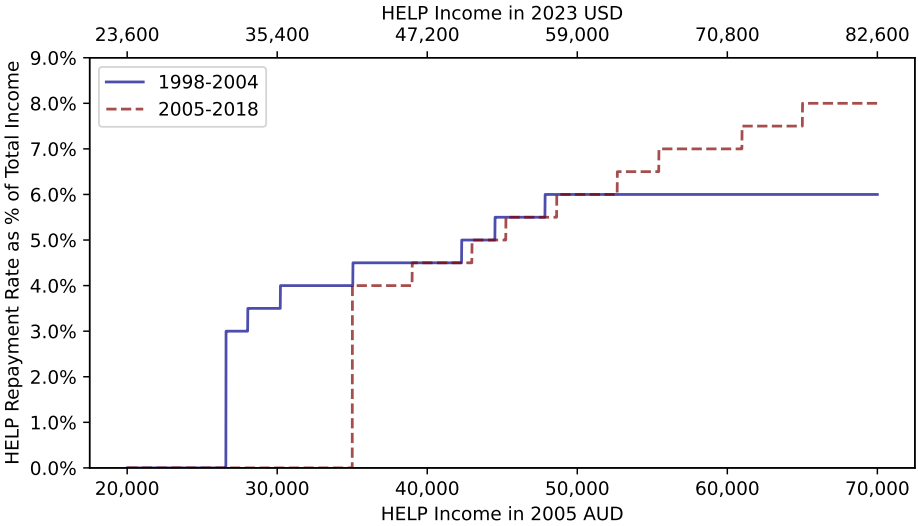
Limitation: cannot identify anything about borrowing choice (e.g. degree, institution)

▸ Summary Stats ▸ Debt by Age ▸ Debt Repay

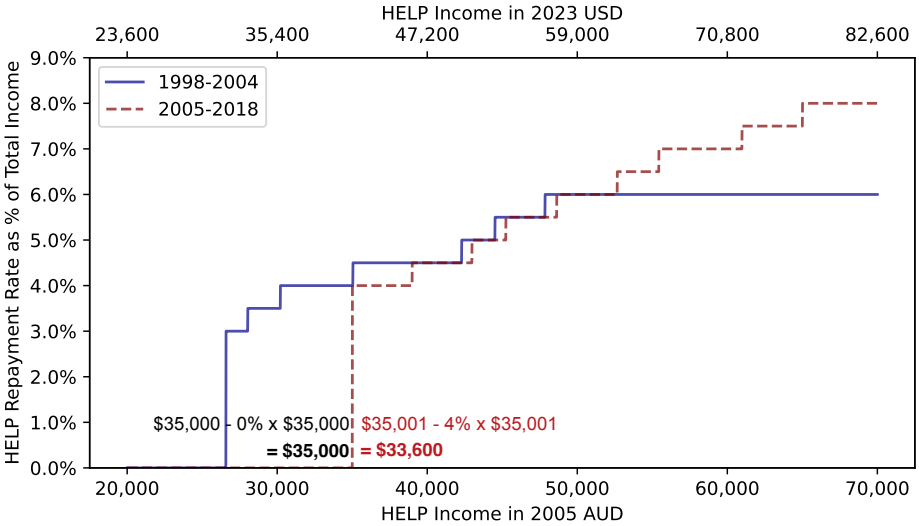
Identifying Variation: Discontinuities in Repayment Rates



Identifying Variation: Policy Change to Repayment Rates



Repayment Threshold Increases **Average** Repayment Rate



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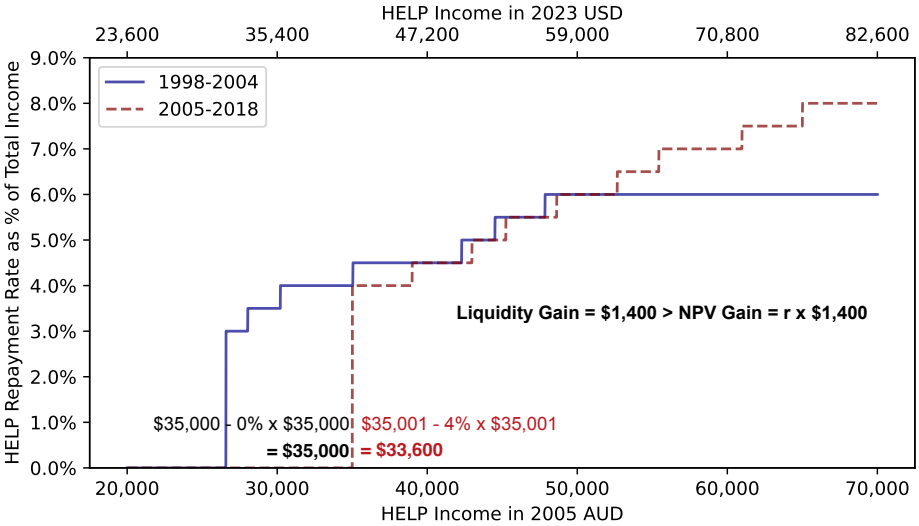

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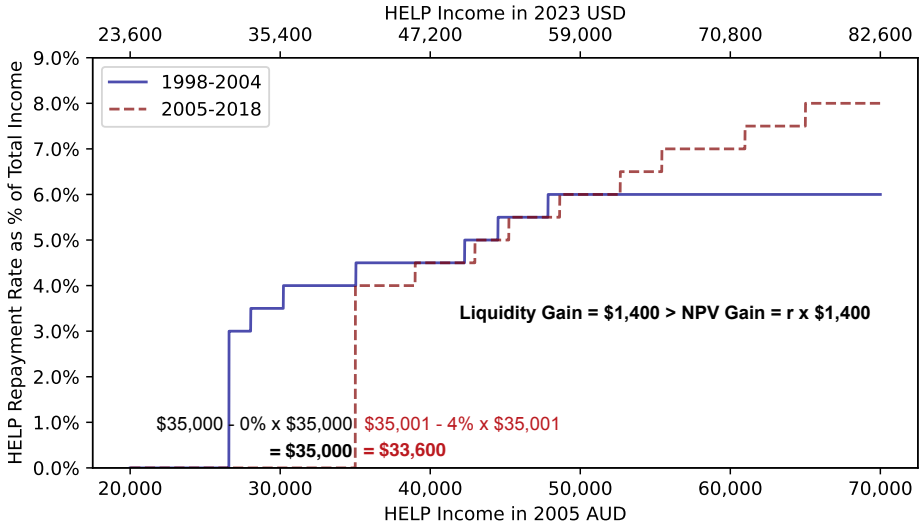
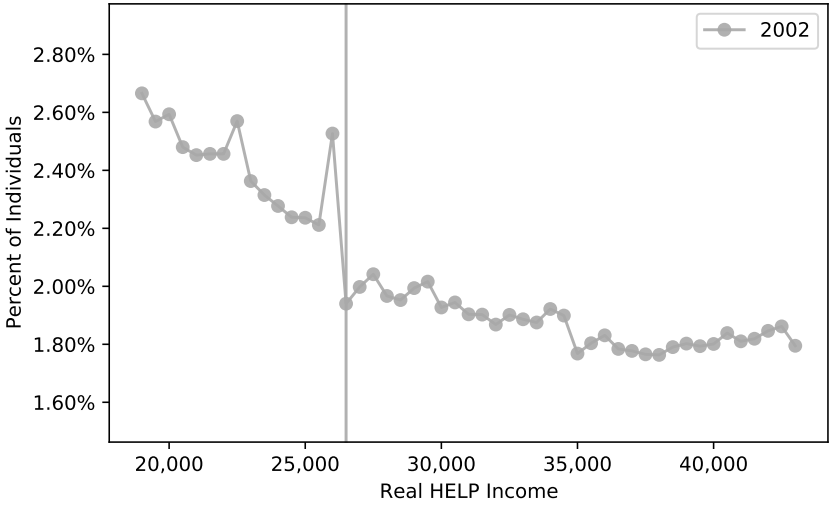


Note: policy change applied to new and existing debtholders

▸ Marginal Rates ▸ Payments ▸ News ▸ Occupations

Outline

Borrowers Adjust Income to Reduce Repayments



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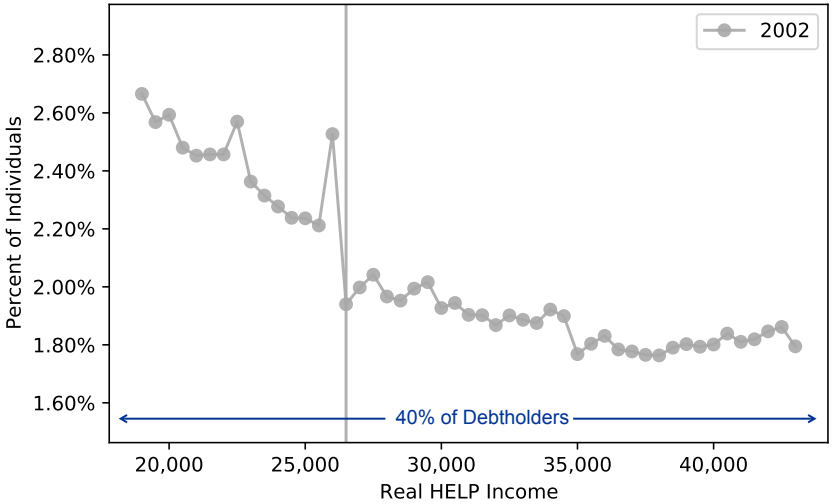

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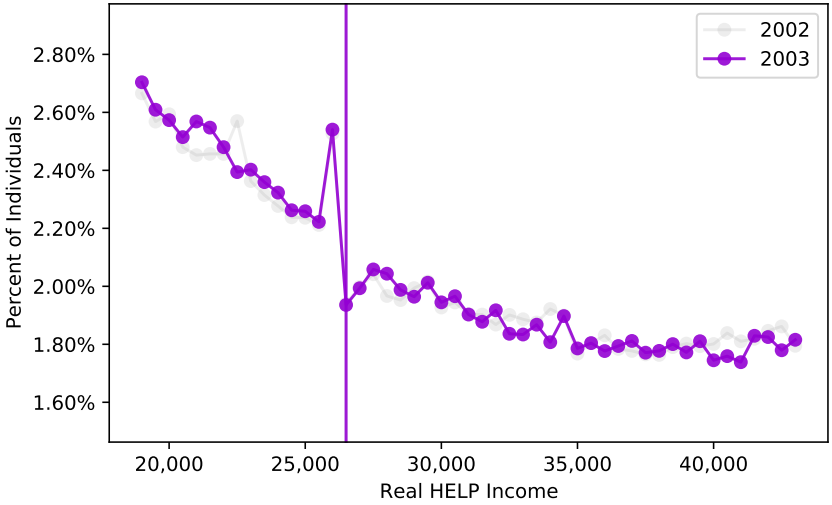

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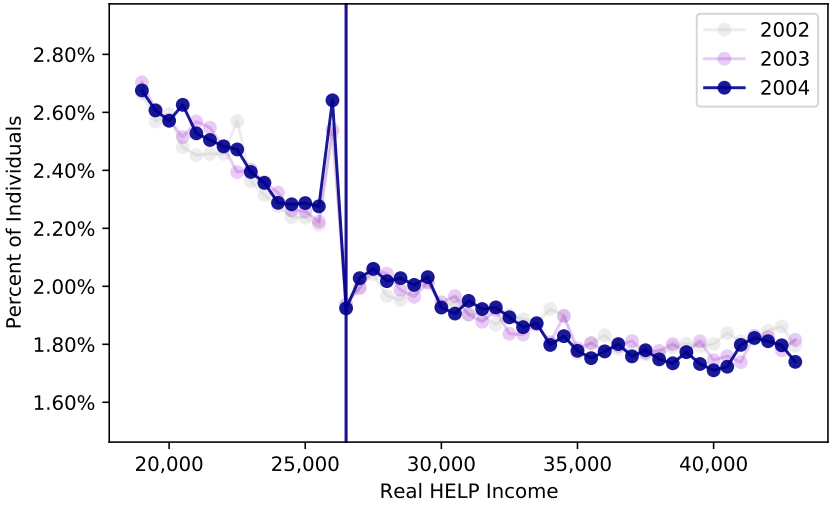

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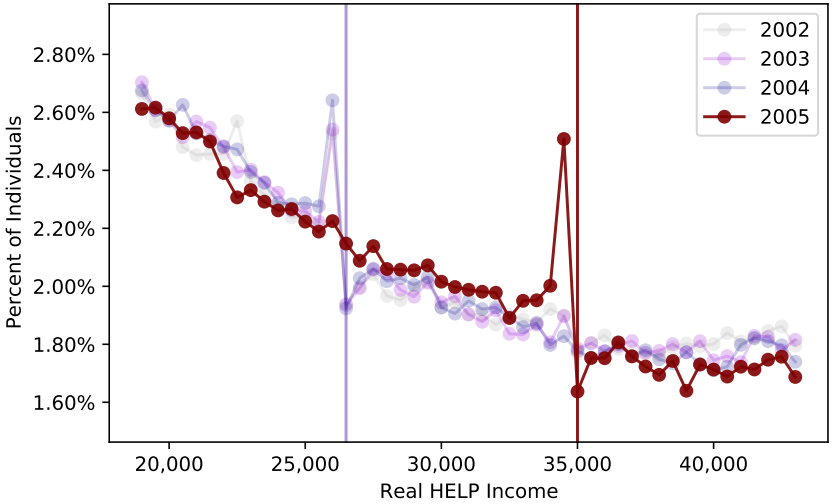

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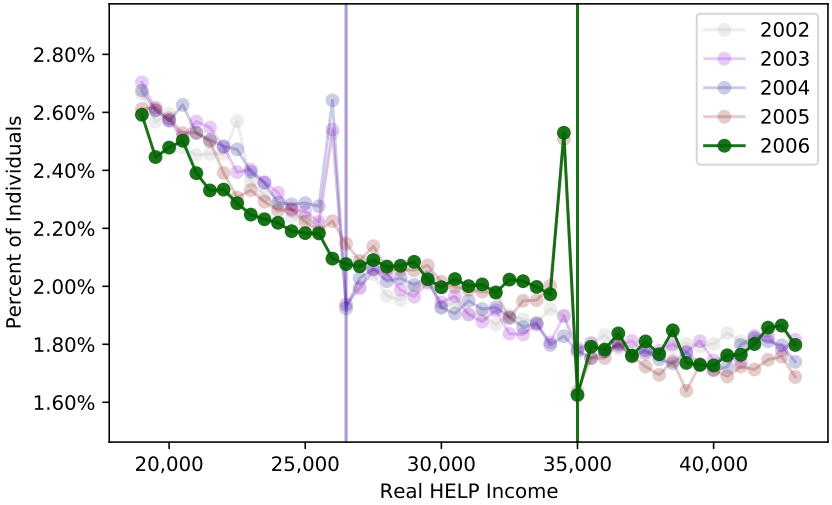

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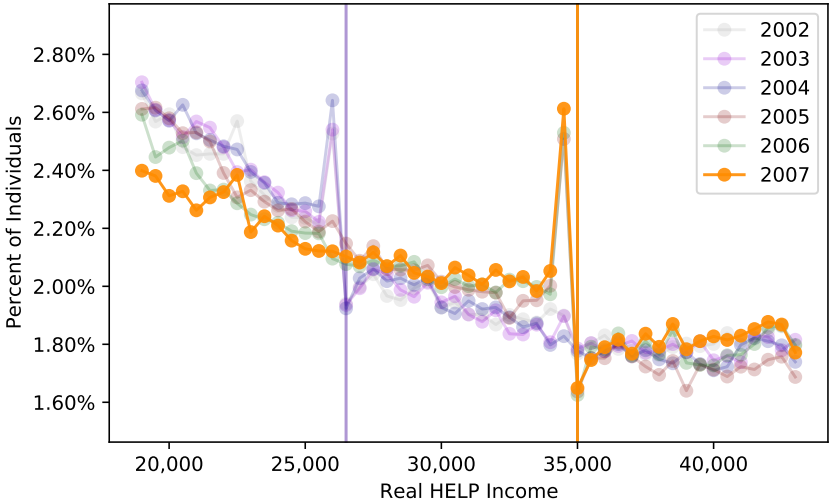

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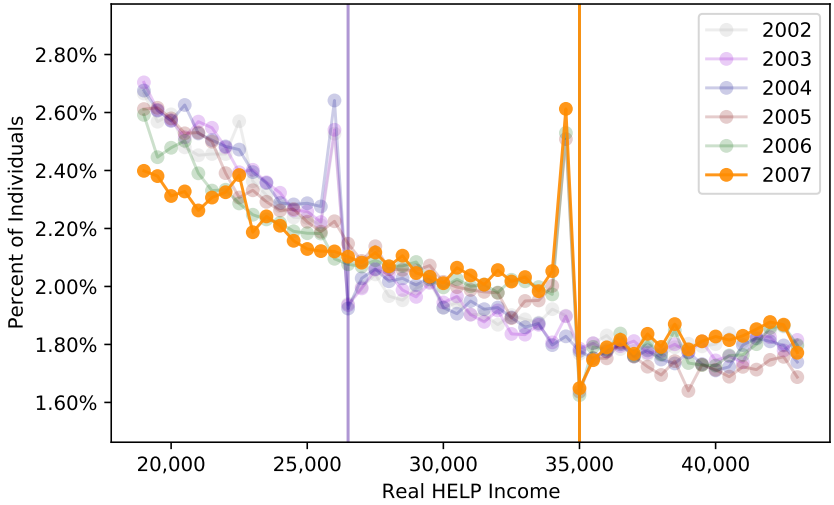
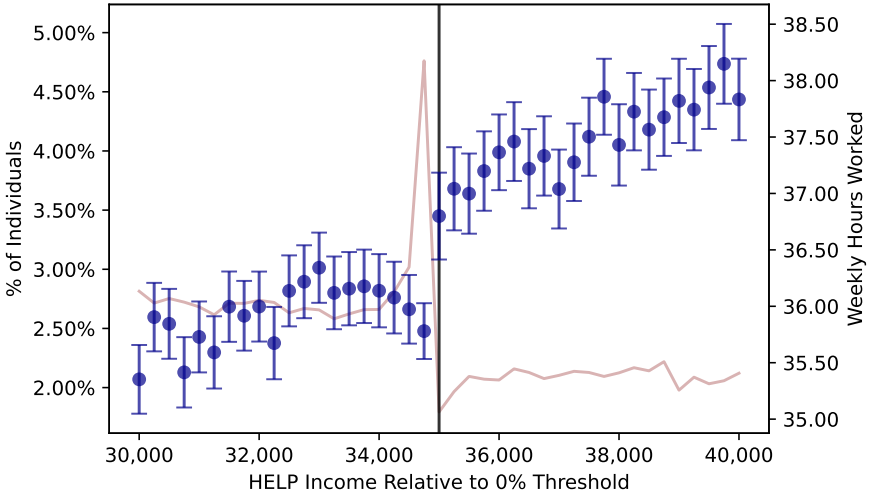


- Next: does bunching reflect labor supply or evasion?

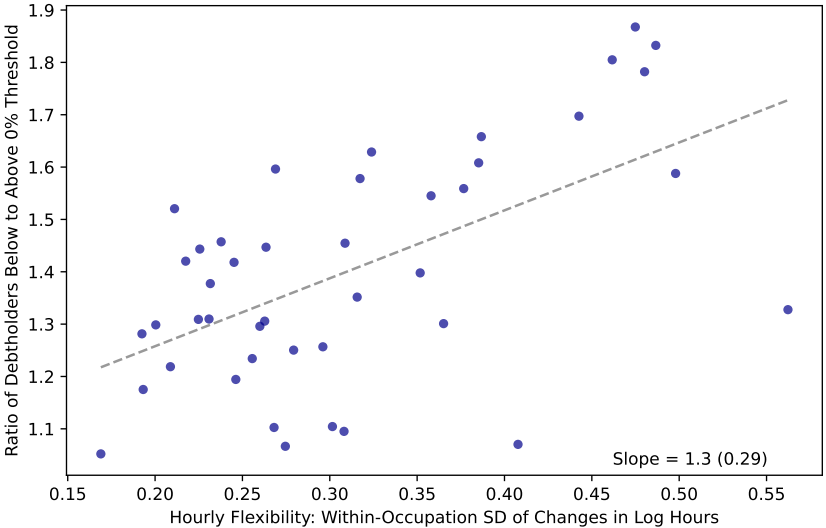
Labor Non-Debt

Borrowers Below Repayment Threshold Work Fewer Hours



- In 2016, reduction is around **1** hour/week = 2.6% of standard workweek

More Bunching in Occupations with Greater Hourly Flexibility



Sample: All wage-earners between 2005-2018

▸ Alt. Measure ▸ Evasion ▸ Table ▸ Profiles

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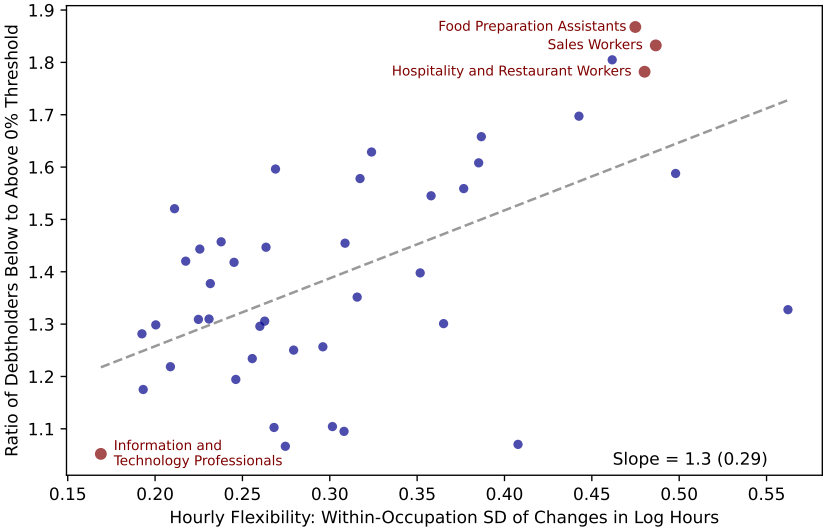

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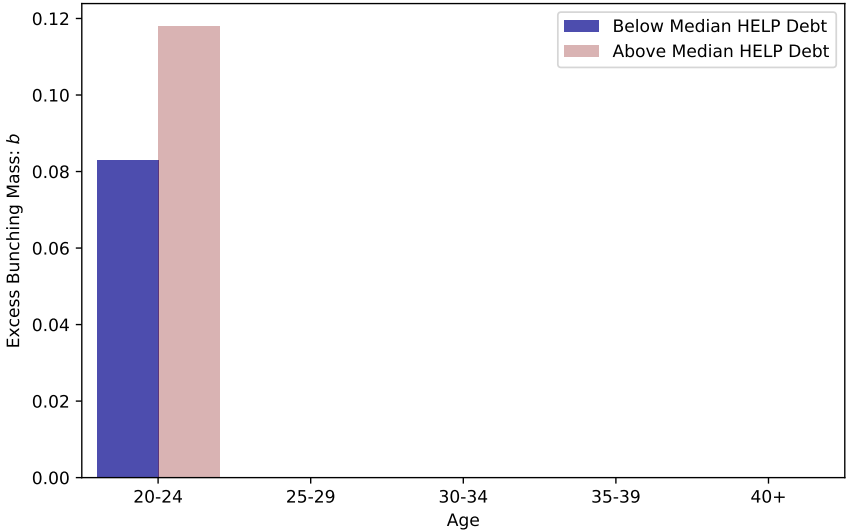
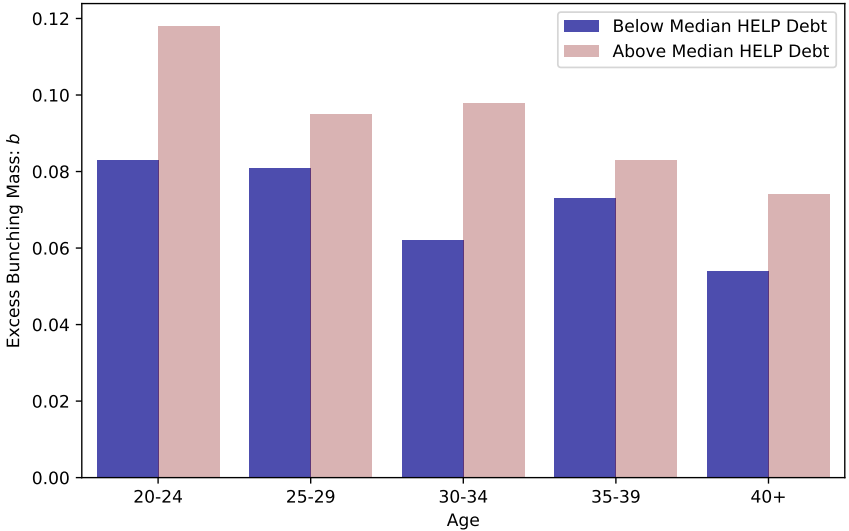


Note: Confidence intervals omitted due to small size

▸ b Details

Bunching Increases with Debt and Decreases with Age



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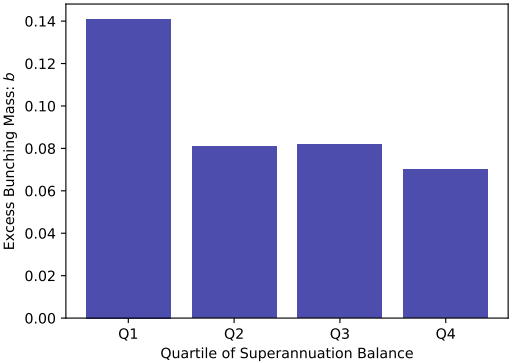

▸ Within Age ▸ House Prices

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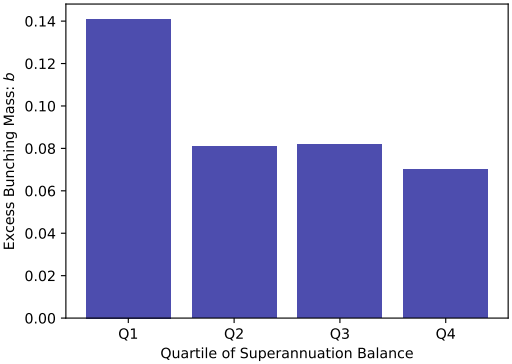

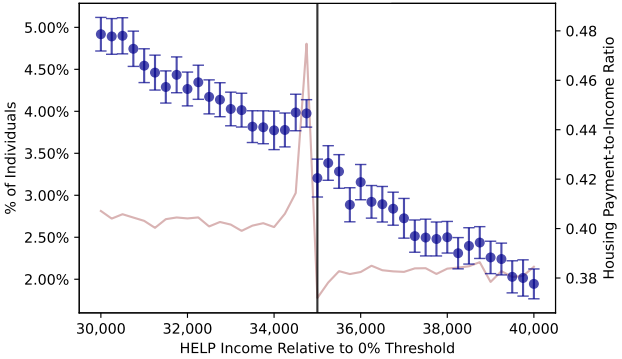

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Facts about moral hazard:

1. Borrowers reduce labor income in response to income-contingent repayment
   - Reflects labor supply: "bunchers" work fewer hours and in more flexible occupations
2. Size of responses depends on
   - Liquidity: increases with liquidity demands, decreases with retirement wealth
   - Dynamics: increases with debt, decreases with lifetime income
3. Limited evidence of future wage reductions from reducing labor supply

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Questions for model:

1. How large are these labor supply responses quantitatively?
2. Do they imply the costs of income-contingent repayment exceed the benefits?

Outline

Model Description

Life cycle model with debt $+$ $\underbrace{\text{incomplete markets}}_{\Rightarrow \text{ demand for insurance}}$ $+$ $\underbrace{\text{endogenous labor supply}}_{\Rightarrow \text{ moral hazard}}$

Life cycle model with debt + incomplete markets + endogenous labor supply

- Overlapping generations born at 22 with heterogeneous assets, wage, and debt
- From 22 to 64, individuals choose consumption, c_a, and labor supply, ℓ_a
  - Wage rate subject to idiosyncratic shocks (no agg. risk, partial eq.)
  - Shocks are uninsurable: borrowing allowed up to age-dependent limit with interest
- After age 64, individuals retire and choose consumption c_a

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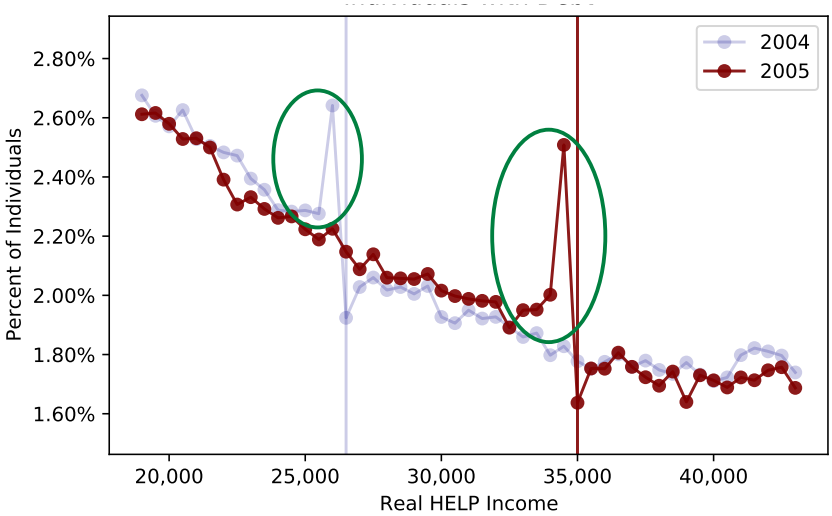
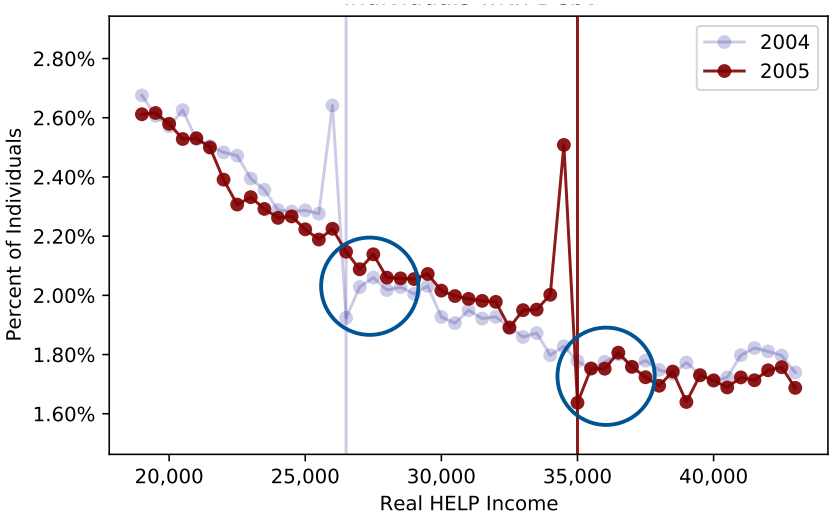
- After age 64, individuals retire and choose consumption c_a
- **Government**
  - Revenues: progressive income taxes, debt repayments
  - Expenses: means-tested unemployment benefits & retirement pension, initial debt

Bunching Consistent with Positive Labor Supply Elasticity



Mass Above Threshold **Inconsistent** with Frictionless Model



- Moving above to below threshold $\Rightarrow$ more leisure **and** \$1400 more cash-on-hand

Labor Supply Optimization Frictions

- Choice of ℓ_a subject to two **optimization frictions** to give mass above threshold
- **Time**-dependent adjustment (Calvo):
  - Fraction λ hit by shock and adjust l_a, other $1 - \lambda$ set $l_a = l_{a-1}$
  - E.g. inattention, arrival of opportunities to change hours/jobs
- **State**-dependent adjustment (sS):
  - Individuals hit by Calvo shock incur utility cost f, **if** they choose $l_a \neq l_{a-1}$
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  - E.g. real or psychological costs of changing hours/jobs
- Extension: add learning-by-doing to generate long-run cost of bunching

Optimization Problem of Individuals Hit by Calvo Shock

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Optimization Problem of Individuals Hit by Calvo Shock

$$V_a(\mathbf{s}_a) = \max_{\substack{A_{a+1} \geq A_{a+1}, \\ \ell_a}} \underbrace{c_a - \kappa \frac{\ell_a^{1+\phi^{-1}}}{1+\phi^{-1}}}_{\text{utility of consumption \& disutility of labor}} - \underbrace{f * \mathbf{1}_{\ell_a \neq \ell_{a-1}}}_{\text{adjustment cost}} + \beta \left[m_a \mathbf{E}_{\mathbf{a}} \left(\underbrace{V_{a+1}(\mathbf{s}_{a+1})}_{\text{continuation value}}^{1-\gamma} \right) \right]^{\frac{1}{1-\gamma}}$$

Optimization Problem of Individuals Hit by Calvo Shock

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$$c_a + A_{a+1} + \underbrace{d(y_a, D_a, t)}_{\substack{\text{debt} \\ \text{repayment}}} + \underbrace{\tau(y_a)}_{\text{taxes + ui}} = \underbrace{y_a}_{\substack{\text{labor} \\ \text{income}}} + \underbrace{A_a R}_{\substack{\text{capital} \\ \text{income}}}$$

Optimization Problem of Individuals Hit by Calvo Shock

$$V_a(\mathbf{s}_a) = \max_{\substack{A_{a+1} \geq \underline{A}_{a+1}, \\ \ell_a}} \left\{ \left[c_a - \kappa \frac{\ell_a^{1+\phi^{-1}}}{1+\phi^{-1}} - f * \mathbf{1}_{\ell_a \neq \ell_{a-1}} \right]^{1-\sigma} + \beta \left[m_a \mathbf{E_a} \left(V_{a+1}(\mathbf{s}_{a+1})^{1-\gamma} \right) \right]^{\frac{1-\sigma}{1-\gamma}} \right\}^{\frac{1}{1-\sigma}}$$

$$c_a + A_{a+1} + d(y_a, D_a, t) + \tau(y_a) = y_a + A_a R$$

$$y_a = \ell_a w_a, \quad \log w_a = \underbrace{g_a}_{\substack{\text{age} \\ \text{profile}}} + \underbrace{\theta_a}_{\substack{\text{permanent} \\ \text{income}}} + \underbrace{\epsilon_a}_{\substack{\text{transitory} \\ \text{shock}}}$$

Optimization Problem of Individuals Hit by Calvo Shock

$$V_a(\mathbf{s}_a) = \max_{\substack{A_{a+1} \geq \underline{A}_{a+1}, \\ \ell_a}} \left\{ \left[c_a - \kappa \frac{\ell_a^{1+\phi^{-1}}}{1+\phi^{-1}} - f * \mathbf{1}_{\ell_a \neq \ell_{a-1}} \right]^{1-\sigma} + \beta \left[m_a \mathbf{E}_{\mathbf{a}} \left(V_{a+1}(\mathbf{s}_{a+1})^{1-\gamma} \right) \right]^{\frac{1-\sigma}{1-\gamma}} \right\}^{\frac{1}{1-\sigma}}$$

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$$\mathbf{s}_a = \begin{pmatrix} a & t & A_a & D_a & \theta_a & \epsilon_a & \ell_{a-1} & \omega_a \end{pmatrix}$$

Optimization Problem of Individuals Hit by Calvo Shock

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- a = age
- t = year to keep track of policy change

Optimization Problem of Individuals Hit by Calvo Shock

$$V_a(\mathbf{s}_a) = \max_{\substack{A_{a+1} \geq \underline{A}_{a+1}, \\ \ell_a}} \left\{ \left[c_a - \kappa \frac{\ell_a^{1+\phi^{-1}}}{1+\phi^{-1}} - f * \mathbf{1}_{\ell_a \neq \ell_{a-1}} \right]^{1-\sigma} + \beta \left[m_a \mathbf{E}_{\mathbf{a}} \left(V_{a+1}(\mathbf{s}_{a+1})^{1-\gamma} \right) \right]^{\frac{1-\sigma}{1-\gamma}} \right\}^{\frac{1}{1-\sigma}}$$

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$$\mathbf{s}_a = \begin{pmatrix} a & t & A_a & D_a & \theta_a & \epsilon_a & \ell_{a-1} & \omega_a \end{pmatrix}$$

- A_a = savings from previous period
- D_a = debt = $R_d D_{a-1} - d(y_{a-1}, D_{a-1}, t)$

Optimization Problem of Individuals Hit by Calvo Shock

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- θ_a = permanent income = $\rho \theta_{a-1} + \nu_a$ $\qquad$ $\nu_a \sim N(0, \sigma_\nu^2)$
- ϵ_a = transitory shock $\sim N(0, \sigma_\epsilon^2)$

Optimization Problem of Individuals Hit by Calvo Shock

$$V_a(\mathbf{s}_a) = \max_{\substack{A_{a+1} \geq \underline{A}_{a+1}, \\ \ell_a}} \left\{ \left[c_a - \kappa \frac{\ell_a^{1+\phi^{-1}}}{1+\phi^{-1}} - f * \mathbf{1}_{\ell_a \neq \ell_{a-1}} \right]^{1-\sigma} + \beta \left[m_a \mathbf{E_a} \left(V_{a+1}(\mathbf{s}_{a+1})^{1-\gamma} \right) \right]^{\frac{1-\sigma}{1-\gamma}} \right\}^{\frac{1}{1-\sigma}}$$

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- θ_a = permanent income = $\rho \theta_{a-1} + \nu_a + \alpha \log \ell_{a-1}$ $\quad \nu_a \sim N(0, \sigma_\nu^2)$
- ϵ_a = transitory shock $\sim N(0, \sigma_\epsilon^2)$ Extension: learning-by-doing

Optimization Problem of Individuals Hit by Calvo Shock

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- ℓ_{a-1} = labor supply from previous period
- ω_a = Calvo shock that determines whether ℓ_a can be adjusted $\sim$ Bernoulli(λ)

Optimization Problem of Individuals Hit by Calvo Shock

$$V_a(\mathbf{s}_a) = \max_{\substack{A_{a+1} \geq \underline{A}_{a+1}, \\ \ell_a}} \left\{ \left[c_a - \kappa \frac{\ell_a^{1+\phi^{-1}}}{1+\phi^{-1}} - f * \mathbf{1}_{\ell_a \neq \ell_{a-1}} \right]^{1-\sigma} + \beta \left[m_a \mathbf{E_a} \left(V_{a+1}(\mathbf{s}_{a+1})^{1-\gamma} \right) \right]^{\frac{1-\sigma}{1-\gamma}} \right\}^{\frac{1}{1-\sigma}}$$

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$$\mathbf{s}_a = \begin{pmatrix} a & t & A_a & D_a & \theta_a & \epsilon_a & \ell_{a-1} & \omega_a \end{pmatrix}$$

- Sources of ex-ante heterogeneity:
  - θ_0 = initial permanent income $\sim N(0, \sigma_I^2)$
  - D_0 = initial debt, A_0 = initial assets

ESTIMATION

First-Stage Calibration

- **Interest rates and borrowing**:
  - Interest rate = 1.84%, borrowing rate = CC rate, debt interest rate = 0%
  - Borrowing limit = average CC limit by age
- **Demographics**: cohort birth rates and mortality risk taken from life tables
  - Consumption adjusted for equivalence scale using HH size (Lusardi et al. 2017)
- **Government**: use exact (non-smooth) formulas provided by ATO
- **Initial conditions**: assets and debt distributions taken from data at age 22
- **Baseline RRA and EIS**: $\gamma = \frac{1}{\sigma} = 2.23$ (Choukhmane-de Silva 2023)
  - Welfare analysis: consider alternative values + preference for early resolution

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- **Learning-by-doing extension**: $\alpha = 0.24$ (median value from Best-Kleven 2013)

$$\text{Parameters} = \left(\qquad \right)$$

- **Estimation** via SMM with 47 moments + 14 parameters
  - Find parameters that minimize % difference between data & model moments
- **Simulated policy change**: unanticipated change in HELP formula at $t = 2005$

$$\text{Parameters} = \left(\overbrace{\phi \quad f \quad \lambda}^{\text{labor supply}} \right)$$

- Labor supply elasticity: identified by bunching below repayment threshold
- Frictions: identified by mass above repayment threshold

▸ Elasticities ▸ SMM Objective

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- Frictions: identified by mass above repayment threshold
- Separate identification of frictions
  - Moments: heterogeneity in bunching with **debt**, bunching at **0.5%** threshold
  - **Intuition**: with $f = 0$, decision to bunch depends on Calvo shock not incentives

▸ Elasticities ▸ SMM Objective

Second-Stage Simulated Method of Moments: **Identification**

$$\text{Parameters} = \Big(\overbrace{\underbrace{\phi \quad f \quad \lambda}_{\text{labor supply}} \quad \kappa \quad \beta}^{\text{preferences}} \quad \underbrace{\delta_0 \quad \delta_1 \quad \delta_2 \quad \delta_0^E \quad \delta_1^E}_{\text{wage profile}} \quad \underbrace{\rho \quad \sigma_\nu \quad \sigma_\epsilon \quad \sigma_i}_{\text{wage risk}} \Big)$$

- Labor supply elasticity: identified by bunching below repayment threshold
- Frictions: identified by mass above repayment threshold
- Separate identification of frictions
  - Moments: heterogeneity in bunching with **debt**, bunching at **0.5%** threshold
  - **Intuition**: with $f = 0$, decision to bunch depends on Calvo shock not incentives
- Note: wage profile & risk cannot be estimated separately in first-stage

▸ Other Parameters ▸ Elasticities ▸ SMM Objective

Parameter Estimates

Parameter		Estimation: Baseline
Labor supply elasticity	ϕ	0.114
Fixed adjustment cost	f	\$377
Calvo parameter	λ	0.183
Labor supply scaling parameter	κ	0.560
Time discount factor	β	0.973
Wage profile parameters	δ_0	8.922
	δ_1	0.073
	δ_2	-0.001
	δ_0^E	-0.487
	δ_1^E	0.020
Persistence of permanent shock	ρ	0.930
Standard deviation of permanent shock	σ_ν	0.236
Standard deviation of transitory shock	σ_ϵ	0.130
Standard deviation of individual FE	σ_i	0.599

▸ Comparison with Literature ▸ Standard Errors

Parameter Estimates

Parameter		Estimation: Baseline	Estimation: No Frictions
Labor supply elasticity	ϕ	0.114	0.005
Fixed adjustment cost	f	\$377	·
Calvo parameter	λ	0.183	·
Labor supply scaling parameter	κ	0.560	0.030
Time discount factor	β	0.973	0.996
Wage profile parameters	δ_0	8.922	9.862
	δ_1	0.073	0.111
	δ_2	-0.001	-0.002
	δ_0^E	-0.487	-0.294
	δ_1^E	0.020	0.032
Persistence of permanent shock	ρ	0.930	0.914
Standard deviation of permanent shock	σ_ν	0.236	0.076
Standard deviation of transitory shock	σ_ϵ	0.130	0.504
Standard deviation of individual FE	σ_i	0.599	0.101

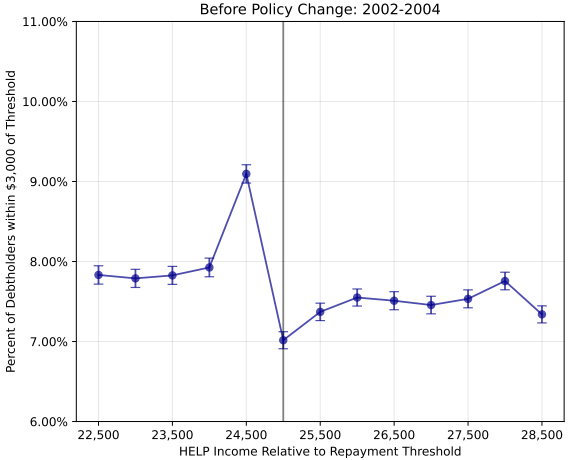
▸ Comparison with Literature ▸ Standard Errors

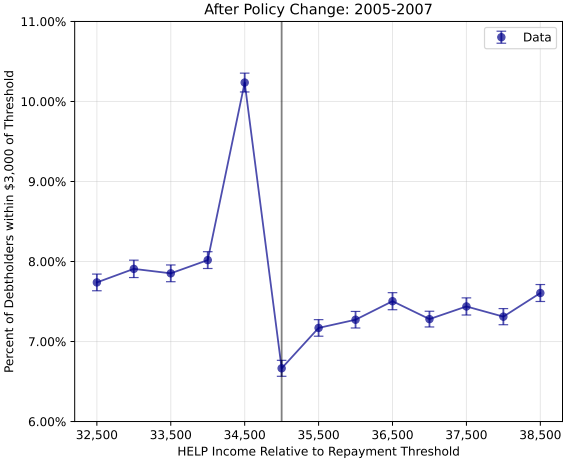
Parameter Estimates

Parameter		Estimation		
		Baseline	No Frictions	LBD
Labor supply elasticity	ϕ	0.114	0.005	0.082
Fixed adjustment cost	f	\$377	·	\$762
Calvo parameter	λ	0.183	·	0.346
Labor supply scaling parameter	κ	0.560	0.030	1.242
Time discount factor	β	0.973	0.996	0.951
Wage profile parameters	δ_0	8.922	9.862	9.197
	δ_1	0.073	0.111	0.070
	δ_2	-0.001	-0.002	-0.001
	δ_0^E	-0.487	-0.294	-0.480
	δ_1^E	0.020	0.032	0.018
Persistence of permanent shock	ρ	0.930	0.914	0.889
Standard deviation of permanent shock	σ_ν	0.236	0.076	0.288
Standard deviation of transitory shock	σ_ϵ	0.130	0.504	0.064
Standard deviation of individual FE	σ_i	0.599	0.101	0.625

▸ Comparison with Literature ▸ Standard Errors

Model Fit: Bunching Before and After Policy Change





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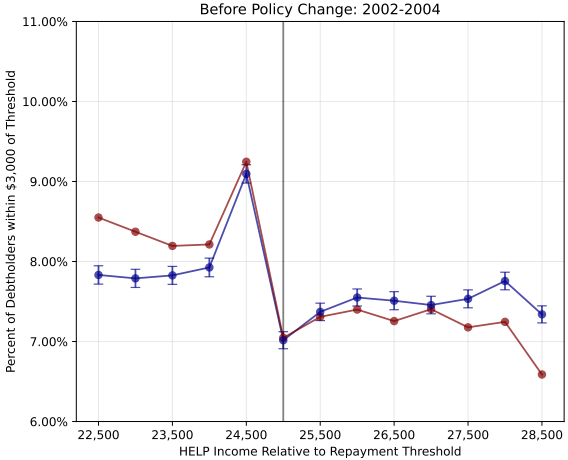
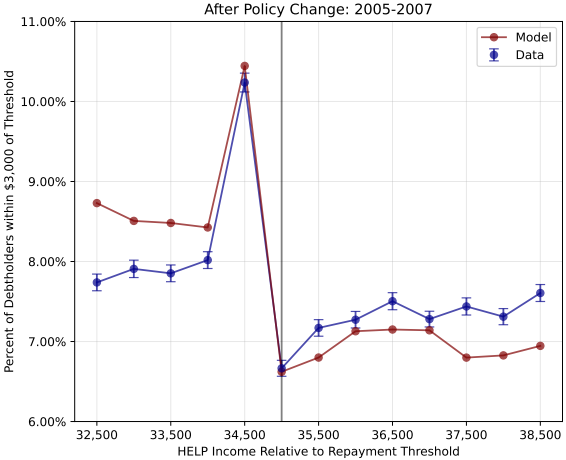
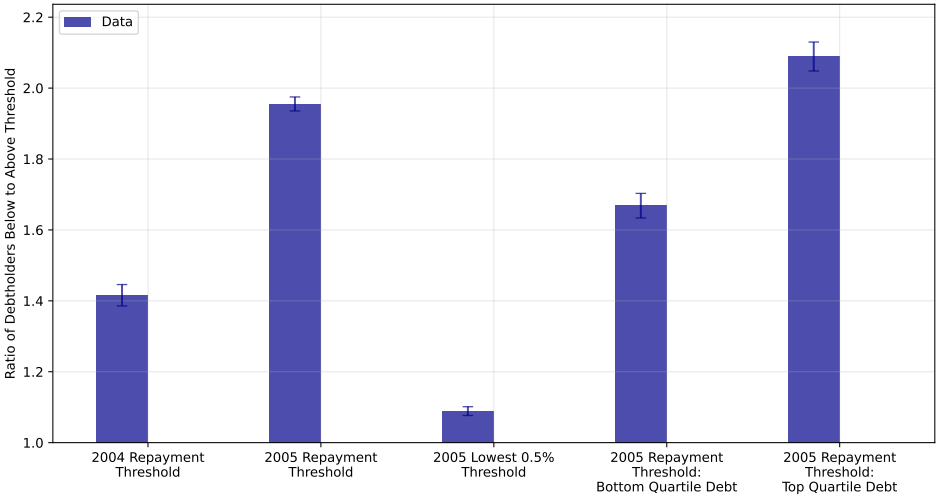


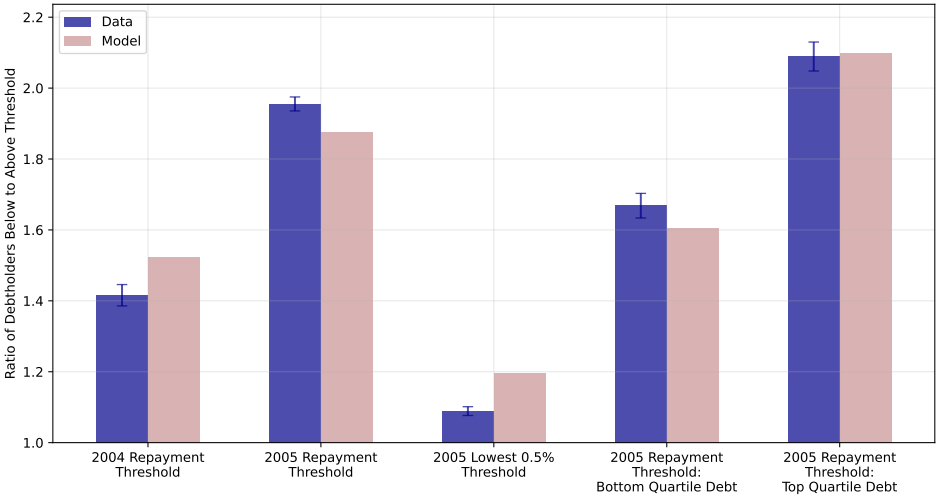


Model Fit: Bunching Heterogeneity



▸ Other Moments ▸ Liquidity ▸ Dynamics

Model Fit: Bunching Heterogeneity



▸ Other Moments ▸ Liquidity ▸ Dynamics

Outline

Normative Perspective

What repayment contract best balances insurance with moral hazard?

- Consider social planner that maximizes borrower welfare with **one** contract
  - Problem faced by governments with one contract (e.g. Australia, UK)
  - Contract is subsidized with zero interest rate, borrowing & prices held fixed

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- Consider social planner that maximizes borrower welfare with **one** contract
  - Problem faced by governments with one contract (e.g. Australia, UK)
  - Contract is subsidized with zero interest rate, borrowing & prices held fixed
- **Step 1**: **Existing** income-contingent loans vs. fixed repayment (not budget-neutral)
  - Four contracts: HELP 2004, HELP 2005, US Old & New IBR = $\psi * \max\{y - K, 0\}$
- **Step 2**: **Optimal** income-contingent contracts vs. fixed repayment (budget-neutral)

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  - Four contracts: HELP 2004, HELP 2005, US Old & New IBR = $\psi * \max\{y - K, 0\}$
- **Step 2**: **Optimal** income-contingent contracts vs. fixed repayment (budget-neutral)
- Note: consider effect of forgiveness in Step 2

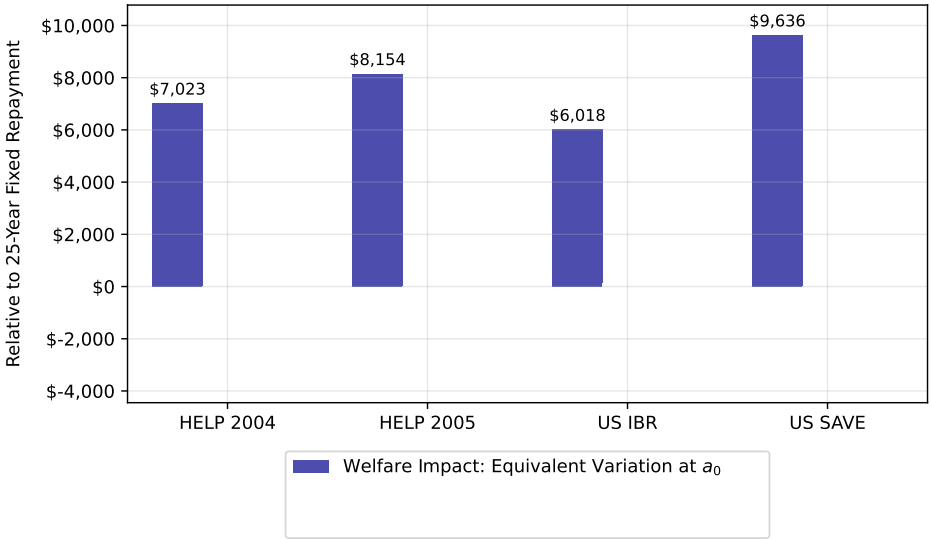
- **Government budget** defined as:

$$\mathcal{G} = \mathbf{E}_0 \sum_{a=a_0}^{a_T} \frac{\text{Repayments}_a + \text{Taxes}_a - \text{Transfers}_a}{\mathcal{R}_a}$$

$$\mathcal{R}_a = \underbrace{\beta^{-(a-a_0)}}_{\text{individual time preference}} * \underbrace{\prod_{s=0}^{a-a_0} m_s}_{\text{mortality}}$$

- **Benchmark**: 25-Year Fixed Repayment = similar duration, not income-contingent
- Robustness with $\mathcal{R}_a =$ risk-free rate & $\mathcal{R}_a =$ risk-free rate $+ 4\%$

Existing Income-Contingent Loans vs. Fixed Repayment



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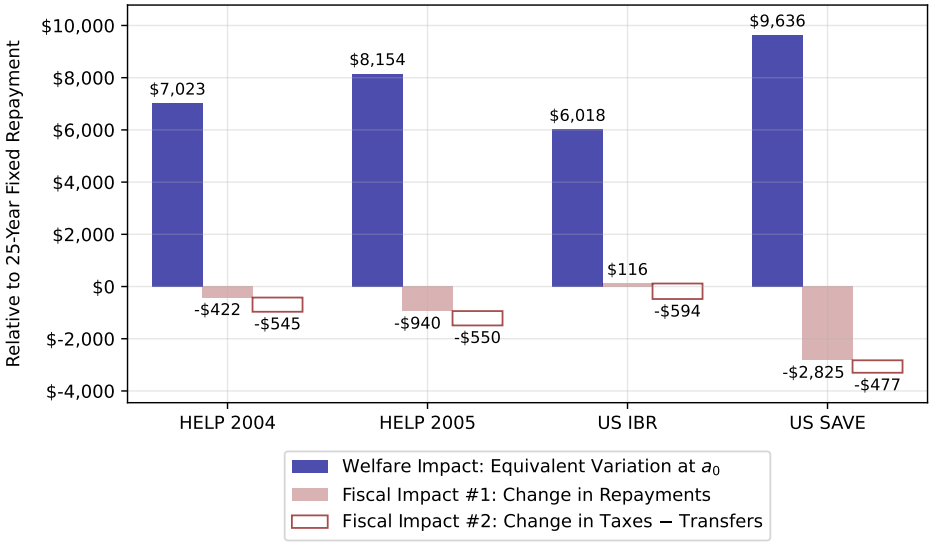
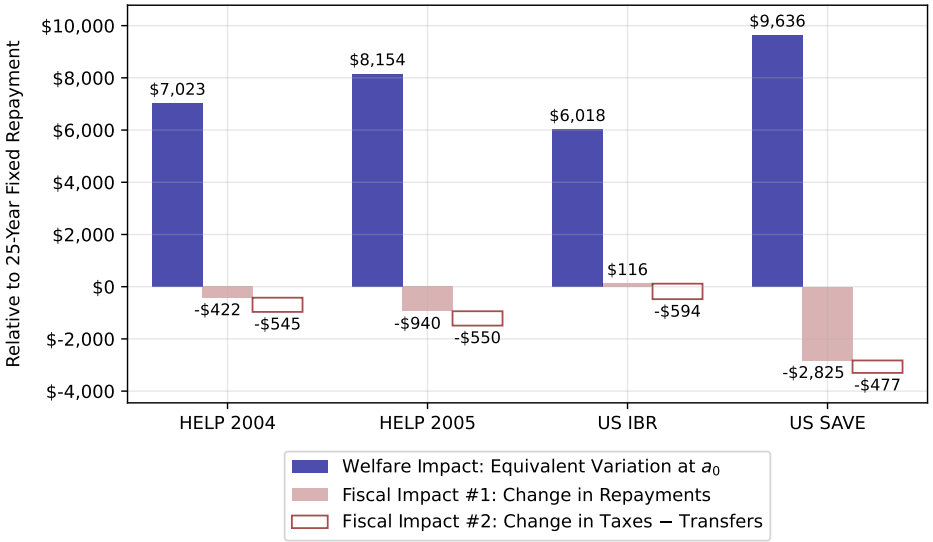


Existing Income-Contingent Loans vs. Fixed Repayment



▸ Decomposition ▸ MVPF

- Contracts have different fiscal costs $\Rightarrow$ need to balance government budget
- **Next**: solve **constrained** planner's problem to construct contracts with same cost

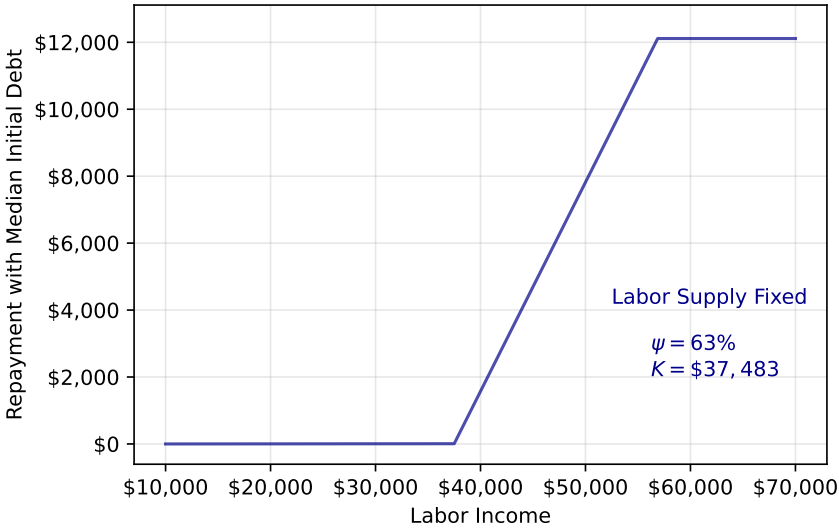
$$\max_{\psi, K} \mathbf{E}_0 \left(V_{a_0}^{1-\gamma} \right)^{\frac{1}{1-\gamma}}$$

subject to:

$$\mathbf{E}_0 \sum_{a=a_0}^{a_T} \frac{\text{Repayments}_a + \text{Taxes}_a - \text{Transfers}_a}{\mathcal{R}_a} \geq \mathcal{G}_{\text{25-Year Fixed}} \tag{1}$$

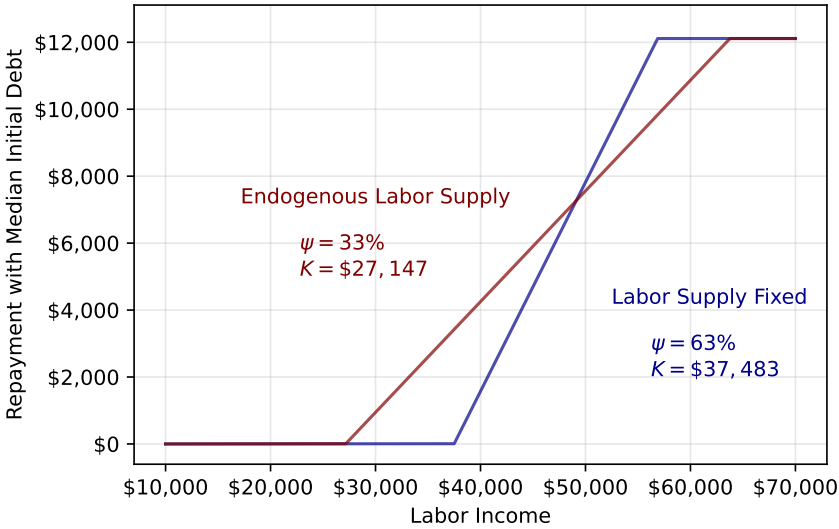
$$\text{Repayments}_a = \min \left\{ \psi * \max \left\{ y_a - K, 0 \right\}, D_a \right\} \tag{2}$$

Solution to Constrained Planner's Problem



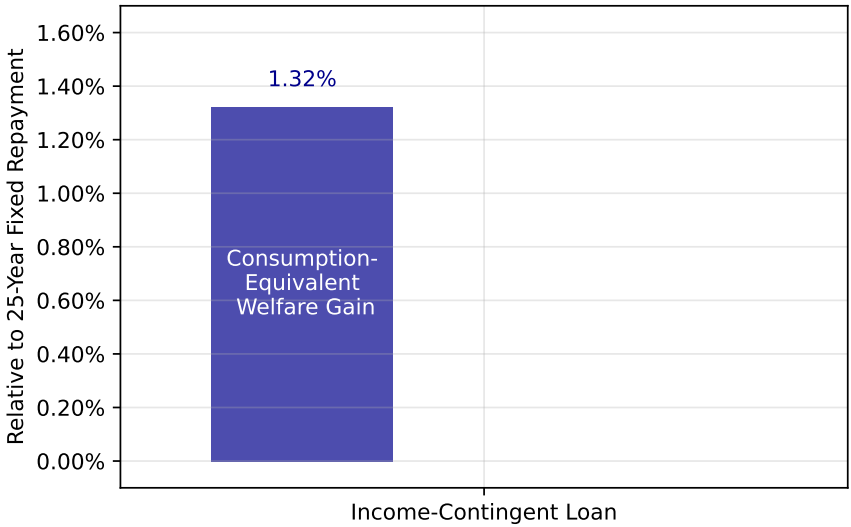
▸ Smooth ▸ vs. Existing

Solution to Constrained Planner's Problem



▸ Smooth ▸ vs. Existing

Constrained-Optimum = 1.3% Increase in Lifetime Consumption



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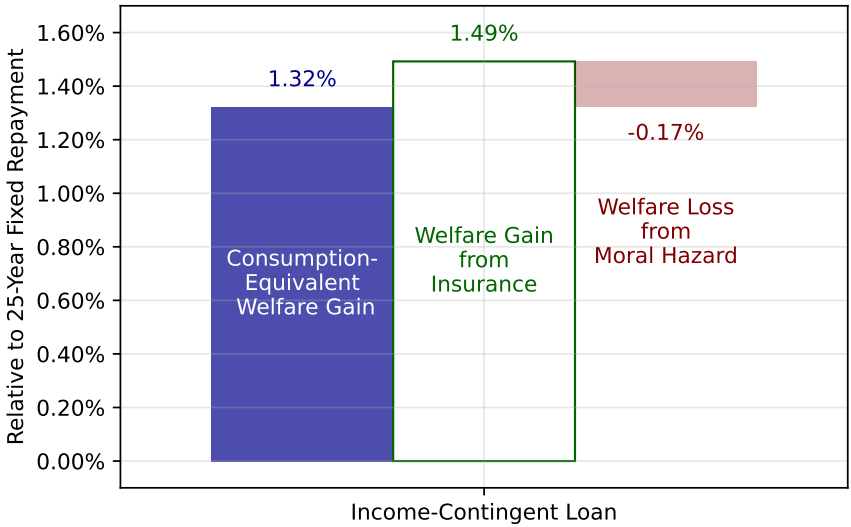
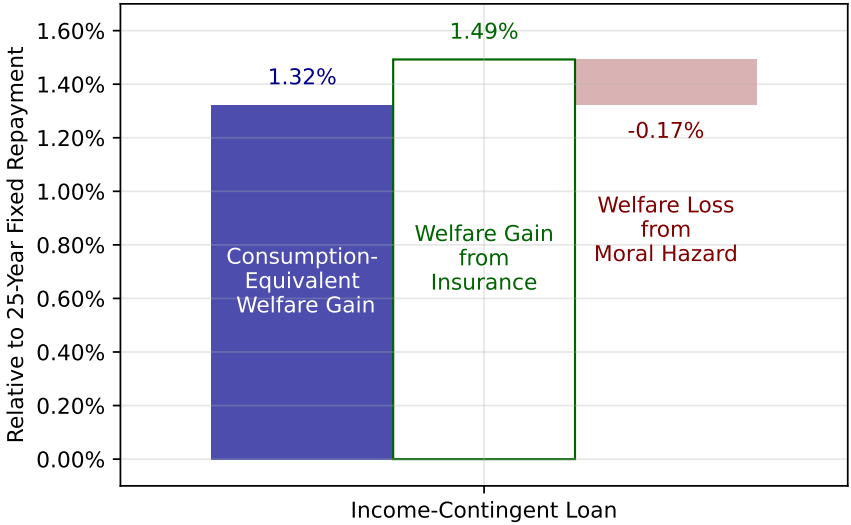
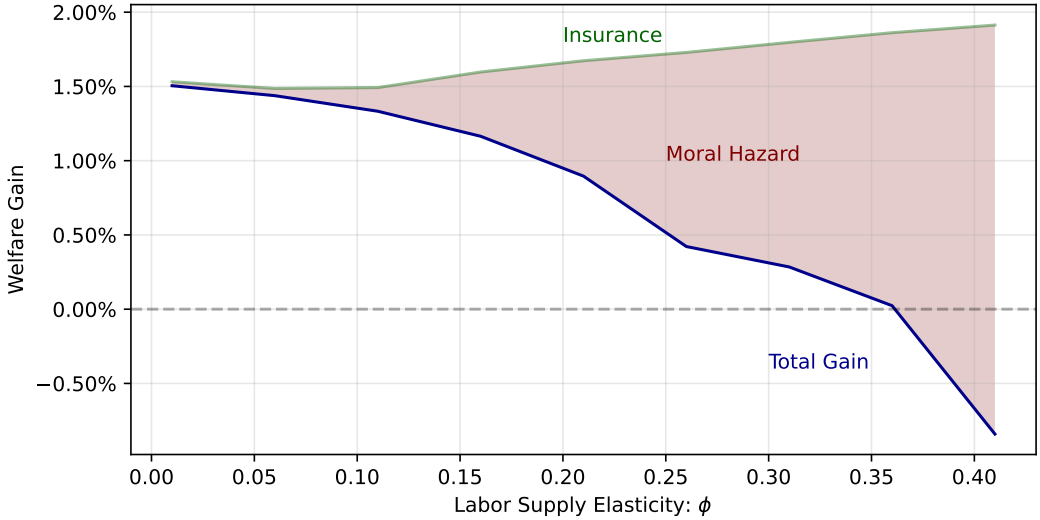


Constrained-Optimum = 1.3% Increase in Lifetime Consumption



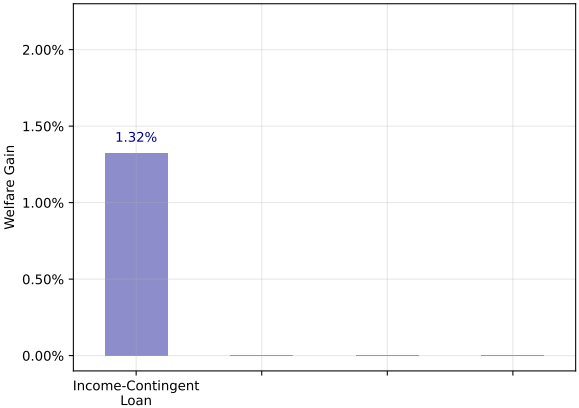
▸ Alt. Models ▸ Distribution ▸ Restrict $\psi \leq 10\%$ ▸ Forgiveness

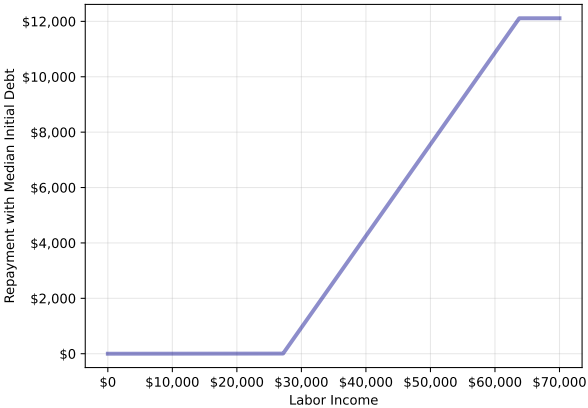
Welfare Gain is Positive as Long as $\phi < 0.37$



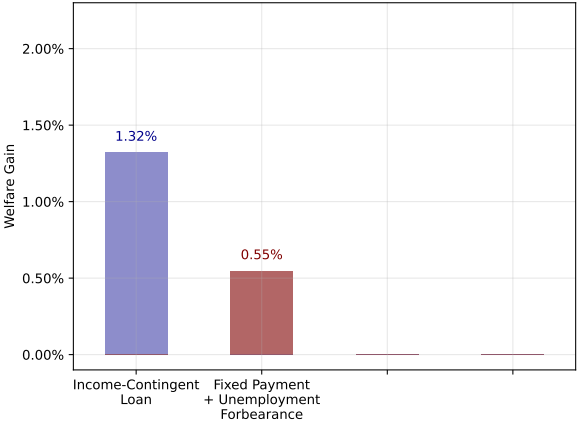
▸ Alt. Models ▸ Implied Bunching ▸ Contracts ▸ Contracts to Reduce MH

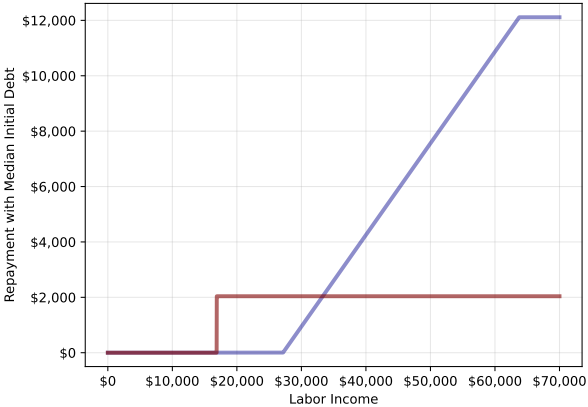
NEXT: OTHER BUDGET-NEUTRAL CONTRACTS...





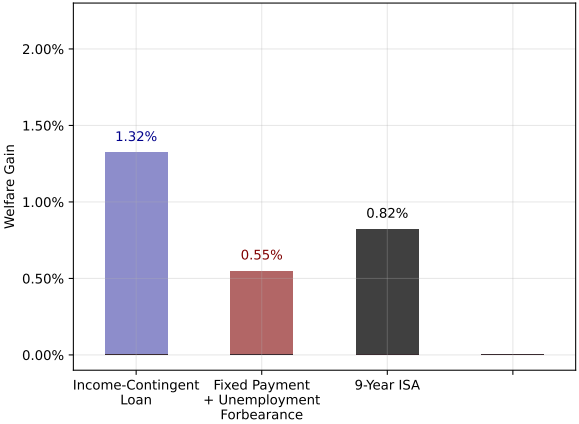
Just Providing Forbearance Gives Smaller Gains

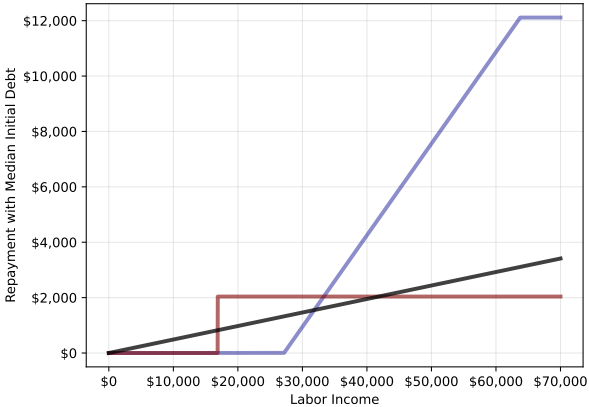




- **Benefit** of income-contingent loan: accelerate payments from high-income ▸ ICL+UI

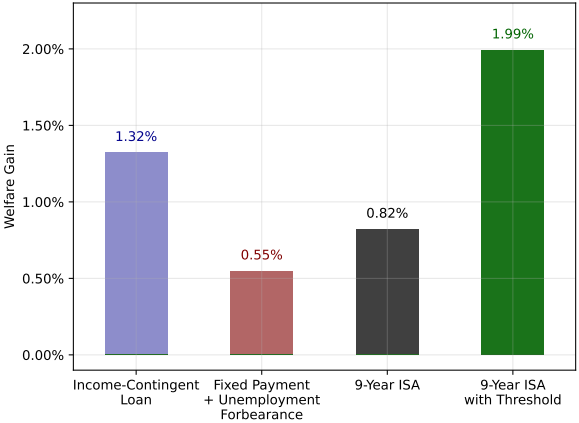
Pure Equity Contract Gives Smaller Gains

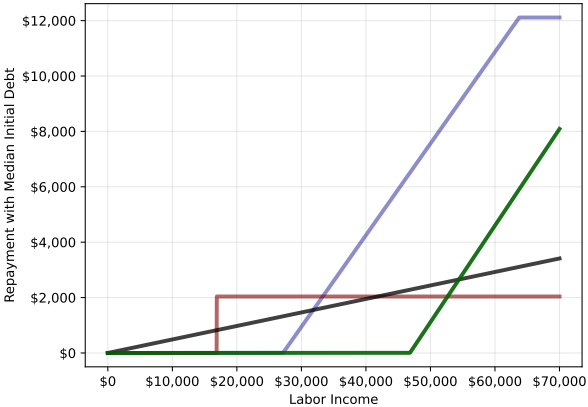




- Losses to transferring payments from (low-income) young $\rightarrow$ (high-income) old

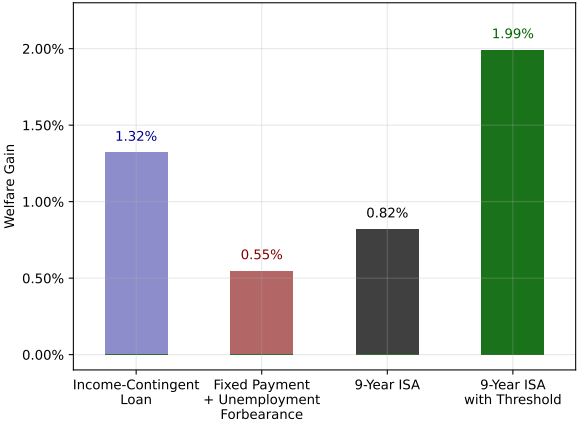
Equity + Threshold Gives Larger Gains

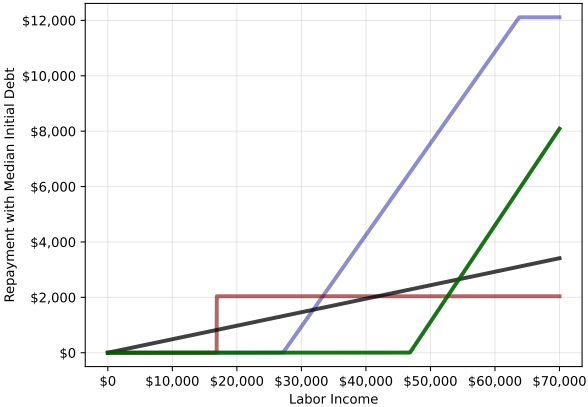




- **Benefit** of ISA: uncapped payments from high-income $\Rightarrow$ **70%** higher threshold

Equity + Threshold Gives Larger Gains, But More **Dispersed**





- **Cost** of ISA: gains more dispersed ⇒ likely to cause **ex-ante** responses ▸ Distribution

Outline

Main Results

1. **Empirics**: borrowers adjust labor supply to $\downarrow$ income-contingent repayments
   - Larger responses in occupations with more hourly flexibility
   - Responses increase with liquidity constraints and decrease with **P**(repayment)

2. **Structural estimation**: labor supply elasticity of **0.11** $+$ adjustment frictions

3. **Contract design**: providing insurance with income-contingent loans $\Rightarrow \uparrow$ welfare
   - Moral hazard significantly reduces optimal amount of insurance
   - Fixed repayment $\rightarrow$ optimal income-contingent loan $\Rightarrow \uparrow$ **1.3%** lifetime consumption
   - Forbearance $+$ fixed repayment does worse because of slower repayment

Main Results

1. **Empirics**: borrowers adjust labor supply to $\downarrow$ income-contingent repayments
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Takeaway: Income-contingent repayment creates moral hazard that affects contract design, but too small to justify fixed repayment

The Big Picture

- US "student debt crisis": **25%** of borrowers default within 5 years of graduation
  - Possible solution = put borrowers on income-contingent repayment (e.g. SAVE)
- **This paper**:
  1. Ex-post moral hazard not a reason to avoid income-contingent repayment
  2. Empirical evidence + model to calibrate effects of different contracts
- **Remaining questions**:
  1. Should income-contingent repayment to be mandated to remove selection?
  2. Effect of income-contingent repayment on borrowing?
- **Broader question**: Is state-contingent repayment useful for other liabilities?
  - HHs: government-provided shared-appreciation mortgages (UK, Canada)
  - Firms: revenue-based financing

THANK YOU!

APPENDIX

START OF APPENDIX

Variable Definitions

- HELP Income = Taxable Income + Fringe Benefits + Foreign Employment Income + Investment or Property Losses + Employer Super Contributions
- Labor Income = Salary/Wages + Allowances & Tips + Self-Employment Income
- Capital Income = Interest and Dividend Income + Annuity Income + Capital Gains + Rental Income + Managed Trust Income
- Net Deductions = Labor Income + Capital Income - HELP Income

Back

AU–US Differences Most Likely to Affect Contract Design

1. More debt in US due to higher tuition, longer degrees, and discretionary items
   - Larger demand for insurance in US, but also more moral hazard
   - Discretionary borrowing in US $\Rightarrow$ possible ex-ante moral hazard
2. Active private market in US cream-skims high-income borrowers Bachas 2019
   - Amount of insurance that can be provided might be lower in US
3. Student loans more subsidized in Australia than US
   - Possibly different moral hazard in US (if there is selection on MH) Karlan-Zinman 2009
4. Tuition and enrollment caps at public universities in Australia
   - Supply-side responses could increase fiscal cost of ICLs in US Kargar-Mann 2023

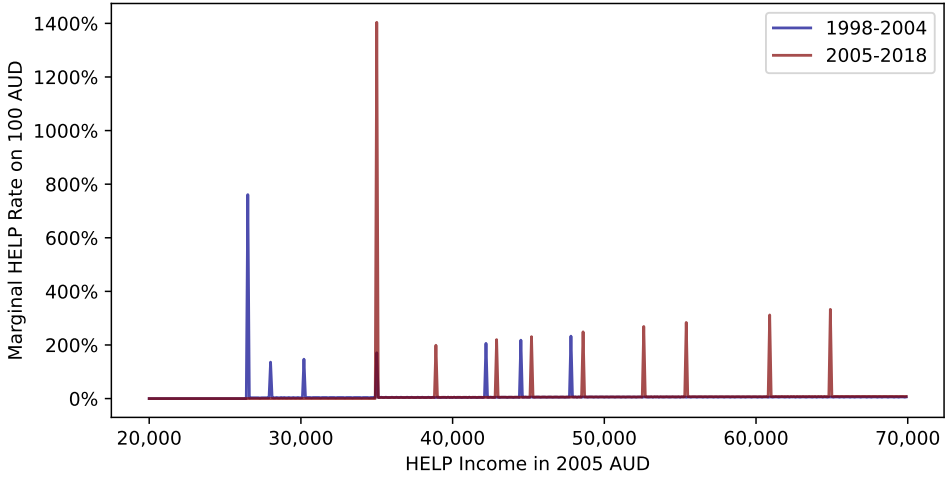
Statistics Back

Differences between Australia and US: Statistics

Feature of Environment	Australia	US
Cost of Higher Education		
Public Undergraduate Tuition Cost	$2,700–$10,100 USD per year for CSPs	$9,500 USD per year for 4-Year In-State $39,000 USD per year for 4-Year Private Nonprofit
Total Cost of Attendance	$15,850 USD per year	$22,700 USD per year
Prevalence of Scholarships	Rare	Common
Initial Student Debt Borrowed	$8,100–$30,300 USD	$51,800 USD (Average)
Student Population		
% of Population with Undergraduate Degree	38%	32%
% of Undergraduates at Private Universities	6%	26%
% of Undergraduates from Abroad	16%	5%
% of Current Students Employed	50%	40%
Income Distribution and Taxes/Transfers		
Median Personal Income	$33,500 USD	$40,500 USD
Poverty Line for Single Individual	$16,200 USD	$14,580 USD
Gini Coefficient for Income	0.32	0.38
Marginal Tax Rate at Average Income	41%	41%
Heathcote et al. (2017) Tax Progressivity	0.133	0.184
1-Month Individual UI Replacement Rate	23%	35%
Union Membership Rate	13.7%	10.3%

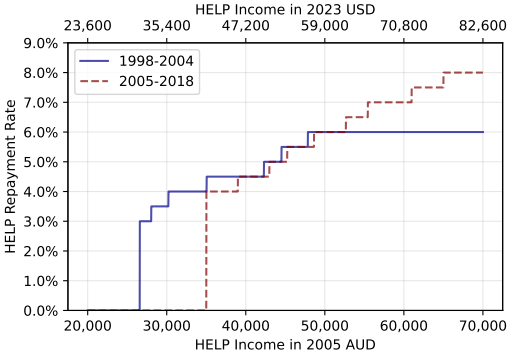
◂ Back: Benefits ◂ Back: Differences

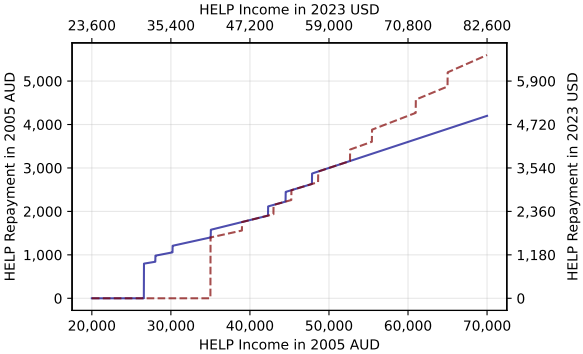
Marginal HELP Repayment Rates on 100 AUD



Back

HELP Repayment Rates and Repayments





Back

FINANCIAL REVIEW

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Print article

Ease HECS burden on students, say universities

Kate Marshall

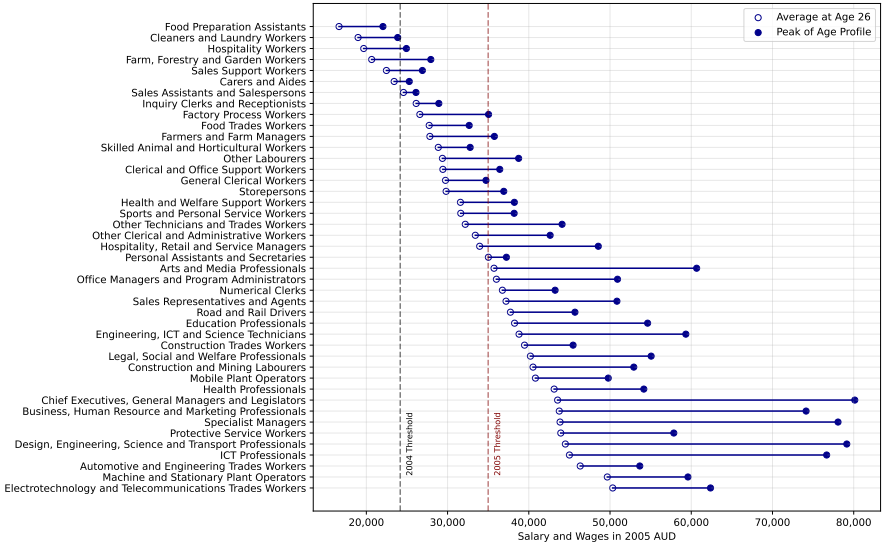
Jan 9, 2003 – 11.00am

Save Share

Australian students owing more than $9 billion of debts to the federal government should be spared financial heartache under a proposal to lift the income threshold for repayments, the Australian Vice-Chancellors Committee said yesterday.

Back

Occupation-Specific Income Profiles Relative to Thresholds

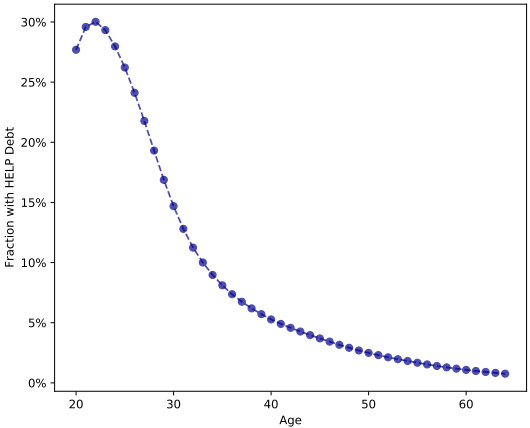


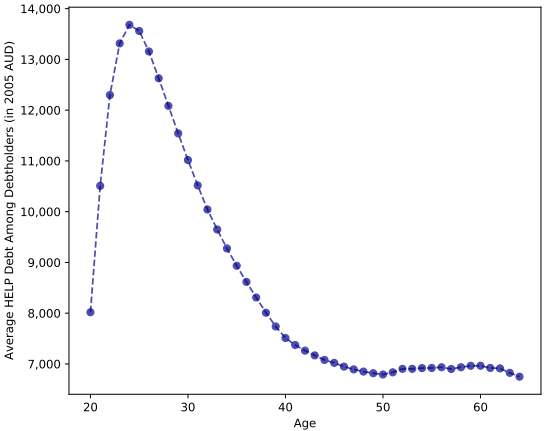
◂ Back: Policy ◂ Back: Hours

Summary Statistics

	Non-Debtholders (1)	Debtholders (2)
Demographics		
Age	41.1	29.5
Female	0.46	0.60
Wage-Earner	0.85	0.91
Income Totals (in 2005 AUD)		
Taxable Income	37,695	27,796
HELP Income	38,756	28,586
Income Components (in 2005 AUD)		
Salary & Wages	32,415	26,068
Labor Income	35,480	27,136
Interest & Dividend Income	726	242
Capital Income	1,221	324
Net Deductions	-1,548	-1,099
HELP Variables		
HELP Debt (in 2005 AUD)	·	10,830
HELP Payment (in 2005 AUD)	·	991
HELP Debt at Age 26 (in 2005 AUD)	·	13,156
HELP Payment at Age 26 (in 2005 AUD)	·	1,305

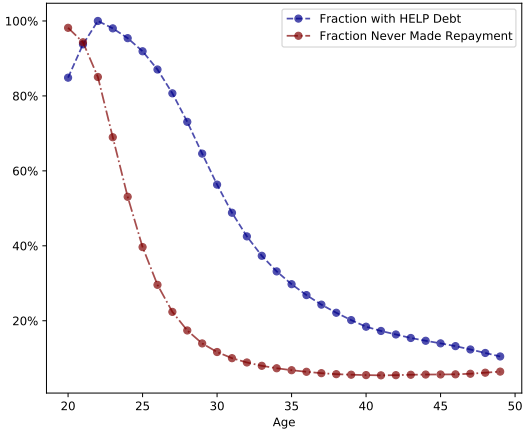
Debt Balances by Age

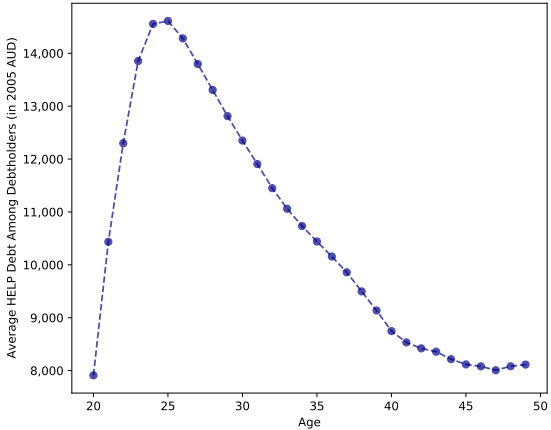




Back

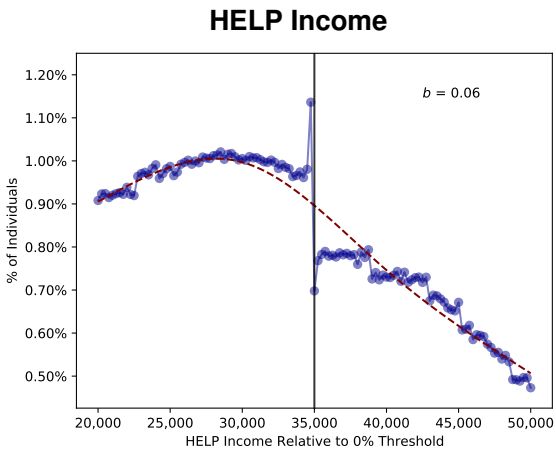
Debt Balances by Age: Individuals with Positive Debt at Age 22

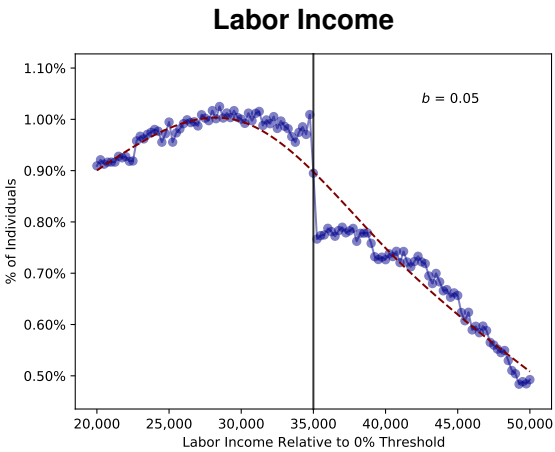




Back

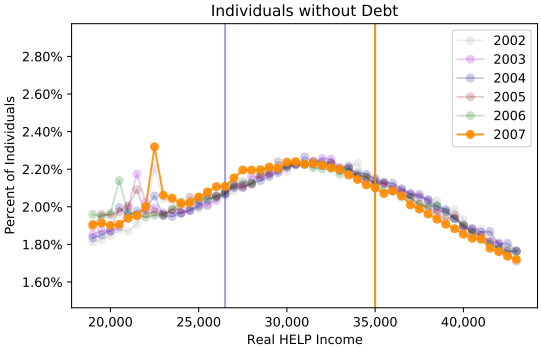
83% of Bunching in HELP Income Present in Labor Income

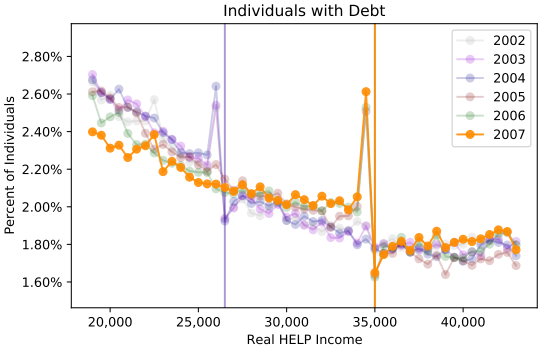




Back

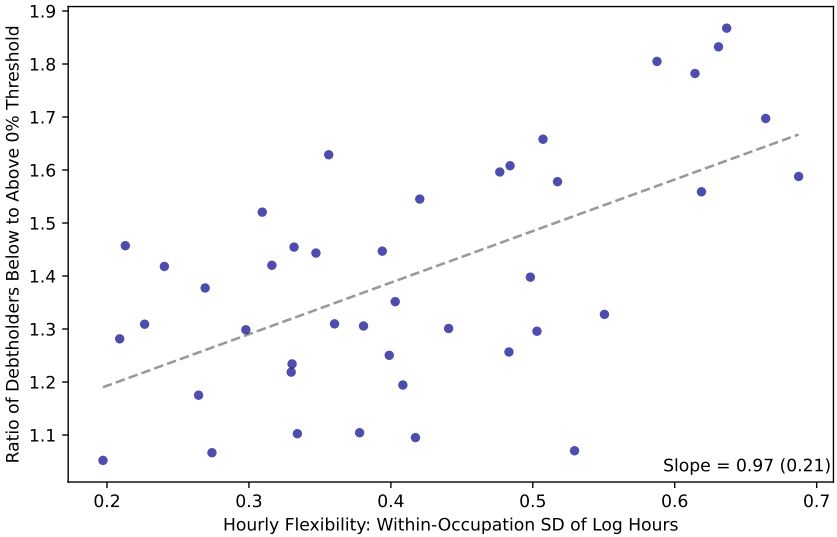
No Bunching at Repayment Threshold for Non-Debtholders





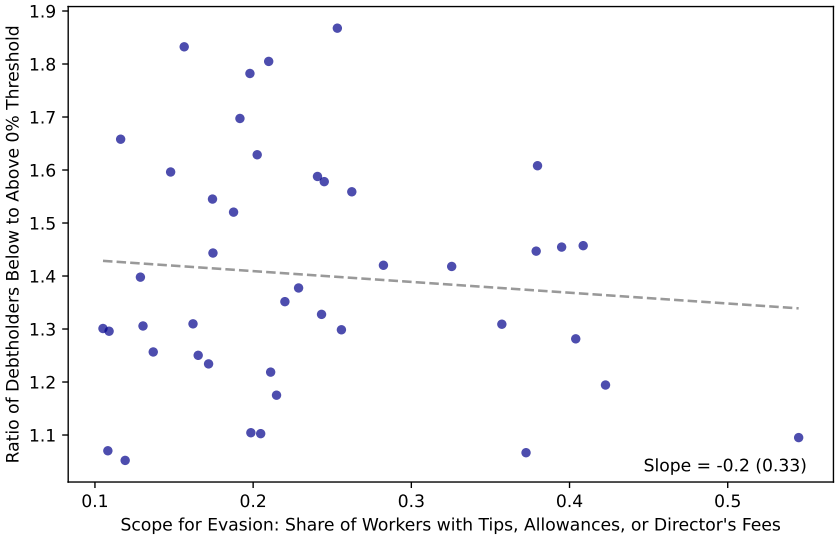
Back

Alternative Measure of Hourly Flexibility



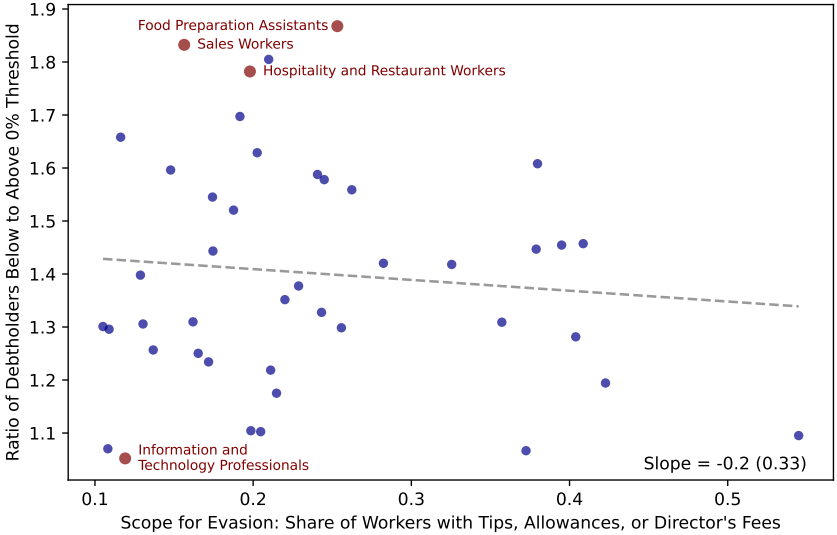
Back

Bunching Uncorrelated with Measure of Evasion



Back

Bunching Uncorrelated with Measure of Evasion



Occupation-Level Regressions

	Ratio of Debtholders Below to Above Threshold						
	(1)	(2)	(3)	(4)	(5)	(6)	(7)
Hourly Flexibility: SD of Changes in Log Hours	1.30	·	·	·	1.30	1.05	0.50
	(0.35)	·	·	·	(0.35)	(0.28)	(0.23)
Evasion: Share with Non-Wage Income	·	−0.20	·	·	−0.02	−0.17	0.05
	·	(0.30)	·	·	(0.30)	(0.30)	(0.25)
Income Slope: Mean Wage at 45 / Mean Wage at 26	·	·	−0.53	·	·	−0.40	·
	·	·	(0.10)	·	·	(0.12)	·
Income Peak: Maximum Wage in Occupation Profile	·	·	·	−0.48	·	·	−0.40
	·	·	·	(0.06)	·	·	(0.07)
R^2	0.34	0.01	0.23	0.58	0.34	0.46	0.62
Number of Occupations	43	43	43	43	43	43	43

◂ Back: Hours ◂ Back: Summary

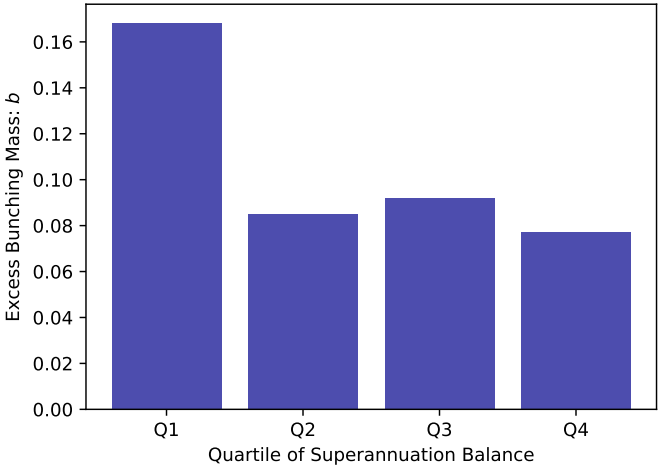
- Bunching statistic calculated as in prior literature (Chetty et al. 2011, Kleven-Waseem 2013)
  1. Fit 5-piece spline leaving out [\$32,500, \$35,000 + X] $\Rightarrow$ **counterfactual density**
  2. Iterate and choose X so that counterfactual density integrates to 1
  3. $$b = \frac{\text{observed mass in [\$32,500, \$35,000]}}{\text{counterfactual mass in [\$32,500, \$35,000]}} - 1$$

- $b = 0.1 \Rightarrow$ 10% more people below threshold than would be absent discontinuity
  - Note: normalization makes b comparable across distributions of different shapes

- **Sample:** All debtholders age 20 to 64 pooled across 2005 to 2018
  - Income deflated to 2005 so 0% threshold constant in real terms at **\$35,000**

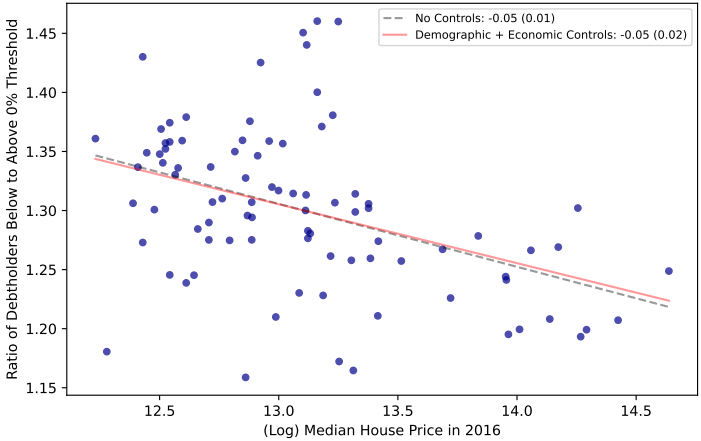
Back

Bunching Heterogeneity by Super Wealth: Ages 20-29



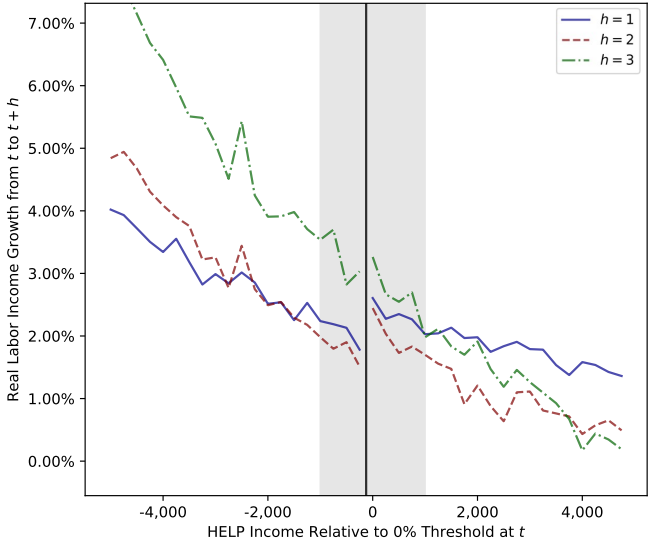
Back

Less Bunching in Regions with More Housing Wealth



Back

Limited Evidence of Dynamic Cost to Bunching



Bunching Among Wage-Earners vs. Entrepreneurs

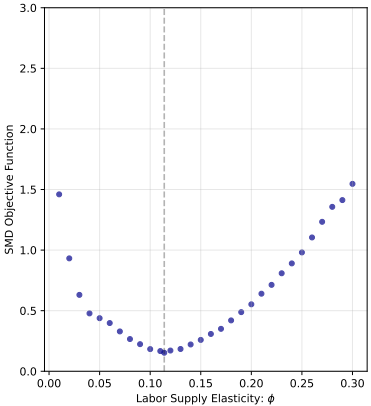
Note: Entrepreneur defined as having positive sole trader, partnership, or personal services income

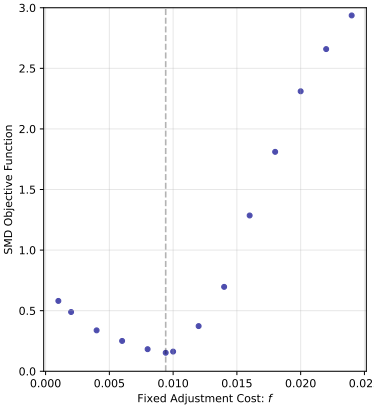
Elasticity of Moments with Respect to Parameters

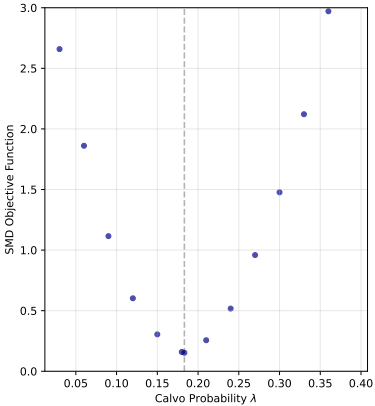
	ϕ	f	λ
Mass Below 2004 Threshold	0.08	-0.16	0.21
Mass Above 2004 Threshold	-0.03	0.09	-0.13
Mass Below 2005 Threshold	0.12	-0.16	0.28
Mass Above 2005 Threshold	-0.04	0.09	-0.19
Ratio 2005 0%	0.22	-0.34	0.64
Ratio 2005 0.5%	0.13	-0.12	0.16
Ratio 2005 0%, Q1 Debt	0.22	-0.34	0.37
Ratio 2005 0%, Q4 Debt	0.20	-0.33	0.82

Back

SMM Objective is Smooth in Labor Supply Parameters







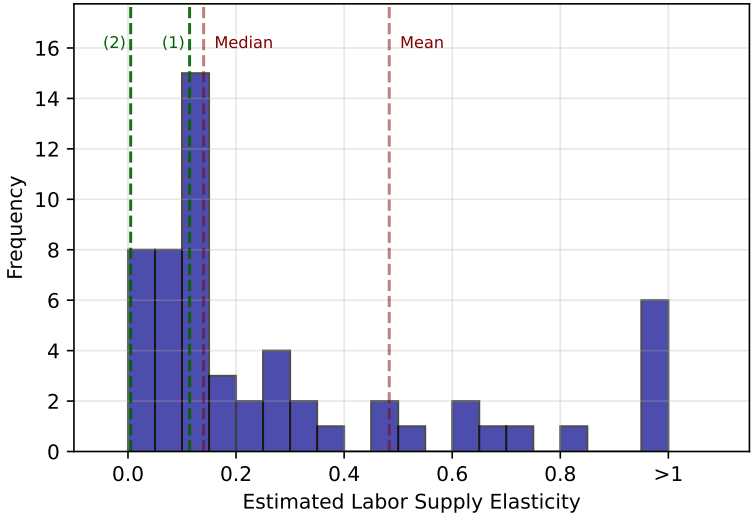
Back

$$\text{Parameters} = \Big(\underbrace{\phi \quad f \quad \lambda \quad \kappa \quad \beta}_{\text{preferences}} \quad \underbrace{\delta_0 \quad \delta_1 \quad \delta_2 \quad \delta_0^E \quad \delta_1^E}_{\text{wage profile}} \quad \underbrace{\rho \quad \sigma_\nu \quad \sigma_\epsilon \quad \sigma_i}_{\text{wage risk}} \Big)$$

- Age profiles of salary & wages $\Rightarrow$ wage profile parameters
- Moments in Guvenen et al. 2022 $\Rightarrow$ wage risk parameters
- Average capital income at ages 40-44 $\Rightarrow \beta$
- Average labor supply $\Rightarrow \kappa$

Back

Comparison with Existing Literature on Labor Supply (1/2)



Source: intensive-margin Hicks and Frisch elasticities in Keane (2011) and Chetty (2012)

Back

Comparison with Existing Literature on Labor Supply (2/2)

Reasons why frictionless elasticity may be smaller/frictions larger:

1. Different sample of college graduates: less flexibility and further from $y_t = w_t l_t$
2. Elasticity is local to threshold: no high-income individuals Gruber-Saez 2002
3. Bunching does not identify extensive margin responses Saez et al. 2012

Contributions:

1. Empirical characterization of responses to income-contingent repayment
   - ℓ_t of indebted households responds to liquidity not wealth, like c_t Ganong-Noel 2020
2. Dynamic model of labor supply with time- and state-dependent adjustment

Back

Full Estimation Results

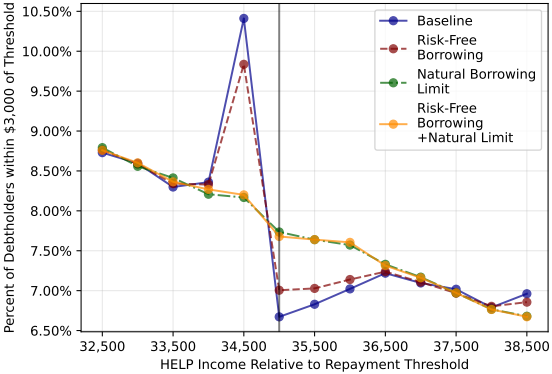
Parameter		Estimation (1)	(2)	(3)	(4)	(5)	(6)	(7)
Labor supply elasticity	ϕ	0.114	0.005	0.188	0.053	0.082	0.111	0.067
		(.004)	(.000)	(.003)	(.002)	(.002)	(.004)	(.002)
Adjustment cost	f	\$377	\$0	\$2278	\$0	\$762	\$513	\$848
		(\$13)	.	(\$21)	.	(\$10)	(\$19)	(\$11)
Calvo probability	λ	0.183	1	1	0.147	0.346	0.191	0.266
		(.003)	.	.	(.002)	(.009)	(.003)	(.005)
Scaling parameter	κ	0.560	0.030	0.059	0.510	1.242	0.593	0.448
		(.007)	(.003)	(.014)	(.012)	(.116)	(.001)	(.001)
Time discount factor	β	0.973	0.996	0.972	0.944	0.951	0.951	0.946
		(.001)	(.000)	(.001)	(.001)	(.001)	(.001)	(.001)
Wage profile parameters	δ_0	8.922	9.862	8.680	9.389	9.197	9.143	9.211
		(.009)	(.002)	(.006)	(.007)	(.007)	(.008)	(.008)
	δ_1	0.073	0.111	0.073	0.063	0.070	0.075	0.074
		(.000)	(.000)	(.000)	(.000)	(.000)	(.000)	(.000)
	δ_2	−0.001	−0.002	−0.001	−0.001	−0.001	−0.001	−0.001
		(.000)	(.000)	(.000)	(.000)	(.000)	(.000)	(.000)
	δ_0^E	−0.487	−0.294	−0.450	−0.530	−0.480	−0.478	−0.505
		(.002)	(.000)	(.001)	(.002)	(.002)	(.002)	(.002)
	δ_1^E	0.020	0.032	0.018	0.021	0.018	0.020	0.021
		(.000)	(.000)	(.000)	(.000)	(.000)	(.000)	(.000)
Persistence of permanent shock	ρ	0.930	0.914	0.943	0.922	0.889	0.907	0.931
		(.000)	(.000)	(.000)	(.000)	(.000)	(.001)	(.001)
Standard deviation of permanent shock	σ_ν	0.236	0.076	0.196	0.268	0.288	0.275	0.246
		(.000)	(.000)	(.000)	(.000)	(.000)	(.001)	(.001)
Standard deviation of transitory shock	σ_ϵ	0.130	0.504	0.168	0.077	0.064	0.080	0.116
		(.000)	(.000)	(.000)	(.002)	(.002)	(.002)	(.001)
Standard deviation of individual FE	σ_i	0.599	0.101	0.541	0.654	0.625	0.612	0.632
		(.003)	(.001)	(.003)	(.003)	(.003)	(.003)	(.003)
Learning-by-doing parameter	α	0	0	0	0	0.24	0	0
Adjustment cost function		Fixed	Fixed	Fixed	Fixed	Fixed	Linear	Fixed
Misperception of debt payoff		No	No	No	No	No	No	Yes

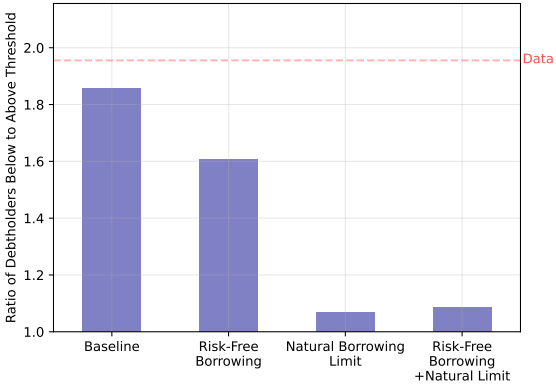
Model Fit: Other Target Moments

Estimation Target	Data	Model
Average Labor Income	$42,639	$45,582
Cross-Sectional Variance of Log Labor Income at Age 22	0.453	0.462
Cross-Sectional Variance of Log Labor Income at Age 32	0.555	0.491
Cross-Sectional Variance of Log Labor Income at Age 42	0.577	0.525
Cross-Sectional Variance of Log Labor Income at Age 52	0.539	0.580
Cross-Sectional Variance of Log Labor Income at Age 62	0.608	0.657
Linear Age Profile Term	0.077	0.080
Quadratic Age Profile Term	−0.001	−0.001
Education Income Premium Constant	−0.574	−0.554
Education Income Premium Slope	0.023	0.023
10th Percentile of 1-Year Labor Income Growth	−0.387	−0.392
10th Percentile of 5-Year Labor Income Growth	−0.667	−0.705
90th Percentile of 1-Year Labor Income Growth	0.415	0.393
90th Percentile of 5-Year Labor Income Growth	0.698	0.710
Average Labor Supply	1.000	0.963
Average Capital Income between Ages 40 and 44	$1,338	$1,332

Back

Liquidity: Borrowing Constraints Amplify Responses

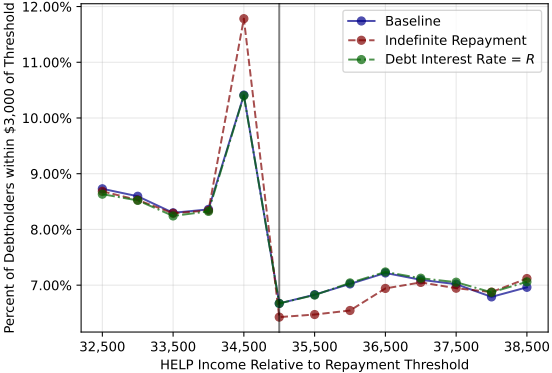




- Model: complete markets $\Rightarrow \downarrow$ value of repayment reduction $\Rightarrow$ bunching $\downarrow$ **90%**
- Data: bunching $\downarrow$ in wealth and $\uparrow$ in liquidity demands

Back

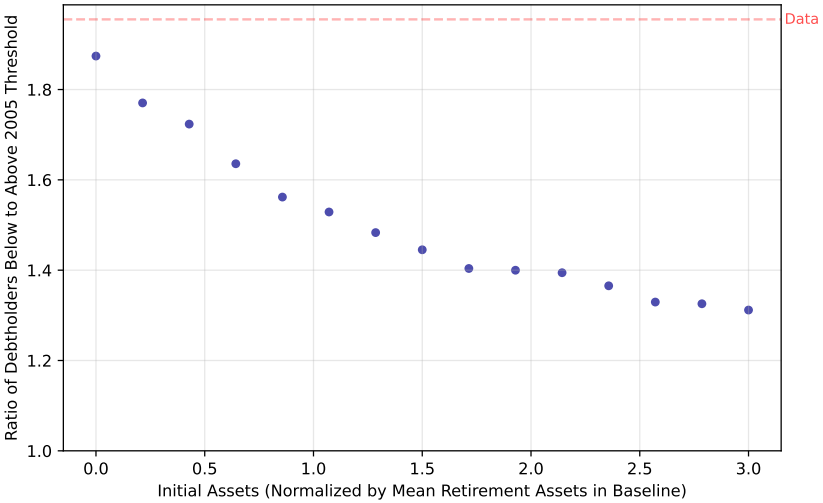
Dynamics: Bunching Depends on Probability of Repayment



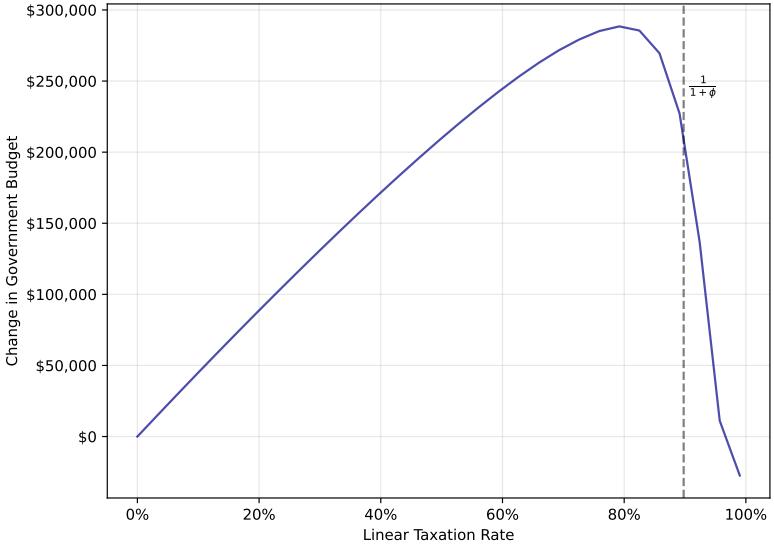
- Model: no repayment limit $\Rightarrow \uparrow$ PDV of repayment reduction $\Rightarrow$ bunching $\uparrow$ **70%**
- Data: bunching increases with debt and decreases with lifetime income

Back

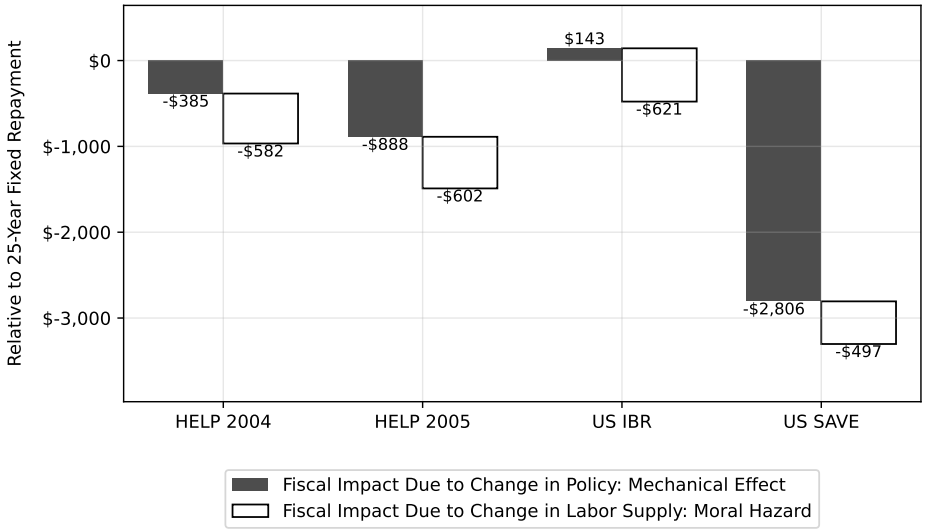
Model: Bunching Decreases in Initial Assets



Laffer Curve from Linear Taxation



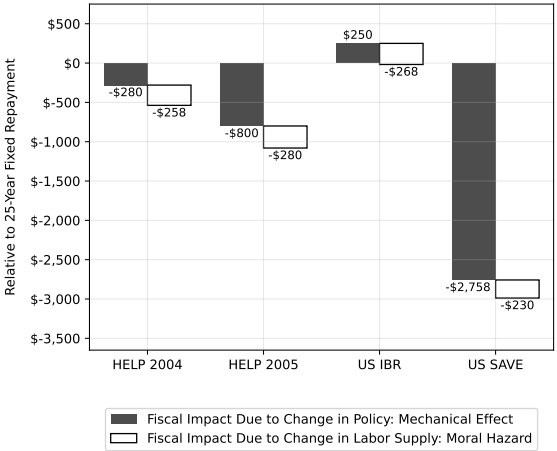
Decomposition of Fiscal Impact: Endogenous Labor Supply



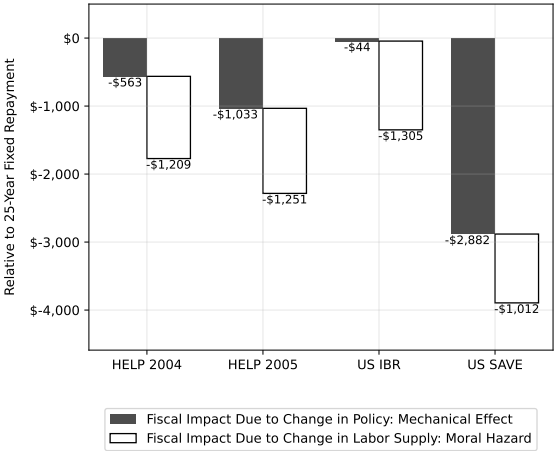
▸ Vary ϕ ◂ Back

Decomposition of Fiscal Impact: Alternative ϕ

$\phi = \mathbf{0.052}$

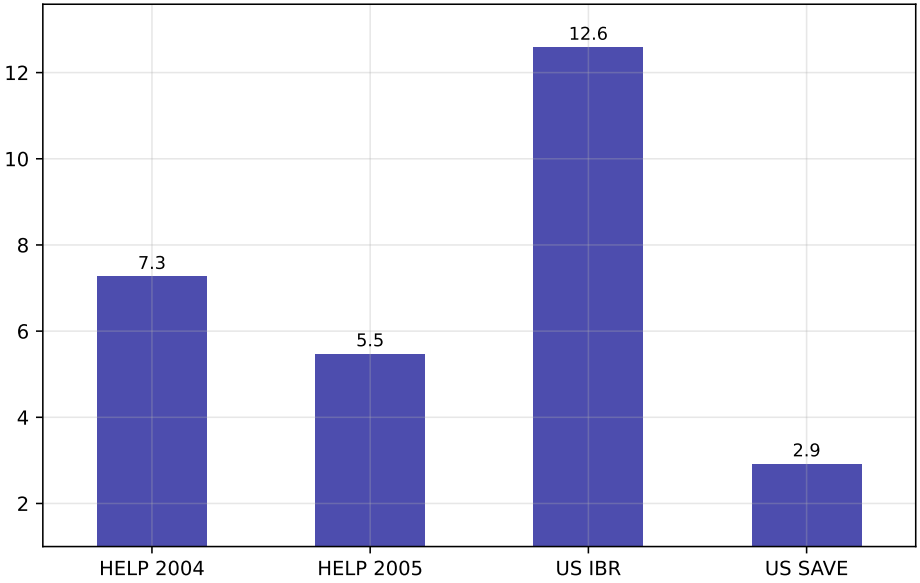


$\phi = \mathbf{0.21}$



Back

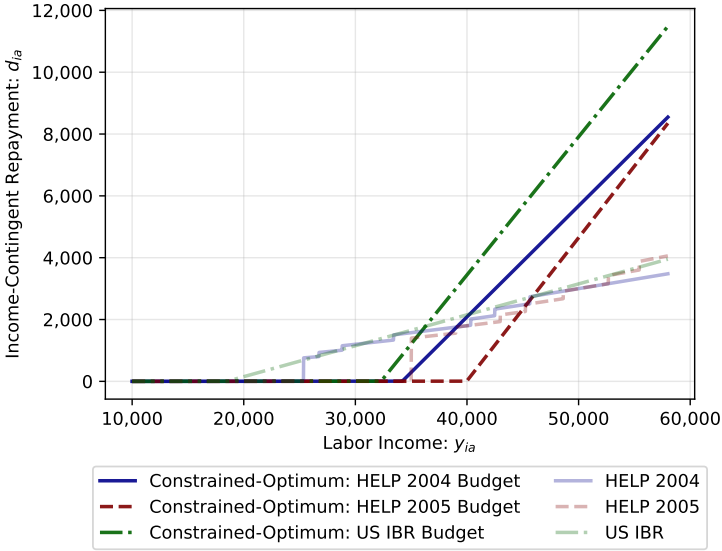
Marginal Value of Public Funds



Solution to Constrained Planner's Problem: Quadratic

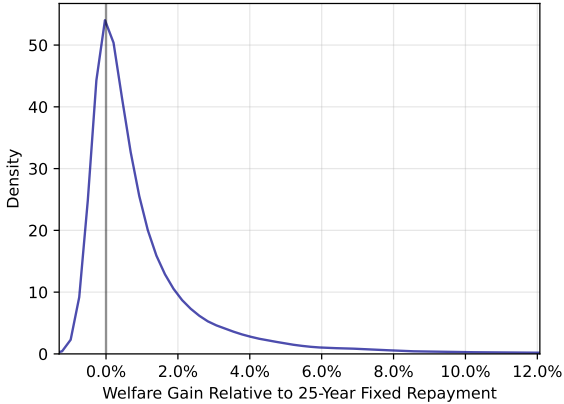
Back

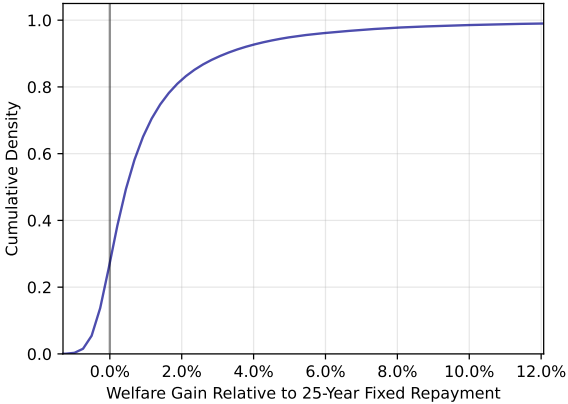
Optimal versus Existing Income-Contingent Loans



Back

Distribution of Initial Welfare Gains: ICL

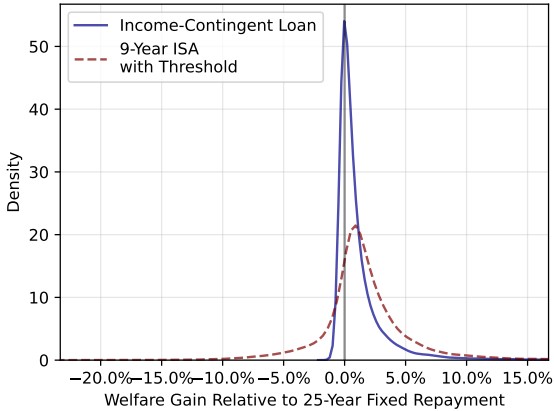


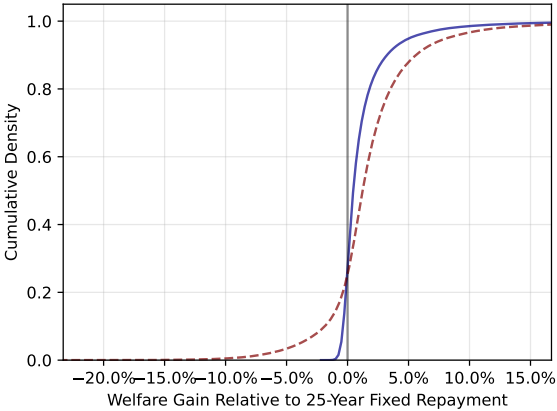


- Only **1.2%** of borrowers have welfare loss above 0.5%

▸ Heterogeneity by States ▸ Losers ▸ Age ◂ Back

Distribution of Initial Welfare Gains: ISA

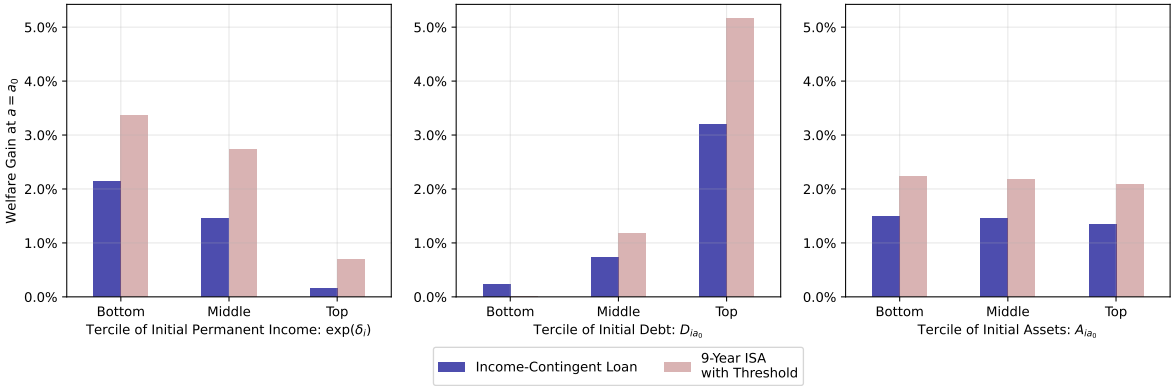




- **18%** of borrowers have welfare loss above 0.5% for ISA vs. **1.2%** for ICL

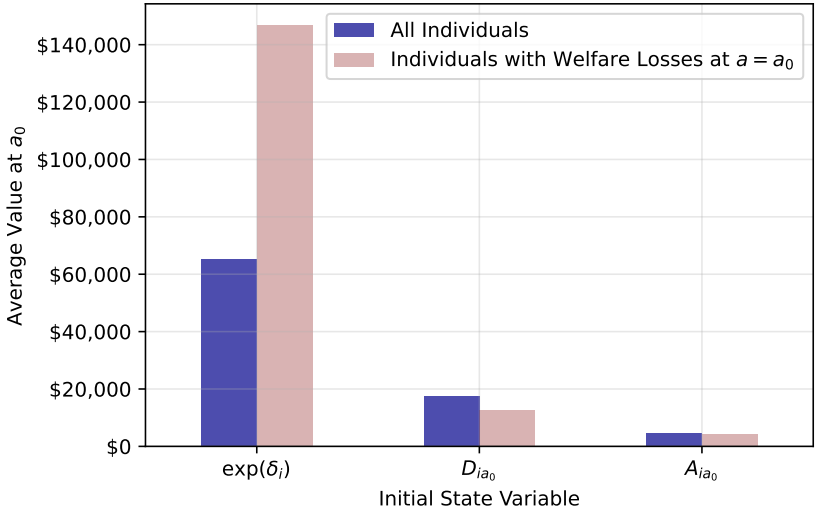
▸ Heterogeneity by States ◂ Back

Heterogeneity in Welfare Gains across Initial States



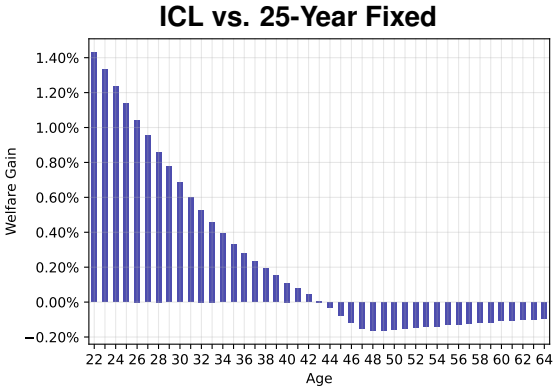
Losers ICL | Age | Initial CEQ | ICL | ISA

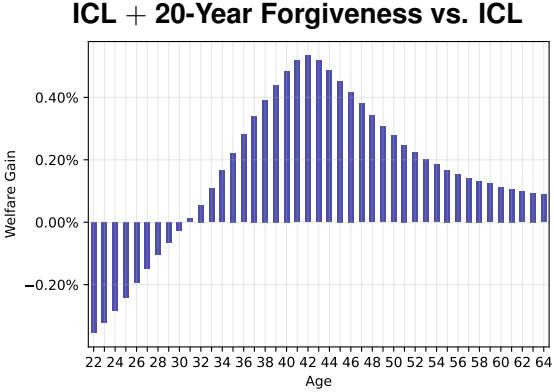
Individuals with Initial Welfare Losses: ICL



Age ICL ISA

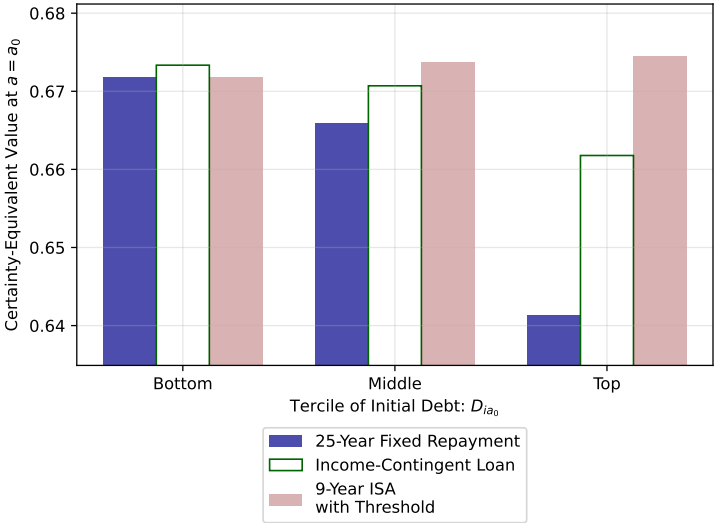
Welfare Gains by Age





◂ ICL ◂ ISA

Certainty-Equivalents across Initial Debt



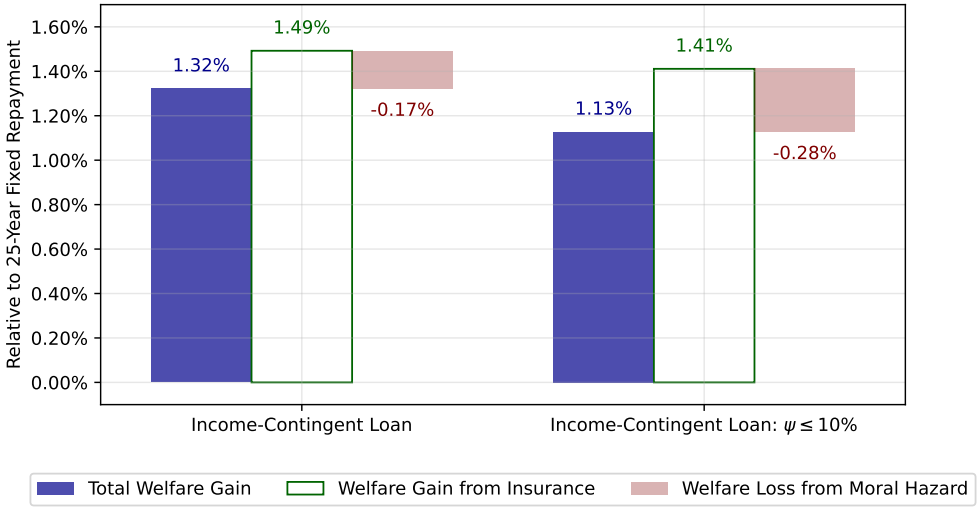
◂ ICL ◂ ISA

Welfare Gains from Income-Contingent Loans: Alt. Models

	Difference from Baseline Model	Welfare Gain	= Insurance	+ Moral Hazard	ψ^*	K^*
(1)	Occupation Heterogeneity	1.32%	1.45%	−0.13%	41%	$28,694
(2)	Learning-by-Doing	1.68%	·	·	35%	$36,615
(3)	Linear Adjustment Costs	1.74%	1.87%	−0.13%	53%	$43,560
(4)	Wealth Effects on Labor Supply	0.82%	1.05%	−0.23%	37%	$30,307
(5)	Less Persistent Shocks: $\rho = 0.8$	0.90%	1.14%	−0.23%	42%	$34,244
(6)	More Persistent Shocks: $\rho = 0.99$	1.35%	1.63%	−0.28%	35%	$18,949
(7)	Non-Normal Permanent Shocks	1.14%	1.43%	−0.30%	28%	$26,933
(8)	Debt Interest Rate = 2%	1.96%	2.14%	−0.18%	38%	$47,731
(9)	Planner Discount Rate = R	1.06%	1.41%	−0.35%	29%	$22,696
(10)	Planner Discount Rate = $R + 4\%$	1.60%	1.65%	−0.05%	46%	$34,441
(11)	US Tax System	1.18%	1.36%	−0.19%	38%	$28,838
(12)	Larger Initial Debt Balances	3.50%	4.72%	−1.22%	36%	$18,867
(13)	No Ex-Post Uncertainty	0.58%	0.76%	−0.17%	27%	$18,098
(14)	No Uncertainty	−0.17%	0.15%	−0.32%	21%	$26,906
	Average	1.33%	1.60%	−0.29%	36%	$29,777
	Baseline Model	**1.32%**	**1.47%**	**-0.15%**	**33%**	**$27,147**

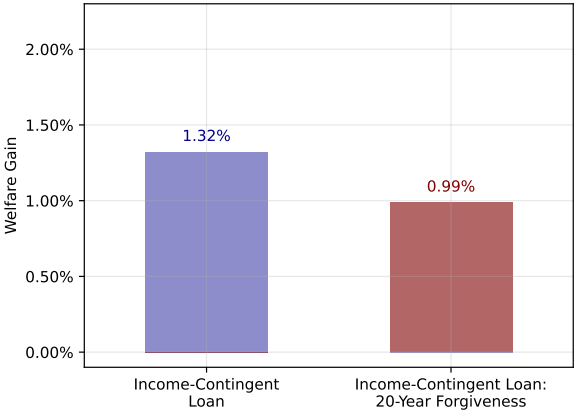
◂ ICL ◂ FP ◂ ISA

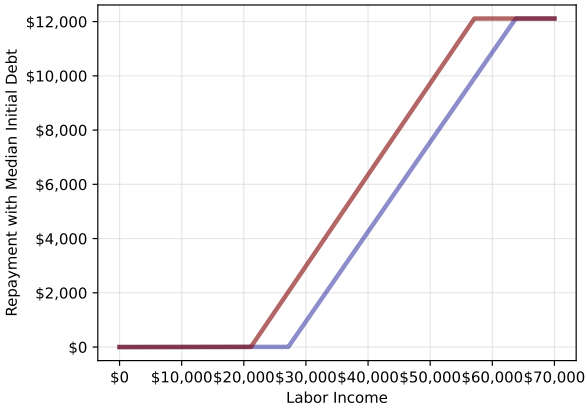
Constraining Repayment Rate Reduces Welfare Gains



Back

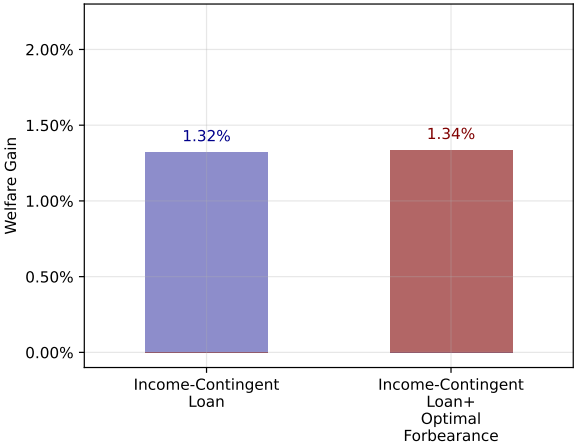
Forgiveness Reduces Welfare Gains

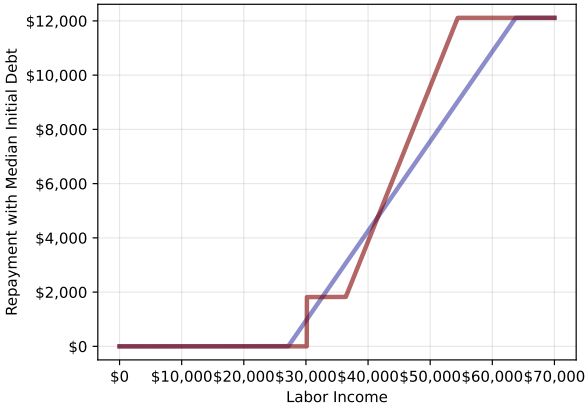




Back

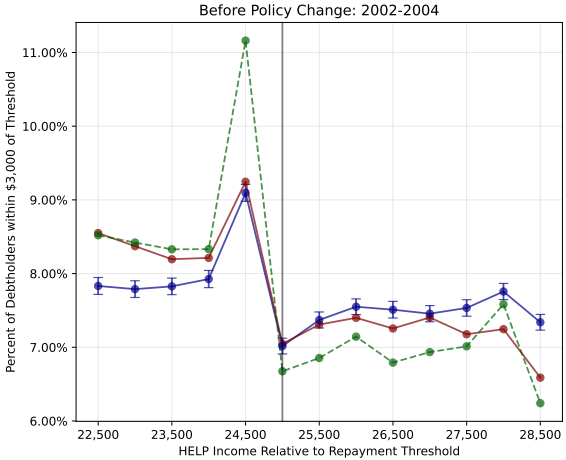
No Gains to Adding Forbearance to Income-Contingent Loans

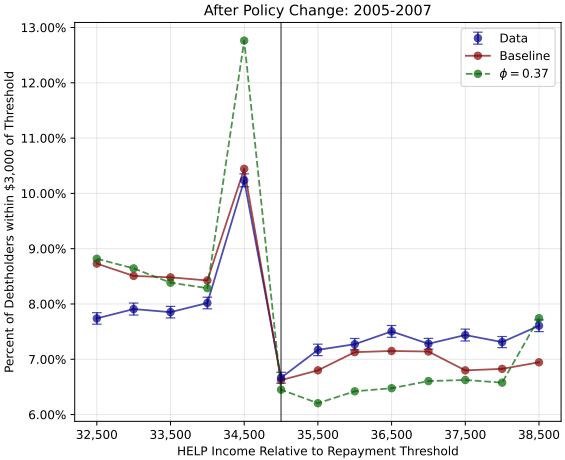




Back

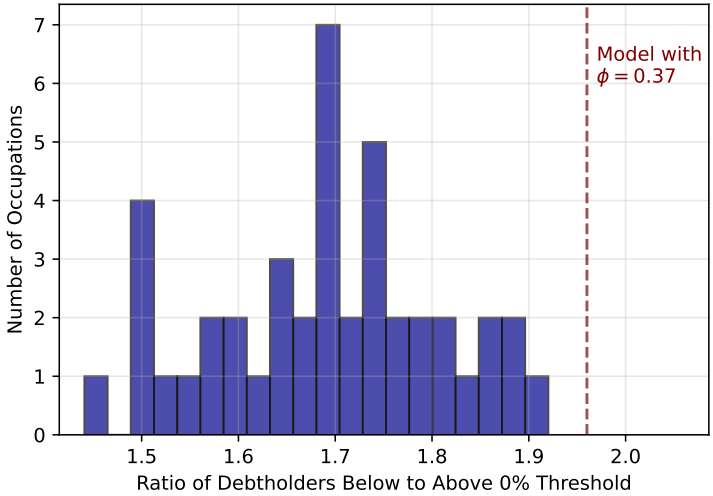
Fit of Model in which Fixed Repayment is Optimal





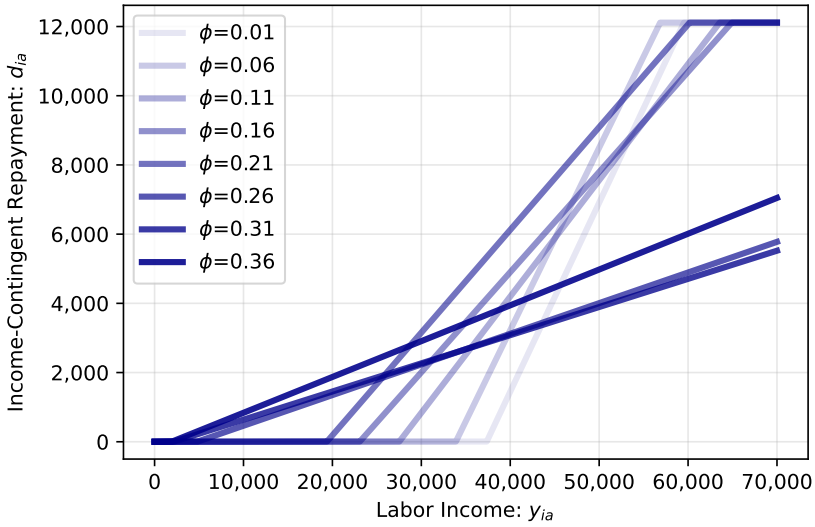
Occupations Back

Bunching when Fixed Repayment is Optimal vs. Occupations



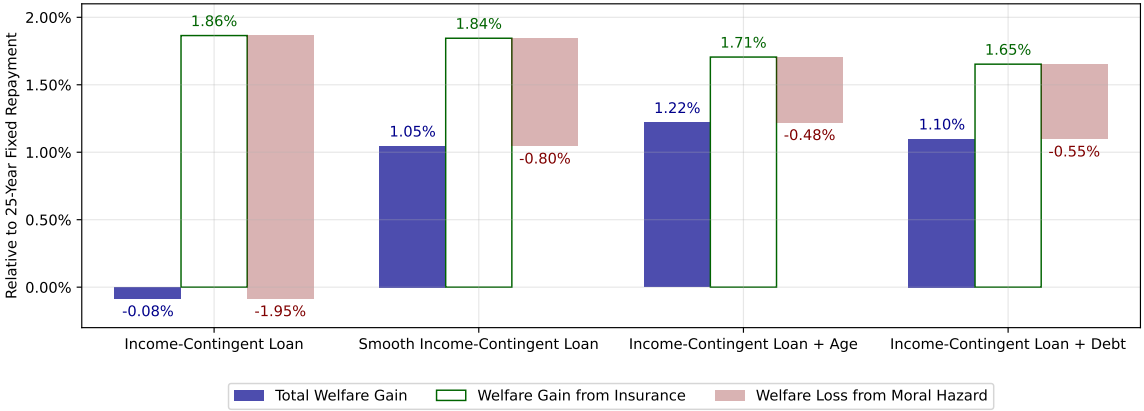
Back

How Income-Contingent Loans Vary with ϕ



Back

Alternative Contracts Reduce Welfare Cost of Moral Hazard



Contracts | Baseline ϕ | Back

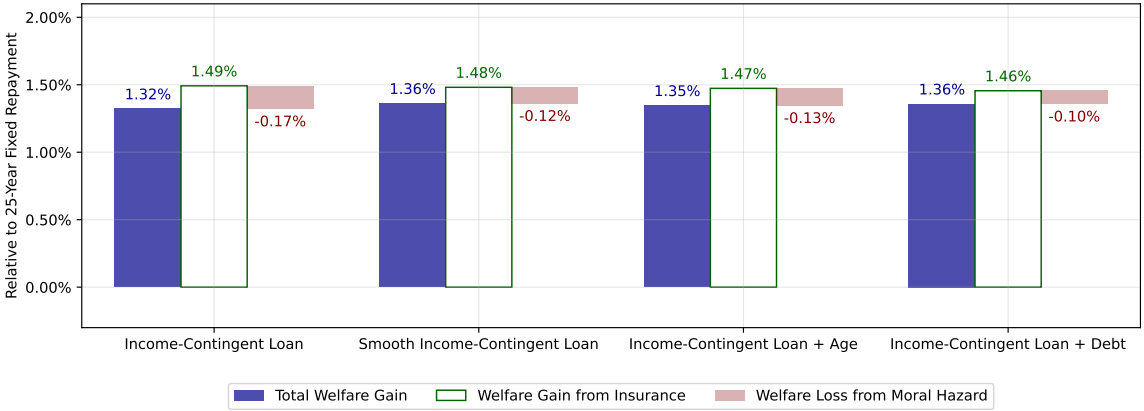
Alternative Forms of Income-Contingent Loans: $\phi = 0.37$

Back

Alternative Forms of Income-Contingent Loans: Baseline ϕ

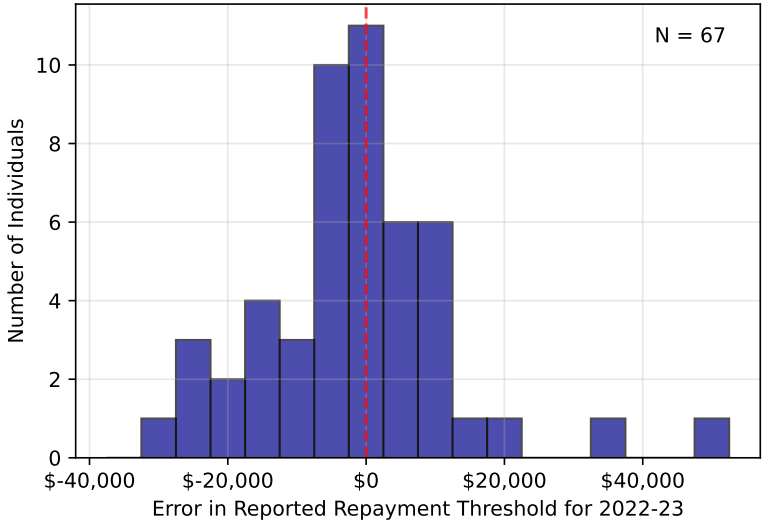
Back

Reducing Welfare Cost of Moral Hazard: Baseline ϕ

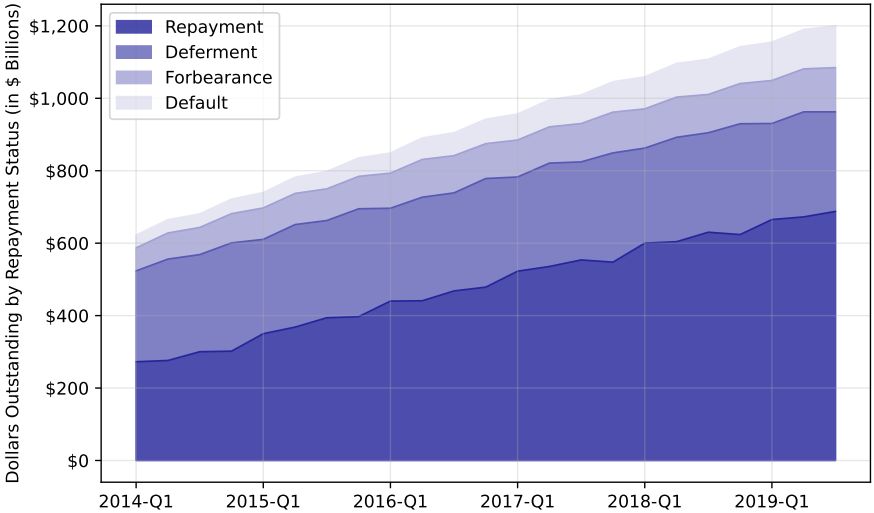


Back

Survey of Threshold Location



Repayment Status of US Student Loans



Physical vs. logical page numbers

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- Mac: Cmd + K, uncheck ”Use Logical Page Numbers”
- Might have to toggle on/off if it’s off already

Jump to page numbers

- Windows: Ctrl + Shift + N
- Mac: Cmd + Shift + N

101 Welfare Gain is Positive as Long as $\phi < 0.37$
102 Next: Other Budget-Neutral Contracts...
103 Next: Other Budget-Neutral Contracts...
104 Next: Other Budget-Neutral Contracts...
105 Next: Other Budget-Neutral Contracts...
106 Next: Other Budget-Neutral Contracts...
107 Outline
108 Main Results
109 Main Results
110 The Big Picture
112 .
113 START OF APPENDIX
114 Variable Definitions
115 AU–US Differences Most Likely to Affect Contract Design
116 Differences between Australia and US: Statistics
117 Marginal HELP Repayment Rates on 100 AUD
118 HELP Repayment Rates and Repayments
119 News Article: Policy Change
120 Occcupation-Specific Income Profiles Relative to Thresholds
121 Summary Statistics
122 Debt Balances by Age
123 Debt Balances by Age: Individuals with Positive Debt at Age 22
124 83% of Bunching in HELP Income Present in Labor Income
125 No Bunching at Repayment Threshold for Non-Debtholders
126 Alternative Measure of Hourly Flexibility
127 Bunching Uncorrelated with Measure of Evasion
128 Bunching Uncorrelated with Measure of Evasion
129 Occupation-Level Regressions
130 Computation of Bunching Statistic
131 Bunching Heterogeneity by Super Wealth: Ages 20-29
132 Less Bunching in Regions with More Housing Wealth
133 Limited Evidence of Dynamic Cost to Bunching

168 Survey of Threshold Location
169 Repayment Status of US Student Loans
170 Shortcuts in Adobe Acrobat