Why do federal loans crowd out the private market?
Evidence from graduate PLUS loans *

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Abstract

I investigate why access to federal student loans crowds out the private market by exploiting the introduction of graduate PLUS loans, which relaxed the federal borrowing limit on graduate students. Access to PLUS loans leads students to replace private with PLUS loans almost one for one, but does not increase borrowing. This suggests that students did not face credit rationing in the absence of PLUS loans. I use credit data to compare private to federal loans. Previous research has been unable to make these comparisons due to a lack of access to private student loan and credit file information. I find that most graduate students could receive private loans with an interest rate below the federal rates. For health students, this amounts to paying an extra $13,000 over ten years. Federal and private loans also differ in that federal loans offer income driven repayment plans. These plans function as insurance against low future wages. I model the expected utilities from federal and private loans, taking this insurance into account, and find the decision to have more expensive federal loans can be rationalized for most borrowers.

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