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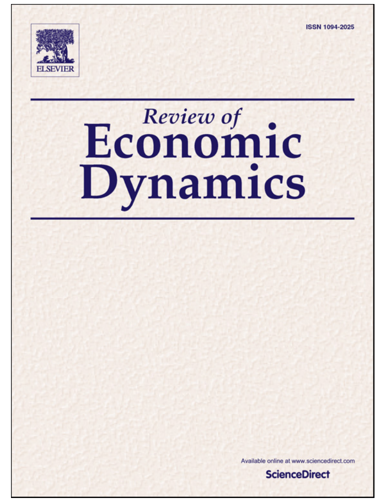

Under-Insurance in Human Capital Models with Limited Enforcement

Tom Krebs, Moritz Kuhn, Mark Wright

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Under-Insurance in Human Capital Models with Limited Enforcement*

Tom Krebs
University of Mannheim†

Moritz Kuhn
University of Bonn

Mark Wright
FRB Chicago and NBER

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Abstract

This paper uses a macroeconomic model calibrated to U.S. data to show that limited contract enforcement leads to substantial under-insurance against human capital risk. The model economy is populated by a large number of risk-averse households who can invest in risk-free physical capital and risky human capital. Expected human capital returns are age-dependent and calibrated to match the observed life-cycle profile of median labor income. Households have access to a complete set of credit and insurance contracts, but their ability to use the available financial instruments is limited by the possibility of default (limited contract enforcement). According to the baseline calibration, young households are severely under-insured against human capital (labor income) risk and the welfare losses due to the lack of insurance are substantial. These results are robust to realistic variations in parameter values.

Keywords: Human Capital Risk, Limited Enforcement, Insurance

JEL Codes: E21, E24, D52, J24

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†Corresponding author: Department of Economics, L7,3-5, 68131 Mannheim, Germany. E-mail: tkrebs@uni-mannheim.de