Health Care Financing: Economic Theory

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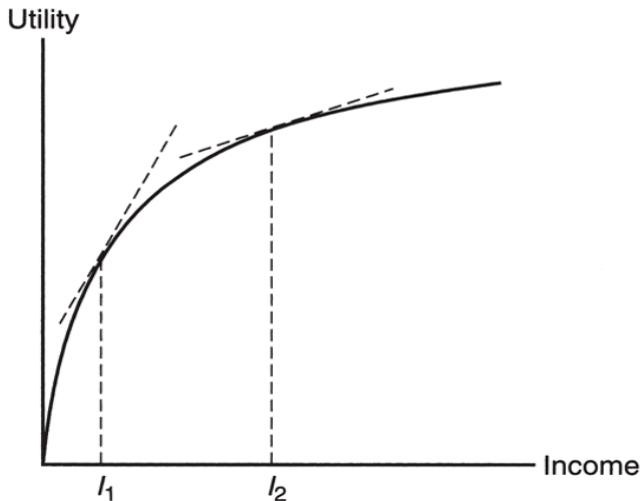May 2017

Outline

1. Health Insurance
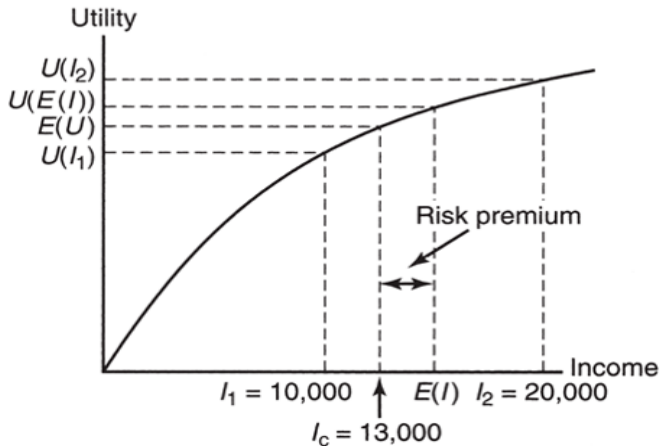
2. Insurance Market

3. Othe issues

Why to demand health insurance

- Health insurance insures against financial risk due to the random nature of illness
- Risk averse decision maker: expected utility is lower than the utility of the expected income
- Simply, utility with insurance is higher than expected utility without insurance
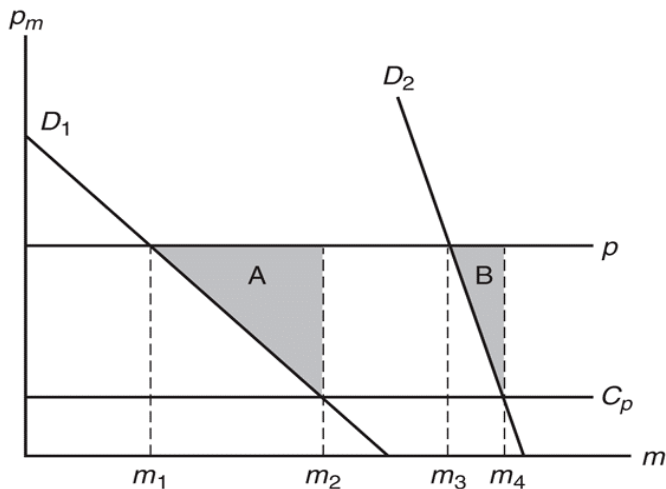
Declining marginal utility with income, risk averse

Benefit from insurance, risk premium
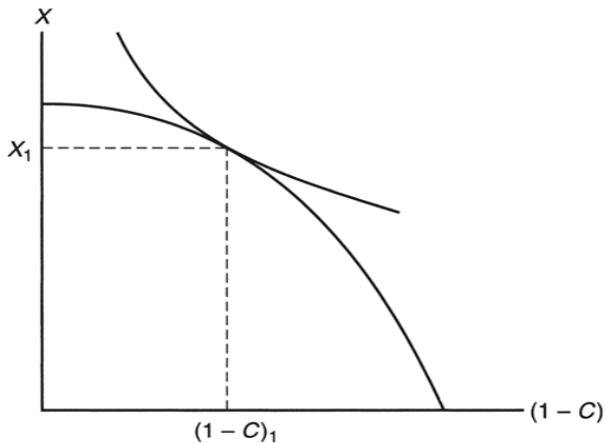
Cost from insurance, welfare loss

Optimal Demand

- Optimal coinsurance rate: balances the welfare gains from reduction of financial risk versus the welfare loss from the effects of increasing demand for medical care

- Greater demand to the more financial risk and the less price elastic demand for medical care
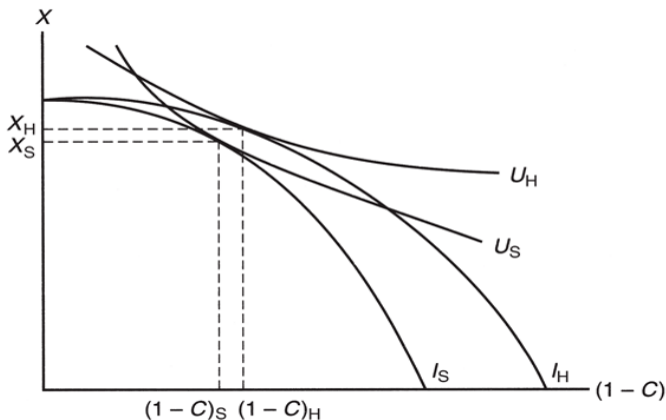
Unstable Market

- Adverse selection due to asymmetric information,
- Competitive separating equilibrium vs. Regulatory community rating outcome,
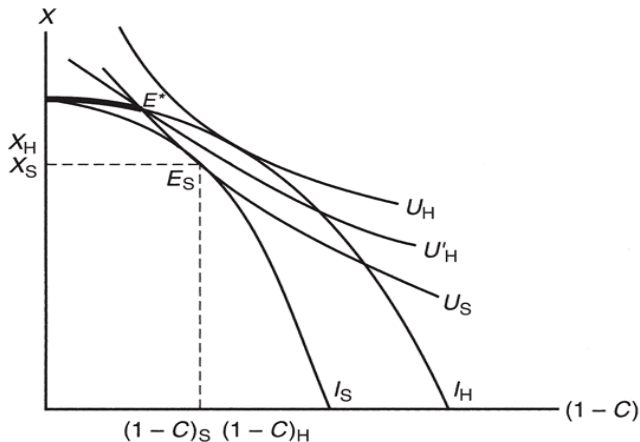
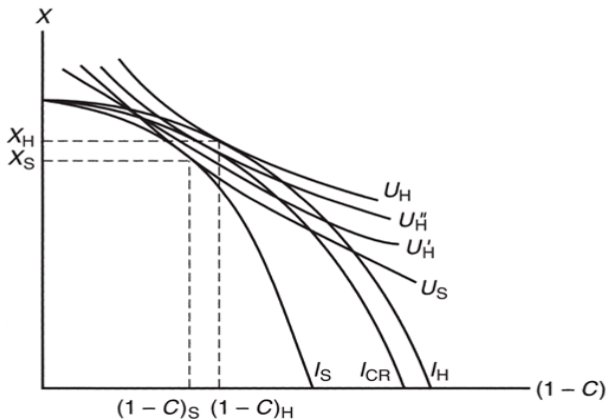## Optimal purchase of insurance

Optimal purchase with experience rating (no asymmetric information)

Separating equilibrium outcome (asymmetric information)

Mandatory community rating outcome (asymmetric information)

Optimal Demand, continued

- Under separating equilibrium outcome: utility loss to healthy consumers

- Under mandatory community rating outcome: possible improvement for both healthy and sick consumers

Conclusion

- Employer provision of heath insurance: tax exemption and job mobility
- New insurances(HMO, PPO, POS etc.): reducing over-consumption while eliminating financial risk.
- Crowding out private insurance.
- Individual mandates, HSA, etc. .

Thanks (wankyo@snu.ac.kr).