Credit, Default, and Optimal Health Insurance*

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Abstract

How do defaults and bankruptcies affect optimal health insurance policy? I answer this question, using a life-cycle model of health investment with an option to default on emergency room (ER) bills and financial debts. I calibrate the model to the U.S. economy and compare the optimal health insurance policies according to whether the option to default is available. I find that the option to default induces the optimal policy to be more redistributive. Without the option to default, the optimal policy expands Medicaid for households whose income is below 30.8 percent of the average income without changing policies related to private health insurance. With the option to default, in addition to Medicaid expansion, the optimal policy offers a progressive subsidy for the purchase of private health insurance to all households whose income is above the threshold of income eligibility for Medicaid and reforms the private health insurance market by improving coverage rates and preventing price discrimination based on pre-existing conditions. This disparity implies that households rely on bankruptcies and defaults on ER bill as implicit health insurance. More redistributive reforms can improve welfare by reducing the dependence on this implicit health insurance and changing households' medical spending behavior to be more preventative.

JEL classification: E21, H51, I13, K35.

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