Reducing medical spending of the publicly insured: the case for cash-out option *

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Abstract

It is well-recognized that individuals' spending on medical care is not entirely necessary but is to some extent discretionary. However, the composition of medical spending into necessary and discretionary parts is not (perfectly) observable. In this paper we attempt to understand how this information friction shapes the optimal insurance policy. We start by constructing a simple theoretical framework in the spirit of Mirrlees (1971) where only total medical spending is observable but not its division into discretionary and non-discretionary parts. We show that to induce truth-telling, individuals with low consumption of medical care should be rewarded with high consumption of regular good. Next, we construct a rich structural life-cycle model and evaluate the quantitative impact of this type of policies with application to the public health insurance. The "success" of each policy is measured by benchmarking it against the full information case where the division of medical spending into discretionary and non-discretionary components is observable. We show that the best results are achieved by introducing an option to substitute public health insurance with cash transfers. This is because this policy creates a trade-off between regular and medical consumption, which is the main mechanism behind our theoretical results.

Keywords: medical spending, insurance, moral-hazard, life-cycle models
JEL Classification Codes: D52, D91, E21, H53, I13, I18

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