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The design of long term care insurance contracts¹

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Abstract

This paper studies the design of long term care (LTC) insurance contracts in the presence of *ex post* moral hazard. While this problem bears some similarity with the study of health insurance (Blomqvist, 1997) the significance of informal LTC affects the problem in several crucial ways. It introduces the potential crowding out of informal care by market care financed through insurance coverage. Furthermore, the information structure becomes more intricate. Informal care is not publicly observable and, unlike the insurer, caregivers know the true needs of their relatives. We determine the optimal second-best contract and show that the optimal reimbursement rate can be written as an A-B-C expression à la Diamond (1998). These terms respectively reflect the efficiency loss as measured by the inverse of the demand elasticity, the distribution of needs and the preferences for risk sharing. Interestingly, informal care directly affects only the first term. More precisely the first term *decreases* with the presence and significance of informal care. Roughly speaking this means that an efficient LTC insurance contract should offer lower (marginal) reimbursement rates than its counterpart in a health insurance context.

JEL classification: I13, I18, H51.

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