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Author: Abe Dunn

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Health Insurance and the Demand for Medical Care: Instrumental Variable Estimates Using Health Insurer Claims Data*

Abe Dunn†

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Abstract

This paper takes a different approach to estimating demand for medical care that uses the negotiated prices between insurers and providers as an instrument. The instrument is viewed as a textbook "cost shifting" instrument that impacts plan offerings, but is unobserved by consumers. The paper finds a price elasticity of demand of around -0.20, matching the elasticity found in the RAND Health Insurance Experiment. The paper also studies within-market variation in demand for prescription drugs and other medical care services and obtains comparable price elasticity estimates.

1 Introduction

U.S. medical care expenditures account for a large and growing share of GDP and policy-makers continue to search for mechanisms to rein in expenditure growth. In this environment, understanding the demand for medical care is critical. Estimates of the price elasticity of demand may improve our understanding of patient incentives and lead to policies to help slow the growth of the health care sector. Unfortunately, estimating medical care demand is particularly challenging. One of the central problems is that the marginal price of medical care faced by consumers is often determined by consumers through their selection of a health insurance plan. For instance, the least healthy individuals may be more likely to choose a plan with the most generous insurance coverage, leading to an overestimate of the effect on medical care demand when looking at correlations between the out-of-pocket price and the utilization of medical care.

Both the economic importance of measuring the elasticity of demand as well as the substantial empirical challenge caused by selection were key motivations for conducting the RAND health insurance experiment in the 1970s. The RAND experiment was specifically designed to address the selection problem. The key to its success was the randomization of health insurance coverage across the sample population that allowed researchers to side-step the selection issue and isolate the effect of cost sharing on demand. Although it has been more than 30 years since the RAND experiment was conducted, it remains the gold standard for

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†Bureau of Economic Analysis; abe.dunn@bea.gov

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