14.41 Public Economics, 2002
Section Handout # 9

Public Provision of Health Insurance and Crowd Out

I. Definitions

a. Medicare – health insurance for the elderly
b. Medicaid – health insurance for the poor

II. Theory (using Medicaid as an example)

Individuals cannot purchase a supplement to Medicaid. Therefore, assuming they are eligible for Medicaid, they choice one of three options :

1. private health insurance
2. Medicaid
3. no health insurance (uninsured)

Eligible individuals may decline Medicaid for a variety of reasons:

1. low Medicaid reimbursement rates makes health care providers reluctant to provide service
2. stigma
3. it may be difficult to shift back into private coverage if a pre-existing condition exists

For these reasons the value of Medicaid to an individual may be relatively low compared to the value of private health insurance.

This situation is very similar to the choice of the level of education – apply the Peltzman framework. Increasing the value of Medicaid relative to the underlying demand for health insurance quality will induce individuals to drop private health insurance in favor of Medicaid. It is very difficult to test this prediction in practice. However, the Peltzman type model also predicts that on average, individuals made eligible for Medicaid will reduce their private health insurance coverage.

The model suggests that expanding the eligibility of Medicaid will lead to the crowd out of private insurance. This may be viewed as a problem because it reduces the "bang for the buck" provided by expenditures on Medicaid.

III. Application: Cutler and Gruber's 1996 QJE paper on the crowd out effect of Medicaid expansion.

We want to determine how expanding eligibility for Medicaid effected the amount of private health insurance coverage. The paper tests the second prediction of the Peltzman style model made above : on average, individuals made eligible for Medicaid will reduce their private health insurance coverage.

Natural experiment:

Medicaid was formerly linked to participation in AFDC (welfare). In the late 1980s and early 1990s this link was broken in order to expand the population covered by Medicaid. By 1992 states were required to cover all pregnant women and children under the age of 6 up to 133% of the poverty line. States could voluntarily expand benefits up to 185% of the poverty line. The natural experiment used here has three key sources of variation:

1. states initially had differing qualification limits
2. the states varied in the timing of the implementation of the expanded benefits
3. state variation in the age threshold for coverage of children

Utilizing these sources of variation avoids the problem of legislative endogeneity

Results:

See table IV.

For each child:

- a 10% increase in Medicaid eligibility leads to a .74% decline in private insurance.
- a 10% increase in Medicaid eligibility leads to a 1.2% decline in those in the uninsured state

Crowd out calculations:

If crowd out is defined as the reduction in private insurance coverage accompanying the increase in Medicaid coverage, then the estimate is 31%.
If crowd out is defined as the percent of the increase in Medicaid that was not associated with a reduction in the uninsured population, the estimate is 49%.

Finally, further results suggest that the crowd out occurs via employees having a lower take-up rate rather than employers offering insurance at a lower rate.

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