Health Insurance for Humans: Understanding Consumer Choice Foundations*

Benjamin R. Handel
Economics Department, UC Berkeley and NBER

Jonathan T. Kolstad
Wharton School, University of Pennsylvania and NBER

December 30, 2012

Abstract

Traditional models of insurance choice, both theoretical and empirical, are predicated on rational choice and risk protection. When these models are taken to data, it is typical to use the choices that consumers make from menus of health insurance options to estimate their risk preferences, conditioning on observed health risk. A key empirical assumption is that risk preferences represent the primary component of persistent unobserved preferences: if other factors such as information about plan option or perceived plan hassle costs also impact choices systematically then risk preference estimates will generally be biased. In addition to having positive implications for choice predictions, omitting such unobserved choice factors can have normative implications for welfare analysis. Such additional factors are generally assumed away because distinguishing between risk preferences and other sources of unobserved heterogeneity is very difficult with administrative data on choices and claims alone.

In this paper we combine administrative data on health plan choices with unique survey data on consumer beliefs and other unobserved preference factors to separately identify risk preferences, various information frictions, and plan hassle costs. These data sets are linked at the individual-level and are used to construct observed measures of information frictions and hassle costs. We develop a simple empirical framework that allows us to account for these additional factors in choice and demonstrate that accounting for these typically unobserved features meaningfully alters estimates for conventional parameters in insurance choice such as risk preferences. We develop a welfare framework that integrates both information frictions and hassle costs and assess the welfare impact of a counterfactual menu design with only a high-deductible health plan option. We illustrate that the welfare implications, and subsequent policy decisions, are quite different when these additional choice factors are accounted for.

*We thank Microsoft Research for their support of this work. We also thank seminar participants at Boston College, Stanford IOFest, USC, the University of Chicago, the University of Rochester, the University of Texas and the ASSA Annual meeting. All errors are our own.