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The Moral Hazard of Bankruptcy

Posted on May 21, 2015 by Sarah Sajewski in Health, Labor & Finance, Research in Brief // 0 Comments

A new study finds that Americans use personal bankruptcy as a substitute for traditional health insurance, encouraged by stringent bankruptcy laws.

Many Americans receive health insurance from an unlikely source: bankruptcy. In 2013, medical bills were the number one cause of bankruptcies. A case currently in front of the Supreme Court could end some government healthcare subsidies. This may increase the number of medical bankruptcies. Given this state of affairs, it is time to incorporate bankruptcy into the health policy debate.

Recent evidence suggests that households' medical payments and coverage rates react to state bankruptcy law. In an article published last month, Neale Mahoney studies the impact of state-level bankruptcy exemptions on the likelihood of a household carrying insurance and paying its medical debts. He finds that households with more at stake in bankruptcy are more likely to hold insurance and pay medical debts.

Before 1986, charity care for those who could not afford medical care was common. But the Emergency Medical Treatment and Labor Act (EMTALA) passed in 1986 codified individuals' rights to care on credit. This law required hospitals to provide emergency medical care on credit, regardless of a patient's insurance status or ability to pay. If they cannot afford care, Americans can discharge large medical debts in personal bankruptcy. While many Americans exercise this option, for others, the mere threat of bankruptcy assists in negotiating a settlement with collectors.

Stringent bankruptcy laws encourage households to make more payments on medical debt. In bankruptcy, households must forfeit any assets not subject to state exemptions. For example, some states provide homestead, vehicle, or wild card exemptions of varying dollar amounts. Mahoney exploits the state-level variation to test households' propensity to pay medical debt. He finds that uninsured households with low levels of medical use make similar payments regardless of state law. As medical use increases, households in states with less generous exemptions make more payments on their debt.

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Bankruptcy also acts as a substitute for traditional health insurance. Health insurance protects households from the financial burden of healthcare. Bankruptcy can also alleviate the financial burden of healthcare, but at a steep cost. Households with less generous bankruptcy exemptions are more protected by health insurance from bankruptcy losses. Mahoney's results show that the cost of bankruptcy is positively correlated with healthcare coverage. Health insurance protects household wealth. Controlling for demographics and income level, households in states with less generous bankruptcy exemptions are more likely to own health insurance.

At times, bankruptcy may be the best option for individual households, but it is not the best option for society. When debtors discharge medical debt under bankruptcy, other actors in the healthcare system pay. Mahoney examines optimal insurance penalties that reflect this loss to society. Currently, households with higher incomes pay more in ACA penalties. This policy is inefficient because higher-income households already have incentives to buy healthcare insurance. To decrease medical bankruptcies, households with lower bankruptcy costs would pay high penalties. Wealthier families with higher bankruptcy costs would face lower penalties. Mahoney finds that under this system, optimal penalties are only 75 percent of the current ACA penalties.

Incentives under the current healthcare system push households to use bankruptcy as a sort of high-deductible health plan.

Mahoney's article adds further evidence to the need for continuing healthcare payment reform. The specific tax suggestion is unlikely to be helpful to policy makers. Lawmakers would likely oppose any increase in ACA penalties for low-income families. Still, incentives under the current healthcare system push households to use bankruptcy as a sort of high-deductible health plan. This system forces families to choose bankruptcy over health insurance at great expense to the family and to society.

Article Source: Bankruptcy as Implicit Health Insurance, Neale Mahoney, *American Economic Review,* 2015.

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Sarah Sajewski is a staff writer for the Chicago Policy Review. She is interested in health policy.

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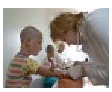
- 

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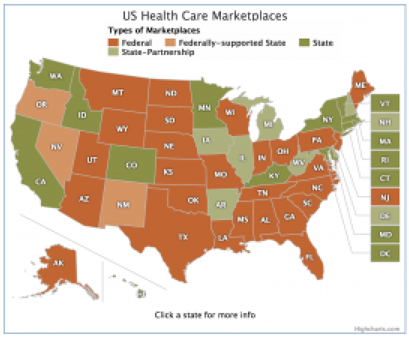
- 

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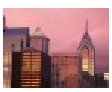
- 

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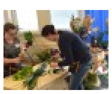
- 

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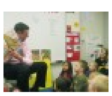
- 

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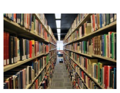
1 

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