Consumer Search Friction, Product Differentiation and Adverse Selection in the Medigap Insurance Market

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Abstract

I consider price dispersion of very similar insurance plans in an environment where adverse selection is a potential concern. This paper aims to empirically disentangle different sources of the price dispersion and investigate how adverse selection affects a market equilibrium and welfare in such an environment. I develop an equilibrium model of a consumer choice of a differentiated insurance plan under search friction and optimal pricing by an insurer. The model is structurally estimated, using data from the Medicare supplement (Medigap) insurance market. In the estimation, I allow for rich heterogeneity of consumers including health risks, income and search costs. The estimates reveal that health risks and search costs are highly correlated, and the unhealthy are more likely to face high search costs. I also decompose causes of price dispersion of Medigap plans and conduct welfare analysis.

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