Liquidity Constraints in Healthcare Expenditure

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Abstract

Liquidity constraints restrain the consumption smoothing ability of optimizing households. This paper evaluates the impact of liquidity constraints on healthcare spending decisions and compares it with the impact on the non-health consumption in particular with food consumption. I show that households deviate from unconstrained level of optimal healthcare spending by the binding liquidity constraints in the current period as well as expected binding constraints one period ahead. In a linearized Euler equation, current binding constraints cause a negative omitted variable bias on income which is predicted to have no impact on consumption growth by permanent income hypothesis, whereas expected binding constraints lead to a positive bias. In the test, the resulting bias depends on which effect is stronger. Moreover, the income elasticity of healthcare expenditure varies significantly between asset poor and rich families, more than the elasticity of non-health consumption among wealth quintiles, a finding that is supportive of the heterogeneous impact of the binding liquidity constraints.

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