DEMAND FOR HEALTH CAPITAL

EE 474 Health Economics

Semester 2/2017

Topics

- The Demand for Health
- Labor–Leisure Trade-Offs
- The Investment/Consumption Aspects of Health
- Investment over Time
- The Demand for Health Capital
- Changes in Equilibrium: Age, Wage, and Education

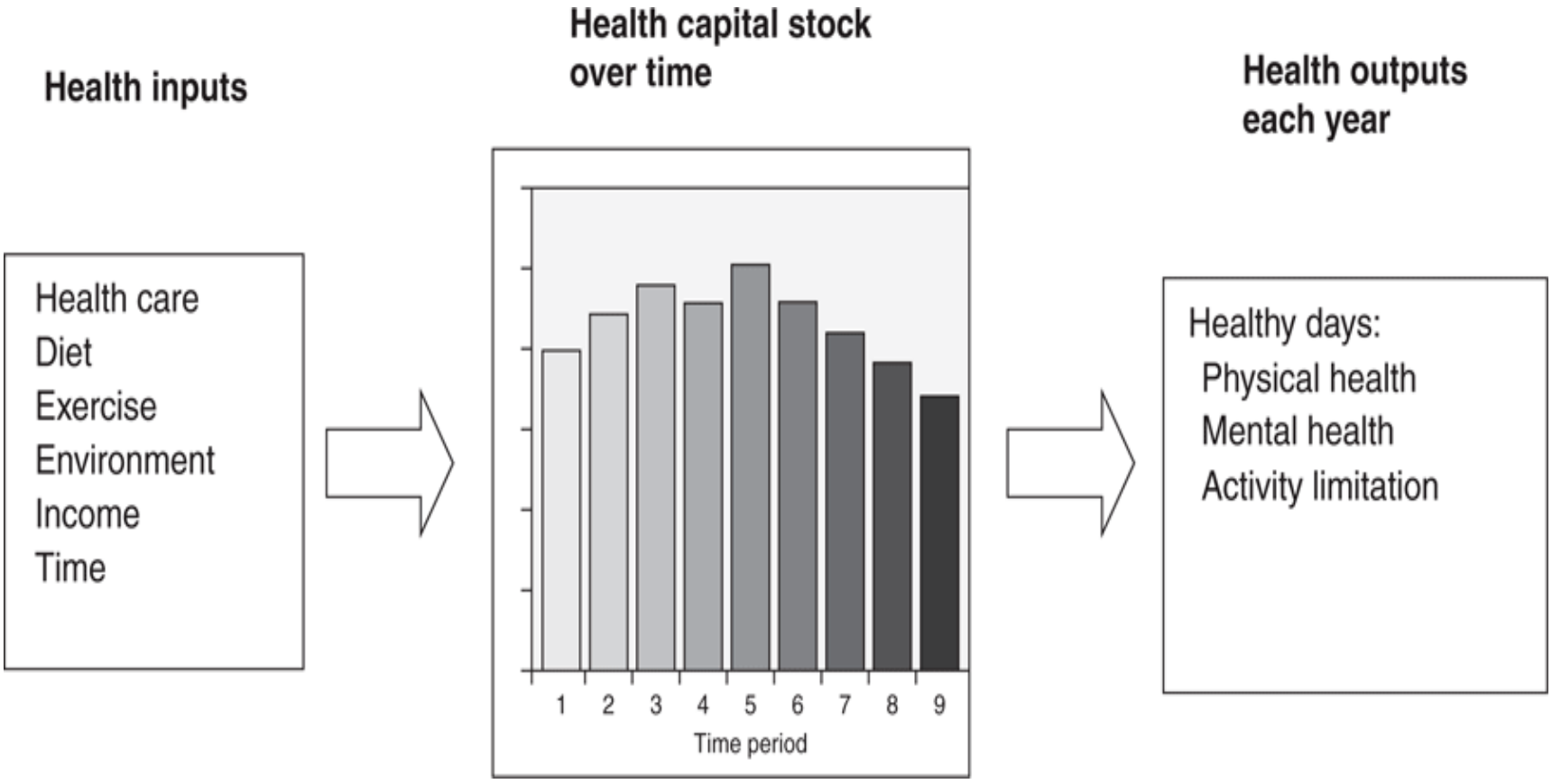
The Demand for Health

- It is not medical care as such that consumers want, but rather health.
  - People demand medical care inputs to produce health.
- Consumers *cannot* simply purchase health from the market.
  - Instead, consumers are *health producers* (by using their own health-improving efforts in combination with purchased medical inputs).
- Health can be thought of as a *capital good*; it lasts for more than one period and depreciates over time.

The Demand for Health

- Health can be treated both as a *consumption good* and an *investment good*.
- As a consumption good, health is desired because:
  - It makes people *feel better*;
  - It makes people *live longer*.
- As an investment good, health is desired because:
  - It *increases the number of healthy days* available to work and to earn income;
  - It *increases the productivity* when working and increase the earning for each working hour.

A Schematic


Health inputs
Health care
Diet
Exercise
Environment
Income
Time
Health capital stock over time
1 2 3 4 5 6 7 8 9
Time period
Health outputs each year
Healthy days:
Physical health
Mental health
Activity limitation

A Model for Time Spent Producing Health

- Production of health (*I = investment in health*):

$$I = I(M, T_H)$$

where M = medical care, T_H = time used in producing health

- Production of other goods:

$$B = B(X, T_B)$$

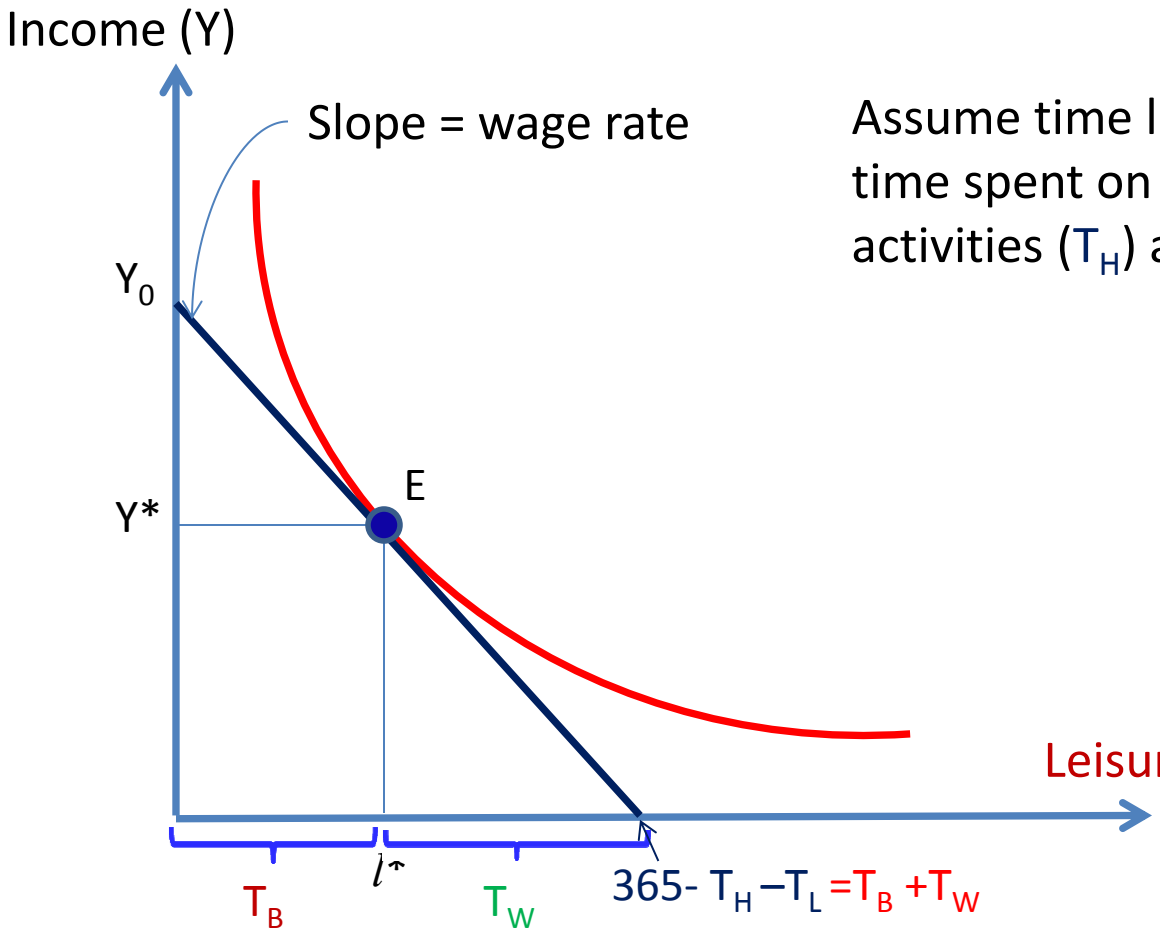
where X = purchased goods, T_B = time used producing other goods

- Total available time:

$$T = 365 = T_H + T_B + T_L + T_W$$

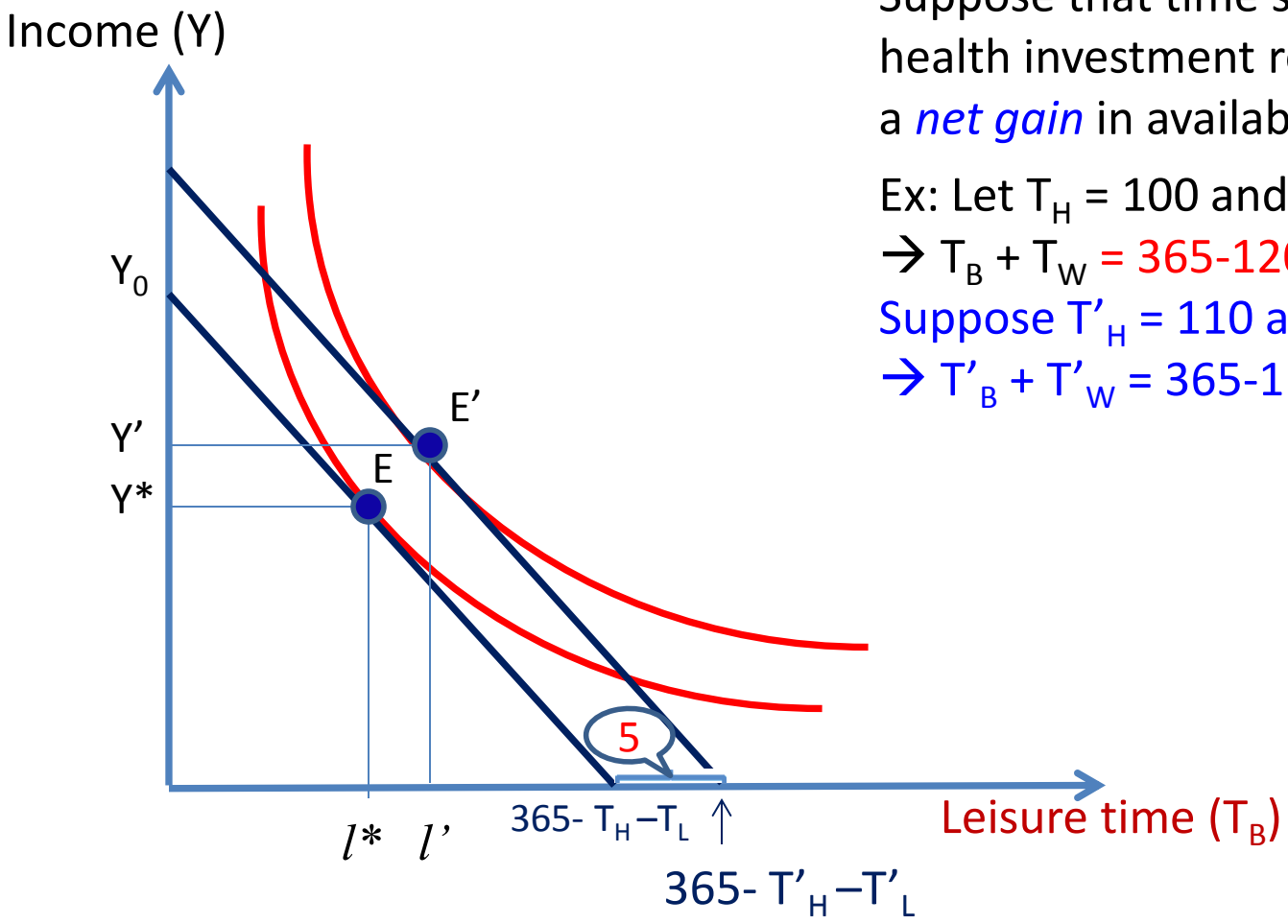
where T_H = improving health, T_B = producing other goods, T_L = lost to illness, and T_W = working

Labor-Leisure Trade-offs



Assume time lost (T_L) and time spent on healthy activities (T_H) are fixed.

Impact of Investments in Health



Suppose that time spent on health investment results in a *net gain* in available time.

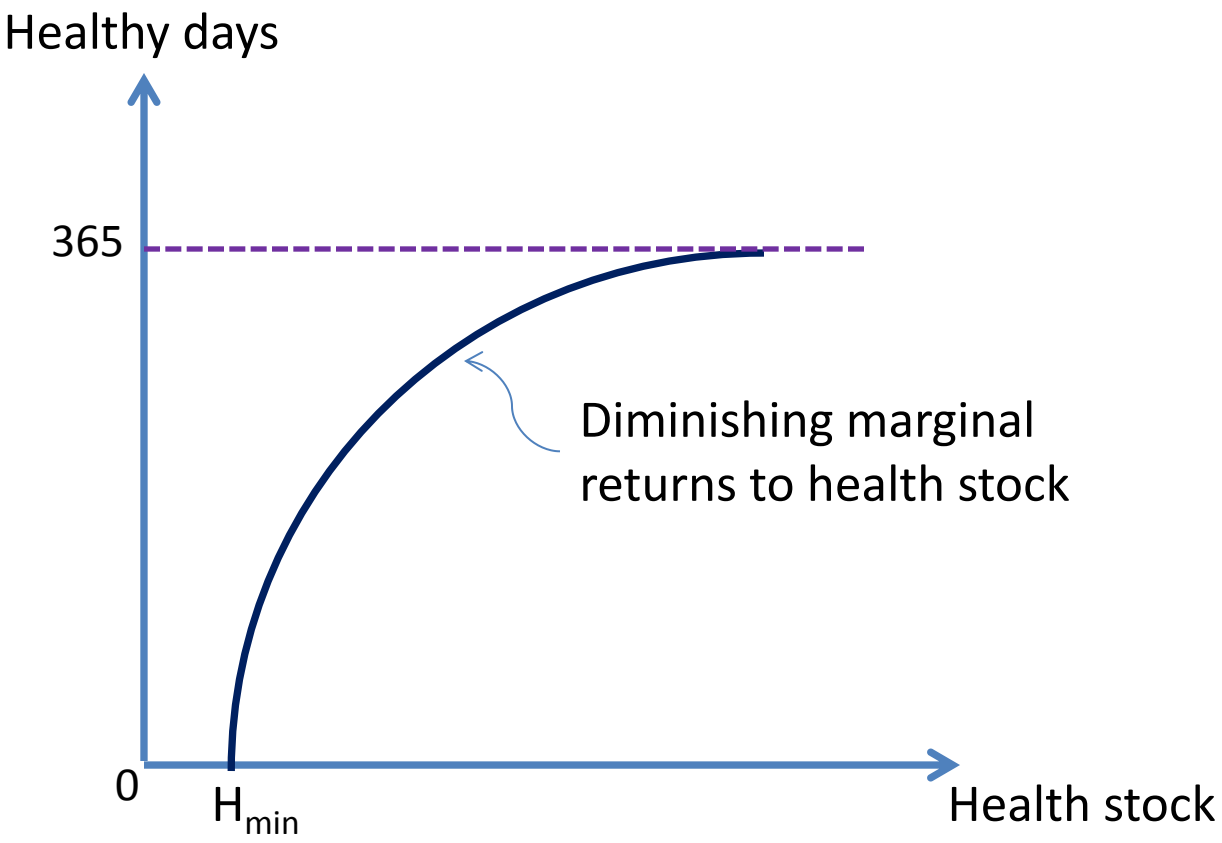
Ex: Let $T_H = 100$ and $T_L = 20$

→ $T_B + T_W = 365\text{-}120 = 245$

Suppose $T'_H = 110$ and $T'_L = 5$

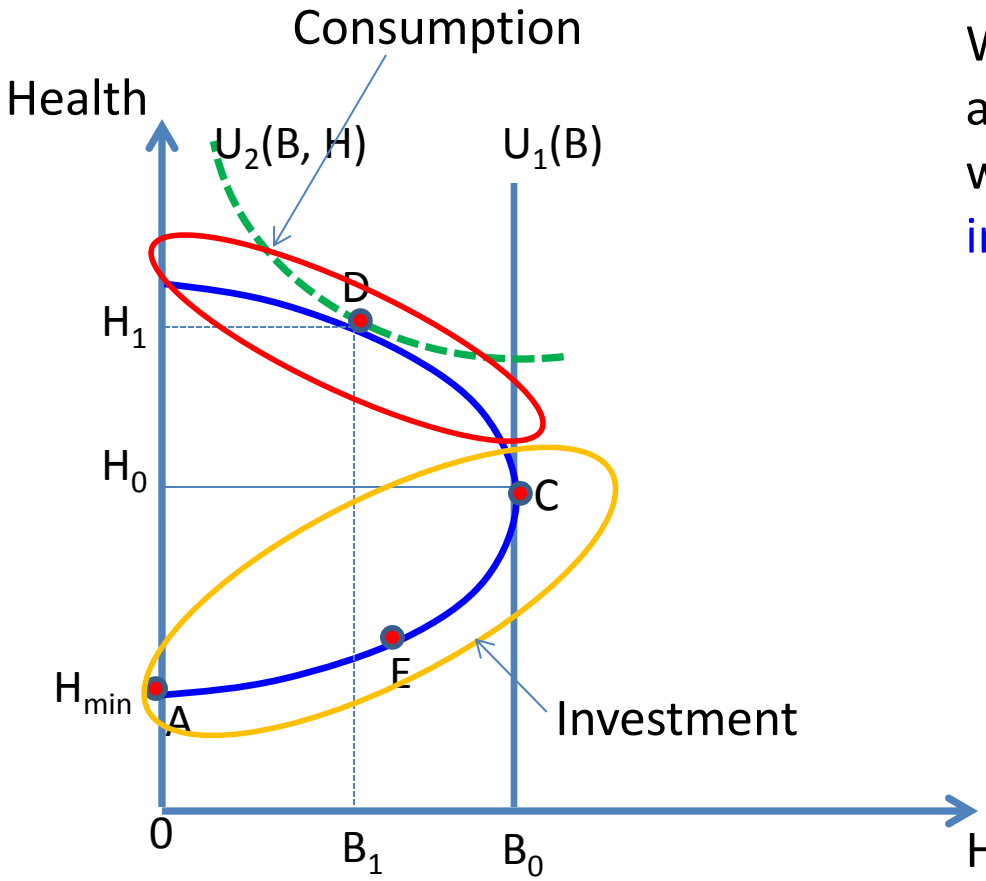
→ $T'_B + T'_W = 365\text{-}115 = 250$

Production of Healthy Days



Investment/Consumption Aspects of Health:

Production of Home and Health Goods



Which part illustrates health as a consumption good, and which illustrates health as an investment good?

Pure investment model
→ (B_0, H_0) is optimal.
Consumption-investment model
→ (B_1, H_1) is optimal.

Investment in Health Over Time

- Think of health as a *capital*. So what does it *cost* to invest in health capital?
- Use an analogy of an investment in an X-ray machine:
  - Costs
  - Future earnings → expected returns
  - Depreciation
- Example: Suppose an X-ray machine costs $100,000, and the interest rate is 5% per year.
  - How much revenue should we receive from the use of this X-ray machine to make it a good investment?

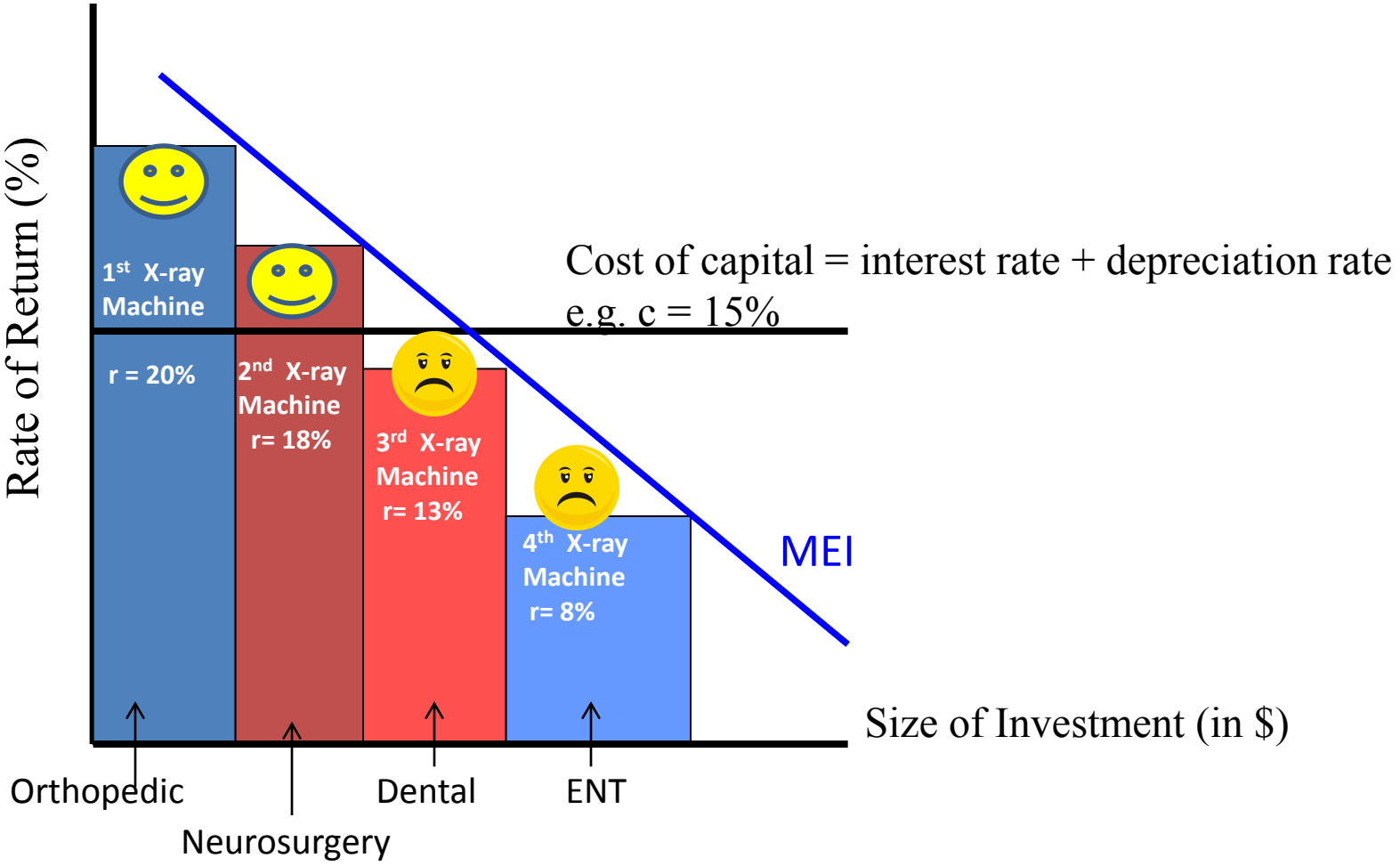
Cost of Capital

- The *cost* of an X-ray machine = $100,000.
- Suppose the machine wears out to half of its value within five years
  - The *total* depreciation cost = $50,000 (i.e. $10000/year)
- Alternative: Invest in a saving account (r=5%)
  - Year 1: 100,000 * 1.05 = 105,000
  - Year 2: 105,000 * 1.05 = 110,250
  - Year 3: 110,250 * 1.05 = 115,763
  - Year 4: 115,763 * 1.05 = 121,551
  - Year 5: 121,551 * 1.05 = 127,628
  - *Total* Incremental Revenue = **27,628**
- Need the total revenue = 27,628+50,000 = 77,628

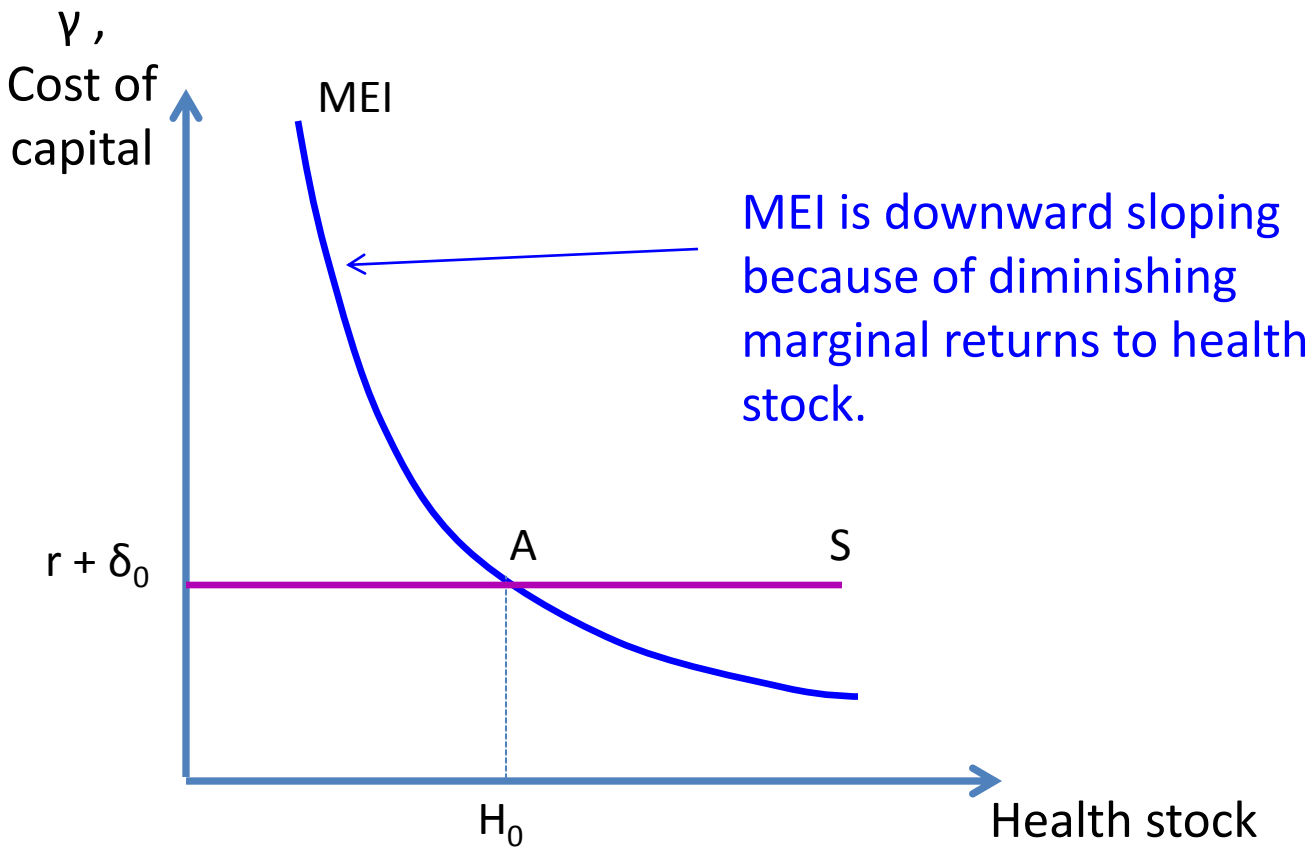
Demand for Health Capital

- Supply Side (r + δ)
  - Cost of capital = Forgone interest rate (r) + Depreciation rate (δ)
- Demand Side
  - Rate of return on investment (γ)
    - Example: Suppose the return from the X-ray machine is $20,000 each year.
      - ➢The annual *rate of return* = 20,000 ÷ 100,000 = **20%**
  - Marginal Efficiency of Investment (MEI): Describes the pattern of rates of return (γ).
    - ➢*Rate of return declines* as the amount of investment increases.
- ***Optimal demand for health*** *occurs at the intersection of the MEI curve and the cost of capital curve.*

Marginal Efficiency of Investment (MEI) and Rate of Return

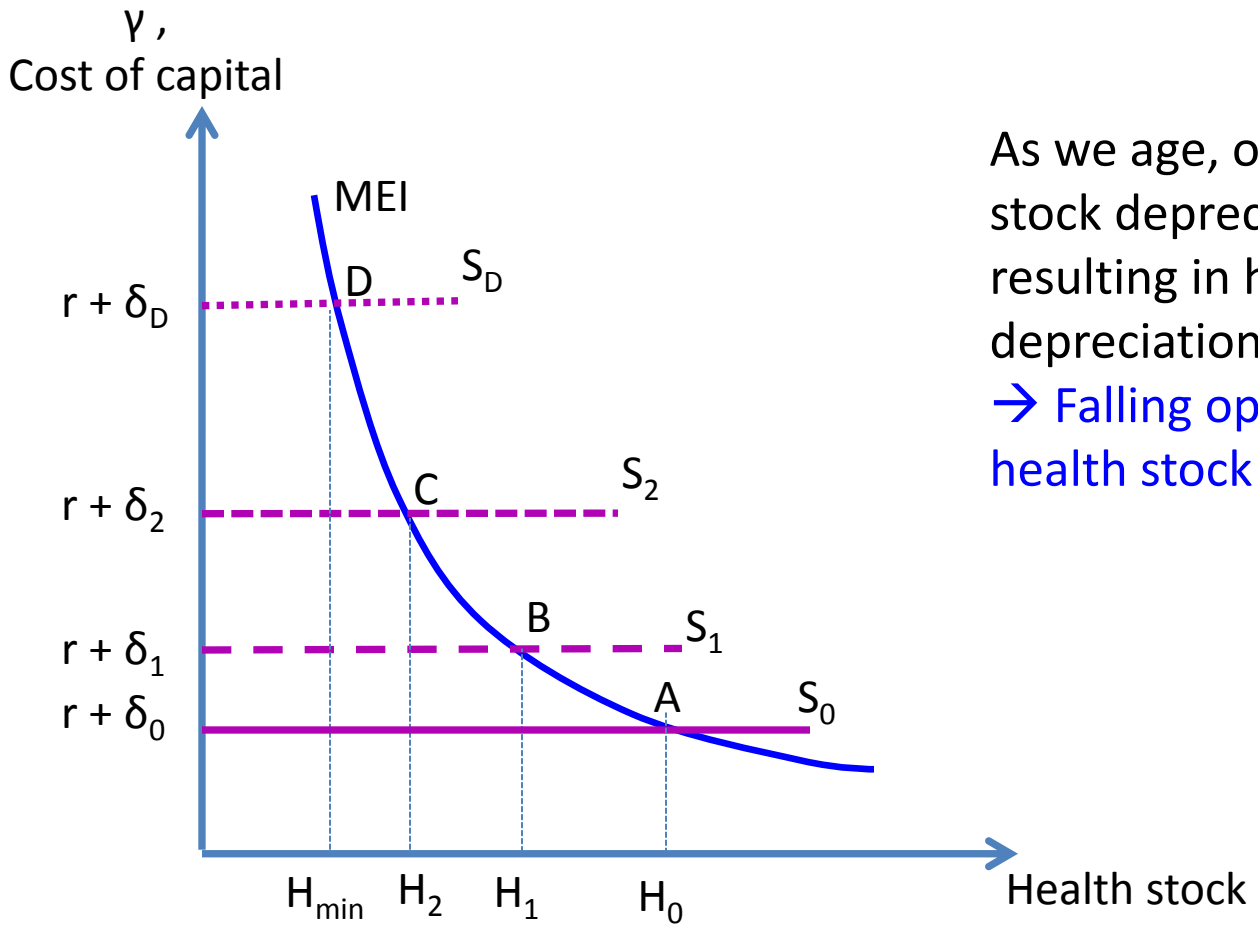


Demand for Health Capital



Demand for Health Capital:

Impact of Age on Investment in Health

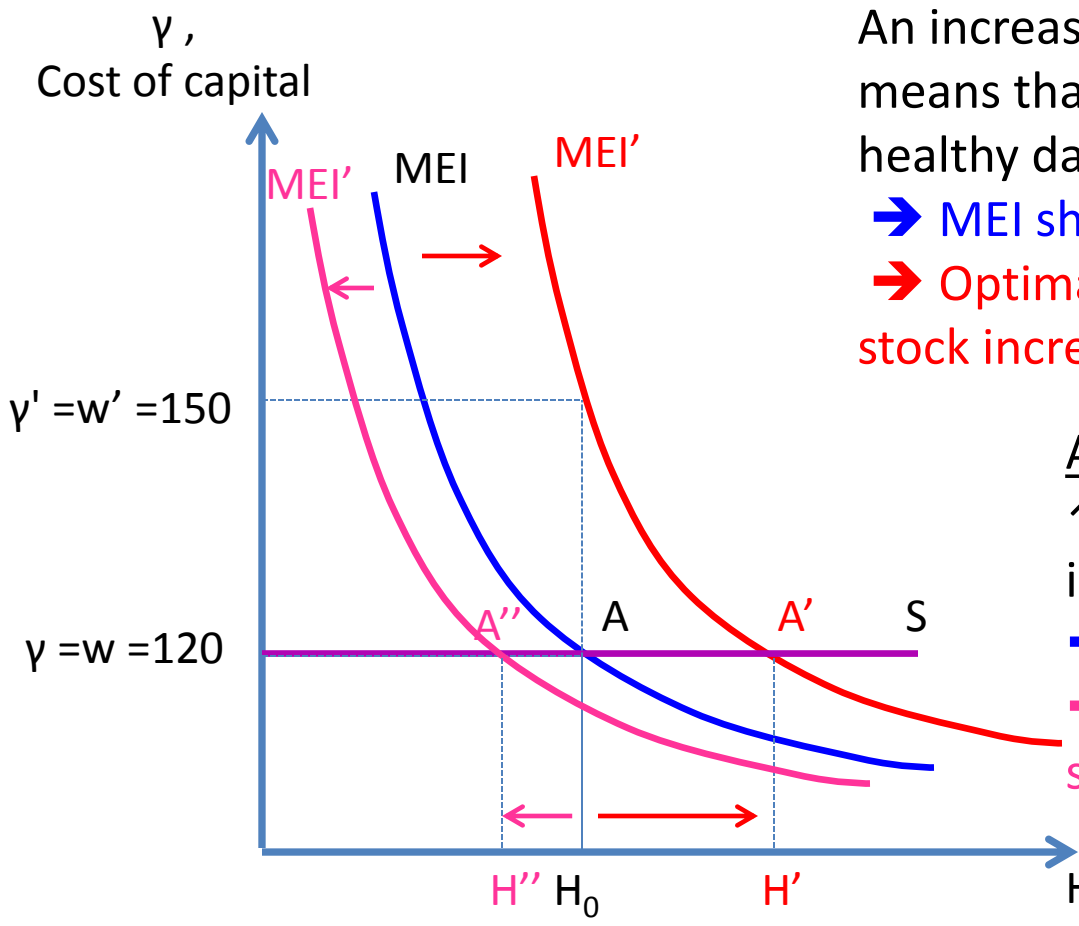


As we age, our health stock depreciates faster, resulting in higher depreciation rates.

→ Falling optimal level of health stock

Demand for Health Capital:

Impact of Wage on Investment in Health



An increase in wage rate means that the return from healthy days rises.

➔ MEI shifts to the right .

➔ Optimal level of health stock increases.

Alternatively:

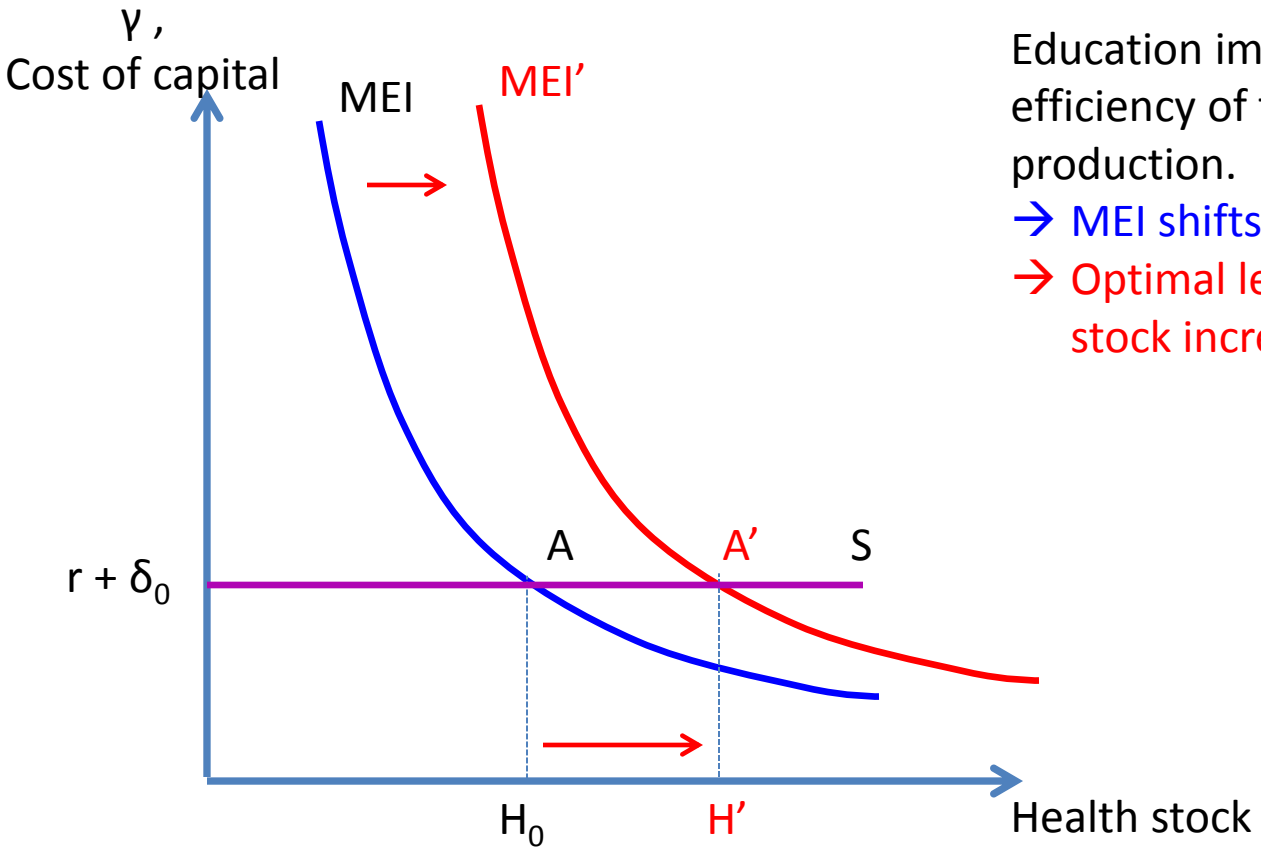
↑ wage ➔ ↑ opportunity cost in producing health.

➔ MEI shifts to the left.

➔ Optimal level of health stock decreases.

Demand for Health Capital:

Impact of Education on Investment in Health



Education improves efficiency of the health production.

→ MEI shifts to the right.

→ Optimal level of health stock increases.

Conclusions

- Health can be considered as a consumption good and an investment good.
  - *Trade-offs* between consuming health and consuming other goods.
  - *Trade-offs* between time spent on producing health and time spent on working and on leisure.
- The demand for health capital is determined by the cost of health capital and the marginal efficiency of investment in health.
  - Factors that affect the demand for health capital are such as: age, wage, education.