Abstract

How costly is bad health and what makes good health valuable over the life cycle? Answering these questions requires carefully modeling health dynamics, including in the longer run, and a rich model of how health can affect households. We estimate a health shock process that allows for both history-dependence and ex-ante heterogeneity, and we introduce it in a rich life-cycle model that we estimate and that matches three sets of important facts: (i) The dynamics of health; (ii) The quantitative impact of bad health on labor earnings, medical spending, and life expectancy; (iii) The large disparity in accumulated wealth between the healthy and the unhealthy at retirement. We find that the costs of bad health among the working age population are steeply increasing in the number of years spent unhealthy and that the largest component of these costs is the loss in labor earnings. In contrast, the effect of out-of-pocket medical spending is relatively small. To also evaluate the non-pecuniary effects of health, we evaluate the willingness to pay to be healthy and we find that the most valuable aspect of being healthy is a longer life expectancy.