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Market Failures in Information - Moral Hazard and Adverse Selection

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MARKET FAILURES IN INFORMATION

- Markets involving risk and uncertainty are plagued by market failures.
- Two of the major failures are adverse selection and moral hazard.
- When these are present, markets may give the wrong signals, incentives may get distorted, and sometimes markets may simply not exist.
- Because of market failures, governments may decide to step in and offer social insurance.



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Moral Hazard and Adverse Selection

- What are the conditions for efficient insurance markets?
- First, there must be a large number of insurable events. Only then will companies be able to spread the risks so that what is a large risk to an individual will become a small risk to many people.



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Moreover, the events must be statistically independent.

No prudent insurance company would sell all its fire re-insurance policies in the same building or sell only hurricane insurance in Miami.

Insurance companies try to diversify their coverage among many independent risks.



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- Additionally, there must be sufficient experience regarding such events so that insurance companies can reliably estimate the losses.
- For example, after the September 11 terrorist attacks, private terrorism insurance was cancelled because insurance companies could not get reliable estimates of the chances of future attacks.



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- Finally, the insurance must be relatively free of moral hazard.
- **Moral hazard** is at work when insurance increases risky behavior and thereby changes the probability of loss. In many situations moral hazard is unimportant.
- Few people will risk death because they have a generous life-insurance policy. In some areas, moral hazard is severe.
- Studies indicate that the presence of insurance increases the amount of cosmetic surgery, and most medical-insurance policies consequently exclude this procedure.



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- When these ideal conditions are met—when there are many outcomes, all more or less independent, and when the probabilities can be accurately gauged and are not contaminated by moral hazard—private insurance markets can function efficiently.



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- Sometimes, private insurance is limited or expensive because of adverse selection.
- **Adverse selection** arises when the people with the highest risk are also those who are most likely to buy the insurance.
- Adverse selection can lead to a market where only the people with the highest risks are insured, or even to a situation where there is no market at all.



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