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Adverse Selection in Real Markets

Comprehension Questions

Indicate whether the statement is true, false, or unclear, and justify your answer. Be sure to cite evidence from the chapter and state any additional assumptions you may need.

1. One of the major predictions of the Rothschild-Stiglitz model is a positive correlation between risk and insurance coverage. This has never been observed in practice due to the confounding influence of moral hazard.

   FALSE. This *is* a prediction of the Rothschild-Stiglitz model, but it has been confirmed in several contexts, including Dutch families seeking supplemental private insurance (van de Ven and van Vliet 1995) and young graduates joining the American workforce (Cardon and Hendel 2001).

2. On average, observed mortality rates are higher for people who buy life insurance than for people who do not. This is best taken as evidence in favor of adverse selection in life insurance markets.

   TRUE. He (2009) finds that this is the case, although other studies of life insurance come to opposite conclusions.

3. In some markets, adverse selection develops over time as customers learn about their own risk levels.

   TRUE. This makes sense, because adverse selection relies on asymmetric information. This phenomenon is in evidence in the Israeli car insurance market (Cohen 2005).

4. Although a firm prediction of Akerlof's model, the adverse selection death spiral has never been observed in practice.

   FALSE. Cutler and Reber (1998) find evidence of an adverse selection death spiral at Harvard, and evidence of other death spirals has been observed in insurance markets in New Jersey and California.

5. *Ex post* risk is typically much lower than *ex ante* risk because uncertainty is largely eliminated by the purchase of an insurance contract.

   FALSE. Ex-post risk is greater than ex-ante risk due to moral hazard. Having health insurance encourages people to take more risks and consume more health care.

6. Cawley and Philipson (1999) find that in life insurance markets, there is a bulk discount (that is, people buying larger policies pay lower per unit prices). They conclude that this finding is inconsistent with the Rothschild-Stiglitz model.

   TRUE. The Rothschild-Stiglitz model predicts bulk markups in markets with asymmetric information.

7. Consider an HIV patient who recently started HAART therapy and whose health is improving rapidly as a result. Viatical settlement firms will offer him more money for his life insurance policy than they would have before he started HAART because his health outlook is much better.

   FALSE. If he is healthier, his life insurance policy is less valuable to viatical firms.

8. The fact that high-risk customers are usually less risk-averse than low-risk customers helps counteract adverse selection.

   TRUE. If low-risk customers are more risk averse and tend to demand more insurance, this is an example of advantageous selection that counteracts adverse selection.

