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Moral Hazard

Comprehension Questions

1. When the price elasticity of demand for health care is zero, health insurance coverage induces no moral hazard.

   TRUE. Moral hazard only occurs if a price distortion induces a change in behavior. If the price elasticity is zero, behavior does not change as a result of being insured.

2. An uninsured patient who incessantly visits his doctor because he always thinks he is getting sick is an example of moral hazard.

   FALSE. Assuming the patient is truly uninsured and must pay the full cost of his treatment, then he faces no price distortion and his actions do not constitute moral hazard.

3. A woman who uses her fireplace only after she buys homeowner's insurance is an example of moral hazard.

   TRUE. If the woman faces a price distortion due to the insurance and would not have used her fireplace otherwise, then this decision is an example of moral hazard.

4. A previously-uninsured man who enrolls in his workplace health insurance plan after being diagnosed with multiple sclerosis is an example of moral hazard.

FALSE. The man was uninsured before he was diagnosed, so his disease is in no way attributable to a price distortion induced by insurance. Meanwhile, we have no indication that the man's behavior changes once he obtains insurance. This is much better described as an example of adverse selection.

5. Pauly (1974) shows that the socially optimal level of insurance in a market is either full or none, depending on whether moral hazard or risk aversion predominates.

   FALSE. The socially optimal level of insurance balances the positive effects of insurance (risk reduction) with the negative effects of insurance (moral hazard). It is possible that this balance could be achieved with a partial insurance contract.

6. Besides the common practice of charging copayments, health insurers have no successful strategies for combating moral hazard.

   FALSE. Insurance customers can also use coinsurance, deductibles, and monitoring techniques to reduce moral hazard. Coinsurance and deductibles combat moral hazard by reducing price distortions; monitoring reduces moral hazard by mitigating information asymmetries.

7. If a health insurance company could somehow monitor everything a customer does and thinks, it could create a full-insurance contract with no moral hazard.

   TRUE. Moral hazard depends entirely on information asymmetry between insurer and customer.

8. It would be easy for private health insurers to eliminate moral hazard by redesigning insurance contracts, but they are prevented from doing so by strict government regulations (at least in most developed countries).

   FALSE. Insurmountable information asymmetry is the cause of moral hazard, not regulations on insurance contract design. Even in an unregulated market, insurers would have no easy way of telling whether their customers are always washing their hands or avoiding friends with the flu.

9. Moral hazard is mostly a problem in countries with universal insurance programs like the United Kingdom.

   FALSE. Moral hazard can arise in any insurance contract, even outside the context of a universal or public insurance program.

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10. The fact that more free-plan participants logged ER visits for broken bones than cost-sharing plan participants in the RAND Health Insurance Experiment is evidence of moral hazard.

    TRUE. Moral hazard occurs when health insurance induces customers to be less careful with their health or induces them to seek more treatment when they do get hurt.

11. An all-you-can-eat buffet is a classic example of moral hazard, because a price distortion induces overconsumption.

    FALSE. Moral hazard only occurs in the presence of asymmetric information. The restaurant could easily charge customers marginal costs for the food they eat, so the fact that they choose not to do so indicates there is something economically valuable about the all-you-can-eat system. Put another way, banning all-you-can-eat buffets would not increase social welfare.

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