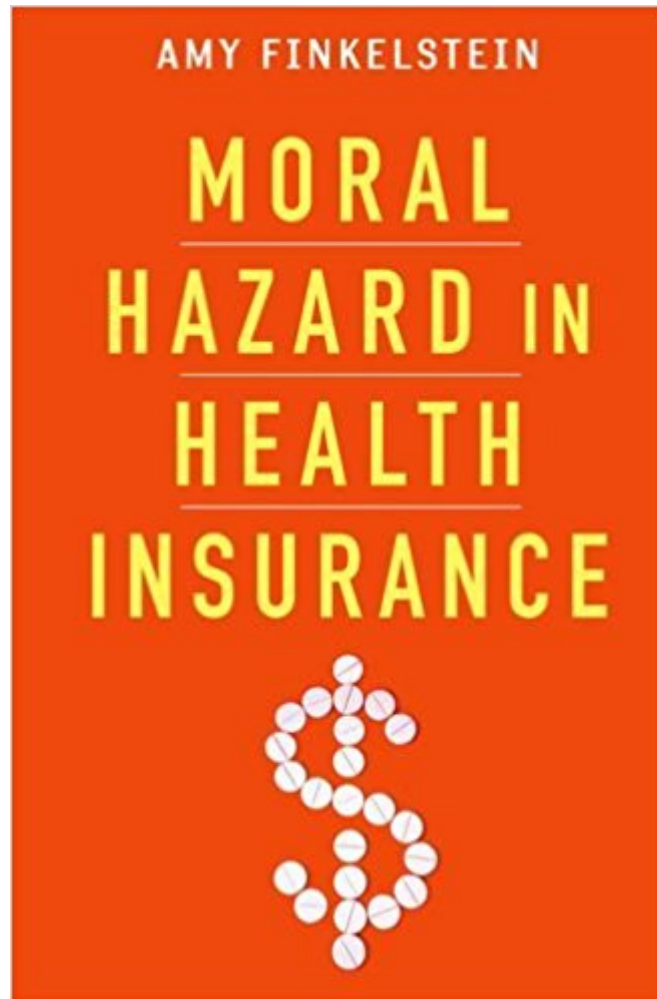


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# Moral Hazard In Health Insurance (Kenneth J. Arrow Lecture Series)



## Synopsis

Moral hazard—the tendency to change behavior when the cost of that behavior will be borne by others—is a particularly tricky question when considering health care. Kenneth J. Arrow’s seminal 1963 paper on this topic (included in this volume) was one of the first to explore the implication of moral hazard for health care, and Amy Finkelstein—recognized as one of the world’s foremost experts on the topic—here examines this issue in the context of contemporary American health care policy. Drawing on research from both the original RAND Health Insurance Experiment and her own research, including a 2008 Health Insurance Experiment in Oregon, Finkelstein presents compelling evidence that health insurance does indeed affect medical spending and encourages policy solutions that acknowledge and account for this. The volume also features commentaries and insights from other renowned economists, including an introduction by Joseph P. Newhouse that provides context for the discussion, a commentary from Jonathan Gruber that considers provider-side moral hazard, and reflections from Joseph E. Stiglitz and Kenneth J. Arrow.

## Book Information

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The backbone of the insurance industry is actuarial science. It is impossible to know whether any given car will be stolen or any given individual will get lung cancer. However, with a sufficiently large population, it is quite possible to estimate the statistical risk of such occurrences—which the insurance industry calls a hazard—to a near certainty. This allows the insurer to establish premium levels sufficient to make a profit from pooling these risks. Moral hazard is the difference between the

actuarial risks in the uninsured pool and the actual claims history when those in the pool obtain insurance coverage. Experience shows that actual claims tend exceed an insurer's actuarial assumptions for two reasons. First, there is typically an adverse selection in those seeking insurance. People are forward looking, so when they see themselves as especially likely to need insurance, they tend to be the first to seek it. Second, those with insurance coverage have less incentive to use preventive care, and this tends to result in higher loss experience than if they had not had insurance. For the most part, there is nothing immoral about moral hazard. Let's face it, if you have a little workshop in your garage, it's probably more important to have fire insurance. Similarly, if your wife discovers that breast cancer runs in her family, she'll want to make sure she and her daughters have good health coverage. To the insurance company, these factors may represent an adverse selection, but from the standpoint of the insurance seeker it's just common sense. As for changed behavior when one obtains insurance, the whole purpose of insurance is to make an unacceptable risk more acceptable.

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