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MORAL HAZARD

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- Traditional models of perfect competition market assume that individuals have complete information about prices quantities, the relationship between products/services and their welfare (utility)

- But in the reality there are at least two broad categories of information problems:

1. Adverse Selection or hidden information: market of lemons

2. Moral Hazard or hidden effort: agency problems

Definitions

- Asymmetric information The situation in which one party to an economic transaction has better information than does the other party.

- Adverse selection: it is impossible to distinguish between two kinds of products, sellers or buyers on the base of their quality.

- Moral hazard: people will take actions after they have entered into a transaction that will make the other party worse off.

Moral Hazard

Moral hazard: actions that are taken by one party but are relevant for and not observed by the other party in the transaction

People take on more risks when they are protected from the consequences of that risk.

Proposition: People are more likely to leave your car unlocked if are insured against theft.

Why? Two explanations

1. Adverse selection—if you know that you are not careful, you are more likely to choose to buy an insurance.
2. Moral hazard—if you are protected from some of the risk of theft, you are more likely to not be careful

Moral Hazard vs Adverse Selection

1. In many markets buyers and sellers have different information, which can lead to market inefficiencies.
2. Asymmetry in information is either due to hidden characteristics or hidden actions.

3. In cases with hidden characteristics, individuals can use their private information to decide whether to participate in a transaction or a market, causing adverse selection.

4. In cases with hidden actions, an individual can take an action that adversely affects another one, causing moral hazard.

5. There are both private and government solutions to reduce the effects of adverse selection and moral hazard.

- The person that is insulated from risk generally has more information about consequences than the one who pays for the negative consequences of the risk.
- Moral hazard occurs when the person with more information has an incentive to take unfair advantage of the other.
- Moral hazard arises when a person (or organization) does not suffer the full consequences of or take responsibility for his/her actions.
- And, therefore, the person has a tendency to act less carefully than he/she should, thus leaving the other side holding the bag and suffering the consequences of those actions.

- Moral hazard occurs when the behavior of the insured person changes in a way that rises costs for the insurer because the insured person no longer bears the full costs.
- For example, because a person no longer bears the cost of medical services, he/she has an incentive to demand costlier and more elaborate medical service, which would otherwise not be necessary.
- Coinsurance, co-payments and deductibles reduce the risk of moral hazard by increasing the out-of-pocket costs of consumers, which decreases their incentive to consume expensive and unnecessary health care and medicine.

Market Solutions to Moral Hazard in the Insurance Market

- ✓ In the insurance market, the way to keep policy holders from acting in a more risky manner is to increase the costs to them if they do. These are three majors ways that policy holders can be forced to be involved "in the game," mitigating their risk behavior.
- ✓ Deductibles
- ✓ Co-payments
- ✓ Coinsurance

Job market

- Moral hazard can occur when a worker is shielded from the consequences of decision making, which happens in many situations:

  - When a worker has a secure position and is hard to fire.
  - When a worker is protected by someone higher up
  - When wage or funding is independent of the project's success.

- When the failure of the project is of minimal overall consequence to the firm, regardless of the local impact on the managed division of the community.
- When there is no clear means of determining who is accountable for a given project.
- When management, union or tenure contracts make it virtually impossible to hold people accountable or fire them.

Incentives as solutions

- Moral hazard occurs when employees or executives have individual remuneration plans as their primary motivation for decision making, such as hitting short-term objectives like earnings targets, without due regard for the medium- or long-term effects on or risks to an organization or its customers.
- The solution is to link the remuneration to the results of the project (bonus added or percentage of the earnings as a part of the wage)

AN INTRODUCTION TO THE COMPETITION LAW AND ECONOMICS OF “FREE”

By

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