II_a: Asymmetric Information: Theory Overview

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Fall 2019
Rationales for social insurance

1. Private market failures
   1. Imperfect competition [go take IO]
   2. **Asymmetric Information**
   3. Aggregate Shocks
   4. Externalties

2. Redistribution

3. Individual failures of rationality / optimization

4. Paternalism
Asymmetric Information

- Adverse selection (hidden types)
  - Individuals have private information about their costs to insurer
  - Can impair efficient operation of market and create scope for welfare improving public policy

- Moral hazard (hidden actions)
  - Individuals take hidden actions in response to insurance contract
  - Prevents attainment of first best insurance policy
  - In general not something the government has a comparative advantage in addressing.
  - Critical though for optimal design of insurance (public or private)
    - Tradeoff between insurance (risk spreading) and incentives (moral hazard)
Lecture outline

- Present simple theoretical frameworks for
  - Adverse selection
  - Moral hazard

- Goals
  - Conceptual clarity
  - Framework for empirical work (coming next)
The problem of adverse selection: under-insurance

- Recall “free lunch” appeal of insurance:
  - By pooling idiosyncratic risk, can make everyone better off
  - Prefer to pay $10 for sure than face a one in ten thousand risk of having to pay $100,000

- But this pooling mechanism may not work if individuals have private information about risk type
  - Risk type: chance become sick, lose job, die etc
  - High risk come into the market and drive up prices for low risk
  - Possible result: no one buys insurance even if for each person benefit of having insurance is greater than the cost of providing it to that person
  - Suggests possible welfare-improving role for mandates
Adverse selection

Key points

- Welfare gain to risk averse individuals from being able to buy actuarially fair insurance
- Market failure: because private information about risk type, may not be able to buy actuarially fair insurance
- Potential scope for welfare improving government intervention

Classic theory: Akerlof (1970); Rothschild and Stiglitz (1976)

- Rothschild and Stiglitz (1976) covered in section
Simplified graphical theoretical framework

- Sketch a simplified graphical theoretical framework
  - To illustrate under-insurance and welfare loss that can arise with private information about health
  - To illustrate tradeoffs involved with potential government interventions (e.g. mandates)

- Up next: Take framework to data to:
  - Test for existence of adverse selection
  - Quantify resultant welfare loss
  - Assess welfare consequences of alternative policy interventions

- Overview follows Einav and Finkelstein (JEP 2011)
  - Will use health insurance as concrete example but naturally applies to any insurance
Perfectly competitive, risk neutral firms offer a single health insurance product that covers you if you get sick

- Consumer choice: buy or not buy the contract
- Important assumption: fixing contract space (Akerlof vs. Rothschild and Stiglitz)

Risk averse individuals identical except for their (privately known) probability of getting sick

- NB: Growing empirical evidence on importance of heterogeneity in preferences (as well as risk).
  - Can create opposite results (advantageous vs adverse selection with over- vs under-insurance).
  - Empirically relevant (e.g. long term care insurance; Medigap)

- Will come back to this...

No additional frictions (e.g. administrative costs)

- so firms’ (and social) costs of providing insurance are expected insurance claims, that is expected payouts on policies
- Will relax later in lecture...
Given this setup, what drives demand?

- {Note: unit demand. so "quantity" is share of population who purchases}
- Because individuals identical except for probability of getting sick, individuals with higher probability of getting sick have higher demand (wtp) for insurance

Implication: downward sloping marginal cost curve

- Individuals with highest willingness to pay have highest expected costs
- Link between demand and cost curve is distinguishing feature of selection markets: production costs depend on which consumers purchase your product
Adverse selection: under-insurance

Demand curve

Price

Quantity

B

E

\( Q_{max} = 1 \)
Adverse selection: under-insurance

Demand curve

MC curve

(sickest individuals have highest willingness to pay)

Risk premium

Price

Quantity

A

B

E

F

Q_{max} = Q_{eff}
Adverse selection: under-insurance

- Demand curve
- AC curve
- MC curve

Price

Quantity

$P_{eqm}$

$Q_{eqm}$

$Q_{eff}$
Adverse selection: under-insurance

Price

Demand curve

AC curve

MC curve

Quantity

$P_{eqm}$

$Q_{eqm}$

$Q_{eff}$

Finkelstein

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Can get complete unraveling

\[
Q_{\text{max}} = Q_{\text{eff}} = 1
\]
Mandates as possible solution

- Demand curve
- AC curve
- MC curve
- \( P_{eqm} \)
- \( Q_{eqm} \)
- \( Q_{eff} \)
Mandates as possible solution

Note: everyone not better off (some value at \( < P_{\text{mandate}} \))
Potential public policy solutions

- Assume government has no better information than firm
- Comparative advantage of government is to manipulate price (tax/subsidies) or manipulate quantity (mandate)
- Subsidize insurance
  - Unambiguous welfare gain (until you consider the cost of public funds or as we will discuss it the "fiscal externalities" of the policy (Hendren 2016))
- Mandate coverage
  - Can achieve efficient outcome (mandate $Q_{mandate} = Q_{max} = Q_{eff}$)
  - Unambiguous welfare gain; magnitude uncertain
  - Note: *No Pareto Improvement* - some will be made worse off by mandate
    - Useful in understanding ’08 Obama-Clinton primary debates...
    - But also model specific (e.g. potential Pareto improving policies in Rothschild-Stiglitz)
Public Policies (Con’t)

- Common policies: restrictions on price differentiation
  - e.g. no pricing on age and gender
  - extreme: "community rating"

- Tradeoff
  - Adverse Selection vs. Reclassification Risk (Handel, Hendel, Whinston EMA 2015)
    - "Reclassification risk" (aka "premium risk") = risk of becoming a bad risk
    - Insurance behind the veil of ignorance (will discuss: Hendren 2017 "ex ante welfare analysis")
Comment: pricing on Xs

- Note: Pricing on X’s does not necessarily reduce welfare cost of adverse selection
- Imagine segment market (price on) gender
  - Now have two distinct insurance markets to analyze / two graphs (one for each market)
- If pricing on gender removes all residual private information (i.e. gender-specific MC curves are flat) then unambiguously welfare improving
- Otherwise ambiguous
  - is sum of area two welfare loss triangles (for men and women) bigger or smaller than area of triangle in gender-pooled market?
Example with three types:

- Type 1 (10% of population) has expected cost of 20 and wtp 30
- Type 2 (60% of population) has expected cost of 5 and wtp 20
- Type 3 (30% of population) has expected cost of 4 and wtp 7.5

Competitive (zero-profit price): is 6.2 and everyone buys insurance (efficient)

If type 2 individuals are all female and type 1 and 3 are all male and price on gender

- women are all insured (price of 5) - efficient
- men: pooled competitive price is 8 at which point type 3 would inefficiently not buy insurance
Comment: pricing on Xs (con’t)

- Real world application: Medicare Advantage introduced finer risk adjustment (i.e. pricing insurance on more Xs)
  - From just demographics to also using health conditions
  - Not clear that reduced advantageous selection ("cream skimming") into this market (Brown et al. 2014 "vs." McWilliams et al. 2012)

- Key conceptual point: reducing but not eliminating a friction is not always welfare improving
  - Creates important opportunities for empirical work!
Why might it not be efficient to insure everyone (i.e. why might MC be above WTP for some individuals?) Assuming everyone is risk averse...

- Loading factors on insurance (administrative costs)
- [Profits – not yet introduced in model]
- Horizontal product differentiation (HMO vs PPO trades off lower oop costs but with more restrictions on doctor's choice)
- [Moral hazard - not yet introduced in model]

With these, everyone may not value insurance at > MC of providing it to them

What if it is not efficient for everyone to buy insurance?

- No longer unambiguous welfare gain from mandate
- Tradeoff between two allocative inefficiencies: under-insurance from adverse selection vs. over-insurance from mandate
  - And this is still without allowing for preference heterogeneity! That introduces further sources of ambiguity...
Adverse selection with loads

Price

Demand curve

AC curve

MC curve

$P_{eqm}$

$P_{eff}$

$Q_{eqm}$

$Q_{eff}$

$Q_{max}$

May not be efficient to insure all
Departure from textbook case II: Preference heterogeneity

- Individuals may differ not only in their risk type but also their preferences (e.g. risk aversion / willingness to bear risk)
  - WTP increasing in risk aversion and in risk
- Creates potential for *advantageous* selection (opposite results of *adverse* selection)
- If high-risk individuals are less risk averse and heterogeneity in risk aversion is large, can get upward sloping marginal (and therefore average) cost curve
  - Individuals with highest WTP are the most risk averse and lowest (vs. highest) expected cost
Advantageous selection

Liran Einav and Amy Finkelstein

If the demand curve is upward sloping, the AC curve will lie everywhere below it. If there were no insurance loads (as in the textbook situation), advantageous selection would not lead to any inefficiency; the MC and AC curves would always lie below the demand curve, and in equilibrium all individuals in the market would be covered, which would be efficient.

With insurance loads, however, advantageous selection generates the mirror image of the adverse selection case, also leading to inefficiency, but this time due to over-insurance rather than under-insurance. Figure 4 depicts this case. The efficient allocation calls for providing insurance to all individuals whose expected cost is lower than their willingness to pay—that is, all those who are to the left of point E (where the MC curve intersects the demand curve) in Figure 4. Competitive equilibrium, as before, is determined by the intersection of the AC curve and the demand curve (point C in Figure 4). But since the AC curve now lies below the MC curve, equilibrium implies that too many individuals are provided insurance, leading to over-insurance: there are \( Q_{\text{eqm}} - Q_{\text{eff}} \) individuals who are inefficiently provided insurance in equilibrium. These individuals value the insurance at less than their expected costs, but competitive forces make firms reduce the price, thus attracting these individuals together with more profitable infra-marginal individuals. Again, the area of the deadweight loss triangle \( \triangle EDC \) quantifies the extent of the welfare loss from this over-insurance.

Figure 4

Advantageous selection

- Over-insurance
  - Opposite problem from adverse selection
- Opposite policy solutions
  - e.g. tax (vs. subsidize) insurance
Ultimately these are empirical questions (to be covered in next few lectures)

- Does adverse selection exist?
  - i.e. is marginal cost curve downward sloping? As you raise the price, is the marginal guy who drops out lower risk than the average guy who remains?

- How large is the welfare loss from adverse selection?

- What are the net welfare effects of various government interventions
Lecture outline

- Present simple theoretical frameworks for
  - Adverse selection [done]
  - Moral hazard
Moral hazard

- Unobserved effort taken by agent in response to insurance contract
- Drives wedge between private and social cost
- Classic tradeoff of insurance vs. incentives
- Cost of insurance (not of social insurance / govt intervention)
Simple model of moral hazard

- Application: unemployment insurance
  - Pays out when you become unemployed
  - highly simplified, static model (see Chetty (2006) for richer model(s))

- The model
  - utility from consumption: additively separable and risk averse: \( u(c) \)
  - immediately: probability \( p \) of becoming unemployed
  - regains employment with probability \( q \) at cost \( h(q) \)
  - income while employed: \( w − \tau \)
  - income when unemployed: \( b \)
  - {simplify: assumed taxes paid only by employed, not by reemployed}

- government {or insurer} budget constraint requires:
  \[
p(1 − q)b = (1 − p)\tau
\]
Suppose can control $q$ (e.g. monitor search effort perfectly).

Set benefits ($b$), taxes ($\tau$) and remployment probability (i.e. effort) $q$ to maximize utility subject to the government break even constraint (benefits financed by tax)

Solve:

$$\max_{q,b,t} \{(1 - p)u(w - \tau) + p[(1 - q)u(b) + qu(w) - h(q)]\}$$

subject to

$$p(1 - q)b \leq (1 - p)\tau$$

First order conditions:

$$\{\tau\}: \quad (1 - p)u'(w - \tau) = \lambda(1 - p)$$

$$\{b\}: \quad p(1 - q)u'(b) = \lambda p(1 - q)$$

$$\{q\}: \quad h'(q) = u(w) - u(b) + \lambda(b)$$
Interpretation

- FOC for $q$ internalizes fiscal cost of benefit $b$. i.e. equates marginal cost of $q$ with marginal benefit which is the private benefit (difference in utility between re-employment and unemployment) and the public benefit (the fiscal cost of the benefit)
- We get "full insurance": marginal utility of consumption equated across states ("consumption smoothing"):

\[ u'(w - \tau) = u'(b) \]  

(note: here we can’t do anything about the fact that consumption is not equalized with the reemployment state, due to our simplifying assumption)
Worker private optimization problem

- Key: social planner can’t choose \( q, b, \tau \). Can set parameters of social insurance \((b, t)\) but then worker privately optimizes / chooses \( q \)

- Worker optimization:

\[
V(b, \tau) = \max_q \left\{ (1 - p)u(w - \tau) + p(1 - q)u(b) + pqu(w) - ph(q) \right\}
\]

- optimum yields \( q^*(b) \) with first order condition

\[
h'(q) = u(w) - u(b)
\]

- Interpretation

  - Worker equates marginal cost of \( q \) with \textit{private} marginal benefit (difference in utility between re-employment and unemployment).
  
  Unlike in the social optimum, he does not take account of the public benefit (fiscal cost of the benefit)

  - Note: if reemployed paid taxes we would have \( q^*(b, \tau) \) [this is what we are buying in simplicity]
Tradeoff between insurance and incentives

- Because of insurance, private marginal benefit from re-employment is less than social marginal benefit
  - Therefore insurance distorts private behavior (here: search effort)
- Consequence: cannot achieve first best (equalizing marginal utility of consumption across states)
  - If consumption were same whether unemployed or not, would exert no search effort
- Holmstrom (1979): presence of moral hazard leads optimal insurance contracts to be incomplete, striking a balance between reducing risk and maintaining incentives
Welfare loss from moral hazard: graphical illustration

Source: Gruber textbook
Moral hazard reduces willingness to pay for insurance

- The extra insurance claims due to moral hazard raise actuarially fair premiums, but are not valued by individuals at their cost.
- Imagine:
  - an insurance policy with a 20% coinsurance (individual pays 20 cents per dollar of claims; insurance pays 80 cents).
  - Insurance increases expected claims by $100 (from say $500 without insurance to $600).
  - Therefore expected insurance costs (hence premiums) by $80.
  - What is individual’s WTP for (how much does individual value) that extra $100 of healthcare use?
Moral hazard is therefore one reason not everyone "should" be insured.
Potential design responses (markets or government)

- Provide only partial insurance
  - High deductibles (Arrow 1963)
    - Concavity of utility function suggests value of insurance is higher for larger losses
    - Optimal trade off between combatting moral hazard through higher consumer cost-sharing with the goal of providing risk protection through lower consumer cost sharing
  - Exclusions (e.g. life insurance policies don't cover suicide or sky diving accidents)
  - Partial experience rating (e.g. automobile insurance) - see discussion of recategorization risk

- Lump sum (indemnity) insurance
  - Observability? Residual Risk?
Recap

- Moral hazard (hidden action)
  - Introduces fundamental tension / tradeoff in design of optimal insurance (private or public)

- Adverse selection (hidden types)
  - Can impair efficient operation of market and create scope for welfare improving public policy
Food for thought

- Are moral hazard and adverse selection really distinct?
- "Ex post adverse selection" (Cabral Restud 2017)
  - Strategically delay healthcare treatment to minimize out of pocket costs (moral hazard)
  - Can generate subsequent adverse selection
  - Helps explain why market for dental insurance has largely unraveled
  - Implications for e.g. open enrollment period
- Selection on moral hazard? (Einav et al. AER 2013)
  - Choice of high deductible vs no deductible health insurance plan can depend on anticipated behavioral response (moral hazard) to the deductible
  - Implications for e.g. policies to combat selection
    - eg better monitoring may not only reduce moral hazard but also selection
- Related to broader idea of Selection on Gains / Roy Model
Up next

- How do we empirically detect adverse selection
- Welfare cost of asymmetric information
- Welfare consequences of government intervention