9.2 Lecture 21: Asymmetric Information and Social Insurance

9.2.1 Social insurance

- In the insurance market, there is information asymmetry. The purchasers of insurance may know more about their insurable risks than the seller (insurer) does.
- In this case, the insurer will be reluctant to sell insurance, since he will be worried that only those with the insured-against problems will demand insurance.
- Moral hazard is a central feature of insurance markets:
  - If families buy fire insurance for their homes, they may be less likely to keep fire extinguishers handy
  - If people have health insurance, they may be less likely to take precautions against getting ill
  - If workers have unemployment insurance, they may be less likely to search hard for a new job
- Moral hazard is a problem because it
  - lowers efficiency by removing productive trades
  - causes revenue raising

9.2.2 Social insurance in the U.S.

- These programs share the following features:
  - Insure you against some adverse event: retirement, illness, injury, job loss
  - Financed by universal payroll taxes: all workers pay in as a function of their earnings
  - Key programs are
    * Social Security insures against loss of earnings due to retirement, disability, and longevity risk.
    * Medicare provides health coverage to the elderly.
    * Disability Insurance, Workers' Compensation, and Unemployment Insurance each protect against specific labor-market contingencies.

9.2.3 TO KNOW – Conceptual Understanding

- Insurance markets face adverse selection: when individuals know their own risk but insurers cannot, high-risk individuals disproportionately enroll, driving up premiums and potentially collapsing the market
- Moral hazard arises once insured: protection against losses reduces precautionary effort, leading to overuse of benefits or riskier behavior that imposes additional cost
- Government intervention (mandates, subsidies, or public provision) can solve adverse selection by pooling risk across a broad population, but must balance against increased moral hazard