On Moral Hazard and Insurance

Chapter

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Foundations of Insurance Economics

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Abstract

Moral hazard refers here to the tendency of insurance protection to alter an individual's motive to prevent loss. This affects expenses for the insurer and therefore, ultimately, the cost of coverage for individuals. Beginning with Arrow [1963] and Pauly [1968], economists have discussed two partial solutions to the problem of moral hazard: (i) incomplete coverage against loss and (ii) "observation" by the insurer of the care taken to prevent loss. Incomplete coverage gives an individual a motive to prevent loss by exposing him to some financial risk; and observation of care also gives an individual a motive to prevent

loss, as it allows the insurer to link to the perceived level of care either the insurance premium or the amount of coverage paid in the event of a claim.

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Preview

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