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On Moral Hazard and Insurance

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Foundations of Insurance Economics

Steven Shavell

Part of the book series: Huebner International Series on Risk, Insurance and Economic Security ((HSRI,volume 14))

1338 Accesses **29** Citations **3** Altmetric

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.

I wish to thank L. Weiss for helpful discussion; K. Arrow, P. Diamond, J. Green, L. Kotlikoff, M. Manove, J. Mirrlees, A. M. Polinsky, and A. Robson for comments; and the National Science Foundation (Grant #S0076-20862) for financial support.

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Cite this chapter

Shavell, S. (1979). On Moral Hazard and Insurance. In: Dionne, G., Harrington, S.E. (eds) Foundations of Insurance Economics. Huebner International Series on Risk, Insurance and Economic Security, vol 14. Springer, Dordrecht. https://doi.org/10.1007/978-94-015-7957-5_15

.RIS .ENW .BIB

DOI
https://doi.org/10.1007/978-94-015-7957-5_15

Publisher Name
Springer, Dordrecht

Print ISBN
978-90-481-5789-1

Online ISBN
978-94-015-7957-5

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Keywords

Optimal Insurance | Moral Hazard | Expected Utility | Full Coverage | Insurance Policy

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