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Third Party Moral Hazard and the Problem of Insurance Externalities

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Abstract

Insurance can lead to loss or claim-creation not just by insureds themselves, but also by uninsured third parties. These externalities—which we term “third party moral hazard”—arise because insurance creates opportunities both to extract rents and to recover for otherwise unrecoverable losses. Using examples from health, automobile, kidnap, and liability insurance, we demonstrate that the phenomenon is widespread and important, and that the downsides of insurance are greater than previously believed. We explain the economic, social and psychological reasons for this phenomenon, and propose policy responses. Contract-based methods that are traditionally used to control first-party moral hazard can be welfare-reducing in the context of its third-party analog, so new approaches are required.

Keywords: Law & behavioral economics, insurance, third party moral hazard, risk, qui tam litigation**JEL Classification:** D91, G22, K23[Suggested Citation](#) >[Show Contact Information](#) >

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