In this discussion, we are going to consider the impact of adverse selection and moral hazard on insurance markets, and how they may be distinguished. You could consider:

* What is the impact of adverse selection?
* What is the impact of moral hazard?
* What is the same about the impact of adverse selection and moral hazard? What is different about them?
* How does distinguishing them affect health policy decisions?

I sometimes help my company set the prices for ‘Extended Coverage Warranty’, which is analogous to insurance but with the difference that this is related to a product that can be serviced and replaced while the same cannot be said about the topic we are interested in. Not every customer purchases the extended coverage warranty.

I have, in a sense, ‘complete information’. I know how the product has performed historically with customers who purchased an extended coverage certificate and those that didn’t. We know for a fact that those that bought the certificates used the product (to the point of abuse) much more than the ones that didn’t.

Should the customer ‘abuse’ the product because of purchasing an extended coverage certificate or should the company offer an ‘incredible’ warranty coverage that will have no significance to the customer (like 12K miles and unlimited time warranty on a sedan to keep the rental customers from buying the contract!, though in reality it is much more complicated because with such contracts the company may lose revenue and/or competitive edge depending on the industry)?

Luckily in my case, most of the players have been playing for a sufficiently long time and I would say both parties have complete information. The customers know they must buy an extended coverage because they use the product beyond the rated/normal use. On the other hand, the company prices the extended coverage knowing that anyone who purchases an extended coverage will use the product beyond the rated regular use and charge a premium significantly higher than if the same were to be offered to someone who uses the product at the recommended rating.

In my opinion, this is at the heart of what we are discussing. The customer (who purchases an extended coverage) abuse is moral hazard, while the company offering a no-use service to keep such players from playing is adverse selection. Both of which result due to an asymmetry in information but differ in the timing relative to the contract. Perfect competition, key players and their incentives may be the key in understanding the overall dynamics of the health insurance.