

BENEFICIAL MORAL HAZARD AND THE THEORY OF THE SECOND BEST

“Moral hazard” is a term economists use to mean any change in behavior induced by the presence of insurance. In the context of health insurance, moral hazard refers to both the fact that insurance coverage may lead some individuals to engage in riskier behaviors and the fact that they consume more medical care, or more expensive medical care, because health insurance leads them to face much lower prices – even zero prices – at the point of purchase. In a perfectly competitive market, moral hazard is inefficient, and we are used to thinking about increasing moral hazard as one of the central problems associated with expanding insurance coverage.

Economists Kevin Frick of Johns Hopkins University and Michael Chernew of Harvard University challenge us to re-think this notion. Frick and Chernew draw on the economic “Theory of the Second Best” to note that in a market that is not in competitive equilibrium, apparent inefficiencies like those resulting from moral hazard may actually move the market *closer* to an optimal outcome. In particular, they note three potential reasons why moral hazard may increase rather than decrease efficiency in the market for medical care:

- **Market power and excessive prices:** If health care providers have “market power,” enabling them to charge prices above the competitive level, consumers without insurance might consume too little medical care. Insurance – and the accompanying moral hazard – can help offset this under-consumption.
- **Externalities:** Some types of medical care – for example, vaccines or prompt treatment of infectious disease – are associated with a positive externality. Moral hazard associated with insurance increases these spillover benefits.
- **Flaws in decision-making:** Most of us do not feel fully informed or entirely rational when it comes to making decisions about our own health, yet the competitive model assumes that we are. If deviations from perfect rationality lead us to consume less medical care than we should, moral hazard associated with insurance may nudge us closer to consuming the right amount.

Particularly in light of evidence that Americans get less than the recommended amount of care for many types of medical care, the arguments presented by Frick and Chernew should lead us to re-think our long-held assumption that increases in the use of medical care as a result of insurance – that is, moral hazard – must be inefficient. They add that even though expansion of coverage may increase aggregate economic welfare, the cost of additional consumption associated with expanding coverage must be addressed. Value based insurance design may be able to minimize the cost of additional consumption associated with coverage by limiting detrimental moral hazard while maximizing access to the health care services that provide substantial value.