Moral Hazard

- The so-called moral hazard problem comes about because of asymmetric information.

An Illustration of the Problem

- When you smoke indoors, you risk burning the house.
- There is a cost and benefit.

With Insurance

- Now you Insure.
- The cost of smoking drops to $C_t$.

An Illustration of the Problem

- When you smoke indoors, you risk burning the house.
- There is a cost and benefit.
- You smoke “U” times, where MB = cost

With Insurance

- Now you Insure.
- The cost of smoking drops to $C_t$. 

Cost of smoking if you are uninsured

- There is a cost and benefit.
Moral Hazard

The Insurance Company’s Problem

- Now you Insure.
- The cost of smoking drops to $C_i$
- You Smoke “I” times.

With Insurance

- You raise the cost of insurance

With Insurance

- You raise the cost of insurance
- The insurance company cannot discriminate between careless and careful smokers.

Moral Hazard

- This problem involves asymmetric information.
- People are induced to change their behavior
- It would not come about if we had perfect information.
- Alas, the world is not that easy.

Producing High and Low Quality Products

- Another example: should you produce a high quality product or cheat your customers and produce a low quality product?
Producing High and Low Quality Products

• Another example: should you produce a high quality product or cheat your customers and produce a low quality product?
  – If there is perfect information, you can’t cheat.
  – If there is asymmetric information, you can.

Will a Monopolist Produce a Quality Product?

• The monopolist can produce a high quality product for $15 or a low quality product for $10.
• During the first period, consumers cannot tell which they are getting.
• The profit-maximizing price and quantity are $20 and 100 units.

Will a Monopolist Produce a Quality Product?

• Produce the low quality product for one period.
  – Sales are $2000; costs are $1000
  – The monopolist makes $1000 but for one period only.

Will a Monopolist Produce a Quality Product?

• Produce the low quality product for one period.
  – Sales are $2000; costs are $1500
  – The monopolist makes $500 a period.

Will a Monopolist Produce a Quality Product?

• Given reasonable discount rates the monopolist will choose to produce the high quality product given these numbers.
What about Competitive Firms?

• Stay Tuned.

End