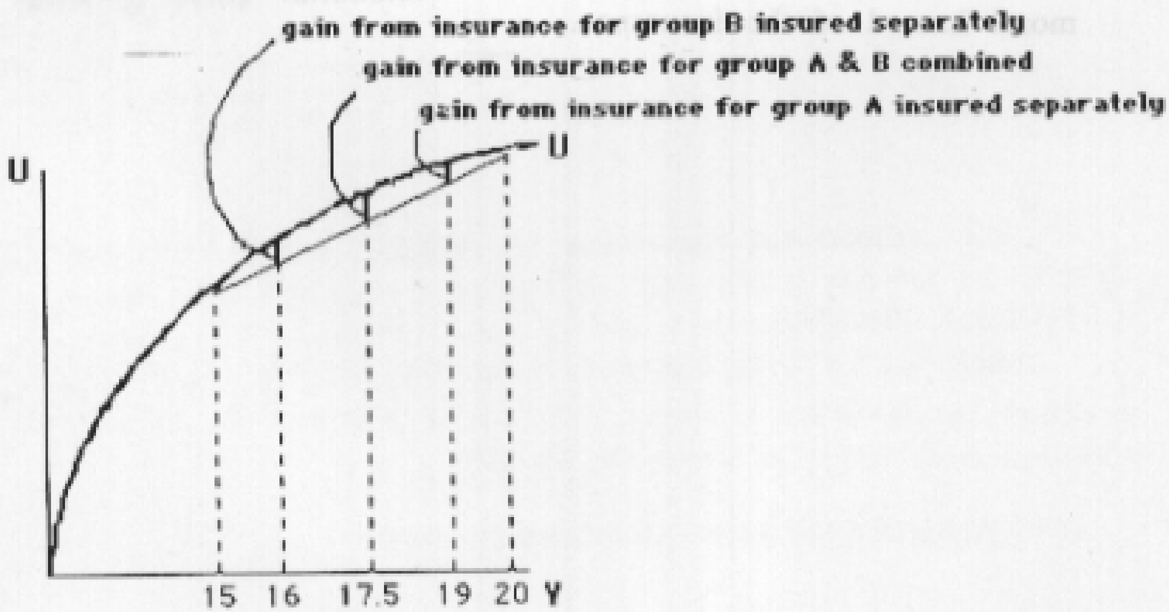
Market Separation

When it is realized that there is a differential risk among groups, such as with A & B above, there are strong competitive incentives for insurance companies to try to separate the insurance markets for the two groups; if the insurer has information on characteristics differentiating the two groups she can charge different premiums according to expected losses. (Note that in the case of adverse selection the insurer lacks information on relevant differentiating characteristics while the consumer knows the relevant risks; in the case of market separation, the insurer know the relevant risks and charges accordingly.)

There is an overall social loss from market separation. Given diminishing marginal utility, every dollar redistributed to group A from group B increases the utility of group A by less than it decreases the utility of group B. This is illustrated in the following diagram:



Thus there may be some grounds for governments trying to prevent market separation. Such rules would clearly be a form of income redistribution. National health insurance is one means of preventing market separation.