Moral Hazard

The concept of risk-sharing through the pool of risks in an insurance fund rests fundamentally on the idea that the underlying risks are stable and predictable in the aggregate. This is what permits the calculation of an actuarily fair premium.

In many cases, however, individual members of the insurance pool can take actions which alters the underlying distribution of risks. The classic example is the arsonist who sets a building on fire in order to collect on fire insurance. With respect to health insurance, the existence of the insurance reimbursement may lead consumers (or their doctors) to undertake procedures or tests that they would not have had there been no insurance. This alters the underlying risk distribution; it is moral hazard. Deductibles (e.g. the consumer pays the first $100 before insurance compensation starts) and co-insurance (e.g. the consumer must pay 20% of charges out-of-pocket and the insurance pays 80%) are features of most policies designed to discourage such frivolous expenditures and to reduce the moral hazard of the insurance.