Chapter 5 The Economics of Health Care

5.3 Information Problems and Externalities in the Market for Health Care

1) A key difficulty facing insurance companies is that people know more about their health than do insurance companies, and that those people who are seriously ill are the most likely to want to obtain health insurance. What is this phenomenon called?
A) moral hazard
B) economic irrationality
C) asymmetric information
D) adverse selection

Diff: 1 Page Ref: 214/146
Topic: Asymmetric Information
Learning Outcome: Micro 21: Describe methods for countering and avoiding risk
AACSB: Reflective Thinking
Special Feature: Economics in Your Life: Why is it Difficult for People Who Are Seriously Ill to Buy Health Insurance?

2) An insurance company is likely to attract customers like Clancy who want to purchase insurance because he knows better than the company that he is more likely to make a claim on a policy. What is the term used to describe the situation above?
A) moral hazard
B) adverse selection
C) asymmetric information
D) economic irrationality

Diff: 1 Page Ref: 214/146
Topic: Asymmetric Information
*: Recurring
Learning Outcome: Micro 21: Describe methods for countering and avoiding risk
AACSB: Reflective Thinking
Special Feature: None

3) The term that is used to refer to a situation in which one party to an economic transaction has less information than the other party is
A) inefficient market hypothesis.
B) moral hazard.
C) information disparity.
D) asymmetric information.

Diff: 1 Page Ref: 214/146
Topic: Asymmetric Information
*: Recurring
Learning Outcome: Micro 21: Describe methods for countering and avoiding risk
AACSB: Reflective Thinking
Special Feature: None
4) Which of the following parties is likely to have the most information about the health of an individual who is trying to purchase a health insurance policy?
A) the company that issues the health insurance policy  
B) the individual who is applying for the health insurance policy  
C) the employer of the individual who is trying to purchase the health insurance policy  
D) All parties in the health insurance market have access to the same level of information.

Diff: 2 Page Ref: 214/146  
Topic: Asymmetric Information  
*: Recurring  
Learning Outcome: Micro 21: Describe methods for countering and avoiding risk  
AACSBB: Reflective Thinking  
Special Feature: None

5) What is adverse selection?
A) It refers to the private, self-interested actions people that people pursue, which when taken collectively leads to a loss in economic surplus.  
B) It refers to the actions people take after they have entered into a transaction that make the other party to the transaction worse off.  
C) It refers to the situation in which one party to a transaction takes advantage of knowing more than the other party to the transaction.  
D) It refers to the actions people take before they enter into a transaction so as to mislead the other party to the transaction.

Diff: 2 Page Ref: 214/146  
Topic: Adverse Selection  
*: Recurring  
Learning Outcome: Micro 21: Describe methods for countering and avoiding risk  
AACSBB: Reflective Thinking  
Special Feature: None

6) Consider a used car market in which half the cars are good and half are bad (lemons). A rational buyer in this market should
A) offer to pay a price equal to the most she would pay for a good car.  
B) offer to pay a price equal to the most she would pay for a lemon.  
C) offer to pay a price somewhere between the price she would pay for a good car and the price she would pay for a lemon.  
D) save up and buy a new car.

Diff: 2 Page Ref: 214/146  
Topic: The Market for Lemons  
*: Recurring  
Learning Outcome: Micro 21: Describe methods for countering and avoiding risk  
AACSBB: Analytic Skills  
Special Feature: None
7) Consider a used car market in which half the cars are good and half are bad (lemons). If buyers are rational, the prices being offered for used cars will result in
A) an equal proportion of a good cars and lemons being sold in an efficient market.
B) a larger proportion of good cars being sold and consequently, consumer surplus is increased.
C) a larger proportion of lemons being sold and consequently, producer surplus is increased.
D) an equal proportion of good cars and lemons being sold in an inefficient market.

Diff: 2 Page Ref: 214/146
Topic: The Market for Lemons
*: Recurring
Learning Outcome: Micro 21: Describe methods for countering and avoiding risk
AACSB: Analytic Skills
Special Feature: None

8) Consider a used car market in which half the cars are good and half are bad (lemons). Suppose the average price of a good car is $9,000 and the average price of a lemon is $3,000. If rational buyers are willing to pay $6,000 for a used car, then sellers will agree to sell mostly the lemons at this price. What is the term used to describe this situation?
A) moral hazard
B) adverse selection
C) an efficient market
D) economic irrationality

Diff: 2 Page Ref: 214/146
Topic: The Market for Lemons
*: Recurring
Learning Outcome: Micro 21: Describe methods for countering and avoiding risk
AACSB: Analytic Skills
Special Feature: None

9) Suppose that in a market for used cars, there are good used cars and bad used cars (lemons). Consumers are willing to pay as much as $6,000 for a good used car but only $1,000 for a lemon. Sellers of good used cars value their cars at $5,000 each and sellers of lemons value their cars at $800 each. Buyers cannot tell if a used car is reliable or is a lemon. Based on this information, what is the likely outcome in the market for used cars?
A) Sellers of good used cars will drop out of the market.
B) Sellers of good used cars will incur losses.
C) Sellers of lemons will drop out of the market.
D) Used cars will sell for $3,000.

Diff: 3 Page Ref: 214/146
Topic: The Market for Lemons
*: Recurring
Learning Outcome: Micro 21: Describe methods for countering and avoiding risk
AACSB: Analytic Skills
Special Feature: None
10) Adverse selection occurs in the market for used cars because used car buyers
A) have more information than used car sellers.
B) have less information than used car sellers.
C) have less incentive to maintain the value of their cars than new car buyers.
D) tend to have more accidents than new car buyers.

Diff: 1 Page Ref: 214/146  
Topic: The Market for Lemons  
*: Recurring  
Learning Outcome: Micro 21: Describe methods for countering and avoiding risk  
AACSB: Reflective Thinking  
Special Feature: None

11) If a buyer in an economic transaction has more information than the seller, the buyer benefits at the expense of the seller. This phenomenon is due to
A) moral hazard.
B) adverse selection.
C) economically irrational behavior.
D) gains from trade.

Diff: 2 Page Ref: 214/146  
Topic: Adverse Selection  
*: Recurring  
Learning Outcome: Micro 21: Describe methods for countering and avoiding risk  
AACSB: Reflective Thinking  
Special Feature: None

12) If a state requires all drivers to purchase auto insurance, insurance companies still face the problem of
A) correctly pricing their insurance.
B) sunk costs.
C) adverse selection.
D) excess demand for their insurance.

Diff: 2 Page Ref: 214-215/146-147  
Topic: Asymmetric Information  
*: Recurring  
Learning Outcome: Micro 21: Describe methods for countering and avoiding risk  
AACSB: Reflective Thinking  
Special Feature: None
13) Which of the following is not an advantage of risk pooling?
A) By insuring large groups as opposed to individuals, health insurance providers reduce adverse selection.
B) It gives very sick people in the group the same access to health care and to pay the same premiums as healthy individuals.
C) It is easier for an insurance company to estimate the average number of claims likely to be filed under a group policy than it is to predict the number of claims likely to be filed under an individual policy.
D) Individuals who are insured and therefore do not have to pay the full cost of health care services may be inclined to over-use those services.

Diff: 2 Page Ref: 214-215/146-147
Topic: Adverse Selection
*: Recurring
Learning Outcome: Micro 21: Describe methods for countering and avoiding risk
AACSB: Reflective Thinking
Special Feature: None

14) The Pre-Existing Condition Insurance Plan is a federally administered part of the Affordable Care Act, and is designed for people with pre-existing medical conditions to obtain insurance. By offering health insurance to all U.S. citizens with pre-existing medical conditions, the Pre-Existing Condition Insurance Plan eliminates ________ for both the insurer and the insured, and eliminates ________ for the issuer of the insurance policy.
A) the principal-agent problem; moral hazard
B) asymmetric information; adverse selection
C) adverse selection; the principal-agent problem
D) moral hazard; adverse selection

Diff: 2 Page Ref: 214-215/146-147
Topic: Asymmetric Information
*: Recurring
Learning Outcome: Micro 21: Describe methods for countering and avoiding risk
AACSB: Reflective Thinking
Special Feature: None
15) When people who buy insurance change their behavior after the purchase because they are protected from loss by the insurance, the insurance market is said to face the problem of
A) moral hazard.
B) adverse selection.
C) asymmetric information.
D) economic irrationality.

Diff: 1 Page Ref: 215/147
Topic: Asymmetric Information
*: Recurring
Learning Outcome: Micro 21: Describe methods for countering and avoiding risk
AACSB: Reflective Thinking
Special Feature: None

16) Which of the following individuals is most likely to purchase a life insurance policy that pays out an annual income beginning at a certain age until the individual's death?
A) Ian, who expects to have a short life expectancy because of an illness
B) Bradley who has six young children
C) Avril, a tax attorney who wants to avoid adverse selection
D) Alma, who expects to live a long life, based on her family history

Diff: 2 Page Ref: 215/147
Topic: Adverse Selection
*: Recurring
Learning Outcome: Micro 21: Describe methods for countering and avoiding risk
AACSB: Reflective Thinking
Special Feature: None

17) One reason why adverse selection problems arise in health insurance markets is that
A) sick people are more likely to want health insurance than healthy people.
B) because of advances in medical technology, people are living longer. These medical advances are costly and drive up the price of insurance for everyone.
C) the average age of citizens of the United States has increased in recent years, and will continue to increase over the next 20 to 30 years. As older citizens retire, more and more of their medical bills will have to be paid by younger workers.
D) fewer men and women are choosing medical careers because of the increase in the cost of malpractice insurance.

Diff: 1 Page Ref: 215/147
Topic: Adverse Selection
*: Recurring
Learning Outcome: Micro 21: Describe methods for countering and avoiding risk
AACSB: Reflective Thinking
Special Feature: None
18) The cost of group health insurance is lower than if an individual buys a policy on his own because
A) the problem of adverse selection is reduced.
B) moral hazard costs of a group tend to move to a low average.
C) it is easier for the company to deny claims from a large group.
D) insuring a group eliminates the problem of buyers having more information than the seller.

Diff: 2 Page Ref: 215/147
Topic: Adverse Selection
*: Recurring
Learning Outcome: Micro 21: Describe methods for countering and avoiding risk
AACSB: Reflective Thinking
Special Feature: None

19) Which of the following is not an advantage to an insurance company of insuring a large group of people for health insurance?
A) The characteristics of a large group are likely to reflect those of the entire population.
B) It is easier to accurately predict the number of claims for a group than for an individual.
C) When all group members pay the premium, the problem of moral hazard is reduced.
D) When all group members pay the premium, the problem of adverse selection is reduced.

Diff: 2 Page Ref: 215/147
Topic: Adverse Selection
*: Recurring
Learning Outcome: Micro 21: Describe methods for countering and avoiding risk
AACSB: Reflective Thinking
Special Feature: None

20) What is moral hazard?
A) It refers to the private, self-interested actions that people pursue, which when taken collectively leads to a loss in economic surplus.
B) It refers to the actions people take after they have entered into a transaction that makes the other party to the transaction worse off.
C) It refers to the situation in which one party to a transaction takes advantage of knowing more than the other party to the transaction.
D) It refers to the actions people take before they enter into a transaction so as to mislead the other party to the transaction.

Diff: 2 Page Ref: 215/147
Topic: Moral Hazard
*: Recurring
Learning Outcome: Micro 21: Describe methods for countering and avoiding risk
AACSB: Reflective Thinking
Special Feature: None
21) Automobile insurance companies have a problem with people who buy insurance and then drive recklessly or take less care to avoid losses after being insured. In other words, the automobile insurance market is subject to
A) asymmetric information.
B) market signaling.
C) moral hazard.
D) adverse selection.

Diff: 2 Page Ref: 215/147
Topic: Moral Hazard
*: Recurring
Learning Outcome: Micro 21: Describe methods for countering and avoiding risk
AACSB: Reflective Thinking
Special Feature: None

22) If a fire insurance company requires firms buying fire insurance to install automatic sprinkler systems, the insurance company is trying to reduce
A) the problem of adverse selection.
B) the moral hazard problem.
C) sunk costs.
D) asymmetric information.

Diff: 2 Page Ref: 215-216/147-148
Topic: Moral Hazard
*: Recurring
Learning Outcome: Micro 21: Describe methods for countering and avoiding risk
AACSB: Reflective Thinking
Special Feature: None

23) Health insurance companies impose deductibles on policies and co-payments on claims
A) to increase sales.
B) to reduce moral hazard problems.
C) to reduces sunk costs.
D) to increase prices.

Diff: 2 Page Ref: 216/148
Topic: Moral Hazard
*: Recurring
Learning Outcome: Micro 21: Describe methods for countering and avoiding risk
AACSB: Reflective Thinking
Special Feature: None
24) In markets with asymmetric information,
A) moral hazard causes adverse selection which in turn causes asymmetric information.
B) adverse selection causes moral hazard which in turn causes asymmetric information.
C) asymmetric information causes moral hazard and then it causes adverse selection.
D) asymmetric information causes adverse selection and then it causes moral hazard.

Diff: 2 Page Ref: 216/148
Topic: Adverse Selection and Moral Hazard
Learning Outcome: Micro 21: Describe methods for countering and avoiding risk
AACSB: Reflective Thinking
Special Feature: Don't Let This Happen to YOU!: Don't Confuse Adverse Selection with Moral Hazard

25) What is the principal-agent problem?
A) It is a problem caused by a person (principal) who hires an agent to act on his behalf but is unwilling to delegate authority to the agent to carry out the task in the best possible way.
B) It is a problem caused by agents pursuing their own interests rather than the interests of the principals who hired them.
C) It is a problem of the power system of boss and subordinate where the boss (principal) exerts influence over his subordinates (agents) using punishment or threat.
D) It is a problem that exists when a person (principal) has more information about the task than the agent he hires to perform the task.

Diff: 2 Page Ref: 216/148
Topic: Principal-Agent Problem
*: Recurring
Learning Outcome: Micro 21: Describe methods for countering and avoiding risk
AACSB: Reflective Thinking
Special Feature: None

26) In the principal-agent relationship, the agent is
A) the owner of a resource that has hired another party to act on his behalf.
B) the person who is placed in control over resources that are not his own, with a contractual obligation to use these resources in the interests of some other party.
C) the person who is placed in control over resources that are not his own and agrees to compensate the resource owner in the event of outcomes that do not satisfy the resource owner.
D) the person who places his resources in professional hands in exchange for the professional's promise to act on the resource owner's behalf.

Diff: 3 Page Ref: 216/148
Topic: Principal-Agent Problem
*: Recurring
Learning Outcome: Micro 21: Describe methods for countering and avoiding risk
AACSB: Reflective Thinking
Special Feature: None
27) If a doctor knows that an insurance company will pay for most of a patient's bill, the doctor has more of an incentive to require additional medical procedures and tests, even if the patient may not require them. This is an example of
A) moral hazard.
B) the principle-agent problem.
C) asymmetric information.
D) adverse selection.

Answer:  B

Diff: 2 Page Ref: 216/148
Topic:  Principal-Agent Problem
*:  Recurring
Learning Outcome:  Micro 21: Describe methods for countering and avoiding risk
AACSB:  Reflective Thinking
Special Feature:  None

28) Suppose a large firm allows its employees to choose whether to participate in its health insurance plan. The firm is trying to decide between two plans: Plan I has a low monthly premium but a high deductible, and Plan II has a high monthly premium but a low deductible. Under which plan is adverse selection likely to be a bigger problem?
A) Plan I because it is likely to draw participants who expect high medical costs. This group expects to consume much health care services and therefore prefer low deductibles.
B) Plan II because it is likely to draw participants who expect high medical costs. Healthy individuals who do not expect to consume much health care services will not be willing to pay the high premiums.
C) Plan I because it is likely to draw the relatively healthy employees who do not expect to spend much on health care. Because the monthly premiums are low, the insurance company has to bear a bigger financial burden in the event of serious illnesses.
D) Plan II because it is likely to draw employees who tend to over-consume health care services because of the low deductible. Insurance companies are likely to end up paying out more claims than the premiums they collect.

Answer:  B

Diff: 3 Page Ref: 216-217/148-149
Topic:  Adverse Selection
*:  Recurring
Learning Outcome:  Micro 21: Describe methods for countering and avoiding risk
AACSB:  Analytic Skills
Special Feature:  None
29) Vaccinating people against a communicable disease such as influenza not only reduces the chances that the person vaccinated will catch the disease but also reduces the probability that an epidemic of the disease will occur. Which of the following statements is true?
A) Reducing the chances that the person vaccinated will catch the disease is a private cost while reducing the probability of an influenza epidemic is a social benefit.
B) Vaccinating people against communicable diseases yields private benefits in excess of social benefits.
C) Reducing the chances that the person vaccinated will catch the disease is a private benefit while reducing the probability of an influenza epidemic is a social benefit.
D) The benefits of the influenza vaccination outweigh the costs.

Answer: C

Diff: 2 Page Ref: 218-220/150-151
Topic: Health Care
Learning Outcome: Micro 23: Discuss the economics of public goods and common resources
AACSB: Analytic Skills
Special Feature: Making the Connection: Should the Government Run the Health Care System?

30) In the United States, the bulk of health care spending is paid by health insurance companies. Such a system is also called a third-party payer system where consumers of health care pay a nominal fee and the rest are paid by the health insurance provider. Why might such a system lead to an inefficient outcome?
A) Health insurance companies have an incentive to control cost and therefore tend to deny consumers many cutting edge medical treatments.
B) Consumers have an incentive to over-consume health care services because they pay prices well below the cost of providing these services.
C) Physicians concerned that insurance companies may not approve payments tend not to order expensive tests for their patients.
D) Consumers fearing that excessive use of health care services may lead to a rise in insurance premiums tend to under-consume health care services.

Answer: B

Diff: 2 Page Ref: 218-220/150-151
Topic: Health Care
Learning Outcome: Micro 5: List ways in which governments intervene in markets and explain the consequences of such intervention
AACSB: Reflective Thinking
Special Feature: Making the Connection: Should the Government Run the Health Care System?
31) How do current tax laws in the United States favor employer-based health care insurance?

A) Individuals who receive health insurance benefits are allowed to deduct the value of these benefits from their taxable income.
B) Employers who provide health insurance benefits are reimbursed by the government and are not taxed on these reimbursements.
C) Individuals who receive health insurance benefits do not pay taxes on the value of these benefits.
D) Health insurance companies that provide insurance to employers are subject to a lower tax rate than those insurance companies that provide insurance to private individuals.

Answer: C

Diff: 2 Page Ref: 218-220/150-151
Topic: Health Care
Learning Outcome: Micro 23: Discuss the economics of public goods and common resources
AACSB: Reflective Thinking
Special Feature: Making the Connection: Should the Government Run the Health Care System?

32) One effect of adverse selection in a market is that the equilibrium quantity of the product may be smaller than it would have been if there were no information problems.

Answer: TRUE

Diff: 2 Page Ref: 214/146
Topic: Asymmetric Information
*: Recurring
Learning Outcome: Micro 21: Describe methods for countering and avoiding risk
AACSB: Reflective Thinking
Special Feature: None

33) The situation in which one party to a transaction takes advantage of knowing more than the other party to the transaction is known as asymmetric information.

Answer: FALSE

Diff: 2 Page Ref: 214/146
Topic: Asymmetric Information
*: Recurring
Learning Outcome: Micro 21: Describe methods for countering and avoiding risk
AACSB: Reflective Thinking
Special Feature: None

34) If a state requires all citizens to buy health insurance, the problem of adverse selection is eliminated.

Answer: TRUE

Diff: 1 Page Ref: 215/147
Topic: Adverse Selection
*: Recurring
Learning Outcome: Micro 21: Describe methods for countering and avoiding risk
AACSB: Reflective Thinking, Ethical Reasoning
Special Feature: None

35) A doctor pursuing his own interests rather than the interests of his patients is an example of
the principal-agent problem.

Diff: 1 Page Ref: 216/148
Topic: Principal-Agent Problem
*: Recurring
Learning Outcome: Micro 21: Describe methods for countering and avoiding risk
AACSB: Reflective Thinking
Special Feature: None

36) Moral hazard refers to the actions people take after they have entered into a transaction that make the other party to the transaction worse off.

Diff: 1 Page Ref: 216/148
Topic: Moral Hazard
*: Recurring
Learning Outcome: Micro 21: Describe methods for countering and avoiding risk
AACSB: Reflective Thinking
Special Feature: None

37) Health insurance companies impose deductibles on policies and co-payments on claims to reduce the problem of adverse selection.

Diff: 1 Page Ref: 216/148
Topic: Moral Hazard
*: Recurring
Learning Outcome: Micro 21: Describe methods for countering and avoiding risk
AACSB: Reflective Thinking
Special Feature: None

38) What is adverse selection?
39) Suppose you see a 2006 Scion xB Sport Wagon advertised in the local newspaper for $8,500. If you knew the car was reliable, you would be willing to pay $10,000 for it. If you knew the car was unreliable, you would only be willing to pay $5,500 for it. Under what circumstances should you buy the car?

Answer: Because of the lemons problem you should buy the car only if the advertisement is placed by a car dealer with a good reputation or by an individual you know well enough to trust, if you can cheaply determine that it isn’t a lemon (for example, by an inspection), or if you’ll receive a solid warranty against defects.

40) What is moral hazard?

Answer: Moral hazard is a tendency for people to act in risky and reckless ways if they know that others will bear the burden of most or all of any bad consequences.

41) Suggest three ways by which health insurance companies can reduce adverse selection?

Answer: Some ways by which insurance companies can reduce adverse selection are:
1. finding out as much information about a person applying for insurance, for example requiring a medical examination
2. refusing to insure some applicants, for example based on prior health conditions
3. by insuring only large groups of people
42) What is an externality? Explain how someone receiving a meningitis vaccination is an example of an externality in the market for health care.

Diff: 2 Page Ref: 218/150
Topic: Externalities
*: Recurring
Learning Outcome: Micro 22: Explain how externalities affect market efficiency
AACSB: Reflective Thinking
Special Feature: None