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Virginia Commonwealth University

THEORY OF CONTRACTS

Adverse Selection, Private Information, and Lowballing in Insurance Markets, by Stephen P. D'Arcy (University of Illinois, Urbana-Champaign) and Neil A. Doherty (University of Pennsylvania)

Recent contributions to the adverse selection literature have focused on a multiperiod competitive enviroment. In this setting a clean distinction arises between the predictions of competing models. Cooper and Hayes extend the model of Rothschild and Stiglitz to multiple periods. The result is a self-selecting equilibrium characterized by price highballing, or systematically overchanging new business. Kunreuther and Pauly suggest that information asymmetries between competing insurance firms render such price-quantity policies infeasible. Their model results in a pooling equilibrium that is characterized by price lowballing, or systematically overchanging new business. Our evidence is consistent with the Kunreuther and Pauly model and reveals the persistence of adverse selection in the automobile insurance market. *The Journal of Business,* Vol. 63, No.2 (April 1990), pp. 145–164. (Reprinted with permission of *The Journal of Business.*)

RISK PERCEPTION AND ECONOMIC BEHAVIOR

A Model of the Demand for Longevity and the Value of Life Extension, by Issac Ehrlich (State of University of New York at Buffalo and Institute for the Study of Free Enterprise Systems) and Hiroyuki Chuma (Tokyo Metropolitan University)

We specify a demand function for longevity, or "quantity of life," along with corresponding demand functions for indicators of "quality of life" and a value-of-health and life extension function. We show that the demand for health must be derived in conjunction with that for longevity and the related consumption plan, and that all choices depend on initial individual endowments and terminal conditions. Our comparative dynamics predictions indicate that optimal health and longevity are increasing functions of endowed wealth rather than, necessarily, current income; that improvments in opportunities to produce health can accentuate the differences between endowed health and attained longevity levels; and that the value individuals ascribe to their health may be increasing over a good portion of their life cycle. We use this model to analyze observed empirical variations in levels and trends of life expectance an din exposure to health risks across different population groups. *Journal of Political Economy,*Vol. 98, No. 4 (August 1990), pp. 761–82. (Reprinted with permission of the University of Chicago)

Anchoring and Adjustment in Judgments Under Risk,by Bruce W. Carlson (Ohio University)

According to the anchoring and adjustment heuristic, and individual anchors an initial judgment of a stimulus with some of its features and then adjusts that initial judgment to reflect the remaining features. This article examines selling prices (MSPs) to three-outcomes gambles. The results of Experiment 1 indicated that people were most heavily influenced by the intermediate outcome in a gamble. On the basis of these results, the following framework was proposed: To forecast what is likely to happen in a play of a gamble, people partition the outcomes into sets based on the similarity of the outcomes. They then form an initial judgment based on the outcomes in the more probable set, which they adjust to reflect the remaining outcomes. Two more experiments show that when one outcome has a probability greater than.50, people do not focus on the intermediate outcome but anchor their judgment with the high- probability outcome. *Journal of Experimental Psychology: Learning, Memory, and Cognition,*Vol. 16, No. 4, pp. 665–76. (Reprinted with permission of the Amercian Psychological Association, Inc.)

Risk Aversion and the Propensities for Self-Insurance and Self-Protection,by Eric Briys (Centre HEC-ISA, Jouy-en- Josas, France) and Harris Schlesinger (Univeristy of Alabama, Tuscaloosa)

Increase in risk aversion always imply increases in the level of self-insurance, but not necessarily increases in self-protection. This result is shown to be quite robust; holding also in models with state-dependent preferences or with multiple support of the wealth distribution to the left, while making more favorable outcomes more likely. This shift can be decomposed preserving contraciton, thus precluding any unanimity among all risk averters. *Southern Economic Journal,*Vol. 57, No. 2 (October 1990), pp. 458–67. (Reprinted with permission of the authors).

UTILITY THEORY

Efficiency Despite Mutually Payoff-Relevant Private Information: The Finite Case,by Scott Johnson (Australian National University), John W. Pratt (Harvard Business School), and Richard J. Zeckhauser (Harvard University)

Individuals have or observe partly private information. They independently choose acts, possibly including messages. The center may also act. Individuals' utilities may depend on all acts and information, including others' private information. Are there incentives depending only on public information that make desired behavior a Bayesian equilibrium? Assume incentive payments are sparable and fully transferable. Appropriate incentives exist either if the center's information - perhaps solely on all relevant private information, or if individuals' relative valuations of acts, however divergent, are not too dissimilarly affected by different states of nature. More generally, we give necessary and sufficient conditions for existence whenever the strategy profile asks agents to reveal all private knowledge relevant to their beliefs about the center's information. We also develop equivalences on the possible values of private information - concepts of similarity of agent types - that are key to resolving existence questions without such responsiveness or requiring budget balance. *Econometrica*, Vol. 58, Vol. 4 (July 1990), pp. 873–900. (Reprinted with permission of *Econometrica*.)

HEALTH CARE AND INSURANCE

Optimal Reimbursement Health Insurance: An Application of Profit Functions and Frischian Demands, by Timothy Besley (Princeton University)

This paper develops a model of reimburesement health insurance which uses a consumer's Frischian demands and their associated profit function. We contrast reimbursement insurance, which covers expenditure fluctuations on a particular subset of goods, with optimal insurance. A restriction on preferences in their profit function representation is shown to yield the fully optimal allocation for an economy with individual risks as described by Malinvaud. *Journal of Economic Theory*, Vol. 51, No. 2 (August 1990), pp. 403–22. (Reprinted with permission of Academic Press, Inc.)

GOVERNMENT INSURANCE PROGRAMS

Principal-Agent Problems in S&L Salvage,by Edward J. Kane (Ohio State University)

New legislation and traditional FDIC insolvency- resolution procedures transform and intensify the principal-agent problems most responsible for the FSLIC mess. These problems explain couterproductive constriants on the governance and operating policies of the agency responsible for rescuing and salvaging assets in insolvent thrifts: the RTC. The contraints solw insolvency resolution, increase interim financing costs, and as preserving evanescent and economically misconceived "Franchise values," the RTC allows insolvents to seek financing on an unconsolidated basis, initiates bidding for one institution at a time, holds back seriously troubled assets, and recruits an overly narrow range of bidders.

The PBGC's Flat Fee Schedule, Moral Hazard, and Promised Pension Benefits, by Gregory R. Niehaus (University of Michigan)

The pension Benefit Guarantee Corporation (PBGC) initially insured private pension benefits in exchange for a premium that was not risk sensitive.

This paper derives conditions under which a moral hazard problem caused promised pension benefits to increase. The hypotheses are tested using data on individual pension contracts from the pre- and post-PBGC periods. *Journal of Banking and Financing*, Vol. 14, No. 1 (March 1990), pp. 55–68. (Reprinted with permission of North- Holland Publishing Company.)

SOCIAL INSURANCE

Unemployment Insurance and Unemployment Spells, by Bruce D. Meyer (Northwestern University)

This paper tests the effects of the level and length of unemployment insurance (UI) benefits on unemployment durations. The paper paricularly studies individual behavior during the weeks just prior to when benefits lapse. Higher UI benefits are found to have a strong negative effect on the probability of leaving unemployment. However, the probability of leaving unemployment rises dramatically just prior to when benefits lapse. When the length of benefits is extended, the probability of a spell ending is high in the week benefits were previously expected to lapse. Individual data are used with accurate information of spell durations, and the level and length of benefits. Semiparametric estimation techniques are used and compared to alternative approaches. The semiparamatric approach yields more plausible estimates and provides useful diagnostics. *Econometrica*, Vol. 58, No. 4 (July 1990), pp. 757–82. (Reprinted with permission of *Econometrica*.)

The Employers' Costs of Workers' Compensation Insurance: Magnitudes, Determinants, and Public Policy, by Alan B. Krueger (Princeton University and National Bureau of Economic Research) and John F. Burton, Jr. (Cornell University).

New estimates of the average cost of workers' compensation insurance for a homogeneous group of employers by state are presented. These data are used to estimate cost equations for variety of alternative spcifications. The main finding is that when cost equations are estimated by ordinary least squares there is unit elasticity of costs with respect to benefits, but instrumental variable estimates of the effect of benefits yield a insurance fund is associated with higher average costs for employers, all else equal. *The Review of Economics and Statistics*, Vol. 72, No. 2 (May 1990), pp. 228–40. (Reprinted with permission of North-Holland Publishing Company).

Benefits Increases in Workers Compensation, by Richard J. Butler (Brigham Young University) and David Appel (Milliman & Robertson, Inc., New York)

This paper finds empirical support that benefit changes in workers' compensation are sensitive to political pressures rather than the result of aggregate economic trends or attempts to reach some target wage replacement. Benefits have tended to increase when a neighboring state increases its benefits, as inflation has increased, and where (group) self- insurance has been possible. Since the national Commision of State workmens' Compensation

Laws issued its report in 1972 recommending that if states don't increase their benefits then they should be federalized, there has been a significant increase in the level and trend of benefit increases. *Southern Economic Journal*, Vol. 56, No. 3 (January 1990), pp. 594–606. (Reprinted with the permission of the *Journal of Economic Literature*).

The Effect of Prospective Payment under DRGs on the Market Value of Hospitals, by Sherman Folland and Robert Kleiman (Oakland University)

This article investigates the effect of a change in Medicare payment regulations on for-profit hospital market values. A theoretical argument on the effects of this regulatory even is presented in which hospital managers are concerned about firm wealth but also value prestige, provider perceptions of quality, and perhaps other perquisites. In this case, DRGs will induce opportunity cost of nonpecuniary benefits. The issue is pursued empirically by estimating the market response to DRG legislation *Economics and Business*, Vol. 30, No. (Summer 1990), pp. 50–68. (Reprinted with permission of the *Quarterly Review of Economics and Business*).

DEMOGRAPHY

An Existence Theorem on the Stationary State of Income Distribution and Population Growth, by C. Y. Cyrus Chu (National Taiwan University and Academia Sinica, Taiwan)

Through a utility-maximizing process, individuals derive their optimal fertility and bequest decisions both as functions of their initial socioeconomic backgrounds. The combination of these two decisions form a multitype Galton-Watson process. Under weak assumptions, it is proved that the economy will converge to a unique stationary state that implies both a constant population growth rate and a time-invariant income distribution. As such, this paper extends the Becker-Willis static microlevel fertility demand model to a dynamic macrolevel be viewed as a generalization of J. Laitner's stockastic income theory where no differential fertility is allowed. *International Economic Review*, Vol. 31, No. 1 (February 1990), pp. 171–85. (Reprinted with permission of the *Journal of Economic Literature*).

HUMAN CAPITAL

Human Capital Investment and Labor Supply under Uncertainty, by Arthur Snow and Ronald S. Warren, Jr. (University of Georgia)

The authors extend the theory of human capital investment under uncertainty by incorporating postinvestment labor supply as a choice variable. They show that human capital investment decreases in response to an increase in risk about its return if such investment is an inferior activity and preferences exhibit decreasing risk aversion. However, if investment is normal, then the effect of an increase in risk is indeterminate. These results highlight the importance of obtaining empirical evidence on the income elasticity of demand for human capital investment for arriving at refutable hypotheses about the effect of risk. *International Economic Review*, Vol. 31, No. 1 (February 1990), pp. 195-206. (Reprinted with permission of the *Journal of Economic Literature*).

PENSIONS AND RETIREMENT

The Gender Gap in Pensions and Wages, by William E. Even and David A. Macpherson (Miami University)

This study provides rationale for the underrepresentation of women in the pension sector, and examines the consequences for the gender wage gap. For a given set of observed characteristics, a woman is 11%-19% less likely than a man to have a pension. Of the unexplained portion of the gender wage gap, 10%-38% is due to unexplained differences in pension coverage. Finally, consistent with a screening effect of pensions, women are paid mare equally in the pension sector. *The Review of Economics and Statistics*, Vol. 72, No. 2 (May 1990), pp. 259-65. (Reprinted with permission of North- Holland Publishing Company).

Have IRAs Increased U.S. Saving?: Evidence From Consumer Expenditure Surveys, by Steven F. Venti (Dartmouth College and National Bureau of Economic Research) and David A. Wise (Harvard University and National Bureau of Economic Research)

The vast majority of Individual Retirement Account contributions represent net new saving, based on evidence form the quarterly Consumer Expenditure Surveys (CES). The results are based on analysis of the relationship between IRA contributions and other financial asset saving. The data show almost no substitution of IRAs for other saving. Estimates are based on a flexible constrianed optimization model, with the IRA limit the principal constriant. The implications of this model for saving in the absence of the IRA option match very closely the actual non-IRA financial asset saving behavior prior to 1982. IRA saving does not show up as other financial asset saving in the pre-IRA period. *The Quarterly Journal of Economics*, Vol. CV, No. 3 (August 1990), pp. 661-98. (Reprinted with permission of *The Quarterly Journal of Economics*).

LIFE INSURANCE AND ANNUITIES

Life-insured Annuities: Market Failure and Policy Dilemma, by Peter G.C. Townley (Acadia University)

Inasmuch as private annuity markets fail because of adverse selection, retirees would benefit if they could spend at least some of their accumulated (non-social security) wealth on publicly provided annuities. Yet governments, although capable of improving upon the competitive outcome, typically do not operate such plans. Whereas it may be impossible for a governmental to implement an optimal scheme because of informational constraints, other potentially welfare-enhancing conpulsory and voluntary annuity plans are feasible. However, if they are ranked on both economic and political criteria, neither dominates. This dilemma may be one reason for government inertia in this area. *Canadian Journal of Economics*, Vol. 23, No. 3, August 1990, pp. 546–62. (Reprinted with permission of the Canadian Economics Association).

INSURER MANAGEMENT AND REGULATION

Reflections on the Regulation of Financial Intermediaries, by Renée Spierings (De Generale Bank, Brussels)

Financial intermediaries are said to belong to the most regulated and supervised sector in the economy. This paper attempts to apply general theories of regulation to the financial services sector. Theoretical and practical attention is given to economic rationales of dergulation. One of the basic arguments in favor regulation - the danger of market failure - holds for almost every type of financial operations compared with that on nonfinancial industries and, more important, the increasing blurring of functions between the financial intermediaries. *Kyklos*, Vol. 43, No. 1, pp. 91–109. (Reprinted with permission of the *Journal of Economic Literature*).

LIABILITY RULES

Economic Negligence, Moral Hazard, and the Coase Theorem, by Frederick H. deB. Harris (University of Texas, Arlington, and Wake Forest University)

Asymmetric accident avoidance or damage information and unceraintty cause the Coase theorem to fail when liability assignment is predetermined. Under these conditions, resource allocation will depend on the direction of liability. In contrast, endogenous liability assignment attributable to an economic negligence rule can induce efficient accident aviodance despite asymmetric information and uncertainty. However, endogenous liability assignment also creates an incentive compatibility conflict, which again causes the Coase theorem to efficient allocative outcomes require more complex procedural mechanisms than simply private voluntary bargaining. *Southern Economic Journal*, Vol. 56, No. 3 (January 1990), pp. 698–704. (Reprinted with permission of the *Journal of Economic Literature*).

Efficient Liability Rules for an Economy with Non- identical Individuals, by Winand Emons (Institut fur Volkswirtschaft, Universitat Basel, Switzerland)

This paper is about accident situations involving two risk-neutral parties. Both parties engage in activities that are profitable but affect the magnitude of possible bilateral accidents. We analyse how the activity choices can be decentralized by liability rules that assign the costs to the two parties to an accident. We show that rules which share damages are superior to rules where on party bears the entire costs. *Journal of Public Economics*, Vol. 42, No. 1 (June 1990), pp. 89–104. (Reprinted with permission of North-Holland Publishing Company).

SAFETY AND LOSS CONTROL

Ex Ante Loss Control by Insurerrs: Public Interest for Higher Profit, by Harris Schlesinger (The University of Alabama, Tuscaloosa) and Emilio C. Venezian (Rutgers University)

This article examines the incentives of an insurer to modify loss distributions prior to the sale of insurance. While actions such as lobbying Congress for mandatory airbags in automobiles are undertaken by insurers for the stated purpose of reducing the aggregate loss in society, they also change the nature of the risk being insured and, hence, affect the profitability of insurance sales. For the case of loss prevention (reducing the probability of a loss), insurers do not always have an incentive to invest in loss control. For loss reduction (reducing the severity of any loss that does occur), the incentive is to reduce the size of small losses while simultaneously increasing the size of large losses. *Journal of FInancial Services Research*, Vol. 4, No. 2 (July 1990), pp. 83–92. (Reprinted with permission of Kluwer Academic Publishers).

Ex Post Liability for Harm vs. Ex Ante Safety Regualtion: Substitutes or Complements? by Charles D. Kolstad (University of Illinois, Urbana), Thomas S. Ulen (University of Illinois, Champaign), and Gary V. Johnson (University of Connecticut)

This paper concerns the regulation of hazardous economic activities. Economists have generally viewed ex ante regulations (safety standards, Pigouvian fees) that regulate an activity before an accident occurs as substitutes for ex post policies (exposure to tort liability) for correcting externalities. This paper shows that where there is uncertainty, there are inefficiencies associated with the exclusive use of negligence liability and that ex ante reulation can correct the inefficiencies. In such a case it is efficient to set the safety in the standard were used alone. *The American Economic Reivew*, Vol. 80, No. 4 (September 1990), pp. 888–901. (Reprinted with permission of *The American Economic Review*.)

Spontaneous Attributional Thinking Following Near-Miss and Loss Producing Traffic Accidents, by David M. DeJoy (University of Georgia)

The purpose of this study was to examine whether spontaneous attributional search increases with accident outcome severity, specifically in near-miss versus loss-producing outcomes. Subjects listed the questions that they would ask themselves following traffic accidents that differed in outcome severity and fault. Outcomes involving injury and damage generated more self-questioning; however, the nature of questions did not indicate increased attributional activity. With injury and damage, the subjects' thinking shifted form causes to appropriate actions and possible consequences. Subjects made more internal attributions of causality when at fault, and more stable attributions following the serious outcomes. Injury and damage outcomes produced substantial negative affects, supporting previously hypothesized outcome-and-causal-dimension-related emotions. Stricter penalties were recommended for either at-fault driver when serious consequences were involved. *Journal of Safety Research*, Vol. 21, No. 3 (Fall 1990), pp. 115–24. (Reprinted with permission of the of Safety Research).

Valuing Risk in the Workplace: Market Price, Willingness to Pay, and the Optimal Provision of Safety, by Henery W. Herzog, Jr. and Alan M. Schlottmann (The University of Tennessee)

The theory of compensating wage differentials, attributable to Adam Smith, suggests that jobs with disagreeable empirical tests of this theory with hedonic wage equations implicitly assume that workers' willingness to pay for risk reduction (safety) in the workplace through diminished wages, and market valuations of the "price" of these reductions, are equivalent. It is shown that this is not the case within the manufacturing sector where willingness to pay exceeds the price (cost) of risk reduction at current levels of risk exposure. Implications for implied value of life estimates are also examined. *The Review of Economics and Statistics*, Vol. 72, No. 3 (August 1990), pp. 463–70. (Reprinted with permission of North-Holland Publishing Company).