THIRD PARTY MORAL HAZARD AND THE PROBLEM OF INSURANCE EXTERNALITIES

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Moral hazard is one of the oldest ideas in insurance economics, and plays a central role in the business of insurance. As has long been understood, it occurs because the transfer of risk from the policyholder to the insurer leaves the former with a diminished incentive to prevent or avoid bad outcomes. This insight profoundly shapes the design of insurance contracts; it has also played a role in thousands of judicial and regulatory decisions in insurance law and has given rise to a vast academic literature. But insurance does not just affect the behavior of the insured policyholder: in many settings, it can influence others who are not parties to the insurance contract, creating a kind of spillover (in economic terms, an externality). Such effects have occasionally been noted in passing, but in "Third Party Moral Hazard and the Problem of Insurance Externalities," authors Gideon Parchomovsky and Peter Siegelman are the first to synthesize the evidence of their importance and systematically characterize their consequences.

To see the intuition behind third party moral hazard, consider a somewhat obscure insurance product that covers kidnapping (a phenomenon that is rare in the US, but prevalent in countries with weak states). Conventional moral hazard occurs if kidnap victims are less careful in protecting themselves, knowing that they have insurance that covers any ransom demands. Third party moral hazard describes the impact of insurance not on potential victims, but on potential *kidnappers*, who may be more likely to undertake kidnaps if insured victims can afford to pay higher ransoms.

Parchomovsky and Siegelman demonstrate that third party effects are significant across a wide domain, from liability to health to auto insurance and beyond. They describe the mechanisms underlying externalities in insurance, and explain why many of the methods used to control conventional moral hazard will be ineffective—or even counterproductive—when the source of moral hazard is someone other than the insured policyholder. (The key problem is that by definition, third parties have no contractual relationship with the insurer, eliminating most of the contractual techniques for governing moral hazard.) To reduce third party moral hazard without disturbing the delicate regulatory balance between insurers and policyholders, the authors propose a bounty-like system that recruits outside parties to police misbehavior by those who exploit the availability of insurance. More generally, they suggest that the complex effects of insurance on those who are not parties to the contract deserve greater scrutiny by scholars.