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# Moral hazard and adverse selection in Australian private hospitals: 1989–1990

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## Abstract

The Australian hospital system is characterized by the co-existence of private hospitals, where individuals pay for services and public hospitals, where services are free to all but delivered after a waiting time. The decision to purchase insurance for private hospital treatment depends on the trade-off between the price of treatment, waiting time, and the insurance premium. Clearly, the potential for adverse selection and moral hazard exists. When the endogeneity of the insurance decision is accounted for, the extent of moral hazard can substantially increase the expected length of a hospital stay by a factor of up to 3.

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## 1. Introduction

Different countries have different health insurance and health care systems. The US has a mainly private system with a small public (free) sector that acts as a safety net for the disadvantaged. On the other hand, the UK has a mainly public (free) system with a small private system for those prepared to pay for their health care. Australia is distinctive in having a mixed system with large private and public (free) sectors. In 1989–1990, around 44% of income units had private hospital insurance and 35% of hospital users used a private hospital. In addition, private hospital insurance is chosen at the individual or family level unlike in the US where health insurance is commonly a compulsory part of the employment contract.

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There is an on going debate in the US concerning whether the public system should be extended and in the UK concerning whether the private system should be extended. A similar debate is going on in Australia and as in the US and UK is concerned with the appropriate sizes of the private and public sectors. Research that analyses the relationship between health insurance and the use of health care in the private and public sectors is needed to inform this debate.

There are two well-known difficulties associated with providing health insurance to individuals. These arise because the insurer does not know (a) the risk class to which a particular individual belongs and (b) the extent of the loss in well being an individual experiences. In a world with purely private health insurance, ignorance of an individual's risk class leads to adverse selection as only high-risk individuals purchase insurance or no insurance market exists. Ignorance of the extent of the illness or the actual loss in well being leads to moral hazard as individuals, who have some control over the extent of their treatment and receive insurance payouts on the basis of their health care expenditure, over-utilize health services.

Private hospital insurance takes the form of a schedule of allowances for particular private hospital services that result in individuals with different insurance policies facing a different set of net prices. One reason insurance policies take this form is because expenditure on hospital services is observable by insurance companies while the individual's health state vector is not. As previously mentioned, this introduces the possibility of moral hazard. Moral hazard can occur because the insurance policy alters the individual's behavior in a way that decreases the expected profit of the insurance company. For example, (i) the existence of insurance might induce the individual to devote less resources to preventive care and so increase the probability of an insurance claim and decrease the expected profit of the insurance company, or (ii) the existence of insurance might induce the individual to purchase more private hospital services than are strictly needed to return the individual to a healthy state. This paper will be concerned with the latter case though both are manifestations of the same phenomena, namely, that private hospital insurance induces individuals to over-utilize private hospital services. In order to determine the appropriate mix of private and public health service and health insurance provision, studies need to be done to ascertain the extent of moral hazard and adverse selection under various insurance and health care regimes.

The aim of the empirical sections of this paper is to ascertain the extent to which the existence of insurance induces individuals to purchase more private hospital services than they would if they faced the true price of those services rather than the net price under insurance. As such, an indication of the extent of welfare loss that results from the price distortion is given.<sup>1</sup> Moral hazard is present if the use of private hospital service,  $k$  is decreasing in the 'net' price of service,  $k$ .

A number of empirical papers have examined the determinants of an individual or family's insurance choice, [Ngui et al. \(1989\)](#); [Propper \(1989, 1993\)](#); [Cameron et al. \(1988\)](#); and [Hurd and McGarry \(1997\)](#). The general findings are that individuals or families are more likely to have private health insurance the greater is their income, the older they are, and if they are employed. Health status variables do not seem to impact on health insurance choice. In the UK, [Besley et al. \(1999\)](#), found that individuals were more likely to have private health

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<sup>1</sup> The classic paper on the welfare losses associated with health insurance is [Feldstein \(1973\)](#). More recent papers include [Feldman and Dowd \(1991\)](#) and [Manning and Marquis \(1996\)](#).

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