

Inviting Moral Hazards

The Danger of Risk-Free Living

By Tod Ginnis

Imagine none of your mistakes or failed gambits caused you serious problems. You can't afford the house you bought? The bank must renegotiate the terms of the loan. Your History of Horror Films major doesn't impress employers? We'll guarantee you the income a college graduate deserves. You want to build a home in an area that floods frequently? No problem. Taxpayers will sell you cheap flood insurance. Ah, what a wonderful world it would be. Or would it?

When our actions don't have potentially negative consequences, people can do some pretty irresponsible things. The risk of harm (physical, financial, social, etc.) is an important factor we consider in every decision we make. But if we believe someone will protect us from harm, why not take extraordinary risks? There's a potential upside, but no downside. It's heads I win, tails...I'm back where I started. Economists refer to a situation when someone receives protection from the consequences of her actions as a moral hazard.

So What's the Big Deal?

Why should we care about moral hazards? Very simple: [there's no free lunch](#). If you don't pay for your mistakes, somebody else does. And if you have no incentive to limit your mistakes, you will undoubtedly make a lot more of them.

Some moral hazards directly encourage risky behaviors. Others merely lessen the ramifications enough that some people choose to engage in riskier activities. My moral hazard isn't necessarily yours. And as a society, many of us are willing to accept some moral hazards as a byproduct of compassion and our "social safety net."

Let's look at some real-life examples of moral hazards:

- Subsidized flood insurance. In recent years, there has been an upswing in homebuilding in areas that flood frequently. This would never happen without taxpayer-subsidized insurance. If consumers in very high-risk areas tried to buy policies from private companies, they would face rejection or prohibitively high premiums. Few would invest their money building an uninsured house in a flood zone. But government-subsidized insurance encourages irresponsible behavior by largely removing the risk from the policyholder (and transferring it to taxpayers). There are more homes at risk of flooding due to the existence of subsidized insurance.
- Mortgage bailouts. It's sad when someone loses his job and no longer can afford his home. But if the government jumps in and bails out every homeowner, what will be the impact? Many people will decide it's a sucker's game to save money and wait until they can afford a home comfortably. They would just pull the trigger whenever they felt like it, knowing that if they default, taxpayers will pick up the tab. If people believe the government will eventually bail them out, they would have no incentive to be responsible. Why not just buy more house than you can afford? If the market goes up you can sell your home and make a nice profit. If it goes down and you can't make your payment, you'll still have your home. This mentality also causes a run-up in prices, as

people who should be renting bid up modestly priced homes. Meanwhile those who can afford modestly priced homes bid up more expensive ones.

- One-way performance bonuses. High bonuses for strong performance are commonplace among money managers. But these managers don't participate on the downside when they do poorly. Indeed, it is a violation of federal regulations. Of course, they could lose their jobs...when the manager isn't the boss. Sometimes this encourages extreme risk-taking: if you win, you make a lot of money; if you lose, your customer or company suffers the consequences. Let's say your management agreement states at the end of each year you earn a bonus equal to 10% of customer profits. No profits, no bonus. Imagine it's October and you haven't made or lost much money for the year. If you invest responsibly for the rest of the year, you'll probably earn little or no bonus money. But if you make some extremely aggressive bets, you could end the year with strong gains and collect a good bonus. If these investments are clobbered, you're no worse off than if you broke even...which is more than we can say for your customers.
- FDIC insurance. Weak banks sometimes offer high interest rates to encourage deposits. This helps bad banks stay in business longer, and raises the amount of losses when they fail. Absent government guarantees, depositors wouldn't be so fast to entrust their money to poorly managed banks. So there would be a lot fewer of these bad banks. Savers would only place their money with banks they trusted, or those with private insurance. And you can bet private insurers would not protect banks that acted irresponsibly.
- Unemployment insurance. Have you ever heard someone say "I'll start really looking for a job when my unemployment runs out"? Without that check, some people would have extra incentive to go out and find work fast. The higher the payment, the greater the disincentive to finding work. The effect is also much more likely among low wage workers, who might decide to stay home for a relatively modest pay cut. How much of a moral hazard this creates is subject to debate, but to deny it exists for some people is not reasonable.
- Trust fund babies. Children born into very wealthy families are at great risk for moral hazard. A lot depends on their parents: if they instill a work ethic, the kids should be fine. But if parents make it clear that no matter how their children behave they will never have to worry about money, human nature suggests many of these kids will act irresponsibly. People have recognized this effect for many years. It is embodied in the proverb "from shirtsleeves to shirtsleeves in three generations" sometimes attributed to self-made industrialist Andrew Carnegie.
- Low-deductible health insurance. Most people think they have a "good" health insurance plan if they absorb a small or no deductible before the insurance company starts paying the bills. But this type of policy encourages people to overuse medical care, and eliminates any concerns about price. A similar moral hazard emerges from the commonly used system of co-payments for prescription drugs: if you pay \$35 for a

prescription regardless of what the pharmacy charges (while your insurance company pays the rest), you have no reason to shop around. You'll just go to the most convenient pharmacy, and likely have no idea what the drug actually costs. Any system where the person consuming something doesn't pay for it directly is bound to lead to unusual behavior. Health insurance functions better when designed for emergencies, not general maintenance. What if your auto insurance covered tune-ups, oil changes, and tire rotation? Your mechanic would be busy, but your premiums would go through the roof.

- Charity. Any act of charity can potentially create a moral hazard. The recipient has less incentive to work hard to support himself. Effective charity requires the donor be involved with recipients to ensure they are genuinely needy, and act responsibly. Government doesn't do this, which explains why it does such an awful job at charity.

I am not arguing that charity is bad! Neither am I arguing that we must eliminate all behaviors that create moral hazards. A compassionate society doesn't want to toss families into the street. But if we let the irresponsible among us stay in homes they can't afford, what's to stop everyone from overspending on homes? When considering policy we must assess the tradeoffs between compassion and moral hazards. A failure to acknowledge moral hazards will almost certainly create more of them. And that hurts all of us.

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