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Insurance, Self-Control, and Contract Flexibility

Heiner Schumacher*

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Abstract

We study a competitive insurance market in which some consumers have too optimistic expectations regarding their future use of preventive measures. When contracts are long-term and inflexible, such naive consumers would increase the costs of insurance for low-risk consumers. The competitive insurance market therefore offers flexible contracts that allow for switching between different tariffs. Sophisticated consumers choose a partial insurance tariff and remain low-risks. Naive consumers choose the same tariff, but later switch to full insurance, and become high-risks. If there are sufficiently many naive consumers, they pay a transfer to sophisticated consumers (so that high-risks subsidize low-risks). In contrast, there are no such transfers when contracts are short-term. The model generates novel implications for the time frame of insurance contracts and insurance requirements.

Keywords: Insurance, Moral Hazard, Hyperbolic Discounting, Sophistication

JEL classification codes: D82, D91, G22

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