Microeconomics, information, final exam practice problems

(The attached PDF file has better formatting.)

*Question 1.1: Life Insurance

Slavic Life sells life insurance in Russia. Because of high vodka consumption, mortality rates are high among Russian men.

Suppose that privacy legislation forbids insurers from asking about vodka consumption or testing levels of blood alcohol. Heavy drinkers seek more life insurance than non-drinkers.

- Non-drinkers, with low mortality, do not want to pay average rates
- Heavy drinkers have expected deaths much higher than average mortality rates.

Which of the following explain why it would be hard to sell life insurance profitably in Russia?

A. Adverse selection
B. Cartel pricing
C. Morale hazard
D. Poor medical care in Russia
E. Premium rates exceed expected benefits

Answer 1.1: A

Adverse selection is an informational asymmetry. The life insurance applicant knows if he or she has high or low expected mortality. The insurer does not know, because it is too expensive to find out or because the government does not allow rate discrimination.

*Question 1.2: Quality

Consumers prefer high quality products, but they sometimes have difficulty judging the quality of a product. Consumers often use brand names as an indication of the quality of a product, and firms spend substantial money to develop these brand names. This situation is an example of

A. Signaling
B. Adverse selection
C. Efficient markets
D. Rent
E. The principal-agent problem

Answer 1.2: A

*Question 1.3: Adverse Selection

When do insurance companies encounter the problem of adverse selection?

A. When having insurance causes people to take more risks than they otherwise would.
B. When they do not have the information to distinguish between good and poor risks.
C. When the price of insurance fully reflects all available information.
D. When the insurance company suffers large losses because a major catastrophe affects many people simultaneously.
E. When neither insurers nor policyholders know who has a greater chance of loss.

Answer 1.3: B