Efficiency and Adverse Selection: The Role OF mutual Contracts

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Abstract

We study competitive equilibria in economies with adverse selection. In our model, a large population of agents contracts with a finite set of firms. Firms compete over privately informed agents by offering non-linear and endogenous contracts. These contracts are allowed to depend on the composition of agents that trade with one firm. In an insurance context, this is equivalent to mutualization of insurance contracts whereby each insuree's contract depends on the distribution of other insurees' claims. Our main result is that when this notion of contracts are allowed, a competitive equilibrium always exists. Furthermore, the competitive equilibrium is always constrained efficient (in the sense of interim efficiency) and is unique. We show this result for a variety of environments (the insurance market a la Rothschild and Stiglitz (1976), Spence's signaling model, Bester's loan market model, among others) and for one-dimensional distributions of private information among agents. Our result sheds light on optimal regulation of markets with adverse selection specially that of health insurance markets. It suggests that rather than using traditional tools such as mandates and regulation of contract characteristics, government must monitor insurance companies and enforce the mutualization of contracts whereby firms share the losses and gains from claims with all the insurers.