

Behavioral Economics and Political Legitimacy Illustrated



Insurance Can Incorporate Risk to Achieve Economic Efficiency

Efficient Insurance Markets

- 1. Symmetric Information with Congruent Preferences**
- 2. Complete Stipulation of Contingent Alternatives**
- 3. Property Rights Are Fully Allocated**
- 4. Judicial Independence Arbitrates All Claims**
- 5. Externalities Are Ruled Out Through Contracts**
- 6. Competitive Insurance Markets Ensure Efficient Pricing**

Wisdom from Casino Royale:

Mercenary ruler: “M. Le Chiffre, do you believe in God?”


Le Chiffre: “I believe in a reasonable rate of return”

Markets Can Fail Under Informational Asymmetry

FINAL **DAILY NEWS** **15¢**
NEW YORK'S PICTURE NEWSPAPER
Vol. 57, No. 105 New York, N.Y., 10012, Thursday, October 20, 1972 Home and Foreign Delivery 10¢

FORD TO CITY: DROP DEAD

Vows He'll Veto Any Bail-Out



**Abe, Carey
Rip Stand**

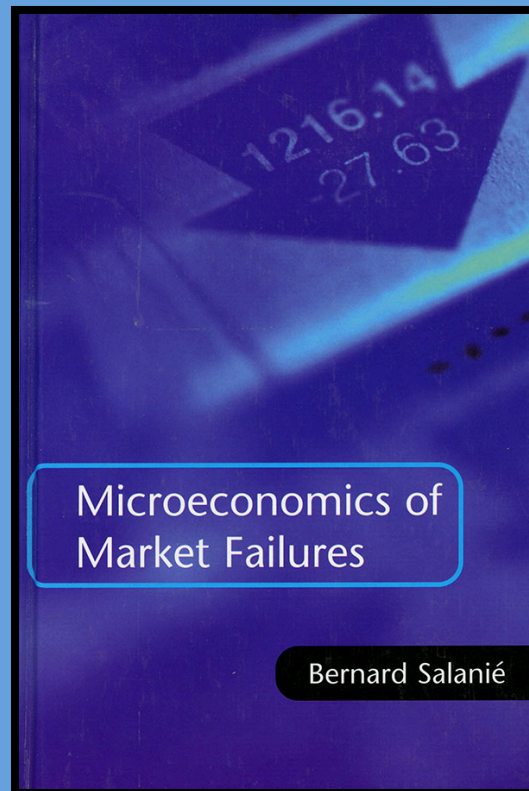
**Stocks Skid,
Dow Down 12**

Three pages of stories
begin on page 3; full text
of Ford's speech on page 26

President Ford gives his message at Washington's National Press Club yesterday.

Sources of Market Failure

1. **Imperfect Competition**
2. **Externalities as Incomplete Markets**
3. **Adverse Selection**
4. **Moral Hazard**
5. **Behavioural biases**



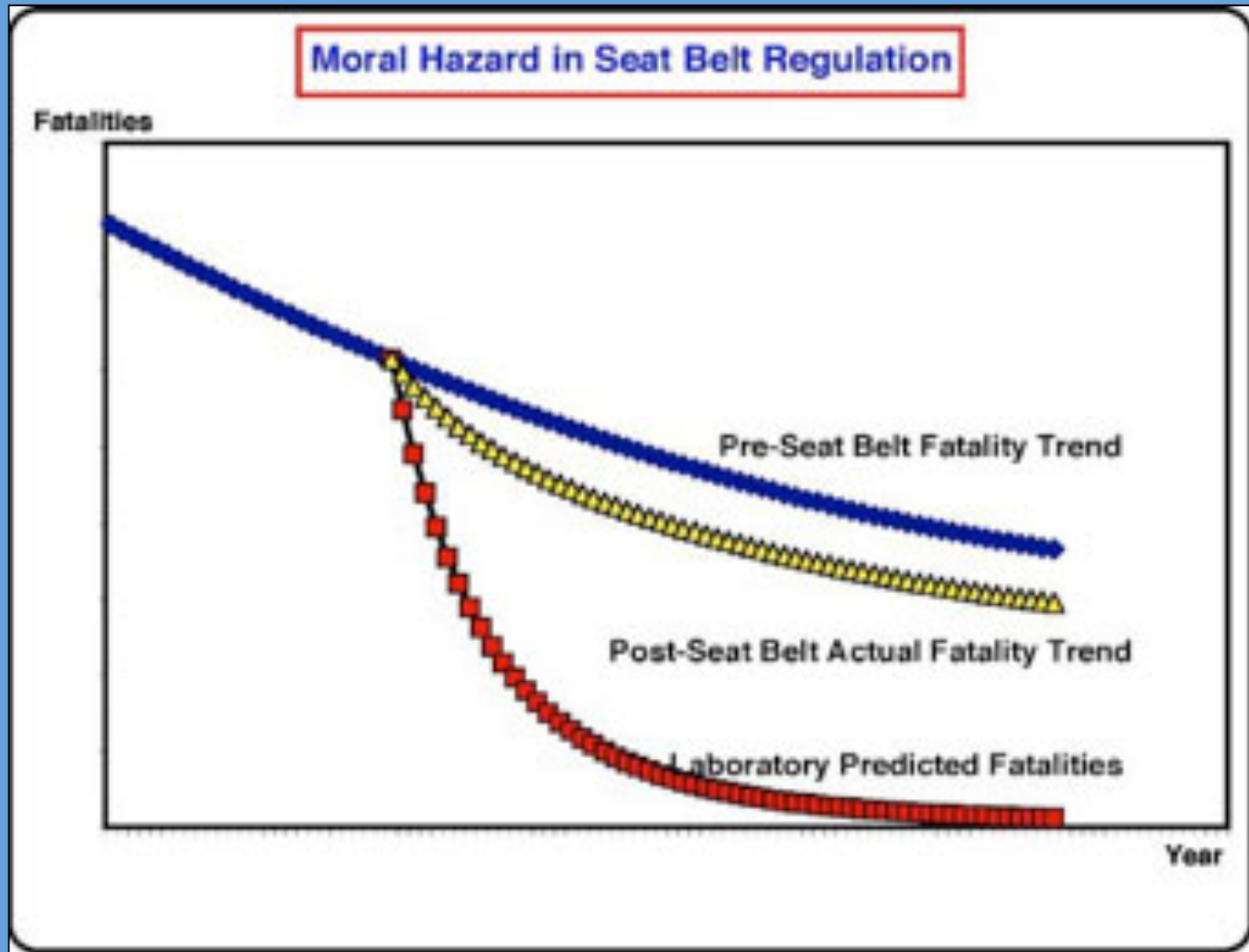
Sources of Government Failure

1. **“Too big to fail” Socializes Risk**
2. **Implicit Standards Send Inefficient Signals**
3. **Government Regulations Distort Responses to Risk**
4. **Government Spending also Can Distort Risk Responses**

I have enough money to live comfortably for the rest of my life, If I die by next Tuesday.

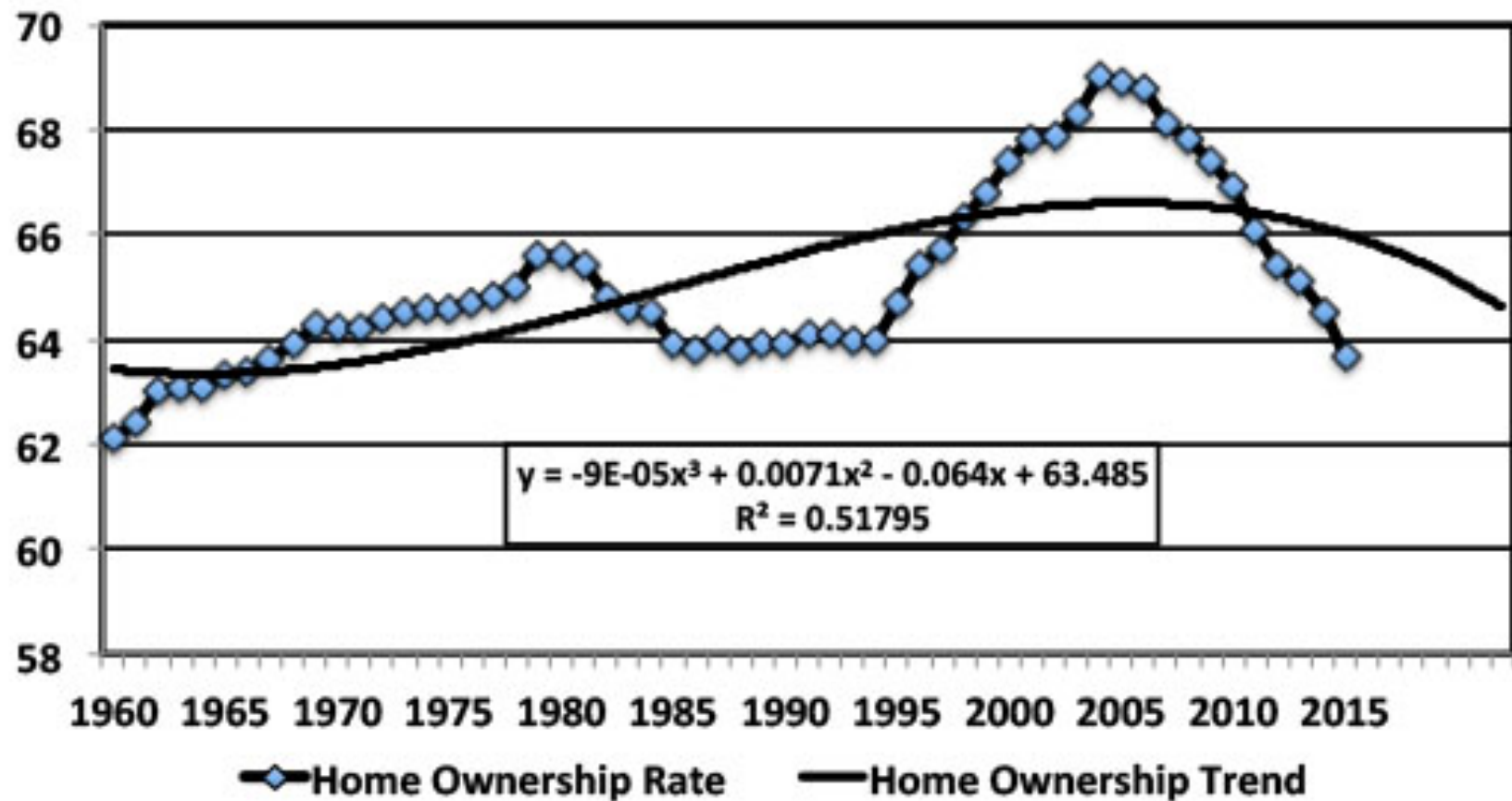


Risk Management Choices (1): Moral Hazard in Seat Belt Safety Standards



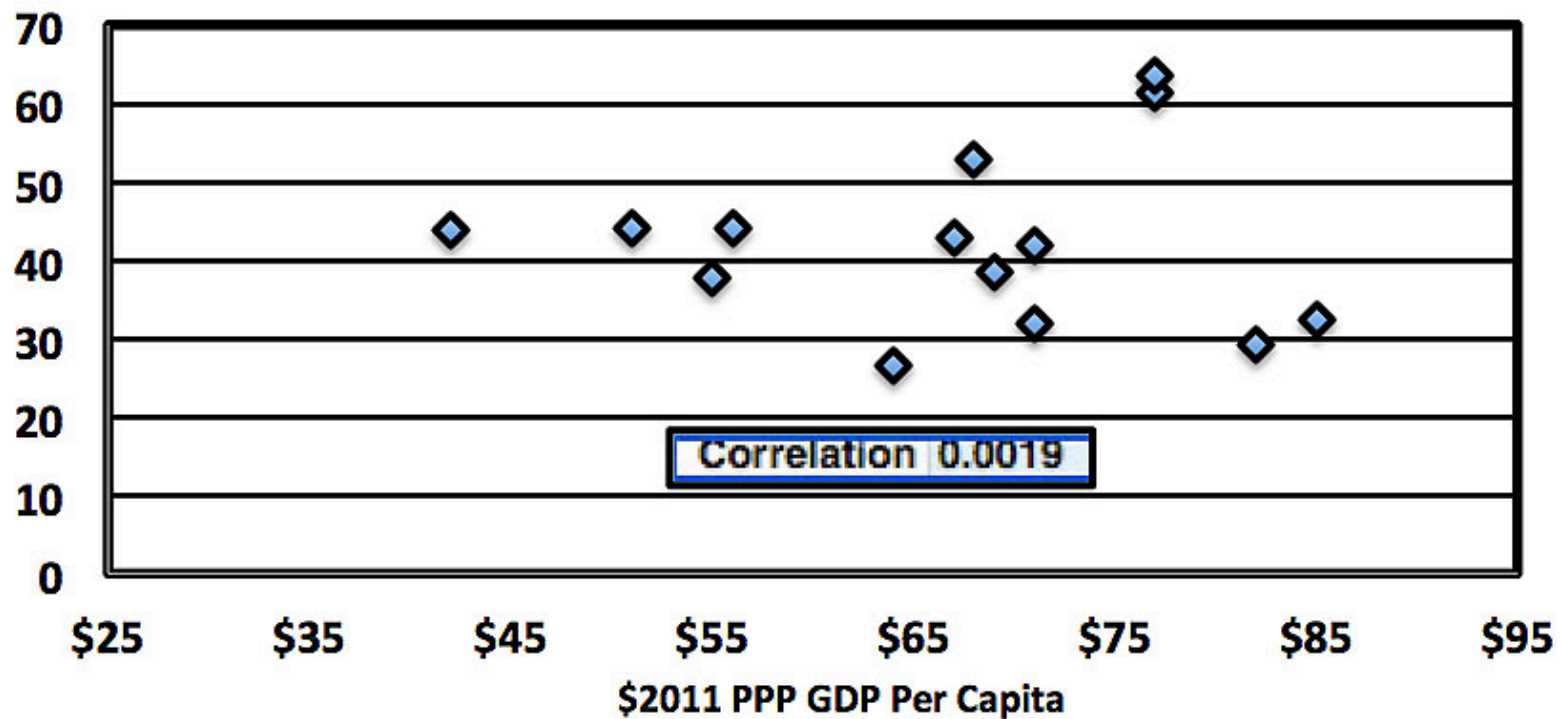
Risk Management Choices (2): Home Ownership Rates Under Asymmetric Information

U.S. Home Ownership Rate



International Home Ownership Rates Differ Significantly

**International Home Ownership Rates
and \$2011 GDP Per Capita**

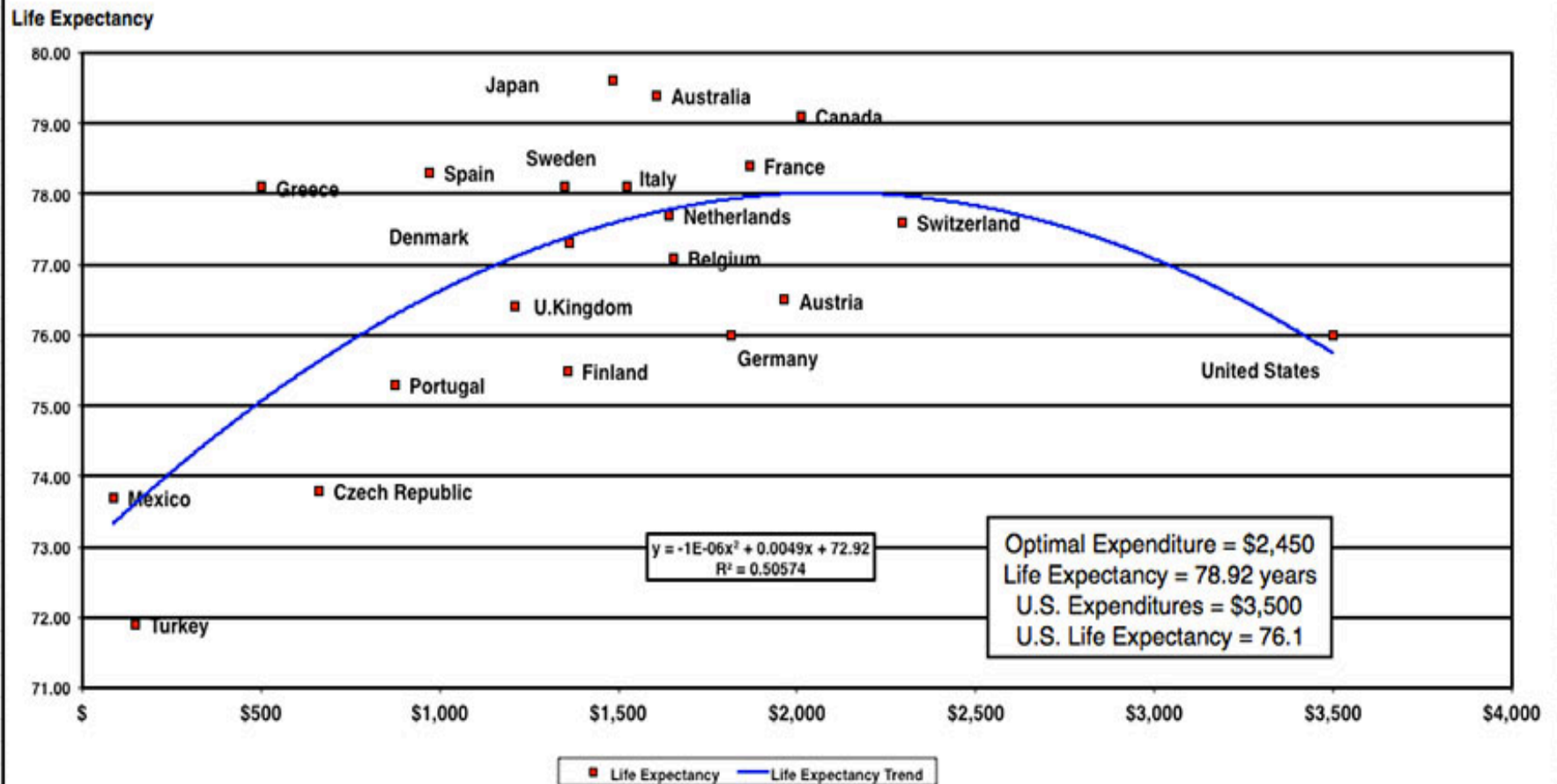


Risk Management Choices (3): Alternative Pension Systems

Alternative Pension Systems Control Panel		
	Base Year Earnings	\$15,000
Annual Growth Rate of Per Capita Income		3.50%
Tax/Contribution Rate		10.00%
	Retirement Age	65
Administrative Cost per dollar of Deposits		1.00%
	Life Expectancy	78
Annual Payout Rate(65+years)		\$16,211
Maximum Basic Payout Rate		\$16,211
Maximum Reinvested Payout Rate		\$29,725
Non-reinvested Solvency Rate		1.0000
Depository Interest Rate		3.00%
Reinvested Solvency Rate		1.8336

Risk Management Choices (4): Health Care

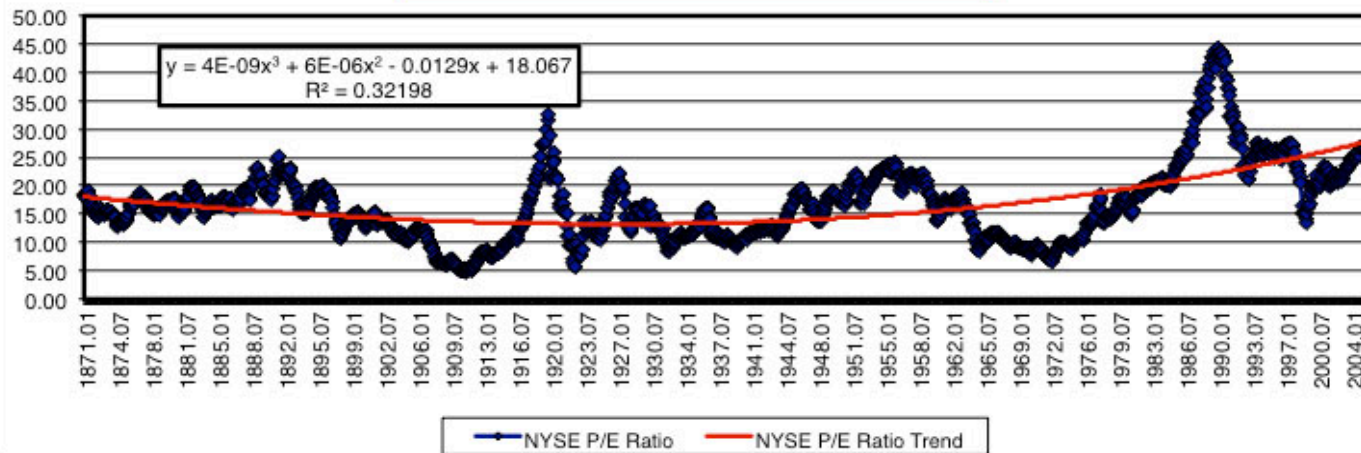
Life Expectancy and Per Capita Health Care Expenditures



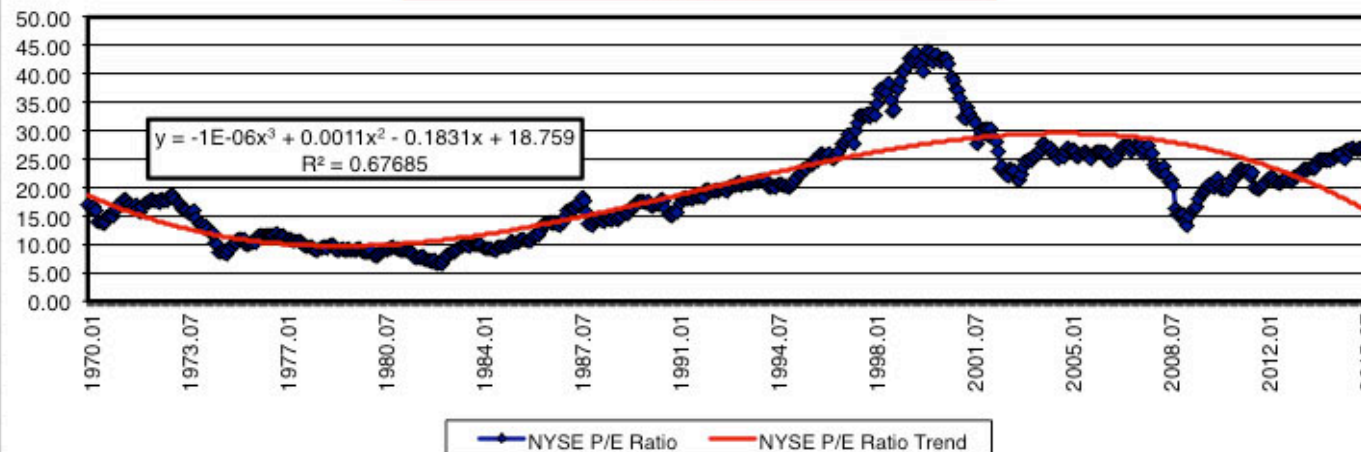
Source: The World Bank, World Databank

Risk Management Choices (5): Asset Bubbles

The New York Stock Exchange P/E Ratio
1870-2015

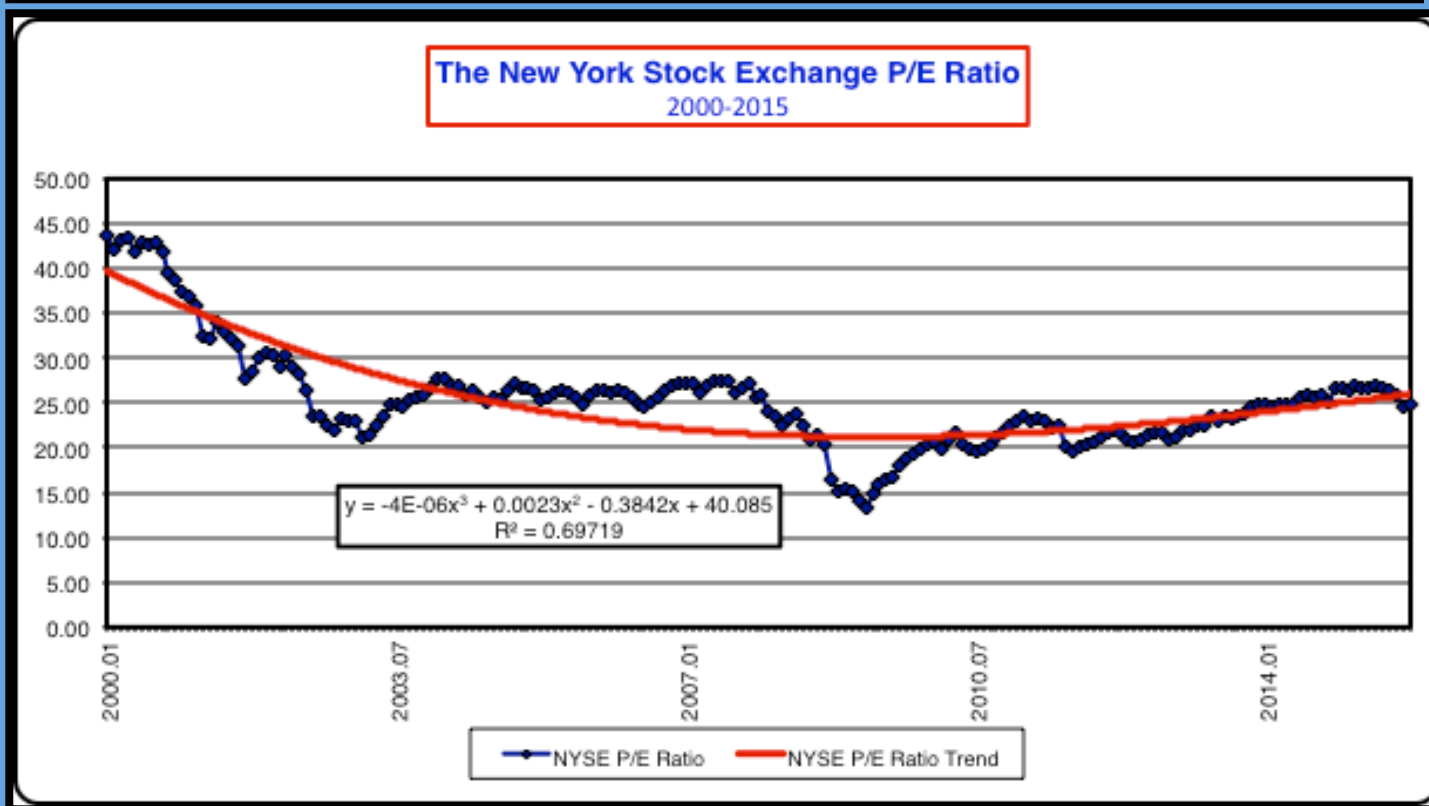


The New York Stock Exchange P/E Ratio
1970-2015



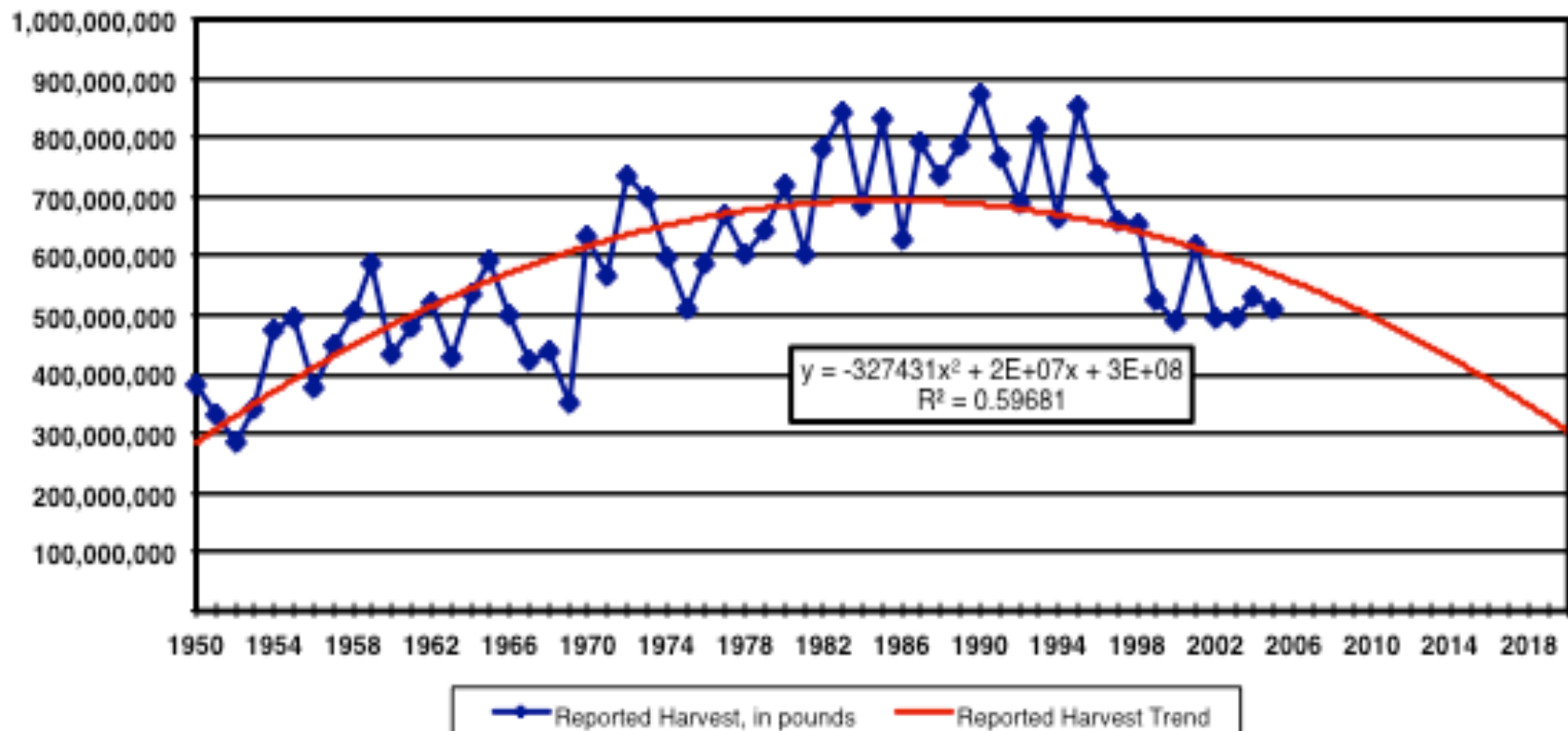
How much should we Backward Discount Past Behavior to Predict Future Asset Prices?

	Basic P/E Statistics				
	1870-2015	1970-2015	1980-2015	1990-2015	2000-2015
Mean	16.64	19.55	21.46	25.32	25.33
StDev.	6.60	8.57	7.23	6.74	5.70
Median	16.03	18.77	23.01	24.66	24.95
C.Var.	0.40	0.44	0.34	0.27	0.22



Risk Management Choices (6): Sustainable Growth and Climate Change

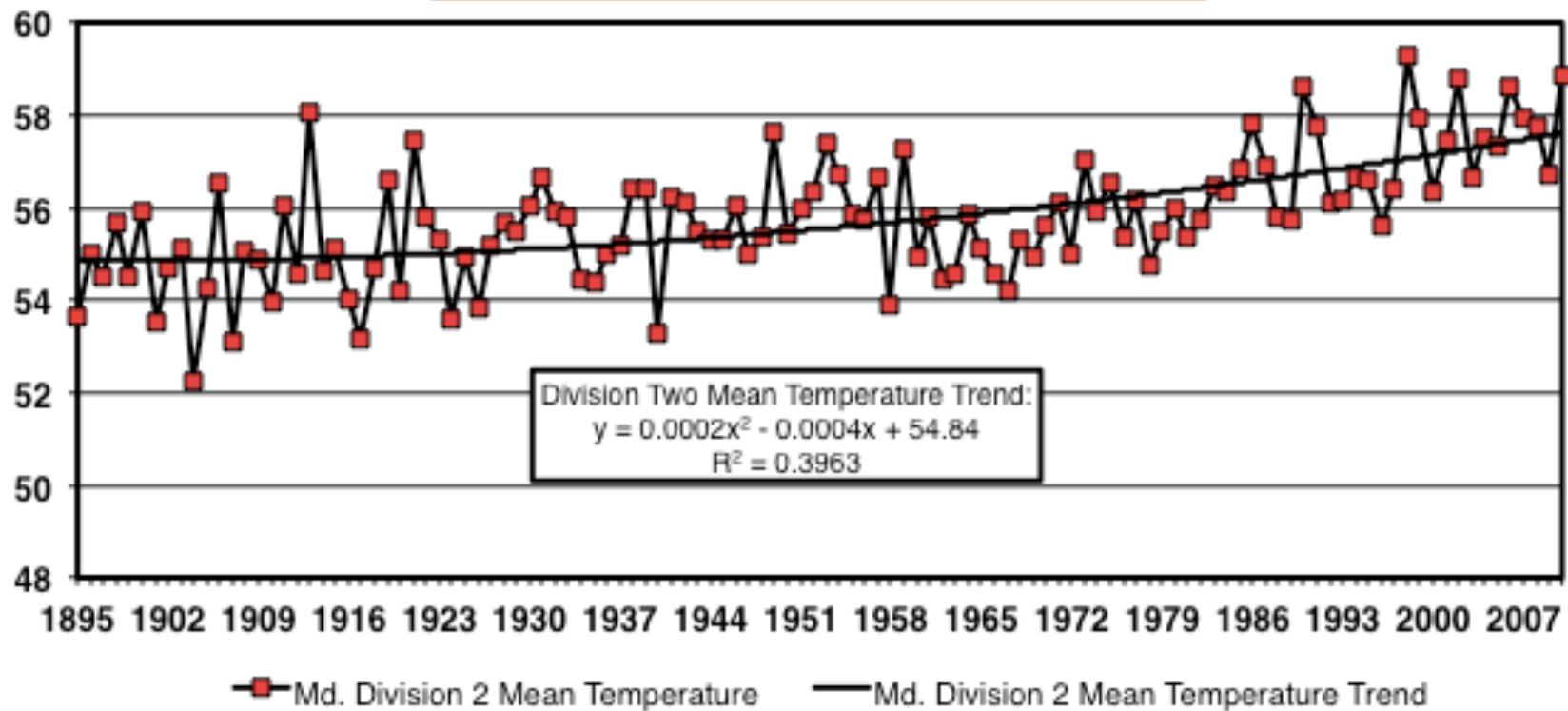
Chesapeake Bay Seafood Harvests, All Species
(commercial landings, in pounds)



Source: U.S. Government, *National Marine Fisheries Statistics*

Evidence of Global Warming on Delmarva

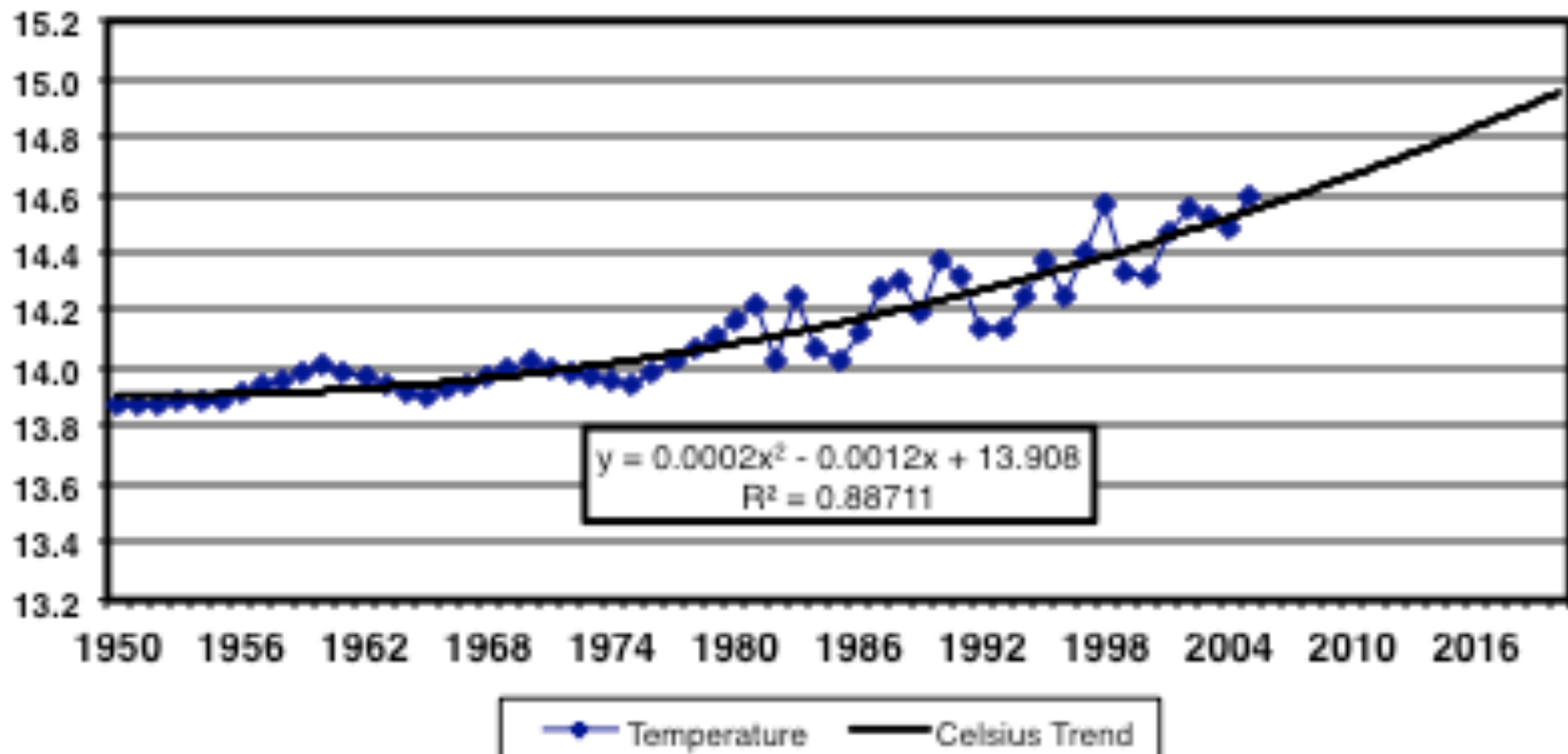
Maryland Division 2 Mean Temperatures
in Fahrenheit Degrees



Source: NOAA

Global Climate Temperature Trend

Global Temperatures
in Degrees Celsius



Source: GISS, BP, IEA, CDIAC, DOE, Scripps Institute of Oceanography