

- In order to find the second-best insurance scheme, we are looking for “least dispersed” values of X and Y that are compatible with both equations. Figure below plots how the LHS of the enforcement constraint changes as we alter X from the perfect insurance case to the no-insurance case.
- We are keeping average income under insurance same, just changing the spread \rightarrow As X increases, Y decreases
- Initially, as X increases, the gains $>$ losses, LHS increases; then gains $<$ losses, LHS decreases.
- Now lets us add RHS to diagram. Why are they horizontal lines?
- Say RHS represented by B , which values of X/Y represent the second-best insurance scheme?

$$u(X) + N\{ pu(X) + (1-p)u(Y) \} \geq u(H) + N\{ pu(H) + (1-p) u(L) \} - S$$

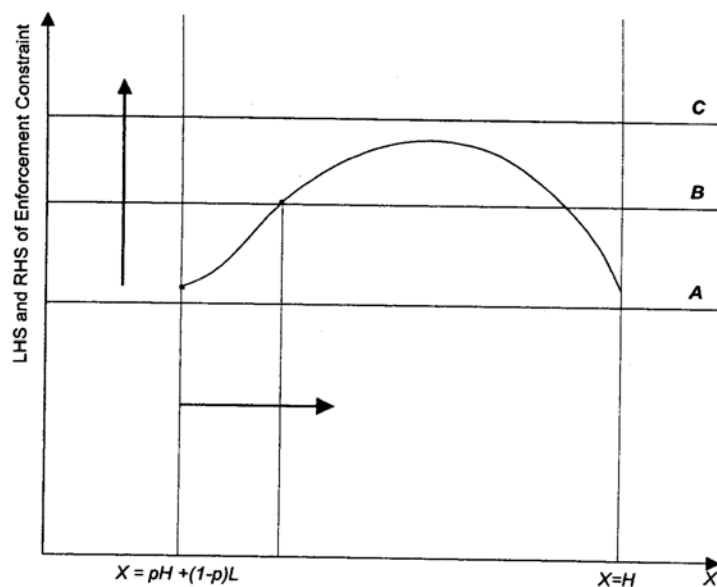


Figure 15.1. The enforcement constraint and imperfect insurance.