Market Failures

ASYMMETRIC INFORMATION

HL Only

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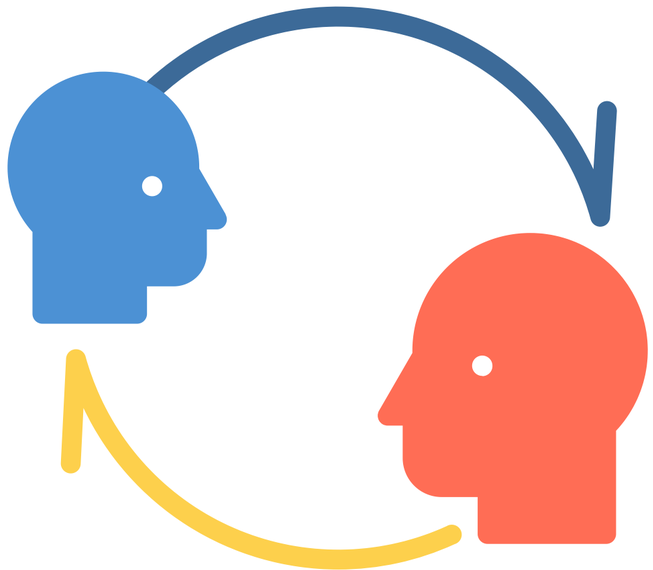

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A Problem With The Free Market

Information . . .

The free market assumes that consumers and producers are rational, profit/utility-maximizing and that both parties have perfect information.

However, all parties typically don't have perfect information. . .

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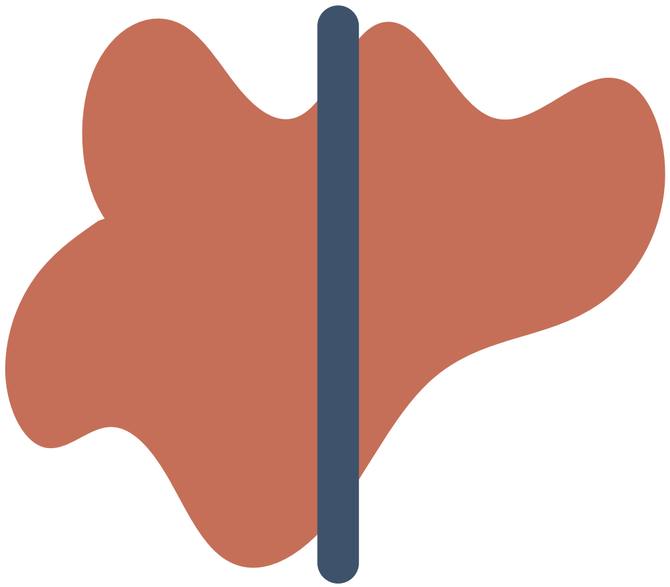
Terms to Know

Asymmetric Information

Where one party in an economic transaction has to more or better information than another. Information is not symmetrical (the same for each side)



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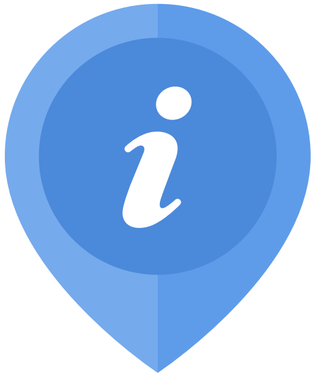
Two Types of Asymmetric Information

Adverse Selection

A situation where one participant has more information than another before the transaction occurs.



Moral Hazard

A situation where one participant takes on more risk because they understand they will not pay the consequences of that risk.

Unlike adverse Selection, the information only changes after the transaction has occured.

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Adverse Selection

A situation where one participant has more information than another before the transaction occurs.

Example: Used Car Market

Used Car Dealers are aware of which used cars are in good condition (A Peach/Plum) and which are in bad condition (A Lemon), but the buyer does not.

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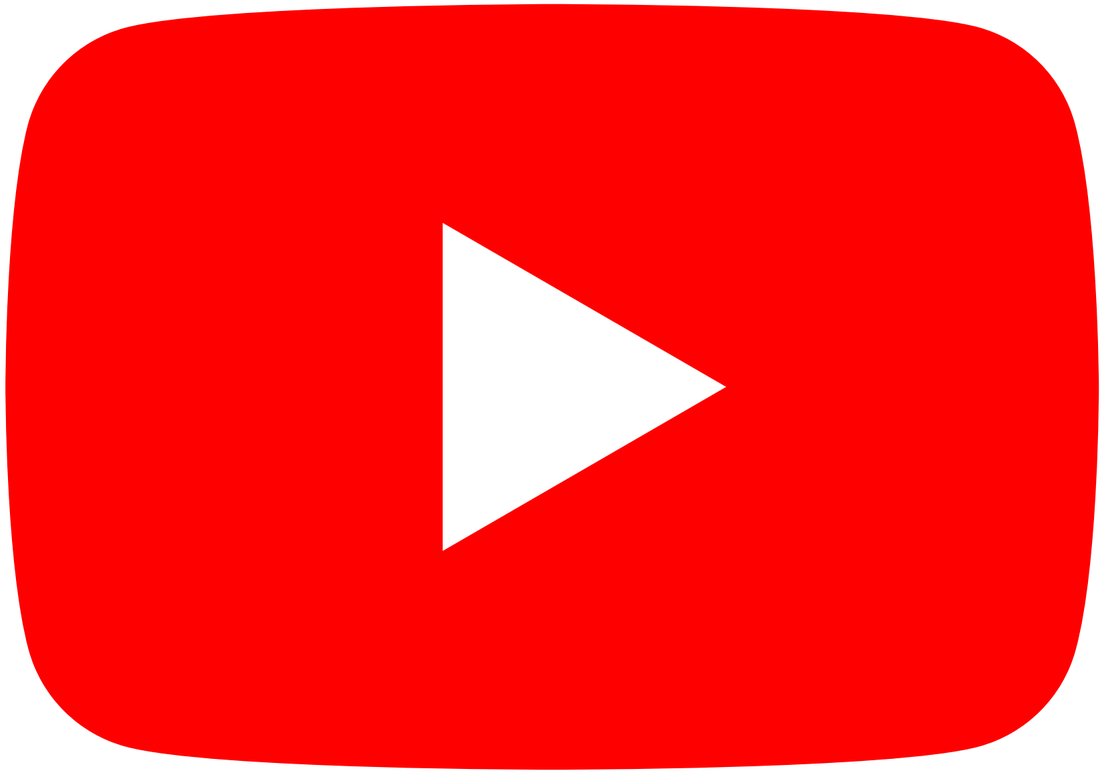

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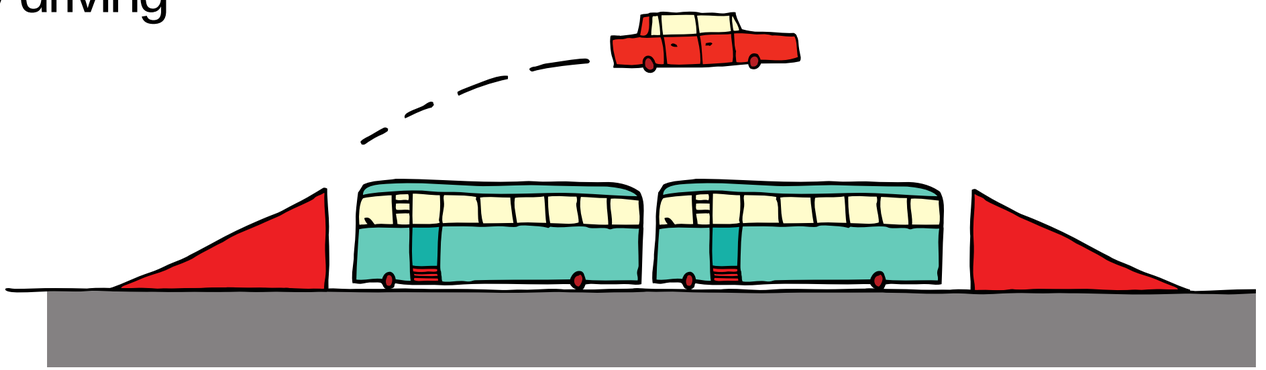
Moral Hazard

A situation where one participant takes on more risk because they understand they will not pay the consequences of that risk.

Remember: Adverse Selection takes place before the transaction while Moral Hazard takes place after.

Example: Car Insurance

Drivers with insurance may feel more at ease when they have insurance because if they are involved in an accident, they only pay a fraction of the costs. This may encourage drivers to engage in more risky driving



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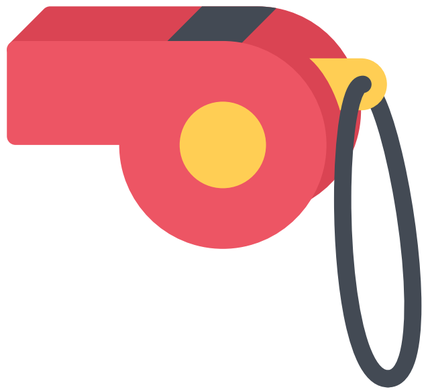
Practice

Determine whether the following scenarios are Moral Hazard or Adverse Selection:

1. A doctor recommending a treatment.
2. A business student applying to a computer science internship knowing they will not be good at it.
3. Someone taking out a loan with no limit.



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Practice

Determine whether the following scenarios are Moral Hazard or Adverse Selection:

1. A doctor recommends a treatment.
    a. **Adverse Selection - the doctor has more information prior to treatment**
2. A business student applying to a computer science internship knowing they will not be good at it.
    a. **Adverse Selection - the student has more information prior to the internship**
3. Someone taking out a loan with no limit.
    a. **Moral Hazard - No-limit loans promote rash spending. Their are programs available for people in severe debt such as Bankruptcy and debt forgiveness.**

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Responses to Asymmetric Information

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How could the government intervene to correct asymmetric market failures?

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Government Responses

Legislation

The government may try to ensure all parties have adequate access to information by legislation.

Examples

- Adding nutritional information and ingredients in food or drinks
- Requiring health warnings on alcohol or cigarettes
- Creating laws that make it illegal for customers to give false information (insurance)

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Government Responses

Regulation

The government may try enforce monitoring of industries to reduce the impact of the market failure.

Examples

- **Financial regulations for financial corporations**
- **Stock market regulations**
- **Regulations to provide information**
  - **Public Health Campaigns**
  - **Information about city planning or disturbances**

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How could people or firms respond to correct asymmetric market failures?

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Private Responses

Firms may choose to implement changes to improve information symmetries.

Signaling

When participants have more information communicate the information to the other party.

Signaling is always done by the participant with more information.

Examples: When hiring staff, employers ask people for their skills via a Resume/CV.

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Private Responses

Pros of Signalling

- Cost-Effective
- Increases amounts of information to all participants
- Improves efficiency

Cons of Signalling

- False information
- Time Consuming

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Private Responses

Screening

When participants lack information force others to reveal information.

Screening is always done by the participant with less information.

Examples: With the same example of hiring, firms could require that all applicants have certain degrees, qualifications, or speak certain languages.

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