HL IB Economics

Your notes

2.10 Market Failure: Asymmetric Information

Contents

2.10.1 Asymmetric Information

Your notes

Understanding Asymmetric Information

- **Information gaps** exist in nearly all free markets and distort market outcomes resulting in market failure

- One of the underlying assumptions of a free market is that there is **perfect information** in the market
  - This means that buyers and sellers have exactly the same level of information about the good/service. This is called **symmetric information**
  - In many markets buyers and sellers have different levels of information. This is called **asymmetric information**. For example, there is **asymmetric information** in the used car market - sellers know more about the vehicle than the buyers
- **Asymmetric information** distorts socially optimal prices and quantities in markets resulting in **over-provision** or **under-provision** of goods/services
  - For example, goods/services with **dangerous side effects** would be sold in lower quantities if buyers were aware of these effects (consider the VW emissions scandal). **Fewer** factors of production should be allocated towards producing these
  - Similarly, goods/services with **extra benefits** would be sold in higher quantities if buyers were aware of them. **More** factors of production should be allocated towards producing these

Adverse Selection & Moral Hazard

- Adverse selection and moral hazard arise in the presence of asymmetric information, where one party has more information than the other in an economic transaction

1. Adverse Selection

- Occurs when the party with more information (typically the buyer) has an advantage in **knowing their own risk profile** as compared to the party offering the service or product
- E.g. In insurance markets, adverse selection can occur if individuals with a **higher likelihood of making a claim** or having a pre-existing condition are more motivated to purchase insurance
  - This can lead to an imbalance in the risk pool, with a higher proportion of higher-risk individuals and insurers may need to raise premiums to compensate for the increased risk
  - This makes insurance less affordable for lower-risk individuals and potentially leads to a further concentration of higher-risk individuals in the pool

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- To reduce adverse selection, insurance companies may **use various strategies such as risk-based pricing or medical underwriting** to ensure that premiums accurately reflect the risk profile of the insured person
- Adverse selection **distorts the process** by which the price and quantity of services are determined - leading to market failure

2. Moral Hazard

- Occurs when one party in a transaction is protected from risk and so they are likely to behave differently than if they were fully exposed to the consequence of the risk
- Economic agents take more risks as the other party have limited knowledge of the risks they are taking
  - E.g. After the 2008 recession, banks continued to take high risk decisions as they **knew the government would bail them out** if they failed
- Moral hazard leads to **market failure** as a party will act in their own self-interest leading to inefficient market outcomes

Government Responses to Asymmetric Information

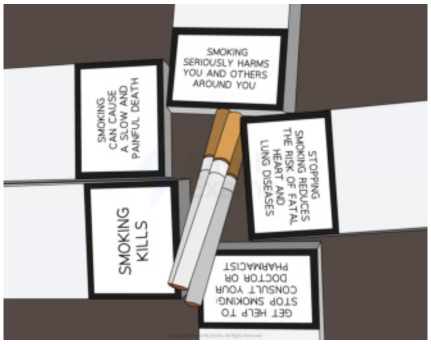
- Firms are aware that asymmetric information can give them more market power
- The government have the responsibility of **removing or reducing information failure** through
  - Legislation and regulation
  - Provision of information

1. Legislation and Regulation

- Laws backed up by enforcement such as fines e.g cigarette firms must point out the danger of smoking on the back of their packaging

Advantages and Disadvantages of Legislation and Regulation

Legislation and Regulation	Advantage	Disadvantage

	▪ They can limit the use of **demerit goods** and goods which generate **negative externalities** ▪ There are **clear legal sanctions** such as fines and bans, which will cause people to change their behaviour	▪ This can lead to **more illegal activity** to bypass legislation and regulation (black markets) ▪ It can create more bureaucracy for firms, **leading to higher costs** and lower profits

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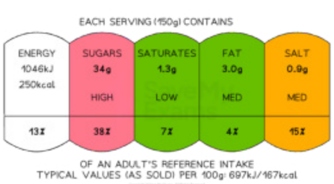
2. Provision of Information

- The government **provide additional information** about goods and services or require firms to do so, so that consumers make more informed choices
  - E.g. food manufacturers providing information about nutritional content on food packaging

Advantages and Disadvantages of Provision of Information

Provision of Information	Advantage	Disadvantages
	▪ This can influence individuals to make better choices in terms of consumption of **merit goods** and goods/services which generate **positive externalities** ▪ The information can be **targeted to the individuals who specifically need the information**	▪ If information is not presented in a clear manner, the targeted individuals **may still make not make the correct decisions** ▪ There is an opportunity cost involved in the cost of information provision ▪ e.g. the Stop Smoking Campaign run by the NHS in 2018 cost £5m

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Private Responses to Asymmetric Information

- Private responses refers to **action taken by private firms or consumers** without any government intervention. These include
  - Signalling
  - Screening

1. Signalling

- This is a strategy used by individuals or firms **with private information** to convey that information to others
- It is useful in situations where one party has **superior information** about their qualities or characteristics, they may **use signals to communicate this information to others,** particularly to gain a competitive advantage or **establish trust**
  - E.g. a Used car seller may offer a comprehensive 60 point checklist of the condition of the car the are selling which would include honest assessments

Advantages and Disadvantages of Signalling

Advantages	Disadvantages
▪ It provides a good indication to consumers about the quality of a good/service ▪ This leads to **more informed choices** for the consumer as asymmetric information is reduced	▪ There may be additional costs associated with signalling which private firms may not be willing to incur ▪ E.g. warranties mean that firms may have to take action which may be expensive if there is an issue with a product/service ▪ Signalling is only effective if the private agent decides to reveal the necessary information

2. Screening

- Another method to tackle adverse selection is to provide buyers with the opportunity to **screen out biased, inaccurate or misleading information** to make better purchasing decisions
- Buyers may employ screening mechanisms to assess the quality or reliability of sellers

- This can involve examining product features, reading reviews, seeking recommendations, or relying on trusted third-party certifications
- By screening sellers, buyers aim to **make informed decisions** and **reduce the risk of purchasing low-quality** products or services

Advantages and Disadvantages of Screening

Advantages	Disadvantages
▪ Screening allows individuals to gather more information ▪ It results in improved purchasing decisions	▪ There may be **additional costs** and time associated with gaining more information ▪ E.g. In the United Kingdom, buyers of a second hand car will have to pay for a government HPI check if they require more information ▪ Reviews used to base decision on may be **flawed or manipulated** by sellers

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