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LECTURE 17: ASYMMETRIC INFORMATION I

I. Asymmetric Information

a. *Asymmetric information* is when two parties don't have equal information concerning the other (e.g. lending, hiring, buying a used car, dating). Two problems occur:

b. *Moral hazard* is when a person reacts to being chosen in an undesirable way. Being chosen (for insurance, for a job, for a relationship) means the chooser trusts that person to act a certain way. That position of trust changes the incentives and thus the trusted may act in a way that's undesirable.

   i. In moral hazard, there's an implicit ethical dilemma. The person was put in a tacit or explicit position of trust and they've betrayed that trust. You can think of moral hazard as dealing with dynamic troubles, people respond to the incentives engendered from the deal itself.

c. *Adverse selection* has no trust issues. Adverse selection occurs when the trade itself is rigged because one party can use its information better. You can think of adverse selection as dealing with static troubles, the moment you encounter something or someone, there's already some quality you won't like.

II. Examples

a. Mastering the difference between these two is best done with many examples.

b. Insurance

   i. *Adverse selection*. Accident-prone individuals love insurance.

   ii. *Moral hazard*. Because they have insurance, people take more risks.

c. Dating

   i. *Adverse selection*. Good liars or very attractive people can get dates even when the other party wants something different from the relationship.

   ii. *Moral hazard*. Knowing it's hard to untangle their lives together, spouses may be less caring and more callous.

d. Hiring

   i. *Adverse selection*. Employers must be careful not to hire the stupid, the incompetent, the lazy, the rude, or other kinds of people with undesirable personality traits. Such individuals are fundamentally flawed from a business perspective.

  ii. *Moral hazard*. Once employed, employers know it is expensive to fire someone. They might also discover how easy it is to get away with things employers may not like. The whole point of hiring someone, after all, is so don't have to worry about whatever task they are doing.

e. Loaning money
  i. *Adverse selection*. Irresponsible people want to borrow money so they can waste it. Irresponsible people rarely think of themselves as irresponsible.
  ii. *Moral hazard*. Banks want to make sure that person remains the right person after they get their money. No longer needing to impress the bank, borrowers may act recklessly.

f. Note that moral hazard only involves choosing people because moral hazard is fundamentally an incentive story. People react to the new incentives that come from being involved.

g. Adverse selection focuses on attributes, qualities that don't change as a result of being involved. Therefore, adverse selection can involve choosing both people and things.