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**Lecture 05: Asymmetric Information**

1. The problems of asymmetric information.
   1. Instead of assuming perfect information (complete and symmetric) as we do in perfect competition, let us assume asymmetric information.
   2. When people don’t know what the other is thinking, we run into two general problems:
   3. *Adverse Selection*—when a person makes a choice that was never the right one. In adverse selection, the problem occurs *before* the transaction was made. 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.
      1. Ex: Most short-term relationships, used cars, hiring an established slacker, lending to a con artist
   4. *Moral Hazard*—when a person chooses someone who then reacts to the incentives that come from being chosen in an undesirable way. In moral hazard, the problem occurs *after* the transaction was made (hence the name, as there’s an implicit ethic dilemma). You can think of moral hazard as dealing with dynamic troubles, people respond to the incentives engendered from the deal.
      1. Ex: Most long-term relationships, national health care, hiring a potential slacker, lending to MC Hammer
      2. Consider the RAND health insurance experiment. Between 1974 and 1982 the government gave 7700 people varying degrees of health insurance. Those with full coverage consumed 30% to 40% more medical services but were not healthier than those that had to pay for all of their medical services.[[1]](#footnote-1)
   5. In both cases, we experience waste and lost opportunities.
   6. Application: Housing bailouts. There was much talk in Congress and the country at large to help people who defaulted on their home loans, such as forcing banks to reduce their debt.
      1. Adverse Selection: Banks have a strong incentive to figure out who they can loan to and who they can’t. But one of the untold stories of the housing market is that loan candidates lied on their loan application. Around 70% overstated their incomes, sometimes as much as five times as much.
      2. Moral Hazard: Not only are borrowers less innocent than people think, bailing them out will have unintended consequences. Bailouts encourage honest people to become dishonest as they realize bad behavior (such as lying) will be rewarded, not punished.
2. Combating asymmetric information
   1. Screening: learning about a target before making a choice.
      1. Combats adverse selection.
      2. Ex: Asking particular questions during a date, Googling the target, credit reports, contacting previous employers
   2. Monitoring: keeping tabs on a target after making a choice
      1. Combats moral hazard
      2. Ex: Following the target around, requiring progress reports, investing insurance claims
   3. Rewarding: creating incentives to discourage bad behavior
      1. Combats moral hazard
      2. Ex: Prenups, profit sharing, deals to loyal bank customers
   4. Efficiency wages: setting wages artificially high to improve your selection of candidates and deter shirking.
      1. Combats adverse selection and moral hazard
      2. Credit rationing is a similar idea, where banks set interest rates artificially low to improve their selection of borrowers
   5. A fifth method—signaling—is a large enough topic that I wish to dedicate a whole class to it.

1. <http://www.overcomingbias.com/2007/05/rand_health_ins.html> [↑](#footnote-ref-1)