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ECON 202—Montgomery College

LECTURE 18: ASYMMETRIC INFORMATION II

I. Combating Asymmetric Information
   a. It's sometimes tricky to distinguish between the two types of asymmetric information. One way to help highlight the difference is think of how one combats each of them.
   b. Combating adverse selection involves sorting through choices before any decision is made.
      i. *Screening*—directly collecting information about possible choices to reduce the asymmetric of information.
      ii. Signaling—conveying meaningful information through demonstrative actions (it's a kind of screening).
      iii. *Efficiency wages*—offering a higher-than-market wage to improve the quality of the pool of candidates, thus reducing the chance of getting a bad employee
   c. Combating moral hazard involves changing the incentives of whoever was chosen.
      i. *Monitoring*—watching the agent to see if they act as promised.
      ii. *Rewards/punishments*—granting bonuses for good work and demotions for poor work, etc. Collateral is an example.
      iii. *Efficiency wages*—these can also be used to combat moral hazard because employees fear losing their job.

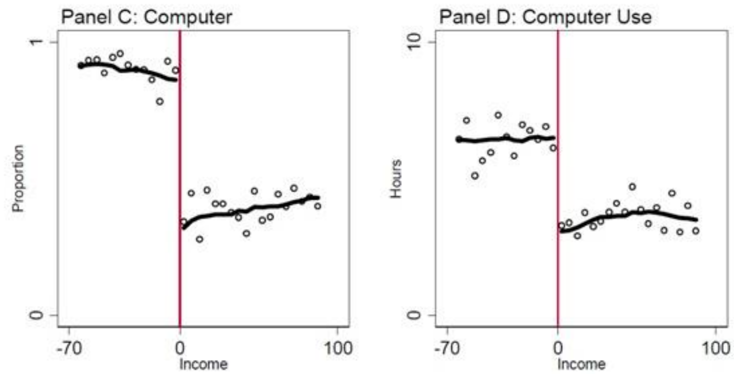
II. Incentives Matter
   a. *Unintended consequences*—outcomes not original intended by an acting individual
      i. What you pay for versus what you want
      ii. Strong incentives might help motivate people to action, but they also might incentivize them to do something unintended
   b. *Piece rates*—payment made directly for output
      i. Output may be hard to measure
   c. *Tournaments*—payment for relative performance to correct for environment
      i. May cause workers to turn on each other or not be motivated at all if a star always outshines everyone
   d. *Corporate culture*—shared collection of values and norms about how people interact
      i. Cannot be precisely constructed nor controlled

III. An Example

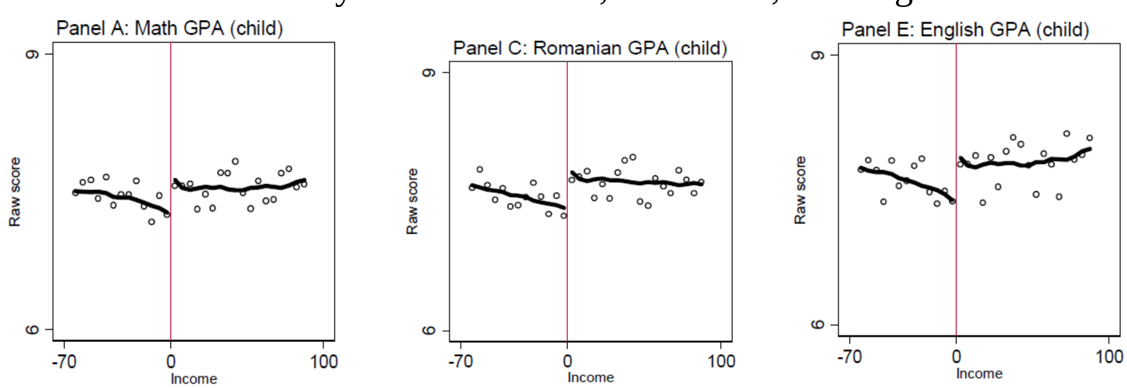
a. When institutions are not aligned properly with incentives, you can get strange effects. You can even get the opposite of what you wanted.

b. In 2008, the Romania government provided vouchers to buy computers to every family below the poverty line. Economists Ofer Malamud and Cristian Pop-Eleches examine the effects.

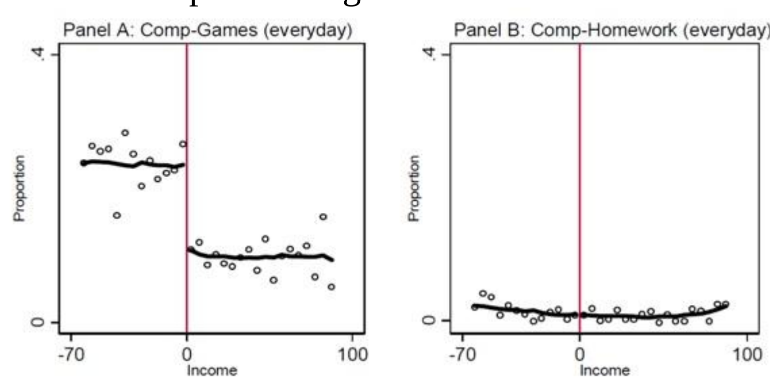
i. First they noted that computer use among the poverty-stricken did increase (the red line is the poverty line).



ii. But they found that math, Romanian, and English scores all fell.



iii. Why? Because they also found out that students just used their new computers for games.



IV. The Limits of Money

a. Money can be a weak incentive if:

   i. If there already is an intrinsic motivation. (Bob *likes* cooking for his parents…you don't need to pay him. Indeed, paying him might spoil his intrinsic motivation.)

   ii. If no social approval comes with the payment. (Bob getting paid by his parents for mowing the lawn can easily be seen as an elaborate allowance but being paid to mow strangers' lawns is a sign of adulthood.)

   iii. If the reward is very high. (Bob can easily answer any Jeopardy! question when he's sitting on his couch but freaks out when he actually appears on the show.)

b. For example, if your friends pay you after you volunteer to make them dinner, you might feel cheap. What you meant as a friendly gesture becomes an impersonal market transaction.

   i. Some economists have tried paying their kids to do dishes. This usually fails because the kids feel less like part of a family.