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ECON 202—Montgomery College

LECTURE 11: ASYMMETRIC INFORMATION II

I. Combating Adverse Selection
   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

II. Combating Moral Hazard
   a. The *principal-agent problem* describes the problem of moral hazard in which the person acting (the agent) is trusted by someone (the principal) to act a certain way, but the agent has an incentive to act in a way the principal would not like.
   b. <u>Because</u> of information asymmetries, the agent can betray the principal and get away with it.
      i. The employer (principal) wants the employee (agent) to work hard, but the employee wants to take long lunches.
      ii. The homeowner (principal) wants the contracts (agent) to charge a normal market price, but the agent wants to rip them off.
      iii. The voter (principal) wants the lawmaker (agent) to create laws that benefit society, but the lawmaker wants to create laws that help a special interest so that group will help him get re-elected.
      iv. The teacher (principal) wants the student (agent) to take tests honestly, but the student wants get a good grade with little work and cheating is one way to accomplish that.
      v. The bank (principal) wants the borrower (agent) to pay off the loan, but the borrower wants to spend their money irresponsibly.

c. Combating moral hazard involves changing the incentives of the agent.
    i. *Efficiency wages*—these can also be used to combat moral hazard because employees fear losing their job.
    ii. *Monitoring*—watching the agent to see if they act as promised.
    iii. *Rewards/punishments*—granting bonuses for good work and demotions for poor work, etc. Collateral is an example.

d. Rewards and punishments deserve special mention because they can backfire. In general, you must remember:
    i. There's a difference between what you pay for versus what you want (remember unintended consequences).
    ii. Strong incentives might help motivate people to action, but they also might incentivize them to do something unintended.

e. *Piece rates*—payment made directly for output
    i. <u>Pro</u>: Everyone gets the benefit if everyone works harder.
    ii. <u>Con</u>: Fortunes can rise and fall due to external factors (e.g. state of the economy)
    iii. <u>Con</u>: Output may be hard to measure

f. *Tournaments*—payment for relative performance
    i. <u>Pro</u>: Corrects for external factors
    ii. <u>Con</u>: May cause workers to turn on each other or not be motivated at all if a star always outshines everyone
    iii. <u>Con</u>: Output may be hard to measure

g. *Corporate culture*—shared collection of values and norms about how people interact
    i. <u>Pro</u>: Can cover lots of different scenarios, avoiding the hard-to-measure-output problem.
    ii. <u>Con</u>: Cannot be precisely constructed nor controlled
        1. Suppose a CEO wants employees to take more vacation days so they feel relaxed and productive, but the CEO doesn't want to take time off herself.
        2. Memos the CEO writes encouraging vacations won't be taken seriously because everyone sees the CEO ignoring her own memos.
        3. Furthermore, other memos the CEO writes runs the danger of not being taken seriously because employees might think of her as two-faced.