Asymmetric Information

- Most economic decisions are made with incomplete information.

Asymmetric Information

- It is important to distinguish between uncertain information and asymmetric information.

Two Examples

- I sell you a ticket to an outdoor concert next July 4. It may or may not be good weather.
  - This is uncertain information
- I want to purchase health insurance
  - This is asymmetric information

The Concert

- Suppose the chance of good weather is 50-50.
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• If the weather is good, the ticket will be worth $100; if it is bad, $20. Fair pricing is $60.
• Neither you nor I has any particular insight into the weather.

The Health Policy

• Half the population is a good health risk, while the other half is a bad risk. For good risk patients, the right charge is $1,000; for bad risks, $10,000.
• How should the company price the policy?

Pricing the Policy

• While the company does not know who is a good and bad risk, people have a pretty good idea of their health.
  – This is asymmetric information.

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• In the extreme case, all good risks will decline and the company will be selling policies at $5,500 which cost $10,000 to service.
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This is the classic “lemon” problem

Other Cases

• You want to switch jobs.
  – You know more about your reasons than potential employers
• You want to borrow money
  – You know financial information not available to banks

Other Cases

• You want to switch jobs.
• You want to borrow money

Used Cars

• You are thinking about buying a used car.
  – The seller knows whether it is a lemon or not.
  – All you know is that he knows more than you.
• You sell a used car which is not a lemon.
  – Potential buyers understand the issue.
  – Your assurances that the car is good will not be taken at face value.

We will develop a model in the next lecture

Used Cars

• You are thinking about buying a used car.
• You sell a used car which is not a lemon.
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End