

Dealing with Asymmetric Information



Remedies to the Lemons Problem

- Warranties

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- People worry about lemons

Warranties

- You are selling used cars
- People worry about lemons
- **Provide a warranty!**

Warranties and Moral Hazard

- However, warranties also create moral hazards.
- What incentives does the buyer have to maintain the car?
- Why should a buyer change the oil with a 100,000 mile warranty?

Remedies to the Lemons Problem

- Warranties
- Testing

Remedies to the Lemons Problem

- Warranties
- Testing
 - Take a used car to a mechanic for testing

Remedies to the Lemons Problem

- Warranties
- Testing
- Reputation.

Remedies to the Lemons Problem

- Warranties
- Testing
- Reputation
 - Buy a used car from a new car dealer

Reputation

- Buy a used car from a new car dealer
- Buy from a close friend or relative

Advertising

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 - Bad stories ruin the reputation of advertised products. Thus you advertise only quality products.
 - Advertising has a cumulative effect on demand. Much advertising doesn't make sense if the dealer does not intend to stay in business.

The Legal Remedy

- Economists stress the importance of the law as a remedy

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The Legal Remedy

- The law requires reasonable disclosures
- Suppose you sell me a car without oil in the tank and save \$20.
 - If you disclose and I don't fill, I am out of luck
 - If you don't disclose, you are liable.

The Game of Baseball

Player Status	Before Free Agency	After Free Agency	Percentage Change
<i>Pitchers (58 in sample)</i>			
<i>Remained with team</i>	3.66	9.57	167
<i>Became Free Agent</i>	5.12	28.97	448
<i>Non-pitchers (97 in sample)</i>			
<i>Remained with team</i>	5.30	9.74	84
<i>Became Free Agent</i>	4.31	9.83	128

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Are Trucks Lemons?

Year	Purchased New	Purchased Used
1976	0.08	0.05
1975	0.10	0.11
1974	0.11	0.13
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If they are, why aren't these numbers radically different?

End

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