Moral Hazard

• The so-called moral hazard problem comes about because of asymmetric information.

An Illustration of the Problem

• When you smoke indoors, you risk burning the house.
• There is a cost and benefit.

With Insurance

• Now you Insure.
• The cost of smoking drops to $C_i$.

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• When you smoke indoors, you risk burning the house.
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• You smoke “U” times, where $MB = cost$

With Insurance

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Moral Hazard

• This problem involves asymmetric information.
• People are induced to change their behavior
• It would not come about if we had perfect information.
• Alas, the world is not that easy.

Producing High and Low Quality Products

• Another example: should you produce a high quality product or cheat your customers and produce a low quality product?
Producing High and Low Quality Products

• Another example: should you produce a high quality product or cheat your customers and produce a low quality product?
  – If there is perfect information, you can’t cheat.
  – If there is asymmetric information, you can.

Will a Monopolist Produce a Quality Product?

• The monopolist can produce a high quality product for $15 or a low quality product for $10.
• During the first period, consumers cannot tell which they are getting.
• The profit-maximizing price and quantity are $20 and 100 units.

Will a Monopolist Produce a Quality Product?

• Produce the low quality product for one period.
  – Sales are $2000; costs are $1000
  – The monopolist makes $1000 but for one period only.

Will a Monopolist Produce a Quality Product?

• Produce the low quality product for one period.
  Produce the high quality product, and get repeat sales.
  – Sales are $2000; costs are $1500
  – The monopolist makes $500 a period.

Will a Monopolist Produce a Quality Product?

• Given reasonable discount rates the monopolist will choose to produce the high quality product given these numbers.
What about Competitive Firms?

• Stay Tuned.

End