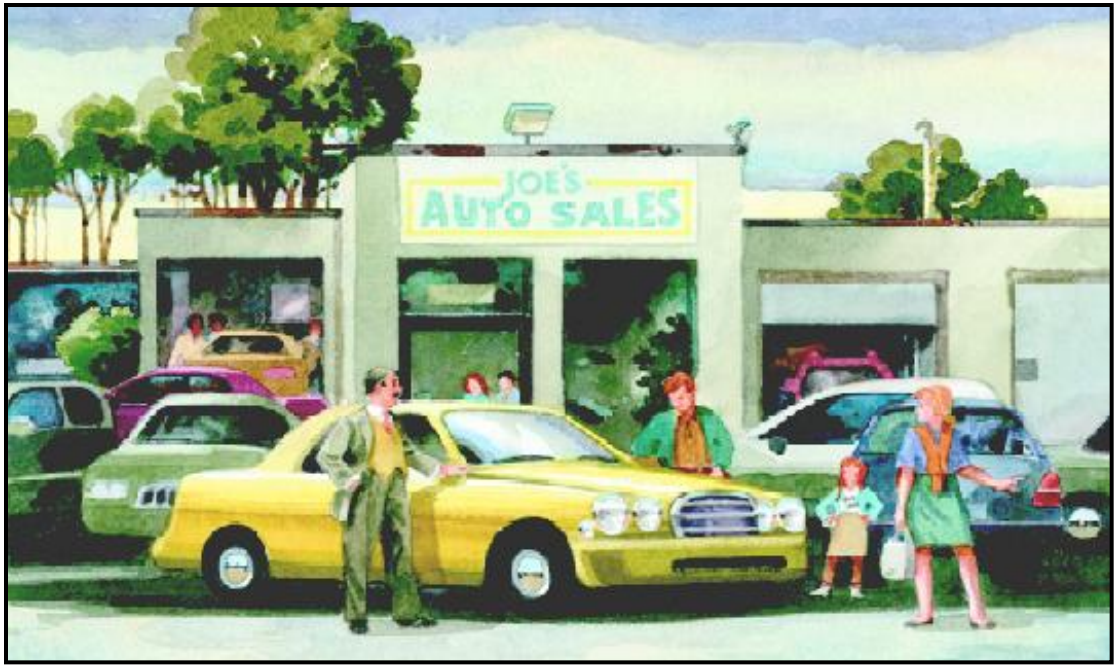

22

Frontiers of Microeconomics

ASYMMETRIC INFORMATION

- A difference in access to relevant knowledge is called information asymmetry.

Hidden Actions: Principals, Agents, and Moral Hazard

- Moral Hazard
  - *Moral hazard* refers to the tendency of a person who is imperfectly monitored to engage in dishonest or otherwise undesirable behavior.
  - Employers can respond to the moral-hazard problem in various ways:
    - Better monitoring.
    - High wages.
    - Delayed payment.

Hidden Actions: Principals, Agents, and Moral Hazard

- Moral Hazard
  - An *agent* is a person who is performing an act for another person, called the principal.
  - The *principal* is a person for whom another person, called the agent, is performing some act.

Hidden Actions: Principals, Agents, and Moral Hazard

- Adverse Selection
  - *Adverse selection* refers to the tendency for the mix of unobserved attributes to become undesirable from the standpoint of an uniformed party.

Hidden Actions: Principals, Agents, and Moral Hazard

- *Example of Adverse Selection:*
  - Many time potential buyers may not even consider used cars because they surmise that the sellers know something bad about the cars. This is also known as the lemons problem.
  - Insurance—People with hidden health problems are more likely to want to buy health insurance than those with good health
  - In certain labor markets, if a firm reduces the wage it pays, high productivity workers tend to quit.

Signaling to Convey Private Information

- How do Markets respond to Asymmetric Information?
  - Signaling
    - *Signaling* refers to an action taken by an informed party to reveal private information to an uninformed party.
  - Screening
    - *Screening* occurs when an action taken by an uniformed party induces an informed party to reveal information.

Asymmetric Information and Markets

- The study of asymmetric information gives us new reason to be wary of markets.

Asymmetric Information and Public Policy

- When some people know more than others do, the market may fail to put the resources to their best uses.

Asymmetric Information and Public Policy

- Although asymmetric information may call for government action, three facts complicate the issue:
  - Private markets can sometimes deal with information asymmetries on their own
  - The government rarely has more information than the private parties.
  - The government itself is an imperfect institution

POLITICAL ECONOMY

- Political economy (public choice) is the application of economic methods to the study of how government works.

POLITICAL ECONOMY

- Problems Associated with How Government Determines Public Policy
  - The Condorcet Paradox
  - Arrow's Impossibility Theorem
  - The Median-Voter Theorem
  - Self-interested Politicians

The Condorcet Voting Paradox

Voter Type			
	Type 1	Type 2	Type 3
Percent of electorate	35	45	20
First choice	A	B	C
Second choice	B	C	A
Third choice	C	A	B

The Condorcet Voting Paradox

- The *Condorcet Paradox* occurs when the majority rule fails to produce transitive preferences for society.
- Transitive preferences imply that if A is preferred to B, and B is preferred to C, then A is preferred to C.

Arrow's Impossibility Theorem

- *Arrow's impossibility theorem* is a mathematical result which shows that, under certain conditions, there is no scheme for aggregating individual preferences into a valid set of social preferences.

Arrow's Impossibility Theorem

- No Voting System Can Satisfy All of the Following
  - Unanimity
  - Transitivity
  - Independence of irrelevant alternatives
  - No dictators

Median Voter Theorem

- The *median voter theorem* is a mathematical result that shows that if voters are choosing a point along a line and each voter wants the point closest to his most preferred point, then majority rule will pick the most preferred point of the median voter.

BEHAVIORAL ECONOMICS

- Recently, a field called behavioral economics has emerged in which economists make use of basic psychological insights to examine economic problems.

Politicians Are People Too

- Some politicians are motivated by self-interest.
- Some politicians sacrifice the national interest to solidify their base of voters.

BEHAVIORAL ECONOMICS

- People aren’t always rational:
  - People are overconfident
  - People give too much weight to a small number of vivid observations
  - People are reluctant to change their minds.
- People care about fairness as demonstrated by the ultimatum game
- People are inconsistent over time.

Summary

- In many economic transactions, information is asymmetric. When there are hidden actions, principals may be concerned that agents suffer from the problem of moral hazard. When there are hidden characteristics, buyers may be concerned about the problems of adverse selection among sellers. Private markets sometimes deal with asymmetric information with signaling and screening.

Summary

- Although government policy can sometimes improve market outcomes, governments are themselves imperfect institutions.
  - The Condorcet paradox shows that majority rule may fail to produce transitive preferences for society.
  - Arrow's impossibility theorem shows that no voting scheme will be perfect.
  - In many situations, democratic institutions will produce the outcome desired by the median voter, regardless of the preferences of the rest of the electorate

Summary

- Individuals who set government policy may be motivated by self-interest rather than the national interest.
- The study of psychology and economics reveals that human decisionmaking is more complex than is assumed in conventional economic theory.
- People are not always rational, they care about the fairness of economic outcomes, and they can be inconsistent over time.