

2.10 Market Failure – Asymmetric Information



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What is Asymmetric Information?

Asymmetric information refers to situations where buyers and sellers do not have equal access to information.

This usually results in an **underallocation or overallocation** of resources to the production of goods or services.

This leads to **allocative inefficiency**.



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What is Asymmetric Information?

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 **In pairs or small groups...**

Think of situations where sellers have more information than buyers?



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Types of problems:

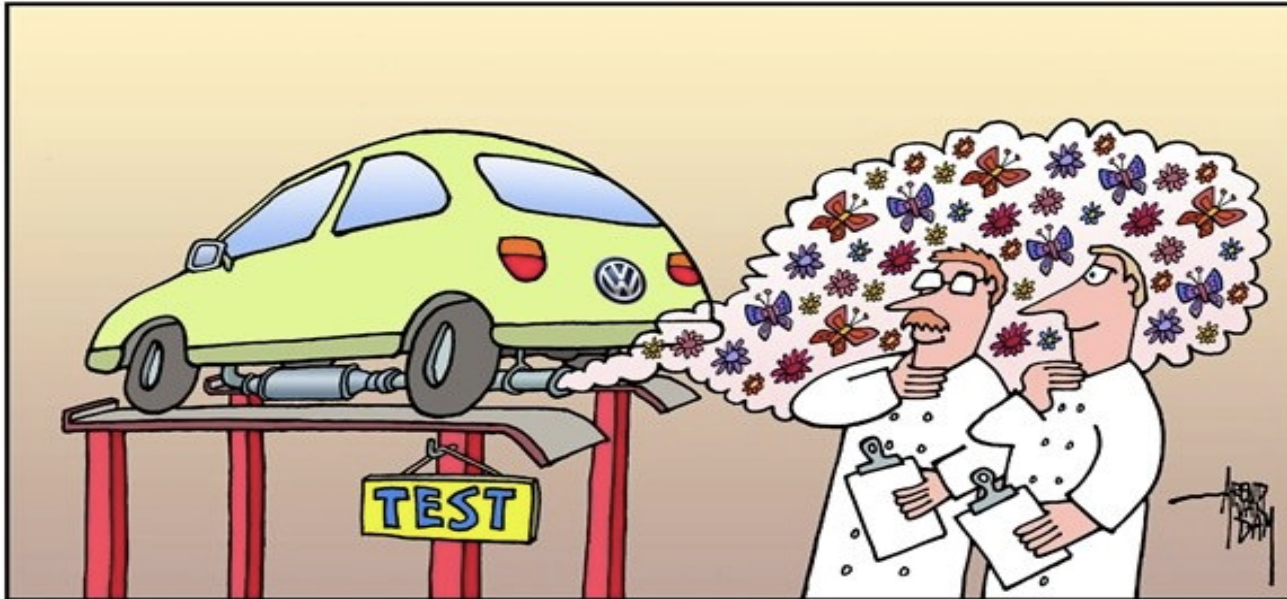
- Adverse selection
- Moral hazard



2.10 Market Failure – Asymmetric Information

Adverse Selection

Adverse selection refers to situations where one party in a transaction has more information about the quality of the product being sold than the other party.



Real world example

Volkswagen admitted in September 2015 that it had installed “defeat devices” in millions of its diesel-powered cars. Software detected when cars were being tested for compliance with emissions rules; the software then adjusted the engines so that they passed. But in normal use, the engines emitted far more pollution, including up to 40 times more nitrogen oxide, which contributes to asthma, bronchitis, and emphysema. It had all been going on for years.

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Sellers possessing more information than buyers:

- Volkswagen Diesel
(Emissions scandal – overconsumption)
- Asbestos Factory
(Health hazard – overproduction)

Possible solutions

Government responses:

- Legislation and regulation
- Provision of information
- Licensure

Private responses:

- Screening
- Signaling

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Adverse Selection

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In small groups...

Find real world examples of the government responses which reduces the chance of market failure from occurring due to adverse selection.

Brainstorm potential drawbacks or limitations of each government response.

Possible solutions

Government responses:

- Legislation and regulation
- Provision of information
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Private responses:

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Adverse Selection

Real world examples

In Hong Kong, toys and children's products are obliged to comply with all applicable requirements in any one of the safety standards specified in Schedules 1 and 2 to the Toys and Children's Products Safety Ordinance.

In the US, The Safe Drinking Water Act (SDWA) is the main federal law that ensures the quality of Americans' drinking water. Under SDWA, EPA sets standards for drinking water quality and oversees the states, localities, and water suppliers who implement those standards.

Possible solutions

Government responses:

- **Legislation and regulation**
- Provision of information
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Private responses:

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Adverse Selection

Real world examples

All kindergartens in Hong Kong are registered under the *Education Ordinance*. Inspectors from the Education Bureau visit kindergartens regularly to give advice to principals and teachers on curriculum, teaching approaches and school administration.

Profile of kindergartens are provided on the [EDB website](#).

In the UK, a [list of information](#) must be shown for labels on food including expiry date, ingredients and warnings.

Possible solutions

Government responses:

- Legislation and regulation
- **Provision of information**
- **Licensure**

Private responses:

- Screening
- Signaling

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Adverse Selection

Screening

Screening is a method used by the party with the limited information - i.e. the buyer.

Consumers may find information provided on the internet or may informally ask friends for information.

This can by no means on its own solve the problem as it cannot provide systematic and complete information.

Possible solutions

Government responses:

- Legislation and regulation
- Provision of information
- Licensure

Private responses:

- **Screening**
- Signaling

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Adverse Selection

Signalling

Signalling is a method used by the party that has more information to convince the buyers that the product being sold is of good quality.



Common methods includes warranties, establishment of brand names or exhibitions.

It is also unlikely to provide full information to buyers.

Possible solutions

Government responses:

- Legislation and regulation
- Provision of information
- Licensure

Private responses:

- Screening
- **Signaling**

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Adverse selection refers to situations where one party in a transaction has more information about the quality of the product being sold than the other party.

Buyers possessing more information than sellers:

- Insurance services (overproduction)

 **Watch the following video...**

Write down the possible solutions for adverse selection for health insurance.



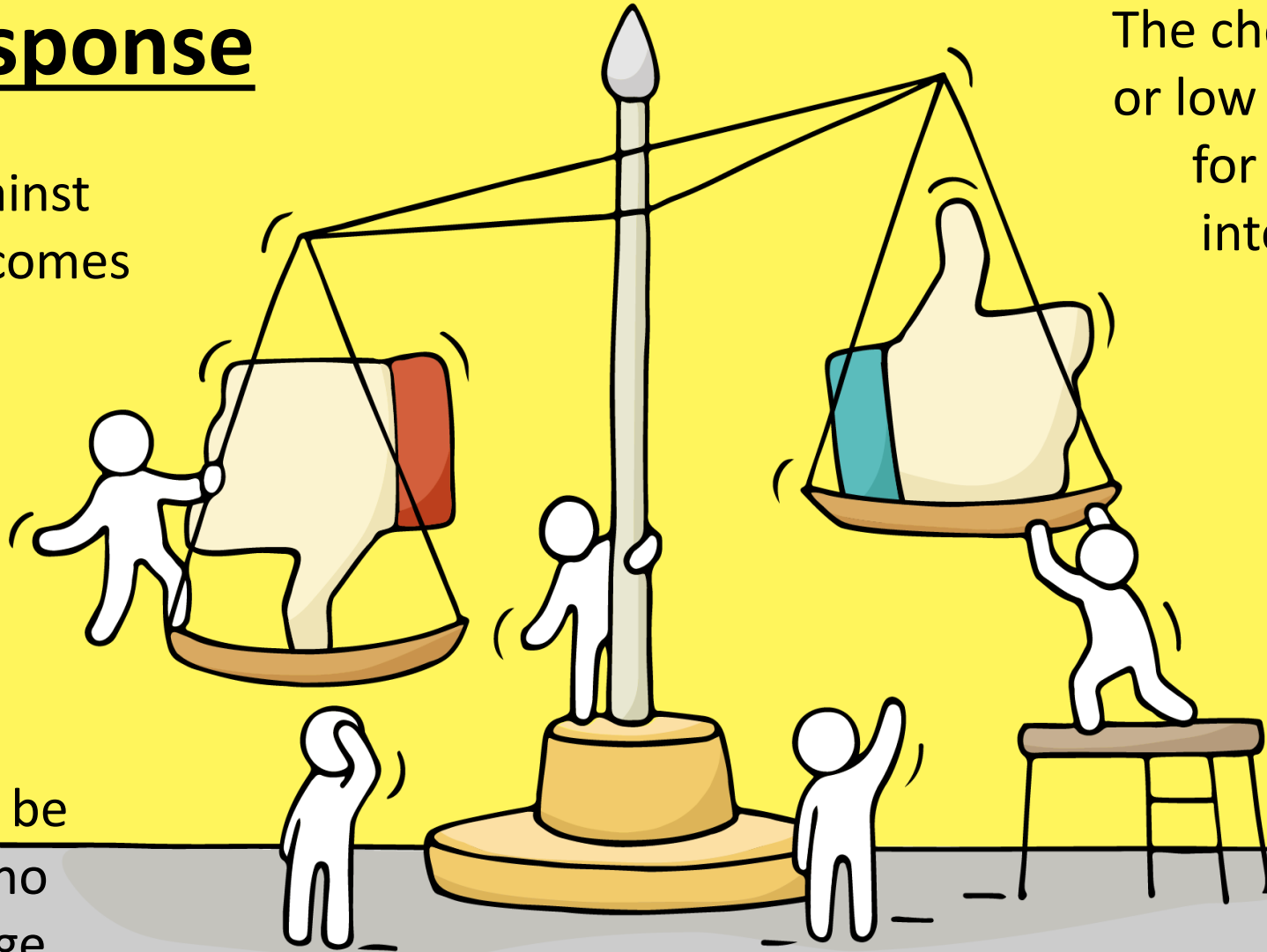
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Private response

Discriminates against buyers on low incomes

Insurance companies may refuse to insure people above a certain age

Some people will be left with little or no insurance coverage



The choice of high (low cost) or low (high cost) deductible for buyers of insurance is intended to screen them

Choice is provided to buyers

Indirectly providing information about their state of health to the seller

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Government response may take the form of direct provision of health care services at low or zero prices to an entire population.



Food for Thought

What are some potential drawbacks of a universal healthcare system?



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Moral Hazard

Moral hazard refers to situations where one party takes risks, but does not face the full costs of these risks because the full costs are borne by the other party.

It usually arises when the buyer of insurance changes their behaviour after getting insurance.

 **In pairs or small groups...**
Brainstorm examples of such situations



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Responses to moral hazard is similar to adverse selection through screening and regulation.

