## Key Concepts and Summary

### 16.1 The Problem of Imperfect Information and Asymmetric Information

Many make economic transactions in a situation of imperfect information, where either the buyer, the seller, or both are less than 100% certain about the qualities of what they are buying or selling. When information about the quality of products is highly imperfect, it may be difficult for a market to exist.

A “lemon” is a product that turns out, after the purchase, to have low quality. When the seller has more accurate information about the product's quality than the buyer, the buyer will be hesitant to buy, out of fear of purchasing a “lemon.”

Markets have many ways to deal with imperfect information. In goods markets, buyers facing imperfect information about products may depend upon money-back guarantees, warranties, service contracts, and reputation. In labor markets, employers facing imperfect information about potential employees may turn to resumes, recommendations, occupational licenses for certain jobs, and employment for trial periods. In capital markets, lenders facing imperfect information about borrowers may require detailed loan applications and credit checks, cosigners, and collateral.

### 16.2 Insurance and Imperfect Information

Insurance is a way of sharing risk. People in a group pay premiums for insurance against some unpleasant event, and those in the group who actually experience the unpleasant event then receive some compensation. The fundamental law of insurance is that what the average person pays in over time cannot be less than what the average person gets out. In an actuarially fair insurance policy, the premiums that a person pays to the insurance company are the same as the average amount of benefits for a person in that risk group. Moral hazard arises in insurance markets because those who are insured against a risk will have less reason to take steps to avoid the costs from that risk.

Many insurance policies have deductibles, copayments, or coinsurance. A deductible is the maximum amount that the policyholder must pay out-of-pocket before the insurance company pays the rest of the bill. A copayment is a flat fee that an insurance policy-holder must pay before receiving services. Coinsurance requires the policyholder to pay a certain percentage of costs. Deductibles, copayments, and coinsurance reduce moral hazard by requiring the insured party to bear some of the costs before collecting insurance benefits.

In a fee-for-service health financing system, medical care providers receive reimbursement according to the cost of services they provide. An alternative method of organizing health care is through health maintenance organizations (HMOs), where medical care providers receive reimbursement according to the number of patients they handle, and it is up to the providers to allocate resources between patients who receive more or fewer health care services. Adverse selection arises in insurance markets when insurance buyers know more about the risks they face than does the insurance company. As a result, the insurance company runs the risk that low-risk parties will avoid its insurance because it is too costly for them, while high-risk parties will embrace it because it looks like a good deal to them.