Adverse Selection and Endogenous Information

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Abstract

We study markets with adverse selection where consumers can learn about their types at a cost. Information acquisition costs present a trade-off: they decrease the quality of consumers' choices but alleviate selection. We prove information acquisition decreases welfare compared to exogenous information, and we find conditions such that equilibrium efficiency is non-monotonic in information costs. We show information decisions produce a negative externality in this economy, causing traditional methods to underestimate the welfare costs of selection. Finally, we connect the theory to applications by constructing tests to detect information acquisition, and by developing a partial framework for counterfactual analysis using sufficient statistics. Our solution method shows that changes in information costs translate into rotations of consumers' demand and producers' cost, lending the model to familiar graphical reasoning.

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