

**Course**  
**on**  
**HS205: consumer Behaviour and Welfare Economics**  
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**Instructor**

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# Markets with Asymmetric Information:

Scores	Scores	Scores	Scores
10			
9	9		
8	8	8	
7	7	7	7
6	6	6	6
5	5	5	5
4	4	4	4
3	3	3	3
2	2	2	2
1	1	1	1
5.5	5	4.5	4

# **Theory of Lemons: (Lemons means bad/low quality):**

## **. The Market for Lemons:**

- . Adverse selection:** Bad quality products drive out the good quality products from the market
- . Asymmetric information and the market failure:**
- . The insurance market and adverse selection:**

# The weighted average probability of becoming ill:

$$\bar{P} = P_H \frac{H}{H+L} + P_L \frac{L}{H+L}$$

$\bar{P}$  = Weighted average probability of illness

So,  $P_H > \bar{P} > P_L$

Let, the cost of insurance is C.

$I \geq C \bar{P}$  [ I = Insurance premium]

# **The Problem of Moral Hazard:**