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:

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

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

H = No. of high risk people

L = No. of low risk people

P_H = Probability of high risk group becoming ill & so becomes entitle to claim

P_L = Probability of low risk group becoming ill & so becomes entitle to claim

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:

The Principal Agent Problem:

Meaning: It refers to the situation when the managers pursue their goals such as high salaries, power, prestige, perquisites even at the cost of the owners

Ways to overcome the Principal –agent problems:

i. Long term contracts
ii. Providing part-ownership
iii. Incentive pay

Winners of 2001 Novel Prize in Economics:

1. George A. Akerlof

2. Michael Spence

3. Joseph E. Stiglitz

Welfare economics:

i. Pareto’s welfare criteria
ii. Kaldor Hicks compensation criterion
iii. Scitovsky Paradox and Scitovsky’s double criterion