Course

on

HS205: consumer Behaviour and Welfare Economics

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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: