IPA
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Coláiste Aitheanta d'Ollscoil na hÉireann

Module:

Public Sector Economics

Lecturer:

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The Economics of Information

Where mystery begins justice ends

Edmund Burke

Imperfect Information

- The model of Perfect Competition assumes that market participants have perfect information
- Does this assumption hold ?
- What occurs if it does not ?

Imperfect Information

- What does perfect information mean?

- It means that firms and consumers have a perfectly defined “opportunity set” i.e. they know everything that is available to them
- They know all characteristics of every good e.g. how long the good will last

Imperfect Information

- What does perfect information mean?

- It also means that consumers know their preferences perfectly i.e. that they know the price of a good and how much of the good they wish to purchase
- This may be easy for goods such as basic foodstuffs but how does an individual know how much education to purchase or legal advice or insurance or medical services or whether a car part needs to be changed?

Imperfect Information

- What does perfect information mean?
- It also means that firms know the best available technology, the productivity of each worker, the cheapest prices of all inputs

The Price System

- The price system generally provides excellent information
- It communicates important information about economic scarcity and coordinates production
- Imperfect information inhibits prices and markets from performing this function

The Market for Information

- Information can be bought and sold.
- Information has a value
- It commands a price
- Is the market for information just like any other good?

- No

The Market for Information

- When you buy a good like a bed – the shopkeeper will let you look at it, lie on it, try it out, etc
- When you buy information – you cannot do the same
- Its pay the provider first and trust that the information is good or receive the information first and then decide whether the information is worth it
- Can you see the problem?

Uncertainty and Risk

- How do we make decisions when the outcome is uncertain
- Consumers generally prefer a world of security and certainty over uncertainty and risk
- This is called risk aversion
- Individuals will pay in order to have certainty - Insurance

The Consequences of Asymmetric Information

- “When you drive a new car out of the showroom, it immediately costs you 5 grand”
- How many times have you have you heard something like this?
- Q. Why is a nearly new car worth so much less than a new car?
- A. Adverse selection

Adverse Selection

- This is a market with asymmetric information
- The seller of the second hand car has more information than a potential buyer
- The potential buyer of a used car estimates in the used car market that there are good cars out there i.e. "peaches" and bad cars "lemons"

Adverse Selection

- The potential buyer will be cautious and only offer a "modest" price for any used cars
- This will generally be below the price the seller of the peach wants but above the price seller of the lemon expects
- This has the effect of deterring the seller of a "peach" and encouraging the seller of the "lemon"

Adverse Selection

- The peaches are forced out of the market while the lemons are encouraged in
- If the situation is chronic the market will fail

- Solutions to AS - Signalling – the seller will offer a warranty
- Regulation – Ingredient disclosure

Moral Hazard

- When you insure a possession, the MC of replacing the insured possession is zero
- You therefore have less incentive to take proper care of the good
- A doctor and insured patient have zero MC to paying for treatment
- They have no incentive to economize on treatment
- Solution – coverage starts after a certain point

Imperfect Information

- In order to make an informed and optimal decision the economic agent must have perfect information
- Three basic elements
  - Information about the quality of the good
  - Information about the price of the good
  - Information about the future

Imperfect Information - Quality

- Information on quality is easily assessed for certain goods e.g. food, but much more difficult for others e.g. healthcare
- Markets are generally more efficient where
  - Consumer information is easily accessed
  - Consumer information can be easily understood
  - Consumer information can be improved cheaply
  - There are low costs of choosing badly
  - The regularity of purchase

Imperfect Information - Price

- Information on price can be easily assessed for certain goods e.g. clothes, but much more difficult for others e.g. car purchase, building
- Markets are generally more efficient where
  - The homogeneity of the good
  - Price information can be improved cheaply (AA check on potential car purchase)
  - The regularity of purchase

Imperfect Information - Future

- The future consumption of certain goods is known reasonably well in advance, e.g. foods, clothes but consumption of other goods may be less well known, healthcare, housing
- The market response here is insurance, but the insurance market may fail due to informational deficiencies e.g. healthcare

Imperfect Information

- The solution to imperfect information is normally regulation, e.g. hygiene laws, licensing, ingredient disclosure regulation
- Where information failure is chronic the state may opt to produce the good or for a social insurance scheme e.g. healthcare

Incomplete Markets

- Closely related to imperfect information is the issue of incomplete markets
- Some insurance and loan markets have failed due to problems of information or because of transactions costs
- Problems of adverse selection and moral hazard

Regulation of Markets with Problems of Informational Asymmetry

- Healthcare, legal markets etc. are characterised by uncertainty, informational asymmetry, & monopoly power
- Informational asymmetry is the major market failure in these markets & consequently conveys a large degree of monopoly & other power on the decision-makers in these markets

Schools of Thought

- Institutional Theories
  - Spontaneous private legal ordering
  - Based on reciprocity
  - Individuals recognise the benefits from behaving in accordance with others' expectations
  - As an economy develops the goods exchanged become more complex. Power moves to the party with greater information
  - Greater need for an independent arbitrator - Government
  - Government can be captured by groups

Schools of Thought

- Institutional Theories
  - Bargaining between parties can achieve efficient outcomes
  - Depends on transactions costs and assignment of property rights
  - Self regulation may be appropriate where bargaining & risk costs are low between transactors

Schools of Thought

- Institutional Theories
  - Transactions costs are determined by
    1. The cost of identifying the parties with whom one has to bargain
    2. The cost of getting together with them
    3. The costs of actually bargaining with them
    4. The costs of observing & enforcing any bargain reached

Schools of Thought

- Public Interest Theories
  - Self regulation analysed as a deliberate delegation of the state's rule making powers to an agency
  - Membership of which is wholly or mainly comprised of representatives of the firms or individuals being regulated
  - Principal agent basis for delegation of power
  - Government (Principal) decides that an activity ought to be regulated due to a market failure
  - What form of regulation is appropriate?
  - What form of regulation delivers the correct result at an acceptable cost?

Schools of Thought

- Public Interest Theories
  - Costs of regulation include the costs of rule formulation, monitoring, adjudication, and enforcement
  - The principal may believe that these costs would be minimised if the above functions were delegated to a self-regulatory agency
  - The agency acts as a "benevolent dictator"
  - What is stop agency regulating in favour of the industry?

Schools of Thought

- Private Interest Theories
  - Private interest theory was sceptical as to the motives of Professional Self-Regulation
  - "The regulation of the markets for professional services is seen to arise or at least is sustained because it is in the interests of the members of the profession" Stephen & Love
  - PSR gave the professions the ability to set the rules of the game and private interest theory believed that the professions set the rules in their own favour
  - Self-regulation potentially gave the professions the ability to set up a state-protected cartel.

Regulatory Means

- The problem areas for any regulator are controlling
  - Who can practice in a particular area
  - How can a practitioner get customers
  - How are prices set in the market
  - Organisational forms

Who can practice?

- Three elements of practice
  - Initial entry
  - What can be practised
  - Fitness to practice
- Licensing has been the traditional tool of choice to ensure quality in a particular profession
- Licensing conveys the legitimacy of the state on the profession
  - "Licensing involves laws and regulation which limits service provision to individuals or entities authorised to practice by the state" Svorny

Other Regulatory and Market Responses

- Certification
  - A government agency certifies that an individual has certain skills but doesn't prevent others from practicing
- Registration
  - Registration involves a list of those confirmed by a body that a person has a set of qualifications recognised by it
- Reputation
  - Individuals build a reputation for quality work
- Information disclosure
  - The seller must reveal certain information
- Ratings Agency
  - Seller submits to be audited by an independent agency
- Civil or criminal penalties

Issues with licensing

- Licensing may not ensure an increase in quality. If restrictions on practice shift a sizeable portion of consumers to "do-it-yourself" or black market activities. Average quality may decline
- Licensing creates a barrier to entry
- With certification competition is not limited. Consumers can purchase lower quality, if that is their choice
- Can the consumer have confidence that a body that is controlled by the profession will provide unbiased certification
- Consumers may not understand or ignore disclosed information
- Consumers may not have the means to judge reputation
- Civil or criminal penalties may be inadequate if the costs of choosing badly are significant

Issues with licensing

- Licensing that restricts who can practice must also set the limit on what can only be practised by the group
- There is an incentive by a self-regulatory agency (SFA) to broaden the restricted practice area so as to broaden the scope of monopolised business area.
- If the SFA is the sole supplier of education determining competence it can elevate the standard to a higher than necessary level and it can restrict the number of entrants into the training course and therefore the profession

Issues with licensing

- How is the equivalence of foreign qualifications determined
- Licensing or certification only proves competence at a particular point in time
- What are the structures for continuous professional education?
- What are the structures for dealing with practitioners that fail to meet acceptable standards of practice?
  - Balance of expertise and independence crucial
- How are these acceptable standards determined?
- How is the disciplinary body funded?

Competition for Customers

- How can practitioners compete for customers?
- Consumers must be able to choose between competing suppliers on the basis of price and quality
- Where there are issues of equity and/or market failure, the government often purchases services on behalf of some consumers
- Two mechanisms of supply – government and market

Competition for Customers

- Government
  - How does the state allocate its contracts to supply?
  - How much does the state pay?
  - How does the state assess needs of consumers?
  - State subject to capture by incumbents
  - State suffers from information deficiencies

Competition for Customers

- Market - Advertising
  - How do businesses attract new customers?
  - Many professions have restrictions on advertising, quoting of fees and recommended fee scales due to fears of diminution of quality, exaggerated claims, and fears of over-consumption.
  - However, truthful advertising supplies information to consumers, lowers their search costs and can allow them to more easily price compare
  - Price lists provide the consumer with an estimate of price *ex ante*. This improves the power of the consumer

Competition for Customers

- Market – Price Setting
  - If government is a major supplier in the market how does it decide how much to pay
  - Collective negotiations on fees prohibited by law
  - Compulsory disclosure of pricing a possibility
  - Contingency fees

Competition for Customers

- Organisational Forms
  - A professions’ function may be divided in to two roles (Quinn 1982)
    - The agency function
    - The service function
  - The agency function defines the clients needs and selects the appropriate strategy
  - The service function uses the profession’s technical expertise to implement the chosen strategy
  - Where the profession provides both functions a problem of supplier induced demand can arise
  - Delineation of roles a solution?

Competition for Customers

- Organisational Forms
  - Profession may be restricted to operate as a sole practitioner or a partnership with other members of the professions
  - Unlimited liability controls the moral hazard problem
  - May prevent economies of scale and scope
  - Sole practitioner rule creates a barrier to new entrants because they cannot benefit from a senior partners' network

Regulation

- Informational asymmetry provides a profession with the ability to behave in its own interest
- i.e. it can hide poor quality or charge high prices
- A regulatory regime can diminish or enhance the professions’ ability to behave in this manner
- A regulatory regime needs the profession to provide information that is unique to that profession
- Letting the profession regulate itself breaches the principle of natural law “Nemo judex in causa sua” (No one should be a judge in their own cause)
- Implication: Keep the profession as much as possible from “judicial” and “market design” roles within the regulatory framework
- They should act as “expert witnesses” as much as possible
- Transactions costs will determine the balance