



2.10 Market failure – asymmetric information (HL only)

Learning objectives

2.10 Market failure – asymmetric information (HL only)	Depth	Diagrams and calculations
Asymmetric information <ul style="list-style-type: none">• Adverse selection• Moral hazard	AO2	
Responses to asymmetric information <ul style="list-style-type: none">• Government responses: legislation and regulation, provision of information• Private responses: signalling and screening	AO3	



Introduction

Asymmetric information refers to a situation where one party possesses more information or better information than the other party (sellers having more information than buyers or vice versa), when making a transaction.

What is adverse selection?

Adverse selection is one of the problems which may arise from asymmetric information. It refers to a situation where the party with more information takes advantage of the imbalance of information, before a contract is written or a transaction occurs.



Can you think of some possible examples of adverse selection?

Adverse selection – examples

Examples of adverse selection

- Insurance buyers possessing more information than **health insurance** providers
e.g., by concealing their smoking habits.
- Car sellers possessing more information than car buyers in the market for **used cars**
e.g., by concealing car defects.





Real world example

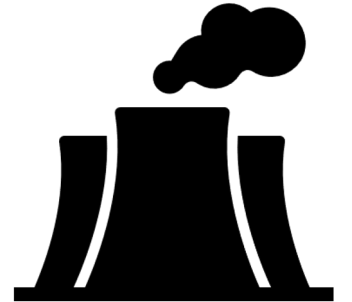
Podcast: [Volkswagen Emissions Scandal](#)

With reference to Volkswagen, explain how adverse selection results in market failure.

Adverse selection – real world example

Volkswagen Diesel Emissions Scandal (2015)

Volkswagen admitted to cheating on carbon dioxide emissions tests in the United States in 2015.



The modified emissions results led buyers to perceive Volkswagen cars to be **more environmentally friendly than they were**. This is an example of **asymmetric information** as the seller (Volkswagen) possessed more information than the buyers.

The asymmetric information resulted in more Volkswagen cars being bought and at a price higher than the socially optimal level. Thus, the imbalance of information gave rise to **market failure**.



Adverse selection – death spiral

Watch the video to find out how asymmetric information may lead to an **adverse selection death spiral**.

Adverse selection – solutions

Real world examples of solutions aimed at addressing adverse selection:

- **CARFAX** vehicle history reports reduce information asymmetry by allowing potential buyers to learn more about the conditions of a used car before making a purchase.
- “**Obamacare**” was aimed at providing affordable health insurance for all American citizens. The **individual mandate** required most Americans to buy health insurance, which encouraged more healthy people to enter the market. This lowered insurance premiums to an affordable rate and prevented an adverse selection **death spiral** from developing.



What is a moral hazard?

A **moral hazard** is another problem which may arise from asymmetric information. It refers to the situation where one party changes their behaviour as they become incentivized to take risks, knowing they are insured against the costs involved.

Article: [How did moral hazard contribute to the 2008 financial crisis?](#)

Real world example

Article: [Why Singapore's Medishield Life Is A Well Designed Healthcare System](#)

1. Using an example, explain what is meant by a moral hazard in health insurance. How does this link to the concept of market failure?
2. Explain how the MediShield Life healthcare system prevents the problem of unnecessary healthcare consumption from arising.



Can you think of other examples that may involve a moral hazard?

Government responses to asymmetric information

Legislation and regulation

Examples:

- Greenhouse gas reporting in Canada
- Health warnings on cigarette packaging
- Quality standards and policies for US food products

+ reduces misinformation and information asymmetry, allowing different parties to make better informed decisions

+ ensures that products meet quality standards

- opportunity costs – government regulations are very time consuming.

Government responses to asymmetric information

Provision of information

Examples:

- Food labelling requirement by the US FDA
- Medical fee schedule regulated by the Japanese Government

+ reduces misinformation and information asymmetry, allowing different parties to make better informed decisions

- opportunity costs – very time consuming to collect information
- may be ineffective if the information provided is inaccurate or outdated.



Real world example

Source: [The New Nutrition Facts Label](#)

1. Explain potential benefits of the nutrition facts label requirement.
2. Explain potential drawbacks of the nutrition facts label requirement.

Private responses to asymmetric information

Signalling: when the seller (party with more information) tries to convince buyers that its products are of good quality.

Possible methods of signalling:

- Branding and franchising
- Warranties and guarantees
- Refunds/ return policies





Real world example – research task

Source: [What is Costco's return policy?](#)

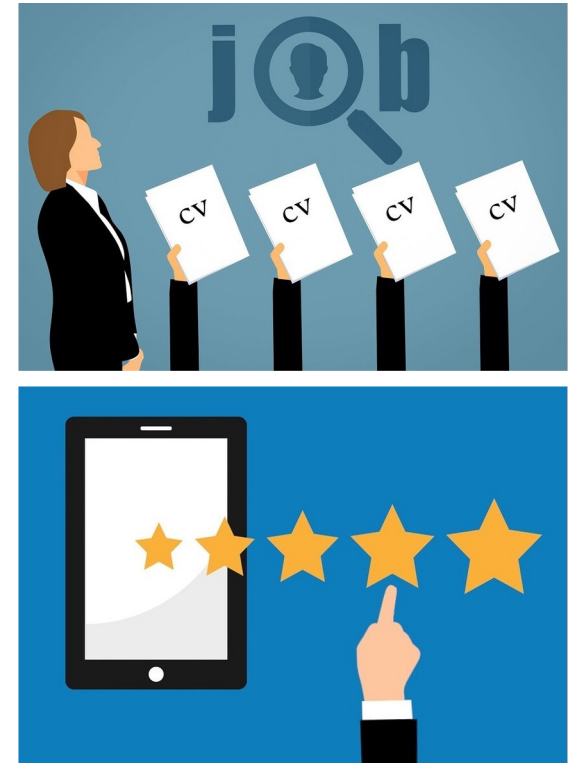
How does Costco signal to consumers that their products are of good quality?

Private responses to asymmetric information

Screening: when the party with limited information tries to gain more information about the other party

Some methods of screening:

- Employers giving job applicants aptitude tests or doing background checks before hiring
- Health insurance providers requesting for health checks or illness records before selling insurance
- Consumers searching for product reviews before purchasing the product.

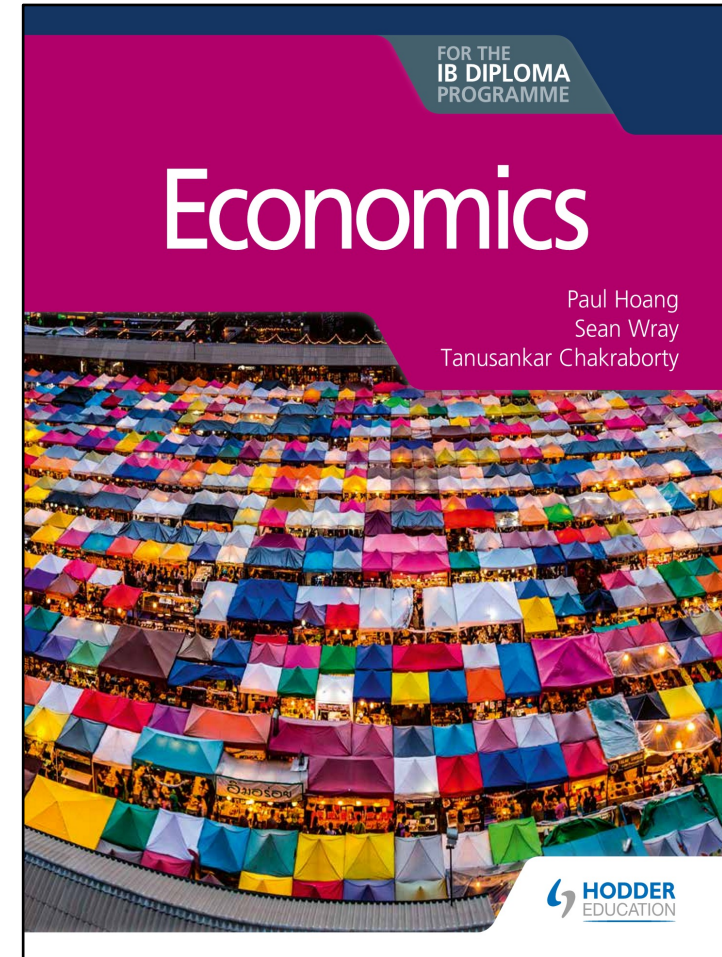


Over to you...

Hoang, Wray, & Chakraborty (2020)

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- [10 marks]





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