



CLUTCH

www.clutchprep.com

CONCEPT: ASYMMETRIC INFORMATION

● To this point, we have assumed that all parties in a transaction have **complete information**.

Complete Information – the state of being _____ regarding an economic choice

Private Information – knowing something others don't know

Information Asymmetry – the situation where one party _____ than another party

- Drivers may be _____ when they have car insurance

- Used Car Salesmen _____ about the cars they are selling than the customers

- Patients _____ about their health condition than insurance companies

● Information asymmetry leads to two informational problems:

Adverse Selection – entering agreements where _____ is used for an advantage



- Adverse Selection relates to _____ characteristics and occurs _____ a transaction

<p><u>Used Car Sale</u></p> <p>Knows the secret: _____</p> <p>Secret: _____</p> <p>Result: _____</p> <p>Even worse: Willingness to pay ____, Good cars ____</p>	<p><u>Health Insurance</u></p> <p>Knows the secret: _____</p> <p>Secret: _____</p> <p>Result: _____</p> <p>Even worse: Premiums ____, Healthy policyholders ____</p>
---	--

Moral Hazard – a party to a contract altering his behavior _____ a contract is made



- **Principal** – a person who entrusts someone (i.e. the _____) with a task

- **Agent** – a person who carries out a task on someone's (i.e. the _____) behalf

<p><u>Employer-Employee Relationship</u></p> <p>Principal: _____</p> <p>Agent: _____</p> <p>Moral Hazard: _____</p>	<p><u>Insurer-Insured Relationship</u></p> <p>Principal: _____</p> <p>Agent: _____</p> <p>Moral Hazard: _____ effort to prevent losses</p>
---	--

CONCEPT: SOLUTIONS TO INFORMATIONAL PROBLEMS

- **Signaling** – An action by the _____ party to reveal private information to the _____ party

<p><u>Used Car Sale</u></p> <p>Informed Party: _____</p> <p>Secret: _____</p> <p>Signal: _____</p>	<p><u>Job Application</u></p> <p>Informed Party: _____</p> <p>Secret: _____</p> <p>Signal: _____</p>
---	---

- **Screening** – An action by the _____ party to induce the _____ party to reveal private information

<p><u>Health Insurance</u></p> <p>Uninformed Party: _____</p> <p>Secret: _____ of policyholders</p> <p>Screening: _____</p> <p>Plan 1: _____ Premium, _____ Deductible</p> <p>Plan 2: _____ Premium, _____ Deductible</p>	<p><u>Employer-Employee Relationship</u></p> <p>Uninformed Party: _____</p> <p>Secret: _____</p> <p>Screening: _____</p> <p>_____</p>
--	--

PRACTICE: Jen has a family history of medical problems, which leads her to purchase health insurance. Her friend, Mark, has a healthier family, decides not to buy health insurance. This is an example of:

- Moral hazard
- Adverse selection
- Signaling
- Screening

PRACTICE: Safe Times Insurance requires a medical examination for all applicants for medical insurance. Those with significant preexisting conditions are charged more. This is an example of:

- Moral hazard
- Adverse selection
- Signaling
- Screening

CONCEPT: MEDIAN VOTER THEOREM

• Voters don't always get their preferred choice. They will choose the option _____ to their preference.

□ **Median** – the value separating the higher half of a dataset from the lower half of a dataset

Preferred spending on military budget				
Ann	Benito	Cathy	Doug	Edward
\$0	\$20	\$50	\$80	\$140

Voters choose between \$20 budget and \$50 budget:

Ann	Benito	Cathy	Doug	Edward

Voters choose between \$100 budget and \$50 budget:

Ann	Benito	Cathy	Doug	Edward

□ **Median Voter Theorem** – the median voter determines the outcome of elections

- Many people will be _____ with the results

- People will _____ to a jurisdiction where the median vote is close to their own preferences

PRACTICE: During a political race for mayor, the key issue is spending on a new water park. The town's 500 voters spending preferences are shown in the table. What amount of spending will win the vote?

Number of Voters	Spending Preference
200	\$60,000
150	\$20,000
150	\$0

- a) \$0
- b) \$20,000
- c) \$40,000
- d) \$60,000

CONCEPT: CONDORCET VOTING PARADOX

- **Condorcet Voting Paradox** – majority voting can result in _____ choices

	First Group	Second Group	Third Group
First Choice	A	B	C
Second Choice	B	C	A
Third Choice	C	A	B

Majority Choice in Pairwise votes:

- **A vs B** → _____
- **B vs C** → _____
- **C vs A** → _____

Conclusions:

- When there are more than two options, the _____ of the voting agenda influences outcomes

We want "A" to win:		We want "C" to win:	
1 st Vote:	Outcome:	1 st Vote:	Outcome:
2 nd Vote:	Outcome:	2 nd Vote:	Outcome:

- Majority voting by itself does not _____ the outcome society wants

PRACTICE: Which of the following is true regarding the Condorcet voting paradox?

- Majority voting is the best method for allocating society's resources
- Voters will not vote if their first choice is not available
- Only unanimous voting systems are efficient
- Different outcomes can occur based on the order of the voting agenda