Example of essay on effect of asymmetrical information on economy

Business, Marketing

Introduction

In any market condition, information plays a critical role in structuring the demand and supply forces. All other things being constant, perfect and complete information to both buyers and sellers ensures that price determination takes place at a point that provides maximum benefit to the society as a whole. In such cases, the buyers or the sellers cannot influence the price. This scenario ensures equitable distribution of benefits to everyone in the society. However, perfect information is a characteristic of an ideal perfect market alone. It is not experienced in real life scenarios. Information asymmetry is a common phenomenon in the real life imperfect markets. It can be defined as the lack of adequate knowledge that is required to make a perfect buying or selling decision.

Asymmetrical information impacts the economy by causing inefficiencies and dissatisfaction in the market. The objective of this paper is to understand the effect of information asymmetry on the market participants and the overall economy. The paper is divided into four sections. The first section explains the information need for a buyer and seller in a market. The second section mentions the effects of asymmetrical information on the economy. The third section uses illustrations from the financial sector and the real estate sector to help understand losses caused by information asymmetry in real life situations. The fourth section concludes the paper.

Information Need for a Buyer and Seller

A rational buyer and seller undergo a decision process prior to a potential transaction. Both the transacting parties require complete information to make efficient decisions. However, the decision making process of a buyer and a seller different as their needs and expectations are different. Information on prevailing market conditions, availability of substitutes and industry forecasts are important for both the buyer and the seller. Both buyers and sellers need more information in addition to this.

A buyer needs complete knowledge of the product and services and the situation of the seller. It is essential to have a detailed knowledge of the product one buys to avoid post purchase surprises and disappointments. Assessing the seller's situation will help recognise the seller's severity of need to sell the product. For example, agriculture produce are seasonal. The farmer usually has an urgent need to sell the product to pay of the short term loans taken for farming. The nearing expiry of stocks, the likelihood of falling product prices and any such adversities may prompt a seller to sell off urgently.

A seller needs to have adequate information on a product's input cost and situation of the buyer. Adequate information on input costs will help him or her better negotiate with the buyer and offer most competitive price. Assessing the buyer's knowledge levels will also help the seller in deciding the best price to offer.

Thus, information need is different for the buyer and seller. With more relevant information, the bargaining power increases for both. The increasing bargaining power ensures price is determined at an equitable level.

Effects of Asymmetrical Information on Economy

Asymmetrical information deals with situations wherein one transacting party is more informed than the other. For example, the producer has more knowledge of its product than the consumers and a bank is better informed of the fine prints of its terms and conditions. This difference impacts the transactions dynamics resulting in accrual of greater benefits to the more informed party, thus leading to failure of market principles of equitable distribution of benefits. It inhibits price determination at the best possible point or the equilibrium point, thereby increasing inefficiencies.

The four distinct consequences emanating from asymmetrical information in a market condition are adverse selection, increase in monitoring cost, moral hazards and creation of monopoly situations.

Adverse Selection

Adverse selection can force the better quality products and services out of the market. The consequence of adverse selection can be best understood with the help of the classical work ‘ The Market for Lemons’ of Akerlof. The example of used cars market in the automobile industry is taken to explain the consequence of adverse selection. Akerlof (489) refers to bad quality cars as lemons. He explains that there are four types of cars depending up on whether they are good or bad and new or old. At the time of purchase of a new car, a person only has general idea of the probability of the car turning out to be a lemon. However, with time and use, the person gets to know more about the car. If the person figures out that the car is a lemon, he or she will attempt to sell it in the used car market. In this case, the seller has more information about the car than the buyer developing information asymmetry. Since a buyer cannot differentiate between a good car and a bad car, the lemon will also sell at the same price as good cars. Good cars will not receive their true value in a used car market and will be forced out. Thus, information asymmetry leads to adverse selection forcing out the better products from the market and creating inefficiencies.

A similar situation can exist when the buyer is more informed, like in case of life insurance policies. The buyer knows best about his health conditions and has incentive to hide it from the insurance sellers. The controls built up insurance companies to tackle this, may affect the high quality customers.

Creation of Monopoly Situations

Monopoly is a situation in which the seller is the only supplier of a particular good or service. A business entity that has monopoly has market power. Natural monopolies are formed by achieving economies of scale or by investing heavily in research and innovation. Such monopolies do not disrupt the market equilibrium in the long run. However, another form of monopoly is created through collusion or cartel formation. Such agreements are kept confidential and only the agreeing parties have information about it. Due to lack of information, even the regulators are unable to take steps against it. Forced monopoly situations created by information asymmetry distort the market, disrupt efficient price determination and impact the overall economy.

Moral Hazards

Information asymmetry results in a situation where one party to the transaction displays irresponsible or immoral behaviour after a transaction has taken place. Insurance is an apt example of creation of moral hazards. When a person takes auto insurance, the risk of damage to the car is transferred to the insurer. As a result, the car owner or the insurance holder may display recklessness and take excessive risk. In other words, the person did not have any incentive to reduce risks with respect to the car as he or she had nothing to lose. In this case, the insurer is less informed as it is not aware of the hidden intentions of the insurance buyer. Frequent incidences of such sort will make the insurer cautious in selling insurance. This will change the market dynamics of the industry for worse.

Occurrence of moral hazards is reduced by adding the buyer’s stake or incentive in the transaction. In case of auto insurance, buyer’s is incentivised to be responsible by offering a no claim bonus or dis-incentivised to be reckless by increasing premium on every insurance claim. In case of home financing, the borrower’s stake in the transaction can be added by asking for equity funding as a percentage of the total fund requirement. The borrower may be asked to an upfront down payment.

Increase in Monitoring Cost

In economic transactions that require one party (agent) to act on behalf of the other transacting party (principal), the agent has develops information advantage. This theory is commonly known as principal-agent theory. The principal suffers from this information asymmetry. The information advantage of the agent can be prevented by adding monitoring controls, which increases cost. On the other hand, if effective monitoring is not in place, the agent has incentive to indulge in inappropriate activities. In any case, the principal cannot completely monitor the agent causing loss to the principal and economy.

The concept can be explained with two examples, an employee-employer relationship and a road contractor-municipal relationship. In an employee-employer relationship, the interests of the employee and employer are not aligned. While an employee works for his or her financial and recognition needs, the shareholders of the company aim to maximum the share value that is altogether different from the employee’s interests. As a result, employee may act inappropriately in the organisation context. He or she may indulge in activities like shirking, fraud and instigating other employees. All these scenarios may cause loss to the organisation, thereby adversely affecting the economy as a whole.

In a road contractor-municipal relationship, the contractor takes the contract of building roads. He or she agrees to build roads at a particular cost with given specifications in a specified time period. However, it is very difficult to monitor each and every activity of the contractor. The contractor may end up using inferior quality material and untrained labour. In addition to this, he or she may delay the project unnecessarily as there is no incentive to do it on time. In public projects of such nature, the principal also does not have any incentive to monitor the agent. This is because the principal or the government body has been appointed by the people and spending people’s money on such projects. This creates inefficiencies resulting from inadequate infrastructure and government support.

The principal-agent problem can be prevented by aligning the interests of the principal and agent to the ultimate cause. Employees' interests in the company can be added by issuing stock options and providing variable pay for overachievement of target. These are reinforcing incentives. Principals can also resort to negative incentives or penalty to ensure proper work is done. Detailed specifications can be laid down for constructing a road. Periodic inspections can help in ascertaining the quality of work. The contractor can be heavily penalised for any deviation.

Application of Asymmetrical Information

The issue of information asymmetry can be explained using practical real life examples. The impact of information asymmetry on the financial sector and the real estate sector is being discussed in this section.

Financial Sector

Sagdeo states that corporate credit reflects three types of asymmetrical information syndrome: adverse selection, moral hazards and monitoring costs. A corporate has to resort to availing external credit as one of the means to finance its business operations. The credit approval and loan disbursement are complex processes. They require flow of lot of information from the corporate to the financial institution and vice versa. However, symmetrical information flow is an ideal situation and information asymmetry is the reality.

The borrower has a tendency to hide information from the lender to depict a stronger case for external finance. The project proposition is displayed in a glamorous way hiding the major drawbacks of the project. Inadequate and erroneous data leads to inaccurate feasibility analysis of the project. This leads to imperfect decision making and has a far reaching effect on the overall economy. It may impact the market in three ways. The first consequence is adverse selection. Imperfect decision making may result in the loan going bad in future. Frequent occurrence of these instances will force the lender to be more cautious about lending and increase controls. The increased controls may impact the genuine borrowers. The second consequence is moral hazards. Once the loan is disbursed, use of funds is in the hands of the borrower. The lender has limited information about it. The corporate may misuse the fund and may divert it to other non-productive uses. The third problem is the increase in monitoring cost. Borrower is the information source for the lender. To ensure that the borrower gives correct information, the lender may establish monitoring and vigilance controls. The additional controls come with a cost, thereby reducing profitability of the company. Thus, information asymmetry prevents accrual of maximum benefits in the financial sector.

Real Estate Sector

Consequences of information asymmetry are experienced in the real estate sector as well. The real estate sector is unique in itself, given the uniqueness of each property and variability in prices. The price of a real estate property depends on various factors like location, changing customer preferences, quality and legality. The seller has more information than the borrower about the legality and quality of the property. Sometimes, a property may be disputed. There may be more than one owner of the property. However, only seller is aware about these details and may resort to immoral behaviour given the large amount of money involved. Evasion of property taxes is another consequence of information asymmetry that may cause huge monetary losses to the government and impair economic growth.

Conclusion

In any economic transaction, perfect and complete information is required to ensure price determination at equilibrium and maximum benefit to the society as a whole. However, perfect information is a characteristic of an ideal perfect market alone. Information asymmetry is a real life scenario. Information need of a buyer and a seller are different. But, with access to more and more relevant information, the bargaining power increases for both ensuring price determination at an equitable level.

The four distinct consequences of asymmetrical are adverse selection, increase in monitoring cost, moral hazards and creation of monopoly situations. Adverse selection forces the better quality products and services out of the market. Monopoly creates market distortion, disruption of efficient price determination process and impacts the overall economy. Moral hazards are caused when one party to the transaction, because of being better informed, displays irresponsible or immoral behaviour after a transaction has taken place. Monitoring cost is also increased to avoid information asymmetry thereby causing economic loss.

The application of information asymmetry can be illustrated through the examples of financial sector and real estate sector. In a financial sector, there is asymmetrical information flow between the buyer and the lender. The imperfect flow of information leads to incorrect project evaluation. Such loans have higher probability of becoming a bad loan increasing economic crisis. The seller is more informed about the legality and quality of a real estate property. Misuse of this information creates moral hazards. Thus, information asymmetry is an avoidable but a grave concern for the economy. Though it cannot be eliminated, focused efforts need to be made to reduce its impact.

Works Cited

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