OCR Economics A-level
Microeconomics

Topic 2: The Role of Markets
2.9 Information Failure

Notes

- **Symmetric information** means that consumers and producers have perfect market information to make their decision. This leads to an efficient allocation of resources.

- **Asymmetric information** leads to market failure. This is when there is unequal knowledge between consumers and producers. For example, a car dealer might know about a fault with the car that the consumer is unaware of. This could lead to a misallocation of resources. Consumers can also know more information than the producer, such as when purchasing insurance policies.

- There could also be imperfect information, where information is missing, so an informed decision cannot be made.

- This leads to a misallocation of resources. Consumers might pay too much or too little, and firms might produce the incorrect amount. For example, monopolies might exploit the consumer by charging them more than they need to.

- Asymmetric information can be linked with the **principal-agent problem.** This is when the agent makes decisions for the principal, but the agent is inclined to act in their own interests, rather than those of the principal. For example, shareholders and managers have different objectives which might conflict. Managers might choose to make a personal gain, rather than maximise the dividends of the shareholders.

- Information asymmetry can also result in **moral hazard**, where an individual takes on more risk than usual because they do not bear the full cost of the risk e.g taking out car insurance may encourage individuals to make riskier decisions when driving. Examples of this includes when there is asymmetric information between a bank and government (the bank holds more information) and as a result the bank makes riskier financial decisions in the knowledge that the government will step in and help if the bank gets in trouble.

- Information could be made more widely available through advertising or government intervention. For example, the harmful effects of smoking could be made public through adverts and messages on cigarette boxes.

- Negative externalities are caused by **demerit goods.** These are associated with information failure, since consumers are not aware of the long run implications of consuming the good, and they are usually overprovided. For example, cigarettes and alcohol are demerit goods. The negative externality to third parties of consuming cigarettes is second-hand smoke or passive smoking. As a result, the MPB>MSB and there is an area of deadweight welfare loss since output is not at the social optimum.

- Positive externalities are caused by **merit goods.** These are associated with information failure too, because consumers do not realise the long run benefits to consuming the good. They are underprovided in a free market. For example, education and healthcare are merit goods. The positive externality to third parties of education is a higher skilled workforce and as a result greater economic output resulting in MSB>MPB.
- The extent to which the market fails involves a value judgement, so it is hard to determine what the monetary value of an externality is. For example, it is hard to decide what the cost of pollution to society is. Different individuals will put a different value on it, depending on their own experiences with pollution, such as how polluted their home town is. This makes determining government policies difficult, too.

Example: Market failure due to information failure

Key examples of market failure owing to information failure is evident in the consumption of unhealthy food or cigarettes. At the point of consumption consumers are unaware of the true nutritional information/ health risks the goods have (there is information asymmetry between the manufacturer and the consumer). As a result, the consumer may consume more than if they had perfect information (MPB>MSB) and there is a triangle of deadweight welfare loss on the diagram.

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