

### 2017 J2H2 Prelim Essay Question 3

When consumers lack accurate or complete information about different goods and services, they often end up making decisions that are less than optimal.

- (a) Explain how market failure arises in markets for different goods and services due to information failure. [10]
- (b) Discuss the measures adopted by private agents and the government in solving market failure due to asymmetric information. [15]

#### Part (a) Answer Outline

##### Introduction

Market failure may arise in markets for different goods and services due to information failure. Information failure refers to economic agents not having perfect or equal information and it can occur in two instances – firstly, it exists when some agents in an economic transaction have imperfect knowledge; secondly, it exists when an agent in an economic exchange has more information than the other, resulting in asymmetric information. Asymmetric information in turn leads to market failure due to adverse selection and moral hazard.

##### Body

###### Imperfect Knowledge

Imperfect knowledge arises when individuals are unable to value their private benefits or private costs of consuming certain goods and services correctly due to incorrect or incomplete information about the actual private benefits or costs.

**[Explain using any valid examples of goods]**

###### Asymmetric Information

Asymmetric information arises when the economic agents involved in a transaction have different amounts of information. It refers to the situation in which a market is characterised by either buyers or sellers having more or superior information than the other party.

###### Adverse Selection

Adverse selection arises due to asymmetric information. It refers to the situation in which the price and quantity of goods or services in a given market is altered due to the hidden characteristics of the good or service before the transaction has been completed. As a result, the product or service is mainly demanded by agents who offer the worst return for other economic agents.

**[Explain using any valid examples of goods]**

###### Moral Hazard

Moral hazard is a situation where an economic agent, having more information about its actions or intentions, has a tendency to take more risks because the costs that could result are not borne completely by the party taking the risk. The party with more information thus has a tendency or incentive to behave inappropriately from the perspective of the party with less information.

**[Explain using any valid examples of goods]**

### **Conclusion**

Since information failure leads to market failure in different product and service markets, there is a need for governments to intervene in these markets as well as for economic agents involved in the transaction to adopt measures that would solve the problems arising due to information failure.

### **Marking Scheme**

<b>Level</b>	<b>Knowledge, Application, Understanding, and Analysis</b>	<b>Marks</b>
L3	Well-developed explanations of how market failure arises due to information failure (imperfect information, adverse selection and moral hazard).  Good use of relevant examples of <b>different products and services</b> to illustrate explanations.	8 – 10
L2	Descriptive explanation of how market failure arises due to information failure.  Answer uses relevant examples that may not necessarily be of different products and services to illustrate explanations.	5 – 7
L1	For an answer that shows descriptive knowledge of how market failure arises due to information failure.	1 – 4

## Part (b) Answer Outline

Discuss the strategies adopted by private agents and the government in solving market failure due to asymmetric information. [15]

### Introduction

- Market failure arises due to asymmetric information as explained in Part (a). Thus, there may be a need for governments to implement policies to correct such market failure.
- With other sources of market failure (e.g. externalities, public goods etc.), private agents have little or no incentive to remedy the market failure. As a result, governments often have to intervene through the implementation of policies in these markets.
- However, in the case of asymmetric information, private agents often have an incentive to correct the market failure by adopting strategies such as signalling, screening, co-payments and no-claim discounts.
- This is in contrast with governments, which implement legislation such as Lemon Law, mandatory participation in health insurance, as well as provision of clear and comprehensive information directly to consumers.

### Body

**I: Explain how private agents' strategies and government policies work to solve market failure due to asymmetric information + Limitations**

#### Private agents' strategies to overcome adverse selection

- Signalling
- Screening

#### Private agents' strategies to overcome moral hazard

- Changing incentives

#### Government policies to overcome adverse selection and moral hazard

- Legislation
- Provision of information

### Conclusion

#### ***Stand + Any valid criteria***

- In conclusion, it would be more effective if a combination of private agents' strategies and government policies were implemented.
- Equity concerns and the need for government intervention

## Marking Scheme

Level	Knowledge, Application, Understanding and Analysis	Marks
<b>L3</b>	For a well-developed explanation of how private agents and governments implement strategies and policies respectively to correct market failure due to asymmetric information	<b>8 – 10</b>
<b>L2</b>	For a descriptive explanation of how private agents and governments implement strategies and policies respectively to correct market failure due to asymmetric information  Answer merely states the limitations of the strategies adopted by private agents as well as the policies implemented by governments	<b>5 – 7</b>
<b>L1</b>	For an answer that shows a descriptive knowledge of the strategies adopted by private agents and the policies implemented by governments to correct market failure due to asymmetric information.	<b>1 – 4</b>
Level	Evaluation	Marks
<b>E3</b>	For an evaluative assessment which synthesises economic arguments to arrive at well-reasoned judgments about other considerations that need to be taken into account.	<b>4 – 5</b>
<b>E2</b>	For an answer that makes some attempt at an evaluative appraisal about other considerations that need to be taken into account.	<b>2 – 3</b>
<b>E1</b>	For an unsupported judgment about the other considerations that need to be taken into account.	<b>1</b>