

Lesson 28: Information

Assumption of Invisible Hand Theory - buyers and sellers are fully informed

MIDDLEMAN

Salespeople - trained & informed on product and competitors (ideally); make recommendations based on your experience level, size, expected usage, etc.

Add Value - create genuine economic value by increasing extent to which goods & services find their way to the consumers who value them most

Example - You want to sell Babe Ruth card for \$300 min (reservation price); can post in local paper for \$5 or sell on EBay for 5%; highest reservation price locally is \$400; on EBay top two are \$900 & \$800... assume sell locally for \$400 or on EBay for \$800; total surplus locally is $(400 - 5) - 300 + (400 - 400) = \mathbf{\$95}$; total surplus on EBay is $(.95 * 800 - 300) + (900 - 800) = \mathbf{\$560}$... surplus created is $560 - 95 = \mathbf{\$465}$

Pay for Service - typically full-service retail sales charge more than internet retailers (have to hire knowledgeable salespeople, put merchandise on display, rent space in expensive shopping malls, etc. (vs. internet store using unskilled telephone clerks and cheap warehouses)

Adds Value - "Spending \$600 on the right skis is better than \$400 on the wrong ones"

OPTIMAL AMOUNT OF INFORMATION

Cost-Benefit - rational consumer will continue to gather information as long as its MB > MC

FREE-RIDER PROBLEM

Free-Rider Problem - incentive problem in which too little of a good or service is produced because nonpayers cannot be excluded from using it

Example - people can take advantage of retail stores without paying for them & then order for less online (e.g., book stores, Best Buy,

GUIDELINES FOR RATIONAL SEARCH

Problem - exact value of additional information is difficult to know, so amount of time & effort one should invest in acquiring it is not always obvious

General -

Expense - spending additional search time is more likely to be worthwhile for expensive items than for cheap ones

Search Cost - when searching becomes more costly, we should expect to do less of it (so you can expect to pay more for the item)

Gamble - no guarantee that searching further will turn up a cheaper or better item

Expected Value of a Gamble - average amount you would win (or lose) if you played the gamble an infinite number of times; sum of possible outcomes of the gambled multiplied by their respective probabilities

Fair Gamble - has expected value of zero

Better-Than-Fair Gamble - expected value is positive

Risk-Neutral Person - would accept any gamble that is fair or better

Risk-Averse Person - would refuse a fair gamble

Commitment Problem - people are rational to end searches even though they know a more attractive option surely exists out there somewhere (but too expensive to find it); problem is if you happen to find that better option by chance; need commitment device (e.g., lease, contract, etc.) to terminate search

ASYMMETRIC INFORMATION

Asymmetric Information - situations in which buyers & sellers are not equally well informed about characteristics of goods & services for sale in marketplace

Lemons Model - by George Akerlof; says asymmetric information tends to reduce the average quality of goods offered for sale because buyers don't know how good sellers product is so they tend to value it less than it's worth ([self-fulfilling prophesy](#))

Example - average used price for car is \$8,000, but seller has babied the car and has a reservation price of \$10,000; buyer is willing to pay \$13,000 for a car in excellent condition, but only \$9,000 otherwise; since there's no way for buyer to tell if seller's car is in excellent condition there will be no sale even though at \$11,000, there would be \$2,000 surplus

Credibility Problem - buyers' and sellers' interest tend to conflict; buyers have incentive to overstate quality of their product; buyers have incentive to understate amount they're willing to pay ("[people tend to interpret ambiguous information in ways that promote their own interests](#)")

Costly-to-Fake Principle - use signal that is costly or difficult to fake to communicate information credibly to potential rival; Examples:

- Warranty - says car is unlikely to need expensive repairs; would be costly to offer for a car that's not in good condition
- "As seen on TV" - expenditure on advertising campaign is sign that product is good (too costly to advertise a product that's not good)
- Elite Education - signal for hardworking, smart person... not a guarantee, but companies play the percentages
- Conspicuous Consumption - lawyer with fancy car sends signal of how good he is (driving a beater implies he doesn't win many cases)... this is a positional externality

RESULTS OF ASYMMETRIC INFORMATION

Statistical Discrimination - practice of making judgments about quality of people, goods, or services based on characteristics of groups to which they belong (e.g., [higher salaries to college grades; colleges favoring applicants with higher SAT scores](#)); NOTE: individual characteristics can differ markedly from those of group

Adverse Selection - pattern in which insurance tends to be purchased disproportionately by those who are most costly for companies to insure... raising premiums and thus making it less attractive to low-risk individuals

Disappearing Political Discourse - theory that people who support a position may remain silent, because speaking out would create a risk of being misunderstood (e.g., [if 95% of politicians who favor death penalty and only 80% of those who oppose it are "serious about crime"; coming out against the death penalty will entail loss of political support even if the politician is extremely serious about crime](#))