

Chapter 16 Project

Information, Risk, and Insurance

Purpose

In this chapter, you learned that imperfect and asymmetric information can affect equilibrium prices and quantities in all markets and what can be done to reduce the impact of imperfect information. You also learned about the problems that imperfect information causes in insurance markets and how insurance companies try to reduce the impact of imperfect information.

The first purpose of this exercise is for you to identify situations where imperfect information is a factor and to suggest ways in which the impact of imperfect information might be decreased. The

second purpose is to identify the problems of adverse selection and moral hazard and explain what can be done to reduce their impact.

Directions

This exercise has two parts. In the first, you will identify situations where there is imperfect information, then indicate missing information from both the buyer's and the seller's perspective and suggest ways to increase information available. In the second part, you will determine if a situation is an example of adverse selection or moral hazard and suggest ways that these problems can be reduced.

Part 1 - Imperfect Information

1. In the following table, for each situation with imperfect information, indicate the information that the buyer and/or the seller are missing and what can be done to increase information available to either or both sides of the market.

In the last two rows, list two transactions where you were affected by imperfect information and indicate what you did, or could do in the future, to reduce the impact of imperfect information.

Situation	Buyer	Seller	Ways to Reduce the Imperfect Information Problem
Buying a used car			
A doctor recommends knee replacement surgery for you			
Booking a hotel for a vacation in Canada			
Hiring someone to paint your house			

Hiring a lawyer to represent your small business			

Part 2 - Adverse Selection and Moral Hazard

Indicate if the following situations are an example of adverse selection or moral hazard. Then, suggest a strategy that would reduce the problem.

1. A university doesn't know if a student that they admit will remain in school, complete their program of study, and graduate.
2. Most of the people buying health insurance are either sick, elderly, or both.
3. If health insurance companies must insure everyone at the same low-cost premium, many people pursue careers in bull riding, ski jumping, and race car driving.
4. Some people respond to credit card offers that promise very low interest rates and encourage balance transfers from other credit cards.
5. People who have homeowners' insurance don't put new batteries in their smoke alarms.

Checklist

Part 1

- Identify situations with imperfect information.
- Suggest ways to reduce imperfect information.

Part 2

- Classify each situation as a moral hazard or adverse selection.
- Provide a possible solution for each situation.