Overview

A large number of economic transactions occur in the presence of asymmetry of information. Sellers often know the quality of a good better than buyers. Buyers have a better idea of their willingness to pay for a good than do sellers. Insurance companies do not know the risk-type of those they are insuring, and after an accident, it is hard to tell if the insured took adequate precaution. Markets and organizations try to overcome constraints on trade imposed by these information asymmetries. Starting with the pioneering contributions of the recent (2001) Nobel Laureates, George Akerlof, Michael Spence and Joseph Stiglitz, a large body of work has emerged devoted to studying the economics of information. (For more on the Nobel Prize to these economists, see the website: http://www.nobel.se/economics/laureates/2001/press.html.)

There are many examples of attempts to address issues of asymmetries of information during economic exchanges. Sellers build reputations and brand names. New products come with introductory offers as an attempt to signal quality. Warranties provide insurance to consumers and may perhaps also be indicative of quality. Insurance contracts screen the insured by a judicious choice of an array of deductible-premium pairs, and deductibles and penalty-premiums provide incentive to drive with caution. Bonuses provide workers to work hard when employers cannot monitor the work effort directly. Piece-rate schemes provide stronger incentive to produce, but may make a worker pay less attention to building firm reputation. Debt contracts minimize on monitoring costs. Collateral can be used to screen good projects.

The object of this course will be to provide the students a framework to systematically think through problems that arise during exchange under asymmetric information.

Prerequisites: Econ 300. Recommended Econ 404, 485.

The analyses will rely on game theoretic concepts although it is not required that students know these concepts prior to the course. Thus, Econ 404 and/or 485 will provide a useful, even if not essential, background.

Students are expected to be comfortable with using elementary partial derivatives and solving systems of equations (at a level similar to Econ 404 and 485).
Outline of Topics

1. Uncertainty

2. Adverse selection

3. Signaling: competitive market; monopoly.

4. Screening: competitive market; second-degree price discrimination; lender-borrower contracts; hierarchical agency.

5. Moral hazard: competitive market; hierarchical agency.

6. Special topics: as time permits – present bias, microfinance

Problem Sets and Exams

Assignments will be handed out periodically and answer keys will follow soon afterwards. They will not be graded, but you are strongly encouraged to do them regularly to check if you are making adequate progress.

There will be three (cumulative) tests:

- Test 1 20% of the grade (Monday, April 22)
- Test 2 30% of the grade (Wednesday, May 15)
- Final 50% of the grade (UW schedule: Thursday, June 13, 2013, 830-1020, LOW 105)

Course Pack

A course pack with the following material is available for purchase from Pearson.


- Chapter 17: Uncertainty
- Chapter 19: Asymmetric Information


- Chapter 6: Moral Hazard and Performance Incentives.
- Chapter 7: Risk Sharing and Incentive Contracts.
Purchasing the Course Pack

Since two chapters are from Perloff’s *Microeconomics (6e)* text, which many students may already possess, there are two versions of the course package, a complete and a partial version (without the Perloff Chapters).

Please purchase the one appropriate for you by following the instructions below.

1. **COMPLETE**

2. **PARTIAL** (without Perloff chapters 17 and 19)

2. If you have previously registered for another CoursePack, log in. If not, click the Register link underneath the Students heading. Complete the registration page and click Continue.

3. Confirm your CoursePack selection and click Continue.

4. Complete your billing information, confirm and click Continue.

5. After completing the purchase pages, you will be taken to your CoursePack.

6. If you have problems, contact XanEdu Customer Service at 1-800-218-5971 (option 4) or email cust.serv@xanedu.com.

7. Each individual student must purchase his/her own access to the CoursePack.