What Is Asymmetric Information?

Asymmetric information" is a term that refers to when one party in a transaction is in possession of more information than the other. In certain transactions, sellers can take advantage of buyers because asymmetric information exists whereby the seller has more knowledge of the good being sold than the buyer. The reverse can also be true.

Advantages and Disadvantages of Asymmetric Information

Advantages:

Asymmetric information isn't necessarily a bad thing. In fact, growing asymmetrical information is the desired outcome of a healthy market economy. As workers strive to become increasingly specialized in their chosen fields, they become more productive, and can consequently provide greater value to workers in other fields.

For example, a stockbroker's knowledge is more valuable to a non-investment professional, such as a farmer, who may be interested in confidently trading stocks to prepare for retirement. On the flip side, the stockbroker does not need to know how to grow crops or tend to livestock to feed themselves, but rather can purchase the items from a grocery store that are provided by the farmer.

In each of their respective trades, both the farmer and the stockbroker hold superior knowledge over the other, but both benefit from the trade and the division of labor.

One alternative to ever-expanding asymmetric information is for workers to study all fields, rather than specialize in fields where they can provide the most value.

However, this is an impractical solution, with high opportunity costs and potentially lower aggregate outputs, which would lower standards of living.

Disadvantages:

In some circumstances, asymmetric information may have near fraudulent consequences, such as adverse selection, which describes a phenomenon where an insurance company encounters the probability of extreme loss due to a risk that was not divulged at the time of a policy's sale.

In certain asymmetric information models, one party can retaliate for contract breaches, while the other party cannot.

For example, if the insured hides the fact that they're a heavy smoker and frequently engage in dangerous recreational activities, this asymmetrical flow of information constitutes adverse selection and could raise insurance premiums for all customers, forcing the healthy to withdraw. The solution is for life insurance providers to perform thorough actuarial work and conduct detailed health screenings, and then charge different premiums to customers based on their honestly disclosed risk profiles.

Difference between Adverse Selection and Moral Hazard

The terms adverse selection and moral hazard are both used in risk management, economics and insurance. Both terms describe situations between parties where one person gains a competitive advantage over the other, leading to the exploitation of the other. Knowing the differences between adverse selection and moral hazard ensures that all parties reach an efficient outcome and helps avoid parties being exploited.

Adverse Selection:

Adverse selection takes place occurs when one entity or person, (more often the seller) has differing or more accurate information about a deal than the other person, (more often the buyer) before reaching an agreement.

Such a situation favours the party that has more info while the other person is forced to enter into an unfavourable deal. And in most cases, it is difficult for the party who does not have sufficient info to access the risk or value out of the deal. And since the more knowledgeable entity or person has all the information, they can easily evaluate the situation and access how they will benefit from it.

Adverse selection is one of the main causes of low-quality goods and services and inefficient outcomes.

- **Example of adverse selection**

If you have ever bought a used car, you know how much information you need to ensure you do not get short-changed. The car seller has more knowledge about the car than a buyer. For instance, if a car has ever been involved in an accident or some parts are faulty, the seller may not always disclose this to the buyer. In most instances, the buyer cannot distinguish between high quality and low-quality car. This results in the buyer purchasing the low-quality car at the price of a high-quality car. The seller benefits since they have more info about the vehicle while the buyer gets short changed.

Another example of adverse selection is the purchase of health insurance. While a person is well aware of the health issues that they face, the insurance company is not. As such, the insurer is at more risk of an unfavourable outcome.

Moral Hazard:

This is a situation where one entity or person entering into a deal provides misleading information that affects the entire agreement once the agreement has been made. It can also occur when one person (more often the buyer) changes their behaviour once the parties enter into an agreement since they believe they will not face consequences for their actions. Moral hazards put the sellers in unfavourable situations since they are forced to deal with the unfavourable outcomes.

- **Example of Moral Hazard**

The insurance industry is often marred with moral hazards. For instance, homeowners who have not purchased flood insurance and live in flood-prone areas are very careful during the storm seasons. Most will move furniture, install drainage pumps and invest in a good drainage system.

However, once they purchase flood insurance, they are less careful with measures to mitigate the risks. This results in a greater risk for claims to the insurance company.

Similarities between Adverse selection and Moral hazard

- Both refer to situations where one entity or person has an advantage over the other

Differences between Adverse selection and Moral hazard

Definition

Adverse selection is a scenario that takes place when one person or entity, (more often the seller) has differing or more accurate information about a deal than the other person, (more often the buyer) before reaching into an agreement. On the

other hand, moral hazard is a situation where one person entering into a deal provides misleading information that affects the entire agreement once the agreement has been made.

Occurrence

While adverse selection occurs before purchase, moral hazard occurs after purchase.

Characteristics	Adverse selection	Moral hazard
Definition	It is a scenario that takes place when one person or entity, (more often the seller) has differing or more accurate information about a deal than the other person, (more often the buyer) before reaching into an agreement	It is a situation where one person entering into a deal provides misleading information that affects the entire agreement once the agreement has been made.
Occurrence	Occurs before purchase	Occur after purchase

What is an example of a moral hazard?

Homeowners who have not purchased flood insurance and live in flood-prone areas are very careful during the storm seasons. Most will move furniture, install

drainage pumps and invest in a good drainage system. However, once they purchase flood insurance, they are less careful with measures to mitigate the risks. This results in a greater risk for claims to the insurance company.

Can adverse selection exist without moral hazard?

Yes, adverse selection can occur without moral hazard.

What is the meaning of adverse selection?

Adverse selection takes place when one person or entity, (more often the seller) has differing or more accurate information about a deal than the other person, (more often the buyer) before reaching an agreement.