Chapter 22: Frontiers of Microeconomics
Principles of Economics, 6th Edition
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1. Introduction
   a. Three topics are covered in this chapter
      i. asymmetric information,
      ii. political economy, and
      iii. behavioral economics.

2. Asymmetric Information
   a. *This is the most important section of this chapter.*
   b. *What is particularly important is how markets have adapted to adjust to the problems created by asymmetric information.*
   c. A difference in access to relevant knowledge is called an information asymmetry.
   d. Hidden Actions: Principals, Agents, and Moral Hazard
      i. Moral hazard is a problem that arises when one person, called the agent, is performing some task on behalf of another person, called the principal.
      ii. Stated a different way: moral hazard is the tendency of people with insurance to do the activity against which they have insurance.
      iii. This often occurs with employment.
         (1) Employers can respond by:
            (a) Better monitoring,
            (b) High wages or
            (c) Delayed payments.
      iv. Def: Moral hazard is the tendency of a person who is imperfectly monitored to engage in dishonest or otherwise undesirable behavior. P 468
      v. Def: An agent is a person performing an act for another person, called the principal. P. 468
      vi. Def: A principal is person for whom another person, called the agent, is performing some act. P. 468
      vii. Some good examples of moral hazard occur with insurance.
         (1) *Screening, deductibles, etc. can be important in controlling behavior.*
      viii. FYI: Corporate Management, P. 469
         (1) An example of using incentives to minimize the principal-agent problem.
   e. Hidden Characteristics: Adverse Selection and the Lemons Problem
      i. Adverse selection is a problem that arises in markets where the seller knows more about the attributes of the good being sold than the buyer does.
         (1) Def: Adverse selection is the tendency for the mix of unobserved attributes to become undesirable from the standpoint of an uninformed party. P. 470
         (2) A classic example is used cars.
         (3) Another example is the use of efficient wages in labor markets.
         (4) Health insurance has major adverse selection problems.

f. Signaling to Convey Private Information
   i. Def: Signaling is an action taken by an informed party to reveal private information to an uninformed party. P 471
   ii. To be an effective signal, it has to be costly.
   iii. Advertising is a good example since a company with a low quality product has little incentive to advertise because it will receive few repeat customers.
   iv. Education is full of examples.
   v. Case Study: Gifts as Signals, P. 471
      (1) People care most about the custom when the strength of the affection is most in question.
      (2) Men give gifts to girl friends, while parents give money to their children.

a. Screening to Induce Information Revelation
   i. Def: Screening is an action taken by an uninformed party to induce an informed party to reveal information. P. 472
   ii. When an informed party takes actions to reveal his private information, the phenomenon is called signaling.
   iii. When an uninformed party takes action to induce the informed party to reveal private information, the phenomenon is called screening.
      (1) The use of deductibles.

b. Asymmetric Information and Public Policy
   i. Private markets can sometimes deal with information asymmetries on their own through a combination of signaling and screening.
   ii. Governments seldom have more information then the private parties.
   iii. Governments are imperfect institutions.

3. Political Economy
   a. *The important thing to take away from this section is that politician and government employees are utility maximizers.*
   b. Political economy is the study of government using the analytic methods of economics. P. 473
   c. The Condorcet Voting Paradox
      i. Def: The Condorcet paradox is the failure of majority rule to produce transitive preferences for society. P. 474
      ii. **Table 1: The Condorcet Paradox, P. 474**
   d. Arrow's Impossibility Theorem
      i. Def: Arrow's impossibility theorem is a mathematical result showing that, under certain assumed conditions, there is no scheme for aggregating individual preferences into a valid set of social preferences. P. 475
      ii. In the News: Arrow's Problem in Practice, P. 476
   e. The Median Voter is King
      i. Def: The median voter theorem is a mathematical result showing that if

voters are choosing a point along a line and each voter wants the point closest to his most preferred point, then majority rule will prick the most preferred point of the median voter. P. 478

ii. **Figure 1: The Median Voter Theorem: An Example, P. 478**

f. Politicians Are People Too

1. Behavioral Economics is the subfield of economics that integrates the insights of psychology. P. 480
   a. People Aren't Always Rational
      i. People can be forgetful, impulsive, confused, emotional, and shortsighted.
      ii. They may attempt to satisfy rather than maximize.
      iii. People make systematic mistakes:
         (1) They can be overconfident.
         (2) People give too much weight to a small number of vivid observations.
         (3) People are reluctant to change their minds.
      iv. The assumption of rationality, even it not exactly right, is still a good approximation.
   b. People Care About Fairness
      i. The ultimate game consists of two parties flipping a coin and then one divides the prize and the other decides whether they will accept the distribution.
      ii. In the ultimate game, my sense is not so much fairness as spite.
      iii. I am willing to incur a small cost to guarantee that you are not going to receive a large gain.
   c. People Are Inconsistent Over Time
      i. People do not maintain commitments.
      ii. **In the News: Sin Taxes, P. 482**

2. Conclusion

3. Summary