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# Information Asymmetry

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In economics, a standard assumption is that market participants have — and base their decisions on — "perfect information." However, in real life, this is not the case; consumers cannot possess all available knowledge concerning all transactions. Even though the assumption of perfect information is widely used, economists have developed methods for studying the behavior of markets with imperfect information. One important kind of imperfection is information asymmetry.

Information asymmetry exists when one party, typically the buyer, has less perfect information than the other. If the price of a good or service does not accurately reflect its quality and the buyer does not possess as much information regarding the product as the seller, this can place the buyer at a disadvantage. The term "information asymmetry" was popularized by George Akerlof in his 1970 paper "The Market for Lemons." This concept was applied further by Michael Spence and Joseph Stiglitz, who, with Akerlof, shared the 2001 Nobel Prize for their work.

Information asymmetry is applicable to many common transactions; a few examples are fixing a car, selecting a college, and obtaining a home mortgage. In each of these instances, the typical consumer weighs the opportunity cost of gathering more information against the potential costs associated with accepting some level of ignorance about the product.

Consider the case of hiring a mechanic. As all car owners know, it would require a substantial investment of time at a trade school or working at a garage to understand a car as well as the average mechanic, so most people do not attempt to make their own repairs. In a worst-case scenario, a dishonest mechanic could overcharge the client and fail to repair the car, resulting in an accident or further damage to the car. However, most consumers seem to agree that this is an unlikely situation, and instead accept the more likely scenario that they may simply be overcharged. As a result, information asymmetry often exists between the average consumer and a mechanic. The consumer does not become fully informed because it would be difficult to do so, and the costs of possibly making a poor decision are acceptably low.

Another significant transaction many people enter into is selecting a college. In this instance, information asymmetry between the buyer, who pays the tuition, and the seller, the college, is largely nonexistent. Here, information is readily available to prospective students and parents. Institutions send comprehensive brochures to students, and a wealth of independent reviews and ranking systems are available on the Internet. Also, the cost of not investigating college choices is particularly high. If a student selects a college that is not a good fit, this may result in a costly and time-consuming transfer to another institution, or years of tuition that could have been better spent elsewhere. In a worst-case scenario, the student may be forced to drop out of college and be unable, for a variety of reasons, to return or attend another. As a result, information asymmetry is largely nonexistent in this market. The consumer seeks to become informed because information is easily accessible, and not doing so creates a large risk that the transaction will fail — a risk that entails significant costs.

Granted, there are limitations to this example; there is information accessible to the consumer only once the student has enrolled in college. It may turn out a school is not a good fit for even a well-informed applicant for reasons that could not have been reasonably predicted. Nonetheless, even in this case, the consumer did everything possible to obtain information equal to that of the college's admissions officer, reducing the possibility of information asymmetry between the two parties.

The final example involves one of the most important purchases most people make: obtaining a home mortgage. As recent issues in the mortgage market demonstrate, there was widespread information asymmetry between many borrowers and their lenders. Even though the terms of a mortgage contract generally are quite explicit, many home buyers find those contracts, especially their most important features, difficult to understand. The costs of not thoroughly understanding the mortgage agreement are large, and may result in years of high-interest payments or even foreclosure. So, the consumer has to make a choice: whether to seek outside help in understanding the contract or simply to trust the mortgage provider. That choice often determines the level of information asymmetry in this market.

These examples illustrate the degree to which information asymmetry is prevalent in many common transactions. In some cases, there are high opportunity costs to spending the time and money to gather information about a purchase, so consumers do not bother with detailed investigations. In other cases, the risks of agreeing to less-than-optimal terms could be highly consequential for a consumer, prompting the consumer to conduct thorough research. Rational consumers must balance these two factors when making decisions in the marketplace. **RF**

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