

# Imperfect Information

**Information failure** occurs when people have inaccurate, incomplete, uncertain or misunderstood data and so make potentially 'wrong' choices. From pensions to computer games consoles, from investing in the stock market to ignorance about the consequences of borrowing and debt, all of us suffer from one or more information failures. The issue is whether the information failure is trivial or whether it has a huge effect on individuals, their families and society as a whole.

There may well be a case for the government to intervene in the market in some way if information failures become serious.

## Examples of information failure

Imperfect information can be caused by

- **Misunderstanding the true costs or benefits of a product:** E.g. the social costs and benefits of different classes of drugs and the private and social benefits from higher education when there are so many universities and courses to choose from.
- **Uncertainty about costs and benefits** e.g. should younger workers be buying into pension schemes when we can only guess at economic conditions in 40 years time?
- **Complex information** e.g. choosing between makes of computers requires specialist knowledge of hardware. Do I buy an Apple or PC computer? The problems of choosing a quality second hand car or when deciding whether or not to buy a property.
- **Inaccurate or misleading information** e.g. persuasive advertising may 'oversell' the benefits of a product leading to more consumption than is optimal. Spam mail can be a cause of misinformation for consumers. [Read this Tim Harford article on spam!](#)
- **Addiction** e.g. drug addicts may be unable to stop consumption of harmful substances

### Health warnings for snacks in bid to improve consumer information

The food industry has made its first move towards issuing health warnings for snack foods. The decision comes as food companies come under increasing pressure to provide more information about the nutritional value of their products amid concern about rising levels of obesity. It marks a shift in the food industry's attitude towards consumers. Food companies have argued that consumer education is not their job but soft drink producers have agreed to a voluntary ban on advertising to children in Europe. They also said they would provide better nutritional information on beverages.

Food and drink manufacturers have already made efforts to cut down on fats, salts and sugars, and provide more nutritional information.

*Source: Adapted from news reports*



## Asymmetric Information

For markets to work, there needs to be symmetric information i.e. consumers and producers have the same level of knowledge about the products, and they know everything there is to know about them.

**Asymmetric information** occurs when somebody knows more than somebody else in the market. This can make it difficult for the two people to do business together

Examples include the following:

- **Warranties:** The miss-selling of extended warranties by high street retailers on domestic electrical goods such as televisions and dishwashers



- Sub-prime mortgages: A lender does not know how likely a borrower is to repay their loan.
- A car insurance company cannot tell the risks associated with each single driver
- A motorist approaching a toll-road may not know how busy it is compared to substitute roads that do not charge a motorist for use.
- A used-car seller knows more about the quality of the car being sold than do buyers. The mini case study below covers this example!

### **The Market for Lemons**

Assume that used cars come in two types: those that are in good repair, and duds (or “lemons” as Americans call them). Suppose further that used-car shoppers would be prepared to pay \$20,000 for a good one and \$10,000 for a lemon. As for the sellers, lemon-owners require \$8,000 to part with their old banger, while the one-owner, careful-driver old lady with the well-maintained estate won't part with hers for less than \$17,000. If buyers had full information they could strike fair trades with the sellers, the old lady getting a high price and the lemon-owner rather less.

If buyers cannot spot the quality difference, though, there will be only one market for all used cars, and buyers will be ready to pay only the average price of a good car and a lemon, or \$15,000. This is below the \$17,000 that good-car owners require; so they will exit the market, leaving only bad cars. This result, when bad quality pushes good quality from the market because of an information gap, is known as “adverse selection”. A great many markets, including those for shares, labour and insurance, often resemble a used-car sale more closely than a McDonald's restaurant.

*Source: Adapted from [the Economist](#), October 2001*



# Poverty and Inequality in Resource Allocation

## Going without

“In the UK people can become poor as a result of social and economic processes, such as unemployment and changing family structures. Poverty is not simply about being on a low income and going without – it is also to do with being denied good health, education, good housing and social activities, as well as basic self-esteem”

Source: [Child Poverty Action Group](#)

In a **market economy** an individual's ability to consume goods & services depends upon his/her income. An **unequal distribution of income and wealth** may result in an unsatisfactory allocation of resources and can also lead to alienation and encourage crime with negative consequences for all. The free-market system will not necessarily respond to the needs and wants of those with **insufficient economic votes** to have any impact on market demand because what matters in a market based system is your **effective demand** for goods and services.

When we are discussing inequality and poverty, we cannot escape making **value judgements**.

## Absolute poverty

Absolute poverty measures the number of people living below a certain income threshold or the number of households unable to afford certain basic goods and services. What we choose to include in a basic acceptable standard of living is naturally open to discussion.

## Relative poverty

Relative poverty measures the extent to which a household's financial resources falls below an **average income level**. Although living standards and real incomes have grown because of higher employment and sustained economic growth, there is little doubt that Britain has become a more unequal society over the last 20-25 years.

## Poorer families have a lower life expectancy

People from poorer backgrounds are unhealthier and die earlier than the rich, according a study measuring the link between health and wealth. Poorer people in their fifties were 10 times more likely to die earlier than those who are richer, according to a report from the Institute of Fiscal Studies (IFS). The poor often have to stop work early due to ill health, the group added and this increases the risk of these groups suffering income poverty during their retirement years.

Source: *BBC news and Institute for Fiscal Studies*

The most commonly used threshold of low income in Britain is **60% of median household income** after deducting housing costs.

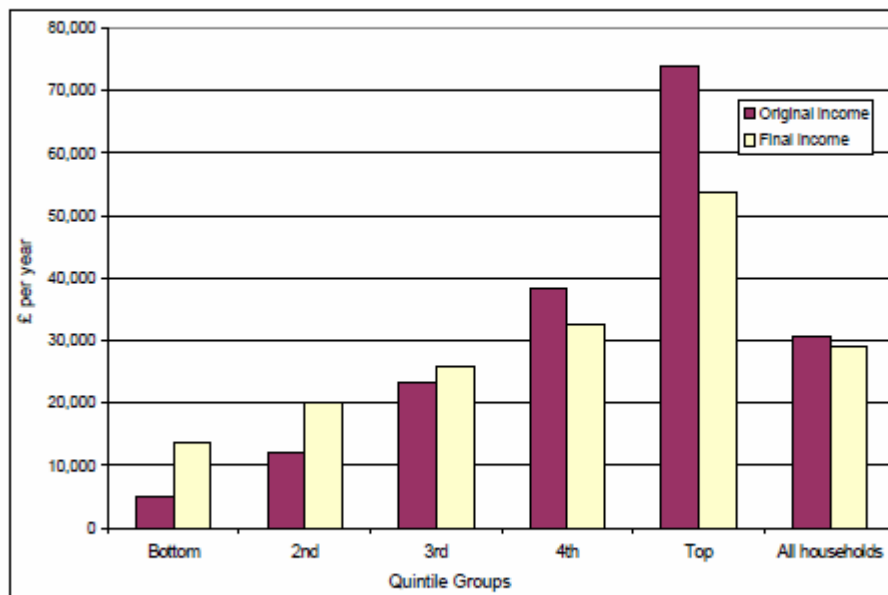
## The distribution of income in the UK

In the UK there is a large degree of income inequality. For example, in 2008/09, income before taxes and benefits of the top fifth of households in the UK was £73,800 per year on average compared with £5,000 for the bottom fifth, a ratio of 15 to one. After taking account of taxes and benefits, the gap between the top and the bottom fifth was reduced with average income of £53,900 per year and £13,600, respectively, a ratio of four to one. This shows that the tax and benefits system works in a progressive way to reduce the scale of income inequality.

The gap between lowest and higher income groups can be seen in this chart produced by the UK Statistics Commission:



## Original income and final income by income quintile group for all households, 2008/09, UK



1 Households are ranked throughout by their grossed equivalised disposable incomes.  
Source: Office for National Statistics

Another way of showing this income data is in the table below – this shows the distribution of disposable income by household income quintile. The data is for 2008-09.

	Bottom Fifth	Next Fifth	Middle Fifth	Next Fifth	Top Fifth
% share of disposable income	7	12	16	22	42

### The Poverty Trap

The **poverty trap** affects people living in households on low incomes. It creates a **disincentive to look for work** or work longer hours because of the effects of the income tax and welfare benefits system. For example, a worker might be given the opportunity to earn an extra £60 a week by working ten additional hours. This boost to his/her gross income is reduced by an increase in **income tax and national insurance contributions**. The individual may also lose some **income-related welfare benefits** and the combined effects of this might be to take away over 70% of a rise in income, leaving little in the way of extra net or disposable income.

When one adds in the possible extra costs of more expensive transport charges and the costs of arranging child care, then the disincentive to work may be quite strong.

### Government Policies to Reduce Poverty

Policies to reduce relative poverty normally focus on (a) changes to the tax and benefits system and (b) policies designed to increase employment and reduce unemployment.

When evaluating different policies to reduce poverty consider some of these related issues:

- Cost
- Effectiveness
- Impact on others in the economy



1. **Changes to the tax and benefits system:** For example, increases in higher rates of income tax would make the British tax system more **progressive** and reduce the post-tax incomes of people at the top of the income scale. The risk is that higher rates of taxation may act as a disincentive for people to earn extra income and might damage enterprise and productivity.
2. **A switch towards greater means-tested benefits: Means testing** allows welfare benefits to go to those people and families in greatest need. A means-test involves a check on the financial circumstances of the benefit claimant before paying any benefit out. This would help the welfare system to **target help** for those households on the lowest incomes. However means tested benefits are often unpopular with the recipients.
3. **Linking the state retirement pension to average earnings rather than prices:** This policy would help to relieve relative poverty among low-income pensioner households. Their pension would rise in line with the growth of average earnings each year
4. **Special employment measures (including New Deal):** Government employment schemes seek to raise employment levels and improve the employment prospects of the long-term unemployed.
5. **Increased spending on education and training:** Unemployment is a cause of poverty and **structural unemployment** makes the problem worse. There are millions of households in the UK where no one in the family is in any kind of work and this increases the risk of poverty.
6. **The National Minimum Wage:** The National Minimum Wage (NMW) was introduced in April 1999. It is a statutory pay floor - employers cannot legally undercut the NMW. Since 1999, the beneficial impact of the minimum wage has been concentrated on the lowest paid workers in service sector jobs where there is little or no trade union protection.

