

Microeconomics, Module 10, “Knowledge and Information”

*Required reading for seventh edition:*

(The attached PDF file has better formatting.)

Updated: November 21, 2007

{The Landsburg textbook is excellent. We say to read certain sections and to skip others. This does not mean that certain sections are better; it means that the homework assignments and exam problems are based on the sections that you must read for this course. Some of the skipped sections are fascinating, but they are not tested.}

Module 10 deals with information and how it affects economic systems and social welfare. This topic was central to the debate between advocates of free markets vs communism. That debate is over: the price system produces more social gains than central planning.

*Jacob:* What happens to economic systems that retain central planning instead of prices?

*Rachel:* Central planning causes the economic system to perform poorly, leading to social failure in authoritarian countries (Soviet Union and Eastern Europe), slow decay in democratic countries (continental Europe), or to economic changes (mainland China).

Information affects free markets many ways. This module focuses on topics highly relevant to actuaries: professional education, adverse selection, morale hazard, and the principal-agent problem.

Skip section 9.1. Landsburg reviews the benefits of the free market price system. This is an important subject, but there is more important material in this textbook. Candidates may want to read pages 300-301 on a military draft (a fascinating section), though this will not be tested on the final exam.

Skip section 9.2. Financial markets are covered in the Brealey and Myers text (corporate finance); there is no need to cover the same material in the microeconomics course.

Read section 9.3. Read the section on “signaling: should colleges be outlawed?” Some readers infer that Landsburg thinks colleges don’t teach anything useful. That’s not correct; Landsburg says that *even if* colleges didn’t teach anything useful, the signals they provide make it worthwhile for students to get a college degree.

The same reasoning applies to the actuarial syllabus. Actuarial education serves a more focused business purpose than most college courses; it has greater business value than many liberal arts courses. Landsburg would add that *even if* the actuarial exams didn’t teach much, they are valuable because of the signal that an FSA or FCAS designation sends to employers.

*Jacob:* Liberal arts courses may not have much business purpose, but they are valuable.

*Rachel:* They may be good, interesting, and existentially worthwhile. A senior thesis on English poetry may be an enjoyable experience. Landsburg examines *why employers should care* that a student has a BA cum laude with a major in English poetry. He argues that the knowledge itself is *no value to the employer*, but the signal is important.

*Jacob:* In many foreign countries, college courses have direct application to business and future employment. This is true in much of the developing world, such as in India, China, Israel, and in most of Asia.

*Rachel:* Landsburg's discussion applies to the U.S. educational system. Since education in the U.S. serves more as a signal than as useful knowledge in its own right, the U.S. educational system is falling steadily behind that in other countries, especially in Asia.

Read the short section on "dressing for success" on page 312. Many employees of insurance companies wonder why we dress up in white shirts, ties, skirts, and suits.

*Jacob:* Does the same logic apply to Mormon Missionaries and other groups who wear white shirts and ties?

*Rachel:* Landsburg would apply similar reasoning, looking for the signal sent by the dress code. You can post your perspective on the discussion board regarding why different groups dress different way, in each case looking for the economic or social signal. You may be surprised at the different views of other candidates.

Skip the sections on "signaling in the animal kingdom" on pages 298-299 and "the supply of jokes" on page 299. These are nice tidbits to read, but the final exam does not test this material.

Read the section on "adverse selection and the market for lemons" on pages 313-314. This is an excellent example of adverse selection, which occurs when buyers and sellers have different information.

Read the section on "adverse selection and insurance markets" on pages 299-301. We compare life insurance, health insurance, and auto insurance in the illustrative test questions to see where adverse selection is a serious problem.

Read the section on "moral hazard" on pages 301-302. Insurance underwriters call this morale hazard (see the definition on the side of page 301); to underwriters, moral hazard is the attempt to defraud the insurer.) We compare life, health, and auto insurance in the illustrative test questions to see where morale hazard is a serious problem.

Read the section on principal-agent problems on pages 302-303, skip the section on efficiency wages (pages 303-304), and read the sections on executive compensation (pages 304-305) and unemployment (page 305-307). Landsburg's perspective is the same as that of Brealey and Myers for principal-agent problems and the same as Barro's for

unemployment; all three on-line courses have the same themes. For unemployment, both Barro and Landsburg do not believe that labor supply is any different from other economic goods. Unemployment occurs when workers do not want jobs at the prevailing market wage; it is voluntary, though it is exacerbated by social programs like high unemployment benefits that raise the wage needed to induce workers to take jobs.

*Jacob:* President Fox of Mexico recently said that Mexican workers are willing to do jobs that U.S. workers are not willing to do. He was condemned for his remarks by a wide range of U.S. politicians. U.S. workers avoid certain jobs because they do not pay a living wage, not because U.S. workers dislike hard work.

*Rachel:* This subject is controversial; we are not defending or criticizing Barro-Landsburg. Landsburg and Barro would say that the living wage issue is obfuscation. The economics courses have the Landsburg-Barro perspective, which is the dominant economic view. Fox was criticized by a wide range of liberal U.S. politicians, not by economists or politicians in developing countries.