

Microeconomics, Module 10, "Knowledge and Information"

Micro mod 10: Readings for ninth edition

(The attached PDF file has better formatting.)

{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 skipped sections are fascinating but 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.

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

Answer: 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).

Question: Might we conclude that democracy performs better than other political systems?

Answer: Economist once believed so. Now it seems that democracy helps the economy up to a point; too much democracy can hinder economic growth. Asian countries with moderate democracy (Taiwan, Hong Kong, South Korea) or with limited economic choices but no political democracy (Singapore, Hong Kong, Vietnam) may do better than western European countries with full democracy (France, Spain, Greece, Ireland, Britain, Portugal). This is a fascinating topic, which Barro (macroeconomics course) discusses in more detail. We don't really know what causes countries to prosper. Twenty years ago, people viewed Japan as the emerging economic giant; now some people see mainland China similarly.

Information affects free markets many ways. This module focuses on topics 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 287-291 on a military draft (a fascinating section), though this will not be tested on the final exam. Most U.S. candidates taking VEE exams were born after the draft ended. Landsburg wrote the first edition of his textbook when the Vietnam war and the military draft were burning issues for his students.

Read section 9.2, "Asymmetric information." Most candidates find this section particularly interesting. The subsection on "signaling: should colleges be outlawed?" is eye-opening. 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. If you major in mathematics, actuarial science, computer science, or statistics, you learn much to prepare you for careers. But even if you major in art history or French drama or Greek/Latin, your BA degree has value as a signal.

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.

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

Answer: They may be interesting and existentially worthwhile. A senior thesis on 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.

Question: 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.

Answer: 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.

The sub-section on *dressing for success* on page 295 helps explain corporate etiquette. Many young actuaries wonder why we dress in white shirts, ties, skirts, suits, and high heels.

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

Answer: 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.

Read the section on "adverse selection and the market for lemons" on pages 296-297. This is an excellent example of adverse selection, which occurs when buyers and sellers have different information.

The sections from this chapter up to now are not much asked on the final exam. You are not tested on the reasons for wearing high heels or ties. But the following sections are tested.

Read the sub-sections beginning with "adverse selection and insurance markets" on page 297 to the end of this section on page 304. We compare life insurance, health insurance, and auto insurance to see where adverse selection is a serious problem. Know Landsburg's comments on moral hazard, principal agent problem, executive compensation, unemployment, and the financial crisis of 2008-2009.

Landsburg uses the term "moral hazard"; insurance underwriters call this morale hazard. To underwriters, moral hazard is the attempt to defraud the insurer. The final exam calls this morale hazard, following the usage in the insurance industry.

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. Barro and Landsburg believe that labor supply is similar to other economic goods. Unemployment occurs when workers do not want jobs at the prevailing market wage; it is voluntary, though it is raised by social programs like high unemployment benefits that raise the wage needed to induce workers to take jobs.

Skip section 9.3 on financial markets. Financial markets are covered in the Brealey and Myers text (corporate finance); there is no need to cover this material in the microeconomics course.

Many sections in this chapter are sensitive political issues. When the president of Mexico said that Mexican workers are willing to do jobs that U.S. workers are not willing to do, he was condemned 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. Landsburg and Barro say that the living wage issue is obfuscation. The economics courses help you disentangle the political talk from economic facts.

Read the summary at the end of this chapter.

Review question 14 on page 311 (Landsburg's perspective on the value of a college degree).

Review questions 16, 18, and 20 on pages 311-312, which apply the concepts to insurers. In 1988, four states prohibited insurers from testing life insurance applicants for HIV. This was political correctness run amok, and the four states soon revoked these laws.