

Chapter 22 - Section 1 & 3

Asymmetric info - moral hazard (MH)  
- adverse selection (AS)

MH → unobservable action  
- imposes cost on other party → e.g. taking care to avoid loss when insured

- impose co-pay - deductibles

AS - unobservable characteristic

- screen - requires signal (costly to send)

contract → principal  
agent does action

- employment contract → process  
stipulated

agency contract → objective stipulated  
not method  
(unobservable)

real estate  
lawyer  
booking agent } commission - incentive  
due diligence

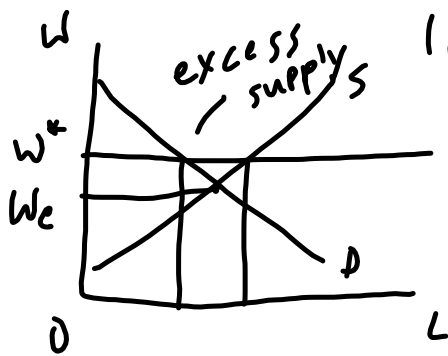
Wells Fargo - incentive to create  
accounts - bonus  
- fake accounts - real customers  
5300 employees fired.  
Exec \$125 million

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Enron  
Countrywide  
Volkswagen

Unobservable actions in  
workforce -  
probability of detection  $< 1$   
some shirking undetected.

"efficiency wage"  
pay more than market  
if lose job (fire) alternative wage  
is much lower  
- buying effort, honesty,



loyalty  
w\* - efficiency wage

Bond to ensures performance  
forfeit bond.

Standard on 321.

"Bond" → paying motel rooms  
for lease holders

Bond less than cost of completion

Reputation effect → loss of future sales

↳ Brand name - bond (cost to  
establish.)

forfeit bond → lose brand  
value

### Section 3 → Behavioral Economics

- decisions in different situations
- seemingly irrational behavior  
fail to respond to incentives

smoke  
drink alcohol  
fail to exercise  
text while driving

- time inconsistency - present bias
  - saving rates too low
  - eat/drink too much

- rewards in future  
discount future payoffs
- Cass Sunstein - Nudge
  - how many times per year  
could eat this without  
harm
  - "100 year flood"  $p = 0.01$

into programs  
fine tune taxes } incentives