



# Public governance of information asymmetries—The gap between reality and economic theory

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## ABSTRACT

There are numerous situations where governments take action due to systematic information asymmetries in society, while economics textbooks do not offer an integrated theory to justify these interventions in terms of utility. This paper starts with a taxonomy of situations where governments try to correct for information asymmetries. A distinction is made between government interventions due to information asymmetries between market partners, within political markets and between the government and citizens. It is then shown that Public Choice Theory offers only few and Public Finance Theory not enough explanations for the prevalence of such government interventions. Further explanations for government actions are given by Institutional Economics and Cultural and Behavioural Economics. The latter will probably generate the best progress towards creating better explanations.

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## 1. Introduction

In social sciences, some circumstances create a broad consensus for government intervention within market economies. Among them are the provision of public goods (Samuelson, 1954, 1955) and the internalisation of externalities (Ayres and Kneese, 1969). However, there are a lot of cases where the state usually intervenes and where no consensus exists among social scientists as to how a normative judgement of this intervention could look. Among the government interventions that do not lend themselves to the standard economic explanations like the public good character, many state interventions have to do with information asymmetries.

Information has both private and public good characteristics (Mackaay, 1990), but certainly defines a distinct category of “goods” (Schiller, 1997). Indeed, information asymmetries have been tried before as a source of justification for government intervention. Musgrave (1959) and some others (Head, 1966, 1969; Folkers, 1974; Ver Eecke, 1998) tried to establish the concept of “merit goods” which, from the prevalence of information asymmetries, derived the need to act publicly. Their arguments, however, never found broad acceptance. This scepticism was mainly due to the fact that the definition of merit goods was weak both on descriptive and normative grounds. There was neither an explicit ethical basis (like

utilitarianism) for the concept, nor a sufficient definition of how merit goods could be identified.

Perhaps welfare economics does not yet have the tools to derive welfare losses from uncured information asymmetries. However, Stiglitz (2002) notes that “some of the huge mistakes which have been made in policy in the last decade (...) might have been avoided if there had been a better understanding of issues (...) to which the new information economics called attention.” This can also be put the other way round: if the real world is full of cases where prevailing information asymmetries lead to government interventions, then modest progress would be to create a taxonomy that shows which type of asymmetries would typically lead to which kind of government intervention. This attempt will be made in the following section. Section 3 then looks for existing explanations from economic theory for this type of government intervention. This should then support the basic hypothesis of this paper that there is still a large gap between the reality of government intervention in cases of information asymmetries and scholarly economic thinking. Section 4 summarizes and gives an outlook on the prospects of a normative theory of information asymmetries.

## 2. Taxonomy

A first important line, as depicted in the summarizing Fig. 1, has to be drawn between information asymmetries that exist between citizens and the government on the one hand and information asymmetries between the market partners themselves on the

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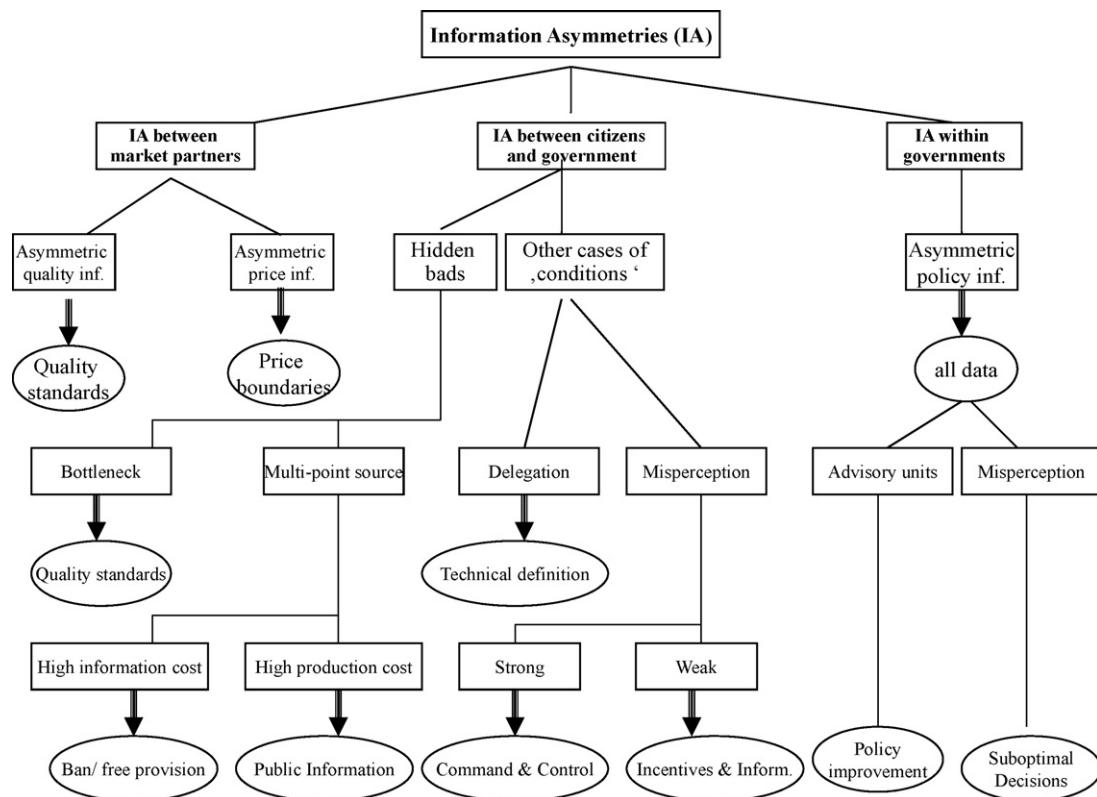


Fig. 1. A taxonomy on government interventions in cases of asymmetric information.

other. In the former case, the government is responsible for directing citizens towards more rational choices, while in the latter case the government may want to ensure more equal conditions for contracts. A third category of information asymmetries exists in political markets.

### 2.1. Asymmetries between market partners

In many cases, the relation between producers and consumers resembles the classic principal-agent relation in economic theory (Grossmann and Hart, 1983). A nail producer usually knows in far greater detail about prices, qualities and other market attributes of nails than a consumer who buys nails once a year. More often than not, these asymmetries are perceived as mainly harmless. In some cases, consumers find ways to protect themselves against damage from information asymmetries, as described in the seminal piece by Akerlof (1970), through institutional choices. In other cases, the invisible hand appears to work less well: Mocan (2007), for example, describes how information asymmetries between child care providers and customers result in a low average quality.

This leads to the possibility of minimum quality standards being laid down by the government. There is a broad academic literature about this issue, with mixed results. Depending strongly on assumptions, government minimum quality standards are shown to lead to welfare losses (Maxwell, 1998; Valletti, 2000) or to welfare gains (Gehrig and Jost, 1995; Currie and Hotz, 2003). For a taxonomy, we do not need to decide between the results but just to note that there are a lot of cases in real life where governments impose minimum quality criteria. Private schools are a case in point. There are a few countries where private schools do not have to meet certain minimum quality criteria (Walford, 2001; Tooley and Dixon, 2005; Batley, 2006). Investment in school education has some peculiarities that may contribute to explaining the high prevalence of minimum quality standards: those who decide do not

usually test the product quality themselves, but do so only through their children; the quality of the product is often only visible after a considerable time period; changes between schools are usually costly in terms of time and money. And society's harm from bad quality of education may be considerable.

For schooling, price levels can much more easily be compared than quality. For other products, this is radically different. While the price of schools is usually publicly available, there are other assets the price of which is known only to two persons. One typical example would be farmland. While everybody familiar with agriculture can roughly judge the quality of farmland, even agricultural economists know only little about its rental and sale price levels. For this case, some governments have chosen to impose price restrictions. The French government, for example, defines a price range for leasing contracts of farmland which is regionally derived from the general price level and from the soil yield capacity (Mann, 2005). Similarly, in Switzerland lease prices for land may not exceed a certain level which is dependent on yield capacity only (Giuliani, 2002). In Japan, lessor and lessee can ask the court to determine a 'fair and reasonable rent' (Noguchi, 1994).

In a lot of other economic sectors in many countries, governments impose fee schedules. It is surprising indeed that economists have devoted very little attention to an instrument that determines a large share of prices for medical services on most continents. In Europe, prices for legal services and to some extent for the work of architects or planners are often steered by fee schedules as well.<sup>1</sup>

<sup>1</sup> The intention of fee schedules for doctors, veterinarians and lawyers is to ensure a certain quality in a certain price range. In other words, the state tries to minimize costs by avoiding negotiations for every single service or administration act. Fee schedules for monetary fines may also guarantee the equality of citizens by using "inexpensive" ways. And from a more normative perspective, the rationale of fee schedules can also be found in the necessity for a strong state (see Chapter 3.4, p. 10).

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