1.25 Asymmetric Information, Merit Goods and Demerit Goods: 10-minute Pack

Total Marks

AQA 7136 · Calculators not allowed · about 10 minutes

Name: _____ Date: ____ / ____ / _____

Answer all questions. Full sentences are required for questions worth 4 marks or more. Time guidance: 10 minutes total.

1 Define asymmetric information as it applies to markets for goods and services, naming which party typically has more information.

(Total for Question 1 is 2 marks)

2 Define adverse selection in the context of insurance markets and give the key causal mechanism in one sentence.

(Total for Question 2 is 2 marks)

3 Define moral hazard in financial or insurance markets and give a brief example involving car insurance.

(Total for Question 3 is 2 marks)

4 Define a merit good and explain in one line why markets may under-consume it, using education as the example.

(Total for Question 4 is 2 marks)

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Mark scheme · 1.25 Asymmetric Information, Merit Goods and Demerit Goods: 10-minute Pack

Question 1

a situation where one party to a transaction has more or better information than the other party **B1**

typically sellers have more information about product quality, or buyers about their own risk, depending on the market **B1**

Answer: Asymmetric information is where one side of a market transaction has better information than the other; for example sellers often know more about product quality than buyers.

Question 2

adverse selection occurs when higher risk individuals are more likely to buy insurance than lower risk individuals **B1**

the causal mechanism is that insurers cannot perfectly observe buyers' risk before the contract, so premiums rise and low-risk buyers withdraw **B1**

Answer: Adverse selection is when higher-risk individuals are more likely to purchase insurance because insurers cannot identify risk perfectly, which can raise premiums and drive out low-risk customers.

Question 3

moral hazard is when a person changes behaviour after obtaining insurance or a contract because they no longer bear the full cost of risky actions **B1**

example: a driver with comprehensive car insurance driving less carefully because repairs are covered **B1**

Answer: Moral hazard is when insured individuals take greater risks because they are protected from the full cost; for example, a driver may be less careful after buying comprehensive car insurance.

Question 4

a merit good is one that has greater long-term private and social benefits than consumers recognise **B1**

markets under-consume education because individuals may underestimate future benefits or face liquidity constraints, so private demand is below the socially desirable level **B1**

Answer: A merit good yields greater private and social benefits than consumers appreciate; for example education is under-consumed because people may undervalue long-term returns or lack funds to invest.

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