1.25 Asymmetric Information, Merit Goods and Demerit Goods: 30-minute Pack

Total Marks

AQA 7136 · Calculators not allowed · about 30 minutes

Name: _____ Date: ____ / ____ / _____

Answer all questions. Full sentences are required for questions worth 4 marks or more. Time guidance: 30 minutes total.

1 Define a demerit good and give one reason why it might be over-consumed, with tobacco as an example.

(Total for Question 1 is 2 marks)

2 State two government policy instruments that could be used to correct under-consumption of a merit good such as vaccination, naming each instrument.

(Total for Question 2 is 2 marks)

3 Explain why imperfect information might lead to the overconsumption of a demerit good such as gambling. Give two separate reasons and one brief evaluative comment.

(Total for Question 3 is 3 marks)

© Revision Library | revisionlibrary.co.uk

4 Distinguish between the private benefits and the social benefits of education, and give one numerical or qualitative example to illustrate the difference.

(Total for Question 4 is 3 marks)

5 Explain, in two separate points, how adverse selection and moral hazard differ as forms of information failure, using insurance markets as the context.

(Total for Question 5 is 3 marks)

6 Explain with an example how signalling can reduce adverse selection in a market, for instance how degree certificates signal ability in the graduate labour market.

(Total for Question 6 is 2 marks)

7 Explain how screening by insurers can reduce adverse selection, using the example of health questionnaires or medical checks before offering cover.

(Total for Question 7 is 2 marks)

© Revision Library | revisionlibrary.co.uk

Mark scheme · 1.25 Asymmetric Information, Merit Goods and Demerit Goods: 30-minute Pack

Question 1

a demerit good is consumed more than is socially desirable because consumers under-estimate its private costs or ignore negative externalities **B1**

example: tobacco may be over-consumed because consumers under-estimate health risks or suffer addiction, reducing rational decision-making **B1**

Answer: A demerit good is over-consumed because people under-estimate private costs or ignore harms; tobacco is over-consumed since users may underestimate health risks or be addicted.

Question 2

subsidies to reduce the private price, increasing consumption **B1**

information campaigns or mandatory vaccination policies to increase private perceived benefits or uptake **B1**

Answer: Examples: subsidies to lower cost; information campaigns or mandates to raise uptake.

Question 3

consumers may under-estimate private costs or over-estimate private benefits because of imperfect information, for example overestimating the chance of winning in gambling **M1**

this leads to higher private demand than if probabilities and long-term losses were fully understood, causing overconsumption relative to the social optimum **A1**

evaluation: addiction and behavioural biases reduce the effectiveness of information alone, so information campaigns may be insufficient without complementary policies **A1**

Answer: Imperfect information, such as overestimating winning odds, raises private demand for gambling above the socially desirable level; however, addiction and biases mean information alone may not correct overconsumption.

Question 4

private benefits are gains accruing to the individual, such as higher wages or better job prospects **B1**

social benefits include wider gains to society, e.g. higher productivity, lower crime, and positive externalities from a more skilled workforce **B1**

example: an individual may gain a 20% higher lifetime income from a degree (private benefit), while society benefits from higher tax revenues and reduced unemployment (social benefits) **B1**

Answer: Private benefits are the individual's higher earnings and opportunities; social benefits include wider productivity and social gains. For instance, a graduate may earn 20% more (private gain), while society gains higher tax receipts and lower crime rates (social gains).

Question 5

adverse selection occurs BEFORE a transaction, when hidden characteristics lead to a disproportionate number of high-risk buyers or low-quality goods entering the market **B1**

moral hazard occurs AFTER a transaction, when the insured or contracted party changes behaviour because they no longer face the full consequences of risk **B1**

adverse selection is about hidden information about inherent characteristics, moral hazard is about hidden actions or behaviour once a contract is in force **B1**

Answer: Adverse selection occurs before a contract, when those with hidden high risk are more likely to buy insurance; moral hazard occurs after a contract, when insured people take more risks because they do not bear full costs. The former is hidden characteristics, the latter hidden actions.

Question 6

signalling is an action by the informed party to reveal private information, e.g. obtaining a degree signals higher ability or productivity **B1**

this reduces adverse selection because employers use the signal to differentiate higher-ability candidates from lower-ability ones, improving the match in the market **B1**

Answer: A degree acts as a signal of ability that helps employers distinguish higher-productivity graduates, reducing adverse selection by revealing private information.

Question 7

screening is where the uninformed party takes actions to elicit information, e.g. insurers require health questionnaires or medical checks **B1**

this reduces adverse selection because insurers can better price risk or refuse very high risks, improving the risk pool and preventing premiums from rising excessively **B1**

Answer: Insurers screen applicants with questionnaires or checks to reveal risk characteristics, enabling better pricing or exclusion and so reducing adverse selection.

© Revision Library | revisionlibrary.co.uk