

## Chapter 3

# Information Asymmetry

### ABSTRACT

*The chapter discusses “information asymmetry” as the critically important phenomenon for the very existence of communication. Information asymmetry is the reason the parties need to communicate to allow acquiring needed information and reducing the uncertainty in making decisions, But, from the other side extends the competences as the factor causing misinforming. The chapter presents misinforming hazards by adding the issue of asymmetric competence and double-sided asymmetry. Information asymmetry is a necessary condition for communication, but also is a factor that may cause misunderstanding.*

### INTRODUCTION

Failures in correct adoption of meaning provided via communication are caused by the phenomenon known as “information asymmetry”. Information asymmetry is a natural reason justifying the need to acquire information from outside – via communication in a way to solve the given problem. One of the parties has information or knowledge of what the other party needs but does not possess. From other side, asymmetrical information, asymmetrical background, or asymmetrical view on the problem is necessary but also is the nutrition for the risk of misunderstanding.

The informational misbalance in the area of business was described for the first time by Kenneth J. Arrow (1963), who introduces it as “moral hazard” related to the medical industry. Later, George Akerlof (1970) used the term asymmetric information, noticing that in a market with asymmetrical information the average value of the commodity tends to go down, even for commodities with a perfect quality. Moreover, it is possible for such a market to decay to the point of nonexistence. Because of

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information asymmetry, unscrupulous sellers can embellish the items and defraud the buyer. As a result, many buyers with a risk-averse attitude will avoid certain types of purchases or will not be willing to spend much on a given item. On the other side those who obtained the product experience unsatisfaction.

The chapter uses ideas originated in Christozov D. and Mateev P. (2005) and Christozov D., Chukova S. and Mateev P. (2006). A more complete explanation was published in Christozov D., Chukova S. and Mateev P. (2009). The approach of quantifying the information asymmetry is explored in Part 2 of the book and developed in chapter 2.1. as the difference between actual and assumed properties of a product.

The chapter is organized into the following two sections. The first one is used for defining information asymmetry, followed by the section defining this phenomenon in the context of misinforming hazards by using a simple communication process.

## **DEFINITION OF INFORMATION ASYMMETRY**

Information asymmetry occurs when one party in a communication transaction has more or better information than the other party. The term originates in economics, addressing commercial transactions, and its impact on markets. The case was called asymmetrical information and related markets are called markets with asymmetrical information. Typically, it is the seller that knows more about the product than the buyer, however, it is possible for the reverse to be true – for the buyer to be better informed compared to the seller.

Examples, where the seller usually has better information than the buyer are numerous and include used-car salespersons, stockbrokers, real estate, and life insurance. On the other hand, there are situations where the buyer is usually better informed than the seller, e.g., in buying property insurance, when a buyer purchases insurance for a property with hidden problems.

The aim of a communication process is to allow one party – the receiver – to obtain information this party needs to solve a problem, or to reduce her/his uncertainty in making a decision regarding how to solve the problem. The other party – the sender – possesses information which may help the receiver in decreasing this uncertainty, or to become informed. Communication is meaningful if the receiver does not possess the information the sender has. Or this is the case when the information asymmetry as the necessary condition for communication exists. This is natural to any meaningful informing process – the sender provides information which the receiver doesn't have but expects and assumes that it is needed and useful to solve her or his problem.

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