

8.5 Signalling: Using an Informational Advantage

Or: why does a con-man such as used-car-dealer Arfur Daley (in the TV series *Minder*) drive a Jag?

Consider the red stag's antlers, almost useless in fighting.

A biological signal such as a pair of antlers actually must have a “cost”, or deleterious effect on viability, if it is to be taken seriously (by other stags).

Furthermore, the cost must be one that stronger stags can pay more easily than their weaker brethren.

The cost or handicap is a guarantee of the honesty of the display.

If there were no cost, then there would be rampant cheating, and observers would quickly learn to ignore the false advertising.

Evolution produces cumbersome antlers because conveying an unmistakable message about one's superior constitution more than compensates for the aggravation, or cost.

Credibility?

If you have an incentive to exaggerate your own worth, how can you *credibly* convey this private information?

- An independent third party?
If the information is truly private, this option may be unavailable.
- A reputation for honesty?
A valuable asset, and recognised as such. But without the visibility or longevity in the market to develop such a reputation, unavailable.
- How else?

What if there is some action — *a signal* — that is costly to take and which is visible to the opponent, which is more costly if lying than if telling the truth. Then the opponent might see the action and infer truth telling.

Signals

Signals are a form of *credible communication*: putting one's money where one's mouth is; one's actions speak louder than words. Talk is cheap ...¹ Clichés.

e.g. The job seeker. Private information: you could do the job well if hired.

Sufficient to tell the employer? Credentials as a signal, if harder to get for an incompetent worker than for a competent worker.

e.g. The would-be borrower. Private information: you intend to repay the loan.

Sufficient to tell the bank? A good credit record as a signal.

When signalling cannot occur — when information cannot be credibly communicated — markets don't function well, and inefficiencies occur.

Signalling is not necessarily cost-effective.

Nor does the existence of a signalling method ensure that signalling occurs: a market equilibrium may occur in which no-one succeeds in signalling, or some, but not others, may be able to signal.

1. because supply exceeds demand.

8.6 The Market for “Lemons”

Previously, uncertainty in Burt the buyer’s valuation. Now, *uncertain quality*, unobservable by Burt the buyer.

What is the effect on bargaining between Sally the seller and Burt the buyer?

- Market for used cars.
- Two qualities: high quality and “lemons”.²
- Sally knows the quality,
- but Burt doesn’t before buying, although Burt does know the proportion of lemons.

2. George Akerlof won the 2001 Nobel prize in Economics for his work on markets with asymmetric information.

Adverse selection

- The risk of buying a lemon may deter buyers.
- And the proportion of lemons offered for sale may exceed the proportion in the population if the owners of good cars are deterred from offering them for sale since they command no premium over lemons because buyers cannot distinguish the two qualities.
- Since a good car is worth more to its owner than a lemon, the sale price may be less than the value of not selling the car.
- No good cars will be offered for sale: only lemons will be offered; the price will slump.
- This is an example of *adverse selection*.

Gresham's Law rules

For the second-hand car market to exist, the price of cars must be:

- low enough for buyers to accept the risk of a lemon.
- and high enough to induce owners of good cars to sell.
- Inconsistent?
If the proportion of lemons is high enough, the price will be too low for the owners of good cars to sell, and the market will die, with efficiency losses (potentially gainful trades exist, but cannot occur).
- A Gresham's law of cars: the bad drive out the good.

8.6.1 Example: Second-Hand Car

- 60% of a model lemons, as Burt knows but can't distinguish.
- To Burt,
 - a good car is worth (a maximum of) \$2000,
 - a lemon (a maximum of) \$1000;
- To Sally, (a minimum of) \$1500 and \$500, respectively.
- Sally knows the quality.

What's the price?

- First, there can be only one price since Burt can't distinguish between lemons and good cars.
- Burt ignores Sally's claims of quality, "Well, she would say that, wouldn't she", as Mandy Rice Davies might have said.
- For risk-neutral Burt, pay up to $0.6 \times \$1000 + 0.4 \times \$2000 = \$1400$.
- If the market operates and potential Burts exceed the numbers of cars for sale, then this is the market price.

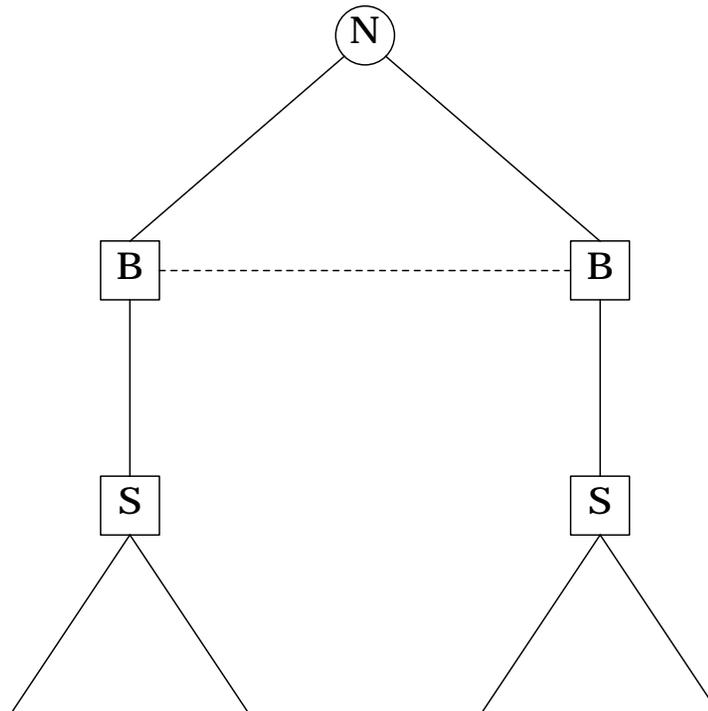
A separating equilibrium

Will the market operate?

Will Sallys be willing to sell at \$1400?

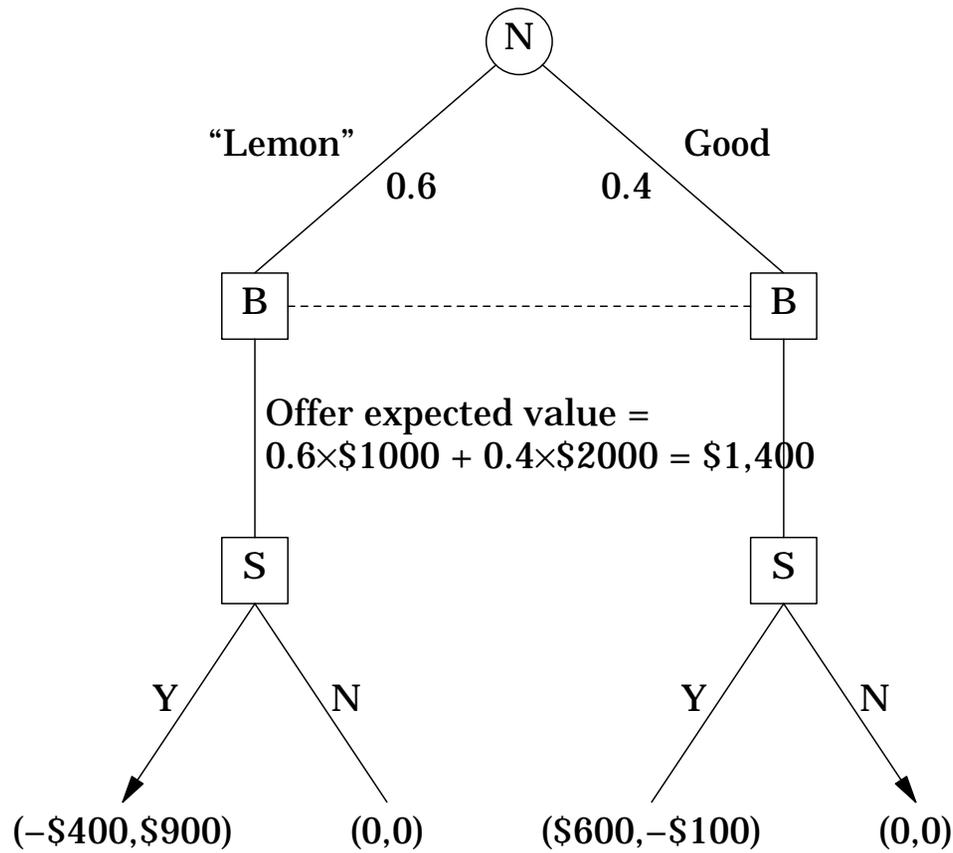
- Certainly the owners of lemons will,
- but what about the owners of good cars?
They won't, since they value good cars at \$1500, and will withhold them.
- But then the proportion of good cars for sale is too low, in consequence.
- The market will not operate, a further inefficiency as a consequence of the privacy of information.
- Potential gains to trade exist (\$2000 to Burt, \$1500 to Sally), but since Burt can't tell good from lemon, then no trade.
- A *separating* equilibrium.

A separating equilibrium game tree



The Market for Lemons with Separating. (B,S)

Insurance markets and private information about health and longevity. Will insurance companies expect a disproportionate number of unhealthy people to be attracted? Consequences? (“Moral hazard.”)



The Market for Lemons with Separating. (B,S)

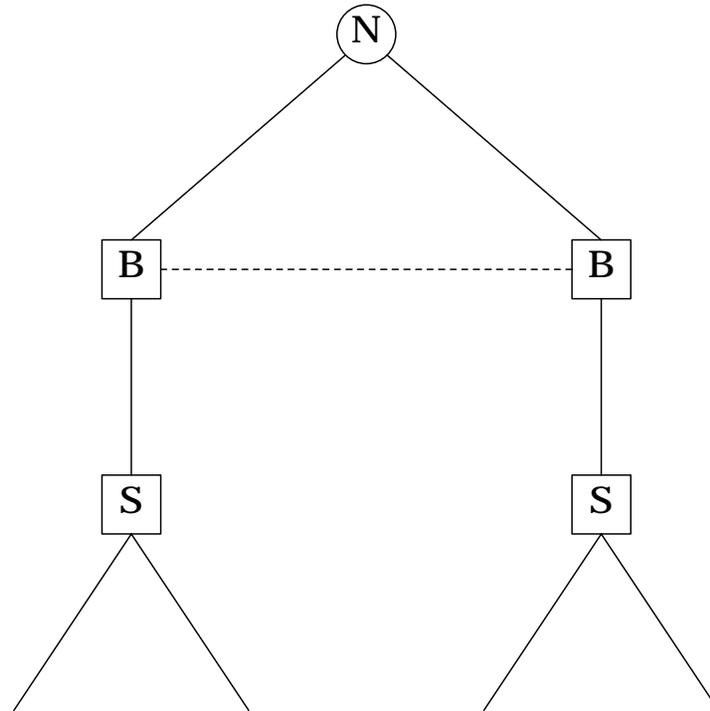
	"Lemon"	Good
Burt	\$1,000	\$2,000
Sally	\$500	\$1,500

A pooling equilibrium

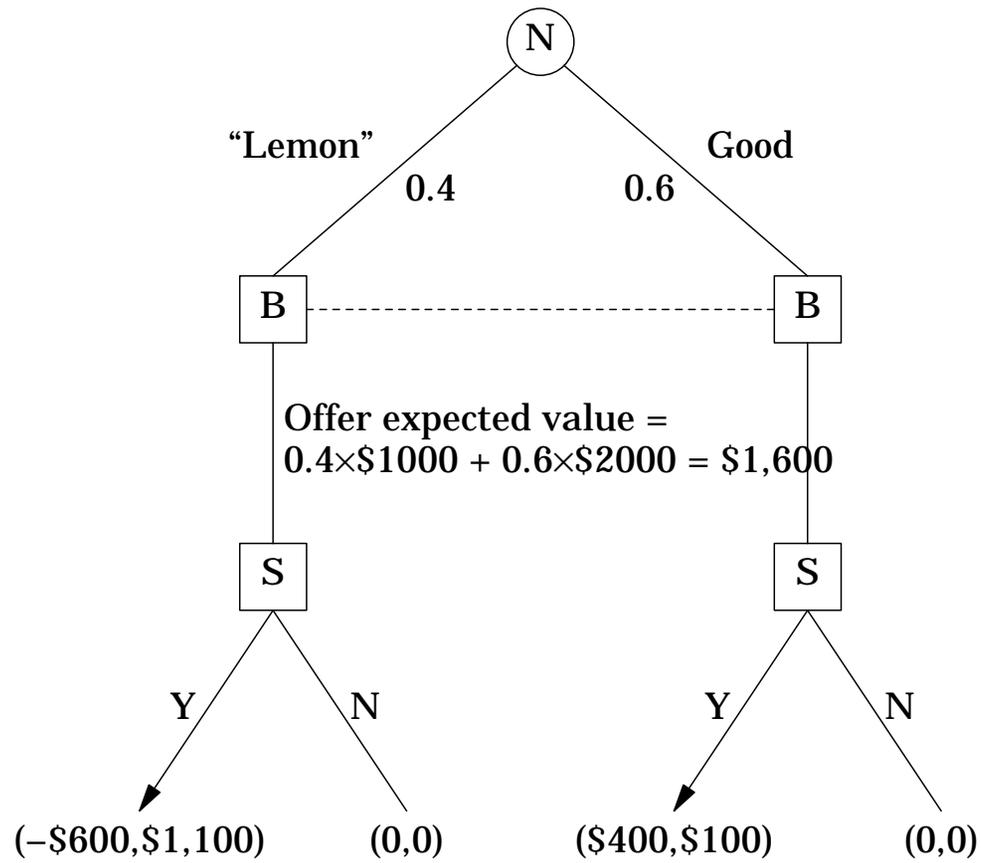
But: Private information not always a problem:

- if the proportion of lemons is 40% and is common knowledge,
- then Burt will pay up to $0.4 \times \$1000 + 0.6 \times \$2000 = \$1600$,
- a price at which Sally selling a good car gets a gain of $\$1600 - \$1500 = \$100$.
- The market will exist, with a price between \$1500 and \$1600, despite the informational asymmetry.
- Although some gain (buyers of good cars) and others lose (sellers of good cars) compared to fully informed trading.

A pooling equilibrium game tree.



The Market for Lemons with Pooling. (B,S)



The Market for Lemons with Pooling. (B,S)

	"Lemon"	Good
Burt	\$1,000	\$2,000
Sally	\$500	\$1,500

Signalling quality

Can sellers signal quality?

Reputation, third-party credentials.

For insurance, medical checks compulsory.

But limited elimination of informational asymmetries.

Credibly?

8.7 Signalling in Markets

*How can Sally signal her good car's quality?*³

A guarantee is more costly for Sally selling a lemon than for selling a good car, and so can signal quality.

Signals can overcome informational frictions, to reduce inefficiencies, but not always, or not always efficiently.

3. Mike Spence, erstwhile dean of the Stanford GSB, won the Nobel prize in Economics in 2001 for his research on signalling.

A worker's quality

Betty wants to hire Wally,

- but can't tell whether Wally is
 - highly productive (HP) or
 - less productive (LP) before hiring him.
- HP workers are worth \$200 to Betty, LP workers are worth \$100.
- Wally knows his worth.
- Competition from other employers forces Betty to pay the full amount of Wally's perceived worth at the time of hiring.
- Wally can choose to receive education before trying for a job, and get a diploma.
- Education has no effect on productivity, but is observed by Betty.
- Assume that schooling costs a LP worker more than an HP worker: \$120 against \$60.
- Can Wally's educational level signal his innate worth?

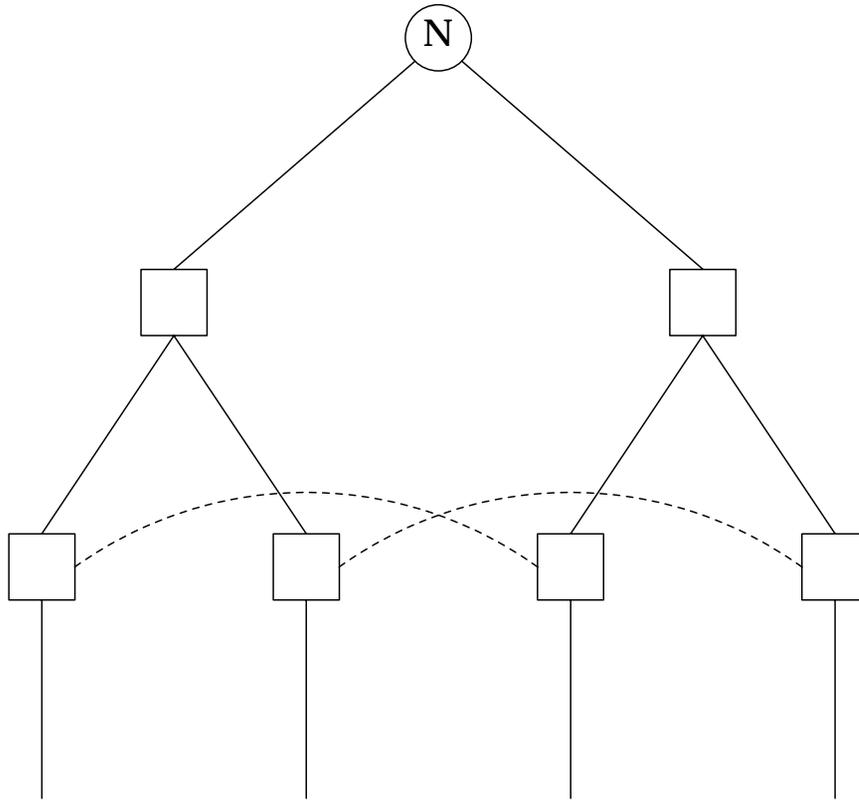
A self-confirming equilibrium:

Wally and Betty begin with beliefs about how to interpret signals, and equilibrium means that, after each acts on his or her beliefs, neither sees anything to indicate the beliefs are mistaken.

(See Bayesian equilibrium, B&F Ch. 13)

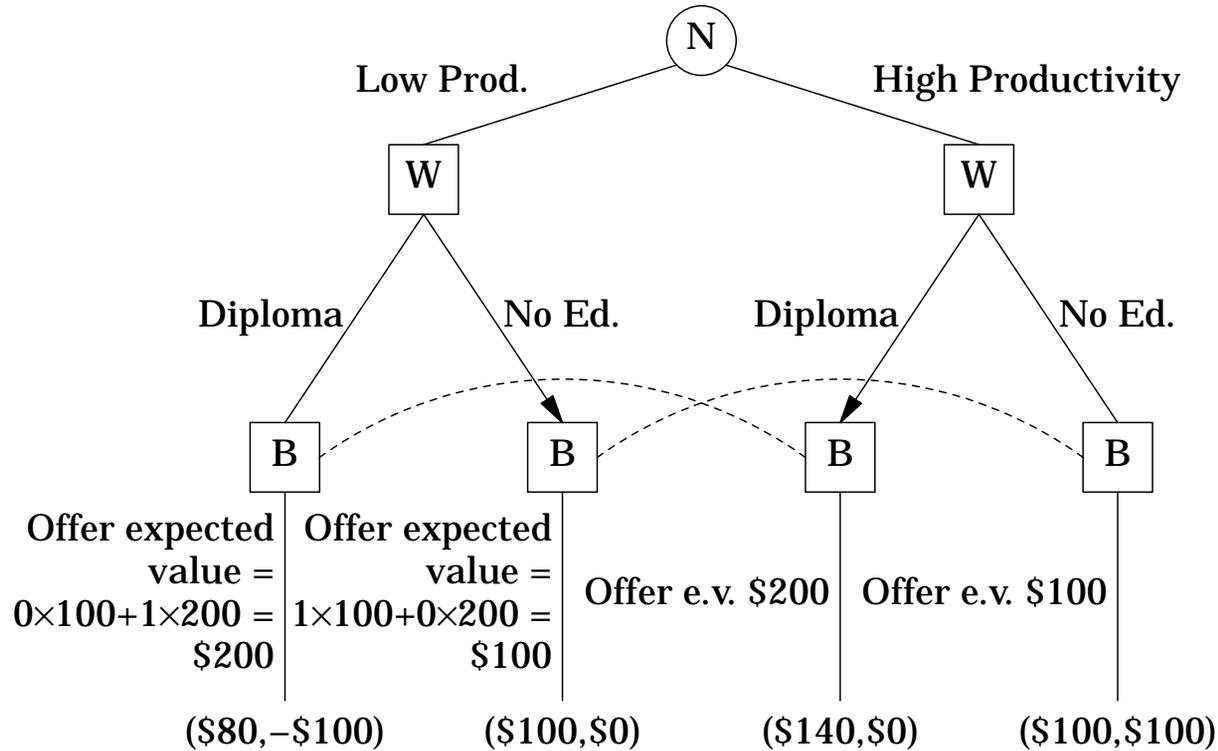
Betty's expectations are crucial.

- If Betty believes that all with the diploma are HP and all without are LP, then she will pay \$200 to graduates and \$100 to others.
- If Wally is HP and a graduate, then he earns net $\$200 - \$60 = \$140$.
- Without the diploma, HP Wally earns net \$100, so education is profitable for HP Wally.
- If Wally is LP and has no diploma, then he earns net \$100; with the diploma LP Wally earns net $\$200 - \$120 = \$80$, so education is unprofitable for LP Wally.



Education as Signalling, with Separating. (W,B)

Betty's expectations are fulfilled, and so are Wally's.
(Bayesian Equilibrium in beliefs.)



Education as Signalling with Separating. (W,B)

	High	Low
Productivity	\$200	\$100
Cost of Diploma	\$60	\$120

Betty's expectations are fulfilled, and so are Wally's.

A separating equilibrium in beliefs

Betty's expectations about education as a signal of productivity (which she learns of after hiring Wally) are confirmed.

Signalling in this example works. The market succeeds in *separating* LP from HP workers, despite the informational asymmetries.

For education to serve as a signal in this example, sufficient that it be

- hard enough to obtain to deter LP Wally,
- but not so hard to deter HP Wally.

How is the credential set?

- By history or custom?
- A social convention about the level of signalling sufficient for credibility.
- Is an M.B.A. a credible signal in Australia in 2003?
Elsewhen?
Elsewhere?

Signalling need not work: ➡ pooling

- Suppose Betty believes that although a diploma implies HP, without a diploma Wally could be HP or LP.
- This can be self-confirming:
suppose there are 40% LP and 60% HP, and Betty knows these proportions.
- Betty's expected worth of Wally is $0.6 \times \$200 + 0.4 \times \$100 = \$160$, which is the wage Betty offers Wally without a diploma.
- Wally with a diploma is paid \$200.

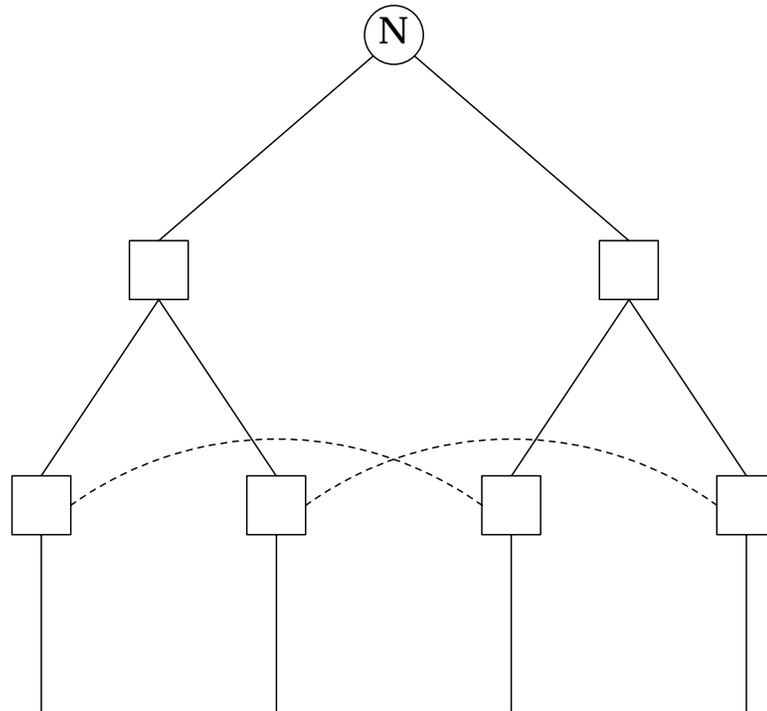
So: will Wally obtain a diploma?

- To HP Wally the value of education is wage minus education costs: $\$200 - \$60 = \$140$, less than Wally could earn without a diploma, so education doesn't pay, even for HP Wally.
- None is educated, and Betty's expectations are confirmed: 40% of the uneducated workers will be LP.

A pooling equilibrium in beliefs

Equilibrium without signalling, even though a signal (education) is available to workers. Signalling cannot be guaranteed to work.

Again, Betty's expectations are crucial.



Education as Signalling, with Pooling. (W,B)
(Bayesian Equilibrium in beliefs)

8.8 “Wasteful” Expenditures as Signals

Generally: expenditures — such as education — that yield no direct benefit in themselves can serve as communication devices, signals. Any observable expenditures that are cheaper for “good” signallers than for “bad” signallers might work.

“Try it, you’ll like it.”

How can you credibly communicate the value of your product (brake linings) to potential customers (car manufactures), when you’re sure that they’ll be satisfied?

Obviously extravagant expenditures may signal (wining & dining, lavish brochures, high-rent address, etc), if the potential buyer knows that you are relying on continued sales to cover these apparently unproductive costs: if your product were of low quality, you couldn’t cover your promotional expenditures.

How costly should signals be?

Diamonds are forever and the game of love?

Signals must be more costly (net of future earnings) for low-quality producers than for high-quality producers.

Wasteful expenditures don't necessarily work as signals: opportunities for signalling don't ensure that signalling actually occurs in the market.

Signalling is pervasive.

By giving a personal guarantee against his private assets, Alan tried to credibly communicate (to signal) that he believed the project wouldn't fail, in order to induce the Bank to lend him more. The bank (or the venture capitalist) might still want to check Alan's judgement, but not — Alan hopes — his sincerity.

Don't eat at a restaurant in Japan with poor-quality plastic models of its meals on display.

Nothing succeeds like the appearance of success.

— Christopher Lasch

8.9 Summary

Negotiation strategies depend on what information is public and what private.

- *Screening*. Strategies to defend yourself against another's informational advantage, against adverse selection (Sally's pricing schedule)
- *Signalling*. Strategies to exploit your own informational advantage (Wally's diploma & Betty)

Signalling is *credible communication* of private information. Signalling must not only cost you to undertake it, but your opponent must understand that your cost is higher if you're misrepresenting yourself than if you're being truthful.

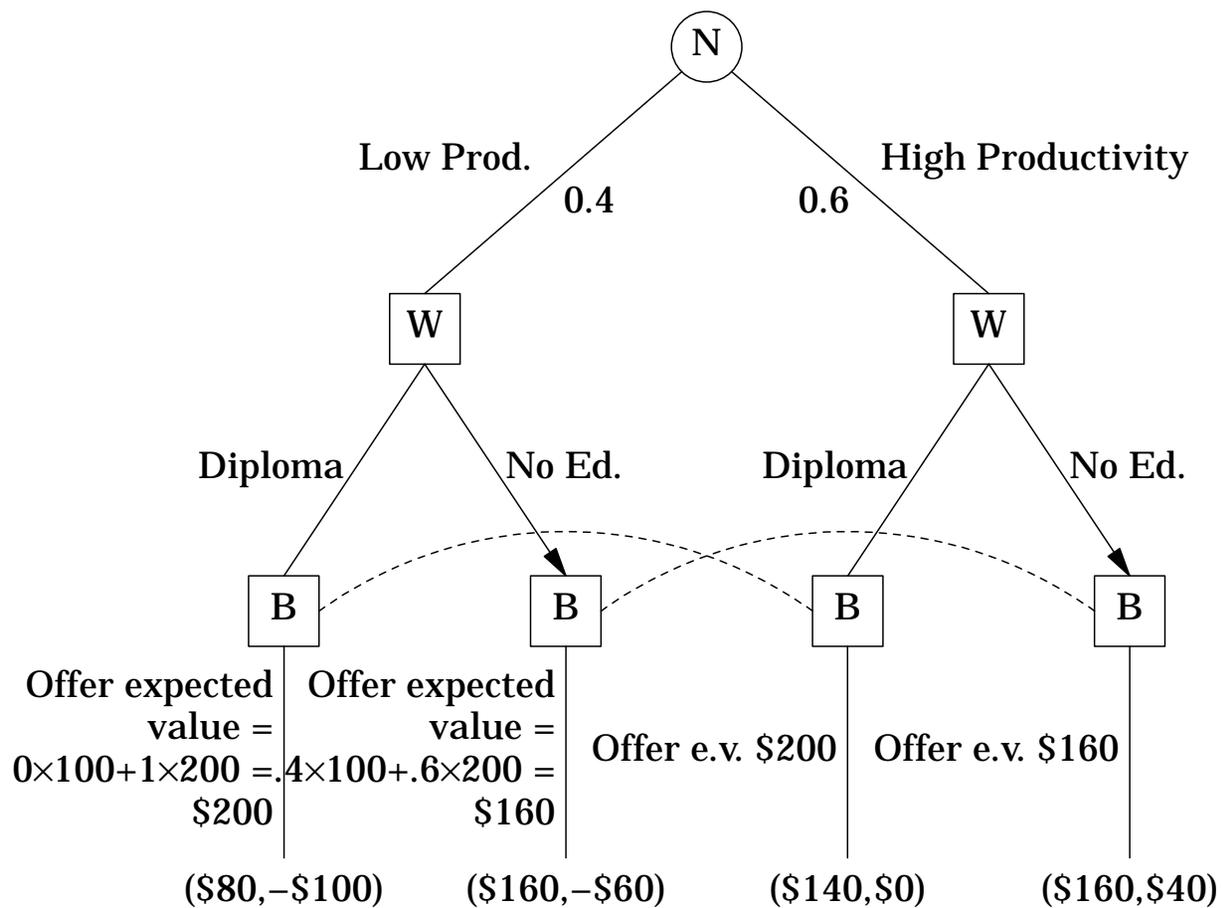
Possible inefficient breakdown

Bargaining under incomplete or asymmetrical information has a PD character: breakdown may occur with its attendant inefficiencies and dead-weight losses. Breakdown doesn't imply irrationality in these circumstances.

You may be able to induce the other party to reveal private information, thus overcoming your informational disadvantage:

- opponent's costs of delay or lack of information over opponent's limits may result in haggling;
- the cost of delay may reveal your opponent's smallest acceptable share of the gains to trade, if you start by demanding a large share.

Another way of reducing your informational handicap is to play one bidder off against another — using competition — to induce them to reveal at least part of what they know, see Bidding In Competition. (Next.)



Education as Signalling with Pooling. (W,B)

	High	Low
Productivity	\$200	\$100
Cost of Diploma	\$60	\$120