

OT

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# 1 The Economic Problem

## 1.1 Setting

A **monopolist** designs a menu of products to sell to a heterogeneous population of consumers.

**Players:**

- **Firm:** Chooses which products to offer and at what prices
- **Consumers:** Each has private willingness-to-pay (WTP) for product attributes
- **Goal:** Maximize profit subject to individual rationality (IR) and incentive compatibility (IC)

**Example:**

- Products: Software bundles with features {basic, analytics, collaboration, API access}
- Consumers: Companies with different valuations for each feature
- Firm must offer a menu (e.g., “Basic \$10”, “Pro \$25”, “Enterprise \$50”) without knowing each consumer’s exact WTP

## 1.2 Mathematical Primitives

### 1.2.1 Consumer Side

**Consumer types:** Each consumer  $i$  is characterized by their WTP vector

$$v_i \in \mathbb{R}^d$$

where  $d$  is the number of attributes (features).

**Interpretation:**  $v_i[j]$  = consumer  $i$ ’s WTP for attribute  $j$

**Population:** We model consumers as draws from a distribution

$$\mu \in \mathcal{P}(\mathbb{R}^d)$$

where  $\mathcal{P}(\mathbb{R}^d)$  is the space of probability measures on  $\mathbb{R}^d$ .

For computation, we observe a finite sample:

$$\{v_1, v_2, \dots, v_N\} \sim \mu$$

### 1.2.2 Product Side

**Bundles:** A product is a vector of attributes

$$b \in \{0, 1\}^d$$

where  $b[j] = 1$  if feature  $j$  is included, 0 otherwise.

**Prices:** Each bundle has a price

$$p \in \mathbb{R}_+$$

**Products in joint space:** A product is the PAIR

$$x = (b, p) \in \{0, 1\}^d \times \mathbb{R}_+$$

### 1.2.3 Menu

A **menu**  $M$  is a finite collection of products:

$$M = \{x_1, x_2, \dots, x_L\} \quad (1)$$

$$= \{(b_1, p_1), (b_2, p_2), \dots, (b_L, p_L)\} \quad (2)$$

where  $L$  is the menu size.

### 1.3 Consumer Preferences

**Utility:** Consumer with type  $v$  derives utility from product  $x = (b, p)$ :

$$u(v, x) = v \cdot b - p$$

This is **quasilinear utility**:

- Positive component:  $v \cdot b$  (value from features)
- Negative component:  $p$  (cost of purchase)

**Outside option:** Consumers can choose not to buy, giving utility 0.

**Choice:** Faced with menu  $M$ , consumer  $v$  chooses:

$$x^*(v) = \operatorname{argmax}_{x \in M \cup \{\emptyset\}} u(v, x)$$

where  $\emptyset$  denotes the outside option with  $u(v, \emptyset) = 0$ .

### 1.4 Firm's Problem

**Cost function:** Producing bundle  $b$  costs

$$C(b) = c_1 \cdot |b| + c_2 \cdot |b|^\alpha$$

where  $|b|$  = number of features in bundle (typically  $\alpha \geq 1$  for convex costs).

**Profit:** If consumer  $v$  chooses product  $x = (b, p)$ , firm earns

$$\pi(v, x) = \begin{cases} p - C(b) & \text{if } u(v, x) \geq 0 \\ 0 & \text{otherwise} \end{cases}$$

**Total profit:** Expected profit over consumer distribution  $\mu$ :

$$\Pi(M) = \int \pi(v, x^*(v)) d\mu(v)$$

**Firm's problem:**

$$\max_M \Pi(M) \quad (3)$$

$$\text{subject to: IC: } x^*(v) = \operatorname{argmax}_{x \in M} u(v, x) \quad \forall v \text{ (incentive compatibility)} \quad (4)$$

$$\text{IR: } u(v, x^*(v)) \geq 0 \quad \forall v \text{ (individual rationality)} \quad (5)$$

## 2 Optimal Transport Formulation

### 2.1 Why This Is Optimal Transport

The key insight is that the firm's problem is equivalent to **choosing a discrete target measure** in the joint  $(b, p)$  space.

**Source measure:** Consumer types distributed according to  $\mu$

**Target measure:** Menu represented as

$$\nu = \sum_{m=1}^L w_m \cdot \delta_{x_m}$$

where:

- $x_m = (b_m, p_m)$  is the  $m$ -th product (an atom in joint space)
- $w_m$  is the mass assigned to product  $m$  (market share)
- $\delta_{x_m}$  is a Dirac mass at  $x_m$

**Transport plan:** The assignment of consumers to products is a coupling

$$\gamma \in \Pi(\mu, \nu)$$

where  $\Pi(\mu, \nu)$  is the set of joint distributions with marginals  $\mu$  and  $\nu$ .

**IC constraint in OT language:** The transport plan  $\gamma$  must be optimal with respect to the utility cost:

$$\gamma = \operatorname{argmin}_{\pi \in \Pi(\mu, \nu)} \int \int c(v, x) d\pi(v, x)$$

where the **cost function** is:

$$c(v, x) = -(v \cdot b - p) \quad (\text{negative utility})$$

This enforces that consumers choose utility-maximizing products!

### 2.2 The Monge-Kantorovich Formulation

**Primal problem** (Monge-Kantorovich):

$$\max_{\nu} \int \max_{x \in \operatorname{supp}(\nu)} \{v \cdot b - p\} d\mu(v) - \int C(b) d\nu(b, p) \quad (6)$$

$$\text{subject to: } \nu = \sum_{m=1}^L w_m \delta_{(b_m, p_m)} \quad (7)$$

$$w_m \geq 0, \sum_m w_m = 1 \quad (8)$$

$$b_m \in \{0, 1\}^d, p_m \in \mathbb{R}_+ \quad (9)$$

**Equivalently** (since we're maximizing profit):

$$\max_{(b_1, p_1), \dots, (b_L, p_L)} \sum_{m=1}^L w_m(b, p) \cdot [p_m - C(b_m)]$$

where:

$$w_m(b, p) = \mu(\{v : m \in \operatorname{argmax}_j (v \cdot b_j - p_j)\})$$

This is the **semi-discrete optimal transport problem**: continuous source ( $\mu$ ), discrete target (finite support).

### 2.3 Kantorovich Dual

The **dual problem** provides important structure:

$$\max_{\varphi, \psi} \int \varphi(v) d\mu(v) + \sum_{m=1}^L \psi_m w_m \quad (10)$$

$$\text{subject to: } \varphi(v) + \psi_m \leq v \cdot b_m - p_m \quad \forall v, \forall m \quad (11)$$

**Dual variables:**

- $\varphi(v)$ : Consumer surplus (utility of optimal choice)
- $\psi_m$ : Shadow price of product  $m$

**Complementary slackness:** At optimum,

$$\varphi(v) + \psi_m = v \cdot b_m - p_m \iff \text{consumer } v \text{ is assigned to product } m$$

**Key insight:** The dual variables encode:

- $\varphi(v) = \max_m \{v \cdot b_m - p_m\}$ : IC constraint (utility-maximizing choice)
- $\varphi(v) \geq 0$ : IR constraint (participation)

So the IC/IR constraints from mechanism design are **automatically encoded** in the OT dual structure!

## 3 Computational Algorithm

### 3.1 Semi-Discrete OT via Lloyd's Algorithm

The **Lloyd's algorithm** (generalized  $k$ -means) solves semi-discrete OT by iteratively:

1. **E-step:** Assign source points to nearest target atom
2. **M-step:** Update target atoms to minimize within-cluster cost

**For our problem:**

#### 3.1.1 E-step: Consumer Assignment

Given current menu  $\{x_1, \dots, x_L\}$ , assign each consumer:

$$m^*(v) = \operatorname{argmax}_{m \in \{1, \dots, L\}} u(v, x_m) \quad (12)$$

$$= \operatorname{argmax}_m (v \cdot b_m - p_m) \quad (13)$$

This is the **OT assignment** – minimum cost transport.

**Output:** Assignment function  $m^* : \operatorname{supp}(\mu) \rightarrow \{1, \dots, L\} \cup \{\emptyset\}$

### 3.1.2 M-step: Atom Update (Voronoi Centroid)

For each product  $m$ , update  $(b_m, p_m)$  to maximize profit from assigned consumers:

$$(b_m^*, p_m^*) = \operatorname{argmax}_{b,p} \sum_{v: m^*(v)=m} [p - C(b)] \cdot \mathbb{1}\{v \cdot b \geq p\}$$

This is the **Voronoi centroid** in joint  $(b, p)$  space.

**Key observation:** This optimization decomposes!

## 3.2 Decomposition of the M-Step

**Problem:** Given assigned consumers  $V_m = \{v : m^*(v) = m\}$ , find optimal  $(b, p)$ .

**Decomposition:**

**Step 1: Fix  $p$ , optimize  $b$**

For fixed price  $p$ , the optimal bundle is:

$$b^*(p) = \operatorname{argmax}_{b \in \{0,1\}^d} |\{v \in V_m : v \cdot b \geq p\}| \cdot (p - C(b))$$

This is a **discrete optimization** over  $2^d$  bundles.

**Algorithm:** Enumerate all bundles, count demand at price  $p$ , compute profit.

**Step 2: Fix  $b$ , optimize  $p$**

For fixed bundle  $b$ , the optimal price is found by **threshold pricing**:

$$p^*(b) = \operatorname{argmax}_{p \geq C(b)} |\{v \in V_m : v \cdot b \geq p\}| \cdot (p - C(b))$$

**Key insight:** Demand is monotone decreasing in  $p$ , so optimal  $p$  is at a consumer's valuation threshold.

**Algorithm:**

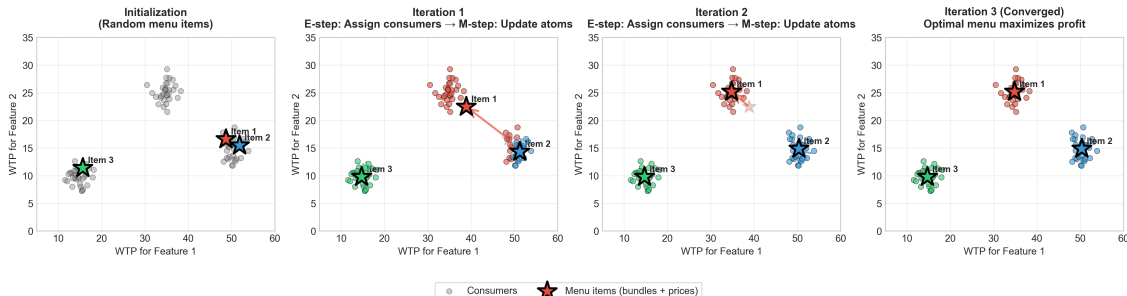
1. Compute valuations:  $T_i = v_i \cdot b$  for  $i \in V_m$
2. Sort in descending order:  $T_{(1)} \geq T_{(2)} \geq \dots \geq T_{(n)}$
3. For each  $k$ , price  $p = T_{(k)}$  gives  $k$  buyers at margin  $T_{(k)} - C(b)$
4. Choose  $k^*$  that maximizes  $k \cdot (T_{(k)} - C(b))$

**Step 3: Coordinate ascent**

Alternate between fixing  $b$  and fixing  $p$  until convergence.

**In practice:** For small  $d$  (e.g.,  $d = 4$ ), we enumerate all  $2^d$  bundles and use threshold pricing for each, finding the global optimum directly.

## 3.3 Intuitive Visualization



### 3.4 Complete Algorithm

### 3.5 Subroutine: Joint $(b, p)$ Optimization

**Complexity:**  $\mathcal{O}(2^d \cdot |V_m| \cdot \log |V_m|)$  per atom update.

For  $d = 4$ : only 16 bundles to check, very fast.

### 3.6 Multi-Start Strategy

Because the problem is **non-convex** (discrete bundles), we use multi-start:

**Typical choice:**  $R = 10$ – $20$  restarts.

## 4 Theoretical Properties

### 4.1 Convergence of Lloyd's Algorithm

**Theorem 1** (Lloyd's Convergence). *The Lloyd's algorithm converges to a local optimum in finite iterations.*

Work in Progress!

**Note:** Global optimum NOT guaranteed (NP-hard problem).

### 4.2 Optimality Conditions (Kantorovich Dual)

At a local optimum, the **complementary slackness conditions** hold:

$$\varphi(v) + \psi_m = v \cdot b_m - p_m \iff \text{consumer } v \text{ assigned to product } m \quad (14)$$

$$\varphi(v) + \psi_m \geq v \cdot b_m - p_m \iff \text{otherwise} \quad (15)$$

where:

- $\varphi(v) = \max_m \{v \cdot b_m - p_m\}$ : consumer surplus
- $\psi_m = -p_m$ : shadow price (in standard OT normalization)

**Interpretation:**

- If consumer  $v$  is assigned to product  $m$ , they get exactly  $\varphi(v)$  utility
- No consumer would strictly prefer any other product
- This encodes both IC (utility maximization) and IR ( $\varphi(v) \geq 0$ )

## 5 Summary

### 5.1 The Mathematical Framework

**Problem:** Design menu  $M = \{(b_1, p_1), \dots, (b_L, p_L)\}$  to maximize profit

**OT Formulation:**

- **Source:** Consumer distribution  $\mu \in \mathcal{P}(\mathbb{R}^d)$

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**Algorithm 1** Semi-Discrete OT for Menu Design

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**Input:** Consumer WTP sample  $V = \{v_1, \dots, v_N\} \sim \mu$ , Menu size  $L$ , Max iterations  $T$

**Output:** Optimal menu  $M^* = \{(b_1^*, p_1^*), \dots, (b_L^*, p_L^*)\}$

**1. Initialize:**

**for**  $m = 1$  to  $L$  **do**

    Sample or heuristically choose  $(b_m^{(0)}, p_m^{(0)})$

**end for**

**2. Main Loop:**

**for**  $t = 1$  to  $T$  **do**

*// E-step: Assign consumers (OT assignment)*

**for** each consumer  $i$  **do**

$m_i = \operatorname{argmax}_m (v_i \cdot b_m^{(t-1)} - p_m^{(t-1)})$

**if**  $\max_m (v_i \cdot b_m^{(t-1)} - p_m^{(t-1)}) < 0$  **then**

$m_i = \emptyset$  *// outside option*

**end if**

**end for**

*// M-step: Update atoms (Voronoi centroids)*

**for** each product  $m$  **do**

$V_m = \{v_i : m_i = m\}$  *// assigned consumers*

**if**  $|V_m| > 0$  **then**

$(b_m^{(t)}, p_m^{(t)}) = \operatorname{argmax}_{b,p} \sum_{v \in V_m} [p - C(b)] \cdot \mathbb{1}\{v \cdot b \geq p\}$

**else**

$(b_m^{(t)}, p_m^{(t)}) = (b_m^{(t-1)}, p_m^{(t-1)})$

**end if**

**end for**

*// Check convergence*

**if**  $\|\text{atoms}^{(t)} - \text{atoms}^{(t-1)}\| < \varepsilon$  **then**

**break**

**end if**

**end for**

**return**  $M^* = \{(b_m^{(t)}, p_m^{(t)})\}_{m=1}^L$

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**Algorithm 2** UpdateAtom

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**Input:** Assigned consumers  $V_m$ , cost function  $C$

**Output:** Optimal  $(b^*, p^*)$

best\_profit  $\leftarrow -\infty$

best\_b  $\leftarrow \text{None}$

best\_p  $\leftarrow \text{None}$

**for** each bundle  $b \in \{0, 1\}^d$  **do**

*// Compute valuations*

$T \leftarrow \{v \cdot b : v \in V_m\}$

*// Sort descending*

$T_{\text{sorted}} \leftarrow \text{sort}(T, \text{descending}=\text{True})$

*// Try each threshold*

**for**  $k = 1$  to  $|T_{\text{sorted}}|$  **do**

$p \leftarrow T_{\text{sorted}}[k]$

**if**  $p < C(b)$  **then**

**break**

**end if**

*// Profit: k buyers at margin (p - C(b))*

    profit  $\leftarrow k \cdot (p - C(b))$

**if** profit  $>$  best\_profit **then**

        best\_profit  $\leftarrow$  profit

        best\_b  $\leftarrow b$

        best\_p  $\leftarrow p$

**end if**

**end for**

**end for**

**return** (best\_b, best\_p)

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**Algorithm 3** Multi-Start Lloyd's

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**Input:**  $V, L$ , restarts  $R$

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best_profit  $\leftarrow -\infty$ 
best_menu  $\leftarrow \text{None}$ 

for  $r = 1$  to  $R$  do
  // Random or heuristic initialization
   $M_0 \leftarrow \text{Initialize}(V, L, \text{seed}=r)$ 

  // Run Lloyd's from this init
   $M_r \leftarrow \text{Lloyd}(V, L, \text{init}=M_0)$ 

  // Evaluate
   $\text{profit}_r \leftarrow \text{EvaluateProfit}(M_r, V)$ 

  if  $\text{profit}_r > \text{best\_profit}$  then
    best_profit  $\leftarrow \text{profit}_r$ 
    best_menu  $\leftarrow M_r$ 
  end if
end for

return best_menu
```

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- **Target:** Discrete measure  $\nu = \sum_m w_m \delta_{(b_m, p_m)}$
- **Cost:**  $c(v, (b, p)) = -(v \cdot b - p) + C(b)$
- **Objective:**  $\max_\nu \int \varphi(v) d\mu(v) - \sum_m C(b_m) w_m$

**Algorithm:** Semi-discrete OT via Lloyd's

- E-step: Assign consumers to utility-maximizing products
- M-step: Update each atom  $(b_m, p_m)$  to maximize profit from assigned consumers
- Multi-start: Run from multiple initializations

**Theory:**

- Dual potentials encode IC/IR
- Lloyd's converges to local optimum
- Complementary slackness at convergence

**Extensions:**

- Column generation for better bundle search
- Continuous relaxation for smooth optimization
- Dual diagnostics for optimality verification

## 6 Notation Reference

### Sets:

- $\mathbb{R}^d$ :  $d$ -dimensional Euclidean space
- $\mathbb{R}_+$ : Non-negative reals
- $\{0, 1\}^d$ : Binary vectors (bundles)
- $\mathcal{P}(X)$ : Probability measures on  $X$

### Consumer side:

- $v \in \mathbb{R}^d$ : WTP vector (type)
- $\mu \in \mathcal{P}(\mathbb{R}^d)$ : Type distribution
- $V = \{v_1, \dots, v_N\}$ : Sample from  $\mu$

### Product side:

- $b \in \{0, 1\}^d$ : Bundle (features)
- $p \in \mathbb{R}_+$ : Price
- $x = (b, p)$ : Product atom
- $M = \{x_1, \dots, x_L\}$ : Menu

### Functions:

- $u(v, x) = v \cdot b - p$ : Utility
- $C(b)$ : Production cost
- $\pi(v, x)$ : Profit from consumer  $v$  buying  $x$

### OT objects:

- $\nu = \sum_m w_m \delta_{x_m}$ : Target measure
- $\gamma \in \Pi(\mu, \nu)$ : Transport plan
- $c(v, x)$ : Transport cost
- $\varphi(v)$ : Consumer surplus (dual potential)
- $\psi_m$ : Shadow price (dual potential)

### Algorithm:

- $m^*(v)$ : Assignment function
- $V_m$ : Consumers assigned to product  $m$
- $T$ : Max iterations
- $R$ : Number of restarts