

# Economics 631 IO - Fall 2019

## Problem Set 2

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### 1 BLP - Random Coefficient

#### Preliminaries

Each firm chooses price to solve the problem

$$\max_{p_j} (p_j - mc_j) M s_j(\mathbf{p}, \mathbf{x}, \sigma)$$

The FOC is

$$0 = (p_j - mc_j) M \frac{\partial s_j}{\partial p_j} + M s_j$$

and so the price will be determined by the following condition:

$$p_j = mc_j - s_j \left( \frac{\partial s_j}{\partial p_j} \right)^{-1}$$

. The market share for product  $j$  is given by

$$s_j(\mathbf{p}, \mathbf{x}, \theta) = \int \frac{\exp(\beta_i x_j - \alpha p_j)}{1 + \sum_{j'} \exp(\beta_i x_{j'} - \alpha p_{j'})} dF(\beta_i)$$

Given our functional form assumptions we can rewrite  $\beta_i = \beta + \sigma v_i$  where  $\beta$  is the mean of the distribution and  $\sigma$  is the standard deviation,  $v_i \sim \mathcal{N}(0, 1)$ . Additionally we can define the mean utility of purchasing product  $j$  as  $\delta_j = \beta x_j - \alpha p_j$  and rewrite the market share expression in terms of  $\delta_j$  and  $\sigma$ .

$$s_j(\mathbf{p}, \mathbf{x}, \boldsymbol{\delta}, \sigma) = \int \frac{\exp(\delta_j + \sigma x_j v_i)}{1 + \sum_{j'} \exp(\delta_{j'} + \sigma x_{j'} v_i)} dF(v)$$

Note that if we rewrite the above expression as

$$s_j(\mathbf{p}, \mathbf{x}, \boldsymbol{\delta}, \sigma) = \int \tilde{s}_j(\mathbf{p}, \mathbf{x}, \boldsymbol{\delta}, \sigma) dF(v_i)$$

we can get a fairly-nice expression for the own-price derivative with respect to the price:

$$\frac{\partial s_j}{\partial p_j} = \int (-\alpha) \frac{\partial \tilde{s}_j}{\partial \delta_j} dF(v) = -\alpha \int \tilde{s}_j (1 - \tilde{s}_j) dF(v)$$

where the last equality is due to properties of the logit error. Thus our final price condition is

$$p_j = mc_j - \int \tilde{s}_j dF(v) [-\alpha \int \tilde{s}_j (1 - \tilde{s}_j) dF(v)]^{-1}$$

## 2 Q1

We are given that  $\alpha = 1, \beta = 1, \sigma = 1, x_1 = 1, x_2 = 2, x_3 = 3$ , and  $mc_j = x_j$ .  
The price vector is:

Q1 Prices	
variable	value
p1	2.17
p2	3.28
p3	4.85

## 3 Q2

Now  $\alpha = .5, \beta = .5, \sigma = .5, x_1 = 1, x_2 = 2, x_3 = 3$ , and  $mc_j = x_j$ . The price vector is:

Q2 Prices	
variable	value
p1	3.36
p2	4.45
p3	5.84

The effect, in theory, is ambiguous. Lowering  $\beta$  would imply that people care less about product characteristics and so will pay less for the goods. This would work to lower prices. Lowering  $\alpha$ , however, means people are less price sensitive and so would be willing to pay more. This works to raise prices. The impact of raising  $\sigma$  is ambiguous as it simply lowers the variance for the random coefficients. This is supporting in our code when we change each parameter one at a time. In practice, however, the impact of the lower sigma is larger and so we see an increase in prices.

## 4 Q3

After the merger the profit maximization problem for the new firm is

$$\max_{p_1, p_2} (p_1 - mc_1)s_1(\mathbf{p}, \mathbf{x}, \sigma) + (p_2 - mc_2)s_2(\mathbf{p}, \mathbf{x}, \sigma)$$

The FOC for  $p_1$  is

$$0 = s_1 + (p_1 - mc_1)\frac{\partial s_1}{\partial p_1} + (p_2 - mc_2)\frac{\partial s_2}{\partial p_1}$$

and so the price will be determined by the following condition:

$$p_1 = mc_1 - (s_1 + (p_2 - mc_2)\frac{\partial s_2}{\partial p_1})(\frac{\partial s_1}{\partial p_1})^{-1}$$

Note that using our previous notation,

$$\frac{\partial s_2}{\partial p_1} = -\alpha \int \tilde{s}_1 \tilde{s}_2 dF(v)$$

The FOC for  $p_2$  is symmetric to that of  $p_1$ , and thus the optimal  $p_1$  and  $p_2$  are given by

$$p_1 = mc_1 - [\int \tilde{s}_1 dF(v) + (p_2 - mc_2)(-\alpha \int \tilde{s}_1 \tilde{s}_2 dF(v))][-\alpha \int \tilde{s}_1(1 - \tilde{s}_1)dF(v)]^{-1}$$

$$p_2 = mc_2 - [\int \tilde{s}_2 dF(v) + (p_1 - mc_1)(-\alpha \int \tilde{s}_2 \tilde{s}_1 dF(v))][-\alpha \int \tilde{s}_2(1 - \tilde{s}_2)dF(v)]^{-1}$$

As firm 3 has not merged it's optimal price condition is the same:

$$p_3 = mc_3 - \int \tilde{s}_3 dF(v) [-\alpha \int \tilde{s}_3 (1 - \tilde{s}_3) dF(v)]^{-1}$$

The price vector from the simulation is:

<b>Q3 Prices</b>	
variable	value
p1	3.76
p2	4.83
p3	5.91

All prices are higher after the merger. This makes sense for p1 and p2 because the firm is now jointly considering the impact of a cut in the price of good one (two) on the demand for good two (one). Another way to think about it is that the firm now has more market power and so they raise their prices to extract profit. Firm 3 also raises prices. Because firm 1 has raised prices, firm three faces less price competition and is able to raise their own prices to extract more profit.

## 5 Q4

The change in consumer surplus is given by the compensating variation, which we can calculate as follows:

$$CV_i = \frac{\log(\sum_j \exp(V_{ij}^{old}) - (\sum_j \exp(V_{ij}^{new}))}{\alpha}$$

where  $V_{ij} = \beta_i x_j - \alpha p_j$ . The total consumer surplus is found by

$$CV = M * \int CV_i dF(v)$$

where  $M$  is the number of people in the market. The change in producer surplus is just the change in profits, and is given by

$$\Delta\pi = \sum_j (p_j^{new} - mc_j^{new}) M s_j^{new} - (p_j^{olds} - mc_j^{old}) M s_j^{old}$$

and the total change in welfare is

$$\Delta\text{Surplus} = \Delta\pi - CV = M[(\sum_j (p_j^{new} - mc_j^{new}) s_j^{new} - (p_j^{olds} - mc_j^{old}) s_j^{old}) - \int CV_i dF(v)]$$

The change in surplus when we normalize  $M = 1$  is

<b>Q4 Surplus Results</b>	
variable	value
Change In Cosumer Surplus Per Person	-0.29
Change In Producer Surplus Per Person	0.05
Change In Total Surplus Per Person	-0.24

## 6 Q5

If we allow the merging firm's marginal costs to decrease from  $x_j$  to  $\frac{x_j}{2}$  we get the following pricing equilibrium and change in consumer, producer and total surplus:

### Q5 Prices

variable	value
p1	3.91
p2	4.89
p3	5.92

### Q5 Surplus Results

variable	value
Change In Cosumer Surplus Per Person	-0.36
Change In Producer Surplus Per Person	0.25
Change In Total Surplus Per Person	-0.11

when MC for merging firms decrease the producer surplus increases by more because they not only increase their market power but become more efficient. CS decreases by a larger amount due to the price increases, but the net decrease in surplus is smaller than without these gains in efficiency.

## 7 Appendix

### 7.1 R Code

## pset 2 631

```
#####  
# ==== pset 2 ====  
#####  
  
require(data.table)  
require(Matrix)  
library(xtable)  
  
# clear objects  
rm(list = ls(pos = ".GlobalEnv"), pos = ".GlobalEnv")  
options(scipen = 999)  
cat("\f")  
  
#set #note output location  
f_out <- "c:/Users/Nmath_000/Documents/Code/Econ_631/ps2/"  
  
#set #note option to save output  
opt_save <- TRUE  
  
#####  
# ==== Question 1 ====  
#####  
  
# set parameters  
x1 = 1  
x2 = 2  
x3 = 3  
n.sim = 10000  
  
# Function to compute shares for a given mean and random utility  
share_f <- function(delta.in, mu.in, opt_tidle = FALSE){  
  
  # get the numerator by exp(delta + xi*vi*sigma)  
  numer <- exp(mu.in) * matrix(rep(exp(delta.in), n.sim), ncol = n.sim)  
  
  # get the denominator by summing over all numerators and adding one  
  denom_i <- matrix(rep(1 + colSums(numer),3), nrow = 1, ncol = n.sim)  
  
  # then replicated this three times so we can divide (probs better way to do this )  
  denom <- rbind(denom_i, denom_i, denom_i)  
  
  if(opt_tidle){  
  
    return(numer / denom)  
  
  }else{  
    # the shares are the mean of numerator/denominator accross simulations  
    shares <- rowMeans(numer / denom)  
  
    return(shares)  
  }  
}
```

```

}
}

# Function to compute the derivative of your own shares wrt own-good mean utility
#note we can just use output of shares function as input here
dSharedOwnP_f <- function(shares.in, alpha.in){

  # dS.i/dP.i is -alpha*share*(1-share)
  dSharedOwnP <- rowMeans(-alpha.in*shares.in*(1-shares.in))

  return(dSharedOwnP)
}

#note switcing this to take shares as the input so we dont recalculate it
dSharedOtherP_f <- function(shares.in, alpha.in){

  # Just using shares output from other function
  # share.i <- matrix(shares.in)

  # dS.i/dDelta.j is integral of -s.i*s.j
  sisj.matrix <- -shares.in%*%t(shares.in)/ncol(shares.in)

  # dS.i/dP.j is -alpha*dS.i/dDelta.j
  #note I don't understand why we are only grabbing 1,2
  dSharedOtherP <- -alpha.in*sisj.matrix[1,2]
  return(dSharedOtherP)
}

# create data.table of xs
xi <- as.matrix(c(x1,x2,x3))

# make simulation matrix
v = matrix(rnorm(1 * n.sim), nrow = 1, ncol = n.sim)

# Now we will guess the price to start and calcualte everything
# fill in an initial price guess to work through functions
# price in iteration k
p.init <- matrix(c(2, 3, 4))

tol <- 10^-10

p_solver <- function(beta.in, alpha.in, sigma.in, xi.in, mc.in, p.guess){
  #####
  # ==== Inside the loop ====
  #####
  i <- 1

  # Initial guess
  p.old <- matrix(c(0, 0, 0))

```

```

while (sum(abs(p.guess - p.old)) > tol)
{
  print(paste0("Iteration:", i, ", Difference:", sum(abs(p.guess - p.old))))

  p.old <- p.guess

  # using the guess, calculate deltas
  delta <- xi.in*beta.in - alpha.in*p.guess

  # calculate x times sigma times v
  mu <- xi.in%*%v*sigma.in

  # Calculate shares and derivative
  shares <- as.matrix(share_f(delta, mu))
  shares_tilde <- share_f(delta, mu, opt_title = TRUE)

  dSharedOwnP <- as.matrix(dSharedOwnP_f(shares_tilde, alpha.in))

  # using the shares and derivative, calculate the equilibrium price
  p.guess <- mc.in - shares*(dSharedOwnP)^-1

  i <- i + 1
}
p.final <- p.guess
return(p.final)
}

# get answer for question 1
p_q1 <- p_solver(1, 1, 1, xi, mc.in = xi, p.init)

#####
# ==== question 2 ====
#####

p_q2 <- p_solver(.5, .5, .5, xi, mc.in = xi, p.init)

#####
# ==== Question 3 ====
#####

p_postmerge_solver <- function(beta.in, alpha.in, sigma.in, xi.in, mc.in, p.guess){
  #####
  # ==== Inside the loop ====
  #####
  i <- 1
  p.old <- matrix(c(0, 0, 0))
  while (sum(abs(p.guess - p.old)) > tol)
  {

```

```

print(paste0("Iteration:", i, ", Difference:", sum(abs(p.guess - p.old))))

p.old <- p.guess

# using the guess, calculate deltas
delta <- xi.in*beta.in - alpha.in*p.guess

# calculate x times sigma times v
mu <- xi.in%%v*sigma.in

# You care about the markup of the other product you own, so create a variable for 2's markup for 1
markup <- p.guess - mc.in

# Definitely a better way to do this...
othergood.markup <- rbind(markup[2,1], markup[1, 1], 0)

# Calculate shares, own price elasticities
shares <- as.matrix(share_f(delta, mu))
shares_tilde <- share_f(delta, mu, opt_title = TRUE)
dSharesdOwnP <- as.matrix(dSharedOwnP_f(shares_tilde, alpha.in))

# Calculate price elasticities wrt the other product we care about.
#note: would rather use an ownership matrix somehow but yolo
dSharesdOtherP <- as.matrix(c(dSharedOtherP_f(shares_tilde, alpha.in), dSharedOtherP_f(shares_tilde

# using the shares and derivative, calculate the equilibrium price
p.guess <- xi.in - (shares + othergood.markup*dSharesdOtherP)*(dSharesdOwnP)^-1

  i <- i + 1
}

p.final <- p.guess

return(p.final)
}

p_q3 <- p_postmerge_solver(.5, .5, .5, xi,mc.in = xi, matrix(c(2, 3, 4)))

#####
# ==== question 4 ====
#####

#####
# ==== change in consumer surplus ====
#####

# define variables for debug
v.in = v

```



```

pv = p_q2

# function for getting sum of value funcitons
vi_f <- function(v.in, pv, xi.in, beta.in, alpha.in, sigma.in){

  # make beta_i
  beta_i <- beta.in + sigma.in*v.in

  # get beta_i times xs
  #note this is old. It does not doe the exponent. Can delet when we are sure it is wrong
  # Vi <- colSums( xi.in %*% beta_i ) - colSums(alpha*pv )
  Vi <- colSums( exp(xi.in %*% beta_i - matrix(rep(alpha.in*pv, ncol(beta_i)), ncol = ncol(beta_i))) )

  return(Vi)
}

# #note temp define these for deubg
# pv_pre = p_q2
# pv_post = p_q3

# NOW write funciton to get cv_i
cv_i_f <- function(v.in, pv_pre, pv_post, xi.in, beta.in, alpha.in, sigma.in ){

  # get vi for pre
  vi_pre <- vi_f(v.in, pv = pv_pre, xi.in, beta.in, alpha.in, sigma.in)

  # et vi for post
  vi_post <- vi_f(v.in, pv = pv_post, xi.in, beta.in, alpha.in, sigma.in)

  # get cv_i
  cv_i <- (log(vi_post) - log(vi_pre))/-alpha.in

  return(cv_i)
}

# run it with correct values
cv_i <- cv_i_f(v.in      = v,
               pv_pre    = p_q2,
               pv_post   = p_q3,
               xi.in     = xi,
               beta.in    = .5,
               alpha.in   = .5,
               sigma.in   = .5)

# now get mean cv
mean_cv <- mean(cv_i)

#####
# ==== Change in producer surplus ====
#####

```

```

# # for debug
# pv      = p_q2
# mc_v     = xi
# v.in     = v
# xi.in    = xi
# alpha.in = .5
# beta.in  = .5
# sigma.in = .5
profit_f <- function(pv,mc_v, v.in, alpha.in, beta.in, xi.in, sigma.in){

  # using the guess, calculate deltas
  delta <- xi.in*beta.in - alpha.in*pv

  # calculate x times sigma times v
  mu <- xi.in**v.in*sigma.in

  shares <- share_f(delta, mu)
  # get profits before and after
  profits <- (pv - mc_v)*shares

  return(profits)
}

# get profits before
profits_before <- profit_f(pv      = p_q2,
                           mc_v    = xi,
                           v.in    = v,
                           xi.in   = xi,
                           alpha.in = .5,
                           beta.in  = .5,
                           sigma.in = .5)

# get profits after
profits_after <- profit_f(pv      = p_q3,
                          mc_v    = xi,
                          v.in    = v,
                          xi.in   = xi,
                          alpha.in = .5,
                          beta.in  = .5,
                          sigma.in = .5)

# get the total difference in profits i.e. producer surplus
change_ps <- sum(profits_after) - sum(profits_before)

# get change in total surplus
total_surplus_change <- change_ps - mean_cv

# table all the info
q4_table <- data.table(variable = c("change in consumer surplus per person",
                                   "change in Producer surplus per person",
                                   "change in total surplus per person"),
                       value = c(-mean_cv, change_ps, total_surplus_change))

```

```

#####
# ==== Question 5 ====
#####
mc_new <- c(.5,1,3)

p_post_q5 <- p_postmerge_solver(.5, .5, .5, xi, mc.in = mc_new, p.init)

# get cv
cv_i <- cv_i_f(v.in      = v,
               pv_pre    = p_q2,
               pv_post    = p_post_q5,
               xi.in      = xi,
               beta.in     = .5,
               alpha.in    = .5,
               sigma.in    = .5)

# now get mean cv
mean_cv <- mean(cv_i)

# get profits after
profits_after_q5 <- profit_f(pv      = p_post_q5,
                             mc_v     = mc_new,
                             v.in      = v,
                             xi.in     = xi,
                             alpha.in  = .5,
                             beta.in   = .5,
                             sigma.in  = .5)

# get the total difference in profits i.e. producer surplus
change_ps <- sum(profits_after_q5) - sum(profits_before)

# get change in total surplus
total_surplus_change <- change_ps - mean_cv

# table all the info
q5_table <- data.table(variable = c("change in cosumer surplus per person",
                                   "change in Producer surplus per person",
                                   "change in total surplus per person"),
                       value = c(-mean_cv, change_ps, total_surplus_change))

#####
# ==== save output to latex ====
#####

# make these tables pretty
p_q1_out <- data.table(variable = c("p1", "p2", "p3"), value = as.numeric(p_q1))
p_q2_out <- data.table(variable = c("p1", "p2", "p3"), value = as.numeric(p_q2))
p_q3_out <- data.table(variable = c("p1", "p2", "p3"), value = as.numeric(p_q3))
p_post_q5_out <- data.table(variable = c("p1", "p2", "p3"), value = as.numeric(p_post_q5))

```

```

# capitolize first letters
q4_table[, variable := sapply(variable, function(x) paste0(sapply(strsplit(x, " "), Hmisc::capitalize),
q5_table[, variable := sapply(variable, function(x) paste0(sapply(strsplit(x, " "), Hmisc::capitalize),

if(opt_save){

  print(xtable(p_q1_out, type = "latex"),
        file = paste0(f_out, "p_q1.tex"),
        include.rownames = FALSE,
        floating = FALSE)

  print(xtable(p_q2_out, type = "latex"),
        file = paste0(f_out, "p_q2.tex"),
        include.rownames = FALSE,
        floating = FALSE)

  print(xtable(p_q3_out, type = "latex"),
        file = paste0(f_out, "p_q3.tex"),
        include.rownames = FALSE,
        floating = FALSE)

  print(xtable(q4_table, type = "latex"),
        file = paste0(f_out, "q4_table.tex"),
        include.rownames = FALSE,
        floating = FALSE)

  print(xtable(p_post_q5_out, type = "latex"),
        file = paste0(f_out, "p_post_q5.tex"),
        include.rownames = FALSE,
        floating = FALSE)

  print(xtable(q5_table, type = "latex"),
        file = paste0(f_out, "q5_table.tex"),
        include.rownames = FALSE,
        floating = FALSE)

}

#####
# ==== run r markdown for tex file ====
#####

rmarkdown::render(input = "C:/Users/Nmath_000/Documents/Code/Econ_631/ps2/ps2_r_markdown.Rmd",
                  output_format = "pdf_document",
                  output_file = paste0(f_out, "assignment_2_r_code_pdf.pdf"))

```