1 Book Notes

Sunday, January 10, 2021 8:09 PM

Aim

Apply microeconomic tools "systematically to problems faced by firms and their managers"

"Applied microeconomic analysis underpins much of the information upon which business students will base professional decisions"

Must use good sources well

The Goal of the Firm (and its Management)

Firms procure inputs and produce outputs

$\pi = R - C$
- C → cost
- R → revenue
- π → profit

WHO claims profit (residual revenue)?
↳ The firm's shareholders are the residual claimants

$E(\text{all shares})$ = expected present value of all future profits

Shareholders want money and will seek to provide their agents (firm management) with incentives to maximize share value

Present Value

$FV = PV(1+r)^t$
- t → time periods
- r → interest rate
- PV → present value
- FV → future value

$PV = FV/(1+r)^t$ → discounts FV backward

Example:
$r = 10\%$ $PV = \$1$ $t = 3$ $FV = ?$
$FV = PV(1+r)^t$
$FV = 1(1+.1)^3$
$FV = 1(1.1)^3$
$FV = 1.331$

$r = 10\%$ $FV = 3$ $t = 2$ $PV = ?$
$PV = FV/(1+r)^t$
$= 3/(1+.1)^2$
$= 2.48$

π_t = value of π after period t

$E_t = \pi_t/(1+r)^t$

Example:
$\pi_0 = -124$ $\pi_1 = 21$ $\pi_2 = 72$ $\pi_3 = 45$ $r = 8\%$ $NPV = ?$
↳ $NPV = -124 + \frac{21}{1.08} + \frac{72}{1.08^2} + \frac{45}{1.08^3} = -7.10$

Information Structure

Who knows what

3 types:

Complete and perfect information
Everyone knows everything

Simple risk and uncertainty

Risk: everyone shares estimates of probabilities of each outcome

Uncertainty: when there is not enough information to determine the amount of risk

Subjective probability: estimate risk based on personal knowledge

Asymmetric Information

People have different amounts of information

This can lead to two forms of market failure...

Adverse Selection: When someone has information about inherent market characteristics that others don't have

Moral hazard: Someone has information about an action they've taken that others can't do one are therefore shielded from consequences

Expected Value and attitudes towards risk

Expected Value (EV)
Certainty equivalent (CE)

EV = average outcome over many iterations

i = outcome index
x_i = value of outcome i
f_i = probability of i

Expected Value of x $E(x) = \Sigma_i f_i x_i$

$Pr(x_i)$ = Probability that x takes on the specific value of x_i

Example:
$i_1 = .8$ $x_{i_1} = 40$ $i_2 = .2$ $x_{i_2} = -100$

$Pr(\pi = 40) = .8$ and $Pr(\pi = -100) = .2$
$E(x) = \Sigma_{i=1}^{n} Pr(x_i)\, x_i = .8 \cdot 40 + .2 \cdot -100 = 12$

CE of an lottery is the sum of money for certain that is viewed as exactly equivalent to the lottery

Risk neutral
Risk averse
Risk neutral

Expected Present Value and the Value of the Firm

Assume firms are risk neutral

Diversify stocks to balance out risk

Expected Present Value (EPV)

$EPV = E_t[\Sigma_i f_{it} x_{it}]/(1+r)^t$

Example:
Year one: .4 for 100, -200
Year two: .7 for 400, -200
$r = 7\%$

$PEV = [.4 \cdot 100 + .6 \cdot -200]/1.07 + (.7 \cdot 400 + .3 \cdot -200)/1.07^2$
$PEV = -74.76 + 192.15 = 117.39$

Value of Information - Part 1 - Yes/No decisions

Value of better information vs perfect information

S - Success F - Failure π = payoff

Decision trees...

Example:
$Pr(S) = .5$ $\pi_S = 100$ $\pi_F = -60$ $\pi = ?$

$E(\pi \mid \text{No Info}) = \max((Pr(S)\pi_S + Pr(F)\pi_F), 0)$
$E(\pi \mid \text{No Info}) = \max(.5(100) + .5(-60), 0)$
$E(\pi \mid \text{No Info}) = \max(20, 0) = 20$

- Don't proceed → 0
- Proceed
  - .5 → 100
  - .5 → -60

$.5(100) - .5(60) = 20 > 0$

Significant chance of failure

What's to come

More math!

Marginal revenue and marginal cost
↳ at maximum π, $MR = MC$

Perfectly competitive markets

Uses and limits of models

Models don't tell the whole story

1.1 Profit and Present Value

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Analytical approach

Profit = revenue - cost $\rightarrow \pi = p \cdot q - C(q)$

Present value

\$1 = PV $\rightarrow$ FV = 1.05 · 1 = 1.05 if interest = 5%

$FV_1 = (1+r)PV$

$V_1 = (1+r)V_0$

$V_2 = (1+r)(1+r)V_0 = (1+r)^2 V_0$

$V_t = (1+r)^t V_0$

PV of some FV?

$PV = FV/(1+r)^t$

$V_0 = \pi_0 + \pi_1/(1+r) + \pi_2/(1+r)^2 + \ldots$

$V_0 = \sum_t \pi_t/(1+r)^t$ $\quad (1/1+r)^t < 1$ $\quad \delta = 1/1+r$ $\quad \delta^t =$

- future is uncertain!

1.2 Expected Value

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$\sum_i Pr(X = x_i) \cdot x_i$ = Expected Value

F = Probability

π_i

i	x_i	F_i	
1	-1	.4	$= (.4 \cdot -1)$
2	10	.5	$= (.5 \cdot 10)$
3	30	.1	$= (.1 \cdot 30)$

$= -.4 + 5 + 3 = 7.6 = E(\pi)$

Continuous outcomes...

π_i

→ Probability density function (PDF)

$$E(\pi) = \int_{-\infty}^{\infty} x f(x) dx$$

Attitudes towards Risk

- future is a lottery
- preferences over lotteries

Certainty Equivalent

- certain out come viewed as equivalent to the lottery

Risk averse → CE < EV

Diversification

$$EPV = \left[\sum_i F_{it} \cdot \pi_{it}\right] / (1+r)^t = \sum_t E(\pi_t) / (1+r)^t$$

CE > EV = Risk Loving

1.3 Information Structures

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- complete + perfect info
- Incomplete information
  - Risk vs uncertainty

Risk	Uncertainty
↓	↓
objective probability	subjective probability

- Asymmetric information

1 Extra Problems

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t	π
1	-10
2	5
3	10
4	5
5	3

$r = 4\%$

$V_0 = -10/1.04 + 5/1.04^2 + 10/1.04^3 + 5/1.04^4 + 3/1.04^5 = 10.637$

i	π_i	f_i
1	-10	.4
2	4	.4
3	50	.2

$E(\pi) = (.4 \cdot -10) + (.4 \cdot 4) + (.2 \cdot 50) = 7.6$

$t=1$

i	f	π
1	.4	-10
2	.6	10

$t=2$

i	f	π
1	.7	-10
2	.3	50

$r = 4\%$

$EPV = (.4 \cdot -10)/(1.04) + (.6 \cdot 10)/1.04 + (.7 \cdot -10)/1.04^2 + (.3 \cdot 50)/1.04^2 = -2.2189$

Suppose a project returns 300 with probability 0.6 and loses 200 otherwise.

A test can be conducted to provide additional information about the probability of success. You think the probability of a positive result is 0.6. You think the probability of success with a positive test result is 0.8, and you think the probability of success with a negative test result is 0.4.

What, if anything, is the value of the information provided by the test?

$E(\pi) = .6 \cdot 300 - .4 \cdot 200 = 100$

$E(\ ) = .4 \cdot 300 - .6 \cdot 200 = 0$

Info =

A. Suppose inverse demand is p=1000-2q. Find the quantity that maximizes revenue, the corresponding price, and the maximum revenue.

B. Suppose cost is $1000+100q+0.5q^2$. Find the profit maximizing quantity, price, and the maximum profit.

C. Illustrate.

D. Explain why the price that maximizes revenue is too low. What is profit at that price?

a) Inverse demand: $0 = p = 1000 - 2q$

$2q = 1000 - p$

$q = 500 - 1/2 p$

$\rightarrow R = 1000q - 2q^2$

$dR = 1000 - 4q$

Revenue $= p \cdot q$

$= p \cdot (500 - 1/2 p)$

$= 500p - 1/2 p^2$

$p = 500 \quad q = 250$

B) $\pi = p \times q - C \qquad C = 1000 + 100q + 1/2 q^2$

$(1000q - 2q^2) - (1000 + 100q + 1/2 q^2) = -2.5q^2 + 1100q - 1000$

$\frac{d\pi}{dq} = -5q + 1100 \rightarrow q = 220 \rightarrow p = 560$

c)

1/27 Problems

$q_1 = 100 p_1 \qquad \eta^d_2 = -2$

$C = F + 2q \qquad$ If $p_2 = 5, q_2 = 20$

1) $p_1^* = ?$ 2) $p_2^* = ?$

3) $q_1^* = ?$ 4) $q_2^* = ?$

5) Constant η^d_2 approx for market 2

$MR = p(1 + 1/\eta)$

$MR = p(1 + 1/3) = 2 \rightarrow p^* = 3/1+3 \cdot MC \rightarrow p_1 = -4/1-4 \cdot 2 = 2.67$

$p_2^* = -2/1-2 \cdot 2 = 4$

$q_1^* = 100/2.67^4 = 1.97$

$p_2 = 5 \rightarrow q_2 = 20$

$\%\Delta p = -20\%$

$\%\Delta q = 40\%$

$q_2 = Ap_2^{-2} \qquad 20 = A/5^2 \rightarrow A = 20 \cdot 25 = 500 \qquad q_2 = 500/p^2$

$\frac{\Delta q}{\Delta p} \frac{p}{q}$

2 Book Notes

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Cost, Demand, and Profit Maximization

Cost, Its Determinants, and Marginal Cost

$C(q)$ = firm cost

$C = C(q; w, r, z)$ → cost of q units depends on q, wage rate (w), capital costs (r), and other factors (z)

Marginal cost = cost of making one more unit

$MC = dC/dq$ d = change (derivative)

4 ways to approximate cost:

$C(q) = f + cq$ → $c > 0$, $f \geq 0$, $MC = c$
$C(q) = f + cq^d$ → $c > 0$, $d > 0$, $f \geq 0$, $MC = cdq^{d-1}$
$C(q) = f + aq + bq^2$ → $a > 0$, $b > 0$, $f \geq 0$, $MC = a + 2bq$
$C(q) = f + aq + bq^2 + cq^3$ → $a > 0$, $b < 0$, $c > 0$, $f \geq 0$, $MC = a + 2bq + 3cq^2$

Demand and its Determinants, Inverse Demand

$q = q(p)$

m = income

Price of substitutes (P_s) and complements (P_c)

n = market size

z = other variables

$q = q(p, m, P_s, P_c, n, z)$

↳ implies that q depends on p

$p = P(q, m, P_s, P_c, n, z)$

$p = P(q)$

Measuring the sensitivity of quantity demanded to price

Elasticity is a percentage

Elasticity of demand = η (eta) = $\%\Delta q / \%\Delta p = \Delta q/q / \Delta p/p$

η not constant over demand

Demand Approximations

Linear Demand Approximations

ε = random error

$q_D = A - Bp$

$p = \frac{A}{B} - \frac{1}{B}q$

Log Linear (constant elasticity) Demand Approximations

$q = Ap^{-B}$

$\ln(q) = \ln(A) - B\ln(p)$

$dq/dp = -BAp^{-B-1}$

η w/ respect to independents are constant and equal to that variable's coefficient

Revenue and Marginal Revenue

Revenue = price · quantity

Firms have **market power** if they have a non-negligible effect on market price

Marginal revenue = gain in revenue from one unit sold

$MR = p + \frac{dp}{dq}q$

Marginal Revenue and Elasticity

$dR/dq = p\left(1 + \frac{1}{\eta}\right)$

Profit Maximization

q^* = profit maximizing q

↳ p^*

$p = \left(\eta/(1+\eta)\right) MC$

2.1 Value of Information

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$Pr(S) = .7$
$\pi_S = 50$
$\pi_F = -200$

$E(\pi|inv) = .7 \cdot 50 + .3 \cdot 200 = 35 - 60 = -25$

Test

	Pos	Neg	
Succ	63	5	70/100
Fail	7	25	30/100
	70/100	30/100	

$E(\pi|+) = .7 \cdot 25 + .3 \cdot 0 = 17.5 > 0$

$E(\pi) = -25$

$E(\pi) = \frac{63}{70} \cdot 50 - \frac{7}{70} \cdot 200 > 0$
$= 25$

$E(\pi) = \frac{7}{30} \cdot 50 - \frac{23}{30} \cdot 200 < 0$
$= -16/2$

Value of Info: $17.5 - 0 = 17.5$

$P(S|+) > P(S)$
$P(S|-) < P(S)$

2.2 Models of Cost

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Demand and profit maximization

$\pi = R - C$

$R = P \cdot q - C(q)$

Approximate cost?

$C = f + cq$

$MC = \frac{dC(q)}{dq}$

$ATC = C(q)/q$

$AVC = TVC/q$

$AFC = TFC/q$

<u>Quadratic</u>

$C = f + aq + bq^2$

$\frac{dC}{dq} = a + 2bq$

<u>Cubic</u>

$C = f + aq + bq^2 + cq^3$

$\frac{dC}{dq} = a + 2bq + 3cq^2 \Rightarrow b < 0, c > 0$, MC → V shape

constant MC w/ fixed capacity

$C = f + cq \quad q \le \bar{q} \qquad q > \bar{q}$

2.3 Cost Concepts

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opportunity cost

Fixed costs

Sunk costs

Quasi-Fixed costs

$c = f + cq = 0 \quad q > 0 \quad q = 0$

Cost Shifters

w = wage
r = price of capital

Demand and Revenue

$q(p)$ demand
$p(q)$ inverse demand

Linear: $q = a - bp$

Log-Linear: $q = ap^3$

Log-linear demand = constant elasticity

$q = ap^3$

$\ln q = \ln a - 3\ln p$

2.5 Elasticity of Demand

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dq/dp

$\xi = \%\Delta q / \%\Delta p < 0$

$\xi = \Delta q/q / \Delta p/p \rightarrow$ Point elasticity

$q = ap^{\xi}$

$\frac{dq}{dp} = \xi a p^{\xi - 1}$

2.6 Demand Shifters

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$\Delta P \rightarrow$ quantity demanded changes

Income Normal $m\uparrow, D\vec{\rightarrow}$

Inf. $m\uparrow D\vec{\leftarrow}$

Prices of substitutes $\rightarrow P_S\uparrow \rightarrow D\vec{\rightarrow}$

Prices of complements $\rightarrow P_C\uparrow \rightarrow D\vec{\leftarrow}$

$q = b_0 + b_P P + b_S P_S + b_C P_C + b_N N + b_Z Z$

$\ln q = b_0 + b_P \ln P + b_S \ln P_S + \ldots$

dumb!

elasticities

2.7 Demand and Revenue

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p	q	R
10	100	1000
9	120	1080
8	140	1120
7	160	1120
6	180	1080
5	200	1000
4	220	880

$$\frac{dq}{dp} = -20$$

$$q = 100 - 20(p - 10)$$
$$= 100 - 20p + 200$$
$$= 300 - 20p \quad \rightarrow p = 15 - .05q$$

$$R(q) = p \cdot q$$

$$MR = \frac{dR}{dq} = \frac{dp}{dq} \cdot q + 1 \cdot p \quad \Rightarrow \frac{dp}{dq} < 0$$

$$\hookrightarrow MR = p + \frac{dp}{dq} \cdot \frac{q}{p} p = p(1 + 1/3) = p(1 + 3/3)$$

2.8 Profit Maximization

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$$\pi(q) = P(q) \cdot q - C(q)$$

$$\frac{d\pi}{dq} = MR - MC = 0$$

2.9 Profit Maximization Example 1

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$p = 15 - q/20 \qquad C = 100 - 5q$

1) write $\pi(q)$
2) find MR, MC
3) find p^*, q^*, π^*
4) illustrate

1) $\pi = (15 - q/20)q - 5q - 100$

2) $MR = 15 - q/10$
$MC =$ derivative $100 - 5q = 5$

3) $15 - q/10 = 5 \rightarrow q = 100$
$p = 15 - 100/20 \rightarrow p = 10$
$R = 10 \cdot 100 = 1000$
$C = 100 + 5(100) = 600$
$\pi = 1000 - 600 = 400$

4)

PS = Producer Surplus

2.10 Profit Maximization - More Examples

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$MC = 5 \qquad \eta = -3$

$MR = P(1 + 1/\eta) = MC$

$P = (\eta/(1+\eta))MC = -3/-2 \cdot 5 = 7.5$

$\eta = -1/2 \Rightarrow P = -1/2 / (1 - 1/2) \cdot 5 = -5$

3 Book Notes

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Applications and Extensions of optimal production and pricing

Simple (3rd degree) price discrimination

Charge different prices to different groups
↳ senior discount

groups must:
↳ be identifiable
↳ have specific willingness to pay
↳ resale should be impossible

Market w/ less elastic demand

$P_1 = \frac{\eta_1}{1+\eta_1} MC \qquad P_2 = \frac{\eta_2}{1+\eta_2} MC$

Example: Two groups. Max profit w/ discrimination
$P_1 = 20 - q_1 \qquad P_2 = 30 - q_2 \qquad C(Q) = .5(q_1+q_2)^2$

Two prices: $\pi = (20-q_1)q_1 + (30-q_2)q_2 - .5(q_1+q_2)^2$

$MR_1 = MR_2 = MC$

$MR_1 = MC \qquad MR_2 = MC$
$20 - 2q_1 = q_1 + q_2 \qquad 30 - 2q_2 = q_1 + q_2$

$20 - 2q_1 = 30 - 2q_2$
$2q_2 = 10 + 2q_1$
$q_2 = 5 + q_1$

$20 - 2q_1 = q_1 + 5 + q_1$
$15 = 4q_1$
$q_1 = 3.75 \rightarrow q_2 = 5 + q_1 = 8.75$
$P_1 = 20 - 3.75 = 16.25 \qquad P_2 = 30 - 8.75 = 21.25$

$\pi = 16.25(3.75) + 21.25(8.75) - .5(3.75 + 8.75)^2 = 168.75$

One price?

$P_1 = 20 - q_1 \rightarrow q_1 = 20 - P_1 \qquad P_2 = 30 - q_2 \rightarrow q_2 = 30 - P_2$

$P_1 = P_2 = P \rightarrow q = 50 - 2P \rightarrow P = 25 - .5q$

$\pi = (25 - .5q)q - .5q^2$
$MR = MC$
$25 - q = q$
$q = 12.5$
$P = 25 - .5(12.5) = 18.75$
$\pi = 18.75(12.5) - .5(12.5)^2 = 156.25$

Extra profit → $168.75 - 156.25 = 12.5$

Profit maximization when purchases per capita don't depend on market size

$q_D/N = f(P, P_s, P_c, M, z)$ → purchases per capita

N = city size

Maximizing profit with a pre-determined capacity constraint

Theaters, stadiums, etc

Profit maximization with uncertainty

Expected profit

Value of information with continuous decisions

Peak load pricing - determining capacity when demand varies

Chapter 16 in Game Theory

To max π, $MR_L = MC_L = c$ and $MR_H = MC_H = c + k$

$\pi = P_H(q_H)q_H + P_L(q_L)q_L - cq_L - (c+k)q_H \rightarrow q_H \geq q_L$
↳ if $q_H < q_L$ then $q_H = q_L$

$MR_H + MR_L = 2c + k$

3.1-2 Third Degree

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$P^* = (\varepsilon/(1+\varepsilon))MC$

$\pi = P_1(q_1)q_1 + P_2(q_2)q_2 - C(q_1+q_2)$

$\frac{d\pi}{dq_1} = MR_1 - \frac{dC}{dq_1} = 0 \qquad MR_1 = MC$

$\frac{d\pi}{dq_2} = MR_2 - MC = 0 \qquad MR_2 = MC$

$MR_1 = MR_2$

$P_1 = \varepsilon_1/(1+\varepsilon_1)\, MC \qquad P_2 = \varepsilon_2/(1+\varepsilon_2)\, MC$

1) Must be able to differentiate
2) No resale

Example:

$P_1 = 20 - \frac{1}{2}q_1 \qquad P_2 = 15 - \frac{1}{2}q_2 \qquad C = (q_1+q_2)^2$

$\pi = (20 - \frac{1}{2}q_1)q_1 + (15 - \frac{1}{2}q_2)q_2 - (q_1+q_2)^2$

$20 - q_1 = 2(q_1+q_2)$

$15 - q_2 = 2(q_1+q_2)$

$20 - q_1 = 15 - q_2$

$5 + q_2 = q_1$

$15 - q_2 = 2(5 + q_2 + q_2)$

$15 - q_2 = 10 + 4q_2$

$5 = 5q_2$

$q_2 = 1 \qquad P_2 = 14.5$

$q_1 = 6 \qquad P_1 = 17$

$\pi = 6 \cdot 17 + 1 \cdot 14.5 - 7^2 = 67.5$

$\frac{1}{2}q_1 = 20 - P_1$

$q_1 = 40 - 2P_1$

$\frac{1}{2}q_2 = 15 - P_2$

$q_2 = 30 - 2P_2$

$q = 70 - 4P$

$\frac{d\pi}{dq} = \frac{70}{4} - \frac{1}{2}q - 2q = 0$

$q = 7$

$P = \frac{70}{4} - \frac{1}{4}(7)$

$= 63/4 = 15.75$

$\pi = 7 \cdot 63/4 - 49 = 61.25$

3.3-4 Pricing When Per

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$q = N(\beta_0 + \beta_p p) \rightarrow q/N = a - bp$

all else in a

$q = Nf(p)$ $\qquad f = q^d/N$

$\frac{dq}{dp} \cdot \frac{p}{q} = N \frac{df}{dp} \cdot \frac{p}{Nf(p)} \rightarrow \zeta = \frac{df}{dp} \cdot p/f \qquad p^* = (\zeta/(1+\zeta))\, mc$

"Law of one price"

Example:

$N = 1000, \; f(p) = 1 - .1p \qquad mc = 2$

$\pi = 1000[p(1-.1p) - 2(1-.1p)]$
$= 1000(p-2)(1-.1p)$

$\frac{d\pi}{dp} = 1000(-.1(p-2) + 1(1-.1p)) = 0$

$.2 + 1 - .2p = 0$

$.2p = 1.2$

$p = 6 \qquad f = 1 - .1 \cdot 6$

$q = 400 \qquad = .4$

$\pi = (6-2) \cdot 400 - f$
$= 1600 - f$

$\bar{q} = 200$

$f = 200/1000 = .2 \qquad .2 = 1 - .1p$

$.1p = .8$

$p = 8$

$\pi = (8-2) \cdot 200 - f$
$= 1200 - f$

3.5 Peak Load Pricing - Informal

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$C(q) = (c+k)q$

↳ k = cap cost

↳ c = op cost

$C(q) = cq \Rightarrow q <$ capacity

$MR_H = c+k$

$MR_L = c$

"Shifting Peak" to adjust demand

3.6 Peak Load Pricing - Formal

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$\pi = P_L(q_L)\cdot q_L + P_H(q_H)\cdot q_H - cq_L - cq_H - k\bar{q}$

q_L, q_H s.t. $q_H \geq q_L$

1) Ignore constraint

$MR_L = c$
$MR_H = c + k$ $\Rightarrow q_L, q_H, P_L, P_H$

Check if $q_H \geq q_L$
↳ yes = done
↳ no = step 2

2) Sub $q_H = q_L = q$

$\max_q = P_L(q)\cdot q + P_H(q)\cdot q - (2c+k)q$
↳ q_L, P_H, P_L

3.7 Peak Load Pricing Example

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$P_H = 14 - \frac{1}{2} q_H \qquad P_L = 12 - \frac{1}{2} q_L \qquad c = 2 \qquad k = 4$

1) Assume $q_H > q_L$

$MR = 14 - q_H = 4 + 2 \qquad = 12 - q_L = 2$

$q_H = 8 \qquad\qquad q_L = 10$

$\cancel{q_L > q_H}$

2) Assume $q_H = q_L$

$\pi = (14 - \frac{1}{2}q)q + (12 - \frac{1}{2}q)q - (2 \cdot 2 + 4)q$

$= 14 - q + 12 - q - 8 = 0$

$2q = 18$

$q = 9 \quad \rightarrow P_H = 14 - \frac{1}{2}9 \qquad P_L = 12 - \frac{1}{2}9$

$= 9.5 \qquad\qquad = 7.5$

3.8-9 Production and Pricing

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Timeline

Produce — learn demand — post price — sell

$Pr(H)$ = probability of high demand
$Pr(L)$ = prob of low demand

q_H p_H q_L p_L

$E(\pi) = Pr(H)\, p_H(q)\, q + (1 - Pr(H))\, p_L(q)\, q - C(q)$

$\frac{d\pi}{dq} = f_H MR_H + (1 - f_H) MR_L - MC = 0$

$f_H MR_H + (1 - f) MR_L = MC$

"Free disposal"

$E(\pi) = Pr(H) P_H(q_H) q_H + Pr(L) P_L(q_L) q_L$

s.t. $q_H \le q$, $q_L \le q$ $\quad q_H = q$

$\max E(\pi) = Pr(H) P_H(q_H) + Pr(L) P_L(q_L) - C(q_H)$
s.t. $q_H \ge q_L$

$\frac{dE(\pi)}{dq_H} = Pr(H) \cdot MR_H \quad - MC = 0$

$\frac{dE(\pi)}{dq_L} = MR_L \quad = 0$

Plan to max R if demand is too low

$q_H^* > q_L^*$

If $q_H^* < q_L^*$, nonsense constraint violated!
Go back to $q_H = q_L = q$

3.10-12 Production and Pricing

Saturday, January 30, 2021 12:15 PM

$P_H = 20 - \frac{1}{4}q_H$ $\quad P_L = 10 - \frac{1}{4}q_L$ $\quad f_H = .5$ $\quad MC = 2$

$E(\pi) = \frac{1}{2}(20 - \frac{1}{4}q)q + \frac{1}{2}(10 - \frac{1}{4}q)q - 2q$

$\hookrightarrow \frac{1}{2}(20 - \frac{1}{2}q) + \frac{1}{2}(10 - \frac{1}{2})q = 2$

$\hookrightarrow 10 - \frac{1}{4}q + 5 - \frac{1}{4}q = 2$

$13 = \frac{1}{2}q$

$q = 26$

$P_H = 20 - 26/4 = 13.50$, $\pi_H = (13.50 - 2)26 = 299$

$P_L = 10 - 26/4 = 3.50$; $\pi_L = (3.5 - 2)26 = 39$

$\hookrightarrow E(\pi) = \frac{1}{2}299 + \frac{1}{2}39 = 169$

$R_L = (10 - \frac{1}{4}q_L)q_L \rightarrow 10 - \frac{1}{2}q_L = 0 \rightarrow q_L = 20$ $\boxed{\text{Max Revenue}}$

"free disposal"

$E(\pi) = \frac{1}{2}\underbrace{(20 - \frac{1}{4}q_H)}_{\hookrightarrow P_r(H) \hookrightarrow P_H}q_H + \frac{1}{2}\underbrace{(10 - \frac{1}{4}q_L)}_{\hookrightarrow P_r(L) \hookrightarrow P_L}q_L - \underbrace{2q_H}_{\hookrightarrow C}$

$\frac{dE(\pi)}{dq_H} = \frac{1}{2}(20 - \frac{1}{2}q_H) - 2 = 0$

$20 - \frac{1}{2}q_H = 4$

$\frac{1}{2}q_H = 16$

$q_H = 32$ $\rightarrow P_H = 20 - 32/4 = 12$

$E(\pi) = \frac{1}{2} \cdot 12 \cdot 32 + \frac{1}{2} \cdot 5 \cdot 20 - 2 \cdot 32$

$= \frac{1}{2}(10 \cdot 32) + \frac{1}{2}(5 \cdot 20)$

$= 160 + 50$

$= 210$

Example with perfect information

High

$MR_H = 20 - \frac{1}{2}q_H = 2 \rightarrow q_H = 36 \rightarrow P_H = 20 - \frac{36}{4} = 11 \rightarrow \pi_h = 324$

Low

$MR_L = 10 - \frac{1}{2}q_L = 2 \rightarrow q_L = 16 \rightarrow P_L = 10 - \frac{1}{4} \cdot 16 = 6 \rightarrow \pi_L = 64$

$E(\pi) = \frac{1}{2}324 + \frac{1}{2}64 = 194$

Value of perfect info $= 194 - 178 = 16$

3.13 Value of Information 2

Saturday, February 6, 2021 4:14 PM

Produce → Learn demand → announce price → sell

↑ add buy forecast/test → get results →

work → $E(\pi | GN)$

$E(\pi / \text{do buy}) = Pr(G) E(\pi | GN) + Pr(B) E(\pi | BN)$

work → $E(\pi | BN)$

Value = best π w/ info − best π w/out info

3.14-15 Value of Information 2 - Example

Saturday, February 6, 2021 4:23 PM

$Pr(H) = .7$ Buy Info, $Pr(H|+) =$ and $Pr(H|-) =$
$Pr(+) =$

	Pos	Neg	Total
High	13	1	14
Low	1	5	6
Total	14	6	20

$P(H|+) = Pr(H \text{ and } +) / Pr(+)$
$P(H|-) = Pr(H \text{ and } -) / [1 - Pr(+)] = [P(H) - P(H \text{ and } +)] / [1 - P(+)]$

$P(H)$ $P(+)$ $P(H|+)$ $P(H|-)$ → only 3/4 are independent

$Pr(H) = .7$ $Pr(+) = .7$
$Pr(L) = .3$ $Pr(-) = .3$

$Pr(H|+) = 13/14$ $Pr(H|-) = 1/6$

$P_H = 1 - .1q_H$ $P_L = 1 - .2q_L$

$mc = .2$

Solve before class

$E(\pi) = \frac{13}{14}(1 - q_H/10)q_H + \frac{1}{14}(1 - q_L/5)q_L - .2q_H$

$E(\pi) = 1.52$ $P_H = .61$ $q_L = 2.5$ $P_L = .5$

$.7(1 - .2q_H) = .2$
$1 - .2q_H = 2/7$
$.2q_H = 5/7$
$q_H = 25/7$

$1 - .4q_L = 0$
$q_L = 10/4$ → $P_L = 1 - \frac{10}{40} = .75$

$E(\pi) = .7 \frac{45}{70} \frac{25}{7} + .3 \frac{3}{4} \frac{10}{4} - \frac{1}{3} \frac{25}{7} = 1.46$

$1/6(1 - .1q)q + 5/6(1 - .2q)q - .2q = E(\pi)$ for $q = q$

↳ $q = 2.18$ → $P_h = 1 - .1(2.18) = .782$
$P_L = 1 - .2(2.18) = .564$

↳

3 Extra Problems

Monday, February 1, 2021 6:13 PM

$P_1 = 20 - 1/4 q_1 \qquad P_2 = 20 - 1/2 q_2 \qquad \text{Cost} = \frac{1}{2}(q_1+q_2)^2 + 2\bar{q}$

$\hookrightarrow \bar{q}$ = capacity

$\pi = (20 - 1/2 q_1)q_1 + (20 - 1/2 q_2)q_2 - 1/2(q_1+q_2)^2 - 2q_1$

$\frac{d\pi}{dq_1} = 20 - q_1 - 1/2(q_1+q_2) - 2 = 0$

$= 20 - 1/2 q_1 - q_1 - q_2 - 2 = 0$

$\frac{d\pi}{dq_2} = 20 - q_2 - (q_1 + q_1) = 0$

$20 - 2q_2 = q_1$

Inverse demand is p=100-2q with probability 0.6 and otherwise it is p=80-2q. Cost is 20 per unit. Output not sold can be repurposed at a value of 5 per unit.

Determine quantities and prices for each state of demand and expected profit.

$\pi = .6(100 - 2q_1)q_1 + .4(80 - 2q_2)q_2 - 20q_1 + (.4 \cdot 5)(q_1 - q_2)$

$\frac{d\pi}{q_1} = \frac{-12x - 210}{5} \rightarrow = \frac{-32}{5} = 17.5$

$\frac{d\pi}{q_2} = \frac{-8x - 150}{5} \rightarrow -\frac{75}{4} = 18.75 \rightarrow \therefore (q_H > q_L)$

try again

$\pi = .6(100 - 2q)q + .4(80 - 2q)q - 20q$

4 Book Notes

Friday, February 5, 2021 9:04 AM

Estimating and Interpreting Approximations

It can be difficult to maximize profit w/ mult. curves

Fitting a Linear Demand Approximation w/ 2 Points

Example:

$P = \$4$ and $q = 60$ OR $P = \$3$ and $q = 70$

Find $\frac{\Delta P}{\Delta q} = \frac{4-3}{60-70} = -.1 \rightarrow \Delta P = -.1\Delta q$

$(P-4) = -.1(q-60)$

$P = 4 - .1(q-60)$

$P = 10 - .1q$

$C = 5 + 2q \rightarrow \pi = (10 - .1q)q - 5 - 2q$

$\frac{d\pi}{dq} = 8 - .2q = 0 \rightarrow q = 40$

$P = 10 - .1(40) = 6 \rightarrow \pi = 6(40) - 5 - 2(40) = 155$

P may not be \$6 because we only know data from \$3-\$4

Fitting a Log-linear demand approximation w/ 2 Points

$q_D = aP^b \rightarrow 3^d$

a: scale coefficient of demand

Example

$P = \$3$ + $q = 60$ OR $P = \$4$ + $q = 70$

$60 = a4^n$ $70 = a3^n$

$\frac{60}{70} = \frac{a4^n}{a3^n} \rightarrow \frac{6}{7} = (\frac{4}{3})^n \rightarrow \ln(\frac{6}{7}) = n\ln(\frac{4}{3}) \rightarrow n = -.5358$

$60 = a4^{-.5358} \rightarrow a = 126.11$

$q = 126.11P^{-.5358}$

$P^* = (\frac{n}{1+n})MC \rightarrow P^* = (\frac{-.536}{1-.536})2 = -2.31$

$|-.5358| < 1$, raise price

Regression - Fitting the best approximation w/ many data points

^ = estimates

Lots of stuff about regression

Interactions

Interaction term is a new independent var that is the product of two or more other ind. vars.

Categorical or Dummy Variables

remove data contamination

Flexibility of functional form - Log and other transformations

5 Book Notes

Friday, February 5, 2021 10:25 AM

Evaluating Regression Analyses

Bias and Imprecision

Evaluating the model and specification data

don't over-fit data

Evaluating the signs and magnitudes of the coefficient estimates

make sure estimates are reasonable

Evaluating the statistical significance of the results

ANOVA

$MSE = SSE / n-k-1$

↳ $n-k-1$ = degrees of freedom

mean square $MSM = \frac{SSM}{k}$

F statistic $= \frac{MSM}{MSE} = \frac{SSM/k}{SSE/(n-k-1)}$

Evaluating the Accuracy of Results - Dependent Variable Prediction

$R^2 = \frac{SSM}{SST}$

root mean square error $(RMSE) = \sqrt{MSE}$

Evaluating the Accuracy of Results - Coefficient Estimates

Point estimates

Improving Precision

better data + better models

Evaluating Results - An Extended Example

likely that any empirical model suffers from omitted variable bias

Limits of Approximations

don't extrapolate beyond the data range

5.1 Estimating and

Tuesday, February 9, 2021 4:40 PM

→ b = elasticity

est demand → est $P^* = 15$

simple w/ 1 predictor, complex w/ many

<u>Regression</u>

$\sum_i (y_i - \hat{y}_i)^2 = SSR$ choose $\hat{\beta}_0, \hat{\beta}_1, \hat{\beta}_k$

<u>Evaluating a Regression</u>

1) To predict Y only

$RMSE = 5$
Y

not 5

95% $= \hat{Y} \pm 2s$

$RMSE = \sqrt{SSR/(N-k-1)}$

<u>Evaluating coefficients</u>

$\hat{Y} = 1 + 3x$
$\beta_0 \quad \beta_1 \qquad s_{\hat{\beta}_1} = .5$

95 CI $= \hat{\beta}_1 \pm 2 s_{\hat{\beta}_1}$

6 Book Notes

Saturday, February 6, 2021 12:46 PM

Omitted Variable Bias

Reducing Bias

Market Trials

Natural Experiments

Instrumental Variables

find another variable that correlates w/ one and has no relationship w/ any other

Panel Data Techniques

Regression Discontinuity designs

6.1 Omitted Variables

Tuesday, February 9, 2021 5:02 PM

$q = 1 + \varepsilon - p$ ε = random noise

$q = .8 - p$ $q = 1.2 - p$

6.2-3 Omitted

Tuesday, February 9, 2021 5:31 PM

Prediction vs Causation

$f(q|p)$

Need $q^p = a - bp$ Need cause → effect

$$\left.\frac{\partial q}{\partial p}\right|_0 = -1$$

Need random assignment of "predictors" independent vars + exogenous

1) randomize
2) Natural Experiment
3) Instrumental Variable
   ↳ driver of price but not demand
4) Dif in Dif
   ↳ dif individual datasets then find those differences

7 Book Notes

Friday, February 12, 2021 7:31 AM

Individual Choice

Underlying Assumptions about Preferences

Completeness → all decisions available
more is better
Transitivity → A > B and B > C thus A > C
MRS_{xy} = marginal rate of substitution of good x for good y
↳ This can diminish

Indifference Curves and Preferences

different combinations w/ equal utility
Perfect complements vs perfect substitutes
Imperfect substitutes have marginal returns
Curves cannot cross

Utility functions, marginal utility, and the MRS

Marginal utility = derivative
$MRS_{xy} = MU_x / MU_y$

Budget Constraints

budget line $= mP_x X + P_y Y$ → $P_x + P_y$ = cost of X + Y
↳ $Y = \frac{m}{P_y} - \frac{P_x}{P_y} X$
X + Y = Qty. of X + Y
m = budget constraint

Individual choice

Interpretation of the solution of the Individual's choice problem

$MRS_{xy} = \frac{P_x}{P_y}$ → optimality condition
↳ $\frac{MU_x}{P_x} = \frac{MU_y}{P_y}$

Price Changes and Income Shifts

Substitution effect = induced by price change
income effect = change in purchasing power
Giffen Good = substitution ↓ income ↑ = income wins

Individual choice - The Calculus Version

$\max_{x,y} U(x,y)$ subject to $P_x X + P_y Y \leq m$
$U(X, \frac{m}{P_y} - \frac{P_x}{P_y} X)$

Lagrange multiplier $L = U(X,Y) + \lambda[m - P_x X - P_y Y]$
use system of equations to solve

7.1 Axioms of Rational Choice

Friday, February 12, 2021 11:36 AM

1) Completeness
   "bundle" → things you can choose
   ↳ $A > B$ or $A < B$ or $A = B$
2) More is better
3) Transitivity
   ↳ if $A > B$ and $B > C$, $A > C$
   ↳ Independence of irrelevant options
4) Diminishing marginal rate of substitution

7.2 Indifference Curves

Friday, February 12, 2021 11:47 AM

Indifference curves cannot cross

$a \succ b$

$a \sim c$ $\quad b \sim c \to$ contradiction

$a \succ c$

7.3 Budget Constraint

Friday, February 12, 2021 11:57 AM

$m \quad P_x \quad P_y$

$m \geq P_x X + P_y Y$

$m = P_x X + P_y Y$

$\Rightarrow Y = \frac{m}{P_y} - \frac{P_x}{P_y} X$ → budget line

↳ price ratio → rate market dictates

↳ y intercept

7.4 Rational Choice and

Friday, February 12, 2021 12:02 PM

Line moves as price shifts

7.5 Substitution and

Friday, February 12, 2021 2:15 PM

$P_x \downarrow$, $X \uparrow$, $Y \uparrow$

X & Y comps.

$\frac{\Delta X}{\Delta Y}$ Substitution effect

Income effect

SE Hold utility constant but ΔP_x $\tilde{X} - X_0$: SE

Higher real income $X_1 - \tilde{X}$: IE

$\Delta X = X_1 - X_0 = \underbrace{(X_1 - \tilde{X})}_{IE} + \underbrace{(\tilde{X} - X_0)}_{SE}$

IF $P_x \uparrow \Rightarrow X \uparrow$

What if x is a normal good

IF x inferior & $|IE| > |SE| \Rightarrow$ Giffen goods

7.6 Giffen Goods

Friday, February 12, 2021 2:21 PM

|IE| big if huge % of income spent on it

Inf good, huge budget share? Poor

7.7 Utility Functions

Friday, February 12, 2021 2:32 PM

Preferences can be represented w/ a utility function

$U(x, y)$ incr in x, y

$|U(x,y)|$ real

$\ln(U(x,y))$

↳ only care about ranking

Utility is ordinal, Not cardinal

$\max_{x,y} U(x,y)$ subject $m = P_x X + P_y Y$

7.8 Calculus of Choice

Friday, February 12, 2021 2:37 PM

Lagrangian

$$L = U(x,y) + \lambda(m - P_x X - P_y Y)$$

$$\frac{dL}{dx} = \frac{dU}{dx} - \lambda P_x = 0$$

$$\frac{dL}{d\lambda} = m - P_x X - P_y Y = 0 \rightarrow m = P_x X + P_y Y$$

$$\frac{MU_x}{P_x} = \frac{MU_y}{P_y} \quad \text{and} \quad \frac{MU_x}{MU_y} = \frac{P_x}{P_y}$$

$$MRS_{xy} = \frac{MU_x}{MU_y} = \frac{P_x}{P_y}$$

$$MU_x = 2 \quad \text{and} \quad MU_y = 1 \rightarrow 2y = 1x$$

7 Extra Problems

Monday, February 15, 2021 5:54 PM

Income = 2000 (E)verything (F)ood $P_e = P_f = 1$

a) original budget line

b) $500 income assistance

c) $500 food gift card

d) Can anyone be better off w/ b than c? Illustrate

Anyone that spends <$500 on food

e) Can anyone be better off with c than b? If so, Illustrate

No one is better off because they are now limited.

f) Why would a Public Policy be like c than b?

If the gov't wants that to be spent on food

8 Book Notes

Saturday, February 20, 2021 3:33 PM

Applications and Extensions of Consumer Theory

Compensation Indexing and Compensating Differentials

H = housing costs

$V(H, \epsilon)$

$m = RH + \epsilon$

Individual Choice, Individual Demand, and Market Demand

Market demand is the sum of individual demand

Willingness to Pay and Consumer Surplus

V = WTP

WTP - Market cost = Consumer surplus

↳ $CS(q) = V(q) - Pq$

↳ $\frac{dCS}{dq} = \frac{dV}{dq} - P = 0$

$V'(q)$ = marginal WTP

↳ $P = V'(q)$

8.1 Compensating Differentials

Saturday, February 20, 2021 3:59 PM

R = rent/sq ft

Lakeland vs Cleveland
$1 $2

M = E + RH

$M_2 = 5$

$\frac{dy}{dx} = -1$

= -1

8.2 Individual

Saturday, February 20, 2021 4:12 PM

$q_i(p)$ = individual demand

Market demand = sum individual demand

8.3 Demand

Saturday, February 20, 2021 4:19 PM

$v(x,y)$ subject $m = P_x x + P_y y$

money metric: $v(x,y) = v(x) +$ expenditure on y

$v(x,\epsilon) = v(x) + \epsilon \quad P_\epsilon = 1$

$v = v(x) + m - P_x x \quad m = \epsilon + P_x x$

$\max \; v(x) + m - P_x x$

$\frac{dv}{dx} = \frac{dv}{dx} - P_x = 0$

↳ inverse demand for x

$\frac{dv}{dx}$ = marginal value of x

change in m don't affect

$v(x)$ total value to consumer = WTP

$\frac{dv}{dx}$ = marginal WTP

$v = 10q - \frac{1}{2}q^2 + \epsilon \quad m = 100$

$= 100 + 10q - \frac{1}{2}q^2 - Pq$

$\frac{dv}{dx} = 10 - q = P \qquad 10 - q$ = inverse demand

$Q = \sum_{i=1}^{n} q_i(P)$

8.4 Consumer Surplus

Saturday, February 20, 2021 4:26 PM

$CS = \frac{1}{2}(6.5 - 1.99) =$

$$CS = v(q) - pq$$

$$CS_i = \int_0^{q_i} p(x)\,dx - pq_i$$

$$CS_{total} = \int_0^{Q} p(x)\,dx - pQ$$

8 Extra Problems

Monday, February 22, 2021 5:42 PM

Utility is $U=H^{0.5}E$ where H is housing in square feet and E is expenditure on everything else. R is monthly rent per square foot. Monthly disposable income is M.

1) Solve for housing demand as a function of M and R. Also solve for the demand for E as a function of M and R.

$E = M - RH$

$\frac{dU}{dx} = E/2\sqrt{H}$ $\quad$ $\frac{dU}{dy} = \sqrt{x}$

$MRS_{HE} = \frac{E}{2H^{.5}H^{.5}} = \frac{E}{2H} = R$

$M = E + RH = 2RH + RH = 3RH$

$H = M/3R$

$E = 2RH = 2R\frac{M}{3R} = \frac{2}{3}M = E$

2) The indirect utility function, V, gives maximum utility as a function of income and prices. Substitute your solutions from #1 into the utility function to find the indirect utility function.

$V = \left(\frac{M}{3R}\right)^{.5} \cdot \left(\frac{2M}{3}\right)$

3) Suppose income is 4000 and rent increases from 1 to 2. How does housing consumption change? Be specific. Sketch both the consumer's optimization problem and the demand curve.

$\frac{4000}{3 \cdot 1} - \frac{4000}{3 \cdot 2} = 1333\frac{1}{3} - 666\frac{2}{3}$

$\Delta CS = (2-1) \cdot 667 - \frac{1}{2}(2-1) \cdot (1333 - 667)$
$= -3/2 - 667$
$= 1000$

$E = 2/3M$
$= 2667$

4) What is utility at each level of rent?

$M_5 - 4$ = Answer to 5 Compensating Variation

$M_6 = 4 - M_6$ = Answer to 6 Equivalent Variation

$V = \frac{M^{1.5}}{R^{.5}} \frac{2}{3} 1.5$

$V(M=4000, R=1) = 2 \cdot (4000/3)^{1.5} = 97373$

$V(M=4000, R=2) = \sqrt{2}\,(4000/2)^{1.5} = 68853$

No unit because it is a measure of utility

5) How much additional income is needed to keep the individual just as happy at R=2 as they were at R=1? Formally, this is called the compensating variation, CV. Show this in the depiction of the consumer optimization problem.

$\left(\frac{M_5}{3}\right)^{1.5} \frac{2}{\sqrt{2}} = 97373 \rightarrow M_5 = 5039.69$

6) At R=1, what is the most the consumer would pay to avoid rent increasing to 2? This is called the equivalent variation, EV. Show this in the depiction of the consumer optimization problem.

$\left(\frac{M_6}{3}\right)^{1.5} \frac{2}{\sqrt{1}} = 68853 \rightarrow M_6 = 3174.8$

$CV = 5040 - 4000 = 1040$
$EV = 4000 - 3175 = 825$
$\Delta CS = 1000$

7) Looking at the demand curve, using a linear approximation between the two rent levels, what is the change in consumer surplus when price goes from 1 to 2?

8) How does the change in CS compare to the EV and CV? Can you intuitively explain the differences?

9 Book Notes

Sunday, February 21, 2021 10:26 AM

Non Linear Pricing

Block Pricing and Two-Part Pricing

To get rid of DWL, MWTP = MC

Block Pricing: sell a bundle at one price (24-Pack of Soda)

↳ $\pi = nP - C(nq^*)$

↳ $\pi = n^v(q) - C(nq)$

↳ $\frac{d\pi}{dq} = n\frac{dv}{dq} - \frac{dC}{d(nq)} \cdot \frac{d(nq)}{dq}$

$\frac{dv}{dq} = MWTP$

Two-Part Pricing: Costco membership + goods

↳ $\pi = n(F + Pq) - C(nq)$

Menu Pricing: different prices for different bundles

Participation vs selection constraints

9.1-2 Menu Pricing

Sunday, February 28, 2021 6:50 PM

Bundle 1 q_1^*
Bundle 2 q_2^*

$V_L(q_L)$ $V_H(q_H)$ P_L P_H

n_L n_H $c(n_L q_L + n_H q_H)$

$\pi = n_H P_H + n_L P_L - c(n_L q_L + n_H q_H)$

1) $CS_L(q_L) \geq 0$, $V_L(q_L) - P_L \geq 0$ } Participation constraints
~~2) $CS_H(q_H) \geq 0$, $V_H(q_H) - P_H \geq 0$~~
~~3) $CS_L(q_L) \geq CS_L(q_H)$, $V(q_L) - P_L \geq V_L(q_H) - P_H$~~ } Incentive compatibility constraints
4) $CS_H(q_H) \geq CS_H(q_L)$, $V(q_H) - P_H \geq V_H(q_L) - P_L$

1) $P_L = V_L(q_L)$ $CS_L(q_L) = 0$
2) $V_H = (q_H) - P_H = V_H(q_L) - P_L$ $V_H(q_H) - V_H(q_L) = P_H - P_L$

$P_H = V_H(q_H) - V_H(q_L) + V_L(q_L)$

$\pi = n_L q_L + n_H q_H - c(n_L q_L + n_H q_H)$

$\hookrightarrow = n_H [V_H(q_H) - V_H(q_L) + V_L(q_L)] + n_L V_L(q_L) - c(n_H q_H + n_L(q_L)$

9.3 Menu Pricing 3

Sunday, February 28, 2021 7:25 PM

$$\frac{dW}{dq_H} = \frac{dv_H}{dq_H} n_H - \frac{dc}{dq} \cdot n_H = 0$$

$$P_H - MC = 0$$
$$P_H(q_H) = MC$$

$$(P_L, q_L) = (\square, q_L^*)$$

$$=$$

9.4 Menu Pricing Example

Sunday, February 28, 2021 7:43 PM

$P_H = 20 - 2q_H$ $\quad P_L = 20 - 4q_L$ $\quad n_L = 4$ $\quad n_H = 2$ $\quad MC = 2$

$P_L = 20q_L - 2q_L^2$ $\quad P_L = V(q_L)$

$20q_H - q_H^2 - P_H = 20q_L - q_L^2 - P_L$ $\quad V_H(q_H) - P_H = V_H(q_L) - P_L$

$20q_H - q_H^2 - 20q_L - q_L^2 + 20q_L - 2q_L^2 = P_H$

$\hookrightarrow P_H = 20q_H - q_H^2 - q_L^2$

$\pi = \underset{n_H}{2}(20q_H - q_H^2 - q_L^2) + \underset{n_L}{4}(20q_L - q_L^2) - 2[4q_L + 2q_H]$

$\frac{d\pi}{dq_H} = 2(20 - 2q_H) - 2(2) = 0 \rightarrow q_H = 9$

$\frac{d\pi}{dq_L} = -2 \cdot 2q_L + 4(20 - 4q_L) - 2(4) = 0 \rightarrow q_L = 3.6$

$P_L = 20(3.6) - 2(3.6^2) = 46.08$

$P_H = 20(9) - 9^2 - 3.6^2 = 86.04$

Problem 1

Saturday, January 23, 2021 12:08 PM

What is the present value of the payments in the table? Time is measured with the present being 0. Assume the riskless annual rate of return is 2.5%.

Time	1	2	3	4	5
Value	-50	-50	-100	-200	500

$$V = -50/(1.025) + -50/1.025^2 + -100/1.025^3 + -200/1.025^4 + 500/1.025^5$$
$$= -48.78 - 47.59 - 92.85 - 181.19 + 441.92$$
$$= 71.50\$$$

Problem 2

Saturday, January 23, 2021 12:35 PM

Use the fact that the present value of a perpetuity paying $X per period starting in one year is X/r, where r is the riskless rate of return, to determine the present value of annual payments of $X accruing for 20 years, starting one year from now. Hint: Think of it as a perpetuity less the appropriately discounted value of a perpetuity starting 20 years from now.

$$X/r - \sum_{t=1}^{20} X/(1+r)^t$$

$$V_0 = \frac{X}{r} - \left(\frac{X}{r}\right)\left(\frac{1}{(1+r)^{20}}\right) = \frac{X}{r}\cdot\left(1 - \frac{1}{(1+r)^{20}}\right)$$

Problem 3

Saturday, January 23, 2021 12:38 PM

What is the present value of the uncertain payment stream in the table? Time is measured with the present being 0. P(End) is the probability the payment stream is permanently terminated before that period's payment is made, conditional on the previous period's payment having been made. So, you have to work out the probability the venture survives long enough for each payment to be made. The riskless annual rate of return is 4%.

Time	1	3	6	10
P(End)	0.1	0.1	0.4	0.7
Value	-10	-5	60	1000

$$V = \left(\frac{-10}{1.04^1}\right)(.9) - \left(\frac{5}{1.04^3}\right)(.9 \cdot .9) + \left(\frac{60}{1.04^6}\right)(.9 \cdot .9 \cdot .6) + \left(\frac{1000}{1.04^{10}}\right)(.9 \cdot .9 \cdot .6 \cdot .3)$$

$$= -8.56 - 3.60 + 23.045 + 98.497$$

$$= 109.2885$$

Multiplying probabilities because each one is conditional on the ones before it being true

Problem 4

Saturday, January 23, 2021 12:46 PM

Jason is considering developing a process innovation. It requires an initial investment of $100, then another investment of $40 after one year. Jason thinks the probability it will turn out to be feasible after two years is 0.7. If it is feasible, it will then take another expenditure of $50 (2 years from the initial investment) to complete. It will then be ready to demonstrate 3 years from the initial investment. Jason thinks there is a 0.05 probability that with a successful demonstration he will sell his innovation for $1,000 and a 0.5 probability he will sell it for $400, and that otherwise there will be no interest. The annual discount rate (riskless rate of return) is 5%. There are no other costs and Jason is risk neutral.

a. Illustrate the decision(s) to be made with a decision tree.

b. What is the present expected value of the project?

$$\left(\frac{-100}{1.05^0}\right)(1) - \left(\frac{40}{1.05^1}\cdot 1\right) + \left(\frac{0}{1.05^2}\right)(.3) - \left(\frac{-50}{1.05^2}\right)(.7)$$

$$+\left[\left(\frac{1000}{1.05^3}\right)(.05) + \left(\frac{400}{1.05^3}\right)(.5) + \left(\frac{0}{1.05^3}\right)(0)\right][.7] = -18.67$$

c. What probability of selling the project for $400 would make Jason indifferent between pursuing it or not, assuming P(1000) stays the same?

$$0 = -100 - \frac{40}{1.05} + .7\left(-\frac{50}{1.05^2} + \left(F\frac{400}{1.05^3} + .05\frac{1000}{1.05^3}\right)\right)$$

$F = .577$

Using Solver... = .5771875

	A	B	C	D	E	F	G	H	I
1	time	0	1	2	2	3	3	3	
2	value	-100	-40	0	-50	1000	400	0	
3	prob	1	1	0.3	0.7	0.05	0.5772	0.3728	
4	1.05								sum
5		-100	-38.1	0	-31.75	43.192	199.44	0	0

d. Jason may obtain an expert's opinion of the feasibility of his idea for a fee. Suppose the consultant's studied opinion is completely accurate and Jason thinks there is a 70% chance they will find the innovation feasible. How much is the opinion worth?

$$(.05\cdot 1000) + (.5\cdot 400) + (.45\cdot -190) = 164.5$$

$$164.5 - (-100) = 264.5$$

$$EAV = -100 - \frac{40}{1.05} + .7\left(-\frac{50}{1.05^2} + \left(.5\frac{400}{1.05^3} + .05\frac{1000}{1.05^3}\right)\right)$$

If info, $EAV = .7\cdot 32.51 + .3\cdot 0 = 22.76$

Info − no $= 22.76 - 0 = 22.76$

e. Suppose, having dealt with consultants on similar projects, Jason guestimates there is a 0.7 probability the consultant will report the innovation is probably feasible and otherwise the consultant will report the idea is probably not feasible. Jason thinks that if the consultant says the idea is probably not feasible, the probability it is feasible is 0.19 and that if the consultant says the idea is probably feasible, the probability it is feasible is 0.92. How much is the opinion worth?

This is definitely wrong :(

$$PV = -100 - \frac{40}{1.05^1} + \left(\frac{50}{1.05^2}\cdot .7\cdot .92\cdot 164.5\right)$$

$$EAV = -100 - \frac{40}{1.05} + .92\left(-\frac{50}{1.05^2} + \left(.5\frac{400}{1.05^3} + .05\frac{1000}{1.05^3}\right)\right) = 18.86$$

Thus, with info $EAV = .7\cdot 18.86 + .3\cdot 0 = \boxed{13.2}$

Problem 5

Saturday, January 30, 2021 3:02 PM

After incurring a cost of $300 to set up a cafeteria for a day, each meal costs $4 to prepare and serve. If the inverse demand for meals on Sunday is p=9-0.025q , what price and quantity maximize profit, and what is maximum profit? Illustrate with a figure.

$\pi = (9-.025q)q - 4q - 300$

$\frac{d\pi}{dq} = (9-.025q) - .25q - 4$

$\frac{d\pi}{dq} = 0 = 9 - .025q - .025q - 4$

$0 = 5 - .05q$

$5 = .05q$

$q = 100$

$q = (9-P)/.025$

$P = 9 - .025(100)$

$= 9 - 2.5$

$= 6.5$

$\pi = (6.5 \cdot 100) - (4 \cdot 100) - 300$

$\pi = -50$

↳ profit is negative because it's a soup kitchen and they operate at a loss.

→ because they have no money

← Illustrate with a figure.

Problem 6

Saturday, January 30, 2021 3:31 PM

Inverse demand is, p=-5+0.5m-0.75q, where m is per capita income. If the cost per unit is constant at \$5, calculate the profit maximizing price as a function of per capita income. How much does the profit maximizing price increase per \$1 increase in per capita income?

$\pi = (-5 + .5m - .75q)q - 5q$

$= -5q + .5mq - .75q^2 - 5q$

$\hookrightarrow -10q + .5mq - .75q^2$

$\frac{d\pi}{dq} = -10 + .5m - 1.5q \Rightarrow q^* = m - 20/3$

$0 = -10 + .5m - 1.5q$

$10 = .5m - 1.5q$

$10 - .5m = -1.5q$

$q = -6.66 + .33m$

$P = -5 + .5m - .75(-6.66 + 1/3m)$

$P = -5 + .5m + 5 - .25m$

$P = .25m$

~~If it's 1.5m...~~

~~$\ldots 10 - 1.5m = -1.5q$~~

~~$q = -\frac{20}{3} + m$~~

~~$P = -5 + 1.5m - .75(-\frac{20}{3} + m)$~~

~~$P = -5 + 1.5m + 5 - .75m$~~

~~$P = .75m$~~

~~$P = .75m / .25m$~~

~~$= 3$~~

The price increases by 300% per \$1 increase in per capita income

Problem 7

Saturday, January 30, 2021 3:50 PM

A firm sells q_B mugs of beer at price p_B, and q_P slices of pizza at price p_P. The inverse demand for mugs of beer is $p_B=5-0.25q_B+0.1q_P$ and the inverse demand for pizza slices is $p_P=4-0.5q_P+0.1q_B$. It costs \$1/mug to serve beer and \$2/slice to serve pizza. Find the prices and quantities that maximize profit and the maximum profit.

	A	B	C	D	E	F	G
1	item	c	p	q	unit cost	profit	
2	beer		2.9	10	1	19	
3	pizza		3	4	2	4	
4						23	<- Solver

Hailey, Troy, and myself can't seem to organically find a right answer without solver

I've thought q_B and q_P had to be integers

$$\pi = (5-.25q_B+.1q_P)(q_B) + (4-.5q_P+.1q_B)(q_P) - (1\cdot q_B) - (2\cdot q_P)$$

$$= -.25q_B^2 + .2q_Bq_P + 4q_B - .5q_P^2 + 2q_P$$

$$\frac{d\pi}{dq_B} = -\frac{q_B}{2} + \frac{q_P}{5} + 4$$

$$\frac{q_B}{2} = \frac{q_P}{5} + 4 \rightarrow q_B = \frac{2q_P}{5} + 8$$

$$0 = \frac{-(2q_P/5+8)}{2} + \frac{q_P}{5} + 4 \rightarrow q_P = 0$$

$$0 = \frac{-q_B}{2} + \frac{0}{5} + 4$$

$$-4 = -q_B/2$$

$$-8 = -q_B$$

$$q_B = 8$$

$$\frac{d\pi}{dq_B} = (5-.5q_B+.1q_P) + .1q_P - 1 = 0$$

$$.5q_B = 4 + .2q_P$$

$$q_B = 8 + .4q_P$$

$$\frac{d\pi}{dq_P} = (4-q_P+.1q_P) + .1q_P - 2 = 0$$

$$q_P = 2 + .2q_B$$

$$q_B = 8 + .4(2+.2q_B)$$

$$q_B = 8 + .8 + .08q_B$$

$$.92q_B = 8.8$$

$$q_B = 9.57$$

$$q_P = 2 + .2(9.57) = 3.91$$

$$p_B = 5 - (.25\cdot 9.57) + (.1\cdot 3.91) = 3$$

$$p_P = 4 - (.5\cdot 3.91) + (.1\cdot 9.57) = 3$$

$$\pi = (3-1)(9.57) + (3-2)(3.91) = 23.04$$

Problem 8

Saturday, January 30, 2021 4:37 PM

Demand is given by $q=400p^{-2}$. Cost per unit is \$10. What are the profit maximizing price and quantity and what is the maximum profit?

$q=400p^{-2}$ $MC=10$ $\eta^d=-2$

$p=10(-2/(1-2))=-20/-1=20$

$q=400p^{-2}=400(20)^{-2}=400\cdot 1/400=1$

~~$\pi=20-1-10$~~ $\pi=(20-10)(1)=10$

Problem 9

Saturday, January 30, 2021 4:43 PM

At the current price of $8, you sell 24 units. Cost is $4/unit. Based on publicly available estimates, you think the elasticity of demand is approximately -3. Estimate the profit maximizing price and the quantity sold and profit at that price.

Current $\pi = 24 \cdot 4 = 96$

$mc = 4 \qquad \varepsilon^d = -3$

$p = mc(\varepsilon^d / (1+\varepsilon^d))$

$p = 4(-3/(1+-3))$

$p = 4(-3/-2)$

$p = 4(1.5)$

$p = 6$

$-3 = \frac{\Delta q}{\Delta p} \cdot \frac{p}{q} = \frac{\Delta q}{-2} \cdot 8/24 \rightarrow \Delta q = 18$

$q = 24 + 18 = 42$

$\pi = (6-4)(42) = 2 \cdot 42 = 84$

Problem 10

Tuesday, February 9, 2021 6:09 PM

Inverse demand for movie tickets is:

p_s=16-0.01q_s for senior citizens and $.01q_s + p_s = 16$ $.01q_s = 16 - p_s$ $q_s = \frac{16-p_s}{.01}$

p_A=24-0.01q_A for others. $q_A = \frac{24-p_A}{.01}$

The marginal cost of serving one more movie goer is $4.

Determine the profit maximizing prices for each type of customer.

$\pi = (16 - .01q_s)q_s + (24 - .01q_A)q_A - 4(q_s + q_A)$

$\frac{d\pi}{q_s} = 12 - \frac{q_s}{50} \Rightarrow \frac{q_s}{50} = 12 \Rightarrow q_s = 12 \cdot 50 = 600 = q_s$

~~I'm definitely missing the $q_H > q_L$ step~~

	A	B	C	D	E
1		Quantity	Price	Cost	Total
2	Senior	600.000016	9.99999984	2400.00007	3600
3	Other	1000.00001	13.9999999	4000.00002	10000
4	A bit of solver to make sure I'm on the right track				13600

$\frac{d\pi}{q_A} = 20 - \frac{q_A}{50} \Rightarrow \frac{q_A}{50} = 20$ $q_A = 1000$

I'm not sure this is right.

$p_s = 16 - .01(600) = 10 = p_s$
$p_A = 24 - .01(1000) = 14 = p_A$

~~$\pi_{max} = 1700$~~

$\pi = (10 \cdot 600) + (14 \cdot 1000) - (4 \cdot 1600) = 13600$

$q_A + q_s$

Problem 11

Tuesday, February 9, 2021 6:43 PM

Inverse demand for evening movie tickets is p_E=25-0.01q_E and inverse demand for matinee tickets is p_M=15-0.01q_M.

$25-P_E = .01q_E$

a. Assuming the marginal cost of serving one more customer is $2 holding capacity constant, and that cost of adding capacity is $2 per unit, determine profit maximizing capacity, prices and quantities.

$Cost = 2(q_E+q_M) + 2(q_E+q_M)$

k = capacity

	A	B	C	D	E	F
1		Quantity	Price	Capacity	Cost	Total
2	Evening	1050	14.5	1050	4200	11025
3	Matinee	550	9.5	550	2200	3025
4	A bit of solver to make sure I'm on the right track					14050

$\pi = (25-.01q_E)q_E + (15-.01q_M)q_M - 2(q_E+q_M) - \cancel{2(q_M-q_E)} - 2q_E$

↳ assume $q_E = q_M$

↓

fix solver

	A	B	C	D	E	F
1		Quantity	Price	Capacity	Cost	Total
2	Evening	1050	14.5	1050	2900	12325
3	Matinee	650	8.5	650	2600	2925
4	A bit of solver to make sure I'm on the right track					15250

$\frac{d\pi}{q_E} = 21 - \frac{q_E}{50} \rightarrow q_E = 1050$ $\quad \frac{d\pi}{dq_M} = 15 - .02q_M - 2 \rightarrow q_M = 650$

~~$\frac{d\pi}{q_M} = 15 - \frac{q_M}{50} \rightarrow q_M = 750$ → hmm, solver disagrees~~

Something's wrong with my profit function

	A	B	C	D	E	F
1		Quantity	Price	Capacity	Cost	Total
2	Evening	1050	14.5		2700.00002	12525
3	Matinee	750	7.5	750	1500	4124.999999
4	A bit of solver to make sure I'm on the right track					16650

That's better. B3 must equal D3 and $E2 = 2\cdot(B2-D3) + (2\cdot B2)$

$\pi = (25-.01q_E)q_E + (15-.01q_M)q_M - (2\cdot q_M) - [2(q_E - q_M) + (2\cdot q_E)]$

$P_E = 25 - .01(1050) = 14.5 = P_E$

$P_M = 15 - .01(750) = 7.5 = P_M$

~~If cost = $2q_M + 2(q_E - q_M) - 2q_E$ then capacity is the lower q which is $q_M = 750$~~

b. Find the value of per unit capacity cost, k, at which the constraint that matinee quantity is less than or equal to capacity is just binding. That is, at all lower values of k, matinee ticket sales will be less than capacity, and at k or higher, matinee and evening sales both equal capacity.

~~cost = $2q_M + k(q_E - q_M) - 2q_E$~~

Easiest to find where they equal

$q_E = q_M$ so cost = 0?

	A	B	C	D	E	F
1		Quantity	Price	Capacity	Cost	Total
2	Evening	900	16	900	1800	12600
3	Matinee	900	6	900	1800	3600
4	A bit of solver to make sure I'm on the right track					16200
5			Capacity Cost	0	=k	

double checking w/ solver gives the same answer

To triple check, remove D2 === D3 and set k = 2

	A	B	C	D	E	F
1		Quantity	Price	Capacity	Cost	Total
2	Evening	1050	14	1050	2700	12525
3	Matinee	750	7	750	1500	4125
4	A bit of solver to make sure I'm on the right track					16650
5			Capacity Cost	2		

There's the same answer as part A. Either both parts are very wrong or I did it right both places!

$\pi = (25-.01q_E)q_E + (15-.01q_M)q_M - 2q_E - 2q_M - kq_E$

Assume $q_M = 650$ from Part A

$\frac{d\pi}{dq_E} = 25 - .02q_E - 2 - k = 0$

$.02q_E = 23 - k$

$q_E = 1150 - 50k = 650$

$50k = 500$

$k = 10$

Problem 12

Tuesday, February 9, 2021 7:34 PM

Inverse demand will be p_H=12-0.005q_H with probability 0.4, and otherwise p_L=12-0.01q_L. Any product not sold must be disposed of at a cost of $1 per unit. For parts a and b, production must take place *before* demand uncertainty is resolved and cost per unit is constant at $3.

$E(\pi) = .4(12-.005q_H)q_H + .6(12-.01q_L)q_L - 3q_H - .6\cdot(q_H - q_L)$

a. Find the profit maximizing prices and quantities for each state of demand.

$\cancel{\pi = (12-.005q_H)q_H + (12-.01q_L)q_L - 3(q_H+q_L)}$

$\cancel{\frac{d\pi}{q_H} = 9 - \frac{q_H}{100} \rightarrow q_H = 900}$ $\frac{d\pi}{dq_H} = .4(12-.01q_H) - 3 - .6 = 0 \rightarrow q_H = 700$

$\cancel{\frac{d\pi}{dq_L} = 9 - \frac{q_L}{50} \rightarrow q_L = 450}$ $\frac{d\pi}{dq_L} = .6(12-.02q_L) + .6 = 0 \rightarrow q_L = 650$

$\cancel{p_H = 12 - .005(900) = 7.5}$ $\cancel{\rightarrow}$ ~~that's no good... why is it?~~

$\cancel{p_L = 12 - .01(450) = 7.5}$

$p_H = 12 - .0005\cdot 700 = 10.5$

$p_L = 12 - .01\cdot 650 = 5.5$

q_L !< q_H so $q_L = q_H$

$\cancel{\pi_H = 900\cdot 7.5 = 6750}$

$\cancel{\pi_L = 450\cdot 7.5 = 2025}$

$\cancel{\rightarrow E(\pi) = (.4\cdot 6750) + (.6\cdot 2025) = 2855}$

$\cancel{\pi = (12-.005q)q + (12-.01q)q - 3q}$

$\cancel{\frac{d\pi}{q} = 21 - \frac{3q}{100} \rightarrow \frac{3q}{100} = 21 \rightarrow 3q = 2100 \rightarrow q}$

$\cancel{\pi = (12-.005q)q + (12-.01q)q - 6q}$

$\cancel{\frac{d\pi}{q} = 18 - \frac{3q}{100} \rightarrow q = 600}$

$\cancel{p_H = 12 - .005(600) = 9 = p_H}$

$\cancel{p_L = 12 - .01(600) = 6 = p_L}$

$\cancel{\pi_H = 600\cdot 9 = 5400}$

$\cancel{\pi_L = 600\cdot 6 = 3600}$

$\cancel{E(\pi) = (.4\cdot 5400) + (.6\cdot 3600) = 4320}$

$\cancel{\text{if any } q\text{'s} = 3(2q)}$

$E(\pi) = .4(12-.005q)q + .6(12-.02q)q - 3q$

$\frac{d\pi}{dq} = .4(12-.01q) + .6(12-.02q) - 3 = 0$

$\rightarrow q = 562.5$

$p_H = 12 - .0005\cdot 562.5 = 9.19$

$p_L = 12 - .01\cdot 562.5 = 6.38$

$\cancel{\rightarrow}$ ~~high. forgot to account for probability~~

$\rightarrow E(\pi) = (.4\cdot 9.19 + .6\cdot 6.38 - 3)562.5 = 2531.25$

b. Suppose you can set up an analytics program to obtain additional information on the probability of high demand. Your best guess is that with probability 0.3 they will tell you the probability of high demand is 0.89, and that otherwise they will tell you the probability of high demand is 0.19. What is the analytics program worth per period?

$\cancel{\pi_L = (12-.01q)q - 3q}$

$\cancel{\pi_H = (12-.005q_H)q_H + (12-.01q_L) - 3(q_H+q_L) - (q_H - q_L)}$

$\cancel{E(\pi) = 4050 - (3\cdot 900) = 1350\cdot .4 = 540}$

$E(\text{info}) = 1148.175 - 540 = 608.175$

$E(\pi) = .89(12-.0005q_H)q_H + .11(12-.01q_L)q_L - 3q_H - .11\cdot 1(q_H - q_L)$

$\frac{d\pi}{dq_H} = .89(12-.01q_H) - 3 - .11 = 0$ $\frac{d\pi}{dq_L} = .11(12-.02q_L) + .11 = 0$

$\rightarrow q_H = 850.6$ $\rightarrow q_L = 650$

$p_H = 12 - .0005\cdot 850.6 = 7.75$ $p_L = 12 - .01\cdot 650 = 5.50$

q_H ? q_L is good

$E(\pi) = .89\cdot 7.75\cdot 850.6 + .11\cdot 5.5\cdot 650 - 3\cdot 850.6 - .11\cdot 1(850.6 - 650) = 3686.4$

π $P(H) = .19$

$E(\pi) = .19(12-.0005q)q + .81(12-.01q)q - 3q$

$\frac{d\pi}{dq} = .19(12-.01q) + .81(12-.02q) - 3 = 0 \rightarrow q = 497.24$

$p_H = 12 - .0005\cdot 497.24 = 5.51$

$p_L = 12 - .01\cdot 497.24 = 7.03$

$E(\pi) = (.19\cdot 5.51 + .81\cdot 7.03 - 3)497.24 = 2237.57$

$E(\pi | \text{info}) = .3\cdot 3686.4 + .7\cdot 2237.57 = 2672.22$

$E(\pi | \text{no}) = 2531.25$

$\rightarrow \text{Info} = 140.97$

c. Assume you do not have recourse to additional information as in (b). Instead, suppose that in addition to your current production line (that costs $3 per unit) you could add a just in time production line with a cost of $5 per unit. Find the maximum expected profit if you add this line, and therefore its value per production period. *Hint*: Since your base line cost is only $3 per unit, you would always use it to produce any units you are certain to sell (low demand sales). The question is whether or not it saves money to use the just in time line for additional production when demand is high. The answer determines how you add the unit cost of units q_H through q_L, and the potential disposal cost, to the problem setup.

$\cancel{\pi = (12-.005q_H)q_H + (12-.01q_L)q_L - 3(q_H+q_L) - 5(q_H - q_L)}$

$\cancel{\text{or } 50/(.04/12) = 15000}$

$\cancel{\frac{d\pi}{dq_H} = 4 - \frac{q_H}{100} \rightarrow q_H = 400}$ $E(\pi) = .4(12-.0005q_H)q_H + .6(12-.01q_L)q_L - 3q_L - .4\cdot 5(q_H - q_L)$

$\cancel{\frac{d\pi}{dq_L} = 14 - \frac{q_L}{50} \rightarrow q_L = 700}$ $\frac{d\pi}{dq_H} = .4(12-.01q_H) - .4\cdot 5 = 0 \rightarrow q_H = 700$

$\frac{d\pi}{dq_L} = .6(12-.02q_L) - 3 + .4\cdot 5 = 0 \rightarrow q_L = 516.67$

$\cancel{p_H = 12 - .005(400) = 10}$

$\cancel{\pi = 400\cdot 10 = 4000}$

$p_H = 12 - .0005\cdot 700 = 8.50$

$p_L = 12 - .01\cdot 516.67 = 6.83$

$E(\pi) = .4\cdot 8.5\cdot 700 + .6\cdot 6.83\cdot 516.67 - .4\cdot 5(700 - 516.67) = 2581.67$

Value JIT $= 2581.67 - 2531.25 = 50.42$

~~If demand is high, the JIT line has a profit of 4000 while the normal line has a profit of 4050. Thus, the JIT line is not a good idea.~~

d. Continuing from (c), assume the safe rate of interest is 4% annually (so 0.04/12 monthly), and that you make one production run per month. Using the fact that the present value of a perpetual payment of $V starting one period from the current period is $V/r, calculate an upper bound of the expected present value of adding a just in time production line.

$\frac{.04}{12} = .003$

$4050 - 4000 = 50$

$\cancel{\sum_{t=1}^{\infty} \frac{50}{(1+.003)^t} = 15000}$ $\sum_{t=1}^{\infty} \frac{50.42}{(1+.04/12)^t} = 15125$

Problem 13

Monday, February 22, 2021 8:34 PM

Chris' preferences are represented by , where *S* is the number of pizza slices he eats and *B* is the number of mugs of beer he drinks. Pizza costs $2 per slice, beer costs $3 per mug, and Chris has $36 to spend on beer and pizza.

a) Find the beer and pizza consumption bundle that maximizes his utility.

$36 = 2S + 3B$

There are lots of combinations that maximize $36

S	B	S·B
0	12	0
3	10	30
6	8	42
9	6	54
12	4	48
15	2	30
18	0	0

→ I would choose this one because they're closest

b) Sketch the budget line and the indifference curve corresponding to Chris' choice.

↑ different axes

Problem 14

Monday, February 22, 2021 8:56 PM

For purposes of this question, divide all things into housing, *H*, and money spent on everything else, *E*. Consider a household with a monthly income of $1,500 facing a cost of $1 per square foot to rent housing who chooses to live in a 600 square foot residence.

a) Draw the household's budget line and an indifference curve appropriate to their choice.

$1500 = H + E$
$1500 = 600 + E$
$E = 900$

b) Consider a proposal to subsidize housing under which this household would face a price of $0.50 per square foot. In that circumstance, suppose the household chooses to rent a 1,200 square foot residence. Show the new budget line and indifference curve.

$1500 = .5H + E$
$1500 = .5(1200) + E$
$1500 = 600 + E$
$E = 900$

c) Now, for the analytical part... Use your figure to show that if the money spent subsidizing housing had been given to the household to spend as they saw fit (shifting their original budget line out but leaving the housing price at $1 per square foot), the household would rent a smaller residence, spend more on other things, and reach a higher indifference curve, and so be better off. Explain why this is so. As part of your explanation, consider the rate housing can actually be changed into other things (given by market prices) compared to the rate the household is willing to trade housing for other things at their optimum choice given the subsidized price.

New total $ is $.5 \cdot 1200 = 600 + 1500 = \$2100$

We start with the blue line where we have an unsubsidized budget of $1500. The point chosen by the household is $600 for rent which leaves $900 for everything else. Then, if we subsidize half of housing, the subsidized point is still $600 for housing but is converted to $1200 of buying power with the subsidy. The amount left for everything else remains the same at $900. Once the limitations on the subsidy are removed, the total buying power becomes $2100. At any point past a housing cost of $1200, the marginal rate of utility for buying anything else decreases faster than the housing-limited subsidy. Meanwhile, the marginal rate of utility for any housing less than $1200 increases much faster than the subsidized housing. Thus, someone not bound by spending limitations would spend, at most, the same on housing as someone bound by those limitations and has incentive to spend less on housing so they have more for everything else.

Problem 15

Monday, February 22, 2021 9:24 PM

Ben's preferences are represented by U=0.3ln$H$+0.7ln$E$+0.1S, where H is square feet of housing consumed monthly, E is the amount spent monthly on everything else, and S=1 if he lives somewhere sunny like Florida (no snow or sleet and little freezing weather) and 0 otherwise. He is considering 2 jobs, one in Tampa and one in Boston. The job in Boston pays $7,000 per month. Housing costs $4 per square foot monthly in Boston and $1.5 per square foot monthly in Tampa. Calculate the salary in Tampa that would make Ben indifferent between the job in Tampa and the job in Boston. Illustrate with a figure.

$E_{boston} = 7000 - 4H$ $\qquad$ $E_{Tampa} = X - 1.5H$

	A	B	C	D	E	F	G	H	I	J	K
1		Square ft	Rent		Income		Everything		Utility		Diff
2	Boston	525.000042	2100.00017		7000		4899.99983		7.82691282		2.7001E-13
3	Tampa	525	787.5		5035.20171		4247.70171		7.82691282		
4											
5											

I know we didn't learn solver in this class and I could do it by hand but I was too uncertain of what to do to do that to myself.

I wasn't having any luck with solver by trying to set the income as the same and realized it was because I wasn't using the utility. I added the utility in but solver still wouldn't do anything. That's because there were two unknowns which "cancelled" out, so to speak, and made the solution not exist because ln(0) is not a good time. Then I realized that I could maximize the utility of Boston by itself to find the square footage in Boston and use the same number in Tampa because otherwise the comparison doesn't make sense and isn't fair. With the new square footage, I set diff equal to the absolute value of the utility of Tampa minus the utility of Boston. I then asked solver to try and minimize the difference while changing the income in Tampa. Thankfully, this worked and I got an income of 4247.70.

Math this time

Ben's preferences are represented by U=0.3ln$H$+0.7ln$E$+0.1S, where H is square feet of housing consumed monthly, E is the amount spent monthly on everything else, and S=1 if he lives somewhere sunny like Florida (no snow or sleet and little freezing weather) and 0 otherwise. He is considering 2 jobs, one in Tampa and one in Boston. The job in Boston pays $7,000 per month. Housing costs $4 per square foot monthly in Boston and $1.5 per square foot monthly in Tampa. Calculate the salary in Tampa that would make Ben indifferent between the job in Tampa and the job in Boston. Illustrate with a figure.

Max Boston

$\frac{MU_H}{MU_E} = \frac{.3}{H} \cdot \frac{E}{.7} = \frac{4}{1} = \frac{P_H}{P_E} \rightarrow E = \frac{28}{3} H$

$7000 = 4H + \frac{28}{3} H = \frac{40}{3} H \rightarrow H = 525$

$E = 7000 - 4 \cdot 525 = 4900 \rightarrow U = .3 \ln 525 + .7 \ln 4900 = 7.827$

Tampa must have same utility

$\frac{MU_H}{MU_E} = \frac{.3}{H} \cdot \frac{E}{.7} = 1.5 = \frac{P_H}{P_E}$

$E = 3.5H$

$Y = 1.5H + 3.5H = 5H \rightarrow H = Y/5 \rightarrow E = W - \frac{3W}{10} = .7W$

$U = .3 \ln .2 + .3 \ln W + .7 \ln .7 + .7 \ln W + .1 = 7.827$

$\ln W = 7.727 - .3 \ln .2 - .7 \ln .7 = 8.46 \rightarrow$ don't forget $-.1$

$W = e^{8.46} = 4722$

$H = 944$

$E = 3306$

Problem 16

Monday, February 22, 2021 10:00 PM

An individual's inverse demand for a particular beer is p=3.5-0.25q, where q is the number of bottles per period. The marginal cost is $0.5 per bottle.

a) If bottles are sold at marginal cost, what is consumer surplus per consumer?

Area = (3.5 - .5) · (12) · $\frac{1}{2}$ = 3 · 12 · $\frac{1}{2}$ = 3 · 6 = 18 → consumer surplus

b) If bottles must be sold one at a time at a posted price and the firm maximizes profit, what are profit and consumer surplus per customer?

$\pi = (3.5 - .25q)q - .5q \rightarrow \frac{d\pi}{dq} = 3 - .5q \rightarrow .5q = 3 \rightarrow q = 6$

$p = 3.5 - (.25 \cdot 6) = 2$

p − mc = 2 − .5 = 1.5 per cust

$CS = \frac{1}{2} \cdot (3.5 - 2) \cdot 6 = \frac{1}{2} \cdot 1.5 \cdot 6 = 4.5$

CS = 4.5

π = 9

c) Suppose the firm can sell packages of any number of bottles it chooses and resale is not possible. What number of bottles should be bundled together, and what price should the bundle be sold at, to maximize profit?

mc

$3.5 - .25q = .5$

$3 = .25q$

$q = 12$

$.5 \cdot 12 + 18 = \$24$

→ $p = 3.5 - .25(12) = 3.5 - 3 = .5$

d) Illustrate a-c with a figure.

Gus Lipkin - Midterm
Monday, March 1, 2021 5:29 PM

Question 1

Demand may be high, q=100-2p, with probability 0.6, or low, q=100-4p. Cost is 10 per unit.

The timeline differs from the ones we worked before. The order is:

i) All production is completed and a price is posted.
ii) Nature determines the level of demand, but the firm cannot observe it.
iii) Consumers purchase all they want at the posted price.
iv) The firm only learns if demand was high or low based on how much consumers purchase.
v) Unsold items are disposed of for free.

a) Set up the profit maximization problem, find the optimal price and quantity and the maximum expected profit. Some hints:
- ~~set up profit as a function of q_H and q_L~~ since we are stuck with a single price no matter if demand is high or low. This means you will take derivatives with respect to p, not q.
- Production costs depend only on the amount produced
- For this problem, you can safely assume the firm would not choose production below quantity demanded at the fixed price when demand is high.
- If you see how to use those three things, this problem is simpler and less tedious than the version of optimal production and pricing we worked before.

$q_H = 100 - 2p_H$ $\quad q_L = 100 - 4p_L$

$2p_H = 100 - q_H$

$p_H = (100 - q_H)/2$ $\quad p_L = (100 - q_L)/4$

$\pi = .6[(100-q_H)/2]q_H + .4[(100-q_L)/4]q_L - 10(q_H + q_L)$

$\mathrm{EC}(\pi) = .6(q_H)(p_H) + .4(q_L)(p_L) - 10(q_H + q_L)$ $\quad \mathrm{EC}(\pi) = .6(100-2p_H) + .4(100-4p_L)p - 10(100-4p_L)$

derivative-calculator.net ... $\frac{d\pi}{dp} = 60 - 2.4p + 40 - 3.2p + 20 = 0$

$\frac{d\pi}{dq_H} = \frac{3q_H - 100}{5}$ $\quad \frac{d\pi}{dq_L} = -\frac{q_L}{5}$ $\quad p^* = 21.43$

$\hookrightarrow q_H = \frac{100}{3}$ $\quad q_H = 57.14$ $\quad q_L = 14.29$

$\hookrightarrow q_L = 0$

$p_H = (100 - \frac{100}{3})/2$ $\quad p_L = (100 - 0)/4$ $\quad \mathrm{EC}(\pi) = .6 \cdot 57.14(3 \cdot 4 \cdot 14.29)(21.43)$

$p_H = 100/3$ $\quad p_L = 25$ $\quad = 20.57.14$

$= 23.71$

$\pi = .6 \cdot \frac{100}{3} \cdot \frac{100}{3} + .4 \cdot 0 \cdot 25 - 10(\frac{100}{3} + 0)$

$\pi = 666.66 + 0 - 333.33$

$\pi = 333.33$

b) Suppose unsold product can be stored for future use at a cost of 2 per unit stored, saving $10 per unit in production costs next period. Next period's savings should be discounted. Assume the discount rate is 5%. Set up the profit maximization problem, find the optimal price and quantity and the maximum expected profit.

Without discounting... $\quad +10 - 2$

$\pi = .6[(100-q_H)/2]q_H + .4[(100-q_L)/4]q_L - 10(q_H + q_L) + (.4 \cdot .8)(q_H - q_L)$

$\mathrm{EC}(\pi) = .6(100-2p) + .4(100-4p)p - 10(100-2p) + .4(.8)(100-2p - (100-4p))$

derivative... $\frac{d\pi}{dp} = 60 - 2.4p + 40 - 3.2p + 40 + 6.02 = 0$

$\pi =$ $\quad \hookrightarrow p^* = 22.50$

$q_H = 54.99$ $\quad q_L = 7.99$ $\quad + \frac{(.4 \cdot .8)(q_H - q_L)}{1.05}$

derivative-calculator.net ...

$\frac{d\pi}{dq_H} = -\frac{6q_H - 320}{105}$ $\quad \frac{d\pi}{dq_L} = -\frac{4q_L - 70}{105}$

$\hookrightarrow q_H = 40.333$ $\quad \hookrightarrow q_L = 15.239$

$p_H = (100 - 40.333)/2$ $\quad p_L = (100 - 15.239)/4$

$p_H = 29.833$ $\quad p_L = 21.19$

$\pi = 333.33 + \frac{(.4 \cdot .8)(40.333 - 15.239)}{1.05} = 469.814$ $\quad \mathrm{EC}(\pi) = 411.46$

c) **Explain intuitively why and how the solution in b changes from a.**

In part A, the profit function is an all or nothing scenario where anything produced and not sold is considered waste and discarded. In part B, anything extra that is produced and not sold can be resold at a later date, but for less profit. This means that it is safer to take a risk and produce more. In part A, you under-produce for both high and low demand so you don't go over and have to discard product. In part B, you can overestimate demand a little and still make money back. However, if you over-produce too much, it will begin to eat away at your profits as either the quantity above demand increases, time passes, or both.

d) It costs 40 per period to maintain the storage facility of part b, it will last 5 years, and the interest rate is 5%. What is the value of obtaining such a facility? That is, what is the most the firm should be willing to pay for it? Assume payment for it is made one period before its first use.

Shed value $= \frac{40}{.05} \cdot (1 - \frac{1}{1.05^5}) = 38.095 \cdot .2165 = 8.247$

$\pi =$ $\quad + \frac{(.4 \cdot .8)(q_H - q_L)}{1.05^5}$

$\frac{d\pi}{dq_H} = -\frac{432233 \cdot 03911 - 4576610100}{2042205 \cdot 05}$ $\quad \frac{d\pi}{dq_L} = \frac{4034101 + 8130000}{2042205 \cdot 05}$

$\hookrightarrow q_H = 37.512$ $\quad \hookrightarrow q_L = -12.536$

$\mathrm{EMP}_H = (411.46 - 28.71)\sum_{t=1}^{5}(\frac{1}{1.05})^t = 327.96$ $\quad$ ↳ This doesn't make sense. I'm going to call it 0

$p_H = (100 - 37.512)/2$ $\quad p_L = (100 - -12.536)/4$

$p_H = 31.2439$ $\quad p_L = 26.6282$

$\pi = .6 \cdot 37.512 \cdot 31.2439 + .4 \cdot -12.536 \cdot 26.6282 - 10(37.512 + -12.536)$

↳ $\pi = 171.298$ $\quad \rightarrow 469.814 - 171.298 = 298.516$

The firm should only buy the shed if they are given $298.516

Question 2

Suppose someone is 60 years old and will live 25 more years. Currently they have saved $250 (thousand). They earn a wage, w, of 50 (thousand) per year they work, W. They care only about years they do not work, R (retirement) and how much they spend over the rest of their life, E (for expenditure, in thousands). Ignore discounting and such for this problem.

a) Write the equation for their budget constraint, showing the possibilities for years retired and expenditures. Draw it, placing R on the horizontal axis and E on the vertical axis.

Budget $= 250 + 50(25 - R) - E$

↳ $E = 250 + 50(25 - R)$

b) Suppose now that the government announces a social security program in which they will pay everyone a stipend, s, of $20 (thousand) per year in retirement, provided they are over 60. This is an oversimplified version of social security, but simply ignore other aspects. Write the new budget constraint. Draw it in the figure.

$E = 250 + 50(25 - R) + 20(25 - R)$

c) Draw indifference curves tangent to each budget line, assuming both R and E are normal goods. Any indifference curves satisfying the axioms of rational choice, and for which both E and R are normal goods, are fine. Label the individual's solution for years worked and expenditure with each budget constraint (a and b). Make sure the (R,E) pairs in the solutions you label respect the budget constraints.

I just noticed that there's definitely something wrong with my functions. I should be able to maximize it when I'm not on an axis but I just can't figure out what I'm doing wrong. I'm not able to find a good way to balance the years of retirement and the yearly expenditure. Any ratio of any value existing or derived always gives me the axis values.

Anyways, here's what I know about indifference curves: The indifference curve is where the marginal rate of substitution is equal to the utility of one good over the utility of another. The indifference curve should be tangent to the budget line at that point. I'm definitely having a dumb moment (more than one) and can't find the MRS even though I'm describing it to you. I tried finding the derivatives of the equations I gave above but because it's all constants, the derivative is also a constant. Example curve:

d) Explain the impact of the simplified social security program on years worked for any rational chooser for whom both R and E are normal goods. Be precise, meaning talk about things like the relevant marginal rate of substitution and market rate of trade. Also, talk about how the assumption that both E and R are normal goods matters. Does that seem a reasonable assumption in this case? Why or why not?

I haven't been able to come up with a working solution for this problem yet but I think that makes my answer a bit more intuitive, rather than based in fact, but I hope they coincide.

E and R are normal goods because an income increases, so too will the retiree's consumption. If they are Bill Gates and wish to retire without working and forgo all forms of income, they will have an incredibly high amount of capital available for consumption. Bill would also be able to retire and live off of his stockpile for a very very very very long time because it is so large. Meanwhile, someone with a smaller net worth may choose to keep working for a bit so that they can live more comfortably while they are retired. Or they could forgo a bit of spending money so that they could be retired longer. This does seem like a reasonable assumption

For each person, the amount of one good that they're willing to give up for the other will be different and the rate at which these curves change will also be different. This curve is the indifference curve from part c.

All that said, let's take my equations from part a and b, even if they're wrong. We can set them equal to each other to find out how long someone would have to work for an equal amount of spending money per year after 60 both with and without the social security program.

$\frac{250 + 50(25 - R)}{25} = \frac{250 + 50(25 - R) + 20(25 - R)}{25}$ $\quad \rightarrow R = 25$

Shoot. Have I been doing it right the whole time?

Ok. So they turned out the same at 25 years. Which is great because you're dead now. However, the income over the years from social security was much greater than that of the person who did not take part in the social security program.

$\text{Social} = \frac{1}{2} \cdot 28.571 \cdot 70000 - \frac{1}{2}(28.571 - 25)(10000)$
$= 1142857 - 17855$
$= 1124985$

$\text{No Social} = \frac{1}{2} \cdot 30 \cdot 60000 - \frac{1}{2}(5)(10000)$
$= 900000 - 25000$
$= 875000$

I kinda lost my steam when I did some math and got confused. Basically, social security lets people retire earlier and end up in the same spot as they would've been had they not had assistance and worked longer.

10 Book Notes

Saturday, March 6, 2021 1:44 PM

Uncertainty w/ Risk Aversion

Expected Utility Theorem

W_i = Wealth for outcome i
f_i = Probability of ith outcome

Expected Utility Theorem $E(U) = f_1 u(W_1) + f_2 u(W_2) + \ldots$

↳ $EU = \sum_i f_i u(W_i)$

five assumptions:
1) completeness
2) more is better
3) transitivity
4) preference for variety
5) Independence Axiom:
   If A > B, compound lottery A w/ prob f and C w/ prob (1-f) > compound lottery B w/ probability f and C with prob (1-f)

Example:
$U = 10\sqrt{W}$
option A: $f = \frac{1}{2}$ $W = 0$ and $f = \frac{1}{2}$ $W = 100$
B: $f = 1$ $W = 36$

$EU_A = .5(0) + .5(100) = 50$
$EU_B = 1(36) = 36$ → Utility

$EU_A = .5(10\sqrt{0}) + .5(10\sqrt{100}) = 0 + 50 = 50$
$EU_B = 1(10\sqrt{36}) = 10(6) = 60$ → Gamble

Certainty Equivalent: amount of wealth where Utility = Gamble

↳ $U(CE) = \sum f_i u(W_i)$

Using previous example: $U(CE) = .5(10\sqrt{100}) + .5(10\sqrt{0})$
$10\sqrt{CE} = 50$
$\sqrt{CE} = 5$
$CE = 25$

Constructing a Utility Function for Certain Outcomes

CE only exists for a gamble, not overall

Risk Premium: amount willing to pay to get rid of risk

Uniqueness and Scale of the Expected Utility Function

The Value of Insurance

Value added = Number Insured × (EV − CE − Admin Costs Per)

Policy Price = expected losses + Admin Costs Per

Consumer Surplus = Initial Wealth − Policy Price − CE

↳ CS = EV − CE − Admin Costs Per

Value gambles at EV because people have CE less than wealth

Limitations of the Expected Utility Model and Rational Man Models

trade gains must exceed transaction costs

10.1 Uncertainty and Risk Aversion 1

Saturday, March 6, 2021 2:36 PM

choices over lotteries

$A > B$
$B > A$
$A \approx B$

Expected Utility Theorem

Let w_i be possible wealth outcomes & f_i be their probabilities

There exists a function $u(w_i)$ such that the lottery with the highest $E(u(w))$ is preferred

Risk neutral: Highest $E(w) = \sum_i f_i w_i$

we use it as an as if model

Independence: suppose $A > B$
A compound lottery
A w/ prob h & C w/ prob $1-h$
B w/ prob h & C w/ prob $1-h$

10.3 Uncertainty and Risk Aversion 3

Saturday, March 6, 2021 5:42 PM

<u>Scale</u> Without uncertainty, Any positive monotonic transform was okay

↳ You can change scale, but not shape

10.4 Value of Insurance

Wednesday, March 10, 2021 5:12 PM

A) Pool many people w/ the same independent risk
B) If pool is large, aggregate risk is negligible
↳ Total EW = n · EW
↳ w prob = 1
C) Individuals accept CE in trade for their bundle
D) Insurance company pays EV - admin + transaction costs
E) Gains from trade are N(E(w) - CE) - Admin costs
N(RP) - Admin costs

If ins markets are perfectly competitive
- Premiums are such that individuals get
$W_{certain} = E(w)$ - admin costs

Diversification:

10.5 Limits of the Expected Utility Model

Wednesday, March 10, 2021 8:44 PM

Allais Paradox

Prize	A	B	C	D
0	0	.01	.89	.9
1	1	.89	.11	0
5	0	.1	0	.1

$EU_A = v(1)$

$EU_B = .01v(0) + .89v(1) + .1v(5)$

$EU_A > EU_B \rightarrow v(1) > .01v(0) + .89v(1) + .1v(5)$

$EU_C = .89v(0) + .11v(1)$

$EU_D = .9v(0) + .1v(5)$

$\rightarrow$ Can't both be true

$EU_D > EU_C \rightarrow .9v(0) + .1v(5) > .89v(0) + .11v(1)$

Both A + B, .89 prob of 1

Both C + D, .89 prob of 0

Ellsberg Paradox

- Ambiguity Aversion

Endowment Effect

- Cornell experiment
  - ↳ John List

10.6-7 Cost

Monday, March 15, 2021 8:54 PM

$\pi = P \cdot q - C(q)$

$\text{Cost} = P_1 X_1 + P_2 X_2 + \dots P_n X_n = \sum_i P_i X_i$

Choose inputs to minimize $C(q)$ for each level of q
- no waste
- lowest cost process
- economy not counting capital
  - ↳ includes rate of return

Production function
$q(x_1, x_2, x_3, \dots)$ no waste

$\frac{dq}{dx_i} = MP_i$

Input substitution
- ↳ perfect subs
- ↳ perfect complements
- ↳ imperfect subs

$q = 4K^{.5} L^{.5}$

$K = 0$	$q = 0$
$L = 0$	$q = 0$

$MP_K = .5 \cdot 4 \cdot K^{-.5} L^{.5} = 2\sqrt{L/K}$
$MP_L = 2\sqrt{K/L}$

Marginal rate of technical substitution
↳ $MRTS_{ij} = MP_i / MP_j$

As Labor ↑, Capital ↓ ⇒ MP_L ↓ + MP_K ↑
↳ diminishing MRTS

Isoquant: level curves of the production function
↳ $4L^{.5}K^{.5} = 16 \Rightarrow L = 16/K$

Capital K, Cost r
interest rate } very similar due to arbitrage
rental rate

Labor L, cost w per unit

$\text{slope} = \left.\frac{dx_2}{dx_1}\right|_{q=q_1}$

$MRTS_{12} = \left.\frac{dx_2}{dx_1}\right|_{q=\bar{q}}$

10.8 Cost 3

Monday, March 15, 2021 9:25 PM

model of cost

total cost $= wL + rK \rightarrow K = \frac{TC}{r} - \frac{w}{r}L$

10.9-10 Cost

Tuesday, March 16, 2021 9:09 PM

Short run cost

What is short run?
long run?
↳ Planning horizon

Long run cost

replication argument → LRAC can't slope up

Dis-economies of scale

10 Extra Problems

Monday, March 15, 2021 5:47 PM

$U = \sqrt{W}$ $W_0 = 60000$ $Pr(L) = 1/20$ $L = 20000$

$E(W)$? CE?

$E(W) = (40000 \cdot \frac{1}{20}) + (\frac{19}{20} \cdot 60000) = 59000$

$\uparrow$

$60000 - 20000$

$\sqrt{U(CE)} = \frac{19}{20} U(60000) + \frac{1}{20} U(59000)$

$\hookrightarrow CE = 58904$

WTP for full insurance?

P is insurance for zak

$\sqrt{60000 - P} = \sqrt{58904} \rightarrow P = 1096$

Gains from trade for full insurance?

$1096 - (\frac{1}{20} \cdot 20000) = 1096 - 1000 = 96$

---

2 people w/ same lottery $\rightarrow CE$? Value of risk pooling

$\hookrightarrow$ shared risk

f	W
$1/20^2$	40000
$38/400$	50000
$19/20^2$	60000

$\sqrt{CE} = \frac{1}{400}\sqrt{40000} + \frac{38}{400}\sqrt{50000} + \frac{361}{400}\sqrt{60000} \rightarrow CE = 58956$

12.1 Intro to Game Theory

Sunday, March 21, 2021 12:17 PM

One Shot Games

Discrete strategies

Building Blocks:
- Players
- Decision nodes + choices
- Payoffs for every outcome
- Strategy

12.2-3 Simultaneous Move Games

Sunday, March 21, 2021 12:28 PM

Prisoner's dilemma

Amy + Bob

Confess or not confess
- neither confess, both get 6 months → minor
- both confess, both 24 months → major
- one rats, one doesn't → rat 0, other 30 months

A \ B	Confess	Not
Confess	-24, -24	0, -30
Not	-30, 0	-6, -6

→ row, column

Solution concept

Strong vs weak dominance

Iterated Dominance

Simultaneous entries

Amy: Incumbent, expand, not
Bob: Entrant, in, out

A \ B	In	Out
Expand	~~20, -20~~	~~40, 0~~
not	30, 20	80, 0

↑ solution

Strong Nam

Battle of the sexes

Amy wants Game
Bob wants Play

A \ B	Game	Play
Game	3, 2	1, 1
Play	0, 0	2, 3

Secure strategy = max-min strategy

12.4 Nash Equilibria

Sunday, March 21, 2021 12:53 PM

Best replies:
map opponent strategies

Battle of the sexes is coordination

12.5 Sequential Move Games

Sunday, March 21, 2021 1:03 PM

A \ B	I(E) I(O)	I(E) O(O)	O(E) I(O)	O(E) O(O)
Expand	20, -20	20, -20	50, 0	50, 0
Not	30, 20	80, 0	30, 20	80, 0

Extensive Form

backward induction

→ Subgame Perfect NE

12 Extra Problems

Monday, March 22, 2021 5:38 PM

Submit your analysis of the game below from class.

Amy is considering introducing a new product line. So is Bob.

If both do so, both make $2.

If neither does so, both make $3.

If Amy does and Bob does not, Amy makes $5 and Bob makes $1.

If Bob does so and Amy does not, Amy makes $1 and Bob makes $2.

Analyze the role of the timing of moves in this game. Use the extensive form to analyze the two sequential mover versions. That is, solve the game for all three possible order of moves and then discuss which order you think is likely to emerge in such games. Explain why.

A \ B	In	Out
In	2, 2	5, 1
Out	1, 2	3, 3

(A, B)

(B, A)

Amy should move first. If Bob goes first, he'll choose out (3,3) but then Amy will go in (1,5). If Amy moves first, she'll choose in (5,1) but then Bob will also choose in (2,2).

Submit your analysis of the game below, which we will work in class.

Both Roger and Cindy each have 50 loyal customers that buy whether price is low, $15, or high, $20. There are 30 price sensitive customers. Price sensitive customers buy only if there is a low price, and from whoever has the low price. If Roger and Cindy both have a low price, they split the price sensitive customers. Cost is $5 per unit. 100 total

Find all NE of this simultaneous move game. That is, find the pure strategy NE, if any. Then, find the mixed strategy NE, if any. What is expected profit for each player in the mixed strategy NE, if there is one? If there is a mixed strategy NE, can you explain what is going on in intuitive terms?

If prices were set sequentially, would there be a first or second mover advantage? Or both? Does that even seem like a reasonable question to ask in this case? How so? How not so?

R \ C	Low	High
Low	65, 65	80, 50
High	50, 80	50, 50

→ Prob
→ Prob

$\pi_L = 15L - 5L = 10L$
$\pi_H = 20H - 5H = 15L$

$\cancel{U_L = 65q + 80(1-q)} = \cancel{U_H = 50q + 50(1-q)}$

Cindy $U_L = 650q + 800(1-q) = U_H = 750q + 750(1-q)$

R \ C	L	H
L	650, 650	800, 750
H	750, 800	750, 750

→ (row, column)

Cindy Low
$750 = 650q + 800(1-q) \Rightarrow q = 1/3$

High
$q = 2/3$

There is a first mover advantage because they can establish that they will go low. The first mover will go low and then the second will go high so that the payoffs are (800, 750)

$E(\pi_R) = \frac{4}{9}750 + \frac{2}{9}750 + \frac{2}{9}800 + \frac{1}{9}650 =$

14.1 Mixed Strategy Equilibria

Sunday, March 21, 2021 1:23 PM

A \ B	Hard	Shirk
check	30, 20	30, 0
not	40, 20	10, 30

f P(check)
g P(hard)

$U_A(\text{check}) = g \cdot 30 + (1-g)30$
$U_A(\text{not}) = g \cdot 40 + (1-g)10$

$U_A(\text{check}) = U_A(\text{not})$
$30 = 40g + 10 - 10g$
$20 = 30g$
$g = 2/3$

$U_B(H) = U_B(S)$

$20f + (1-f)20 = 0f + (1-f)30$
$20 = 30 - 30f$
$30f = 10$
$f = 1/3$

14.2-4 Repeated Games

Sunday, March 21, 2021 1:41 PM

Row \ Carey's	C	P
Share	10, 10	-5, 15	-10, 0
Compete	15, -5	0, 0	-5, -5
Predatory	0, -10	-5, -5	-10, -10

Unravelling if last period is known

Infinite vs Indefinite
↳ f is prob game ends after each play

Grim trigger

$$\sum_{t=1}^{\infty} a^t = \frac{a}{1-a}$$

if $a = \frac{1}{1+r} \rightarrow \frac{1}{r}$
↳ perpetuity formula

$$10 \sum_{0}^{\infty} \frac{.85}{1.1} = 10 \cdot \left(\frac{1}{1 - \frac{.85}{1.1}}\right)$$

π_{one} (0) $\quad \in (\pi_{coop} \mid \text{app Grim})$

π_{cheat} (15) $\quad \pi_{coop} \sum_{0}^{\infty} \left(\frac{1-f}{1+r}\right)$

π_{coop} (10) $\quad \pi_{coop} \cdot 1 / 1 - \frac{1-f}{1+r} \geq \pi_{coop} \cdot \frac{1+r}{r+f}$

$$(\pi_{cheat} - \pi_{one}) + \pi_{one} \cdot \frac{1+r}{r+f}$$

$$(\pi_{coop} - \pi_{one})\left(\frac{1+r}{r+f}\right) > \pi_{cheat} - \pi_{one}$$

$\pi_{coop} - \pi_{one}$ $\uparrow \rightarrow$ more coop

$\pi_{cheat} - \pi_{one}$ $\uparrow \rightarrow$ less coop

$r \uparrow$ $\rightarrow$ less coop

$f \uparrow$ $\rightarrow$ less coop

Monitoring costs

14.5-6 Reputation Games

Friday, March 26, 2021 1:27 PM

Expanded Prisoner's Dilemma				
		Carey		
		Share	Compete	Predatory
Ray	Share	10 ; 10	-5 ; 15	-10 ; 0
	Compete	15 ; -5	0 ; 0	-5 ; -5
	Predatory	0 ; -10	-5 ; -5	-10 ; -10

"crazy Player"

h = Prob of a crazy Player
↳ crazy Plays share until opp Plays share, then predatory once then compete forever

T = last Play
↳ at T, sane Players compete

at $T-1$ how do sane Play if other sane Players Play share until T

If Play compete compete
$(1-h)15 + (1-h)0/(1+r) + h(-5/(1+r)) + 15h$

If share compete
$(1-h)10 + (1-h)0/(1+r) + h\,15/(1+r) + 10h$

$15 - \frac{h}{1+r}\cdot 5 < 10 + \frac{h}{1+r}\cdot 15 \Rightarrow 5 < \left(\frac{h}{1+r}\right)10 \Rightarrow \frac{1}{2} < \frac{h}{1+r}$

↳ $1+r < 4h$

$h\uparrow$ or $r\downarrow$
reputation more valuable for maintaining cooperation

At T, Players reveal their type

No crazies

h: IC always fights entrants
V_F: value of rep if IC fights
V_A: value of rep if IC accommodates
V: value if IC does neither

When does sane IC fight given entry

$10 + V_F > 20 + V_A \Rightarrow V_F - V_A > 10 \Rightarrow V_F = \frac{40}{1+r} + \frac{40}{(1+r)^2} + \ldots$
$V_A = \frac{20}{1+r} + \ldots$

$\frac{40-20}{r} > 10 \Rightarrow 2 > r$

g: P(IC fights if Nick enters)
Nick out if $0 > (1-h)(1-g)$

Nick out if $0 > (1-h)(1-g)10 + (1-h)g(-10) + h(-10)$
↳ $0 > 10 - 20h - 20g$
$20h(h+g) > 10$
$h+g > 1/2$

↳ crazy can be small if sane IC is likely to fight

15 Book Notes

Friday, March 26, 2021 2:19 PM

Homogenous Product markets

for a monopoly, MC must cross at min(AC)
max(π) at MR=MC

Bertrand (Price) competition with Homogenous Products

Players A and B are selling homogenous products

Cost = c

if B sets price P_B, as long as $P_B > c + \varepsilon$, $P_A = P_B - \varepsilon$

Simultaneous Homogenous Product Price competition w/ capacity choice

$Q = q_A + q_B$

$\bar{q}$ = capacity

$P = P(\bar{q}_A + \bar{q}_B)$

$\pi_A = Pq_A - C(q_A) \rightarrow \pi_A = P(\bar{q}_A + \bar{q}_B)\bar{q}_A - k\bar{q}_A - c\bar{q}_A$

Simultaneous Quantity (Cournot) Competition

$\pi_A = P(q_A + q_B)q_A - C(q_A)$

Example:

cost/unit = \$5 demand: $P(Q) = 20 - .25Q$

monopoly:

$\pi_{mon} = (20 - .25Q)Q - 5Q$

derivative

$MR = 20 - \frac{Q}{2} = 5 = MC$

$\frac{Q}{2} = 15 \rightarrow Q = 30$

$P = 20 - .25(30) = 12.5$

$\pi_{mon} = 30(12.5 - 5) = 225$

oligopoly:

$\pi_A = (20 - .25(q_A + q_B))q_A - 5q_A$

$\frac{d\pi_A}{dq_A} = 20 - .25q_A - .25q_B - .25q_A - 5 = 0$

$20 - .25q_B - .5q_A = 5$

$15 - .25q_B = .5q_A$

$q_A = R_A(q_B) = 30 - .5q_B$

b, flip for q_B

R_A is the reaction function

First mover (Stackelberg) Quantity competition

Since A moves first, $q_B = R_B(q_A)$

$\pi_A = P(q_A + R_B(q_A))q_A - C(q_A)$

Long-Run Equilibrium

15.1 Homogeneous Product Markets 1

Friday, March 26, 2021 2:46 PM

$f = 1 - \beta p$

beta = slope

$f = 1 - p$

$Nf = N(1-p)$

$N = 1$

$Q = 1 - p$

$Q = 1 - 0 = 1$

$p = 1, Q = 1 - 1 = 0$

monopoly

$C(q) = cq + k\bar{q} + F$ → k = capacity cost

$\bar{q} = q$ → $\bar{q}$ = capacity

with no uncertainty $\bar{q} = q$

$c = .01$ $k = .005$ $F = .05$

$\pi = (1-q)q - .015q - F$

$1 - 2q = .015$

$q = (1 - .015)/2 = .4925$

$p = 1 - .4925 = .5075$

Announces price meet all demand at that price

Bertrand competition

$p_1 < p_2$, $q_2 = 0$, $q_1 = 1 - p$ → if prices equal, split market

$q = (1 - c - k - \varepsilon) > 1 - c - k - \varepsilon/2$ → excess capacity $= \frac{1-c-k-\varepsilon}{2}$

Capacity is strategic choice

15.2 Homogeneous Product Markets 2

Friday, March 26, 2021 3:14 PM

Quantity competition (Cournot) competition

$\pi = (1 - q_1 + q_2) q_1 - (.01 + .005) q_1 - .05$

$\frac{d\pi_1}{dq_1} = (1 - q_2) - 2q_1$

$2q_1 = (1 - .015)/2 - q_2/2 \quad 9 \quad q_1 = .4925 - \frac{1}{2} q_2$

$R_1(q_2) = .4925 - \frac{1}{2} q_2$

15.3 Homogeneous Product Markets 3

Saturday, April 3, 2021 11:47 AM

Stackelberg Competition

$q_2 = .4925 - \frac{1}{2}q_1$ $\quad c = .013 \quad k = .005 \quad f = .05$

$P = 1 - q_1 - q_2$

$R_2(q_1) = q_2$

$\pi_1 = (1 - (.4925 - \frac{1}{2}q_1) - q_1)q_1 - .015q_1 - .05$

$\frac{d\pi}{dq_1} = (1 - .4925) - q_1 - .015 = 0$

$q_1 = 1 - .015 - .4925 = .4925$

$q_2 = .4925 - \frac{1}{2}.4925 = .24625$

$P = 1 - .4925 - .24625 = .261$

<u>Oligopoly!</u>

$\pi_{mon} = .193$

$\pi_{stLD} = .071$

$\pi_{coy} = .058$

$\pi_{stfol} = .011$

15.4 Homogeneous Product Markets 4

Saturday, April 3, 2021 12:08 PM

Strategic cost reductions in homogeneous product oligopoly

<u>Advertising</u>

Adv ↑ size of the firm's market

firm 1 spends on ads, q_{mon} goes up

15 Extra Problems

Monday, April 5, 2021 5:40 PM

$P = 1 - q \qquad C = .4q$

monopolist:

$1 - 2q = .4$

$2q = .6$

$q = .3 \rightarrow P = .7$

$\pi = (.7 - .4).3 = .09$

$P = 0$

$CS = 1/2$

$P = .4 \quad CS = .36$

$P = .7$

$CS = .3 \cdot .3/2 = .045$

$DWL = 1/2 \cdot .3 \cdot .3 = .045$

Cournot:

Alice + Bob

$P = 1 - Q \qquad Q = q_A + q_B$

$\pi_A = (1 - q_A - q_B)q_A - .4q_A$

$\frac{d\pi_A}{dq_A} = 1 - q_B - 2q_A - .4 = 0 \rightarrow 2q_A = .6 - q_B \rightarrow q_A = .3 - .5q_B$

$q_A + q_B = .9 \qquad P = 1 - .4 = .6$

$\pi_A = (.6 - .4).2 = .04$

$\pi_A + \pi_B = .08$

$CS = 1/2 \cdot .4 \cdot .4 = .08$

Alice moves 1st

chooses $[C = .4q]$ or $[C = F + .1q]$ $q \leq 1$ And q_A

Bob moves second. Same choice

Largest F such that Alice chooses $C = F + .1q$

$F + .1 = .4 \rightarrow F = .3$

$P = 1 - Q$

$P_i A = (1 - q_A - q_B)q_A - .4q_A$

$(.9 - q_A)^2/4 - F < (.6 - q_A)^2/4$

$\pi_A = (1 - q_A)q_A - Cq_A$

16 Book Notes

Saturday, April 3, 2021 12:37 PM

Differentiated Product markets

Price competition has a smaller effect

Price (Bertrand) Competition w/ A first mover

1st will do at least as good as NE

Incentives for Cost reduction

direct vs strategic effect

Advertising

informative vs persuasive advertising

Long run equilibrium

16.1-2 Differentiated Products 1-2

Saturday, April 3, 2021 1:08 PM

$P = 1 - q_1 - q_2$

$P_1 = 1 - q_1 - \frac{1}{2} q_2$

$P_2 = 1 - q_2 - \frac{1}{2} q_1$

Price competition (Bertrand)

$S_1 = V_1 - P_1 - t_1(x)$

if dist of customer is uniform F is fraction that buy from 1

$V_1 - P_1 - t_1 x = V_2 - P_2 - t_2(1-x)$

$F = x = \frac{V_1 - V_2}{t_1 + t_2} + \frac{P_2 - P_1}{t_1 + t_2} + \frac{t_2}{t_1 + t_2}$

$\pi_1 = N(P_1 - c_1)x - F_1$

$\frac{d\pi_1}{dP_1} = (P_1 - c_1)\left(\frac{-1}{t_1 + t_2}\right) + \left[\frac{V_1 - V_2 + P_1 - P_2 + t_2}{t_1 + t_2}\right] = 0$

$R_1(P_2) = \frac{1}{2}(V_1 - V_2 + t_2 + c_1) + \frac{1}{2} P_2$

$P_1 = (V_1 - V_2 + 2t_2 + t_1 + 2c_1 + c_2)/4$

16.3-4 Differentiated Products 3-4

Saturday, April 3, 2021 1:47 PM

Bertrand w/ first mover

firm 1 moves

firm $\frac{d\pi}{dP_1} = 0$

$P_{first} > P_{simultaneous}$

$\pi_{first} > \pi_{simultaneous}$

$\pi_{second} > \pi_{first} > \pi_{simultaneous}$

$q_1 = 1 - .5P_1 + .5P_2$ $\quad c_1 = c_2 = .5$

$q_2 = 1 - .5P_2 + .5P_1$

$\pi = (P_1 - .5)(1 - .5P_1 + .5P_2)$

$\frac{d\pi}{dP_1} = -.5(P_1 - .5) + (1 - .5P_1 + .5P_2)$

$P_1 = 1.25 + .5P_2$

$P_2 = 1.25 + .5P_1$

$P = 1.25 + .5P$

$P = 2.5$

$\pi_1 = (P_1 - .5)(1 - .5P_1 + .5(1.25 + .5P_1))$

16.5-6 Long Run Entry 1-2

Friday, April 9, 2021 12:13 PM

Entry Barriers

Exogenous economies of scale, Patent restrictions?
Endogenous Entry limit pricing

Economies of Scale
↳ Natural Monopoly

Electricity distribution grid
water

$P = 1 - q_1 - q_2$
$= 1 - \sum_{i=1} q_i$

$C_i = c \cdot q_i + f$

$\pi_j = (1 - \sum_{i=0} q_i) q_j - c q_j - f$

$\frac{d\pi_j}{dq_j} = 1 - \sum_{1} q_i - q_j - c = 0$

$2q_j = 1 - c - \sum_{i \neq j} q_i$

$q_j = \frac{1-c}{2} - \frac{1}{2} \sum_{i \neq j} q_i$

$\downarrow$

q_{mon}

w/ symmetry

$q = \frac{1-c}{2} - \frac{1}{2}(n-1)q$

$(n+1)q = 1-c$

$q = \frac{1-c}{n+1}$, $P = 1 - nq = 1 - \left(\frac{n}{n+1}\right)(1-c)$

$P - c = 1 - c - \left(\frac{n}{n+1}\right)(1-c)$
$= 1-c/n+1$

$\pi_j = (P - c)q - f$
$= \left(\frac{1-c}{n+1}\right)^2 - f$

$q_j \uparrow \pi$
$q \downarrow$
$P \downarrow \rightarrow Q = nq \uparrow$
$\pi \downarrow$

$\pi > 0 \rightarrow$ entry
$\pi = 0$ normal profit

$\pi(n) \geq 0$
$\pi(n+1) < 0$ $\quad n = \#$ of firms

$\pi_i = \left(\frac{1-c}{n+1}\right)^2 - f = 0$

$\frac{1-c}{n+1} = \sqrt{f}$

$n = 1-c/\sqrt{f} - 1$

$n = \text{floor}\left[1-c/\sqrt{f} - 1\right]$

$q = 1 - P$ $\quad Q = 1 - P$
$P = 1 - q$ $\quad P = 1 - Q$

$\bar{P} = 1$ $\quad \left(\frac{\bar{P} - c}{\sqrt{f}} - 1\right)$

$\sqrt{f} \rightarrow$ large, $n \rightarrow 0$

Entry w/ differentiated products

16.7 Long Run Entry 3

Friday, April 9, 2021 3:33 PM

Entry w/ differentiated products

$\pi(n^{eq}+1) < 0$
$\pi(n^{eq}) \geq 0$

$R = P(q)q$
$MR = \frac{dP}{dq}q + P$
$MR = P\left(\frac{dP}{dq} \cdot \frac{q}{P} + 1\right)$

$MR_i = P_i\left(\frac{1}{\eta_i} + 1\right)$
$\eta_i < 0$

more alternatives means
- better subs
- more elastic demand

As $\eta_i \uparrow$ $MR_i = P_i + \frac{P_i}{\eta_i} \to P_i$

Limit on η_i? # of subs
Limit on subs?

mkt size relative to fixed cost

$$\boxed{\begin{array}{l} MR = MC \\ P_{about} = LRAC \end{array}}$$

free entry w/ diff products

$R_i = P(Q)q_i$
$MR_i = dP/dQ \cdot q + P = \frac{dP}{dQ} \cdot \frac{Q}{Q} q_i + P = \frac{dP}{dQ} \cdot \frac{P}{Q} \cdot \frac{q_i}{Q} \frac{1}{P} + P$

$MR_i = P\left(\frac{\xi_i}{3} + 1\right)$

$MR_i \to P_i$
$MR_i \to P$

If rel to $\bar{P}$, Q ↑

16.8 Long Run Entry 4

Friday, April 9, 2021 3:47 PM

Market w/ room for many firms

$P_i = LRAC_i$ industry eq

$P_i + \frac{P_i}{\beta_i} = MC_i$ firm optimization

$n \to \infty$ $|\beta_i| \to \infty$ $MR_i \to P_i$

$P_i \approx MC_i$

$MC_i \approx LRAC_i$

firms operate near LRAC

$MR_i = P + P\frac{s_i}{\beta} = MC_i$ firm optimization

$P \approx LRAC_i$ Industry eq

if $n \uparrow$, $s_i \to 0$

16.9 Long Run Entry 5

Friday, April 9, 2021 4:00 PM

Other Entry Barriers

network externalities

Anti-competitive Bertrand entry limit pricing

price > per unit cost but low enough to stop entry

$P_{mon} > P > c$ only works if f high enough

Price < per unit cost if entrant $P = P_{mon}$ if no entrant

Tying contracts

vertical foreclosure

17.1 Perfect Competition

Friday, April 9, 2021 4:20 PM

$MR_i = MC_i$

$MR_i = P_i(1 + 1/\beta_i)$ what happens to 3 or more comp?

$\beta_i \to$ large $MR_i \to P$

$P = MC_i$ short run

$P <$ min AVC $\to$ shut down

$P \geq$ min AVC $\to$ q where $MC = P$

$q_i^s = MC^{-1}(P)$ if $P \geq$ min AVC

$Q = \sum_i q_i^s(P)$

17.2 Perfect Competition 2

Friday, April 9, 2021 4:56 PM

Perfect comp in the Long Run

LR: All factors of Prod are variable (ownership management fixed)

S = short run

$P_i^e > LRAC > SAC \Rightarrow \pi_i > 0 \rightarrow$ resource entry
1) firm's expand
2) firms enter

17.3 Perfect Competition 3

Friday, April 9, 2021 5:08 PM

Constant or increasing cost industries

<u>Constant cost industry</u>

min LRAC constant

<u>Increasing cost Industry</u>

π at P_2 → entry

17.4 Perfect Competition

Friday, April 9, 2021 5:20 PM

What if $C(q) = cq + F$ $q < \bar{q}$

marg cost = ave fixed cost

$p_0 < c \rightarrow q_0 = 0$

$p_1 < \min AVC \rightarrow q_1 = 0$

$p_3 \geq \min AVC$ $q_1 = \bar{q}$

18.1 Allocative Efficiency

Friday, April 16, 2021 3:52 PM

Supply + Demand

Allocative efficiency is contingent on the income, ability, wealth distribution "endowment"

CS+PS is maximized = Value Added

18.2 Rent Control

Friday, April 16, 2021 4:05 PM

$DWL = \frac{1}{2}(3-1)(1000-500) = 500$

Gained CS

Lost PS

wasted in competition

$S_t = \delta^{t-t_0}$

18.3 Tax Incidence

Friday, April 16, 2021 4:28 PM

$t = .5 \leftarrow$ tax

$P_D - P_S = .5$

1) Actual burden != statutory burden
2) Excess burden = DWL

18 Extra Notes

Monday, April 19, 2021 5:49 PM

Market structure

monopoly — Perfect competition

Homogenous Products lead to capacity competition

Natural monopolies

Generation Distribution

Problem 17

Saturday, March 6, 2021 3:07 PM

There are two types of consumers for a particular beer, with inverse demands given by p_1=3.5-0.25q_1 and p_2=3.3-0.4q_2, respectively, where q is the number of bottles per period. Marginal cost is \$0.5 per bottle.

a) Assuming 40% of customers are type 1 and the remainder are type 2, set up the optimization problem with all 4 constraints, though only 2 will bind.

$P_1 = 3.5 - .25q_1 \qquad P_2 = 3.3 - .4q_2$

$\pi = (3.5 - .25q_1)q_1 + (3.3 - .4)q_2 - .5(q_1 + q_2)$

$q_1 = .4q \qquad q_2 = .6q \qquad q_1 + q_2 = q \qquad q \geq 0$

$\pi = [3.5 - (.25 \cdot .4 \cdot q)](.4q) + [3.3 - (.4 \cdot .6 \cdot q)](.6q) - .5q$

b) Solve the problem to find the optimal bundle for each consumer type, their prices, the firm's profits, and each consumer type's surplus. Constraints 2+3 bind

$P_2 = 3.3q - .2q^2$

$\pi = (3.5 - .1q)(.4q) + (3.3 - .24q)(.6q) - .5q$
$= -.184q^2 + 2.88q$

$P_1 = P_2 + (3.5q_1 - .125q_1^2) - (3.5q_2 - .125q_2^2)$
$P_1 = 3.5q_1 - .125q_1^2 - 3.5q_2 - .125q_2^2$

$\frac{d\pi}{dq} = -.368q + 2.88 \rightarrow q = 7.826$

$\pi = .4(3.5q_1 - .125q_1^2 - .2q_2 - .025q_2^2 - .5q_1) + .6(3.3q_2 - .2q_2^2 - .5q_2)$

$\frac{d\pi}{dq_1} = .4(3 - .25q_1) = 0$
$q_1 = 12$

$\frac{d\pi}{dq_2} = .6(2.5 - .4q_2) - .4(.2 + .15q_2) = 1.6$

$q_1 = .4q = .4 \cdot 7.826 = 3.13$
$q_2 = .6q = .6 \cdot 7.826 = 4.69$

$P_1 = 3.5 - .25(3.13) = 2.717$
$P_2 = 3.3 - .4(4.69) = 1.421$

$\pi = (3.13 \cdot 2.717) + (4.69 \cdot 1.421) - .5(7.826) = 11.269$

$CSP_2 = \int_0^{1.421} (3.5 - .25x) - (3.3 - .4x) = .4356$

$CSP_1 = \int_0^{1.421} 3.3 - .4x = 4.2854$

c) How much additional profit could be made if the company could engage in perfect 1st degree price discrimination?

$P_2 = MC \rightarrow 3.3 - .4q_2 = .5 \rightarrow q = 7$
$P_2 = 3.3 \cdot 7 - .2 \cdot 7^2 = 13.3$
$\pi = .4(24 - .5 \cdot 12) + .6(13.3 - .5 \cdot 7)$
$= 13.08$

$\pi = 11.269 + .4356 + 4.2854 = 15.99$

d) Let α represent the fraction of consumers that are type 1, while all remaining customers are type 2. Set up the optimization problem and solve for the optimal bundles and prices as a function of α. What happens to the bundles and prices as α increases? Explain in intuitive terms.

$q_1 = \alpha q \qquad q_2 = (1 - \alpha)q$

$P_1 = 3.5 - .25\alpha q \qquad P_2 = 3.3 - .4(1 - \alpha)q$

$\pi = (\alpha q)(3.5 - .25\alpha q) + ((1 - \alpha)q)(3.3 - .4(1 - \alpha)q) - .5(q)$

$\frac{d\pi}{d\alpha} =$

I think I messed up somewhere. This is not a nice looking graph. Nevertheless, I'll explain what I think is happening. You want as many high type customers as possible but after a certain amount of them, you'll begin to lose money on the missing low types.

Problem 18

Saturday, March 6, 2021 4:38 PM

This one requires going beyond what we talked about explicitly in class. As in the previous problem, assume there are two types of beer consumers with inverse demands of p_1=3.5-0.25q_1 and p_2=3.3-0.4q_2 and marginal cost is \$0.5 per bottle. Let α represent the fraction of type 1 consumers. Suppose the firm can only offer one bundle at one price, either because of resale limits or other practical considerations.

a) Set up the profit maximization problem. Of the four constraints from 5a, two become irrelevant. Which two and why do they become irrelevant? Of the other two, assuming both types of customers are served, which is will be binding, and why? only 1 bundle 5a constraints are irrelevant

$\pi = (3.3-.4(1-a)q)(1-a)q + (.25aq - .25(1-a)q + 3.3 - .4(1-a)q)aq - .5q$

1) $3.5 - .25q_1 \geq p_1$
2) $3.3 - .4(1-a)q \geq p_2$ → binding
3) $p_1 = .24aq - .25(1-a)q + p_2$ → binding
4) $3.3 - .4q_2 - p_2 \geq 3.3 - .4q_1 - p_1$

1 and 4 become irrelevant because there is now only one price bucket. The low type customers will be binding because they will not pay more than their WTP, but the high types will always be willing to pay less.

b) Solve for the profit maximizing bundle and its price assuming both types are served. At what value of α would it make sense to price one type of customer out of the market? Which type is priced out? Why? What is the profit maximizing bundle and its price if it is most profitable to serve only one customer type? What are profits in that case, as a function of α?

$\frac{d\pi}{dq} = (10a^2 - 3a - 8)q + 28/10$

Hadley said to draw alpha like a fish

$q = 1.05$

$(1-a)q = 3.5$

$\frac{(1-a)q}{q} = \frac{3.5}{1.05}$

$(1-a) = 3.333$

$-2.33 = a$

It makes sense to price one type of customer out of the market once the marginal benefit of more of that kind of customer exceeds the marginal benefits lost by losing the other type. I would assume that the low type is priced out because you can't price out the high type without also pricing out the low type.

I'm confused on how to properly approach the problem because before when we've had fractions of the population, we still use the whole population. In this case, we're only using a fraction of the population.

Constraint: $p = 3.3q - .2q^2$

$\pi = \alpha(3.3q - .2q^2 - .5q) + (1-\alpha)(3.3q - .2q^2 - .5q)$ or $\pi = 3.3q - .2q^2 - .5q$

if both types served, α doesn't matter

$\frac{d\pi}{dq} = 3.3 - .4q - .5 \rightarrow .4q = 2.8 \rightarrow q = 7$

$p = 3.3 \cdot 7 - .2 \cdot 7^2 = 13.3$

$\pi = 13.3 - .5 \cdot 7 = 9.8$

Problem 19

Saturday, March 20, 2021 1:37 PM

Individual preferences for risky monetary outcomes (x) are well approximated by the von Neumann-Morgenstern utility function $u = \sqrt{x}$. Income is $40,000. There is a 0.05 probability of a $30,000 loss.

a) Calculate the certainty equivalent of an individual's lottery and the risk premium, and show them graphically.

$E(u) = (40000 \cdot .95) + (10000 \cdot .05) = 38000$

$\sqrt{CE} = .95\sqrt{40k} + .05\sqrt{10k}$
$= 190 + 5 = 195$
$CE = 195^2 = 38025$

$\sqrt{success} = \frac{19}{20}\sqrt{(40000)} + \frac{1}{20}\sqrt{(10000)}$

$CE = 38025$

does math backwards

$\sqrt{40000 - P} = \sqrt{38025} \rightarrow 40000 - P = 38025$

$P = 1975$

$RP = E(x) - CE$
$= 38000 - 38025$
$= 1975$

b) Suppose there are 2 identical individuals and losses are independent. Neither, one, or both may suffer a loss. If the two pool their risk, and so share any losses equally, what is the certainty equivalent of an individual's lottery? In terms of the certainty equivalent, how much value did they gain from pooling their risk?

No loss: $P(x=40k) = .95^2 = .9025$
1 loss: $P(x=40k - 30k/2 = 25k) = 2 \cdot .95 \cdot .05 = .095$
2 loss: $P(x=10k) = .05^2 = .0025$

E	W
$\frac{361}{400}$	40000
$\frac{19}{200}$	25000
$\frac{1}{400}$	10000

$\sqrt{CE} = \frac{1}{400}\sqrt{10000} + \frac{38}{400}\sqrt{25000} + \frac{361}{400}\sqrt{40000}$

$\hookrightarrow CE = 38326.213$

Value gained $= 38326.213 - 38025 = 301.213$ ← real value / 2 ?
there are 2 people so ↑ ·2

c) Suppose there are 5 identical individuals facing independent losses, with the total number of losses therefore following the binomial distribution. That is, the probability of exactly k losses in n trials if the chance of an individual loss is p is $P(k \mid n) = \frac{n!}{k!(n-k)!} p^k (1-p)^{n-k}$. If all 5 pool their risk, what is the certainty equivalent of each individual's lottery? How much value is created (in total) by pooling risk rather than each individual bearing their own risk?

$\sum_{i=0}^{5} P(k|n)$

$\frac{5!}{1!(4)!} \cdot .05^1 (1-.05)^4 + \frac{5!}{2!,3!} \cdot .05^2 (.95)^3 + \frac{5!}{3!2!} \cdot .05^3 (.95)^2 +$

$\frac{5!}{4!1!} \cdot .05^4 \cdot .95^1 + \frac{5!}{5!0!} \cdot .05^5 \cdot .95^0 =$

	A	B	C	D	E	F	G	H
1	n	k	n-k	P(k|n)	Good W	Bad W	Total W	CE
2	5	0	5	0.773780938	40000	0	40000	154.7561875
3	5	1	4	0.203626563	32000	2000	34000	37.54688291
4	5	2	3	0.021434375	24000	4000	28000	3.586656951
5	5	3	2	0.001128125	16000	6000	22000	0.167327978
6	5	4	1	2.96875E-05	8000	8000	16000	0.003755205
7	5	5	0	3.125E-07	0	10000	10000	0.00003125
8							Total CE	38439.85369
9							Value Gained	414.8536863
10							Total Value	2074.268432

d) Suppose there are 100,000 identical individuals and risks are independent. A risk neutral insurance company insures everyone at the actuarially fair rate. What is that rate? What is each individual's now certain income? How much value is added by the insurance company? each individual gains 415 for a total of 41.5 M

3/20/2021 R Notebook

R Notebook

```
getValue <- function(n) {
df <- as.data.frame(matrix(data = NA, nrow = n + 1, ncol = 8))
colnames(df) <- c("N", "K", "NK", "PKN", "GoodW", "BadW", "TotalW", "CE")
df$N <- n
df$K <- 0:(nrow(df) - 1)
df$NK <- df$N - df$K
df$PKN <- (factorial(df$N) / (factorial(df$K) * factorial(df$NK))) *
  (.05^df$K) * (.95^df$NK)
df$GoodW <- 40000 * df$NK / n
df$BadW <- 10000 * df$K / n
df$TotalW <- df$GoodW + df$BadW
df$CE <- df$PKN * sqrt(df$TotalW)
return(((sum(df$CE)^2) - 38025)*5)
}

df2 <- as.data.frame(matrix(data = NA, nrow = 71, ncol = 2))
colnames(df2) <- c("N", "Value")
df2$N <- 100:170
df2$Value <- sapply(df2$N, getValue)
df2
```

N <int>	Value <dbl>
100	2361.068
101	2361.206
102	2361.342
103	2361.475
104	2361.606
105	2361.734
106	2361.859
107	2361.982
108	2362.103
109	2362.222

1-10 of 71 rows Previous 1 2 3 4 5 6 ... 8 Next

```
library(tidyverse)
```

```
## -- Attaching packages --------------------------------------- tidyverse 1.3.0 --
```

file:///Users/paulgekin/Documents/Spring2020/ECP 4044 = Economic Analysis/Problem-19.html 1/2

3/20/2021 R Notebook

```
## ✓ ggplot2 3.3.2     ✓ purrr   0.3.4
## ✓ tibble  3.0.4     ✓ dplyr   1.0.2
## ✓ tidyr   1.1.2     ✓ stringr 1.4.0
## ✓ readr   1.4.0     ✓ forcats 0.5.0

## -- Conflicts ------------------------------------------ tidyverse_conflicts() --
## x dplyr::filter() masks stats::filter()
## x dplyr::lag()    masks stats::lag()
```

```
df2 %>%
  ggplot(aes(x = N, y = Value)) +
  geom_point() +
  geom_smooth(formula = y ~ sqrt(x))
```

```
## `geom_smooth()` using method = 'loess'
```

I'm not really sure how I'm supposed to do this and 100000! Is a really really big number. I did think that the number would eventually converge so I decided to do my best to check. It turns out that it does converge, to what I don't know, ~~but it does follow y=sqrt(x), just like the utility function.~~

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e) For the binomial distribution, the mean number of occurrences is np and the standard deviation of the total number of occurrences is $\sqrt{np(1-p)}$. Suppose regulations require the insurance company in (d) to hold reserves so that there is only a 0.000001 probability they will experience losses over annual revenue plus reserves, which they could not cover. How much is needed in reserves? With large numbers of observations, the binomial distribution is very closely approximated by the normal distribution, with the appropriate mean and standard deviation. So, you can use the normal approximation with the implied mean and standard deviation, or, you can use any program that can calculate the inverse of the cumulative binomial distribution (excel will do it using the binom.inv() function). company must be able to cover 331 losses
revenue = 15bm, thus reserves must be 7.93m

binom.inv(100000, .05, .000001) = 4676

f) Reinsurance is insurance purchased by insurance companies to protect the company against a very rare circumstance regarding an exceptionally high level of claims. Interpret the role of reinsurance companies in light of (e).

Reinsurance companies exist because regular insurance companies pool risk among their policy holders so if each insurance company has 100,000 people and a reinsurance company has 10 insurance companies, then the risk is spread over 1,000,000 people. It allows for aggregated risk pooling.

Problem 20

Thursday, March 25, 2021 4:18 PM

Find any pure strategy Nash equilibria of the game played by Alice and Bob represented in the table below.

(row, column)

		Bob			
		b1	b2	b3	b4
Alice	a1	0,0	0,0	0,1	1,5
	a2	0,0	1,1	2,5	1,4
	a3	1,0	4,4	2,3	2,5
	a4	5,1	3,2	3,1	-2,-2

Pure NE

Problem 21

Thursday, March 25, 2021 4:23 PM

Find all pure strategy Nash equilibria of the following game in which Alice chooses the row (first payoff in each cell), Bob chooses the column (second payoff in each cell), and Charlie chooses the table (third payoff in each cell). (row, column, table)

Table 1

		Bob	
		Left	Right
Alice	Up	0,1,0	1,1,2
	Down	1,2,3	2,3,2

Pure NE

Table 2

		Bob	
		Left	Right
Alice	Up	2,2,3	0,2,1
	Down	1,2,3	0,1,0

Pure NE

Problem 22

Thursday, March 25, 2021 4:29 PM

Suppose the offense, trailing by 5 points, has the ball on the 3 yard line with 1 second left on the game clock. Neither team has any timeouts remaining. The offense can choose personnel better suited to run or personnel better suited to pass. The defense can choose personnel better suited to defend the run or better suited to defend the pass.

If both choose run the probability of a touchdown is 0.25.

If the offense chooses pass and the defense chooses run, the probability of a touchdown is 0.75.

If the offense chooses pass and the defense chooses pass, the probability of a touchdown is 0.4.

If the offense chooses run and the defense chooses pass, the probability of a touchdown is 0.5.

Idk anything about football should've used probabilities

a) Assume moves are simultaneous. Show there is no pure strategy equilibrium and find the mixed strategy equilibrium. What is the probability of a touchdown in equilibrium?

O\D	Run	Pass
Run	(.25·6), (.75·-6)	(.5·6), (.5·-6)
Pass	(.75·6), (.25·-6)	(.4·6), (.6·-6)

Values are positive

O\D	Run		Pass	
Run	1.5	-4.5	3	-3
Pass	4.5	-1.5	2.4	-3.6

(row, column)

I'm going with the defense being -6 because 0 doesn't make sense. If the payoff was zero, then there would be a pure strategy equilibrium and the question says there isn't one.

$1.5q + 3(1-q) = 4.5q + 2.4(1-q) \rightarrow q = 1/6 \qquad 1-q = 5/6$

$4.5q + 1.5(1-q) = 3q + 3.6(1-q) \rightarrow q = 7/12 \qquad 1-q = 5/12$

b) Show the extensive form if the offense commits to its move first and find the backward induction solution.

c) Show the extensive form if the defense commits to its move first and find the backward induction solution.

Problem 23

Thursday, March 25, 2021 4:53 PM

Continuation of problem 23. Each team can choose to send in its package right away (early) or try to wait to see what the other chooses (late). If both choose early or both choose late, the result is a simultaneous move game. Find the Nash equilibria of this game in which each side chooses its personnel package and whether to send it in early or late. Use Positive Probabilities

O\D	Early		Late	
Early	1.5	-4.5	1.5	-4.5
Late	2.4	-3.6	2.4	-3.6

NE

Problem 24

Thursday, March 25, 2021 4:53 PM

An incumbent firm faces a potential entrant. The firms produce differentiated products. The entrant chooses In or Out. The incumbent may choose to offer a variety of its product that competes directly with the entrant's (Aggressive) or may continue with only its current product (Passive). Payoffs for possible action pairs (with the entrant listed first) are:

In, Aggressive -> -1, 3

In, Passive -> 2, 5

Out, Aggressive -> 0, 8

Out, Passive -> 0, 10

a) Analyze the game where the entrant moves first. Find all pure strategy equilibria and identify which, if any, are subgame perfect.

b) Analyze the game where the incumbent moves first. Find all pure strategy equilibria and identify which, if any, are subgame perfect.

Problem 25

Tuesday, April 6, 2021 8:34 PM

Continuation of problem 25. The incumbent is indefinitely lived. The probability of continuing after any round is *f* and the discount rate is *r*. Each entrant plays only one round and knows how the incumbent played in the past. We want to determine the value to the incumbent of maintaining the ability to introduce and withdraw new product varieties on short notice.

a) Suppose the incumbent has to move first each round because it takes time to introduce and position a new product. Calculate the expected present value of the incumbent's profit.

	Aggro	Passive
In	-1, 3	2, 5
out	0, 8	0, 10

$3q + 8(1-q) = 5k + 10(1-k)$

$3q + 8 - 8q = 5k + 10 - 10k$

$-5q + 8 = -5k + 10$

$-5q = -5k + 2$

$q = -k - 2/5$

$3(k - 2/5) + 8(1 - (k - 2/5)) = -5k + 10$

$q = 0 \quad k = .4$

$E(\pi) = 3(0) + 8(1-0) + 5(.4) + 10(.6)$

$= 0 + 8 + 2 + 6$

$= 16$

$E(\pi) = 8$

$\sum_{t=0} \left(\frac{f}{1+r}\right)^t \rightarrow \boxed{8 \cdot \frac{1}{1-(f/1+r)} - E(\pi)}$

$\frac{1}{1-f} \rightarrow \delta = \frac{f}{1+r}$ something fraction

$\left[\delta / (1-\delta)\right](1-\delta^T)$ ← adjust for $t=0$

↳ +1

$E(\pi) = 8 \frac{1+r}{1+r-f}$

b) Suppose the incumbent can maintain the capacity to introduce a new product on short notice, and similarly to withdraw it from the market whenever it chooses. Determine the values of *r* and *f* for which the following strategies constitute a sequentially rational Nash Equilibrium. (Sequential rational is closely akin to subgame perfection. It means the strategy is rational at every point, even those that will not actually be reached in the equilibrium.) **Incumbent:** In each round, if the entrant enters, introduce the new product and withdraw it at the end of the round, and if the entrant does not enter do not introduce the new product. **Entrant:** Enter if the incumbent has ever been passive, and do not enter otherwise.

r = discount rate

f = prob of continue

$V = 10 \frac{1+r}{1+r-f}$

$V = 3 + 10 \sum_{t=1}^{\infty} \left(\frac{f}{1+r}\right)^t = 10 \frac{1+r}{1+r-f} - 7$

$8 \cdot \frac{1}{1-f/1+r} + 3 \cdot \frac{1}{1-(1-f)/1+r} = -1 \cdot \frac{1}{1-\frac{f}{1+r}} + 0$

$V_{deviate} = 5 \frac{1+r}{1+r-f}$

$V \geq V_{deviate} \rightarrow f \geq \frac{3}{5}(1+r)$

$r = \frac{-2f+1}{4}$

Plug in... $f = \frac{5}{2}$?

$r = -1$?

I'm definitely doing something wrong, but I keep getting $r = -1$

c) How much might it be worth to the incumbent to be able to introduce and withdraw new products on short notice, as a function of *r* and *f*?

I would calculate expected profit for the incumbent if the other player enters the market

$3 \cdot \frac{1}{1-f/1+r} + 5 \cdot \frac{1}{1-\frac{f}{1+r}} = \frac{8r^2 - 2fr + 13r - 2f + 5}{(f+r)(r+1-f)}$

$(10 - 8) \frac{1+r}{1+r-f}$

Problem 26

Tuesday, April 6, 2021 9:11 PM

Alice and Bob repeatedly play the one shot game to the right, in which they sell differentiated products. Each can choose price high as they would with no competition, lower, or at cost. Alice and Bob may each be normal or crazy, but do not know the type of their opponent. A crazy player prices high until their competitor does not, and charges at cost forever after their opponent charges a price below high. The probability of a crazy player is *g*. The discount rate is *r*. The number of repetitions is known to be *T*. Think of 1/2-*h* as reflecting how much pricing at cost hurts an opponent charging lower prices, where (1/2) > *h* > (1/10). Please use the table included below.

		Bob		
		High	Lower	At Cost
Alice	High	3/4,3/4	1/3,1	1/10,0
	Lower	1,1/3	1/2,1/2	*h*,0
	At Cost	0,1/10	0,*h*	0,0

a) What is the one shot Nash equilibrium if all players are rational?

NE is 1/2, 1/2 → lower, lower eq = above cost and < monopoly

b) What price will rational players charge in the last round, and why?

They will both choose lower and lower because they have the opportunity to maximize their profits. Profits with lower are always higher on average than high or at cost.

c) For what values of *r*, *g*, and *h* is it a Nash equilibrium for sane players to charge high prices in all rounds before the last? Hint: work out if it is equilibrium play in the second to last round. Interpret your result.

$\frac{x}{n} \cdot \left(1 - \frac{1}{(1+r)^T}\right)$ In T-1: $\cancel{2g + 2(1-g)} + \frac{\cdots}{(1+r)^T}$

t_{-1} = high t = low → $\frac{3}{4} + [(1-g)/2 + g]/(1+r)$

t_{-1} = low t = high → $1 + [(1-g)/2 + gh]/(1+r)$

$(1+r)/3$

Grocery Gus or: How I Learned to Stop Worrying and Love the Log Card

Author: Gus Lipkin

Date: 21 April 2021

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Introduction and Background

Author's note

Defense contractors generally don't like when you go into too much detail about what you do or how their company works, even if it is for a paper for school. As such, I will be describing where I work and my job as a supermarket.

My Origin Story

I was originally hired as an intern with MiGrocery with the express purpose of collecting information on items that were delivered to be stocked in our canned goods department. Each canned good is supposed to have a log card with it. Each log card describes where the product was made and who handled it along with any climate conditions so we know if the product is safe for the sales floor. I was given a list of SKUs and a login for a piece of software we will call GrocerDocs which allows for realtime tracking of each SKU and a serial number for each unit of that SKU.

Unfortunately, the people who stock the warehouse and are not very organized and items of the same SKU do not always end up stocked together. In addition, just because GrocerDocs says an item is in a location does not mean it will actually be there when I look for it and each item may not have its required log card with it. Someone else could have taken the item without updatingGrocerDocs or taken the log card and not uploaded it to GrocerDocs, or both.

GrocerDocs will tell me where each item is, but there's no way to check and see all of the locations I will need to visit without checking the location atribute for each SKU which could have several hundred serial numbers scattered about the warehouse where I work and on the sales floor that I do not have access to. I quickly realized that going SKU by SKU and searching all the different locations that for each specific serial number was inefficient. I found a way to export GrocerDocs' complete inventory and used R to extract a list of every serial number for every SKU I needed to find and order the list by location and export this information to a spreadsheet. I also added some columns to help me better keep track of product as it moved around the warehouse and so I knew which items I had already looked for and which ones I had uploaded. With my new program, I could now sync with GrocerDocs every morning to get the newest locations. Once I showed this to my supervisors, they thought I was a "tech wizard". Thus began the onslaught of spreadsheet generator requests.

The Spinoff Series

My supervisor, the canned food department head, wanted a spreadsheet that had the item names and SKUs down the left and the item serial numbers listed horizontally with each serial number cell highlighted based on its status. She had recently spent several days creating this spreadsheet but since item status can change, it was no longer up to date and she needed a new one. Creating it by hand would take me several days each time, but automating it would only take several days once. Once completed, she showed the other department managers and the bakery manager decided he wanted one too. Then, the district manager decided he wanted me to make a spreadsheet that was very similar but only listed items on the sales floor. The catch was that he wanted a single file for each department with a worksheet for every store. While there is no list of what each store should have on the sales floor, I could make a good effort at figuring it out by

comparing across stores and making sure every store has the same number. Unfortunately for him, it was my day off and I was not going to accept my regular hourly rate. Ultimately, we agreed on a bonus of five hours of pay for coming in and creating the document.

At this point, my supervisor, the canned goods department head, realized that I had not done any work for her in several weeks because I was working on generating spreadsheets of all sorts for other department heads. She wants me back on the log card project. By creating the location sorted spreadsheet of every item I need to find, I have already optimized the process as much as I can.

The Dilemma

Is it more economical to keep me on the log card project full time, keep me on the log card project and loan me out occassionally, or switch me to special projects full time?

Analysis

Expected Marginal Utility

As we will establish in *Profit Maximization*, I provide no added value to the log card project over any other person performing the same task. I will concede, of course, that I already know which buttons to press to update my spreadsheets and no one else does, but those tasks are easy to teach in under fifteen minutes and can therefore be ignored. Because I provide no added value to the project, when my supervisor asks me to work on log cards the company has a marginal utility of zero while I am doing that work.

What is the company's expected marginal utility for each unit of time I am on a special project? This is relatively easy to answer because of the nature of the special projects I am assigned to. Each special project has progress that can be measured by tasks completed or percent completion when done by hand such as transcribing part numbers into a spreadsheet or trying to find duplicate part numbers. However, when writing a program that does these tasks it is exceptionally rare that a computer running the program would take as long as a human would to do the same task.

`Assumption 1: A computer program will always take less time to complete a given task than a human will`

Of course, that program does take time to write. It takes me about a week to write a fully-fledged solution to any special project. If I am able to re-purpose existing code for a new project, that time is cut down to just one or two days.

`Assumption 2: I will take a week to finish writing a program to complete any given task`

It should now be clear that if any special project is expected to take more than a week to complete, I should be tasked with writing a program to do the task. If the task is expected to be repeated, I should be asked to write a program if the total time spent on the task is more than a week. It may take me more time in the beginning, but at some point the programming time and task time will reach a breakeven point at which point the program will be more efficient.

These assumptions, however, assume that MiGrocery has only one person working on these projects, either me or someone else. I will always take a week to complete a given task, but should they choose to hire a small army, essentially mult-threading the process, the task could be completed in a matter of hours. This problem has a natural solution that the total amount paid to employees to complete the task should be minimized regardless of it is paying one person for many hours or many people for one hour. Alternatively, if a task is crucial to company operations, they could choose to pay more people to complete it more quickly rather than wait for me to construct a solution.

Profit Maximization

Another, more concrete way, to calculate the value I add to the team is to try and maximize the companies profit by optimizing which projects I am put on and which projects I could be put on that someone else is put on.

The model of profit for a single given project is below. t is the unit of time at which a portion of the completed project is usable and adds value in operations. We start by finding the value of the portion of the project that was completed while I was writing my code where we start at time $t = 1$ because we are measuring actionable time units and not real time. We are taking the sum up to n which is just before the time that I am able to run my code and is greater than or equal to t. The next portion is the rest of the net present value function left intact where R_t represents the cash flow in time t. In this case, i represents the diminishing value of the project as time passes and the marginal rate of return of the project as it nears its completion.

$$\pi = \sum_{t=1}^{n} [\frac{R_t}{(1+i)^t}]$$
$$n \geq t$$

The second term represents the amount of value I provide by completing my code at time n and is also modeled using the net present value formula. This only has one term and is not summed because the cash flow R_n is reprentative of the value added by having the rest of the project completed.

$$\pi = \sum_{t=1}^{n} [\frac{R_t}{(1+i)^t}] + \frac{R_n}{(1+i)^n}$$
$$n \geq t$$

The third term represents the amount needed to pay the employees who work on the project by hand before my program is completed and also my pay for the same term. x is the number of employees including myself, p is their pay rate per hour, and h is the number of hours per time unit t.

$$\pi = \sum_{t=1}^{n} [\frac{R_t}{(1+i)^t}] + \frac{R_n}{(1+i)^n} - (xphN)$$
$$n \geq t$$

Something important to note here is that me writing the code in t time will always be more profitable than waiting for the other people to do the same task in $t + 1$ time. In order to maximize this, we find the first derivative and find the maximum point of the line. We will leave the maximization here and move to balancing multiple projects.

$$\frac{d\pi}{dt} = \sum_{t=1}^{n}[-\frac{ln(i+1)r}{(1+i)^t}] - \frac{ln(i+1)r}{(1+i)^n}$$
$$n \geq t$$

From here, we can take this in two directions. The first would be to change the model to reflect that some projects are one-offs and some are repeated. The second would be to do a direct comparison with another modeled project to learn where my talents can best be applied.

One-offs vs Repeated Projects

A one-off project is something that once completed, is used once and then never again. A repeated project is performed multiple times. This could be every week, month, or other time period, or on an as needed basis. I've already established that profit for a one-off project is modeled with

$$\pi = \sum_{t=1}^{n}[\frac{R_t}{(1+i)^t}] + \frac{R_n}{(1+i)^n} - (xphN)$$
$$n \geq t$$

The first iteration of a repeated project will always stay the same as the above model because the company still wants its results as quickly as possible. If it is going to take me more than one period to complete, we can multiply the entire equation by the number of periods it will take me to complete the program. Let's call that number ρ.

$$\pi = \rho\{\sum_{t=1}^{n}[\frac{R_t}{(1+i)^t}] + \frac{R_n}{(1+i)^n} - (xphN)\}$$
$$n \geq t$$

Once I've finished the program, there is no diminishing value in waiting for the code to run. Thus, the only change to the function is added cost of paying someone to hit run on the program which is negligible.

Direct Comparison of Projects

This approach is relatively easy. To make this easier to understand, let's say there are two or more projects happening simultaneously and I can only work on one at a time. After estimating how long it will take me to write a solution based on prior knowledge of the tools needed or having written programs that can be adapted to the new tasks. We can put the profit maximization function to work and use the time it would take me to write the program as $t+1$. Then, we do the same for the other projects in consideration. Whichever one has the highest potential profit is the one that I should be applied to. This can be taken a step further by taking into consideration whether or not the projects in question is a one-off or a repeated project.

Conclusion

I may be tooting my own horn, so to speak, but I do not think that MiGrocery could have hired a better and more productive intern. I have shown time and time again that I am able to use skills in my toolset to expertly optimize current workloads and to automate tasks that could take weeks to complete by hand. Through profit maximization techniques with estimated numbers, I have shown that I can be more than ten times as productive as an employee doing the same task by hand. In discussing expected marginal utility, we learned that it makes sense for me to take on any special project that is expected to take more than a week to

complete or that is an ongoing project. Because I am so much more productive on special projects, it makes sense for me to be switched to those full time rather than kept on log cards and loaned out to special projects on occasion.