

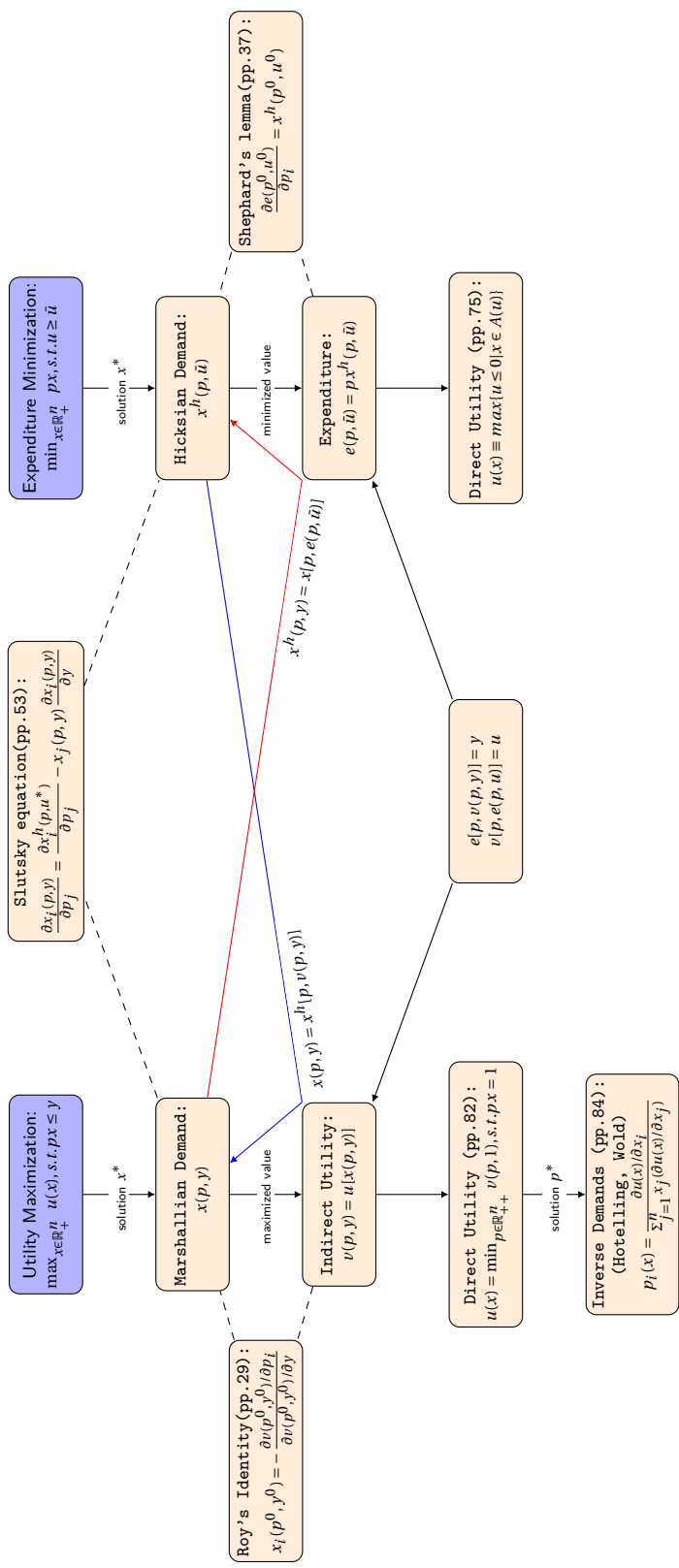
Seminar 3.Duality of Consumers Behavior

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Consumption Duality

You will never lose your way with this Consumption Duality map!
 All "derive this from that and verify some guy's equation"-like questions can be solved by finding the correct (shortest) route.



1 Jehle & Reny 2.3

Derive the consumers direct utility function if his indirect utility function has the form $v(p, y) = yp_1^\alpha p_2^\beta$ for negative α and β .

THEOREM 2.3 Duality Between Direct and Indirect Utility(Jehle & Reny pp.81)

Suppose that $u(x)$ is quasiconcave and differentiable on \mathbb{R}_{++}^n with strictly positive partial derivatives there. Then for all $x \in \mathbb{R}_{++}^n$, $v(p, p \cdot x)$, the indirect utility function generated by $u(x)$, achieves a minimum in p on \mathbb{R}_{++}^n , and

$$u(x) = \min_{p \in \mathbb{R}_{++}^n} v(p, y), \text{ s.t. } px = y$$

Let's call the solution p^*

Note that by **Theorem 1.6**(Jehle & Reny pp.29), $v(p, y)$ is homogeneous of degree zero in (p, y) . We have $v(p, p \cdot x) = v(p/(p \cdot x), 1)$ whenever $p \cdot x > 0$. Thus the equation above can also be written as:

$$u(x) = \min_{p \in \mathbb{R}_{++}^n} v(p, 1), \text{ s.t. } px = 1$$

The solution $\hat{p} = p^* / p^* \cdot x = p^* / y$. We don't care about the difference between \hat{p} and p^* because once you substitute them into $v(p, p \cdot x)$, you have the same result (homogeneity of degree zero).

$$u(x) = \min_{p \in \mathbb{R}_{++}^n} v(p, 1) = p_1^\alpha p_2^\beta, \text{ s.t. } px = 1$$

Lagrangian:

$$L = p_1^\alpha p_2^\beta + \lambda(1 - p_1 x_1 - p_2 x_2)$$

Note there should not be interior solution since

- $\frac{\partial v(p_1, p_2, 1)}{\partial p_1} = \alpha p_1^{\alpha-1} p_2^\beta, \alpha, \beta < 0. \lim_{p_1 \rightarrow 0} \frac{\partial v(p_1, p_2, 1)}{\partial p_1} = -\infty$
- $\frac{\partial v(p_1, p_2, 1)}{\partial p_2} = p_1^\alpha \beta p_2^{\beta-1}, \alpha, \beta < 0. \lim_{p_2 \rightarrow 0} \frac{\partial v(p_1, p_2, 1)}{\partial p_2} = -\infty$
- $v(p, 1)$ is decreasing in p (this is always true for indirect utility function, see pp.29). For any $px < 1$, you can always decrease $v(p, 1)$ by increasing p until $px = 1$.

FOCs.

$$\begin{cases} \frac{\partial L}{\partial p_1} = \alpha p_1^{\alpha-1} p_2^\beta - \lambda x_1 = 0 \\ \frac{\partial L}{\partial p_2} = p_1^\alpha \beta p_2^{\beta-1} - \lambda x_2 = 0 \\ p_1 x_1 + p_2 x_2 = 1 \end{cases}$$

Simplify:

$$\begin{cases} \alpha p_1^{\alpha-1} p_2^\beta = \lambda x_1 \\ \beta p_1^\alpha p_2^{\beta-1} = \lambda x_2 \\ p_1 x_1 + p_2 x_2 = 1 \end{cases} \quad (1)$$

Take the ratio between first and second condition to get:

$$\frac{x_1}{x_2} = \frac{\alpha}{\beta} \frac{p_2}{p_1}$$

Thus: $p_2 = \frac{\beta}{\alpha} \frac{x_1}{x_2} p_1$

Substitute p_2 with p_1 in the 3rd condition to get:

$$\begin{aligned} p_1 x_1 + \frac{\beta}{\alpha} \frac{x_1}{x_2} p_1 x_2 &= 1 \\ p_1 (x_1 + \frac{\beta}{\alpha} x_2) &= 1 \\ p_1^* &= \frac{1}{x_1 (1 + \frac{\beta}{\alpha})} \\ \Rightarrow p_2^* &= \frac{\beta}{\alpha} \frac{x_1}{x_2} p_1^* = \frac{\beta}{\alpha} \frac{x_1}{x_2} \frac{1}{x_1 (1 + \frac{\beta}{\alpha})} = \frac{1}{x_2 (1 + \frac{\alpha}{\beta})} \end{aligned}$$

Substitute p_1^* and p_2^* into $v(p, 1)$ we get the minimized value, i.e. the direct utility function:

$$\begin{aligned} u(x_1, x_2) &= \left[\frac{1}{x_1 (1 + \frac{\beta}{\alpha})} \right]^\alpha \left[\frac{1}{x_2 (1 + \frac{\alpha}{\beta})} \right]^\beta \\ &= A x_1^a x_2^b \end{aligned}$$

Where $A = \left[\frac{1}{1 + \frac{\beta}{\alpha}} \right]^\alpha \left[\frac{1}{1 + \frac{\alpha}{\beta}} \right]^\beta$, $a = -\alpha > 0$, $b = -\beta > 0$. The utility function is a Cobb-Douglas function.

As a cautious proof, you may want to check if $u(x)$ is quasiconcave and differentiable on \mathbb{R}_{++}^n with strictly positive partial derivatives there, as assumed by Theorem 2.3.

In exam for this course, again, if the function is one- dimension, you should prove it; if it's a higher-dimension function, the proof is not required.

Like Jehle & Reny 1.51, you can actually transform $v(p_1, p_2, 1)$ into a function of only p_1 or p_2 using $p_1 x_1 + p_2 x_2 = 1$.

$$p_1 = \frac{1 - p_2 x_2}{x_1}$$

Substitute into $v(p_1, p_2, 1)$ to have:

$$v(p_1, p_2, 1) = \left[\frac{1 - p_2 x_2}{x_1} \right]^\alpha p_2^\beta$$

Since the question ask you to minimize $v(p_1, p_2, 1)$, if you solve $\frac{de(p_2)}{dp_2} = 0$ and get only one solution, it is the solution.

$$\begin{aligned} \frac{de(p_2)}{dp_2} &= \alpha \left(\frac{1 - p_2 x_2}{x_1} \right)^{\alpha-1} \left(\frac{-x_2}{x_1} \right) p_2^\beta + \frac{1 - p_2 x_2}{x_1}^\alpha \beta p_2^{\beta-1} = 0 \\ \alpha \left(\frac{1 - p_2 x_2}{x_1} \right)^{\alpha-1} \left(\frac{x_2}{x_1} \right) p_2^\beta &= \frac{1 - p_2 x_2}{x_1}^\alpha \beta p_2^{\beta-1} \\ \alpha \left(\frac{x_1}{1 - p_2 x_2} \right) \left(\frac{x_2}{x_1} \right) p_2 &= \beta \\ \alpha \left(\frac{x_2}{1 - p_2 x_2} \right) p_2 &= \beta \\ \alpha x_2 p_2 &= \beta - \beta x_2 p_2 \\ (\alpha x_2 + \beta x_2) p_2 &= \beta \\ p_2^* &= \frac{\beta}{(\alpha + \beta) x_2} \end{aligned}$$

You then solve p_1^* with the budget constraint.

2 Jehle & Reny 2.5(a)

Consider the solution, $e(p, u) = u p_1^{\alpha_1} p_2^{\alpha_2} p_3^{\alpha_3}$ at the end of Example 2.3. Derive the **indirect utility function** through the relation $e(p, v(p, y)) = y$ and verify Roy's identity.

Indirect utility function:

We already know $e(p, v(p, y)) = y$.

Substitute $v(p, y)$ into $e(p, u) = y$ will solve the question directly:

$$\begin{aligned} e(p, u) &= v(p, y) p_1^{\alpha_1} p_2^{\alpha_2} p_3^{\alpha_3} = y \\ \Rightarrow v(p, y) &= \frac{y}{p_1^{\alpha_1} p_2^{\alpha_2} p_3^{\alpha_3}} \end{aligned}$$

Verify Roy's identity:

Roy's Identity(Jehle & Reny pp.29):

$$x_i(p^0, y^0) = - \frac{\partial v(p^0, y^0) / \partial p_i}{\partial v(p^0, y^0) / \partial y}$$

Intuition: Your optimal consumption plan (Marshallian demand) is a trade-off between the importance of "commodity i " and "money (y)".

3 Jehle & Reny 2.7

Derive the consumer's **inverse** demand functions, $p_1(x_1, x_2)$ and $p_2(x_1, x_2)$, when the utility function is of the Cobb-Douglas form, $u(x_1, x_2) = Ax_1^\alpha x_2^{1-\alpha}$ for $0 < \alpha < 1$.