

Economics 101A

(Lecture 18)

Stefano DellaVigna

April 1, 2014

Outline

1. Consumer Surplus
2. Trade
3. Rent Control
4. Market Equilibrium in The Long-Run

1 Welfare: Consumer Surplus

- Nicholson, Ch. 5, pp. 169-173
- Welfare effect of price change from p_0 to p_1
- Proposed measure:

$$e(p_0, u) - e(p_1, u)$$

- Can rewrite expression above as

$$\begin{aligned} e(p_0, u) - e(p_1, u) &= \left(e(0, u) + \int_0^{p_0} \frac{\partial e(p, u)}{\partial p} dp \right) - \\ &\quad - \left(e(0, u) + \int_0^{p_1} \frac{\partial e(p, u)}{\partial p} dp \right) \\ &= \int_{p_1}^{p_0} \frac{\partial e(p, u)}{\partial p} dp \end{aligned}$$

- What is $\frac{\partial e(p, u)}{\partial p}$?

- Remember envelope theorem...

- Result:

$$\frac{\partial e(p, u)}{\partial p} = h(p, u)$$

- Welfare measure is integral of area to the side of Hicksian compensated demand
- Graphically,

- Example of welfare effects: Imposition of Tax
- Welfare before tax
- Welfare after tax

2 Trade

- Assume that domestic industry opens to trade
- Is this a good or a bad thing?
- Consider graphically
- Equilibrium with no trade at quantity X_D^* and price p_D^*

- Trade: Goods available at lower price p_T^*
- (Otherwise, openness to trade irrelevant)
- Shift in price to $p_T^* < p_D^*$ and in quantity to $X_T^* > X_D^*$
- Label domestic production and imports

- What happens to profits of domestic firms?
- What happens to consumer surplus?
- More total surplus, but firms lost some profits and some employment → Difficult trade-off

3 Rent Control

- Rent control: Restrict increase of rent that can be charged
 - San Francisco + Berkeley: only 1-2% increase per year
 - Covers all rental units built before 1979
- Intent: Keep area affordable
- Consider graphically effect of Rent control

- Two costs of rent control:
 - Cost 1. Some units will not be rented
 - Cost 2. Existing units may be misallocated

4 Market Equilibrium in the Long-Run

- Nicholson, Ch. 12, pp. 425-435
- So far, short-run analysis: no. of firms fixed to J
- How about firm entry?
- Long-run: free entry of firms
- When do firms enter? When positive profits!
- This drives profits to zero.

- Entry of one firm on industry supply function $Y^S(p, w, r)$ from period $t - 1$ to period t :

$$Y_t^S(p, w, r) = Y_{t-1}^S(p, w, r) + y(p, w, r)$$

- Supply function shifts to right and flattens:

$$\begin{aligned} Y_t^S(p, w, r) &= Y_{t-1}^S(p, w, r) + y(p, w, r) \\ &> Y_{t-1}^S(p, w, r) \text{ for } p \text{ above } AC \end{aligned}$$

since $y(p, w, r) > 0$ on the increasing part of the supply function.

- Also:

$$Y_t^S(p, w, r) = Y_{t-1}^S(p, w, r) \text{ for } p \text{ below } AC$$

since for p below AC the firm does not produce ($y(p, w, r) = 0$).

- Flattening:

$$\begin{aligned}\frac{\partial Y_t^S(p, w, r)}{\partial p} &= \frac{\partial Y_{t-1}^S(p, w, r)}{\partial p} + \frac{\partial y(p, w, r)}{\partial p} \\ &> \frac{\partial Y_{t-1}^S(p, w, r)}{\partial p} \text{ for } p \text{ above } AC\end{aligned}$$

since $\partial y(p, w, r) / \partial p > 0$.

- Also:

$$\frac{\partial Y_t^S(p, w, r)}{\partial p} = \frac{\partial Y_{t-1}^S(p, w, r)}{\partial p} \text{ for } p \text{ below } AC$$

- Profits go down since demand curve downward-sloping

- In the long-run, price equals minimum of average cost
- Why? Entry of new firms as long as $\pi > 0$
- ($\pi > 0$ as long as $p > AC$)
- Entry of new firm until $\pi = 0 \implies$ entry until $p = AC$
- Also:

$$\text{If } C'(y) = \frac{C(y)}{y}, \text{ then } \frac{\partial C(y)}{\partial y} = 0$$

- Graphically,

- Special cases:
- **Constant cost industry**
- Cost function of each company does not depend on number of firms

- **Increasing cost industry**
- Cost function of each company increasing in no. of firms
- Ex.: congestion in labor markets

- **Decreasing cost industry**
- Cost function of each company decreasing in no. of firms
- Ex.: set up office to promote exports

5 Next Lecture

- Market Power
- Monopoly
- Price Discrimination
- Then... Game Theory