Economics 101A
(Lecture 18)

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Outline

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

1 Welfare: Producer Surplus

- Nicholson, Ch. 11, pp. 386-389

- Producer Surplus is easier to define:

$$\pi\left(p, y_0\right) = p y_0 - c\left(y_0\right).$$

- Can give two graphical interpretations:

- **Intepretation 1.** Rewrite as

$$\pi\left(p, y_0\right) = y_0\left[p - \frac{c\left(y_0\right)}{y_0}\right].$$

- Profit equals rectangle of quantity times (p - Av. Cost)

- **Intepretation 2.** Remember:

$$f(x) = f(0) + \int_0^x f'_x(s)\,ds.$$

- Rewrite profit as

$$\left[p * 0 + p\int_0^{y_0} 1dy\right] - \left[c(0) + \int_0^{y_0} c'_y(y)\,dy\right] =$$

$$= \int_0^{y_0}\left(p - c'_y(y)\right)dy - c(0).$$

- Producer surplus is area between price and marginal cost (minus fixed cost)

2 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

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

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

- Remember envelope theorem...

- Result:
$$\frac{\partial e(p,u)}{\partial p} = h\left(p,u\right)$$

- Welfare mesure 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

3 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, opennness 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 suprlus?

- More total surplus, but firms lost some profits and some employment –> Difficult trade-off

4 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

5 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 $\pi = 0 \Longrightarrow$ entry until $p = AC$

- Also:

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

- 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

6 Next Lecture

- Market Power

- Monopoly

- Price Discrimination

- Then... Game Theory