

Problem Set 12

Problem 1 (Externality)

- a) Give four examples of market interactions with externalities: two positive and two negative ones.
- b) In each of your examples is the outcome Pareto efficient or not? Why or why not? (you can answer this question assuming that market is not regulated)
- c) In each case explain how possibly we could change incentives of the agents so that they are closer to socially optimal outcome?

Problem 2 (Positive externality)

In this problem we study market interactions with positive externalities. We consider a plant that manufactures dynamite d and a nearby farm producing tomatoes t . The dynamite's production cost is:

$$TC_d(d, x) = (1/2)d^2 + (x - 2)^2$$

where d is the amount of dynamite produced and x is the intensity of use of a nitrogen in the production process. The side product associated with use of the nitrogen is ammonia - a fertilizer that is released to the air. Such fertilizer promotes growth of tomatoes making the production on the farm cheaper. In particular the higher the intensity x the lower is the farmer's cost:

$$TC_t(t, x) = (1/2)t^2 + 2t - xt$$

The prices of tomatoes and dynamite are: $p_d = p_t = \$1$

- a) Is the market interaction associated with a positive or negative externality?
- b) Find the level of production of dynamite d and intensity x that maximizes the profit of the dynamite manufacturer. What is the maximal level of profit?
- c) What is the marginal benefit (negative of marginal cost) from using x in optimum. Give one number and show it on the graph with x is on the horizontal axis. Explain why this is a reasonable number.
- d) Given the intensity x from a) find the optimal level of production of tomatoes t , and the profit of the farmer.
- e) Find the joint profit of the dynamite manufacturer and the farmer.
- f) Find the *pareto efficient* level of production of d, t and use of nitrogen x . Compare these values to the ones obtained in points b and d.
- g) Is the marginal benefit from using x in f positive, zero, or negative? Why?
- h) Economists say that the positive externality is associated with too little activity, compared to the efficient outcome. Are your findings in this problem confirming this statement?

Problem 3 (Nonexcludable and Non-Rival Goods)

- a) Explain what a non-excludable and non-rival good is
- b) Give an example of:
- excludable and rival good
 - nonexcludable and rival good
 - excludable and nonrival good
 - non excludable and nonrival good
- The examples should be different from the ones given in class. In each example explain why the good belongs to the given category
- c) Which of the four categories is called a pure public good?

Problem 4 (Provision of Public Good)

There are two major owners of real estate in Shorewood Hills area in Madison, WI, called Alfon Inc (A) and Beton Inc. (B). Both firms specialize in renting their apartments to UW faculty. Each year firm A and firm B decides how much to spend on the common areas in Shorewood Hills, such us playgrounds and bike paths. x^A and x^B are spendings for Alfon and Beton respectively and $x = x^A + x^B$ is the total spending for both firms. The common area is used by all members of the community, and hence x is non-excludable. The market rent received by firm A depends on the quality of the property and its surrounding common area. The profit then is given by:

$$\pi^A = \ln(x^A + x^B) - x^A$$

The customers of firm B value the common area more hence the the profit of firm B is given by:

$$\pi^B = 2\ln(x^A + x^B) - x^B$$

- a) suppose $x^B = 0.5$. Find the optimal level of investment in a common area by firm A, x^A . Mark this point in space (x^A, x^B) .
- b) Find analytically the best response function for firm A (an optimal investment x^A as a function of x^B) and plot the entire function in your graph from a) Make sure you also show the optimal x^A for $x^B > 1$.
- c) Find the best response function for firm B. Add it to the graph.
- d) Find in your graph the (Nash) equilibrium for two firms (x^{*A}, x^{*B}) . What is the total amount of money invested in common area?
- e) Is the predicted outcome associated with free riding? If yes by which firm? Explain why this firm is free riding?
- f) What is the Pareto efficient joint level of investment in the common area? Is it greater, smaller or equal to the one observed in the market (point d)? Explain intuitively why is it so?

Problem 5 (Adverse Selection)

Consider a second-hand car market. For each trader the value of a car depends on whether a trader is a buyer or a seller, and also on whether a car is a lemon or a plum. The values of cars are given by

	Lemon	Plum
Seller	0	100
Buyer	30	120

a) What are the total gains-to-trade in the market for second-hand cars?

b) Assuming perfect information and equal splitting of gains-to-trade between buyers and sellers on each segment of the market, give the two prices for lemons and plums. Is an allocation *pareto efficient* if information is perfect?

Suppose the buyers cannot tell a lemon from a plum now. (asymmetric information).

c) What is the expected value of a car for a buyer if (1/3) of the cars are lemons? What is the maximal price that a buyer might pay?

d) Shall we observe a pooling or separating equilibrium if (1/3)? Are plums traded in equilibrium?

e) Is the outcome of market interactions in a separating equilibrium *pareto efficient*? Why or why not?

f) Find a threshold probability of a lemon for which we might observe a pooling equilibrium.

g) Is the allocation in pooling equilibrium Pareto efficient? Why or why not?

h) Propose a signal by which plum owners can differentiate themselves from the lemon owners.

Problem 6 (Signalling)

Consider a signalling model presented in the class. Suppose GMC is looking for new workers to its new factory in China (the same we considered in PS10). The pool of potential workers consists of two types workers: workaholics (w) and lazybones (l). The productivity of a workaholic is 10 cars, while a lazybones produces only 4 cars. Labor market is competitive - the wage is equal to the expected productivity of a worker (and one car costs one \$)

a) Find a pooling equilibrium in which workers cannot credibly signal their true type.

Suppose now that before being hired by GMC workers can take a number of skill tests (the number of passed tests is e) that prove their abilities. The attempt to pass a test costs \$1. If they are workaholics, they pass each test in the first approach and hence e passed tests cost them $c^w(e) = e$ dollars. If they are lazybones, then it takes two approaches to pass one test. Consequently e passed tests cost $c^l(e) = 2e$

b) Are two passed tests a credible signal that a worker is a workaholic? Why or why not?

c) What is the minimal number of tests that constitutes a credible signal for the employer?

d) Is signalling in form of taking tests efficient from the point of view of the society?