Economics 101A
(Lecture 11)

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Outline

1. Mid-Term Suggestions
2. Charitable Donations II
3. Risk Aversion
4. Insurance
5. Investment in Risky Asset
6. Measures of Risk Aversion

1 Mid-Term Suggestions

- Suggestions from you...

2 Charitable Donations II

- A quick look at the evidence

- From Andreoni (2002)

3 Risk aversion

- Nicholson, Ch. 18, pp. 535–541 [OLD: Ch. 8, pp. 200-206].

- Risk aversion:

  - individuals dislike uncertainty

  - u concave, $u'' < 0$

- Implications?

  - purchase of insurance (possible accident)

  - investment in risky asset (risky investment)

  - choice over time (future income uncertain)

- Experiment — Are you risk-averse?

4 Insurance

- Nicholson, Ch. 18, pp. 545–551 [OLD: Ch. 8, pp. 211-216] Notice: different treatment than in class

- Individual has:
  - wealth w
  - utility function u, with $u' > 0$, $u'' < 0$

- Probability p of accident with loss L

- Insurance offers coverage:
  - premium \$$q$ for each \$1 paid in case of accident
  - units of coverage purchased α

- Individual maximization:

$$\max_{\alpha} (1-p)\, u\,(w - q\alpha) + pu\,(w - q\alpha - L + \alpha)$$
$$s.t.\alpha \geq 0$$

- Assume $\alpha^* \geq 0$, check later

- First order conditions:

$$\begin{aligned} 0 &= -q\,(1-p)\,u'\,(w - q\alpha) \\ &\quad +(1-q)\,pu'\,(w - q\alpha - L + \alpha) \end{aligned}$$

or

$$\frac{u'\,(w - q\alpha)}{u'\,(w - q\alpha - L + \alpha)} = \frac{1-q}{q}\frac{p}{1-p}.$$

- Assume first $q = p$ (insurance is fair)

- Solution for $\alpha^* =?$

- $\alpha^* > 0$, so we are ok!

- What if $q > p$ (insurance needs to cover operating costs)?

- Insurance will be only partial (if at all)

- Exercise: Check second order conditions!

5 Investment in Risk Asset

- Individual has:
  - wealth w
  - utility function u, with $u' > 0$

- Two possible investments:
  - Asset B (bond) yields return 1 for each dollar
  - Asset S (stock) yields uncertain return $(1 + r)$:
    * $r = r_+ > 0$ with probability p
    * $r = r_- < 0$ with probability $1 - p$
    * $Er = pr_+ + (1 - p)\, r_- > 0$

- Share of wealth invested in stock S $= \alpha$

- Individual maximization:

$$\max_{\alpha} (1-p)\, u\left(w\left[(1-\alpha)+\alpha\,(1+r_{-})\right]\right)+$$
$$+pu\left(w\left[(1-\alpha)+\alpha\,(1+r_{+})\right]\right)$$
$$s.t. 0 \le \alpha \le 1$$

- Case of risk neutrality: $u(x) = a + bx$, $b > 0$

- Assume $a = 0$ (no loss of generality)

- Maximization becomes

$$\max_{\alpha} b\,(1-p)\left(w\left[1+\alpha r_{-}\right]\right)+bp\left(w\left[1+\alpha r_{+}\right]\right)$$

or

$$\max_{\alpha} bw + \alpha bw\left[(1-p)\, r_{-} + pr_{+}\right]$$

- Sign of term in square brackets? Positive!

- Set $\alpha^* = 1$

- Case of risk aversion: $u'' < 0$

- Assume $0 \leq \alpha^* \leq 1$, check later

- First order conditions:

$$\begin{aligned} 0 &= (1-p)(wr_-)\,u'(w[1+\alpha r_-]) + \\ &\quad +p(wr_+)\,u'(w[1+\alpha r_+]) \end{aligned}$$

- Can $\alpha^* = 0$ be solution?

- Solution is $\alpha^* > 0$ (positive investment in stock)

- Exercise: Check s.o.c.

6 Next lecture and beyond

- Tu:
  - Time consistency
  - Time inconsistency
  - Application to health clubs

- Th:
  - Production!
  - Returns to scale
  - Cost minimization