

Economics 101A

(Lecture 12)

Stefano DellaVigna

October 6, 2005

Outline

1. Altruism and charitable donations II
2. Introduction to probability
3. Expected Utility
4. Risk Aversion

1 Altruism and Charitable Donations II

- Wendy computes the utility of Mark as a function of the donation D
- Mark maximizes

$$\begin{aligned} \max_{c_M} u(c_M) \\ \text{s.t. } c_M \leq M_M + D \end{aligned}$$

- Solution: $c_M^* = M_M + D$

- Wendy maximizes

$$\begin{aligned} \max_{c_M, D} u(c_W) + \alpha u(M_M + D) \\ \text{s.t. } c_W \leq M_W - D \end{aligned}$$

- Rewrite as:

$$\max_D u(M_W - D) + \alpha u(M_M + D)$$

- First order condition:

$$-u'(M_W - D^*) + \alpha u'(M_M + D^*) = 0$$

- Second order conditions:

$$u''(M_W - D^*) + \alpha u''(M_M + D^*) < 0$$

- Assume $\alpha = 1$.

- Solution?

- $u'(M_W - D) = u'(M_M + D^*)$

- $M_W - D^* = M_M + D^*$ or $D^* = (M_W - M_M) / 2$

- Transfer money so as to equate incomes!

- Careful: $D < 0$ (negative donation!) if $M_M > M_W$

- Corrected maximization:

$$\begin{aligned} & \max_D u(M_W - D) + \alpha u(M_M + D) \\ & \text{s.t. } D \geq 0 \end{aligned}$$

- Solution ($\alpha = 1$):

$$D^* = \begin{cases} (M_W - M_M) / 2 & \text{if } M_W - M_M > 0 \\ 0 & \text{otherwise} \end{cases}$$

- Assume interior solution. ($D^* > 0$)

- Comparative statics 1 (altruism):

$$\frac{\partial D^*}{\partial \alpha} = -\frac{u'(M_M + D^*)}{u''(M_W - D^*) + \alpha u''(M_M + D^*)} > 0$$

- Comparative statics 2 (income of donor):

$$\frac{\partial D^*}{\partial M_W} = -\frac{-u''(M_W + D^*)}{u''(M_W - D^*) + \alpha u''(M_M + D^*)} > 0$$

- Comparative statics 3 (income of recipient):

$$\frac{\partial D^*}{\partial M_M} = -\frac{\alpha u''(M_M + D^*)}{u''(M_W - D^*) + \alpha u''(M_M + D^*)} < 0$$

- A quick look at the evidence
- From Andreoni (2002)

2 Introduction to Probability

- So far deterministic world:
 - income given, known M
 - interest rate known r
- But some variables are unknown at time of decision:
 - future income M_1 ?
 - future interest rate r_1 ?
- Generalize framework to allow for uncertainty
 - Events that are truly unpredictable (weather)
 - Event that are very hard to predict (future income)

- Probability is the language of uncertainty
- Example:
 - Income M_1 at $t = 1$ depends on state of the economy
 - Recession ($M_1 = 20$), Slow growth ($M_2 = 25$), Boom ($M_3 = 30$)
 - Three probabilities: p_1, p_2, p_3
 - $p_1 = P(M_1) = P(\text{recession})$
- Properties:
 - $0 \leq p_i \leq 1$
 - $p_1 + p_2 + p_3 = 1$

- Mean income: $EM = \sum_{i=1}^3 p_i M_i$

- If $(p_1, p_2, p_3) = (1/3, 1/3, 1/3)$,

$$EM = \frac{1}{3}20 + \frac{1}{3}25 + \frac{1}{3}30 = \frac{75}{3} = 25$$

- Variance of income: $V(M) = \sum_{i=1}^3 p_i (M_i - EM)^2$

- If $(p_1, p_2, p_3) = (1/3, 1/3, 1/3)$,

$$\begin{aligned} V(M) &= \frac{1}{3}(20 - 25)^2 + \frac{1}{3}(25 - 25)^2 + \frac{1}{3}(30 - 25)^2 \\ &= \frac{1}{3}5^2 + \frac{1}{3}5^2 = 2/3 * 25 \end{aligned}$$

- Mean and variance if $(p_1, p_2, p_3) = (1/4, 1/2, 1/4)$?

3 Expected Utility

- Nicholson, Ch. 18, pp. 533–541 [OLD: Ch. 8, pp. 198–206]

- Consumer at time 0 asks: what is utility in time 1?

- At $t = 1$ consumer maximizes

$$\begin{aligned} & \max U(c^1) \\ & s.t. c_i^1 \leq M_i^1 + (1+r)(M^0 - c^0) \end{aligned}$$

with $i = 1, 2, 3$.

- What is utility at optimum at $t = 1$ if $U' > 0$?

- Assume for now $M^0 - c^0 = 0$

- Utility $U(M_i^1)$

- This is uncertain, depends on which i is realized!

- How do we evaluate future uncertain utility?

- **Expected utility**

$$EU = \sum_{i=1}^3 p_i U(M_i^1)$$

- In example:

$$EU = 1/3U(20) + 1/3U(25) + 1/3U(30)$$

- Compare with $U(EC) = U(25)$.

- Agents prefer riskless outcome EM to uncertain outcome M if

$$\begin{aligned} 1/3U(20) + 1/3U(25) + 1/3U(30) &< U(25) \text{ or} \\ 1/3U(20) + 1/3U(30) &< 2/3U(25) \text{ or} \\ 1/2U(20) + 1/2U(30) &< U(25) \end{aligned}$$

- Picture

- Depends on sign of U'' , on concavity/convexity

- Three cases:

- $U''(x) = 0$ for all x . (linearity of U)

- * $U(x) = a + bx$

- * $1/2U(20) + 1/2U(30) = U(25)$

- $U''(x) < 0$ for all x . (concavity of U)

- * $1/2U(20) + 1/2U(30) < U(25)$

- $U''(x) > 0$ for all x . (convexity of U)

- * $1/2U(20) + 1/2U(30) > U(25)$

- If $U''(x) = 0$ (linearity), consumer is indifferent to uncertainty
- If $U''(x) < 0$ (concavity), consumer dislikes uncertainty
- If $U''(x) > 0$ (convexity), consumer likes uncertainty
- Do consumers like uncertainty?
- Do *you* like uncertainty?

- **Theorem. (Jensen's inequality)** If a function $f(x)$ is concave, the following inequality holds:

$$f(Ex) \geq Ef(x)$$

where E indicates expectation. If f is strictly concave, we obtain

$$f(Ex) > Ef(x)$$

- Apply to utility function U .

- Individuals dislike uncertainty:

$$U(Ex) \geq EU(x)$$

- Jensen's inequality then implies U concave ($U'' \leq 0$)

- Relate to diminishing marginal utility of income

4 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?

5 Next Lectures

- Risk Aversion
- Coefficient of risk aversion
- Applications:
 - Insurance
 - Portfolio choice
 - Consumption choice II