

Economics 101A

(Lecture 18)

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Outline

1. Comparative Statics of Equilibrium
2. Elasticities
3. Response to Taxes
4. Trade

1 Comparative statics of equilibrium

- Nicholson, Ch. 12, pp. 403-406 (Ch. 10, pp. 293-295, 9th)
- Supply and Demand function of parameter α :
 - $Y_i^S(p_i, w, r, \alpha)$
 - $X_i^D(\mathbf{p}, \mathbf{M}, \alpha)$
- How does α affect p^* and Y^* ?
- Comparative statics with respect to α

- Equilibrium:

$$Y_i^S(p_i, w, r, \alpha) = X_i^D(\mathbf{p}, \mathbf{M}, \alpha)$$

- Can write equilibrium as implicit function:

$$Y_i^S(p_i, w, r, \alpha) - X_i^D(\mathbf{p}, \mathbf{M}, \alpha) = 0$$

- What is $dp^*/d\alpha$?

- Implicit function theorem:

$$\frac{\partial p^*}{\partial \alpha} = - \frac{\frac{\partial Y^S}{\partial \alpha} - \frac{\partial X^D}{\partial \alpha}}{\frac{\partial Y^S}{\partial p} - \frac{\partial X^D}{\partial p}}$$

- What is sign of denominator?

- Sign of $\partial p^*/\partial \alpha$ is negative of sign of numerator

- Examples:

1. *Fad*. Good becomes more fashionable: $\frac{\partial X^D}{\partial \alpha} > 0 \implies \frac{\partial p^*}{\partial \alpha} > 0$

2. *Recession in Europe*. Negative demand shock for US firms: $\frac{\partial X^D}{\partial \alpha} < 0 \implies \frac{\partial p^*}{\partial \alpha} < 0$

3. *Oil shock*. Import prices increase: $\frac{\partial Y^S}{\partial \alpha} < 0 \implies \frac{\partial p^*}{\partial \alpha} > 0$

4. *Computerization*. Improvement in technology. $\frac{\partial Y^S}{\partial \alpha} > 0 \implies \frac{\partial p^*}{\partial \alpha} < 0$

2 Elasticities

- Nicholson, Ch.1, pp. 26-27 (pp. 27–28, 9th)
- How do we interpret magnitudes of $\partial p^* / \partial \alpha$?
- Result depends on units of measure.
- Can we write $\partial p^* / \partial \alpha$ in a unit-free way?
- Yes! Use **elasticities**.
- Elasticity of x with respect to parameter p is

$$\varepsilon_{x,p} = \frac{\partial x}{\partial p} \frac{p}{x}$$

- Interpretation: Percent response in x to percent change in p :

$$\begin{aligned}\varepsilon_{x,p} &= \frac{\partial x}{\partial p} \frac{p}{x} = \lim_{dp \rightarrow 0} \frac{x(p+dp) - x(p)}{dp} \frac{p}{x} = \\ &= \lim_{dp \rightarrow 0} \frac{dx/x}{dp/p}\end{aligned}$$

where $dx \equiv x(p+dp) - x(p)$.

- Now, show

$$\varepsilon_{x,p} = \frac{\partial \ln x}{\partial \ln p}$$

- Notice: This makes sense only for $x > 0$ and $p > 0$

- Proof. Consider function

$$x = f(p)$$

- Rewrite as

$$\ln(x) = \ln f(p) = \ln f(e^{\ln(p)})$$

- Define $\hat{x} = \ln(x)$ and $\hat{p} = \ln(p)$

- This implies

$$\hat{x} = \ln f(e^{\hat{p}})$$

- Get

$$\begin{aligned} \frac{\partial \hat{x}}{\partial \hat{p}} &= \frac{\partial \ln x}{\partial \ln p} = \\ &= \frac{1}{f(e^{\hat{p}})} \frac{\partial f(e^{\hat{p}})}{\partial \hat{p}} e^{\hat{p}} = \frac{\partial x}{\partial p} \frac{p}{x} \end{aligned}$$

- Example with Cobb-Douglas utility function

- $U(x, y) = x^\alpha y^{1-\alpha}$ implies solutions

$$x^* = \alpha \frac{M}{p_x}, y^* = (1 - \alpha) \frac{M}{p_y}$$

- Elasticity of demand with respect to own price ε_{x,p_x} :

$$\varepsilon_{x,p_x} = \frac{\partial x^*}{\partial p_x} \frac{p_x}{x^*} = -\frac{\alpha M}{(p_x)^2} \frac{p_x}{\alpha \frac{M}{p_x}} = -1$$

- Elasticity of demand with respect to other price $\varepsilon_{x,p_y} = 0$

- Go back to problem above:

$$\frac{\partial p^*}{\partial \alpha} = - \frac{\frac{\partial Y^S}{\partial \alpha} - \frac{\partial X^D}{\partial \alpha}}{\frac{\partial Y^S}{\partial p} - \frac{\partial X^D}{\partial p}}$$

- Use elasticities to rewrite response of p to change in α :

$$\frac{\partial p^*}{\partial \alpha} \frac{\alpha}{p} = - \frac{\left(\frac{\partial Y^S}{\partial \alpha} - \frac{\partial X^D}{\partial \alpha} \right) \frac{\alpha}{Y}}{\left(\frac{\partial Y^S}{\partial p} - \frac{\partial X^D}{\partial p} \right) \frac{p}{Y}}$$

or (using fact that $X^{D*} = Y^{S*}$)

$$\varepsilon_{p,\alpha} = - \frac{\varepsilon_{S,\alpha} - \varepsilon_{D,\alpha}}{\varepsilon_{S,p} - \varepsilon_{D,p}}$$

- We are likely to know elasticities from empirical studies

3 Response to taxes

- Nicholson, Ch. 12, pp. 423-426 (Ch. 11, pp. 322–323, 9th)

- Per-unit tax t

- Write price p_i as price including tax

- Supply: $Y_i^S(p_i - t, w, r)$

- Demand: $X_i^D(\mathbf{p}, \mathbf{M})$

$$Y_i^S(p_i - t, w, r) - X_i^D(\mathbf{p}, \mathbf{M}) = 0$$

- What is dp^*/dt ?

- Comparative statics:

$$\begin{aligned}
 \frac{\partial p^*}{\partial t} &= -\frac{\frac{\partial Y^S}{\partial t}}{\frac{\partial Y^S}{\partial p} - \frac{\partial X^D}{\partial p}} = \\
 &= \frac{-\frac{\partial Y^S}{\partial p} \frac{p}{X}}{\left(\frac{\partial Y^S}{\partial p} - \frac{\partial X^D}{\partial p}\right) \frac{p}{X}} = \\
 &= \frac{\varepsilon_{S,p}}{\varepsilon_{S,p} - \varepsilon_{D,p}}
 \end{aligned}$$

- How about price received by suppliers $p^* - t$?

$$\begin{aligned}
 \frac{\partial (p^* - t)}{\partial t} &= \frac{\frac{\partial Y^S}{\partial p}}{\frac{\partial Y^S}{\partial p} - \frac{\partial X^D}{\partial p}} - 1 = \\
 &= \frac{\varepsilon_{D,p}}{\varepsilon_{S,p} - \varepsilon_{D,p}}
 \end{aligned}$$

- *Inflexible Supply.* (Capacity is fixed) Supply curve vertical ($\varepsilon_{S,p} = 0$)

- Producers bear burden of tax

- *Flexible Supply.* (Constant Returns to Scale) Supply curve horizontal ($\varepsilon_{S,p} \rightarrow \infty$)

- Consumers bear burden of tax

- *Inflexible demand.* Demand curve vertical ($\varepsilon_{D,p} = 0$)?

- Consumers bear burden

- General lesson: Least elastic side bears larger part of burden

- What happens with a subsidy ($t < 0$)?

- What happens to quantity sold?

- Use demand curve:

$$\frac{\partial X^{D*}}{\partial t} = \frac{\partial X^{D*}}{\partial p^*} \frac{\partial p^*}{\partial t}$$

and use expression for $\partial p^* / \partial t$ above

4 Trade

- Nicholson, Ch. 12, pp. 427-429 (Ch. 11, pp. 326–327, 9th)
- 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 \rightarrow Difficult trade-off
- Define surplus formally in next lecture

5 Next Lecture

- Market Equilibrium in the Long-Run
- Consumer and Producer Surplus
- Market Power
- Monopoly
- Price Discrimination