UNIVERSITY OF DELHI
DELHI SCHOOL OF ECONOMICS
DEPARTMENT OF ECONOMICS

Minutes of Meeting

Subject	:	B.A. (Hons) Economics – 4th Sem. (2016)
Course	:	Intermediate Microeconomics - II
Date of Meeting	:	11th January, 2016
Venue	:	Department of Economics, Delhi School of Economics, University of Delhi
Chair	:	Dr. Anirban Kar

Attended by:

1	Sakshi Goel Bansal	Janki Devi Memorial College
2	Neelam	Satyawati College (E)
3	Shivani Guha	Shivaji College
4	Bhawna Jha	Satyawati College (M)
5	Shikha Singh	Daulat Ram College
6	S. Rubina Naqvi	Hindu College
7	Navin Kumar	Lakshmibai College
8	Shashi Bala Garg	LSR
9	Payal Malik	PGDAV (M)
10	Shirin Akhter	Zakir Hussain College (Day)
11	Vandana Tulsyan	Dyal Singh College
12	Gaurav Bhattacharya	Kamala Nehru College
13	Surajit Deb	Aryabhatta College
14	Samir Kr Singh	KMC
15	Amrat Lal Meena	MLNC
16	Ravinder Jha	Miranda House
17	Sanjeev Grewal	St.Stephens' College
18	Rajiv Jha	SRCC
19	Sandhya Varshney	Dyal Singh College

Note :

1) The 'Vickrey-Clarke-Groves Mechanism' (p711-p715 from Varian, 8th edition) is excluded from this year's syllabus.

2) Except point 1, the syllabus remains unchanged.

1 Syllabus and Readings

Course Description

This course is a sequel to Intermediate Microeconomics I. The emphasis will be on giving conceptual clarity to the student coupled with the use of mathematical tools and reasoning. It covers general equilibrium and welfare, imperfect markets and topics under information economics.

Textbooks

1. Hal R. Varian [V]: Intermediate Microeconomics: A Modern Approach, 8th edition, W.W. Norton and Company/Affiliated East-West Press (India), 2010. The workbook by Varian and Bergstrom could be used for problems.

2. C. Snyder and W. Nicholson [S-N]: Fundamentals of Microeconomics, Cengage Learning (India), 2010, Indian edition.

Course Outline

1. General Equilibrium, Efficiency and Welfare
Equilibrium and efficiency under pure exchange and production; overall efficiency and welfare economics Readings:
(i) [V]: Chapters 31 and 33
(ii) [S-N]: Chapter 13, p418-p427. Numericals need not be done.

2. Market Structure and Game Theory
Monopoly; pricing with market power; price discrimination; peak-load pricing; two-part tariff; monopolistic competition and oligopoly; game theory and competitive strategy Readings:
(*i*) [S-N]: Chapter 14 (p464-p485); Chapter 8 (p231-p253);Chapter 15(p492p507 and p511-p519)

3. Market Failure
Externalities; public goods and markets with asymmetric information
Readings:
(*i*) [V]: Chapter 34, 36 and 37

<u>Assessment</u> Semester
Examination:
Topics 1,2,3 will get 30%, 40% and 30% weightage respectively. The question paper will have two sections. Section A will contain 4 questions from topic 1 and 3. Students will be required to answer 3 questions out of 4. Section B will contain 3 questions from topic 2. Students will be required to answer 2 questions out of 3.

Internal Assessment:
There will be two tests/assignments (at least one has to be a test) worth 10 and 15 marks.

2 Corrections and Clarifications

Clarification 1: The VCG mechanism Line:3**, Page:713, Chapter:36, Varian, 8th edition**

$$W_i - R_i = \sum_{j \neq i} r_j(x) - \max_z \sum_{j \neq i} r_j(z)$$

should be replaced by

$$R_i - W_i = \max_z \sum_{j \neq i} r_j(z) - \sum_{j \neq i} r_j(x)$$

Note that $(R_i - W_i)$ is always non negative, that is everyone pays tax (can be zero for some agents) and no one receives subsidy.

Clarification 2: Smokers and Non-Smokers Diagram Figure:34.1**, Page:646, Chapter:34, Varian, 8th edition**

A's money is measured horizontally from the lower left-hand corner of the box, and B's money is measured horizontally from the upper right-hand corner. But the total amount of smoke is measured vertically from the lower left-hand corner.

Clarification 3: Bertrand Price competition Paragraph:6, Page:494, Chapter:15, Nicholson and Snyder, 2010 Indian Edition

Case (*ii*) cannot be a Nash equilibrium, either. Let us look at two sub-cases separately (*ii* – *a*) $c < p_1 = p_2$ and (*ii* – *b*) $c < p_1 < p_2$.

(*ii*–*a*) We shall show that Firm 2 has an incentive to deviate. In this subcase Firm 2 gets only half of market demand. Firm 2 could capture all of market demand by undercutting Firm 1's price by a tiny amount . This could be chosen small enough that market price and total market profit are hardly affected. To see this formally, note that Firm 2 earns a profit ($p_2 - c)\frac{D(p_2)}{2}$ by charging p_2 and can earn ($(p_2 - \epsilon - c)D(p_2 - \epsilon$) by undercutting. Change in profit due to price cut is,

$$\left[(p_2 - \epsilon - c)D(p_2 - \epsilon)\right] - \left[(p_2 - c)\frac{D(p_2)}{2}\right]$$

Because $D(p_2 - \epsilon) > D(p_2$) (downward sloping demand curve)

$$\left[(p_2{-}\epsilon{-}c)D(p_2{-}\epsilon)\right] - \left[(p_2 - c)\frac{D(p_2)}{2}\right] > \left[(p_2{-}\epsilon{-}c)D(p_2)\right] - \left[(p_2 - c)\frac{D(p_2)}{2}\right]$$

We want to show that Firm 2 can suitably choose the level of price cut, that is , so that the above difference is positive.

$$\left[(p_2 - \epsilon - c)D(p_2)\right] - \left[(p_2 - c)\frac{D(p_2)}{2}\right] = D(p_2)\left[\frac{(p_2 - c)}{2} - \epsilon\right]$$

Since $p_2 > c$, any choice of strictly positive smaller than $\frac{p_2 - c}{2}$ would be profitable deviation for Firm 2.

(*ii* – *b*) If $p_1 < p_2$ Firm 2 earns zero profit. It can deviate to p_1 and earn positive profit.

Clarification 4: Capacity constraint Page: 501**, Chapter:**15**, Nicholson and Snyder, 2010 Indian Edition**

For the Bertrand model to generate the **Bertrand paradox** (the result that two firms essentially behave as perfect competitors), firms must have unlimited capacities. Starting from equal prices, if a firm lowers its price the slightest amount then its demand essentially doubles. The firm can satisfy this increased demand because it has no capacity constraints, giving firms a big incentive to undercut. If the undercutting firm could not serve all the demand at its lower price because of capacity constraints, that would leave some residual demand for the higher-priced firm and would decrease the incentive to undercut. The following discusses a situation where price competition does not lead to marginal cost pricing.

Consider the following simplified model, where two firms take part in a twostage game. In the first stage, firms build capacity K_1,K_2 simultaneously. In the second stage (first stage choices are observable in this stage) firms simultaneously choose prices p_1 and p_2. Firms cannot sell more in the second stage than the capacity built in the first stage. Let q_i be the output sell of Firm i in stage 2, then $q_i \leq K_i$. Suppose that the marginal cost of production is zero and capacity building cost is c per unit. Let us assume that capacity building cost is sufficiently high, $\frac{3}{4} \leq c \leq 1.$

Market demand curve is $D(p) = 1 - p$. If the firms choose different prices, say $p_i > p_j$, then the firm which has set lower price (Firm j) face the demand $D(p_j)$ and sell the minimum of $D(p_j)$ and K_j (because it can not produce more than its capacity). That is $q_j = \min\{D(p_j),K_j\}$. Firm i, which has chosen a higher price, faces the residual demand at p_i, which is $(D(p_i)-q_j)$. Therefore, sell of Firm i is the minimum of the residual demand and it's capacity, that is $q_i = \min\{(D(p_i) - q_j),K_i\}$.

If the firms choose the same price $p_i = p_j = p$, then the demand is equally shared (that is each firm faces demand $\frac{D(p)}{2}$). However if a firm has a capacity smaller than $\frac{D(p)}{2}$, it supplies its capacity and the residual demand goes to the other firm.

Before we start our analysis, note that the maximum gross profit a firm can earn is bounded by the monopoly profit, which is

$$\max_p pD(p) = \max_p [p(1-p)] = \frac{1}{4}$$

Thus the maximum profit net of capacity cost is $(\frac{1}{4} - cK_i)$. Since c is greater than $\frac{3}{4}$, to earn non-negative profit, firms will choose a capacity smaller than $\frac{1}{3}$.

We will analyze the game using backward induction. Consider the secondstage pricing game supposing the firms have already built capacities K_1^*, K_2^* in the first stage. We shall show that $p_1 = p_2 = p^* = (1 - K_1^* - K_2^*)$ is a

Nash equilibrium. Note that at this price, total demand is $D(p) = K_1^* + K_2^*$. Hence output sells are, $q_1 = K_1^*, q_2 = K_2^*$.

Is a deviation $p_j < p^*$ profitable?

In case of such deviation Firm *j* charges a smaller price than Firm *i*, because $p_j < p^* = p_i$. This increases Firm *j*'s demand. However it does not increase Firm *j*'s sell because it is already selling at its capacity K_j^*. This reduces *j*'s profit and such deviation is not profitable.

Is a deviation $p_j > p^*$ profitable?

In case of such deviation Firm *j* charges a higher price than Firm *i*, because $p_j > p^* = p_i$. Firm *i* still sells K_i^* and Firm *j* faces the residual demand $(D(p_j) - K_i^*) = (1 - p_j - K_i^*)$. Gross profit of *j* is $[p_j(1 - p_j - K_i^*)]$. If this profit is a decreasing function of p_j, then we can claim that the deviation (price increase) was unprofitable. To check, let us differentiate $[p_j(1 - p_j - K_i^*)]$ with respect to p_j.

$$\frac{d[p_j(1 - p_j - K_i^*)]}{dp_j} = (1 - 2p_j - K_i^*)$$

$<$ $(1 - 2p^* - K_i^*)$ because $p_j > p^*$

$= [1 - 2(1 - K_i^* - K_j^*) - K_i^*]$ because $p^* = (1 - K_1^* - K_2^*)$ $= K_{i*} + 2K_{j*} - 1$

≤ 0 because $K_i^*, K_j^* \leq \frac{1}{3}$

Therefore $p_1 = p_2 = p^* = (1 - K_1^* - K_2^*)$ is a Nash equilibrium of the second stage price competition game. At this equilibrium firms use their full capacity, that is $q_1 = K_1^*, q_2 = K_2^*$. Gross profit of Firm 1 is $[(1 - K_1^* - K_2^*)K_1^*]$ and that of Firm 2 is $[(1 - K_1^* - K_2^*)K_2^*]$.

It can be shown that the above is the only Nash equilibrium of the second stage game. A situation in which $p_1 = p_2 < p^*$ is not a Nash equilibrium. At this price, total quantity demanded exceeds total capacity, so Firm 1 could increase its profits by raising price slightly and continuing to sell K_1^*. Similarly, $p_1 = p_2 > p^*$ is not a Nash equilibrium because now total sales fall short of capacity. Here, at least one firm (say, Firm 1) is selling less than its capacity. By cutting price slightly, Firm 1 can increase its profits (formal analysis is similar to the case $p_j > p^* = p_i$).

Now we are ready to analyze the first stage of this game. Firm *i*'s profit net of capacity cost is, $\pi_i = [(1 - K_i^* - K_j^*)K_i^*] - cK_i^*$. Firms are choosing capacities simultaneously. This is exactly like the Cournot game. We can obtain equilibrium choice of capacities by solving the best response functions. Equilibrium choice of capacities are $K_1^* = K_2^* = \frac{c}{3}$. Thus the price at the second stage will be $p^* = (1 - \frac{2c}{3})$, which is greater than zero. Therefore unlike Bertrand competition, 'price-competition' in this game does not lead to marginal cost pricing.