Expected Utility

Health Economics
Fall 2018

1

Intermediate Micro

- Workhorse model of intermediate micro
  - Utility maximization problem
  - Consumers Max U(x,y) subject to the budget constraint, $I=P_x x + P_y y$
- Problem is made easier by the fact that we assume all variables are known with certainty
  - Consumers know prices and income
  - Know exactly the quality of the product

2

- Many cases, there is uncertainty about some variables
  - Uncertainty about income?
  - What are prices now? What will prices be in the future?
  - Uncertainty about quality of the product?
- This section, will review utility theory under uncertainty

3

- Will emphasize the special role of insurance in a generic sense
  - Why insurance is 'good' ?
  - How much insurance should people purchase?
  - Compare that to how insurance is usually structured in health care

4

Special problems of health care insurance

- Moral hazard
  - Reimbursement structure of health insurance encourages more use of medical care
- Adverse selection
  - Those with the most needs for medical care are attracted to insurance
- What these problems do to markets?
- What these problems due to welfare?

Definitions

- Probability - likelihood discrete event will occur
  - n possible events, i=1,2,..n
  - P_i be the probability event i happens
  - $0 \leq P_i \leq 1$
  - $P_1+P_2+P_3+\ldots P_n=1$
- Probabilities can be 'subjective' or 'objective', depending on the model
- In our work, probabilities will be know with certainty

- Expected value –
  - Weighted average of possibilities, weight is probability
  - Sum of the possibilities times probabilities
- $x=\{x_1,x_2\ldots x_n\}$
- $P=\{P_1,P_2,\ldots P_n\}$
- $E(x) = P_1X_1 + P_2X_2 + P_3X_3 +\ldots P_nX_n$

- Roll of a die, all sides have (1/6) prob. What is expected roll?
- $E(x) = 1(1/6) + 2(1/6) + \ldots 6(1/6) = 3.5$
- Suppose you have: 25% chance of an A, 50% B, 20% C, 4% D and 1% F
- E[quality points] = 4(.25) + 3(.5) + 2(.2) + 1(.04) + 0(.01) = 2.94

Expected utility

- Suppose income is random. Two potential values (Y_1 or Y_2)
- Probabilities are either P_1 or $P_2=1-P_1$
- When incomes are realized, consumer will experience a particular level of income and hence utility
- But, looking at the problem beforehand, a person has a particular 'expected utility'

9

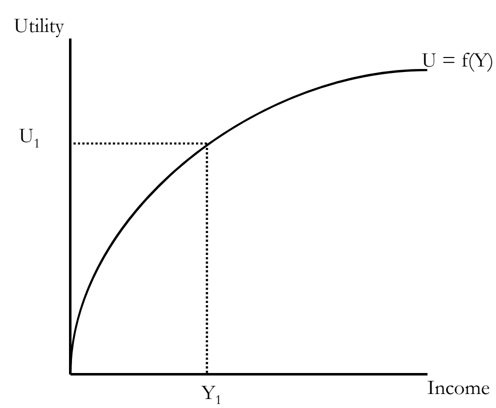
- However, suppose an agent is faced with choice between two different paths
  - Choice a: Y_1 with probability P_1 and Y_2 with P_2
  - Choice b: Y_3 with probability P_3 and Y_4 with P_4
- Example: You are presented with two option
  - a job with steady pay or
  - a job with huge upside income potential, but one with a chance you will be looking for another job soon
- How do you choose between these two options?

10

Assumptions about utility with uncertainty

- Utility is a function of one element (income or wealth), where U = U(Y)
- Marginal utility is positive
  - $U' = dU/dY > 0$
- Standard assumption, declining marginal utility $U'' < 0$
  - Implies risk averse but we will relax this later

11



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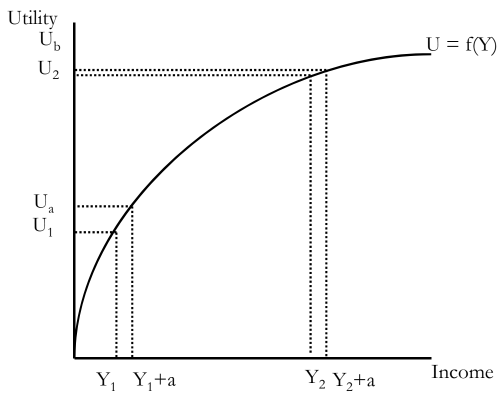

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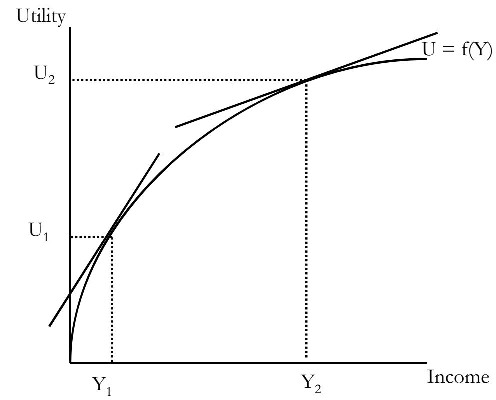


14

Von Neumann-Morganstern Utility

- N states of the world, with incomes defined as Y_1 Y_2 ….Y_n
- The probabilities for each of these states is P_1 P_2…P_n
- A valid utility function is the expected utility of the gamble
- $E(U) = P_1U(Y_1) + P_2U(Y_2) \dots + P_nU(Y_n)$

15

- E(U) is the sum of the possibilities times probabilities
- Example:
  - 40% chance of earning $2500/month
  - 60% change of $1600/month
  - $U(Y) = Y^{0.5}$
  - Expected utility
    - $E(U) = P_1U(Y_1) + P_2U(Y_2)$
    - $E(U) = 0.4(2500)^{0.5} + 0.6(1600)^{0.5}$
      $= 0.4(50) + 0.6(40) = 44$

16

- Note that expected utility in this case is very different from expected income
  - $E(Y) = 0.4(2500) + 0.6(1600) = 1960$
- Expected utility allows people to compare gambles
- Given two gambles, we assume people prefer the situation that generates the greatest expected utility
  - People maximize expected utility

17

Example

- Job A: certain income of $50K
- Job B: 50% chance of $10K and 50% chance of $90K
- Expected income is the same ($50K) but in one case, income is much more certain
- Which one is preferred?

18

- $U=\ln(y)$
- $EU_a = \ln(50,000) = 10.82$
- $EU_b = 0.5 \ln(10,000) + 0.5\ln(90,000) = 10.31$
- Job (a) is preferred

19

Another Example

- Job 1
  - 40% chance of $2500, 60% of $1600
  - $E(Y_1) = 0.4*2500 + .6*1600 = \$1960$
  - $E(U_1) = (0.4)(2500)^{0.5} + (0.6)(1600)^{0.5} = 44$
- Job 2
  - 25% chance of $5000, 75% of $1000
  - $E(Y_2) = .25(5000) + .75(1000) = \$2000$
  - $E(U_2) = 0.25(5000)^{0.5} + 0.75(1000)^{0.5} = 41.4$
- Job 1 is preferred to 2, even though 2 has higher expected income

20

The Importance of Marginal Utility: The St Petersburg Paradox

- Bet starts at \$2. Flip a coin and if a head appears, the bet doubles. If tails appears, you win the pot and the game ends.
- So, if you get H, H, H T, you win \$16
- What would you be willing to pay to 'play' this game?

- Probabilities?
- Pr(h)=Pr(t) = 0.5
- All events are independent
- Pr(h on 2nd | h on 1st) = Pr(h on 2nd)
- Recall definition of independence
- If A and B and independent events
  - $\Pr(A \cap B) = \Pr(A)\Pr(B)$

- Note, Pr(first tail on kth toss) =
- Pr(h on 1st)Pr(h on 2nd …)…Pr(t on kth)=
- $(1/2)(1/2)\ldots(1/2) = (1/2)^k$
- What is the expected pot on the k^{th} trial?
- 2 on 1st or 2^1
- 4 on 2nd or 2^2
- 8 on 3rd, or 2^3
- So the payoff on the k^{th} is 2^k

- What is the expected value of the gamble
- $E = (1/2)\$2^1 + (1/2)^2\$2^2 + (1/2)^3\$2^3 + (1/2)^4\$2^4$

$$E = \sum_{k=1}^{\infty} \left(\frac{1}{2}\right)^k \left(2^k\right) = \sum_{k=1}^{\infty} (1) = \infty$$

- The expected payout is infinite

Round	Winnings	Probability
5^{th}	\$32	0.03125
10^{th}	\$1,024	0.000977
15^{th}	\$32,768	3.05E-5
20^{th}	\$1,048,576	9.54E-7
25^{th}	\$33,554,432	2.98E-8

25

Suppose Utility is $U=Y^{0.5}$? What is E[U]?

$$E=\sum_{k=1}^{\infty}\left(\frac{1}{2}\right)^{k}\left(2^{k}\right)^{1/2}=\sum_{k=1}^{\infty}\left(\frac{1}{2}\right)^{k/2}\left(\frac{1}{2}\right)^{k/2}\left(2^{k}\right)^{1/2}$$

$$=\sum_{k=1}^{\infty}\left(\frac{1}{2}\right)^{k/2}\left(\frac{1}{2}\right)^{k/2}(2)^{k/2}=\sum_{k=1}^{\infty}\left(\frac{1}{2}\right)^{k/2}=\sum_{k=1}^{\infty}\left(\frac{1}{\sqrt{2}}\right)^{k}=$$

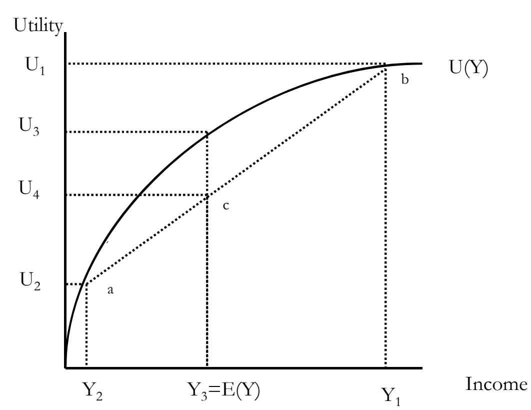
$$\text{Can show that}=\sum_{k=1}^{\infty}\left(\sqrt{\frac{1}{2}}\right)^{k}=\left(\frac{1}{1-\sqrt{\frac{1}{2}}}\right)-1=2.414$$

26

How to represent graphically

- Probability P_1 of having Y_1
- $(1-P_1)$ of having Y_2
- U_1 and U_2 are utility that one would receive if they received Y_1 and Y_2 respectively
- $E(Y) = P_1Y_1 + (1-P_1)Y_2 = Y_3$
- U_3 is utility they would receive if they had income Y_3 with certainty

27



28

- Notice that E(U) is a weighted average of utilities in the good and bad states of the world
- $E(U) = P_1U(Y_1) + (1-P_1)U(Y_2)$
- The weights sum to 1 (the probabilities)
- Draw a line from points (a,b)
- Represent all the possible 'weighted averages' of $U(Y_1)$ and $U(Y_2)$
- What is the one represented by this gamble?

29

- Draw vertical line from E(Y) to the line segment. This is E(U)
- U_4 is Expected utility
- $U_4 = E(U) = P_1U(Y_1) + (1-P_1)U(Y_2)$

30

- Suppose offered two jobs
  - Job A: Has chance of a high (Y_1) and low (Y_2) wages
  - Job B: Has chance of high (Y_3) and low (Y_4) wages
  - Expected income from both jobs is the same
  - P_a and P_b are the probabilities of getting the high wage situation

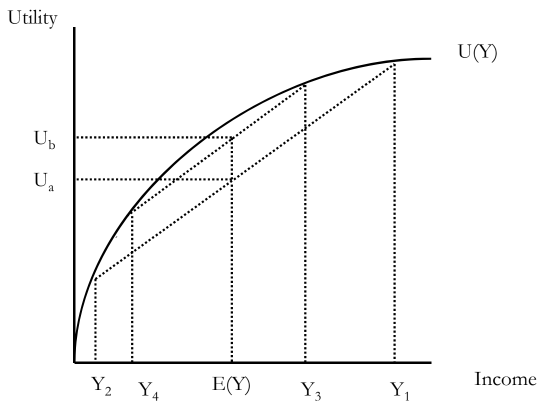
$$P_aY_1 + (1-P_a)Y_2 = P_bY_3 + (1-P_b)Y_4 = E(Y)$$

31

Numeric Example

- Job A
  - 20% chance of $150,000
  - 80% chance of $20,000
  - E(Y) = 0.2(150K) + 0.8(20K) = $46K
- Job B
  - 60% chance of $50K
  - 40% chance of $40K
  - E(Y) = 0.6(50K) + 0.4(40K) = $46K

32



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- Notice that Job A and B have the same expected income
- Job A is riskier – bigger downside for Job A
- Prefer Job B (Why? Will answer in a moment)

34

- The prior example about the two jobs is instructive. Two jobs, same expected income, very different expected utility
- People prefer the job with the lower risk, even though they have the same expected income
- People prefer to 'shed' risk – to get rid of it.
- How much are they willing to pay to shed risk?

35

Example

- Suppose have $200,000 home (wealth).
- Small chance that a fire will damage you house. If does, will generate $75,000 in loss (L)
- U(W) = ln(W)
- Prob of a loss is 0.02 or 2%
- Wealth in "good" state = W
- Wealth in bad state = W-L

36

- E(W) = (1-P)W + P(W-L)
- E(W) = 0.98(200,000) + 0.02(125,000) = $198,500

- E(U) = (1-P) ln(W) + P ln(W-L)
- E(U) = 0.98 ln(200K) + 0.02 ln(200K-75K) = 12.197

37

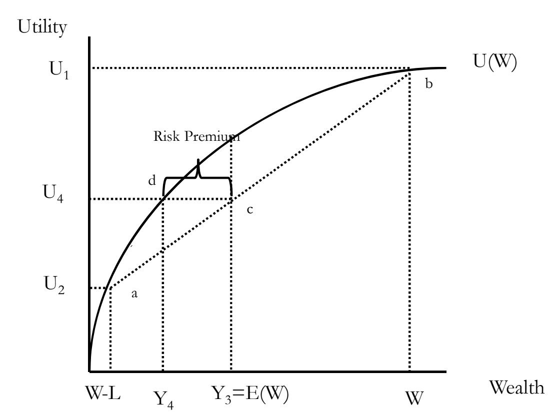
- Suppose you can add a fire detection/prevention system to your house.
- This would reduce the chance of a bad event to 0 but it would cost you $C to install
- What is the most you are willing to pay for the security system?
- E(U) in the current situation is 12.197
- Utility with the security system is U(W-C)
- Set U(W-C) equal to 12.197 and solve for C

38

- ln(W-C) =12.197
- Recall that $e^{\ln(x)} = x$
- Raise both sides to the e
- $e^{\ln(W-C)}$ = W-C = $e^{12.197}$ = 198,128
- 198,500 – 198,128 = $372

- Expected loss is $1500
- Would be willing to pay $372 to avoid that loss

39



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- Will earn Y_1 with probability p_1
  - Generates utility U_1
- Will earn Y_2 with probability p_2=1-p_1
  - Generates utility U_2
- E(I) =p_1Y_1 + (1-p_1)Y_2 = Y_3
- Line (ab) is a weighted average of U_1 and U_2
- Note that expected utility is also a weighted average
- A line from E(Y) to the line (ab) give E(U) for given E(Y)

41

- Take the expected income, E(Y). Draw a line to (ab). The height of this line is E(U).
- E(U) at E(Y) is U_4
- Suppose income is know with certainty at I_3. Notice that utility would be U_3, which is greater that U_4
- Look at Y_4. Note that the Y_4<Y_3=E(Y) but these two situations generate the same utility – one is expected, one is known with certainty

42

- The line segment (cd) is the "Risk Premium." It is the amount a person is willing to pay to avoid the risky situation.
- If you offered a person the gamble of Y_3 or income Y_4, they would be indifferent.
- Therefore, people are willing to sacrifice cash to 'shed' risk.

43

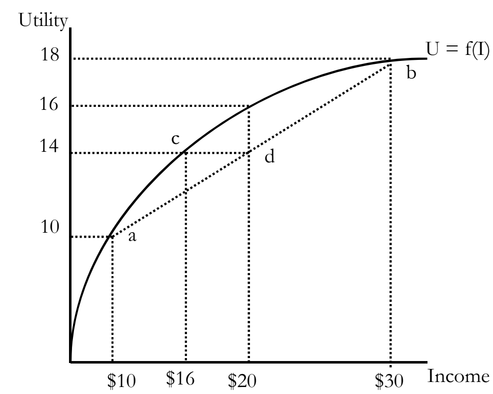
Some numbers

- Person has a job that has uncertain income
  - 50% chance of making $30K, U(30K) = 18
  - 50% chance of making $10K, U(10K) = 10
- Another job with certain income of $16K
  - Assume U($16K)=14

- E(I) = (0.5)($30K) + (0.05)($10K) = $20K
- E(U) = 0.5U(30K) + 0.5U(10K) = 14

44

- Expected utility. Weighted average of U(30) and U(10). E(U) = 14
- Notice that a gamble that gives expected income of $20K is equal in value to a certain income of only $16K
- This person dislikes risk.
  - Indifferent between certain income of $16 and uncertain income with expected value of $20
  - Utility of certain $20 is a lot higher than utility of uncertain income with expected value of $20



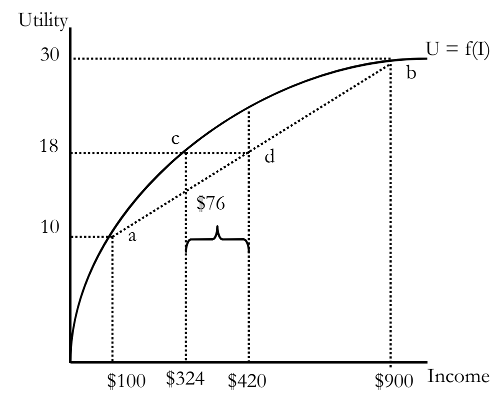
- Although both jobs provide the same expected income, the person would prefer the guaranteed $20K.
- Why? Because of our assumption about diminishing marginal utility
  - In the ‘good’ state of the world, the gain from $20K to $30K is not as valued as the 1st $10
  - In the ‘bad’ state, because the first $10K is valued more than the last $10K, you lose lots of utils.

- Notice also that the person is indifferent between a job with $16K in certain income and $20,000 in uncertain
- They are willing to sacrifice up to $4000 in income to reduce risk, risk premium

Example

- $U = y^{0.5}$
- Job with certain income
  - $400 week
  - $U = 400^{0.5} = 20$
- Can take another job that
  - 40% chance of $900/week, U=30
  - 60% chance of $100/week, U=10
  - E(I) = 420, E(U) = 0.4(30) + 0.6(10) = 18

49



50

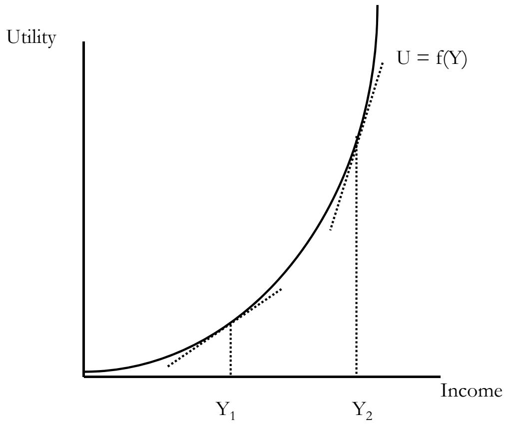
- Notice that utility from certain income stream is higher even though expected income is lower
- What is the risk premium??
- What certain income would leave the person with a utility of 18? $U=Y^{0.5}$
- So if $18 = Y^{0.5}$, $18^2 = Y = 324$
- Person is willing to pay 400-324 = $76 to avoid moving to the risky job

51

Risk Loving

- The desire to shed risk is due to the assumption of declining marginal utility of income
- Consider the next situation.
- The graph shows increasing marginal utility of income
- $U`(Y_1) > U`(Y_2)$ even though $Y_1 > Y_2$

52



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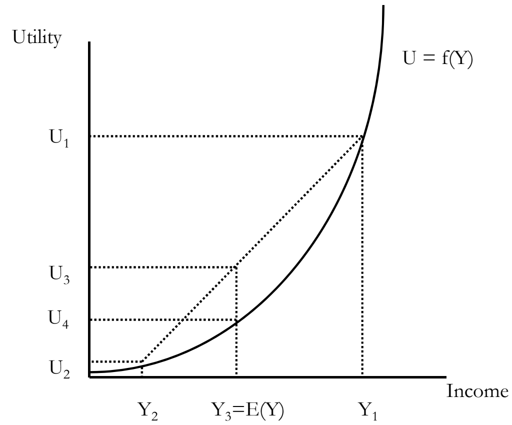


54

- What does this imply about tolerance for risk?
- Notice that at E(Y) = Y_3, expected utility is U_3.
- Utility from a certain stream of income at Y_3 would generate U_4. Note that $U_3 > U_4$
- This person prefers an uncertain stream of Y_3 instead of a certain stream of Y_3
- This person is 'risk loving'. Again, the result is driven by the assumption are U``

55

Risk Neutral

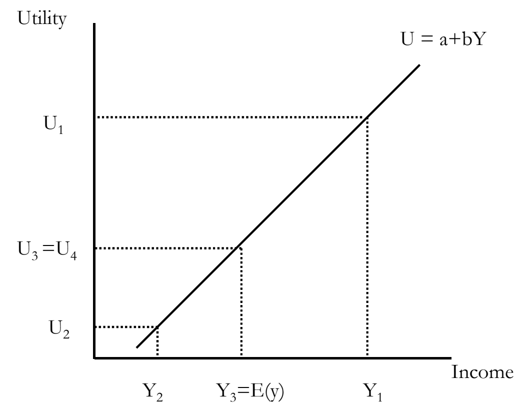
- If utility function is linear, the marginal utility of income is the same for all values of income
  - U ' >0
  - U ' ' =0
- The uncertain income E(Y) and the certain income Y_3 generate the same utility
- This person is considered risk neutral
- We usually make the assumption firms are risk neutral

56

Example

- 25% chance of $100
- 75% chance of $1000
- E[Y] = 0.25(100) + 0.75(1000) = $775
- U = Y
- Compare to certain stream of $775

57



58

Benefits of insurance

- Assume declining marginal utility
- Person dislikes risk
  - They are willing to receive lower certain income rather than higher expected income
- Firms can capitalize on the dislike for risk by helping people shed risk via insurance

59

Simple insurance example

- Suppose income is know (Y_1) but random --shocks can reduce income
  - House or car is damaged
  - Can pay $ to repair, return you to the normal state of world
- L is the loss if the bad event happens
- Probability of loss is P_1
- Expected utility without insurance is
- $E(U) = (1-P_1)U(Y_1) + P_1U(Y_1-L)$

60

- Suppose you can buy insurance that costs you PREM. The insurance pay you to compensate for the loss L.
  - In good state, income is
    - Y-Prem
  - In bad state, paid PREM, lose L but receive PAYMENT, therefore, income is
    - Y-Prem-L+Payment
  - For now, lets assume PAYMENT=L, so
  - Income in the bad state is also
    - Y-Prem

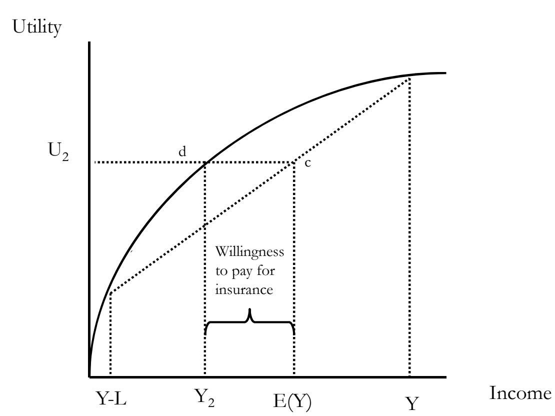
61

- Notice that insurance has made income certain. You will always have income of Y-PREM
- What is the most this person will pay for insurance?
- The expected loss is p_1L
- Expected income is E(Y)
- The expected utility is U_2
- People would always be willing to pay a premium that equaled the expected loss

62

- But they are also willing to pay a premium to shed risk (line cd)
- The maximum amount they are willing to pay is expected loss + risk premium

63



64

- Suppose income is \$50K, and there is a 5% chance of having a car accident that will generate \$15,000 in loss
- Expected loss is .05(15K) = \$750
- U = ln(y)
- Some properties of logs

  $Y=\ln(x)$ then $e^y = \exp(y) = x$

  $Y=\ln(x^a) = a \ln(x)$

  $Y=\ln(xz) = \ln(x) + \ln(z)$

65

- $E(U) = P \ln(Y-L) + (1-P)\ln(Y)$
- $E(U) = 0.05 \ln(35{,}000) + 0.95 \ln(50{,}000)$
- $E(U) = 10.8$

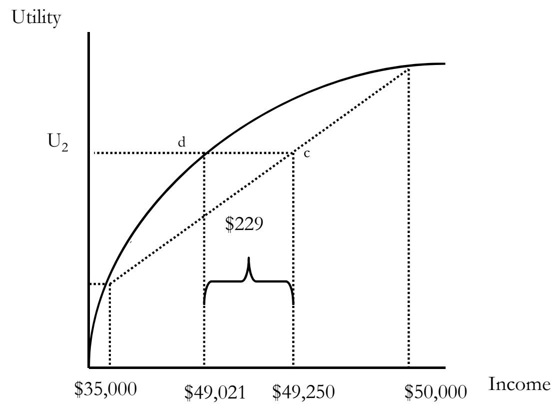
66

- What is the most someone will pay for insurance?
- People would purchase insurance so long as utility with certainty is at least 10.8 (expected utility without insurance)
- $U_a = U(Y - \text{Prem}) \geq 10.8$
- $\ln(Y\text{-PREM}) \geq 10.8$
- $Y\text{-PREM} = \exp(10.8)$
- $\text{PREM} = Y - \exp(10.8) = 50{,}000 - 49{,}021 = 979$

67

- Recall that the expected loss is \$750 but this person is willing to pay more than the expected loss to avoid the risk
- Pay \$750 (expected loss), plus the risk premium (\$979- \$750) = 229

68



Supply of Insurance

- Suppose there are a lot of people with the same situation as in the previous slide
- Each of these people have a probability of loss P and when a loss occurs, they have L expenses
- A firm could collect money from as many people as possible in advance. If bad event happens, they pay back a specified amount.

- Firms are risk neutral, so they are interested in expected profits
- Expected profits = revenues – costs
  - Revenues are known
  - Some of the costs are random (e.g., exactly how many claims you will pay)

- Think of the profits made on sales to one person
- A person buys a policy that will pay them q dollars ($q \leq L$) back if the event occurs
- To buy this insurance, person will pay "a" dollars per dollar of coverage
- Cost per policy is fixed t

- Revenues = aq
  - a is the price per dollar of coverage
- Costs =pq +t
  - For every dollar of coverage (q) expect to pay this p percent of time
- $E(\pi)$ = aq – pq – t
- Let assume a perfectly competitive market, so in the long run π =0
- What should the firm charge per dollar of coverage?
- $E(\pi)$ = aq – pq – t = 0

73

- a = p + (t/q)
- The cost per dollar of coverage is proportion to risk
- t/q is the loading factor. Portion of price to cover administrative costs
- Make it simple, suppose t=0.
  - a = p
  - If the probability of loss is 0.05, will change 5 cents per $1.00 of coverage

74

- In this situation, if a person buys a policy to insure L dollars, the 'actuarially fair' premium will be LP
- An actuarially fair premium is one where the premium equals the expected loss
- In the real world, no premiums are 'actuarially fair' because prices include administrative costs called 'loading factors'

75

How much insurance will people purchase when prices are actuarially fair?

- With insurance
  - Pay a premium that is subtracted from income
  - If bad state happens, lose L but get back the amount of insurance q
  - They pay p+(t/q) per dollar of coverage. Have q dollars of coverage – so they to pay a premium of pq+t in total
- Utility in good state
  - U = U[Y – pq - t]

76

- Utility in bad state
  - U[Y- L + q – pq - t]

- E(u) = (1-p)U[Y – pq – t] + pU[Y-L+q-pq-t]
- Simplify, let t=0 (no loading costs)
- E(u) = (1-p)U[Y – pq] + pU[Y-L+q-pq]
- Maximize utility by picking optimal q
- dE(u)/dq = 0

77

- E(u) = (1-p)U[Y – pq] + pU[Y-L+q-pq]

- dE(u)/dq = (1-p) U'(y-pq)(-p)
- + pU'(Y-L+q-pq)(1-p) = 0

- p(1-p)U'(Y-L+q-pq) = (1-p)pU'(Y-pq)

- (1-p)p cancel on each side

78

- U'(Y-L+q-pq) = U'(Y-pq)
- Optimal insurance is one that sets marginal utilities in the bad and good states equal
- Y-L+q-pq = Y-pq
- Y's cancel, pq's cancel,
- q=L
- If people can buy insurance that is 'fair' they will fully insure loses.

79

Insurance w/ loading costs

- Insurance is not actuarially fair and insurance does have loading costs
- Can show (but more difficult) that with loading costs, people will now under-insure, that is, will insure for less than the loss L
- Intution? For every dollar of expected loss you cover, will cost more than a $1
- Only get back $1 in coverage if the bad state of the world happens

80

- Recall:
  - q is the amount of insurance purchased
  - Without loading costs, cost per dollar of coverage is p
  - Now, for simplicity, assume that price per dollar of coverage is pK where K>1 (loading costs)
- Buy q $ worth of coverage
- Pay qpK in premiums

81

- E(u) = (1-p)U[Y – pqk] + pU[Y-L+q-pqk]
- dE(u)/dq = (1-p) U' (y-pqk)(-pk)
-         + pU'(Y-L+q-pqk)(1-pk) = 0
- p(1-pk)U'(Y-L+q-pqk) = (1-p)pkU'(Y-pqk)
- p cancel on each side

82

- (1-pk)U'(Y-L+q-pkq) = (1-p)kU' (Y-pkq)
-                   (a)(b) = (c)(d)
- Since k > 1, can show that
- (1-pk) < (1-p)k
- Since (a) < (c), must be the case that
- (b) > (d)
- U'(Y-L+q-pkq) > U'(Y-pkq)
- Since U'(y1) > U'(y2), must be that y1 < y2

83

- (Y-L+q-pqk) < (Y-pqk)
- Y and –pqk cancel
- -L + q < 0
- Which means that q < L
- When price is not ‘fair’ you will not fully insure

84

Demand for Insurance

- Both people have income of Y
- Each person has a potential health shock
  - The shock will leave person 1 w/ expenses of E1 and will leave income at Y1=Y-E1
  - The shock will leave person 2 w/ expenses of E2 and will leave income at Y2=Y-E2
- Suppose that
  - E1>E2, Y1<Y2

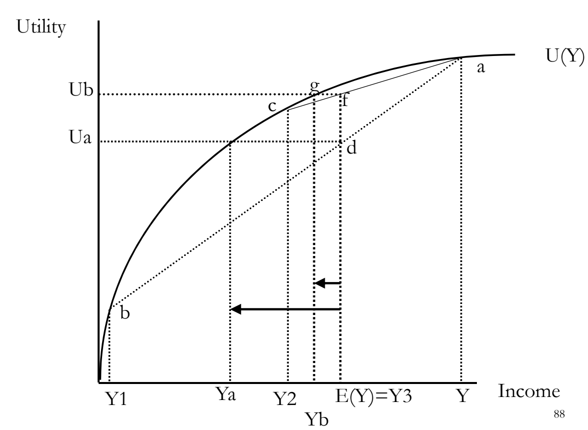
85

- Probabilities the health shock will occur are P1 and P2
- Expected Income of person 1
  - $E(Y)_1 = (1\text{-}P1)Y + P1^*(Y\text{-}E1)$
  - $E(Y)_2 = (1\text{-}P2)Y + P2^*(Y\text{-}E2)$
  - Suppose that $E(Y)_1 = E(Y)_2 = Y3$

86

- In this case
  - Shock 1 is a low probability/high cost shock
  - Shock 2 is a high probability/low cost shock
- Example
  - Y=$60,000
  - Shock 1 is 1% probability of $50,000 expense
  - Shock 2 is a 50% chance of $1000 expense
  - E(Y) = $59500

87



88

- Expected utility locus
  - Line ab for person 1
  - Line ac for person 2
- Expected utility is
  - Ua in case 1
  - Ub in case 2
- Certainty premium –
  - Line (de) for person 1, Difference Y3 – Ya
  - Line (fg) for person 2, Difference Y3 - Yb

89

Implications

- Do not insure small risks/high probability events
  - If you know with certainty that a costs will happen, or, costs are low when a bad event occurs, then do not insure
  - Example: teeth cleanings. You know they happen twice a year, why pay the loading cost on an event that will happen?

90

- Insure catastrophic events
  - Large but rare risks
- As we will see, many of the insurance contracts we see do not fit these characteristics – they pay for small predictable expenses and leave exposed catastrophic events

91

Some adjustments to this model

- The model assumes that poor health has a monetary cost and that is all.
  - When experience a bad health shock, it costs you L to recover and you are returned to new
- Many situations where
  - health shocks generate large expenses
  - And the expenses may not return you to normal
  - AIDS, stroke, diabetes, etc.

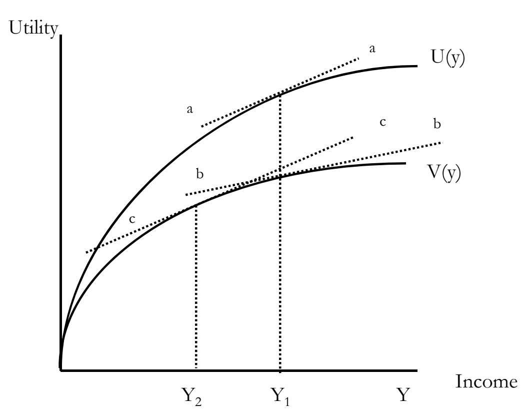
92

- In these cases, the health shock has fundamentally changed life.
- We can deal with this situation in the expected utility model with adjustment in the utility function
- "State dependent" utility
  - U(y) utility in healthy state
  - V(y) utility in unhealthy state

93

- Typical assumption
  - U(Y) >V(Y)
    - For any given income level, get higher utility in the healthy state
  - U`(Y) > V`(Y)
    - For any given income level, marginal utility of the next dollar is higher in the healthy state

94



95

Note that:

- At Y_1,
  - $U(Y_1) > V(Y_1)$
  - $U`(Y_1) > V`(Y_1)$
  - Slope of line aa > slope of line bb
- Notice that slope line aa = slope of line cc
  - $U`(Y_1) = V`(Y_2)$

96

What does this do to optimal insurance

- $E(u) = (1-p)U[Y - pq - t] + pV[Y-L+q-pq-t]$
- Again, lets set t=0 to make things easy
- $E(u) = (1-p)U[Y - pq] + pV[Y-L+q-pq]$

- $dE(u)/dq = (1-p)(-p)U`[Y-pq]$
  $+p(1-p)V`[Y-l+q+pq] = 0$
- $U`[Y-pq] = V`[Y-l+q-pq]$

97

- Just like in previous case, we equalize marginal utility across the good and bad states of the world
- Recall that
  - $U`(y) > V`(y)$
  - $U`(y_1) = V`(y_2)$ if $y_1 > y_2$
- Since $U`[Y-pq] = V`[Y-l+q-pq]$
- In order to equalize marginal utilities of income, must be the case that
  $[Y-pq] > [Y-l+q+pq]$

98

- Income in healthy state > income in unhealthy state
- Do not fully insure losses. Why?
  - With insurance, you take \$ from the good state of the world (where MU of income is high) and transfer \$ to the bad state of the world (where MU is low)
  - Do not want good money to chance bad

99

Allais Paradox

- Which gamble would you prefer
  - 1A: \$1 million w/ certainty
  - 1B: (.89, \$1 million), (0.01, \$0), (0.1, \$5 million)

- Which gamble would you prefer
  - 2A: (0.89, \$0), (0.11, \$1 million)
  - 2B: (0.9, \$0), (0.10, \$5 million)

100

- 1st gamble:
  - $U(1) > 0.89U(1) + 0.01U(0) + 0.1U(5)$
  - $0.11U(1) > 0.01U(0) + 0.1U(5)$

- Now consider gamble 2
  - $0.9U(0) + 0.1U(5) > 0.89U(0) + 0.11U(1)$
  - $0.01U(0) + 0.1U(5) > 0.11U(1)$

- Choice of Lottery 1A and 2B is inconsistent with expected utility theory