Practice Midterm Solution.

Question 1.

a) Contract A: $\$200{,}000 + \$310{,}000/(1+0.1)^3 = 432{,}908$
   Contract B: $\$200{,}000 + \$100{,}000/(1+0.1)^2 + \$200{,}000/(1+0.1)^3 = 432{,}908$

b) You can choose either contract (you should be indifferent between them), as they have the same PDV, require the same amount of effort and you like the two jobs the same. So they give you the same PDV and, most likely, the same utility.

c) Contract B.

When you are borrowing constrained, it is not the PDV, but the income that is immediately available matters. In the first year, the two contracts give you the same income. However, in 2 years, you might still be borrowing-constrained. In this case, you would prefer contract B, as it gives you immediate income. As the two contracts give you the same PDV, you are not losing anything by choosing contract B today and gain the opportunity to have immediate income in 2 years.