

Wrzaczek, Stefan; Kuhn, Michael; Frankovic, Ivan

Working Paper

Using age-structure for a multi-stage optimal control model with random switching time

ECON WPS, No. 06/2019

Provided in Cooperation with:

TU Wien, Institute of Statistics and Mathematical Methods in Economics, Economics Research Unit (ECON)

Suggested Citation: Wrzaczek, Stefan; Kuhn, Michael; Frankovic, Ivan (2019) : Using age-structure for a multi-stage optimal control model with random switching time, ECON WPS, No. 06/2019, Vienna University of Technology, Institute of Statistics and Mathematical Methods in Economics, Research Group Economics, Vienna

This Version is available at:

<https://hdl.handle.net/10419/204558>

Standard-Nutzungsbedingungen:

Die Dokumente auf EconStor dürfen zu eigenen wissenschaftlichen Zwecken und zum Privatgebrauch gespeichert und kopiert werden.

Sie dürfen die Dokumente nicht für öffentliche oder kommerzielle Zwecke vervielfältigen, öffentlich ausstellen, öffentlich zugänglich machen, vertreiben oder anderweitig nutzen.

Sofern die Verfasser die Dokumente unter Open-Content-Lizenzen (insbesondere CC-Lizenzen) zur Verfügung gestellt haben sollten, gelten abweichend von diesen Nutzungsbedingungen die in der dort genannten Lizenz gewährten Nutzungsrechte.

Terms of use:

Documents in EconStor may be saved and copied for your personal and scholarly purposes.

You are not to copy documents for public or commercial purposes, to exhibit the documents publicly, to make them publicly available on the internet, or to distribute or otherwise use the documents in public.

If the documents have been made available under an Open Content Licence (especially Creative Commons Licences), you may exercise further usage rights as specified in the indicated licence.

Using Age-Structure for a Multi-Stage Optimal Control Model with Random Switching Time



by
Stefan Wrzaczek
Michael Kuhn
Ivan Frankovic

Using Age-Structure for a Multi-Stage Optimal Control Model with Random Switching Time*

Stefan Wrzaczek[†] Michael Kuhn[†] Ivan Frankovic[†]

Abstract

The paper presents a transformation of a multi-stage optimal control model with random switching time to an age-structured optimal control model. Following the mathematical transformation, the advantages of the present approach, as compared to a standard backward approach, are discussed. They relate in particular to a compact and unified representation of the two stages of the model, the applicability of well-known numerical solution methods, and the illustration of state- and control dynamics. The paper closes with a simple example on a macroeconomic shock, illustrating the workings and advantages of the approach.

Keywords: optimal control theory, age-structured optimal control theory, multi-stage, random switch, catastrophic disaster

JEL codes: 34K35, 49J55, 49K15

1 Introduction

Optimal control models with a variable time horizon continue to be the object of intensive research interest from both a theoretical and an applied point of view. Contributions can, in principle, be subdivided into two classes: i) optimal control models with random time horizon and ii) multi-stage optimal control models.

Class i) comprises optimal control models that are deterministic in their state variables but stochastic in the time horizon. The decision maker is assumed to know the distribution of the terminal time (which is a random variable) and can thus derive the expected objective function. Once the random variable is realized, the optimal control model terminates and the decision maker obtains some salvage value, possibly depending on the final state and the terminal time. Class ii) comprises optimal control models with a change in the dynamics and/or

*We thank Michael Freiberger and two anonymous reviewers for very helpful suggestions towards improving and clarifying this manuscript, as well as Werner Richter for expert advice on language matters. This research was supported by the Austrian Science Fund (FWF) under Grant P 30665-G27.

[†]Wittgenstein Centre (IIASA, VID, WU), Vienna Institute of Demography, Vienna, Austria.

in the objective function at a certain switching time. In this stream of the literature, the deterministic switching time is endogenously determined by the decision maker.

While both model classes have been developed and applied extensively (see literature review at the end of this section), there are but a few examples, where they have been combined (see, e.g., [1, 2, 3, 4, 5]) although this seems a necessity when analyzing settings in which a random transition induces drastic changes in the objective function or the constraints of an optimal control problem (examples given further on below). One reason is that, while such models can be formulated as optimal control models with a random time horizon, they are difficult to solve. For many applications, even a numerical treatment is computationally involved to the point of intractability, as the solution up to the switching time includes an explicit expression of the post-switching value function in terms of the state variables and time.

In this contribution, we consider a general model that changes the dynamics and/or the objective function at a random switching time, characterized by a known distribution depending on the state and the control variables. This implies that the model belongs both to class i) because of the random termination of the first stage, and to class ii) because of the assumed change in the dynamics and/or objective in the second stage. We then propose a transformation to a deterministic age-structured optimal control model that allows for a convenient and complete presentation of the solution to the original problem. Specifically, the reformulation has the following advantages (for a deeper discussion we refer to the end of Section 2):

- 1. Numerical solution:** Considering the model as an age-structured optimal control model, a complete numerical solution can be found with well-established methods (see, e.g., [6]).
- 2. Analytical insights:** If the model is treated as an optimal control model with random time horizon the solution only describes the stage before the switch. All information concerning stage 2 is implicitly included in the post-switch value function. By treating both stages simultaneously the new approach allows for a unified representation of the model and its solution, revealing explicitly the links between the two stages, and for a convenient and intuitive characterization of the mechanisms behind the optimal dynamics of the controls and states.

The idea of this reformulation has been briefly suggested in [7] (section 3.5, page 232) but has not been presented in a formal and exhaustive way. As part of this contribution, we develop the advantages of this method as compared to the classical formulation as an optimal control model with a random time horizon.

Applications of such models are plentiful. In the Appendix, we sketch three types of setting relating to innovation, natural disaster and climate change, and political shocks, respectively. Further applications include the analysis of shock-like (health) events over the individual life-cycle (see [5] on the random transition into addiction) and security crises due to, e.g., terror attacks.

The following provides a brief overview of the literature that forms the foundation of our approach. The literature on optimal control models with a stochastic terminal time started with the seminal paper by Yaari [8]. In that early approach to modelling an individual life-cycle under a mortality risk, no salvage value function was included. The model in the seminal article by Kamien and Schwartz [9] includes an optimal control model of machine replacement with a random time horizon, where the failure rate of the machine can be reduced by maintenance expenditure. At the point of break down, there is still some positive salvage value. This model has been extended in numerous works, e.g., [10, 11, 12, 13, 14]. For an overview we refer to [15] (section 9), [16] or [17].

The theoretical basis for optimal control models with random stopping time has been provided in [18, 19, 20, 21]. In these papers it is shown that the stochastic optimal control problems can be reformulated as deterministic optimal control problems with infinite time horizon. This approach is the starting point of our paper (see Section 2).

In multi-stage optimal control models, the time horizon consists of two (or more) stages with different model dynamics and/or objective functions. The switching time is a decision variable, possibly subject to switching costs. The theoretical basis for this literature has been provided in [22, 23, 24]. For further theoretical contributions we refer to [25, 26] and references therein. Recent applications relate to the economics of the firm (e.g., [27, 28, 29, 30]), to environmental economics (e.g., [31, 25]), to the economics of open-source software (e.g., [32]), to the analysis of drug prevention and corruption (e.g., [33]), and to labour and health economics (e.g., [34, 35]).

We present a transformation of a multi-stage optimal control model with a random switching time to an age-structured optimal control model. Early models of the latter class dealt with optimal harvesting from age-structured populations (e.g., [36, 37, 38]). The Maximum Principles in these papers, however, were specific to the problems. A general version of the Maximum Principle for age-structured optimal control models was first provided by Brokate [39], with [40, 41, 7, 42] adding further generalizations. Applications of this theory can be found amongst others in economics (e.g., [43, 44, 45, 46, 47]), demography and population dynamics (e.g., [48, 49, 50]), health and population economics (e.g., [51, 52]) and epidemiology (e.g., [53, 54, 55, 56]).

The remainder of the paper is structured as follows. Section 2 presents the model and its transformation, first to a deterministic optimal control model and subsequently to a deterministic age-structured optimal control model. Section 3 illustrates the method by way of an application to an example relating to the prevention of catastrophic macroeconomic disasters. Conclusions are given in Section 4.

2 Model Setting and Transformation

In this section, we first present the model and the deterministic representation derived in [18], and then continue with the transformation to an optimal control

model with age-structure.

2.1 The Model and its Reformulation as a Deterministic Optimal Control Model

Let us assume that the time horizon is separated by the switching time τ into two stages, subsequently referred to as stages 1 and 2. Here, τ is a random variable out of the sample space $\Omega = [0, \infty[$. The probability space is then denoted by $(\Omega, \Sigma, \mathbb{P})$ with Σ denoting the Borel σ -Algebra on Ω and $\mathcal{F}(t)$ (with corresponding density $\mathcal{F}'(t)$) denoting the cumulative probability that the model has switched by time t , i.e., $\mathcal{F}(t) = \mathbb{P}(\tau \leq t)$. The switching rate, which is assumed to depend continuously on the state and control variables, can then be defined as

$$\eta(x(t), u(t), t) = \frac{\mathcal{F}'(t)}{1 - \mathcal{F}(t)}, \quad (1)$$

where $\eta : \mathbb{R}^n \times \mathbb{R}^m \times \mathbb{R} \rightarrow \mathbb{R}$ is a continuous function in the state variable $x(t) \in \mathbb{R}^n$, the control variable $u(t) \in \mathbb{R}^m$ and t .

The dynamics of the model (separated into stage 1 and stage 2 by the random variable τ) is defined by the following system of ordinary differential equations

$$\begin{aligned} \dot{x}(t) := \frac{dx(t)}{dt} &= \begin{cases} f_1(x(t), u(t), t) & \text{for } t < \tau, \\ f_2(x(t), u(t), t, x(\tau), \tau) & \text{for } t \geq \tau, \end{cases} \\ x(t_0) &= x_{t_0}, \quad x(\tau) = \lim_{t \nearrow \tau} \varphi(x(t), t). \end{aligned} \quad (2)$$

Here, $f_1 : \mathbb{R}^n \times \mathbb{R}^m \times \mathbb{R} \rightarrow \mathbb{R}^n$ and $f_2 : \mathbb{R}^n \times \mathbb{R}^m \times \mathbb{R} \times \mathbb{R}^n \times \mathbb{R} \rightarrow \mathbb{R}^n$ are assumed to be piecewise continuous in x , u and t , and $\varphi : \mathbb{R}^n \times \mathbb{R} \rightarrow \mathbb{R}^n$ is assumed to be piecewise continuous in x and t . We understand $(u(\cdot), x(\cdot))$ to be admissible if the measurable control function $u(\cdot)$ and the absolutely continuous state function $x(\cdot)$ solve the dynamic system (2) uniquely.

Let $g_1 : \mathbb{R}^n \times \mathbb{R}^m \times \mathbb{R} \rightarrow \mathbb{R}$ and $g_2 : \mathbb{R}^n \times \mathbb{R}^m \times \mathbb{R} \times \mathbb{R}^m \times \mathbb{R} \rightarrow \mathbb{R}$ be continuous in x , u and t with continuous $\partial g_i(\cdot)/\partial x$. Then, the objective functional is defined by

$$g(x(t), u(t), t) = \begin{cases} g_1(x(t), u(t), t) & \text{for } t < \tau, \\ g_2(x(t), u(t), t, x(\tau), \tau) & \text{for } t \geq \tau. \end{cases} \quad (3)$$

Given a discount rate ρ , the decision maker aims to maximize

$$\mathbb{E} \left[\int_{t_0}^{\tau} e^{-\rho t} g_1(x(t), u(t), t) dt + e^{-\rho \tau} V^*(x(\tau), \tau) \right] \quad (4)$$

with respect to $u(t)$ subject to the dynamic system (2) and the intensity rate of the switch (1). The decision maker anticipates optimal behaviour in stage 2,¹

¹By assuming perfect rationality, we follow the extant literature in economics and management. Assuming biased expectations would not change our approach in qualitative terms.

which is reflected in the optimal value of stage 2 as defined by

$$\begin{aligned} V^*(x(\tau), \tau) &:= \max_{u(\cdot)} V(x(\tau), u(\cdot), \tau) \\ &= \max_{u(\cdot)} \int_{\tau}^{\infty} e^{-\rho(t-\tau)} g_2(x(t), u(t), t, x(\tau), \tau) dt. \end{aligned} \quad (5)$$

Here, the function $V(\cdot)$ denotes the value of stage 2 for any admissible path of the control $u(\cdot)$ on $[\tau, \infty[$. The asterisk refers to optimal/optimized values, i.e., to the value function of the stage-2 optimal control problem.

Note that the statement of the stage-1 objective function in (4) is analogous to the objective function in [18] (equation (4)). The only difference is that in [18] the decision maker faces an exogenous salvage value function at τ , whereas in our case the model changes and the decision maker faces a different optimal control model.

Assuming $\lim_{t \rightarrow \infty} \mathcal{V}(t)z_1(t) = 0$ with

$$\mathcal{V}(t) = \int_{t_0}^t e^{-\rho t'} g_1(x(t'), u(t'), t') dt' \quad (6)$$

$$z_1(t) = e^{\int_{t_0}^t -\eta(x(t'), u(t'), t') dt'}, \quad (7)$$

and considering the value of stage 2 as a function for which $V^*(x(\tau), \tau) < \infty$ holds,² we can apply the reformulation into a deterministic optimal control model with infinite time horizon presented in [18] and obtain

$$\begin{aligned} \max_{u(t)} \quad & \int_{t_0}^{\infty} e^{-\rho t} z_1(t) \left[g_1(x(t), u(t), t) + \eta(x(t), u(t), t) V^*(x(t), t) \right] dt \\ \text{s.t.} \quad & \dot{x}(t) = f_1(x(t), u(t), t), \quad x(t_0) = x_{t_0}, \\ & \dot{z}_1(t) = -\eta(x(t), u(t), t) z_1(t), \quad z_1(t_0) = 1, \end{aligned} \quad (8)$$

with

$$\begin{aligned} V^*(x(t), t) &= \max_{u(s)} \int_t^{\infty} e^{-\rho(s-t)} g_2(x(s), u(s), s, x(t), t) ds \\ \text{s.t.} \quad & \dot{x}(s) = f_2(x(s), u(s), s, x(t), t), \quad x(t) = \lim_{t' \nearrow t} \varphi(x(t')), \end{aligned} \quad (9)$$

and with $z_1(t)$ being an auxiliary state variable. The interpretation is similar to a survival probability, i.e., $z_1(t)$ is the probability that the switch has not occurred in the interval $[t_0, t[$. It enters the objective function (8) similar to a discount rate, reflecting the decision maker's anticipation that a switch will occur at some point over the course of time. The value of the second stage is included with the rate $\eta(x(t), u(t), t)$ at which the switch arrives at t and changes the model to stage 2 with the corresponding initial conditions.

²Note that the conditions on $g_2(\cdot)$ and $f_2(\cdot)$ imply that the value function $V^*(\cdot)$ is continuously differentiable in x (see [57]).

Note that in (9) we slightly abuse the notation in the sense that V^* only depends on $x(t)$ and t , although the initial condition for stage 2 is defined by evaluating φ in the limit (from the left) of $x(t)$ during stage 1. Here, φ can be understood as a function that transforms the state from stage 1 to stage 2, embracing in particular the scope for a jump. Consider, e.g. a state that measures the stock of infrastructure and a natural disaster occurring at τ . Then $\lim_{t' \nearrow t} \varphi(x(t'))$ describes the infrastructure that has not been destroyed at τ .

Note that stage 2 of the above model explicitly depends on the state variable at the switching time. This can be an important feature of certain models, as is demonstrated in the example we consider in Section 3. Considering stage 2 alone, the dependence on $x(\tau)$ shifts the trajectories of the canonical system similar to the explicit dependence on t within a non-autonomous optimal problem. I.e. even for an autonomous optimal control problem it is not possible to derive a (single) phase diagram of the canonical system that is valid for all states and switching times.

The optimal control models (8) and (9) can be solved with classical optimal control theory (see e.g., [57]). The problem of the second stage is straightforward if the state variable of stage 1 is given. However, a solution of stage 1 requires the value function of stage 2 to be expressed as a function of the state and the time. This is a difficult task even numerically. Since the optimal control model is generally non-autonomous, the value function cannot be expressed as the Hamiltonian divided by the discount rate for all possible switching times (see Proposition 3.75 in [57]). Even if the optimal control model is autonomous the phase diagram, and thus the Hamiltonian of the model, switch when the objective functional and/or the state dynamics depend on the state at the switching time, as generally they may do. In Section 3, we present an example which exhibits this second property.

In order to address these difficulties, we present in the next subsection a further transformation of the model, allowing its representation as a deterministic age-structured optimal control model. This has two advantages. First, the model can be solved numerically with established methods (see [6]). Second, the age-structured optimal control representation allows a simultaneous solution of both stages. The result will represent the optimal behaviour for any possible switching time and, therefore, afford a broader understanding and additional insights into the solution.

2.2 Transformation to an Age-Structured Optimal Control Model

For expositional clarity, let us first change the notation of the state and the control variable in stage 2. From now on we use $v(t, \tau)$ ($y(t, \tau)$) for the control (state) variable at time t if the switch happened at τ . Note that the dependence on τ is important here, as it governs the value of the control and the state. Given

a switch at τ , the state dynamics during stage 2 reads

$$\begin{aligned} \frac{dy(t, \tau)}{dt} &= f_2(y(t, \tau), v(t, \tau), t, x(\tau), \tau), & t \geq \tau, \\ y(\tau, \tau) &= \varphi(x(\tau), \tau). \end{aligned} \quad (10)$$

Redefining the state in the second stage accordingly for every possible switching instant, i.e., $\forall \tau \geq 0$, and again abusing notation with respect to the initial condition for the state, one obtains a state variable $y(\cdot)$ that is age-structured.

Remark on notation: The literature on age-structured optimal control models frequently denotes by (t, a) the time arguments (t as time, a as age) of the (control and state) variables. Defining $s = t - a$, this notation is equivalent to the (t, s) notation we employ, where an explicit statement of the switching time s provides a clearer description in our context. For instance, every characteristic line of the optimal control model is then marked by (\cdot, s) , the switching time s being a more direct marker.

For the transformation of the general problem defined in (8) and (9) to an age-structured optimal control model, we first have to transform the objective function. The following Lemma presents the resulting objective function, accounting for time t and switching time s , as is defined in (10).

Lemma 1 *For every admissible path of the control variables $u(t)$ and $v(t, s)$ and corresponding state trajectories, the objective function (4) of the general model can be transformed into*

$$\begin{aligned} \mathbb{E} & \left[\int_{t_0}^{\tau} e^{-\rho t} g_1(x(t), u(t), t) dt + e^{-\rho \tau} V(x(\tau), v(\cdot), \tau) \right] \\ &= \int_{t_0}^{\infty} e^{-\rho t} \left[z_1(t) g_1(x(t), u(t), t) + \right. \\ & \quad \left. \int_{t_0}^t z_1(s) \eta(x(s), u(s), s) g_2(y(t, s), v(t, s), t, x(s), s) ds \right] dt. \end{aligned} \quad (11)$$

where $V(x(\tau), v(\cdot), \tau)$ denotes the value of stage 2 for admissible $v(\cdot) := v(t, \tau)$ for $t \in [\tau, \infty[$ and corresponding state trajectory (see (5) for the definition).

Proof of Lemma 1.

Starting from the objective function (4) and its transformation into (8), we

use the explicit expression of the value function of stage 2, i.e.,

$$\begin{aligned}
& \mathbb{E} \left[\int_{t_0}^{\tau} e^{-\rho t} g_1(x(t), u(t), t) dt + e^{-\rho \tau} V(x(\tau), v(\cdot), \tau) \right] \\
&= \int_{t_0}^{\infty} e^{-\rho t} \left[z_1(t) g_1(x(t), u(t), t) + z_1(t) \eta(x(t), u(t), t) V(x(t), v(\cdot), t) \right] dt \\
&= \int_{t_0}^{\infty} e^{-\rho t} \left[z_1(t) g_1(x(t), u(t), t) + \right. \\
&\quad \left. z_1(t) \eta(x(t), u(t), t) \int_t^{\infty} e^{-\rho(s-t)} g_2(y(s, t), v(s, t), s, x(t), t) ds \right] dt \\
&= \int_{t_0}^{\infty} e^{-\rho t} z_1(t) g_1(x(t), u(t), t) dt + \\
&\quad \int_{t_0}^{\infty} \int_t^{\infty} e^{-\rho s} z_1(t) \eta(x(t), u(t), t) g_2(y(s, t), v(s, t), s, x(t), t) ds dt \quad (12)
\end{aligned}$$

Applying Fubini's theorem, we can now change the order of integration for the second integral and obtain

$$\begin{aligned}
& \int_{t_0}^{\infty} e^{-\rho t} z_1(t) g_1(x(t), u(t), t) dt + \\
& \int_{t_0}^{\infty} e^{-\rho t} \int_{t_0}^t z_1(s) \eta(x(s), u(s), s) g_2(y(t, s), v(t, s), t, x(s), s) ds dt. \quad (13)
\end{aligned}$$

In contrast to the summation of the objective functional over time s for every switching time t used in the previous expression (12), we change to the summation of the objective functional over all switching times before t . For an illustration, see Figure 1, where the left panel corresponds to (12): summation over time for the characteristic line starting at t ; and where the right panel corresponds to (13): summation over all switching times before t . This implies that the discount factor in the second integral disappears and that age-structured optimal control theory can be applied. After rearranging terms, we arrive at (11).

□

The reformulation of the objective function presented in the above Lemma is crucial for considering the general model as an age-structured optimal control model. To write (11) in a more compact form, we introduce the aggregate state $Q(t)$ as sum of the objective functionals of all active characteristic lines $0 \leq s \leq t$ at t , i.e.,

$$Q(t) = \int_{t_0}^t z_1(s) \eta(x(s), u(s), s) g_2(y(t, s), v(t, s), t, x(s), s) ds. \quad (14)$$

In other words, $Q(t)$ denotes the sum of all instantaneous utilities for all possible regimes (i.e., all possible switches) up to time t , weighted by the probability for

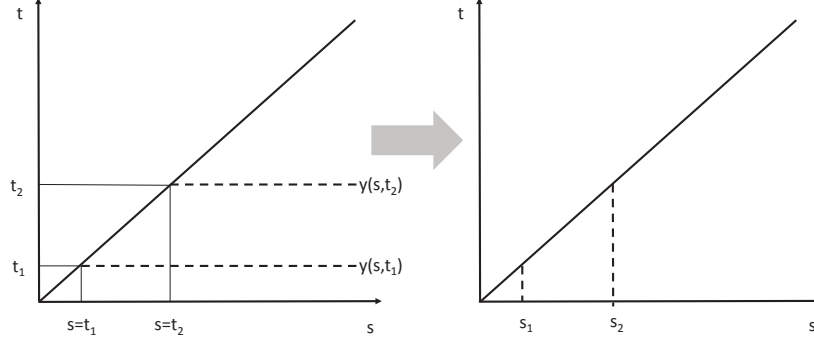


Figure 1: Change in the direction of summation.

their realization at $s \in [t_0, t]$. Here, the instantaneous utilities at t may well depend on the state $x(s)$ at the time of the switch. Thus, there are two time lags in the integral, which complicates the use of the standard form of the Maximum Principle. To avoid this complication, we define two auxiliary state variables $z_2(t, s)$ and $z_3(t, s)$ in the following way

$$\begin{aligned} \frac{dz_i(t, s)}{dt} &= 0, \quad i = 2, 3, \forall t \geq s, \\ z_2(s, s) &= z_1(s)\eta(x(s), u(s), s), \\ z_3(s, s) &= x(s). \end{aligned}$$

Here, $z_2(t, s)$ denotes the probability that the switch happened at s , where $z_2(s, s) = z_2(t, s) \forall t \geq s$ reflects that, for any switching point s , this probability does not change over time. Analogously, $z_3(t, s)$ denotes the value of the state variable at the switching time s . Using this in (14), it is possible to eliminate the time lag and write

$$Q(t) = \int_{t_0}^t z_2(t, s) g_2(y(t, s), v(t, s), t, z_3(t, s), s) ds. \quad (15)$$

Finally, Lemma 1 and the above calculations result in the following Theorem.

Theorem 1 *A multi-stage optimal control model with random switching time, i.e., problem (4) subject to (2), (1) and (5), is equivalent to the following age-*

structured optimal control model:

$$\begin{aligned}
& \max_{u(t), v(t,s) \geq 0} \int_{t_0}^{\infty} e^{-\rho t} \left[z_1(t) g_1(x(t), u(t), t) + Q(t) \right] dt \\
& \text{s.t.} \quad \dot{x}(t) = f_1(x(t), u(t), t), \quad x(t_0) = x_{t_0}, \\
& \quad \dot{z}_1(t) = -\eta(x(t), u(t), t) z_1(t), \quad z_1(t_0) = 1, \\
& \quad \frac{dy(t, s)}{dt} = f_2(y(t, s), v(t, s), t, z_3(t, s), s), \quad t \geq s, \\
& \quad y(s, s) = \varphi(x(s), s), \quad \forall s \geq 0 \\
& \quad \frac{dz_i(t, s)}{dt} = 0, \quad i = 2, 3, \quad t \geq s, \\
& \quad z_2(s, s) = z_1(t) \eta(x(s), u(s), s), \quad \forall s \geq 0 \\
& \quad z_3(s, s) = x(s), \quad \forall s \geq 0 \\
& \quad Q(t) = \int_{t_0}^t z_2(t, s) g_2(y(t, s), v(t, s), t, z_3(t, s), s) ds. \quad (16)
\end{aligned}$$

This problem can be solved with age-structured optimal control theory ([39, 40, 41]) and established numerical methods ([6]).

The transformation of the multi-stage optimal control model with a random switching time ((4) subject to (2), (1) and (5)) to a deterministic optimal control model (8) enables the application of the standard Maximum Principle for a given value function (depending on the state and time), relating to stage 2 of the original problem. Thus the stage-2 problem has to be solved first and used for the first order conditions of the original problem ((4) with respect to (2)). This way of deriving the optimal solution will be referred to as *backward approach*. As compared to this, working with the transformed age-structured optimal control problem (Theorem 1) has considerable advantages:

Numerical solution: Applying the backward approach makes it necessary to calculate the value function of stage 2, depending on the state and on time. This is manageable (by deriving the stable trajectories of the canonical system and evaluating the slice manifold, for details we refer to [57]) if the stage-2 problem is autonomous and if neither the objective functional nor the dynamics depend on the state at the switching time, i.e., if $g_2(x(t), u(t), t, x(\tau), \tau) = g_2(x(t), u(t), t)$ in (3) and if $f_2(x(t), u(t), t, x(\tau), \tau) = f_2(x(t), u(t), t)$ in (2). Non-autonomy and/or dependence on the state at the switching time is likely to imply huge numerical effort, as it leads to a shift in the phase diagram. The stage-2 optimal control problem would then have to be solved for every admissible state and every t . In contrast, the problem is solved at a single blow in the age-structured optimal control form, as it is no longer defined over the two distinct stages. Here, established numerical methods (see [6]) can be applied.

Analytical insights: The general model formulated in (8) and (9) includes stochasticity (i.e., a random time horizon) and two non-trivial optimiza-

tion problems, one being nested in the other (i.e., the value function of stage 2 as salvage value of stage 1). The representation as an age-structured optimal control model (see (16) in Theorem 1) is deterministic and includes both stages simultaneously. The switching rate is naturally included as a function that depends on the control and state variables. Thus, the model, the first order conditions and the dynamics can be presented in a compact way, allowing for the explicit and intuitive incorporation of the interaction between the two stages and the switching rate. This comes at the expense of three additional state variables, where $z_1(t)$ can be interpreted as a survival probability, and where $z_i(t, s)$ ($i = 2, 3$) adjust for the time lag. This complication, however, is then independent of the number of control and state variables in the original model, allowing the addition of a lot of detail without compromising the tractability of the transformed model. In contrast, the complexity of the backward solution (see previous item) strongly depends on the number of control and state variables, as the value function has to be derived for every switching time and every possible value of the state variables.

Model illustration: The age-structured optimal control approach offers additional ways for illustrating the results of the model. In particular, it is now possible to represent the dynamics of the control and state variables across the range of switching times, i.e., $\frac{dv(t,s)}{ds}$, in addition to the more common dynamics over time, t . Combining the two, this also allows for an easy representation of the role of duration $t - s$. Section 3 provides both analytical and visual representations of the dynamics for a numerical example. Altogether, the broader scope for illustrating the model dynamics is possible because in the age-structured optimal control formulation switching time is represented as an independent variable s , whereas the backward approach represents stage 2 by an isolated optimal control problem.

In the next section we present a simple model of catastrophic macroeconomic disaster to illustrate the above transformation together with a numerical solution.

3 Example: Preventing and Responding to Catastrophic Macroeconomic Disaster

In the light of rising concerns about catastrophic changes to environmental conditions due to climate change (see, e.g., [58]) and the reduction in biodiversity, a growing interest has emerged in the modelling of rare macroeconomic disasters (see, e.g., [59, 60, 61, 3, 4] on the modelling of catastrophic climate change and [62] for a general survey on macroeconomic disasters). The modelling of a singular catastrophic macroeconomic shock is a natural application for our framework, where in stage 1 the economy operates under the risk of a severe

disaster, the arrival of which can be lowered by preventive investments; and where stage 2 is characterized by, e.g., a vastly diminished capacity for production. As is pointed out in [4], one important feature of such catastrophic shocks is that they yield permanent, or at least very long-lasting impacts.

In the following, we provide a simple, highly stylized model of such a setting, which aims at illustrating how our transformation approach functions and to what uses it can be gainfully employed. Within this section, we use subscript (superscript) i to indicate variables (functions) for stage $i = 1, 2$. In the stage before a shock takes place, referred to as stage 1, we have the following set-up. The economy produces output with capital stock $K_1(t)$ according to the production function $F^1(K_1(t))$. This output can be consumed, $c_1(t)$, invested to increase the capital stock in production, or invested into a protective capital stock $D(t)$ to reduce the risk of a disaster and/or the negative impact of such a disaster in the follow-up, referred to as stage 2. Investments into protective capital are denoted by $p(t)$. Protective capital is built up through investments according to $h(p(t))$ and depreciates at a constant rate δ . The decision maker aims at maximizing the stream of utility from consumption $u(c_1(t))$. The shock to the economy is assumed to take place at a rate $\eta(D(t))$ that falls in the stock of protective capital. For concreteness, one could think, for instance, of $\eta(D(t))$ as a risk of permanent flooding which diminishes in the capital stock $D(t)$ invested in the strength and height of dams and other means of flood protection.

Altogether, the model reads

$$\begin{aligned} \max_{c_1, p \geq 0} \quad & \mathbb{E} \left[\int_0^\tau e^{-\rho t} u(c_1(t)) dt + e^{-\rho \tau} V^*(D(\tau), K_1(\tau)) \right] \\ \text{s.t.} \quad & \dot{K}_1(t) = F^1(K_1(t)) - c_1(t) - p(t), \quad K_1(0) = K_{10}, \lim_{t \rightarrow \infty} K_1(t) \geq 0, \\ & \dot{D}(t) = h(p(t)) - \delta D(t), \quad D(0) = 0, \end{aligned} \quad (17)$$

where $V^*(D(\tau), K_1(\tau))$ denotes the value of stage 2, which is defined similarly. The difference is that physical capital is less productive in stage 2 due to the negative effect of the disaster, i.e., $F^2(K, D) \leq F^1(K)$ ($K > 0, \forall t$). The negative impact is mitigated by the protective capital at the time of the shock, i.e., $F_D^2(\cdot) > 0$. Protective capital is assumed to be fixed during stage 2, implying no further depreciation and the impossibility of further investment. Altogether, the stage-2 model reads

$$\begin{aligned} V^*(D(\tau), K_1(\tau)) &= \max_{c_2 \geq 0} \int_\tau^\infty e^{-\rho(t-\tau)} u(c_2(t)) dt \\ \text{s.t.} \quad & \dot{K}_2(t) = F^2(K_2(t), D(\tau)) - c_2(t), \\ & K_2(t) = K_1(t), \lim_{t \rightarrow \infty} K_2(t) \geq 0. \end{aligned} \quad (18)$$

Concavity is assumed for the utility function, the production function and the investment function into protective capital.

Our model bears a lot of similarity to an innovative approach developed by van der Ploeg and de Zeeuw (see [3, 4]) to analyze optimal policy-making in the

face of a potentially catastrophic climate shock. Notably, [3, 4] are relying on the backward approach when solving their model. Our approach is parsimonious and lacks much of the environmental and policy detail (e.g., scope for emission abatement, emission taxes, etc.) considered in [3, 4]. One crucial distinction, however, is that we allow the stage-2 production function, and, thus, the stage-2 value function, to depend on the state of protective capital at the time of the shock, $D(\tau)$. This captures that protective capital may not only diminish the probability of a disaster but also its impact, and it differs from [3, 4] where a shock induces an exogenous (possibly time-varying) shift in the production function (see equation (1), p. 1581 in [3] and equation (4), p. 32 in [4]).³ As we have argued above (see 'numerical solution' on p. 10), it is precisely the analysis of such a form of state-dependency (at the point of shock) for which our transformation is particularly well suited. As we will see shortly, the compact representation of the two stages and their linkage in the age-structured optimal control framework provides the basis for a complete and intuitive representation of the dynamics that unfold, depending non-trivially on both time t and the timing of the disaster s .

Applying the transformation described in Theorem 1, the model can be reformulated as the following age-structured optimal control model⁴

$$\begin{aligned}
& \max_{c_1, c_2, p \geq 0} \int_0^\infty e^{-\rho t} [z_1(t)u(c_1(t)) + Q(t)] dt \\
& \text{s.t.} \quad \dot{K}_1(t) = F^1(K_1(t)) - c_1(t) - p(t), \\
& \quad \quad K_1(0) = K_{10}, \lim_{t \rightarrow \infty} K_1(t) \geq 0, \\
& \quad \quad \dot{D}(t) = h(p(t)) - \delta D(t), \quad D(0) = 0, \\
& \quad \quad \dot{z}_1(t) = -\eta(D(t))z_1(t), \quad z_1(0) = 1, \\
& \quad \quad \frac{dK_2(t, s)}{dt} = F^2(K_2(t, s), z_3(t, s)) - c_2(t, s), \quad t \geq s, \forall s \geq 0, \\
& \quad \quad K_2(s, s) = K_1(s), \quad \lim_{t \rightarrow \infty} K_2(t, s) \geq 0, \\
& \quad \quad \frac{dz_i(t, s)}{dt} = 0, \quad i = 2, 3, \quad t \geq s, \forall s \geq 0, \\
& \quad \quad z_2(s, s) = z_1(s)\eta(D(s)), z_3(s, s) = D(s) \\
& \quad \quad Q(t) = \int_0^t z_2(t, s)u(c_2(t, s)) ds. \tag{19}
\end{aligned}$$

This compact representation of model (17) and (18) highlights the advantage of a transformation into an age-structured optimal control model (see 'analytical insights' on p. 10). The model is deterministic, the switching rate enters in the dynamics of $z_1(t)$, and both stages are considered simultaneously.

³Interestingly, van der Ploeg and de Zeeuw [4] themselves argue in their conclusion that 'some forms of adaptation capital might however give a return once the catastrophe hits and typically lasts for much longer than other forms of capital'.

⁴Note that, in general, we would also have to add the dynamics of the protective capital in stage 2. However, we suppress it at this stage, as $D(t)$ does not change during that stage and only the value $D(s)$ at the time of the disaster enters the production function.

The standard Maximum Principle for age-structured optimal control theory (see [40]) can be applied to this problem, yielding the following first order conditions for the controls (ensured to be positive by appropriate Inada conditions for $u(\cdot)$ and $h(\cdot)$)

$$\begin{aligned} 0 &= e^{-\rho t} z_1(t) u_{c_1}(c_1(t)) - \lambda_1(t) \\ 0 &= \lambda_2(t) h_p(p(t)) - \lambda_1(t) \\ 0 &= \zeta(t) z_2(t, s) u_{c_2}(c_2(t, s)) - \xi_1(t, s) \end{aligned} \quad (20)$$

and corresponding adjoint equations

$$\begin{aligned} \dot{\lambda}_1(t) &= -\lambda_1(t) F_{K_1}^1(K_1(t)) - \xi_1(t, t) \\ \dot{\lambda}_2(t) &= \delta \lambda_2(t) + \eta_D(D(t)) z_1(t) [\lambda_3(t) - \xi_2(t, t)] - \xi_3(t, t) \\ \dot{\lambda}_3(t) &= \eta(D(t)) [\lambda_3(t) - \xi_2(t, t)] - e^{-\rho t} u(c_1(t)) \\ \frac{d\xi_1(t, s)}{dt} &= -\xi_1(t, s) F_{K_2}^2(K_2(t, s), z_3(t, s)) \\ \frac{d\xi_2(t, s)}{dt} &= -\zeta(t) u(c_2(t, s)) \\ \frac{d\xi_3(t, s)}{dt} &= \xi_1(t, s) F_{z_3}^2(K_2(t, s), z_3(t, s)) \\ \zeta(t) &= e^{-\rho t}, \end{aligned} \quad (21)$$

where $\lambda_i(t)$ ($i = 1, 2, 3$) denote the adjoint variables for the states $K_1(t)$, $D(t)$ and $z_1(t)$, respectively, and where $\xi_i(t, s)$ ($i = 1, 2, 3$) denote the adjoint variables for $K_2(t, s)$, $z_2(t, s)$ and $z_3(t, s)$, respectively. Finally, $\zeta(t)$ denotes the adjoint variable for $Q(t)$.

Since every stage-2 path emanating from a shock at time s (i.e., every characteristic line of a post-shock economy) is isolated in the model (i.e., there are no spillovers), the transversality conditions for (time-dependent) optimal control models with infinite time horizon can be applied (see [57]). For our example, this implies

$$\begin{aligned} \lim_{t \rightarrow \infty} e^{-\rho t} \lambda_i(t) &= 0 \quad \text{for } i = 1, 2, 3, \\ \lim_{t \rightarrow \infty} e^{-\rho t} \xi_i(t, s) &= 0 \quad \text{for } s \geq 0, \quad i = 1, 2, 3. \end{aligned} \quad (22)$$

The systems of equations in (20)–(22) represent the first order conditions relating to both stages of the model and include the stochastic switch between them. It is not necessary to use the value function of stage 2. As both stages are treated simultaneously (see 'analytical insights' on p. 10), it is immediately obvious how the stage-2 allocation enters the control and adjoint variables that correspond to stage 1.

By differentiating the first order conditions with respect to time and switching time, respectively, we obtain the dynamics of the control variables (their dependence on time and switching time as well as on control and state variables

being suppressed for clarity).

$$\dot{c}_1(t) = (\rho - F_{K_1}^1) \frac{u_{c_1}}{u_{c_1 c_1}} - \eta \frac{u_{c_2} - u_{c_1}}{u_{c_1 c_1}} \quad (23)$$

$$\dot{p}(t) = \underbrace{-\frac{h_p}{h_{pp}}}_{>0} \left(\underbrace{\delta + F_{K_1}^1}_i - \underbrace{\frac{h_p \xi_3 - \xi_1}{e^{-rt} z_1 u_{c_1}}}_{ii} + \underbrace{\frac{\lambda_3 - \xi_2}{e^{-rt} u_{c_1}} h_p \eta_D}_{iii} \right) \quad (24)$$

$$\frac{dc_2(t, s)}{dt} = (\rho - F_{K_2}^2) \frac{u_{c_2}}{u_{c_2 c_2}} \quad (25)$$

$$\frac{dc_2(t, s)}{ds} = \underbrace{-\frac{u_{c_2}}{u_{c_2 c_2}}}_{>0} \left(- \underbrace{\eta}_i + \underbrace{\frac{\eta_D \dot{D}}{\eta}}_{ii} - \underbrace{\frac{1}{\xi_1} \frac{d\xi_1}{ds}}_{iii} \right). \quad (26)$$

Equations (23) and (25) are the consumption Euler equations relating to stages 1 and 2, respectively. While (25) is of the standard form and requires no further discussion, (23) contains an additional term related to the shock. If a disaster at time t leads to a collapse of production capabilities and, thus, of consumption, such that $c_2 < c_1$, then the marginal utility of consumption satisfies $u_{c_2} > u_{c_1}$. In such a case, consumption is deferred (note that $u_{c_1 c_1} < 0$) in order to accumulate precautionary savings early on and, thereby, to soften the shock-related drop in consumption. Note that this is equivalent to the precautionary build-up of the capital stock in [3, 4].

According to (24), protective investment increases over time (i.e., is deferred) in line with (i) its current opportunity cost (the latter being the return to productive capital); and declines over time (i.e., is advanced) with (ii) the excess value of protective capital over productive capital after the shock, and with (iii) the net value of reducing the risk of a disaster (note that $\eta_D < 0$), with λ_3 being the value of prevention (equal to the value of survival in stage 1) and with ξ_2 being the value of stage 2.

According to (26), the experience of a later shock (i.e., a higher s) implies (i) a lower level of consumption, as more consumption has been advanced due to the risk of a shock; (ii) a lower level of consumption due to the accumulation of protective capital (the effect reverses if $\dot{D} < 0$); (iii) a higher level of consumption if the stage-2 value of productive capital is smaller for later shocks (i.e., if $\frac{d\xi_1}{ds} < 0$), or, in other words, if more productive capital has been accumulated at a later arrival of the shock.

Note that the first three equations (derivatives with respect to time) can also be obtained by the standard approach, while the fourth one (derivative with respect to switching time) can only be obtained after applying the transformation into an age-structured model. As has been discussed in 'Model illustration' on p. 11, expressions for the "switching time"-dynamics lend additional insight in many applications, especially in economics. Although some variables cannot be solved for in a closed form (since they are nested with other variables), it is possible to disentangle the basic terms and to understand the transmission channels through which shocks influence the system at different time points of

their occurrence.

A numerical solution based on the backward approach would be extremely involved even for this simple model. This is because the dynamics of the state variable of stage 2 depend on the protective capital at the time of the shock (see 'numerical solution' on p. 10). This becomes obvious when deriving the steady-state capital stock as a function of switching time s , i.e.,

$$\hat{K}_2(s) := \lim_{t \rightarrow \infty} K_2(t, s) = \left[\frac{\rho}{A_2 \beta} \left(1 - e^{-\bar{\eta} D(s)} \right)^{-1} \right]^{\frac{1}{\beta-1}}, \quad \forall s. \quad (27)$$

Given that the switch has happened at s , the optimal solution of stage 2 then follows the stable manifold leading to $\hat{K}_2(s)$. Notably, the value for $\hat{K}_2(s)$ will vary with $D(s)$. Thus, it is not enough to derive the slice manifold for every possible switching time s , but one would have to derive the value function separately, depending on both s and $D(s)$.

In contrast, a numerical solution can be readily obtained for the age-structured formulation. We employ the following functional specification (the dependence on t and s being suppressed)

$$\begin{aligned} \eta(D) &= \eta e^{-\bar{\eta} D}, \\ h(p) &= p^\alpha, \\ u(c_i) &= c_i^\sigma, \quad i = 1, 2 \\ F^1(K_1) &= A_1 K_1^\beta, \\ F^2(K_2, z_3) &= A_2 K_2^\beta (1 - e^{-\bar{\eta} z_3}), \end{aligned}$$

with the following parameter values

$$\alpha = 0.75, \beta = 0.5, \sigma = 0.75, \eta = 0.25, \bar{\eta} = 0.5, \rho = 0.03, \delta = 0.2, A_1 = A_2 = 0.75.$$

Furthermore, we set the initial capital stock at $K_{10} = 50$.

Note that the utility function is continuously differentiable in c_i and does not depend on any state. Thus, the assumptions concerning the objective functional (see (3) on p. 4) are fulfilled. Similarly, the production functions of both stages are continuously differentiable in the states, implying that the stated assumptions are fulfilled (see (2) on p. 4).

The key outcomes are illustrated in Figures 2 through 6. Figure 2 plots how consumption develops over time for stages 1 and 2, depending on the arrival of the disaster at $s = 5, 10, 15$. As long as no disaster hits, $c_1(t)$ declines and converges towards a steady state. At the point of a disaster at s , consumption drops sharply. Although $c_2(t, s)$ recovers afterwards, it converges to a new steady-state level below the one of stage 1. The lower level of the consumption is implied by the detrimental impact of the disaster on productivity and, thus, on total output.

However, the stage-2 consumption paths vary strongly with the timing of the shock. While later shocks, represented by higher s , are characterized by a more pronounced instantaneous drop, consumption then recovers at a higher rate and

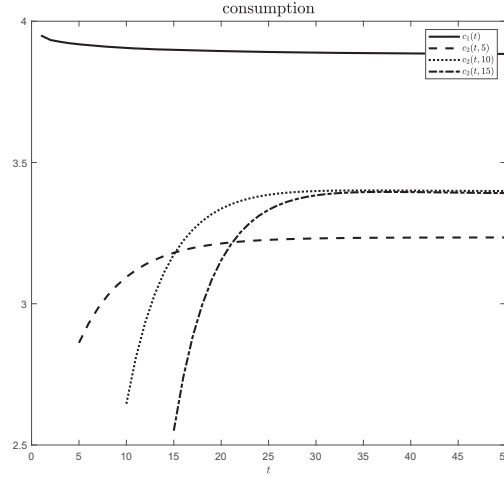


Figure 2: Stage-1 consumption path and stage-2 consumption paths for $s = 5, 10, 15$.

converges towards a higher steady-state level. While the gradual conversion of physical capital into protective capital taking place during stage 1 (see Figure 5 below) leads to a sharper instantaneous decline in consumption for later shocks, late-arriving shocks benefit the subsequent recovery of the economy by allowing a longer accumulation of protective capital (see Figure 4 below). The latter serves to dampen the long-run productivity impact of the disaster.

The left panel of Figure 3 shows the consumption profile for stage 2 over time and switching time (i.e., for every possible realization of the disaster), providing information about the structure of consumption in stage 2 (see paragraph 'model illustration' on p. 11). Specifically, it shows how optimal consumption choices during stage 2 vary with the time s at which disaster strikes. While this figure can be plotted directly after our transformation, it could only be developed under considerable effort when using the backward solution. The right panel plots stage-2 consumption at time $t = 5, 10, 15$ (corresponding to the three curves), depending on the time $s \leq t$ at which the disaster hits. Increasing s for any given t implies a shorter duration since the disaster. It can be seen that, at any point in time t , the consumption level varies in a non-monotonous way with the duration since the shock. If disaster has just occurred (corresponding to the respective RHS end points of the three curves) consumption is low due to the instantaneous impact. Consumption is also low (and sometimes lower) for early realizations of the shock (corresponding to the LHS end points of the three curves), where the low level of protective capital disallows a recovery of the economy. By contrast, consumption is highest for intermediate realizations of the shock, for which (a) there was sufficient time for recovery as opposed to later realizations, while at the same time (b) the recovery process was more

effective than for earlier realizations.

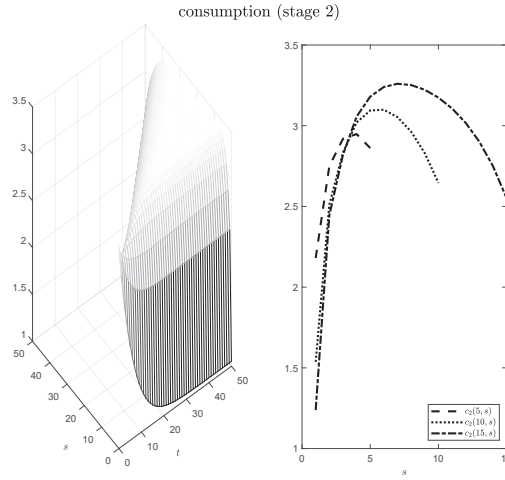


Figure 3: Stage-2 consumption over time and switching time (left panel) and across switching times (right panel).

Figure 4 plots protective investments, p , (left panel) and protective capital, D , (right panel) over time. Investments are very high at the beginning, as the steady-state level of the protective capital stock has to be built up. The protective capital stock increases until a steady state is reached.

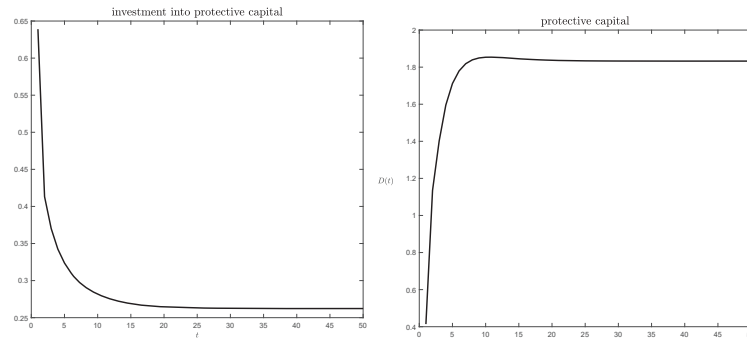


Figure 4: Protective investments and protective capital over time.

Figures 5 and 6 plot various surfaces of the productive capital stock, K . The structure is analogous to that of the consumption profiles in Figures 2 and 3. During stage 1, the capital stock decreases from a high initial value towards the steady-state value it would attain in the absence of a shock. In case of a

disaster, the capital stock does not drop. The production function, however, is less effective implying that a higher steady-state capital stock needs to be built up during stage 2. The level of this steady-state capital stock then depends on the timing of the shock: early shocks, for which the impact on productivity was strong and lasting due to a low level of protective capital, inhibit even the long-run accumulation of physical capital, leading to a lower steady-state level.

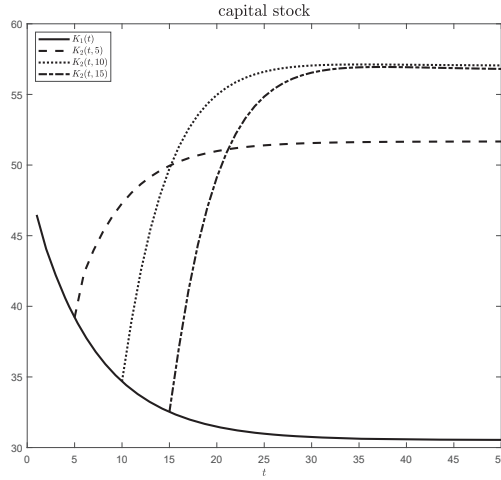


Figure 5: Stage-1 productive capital stock and stage-2 productive capital for $s = 5, 10, 15$.

Figure 5 mirrors the insights from Figure 3. Similar to consumption, the stage-2 level of the productive capital stock depends in a non-monotonous way on the duration since the shock. A short duration since the shock (i.e., at the RHS end points of the three curves) implies that very little productive capital could be accumulated, starting from a low level. By contrast, a long duration since the shock implies a comparatively slow rebuilding of the capital stock due to a strong permanent decline in capital productivity for early shocks. Once again, the capital stock is highest for intermediate durations, where the time available for capital rebuilding and its effectiveness are well balanced. Recall that the time and scope for capital rebuilding also explains the stage-2 allocation of consumption.

We conclude by recalling that the numerical example lacks important modelling features, as well as the necessary calibration that would allow it to explain the economics of real-world catastrophic disasters, such as climate shocks. With the present analysis predominantly serving as an illustration of how the transformation of a multi-stage model with random switching time into an age-structured optimal control model can be usefully applied, the formulation and analysis of a more realistic model is relegated to future work.

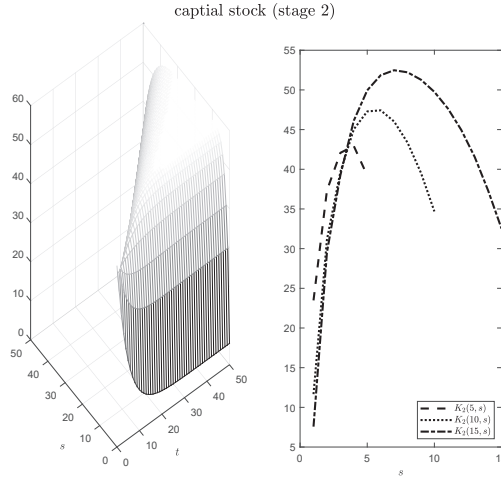


Figure 6: Stage-2 productive capital stock over time and switching time (left panel) and across switching times (right panel).

4 Conclusions

The paper considers multi-stage optimal control models with a random switching time. Although the model can be transformed into a deterministic optimal control model a la Kamien-Schwartz, the numerical solution remains involved. This is the case, in particular, if the objective functional or the state dynamics depend on the state evaluated at the switching time or on the switching time itself. Transforming the model into an age-structured optimal control model allows one to derive the solution of both stages simultaneously. This is a considerable numerical advantage. Moreover, owing to the unified representation of both stages, the age-structured optimal control formulation offers additional analytical insights and the scope for a complete representation of the dynamics, in particular, when it comes to studying the impact of the timing of the shock and the duration since.

Naturally, the assumptions concerning the switch can be extended in various ways. In future work, we intend to allow for multiple switches, where we need to distinguish whether the switches are independent or whether they are linked through model states. Another important extension involves the modeling of a distributed impact of the switch. In our example of a natural disaster, for instance, not only the arrival of the shock is random but also its severity. The distribution of severity (for different arrival dates) would then have to be considered as an additional part to the control problem.

Appendix

Innovation: While the probability of arriving at an innovation can be influenced by education (at individual or societal level) or R&D investments (at firm or government level), a technical breakthrough remains a stochastic event. Some innovations have the power to change considerably the dynamics of firms (e.g., new products; drastic innovations that lead to the domination of the market) or societies (e.g., a carbon-free backstop technology; a vaccine that leads to the eradication of certain infectious diseases, or a comprehensive anti-cancer treatment).

Natural disasters/climate change: While the prevention of and response to natural (e.g., storms, flooding, volcano eruptions, earthquakes) or man-made environmental disasters (e.g. oilspills, chemical or nuclear accidents) provides a long-standing context for such analysis, the growing prospect of collapse of particular climate patterns (e.g., a stand-still of the Gulf stream due to the erosion of thermal differentials within the Atlantic ocean; a substantial weakening of the jet-stream; or a polar melt-down) is adding a global scale to the issue.

Political shocks: With revolutions or landslide political change, societies can experience shock-like political events with potentially far-reaching economic and social consequences. These experiences raise issues about optimal patterns of investment in the prevention or arrival, for that matter, of radical political change. Similar issues relate to the art of "brinkmanship", where negotiations are structured in a way that maximizes the domestic objective while at the same time containing the risk of an international crisis.

References

- [1] Laporte, A., Ferguson, B.S.: Investment in health when health is stochastic. *Journal of Population Economics* 20, 423-444 (2007)
- [2] Laitner, J., Silverman, D., Stolyarov, D.: The role of annuitized wealth in post-retirement behavior. *American Economic Journal: Macroeconomics* 10 (3), 71-117 (2018).
- [3] van der Ploeg, F., de Zeeuw, A.: Climate tipping and economic growth: precautionary capital and the price of carbon. *Journal of the European Economic Association* 16 (5), 1577-1617 (2018)
- [4] van der Ploeg, F., de Zeeuw, A.: Pricing Carbon and Adjusting Capital to Fend Off Climate Catastrophes. *Environmental and Resource Economics* 72, 29-50 (2019)
- [5] Kuhn, M., Wrzaczek, S.: Rationally risking addiction: a two-stage approach. *Mimeo* (2019)

- [6] Veliov, V.M.: Newton's method for problems of optimal control of heterogeneous systems. *Optimization Methods and Software* 18 (6), 689-703 (2003)
- [7] Veliov, V.M.: Optimal control of heterogeneous systems: Basic theory. *Journal of Mathematical Analysis and Applications* 346, 227-242 (2008)
- [8] Yaari, M.E.: Uncertain lifetime, life insurance, and the theory of the consumer. *Review of Economic Studies* 32 (2), 137-150 (1965)
- [9] Kamien, M.I., Schwartz N.L.: Optimal maintenance and sale age for a machine subject to failure. *Management Science* 17, B495-B504 (1971)
- [10] Alam, M., Sarma, V.V.S.: Optimal maintenance policy for equipment subject to deterioration and random failure. *IEEE Transactions on System, Man, and Cybernetics SMC-4*, 172-175 (1974)
- [11] Sarma, V.V.S., Alam, M.: Optimal maintenance policies for machines subject to deterioration and intermittent breakdowns. *IEEE Transactions on Systems, Man, and Cybernetics SMC-5*, 396-398 (1975)
- [12] Alam, M., Lynn, J.W., Sarma, V.V.S.: Optimal maintenance policy for equipment subject to random deterioration and random failure. *International Journal of Systems Science* 7, 1071-1080 (1976)
- [13] Gaimon, C., Thompson, G.L.: Optimal preventive and repair maintenance of a machine subject to failure. *Optimal Control Applications & Methods* 5, 57-67 (1984)
- [14] Gaimon, C., Thompson, G.L.: Optimal preventive and repair maintenance of a machine subject to failure and a declining resale value. *Optimal Control Applications & Methods* 10, 211-228 (1989)
- [15] Sethi, S.P., Thompson, G.L.: *Optimal Control Theory, Applications to Management Science and Economics*, Springer (2000)
- [16] Sethi, S.P., Bass, F.M.: Optimal pricing in a hazard rate model of demand. *Optimal Control Application Methods* 24, 183-196 (2003)
- [17] Bensoussan, A., Sethi, S.P.: The machine maintenance and sale age model of Kamien and Schwartz revisited. *Management Science* 53, 1964-1976 (2007)
- [18] Boukas, E.K., Haurie, A., Michel, P.: An Optimal Control Problem with a Random Stopping Time. *Journal of Optimization Theory and Applications* 64 (3), 471-480 (1990)
- [19] Boukas, E.K., Haurie, A.: Optimality conditions for continuous-time systems with controlled jump Markov disturbances: Application to an FMS planning problem. In: Bensoussan, A., Lions, J.L. (eds.): *Analysis and Optimization of Systems*, 633-676. Springer, Berlin (1988)

- [20] Sorger, G.: Maximum principle for control problems with uncertain horizon and variable discount rate. *Journal of Optimization Theory and Applications* 70 (3), 607-618 (1991)
- [21] Carlson, D.A., Haurie, A.B., Leizarowitz, A.: *Infinite Horizon Optimal Control: Deterministic and Stochastic Systems*, Springer (1991)
- [22] Tomiyama, K.: Two-stage optimal control problems and optimality conditions. *Journal of Economic Dynamics and Control* 9 (3), 317-337 (1985)
- [23] Tomiyama, K., Rossana, R.J.: Two-stage optimal control problems with an explicit switch point dependence: Optimality criteria and an example of delivery lags and investment. *Journal of Economic Dynamics and Control* 13 (3), 319-337 (1989)
- [24] Makris, M.: Necessary conditions for infinite-horizon discounted two-stage optimal control problems. *Journal of Economic Dynamics and Control* 25 (12), 1935-1950 (2001)
- [25] Boucekkine, R., Pommeret, A., Prieur, F.: Optimal regime switching and threshold effects. *Journal of Economic Dynamics and Control* 37, 2979-2997 (2013)
- [26] Caputo, M.R., Forster, M.: Optimal plans and timing under additive transformations to rewards. *Oxford Economic Papers* 68 (2), 604-626 (2016)
- [27] Boucekkine, R., Saglam, H.C., Vallee, T.: Technology adoption under embodiment: A two-stage optimal control approach. *Macroeconomic Dynamics* 8 (2), 250-271 (2004)
- [28] Saglam, C.: Optimal pattern of technology adoptions under embodiment: A multi-stage optimal control approach. *Optimal Control Applications and Methods* 32 (5), 574-586 (2011)
- [29] Grass, D., Hartl, R.F., Kort, P.: Capital accumulation and embodied technical progress. *Journal of Optimization Theory and Applications* 154, 588-614 (2012)
- [30] Vallee, T., Moreno-Galbis, E.: Optimal time switching from tayloristic to holistic workplace organization. *Structural Change and Economic Dynamics* 22, 238-246 (2011)
- [31] Moser, E., Seidl, A., Feichtinger, G.: History-dependence in production-pollution-trade-off models: a multi-stage approach. *Annals of Operations Research* 222 (1), 457-481 (2014)
- [32] Caulkins, J.P., Feichtinger, G., Grass, D., Hartl, R.F., Kort, P.M., Seidl, A.: When to make proprietary software open source. *Journal of Economic Dynamics and Control* 37 (6), 1182-1194 (2013b)

- [33] Caulkins, J.P., Feichtinger, G., Hartl, R.F., Kort, P.M., Novak, A.J., Seidl, A.: Long term implications of drug policy shifts: Anticipating and non-anticipating consumers. *Annual Reviews in Control* 37 (1), 105-115 (2013a)
- [34] Burbridge, J.B., Robb, A.L.: Pensions and retirement behavior. *Canadian Journal of Economics* 13, 421-437 (1980)
- [35] Kuhn, M., Wrzaczek, S., Prskawetz, A., Feichtinger, G.: Optimal choice of health and retirement in a life-cycle model. *Journal of Economic Theory* 158A, 186-212 (2015)
- [36] Gurtin, M.E., MacCamy, R.C.: Nonlinear age-dependent population dynamics. *Archive for Rational Mechanics and Analysis* 54, 281-300 (1974)
- [37] Gurtin, M.E., Murphy, L.F.: On the optimal harvesting of age-structured populations: some simple models. *Journal of Mathematical Biosciences* 55, 115-136 (1981a)
- [38] Gurtin, M.E., Murphy, L.F.: On the optimal harvesting of persistent age-structured populations. *Journal of Mathematical Biology* 13, 131-148 (1981b)
- [39] Brokate, M.: Pontryagin's principle for control problems in age-dependent population dynamics. *Journal of Mathematical Biology* 23, 75-101 (1985)
- [40] Feichtinger, G., Tragler, G., Veliov, V.M.: Optimality conditions for age-structured control systems. *Journal of Mathematical Analysis and Applications* 288, 47-68 (2003)
- [41] Skritek, B., Veliov, V.M.: On the infinite-horizon optimal control of age-structured systems. *Journal of Optimization Theory and Applications* 167 (1), 243-271 (2015)
- [42] Krastev, V.: Arrow-type sufficient conditions for optimality of age-structured control problems. *Central European Journal of Mathematics* 11, 1094-1111 (2013)
- [43] Feichtinger, G., Hartl, R.F., Kort, P.M., Veliov, V.M.: Anticipation effects of technological progress on capital accumulation: a vintage capital approach. *Journal of Economic Theory* 126 (1), 143-164 (2006)
- [44] Wrzaczek, S., Kort, P.M.: Anticipation in innovative investment under oligopolistic competition. *Automatica* 48, 2812-2823 (2012)
- [45] Boucekkine, R., del Rio, F., Licandro, O.: Endogenous vs exogenously driven fluctuations in vintage capital models. *Journal of Economic Theory* 88, 161-187 (1999)
- [46] Boucekkine, R., Germain, M., Licandro, O., Magnus, A.: Creative destruction, investment volatility and the average age of capital. *Journal of Economic Growth* 3, 361-384 (1998)

- [47] Boucekkine, R., Licandro, O., Puch, L., del Rio, F.: Vintage capital and the dynamics of the AK model. *Journal of Economic Theory* 120, 39-72 (2005)
- [48] Feichtinger, G., Prskawetz, A., Veliov, V.M.: Age-structured optimal control in population economics. *Theoretical Population Biology* 65, 373-387 (2004)
- [49] Feichtinger, G., Veliov, V.M.: On a distributed control problem arising in dynamic optimization of a fixed-size population. *SIAM Journal of Optimization* 18, 980-1003 (2007)
- [50] Wrzaczek, S., Kuhn, M., Prskawetz, A., Feichtinger, G.: The reproductive value in distributed optimal control models. *Theoretical Population Biology* 77, 164-170 (2010)
- [51] Kuhn, M., Wrzaczek, S., Oeppen J.: Recognizing progeny in the value of life. *Economics Letters* 107, 17-21 (2010)
- [52] Kuhn, M., Wrzaczek, S., Prskawetz, A., Feichtinger, G.: Externalities in a life cycle model with endogenous survival. *Journal of Mathematical Economics* 47:627-641 (2011)
- [53] Greenhalgh, D.: Some results on optimal control applied to epidemics. *Mathematical Biosciences* 88, 125-158 (1988)
- [54] Hethcote, H.W.: Optimal ages of vaccination for measles. *Mathematical Biosciences* 89, 29-52 (1988)
- [55] Müller, J.: Optimal vaccination patterns in age-structured populations. *SIAM Journal on Applied Mathematics* 59, 222-241 (1999)
- [56] Müller, J.: Optimal vaccination patterns in age-structured populations: endemic case. *Mathematical and Computer Modeling* 31, 149-260 (2000)
- [57] Grass, D., Caulkins, J.P., Feichtinger, G., Tragler, G., Behrens, D.: *Optimal Control of Nonlinear Processes: With Applications in Drugs, Corruption and Terror*. Springer, Berlin (2008)
- [58] Alley, R.B., Marotzke, J., Nordhaus, W.D., Overpeck, J.T., Peteet, D.M.: Abrupt Climate Change. *Science* 299, 2005-2010 (2003)
- [59] Weitzman, M.L.: Fat Tails and the Social Cost of Carbon. *American Economic Review: Papers & Proceedings* 104 (5), 544-546 (2014)
- [60] Barro, R.J.: Environmental Protection, Rare Disasters and Discount Rates. *Economica* 82, 1-23 (2015)
- [61] Martin, I.W.R., Pindyck, R.S.: Averting Catastrophes: The Strange Economics of Scylla and Charybdis. *American Economic Review* 105 (10), 2947-2985 (2015)
- [62] Barro, R.J., Ursua, J.F.: Rare Macroeconomic Disasters. *Annual Review of Economics* 4, 83-109 (2012)

Published Working Papers

- WP 06/2019:** Using Age-Structure for a Multi-Stage Optimal Control Model with Random Switching Time
- WP 05/2019:** Does One Size Fit All in the Euro Area? Some Counterfactual Evidence
- WP 04/2019:** Size and persistence matter: Wage and employment insurance at the micro level
- WP 03/2019:** Endogenously (Non-)Ricardian Beliefs
- WP 02/2019:** Optimal time allocation in active retirement
- WP 01/2019:** Do monetary unions dream of structural reforms?
- WP 02/2018:** Aggregate public-private remuneration patterns in South Africa
- WP 01/2018:** Health insurance, endogenous medical progress, and health expenditure growth
- WP 08/2017:** Medical Progress, Demand for Health Care, and Economic Performance
- WP 07/2017:** You can't always get what you want? A Monte Carlo analysis of the bias and the efficiency of dynamic panel data estimators
- WP 06/2017:** Robots and the skill premium: an automation-based explanation of wage inequalities
- WP 05/2017:** Boosting Taxes for Boasting about Houses: Status Concerns in the Housing Market
- WP 04/2017:** The Marriage Gap: Optimal Aging and Death in Partnerships
- WP 03/2017:** Redistributive effects of the US pension system among individuals with different life expectancy
- WP 02/2017:** The Impact of Climate Change on Health Expenditures
- WP 01/2017:** Optimal investment and location decisions of a firm in a flood risk area using Impulse Control Theory
- WP 11/2016:** Hyperbolic Discounting Can Be Good For Your Health
- WP 10/2016:** On the long-run growth effect of raising the retirement age
- WP 09/2016:** The importance of institutional and organizational characteristics for the use of fixed-term and agency work contracts in Russia
- WP 08/2016:** A Structural Decomposition Analysis of Global and National Energy Intensity Trends
- WP 07/2016:** Natural Disasters and Macroeconomic Performance
- WP 06/2016:** Education, lifetime labor supply, and longevity improvements
- WP 05/2016:** The Gender Gap in Mortality: How Much Is Explained by Behavior?
- WP 04/2016:** The implications of automation for economic growth and the labor share of income

More working papers can be found at <http://www.econ.tuwien.ac.at/wps/>

Please cite working papers from the ECON WPS like this example:

Freund, I., B. Mahlberg and A. Prskawetz. 2011. "A Matched Employer-Employee Panel Data Set for Austria: 2002-2005." *ECON WPS 01/2011*. Institute of Mathematical Methods in Economics, Vienna University of Technology.

**The Series “Vienna University of Technology Working Papers
in Economic Theory and Policy” is published by the**

Research Group Economics
Institute of Statistics and Mathematical Methods in Economics
Vienna University of Technology

Contact

Research Group Economics
Institute of Statistics and Mathematical Methods in Economics
Vienna University of Technology

Wiedner Hauptstraße 8-10
1040 Vienna
Austria

Editorial Board

Alexia Fürkranz-Prskawetz
Emanuel Gasteiger
Nawid Siassi
Hardy Hanappi

Phone: +43-1-58801-1053- 1
Fax: +43-1-58801-1053-99
E-mail: wps@econ.tuwien.ac.at