Lecture 13: Game Theory // Nash equilibrium

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Examples - Continued

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Cournot Competition

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- Benefits of firm j are:

$$\Pi^j(q^1, ...q^N) = \left(a - b\sum_{i=1}^{N} q^i\right) q^j - cq^j.$$

Cournot Competition

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- Thus

$$\begin{aligned}
\sum_{j=1}^{N} q^j &= \frac{N(a-c)}{b(N+1)} \\
p &= a - N\frac{a-c}{(N+1)} < a \\
\Pi^j &= \frac{(a-c)^2}{b(N+1)^2}
\end{aligned}$$

Cournot Competition

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- As $N \to \infty$ we get close to perfect competition
- $N = 1$ we get the monopoly case

Bertrand Competition

- Consider the alternative model in which firms set prices
- In the monopolist's problem, there was not distinction between a quantity-setting model and a price setting
- In oligopolistic models, this distinction is very important

Bertrand Competition

- Consider two firms with the same marginal constant marginal cost of production and demand is completely inelastic
- Each firm simultaneously chooses a price $p_i \in [0, +\infty)$
- If p_1, p_2 are the chosen prices, then the utility functions of firm i is given by:

$$\pi_i(p_i, p_{-i}) = \begin{cases} 0 & \text{if } p_i > p_{-i}, \\ (p_i - c)\frac{Q(p_i)}{2} & \text{if } p_i = p_{-i}, \\ (p_i - c)Q(p_i) & \text{if } p_i < p_{-i}. \end{cases}$$

Bertrand Competition

- Assume that the marginal revenue function is strictly decreasing ($MR'(p_i) < 0$):

$$
\begin{aligned}
R(p_i) &= p_i Q(p_i) && (1)\\
MR(p_i) &= Q(p_i) + p_i Q'(p_i) && (2)\\
&= Q(p_i)\left(1 + \varepsilon_{Q,p}(p_i)\right). && (3)
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- Let $p^m > c \geq 0$ be the monopoly price such that $MR(p^m) = c$.

- Then

$$MR(p_i) - c > 0 \text{ if } p_i < p^m, MR(p_i) - c < 0 \text{ if } p_i > p^m.$$

Bertrand Competition

- The best response function is:

$$BR_i(p_{-i}) = \begin{cases} p^m & \text{if } p_{-i} > p^m, \\ p_{-i} - \varepsilon & \text{if } c < p_{-i} \leq p^m, \\ [c, +\infty) & \text{if } c = p_{-i} \\ (c, +\infty) & \text{if } c > p_{-i}. \end{cases}$$

- Where ε is the smallest monetary unit

Bertrand Competition

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- $p_2^* = p^m$

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Bertrand Competition

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Bertrand Competition

Case 3: $p_1^* < c$

- $BR_2(p_1^*) \in [p_1^* + \varepsilon, \infty)$

Bertrand Competition

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Bertrand Competition

Case 4: $p_1^* = c$

- $BR_2(p_1^*) = (c, +\infty)$

Bertrand Competition

Case 4: $p_1^* = c$

- $BR_2(p_1^*) = (c, +\infty)$
- The unique pure strategy Nash equilibrium is $p_1^* = p_2^* = c$

Bertrand Competition

Thus in contrast to the Cournot duopoly model, in the Bertrand competition model, two firms get us back to perfect competition ($p = c$)

Bertrand Competition - different costs

- Suppose that the marginal cost of firm 1 is equal to c_1 and the marginal cost of firm 2 is equal to c_2 where $c_1 < c_2$.

- The best response for each firm:

$$BR_i(p_{-i}) = \begin{cases} p_m^i & \text{if } p_{-i} > p_m^i, \\ p_{-i} - \varepsilon & \text{if } c_i < p_{-i} \leq p_m^i, \\ [c_i, +\infty) & \text{if } p_{-i} = c_i \\ (p_{-i}, +\infty) & \text{if } p_{-i} < c_i. \end{cases}$$

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- No NE because of continuous prices

Bertrand Competition - discreet prices

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Bertrand Competition - discreet prices

- Suppose $c_1 = 0 < c_2 = 10$
- Firms can only set integer prices.
- Suppose that (p_1^*, p_2^*) is a pure strategy Nash equilibrium...

Bertrand Competition - discreet prices

Case 1: $p_1^* = 0$

- Best response of firm 2 is to choose some $p_2^* > p_1^*$

Bertrand Competition - discreet prices

Case 1: $p_1^* = 0$

- Best response of firm 2 is to choose some $p_2^* > p_1^*$
- p_1^* cannot be a best response to p_2^* since by setting $p_1 = p_2^*$ firm 1 would get strictly positive profits

Bertrand Competition - discreet prices

Case 2: $p_1^* \in \{1, 2, \ldots, 9\}$

- Best response of firm 2 is to set any price $p_2^* > p_1^*$

Bertrand Competition - discreet prices

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- Best response of firm 2 is to set any price $p_2^* > p_1^*$
- If $p_2^* > p_1^* + 1$, then this cannot be a Nash equilibrium since then firm 1 would have an incentive to raise the price

Bertrand Competition - discreet prices

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- Best response of firm 2 is to set any price $p_2^* > p_1^*$
- If $p_2^* > p_1^* + 1$, then this cannot be a Nash equilibrium since then firm 1 would have an incentive to raise the price
- The only equilibrium is $(p_1^*, p_1^* + 1)$

Bertrand Competition - discreet prices

Case 3: $p_1^* = 10$

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- It cannot be that $p_2^* = p_1^*$ since then firm 1 would rather deviate to a price of 9 and control the whole market:

$$\frac{1}{2}(10) = 5 < 9.$$

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$$\frac{1}{2}(10) = 5 < 9.$$
- We must have $p_2^* = p_1^* + 1$ since otherwise, firm 1 would have an incentive to raise the price higher

Bertrand Competition - discreet prices

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- It cannot be that $p_2^* = p_1^*$ since then firm 1 would rather deviate to a price of 9 and control the whole market:
$$\frac{1}{2}(10) = 5 < 9.$$
- We must have $p_2^* = p_1^* + 1$ since otherwise, firm 1 would have an incentive to raise the price higher
- $(p_1^*, p_2^*) = (10, 11)$ is a Nash equilibrium

Bertrand Competition - discreet prices

Case 4: $p_1^* = 11$

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- Firm 1 would not be best responding since by setting a price of $p_1 = 10$, it would get strictly positive profits

Bertrand Competition - discreet prices

Case 5: $p_1^* \geq 12$

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- Firm 2's best response is to set either $p_2^* = p_1^* - 1$ or $p_2^* = p_1^*$
- Firm 1 is not best responding since by lowering the price it can get the whole market.

Bertrand Competition - 3 firms

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- Best response of firm i is given by:

$$BR_1(p_2, p_3) = \begin{cases} p^m & \text{if } \min\{p_2, p_3\} > p^m, \\ \min\{p_2, p_3\} - \varepsilon & \text{if } c < \min\{p_2, p_3\} \leq p^m, \\ [c, +\infty) & \text{if } c = \min\{p_2, p_3\}, \\ (\min\{p_2, p_3\}, +\infty) & \text{if } c > \min\{p_2, p_3\}. \end{cases}$$

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- (c, c, c) is indeed a pure strategy Nash equilibrium as in the two firm case

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- There must be at least two firms that set price equal to marginal cost

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- Can there be a pure strategy Nash equilibrium in which just one firm sets price equal to c? No since that firm would want to raise his price a bit and get strictly better profits
- There must be at least two firms that set price equal to marginal cost
- Set of all pure strategy Nash equilibria are given by:

$$\{(c, c, c+\varepsilon) : \varepsilon \geq 0\} \cup \{(c, c+\varepsilon, c) : \varepsilon \geq 0\} \cup \{(c+\varepsilon, c, c) : \varepsilon \geq 0\}.$$

Hotelling

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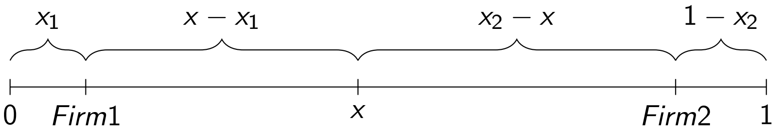
- If the firms $i = 1, 2$ respectively produce products of characteristic x_1 and x_2, then a consumer at θ would consume whichever product is closest to θ
- The game consists of the two players $i = 1, 2$, each of whom chooses a point $x_1, x_2 \in [0, 1]$ simultaneously.

Hotelling



Hotelling

Then the profits that accrue to firm 1 is given by the mass of consumers that are closest to firm 1:

$$u_1(x_1, x_2) = \begin{cases} \frac{x_1+x_2}{2} & \text{if } x_1 < x_2, \\ \frac{1}{2} & \text{if } x_1 = x_2, \\ 1 - \frac{x_1+x_2}{2} & \text{if } x_1 > x_2. \end{cases}$$

Similarly,

$$u_2(x_1, x_2) = \begin{cases} 1 - \frac{x_1+x_2}{2} & \text{if } x_1 < x_2, \\ \frac{1}{2} & \text{if } x_1 = x_2, \\ \frac{x_1+x_2}{2} & \text{if } x_1 > x_2. \end{cases}$$

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Compute the best response functions

- **Case 1:** Suppose first that $x_2 > 1/2$. Then setting x_1 against x_2 yields a payoff of

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  This utility function has a discontinuity at $x_1 = x_2$ and jumps down to $1/2$ at $x_1 = x_2$. There will be no best response for firm 1 (try to set as close to the left the other firm as possible)

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- **Case 2:** Suppose next that $x_2 < 1/2$. Again there will be no best response for firm 1 (try to set as close to the right the other firm as possible)

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  This utility function has a discontinuity at $x_1 = x_2$ and jumps down to $1/2$ at $x_1 = x_2$. There will be no best response for firm 1 (try to set as close to the left the other firm as possible)

- **Case 2:** Suppose next that $x_2 < 1/2$. Again there will be no best response for firm 1 (try to set as close to the right the other firm as possible)

- **Case 3:** Suppose next that $x_2 = 1/2$. Here there will be a best response for firm 1 at $1/2$

Hotelling

$$BR_1(x_2) = \begin{cases} \emptyset & \text{if } x_2 > 1/2 \\ 1/2 & \text{if } x_2 = 1/2 \\ \emptyset & \text{if } x_2 < 1/2. \end{cases}$$

Symmetrically, we have:

$$BR_2(x_1) = \begin{cases} \emptyset & \text{if } x_1 > 1/2 \\ 1/2 & \text{if } x_1 = 1/2 \\ \emptyset & \text{if } x_1 < 1/2. \end{cases}$$

The unique Nash equilibrium is for each firm to choose $(x_1, x_2) = (1/2, 1/2)$. Each firm essentially locates in the same place

Hotelling

- Hotelling can also be done in a discreet setting
- Hotelling can be applied to a variety of situations (e.g., voting)
- But this predicts the opposite of polarization
- With three candidates, predictions are quite different
- All candidates picking $\frac{1}{2}$ is no longer a Nash equilibrium
- What are the set of pure strategy equilibria here? (this is a difficult problem).