Lecture 16: Applications of Subgame Perfect Nash Equilibrium

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Ultimatum Game

Alternating offers

Stackelberg Competition

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1. Player 1 makes a proposal $(x, 1000 - x)$ of how to split 100 pesos among $(100, 900), \ldots, (800, 200), (900, 100)$

2. Player 2 accepts or rejects the proposal

3. If player 2 rejects both obtain 0. If 2 accepts, then the payoffs or the two players are determined by $(x, 1000 - x)$

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- In any SPNE, player 1 makes the proposal $(900, 100)$

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- When extreme offers like $(900, 100)$ are made, player 2 rejects in many cases
- Player 2 may care about inequality or positive utility associated with "punishment" aversion

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- Two players are deciding how to split a pie of size 1

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- The players would rather get an agreement today than tomorrow (i.e., discount factor)

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- ... and on and on for T periods

- Player 1 makes an offer θ_1
- Player 2 accepts or rejects the proposal
- If player 2 rejects, player 2 makes an offer θ_2
- If player 1 accepts or rejects the proposal
- If player 1 rejects, player 1 makes an offer θ_3
- ... and on and on for T periods
- If no offer is ever accepted, both payoffs equal zero

The discount factor is $\delta \leq 1$.
If Player 1 offer is accepted by Player 2 in round m,

$$\begin{aligned} \pi_1 &= \delta^m \theta_m, \\ \pi_2 &= \delta^m (1 - \theta_m). \end{aligned}$$

If Player 2 offer is accepted, reverse the subscripts

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- There is a unique SPNE: The player that makes the last offer gets the whole pie
- Last-mover advantage

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- In period $(T-1)$, Player 2 could offer Smith δ, keeping $(1-\delta)$ for himself
- Player 1 would accept (indifferent between accepting and rejecting) since the **whole pie** in the next period is worth δ

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- In period $(T-3)$, Player 2 would offer Player 1 $\delta[1-\delta(1-\delta)]$, keeping $(1-\delta[1-\delta(1-\delta)])$ for himself

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- Player 1 would accept...
- ...
- In equilibrium, the very first offer would be accepted, since it is chosen precisely so that the other player can do no better by waiting

Table 1 shows the progression of Player 1's shares when $\delta = 0.9$.

Table 1: Alternating Offers over Finite Time

Round	1's share	2's share	Total value	Who offers?
$T-3$	$\delta(1-\delta(1-\delta))$	$1-\delta(1-\delta(1-\delta))$	δ^{T-4}	2
$T-2$	$1-\delta(1-\delta)$	$\delta(1-\delta)$	δ^{T-3}	1
$T-1$	δ	$1-\delta$	δ^{T-2}	2
T	1	0	δ^{T-1}	1

- If $T = 3$ (i.e, 1 offers, 2 offers, 1 offers)

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- One offers $\delta(1-\delta)$, 2 accepts in period 1

- Player 1 always does a little better when he makes the offer than when Player 2 does

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- If we consider just the class of periods in which Player 1 makes the offer, Player 1's share falls

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- Firms have the cost functions $c_i(q_i)$.

Te timing of the game is given by:

1. First Firm 1 chooses $q_1 \geq 0$

2. Second Firm 2 observes the chosen q_1 and then chooses q_2

- The game tree in this game is then depicted by an infinite tree

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- A pure strategy for firm 1 is just a choice of $q_1 \geq 0$
- A strategy for firm 2 specifies what it does after every choice of q_1
- Firm 2's strategy is a function $q_2(q_1)$ which specifies exactly what firm 2 does if q_1 is the chosen strategy of player 1

The utility functions for firm i when firm 1 chooses q_1 and firm 2 chooses the strategy (or function) $q_2(\cdot)$ is given by:

$$\pi_1(q_1, q_2(\cdot)) = P(q_1 + q_2(q_1))q_1 - c_1(q_1)$$
$$\pi_2(q_1, q_2(\cdot)) = P(q_1 + q_2(q_1))q_2(q_1) - c_2(q_2(q_1))$$

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- Cconsider the following specific game with demand function given by:

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- Then the normal form simplifies:

$$u_1(q_1, q_2(\cdot)) = (A - q_1 - q_2(q_1))q_1,$$
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$$q_1^* = \alpha, q_2^*(q_1) = \begin{cases} A & \text{if } q_1 \neq \alpha, \\ \frac{A-\alpha}{2} & \text{if } q_1 = \alpha. \end{cases}$$

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- Let us check that indeed this constitutes a Nash equilibrium

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$$u_1(q_1, q_2^*(\cdot)) = \begin{cases} \left(A - \alpha - \left(\frac{A-\alpha}{2}\right)\right)\alpha > 0 & \text{if } q_1 = \alpha \\ -q_1^2 \leq 0 & \text{if } q_1 \neq \alpha. \end{cases}$$

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- In particular, in the Nash equilibrium corresponding to $\alpha = 0$, the equilibrium outcome is for firm 1 to choose a quantity of 0 and firm 2 setting a price of $A/2$
- This would be the same outcome if firm 2 were the monopolist in this market

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- If firm 1 were to hypothetically choose $q_1 > 0$, then firm 2 would obtain negative profits if it indeed follows through with $q_2^*(q_1)$.

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- To eliminate such counterintuitive equilibria, we focus instead on SPNE instead of NE
- Lets continue with the setting in which marginal costs are zero and the demand function is given by $A - q_1 - q_2$

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- So, player 2 solves:

$$\max_{q_2(\cdot)} (A - q_1 - q_2(q_1))q_2(q_1).$$

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- **Case 2:** $q_1 \leq A$
- In this case, the first order condition implies:

$$q_2^*(q_1) = \frac{A - q_1}{2}.$$

- Thus, in any SPNE, player 2 must play the following strategy:

$$q_2^*(q_1) = \begin{cases} \frac{A-q_1}{2} & \text{if } q_1 \leq A \\ 0 & \text{if } q_1 > A. \end{cases}$$

- Then player 1's utility function given that player 2 plays q_2^* is given by:

$$u_1(q_1, q_2^*(\cdot)) = q_1(A - q_1 - q_2^*(q_1)) = \begin{cases} q_1(A - q_1) & \text{if } q_1 > A, \\ q_1 \frac{A - q_1}{2} & \text{if } q_1 \leq A. \end{cases}$$

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- Firm 1 will never choose $q_1 > A$ since then it obtains negative profits
- Thus, firm 1 maximizes:

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- The **equilibrium outcome** is for firm 1 to choose $A/2$ and firm 2 to choose $A/4$

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- Lets solve for the set of SPNE (which is the same as NE) in the Cournot game with the same demand function and same costs

- In this case, (q_1^*, q_2^*) is a NE if and only if

$$q_1^* \in BR_1(q_2^*), q_2^* \in BR_2(q_1^*).$$

- For $q_1^* \in BR_1(q_2^*)$, we need q_1^* to solve the following maximization problem:

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- Similarly for $q_2^* \in BR_2(q_1^*)$,

$$q_2^* = \frac{A - q_1^*}{2}.$$

- As a result, solving these two equations, we get:

$$q_1^* = q_2^* = \frac{A}{3}.$$

In the Cournot game, note that firms' payoffs are:

$$\pi_1^c = \frac{A^2}{9}, \pi_2^c = \frac{A^2}{9}.$$

As we already saw, this was not Pareto efficient since each firm is getting a payoff that is strictly less than $1/2$ of the monopoly profits.

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- Thus, the firms' payoffs in the SPNE is:

$$\pi_1^s = \frac{1}{4}A \cdot \frac{A}{2} = \frac{A^2}{8}, \pi_2^s = \frac{1}{4}A \cdot \frac{A}{4} = \frac{A^2}{16}.$$

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- But by choosing something optimal, firm 1 will be able to do even better