

# Extensions and Variants

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Grad IO

## BLP Extensions: Demographics

- It is helpful to allow for interactions with consumer demographics (such as income).
- A few ways to do this:
  - You could just use cross sectional variation in  $s_{jt}$  and  $\bar{y}_t$  (mean or median income).
  - Better: Divide up your data into additional “markets” by demographics: do you observe  $s_{jkt}$  at this level? [May not be possible!]
  - Better: Draw  $y_{it}$  from a geographic specific income distribution. Draw  $\nu_i$  from a general distribution of unobserved heterogeneity.
- Ex: Nevo (2000) Cereal demand sampled individual level  $D_i$  from geographic specific CPS data
- Joint distribution of income, income-squared, age, child at home.

$$\beta_i = \bar{\beta} + \Pi D_i + \sigma \nu_i$$

## BLP Extensions: Panel Data

- with enough observations on the same product it is possible to include fixed effects

$$\delta_{jt}(\tilde{\theta}_2) = x_{jt}\beta - \alpha p_{jt} + \underbrace{\xi_{jt}}_{\xi_j + \xi_t + \Delta\xi_{jt}}$$

- What does  $\xi_j$  mean in this context?
- What would  $\xi_t$  mean in this context?
- $\Delta\xi_{jt}$  is now the structural error term, this changes our identification strategy a little.
- We need instruments that change **within product and across market**.

## Extensions: Micro Data (Petrin 2002), (microBLP 2004)

Suppose we had additional data on behavior of individuals (in addition to aggregate market).

- Examples:
  - For some customers have answer to “Which car would you have purchased if the car you bought was not available?”
  - Demographic data on purchasers of a single brand.
  - Full individual demographic and choice data.

## Extensions: Micro Data (Petrin 2002), (microBLP 2004)

- Previously we had moment conditions from orthogonality of structural error ( $\xi$ ) and  $(X, Z)$  in order to form our GMM objective.

$$E[\xi_{jt}|x_{jt}, z_{jt}] = 0 \rightarrow E[\xi'[Z \ X]] = 0$$

- We can incorporate additional information using “micro-moments” or additional moment conditions to match the micro data.
  - $Pr(i \text{ buys } j | y_i \in [0, \$20K]) = c_1$
  - $Cov(d_i, s_{ijt}) = c_2$
  - Construct an additional error term  $\zeta_1, \zeta_2$  and interact that with instruments to form additional moment conditions.
  - Econometrics get tricky when we have a different number of observations for  $E[\zeta'[XZ]] = 0$  and  $E[\xi'[XZ]] = 0$ .
  - May not be able to get covariance of moments taken over different sets of observations!

## Alternative: Vertical Model (Bresnahan 1987)

- Imagine everyone agreed on the quality of the products offered for sale.
- The only thing people disagree on is willingness to pay for quality

$$U_{ij} = \bar{u} + \delta_j - \alpha_i p_j$$

- How do we estimate?
  - Sort goods from  $p_1 < p_2 < p_3 \dots < p_J$ .  
It must be that  $\delta_1 < \delta_2 < \dots < \delta_J$ . Why?
  - Normalize o.g. to 0 so that  $0 > \delta_1 - \alpha_i p_1$  or  $\alpha_i > \delta_1/p_1$ .
  - $s_0 = F(\infty) - F(\frac{\delta_1}{p_1}) = 1 - F(\frac{\delta_1}{p_1})$  where  $F(\cdot)$  is CDF of  $\alpha_i$ .
  - In general choose  $j$  IFF:

$$\frac{\delta_{j+1} - \delta_j}{p_{j+1} - p_j} < \alpha_i < \frac{\delta_j - \delta_{j-1}}{p_j - p_{j-1}}$$
$$s_j = F\left(\frac{\delta_{j+1} - \delta_j}{p_{j+1} - p_j}\right) - F\left(\frac{\delta_j - \delta_{j-1}}{p_j - p_{j-1}}\right)$$

## Alternative: Vertical Model (Bresnahan 1987)

### Estimation

- Choose parameters  $\theta$  of  $F(\cdot)$  in order to best match  $s_j$ .
  - Can do MLE  $\arg \max_{\theta} \sum_j -\mathfrak{s}_j \log s_j(\theta)$ .
  - Can do least squares  $\sum_j (\mathfrak{s}_j - s_j(\theta))^2$ .
  - Can do IV/GMM if I have an instrument for price.  $\delta_j = x_j\beta + \xi_j$ .
  - Extremely easy when  $F \sim \exp(\lambda)$ .
- What about elasticities?
  - When I change the price of  $j$  it can only affect  $(s_{j-1}, s_j, s_{j+1})$ .
  - We have set all of the other cross-price elasticities to be zero.
  - If a luxury car and a truck have similar prices, this can create strange substitution patterns.

## Pure Characteristics Model: Berry Pakes (2001/2007)

$$u_{ij} = \delta_j + \sum_k \nu_{ik} x_{jk} + \xi_j + \underbrace{\sigma_i \epsilon_{ij}}_{\rightarrow 0}$$

- Can think of this like random coefficients model where we take the variance of  $\epsilon$  to zero.
- Can think of this a vertical model, with vertical tastes over several characteristics.
  - PCs: everyone prefers more Mhz, more RAM, and more storage but differ in WTP.
  - Possible that there is no PC specific  $\epsilon$ .
- Advantages
  - Logit error means there is always some substitution to all other goods.
  - Reality may be you only compete with a small number of competitors.
  - Allows for **crowding** in the product space.
- Disadvantage: no closed form for  $s_j$ , so estimation is extremely difficult.
- Minjae Song (Homotopy) and Che-Lin Su (MPCC) have made progress using two different approaches.



## Adding Supply

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- Economic theory gives us some additional powerful restrictions.
- We may want to impose  $MR = MC$ .
- Alternatively, we can ask – what is a good instrument for demand? something from another equation (ie: supply).

We can break up the parameter space into three parts:

- $\theta_1$ : linear exogenous demand parameters,
- $\theta_2$ : parameters including price and random coefficients (endogenous / nonlinear)
- $\theta_3$ : linear exogenous supply parameters.

# Supply Side

Consider the multi-product Bertrand FOCs:

$$\begin{aligned}\arg \max_{p \in \mathcal{J}_f} \pi_f(\mathbf{p}) &= \sum_{j \in \mathcal{J}_f} (p_j - c_j) \cdot s_j(\mathbf{p}) + \kappa_{fg} \sum_{k \in \mathcal{J}_g} (p_k - c_k) \cdot s_k(\mathbf{p}) \\ 0 &= s_j(\mathbf{p}) + \sum_{k \in \mathcal{J}_f} (p_k - c_k) \frac{\partial s_k}{\partial p_j}(\mathbf{p})\end{aligned}$$

It is helpful to define the **ownership matrix**  $\Omega_{(j,k)}(\mathbf{p}) = -\frac{\partial s_j}{\partial p_k}(\mathbf{p})$ :

$$A(\kappa)_{(j,k)} = \left\{ \begin{array}{ll} 1 & \text{for } (j,k) \in \mathcal{J}_f \text{ for any } f \\ 0 & \text{o.w} \end{array} \right\}$$

We can re-write the FOC in matrix form where  $\odot$  denotes Hadamard product (element-wise):

$$\begin{aligned}s(\mathbf{p}) &= (A \odot \Omega(\mathbf{p})) \cdot (\mathbf{p} - \mathbf{mc}), \\ \mathbf{mc} &= \mathbf{p} - \underbrace{(A \odot \Omega(\mathbf{p}))^{-1} s(\mathbf{p})}_{\eta(\mathbf{p}, \mathbf{s}, \theta_2)}.\end{aligned}$$

## Recovering Marginal Costs

Recover implied markups/ marginal costs, and assume a functional form for  $mc_{jt}(x_{jt}, w_{jt})$ .

$$\begin{aligned}\widehat{\mathbf{mc}}(\theta) &= \mathbf{p} - \Omega(\mathbf{p}, \theta)^{-1} q(\mathbf{p}, \theta) \\ f(mc_{jt}) &= [x_{jt}, w_{jt}] \gamma + \omega_{jt}\end{aligned}$$

Which we can solve for  $\omega_{jt}$ :

$$\omega_{jt} = f(\mathbf{p} - \Omega(\mathbf{p}, \theta)^{-1} q(\mathbf{p}, \theta)) - x_{jt} \gamma_1 - w_{jt} \gamma_2$$

- $f(\cdot)$  is usually  $\log(\cdot)$  or identity.
- I can use this to form additional moments:  $E[\omega'_{jt} Z^s_{jt}] = 0$ . <sup>1</sup>

# Simultaneous Supply and Demand

- (a) For each market  $t$ : solve  $\mathcal{S}_{jt} = s_{jt}(\delta_{\cdot,t}, \theta_2)$  for  $\widehat{\delta}_{\cdot,t}(\theta_2)$ .
- (b) For each market  $t$ : use  $\widehat{\delta}_{\cdot,t}(\theta_2)$  to construct  $\eta_{\cdot,t}(\mathbf{q}_t, \mathbf{p}_t, \widehat{\delta}_{\cdot,t}(\theta_2), \theta_2)$
- (c) For each market  $t$ : Recover  $\widehat{mc}_{jt}(\widehat{\delta}_{\cdot,t}(\theta_2), \theta_2) = p_{jt} - \eta_{jt}(\widehat{\delta}_{\cdot,t}(\theta_2), \theta_2)$
- (d) Stack up  $\widehat{\delta}_{\cdot,t}(\theta_2)$  and  $\widehat{mc}_{jt}(\widehat{\delta}_{\cdot,t}(\theta_2), \theta_2)$  and use linear IV-GMM to recover  $[\widehat{\theta}_1(\theta_2), \widehat{\theta}_3(\theta_2)]$  following the recipe in Appendix
- (e) Construct the residuals:

$$\begin{aligned}\widehat{\xi}_{jt}(\theta_2) &= \widehat{\delta}_{jt}(\theta_2) - x_{jt}\widehat{\beta}(\theta_2) + \alpha p_{jt} \\ \widehat{\omega}_{jt}(\theta_2) &= \widehat{mc}_{jt}(\theta_2) - [x_{jt} w_{jt}] \widehat{\gamma}(\theta_2)\end{aligned}$$

- (f) Construct sample moments

$$\begin{aligned}g_n^D(\theta_2) &= \frac{1}{N} \sum_{jt} Z_{jt}^{D'} \widehat{\xi}_{jt}(\theta_2) \\ g_n^S(\theta_2) &= \frac{1}{N} \sum_{jt} Z_{jt}^{S'} \widehat{\omega}_{jt}(\theta_2)\end{aligned}$$

- (g) Construct GMM objective  $Q_n(\theta_2) = \begin{bmatrix} g_n^d(\theta_2) \\ g_n^s(\theta_2) \end{bmatrix}' W \begin{bmatrix} g_n^d(\theta_2) \\ g_n^s(\theta_2) \end{bmatrix}$

Some different definitions:

$$\begin{aligned}y_{jt}^D &:= \widehat{\delta}_{jt}(\theta_2) + \alpha p_{jt} = (x_{jt} \ v_{jt})' \beta + \xi_t =: x_{jt}^{D'} \beta + \xi_{jt} \\y_{jt}^S &:= \widehat{m} c_{jt}(\theta_2) = (x_{jt} \ w_{jt})' \gamma + \omega_t =: x_{jt}^{S'} \gamma + \omega_{jt}\end{aligned}\tag{1}$$

Stacking the system across observations yields:<sup>1</sup>

$$\underbrace{\begin{bmatrix} y_D \\ y_S \end{bmatrix}}_{2N \times 1} = \underbrace{\begin{bmatrix} X_D & 0 \\ 0 & X_S \end{bmatrix}}_{2N \times (K_1 + K_3)} \underbrace{\begin{bmatrix} \beta \\ \gamma \end{bmatrix}}_{(K_1 + K_3) \times 1} + \underbrace{\begin{bmatrix} \xi \\ \omega \end{bmatrix}}_{2N \times 1}\tag{2}$$

## Instruments and Identification

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# Parametric Identification

- Once we have  $\delta_{jt}(\theta)$  identification of linear parameters is pretty straightforward

$$\delta_{jt}(\theta) = x_{jt}\beta - \alpha p_{jt} + \xi_j + \xi_t + \Delta\xi_{jt}$$

- This is either basic linear IV or panel linear IV.
- How are  $\sigma$  taste parameters identified?
  - Consider increasing the price of  $j$  and measuring substitution to other products  $k, k'$  etc.
  - If sales of  $k$  increase with  $p_j$  and  $(x_j^{(1)}, x_k^{(1)})$  are similar then we increase the  $\sigma$  that corresponds to  $x^{(1)}$ .
  - Price is the most obvious to vary, but sometimes this works for other characteristics (like distance).
  - Alternative: vary the set of products available to consumers by adding or removing an option.

- Recall the nested logit, where there are two separate endogeneity problems
  - **Price**: this is the familiar one!
  - **Nonlinear characteristics**  $\sigma$  this is the other one.
- We are doing nonlinear GMM: Start with  $E[\xi_{jt}|x_{jt}, z_{jt}] = 0$  use  $E[\xi'[ZX]] = 0$ .
  - In practice this means that for valid instruments  $(x, z)$  any function  $f(x, z)$  is also a valid instrument  $E[\xi_{jt}f(x_{jt}, z_{jt})] = 0$ .
  - We can use  $x, x^2, x^3, \dots$  or interactions  $x \cdot z, x^2 \cdot z^2, \dots$
  - What is a reasonable choice of  $f(\cdot)$ ?
  - Where does  $z$  come from?

## Exclusion Restrictions

$$\begin{aligned}\delta_{jt}(\mathcal{S}_t, \tilde{\theta}_2) &= [x_{jt}, v_{jt}]\beta - \alpha p_{jt} + \xi_{jt} \\ f(p_{jt} - \eta_{jt}(\theta_2, \mathbf{p}, \mathbf{s})) &= h(x_{jt}, w_{jt}; \theta_3) + \omega_{jt}\end{aligned}$$

The first place to look for exclusion restrictions/instruments:

- Something in another equation!
- $v_j$  shifts demand but not supply
- $w_j$  shifts supply but not demand
- If it doesn't shift either is it really relevant?

# Markup Shifters

The equilibrium markup is a function of **everything!**  $\eta_{jt}(\mathbf{p}, \mathbf{s}, \xi_t, \omega_t, x_t, w_t, v_t, \theta_2)$ :

- It is literally **endogenous** (depends on error terms)!
- But lots of potential instruments beyond **excluded**  $v_t$  or  $w_t$ .
- Also  $v_{-j}$  and  $w_{-j}$  and  $x_{-j}$ .
- Not  $p_{-j}$  or  $\xi_{-j}$ , etc.
- The idea is that these instruments shift the **marginal revenue curve**.
- What is a good choice of  $f(x_{-j})$ ? etc.

- Common choices are average characteristics of other products in the same market  $f(x_{-j,t})$ . **BLP instruments**
  - Same firm  $z_{1jt} = \bar{x}_{-j_f,t} = \frac{1}{|F_j|} \sum_{k \in F_j} x_{kt} - \frac{1}{|F_j|} x_{jt}$ .
  - Other firms  $z_{2jt} = \bar{x}_{\cdot,t} - \bar{x}_{-j_f,t} - \frac{1}{J} x_{jt}$ .
  - Plus regressors  $(1, x_{jt})$ .
  - Plus higher order interactions
- Technically linearly independent for large (finite)  $J$ , but becoming highly correlated.
  - Can still exploit variation in number of products per market or number of products per firm.
- Correlated moments  $\rightarrow$  “many instruments”.
  - May be inclined to “fix” correlation in instrument matrix directly.

## Armstrong (2016): Weak Instruments?

Consider the limit as  $J \rightarrow \infty$

$$\frac{s_{jt}(\mathbf{p}_t)}{\left| \frac{\partial s_{jt}(\mathbf{p}_t)}{\partial p_{jt}} \right|} = \frac{1}{\alpha} \frac{1}{1 - s_{jt}} \rightarrow \frac{1}{\alpha}$$

- Hard to use markup shifting instruments to instrument for a constant.
- How close to the constant do we get in practice?
- Average of  $x_{-j}$  seems like an especially poor choice. Why?
- Shows there may still be some power in: products per market, products per firm.
- Convergence to constant extends to mixed logits (see Gabaix and Laibson 2004).
- Suggests that you really need cost shifters.

## Differentiation Instruments: Gandhi Houde (2017)

- Also need instruments for the  $\Sigma$  or  $\sigma$  random coefficient parameters.
- Instead of average of other characteristics  $f(x) = \frac{1}{J-1} \sum_{k \neq j} x_k$ , can transform as distance to  $x_j$ .

$$d_{jt}^k = x_k - x_j$$

- And use this transformed to construct two kinds of IV (Squared distance, and count of local competitors)

$$\begin{aligned} DIV_1 &= \sum_{j \in F} d_{jt}^2, & \sum_{j \notin F} d_{jt}^2 \\ DIV_2 &= \sum_{j \in F} I[d_{jt} < c] & \sum_{j \notin F} I[d_{jt} < c] \end{aligned}$$

- They choose  $c$  to correspond to one standard deviation of  $x$  across markets.

- Since any  $f(x, z)$  satisfies our orthogonality condition, we can try to choose  $f(x, z)$  as a **basis** to approximate optimal instruments.
- This is challenging in practice – and in fact suffers from a curse of dimensionality.
- This is frequently given as a rationale behind higher order  $x$ 's.
- When the dimension of  $x$  is low – this may still be feasible. ( $K \leq 3$ ).



# Optimal Instruments

Chamberlain (1987) tells us the optimal instruments for this supply-demand system of  $G\Omega^{-1}$  where for a given observation  $n$ ,

$$G_n := \underbrace{\begin{bmatrix} \frac{\partial \xi}{\partial \beta} & \frac{\partial \omega}{\partial \beta} \\ \frac{\partial \xi}{\partial \alpha} & \frac{\partial \omega}{\partial \alpha} \\ \frac{\partial \xi}{\partial \sigma} & \frac{\partial \omega}{\partial \sigma} \\ \frac{\partial \xi}{\partial \gamma} & \frac{\partial \omega}{\partial \gamma} \end{bmatrix}}_{(K_1+K_2+K_3) \times 2} = \begin{bmatrix} -x & 0 \\ \xi_\alpha & \omega_\alpha \\ \xi_\sigma & \omega_\sigma \\ 0 & -x \\ 0 & -w \end{bmatrix}_n \quad \Omega := \underbrace{\begin{bmatrix} v_\xi^2 & v_{\xi\omega} \\ v_{\xi\omega} & v_\omega^2 \end{bmatrix}}_{2 \times 2}$$

## #4: Optimal Instruments

$$G_n \Omega^{-1} = \frac{1}{v_\xi^2 v_\omega^2 - (v_{\xi\omega})^2} \times \begin{bmatrix} -v_\omega^2 x & v_{\xi\omega} x \\ v_\omega^2 \xi_\alpha - v_{\xi\omega} \omega_\alpha & v_\xi^2 \omega_\alpha - v_{\xi\omega} \xi_\alpha \\ v_\omega^2 \xi_\sigma - v_{\xi\omega} \omega_\sigma & v_\xi^2 \omega_\sigma - v_{\xi\omega} \xi_\sigma \\ v_{\xi\omega} x & -v_\xi^2 x \\ v_{\xi\omega} w & -v_\xi^2 w \end{bmatrix}_n$$

Clearly rows 1 and 4 are co-linear.

## #4: Optimal Instruments

$$(G_n \Omega^{-1}) \circ \Theta = \frac{1}{v_\xi^2 v_\omega^2 - (v_{\xi\omega})^2} \times \begin{bmatrix} -v_\omega^2 x & 0 \\ v_\omega^2 \xi_\alpha - v_{\xi\omega} \omega_\alpha & v_\xi^2 \omega_\alpha - v_{\xi\omega} \xi_\alpha \\ v_\omega^2 \xi_\sigma - v_{\xi\omega} \omega_\sigma & v_\xi^2 \omega_\sigma - v_{\xi\omega} \xi_\sigma \\ 0 & -v_\xi^2 x \\ v_{\xi\omega} w & -v_\xi^2 w \end{bmatrix}_n$$

Now we can partition our instrument set by column into “demand” and “supply” instruments as

$$z_{nD} := (G_n \Omega^{-1} \circ \Theta)_{.1}$$

$$z_{nS} := (G_n \Omega^{-1} \circ \Theta)_{.2}$$

## Aside: What does Supply tell us about Demand?

$$\begin{aligned}\partial\alpha : v_{\omega}^2\xi_{\alpha} - v_{\xi\omega}\omega_{\alpha} & \quad v_{\xi}^2\omega_{\alpha} - v_{\xi\omega}\xi_{\alpha} \\ \partial\sigma : v_{\omega}^2\xi_{\sigma} - v_{\xi\omega}\omega_{\sigma} & \quad v_{\xi}^2\omega_{\sigma} - v_{\xi\omega}\xi_{\sigma}\end{aligned}$$

- Under optimal IV these are **overidentifying restrictions**
- Maybe cases where one part of these instruments is trivial.

# Optimal Instruments

How to construct optimal instruments in form of Chamberlain (1987)

$$E \left[ \frac{\partial \xi_{jt}}{\partial \theta} | X_t, w_{jt} \right] = \left[ \beta, E \left[ \frac{\partial \xi_{jt}}{\partial \alpha} | X_t, w_{jt} \right], E \left[ \frac{\partial \xi_{jt}}{\partial \sigma} | X_t, w_{jt} \right] \right]$$

Some challenges:

1.  $p_{jt}$  depends on  $X_t, w_t, \xi_t$  in a highly nonlinear way (no explicit solution!).
2.  $E[\frac{\partial \xi_{jt}}{\partial \sigma} | X_t, w_t] = E[[\frac{\partial \mathbf{s}_t}{\partial \delta_t}]^{-1} [\frac{\partial \mathbf{s}_t}{\partial \sigma}] | X_t, w_t]$  (not conditioned on endogenous  $p$ !)

“Feasible” Recipe:

1. Fix  $\hat{\theta} = (\hat{\alpha}, \hat{\beta}, \hat{\sigma})$  and draw  $\xi_t$  from empirical density
2. Solve fixed point equation for  $p_{\hat{jt}}$
3. Compute necessary Jacobian
4. Average over all values of  $\xi_t$ . (Lazy approach: use only  $\xi = 0$ ).

## Simplified Version: Reynaert Verboven (2014)

- Optimal instruments are easier to work out if  $p = mc$ .

$$c = p + \underbrace{\Delta^{-1}s}_{\rightarrow 0} = X\gamma_1 + W\gamma_2 + \omega$$

- Linear cost function means linear reduced-form price function.

$$\begin{aligned} E\left[\frac{\partial \xi_{jt}}{\partial \alpha} | z_t\right] &= E[p_{jt} | z_t] = x_{jt}\gamma_1 + w_{jt}\gamma_2 \\ E\left[\frac{\partial \omega_{jt}}{\partial \alpha} | z_t\right] &= 0, \quad E\left[\frac{\partial \omega_{jt}}{\partial \sigma} | z_t\right] = 0 \\ E\left[\frac{\partial \xi_{jt}}{\partial \sigma} | z_t\right] &= E\left[\frac{\partial \delta_{jt}}{\partial \sigma} | z_t\right] \end{aligned}$$

- If we are worried about endogenous oligopoly markups is this a reasonable idea?
- Turns out that the important piece tends to be **shape** of jacobian for  $\sigma_x$ .

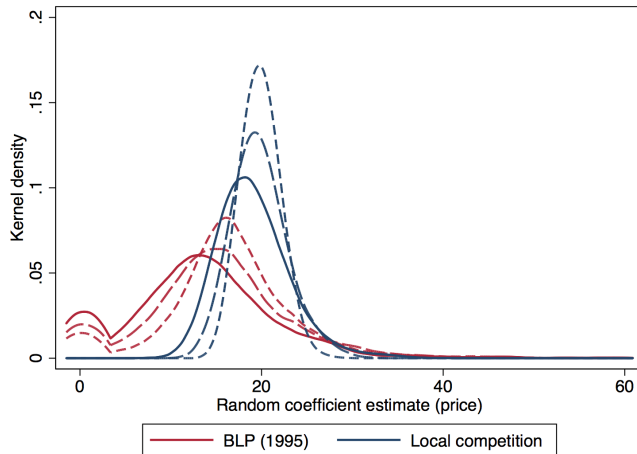
Table 2: Bias and Efficiency with Imperfect Competition

Single Equation GMM										
		$g_{jt}^1$			$g_{jt}^2$			$g_{jt}^3$		
	True	Bias	St Err	RMSE	Bias	St Err	RMSE	Bias	St Err	RMSE
$\beta^0$	2	-0.127	0.899	0.907	-0.155	0.799	0.814	-0.070	0.514	0.519
$\beta^1$	2	-0.068	0.899	0.901	0.089	0.766	0.770	-0.001	0.398	0.398
$\alpha$	-2	0.006	0.052	0.052	0.010	0.049	0.050	0.010	0.043	0.044
$\sigma^1$	1	-0.162	0.634	0.654	-0.147	0.537	0.556	-0.016	0.229	0.229
Joint Equation GMM										
		$g_{jt}^1$			$g_{jt}^2$			$g_{jt}^3$		
	True	Bias	St Err	RMSE	Bias	St Err	RMSE	Bias	St Err	RMSE
$\beta^0$	2	-0.095	0.714	0.720	-0.103	0.677	0.685	0.005	0.459	0.459
$\beta^1$	2	0.089	0.669	0.675	0.098	0.621	0.628	-0.009	0.312	0.312
$\alpha$	-2	0.001	0.047	0.047	0.002	0.046	0.046	-0.001	0.043	0.043
$\sigma^1$	1	-0.116	0.462	0.476	-0.110	0.418	0.432	0.003	0.133	0.133

Bias, standard errors (St Err) and root mean squared errors (RMSE) are computed from 1000 Monte Carlo replications. Estimates are based on the MPEC algorithm and Sparse Grid integration. The instruments  $g_{jt}^1$ ,  $g_{jt}^2$ , and  $g_{jt}^3$  are defined in section 2.4 and 2.5.

# Differentiation Instruments: Gandhi Houde (2016)

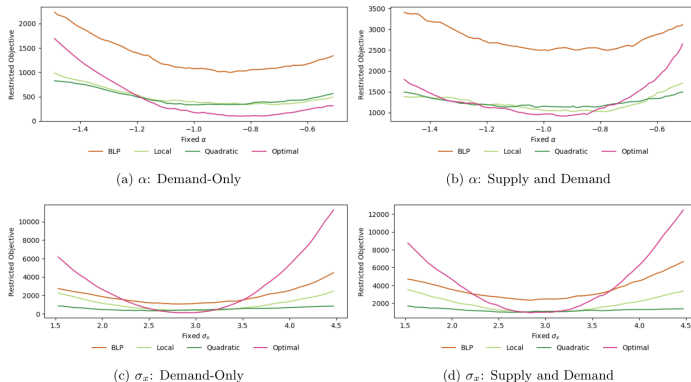
Figure 4: Distribution of parameter estimates in small and large samples





## IV Comparison: Conlon and Gortmaker (2019)

Figure 2: Profiled GMM Objective with Alternative IV (“Simple” simulation)



Each plot profiles the GMM objective  $Q(\theta)$  with respect to a single parameter for our “Simple” simulation scenario and a single simulation. We fix either  $\sigma_x$  or  $\alpha$  and re-optimize over other parameters and plot the restricted objective in each subplot. The top row profiles the objective over the price parameter  $\alpha$ , while the bottom row profiles over the random coefficient  $\sigma_x$ . The left column uses moments from demand alone, while the right column uses both supply and demand moments.

# BLP Alternatives

- BLP give us both a statistical **estimator** and an **algorithm** to obtain estimates.
- Plenty of other algorithms exist
  - We could solve for  $\delta$  using the contraction mapping, using `fsolve` / Newton's Method / Guess and Check (not a good idea!).
  - We could try and consider a non-nested estimator for the BLP problem instead of solving for  $\delta(\theta), \xi(\theta)$  we could let  $\delta, \xi, \alpha, \beta$  be free parameters.
- We could think about different statistical estimators such as  $K$ -step GMM, Continuously Updating GMM, etc.

$$\begin{aligned}
 \arg \min_{\theta_2} \quad & \psi' \Omega^{-1} \psi \quad \text{s.t.} \\
 \psi \quad &= \quad \xi(\theta_2)' Z \\
 \xi_{jt}(\theta) \quad &= \quad \delta_{jt}(\theta_2) - x_{jt} \beta - \alpha p_{jt} \\
 \log(S_{jt}) \quad &= \quad \log(s_{jt}(\delta, \theta_2))
 \end{aligned} \tag{3}$$

$$\begin{aligned}
 \arg \min_{\theta_2, \alpha, \beta, \xi, \psi} \quad & \psi' \Omega^{-1} \psi \quad \text{s.t.} \\
 \psi \quad &= \quad \xi' Z \\
 \xi_{jt} \quad &= \quad \delta_{jt} - x_{jt} \beta - \alpha p_{jt} \\
 \log(S_{jt}) \quad &= \quad \log(s_{jt}(\theta_2, \delta))
 \end{aligned} \tag{4}$$

# Comparing Approaches

- The original BLP paper and the DFS paper define different **algorithms** to produce the same statistical **estimator**.
  - The BLP algorithm is a **nested fixed point** (NFP) algorithm.
  - The DFS algorithm is a **mathematical program with equilibrium constraints** (MPEC).
  - The unknown parameters satisfy the same set of first-order conditions. (Not only asymptotically, but in finite sample).
  - $\hat{\theta}_{NFP} \approx \hat{\theta}_{MPEC}$  but for numerical differences in the optimization routine.
- Our choice of algorithm should mostly be about computational convenience.

# BLP: NFP Advantages/Disadvantages

- Advantages
  - Concentrate out all of the linear in utility parameters  $(\xi, \delta, \beta)$  so that we only search over  $\Sigma$ . When  $\dim(\Sigma) = K$  is small (few dimensions of unobserved heterogeneity) this is a big advantage. For  $K \leq 3$  this is my preferred approach.
  - When  $T$  (number of markets/periods) is large then you can exploit solving in parallel for  $\delta$  market by market.
- Disadvantages
  - Small numerical errors in contraction can be amplified in the outer loop,  $\rightarrow$  tolerance needs to be very tight.
  - Errors in numerical integration can also be amplified in the outer loop  $\rightarrow$  must use a large number of draws/nodes.
  - Hardest part is working out the Jacobian via IFT.

$$D\delta_{\cdot t} = \begin{pmatrix} \frac{\partial \delta_{1t}}{\partial \theta_{21}} & \dots & \frac{\partial \delta_{1t}}{\partial \theta_{2L}} \\ \vdots & \ddots & \vdots \\ \frac{\partial \delta_{Jt}}{\partial \theta_{21}} & \dots & \frac{\partial \delta_{Jt}}{\partial \theta_{2L}} \end{pmatrix} = - \begin{pmatrix} \frac{\partial s_{1t}}{\partial \delta_{1t}} & \dots & \frac{\partial s_{1t}}{\partial \delta_{Jt}} \\ \vdots & \ddots & \vdots \\ \frac{\partial s_{Jt}}{\partial \delta_{1t}} & \dots & \frac{\partial s_{Jt}}{\partial \delta_{Jt}} \end{pmatrix}^{-1} \begin{pmatrix} \frac{\partial s_{1t}}{\partial \theta_{21}} & \dots & \frac{\partial s_{1t}}{\partial \theta_{2L}} \\ \vdots & \ddots & \vdots \\ \frac{\partial s_{Jt}}{\partial \theta_{21}} & \dots & \frac{\partial s_{Jt}}{\partial \theta_{2L}} \end{pmatrix},$$

# BLP: MPEC Advantages/Disadvantages

- Advantages
  - Problem scales better in  $\dim(\Sigma)$ .
  - Because all constraints hold at the optimum only: less impact of numerical error in tolerance or integration.
  - Derivatives are less complicated than  $\frac{\partial \delta}{\partial \theta}$  (no IFT).
- Disadvantages
  - We are no longer concentrating out parameters, so there are a lot more of them! Storing the (Hessian) matrix of second derivatives can be difficult on memory.
  - We have to find the derivatives of the shares with respect to all of the parameters  $\beta, \xi, \theta$ . (The other derivatives are pretty easy).
  - Parallelizing the derivatives is trickier than NFP case.