

# **ECON8853 - Industrial Organization I**

*Lecture Notes from Julie H. Mortimer's lectures*

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# Chapter 1

## Overview of Demand Systems and Vertical Model

### 1.1 Introduction

Demand system estimation is at the core of the Industrial Organization field of economics. In fact, it is central to many economic applications such as the study of comparative statics, welfare impacts, advertising, etc. Since there are many types of markets where estimating demand is useful, there are also many approaches to estimate demand. The goal of this chapter is to present the standard and most common approaches, work out the intuition to apply these methods and discuss their advantages and disadvantages.

#### 1.1.1 Intuition

Before diving in the theory, let's get some intuition. A demand system is the relationship between prices and goods purchased on the consumer side. Thus, IO researchers typically want to estimate the effect of products characteristics, most commonly price, on consumers' propensity to buy the products. To do this, the IO researcher needs to observe a market and its interactions. A unit of observation is therefore a market interaction such as the purchase of a good. In

this unit of observation, we would ideally observe what good was purchased, its defining characteristics, its price, the state of available competing products, etc. This makes the data requirements pretty big, which is why acquiring a good enough dataset is complicated and often expensive.

### **1.1.2 An early example: Bresnahan (1987)**

Demand system estimation is not only used for the sake of demand analysis, it can be a very useful tool to study broader industry topics. The use of demand models to talk about an industry as a whole is the main contribution of the NEIO movement (New Empirical IO). Bresnahan (1987) is one of the first empirical assessment of competition using demand estimation. The paper studies the presence of collusion in the automobile industry by looking at a dramatic price decrease event that happened in 1955.

The intuition of this paper is quite simple: assuming marginal costs stayed relatively constant during that period, Bresnahan estimates the variation in demand elasticities and compares it to a change in competition model. Using data on 85 models over 3 years, he finds that a change from a collusive to a more competitive equilibrium is consistent with the estimated change in elasticities.

### **1.1.3 Approaches to demand estimation**

We consider different approaches to demand estimation based on three main divides:

1. Single product vs. multi-products: whether the system to estimate allows for differentiated products or a unique product.
2. Representative agent vs. heterogeneous agents: whether the system allows for consumers to have different tastes and behavior or not.
3. Product space vs. characteristic space: whether the system considers products as whole entities or as combinations of characteristics.

## 1.2 Single product demand

### 1.2.1 Representative agent

A demand system is generally thought to be a (more or less) general approximation of a true underlying demand curve, for example:

$$\ln(q) = \alpha p + X\beta + \varepsilon$$

where the  $\varepsilon$  captures any variation that is unobserved by the econometrician. Using that equation, the objective of the econometrician is to recover the underlying parameters  $(\alpha, \beta)$  in order to understand the effects of prices and characteristics on demand. Note that this specification assumes a representative consumer choosing a (total) quantity  $q$  for a given price  $p$ . On the other side of the market, the firms that provide the good might also choose their prices  $p$  and characteristics  $x$  as a function of the expected demand, which is correlated with  $q$ . If this is the case, we say that we have endogeneity (from simultaneous equations, as we've seen in econometrics). Since the coverage of IV estimation in that case is more of an econometrics topic, we will assume knowledge of this in the rest of the chapter.

### 1.2.2 Heterogeneous agents

While the previous model is very simple, a straightforward extension would be to allow for heterogeneous agents on the market. To do that, we need to extend the previous model in two ways: (1) use a micro-founded model for individual demand that aggregates nicely and (2) estimate aggregated demand as:

$$\ln(q) = \int \gamma_i g(\gamma) d\gamma + \int \alpha_i p f(\alpha) d\alpha + \int \beta_i x h(\beta) d\beta + \epsilon$$

where  $\alpha, \beta$  and  $\gamma$  follow known distributions with unknown parameters to be estimated. This extension gives us some flexibility in terms of the potential interpretations. In a simple case where there are two types of agents: women and men for example, we will be able to estimate different tastes for different characteristics.

## 1.3 Multi-product demand

When we enter demand systems with multiple products, we need a way to differentiate those products. There are two approaches to do this: the product space approach, where a product is a nonseparable single entity; and the characteristic space approach, where a product is a combination of various characteristics.

### 1.3.1 Which approach to chose?

#### **Disadvantages of the product space approach**

In the product space approach, all competing products are estimated as fixed effects, meaning that, for a demand system with  $J$  products, each demand equation will have  $J$  parameters to estimate (at least). As the number of products increase, the number of parameters to estimate will become huge ( $J^2$  in the simplest model). This issue is called the “too many parameters” problem. Note that some alternatives with groups of products will reduce this issue, while not solving it completely. A second issue with this approach is the introduction of a new good in the market, since it is not possible to estimate fixed effects when products are not yet available.

#### **Disadvantages of the characteristic space approach**

In the characteristic space approach, the data requirements are way higher than in the product space approach. This creates two main issues: first, obviously it will be hard to get all the data about all characteristics for all products; second, inevitably some characteristics will not be observed and might create endogeneity if they have an important role in demand. Moreover, we will get the same issue as in the product space approach when new dimensions are introduced (not new products, since we would be able to estimate consumers’ preferences using other products).

### 1.3.2 Product Space approach

This course explores product space approaches only briefly since most of modern IO revolves around the characteristic space approach.

As we've seen, the product space approach considers each product as an entity on its own, meaning that all observed and unobserved features of the product enter the "utility" derived from the product. Because different consumers can derive different utilities from the same product, we might be interested in using heterogeneous agents models. In fact, in this approach, the basic breakdown between models is whether they include a representative agent or heterogeneous agents. The heterogeneous agents models use more of the available information (better estimates) but also provide a framework for distributional policy analysis (estimating the distribution of responses). While these models have been around for a long time, they still face big issues such as treatment of zeroes (when some consumers have no access to a particular good) or aggregation issues (computational). This is why much of the work that has been done in product space revolves around representative agent models, starting with the AIDS model by Deaton and Muellbauer (1980).

In a representative agent model, the general demand model is defined as:

$$\ln q_j = \alpha p_j + \beta p_{-j} + \gamma x_j + \epsilon_j$$

where  $p_j$  represents the own-price,  $p_{-j}$  is the vector of all competing products' prices and  $x_j$  is a vector of all other observed characteristics.

As we know, prices in this model are endogenous (simultaneity issue) but here we have more than one endogenous price (we have as many as products), thus estimating this model will require a very demanding IV strategy. Moreover, we can see that each product's demand function has at least  $J$  parameters, so that the number of parameters to be estimated will increase quadratically compared to the number of products: we will typically need to reduce the dimensionality of the problem to be able to estimate the demand model.



## Reducing the dimensionality

There are three popular approaches to reduce the dimensionality of the product space problem. The first two approaches are useful only for a particular set of questions, such as situations when variety is very important (e.g. in international trade they use them all the time), while the last one is the most often used in IO.

The first approach is to use a Constant Elasticity of Substitution model, such that utility is defined as:

$$u(q) = \left( \sum_k q_k^\rho \right)^{1-\rho} \Rightarrow q_j(p) = \frac{p_j^{-1/(1-\rho)}}{\sum_k p_k^{-\rho/(1-\rho)}} \cdot M$$

This approach is very efficient at reducing dimensionality since we now have only one parameter to estimate:  $\rho$ . However, it comes with the property that all goods have the same own-price elasticity and the same cross-price elasticities. While this definitely seems implausible, this approach is used in macro models and in trade.

The second approach is to use a logit demand model (not the same logit as in the characteristic approach). In this model, we have that:

$$u(q) = \sum_k (\delta_k - \ln(q_k)) q_k$$

The problem with this approach is the IIA property, which implies that elasticities depend on market shares rather than “closeness” between products.

Finally, the third empirical approach is to use a model of multi-level budgeting, as in a “utility tree”. This approach’s intuition is to divide the set of products into small groups and sub-groups, while allowing flexible substitution within groups. To use this approach, we need to assume two properties:

- Separability: this property ensures that preferences for products coming from one group are independent of consumption of products from other groups. Formally, this implies that the utility function takes the following form:

$$u(q) = f(u_1(q^1), \dots, u_n(q^n))$$

where there are  $n$  groups.

- Multi-stage budgeting: this property ensures that consumers can allocate expenditures in stages, considering only the current level of grouping and not what is inside the group.

It follows that this approach has three steps:

1. Grouping the products together in a (defensible) way.
2. Allocate expenditures to each group.
3. Allocate expenditures dynamics between groups.

### **Almost Ideal Demand System (AIDS)**

One of the most popular model of the multi-level budgeting approach is the Almost Ideal Demand System (AIDS) model, designed by Deaton and Muellbauer.

Within a group  $g$ , demand for a product  $i$  is defined as:

$$w_i = \alpha_i + \beta_i \ln(y_g/P_g) + \sum_{j \in g} \gamma_{ij} \ln p_j + \epsilon_i$$

where  $w_i$  is total expenditure on product  $i$ ,  $y_g/P_g$  is the real expenditure on group  $g$  and  $p_j$  is the price of other products in group  $g$ . As such, we can see that demand is not affected by products in other groups, except through the effect on the group  $g$ 's expenditure. Note that  $y_g/P_g$  depends on the price index of group  $g$ , which can be computed in multiple ways. The two most important ways to compute it are the simple logarithmic index:

$$P_g = \sum_{j \in g} w_j \ln p_j$$

which is a weighted average of log prices of products inside group  $g$  (weights are given by the expenditure level of each product). The second way is the exact price index of Deaton and Muellbauer (based on Shepard's lemma):

$$P_g = \alpha_0 + \sum_{j \in g} \alpha_j p_j + (1/2) \sum_{j \in g} \sum_{k \neq j \in g} \gamma_{jk} \ln p_j \ln p_k$$

which is more complex to estimate (more parameters).

Then, if there is a middle level between groups, demand can be estimated with AIDS again (using price indices instead of product prices) or by a simpler log-log specification. At this level of decision-making, both approaches are the same (in the sense that they do not follow a theoretical model). A log-log specification would look like:

$$\ln q_g = \alpha_g + \beta_g \ln y + \sum_h \delta_{g,h} \ln P_h + \epsilon_g$$

Finally, the top-level is a single log-log equation, with the addition of a set of demand shifters:

$$\ln q = \alpha + \beta \ln y + \delta \ln P + Z\gamma + \epsilon$$

### Issues with AIDS

All in all, AIDS works very well when products are actually grouped in certain categories. This is the reason why it is widely used in the trade and macro-consumption literatures. It can be used in IO settings where groups could be single products but it requires instrumenting for every good!

Think of the case where there are  $J$  goods, then you need to estimate  $J^2$  elasticities or at least  $J \times (J + 1)/2$  if you are assuming that cross-price elasticities are symmetric. Usually, IO economists try to escape the problem by actually grouping the goods, however all the results will be dependent on your initial choice of grouping. Researchers have to think very deeply in the mechanism they use for grouping. Grouping subject to particular characteristics lead you closer to characteristic space models, but even then, how do you group when the characteristics are continuous etc.

Finally, let's look at one of the main challenges with the product space approach. Suppose a new good is introduced in a market, how can you use the previous demand estimated which did not account for the new product? This creates two issues:

1. Equilibrium effects: the introduction of a new good typically has significant effects on the pricing of the previously existing goods.
2. Extrapolation: using the previously estimated demand implies projecting demand where it is not defined.

### Examples: Hausman, Leonard and Zona (1994)

The goal of the paper is to estimate demand for beer in the US in order to perform a merger analysis and test assumptions about the firms' conduct.

The market is divided hierarchically in three levels:

1. The top-level is beer against other goods. This is estimated using a log-log expenditure function:

$$\ln e_t = \beta_0 + \beta_1 \ln y_t + \beta_2 \ln P_{bt} + Z_t \delta + \varepsilon_3$$

where  $e_t$  is total expenditures,  $y_t$  is income and  $P_{bt}$  is the beer price index.

2. Within the beer group, the middle-level are the segments: premium, popular and light. Again, a log-log functional form is assumed so that for a given segment  $m$ , the demand for the segment is:

$$\ln q_m = \beta_m \ln e_t + \sum_{m'} \sigma_{m'} \ln \pi_{m'} + \alpha_{m'} + \varepsilon_2$$

3. Within each segment, the bottom-level contains five brands. This level is assumed to follow an AIDS:

$$w_k = a_k + \sum_j a_{jk} \ln p_j + \beta_k \ln(x/P) + \varepsilon_1$$

In the bottom-level, you have to instrument the price since it is correlated with unobserved product quality (taste, etc.) and unobserved demand shocks (special events like the World Cup, etc.). Then you must find brand-level instruments: this is where the infamous Hausman instruments come in. Hausman instruments use prices in one city to instrument for prices in other cities. These instruments are typically strong, however, their relevance is very questionable. In particular, think about nation-wide advertising which was the main criticism of these instruments. They would clearly affect both cities' prices in the same way creating correlation. Most of the time you can observe these patterns but be wary of unobserved shocks that could affect the complete market. Optimally, the best instrument would be observed input costs for the brand, tax rates, etc.

### 1.3.3 Characteristic Space Approach

The characteristic space approach follows a different philosophy than the product space:

- Products are considered as a vector of characteristics
- Consumers' preferences (and thus their utility functions) are defined over these characteristics.
- Consumers are assumed to choose the characteristic vector (the product) that maximize their utility.
  - One consumer makes one choice to buy a single product. Allowing for buying more than one product is computationally costly and is an open area for research.
- Demand is aggregated by simply summing over consumers' choices.

#### Formal base model

Assume the following context:

- A consumer  $i$  is offered  $J$  alternatives. Consumer  $i$  is identified by his characteristics,  $v_i$ , similarly to the product being defined by its characteristics  $x_j$  and its price  $p_j$ .
- He must choose one option only  $j \in J$ , which he will do with probability  $P_{ij}$
- Utility of an individual  $i$  for a good  $j$  is given by:

$$U_{i,j} \equiv U(x_j, p_j, v_i, \theta) \text{ for all } j = 0, 1, \dots, J$$

where good  $j = 0$  is referred to as the outside good.

The variable (or most probably the vector)  $x_j$  contains non-price characteristics about good  $j$ , for example the size of the engine, the AC system, the dashboard software, etc.; while  $v_i$  is the vector of consumer characteristics such as income, age, etc. Finally,  $\theta$  is the vector of parameters of the utility which is to be estimated. Note that in order to estimate the model correctly, you need to be sure that all consumers (or groups of consumers) in the sample have the same access to all  $J$  goods, or in other words, they face the same choice set.

Consumer  $i$  will choose good  $j$  if and only if  $U_{i,j} > U_{i,k}$  for any other good  $k$ . This means that the probability of consumer  $i$  buying good  $j$  is given by:

$$\Pr [U_{ij} > U_{ik} \text{ for all } k \neq j]$$

Now assuming that utility is given by an observable component  $V_{ij}$  and an unobservable component  $\varepsilon_{ij}$ , we can rewrite the probability of buying the good as:

$$\begin{aligned} P_{ij} &= \Pr [U_{ij} > U_{ik} \text{ for all } k \neq j] \\ &= \Pr [V_{ij} + \varepsilon_{ij} > V_{ik} + \varepsilon_{ik} \text{ for all } k \neq j] \\ &= \Pr [\varepsilon_{ij} - \varepsilon_{ik} > V_{ik} - V_{ij} \text{ for all } k \neq j] \end{aligned}$$

Finally, define  $f(\varepsilon_i)$  as the  $J$ -dimensional probability density function for consumer  $i$ . Then the probability  $P_{ij}$  can be written as:

$$P_{ij} = \int \mathbb{I}\{\varepsilon_{ij} - \varepsilon_{ik} > V_{ik} - V_{ij}\} f(\varepsilon_i) d\varepsilon_i$$

which is (as  $\varepsilon_i$ ) a  $J$  dimensional integral over  $f(\varepsilon_i)$ .

We will see later on that some choices could make our life easier in estimating this integral (hard to do it analytically), mainly by parameterizing the error term:

- **Multivariate normal:**  $\varepsilon_i \sim N(0, \Omega)$   $\rightarrow$  multinomial probit model.
- **Type 1 Extreme-value:**  $f(\varepsilon_i) = e^{-\varepsilon_{ij}} e^{-e^{-\varepsilon_{ij}}}$   $\rightarrow$  multinomial logit model.
- other variants...

We could also turn to thinking about absolute demand for good  $j$  instead of its probability, which is given by the size of the set  $S_j(\theta)$  defined as:

$$S_j(\theta) \equiv \{i : U_{i,j} > U_{i,k} \text{ for all } k\}$$

Now suppose consumers are distributed following a pdf  $f(v|\theta)$ , we could recover the market share of good  $j$  as:

$$s_j(\mathbf{x}, \mathbf{p}|\theta) = \int_{i \in S_j(\theta)} f(v) dv$$

Given a total market size of  $M$ , total demand for good  $j$  is:  $M \cdot s_j(\mathbf{x}, \mathbf{p}|\theta)$

As we've seen the complete model of characteristic space relies on utility functions and error terms distributions. This is why, unsurprisingly, the functional forms of utility and errors are exactly what will differentiate the models within the characteristic space approach.

There are 5 main models of characteristic space.

### **Pure horizontal model**

Analog to the Hotelling model (in its simplest form), there are  $n$  ice cream sellers along a beach where consumers are distributed. A consumer  $i$  has utility:

$$U_{ij} = \bar{u} - p_j + \theta(\delta_j - v_i)^2$$

where the term  $(\delta_j - v_i)^2$  captures some kind of quadratic transportation cost in the distance from  $i$ 's preferences ( $v_i$ ) to the characteristics of product  $j$  ( $\delta_j$ ). In the simple Hotelling model,  $\delta_j$  and  $v_i$  are location parameters (where ice cream seller  $j$  and consumer  $i$  are on the beach).

### **Pure vertical model**

On the pure vertical, you don't need to model a distance from consumer preferences since everyone agrees on what product is better. In this case, utility is given by:

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

The interaction between consumer characteristics and prices show that although every consumer has the same utility for the characteristics of good  $j$  (i.e.  $\bar{u} + \delta_j$ ), consumers differ in their willingness to pay ( $v_i$ ).

### **Logit model**

In the logit model, consumers have the same taste for the goods' characteristics but are subject to an idiosyncratic shock depending on both the product and the

consumer. Utility is given by:

$$U_{ij} = \delta_j - p_j + \varepsilon_{ij}$$

where  $\varepsilon_{ij}$  follows an iid extreme-value type I distribution. Analogous to the OLS, the error term allows for identification of the other parameters as long as it is not correlated with the  $\delta_j$  and the price.

### **Pure characteristic model**

This model nests both concepts of verticality and horizontality of differentiation.

Utility is given by:

$$U_{ij} = f(v_i, p_j) + \sum_k \sum_r g(x_{jk}, v_{ir}, \theta_{kr})$$

so that it could handle vertical model if  $g(\cdot)$  is 0 for cross-products variables. It could also handle the horizontal model. It is a very general form and rarely used?

### **BLP model**

The BLP model (for the authors' names Berry, Levinsohn and Pakes), is a parameterized version of the pure characteristics model. It is probably the most commonly used demand model in the empirical literature as of now, and is also very popular in non-research applications of IO. Utility is given by:

$$U_{ij} = f(v_i, p_j) + \sum_k \sum_r x_{jk} v_{ir} \theta_{kr} + \varepsilon_{ij}$$

where the  $\varepsilon_{ij}$  extreme-value Type I error term has been added.



## 1.4 Applications

### 1.4.1 Purely vertical model

As we have mentioned in earlier, in a vertical model, all consumers agree on the relative quality of products (i.e. there is a clear ranking). However, people differ in their willingness to pay for such quality. The general form of utility is:

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

From this equation, the objective is to recover the implied shares as a function of the parameters, and then estimate these parameters by comparing with the observed shares in the data.

#### Recovering the shares

In order to recover the shares, we first need to know the shape of the distribution of  $v_i$ . In this application, we assume it follows a lognormal distribution with implicit mean  $\mu$  and variance  $\sigma^2$ .

Then, we order all goods in increasing order of price (or  $\delta_j$ ) but by assumption, it has to be the same order since people would buy a better alternative if it was also cheaper.

We can show that if  $U_{ij} < U_{ij+1}$ , then,  $U_{ij} < U_{ik}$  for all  $k \geq j + 1$ , assuming that  $(\delta_{j+1} - \delta_j)/(p_{j+1} - p_j)$  is decreasing in  $j$  (the improvement in quality is not as fast as the increase in prices).

Normalize the outside good to 0, and you get that a consumer would choose the outside good if and only if:

$$0 \geq \max_{j \geq 1} U_{ij}$$

Using the property of the previous paragraph, we know that this is equivalent to:

$$0 \geq U_{i1}$$

Thus, we have that the probability that a consumer buys the outside good is:

$$P_{i0} = \Pr [0 \geq -v_i p_1 + \delta_1] = \Pr [v_i \geq \delta_1/p_1]$$

and more generally, the share of the outside good is given by:

$$s_0(\theta) = 1 - F(\delta_1/p_1)$$

where  $\theta$  is the parameter vector containing all  $\delta$ s,  $\mu$  and  $\theta$  and  $F(\cdot)$  is the cdf of the lognormal distribution.

For inside goods, we have that a consumer would choose good 1 if and only if  $U_{i1} > 0$  and  $U_{i1} > U_{i2}$ . Thus, the probability is:

$$\begin{aligned} P_{i1} &= \Pr [0 \leq -v_i p_1 + \delta_1 \geq -v_i p_2 + \delta_2] \\ &= \Pr [v_i \leq \delta_1/p_1 \text{ and } v_i \geq (\delta_2 - \delta_1)/(p_2 - p_1)] \end{aligned}$$

and more generally, the share of the first good is:

$$s_1(\theta) = F(\delta_1/p_1) - F((\delta_2 - \delta_1)/(p_2 - p_1))$$

Following the same argument for the following products, we get:

$$s_j(\theta) = F[(\delta_j - \delta_{j-1})/(p_j - p_{j-1})] - F[(\delta_{j+1} - \delta_j)/(p_{j+1} - p_j)] \text{ for all } j = 2, \dots, J-1$$

$$\text{and } s_J(\theta) = F[(\delta_J - \delta_{J-1})/(p_J - p_{J-1})]$$

This gives us a system of  $J$  equations with  $J + 2$  unknown parameters in  $\theta$ . This means that we can only identify  $J$  parameters (the  $\delta$ s, provided we know/assume the parameters of the consumer characteristic distribution). Each  $\delta$  will be identified using the associated market share and price.

## Estimation

As we have seen in the previous section, our pure vertical model is not identified if the parameters of  $v_i$ 's distribution are unknown. That's why, in this particular case, we need to reduce the dimension of the problem first, and then estimate via maximum likelihood.

In the vertical model, we need to “project” the product quality  $\delta_j$  onto a few characteristics  $x_j$  (a  $K$  dimension vector, such that  $K < J$ ). Formally, we have that:

$$\delta_j = \sum_{k=1}^K \beta_k x_{kj}$$

Now that all goods have the same  $K$  coefficients governing the value of  $\delta$ ,  $\theta$  is effectively a  $K + 2$  dimension vector, estimable using the  $J$  shares!

### Issues with the vertical model

There is a number of issues that arise when using this model:

1. Cross-price elasticities are 0 for all goods that are further away than direct neighboring products. This cannot capture a lot of actual variation in these elasticities.
2. Own-price elasticities are not decreasing in  $j$ , thus leading to high-priced products having comparable elasticities to low-priced products, which is thought of as an undesirable property.
3. Estimating the model relies on multiple researcher assumptions:
  - The outside good has to be chosen to be the lowest or highest good.
  - The functional form of the distribution of  $v_i$  has to be assumed.
4. The error term is deterministic given the functional form of  $f(v)$ .

### 1.4.2 Mortimer (2007)

#### Background

This paper studies the effects of “indirect” price discrimination on consumer welfare and retailer profits in the industry for video rentals, using the vertical differentiation between VHS and DVDs (same content, clearly defined quality scale).

## **Data**

Rentrak dataset. Observation unit is the store-title level, where observed variables include title characteristics, contract with retailer (only sell-through priced movies are included), format, price, etc. + aggregate store-level characteristics to account for competition, demographics, etc.

## **Model**

Consumer demand: four vertically differentiated products (outside good, rental and purchase in periods 1 or 2, to account for indirect price discrimination) with heterogeneous agents (non-random coefficients).

Pricing: decision for wholesale prices on rental and final sales markets, considering demand from consumer model, considering consumer interest decay.

## **Assumptions**

- Model: ordering of products is used, rental and new; only two time periods for purchasing (not dynamic); Weibull distribution for income (random coefficients).
- Instruments: “jackknife” instruments for prices using (1) expected average cost across other titles in the same store and (2) expected average inventory across other titles in the same store, but should also consider that prices are very sticky, thus might not need instrumenting.

## **Results**

Substantial evidence that pricing is done optimally, in the face of forbidden direct discrimination. Direct discrimination would benefit movie providers and consumers but hurt retailers.

## Chapter 2

# Logit, Nested Logit and Multinomial Probit

### 2.1 Identification of Choice Models

In order to identify all choice models we are going to see in this chapter, we will need to make several specification assumptions. These assumptions will allow us to go around two main issues that arise because of the choice process. These issues can be summarized in two statements: “only differences in utility matter” and “the scale of utility is arbitrary”.

#### 2.1.1 Only Differences in Utility Matter

Recall the choice process between products as described in the previous chapter: a consumer  $i$  will choose a product  $j$  over its alternatives if the utility derived from  $j$ , denoted  $U_{ij}$  is greater than of all other alternatives. This means that the consumer will choose the product with the greatest perceived utility, and adding the same constant to all alternatives will not change the decision. This phenomenon has a particularly important implication: only parameters that capture differences across alternatives can be identified.

### Product-specific constants

It is often reasonable to include an unobserved product-specific constant in the utility derived from a product  $j$  such that  $U_{ij} = V_{ij} + \varepsilon_{ij}$ , where

$$V_{ij} = X_j\beta + \xi_j$$

However, since only differences in utility matter, we will only be able to capture difference between  $\xi$ s, not their absolute level. To see that consider a binary choice model where  $\tilde{\xi}_j - \tilde{\xi}_k = \xi_j - \xi_k$ , then, we would have

$$U_{ij} > U_{ik} \Leftrightarrow \tilde{U}_{ij} > \tilde{U}_{ik}$$

and we would not be able to identify which value of  $\xi$  or  $\tilde{\xi}$  is the right one. That is why, in a model with  $J$  alternatives, at most  $J - 1$  alternative specific constant can enter the model, and one product must have its  $\xi$  normalized to zero.

### 2.1.2 Irrelevance of utility scale

Just as adding a constant to the utility of all alternatives does not change the decision maker's choice, neither does multiplying each alternative's utility by a constant, i.e. the product with the highest utility would stay the same. The scale of utility and the variance of the error term are linked by definition, since multiplying  $U_{ij}$  by a constant  $\lambda$  for all  $j$  would imply multiplying the variance of  $\varepsilon_{ij}$  by  $\lambda^2$  for all  $j$ . That is why the econometrician will have to normalize the model by normalizing the variance of the error term.

### Normalization with iid errors

In the case of iid error terms, normalizing the variance is straightforward since normalizing the variance of one error term will normalize the variance of all error terms.

### Normalization with heteroskedastic errors

In the case of heteroskedastic error terms, when at least one segment of the population/alternatives has a different variance than other segments, normalizing the model has to be done by normalizing the variance of one segment and estimating the variance for all others relative to that segment.

### Normalization with correlated errors

Finally, when the error term is correlated across products, normalizing for scale is more of an issue, indeed, in that case, normalizing the variance for one product is not enough to normalize the variance of other products. The solution is to set the variance of one of the error differences to a number, then estimating all other variances and covariances relative to the constant.

## 2.2 “Plain-vanilla” Logit

### 2.2.1 Choice probabilities

To derive the logit model, recall the notation used in the previous chapter where each product has a mean quality level  $\delta_j$  that incorporates the characteristics of the product as well as its price, and an idiosyncratic error term  $\varepsilon_{ij}$ . Thus, we have:

$$U_{ij} = \delta_j + \varepsilon_{ij}$$

In the logit model, we assume that the error term is drawn iid, from a Type-I Extreme Value (or Gumbel) distribution. The Gumbel distribution has the following laws of probability:

$$f(x) = e^{-x}e^{-e^{-x}} \text{ and } F(x) = e^{-e^{-x}}$$

Moreover, the variance of the distribution is assumed to be  $\pi^2/6$ ; this assumption is crucial for identification since it implies normalization of the scale of utility (this is explained in the first section of this chapter). The mean of this distribution

is not 0 (!) but since only differences between utility levels are important, this fact will not cause any issues. Finally, this distribution assumption allows us to have a closed-form solution for the distribution of the difference between two error terms: specifically, let  $\tilde{\varepsilon}_{ijk} = \varepsilon_{ij} - \varepsilon_{ik}$ , we have that:

$$F(\tilde{\varepsilon}_{ijk}) = \frac{\exp(\tilde{\varepsilon}_{ijk})}{1 + \exp(\tilde{\varepsilon}_{ijk})}$$

This distribution law is almost exactly the same as the Normal distribution, so that even if the extreme-value assumption gives fatter tails and slight asymmetry, we get back a Normal distribution in the differences. Nevertheless, note that the shape of the distribution is not that important and that the more important assumption is independence of errors, which requires a well-specified model to be justifiable (i.e. no missing variables, etc.). The independence assumption also requires that the unobserved part of utility for each product ( $\varepsilon_{ij}$ ) is completely independent with respect to other products! In other words, taste for products cannot be correlated in an unobserved way. If this is the case, then we need to use other models that will be described later.

The probability that consumer  $i$  buys good  $j$ , given  $\varepsilon_{ij}$ , is the conditional probability that he chooses  $j$  over all other  $k$ :

$$\begin{aligned} P_{ij}|\varepsilon_{ij} &= \Pr [U_{ij} > U_{ik} \text{ for all } j \neq k | \varepsilon_{ij}] = \Pr [\delta_j + \varepsilon_{ij} > \delta_k + \varepsilon_{ik} \text{ for all } j \neq k] \\ &= \Pr [\varepsilon_{ik} < \varepsilon_{ij} + \delta_j - \delta_k \text{ for all } j \neq k] \\ &= \prod_{j \neq k} F(\varepsilon_{ij} + \delta_j - \delta_k) \text{ (by indep.)} \end{aligned}$$

We can then proceed to compute the unconditional probability by integrating over all possible values of  $\varepsilon_{ij}$  from the Gumbel distribution:

$$P_{ij} = \int \left( \prod_{k \neq j} F(\varepsilon_{ij} + \delta_j - \delta_k) \right) f(\varepsilon_{ij}) d\varepsilon_{ij} = \frac{e^{\delta_j}}{\sum_{k=0}^J e^{\delta_k}}$$

which is called the logit choice probability, and also equivalent to the market share of product  $j$ , under the assumption that all consumers are identical in their distributions.



## Some properties

This model is very practical in the sense it is very easy to set up and displays several desirable properties:

- $s_j = P_{ij} \in (0, 1)$  so that any market share can be rationalized by the model, except in extreme cases with only one product having all the sales (in those cases we would not want a logit model anyway), or some products having no sales (then we should take them out of the sample).
- As  $\delta_j$  increases, reflecting higher attributed quality, the market share will increase to 1. If  $\delta_j$  decreases, then the market share goes to 0. However, note that these results only hold at the limit, meaning a good will never have a market share equal to 0 or 1. If that is the case in the data, the researcher should take the product out of the dataset. This is why estimating a logit model must be done on a time-period long enough so that all goods considered have been sold at least once (think about vending machines).
- $\sum_j s_j = 1$ , meaning that one alternative will be chosen, always.
- $s_j = P_{ij}$  is everywhere continuously differentiable in the characteristics  $\delta_j$  and in price  $p_j$ .

The last point is useful to compute price derivatives (and elasticities):

$$\begin{aligned} \frac{\partial s_j(\theta)}{\partial p_j} &= \frac{-\alpha e_j^\delta \cdot (1 + \sum_k e_k^\delta) + \alpha e_j^\delta e_j^\delta}{(1 + \sum_k e_k^\delta)^2} = \frac{-\alpha e_j^\delta \cdot [1 + \sum_k e_k^\delta - e_j^\delta]}{(1 + \sum_k e_k^\delta)^2} \\ &= -\alpha \cdot \frac{e_j^\delta}{1 + \sum_k e_k^\delta} \cdot \frac{1 + \sum_k e_k^\delta - e_j^\delta}{1 + \sum_k e_k^\delta} \\ &= -\alpha s_j(1 - s_j) \end{aligned}$$

And using the same method, we find  $\partial s_j(\theta)/\partial p_k = \alpha s_j s_k$

## Characterizing mean utility

The estimation of the mean quality characteristic  $\delta_j$  can be done over a set of non-price characteristics  $X_j$ . In particular, consider the following:

$$\delta_j = X_j \beta - \alpha p_j + \xi_j$$

where  $\alpha$  and  $\beta$  are taste parameters for the given characteristics and  $\xi_j$  is an independent, unobserved mean utility shock. This shock is important in order to rationalize any pattern of market shares (suppose a product has better characteristics in every way but still has lower shares).

As introduced in the first section of this chapter, product-specific constants can only be estimated by normalizing the  $\xi$  of one product to a constant. Here, the choice is already made since the outside good has a zero utility by assumption. However, another issue arises by introducing this term. If consumers know  $\xi_j$ , firms must also know it and price their products accordingly. This introduces endogeneity in the error term with respect to prices. Thus, the econometrician needs instruments to correct for that endogeneity. Typically, these instruments include cost shifters that would not affect intrinsic demand for the good but would definitely have an effect on prices. Note that any non-price characteristic included in  $X_j$  that would also be correlated with the unobservable characteristics  $\xi_j$  needs to be instrumented as well.

## 2.2.2 Logit and taste variation

The logit model is very efficient and easy to set up if you need to measure systematic taste variation, that is, variation in tastes associated with observable characteristics  $X_j$ . Variations associated with idiosyncratic randomness,  $\varepsilon_{ij}$  are assumed away as type-I extreme value random variables.

In reality, the value that agents put on a particular attribute varies across these individuals. Sometimes these tastes vary in an identifiable way, for example, low-income agents might be more concerned about the price than others; sometimes you might observe people with the exact same observable characteristics choosing different options. Logit models allow for identification of these taste variations only within limits: if this variation is linked with observable characteristics, then logit models can be applied; if this variation is purely random, then we will require other models.

As an example, consider the choice of households between cars, where two characteristics enter the decision: price  $p_j$  and shoulder room  $x_j$ . A household  $i$

places value  $U_{ij}$  on buying good  $j$  such that:

$$U_{ij} = \beta_i x_j - \alpha_i p_j + \varepsilon_{ij}$$

where you can see that the parameters  $\alpha, \beta$  vary across households  $i$ . Say the shoulder room taste  $\beta_i$  depends only on the number of members in the household  $m_i$  such that  $\beta_i = \rho M_i$ ; this means that  $m_i$  is positively correlated with  $\beta_i$ . Similarly let's say the importance of price is negatively correlated to income  $I$  so that  $\alpha_i = \theta/I_i$ . Substituting back into the utility function we get:

$$U_{ij} = \rho M_i x_j - \theta p_j / I_i + \varepsilon_{ij}$$

which can be estimated with a standard logit model where variables are interaction between characteristics of the product and characteristics of the household.

In contrast, suppose taste variation was subject to an error term such that  $\beta_i = \rho M_i + \mu_i$  where  $\mu_i$  is non-observable (a random variable). Then the utility would be written as:

$$U_{ij} = \rho M_i x_j - \theta p_j / I_i + \varepsilon_{ij} + \mu_i x_j$$

and the logit would confound the error term with  $\tilde{\varepsilon}_{ij} = \varepsilon_{ij} + \mu_i x_j$  which is clearly correlated across product specifications and households.

Bottomline is logit models can handle systematic taste variation but not random taste variation. For the latter, we will need more complex models, such as the BLP model studied in the next chapter.

### 2.2.3 Derivatives and Elasticities

The logit model presented above displays features that are not desired in the context of elasticities. These problems imply that one would run into issues while trying to expand logit results in terms of welfare analysis, antitrust analysis, etc.

First, recall the own- and cross-price derivatives and elasticities:

$$\frac{\partial s_j}{\partial p_j} = -\alpha s_j(1 - s_j); \quad \frac{\partial s_j}{\partial p_k} = \alpha s_j s_k; \quad \epsilon_{jj} = -\alpha p_j(1 - s_j); \quad \epsilon_{jk} = \alpha p_k s_k$$

These imply that:

- Two products with the same market shares will have the same markups. Indeed, from the first-order conditions, we have that:

$$p_j - mc_j = \frac{1}{|\epsilon_{jj}|} \Leftrightarrow \frac{p_j - mc_j}{p_j} = \frac{1}{\alpha(1 - s_j)}$$

which would be the same for  $s_j = s_k$ . This is obviously not intuitive but also not observed in reality.

- Own-price elasticities are higher for higher priced goods. This fact comes directly from the formula of the own-price elasticity that shows a positive effect (in absolute value) from the prices. This is counter-intuitive since it would imply that people buying higher-priced items would be more price-sensitive than people buying lower-priced goods.
- Substitution between goods only depends on relative shares and not proximity of product characteristics. In fact, cross-price elasticities are given by  $\frac{\partial s_j}{\partial p_k} \frac{p_k}{s_j} = \alpha p_k s_k$ , which is not a function of characteristics of neither products.

#### 2.2.4 Independence of Irrelevant Alternatives (IIA)

We have seen in the overview of the logit model that idiosyncratic errors are independently distributed across products, following a type-I extreme value distribution. The choice of the distribution turns out not to be very important, but the independence property has some implications that the researcher should know about. In fact, the independence assumption means that the unobserved utility derived from one good ( $\varepsilon_{ij}$ ) is unrelated unconditionally to the unobserved utility from another good. This assumption seems to be rather restrictive in the context of goods but helped us a lot in coming up with the solution of the logit model.

The independence of the error terms turns out to have problematic implications in the realism of the choice mechanism. In fact, suppose a consumer has a choice of going to work by car ( $c$ ) or taking a blue bus ( $bb$ ). Say that utility derived from both models are the same, such that  $P_c = P_{bb} = 1/2$ , meaning the ratio of probabilities is one. Now suppose that a red bus ( $rb$ ) is introduced in the market such that it is identical in every aspect except the color to the blue bus. The

probability of taking the red bus should therefore be the same as taking the blue bus:  $P_{rb}/P_{bb} = 1$ . However, the ratio of probabilities between the car and the blue bus has not changed because of independence of irrelevant alternatives, meaning that  $P_{bb}/P_c = 1$ , thus  $P_c = P_{bb} = P_{rb} = 1/3$  is the prediction of the logit model. In real life though, we would expect the probability to take the car to remain exactly the same since the actual problem is to either take the bus (regardless of the color) or the car, yielding  $P_c = 1/2, P_{bb} = P_{rb} = 1/4$ .

This IIA problem is nonetheless also a feature of the logit model when it corresponds to reality. In fact, this property allow the researcher to consider only subsets of the complete set of alternatives and still get consistent estimates, as long as for each observation, the actual choice is kept in the set. Another practical use of that property is that if the researcher is only interested in a few choices, then they do not need to include the other choices in the dataset, leaving the data research part out of the picture.

### 2.2.5 Consumer Surplus

For policy analysis, the researcher is often interested in measuring the change in consumer surplus that is associated with a particular event (introduction of a product, merger, etc.). Under the logit assumption, this value of the consumer surplus also takes a simple closed form that can be easily computed from the model. We know that each consumer will choose the product that yields the highest utility. In the aggregate case, all consumers have the same tastes so that in expectation (the econometrician does not observe  $\varepsilon_{ij}$ ), consumer surplus is defined as the value of utility derived from the best good. Formally,

$$E[CS] = E \left[ \max_j \{U_{ij}\} \right] = E \left[ \max_j \{\delta_j + \varepsilon_{ij}\} \right]$$

which yields:

$$E[CS] = \ln \left( \sum_{j=1}^J e^{\delta_j} \right) + C$$

where  $C$  is an unknown that represents the fact that absolute utility cannot be measured. This value is called the logit inclusive value, or the log-sum term.

As you can see, comparing two policies is easy in this setting, let one policy be denoted by the superscript 0 and the other by the superscript 1. Then,

$$\Delta E[CS] = \ln \left( \sum_{\mathcal{J}^1} e^{\delta_j^1} \right) - \ln \left( \sum_{\mathcal{J}^0} e^{\delta_j^0} \right)$$

If we had transaction-level data with individual characteristics, we could perform this analysis of consumer surplus at each unit of observation and aggregate to find our results.

## 2.3 Nested Logit

A natural extension of the simple logit model, allowing for richer substitution patterns and a somewhat less restrictive IIA property is the nested logit model.

A nested logit model partitions the choice set in different subsets called nests such that the actual choice of one good follows from choices among nests. For example, in the simplest nested logit, with one nest, consumers first choose a nest (a category of products) as modelled in a simple logit, then within a nest, they choose a product inside the nest (again modelled as a simple logit). This sequence of logit models creates a different type of model called the nested logit. These nests are chosen by the researcher (which is not ideal) and they provide a strong structure to the model which could affect results significantly. Following the notation of Cardell (1991) and Berry (1994), we model utility as:

$$U_{ij} = \delta_j + \zeta_{ig} + (1 - \sigma)\varepsilon_{ij}$$

where the new terms are:  $\zeta_{ig}$  an idiosyncratic “nest” taste shock that applies to all goods  $j$  in the nest  $g$ ; and  $\sigma$  a parameter of correlation in tastes within nests (if  $\sigma$  is high, tastes within group are very correlated and the nest structure matters, if  $\sigma$  is low, then the correlation in tastes within the nest is small and the nest structure is irrelevant). At first, it might seem that the  $\sigma$  term will not allow for the simple logit model, but in fact, the  $\zeta_{ig}$  error term follows a unique distribution distribution function such that  $\zeta_{ig} + (1 - \sigma)\varepsilon_{ij}$  follows an extreme-value distribution (not type-I however, we call it Generalized Extreme Value or

GEV). This makes  $\sigma$  important to both terms, and in particular, when  $\sigma \rightarrow 0$  we go to the simple logit, and  $\sigma \rightarrow 1$  yields to more within-group correlation.

We know that within the same nest, the utility level  $u_{ij} = \delta_j + \zeta_{ig}(1 - \sigma) + \varepsilon_{ij}$ , can be reduced down to ignore the effect of  $\zeta$ , since it is the same across products. We end up in the same setting as the simple logit model. This implies that the conditional share of product  $j$ , or the share within the nest, is given by the same formula as the simple logit:

$$s_{j|g} = \frac{\exp(\delta_j/(1 - \sigma))}{\sum_{k \in \mathcal{J}_g} \exp(\delta_k/(1 - \sigma))}$$

where the denominator for this expression can be written as  $D_g$ , the total demand for products in the group  $g$ .

Meanwhile, across groups, we have that both error terms still give a type-I EV, so again, we can think about the demand for a group as we did in the logit case:

$$s_g = \frac{D_g^{(1-\sigma)}}{\sum_h D_h^{(1-\sigma)}}$$

Finally, the share of a product  $j$  is given by the product of both the share of the group containing  $j$  and the conditional share of  $j$  within the group:

$$s_j = s_{j|g} \cdot s_g = \frac{\exp(\delta_j/(1 - \sigma))}{D_g^\sigma \cdot \left( \sum_h D_h^{(1-\sigma)} \right)}$$

As we can see, demand for product  $j$  depends on its own quality level relative to its group, the quality of the group relative to the other groups and  $\sigma$ , the correlation in tastes within nests.

The outside good in this model is considered as one of its own group, so that  $s_{0|0} = 1$  and with the normalization of  $\delta_0 = 0$  and  $D_0 = 1$ , we get:

$$s_0 = 1 \cdot s_0 = \frac{1}{\sum_h D_h^{(1-\sigma)}}$$

This analytical derivation is the same when we extend the model to have nests within nests and more.

### 2.3.1 IIA and substitution patterns

The nest structure of this model satisfies two properties:

1. For any two alternatives that are in the same nest, the ratio of probabilities is independent of the attributes and/or existence of other products in the nest or in other nests.

$$s_j/s_k = s_{j|g}/s_{k|g} = \frac{\exp(\delta_j/(1-\sigma))}{\exp(\delta_k/(1-\sigma))}$$

Equivalently, we say that IIA holds within the nest.

2. For any two alternatives that are in different nests, the ratio of probabilities depends on the attributes and/or existence of other products in the two nests.

$$s_j/s_k = s_{j|g}/s_{k|h} \cdot s_g/s_h = \frac{\exp(\delta_j/(1-\sigma))}{\exp(\delta_k/(1-\sigma))} \cdot \frac{D_g^{1-\sigma}}{D_h^{1-\sigma}}$$

Equivalently, we say that IIA does not hold across nests.

### 2.3.2 Research considerations

As we have seen, the nested logit is a fairly simple extension on the simple logit case, which relies on relaxation of the IIA property across groups (or nests). The model is often told in a narrative of sequential choice: consumers first choose a group  $g$  ( $s_g$ ), then a product (or group)  $j$  within group  $g$  ( $s_{j|g}$ ).

The results of the model depend very strongly on the ex ante nesting structure chosen by the researcher. Therefore, it is very important (and hard) to understand what the appropriate structure should be. The sequential narrative is supposed to help the researcher come up with an accurate structure but it might be unhelpful at times.

Identification comes in different flavors:

- Parameters associated with characteristics and prices are identified within group by variation in these exact characteristics.
- The correlation in tastes parameter ( $\sigma$ ) is identified by variation in



## 2.4 Multinomial Probit

### 2.4.1 Intuition

The two previous models covered in this chapter had two main issues: they cannot handle random taste variation and they imply restrictive substitution patterns due to IIA (even though the nested logit solves this issue in some way). The multinomial probit on the other side, is not affected by these two issues at all. In essence, the MNP approach allows for correlation between choices thanks to a flexible covariance matrix of the errors.

### 2.4.2 Choice probabilities

As in the general case, we start with writing the individual (unconditional) probability of choosing product  $j$ :

$$\begin{aligned} P_{ij} &= E \left[ \Pr \left[ U_{ij} > U_{ik} \text{ for all } j \neq k | \varepsilon_{ij} \right] \right] \\ &= E \left[ \Pr \left[ \delta_j + \varepsilon_{ij} > \delta_k + \varepsilon_{ik} \text{ for all } j \neq k | \varepsilon_{ij} \right] \right] \\ &= E \left[ \Pr \left[ \varepsilon_{ik} < \varepsilon_{ij} + \delta_j - \delta_k \text{ for all } j \neq k | \varepsilon_{ij} \right] \right] \\ &= \int \prod_{j \neq k} F(\varepsilon_{ij} + \delta_j - \delta_k) f(\varepsilon_{ij}) d\varepsilon_{ij} \end{aligned}$$

But in the multinomial probit case, the law of probability for  $\varepsilon_{ij}$  depends on all the other error terms! Thus we have correlation between choices, that we estimate.

Formally, we have:

$$\varepsilon_i \sim N(\mu, \Omega)$$

where  $\varepsilon_i$  is the vector of all product error terms. This means that  $\Omega$  is a  $(J + 1)^2$ -elements symmetric matrix. In practice, we restrict  $\mu$  to be 0 (especially if we estimate  $\xi$ s), but following the first section of this chapter we will also need to restrict the variance of the error terms heavily. In fact, as mentioned in that section, in the case of iid but correlated error terms, we need to normalize one diagonal term of the error-differences distribution and estimate the other terms relative to that term.

### 2.4.3 Applications

The MNP approach is interesting in most cases where choice correlations are important, but is limited by the fact that data requirements get huge when we increase the number of products.

## 2.5 Estimation Strategy for Product-level data

The general estimation strategy that applies to logit models with product-level data is detailed in the following steps:

1. Assume that data is drawn from markets with large  $n$ .
2. Assume that observed market shares are measured without errors.
3. For each  $\theta$  (vector of parameters), there exists a unique  $\xi$  such that the model shares and observed shares are equal ( $J$  equations,  $J$  unknowns).
4. We invert the model to get  $\xi$  as a function of the parameters. How this step is performed depends on the functional form of the model.
5. Using  $\xi$ , we can create the moments of the model, estimating them by GMM.

### 2.5.1 Inversion in the logit case

We need to express the quality unobservable term  $\xi_j$  in terms of all observable characteristics. First, recall that:

$$\delta_j = X_j\beta - \alpha p_j + \xi_j$$

but in this equation,  $\delta_j$  is unknown (there is no such thing as a perceived mean quality level). Nevertheless, we can use the market shares formulas that link the  $\delta_j$  to the observed market shares  $s_j$  (observed without errors). Thus,

$$s_j = \frac{\exp(\delta_j)}{1 + \sum_k \exp(\delta_k)}$$

but again, we run into a problem since it is expressed as a function of other  $\delta_k$ : we could solve a system of equations, or simplify the model using the normalized

good. Indeed,

$$\frac{s_j}{s_0} = \exp(\delta_j) \Leftrightarrow \ln(s_j) - \ln(s_0) = \delta_j \Leftrightarrow \ln(s_j) - \ln(s_0) = X_j\beta - \alpha p_j + \xi_j$$

which in turn yields the inversion equation:

$$\ln(s_j) - \ln(s_0) + \alpha p_j - X_j\beta = \xi_j$$

### 2.5.2 Inversion in the nested-logit case

In the same way as in the simple logit model, our main objective is to get the link between  $\delta_j$  and observables so that we can identify  $\xi_j$ . In this case:

$$s_j = \frac{\exp(\delta_j/(1-\sigma))}{D_g^\sigma \cdot \left(\sum_h D_h^{(1-\sigma)}\right)} \text{ and } s_0 = \frac{1}{\sum_h D_h^{(1-\sigma)}}$$

so that

$$\ln(s_j) - \ln(s_0) = \frac{1}{1-\sigma} \cdot \delta_j - \sigma \ln(D_g)$$

We turn into a new problem caused by the two-level structure, which is  $D_g$  is not parameterized. Again, we solve this issue by using the normalized good:

$$s_g/s_0 = D_g^{(1-\sigma)} \Leftrightarrow \ln(s_g) - \ln(s_0) = (1-\sigma) \cdot \ln(D_g)$$

which we can plug back in the previous equation to get:

$$\begin{aligned} \ln(s_j) - \ln(s_0) &= \frac{1}{1-\sigma} \cdot \delta_j - \frac{\sigma}{1-\sigma} [\ln(s_g) - \ln(s_0)] \\ \Leftrightarrow (1-\sigma) \cdot [\ln(s_j) - \ln(s_0)] &= \delta_j - \sigma [\ln(s_g) - \ln(s_0)] \\ \Leftrightarrow (1-\sigma) \cdot \ln(s_j) + \sigma \ln(s_g) - \ln(s_0) &= \delta_j \end{aligned}$$

Finally, using the fact that  $s_g = s_j/s_{j|g} \Leftrightarrow \ln(s_g) = \ln(s_j) - \ln(s_{j|g})$ , we can get:

$$\Leftrightarrow \ln(s_j) - \sigma \ln(s_{j|g}) - \ln(s_0) - X_j\beta + \alpha p_j = \xi_j$$

### 2.5.3 Endogeneity issues

#### Simultaneity

Regardless of the model we use, we will have to deal with endogeneity issues regarding many dimensions, such as prices, observable characteristics or market shares.

In fact, in both models price was correlated to the unobservable term as firms make their decision based on demand which includes this term; moreover, in the nested logit case, we also have to deal with endogeneity in the within-share term. In general, anything that is correlated with the unobservable quality term  $\xi$  will have to be instrumented.

#### Measurement errors

Measurement errors in observed prices, characteristics or quantities may also create difficulties for the estimation procedure outlined above. Prices enter linearly in the estimation and are already endogenous so that these errors do not create too important biases. However, when these errors are present in market shares or quantities data then this issue becomes more important. Indeed, market share data is used to invert the model and get the unobservable term as a function of observed data. If shares include measurement errors, the non-linear inversion will accentuate the errors in a non-tractable way, creating a lot of issues in estimation. In practice, maximum likelihood will not have this kind of issue, but will make IV strategies harder.

#### Instruments

For identification, we need to satisfy orthogonality conditions between  $\xi_j$  and the covariates (product characteristics  $x_j$  and price  $p_j$ ). As discussed earlier, price will for sure be endogenous, so we need at least one instrument for this. Formally, we need a set of instruments  $w$  such that  $E[\xi|x, w] = 0$ . In practice, we consider three types of instruments:

- Cost shifters: they are the ideal instruments but are not always observed.
- Hausman instruments: they consist of prices of the same product in other markets, however, they might not be valid when the same shock affects all markets together.
- BLP instruments: they are the competing products' characteristics. This approach is purely based on heuristics (no model) and is usually combined with other instruments to reduce the dimensionality requirement of other more valid instrument.

## 2.6 Estimating the supply side

We may also be interested in estimating a supply side, either on its own for counterfactual estimation or as a mean to improve efficiency of demand parameter estimation. In order to do this, we need two assumptions: one on the cost function that firms face, and another on the type of competition in the market.

Consider the following example. We start with a linear marginal cost function:

$$\ln(mc_{jt}) = w_{jt}\gamma + \omega_{jt}$$

where  $w_{jt}$  are the observed cost shifters and  $\omega_{jt}$  the unobserved ones. Then, using the competition assumption, we recover the first-order conditions vector which has the following general form:

$$p_t - mc_t = -(\Omega \star \Delta)^{-1} s_t$$

where  $\Omega$  is the ownership matrix and  $\Delta$  the  $J \times J$  elasticity matrix. Note also that the  $\star$  operator represents element-wise multiplication.

We can clearly see why demand estimation is important in that case: elasticities! Without the elasticities it is impossible to recover the marginal cost from the FOCs. Now, we can rewrite the equation as:

$$\begin{aligned} mc_t &= p_t + (\Omega \star \Delta)^{-1} s_t \\ \Leftrightarrow \ln(mc_t) &= \ln(p_t + (\Omega \star \Delta)^{-1} s_t) \\ \Leftrightarrow \omega_{jt} &= \ln(p_t + (\Omega \star \Delta)^{-1} s_t) - w_{jt}\gamma \end{aligned}$$

And using the same instruments as in our demand estimation procedure, we should have that  $E[\omega|x, w] = 0$ . Then, we collect all demand and supply moments and estimate by GMM simultaneously.

## **2.7 Goldberg (1995)**

**Background**

**Model**

**Data**

**Assumptions**

**Results**

## Chapter 3

### Mixed Logit (BLP)

For now we have seen three types of discrete-choice models and their applications to demand estimation for differentiated products: the simple logit model, the nested logit model and the multinomial probit model. The first two models, although quite useful and fairly simple to estimate were limited in three dimensions: they do not allow for random taste variation (2.2.2), they have restricted substitution patterns (2.2.4), they do not allow for correlation over time. Mixed logit models (which contains BLP) are highly flexible models that can deal with the previously mentioned issues.

Mixed logit models are a class of models that encompasses all types of models where the market shares are computed as integrals over simple logit functional form. We'll see in detail later what that means but intuitively, you should think of the model as everyone having her/his own logit model of demand, and aggregate demand would be computed by integrating over consumer attributes. In particular, IO economists are most interested in the BLP (for [?]) model and extensions of it like [?].

We'll first cover the basics of mixed logit and random coefficients, before talking in depth about estimation techniques as found in BLP and DFS.

### 3.1 Model

Generally, we write utility derived from consumption of a good  $j$  by consumer  $i$  as the function  $u_{ij}(X_j, p_j, \xi_j, v_i, \theta)$ , which is a function of product  $j$  observable characteristics ( $X_j$  of dimension  $L - 1$ ), price ( $p_j$ ), unobservable characteristics ( $\xi_j$ ) and consumer characteristics (observable  $z_i$  and unobservables  $v_i$ ), all entering the utility function through a vector of parameters  $\theta$ .

As a simpler case, define utility as a linear function of those parameters such that:

$$U_{ij} = \sum_{l=1}^L x_{jl} \beta_{il} + \xi_j + \varepsilon_{ij}$$

$$\text{where } \beta_{il} = \lambda_l + \beta_l^o z_i + \beta_l^u v_i$$

Notice the main differences with logit models as we know them: first, price is not separated but included in observable characteristics of product  $j$  because of the second point, that  $\beta_i$  is a coefficient dependent on consumer characteristics. This means that different consumers will have different tastes in the same characteristics. For example, some person might be interested in the price of a phone while someone would disregard this and focus only on memory, another one on camera quality, etc.

We can rewrite the utility function by plugging in the definition of  $\beta$ :

$$\begin{aligned} U_{ij} &= \sum_{l=1}^L x_{jl} (\lambda_l + \beta_l^o z_i + \beta_l^u v_i) + \xi_j + \varepsilon_{ij} \\ &= \underbrace{\sum_{l=1}^L x_{jl} \lambda_l + \xi_j}_{\delta_j: \text{product mean utility}} + \sum_{l=1}^L x_{jl} \beta_l^o z_i + \sum_{l=1}^L x_{jl} \beta_l^u v_i + \varepsilon_{ij} \end{aligned}$$

There are five elements in this utility function:

- Observed ( $x_j \lambda$ ) and unobserved ( $\xi_j$ ) product quality.
- Observed ( $x_j \beta^o z_i$ ) and unobserved ( $x_j \beta^u v_i$ ) consumer-product interactions.
- A type-I EV iid error term ( $\varepsilon_{ij}$ ).



The main features of the mixed logit model rely on the consumer-product interactions. Because they are not restricted to take the logit form, they will display more reasonable substitution patterns when aggregated. With these interactions, products will be close in terms of the characteristics of the consumers who buy the product. For example, consider an auto market following a price increase for the BMW 7 series (very expensive and luxurious car). In the logit model, this would create substitution to all other cars based on their market shares, meaning that a small Toyota Echo would benefit from the price increase. In the nested logit, provided we defined nests correctly, only cars within the same nest would be affected (luxury cars). Already, this makes more sense, but in the mixed logit model, we use parameters estimated from price variation to figure out what happened to the people who were buying BMW 7 series.

### **Aggregate vs. micro data**

We have seen that the general form of the mixed logit model includes both observed and unobserved consumer characteristics. In general however, market data does not come with exact description of consumer characteristics for each interaction. At best, we might have aggregate consumer data (about a geographical region, a point in time, ...) but most often we cannot observe any characteristic.

When we do observe consumer characteristics, we can use them in  $z_i$  to estimate the model. A particularly influential paper using this type of data is the MicroBLP paper. When such data is unobserved, we work with just the  $v_i$  part of the model, as in the original BLP paper. For the rest of this section, we assume that we do not observe  $z_i$ .

#### **3.1.1 Building the shares**

Recall the utility function from the previous section (without  $z_i$  by assumption):

$$U_{ij} = \delta_j + \sum_{l=1}^L x_{jl} \beta_l^u v_i + \varepsilon_{ij}$$

Using the fact the error term is a type-I EV as in the simple logit, we can integrate it and get logit shares, but only conditional on  $v_i$ ! Formally, we get:

$$P_{ij}|v_i = \frac{\exp(\delta_j + x_j\beta v_i)}{\sum_k \exp(\delta_k + x_k\beta v_i)}$$

$$\Rightarrow P_{ij} = \int \frac{\exp(\delta_j + x_j\beta v_i)}{\sum_k \exp(\delta_k + x_k\beta v_i)} f(v_i) dv_i$$

### Latent-class models

In the simplest case, consider that there are only two types of people, such that only two  $\beta_i$  are possible, say  $\beta_H$  and  $\beta_L$ . There are also two probabilities associated with the types. Thus the shares become:

$$P_{ij} = \frac{\exp(\delta_j + x_j\beta_H)}{\sum_k \exp(\delta_k + x_k\beta_H)} \cdot p_H + \frac{\exp(\delta_j + x_j\beta_L)}{\sum_k \exp(\delta_k + x_k\beta_L)} \cdot (1 - p_H)$$

## 3.2 BLP algorithm

Consider the situation where data is available only on the aggregate product-level, and no consumer data is observable. We will work out the estimation of demand following four steps:

1. Work out the aggregate shares conditional on both  $\delta$  (mean utility) and  $\beta$  (taste variation).
2. Invert the shares to get  $\xi$ .
3. Estimate the model using the method of moments.
4. Repeat until convergence of all parameters.

To help understanding the details of the following steps, you should keep in mind a quick summary of what it to be done. As always, we are interested in the parameters of utility (that affect demand), thus  $\lambda$  and  $\beta^u$  (that we now call  $\beta$  only). These parameters are estimated using the interaction of the unobservable product characteristic  $\xi$  and adequate instruments. Until now, nothing should surprise you as we follow the same steps as described the GMM estimation strategy

for logit and nested-logit models. However, this time it is different since to get  $\xi$ , you will need the parameters you are looking for (this is the main difference of BLP). That is why you use starting values for those, and iterate until you find the parameters that are stable through estimation (this is a fixed point problem).

### Step 1: Conditional aggregate shares

Recall that in the simple and nested logit models we studied, the probability  $P_{ij}$  that a consumer  $i$  buys product  $j$  was equal to the market share since they did not differ from the representative consumer in any way. This time, we now that two different consumers will have different probabilities of buying the product. Consequently, the market share is going to be the integral of consumers individual probabilities over their characteristics (here  $v_i$  since we do not observe any consumer characteristics).

Recall that we computed the market shares as a function of product characteristics:

$$s_j(\delta, \beta) = \int \frac{\exp(\delta_j + X_j v_i \beta^u)}{1 + \sum_k \exp(\delta_k + X_k v_i \beta^u)} f(v) dv$$

The issue with this integral is that it cannot be solved analytically ( $v_i$  is usually a multivariate normal distribution, which makes the market share a multi-dimensional integral); we can approximate it by taking the sample average over a set of  $ns$  draws in a simulation. This yields:

$$\hat{s}_j^{ns}(\delta, \beta) = \frac{1}{ns} \sum_i \frac{\exp(\delta_j + X_j v_i \beta^u)}{1 + \sum_k \exp(\delta_k + X_k v_i \beta^u)}$$

which is a function of parameters that we want to estimate ( $\delta$  and  $\beta$ ). We will see that  $\delta$  will be computed, and  $\beta$  will be estimated by doing this step multiple times and finding the best one. This is why you should keep the simulated  $v_i$  for the whole exercise, else it is never going to converge.

Note that integration over the distribution of  $v_i$  is a different problem than  $\varepsilon_{ij}$  for which we can use the form of the type-I EV distribution to help us with analysis. In the case of  $v_i$ , we assume a multivariate normal distribution (across multiple consumer unobserved characteristics). If the distribution (not observations, but at least the pdf) is observed, then we can draw from the said distribution.

Moreover, notice that the use of a finite number of draws in the simulation will create a new source of errors within our estimation routine. Enough simulation draws should help tampering this issue, although finding the good number of draws is not an exact science, but more like a tradeoff between computation speed and errors. Overall, numerical evaluation of integrals is a particular topic that is deep enough to think about it carefully.

## Step 2: BLP inversion

We now need to recover the product unobservable term  $\xi_j$ . In the same way as we did in the simple logit models, we already have the link between  $\delta$  and  $\xi$ , but  $\delta$  is "buried" in a nonlinear fashion into the the market shares: we need to invert the market shares to get delta, thus  $\xi$ , as a function of the shares (rather than the opposite). Doing that requires a special trick that is at the very core of[?] contribution.

Their trick is to use the fact that the following system:

$$\delta_j^k(\beta) = \delta_j^{k-1}(\beta) + \ln(s_j) - \ln(\hat{s}_j^{ns}(\delta^{k-1}, \beta))$$

is a contraction mapping. To see it, understand that  $s_j$  is the observed market share, the exponent  $k$  represents the iteration process. In other words, by iterating over this function, the  $\delta$  values will converge to the true value,  $\delta^*(\beta, s, \hat{s})$ , where  $s, \hat{s}$  are respectively the vectors of observed and estimated shares conditional on  $\beta$ . Finally, we can write:

$$\xi(\beta, s, \hat{s}) = \delta^*(\beta, s, \hat{s}) - X_j \lambda$$

and use this form to construct the moments.

## Step 3: Constructing the moments

Now that we have recovered  $\xi$  as a function of  $\beta$  (and  $\lambda$  through  $\beta$  since there is a way to write  $\lambda$  as a function of  $\beta$ ), we can construct the moment conditions for demand estimation. To do this, we can go the OLS route if no component of  $x$  is

endogenous but most probably we will go the IV route, using  $w$  as the instrument matrix. The moment condition would therefore be:

$$E [\xi_j(\beta)w_j] = 0$$

As always in GMM, we want to select  $\beta$  such that the average analog to the moment equation is the closest possible to 0.

#### **Step 4: Algorithm iteration**

The first three steps were performed for a given  $\beta$ , thus we now need to find the best  $\beta$ , using a nonlinear search over  $\beta$ .

### **3.2.1 Identification**

In order to fully identify the model, we need four sources of variation:

1. Choice set variation:
2. Product characteristics variation:
3. Consumer characteristics variation:
4. Functional form:

### **3.2.2 Adding a supply side**

Supply-side estimation in BLP is similar to what was done in simpler logit models. Refer to section 2.6 for more information.

# Chapter 4

## Product Availability

### 4.1 Introduction

As we have seen in the previous chapters, many common models of demand estimation assume that the set of available choices (the “availability set”) is the same for all agents. While this assumption simplified computations by a lot, it may be a poor approximation of reality (think of retail environments). In fact, many consumers in many settings might encounter stockouts of products they intended to purchase. Moreover, availability variation can also come from assortment decisions (different stores displaying different products) or imperfect consideration (consumers not being aware of some alternatives). If availability variation arise exogenously, it could provide helpful sources of identification but in all cases, ignoring this variation will bias estimation.

There are three main sources of availability variation, from most to least aggregated:

- Assortment selection
- Stockout events
- Limited consumer information

This chapter will focus mainly on the first two, in relation to demand estimation (note that these topics might also be important on the supply-side).

## 4.2 Assortment variation

Understanding the effects of assortment on sales is mostly useful for two groups of agents: economists and policymakers who use demand estimates to evaluate welfare; and firms who want to explore these issues to come up with optimal choices.

Assortment variation is very prevalent in markets. For example, Tenn and Yun (2008) show that in grocery stores, 16% to 33% of sales happen in a time of intermediate availability. Bruno and Vilcassim (2008) show that in the confections market, the median availability of products is only 80%. If we consider time-series, we can see even more variability as Tenn and Yun explain by showing that only a third of products are available within a year and a third are discontinued every year.

Depending on the dataset, we can separate the problem of estimating demand with assortment variation in two cases: (1) assortment variation is unobserved and (2) assortment variation is observed.

### 4.2.1 Unobserved assortment variation

There are three main papers that discuss the challenges of estimating demand with unobserved assortment variation, using market-level data. The first one (Tenn, 2009) examines the sufficient assumptions for consistent estimates of own and cross-price elasticities in a linear demand model in product space. The second one (Tenn and Yun, 2008) explores the biases that arise due to assortment variation in logit types of model. Finally, Bruno and Vilcassim (2008) propose a method to account for this variation using additional assumptions.

#### **Tenn (2009)**

Tenn (2009) explores the potential issues of estimating linear demand using aggregate market-level data while ignoring assortment variation. The paper comes up with three conditions under which such a model would still yield

consistent estimates:

- All prices within a market are the same, or in other words, all stores carry products at the same price.
- The fraction of stores that carry a product within a market is fixed across markets.
- Demand for each product is independent of the assortment.

Note how these assumptions are very strict and will be violated in many settings.

They show that the plim of estimated elasticities (again, when assortment is not accounted for) is given by:

$$\bar{\varepsilon}_{jkm} = E \left[ \varepsilon_{jkm}^g | j, k \in g \right] \cdot \Pr [k \in g | j \in g]$$

where  $\varepsilon_{jkm}^g$  is the cross-price elasticity of product  $j$  with respect to  $k$ , given the assortment  $g$  (the object of interest). Intuitively, this means that  $\bar{\varepsilon}_{jkm}$  is an “attenuated” (multiplied by a probability between 0 and 1) average of the elasticity for consumers who were presented assortments containing both  $j$  and  $k$ . In that regard, it will be biased towards 0! In the particular case of own-price elasticities however, this bias is absent since  $\Pr [j \in g | j \in g] = 1$ .

### Tenn and Yun (2008)

Tenn and Yun (2008) consider a more complex model of demand in a standard logit. Utility derived from choosing good  $j$  in market  $m$  is given by the equation seen in chapter 2:  $U_{ijm} = X_{jm}\beta - \alpha p_{jm} + \xi_{jm} + \varepsilon_{ijm}$ , which yields the same type of elasticities:

$$\begin{aligned} \varepsilon_{jmr} &= -\alpha p_{jm}(1 - s_{jmr}) \text{ for all } j \in J_{mr} \\ \varepsilon_{jkmr} &= \alpha p_{km} s_{kmr} \text{ for all } j, k \in J_{mr} : j \neq k \end{aligned}$$

Which at first do not seem biased, but in fact are because of (1) price coefficient bias and (2) elasticity estimates bias!

The price coefficient  $\alpha$  can be biased in two ways. First, there might be an omitted variable bias, that arises with the failure to account for heterogenous retailers. In fact, a homogenous model such as the ones seen in chapter 2, will ignore the



variation in availability of products ( $X_{jm}$  does not include a measure of availability, since it is not measured), thus introducing bias in the estimates. The second source of bias in the price coefficients is the choice of instruments. Indeed, we usually use input prices or any “supply-side” variables to instrument for  $\alpha$ , however, these variables might also have an effect on the assortment. For example, consider a sudden wholesale cost shock on a particular brand: the retailer might not want to purchase the good that period and change its assortment!

The elasticity estimates can also be biased in two ways: composition bias and weighting bias. As in the linear demand model, composition bias arises because of the fact that we average over all consumers, while some might not have had access to the same assortment. Moreover, bias in that case could go either way, depending on availability of the product (high availability means upward bias, low availability means downward bias). Weighting bias is the analog of the previous bias in aggregate, considering that markets as entities might have stores with different assortments.

### Bruno and Vilcassim (2008)

Bruno and Vilcassim (2008) present an approach to correct the bias in a random-coefficients multinomial logit model such as the one discussed in chapter 3. Starting with a BLP-style utility where  $U_{ijm} = X_{jm}\beta_i - \alpha_i p_{jm} + \xi_{jm} + \varepsilon_{ijm}$ , we assume no observed individual variation so that we can rewrite utility as the sum of mean utility  $\delta_{jm} = X_{jm}\beta - \alpha p_{jm} + \xi_{jm}$  and a consumer-specific term  $\mu_{jm}(\theta_i) = X_{jm}\Sigma_\beta v_i - \sigma_\alpha \eta_i p_{jm}$ .

Then, given an availability vector  $a_m = (a_{1m}, \dots, a_{Jm})$  of indicator variables (if product  $j$  is available in market  $m$  or not), market shares can be written as:

$$\bar{S}_{jm}(a_m) = \int \frac{a_{jm} \cdot \exp(\delta_{jm} + \mu_{jm}(\theta_i))}{1 + \sum_{k=1}^J a_{km} \cdot \exp(\delta_{km} + \mu_{km}(\theta_i))} dG(\theta_i)$$

Then, given a probability mass function for  $a_m$ , denoted  $\pi(a_m)$ , the observed market shares are given by:

$$S_{jm} = \sum_{a_m} \bar{S}_{jm}(a_m) \pi(a_m)$$

To implement this, we need to add an outer loop in between the actual outer loop of BLP and the inner loop, in which we simulate the joint distribution of  $a_m$  to get the actual shares.

However, this method relies on two particularly “shaky” assumptions:

- Consumers’ tastes do not vary systematically with availability.
- Marginal distributions of availability are mutually independent.

#### 4.2.2 Observed assortment variation

Including observed assortment variation looks like the solution to all our problems from the previous sections. However, Draganska, Mazzeo and Seim (2009) show that other challenges arise even when assortment is observed. Their method is analogous to the one described in Bruno and Vilcassim (2008), but does not relate on simulating availability since it is now observed for each market. However, if the unobservable quality of a good affects its presence in the assortment, the econometrician cannot identify  $\delta_{jm}$  from  $\xi_{jm}$ , thus cannot use the BLP approach as in Bruno and Vilcassim. To go around that issue, they assume  $\xi_{jm}$  is simply uncorrelated with either price or assortment.

This issue is called assortment endogeneity and is treated in three more recent papers. The first one considers a simple reduced-form equation to recover availability of a product as a function of characteristics, and uses it as a control to relieve  $\xi_{jm}$  from its endogeneity. The second adds a reduced-form pricing equation. Finally, the third approach models a structural supply-side in order to solve for the equilibrium.

#### Iaria (2014)

Iaria (2014) deals with endogeneity of assortment by estimating a reduced form equation for assortment such that given product and market data, it is possible to recover if a product will be available or not. Note that this strategy, while not structural, is still valid since we only care about the demand side in this paper. Nonetheless, this approach relies on multiple regularity assumptions for

identification.

### **Shah, Kumar and Zhao (2015)**

Shah, Kumar and Zhao (2015) differs from Iaria (2014) in two main ways: first, they add a reduced-form pricing choice to control for endogeneity in that direction too and second, they estimate demand and the two reduced-form equations as a system, simultaneously.

### **Musalem (2015)**

Finally, Musalem (2015) uses a more structural approach by modeling a supply-side directly in the model. Solving the model using Mathematical Programming with Equilibrium Constraints (MPEC). The supply side is a two-stage game in which firms choose the assortment first, then the prices. While this approach is the most structural, it requires assumptions on the equilibria played on both sides, and a game structure that approximates the real world.

## **4.3 Stockouts**

When a product stocks out, the observed sales for this particular product or its substitutes does not correspond to the underlying demand anymore. By ignoring this phenomenon, demand estimates would be biased as in the assortment variation case. In fact, demand for stocked out products will be underestimated, which we call censoring bias while demand for the available substitutes will be overestimated, which we call forced substitution bias. Stockouts also have an effect on price coefficients if the events are correlated with price variation (stockout during a sale for example). If both types of bias arise in the same event, we cannot sign the bias anymore and estimation is confounded. However, exogenous stock-out events could provide interesting data about demand, especially if we look at diversion, etc.

There are two types of dataset used in this part of the literature: “periodic in-

ventory” where we observe sales periodically, thus aggregating all sales within a period and “perpetual inventory” where we observe individual transactions. In the first type, stockouts are only partially observed since, within a period, we cannot identify which sale created the stockout. In the second type though, stockouts are fully observed. The rest of this chapter describes the differences in treating these two types of datasets.

### **4.3.1 Partially observed stockouts**

Both papers presented next develop demand estimation approaches for use with periodic store data, with inventory levels. This implies that stockouts will only be partially observed (who got the last unit of a product is unknown). Thus, the efforts should be directed towards estimating the timing of the stockout, or a distribution of sales of other products.

#### **Conlon and Mortimer (2013)**

The key insight in Conlon and Mortimer (2013) is that discret-choice models of demand imply a distribution for the sales of all products given availability. In other words, it is possible to recover the sales using only the purchase probability implied by the demand model (total sales are thus a sufficient statistic). Here, the sales is the missing data.

Without going too deep in the details, the approach first recovers a probability distribution of the number of alternative sales before a stockout and integrates over it to get the expected sales of a particular alternative after the stockout (given the sales made before the stockout). This approach uses combinatorial computations, which makes evaluating the model very cumbersome when multiple stockouts arise. However, evaluating demand for a large number of products is possible since you only need information on the product of interest and the stockouts to get a result.

### **Musalem et al. (2010)**

In Musalem et al. (2010), they do not consider the amount of sales as missing data but rather the sequence of sales. Using the fact that multiple sequences of sales could lead to the same end-of-period inventory, they express a likelihood function conditional on the missing sequences and sum it over markets to recover the parameters. However, in this case, adding products is an issue since it will increase the possible sequences a lot, while adding stockouts will not affect computation.

#### **4.3.2 Observed stockouts**

### **4.4 Limited consumer information**

# **Chapter 5**

## **Entry Models**

### **5.1 Introduction**

#### **5.1.1 Industry structure**

#### **5.1.2 Concentration measures**

### **5.2 Sutton (1991)**

The main question of the book from Sutton (1991) revolves around how do markets evolve to be less or more concentrated? Moreover, Sutton tries to explain why advertising is higher in concentrated industries. In order to explore the answers to these questions, he looks at different market structures and analyzes what makes these structure coherent with the data.

### 5.2.1 Perfect competition

Consider a market with perfect competition (price-taking assumption), exogenous sunk costs and free entry. The minimum efficient level of production (in the long run) is where  $p = \min AC$ .

This assumption means that, in the long run, firms will produce only the quantity satisfying this assumption, not more, not less. This implies that the number of firms in a market only depends on the size of the market,  $M$ . In particular, if you denote the quantity produced by firms at the optimum as  $q^*$ , you will have that the optimal number of firms  $n^*$  is given simply by:

$$n^* = M/q^*$$

As  $M \rightarrow \infty$ , we also have  $n^* \rightarrow \infty$ , thus the concentration ratio will tend to 0.

The issue with this simplistic model is that it might not hold in many settings where (1) competition might be imperfect or (2) sunk costs might be endogenous. As an example consider the increase of population in the United States since the creation of Pepsi and Coca-Cola. Even though the population has more than doubled, their respective market shares are still about 30% and 60%, which clearly disproves the previous model. For that reason he explores both directions.

### 5.2.2 Imperfect competition

Now suppose you allow for imperfect competition. For that purpose, we consider a two-stage game where in the first stage, firms choose to enter a market and incur a cost of  $A$ ; then in the second stage, firms play the market game. Moreover, assume that all  $M$  consumers have an income of 1 to spend exclusively on the good produced by the firms, such that in equilibrium:

$$p \cdot Q = M$$

Finally, suppose the marginal cost of production is  $c > 0$ .

Let  $N$  be the number of firms entering the market, each firm's profit will be denoted by  $\Pi(N, M)$ . Under free entry, we can get the equilibrium number of

firms,  $N^*$ , such that:

$$\Pi(N^*, M) > A \text{ and } \Pi(N^* + 1, M) < A$$

or in words,  $N^*$  is the number of firms such that any potential entrant would incur a loss by entering.

Moreover, it seems straightforward to say that for a given  $M$  (market size),  $\Pi(\cdot)$  is a decreasing function of  $N$  (more competitors decrease profits if demand is fixed); and for a given  $N$ ,  $\Pi(\cdot)$  is an increasing function of  $M$  (more demand yields higher profits if we have the same number of competitors). Thus, as  $M \rightarrow \infty$ , we can say that  $N^* \rightarrow \infty$  and concentration will still go to 0.

### 5.2.3 Endogenous sunk costs

Finally, consider a market with endogenous sunk costs, meaning that sunk costs will vary as a function of the current market structure. Two examples of this are advertising (being shown on the top of Google results pages is harder with more competitors) and R&D (having a better medication formula is also harder when competition is high). To introduce this intuition, consider a three-stage game with (1) firms enter the market, (2) they advertise their products and (3) they play the market game.

Under free entry, the equilibrium number of firms, denoted by  $N^*(M)$ , is determined as:

$$\Pi(N^*, M) > A(N^*) \text{ and } \Pi(N^* + 1, M) < A(N^* + 1)$$

## 5.3 Bresnahan and Reiss (1991)

In a realistic research setting, it is hard to observe strategic variables on a market level (prices, costs, advertising expenses, for all firms). This is the reason why Bresnahan and Reiss (1991) innovated on an estimation using mainly superficial market observables: the number of firms (but not the shares) and other general market characteristics (population, income, etc.). The main assumptions of this model rely on a static Sutton model with symmetric firms and free entry.



## Behavioral model

As in the Sutton-type of models, we solve it backwards, assuming the fixed costs of entry are incurred as sunk in the second period, when firms are choosing production.

Demand in the market  $m$  is given by:

$$Q_m = d(Z_m, p) \cdot S(Y_m)$$

where  $d(\cdot)$  represents the demand function of a representative consumer and  $S(\cdot)$  is the total number of consumers that would buy the product. Note that this demand specification has constant returns to scale: doubling  $S$  will double  $Q$ . Finally, we define the inverse demand curve as  $P(Q, Z, Y)$ .

Therefore in the second-stage under Cournot competition, each firm solves:

$$\max_{q_i} \Pi_{N,m} \equiv P(q_i, q_{-i}, Z_m, Y_m) \cdot q_i - F_N - C(q_i)$$

where  $F_N$  is the endogenous sunk cost associated with  $N$  firms entering the market. Without loss of generality (we proved a similar result in the Cournot-Sutton context), assume that in equilibrium, quantities will be symmetric such that  $q_i = q_j = q^*$  for all  $i, j$ . Because  $N$  is already “chosen” in the second stage, we can write individual equilibrium production as  $q^* \equiv d(Z_m, p) \cdot \frac{S(Y_m)}{N}$ . Then, using this, the profits of each firm is given by:

$$\Pi_{N,m} = P(q^*, q^*, Z_m, Y_m) \cdot q^* - F_N - C(q^*) = \left( P_N - \frac{C(q^*)}{q^*} \right) \cdot d(Z_m, P_N) \cdot \frac{S}{N} - F_N$$

Now, for both the average variable cost  $\frac{C(q^*)}{q^*}$  and the fixed cost  $F_N$ , let's allow them to be additively separable in components, one of them being dependent on the firm only (respectively  $AVC$  and  $F$ ) and the other component being endogenous on the number of firms (respectively  $b_N$  and  $B_N$ ), such that the total profit of an individual firm, facing a market with  $N$  total firms, is defined as:

$$\Pi_{N,m} = (P_N - AVC(q^*) - b_N) \cdot d(Z_m, P_N) \cdot \frac{S}{N} - F - B_N$$

In the first stage, using the free entry assumption, we know that if  $N^*$  firms enter a market  $m$ , it must be that  $\Pi_{N^*,m} > 0$  and  $\Pi_{N^*+1,m} < 0$ . Conversely, we can look

at the entry threshold  $s_N$ , which is the minimum additional demand, not already covered by existing  $N - 1$  firms that is required in order for the  $N$ th firm to enter. This threshold is the value of  $s_N \equiv S_N/N$  such that:

$$\Pi_{N,m} = 0 \Leftrightarrow \frac{S_N}{N} = \frac{F + B_N}{(P_N - AVC_N - b_N)d_N}$$

We can finally also look at the ratio of successive thresholds:

$$s_{N+1}/s_N = \frac{F + B_{N+1}}{F + B_N} \frac{(P_N - AVC_N - b_N)d_N}{(P_{N+1} - AVC_{N+1} - b_{N+1})d_{N+1}}$$

Thus, in a fully competitive market, a firm would enter each time its cost to enter could be recovered in the market, making  $s_{N+1}/s_N$  tend to 1, as  $N \rightarrow \infty$ .

### Empirical strategy

The threshold equations derived above ask for a lot of observed variables, namely prices, costs (variable and sunk) and more. In reality, it is very difficult to observe all these at the same time for all firms in a market, thus we need a model that could allow for less information, which is the essence of [?].

Consider a reduced-form profit function given by:

$$\Pi_{N,m} = \underbrace{S(Y_m, \lambda)}_{\text{size}} \cdot \underbrace{V_N(Z_m, W_m, \alpha, \beta)}_{\text{variable profit}} - \underbrace{F_N(W_m, \gamma)}_{\text{fixed}} + \epsilon_m$$

$\bar{\Pi}_{N,m}$

which has an endogenous component  $\bar{\Pi}_{N,m}$ , and an error-term  $\epsilon_m$  that is not dependent on  $N$ . This should raise some memories to anyone who covered the demand estimation part of the course. In fact, assuming a specification on the error term reveals the model as an ordered probit model, very similar to the logit or multinomial probit models. To see this, consider a market with  $N$  firms, this means that:

$$\bar{\Pi}_{N,m} + \epsilon_m > 0 \text{ and } \bar{\Pi}_{N+1,m} + \epsilon_m < 0$$

which is equivalent to:

$$\bar{\Pi}_{N,m} > \epsilon_m > \bar{\Pi}_{N+1,m}$$

Assuming  $\epsilon_m$  is drawn from an iid normal distribution with mean 0 and variance  $\sigma^2$ , we have that:

$$\Pr[N_m] = \begin{cases} \Phi(\bar{\Pi}_{N,m}) - \Phi(\bar{\Pi}_{N+1,m}) & \text{if } N_m > 1 \\ 1 - \Phi(\bar{\Pi}_{2,m}) & \text{if } N_m = 1 \end{cases}$$

Before going on to the estimation of the model, we need to look at the reduced-form of each component of the profit function:

- The market size includes a combination of market size characteristics  $Y_m$ , such as the population, the neighbouring population, growth, commuting possibilities, etc.
- The variable profit per capita is defined as:  $V_N = \alpha_1 + X\beta - \sum_{n=2}^N \alpha_n$  where:
  - $X$  is a vector of relevant economic variables such as demand characteristics for the product ( $Z$ ) and cost-shifters ( $W$ ).
  - $\alpha_n \geq 0$  is an intercept component such that each firm entering a market has a negative effect on profits.
- The endogenous fixed costs defined as:  $F_N = \gamma_1 + \gamma_L w_L + \sum_{n=2}^N \gamma_n \cdot \gamma_n$

Finally, the estimation is performed using maximum likelihood. In fact, for each observation of the market, we use the probability function defined above. This gives us a likelihood function as a function of all observed variables described in the list above. Taking the log of it yields the log-likelihood to be maximized in order to estimate the parameters of interest.

## 5.4 Berry (1992)

The previous paper was lacking heterogeneity in the sense that its results applies for the case where all firms have the same costs, same continuation payoffs, etc. A step in the direction of allowing some differentiation was made by [?], where fixed costs can vary across firms. Thus, the behavioral model stays identical, but the profit of firm  $k$  can now be divided into a common component  $v_m(N)$ , incurred by all firms in the same way, and an idiosyncratic component  $\phi_{m,k}$  applying only

to firm  $k$ . In particular, we have:

$$\Pi_{N,m,k} = \underbrace{X_m\beta - \delta \ln(N) + \rho u_{m,0}}_{v_m(N)} + \underbrace{Z_k\alpha + \sqrt{1 - \rho^2} \cdot u_{m,k}}_{\phi_{m,k}}$$

Note that in this equation, the combination of the terms  $\rho \cdot u_{m,0} + \sqrt{1 - \rho^2} \cdot u_{m,k}$  actually represents the error term, denoted  $\epsilon_{m,k}$ . In this setting,  $\rho$  represents the correlation between error terms across firms in a given market. Finally, [?] assumes that:

$$\epsilon_{m,k} \sim N(0, \Sigma)$$

where  $\Sigma$  is a matrix with all off-diagonal terms equal to  $\rho$ .

As in the demand estimation case, this error term is known to the players (the firms) but not to the econometrician. We are still in the static, full information game where all firms know everything about all other firms. However this time we are not in an ordered probit setting since the very structure of the problem is endogenous to the number of firms. To see that, recall the error of the previous model did not include any other subscript than  $m$ , while this one includes something about  $k$  which is intrinsically linked to the number of firms.

Contrary to the previous models, this one can display multiplicity of equilibria. In fact, although the equilibrium number of firms is unique, the exact firms that enter the market can be different. This implies that we lose information on which firms enter a market. For example, the model might predict that in a given market, two firms will ultimately enter, but you could have firms 1 and 2, firms 2 and 3 or firms 1 and 3. In order to control that issue, the author assumes that firms enter in the order of their profitability. Using that assumption, we can simplify the paper and compute the probability of observing  $N$  firms in the market as:

$$\begin{aligned} \Pr[n_m = N | Z_m] &= \Pr \left[ \epsilon_{m,1}, \dots, \epsilon_{m,K_m} : \sum_{k=1}^{K_m} \mathbb{I}\{v_m(N, Z_m) > \phi_{m,k}\} = N \right] \\ &= \underbrace{\int \dots \int}_{K_m \text{ times}} \mathbb{I} \left\{ \sum_{k=1}^{K_m} \mathbb{I}\{v_m(N, Z_m) > \phi_{m,k}\} = N \right\} dF(\epsilon_{m,1}, \dots, \epsilon_{m,K_m}, \theta) \end{aligned}$$

which is a multi-dimensional integral (of  $K_m$  dimensions) and as we've seen in the previous two chapters, it is hard to compute. In order to circumvent this

computational issue, we could use the same method as in BLP: an inner loop simulating the sample moment of the integral for each value of  $\theta$ , and an outer loop solving for the value of  $\theta$  that minimizes the square distance between the observed and simulated number of firms. This technique is called the Simulated Nonlinear Least Squares (or SNLS).

Formally, the outer loop finds

$$\hat{\theta} = \arg \min_{\theta} \frac{1}{M} \sum_m (N_m - E [n_m | Z_m, \theta, \epsilon_{m,1}, \dots, \epsilon_{m,K_m}])^2$$

where the expectation term is approximated by its simulated sample average over random iid draws of  $(\epsilon_{m,1}, \dots, \epsilon_{m,K_m})$ . The simulated sample average is defined as:

$$E [n_m | Z_m, \theta, \epsilon_{m,1}, \dots, \epsilon_{m,K_m}] \approx \frac{1}{S} \sum_s n_m^{*,s}(\epsilon^s, \theta)$$

$$\text{where } n_m^{*,s}(\epsilon^s, \theta) \equiv \max_{0 \leq n \leq K_m} \left\{ n : \sum_{k=1}^{K_m} \mathbb{I}\{v_m(n, Z_m) > \phi_{m,n} | \epsilon^s\} \geq n \right\}$$

or in words, the maximum number of firms  $n$ , such that the number of firms entering the market with a positive profit is greater than  $n$ .

## 5.5 Two-period models

Two-period models have been introduced for the first time in entry models, but they have been used in several other settings since, for example in models of investment, contracting, etc. Typically, these models rely on:

- A first period where the agents choose a state variable that will determine the nature of the game in the second period.
- A second period where the game is played following the state of the world decided on the first.

The solution concept used to determine the outcome of the game is called "subgame perfection" which means a Nash equilibrium is chosen at each step played in the game. We also call this equilibrium the Subgame Perfect Nash Equilibrium, or SPNE. In the simple case of a two-period game, the SPNE is quite easy to determine by backwards induction:

- You solve for the NE of the second period game for each potential game played following first period choices.
- Assuming the outcomes computed above are realized, you solve for the first period choice that is a NE.

Consider a typical two-period à la Stackelberg game where a firm chooses a level of capital ( $K_1 \geq 0$ ) in the first period, and the second firm chooses its own level ( $K_2 \geq 0$ ) in the second period. A firm that chooses a capital level of 0 is choosing to stay out of the market. A firm that chooses a level strictly greater than 0 enters the market, although firm 2 would have to pay a fixed cost of entry equal to  $F$ .

The profits of firm 1 are:

$$\pi_1(K_1, K_2) = K_1 \cdot (1 - K_1 - K_2)$$

while the profits of firm 2 are:

$$\pi_2(K_1, K_2) = \begin{cases} K_2 \cdot (1 - K_1 - K_2) - F & \text{if } K_2 > 0 \\ 0 & \text{if } K_2 = 0 \end{cases}$$

In order to solve the game, we proceed by backwards induction. In the second period, we consider the decision of firm 2 over the level  $K_2$ . It will choose a level  $K_2 > 0$  if and only if the profit associated is greater than 0, meaning that:

$$K_2(1 - K_1 - K_2) - F \geq 0 \Leftrightarrow K_2(1 - K_1 - K_2) \geq F$$

In that case, firm 2 will choose:

$$K_2^* = \arg \max_{K_2} K_2(1 - K_1 - K_2) - F$$

which is the solution to the following FOC:

$$1 - K_1 - 2K_2^* = 0 \Leftrightarrow K_2^* = \frac{1 - K_1}{2}$$

Plugging this solution into the participation condition above, we get that:

$$\frac{1 - K_1}{2} \left(1 - K_1 - \frac{1 - K_1}{2}\right) \geq F \Leftrightarrow \frac{(1 - K_1)^2}{4} \geq F \Leftrightarrow K_1 \leq 1 - 2\sqrt{F}$$

and thus the optimal level  $K_2^*$  is defined as:

$$K_2^* = \begin{cases} \frac{1-K_1}{2} & \text{if } K_1 \leq 1 - 2\sqrt{F} \\ 0 & \text{if } K_1 > 1 - 2\sqrt{F} \end{cases}$$

Now that the second period is solved, we can go into the first period. Firm 1 will choose a level  $K_1$  to maximize its profits, which are now known to be:

$$\pi_1(K_1) = \begin{cases} K_1 \cdot \left(1 - K_1 - \frac{1-K_1}{2}\right) & \text{if } K_1 \leq 1 - 2\sqrt{F} \\ K_1 \cdot (1 - K_1) & \text{if } K_1 > 1 - 2\sqrt{F} \end{cases}$$

From this perspective, it is clear that, for a given  $K_1$ , allowing the other player to enter the market is worse than deterring entry. However, deterring entry can only be done for  $K_1 > 1 - 2\sqrt{F}$ . This creates a discontinuous profit function where deterring entry is always better but can be achieved only at some points that might yield a lower profit than allowing firm 2 to enter. The following graph represents this discrepancy nicely:

## 5.6 Entry models with multiple equilibria

In this section, we will reconsider static entry games (with two firms for simplicity) in order to introduce new ideas related to partial identification. In fact, as we have already discussed in this chapter, entry games have the potential to display multiple equilibria, which make straightforward estimation impossible. We have to move to a new way of estimation called “partial identification” of structural parameters. This concept simply means that instead of having a definite value for our structural parameters, we will recover multiple values, all coinciding with the model and the data. To recover these sets, we will need a new type of estimating equations called “moment inequalities”, which a very recent topic in econometrics.

There are two ways to get to these moment inequalities: (1) using “structural” errors (as in Ciliberto and Tamer, 2009) or (2) using expectational or measurement errors (as in Pakes, Porter, Ho and Ishii, 2015).

### 5.6.1 Entry games with structural errors

Consider a simple two-firm entry model. Let  $a_i \in \{0, 1\}$  denote the action of player  $i = 1, 2$ . The profits are given by:

$$\Pi_i(s) = \begin{cases} \beta' s - \delta a_{-i} + \varepsilon_i & \text{if } a_i = 1 \\ 0 & \text{if } a_i = 0 \end{cases}$$

where  $\beta' s$  is the market profits (does not depend on the number of firms). We can see here that choices will be interdependent as profits are linked to the competitor's choice as well as the agent's. Moreover, note that there is an error term  $\varepsilon_i$  which is “structural”, meaning that both firms observe it, but the econometrician does not. In that sense, this model is a perfect information game.

#### Solving the game

For fixed values of the errors and parameters, the Nash equilibrium values  $a_1^*$  and  $a_2^*$  will satisfy best-response conditions, which are as follows:

$$a_1^* = 1 \Leftrightarrow \Pi_1(a_2^*) \geq 0 \Leftrightarrow \beta' s - \delta a_2^* + \varepsilon_1 \geq 0$$

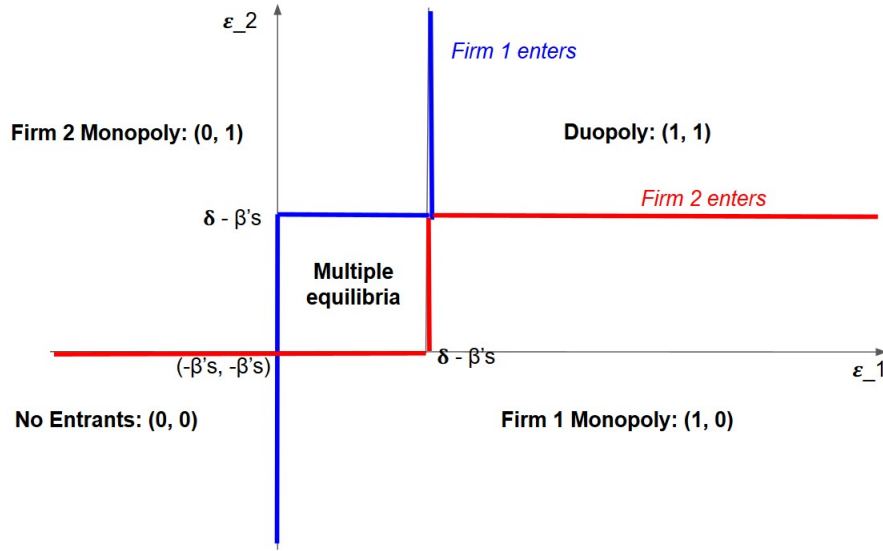
$$a_1^* = 0 \Leftrightarrow \Pi_1(a_2^*) \leq 0 \Leftrightarrow \beta' s - \delta a_2^* + \varepsilon_1 \leq 0$$

$$a_2^* = 1 \Leftrightarrow \Pi_2(a_1^*) \geq 0 \Leftrightarrow \beta' s - \delta a_1^* + \varepsilon_2 \geq 0$$

$$a_2^* = 0 \Leftrightarrow \Pi_2(a_1^*) \leq 0 \Leftrightarrow \beta' s - \delta a_1^* + \varepsilon_2 \leq 0$$

Using these, we can see that under some values of parameters, we might find multiple equilibria. Intuitively, think of a situation in which the market can hold only one firm, so that both  $(1, 0)$  and  $(0, 1)$  are possible equilibria. Alternatively, this picture shows this fact clearly:





### Deriving the inequalities

Given this setup, we can derive inequalities for the probabilities of observing any state of the markets, using the distribution of the structural errors:

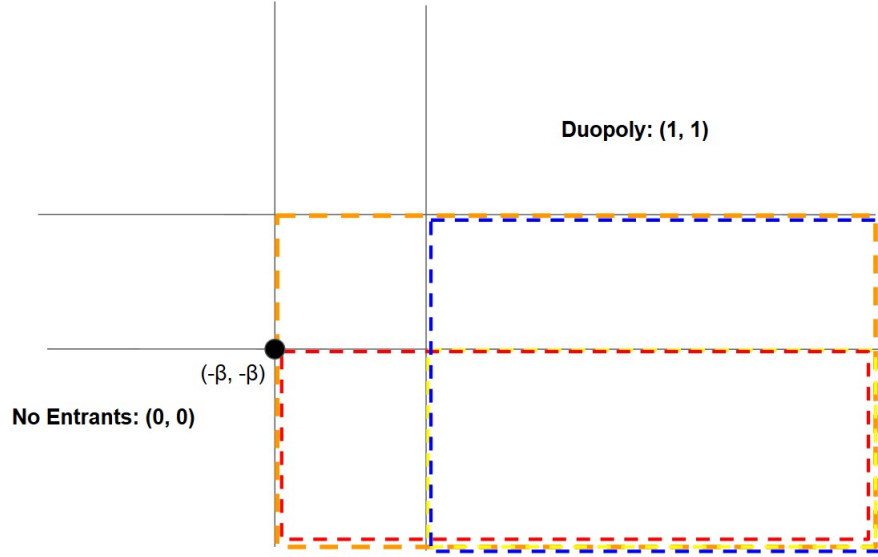
The probability of observing none of the two firms in the market is given by:

$$\Pr [a_1^* = a_2^* = 0 | s] = \Pr [\varepsilon_1 \leq -\beta' s \text{ and } \varepsilon_2 \leq -\beta' s] = F(-\beta' s)^2$$

For the two firms to be observed in the market:

$$\Pr [a_1^* = a_2^* = 1 | s] = \Pr [\varepsilon_1 \geq \delta - \beta' s \text{ and } \varepsilon_2 \geq \delta - \beta' s] = (1 - F(\delta - \beta' s))^2$$

For a monopoly of firm 1 to be observed, we have an issue because of the central square in the graph, where we do not know which firm is supposed to be in the market. We can however find an interval for that probability, using the following graph:



In fact, the probability of finding a firm 1 monopoly must be lower than firm 1 always being a monopoly (even when we see multiple equilibria), which is the orange area in the graph above:

$$\begin{aligned} \Pr [\varepsilon_1 \geq -\beta' s \text{ and } \varepsilon_2 \leq \delta - \beta' s] &\geq \Pr [a_1^* = 1, a_2^* = 0 | s] \\ \Leftrightarrow [1 - F(-\beta' s)] \cdot F(\delta - \beta' s) &\geq \Pr [a_1^* = 1, a_2^* = 0 | s] \end{aligned}$$

On the other side, if all multiple equilibria go to firm 2, we would observe at least a probability equal to the blue and red areas, minus the yellow:

$$\begin{aligned} \Pr [\varepsilon_1 \geq -\beta' s \text{ and } \varepsilon_2 \leq -\beta' s] + \Pr [\varepsilon_1 \geq \delta - \beta' s \text{ and } \varepsilon_2 \leq \delta - \beta' s] \\ - \Pr [\varepsilon_1 \geq \delta - \beta' s \text{ and } \varepsilon_2 \leq -\beta' s] &\leq \Pr [a_1^* = 1, a_2^* = 0 | s] \\ \Leftrightarrow [1 - F(-\beta' s)] \cdot F(-\beta' s) + [1 - F(\delta - \beta' s)] \cdot F(\delta - \beta' s) \\ - [1 - F(\delta - \beta' s)] \cdot F(-\beta' s) &\leq \Pr [a_1^* = 1, a_2^* = 0 | s] \end{aligned}$$

Obviously, the same computation can be done for the probability of observing only firm 2 in the market.

Now, define mutually exclusive outcome indicators as:

$$Y_1 = \mathbb{I}\{a_1 = 1, a_2 = 0\}$$

$$Y_2 = \mathbb{I}\{a_1 = 0, a_2 = 1\}$$

$$Y_3 = \mathbb{I}\{a_1 = 0, a_2 = 0\}$$

$$Y_4 = \mathbb{I}\{a_1 = 1, a_2 = 1\}$$

where  $a_i$  is the observed decision of the agent  $i$ . As such, we observe (or compute from observations) in the dataset the variables  $Y_t = \{Y_{1t}, Y_{2t}, Y_{3t}, Y_{4t}\}$  for all  $t = 1, \dots, T$ . Using these variables, we can estimate the outcome probabilities  $\hat{P}_{00}, \hat{P}_{01}, \hat{P}_{10}$  and  $\hat{P}_{11}$  (naively, without using any covariates), which we can then use in our inequalities from above to estimate the set of parameters  $(\beta, \delta)$ .

**Ciliberto and Tamer (2009)**

### 5.6.2 Entry games with expectational errors

In contrast to the above, Pakes, Porter, Ho and Ishii (henceforth PPHI) derive the moment inequalities directly from the optimality conditions. Thus, the error term is not only unobserved to the econometrician but also to the firms.

#### Deriving the inequalities

In the two-firm entry game, if we observe actions  $(a_1^*, a_2^*)$ , then the Nash condition tells us that, given information sets  $I_1$  and  $I_2$ , we have:

$$E [\pi(a_1^*, a_2^*, z) | I_1] - E [\pi(a, a_2^*, z) | I_1] > 0, \text{ for all } a \neq a_1^*$$

$$E [\pi(a_1^*, a_2^*, z) | I_2] - E [\pi(a_1^*, a, z) | I_2] > 0, \text{ for all } a \neq a_2^*$$

where  $z$  is the vector of variables that have an effect on the profits (some might be unobserved to the agents). Because of that, PPHI suggests to parameterize the profit function as a function of actions and variables  $z$ , given a set of parameters  $\theta$  to estimate. Formally,

$$\pi_i(a_1, a_2, z) = r_i(a_1, a_2, z; \theta)$$

which we can then use in the conditional moment inequalities from above to get:

$$E [r_1(a_1^*, a_2^*, z; \theta) - r_1(a, a_2^*, z; \theta)] > 0, \text{ for all } a \neq a_1^*$$

$$E [r_2(a_1^*, a_2^*, z; \theta) - r_2(a_1^*, a, z; \theta)] > 0, \text{ for all } a \neq a_2^*$$

**Ho, Ho and Mortimer (2012)**

# Chapter 6

## Moment Inequalities

This chapter provides a more rigorous introduction to estimation of models through the use of inequality restrictions, henceforth called moment inequalities. We have seen them in the previous chapter on entry, but they can be applied more generally to any type of games that would yield cumbersome computations using traditional methods, or for estimation when data are imperfect.

### 6.1 Framework

#### 6.1.1 The agent's decision problem

Consider a situation with  $n$  decision makers indexed by  $i$ , having access to their own information set  $I_i$  when decisions are made and  $D_i$  the set of available decisions. The strategy played by agent  $i$  is a mapping  $s_i : I \rightarrow D$  (from information to action), such that it generates the observed decisions  $d_i$  (which could be a vector).

The profit function of agent  $i$  is determined by his decision ( $d_i$ ), the other agents' decisions ( $d_{-i}$ ) and other environment variables  $y_i$ . At the time of the decision, the agent has expectations over what happens in the game ( $\pi(\cdot)$ ,  $s_i$ ,  $I_i$  and  $Y_i$ ); they are denoted by  $\mathcal{E}[\cdot]$ , which is not the same operator as the typical expectation

operator.

### Best-response condition (Nash)

If  $d_i$  is the observed decision of player  $i$ , we assume:

$$\sup_{d \in \mathcal{d}_i} \mathcal{E} [\pi(d, d_{-i}, y_i) | I_i] \leq \mathcal{E} [\pi(d_i, d_{-i}, y_i) | I_i] \text{ for all } i = 1, \dots, n$$

Quite obviously, we can see this assumption as an assumption for “rationality”, meaning that at the time of the decision, the agent chose the best option. In single agent problems, this comes directly from optimization behavior, while in games, it is only a necessary condition for a Bayes-Nash equilibrium to be played, but it does not rule out multiple equilibria, or restrict the selection between equilibria.

### Counterfactual condition

In order for the agents to ensure optimal behavior, they need to evaluate the alternative decisions in their counterfactual environment. Thus we need to define what happens to  $d_{-i}$  and  $y_i$  following the decision of agent  $i$ . Note that in single-agent problems and simultaneous games, the counterfactual is assumed away using a conditional independence assumption.

In other cases, we assume that  $y_i = y(z_i, d, d_{-i})$  and that the distribution of  $(d_i, z_i)$  conditional on  $I_i$  and  $d$  do not depend on  $d$ . In words, this assumption means that environment variables  $y_i$  depend only on variables  $z_i$  and decisions by the agents (which are all exogenous conditional on  $I_i$  and  $d$ ).

Using this, we define the “differential profit” as:

$$\Delta\pi(d, d', d_{-i}, z_i) = \pi(d, d_{-i}, y(z_i, d, d_{-i})) - \pi(d', d_{-i}, y(z_i, d', d_{-i}))$$

as the difference in profits between two decisions.

Finally, we rewrite the first condition as:

$$\mathcal{E} [\Delta\pi(d_i, d, d_{-i}, z_i) | I_i] \geq 0 \text{ for all } i = 1, \dots, n$$

This might seem like the inequality to use in estimation, however, recall that the expectation is only the agent's so we need to recover empirical analogues of these in order to use them.

### 6.1.2 Observables and disturbances

We assume that the econometrician has a parametric function, denoted  $r(\cdot)$ , that approximates  $\pi(\cdot)$  given arguments  $d_i$ ,  $d_{-i}$ , observable variables of  $z_i$ , denoted  $z_i^o$  and unknown parameters  $\theta$  to estimate.

Using that function, we can approximate the differential profit with  $\Delta r(d, d', d_{-i}, z_i^o, \theta)$ . From there, define two types of errors:

$$\begin{aligned} v_{2,i,d,d'} &= \mathcal{E} [\Delta \pi(d, d', d_{-i}, z_i) | I_i] - \mathcal{E} [\Delta r(d, d', d_{-i}, z_i^o, \theta) | I_i] \\ v_{1,i,d,d'} &= v_{1,i,d,d'}^\pi - v_{1,i,d,d'}^r \\ v_{1,i,d,d'}^\pi &= \Delta \pi(d_i, d, d_{-i}, z_i) - \mathcal{E} [\Delta \pi(d_i, d, d_{-i}, z_i) | I_i] \\ v_{1,i,d,d'}^r &= \Delta r(d, d', d_{-i}, z_i^o, \theta) - \mathcal{E} [\Delta r(d, d', d_{-i}, z_i^o, \theta) | I_i] \end{aligned}$$

that we refer to in general as  $v_{2,i}$  and  $v_{1,i}$  (composed of  $v_{1,i}^\pi$  and  $v_{1,i}^r$ ). Note that the first error, while not observed by the econometrician, is a part of the information set  $I_i$  of the agent (he “knows”  $v_{2,i}$ ). The second error is not observed by either the agent nor the econometrician.

### 6.1.3 Moment inequalities

## 6.2 Applications

# Chapter 7

## Single-agent Discrete Dynamic Programming

### 7.1 Definition

A discrete dynamic programming is a maximization problem of an objective function, over an infinite horizon, with discounting. More formally, the objective function takes the following form:

$$E \left[ \sum_{t=0}^{\infty} \beta^t \cdot r(s_t, a_t) \right]$$

where  $s_t$  is the state variable,  $a_t$  is an action,  $\beta$  is the discount factor and  $r(\cdot)$  is the “reward” function for taking action  $a_t$  in the state  $s_t$ . While the action is deliberately taken by the optimizing agent, the state is pinned down by previous actions and states. We say that at each point in time, the state summarizes the information about the world. Hence,  $s_t$  not only contains information about the present time period but also all previous time periods. This means that each pair  $(s_t, a_t)$  will determine the potential state  $s_{t+1}$ ; we denote the probability of moving to state  $s_{t+1}$  given taking action  $a_t$  in state  $s_t$  as  $Q(s_t, a_t, s_{t+1})$ . In other words, the actions that the agent takes influence not only current rewards but also the future time path of the state, and thus future rewards as well. The essence of



dynamic programming problems is solving this trade-off between current and future rewards at each point in time.

## Policies

The most fruitful way to think about solutions to DDP problems is to compare what we call policies. A policy is a mapping from past actions and states to current action. In other words, it is a sort of code of conduct for the agent. Recall that the current state holds sufficient information about past actions and past states, therefore, a policy can also be represented as a mapping from current state to current action. This type of policies is called stationary Markov policies. A stationary Markov policy (henceforth just policy) is denoted as  $\sigma(\cdot)$  which maps actions to states such that  $a_t = \sigma(s_t)$ . It is known that, for any arbitrary policy, there exists a stationary Markov policy that dominates it at least weakly: this is why solving the previous problem can be reduced to finding the best policy, only among Markov stationary policies.

## Formal definition

A discrete dynamic program consists of:

- A finite set of states  $S = \{1, \dots, n\}$ .
- A finite set of feasible actions  $A(s)$  defined for each  $s \in S$ , and thus a set of feasible state-action pairs:  $SA = \{(s, a) : s \in S, a \in A(s)\}$ .
- A reward function  $r : SA \rightarrow \mathbb{R}$ .
- A transition probability function  $Q : SA \rightarrow \Delta S$ , where  $\Delta S$  is the set of probability distributions over  $S$ .
- A discount factor  $\beta \in [0, 1)$ .

Over this definition, we provide other definitions to help us solve the problem. First, we define a policy as a function  $\sigma : S \rightarrow A$ . Then, in the set of policies are the feasible policies such that  $\sigma(s) \in A(s)$  for all  $s \in S$ . This subset is denoted  $\Sigma$ .

Now that we have a structure, let's remind ourselves how the problem works. If an agent uses a policy  $\sigma \in \Sigma$ , then he gets the current reward  $r(s_t, \sigma(s_t))$  at

time  $t$  and the probability that next period's state is  $s'$  is given by  $\Pr[s_{t+1} = s'] = Q(s_t, \sigma(s_t), s')$ .

Then, for each feasible policy  $\sigma \in \Sigma$ , define:

- $r_\sigma = r(s, \sigma(s))$ , the vector of possible rewards at each state, for a given policy.
- $Q_\sigma = Q(s, \sigma(s), s')$ , the state-transition matrix from  $s$  to  $s'$ , also called the stochastic matrix on  $S$ .

Using these definitions, note that a row of  $Q_\sigma$  contains the probabilities of all future states given the state of the row happened. For example, the  $s$ -th row would be a row vector of probabilities of each state  $s_i$  happening in the next period, which would sum to 1. This is interesting because, coupled with  $r_\sigma$ , we get that:

$$(Q_\sigma \cdot r_\sigma)(s) = E[r(s_t, \sigma(s_t)) | s_{t-1} = s]$$

where  $(Q_\sigma \cdot r_\sigma)(s)$  denotes the  $s$ -th row, of the column vector  $Q_\sigma \cdot r_\sigma$  and assuming  $s_t \sim Q_\sigma$ .

## Value and Optimality

Let  $v_\sigma(s)$  denote the discounted sum of expected rewards following policy  $\sigma$ , given an initial state of  $s$ , or formally:

$$v_\sigma(s) = \sum_{t=0}^{\infty} \beta^t (Q_\sigma \cdot r_\sigma)(s)$$

This function is called the policy value function for  $\sigma$ .

A policy  $\sigma \in \Sigma$  is optimal if, for all  $s \in S$ , we have that:

$$\sigma \in \arg \max_{\sigma \in \Sigma} v_\sigma(s)$$

The optimal value function, or simply value function, is, as its name suggests, the value function of the previous problem, or formally,  $v^* : S \rightarrow \mathbb{R}$  such that:

$$v^*(s) = \max_{\sigma \in \Sigma} v_\sigma(s)$$

Finally, given any value function  $w : S \rightarrow \mathbb{R}$ , a feasible policy  $\sigma \in \Sigma$  is called  $w$ -greedy if

$$\sigma(s) \in \arg \max_{a \in A(s)} r(s, a) + \beta \sum_{s' \in S} w(s') Q(s, a, s') \quad \text{for all } s \in S$$

This means that, given an expected future path of rewards determined by  $w$ , the  $w$ -greedy policy  $\sigma$  is a policy that yields the best current action to take, for each state. Hence, it follows that if we knew the optimal value function  $v^*$ , we would be looking for policies that are  $v^*$ -greedy, or that would suggest the best current action to take given following the optimal path in the future.

## Operators

Before going further into solving the problem, we define two useful operators.

The Bellman operator,  $T : \mathbb{R}^S \rightarrow \mathbb{R}^S$  is defined by:

$$(Tv)(s) = \max_{a \in A(s)} r(s, a) + \beta \sum_{s' \in S} v(s') Q(s, a, s') \quad \text{for all } s \in S$$

This operator transforms any value function by changing its current action to the optimal one in any state. In other words, if your current value function is bad, the Bellman operator will make it slightly better by altering the current action to its optimal value, thus increasing the level of the overall value function. In that sense, the Bellman operator is monotonic, such that if  $v \leq w$ , then  $Tv \leq Tw$ . Moreover, we can show that the Bellman operator is also a contraction mapping, or formally that:  $\|Tv - Tw\| \leq \beta \|v - w\|$ . Using these two facts, we will be able to design an iterative algorithm to get to the solution of the problem.

The other operator is ...

## Bellman equation and Optimality

We know that the solution of the DDP problem is to find a value function such that:

$$v(s) = \max_{a \in A(s)} r(s, a) + \beta \sum_{s' \in S} v(s') Q(s, a, s') \quad \text{for all } s \in S$$

which can be written using the Bellman operator as:

$$v(s) = Tv(s) \quad \text{for all } s \in S$$

In this form, it is now clear that the essence of the problem is to find the fixed-point of the operator  $T$ .

Moreover, using the fact that we know  $T$  as a contraction mapping of modulus  $\beta$ , we get a natural way to get the fixed-point of  $T$  by applying it infinitely many times to any initial value function  $v^0$ . Formally,

$$v^* = \lim_{k \rightarrow \infty} T^k v^0$$

However, in real applications, there is no such thing as infinite operations, thus we will need a finite approximation of this procedure.

### Value Function Iteration

The value function iteration procedure is a finite approximation of the infinite Bellman operation we discussed just above. In fact, it relies on applying the Bellman operator as many times as needed to get a value function that is stable enough (close to the fixed point). The procedure goes as follows:

1. Choose any  $v^0 \in \mathbb{R}^n$ , and specify an error  $\varepsilon > 0$  (close to 0). This is the initial step,  $k = 0$ .
2. Compute  $v^{k+1} = Tv^k$ , meaning that you need to solve the maximization problem defined as:

$$v^{k+1}(s) = \max_{a \in A(s)} r(s, a) + \beta \sum_{s' \in S} v^k(s') Q(s, a, s')$$

for each state  $s \in S$ .

3. Evaluate the continuation condition:

$$\sup_s \|v^{k+1}(s) - v^k(s)\| < \left\lceil \frac{(1 - \beta)}{2\beta} \right\rceil \varepsilon$$

If it is true, then go to the next step, otherwise go back to step 2 and set  $k = k + 1$ .

4. The optimal value function computed is  $v^{k+1}$  and the optimal policy function is  $\sigma$ , a  $v^{k+1}$ -greedy policy.

By performing this procedure, you get a  $\varepsilon$ -approximation of the optimal value function.

## 7.2 Rust (1987)

Harold Zurcher is the manager of a bus depot in Madison, WI. Each month, for each bus, he must decide if the bus should continue with the current engine or if it should be replaced. If the bus continues without replacing the engine, then it pays a constant marginal cost for each additional mile. If the bus gets replaced, then Harold pays a fixed replacement cost. The problem that Harold faces is to minimize long run expected cost.

This is a clear discrete state dynamic programming problem as defined above, and as such, should have been fairly easy to estimate at the time the paper was written. However, Rust (1987) is about estimating the parameters of the model, using the actual data from the decisions of Harold Zurcher. In that sense, solving the model is really the first step (the inner loop) of a more intricate process to recover the parameters of the model (fixed costs, marginal costs, etc.).

In this chapter, we will go over both the solution to the model (given a set of parameters) and the estimation of it. We draw on the problem set 4 given by Prof. Julie Mortimer.

### 7.2.1 Setup

#### Optimal stopping problem as a DDP

First we setup the model, using the formal definition of a DDP given in the first section. The model is set for a single bus (recall the assumption that there are no correlations between buses) for time periods  $t = 1, 2, \dots, +\infty$  representing weeks (for each time HZ can take a decision on the bus).

The state variable  $s$  will be the mileage on the bus. Hence the set of states  $S$  should be the set  $\mathbb{R}_+$  of all possible mileages.

In each state, there are two feasible actions, which are the same for any state: “not replace” ( $a^0$ ) or “replace” ( $a^1$ ). The feasible action set is constant for all states:  $A(s) = \{a^0, a^1\} = A$ . Thus, the feasible state-action pairs set is:  $SA = \{(s, a) : s \in S, a \in A\}$ .

The reward function is the profit function for each feasible state-action pair. For any state-action  $(s, a)$  where  $a = a^1$ , the profit will be a negative fixed replacement cost  $RC$ . For state-action pairs in which  $a = a^0$ , then the profit will be a negative cost depending on the mileage (the state  $s$ ). Formally, we get:

$$r(s, a) = \begin{cases} -RC & \text{if } a = 1 \\ -c(s, \theta) & \text{if } a = 0 \end{cases}$$

The transition probability function yields a probability distribution over all states for each feasible state-action pair. To stay very general, we write:

$$s_{t+1}|s, a \begin{cases} = 0 & \text{if } a = 1 \\ \sim G(\cdot|s) & \text{if } a = 0 \end{cases}$$

where  $G$  is unknown up to parameters.

Finally, the discount factor is denoted as  $\beta$ .

Therefore, Harold Zurcher chooses the infinite sequence of actions  $\{a_t\}_{t=1,\dots}$  to maximize the objective function:

$$\max_{\{a_t\}_{t=1,\dots}} \mathbb{E} \left[ \sum_{t=1}^{\infty} \beta^t \cdot r(s_t, a_t; \theta) \right]$$

Define the (optimal) value function as:

$$V(s_t) = \max_{\{a_t\}_{t=1,\dots}} \mathbb{E} \left[ \sum_{\tau=t}^{\infty} \beta^{\tau-t} \cdot r(s_\tau, a_\tau; \theta) | s_t \right]$$

And finally we write the Bellman equation:

$$a_t = \arg \max_a r(s_t, a; \theta) + \beta E[V(s')|s_t, a]$$

Solving the model requires knowledge of everything described until now, then performing a value function iteration as described in the first section. However, there are parameters in the model that are not observed in the data, hence the need to estimate them. To estimate is different than to solve, thus we will need to add crucial elements and assumptions to the model.

### **Adding structural errors**

In particular, the main addition required is a structural error in the reward function. This structural error will allow for “positive likelihood” given our imperfect model (because the econometrician cannot recover the function perfectly). Recall that a structural error is observed by the agent at the time of the decision, but is never observed by the econometrician.

We get that the “new” reward function is thus given by:

$$r(s, a) = \begin{cases} -RC + \varepsilon_1 & \text{if } a = 1 \\ -c \cdot s + \varepsilon_0 & \text{if } a = 0 \end{cases}$$

We are left with three types of parameters to estimate that are summarized in  $\theta$ :

- Parameters of the  $c(\cdot)$  function.
- Value of replacement cost  $RC$ .
- Parameters of the mileage transition function  $G(\cdot|x)$ .

Note that both the discount factor  $\beta$  and the distribution of structural errors are not to be estimated. In fact, most dynamic-discrete choice settings are shown to be nonparametrically underidentified. Intuitively,  $\beta$  is difficult to disentangle from  $RC$ .

### 7.2.2 Econometric model

We observe actions and mileages for  $t = 1, \dots, T$  and 62 buses. We treat all buses as independent draws of the same distribution (as if all buses were equivalent).

The likelihood function for a bus, over  $T$  periods is given by:

$$\begin{aligned}
 L(\theta) &= f(s_1, \dots, s_T, a_1, \dots, a_T | s_0, a_0, \theta) \\
 &= \prod_{t=1}^T \Pr [s_t, a_t | s_0, a_0, s_1, a_1, \dots, s_{t-1}, a_{t-1}, \theta] \\
 &= \prod_{t=1}^T \Pr [s_t, a_t | s_{t-1}, a_{t-1}, \theta] \\
 &= \prod_{t=1}^T \Pr [a_t | s_t, \theta] \cdot \Pr [s_t | s_{t-1}, a_{t-1}, \theta_3]
 \end{aligned}$$

where  $\theta_3$  is the vector of the parameters that govern the distribution of mileages.

First of all, from the second to the third lines, we use the stationary Markov policy property (the best policies are Markov stationary, meaning that they only require information about the previous period).

Second, from the third to last equations, we use a new assumption called conditional independence. Formally, this assumption implies that (1) conditional on the current state, actions are independent over time (actions depend only on previous actions through the state variable) and that (2) conditional on the previous state and previous action, the current state is independent of parameters from the cost function or the structural errors.

From the likelihood derived above, in order to estimate the model, we first need to recover each element in the final equation:

1. Recover  $\theta_3$  to get  $\Pr [s_t | s_{t-1}, a_{t-1}, \theta_3]$ .
2. Estimate  $\theta$  using  $\Pr [a_t | s_t, \theta]$ .



### Markov transition probabilities ( $\theta_3$ )

Instead of assuming a functional form for the mileage distribution  $G(\cdot)$ , Rust uses a simplifying trick where we assume a discrete distribution for the incremental mileage  $\Delta s_t = s_t - s_{t-1}$  such that:

$$\Delta s_t = \begin{cases} [0, 5000) & \text{w/ probability } p \\ [5000, 10000) & \text{w/ probability } q \\ [10000, \infty) & \text{w/ probability } 1 - p - q \end{cases}$$

so that  $\theta_3 = \{p, q\}$ . Note that this step does not depend on the rest of the model and can be estimated right away, nonparametrically.

### Dynamic Logit

For the other part of the likelihood function, we use an additional assumption on  $\varepsilon_{1t}$  and  $\varepsilon_{0t}$  such that they are iid draws from two independent Type-I Extreme Value distributions (with the standard normalizations). This is why we call this part a dynamic logit.

Expanding the probabilities:

$$\begin{aligned} \Pr[a_t = 1 | s_t, \theta] &= \Pr[r(s_t, 1; \theta) + \beta E[V(s') | s_t, 1] > r(s_t, 0; \theta) + \beta E[V(s') | s_t, 0]] \\ &= \Pr[-RC + \varepsilon_{1t} + \beta V(0) > -c \cdot s_t + \varepsilon_{0t} + \beta E[V(s') | s_t]] \\ &= \Pr[\varepsilon_{1t} - \varepsilon_{0t} > RC - \beta V(0) - c \cdot s_t + \beta E[V(s') | s_t]] \\ &= \frac{\exp(-RC + \beta V(0))}{\exp(-RC + \beta V(0)) + \exp(-c \cdot s_t + \beta E[V(s') | s_t])} \end{aligned}$$

as in the logit model! Obviously, this result applies also to the opposite action:

$$\Pr[a_t = 0 | s_t, \theta] = \frac{\exp(-c \cdot s_t + \beta E[V(s') | s_t])}{\exp(-RC + \beta V(0)) + \exp(-c \cdot s_t + \beta E[V(s') | s_t])}$$

The main issue with this probability is that  $E[V(s') | s_t]$  does not have a closed form (it is precisely what we want to solve in a DDP). This is why the estimation method will rely on compute this element in an inner loop, for every guess of parameters (outer loop). The next section explain this procedure.

### 7.2.3 Estimation Method

As mentioned in the previous section, the estimation procedure has to rely on two loops, because the expected value function is not known up to parameters  $\theta$ . Thus, the first loop (the outer loop) will try to find the optimal  $\theta$  given the value function computed in the second loop (the inner loop) which solves the model for a given  $\theta$ .

#### Computational details

The goal of the second step is to compute the value function for a given value of  $\theta$ . A clever and computationally convenient feature in the Rust paper is to perform value function iteration not on the value function per se, but on the expected value function denoted  $EV(s, a)$  defined as:

$$EV(s, a) \equiv E[V(s')|s, a]$$

We can develop the expectation to get:

$$EV(s, a) = \int_{s'} \log \left( \sum_{a' \in \{0,1\}} \exp(r(s', a'; \theta) + \beta EV(s', a')) \right) \cdot \Pr[s'|s, a]$$

and now we see the parallel between this equation and the value function before the value function iteration of the first section. The only difference is that we do not need to “solve” for the best current action since we can use the logit inclusive value to recover the utility of the best choice! This yields a huge improvement in computational complexity.

#### Nested Fixed-point Algorithm

What follows after is the analog to the value function iteration. Let  $\tau$  index the iterations, such that  $EV^\tau(s, a)$  is the expected value approximation after  $\tau$  iterations.

1. Choose any  $EV^0$  and specify a tolerance  $\eta > 0$  but very small. Usually, we choose  $EV^0 = 0$ .
2. Use  $EV^{\tau-1}$  to compute:

$$\begin{aligned}
EV^\tau(s, a) &= \int_{s'} \log \left( \sum_{a' \in \{0,1\}} \exp(r(s', a'; \theta) + \beta EV^{\tau-1}) \right) \cdot \Pr[s' | s, a] \\
&= p \cdot \int_s^{s+5000} \log \left( \sum_{a' \in \{0,1\}} \exp(r(s', a'; \theta) + \beta EV^{\tau-1}) \right) ds' \\
&\quad + q \cdot \int_{s+5000}^{s+10000} \log \left( \sum_{a' \in \{0,1\}} \exp(r(s', a'; \theta) + \beta EV^{\tau-1}) \right) ds' \\
&\quad + (1 - p - q) \cdot \int_{s+10000}^{\infty} \log \left( \sum_{a' \in \{0,1\}} \exp(r(s', a'; \theta) + \beta EV^{\tau-1}) \right) ds'
\end{aligned}$$

for each state and action  $(s, a)$ .

3. Evaluate the continuation condition:

$$\sup_{(s,a)} \|EV^\tau(s, a) - v^{\tau-1}(s, a)\| < \eta$$

If it is true, then we're done and  $EV^\tau$  will serve as our best approximation (given  $\theta$ ), otherwise go back to step 2 and increment  $\tau$ .

Using the newly computed function  $EV(s, a)$ , we can derive the probabilities that were unknown previously and come up with a value for the likelihood function. The outer loop will take that value and suggest another  $\theta$  to compute a new approximation of the  $EV$  function, new probabilities and a new likelihood function value, until convergence to  $\theta_0$ : the true value of structural parameters.

### 7.3 Hotz-Miller approach

# Chapter 8

## Retailing and Inventories

### 8.1 Aguirregabiria (1999)

#### Background

There is substantial evidence of price dispersion and staggering (prices are not flexible), most commonly explained by menu costs (changing prices is costly) and not perfect correlation in demand (different demand shocks across firms). Confirmed by theory of (S, s) rule (= target price and adjustment bands with adjustment only outside the bands). But what to make of evidence that retail firms might not use (S, s) rules, or that prices go down sometimes (with inflation, prices should always go up)? Most explanations rely on “consumer-side” phenomena, not on inventories (supply-side)!

Maybe a model of (S, s) rule with inventories would explain some variation!

#### Model

Firms maximize profits as a function of expected sales, order costs, inventory costs and menu costs (all three are lump-sum!) = (S, s) rule is still optimal!

Without menu costs, inventories are perfectly negatively correlated with markups: giving evidence of price markdowns when inventory is high (right after an order) but no price staggering.

With menu costs, you get price staggering as well as markdowns.

## **Data**

Monthly information on prices, sales, orders and inventories for every item = balanced panel data. Price data is monthly averages (for regular price and sales price).

## **Assumptions**

- Monopolistic competition in product market, price-taker in wholesale market
- Typical Rust + utility assumptions: additive separability, independence of errors, first-order Markov processes, logit errors, etc.
- Hotz-Miller approach where estimate policy functions then include in moments.

## **Empirical evidence**

Naive analysis and reduced form regressions show infrequent price changes, prevalence of sales promotions, infrequent orders, negative correlations between inventories and prices.

Using a Hotz-Miller approach, authors find the same results: data is consistent with high lump-sum cost of ordering and menu costs.

## **Counterfactuals**

Removing these lump sum costs actually leads to more variability = they explain a lot of price staggering and price reductions! Demand might explain the rest.

## **8.2 Hendel and Nevo (2002)**

### **Background**

When goods are storable, price variation might create bias in demand estimation. In fact, if prices decrease (during sales for example), then consumers might stockpile: creates large demand increase in the short run which, measured in long-run (when prices have gone back up) will inflate own-price elasticities. Cross-price elasticities be ambiguous. Because these elasticities are so important in industry analysis, you have to get them right!

This is the analog analysis to the Aguirregabiria (1999) paper where he studies price variation and inventories (= the supply side).

### **Data**

Scanner data on store-level and household-level consumption in the detergent market. Hendel and Nevo observe price, quantities, some measure of advertising, sales, inventories (both at the store and household levels).

Reduced form analysis shows that duration between purchases has a positive effect on quantity purchased (= household do hold inventories); storage costs are negatively correlated with buying on sale (= not being able to store leads to less storage?); households buy more on sale, even when they do hold inventories already (= stockpiling).

## **Model**

Do not model quantity purchases but only sizes! Dynamic discrete choice model with utility of purchase and inventory costs.

## **Assumptions**

- Typical Rust + utility assumptions: additive separability, independence of errors, first-order Markov processes, logit errors, etc.
- Purchase of different brands yield different utilities but consumption of different brands yields the same utility.
- Recover initial inventory by simulation and likelihood mapping with sequence of purchases.
- To reduce dimensionality: for each “size” estimate a static demand model to recover logit inclusive value of each size, and use this in standard approach (with prices and ads only for those sizes).

# Chapter 9

## Conduct and Antitrust

### 9.1 Introduction

Antitrust laws are designed with the goal to control how firms attain and maintain their market position, in order to improve consumer welfare, or welfare in a broader sense.

Around the end of the 19th century, people were growing frustrated at the excessive control of monopolies and cartels over markets. This led to the passage of key legislation and the creation of regulatory agencies. Today, the main institutional actors in antitrust are the Department of Justice (DOJ) and the Federal Trade Commission (FTC).

The creation of these agencies show the implicit belief that society cannot rely on private firms to control the market, nor on consumers to organize and fight against market power. But it remains that the goals of antitrust institutions are unclear: are they fighting for consumer welfare? for economic efficiency? What would happen if some consumers win and some lose?



## **9.2 Mergers**

Mergers are the simplest antitrust situation to analyze because there exists a pre and post outcome.

### **9.2.1 Some cases**

### **9.2.2 Merger guidelines**

The Merger Guidelines are a document issued by the DOJ and the FTC (for the first time in 1982, most recently in 2010) with the purpose of clarifying situations where antitrust agencies might impede merger.

These “rules” seek to prevent firms from merging if it would lead to unilateral exercise of market power or to coordinated interactions. They describe tools for merger analysis in two main sections: screening and analysis.

The role of screening is to raise flags in markets where mergers would lead to significantly concentrated markets, where unfair markups could be sustained. Merger analysis is then completed by simulating over the market under merger and not, to compare both outcomes in terms of welfare, prices, markups, etc.

### **9.2.3 Screening**

Screening can be done using one of two tools:

#### **Using HHI**

The Herfindahl-Hirschman Index, or HHI, is defined as the sum of squared market shares in a market. While previously designed on its own, it can be derived analytically using the Cournot model of competition.

Using it for merger analysis is done by looking at the current HHI in combination with the potential post-merger HHI and their difference. Small changes would then not be challenged compared to bigger changes, but given a change in HHI, more concentrated markets will get challenged more often.

The problem with using the HHI is market definition. In fact, using market shares implies that competitors are clearly defined, whereas in reality, it is not often the case. Moreover, market definition will have a huge impact on the numbers, and thus on what the guidelines have to say about the merger.

### **Using UPP**

Using the intuition that a merger might induce a price change, the Upward Pricing Pressure is a theoretical measure of the incentives of raising prices after a potential merger between two firms. By definition it does not require any market definition because it looks at only the two merging firms. However, it assumes away the price responses of potential competitors, uses the pre-merger prices for one of the goods.

All in all, it is not a perfect measure but can be used as a quick screening process for unilateral mergers.

## **9.2.4 Market definition**

A market is defined as group of products and a geographic area such that a hypothetical profit-maximizing firm (hypothetical monopolist), not subject to price regulation, likely would impose a small but significant and nontransitory increase in price (SSNIP), assuming that the terms of sale of all other products is held constant. A relevant market is no larger (in terms of products and geography) than is needed to satisfy this criteria.

The intuition behind this definition is to use the fact that if a monopolist (one with the most market power) would not increase prices by a significant amount, then no one would.

Usually, this threshold is set at 5% although it varies across industries and situations.

Then, we need to define market participants which obviously would include the firms that own the products in the market, but also other firms such as potential entrants (that could enter if only one firm was in the market).

### **9.2.5 Merger Analysis**

As mentioned earlier, the three steps to studying a merger is:

1. Define a market.
2. Screen using HHI or UPP.
3. Simulate the merger (fully or partially).

The last step is the only one we have not looked at yet.

#### **Merger Simulation**

There are two ways of simulating a merger:

- Partial Merger Simulation: where market outcomes are simulated for the merging products only, holding everything else fixed, then the effects are compared to synergies or cost savings.
- Full Merger Simulation: where market outcomes are simulated using a structural model describing the behavior of all firms in the market.

#### **Potential issues**

Merger analysis typically will not allow for some elements that will bias the analysis in questions. Among others, we find product repositioning, committed entry, possible entry, efficiency gains, exit, etc.

### **9.3 Conlon and Mortimer (2018)**

# Chapter 10

## Auctions

### 10.1 Introduction

Auctions are an important part of economic research because of their features and applications: they rely on a simple game, with well-specified rules (= less assumptions needed), they can be observed directly, they are used in a lot of settings and are very diverse. All these elements make auctions markets particularly interesting for IO research.

First, we need to define four types of auctions based on the type of bidding and the payment rules:

1. First-price sealed-bid auctions: No agent sees the opponents' bids. Highest bidder wins and pays their bid. Losers get nothing.
2. Second-price sealed-bid auctions: No agent sees the opponents' bids. Highest bidder wins and pays second highest bid. Losers get nothing.
3. English auction: Price goes up until only one player is willing to pay the price. Effectively pays the second highest valuation (in eqm).
4. Dutch auction: Price goes down until one player is willing to pay the price. Effectively pays the highest valuation (in eqm).

Dutch auctions are not very common and most of the empirical work is centered on the three other types (depending on the situation). Theoretically, we consider

FPSB and Dutch auctions to be equivalent (same equilibrium strategies). The same holds between SPSB and English auctions.

Not covered in this chapter are multi-unit and combinatorial auctions, which both usually ask for a lot more computation power for empirical work.

In the empirical IO literature, the goals of studying auction markets are to (1) describe and elicit, among others, how agents bid, their valuations for the goods, the difference with the models, or the presence of collusion; but also (2) to identify optimal rules given the setting. Researchers typically use two approaches to do this:

- Reduced-form: to test assumptions or theoretical predictions, make inferences about behavior or the bidding environment.
- Structural: assuming theory holds, to estimate the primitives of the model (distribution of private values, affiliation, etc.)

## **10.2 Private Value Auctions**

## **10.3 Common Value Auctions**

## **10.4 Estimation of Auction Models**

## **10.5 Asker (2010)**

### **10.5.1 Summary**

#### **Background**

Collusion in an English auction can yield lower winning bids (thus lower auction revenues). To see that, consider three bidders with values 10, 8, and 5 in an English auction, such that in a competitive outcome, the price would be 8. If bidders 1 and

2 collude, they can bring the price to 5. Note that it needs not to happen as when bidders 1 and 3 collude, the price is still 8. The research questions are thus: how do bidding rings work in practice? and how do they affect market outcomes?

To study this: look at bidding ring in the stamps auction market! Eleven dealers are part of a “ring” (subset of all bidders). They are organized in two periods: knockout stage and target auction. The first is to determine who from the ring will get the object if the ring wins, and the price at which they stop (with payments), while the second is the actual auction.

## **Model**

Structural approach: design of a IPV-style model, with two types of bidders (because weaker bidders in data) and focus only on auctions with two bidders in the knockout phase!

## **Data**

Complete record of ring’s activity. Observation unit is an auction, observed variables are bidders in the knockout, amount bid, side payments, price of target auction etc.

## **Assumptions**

## **Results**

Bidding rings can introduce inefficiencies in auctions, but in that case, effect is small. Asymmetry of bidders is a big weakness of maintaining rings. Other bidders (outside the ring) are also affected by the ring.

# Chapter 11

## Vertical Contracts

### 11.1 Introduction

Manufacturers rarely supply final consumers directly but are usually vertically separated by one or more intermediaries. In this particular type of setting, we often refer to the manufacturer as the upstream firm, and the intermediary as the downstream firm. This relationship is the same as in a typical market, considering the downstream firm as the customer and the upstream firm as the producer, thus leading to the same topics as usual: endogenous pricing, price discrimination, etc.

The main addition to the usual models is that now the downstream firm is not the end consumer, but rather an agent that will serve the end consumers, thus doing its own share of pricing, advertising, etc. Because these activities will affect the consumers, the upstream firm has incentives to control the downstream firms in some way, we call this “vertical control”. There are several types of vertical restraints used by firm:

- Exclusive territories: a single retailer is assigned to a “territory” (geographical or not) and has monopoly rights over the area.
- Exclusive dealings: a retailer that chooses the upstream firm cannot sell nor carry any of the competitors’ goods.
- Full-line forcing: a dealer is committed to sell the whole product line of the



upstream manufacturer.

- Resale Price Maintenance (RPM): a dealer commits to retail prices (or a range) that will hold for the product. Equivalently, quantity forcing or rationing will commit the retailer on the quantity side.
- Contractual arrangements: more flexible agreement between upstream and downstream firms to transfer the product. Profit and revenue sharing are the most common.

## 11.2 Theoretical insights

### 11.2.1 Basic Framework

Start with a simple model with a homogeneous good with demand given by  $p = a - Q$ . Moreover, both the upstream and downstream firms are monopolists. The downstream firm has a distribution cost equal to  $d$  (the price it pays for the upstream good), while the upstream firm has a marginal cost equal to  $c$ .

### 11.2.2 Externalities

Because the downstream firm has a monopoly over retailing, its optimal strategy is to charge the monopoly price for the product. The manufacturer also has a monopoly over the production of the good, thus will charge a monopoly price to the retailer!

From this example we can draw multiple results:

- The upstream firm earns higher profits than the retailer.
- The upstream firm would earn even more by selling directly to the market.
- Total industry profits are lower than vertically integrated profits.

These results come from the presence of two markups! This is what we call double marginalization. Going around this issue can be done by including additional terms in the contracts (RPM, quantity forcing, etc.).

### **11.2.3 Downstream Moral Hazard**

### **11.2.4 Interbrand Competition and Legal Issues**

## **11.3 Papers**

### **11.3.1 Mortimer (2008)**

#### **Background**

This paper studies the efficiency improvements linked to vertical contracts in the video rental industry. It follows the contractual innovation of revenue-sharing which became widespread after 1998. The revenue sharing contracts are designed as an upfront fee per tape, then a royalty based on rentals. This comes in contrast to the previous main contract called “linear-pricing” where the retailer would just buy the tape upfront and hold it in inventory at whatever price they chose.

#### **Model**

Straightforward model of vertical market with contracting. The main resulting equations are used as moment equations in the estimation (by GMM).

#### **Data**

Main observation unit is the store-title-week level, where observed variables include number of transactions (rentals), etc. At more aggregated levels, store-title pairs include average rental price, type of contract, etc. Title data include the type of movie, the box-office, rating etc. and finally the store data include demographics about the area.

#### **Assumptions**

- No coordination between stores, even within a chain.
- No competition between films and film distributors (= monopolistic suppliers).

## **Results**

Revenue-sharing contracts had positive effects on welfare across the board (consumer surplus, profits, etc.). Other vertical contracts are having a positive effect on profits while decreasing consumer surplus.

### **11.3.2 Conlon and Mortimer (2017)**

#### **Background**

This paper studies the effects of vertical rebates on efficiency (greater retail effort) and foreclosure (of competing products). Using field experiment, consumer choice and retailer behavior. Vending machine industry: AUD (all-units discount) gives discount per-unit, quantity target and facing requirement.

#### **Model**

Consumer choice model: random-coefficients logit.

Retailer behavior (portfolio and effort): dynamic model of restocking à la Rust (1987).

#### **Data**

Dataset from field experiment: observation unit is machine-visit, observed variables are quantity vended, price, other facings, etc.

Data from Mars: AUD contractual terms.

#### **Assumptions**

- Instruments: no price coefficient because no variation.

#### **Results**

Vertical rebates do increase effort levels for the retailer.

### **11.3.3 Ho, Ho and Mortimer (2012)**

#### **Background**

This paper studies the effects of bundling as a vertical contract between manufacturers and retailers (= full-line forcing) on welfare. In the video rental industry, the content is very important so need of both supply and demand models (always renewed, etc.).

#### **Model**

Sort of dynamic nested-logit model (static with decay) with focus on changing choice sets: typical nested-logit with a decay term (months since release fixed effect).

Portfolio choice for the retailer: using moment inequalities, under the assumption that on average portfolio choice is optimal.

Profit model for counterfactuals.

#### **Data**

Dataset from Rentrak. Observation unit is transaction (store-title), observed variables are distributor, genre, box-office categories, type of release, etc. and type of vertical contract. Additional information on demographics.

#### **Assumptions**

- Data and computation limitation: no stockouts, month-level aggregation, nests based on box-office categories (not genre?), monopolies (because don't observe competition).
- Instruments: average inventory in other stores of same size (for inventory); average number of movies in group and average within group share in

other stores of same size (for within group share); no instrument for price (results were the same).

- Supply side: stores have perfect foresight of demand

## **Results**

### **11.3.4 Crawford et al. (2017)**

#### **Background**

This paper studies the welfare effects of vertical integration (a type of vertical contract), in terms of reduced double marginalization (positive) and foreclosure (negative). In the multichannel TV market: acquisitions of regional sports networks by multichannel video programming distributors.

#### **Model**

Viewership: Static time-allocation problem yields value function.

Subscription: Typical logit model including viewership based utility parameters.

Distributor pricing: Static profit maximization given fees, over bundle choice and price.

Affiliate fee bargaining: Nash-in-Nash bargaining.

#### **Data**

Downstream data: prices, quantities and characteristics for both cable TV and satellite providers.

Viewership data: individual viewership data and aggregate data.

Channel fees and ad revenues: fees (per subscriber) paid to distribute channel; average ad revenue per subscriber.

#### **Assumptions**

#### **Results**



# Chapter 12

## Additional papers

### 12.1 Lee (2013)

- **Research questions:** What are the effects of vertical integration and exclusive dealing on industry (1) structure and (2) welfare?
- **Goals of the paper:** test a model (competitive effects of networks) + measure an effect (effects on structure and welfare).
- **Importance of the paper:** New knowledge on network industries (which are more and more common).
- **Theoretical foundations:** (1) Two-level demand system (for consoles and software) and (2) developer choice for consoles.
  - Strengths:
  - Shortcomings: No competition between consoles, no console-level strategies.
- **Empirical strategy:** (1) use dynamic demand and (2) use moment inequalities for developing process.
  - Strengths:
  - Shortcomings:
- **Data:** (1) Software sales (genre, release date, exclusivity contract, price, shares, etc.) (2) Hardware sales (shares, prices) and (3) market-level (demographics + survey for heterogeneity).

- Exogenous:
- Endogenous:
- **Results:** Exclusive arrangements have (1) helped entrants, (2) hurt incumbent and (3) increased differentiation.

## 12.2 Ho (2009)

### 12.2.1 Discussion

- **Research questions:** (1) How do insurer-provider networks arise? (2) What are the effects of “star” hospitals, capacity-constrained hospitals and merged hospitals on the bargaining process?
- **Goals of the paper:** test a model (contracting between insurers and providers) + measure an effect (hospital demand or size on bargaining) and maybe slightly interested in policy implications.
- **Importance of the paper:** Implications on policy since health providing is so important.
- **Theoretical foundations:** (1) Two-level BLP demand system (for insurers and providers) and (2) bargaining game between insurers and providers.
  - Strengths:
  - Shortcomings:
- **Empirical strategy:** (1) use BLP moments and (2) use moment inequalities for bargaining process (profits from observed network must be higher than reversing decision on one hospital).
  - Strengths:
  - Shortcomings:
- **Data:** (1) Hospital-level (size, teaching?, for-profit?, staff size, services, etc.) (2) Plan-level (shares, premia, network size, services included, people included, type of plan, etc.) and (3) market-level (demographics).
  - Exogenous:
  - Endogenous: contracts, prices, shares.
- **Results:** Consumer demand, hospital costs, “star” status, capacity constraints and system hospitals are the main features to determine bargaining power of hospitals.