

Problem Set #1

Danny Edgel
Econ 761: Industrial Organization Theory
Fall 2021

September 27, 2021

1. Consider a market in which the goods are homogenous.

(a) The elasticity of demand, $\varepsilon < 0$, can be written as:

$$\varepsilon = (P'(Q))^{-1} \frac{P(Q)}{Q}$$

Thus, letting ε remain constant, we can derive:

$$\begin{aligned} P(Q) &= QP'(Q)\varepsilon \\ P'(Q) &= (QP''(Q) + P'(Q))\varepsilon \end{aligned}$$

Thus, with $P'(Q) < 0$ and $\varepsilon < 0$, $QP''(Q) + P'(Q) > 0$ for all Q .

(b) Under Cournot competition, each firm, i , solves the following problem:

$$\max_{q_i} \Pi_i = P(Q)q_i - c(q_i), \quad Q = \sum_{j=1}^N q_j$$

Which yields the following FOC, which is identical for all firms:

$$P(Q) + P'(Q)q_i = c'(q_i) \Rightarrow q_i = (P'(Q))^{-1} (c'(q_i) - P(Q))$$

Since cost functions are identical by assumption, $q_i = q_j = q \forall i, j$ in equilibrium, so we use the implicit function theorem to solve:¹

$$\begin{aligned} c'(q) - qP'(Nq) &= P(Nq) \\ \frac{\partial q}{\partial N} [c''(q) - P'(Nq)] &= [P'(Nq) + qP''(Nq)] \left(q + N \frac{\partial q}{\partial N} \right) \\ \frac{\partial q}{\partial N} \left[1 - N \frac{P'(Nq) + qP''(Nq)}{c''(q) - P'(Nq)} \right] &= q \left[\frac{P'(Nq) + qP''(Nq)}{c''(q) - P'(Nq)} \right] \end{aligned}$$

¹Due to algebraic errors, I had to redo this several times, spending a long time on it. As a result, many intermediate steps are omitted below.

By assumption (A1), we know $c''(q) - P'(Nq) \geq 0$, and by assumption (A2), we know $P'(Nq) + qP''(Nq) \leq 0$. Thus, by the equation above, $\frac{\partial q}{\partial N} \leq 0$.

Since demand slopes downward and $Q = Nq$, an increase in q necessarily increases Q , decreasing price. Thus, equilibrium price and price per firm quantity are decreasing in N .

2. (a) Each player, $i \in \{1, 2\}$ chooses $b_i \in \mathbb{R}_+$ to maximize:

$$\pi_i(b_i, b_j) = \begin{cases} V - b_i, & b_i > b_j \\ \frac{1}{2}(V - b_i), & b_i = b_j \\ 0, & b_i < b_j \end{cases}$$

Since payoffs and valuations are symmetric, $b_i = b_j$ in equilibrium. For all $b_i = b_j < V$, each player has an incentive to raise their bid. Thus, the unique equilibrium is:

$$b_1^* = b_2^* = v \qquad \pi_1^* = \pi_2^* = 0$$

- (b) In all all-pay auction, player 1's payoff function is:

$$\pi_1(b_1, b_2) = \begin{cases} V - b_1, & b_1 > b_2 \\ \frac{1}{2}V - b_1, & b_1 = b_2 \\ -b_1, & b_1 < b_2 \end{cases}$$

- (c) suppose \exists a pure-strategy equilibrium with bids (b_1^*, b_2^*) . Since Payoffs and valuations are identical, any pure strategy equilibrium has $b_1^* = b_2^* = b^*$. Then, $\pi^* = \frac{1}{2}V - b$. Thus, either player could improve their payoff by deviating to $b_i = b^* + \varepsilon$ for $\varepsilon > 0$. Thus, $b_1 = b_2$ cannot be a pure-strategy Nash equilibrium.²
- (d) A mixed-strategy Nash equilibrium is a pair of distribution functions, $(F_1(b), F_2(b))$, from which each player draws their bid. Since bids must be weakly positive, $F_i(0) = 0$. Since payoffs are negative for all $b > V$ but zero for a bid of zero, $F_i(V) = 1$. Each player i chooses F_i to maximizes expected payoff:³

$$\mathbb{E}[\pi_i(b_i, b_j)] = F_j(b_i)V - b_i$$

From the first-order condition of this problem, we can obtain the

²The nonexistence of a $b_1 \neq b_2$ equilibrium is trivial.

³Using the same logic as in (c), we can rule out any mass points, since such mass points will exist in both players' distributions, and either player could improve their payoffs by shifting the mass to a slightly higher bid.

symmetric equilibrium distribution function:

$$\begin{aligned} V f_j(b_i) - 1 &= 0 \\ f_j(b_i) &= \frac{1}{V} \\ F_j(b) &= \int_0^b \frac{1}{V} dx = \frac{b}{V} \end{aligned}$$

Since payoffs and valuations are constant, $F_i^*(b) = F_j^*(b) = F^*(b)$. Thus, the mixed-strategy equilibrium is for each player to submit a uniformly random bid between 0 and V . The seller's expected revenue is:

$$R = 2\mathbb{E}[b^*] = 2 \int_0^V \left(\frac{1}{V} \right) b db = \frac{1}{V} [b^2]_0^V = V$$

- (e) If the seller sets some reserve price $R \in (0, V)$, then the lower bound of the equilibrium distribution will be truncated such that $F^*(b)$ is instead be a uniform distribution from R to V . Intuitively, this would increase the seller's revenue by increasing the mean of the equilibrium bid distribution.

3. (a) The marginal consumers on either side of Esquires are indifferent to purchasing a cup of coffee from Starbucks and Esquires. Letting p_i represent the price from the nearest Starbucks for $i \in \{0, 1\}$ and $x_i \in [0, 1]$ represent the location of the consumer on Main Street, where $i = 1$ is the consumer closer to the Starbucks on the end of main street:

$$\begin{aligned} v - x_0^2 - p_0 &= v - (.5 - x_0)^2 - q \\ v - (1 - x_1)^2 - p_1 &= v - (x_1 - .5)^2 - q \end{aligned}$$

Solving for x_i yields:

$$x_0 = q - p_0 + \frac{1}{4} \qquad x_1 = p_1 - q + \frac{3}{4}$$

- (b) Assuming Starbucks can set different prices at each location, the firms' optimization problems are:

$$\begin{aligned} q(p) &= \arg\max_q q \left[p_1 - q + \frac{3}{4} - \left(q - p_0 + \frac{1}{4} \right) \right] \\ &= \frac{1}{4} (p_0 + p_1) + \frac{1}{8} \\ p(q) &= \arg\max_{p_0, p_1} p_0 \left[q - p_0 + \frac{1}{4} \right] + p_1 \left[1 - \left(p_1 - q + \frac{3}{4} \right) \right] \\ &= \left(\frac{\frac{1}{2}q + \frac{1}{8}}{\frac{1}{2}q + \frac{1}{8}} \right) \end{aligned}$$

- (c) Since $p_0 = p_1$ in equilibrium, Esquires's best response function can be simplified as $\frac{1}{2}p + \frac{1}{8}$. Then, we can solve for the equilibrium as follows:

$$\begin{aligned} q &= q(p(q)) = \frac{1}{2} \left(\frac{1}{2}q + \frac{1}{8} \right) + \frac{1}{8} \\ \Rightarrow q^* &= \frac{1}{4} \\ p^* &= p(q^*) = \frac{1}{2} \left(\frac{1}{8} \right) + \frac{1}{8} = \frac{1}{4} \end{aligned}$$

Given these equilibrium prices, we can solve for market shares using the equations derived in (a) for the marginal consumer on either side of Esquires:

$$x_0 = \frac{1}{4} \qquad x_1 = \frac{3}{4}$$

Thus, the middle half of the distribution buys from Esquires, while the ends buy from Starbucks. Starbucks and Esquires, then, each take half of the market.

- (d) Assume that the Starbucks at the end of the street swaps with Esquires. Then, the best response functions are now:

$$q(p) = \operatorname{argmax}_q q \left(q - p_1 + \frac{3}{4} \right) = \frac{1}{2}p_1 + \frac{3}{8}$$

$$p(q) = \operatorname{argmax}_{p_0, p_1} p_0 \left[p_1 - p_0 + \frac{1}{4} \right] + p_1 \left[q - p_1 + \frac{3}{4} - \left(p_1 - p_0 + \frac{1}{4} \right) \right]$$

$$\begin{pmatrix} 1 & -1 \\ -1 & 2 \end{pmatrix} p = \begin{pmatrix} 1/8 \\ \frac{1}{2}q + 1/8 \end{pmatrix}$$

Plugging the best response function for q into the best response for p , we can solve for prices in the new equilibrium:

$$p^* = \begin{pmatrix} 1 & -1 \\ -1 & 7/4 \end{pmatrix}^{-1} \begin{pmatrix} 1/8 \\ 5/16 \end{pmatrix} = \begin{pmatrix} 17/24 \\ 7/12 \end{pmatrix} \approx \begin{pmatrix} .71 \\ .58 \end{pmatrix}$$

$$q^* = \frac{1}{2} \begin{pmatrix} 7 \\ 12 \end{pmatrix} + \frac{3}{8} = \frac{2}{3}$$

Again using the equations for marginal consumers from (a), we can compute market shares:

$$x_0 = 3/8 \approx 0.37 \quad x_1 = 5/6 \approx 0.83$$

Since marginal consumer $i = 0$ is indifferent between two Starbucks locations, only x_1 is informative for market share purposes.⁴ In this equilibrium, Starbucks takes five sixths, or about 83% of the market.

This equilibrium differs from (c) because in (c), there were no marginal consumers choosing between two Starbucks locations, so Starbucks faced a tradeoff between increasing its price and increasing its market coverage at both of its locations. However, in this equilibrium, the marginal consumer on the left side of the street was indifferent between two Starbucks locations, so Starbucks only faced a tradeoff between losing consumers to its lower-price location (which competes with Esquire's) and losing consumers to Esquire's.

- (e) Now suppose that Esquires is still located at the center of the road, but Starbucks sells the location at the end of the road to Seattle's Best, which charges price z . The resulting equilibrium is identical to the one in (c) because, as I mentioned in (d), both Starbucks locations in (c) had to price competitively to avoid losing business to Esquire's. The same will be true with Starbucks and Seattle's Best in this equilibrium, resulting in $p^* = q^* = z^* = 1/4$, with Esquire's taking half of the market and the remaining half split equally between Starbucks and Seattle's Best.⁵

⁴Further note that the consumer at x_0 still derives positive utility under this price regime, so the market is covered.

⁵An interesting addition to this question would be to ask what price Starbucks would charge for this location, given some prevailing interest rate and the assumption of certainty over an infinite time horizon.