

Data 88: Economic Models

Lecture 7: Game Theory

- Project 3 will be released tonight; due Mon 10/26 at 11:59 PM
 - more on this at the end of lecture
- Lab 7 will be released later today; due Mon 10/19 at 11:59 PM



Lecture 7 Outline

- Game Theory Overview
- Strategy
- Expected Utility
- Prisoner's Dilemma
- Nash Equilibria
- Oligopolies
- Cournot Competition
- Bertrand Competition
- Iterated Prisoner's Dilemma
- A Healthy Dose of Irony: Webcam Placement Study

- Branch of mathematics concerned with the strategic interaction of rational decision-makers
- Different types of games:
 - cooperative vs. non-cooperative
 - symmetric vs. asymmetric
 - simultaneous vs. sequential
 - perfect vs. imperfect information
- We will study simultaneous games of imperfect information.

- Systematic methods of playing games
 - tell players what move to make based on available information
 - essentially a probability distribution over a player's choices
- Different types
 - **pure** strategies pull all probability on a single choice
 - **mixed** strategies divide probabilities over an array of choices
- Strategies can be random but often aren't
 - expected utility is a common counter-strategy for randomness
 - Nash equilibria (if they exist) tell us the “best” move to make in games of imperfect information

Aside: Payoff Matrices

Alan is trying to schedule his classes and wants to enroll in two classes with conflicting final exam times. One class will not give accommodations and is required for his degree. Alan knows the other class will give an accommodation with probability 0.6. Consider the payoff matrix below.

		Other Class	
		Give accommodations	Don't give accommodations
		(10, 10)	(-10, 8)
Alan	Enroll in both classes	(10, 10)	(-10, 8)
	Don't enroll in both classes	(2, 5)	(5, 0)

Expected Utility

		Other Class	
		Give accommodations	Don't give accommodations
Alan		(10, 10)	(-10, 8)
①	Enroll in both classes	(10, 10)	(-10, 8)
	② Don't enroll in both classes	(2, 5)	(5, 0)

Handwritten annotations:

- Red circles highlight the "Give accommodations" and "Don't give accommodations" columns.
- Blue arrows point from the column headers to the probabilities 0.6 and 1 - 0.6 = 0.4.
- A blue bracket on the left indicates the two strategies for Alan.
- A green oval encloses the payoffs for strategy 2 (2, 5) and (5, 0).

$$1) E[u(x)] = 0.6 \cdot 10 + 0.4 \cdot (-10) = 6 - 4 = 2$$

$$2) E[u(x)] = 0.6 \cdot 2 + 0.4 \cdot 5 = 5.2$$

Expected Utility Hypothesis

- The **expected utility** of a set of n outcomes x_i is the average utility of each outcome $u(x_i)$ weighted by the probability of that outcome's occurrence p_i :

x is a set of
outcomes $\{x_i\}$

$$E[u(x)] = \sum_{i=1}^n p_i u(x_i)$$

expectation

- The **expected utility hypothesis** says that when an individual makes a **gamble**, they will choose the option that **maximizes their expected utility**
 - the utility of each option is based on their **preferences**
- Expected utility maximization (under the EUH) is one way of strategizing in the face of randomness

Prisoner's Dilemma

- Prolific game first considered in the 1950s
- Single-round symmetric simultaneous non-cooperative game of perfect information
- Each prisoner can either cooperate (maintain their silence) or defect (talk to the police)
- *Note on payoff matrix convention:* here, the values in the payoff matrix are inverted— a higher value (more years in prison) is worse! keep this in mind when working with the prisoner's dilemma

		Prisoner B	
		Cooperate	Defect
Prisoner A	Cooperate	(2, 2)	(5, 0)
	Defect	(0, 5)	(4, 4)

A set of strategy choices in a **non-cooperative** game in which no player can increase their payoff by unilaterally changing their strategy.

if I'm the only person to change
my strategy, my payoff won't
increase

A set of strategy choices in a **non-cooperative** game in which no player can increase their payoff by unilaterally changing their strategy.

What about the prisoner's dilemma?

		Prisoner B	
		Cooperate	Defect
Prisoner A	Cooperate	(2, 2)	(5, 0)
	Defect	(0, 5)	(4, 4)

Handwritten annotations include:

- A blue arrow points from the text "C, C: No - same as C, D" to the cell (4, 4).
- A green circle highlights the cell (4, 4) at the bottom-right corner of the matrix.
- A blue arrow points from the text "D, C: No - same as C, D" to the cell (4, 4).

C, C: No - A, B can get fewer years by defecting

C, D: No - A can get 4 years by defecting

D, C: No - same as C, D

D, D: Yes - switching gets either player 5 years

A set of strategy choices in a **non-cooperative** game in which no player can increase their payoff by unilaterally changing their strategy.

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Nash equilibria can be read from payoff matrices: to see if a game state is a Nash equilibrium, the first value in the cell must be the maximum among all first values in that column and the second value must be the maximum across all second values in that row.

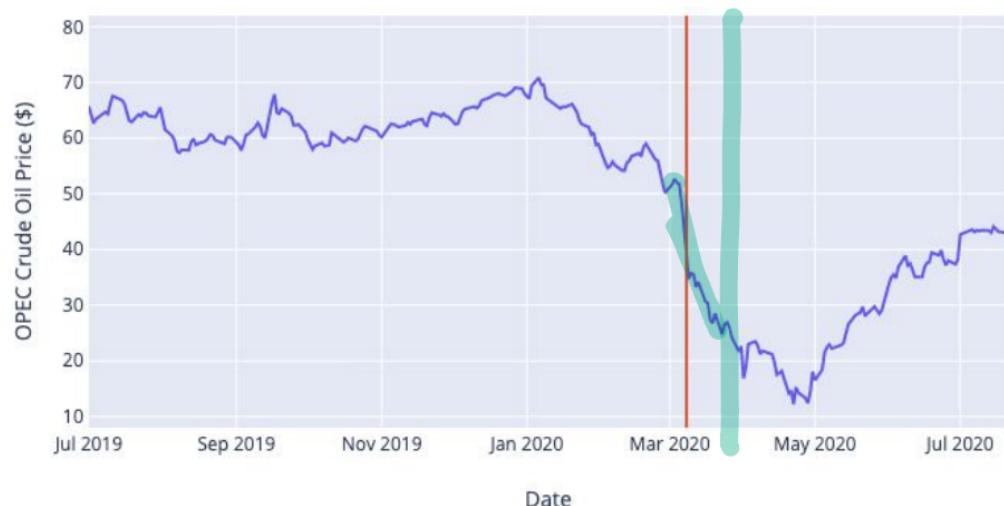
- Markets in which the number of participants is limited, e.g. airlines
- Allow their participants to function collectively in a manner similar to a monopoly
 - when this collective monopoly is illegal, these are referred to as **cartels**

↑
not what
you're
thinking

- Markets in which the number of participants is limited, e.g. airlines
- Allow their participants to function collectively in a manner similar to a monopoly
 - when this collective monopoly is illegal, these are referred to as **cartels**
- Within oligopolies, however, we can observe competition
 - participants try to take market share by lowering prices below the agreed-upon floor

↳ defection

- Within oligopolies, however, we can observe competition
 - participants try to take market share by lowering prices below the agreed-upon floor
 - e.g. 2020 oil price war that was started when Saudi Arabia lowered its prices below the OPEC price in response to Russia refusing to reduce production



Cournot Competition

- Model of a market in which firms compete by changing their output
 - market has a fixed number of firms that produce the same product
 - firms do not collude but have market power
 - each firm knows the number of firms and has its own cost function used to determine its level of output
 - firms share a single, fixed marginal cost

duopolies

2
c

- Model of a market in which firms compete by changing their output
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 - firms do not collude but have market power
 - each firm knows the number of firms and has its own cost function used to determine its level of output
 - firms share a single, fixed marginal cost
- OPEC is a ~~good~~ example of a Cournot oligopoly
 - its members affect market prices by changing their level of production
 - but this shows a flaw: Cournot equilibrium implies that collusion is the rational policy, but game theory shows us that cartel members undercut one-another

Cournot Competition

$P(Q) = \text{mkt demand}$ $q_1 = \text{firm 1 quantity}$, $q_2 = \text{firm 2 quantity}$

Equn. price $P_1 = P_2 = P(q_1 + q_2)$ how to find q_1^*, q_2^* ?

draw firm 1's residual demand curve

Fix q_2 , vary q_1 $d_1 = P(q_1 + q_2)$

$q_2 = 10$ $d_1 = P(q_1 + 10)$

Cournot Competition

Optimal level of output for Firm 1 is where its Marginal Revenue intersects C

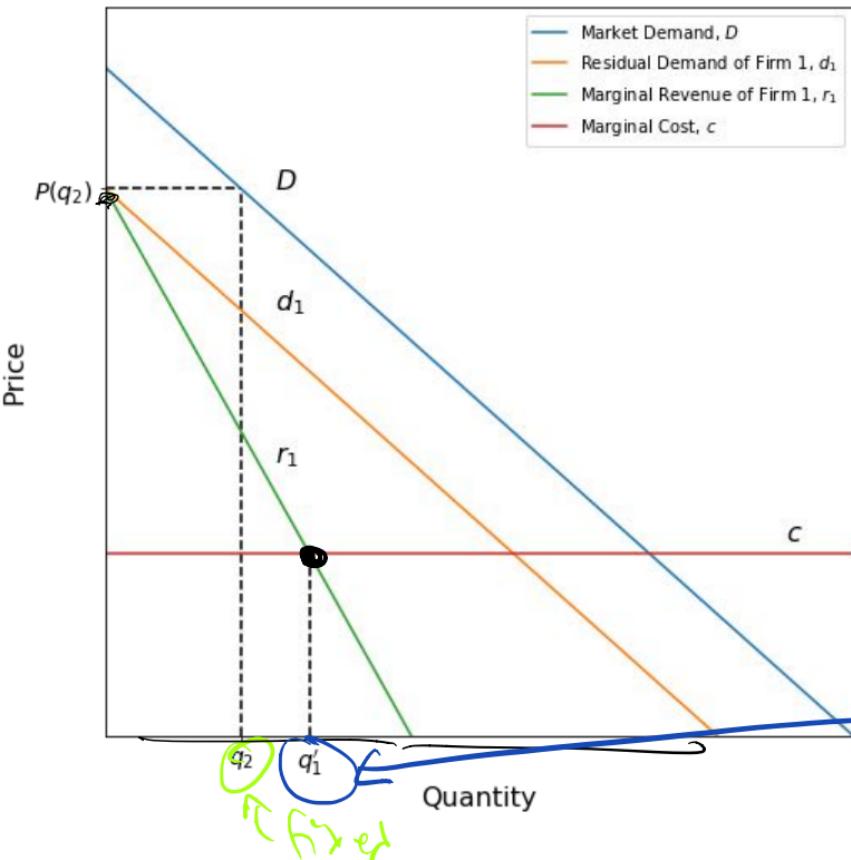
$$P(Q) = mQ + b$$

$$MR = \frac{d}{dQ} TR = \frac{d}{dQ} (P(Q) \cdot Q) = \frac{d}{dQ} mQ^2 + bQ$$

$$= 2mQ + b$$

$$\text{Firm 1's } MR: r_1(q_1) = 2 d_1(q_1) - \underline{d_1(0)}$$

Cournot Competition



$$D = P(Q)$$

$$d_1 = P(q_1 + q_2)$$

$$r_1 = 2d_1(q_1) - d_1(0)$$

$c = \text{fixed } MC$

optimal level of output
assuming Firm 2 produces q_2

Cournot Competition

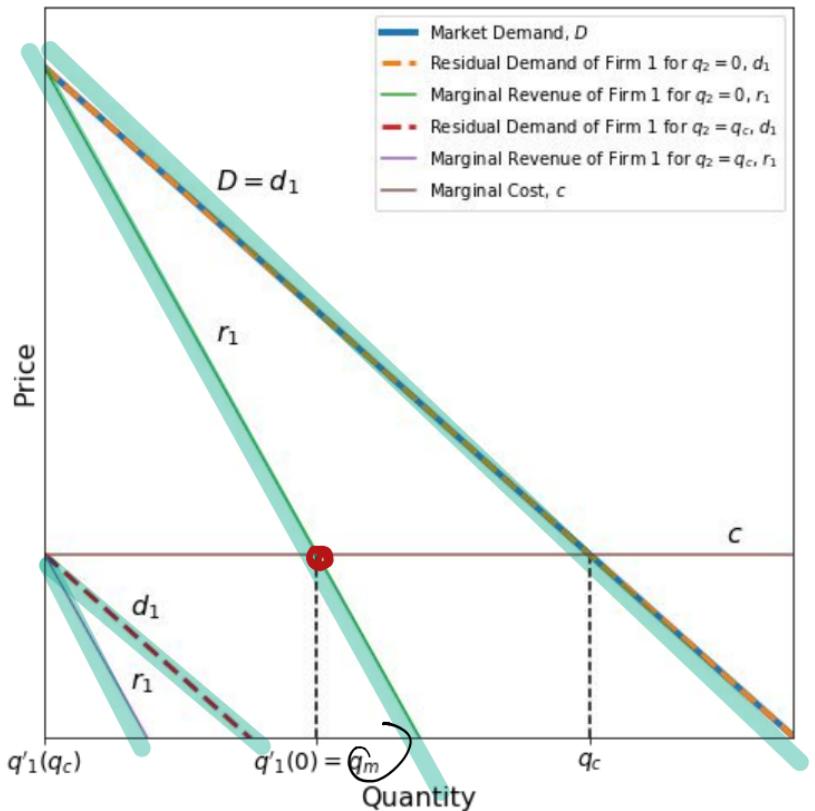
For a fixed q_2 .

How do we get eqm? Define q_1 as a function ~~of~~ of q_2

that tells us the quantity firm 1 should produce at

All we need to construct is 2 pts

Cournot Competition



q_c = perfect competitive quantity

q_m = monopoly quantity

When $q_2 = 0$, $q_i'(0) = q_m$

When $q_2 = q_c$, $q_i'(q_c) = 0$

Cournot Competition

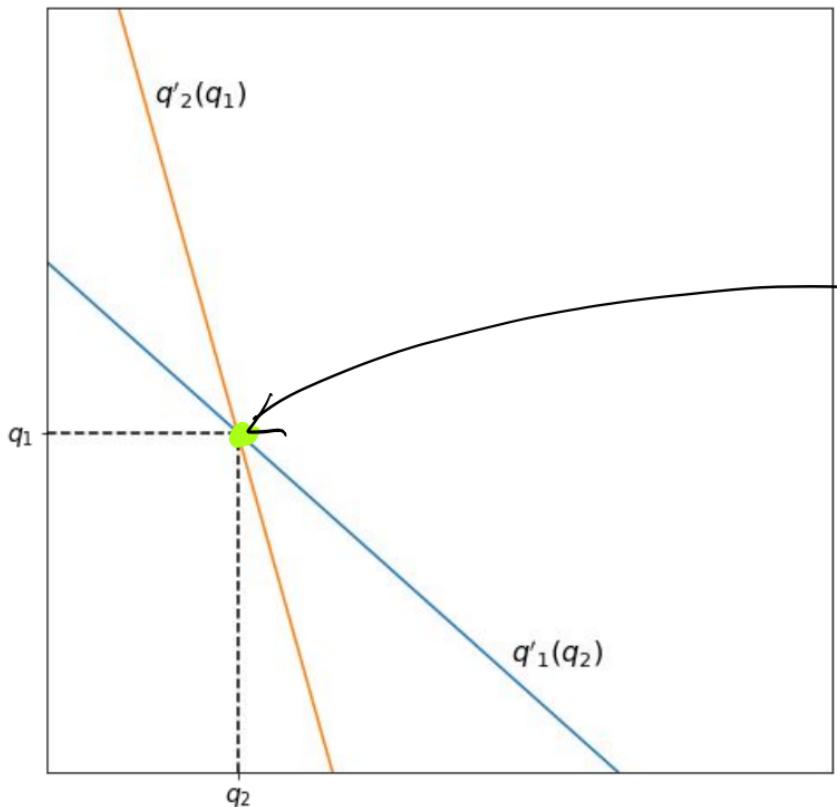
$$q_1'(0) = \underline{q_m} \quad q_1'(\underline{q}_c) = 0$$

$$q_1'(\underline{q}_2) = -\frac{\underline{q}_m}{\underline{q}_c} \underline{q}_2 + \underline{q}_m$$

What about $q_2'(q_1)$? if just the inverse of q_1'

$$q_2'(q_1) = -\frac{\underline{q}_c}{\underline{q}_m} q_1 + \underline{q}_c$$

Cournot Competition



$$q'_1(q_2) = q'_2(q_1)$$

Cournot Competition

- Similar to Cournot, but instead firms compete by changing price rather than output
 - assumes consumers want to pay the lowest price for goods
 - they will buy everything at the lower price
 - assumes that the firm offering the lower price has the capacity to meet the demand of the entire market at that price
 - if prices are equal, demand will be split evenly among them
 - predicts that even small competition (e.g. a duopoly) will result in prices being reduced to the marginal cost level

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- Coke vs. Pepsi is a good example of a Bertrand duopoly
 - both firms compete on price and take into account the price of their competitor

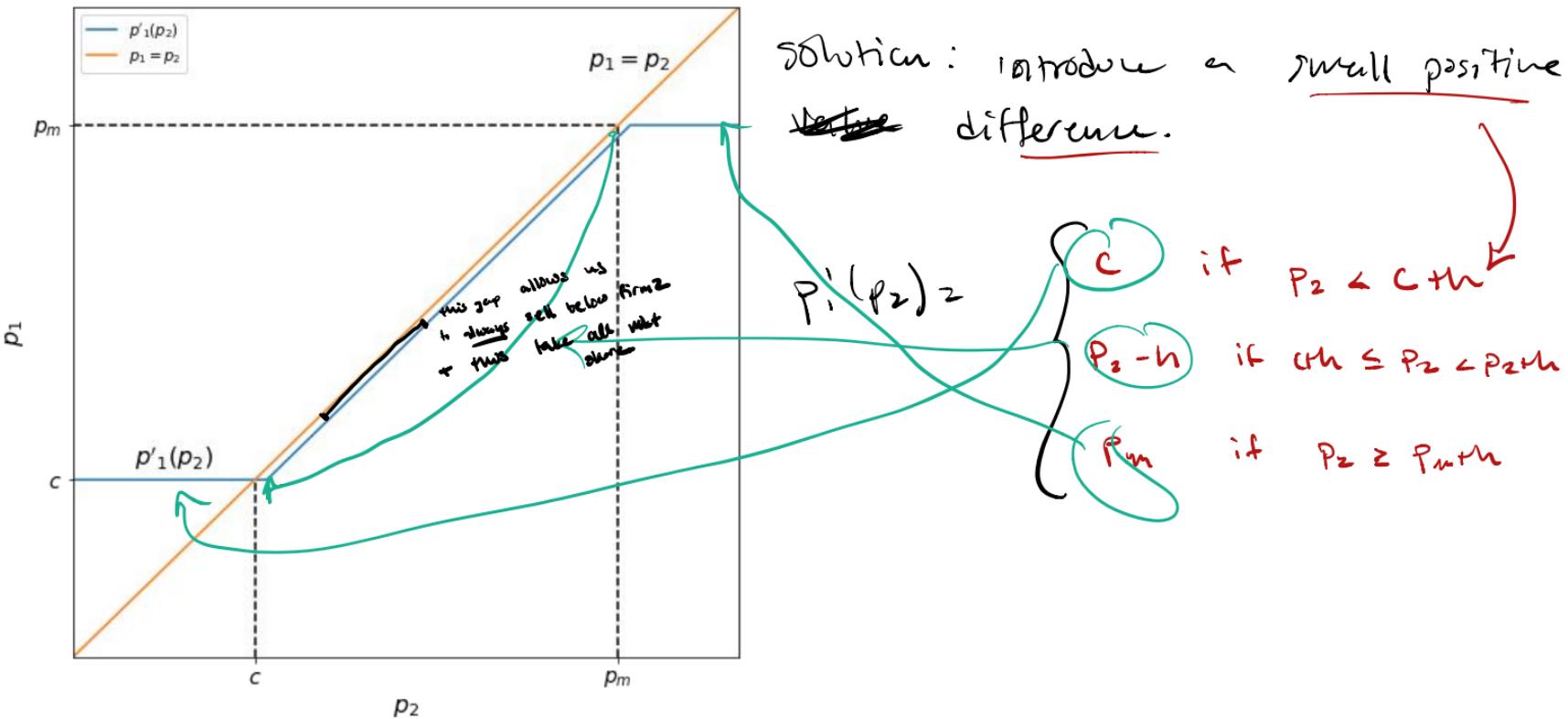
P_m = monopoly price level \downarrow

When the MR of marginal demand = c

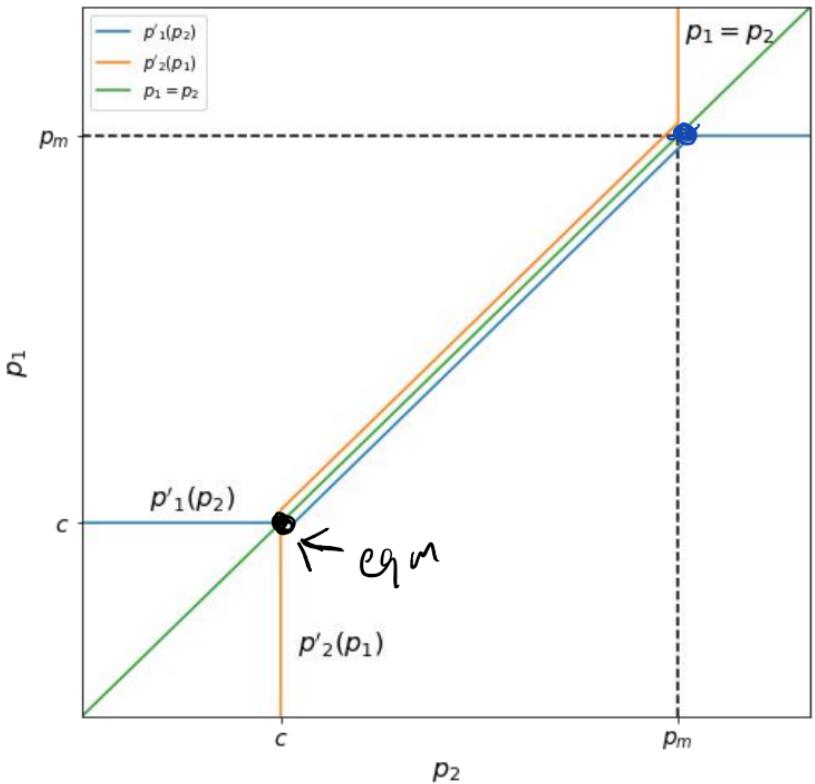
$$MR = 2D(Q) - D(0) = c$$

How to sell at a profit but below P_2 ?

Bertrand Competition



Bertrand Competition



Where is the optimum?

if p_1, p_2 are anywhere else, the other firm ~~will~~ will undercut them to steal market share + they end up w/ more revenue

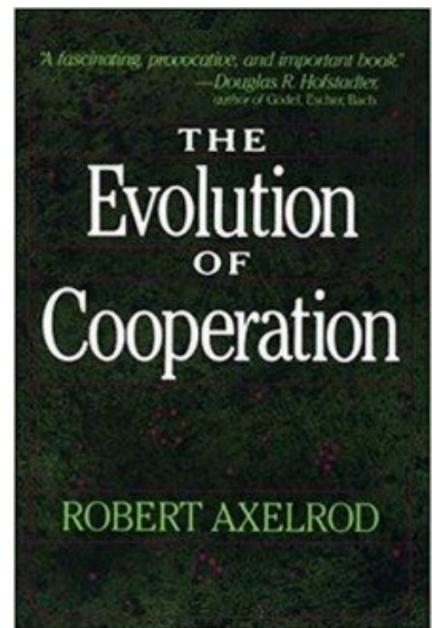
but can't go below c

- Implications:
 - even a duopoly in a market is enough competition to push prices down to the level of perfect competition $P_1 = P_2 = C$
 - but this model relies on serious assumptions
 - there are many reasons why consumers might not buy the lowest-priced item (e.g. non-price competition, search costs)
 - ignores the fact that firms may not be able to supply the entire market
 - including these factors results in a different conclusion

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 - including these factors results in a different conclusion
- the model also demonstrates big incentives to cooperate and raise prices to the monopoly level
 - but this is not the Nash equilibrium of the model

↳ PP again!

- Paradigm in which the prisoner's dilemma is played repeatedly over multiple rounds
- Players know the history of their opponent but not their current move
- Was used to model the Cold War and MAD in the 1950's
 - different strategies for playing this game were analyzed in order to see which was most effective at winning the game
- A famous tournament for the Iterated Prisoner's Dilemma was run by Robert Axelrod
 - the winning strategy at this tournament was tit-for-tat
 - excellent episode of [Radiolab](#) on this tournament



In Project 3, you will

- study the iterated prisoner's dilemma and recreate Axelrod's tournament
- study an experiment by Thomas and Pemstein (2015) relating the perception of height to game strategies
- recreate the analysis of Thomas and Pemstein (2015) using A/B testing
 - webcam placement influences leader-follower behavior in games