Lecture 5-6
Applications of Nash equilibrium
Rationalizablity & Backwards Induction

14.12 Game Theory
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Road Map

1. Cournot (quantity) Competition
   1. Nash Equilibrium in Cournot duopoly
   2. Nash Equilibrium in Cournot oligopoly
   3. Rationalizability in Cournot duopoly
2. Bertrand (price) Competition
3. Commons Problem
4. Quiz
5. Mixed-strategy Nash equilibrium
6. Backwards induction
Cournot Oligopoly

- \( N = \{1,2,\ldots,n\} \) firms;
- Simultaneously, each firm \( i \) produces \( q_i \) units of a good at marginal cost \( c \),
- and sells the good at price
  \[ P = \max\{0,1-Q\} \]
  where \( Q = q_1+\ldots+q_n \).
- Game = \((S_1,\ldots,S_n; \pi_1,\ldots,\pi_n)\)
  where \( S_i = [0,\infty) \),

\[ \pi_i(q_1,\ldots,q_n) = q_i[1-(q_1+\ldots+q_n)-c] \text{ if } q_1+\ldots+q_n < 1, \]
\[ -q_i c \text{ otherwise.} \]

Cournot Duopoly -- profit

Cost function:
\[ -cq_i \]
\[ q_i(1-q_i-c) \]
C-D – best responses

• $q_i^B(q_j) = \max\{(1-q_j-c)/2,0\}$;
• Nash Equilibrium $q^*$:
  $q_1^* = (1-q_2^*-c)/2$;
  $q_2^* = (1-q_1^*-c)/2$;
• $q_1^* = q_2^* = (1-c)/3$

![Graph showing best responses](image)

Cournot Oligopoly --Equilibrium

• $q>1-c$ is strictly dominated, so $q \leq 1-c$.
• $\pi_i(q_1,\ldots,q_n) = q_i[1-(q_1+\ldots+q_n)-c]$ for each $i$.
• FOC: $\frac{\partial \pi_i(q_1,\ldots,q_n)}{\partial q_i} \bigg|_{q^*} = \frac{\partial [q_i(1-q_1-\ldots-q_n-c)]}{\partial q_i} \bigg|_{q^*} = (1-q_1^*-\ldots-q_n^*-c) - q_i^* = 0$.

• That is,
  $2q_1^* + q_2^* + \ldots + q_n^* = 1 - c$
  $q_1^* + 2q_2^* + \ldots + q_n^* = 1 - c$
  \vdots
  $q_1^* + q_2^* + \ldots + nq_n^* = 1 - c$
• Therefore, $q_1^* = \ldots = q_n^* = (1-c)/(n+1)$. 

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Cournot oligopoly – comparative statics

Rationalizability in Cournot Duopoly

Assume that players are rational.
Players are rational:

Assume that players know this.

Players are rational and know that players are rational

Assume that players know this.
Players are rational; players know that players are rational; players know that players know that players are rational

Assume that players know this.

Rationalizability in Cournot duopoly

- If i knows that $q_j \leq q$, then $q_i \geq (1-c-q)/2$.
- If i knows that $q_j \geq q$, then $q_i \leq (1-c-q)/2$.
- We know that $q_j \geq q^0 = 0$.
- Then, $q_i \leq q^1 = (1-c-q^0)/2 = (1-c)/2$ for each i;
- Then, $q_i \geq q^2 = (1-c-q^1)/2 = (1-c)(1-1/2)/2$ for each i;
- …
- Then, $q^n \leq q_i \leq q^{n+1}$ or $q^{n+1} \leq q_i \leq q^n$ where
  
  $q^{n+1} = (1-c-q^n)/2 = (1-c)(1-1/2+1/4-\ldots+(-1/2)^n)/2$.
- As $n \to \infty$, $q^n \to (1-c)/3$.
Bertrand (price) competition

- $N = \{1,2\}$ firms.
- Simultaneously, each firm $i$ sets a price $p_i$;
- If $p_i > p_j$, firm $i$ sells $Q = \max\{1 - p_i, 0\}$ unit at price $p_i$; the other firm gets 0.
- If $p_1 = p_2$, each firm sells $Q/2$ units at price $p_1$, where $Q = \max\{1 - p_1, 0\}$.
- The marginal cost is 0.

$$\pi_1(p_1, p_2) = \begin{cases} p_1(1 - p_1) & \text{if } p_1 < p_2 \\ p_1(1 - p_1)/2 & \text{if } p_1 = p_2 \\ 0 & \text{otherwise.} \end{cases}$$

Bertrand duopoly -- Equilibrium

Theorem: The only Nash equilibrium in the “Bertrand game” is $p^* = (0,0)$.

Proof:
1. $p^* = (0,0)$ is an equilibrium.
2. If $p = (p_1, p_2)$ is an equilibrium, then $p = p^*$.
   1. If $p = (p_1, p_2)$ is an equilibrium, then $p_1 = p_2$...
   2. Given any equilibrium $p = (p_1, p_2)$ with $p_1 = p_2$, $p = p^*$. 
Commons Problem

- \( N = \{1, 2, \ldots, n\} \) players, each with unlimited money;
- Simultaneously, each player \( i \) contributes \( x_i \geq 0 \) to produce \( y = x_1 + \ldots + x_n \) unit of some public good, yielding payoff
  \[ U_i(x_i, y) = y^{1/2} - x_i. \]

Stag Hunt

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Equilibrium in Mixed Strategies

What is a strategy?
- A complete contingent-plan of a player.
- What the others think the player might do under various contingency.

What do we mean by a mixed strategy?
- The player is randomly choosing his pure strategies.
- The other players are not certain about what he will do.

Stag Hunt

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Mixed-strategy equilibrium in Stag-Hunt game

- Assume: Player 2 thinks that, with probability $p$, Player 1 targets for Rabbit. What is the best probability $q$ she wants to play Rabbit?
- His payoff from targeting Rabbit:
  \[ U_2(R; p) = 2p + 4(1-p) = 4 - 2p. \]
- From Stag:
  \[ U_2(S; p) = 5(1-p) \]
- She is indifferent iff 
  \[ 4 - 2p = 5(1-p) \text{ iff } p = \frac{1}{3}. \]

Best responses in Stag-Hunt game

\[
q_{BR}(p) = \begin{cases} 
0 & \text{if } p < \frac{1}{3} \\
q \in [0,1] & \text{if } p = \frac{1}{3} \\
1 & \text{if } p > \frac{1}{3}
\end{cases}
\]
Bertrand Competition with costly search

- N = {F1,F2,B}; F1, F2 are firms; B is buyer
- B needs 1 unit of good, worth 6;
- Firms sell the good; Marginal cost = 0.
- Possible prices P = {1,5}.
- Buyer can check the prices with a small cost c > 0.

Game:
1. Each firm i chooses price \( p_i \);
2. B decides whether to check the prices;
3. (Given) If he checks the prices, and \( p_1 \neq p_2 \), he buys the cheaper one; otherwise, he buys from any of the firm with probability \( \frac{1}{2} \).

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Bertrand Competition with costly search

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Check Don’t Check
Mixed-strategy equilibrium

- Symmetric equilibrium: Each firm charges “High” with probability q;
- Buyer Checks with probability r.
- \( U(\text{check}; q) = q^2 l + (1-q^2)r - c = 5 - 4q^2 - c; \)
- \( U(\text{Don’t}; q) = q l + (1-q)r = 5 - 4q; \)
- Indifference: \( 4q(1-q) = c; \) i.e.,
- \( U(\text{high}; q, r) = 0.5(1-r(1-q))r; \)
- \( U(\text{low}; q, r) = qr l + 0.5(1-qr) \)
- Indifference = \( r = 4/(5-4q). \)

Dynamic Games of Perfect Information

&

Backward Induction
Definitions

**Perfect-Information game** is a game in which all the information sets are singleton.

**Sequential Rationality:** A player is sequentially rational iff, at each node he is to move, he maximizes his expected utility conditional on that he is at the node – even if this node is precluded by his own strategy.

In a finite game of perfect information, the “common knowledge” of sequential rationality gives **“Backward Induction”** outcome.

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**A centipede game**

```
1       A       2       α       1       a
     |       |       |       |       |   (1,-5)
     D       δ       d
   (4,4)   (5,2)   (3,3)
```
Backward Induction

1. Take any pen-terminal node
2. Pick one of the payoff vectors (moves) that gives ‘the mover’ at the node the highest payoff
3. Assign this payoff to the node at the hand;
4. Eliminate all the moves and the terminal nodes following the node

- Any non-terminal node
- Yes
- No

The picked moves

Battle of The Sexes with perfect information

```
    1
   / \  
  L   R  
 /     /  
(2,1) (2,1)
```

```
    1
   / \  
  L   R  
 /     /  
(0,0) (0,0) (0,0) (1,2)
```
Note

- There are Nash equilibria that are different from the Backward Induction outcome.
- Backward Induction always yields a Nash Equilibrium.
- That is, Sequential rationality is stronger than rationality.

Matching Pennies (wpi)
**Stackelberg Duopoly**

**Game:**
N = {1,2} firms w MC = 0;
1. Firm 1 produces \( q_1 \) units
2. Observing \( q_1 \), Firm 2 produces \( q_2 \) units
3. Each sells the good at price
   \[ P = \max\{0,1-(q_1+q_2)\} \]

\[ \pi_i(q_1, q_2) = q_i[1-(q_1+q_2)] \text{ if } q_1 + q_2 < 1, \]
\[ 0 \text{ otherwise.} \]

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**“Stackelberg equilibrium”**

- If \( q_1 > 1 \), \( q_2^*(q_1) = 0 \).
- If \( q_1 \leq 1 \), \( q_2^*(q_1) = (1-q_1)/2 \).
- Given the function \( q_2^* \), if \( q_1 \leq 1 \)
  \[ \pi_i(q_1; q_2^*(q_1)) = q_i[1-(q_1+ (1-q_1)/2)] \]
  \[ = q_i (1-q_1)/2; \]
  0 otherwise.
- \( q_1^* = \frac{1}{2} \).
- \( q_2^*(q_1^*) = \frac{1}{4} \).