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COMPARING COURNOT AND STACKELBERG DUOPOLY*

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Abstract

Equilibrium properties of Cournot and Stackelberg duopoly are compared with respect to outputs, profits, and welfare, the results of which depend on some conditions expressed in terms of the elasticities of the cost and demand functions. In particular, the case where the condition owing to Fisher (1961), Hahn (1962), and Okuguchi (1964, 1976, 1999) is not satisfied exactly corresponds to the case where the marginal revenue curve is steeper than the demand curve, the marginal cost curve is decreasing, and the demand curve is elastic to some extent, the case of which gives rise to different results from Okuguchi's (1999).

Key words: Cournot and Stackelberg duopoly, the elasticities of the cost and demand functions, Fisher-Hahn-Okuguchi condition

JEL Classification Codes: D43, L13

I. Introduction

In a sequential game with two identical players, Gal-Or (1985) explored the conditions on which a first mover (a leader) or a second mover (a follower) gains a higher profit than the other and showed that the first-mover or second-mover advantage over the rival arises if the reaction function of the follower is downward or upward sloping, respectively.

Okuguchi (1999) compared Cournot duopoly (a simultaneous-mover game) and Stackelberg duopoly (a sequential-mover game) with respect to outputs and profits and showed the results as follows. First, if the follower's reaction function is downward sloping, then the outputs and the profits are the largest in the (Stackelberg) leader case, the second largest in the Cournot case, and the smallest in the (Stackelberg) follower case. Second, if the follower's reaction function is upward sloping, then the outputs are the largest in the Cournot case, the second largest in the follower case, and the smallest in the leader case, whereas the profits are the largest in the follower case, the second largest in the leader case, and the smallest in the Cournot case.

Fisher (1961), Hahn (1962), and Okuguchi (1964, 1976, 1999) assumed that (1) for each firm, the marginal cost should rise more rapidly than the marginal revenue, with other firms

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expanding their ‘collective’ output, and that (2) for each firm, the marginal cost should not fall more rapidly than the demand for total industry output. The first assumption was given as a sufficient condition for each firm to maximize the profit with respect to its output, which is known as the second-order condition for the optimum. The second assumption was given as a condition for the Cournot equilibrium to be stable, which we call Fisher-Hahn-Okuguchi condition.

In this paper we compare equilibrium properties of Cournot and Stackelberg duopoly with respect to outputs, profits, and welfare, also examining the case where F-H-O condition is not satisfied whereas the second-order condition for the optimum is still satisfied, the case of which Okuguchi (1999) did not examine. In order to deal simultaneously with conditions on whether the follower’s reaction function is downward or upward sloping and those on whether F-H-O condition is satisfied or not, given the second-order condition for the optimum, we express these conditions in terms of the elasticities of the cost and demand functions.

We show that the results of comparison with respect to outputs and profits are different from Okuguchi’s (1999) in the case where F-H-O condition is not satisfied whereas the second-order condition for the optimum is still satisfied. That is, the output is the largest in the follower case, the second largest in the Cournot case, and the smallest in the leader case, even if the follower’s reaction function is downward sloping, whereas the profit is the largest in the Cournot case.

As for consumer surplus, the results of comparison are summarized as follows. Consumer surplus is larger in the Cournot equilibrium than in the Stackelberg equilibrium if the follower’s reaction function is upward sloping and not so steep. On the contrary, consumer surplus is smaller in the Cournot equilibrium if the follower’s reaction function is downward sloping, or if the follower’s reaction function is upward sloping and so steep.

As for producer surplus, the results of comparison are summarized as follows. Producer surplus is larger in the Cournot equilibrium than in the Stackelberg equilibrium if (1) the marginal revenue function is steeper than the demand function, the marginal cost functions are non-decreasing, and the demand function is weakly convex and less elastic, or if (2) the marginal revenue function is steeper than the demand function, the marginal cost functions are decreasing, and the demand function is weakly convex and elastic to some extent, with some additional condition for the outputs. On the contrary, producer surplus is smaller in the Cournot equilibrium if (3) the demand function is steeper than the marginal revenue function, the marginal cost functions are non-decreasing, and the demand function is convex to some extent and less elastic, if (4) the demand function is steeper than the marginal revenue function, the marginal cost functions are decreasing, and the demand function is convex to some extent and elastic to some extent, or if (5) the marginal cost functions are steeper than the marginal revenue function, the marginal cost functions are non-decreasing, and the demand function is strongly convex and more elastic.

The remainder of this paper is organized as follows. In Section II we formulate basic models of Cournot and Stackelberg duopoly. In Section III we compare equilibrium properties of Cournot and Stackelberg duopoly with respect to outputs, profits, and welfare, i.e., consumer surplus, producer surplus, and total surplus (defined as the sum of consumer surplus and producer surplus). We attempt to classify the results of comparison by some conditions on the slope of the follower’s reaction function expressed in terms of the elasticities of the cost and demand functions. In Section IV we provide concluding remarks.
II. Basic Models

We assume that there are two firms, labeled 1, 2 respectively, in an industry, each of which produces $x_i$ ($i=1, 2$) units of homogenous commodities to be sold in a single market; all the outputs are non-negative, i.e., $x_i \geq 0$, $i=1, 2$. Denote by $X=x_1+x_2$ the total output in the industry.

Let $p=P(X)$ be the (inverse) demand, where $p$ is the market price of the good. We assume that the function $P(X)$ is continuous, twice differentiable, and monotonically decreasing. We also assume that $0 \leq x_i \leq M$, $i=1, 2$, such that $P(X)=0$ if $X=x_1+x_2 \geq M$ for some $M>0$.

Let $C_i(x_i)$ be the (total) cost function of firm $i$ that produces $x_i$ units of the output. We assume that the function $C_i(x_i)$ is continuous, twice differentiable, and monotonically non-decreasing.

The profit of firm $i$ is written in the form $\pi_i(x_i, x_j)=x_iP(X)-C_i(x_i)$, $i, j=1, 2$, $j \neq i$. In order to guarantee the non-negative profit, we may assume that $C_i(0)=0$ for all $i$.\(^1\) Note that since $P(X)$ and $C_i(x_i)$ are continuous and twice differentiable by assumption, so is $\pi_i(x_i, x_j)$.

Firm $i$ maximizes the profit $\pi_i(x_i, x_j)=x_iP(X)-C_i(x_i)$ with respect to the output $x_i$. The first-order condition for the optimum for firm $i$ is given by

$$P(\varphi_i(x_i)+x_i)+\varphi_i(x_i)P'(\varphi_i(x_i)+x_i)-C'_i(\varphi_i(x_i))=0,$$

(1)

where $\varphi_i(x_i)=x_i^c$ is the reaction function of firm $i$. One could show the following properties of the function $\varphi_i$, which we use hereafter:\(^2\)

(i) $\varphi_i$ is continuous.
(ii) $\varphi_i$ is differentiable in an open neighborhood of $x_i^c$.

A point $(x_i^c, x_j^c)$ at which the curves $\varphi_1$ and $\varphi_2$ cross with each other defines the Cournot duopoly equilibrium. In order to guarantee that the solution $x_i^c$ of equation (1) uniquely exists, we assume that $\pi_i$ is strictly concave, namely:

**Condition 1.** \(\partial^2 \pi_i/\partial x_i^2=(P'+x_iP'')(P'-C'_i)<0\) at $x_i^c$ for $i=1, 2$.

Given Condition 1, the second-order condition for the optimum is satisfied. Throughout the paper we assume that Condition 1 is always satisfied.

Differentiating (1) with respect to $x_j$ and arranging terms, we have

$$\varphi'_i(x_i)=-(\partial^2 \pi_i/\partial x_i \partial x_j)/\partial^2 \pi_i/\partial x_i^2=-(P'+x_iP'')/\partial x_i(x_i+P'+x_iP'')+(P'-C'_i),$$

(2)

which gives the slope of the reaction curve of firm $i$. From (2) we see that, given Condition 1, $\varphi'_i<0$ (resp. $>0$) as $\partial^2 \pi_i/\partial x_i \partial x_j=0 (resp. >0)$, that is, quantities of the outputs are

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\(^1\) As for this point, see Okuguchi (1976).

\(^2\) Let $U$ be open in $\mathbb{R}^2$ and let $\partial \pi_i/\partial x_j: U \rightarrow \mathbb{R}$ be continuous and differentiable. Let $(x_i^c, x_j^c) \in U$, that is, $U$ is an open neighborhood of a point $(x_i^c, x_j^c)$, and assume that $\partial \pi_i(x_i^c, x_j^c)/\partial x_i=0$ but $\partial \pi_i(x_i^c, x_j^c)/\partial x_j \neq 0$. By the Implicit Function Theorem we observe that there exist an open neighborhood $U'$ of $x_i^c$ and a continuous and differentiable function $\varphi_j: U' \rightarrow \mathbb{R}$ such that $\varphi_j(x_i^c)=x_j^c$ and $\partial \pi_i(\varphi_j(x_i), x_j)/\partial x_j=0$ for all $x_j \in U'$, Okuguchi (1976) proved that the follower’s reaction function is continuous, focusing on the property that a real-valued and strictly concave function on a set in $\mathbb{R}$ has a unique (global) maximum. As for the proof, see Takayama (1986).
strategic substitutes (resp. complements).

The following is what we call Fisher-Hahn-Okuguchi condition:

**Condition 2.** \( P' - C'' < 0 \) at \( x_i^c \) for \( i = 1, 2 \).

Note that Condition 2 is equivalent to saying that \( |\partial^2 \pi_i / \partial x_i^2| > |\partial^2 \pi_j / \partial x_i \partial x_j| \) at \( x_i^c \) for \( i, j = 1, 2, j \neq i \). F-H-O condition means that for each firm, the marginal cost should not fall more rapidly than the demand for total industry output.\(^3\)

It follows that at \( x_i^c \) for \( i = 1, 2, \)

\[
P' + x_i P'' = (P/X \varepsilon)(1 + \sigma_i/\eta) < 0 \quad \text{(resp. } > 0\text{)} \quad \text{as } 1 + \sigma_i/\eta > 0 \quad \text{(resp. } < 0\text{)},
\]

\[
P' - C'' = (P/X \varepsilon)(1 - \mu_i(1 + \varepsilon)/\sigma_i) < 0 \quad \text{(resp. } > 0\text{)} \quad \text{as } -\mu_i + \sigma_i(1 + \varepsilon)/\sigma_i < 0 \quad \text{(resp. } < 0\text{)},
\]

\[
(P' + x_i P'')(P' - C'') = (P/X \varepsilon)[2 + \sigma_i/\eta - \mu_i(1 + \varepsilon)/\sigma_i] < 0 \quad \text{as } -\mu_i + \sigma_i(2 + \sigma_i/\eta) > \mu_i \varepsilon,
\]

where \( \sigma_i = x_i/X \) with \( 0 < \sigma_i < 1 \) represents the ratio of the size of firm \( i \)'s production to the total production of the good, i.e., the market share of firm \( i \)'s products; \( \varepsilon = P/X \varepsilon \) with \( \varepsilon < -1 \) by (1), \( \eta = P'/XP'' \) with \( \eta \geq 0 \) (resp. \( < 0 \)) as \( P' \leq 0 \) (resp. \( > 0 \)), and \( \mu_i = x_i C''/C_i' \) with \( \mu_i \geq (\text{resp. } < 0) \) as \( C_i'' \geq 0 \) (resp. \( < 0 \)) represent the elasticity of the demand function, the elasticity of the slope of the demand function, and the elasticities of the marginal cost functions, respectively.\(^4\)

Using the terminology in Brander and Spencer (1984), we may say that \( \eta \) and \( \mu_i \) measure the “relative curvature” of \( P \) and that of \( C_i \) at \( x_i^c \), respectively. Since

\[
\begin{align*}
-1 + \sigma_i/\mu_i &\geq (\text{resp. } <) -1 \quad \text{as } \mu_i > 0 \quad \text{(resp. } < 0\text{)}, \\
-1 + (\sigma_i/\mu_i)(2 + \sigma_i/\eta) &\geq (\text{resp. } <) -1 + \sigma_i/\mu_i \quad \text{as } \mu_i(1 + \sigma_i/\eta) \geq (\text{resp. } < 0) \quad 0, \\
-1 + (\sigma_i/\mu_i)(2 + \sigma_i/\eta) &\geq (\text{resp. } <) -1 \quad \text{as } \mu_i(2 + \sigma_i/\eta) \geq (\text{resp. } < 0) \quad 0,
\end{align*}
\]

we have the following lemma:

**Lemma 1.** In any of the following cases, Condition 1 is satisfied:

(a) We have \( P' + x_i P'' < 0 \) and \( P' - C'' < 0 \) if and only if 

(i) \( \sigma_i/\eta > -1, \mu_i \geq 0, \) and \( \varepsilon < -1, \) or (ii) \( \sigma_i/\eta > -1, \mu_i < 0, \) and \( -1 + \sigma_i/\mu_i < \varepsilon < -1. \)

(b) We have \( P' + x_i P'' > 0 \) and \( P' - C'' < 0 \) if and only if 

(i) \( -2 < \sigma_i/\eta < -1, \mu_i \geq 0, \)

(ii) \( -2 < \sigma_i/\eta < -1, \mu_i < 0, \)

or (iii) \( \sigma_i/\eta < -2, \mu_i \geq 0, \) and \( -1 + (\sigma_i/\mu_i)(2 + \sigma_i/\eta) < \varepsilon < -1, \) or (iii) \( \sigma_i/\eta < -2, \mu_i < 0, \) and \( \varepsilon < 1 + (\sigma_i/\mu_i)(2 + \sigma_i/\eta). \)

(c) We have \( P' + x_i P'' < 0 \) and \( P' - C'' > 0 \) if and only if \( \sigma_i/\eta > -1, \mu_i < 0, \) and \( -1 + (\sigma_i/\mu_i)(2 + \sigma_i/\eta) < \varepsilon < -1 + \sigma_i/\mu_i. \)

Note that Case (a) and Case (b) in Lemma 1 correspond to the case where Condition 1 and Condition 2 are satisfied and Case (c) corresponds to the case where Condition 2 is not satisfied whereas Condition 1 is still satisfied. Also note that \( -1 < \varphi_i' \leq 0 \) in Case (a), \( \varphi_i' > 0 \) in Case (b), and \( \varphi_i' < -1 \) in Case (c). Thus the slope of firm \( i \)'s reaction function has been expressed by the elasticities of the demand function and the market share of firm \( i \)'s products.

In other words, strategic substitution/complementarity is regarded as a consequence, not as an

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\(^3\) The Cournot (oligopoly or duopoly) equilibrium may be unstable even if F-H-O condition is satisfied. As for this point, see Seade (1980), Al-Nowaihi and Levine (1985), and Chuman (2008, 2009).

\(^4\) In particular, the equality of the second of the three equations in (3) can be derived as follows: Since \( P(1 + 1/\varepsilon) = C_i' \) by (1), expressing that for firm \( i \) the marginal revenue is equal to the marginal cost at \( x_i^c \), we have \( P' - C'' = (P/X \varepsilon)[(XP'/P) - (X/x_i)(x_i C''/C)(P'/P)] = (P/X \varepsilon)[1 - \mu_i(1 + \varepsilon)/\sigma_i], \) using \( C_i'' = P = 1 + 1/\varepsilon. \)
assumption often appeared in the industrial organization literature.\(^5\)

**Remark.** Let \(\sigma_1 = \sigma_2 = 1/2\) and \(\mu_1 = \mu_2 = \mu\) in Lemma 1. Then by (3) we can check that:

(a) \(-1 < \varphi_\eta ' < 0\) if and only if (i) \(\eta \geq 0\) or \(-1/2 \leq \mu \leq 0\), and \(\varepsilon < -1\), or (ii) \(\eta \geq 0\) or \(-1/2 \leq \mu \leq 0\), and \(\varepsilon < -1\), or (iii) \(\eta \leq 0\) or \(-1/2 \leq \mu \leq 0\), and \(\varepsilon < -1\); 

(b) \(0 < \varphi_\eta ' < 1\) if and only if (i) \(\mu \geq 0\), \(-1/2 < \eta < -1/3\), and \(\varepsilon < -1\), (ii) \(\mu < 0\), \(-1/3 < \eta < -1/4\), and \(\varepsilon < -1 + (1/\mu)(3/2 + 1/2\eta)\), (iii) \(\mu \geq 0\), \(-1/4 < \eta < 0\), and \(\varepsilon < -1 + (1/\mu)(3/2 + 1/2\eta)\), or (iv) \(\mu < 0\), \(-1/2 < \eta < -1/3\), and \(-1 + (1/\mu)(3/2 + 1/2\eta) < \varepsilon < -1\); 

(c) \(\varphi_\eta ' < -1\) if and only if \(\eta \geq 0\) or \(-1/2 < \eta < -1/3\), and \(\mu < 0\), and \(-1 + (1/\mu)(1 + 1/4\eta) < \varepsilon < -1 + (1/\mu)(3/2 + 1/2\eta)\), or (viii) \(\mu < 0\), \(-1/3 < \eta < -1/4\), and \(-1 + (1/\mu)(1 + 1/4\eta) < \varepsilon < -1\);

In addition, we can check that conditions (b)(i)-(iii)(v) correspond to Case (b)(i) in Lemma 1, conditions (b)(iv)(vii)(viii) correspond to Case (b)(ii) in Lemma 1, and conditions (b)(iii)(vi) correspond to Case (b)(iii) in Lemma 1.

Further note that \(\sigma_\eta / \eta > -1\), corresponding to the case where the demand function is not too convex, is equivalent to that \(|2P' + x_iP''| > |P'|\), that is, the marginal revenue function is steeper than the demand function; \(-2 < \sigma_\eta / \eta < -1\) is equivalent to that \(|2P' + x_iP''| < |P'|\), that is, the demand function is steeper than the marginal revenue function; \(\sigma_\eta / \eta < -2\), corresponding to the case where the demand function is too convex, is equivalent to that \(0 < 2P' + x_iP'' < C_i'\), that is, the marginal cost functions are strictly increasing and steeper than the marginal revenue function.

In summary, Case (a) in Lemma 1 occurs if (i) the marginal revenue function is steeper than the demand function, the marginal cost functions are non-decreasing, and the demand function is less elastic, or if (ii) the marginal revenue function is steeper than the demand function, the marginal cost functions are decreasing, and the demand function is elastic to some extent; Case (b) occurs if (i) the demand function is steeper than the marginal revenue function, the marginal cost functions are non-decreasing, and the demand function is less elastic, if (ii) the demand function is steeper than the marginal revenue function, the marginal cost functions are decreasing, and the demand function is elastic to some extent, or if (iii) the marginal cost functions are steeper than the marginal revenue function, the marginal cost functions are non-decreasing, and the demand function is more elastic; Case (c) occurs if the marginal revenue function is steeper than the demand function, the marginal cost functions are decreasing, and the demand function is elastic to some extent.

Hereafter we focus on the case where all firms are identical, i.e., \(C_i(x_i) = C(x), \ i = 1, 2\). Denote the total output and firm \(i\)'s profit in the Cournot duopoly equilibrium by \(X^C\), where \(X^C = x_1^C + x_2^C\), and \(\pi_i^C\), respectively. Since all firms compete in the same product market and produce with the identical marginal cost functions by hypothesis, we have \(x_1^C = x_2^C\) and \(\pi_1^C = \pi_2^C\). Immediately, \(\sigma_1 = \sigma_2 = 1/2\) and \(\mu_1 = \mu_2 = \mu\) (constant).

Let us explore the Stackelberg duopoly. Let firm 1 be the leader and firm 2 the follower. Firm 2, taking firm 1's output \(x_1\) as given, maximizes the profit \(\pi_2(x_1, x_2) = x_2P(x_1 + x_2) - C(x_2)\) with respect to the output \(x_2\). Firm 1, knowing firm 2's reaction function \(\varphi_2(x_1)\), maximizes the

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\(^5\) As for this point, see Brander (1995) and Shapiro (1989), for example.
profit \( \pi_i(x_1, \varphi_2(x_1)) = x_1P(x_1 + \varphi_2(x_1)) - C(x_1) \) with respect to the output \( x_1 \). Denote by \( x^L_1 \) and \( x^F_1 \) the equilibrium output of the follower and that of the leader, respectively, where \( x^L_1 = \varphi_2(x^F_1) \). Denote by \( X^S \) the total output in the Stackelberg duopoly equilibrium, where \( X^S = x^L_1 + x^F_1 \).

The first-order condition for firm 2 to maximize \( \pi_2(x_1, x_2) = x_2P(x_1 + x_2) - C(x_2) \) with respect to \( x_2 \), taking \( x_1 \) as given, is given by

\[
P(X^S) + x^F_1P'(X^S) - C'(x^F_1) = 0.
\]

The first-order condition for firm 1 to maximize \( \pi_1(x_1, \varphi_2(x_1)) = x_1P(x_1 + \varphi_2(x_1)) - C(x_1) \) with respect to \( x_1 \) is given by

\[
P(X^S) + x^L_1\{1 + \varphi_2'(x^L_1)\}P'(X^S) - C'(x^L_1) = 0.
\]

Denote by \( \pi^L_1 \) and \( \pi^F_1 \), \( i = 1, 2 \), the profit of the leader and that of the follower in the Stackelberg duopoly equilibrium, respectively. Since all firms are identical and compete in the same product market by hypothesis, we have \( x^L_1 = x^F_1, x^L_2 = x^F_2, \pi^L_1 = \pi^L_2, \) and \( \pi^F_1 = \pi^F_2 \). So it will suffice to explore firm 1’s side alone.

### III. Comparison of the Two Duopoly Equilibria

Let us now compare equilibrium properties of the Cournot and Stackelberg duopoly with respect to outputs, profits, and welfare.

First, as for the results of comparison with respect to the equilibrium outputs and profits, we have the following proposition:

**Proposition 1.**

(a) In the case where \(-1 < \varphi_2' < 0\) (that is, the follower’s reaction function is downward sloping and not so steep), \( x^L_1 > x^F_1 > x^L_2 \) and \( \pi^L_1 > \pi^F_1 > \pi^L_2 \).

(b) In the case where \(0 < \varphi_2' < 1\) (that is, the follower’s reaction function is upward sloping and not so steep), \( \pi^L_1 > \pi^F_1 > \pi^L_2 \) and \( x^L_1 > x^F_1 > x^L_2 \); in the case where \( \varphi_2' > 1 \) (that is, the follower’s reaction function is upward sloping and so steep), \( \pi^L_1 > \pi^F_1 > \pi^L_2 \) and \( x^L_1 > x^F_1 > x^L_2 \).

(c) In the case where \( \varphi_2' < -1 \) (that is, the follower’s reaction function is downward sloping and so steep), \( x^L_1 > x^F_1 > x^L_2 \); \( \pi^L_1 > \pi^L_2 > \pi^F_1 \) if \( P(X^S) - C(x^S) > 0 \) and \( \pi^L_1 > \pi^L_2 > \pi^F_1 \) otherwise, where \( x^S \) is a number between \( x^L_1 \) and \( x^F_1 \) such that \( C(x^L_1) - C(x^F_1) = (x^L_1 - x^F_1)C'(x^S) \).

*Proof. See Appendix A1.*

Intuition for the results in Proposition 1 can be explained as follows. As for Part (a), which corresponds to the strategic-substitutes case (i.e., \( \partial^2 \pi_2 / \partial x_1 \partial x_2 < 0 \)), firm 1, by producing
the output $x_1$ more, forces firm 2 to gain the marginal profit $\partial \pi_2 / \partial x_2$ less and to produce the output $x_2$ less, which leads to $x_1^I > x_1^F$ and $x_2^F < x_2^F$. Assuming gross substitutes (i.e., $\partial \pi_i / \partial x_i = x_i P_i < 0$ for $i, j = 1, 2, j \neq i$), we have $\pi_1^I > \pi_1^F$ and $\pi_2^I > \pi_2^F$. As for Part (b), which corresponds to the strategic-complements case (i.e., $\partial^2 \pi_i / \partial x_i \partial x_2 > 0$), in case $0 < \phi_2' < 1$, firm 1, by producing $x_1$ less, forces firm 2 to gain the marginal profit $\partial \pi_2 / \partial x_2$ less and to produce the output $x_2$ less, which leads to $x_1^F < x_1^F$ and $x_2^F > x_2^F$. Assuming gross substitutes, we have $\pi_1^I > \pi_1^F$ and $\pi_2^F > \pi_1^F$.

Note that the results of comparison in Part (c) are much different from those in Part (a), both of which correspond to the strategic-substitutes cases, in that whereas the output of the leader is the largest in Part (a), it is the smallest in Part (c). This is because whereas the output of the leader is larger than that of the follower if F-H-O condition is satisfied, this is not the case if F-H-O condition is not satisfied. Likewise, as for Part (b), the results of comparison in the second case are much different from those in the first case, both of which correspond to the strategic-complements cases, in that whereas the output of the Cournot player is the largest in the first case, it is the smallest in the second case. This is because whereas the output of the Cournot player is larger than that of the Stackelberg leader if the follower’s reaction function is not so steep, this is not the case if the follower’s reaction function is so steep.

Define consumer surplus by $\Gamma(X) = \int_{y_0}^{y_1} P(Y) dY - P(X) X$. Write $\Gamma^S = \Gamma(X^S)$ and $\Gamma^C = \Gamma(X^C)$. Then we have the following proposition:

**Proposition 2.**

(a) In the case where $-1 < \phi_2' < 0$, consumer surplus is smaller in the Cournot equilibrium than in the Stackelberg equilibrium.

(b) In the case where $0 < \phi_2' < 1$, consumer surplus is larger in the Cournot equilibrium than in the Stackelberg equilibrium; in the case where $\phi_2' > 1$, consumer surplus is smaller in the Cournot equilibrium than in the Stackelberg equilibrium.

(c) In the case where $\phi_2' < -1$, consumer surplus is smaller in the Cournot equilibrium than in the Stackelberg equilibrium.

*Proof.* See Appendix A2. ■

Intuition for the results in Proposition 2 can be explained as follows. $X^S$ (resp. $< X^C$ corresponds to $P(X^S)$ (resp. $> P(X^C)$, which corresponds to $\Gamma^S$ (resp. $< \Gamma^C$). In other words, the larger the total output in the industry, the lower the price of the good, and hence consumer surplus is the larger.

Proposition 2 means that consumer surplus is smaller in the Cournot equilibrium than in the Stackelberg equilibrium if the follower’s reaction function is downward sloping or if the follower’s reaction function is upward sloping and so steep. On the contrary, consumer surplus is larger in the Cournot equilibrium if the follower’s reaction function is upward sloping and not so steep.

Define producer surplus by $\Pi = \pi_1 + \pi_2$. Write $\Pi^S = \pi_1^I + \pi_2^F = P(X^S) X^S - \{C(x_1^I) + C(x_2^F)\}$ and $\Pi^C = \pi_1^I + \pi_2^F = P(X^C) X^C - \{C(x_1^I) + C(x_2^F)\}$. Then we have the following proposition:

**Proposition 3.**

(a) In the case where $-1 < \phi_2' < 0$ with $\eta \leq -1/2$ and $\mu \geq 0$, producer surplus is larger in the Cournot equilibrium than in the Stackelberg equilibrium.
(b) In the case where $$\varphi'_2 > 0$$, producer surplus is smaller in the Cournot equilibrium than in the Stackelberg equilibrium.

(c) In the case where $$\varphi'_2 < -1$$ with $$\gamma \leq -1/2$$, producer surplus is larger in the Cournot equilibrium than in the Stackelberg equilibrium, provided that $$x^+ > x^{++}$$, where $$x^+$$ is a number between $$x^1$$ and $$x^1$$ such that $$C(x^1) - C(x^1) = (x^1 - x^1)C'(x^1)$$ and $$x^{++}$$ is a number between $$x^2$$ and $$x^2$$ such that $$C(x^2) - C(x^2) = (x^2 - x^2)C'(x^{++})$$.

Proof. See Appendix A3. ■

Proposition 3 means that producer surplus is larger in the Cournot equilibrium than in the Stackelberg equilibrium if (1) the marginal revenue function is steeper than the demand function, the marginal cost functions are non-decreasing, and the demand function is strongly convex and less elastic to some extent, if (2) the demand function is steeper than the marginal revenue function, the marginal cost functions are non-decreasing, and the demand function is convex to some extent and less elastic, if (3) the demand function is steeper than the marginal revenue function, the marginal cost functions are increasing, and the demand function is convex to some extent and elastic to some extent, if (4) the marginal cost functions are steeper than the marginal revenue function, the marginal cost functions are non-decreasing, and the demand function is convex to some extent and more elastic, or if (5) the marginal revenue function is steeper than the demand function, the marginal cost functions are decreasing, and the demand function is weakly convex and elastic to some extent, together with $$x^+ > x^{++}$$.

Define total surplus by $$\Omega = \Pi + \Pi^c$$. Write $$\Omega^s = \Pi^s + \Pi^c$$ and $$\Omega^c = \Pi^c + \Pi^c$$. Then we have the following proposition:

Proposition 4.

(a) In the case where $$-1 < \varphi'_2 < 0$$, total surplus is smaller in the Cournot equilibrium than in the Stackelberg equilibrium if $$C' \geq 0$$, $$\varphi_2(x^*) > x^*$$, and $$-1 \leq -P/(P' - C') < \varphi'_2$$, if $$C' < 0$$, $$\varphi_2(x^*) > x^*$$, and $$-P/(P' - C') < -1 < \varphi'_2$$, or if $$C'' > 0$$, $$\varphi_2(x^*) > x^*$$, and $$-1 < \varphi'_2 < -P'/P - C'$$, where $$x^*$$ is a number between $$x^1$$ and $$x^1$$ such that $$\Omega(x^1) - \Omega(x^1) = (x^1 - x^1)Q(x^*)$$.

(b) In the case where $$0 < \varphi'_2 < 1$$, total surplus is larger in the Cournot equilibrium than in the Stackelberg equilibrium if $$C'' \geq 0$$ and $$\varphi_2(x^*) < x^*$$, or if $$C'' < 0$$ and $$\varphi_2(x^*) < x^*$$; in the case where $$\varphi'_2 > 1$$, total surplus is smaller in the Cournot equilibrium than in the Stackelberg equilibrium if $$C'' \geq 0$$ and $$\varphi_2(x^*) > x^*$$, or if $$C'' < 0$$ and $$\varphi_2(x^*) > x^*$$.

(c) In the case where $$\varphi'_2 < -1$$, total surplus is larger in the Cournot equilibrium than in the Stackelberg equilibrium if $$\varphi_2(x^*) < x^*$$.

Proof. See Appendix A4. ■

Proposition 4 implies that, as long as the follower’s reaction function is not so steep (i.e., $$|\varphi'_2| < 1$$), the policy such that welfare is improved in behalf of consumers will be preferable. That is, the policy such that the Stackelberg leader should be advantageous in the industry will be preferable in case $$-1 < \varphi'_2 < 0$$, whereas the policy such that the Cournot player should be advantageous in the industry will be preferable in case $$0 < \varphi'_2 < 1$$. On the contrary, as long as the follower’s reaction function is so steep (i.e., $$|\varphi'_2| > 1$$), the policy such that welfare is
improved in behalf of producers will be preferable. That is, the policy such that the Stackelberg follower should be advantageous in the industry will be preferable in case \( \varphi_2' > 1 \) and in case \( \varphi_2' < -1 \).

IV. Concluding Remarks

In this paper we have compared equilibrium properties of Cournot and Stackelberg duopoly with respect to outputs, profits, and welfare, focusing on whether F-H-O condition is satisfied or not, provided that the second-order condition for the optimum is still satisfied. The analysis can be extended to a case with symmetric more-than-two firms. We have pointed out that the results of comparison depend on some conditions expressed in terms of the elasticities of the cost and demand functions. In particular, we have shown that the case where F-H-O condition is not satisfied exactly corresponds to the case where the marginal revenue function is steeper than the demand function, the marginal cost functions are decreasing, and the demand function is elastic to some extent, the case of which gives rise to different results from Okuguchi’s (1999).

We have derived conditions for a first mover, a second mover, or a simultaneous mover to be more advantageous than the others, those of which are expressed in terms of the elasticities of the cost and demand functions. Conversely, given the Cournot and Stackelberg duopoly, will the elasticities be estimated as those derived above? It is left to future studies to investigate this problem.

**Appendix**

In this Appendix, we first introduce several lemmas, which we use in turn to prove the propositions. It follows from (2) that

\[
1 + \varphi_2'(x_1) = (P' - C''/((P' + x_2P') + (P' - C'')) > 0 \text{ (resp. } < 0) \text{ as } P' - C'' < 0 \text{ (resp. } > 0). \tag{A1}
\]

It follows from (A1) and (6) that

\[
P(X^o) - C'(x_1^o) = -x_1^o(1 + \varphi_2'(x_1^o))P'(X^o) > 0 \text{ (resp. } < 0) \quad \text{as } 1 + \varphi_2'(x_1^o) > 0 \text{ (resp. } < 0), \text{ i.e., } P' - C'' < 0 \text{ (resp. } > 0). \tag{A2}
\]

It follows from (5) that

\[
P(X^o) - C'(x_1^o) = -x_1^oP'(X^o) > 0. \tag{A3}
\]

It follows from (A2) and (A3) that

\[
C'(x_1^o) - C'(x_2^o) = (x_1^o - x_2^o) + x_1^o\varphi_2'(x_1^o)P'(X^o). \tag{A4}
\]

As for the left-hand side of (A4), since by the Mean Value Theorem there is some number \( x' \) between \( x_1^o \) and \( x_2^o \) such that \( C'(x_1^o) - C'(x_2^o) = (x_1^o - x_2^o)C''(x') \), we obtain

\[
(x_1^o - x_2^o)P'(X^o) - C'(x') = -x_1^o\varphi_2'(x_1^o)P'(X^o). \tag{A5}
\]
Putting \( x_1 = x'_1 \) into (A5), we obtain
\[
\text{sign}(x_1 - x'_1)\{P'(X_0) - C'(x')\} = \text{sign}\{\varphi'_1(x'_1)\}. \tag{A6}
\]

In light of (A6), we have

(i) If \( P' - C' < 0 \), then \( x_1 > x'_1 \) (resp. \( x_1 < x'_1 \)) as \( \varphi'_1 < 0 \) (resp. \( > 0 \)).

(ii) If \( P' - C' > 0 \), then \( x_1 < x'_1 \) as \( \varphi'_1 < 0 \). \tag{A7}

By the Mean Value Theorem, we have \( x_1 - x'_1 = \varphi'_1(x'_1) - \varphi'_2(x'_1) = (x_1 - x'_1)\varphi'_2(x'_1) \), where \( x_0 \) is a number between \( x_1 \) and \( x'_1 \). Hence
\[
X^a - X^c = (x_1 - x'_1) + (x'_1 - x'_2) = (x_1 - x'_1)\{1 + \varphi'_2(x'_1)\}. \tag{A8}
\]
It follows that \( \pi_1 - \pi'_1 = (x_1 - x'_1)P(X^c) - \{C(x_1) - C(x'_1)\} \) and hence
\[
\pi_1 - \pi'_1 = (x_1 - x'_1)\{P(X_0) - C'(x')\}, \tag{A9}
\]
where \( x'_1 \) is a number between \( x_1 \) and \( x'_1 \) such that \( C(x'_1) - C(x_1) = (x'_1 - x_1)C'(x'_1) \).

Consider Case (a) in Lemma 1. By the first part of (A7), since \( -1 < \varphi'_1 < 0 \), we see that
\[
x_1 - x'_1 > x_1 - x'_1 = x'_1 - x'_1 = \varphi'_1(x'_1) - \varphi'_2(x'_1) = (x'_1 - x'_1)\varphi'_2(x'_1), \tag{A10}
\]
whence \( (x_1 - x'_1)\{1 - \varphi'_2(x'_1)\} > 0 \), which implies that \( x_1 > x'_1 \). Hence \( x_1 < x'_1 \) by (A10). We see that
\[
\pi_1 = x_1 P(x_1 + x'_1) - C(x_1) \\
< x_1 P(x_1 + x'_1) - C(x'_1) \text{ since } x_1 > x'_1 \\
< x_1 P(x_1 + x'_1) - C(x_1) \text{ as } x'_1 = x'_1 \\
< x_1 P(x_1 + x'_1) - C(x'_1) = \pi'_1, \tag{A11}
\]
where the last inequality holds since \( x_1 P(x_1 + x'_1) - C(x_1) \) has a maximum at \( x_1 = x'_1 \). In like manner,
\[
\pi'_1 = x'_1 P(x'_1 + x'_2) - C(x'_1) \\
< x'_1 P(x'_1 + x'_2) - C(x'_1) \text{ since } x'_1 = \varphi'_2(x'_1) < \varphi'_2(x'_1) \text{ as } x'_1 > x'_1 \\
< x'_1 P(x'_1 + x'_2) - C(x'_1) = \pi_1, \tag{A12}
\]
where the last inequality holds since \( x_1 P(x_1 + x'_1) - C(x_1) \) has a maximum at \( x_1 = x'_1 \). If \( C' \geq 0 \), then, since \( x'_1 < x'' < x_1 \) by the first part of (A7), \( C'(x'_1) \leq C'(x'') \leq C'(x_1) \). Taking into account (A2), we obtain \( P(X_0) - C'(x'') \geq P(X_0) - C'(x'_1) > 0 \). Hence \( \pi'_1 > \pi_1 \) by (A9). On the other hand, if \( C' < 0 \), then, since \( x'_1 < x'' < x'_1 \) by the first part of (A7), \( C'(x'_1) < C'(x'') < C'(x'_1) \). Taking into account (A3), we obtain \( P(X_0) - C'(x') > P(X_0) - C'(x'_1) > 0 \). Hence we have \( \pi'_1 > \pi_1 \) by (A9).

Consider Case (b) in Lemma 1. By the first part of (A7), since \( \varphi'_1 > 0 \), we see that
\[
x_1 - x'_1 < x'_1 - x'_1 = x'_1 - x'_1 = \varphi'_1(x'_1) - \varphi'_2(x'_1) = (x'_1 - x'_1)\varphi'_2(x'_1), \tag{A13}
\]
whence \( (x'_1 - x'_1)\{1 - \varphi'_2(x'_1)\} < 0 \), which implies that \( x'_1 < x'_1 \) if \( 0 < \varphi'_2 < 1 \) and \( x'_1 > x'_1 \) if \( \varphi'_2 > 1 \). Hence by
(A13), \( x'_1 < x'_1 \) if \( 0 < \varphi'_1 < 1 \) and \( x'_1 > x'_1 \) if \( \varphi'_1 > 1 \). First, if \( 0 < \varphi'_1 < 1 \), then we have
\[
\pi_1 = x_1 P(x_1 + x'_1) - C(x_1) \\
< x_1 P(x_1 + x'_1) - C(x'_1) \text{ since } x_1 < x'_1 \text{ and } x_1 + x'_1 = X_0 < X_c = x'_1 + x'_1 \text{ by (A8)} \\
< x_1 P(x_1 + x'_1) - C(x'_1) = \pi'_1, \tag{A14}
\]
where the last inequality holds since \( x_1 P(x_1 + x_1^\ast) - C(x_1) \) has a maximum at \( x_1 = x_1^\ast \), and
\[
\pi_1^\ast = x_1^\ast P(x_1^\ast + \varphi_2(x_1^\ast)) - C(x_1^\ast)
\]
\[
< x_1^\ast P(x_1^\ast + \varphi_2(x_1^\ast)) - C(x_1^\ast) \quad \text{since } x_1^\ast = \varphi_2(x_1^\ast) < \varphi_2(x_1^\ast) \quad \text{as } x_1^\ast < x_1^\ast
\]
\[
< x_1^\ast P(x_1^\ast + x_1^\ast) - C(x_1^\ast) = \pi_1^\ast
\]
where the last inequality holds since \( x_1 P(x_1 + x_1^\ast) - C(x_1) \) has a maximum at \( x_1 = x_1^\ast \). If \( C^* \geq 0 \), then, since \( x_1^\ast > x^* > x_1^\ast \) by the first part of (A7), \( C'(x_1^\ast) \geq C'(x^*) \geq C'(x_1^\ast) \). Taking into account (A3), we obtain \( P(x^*) - C'(x^*) \geq P(x_1^\ast) - C'(x_1^\ast) > 0 \). Hence \( \pi_1^\ast < \pi_1^\ast \) by (A9). If \( C^* < 0 \), then, since \( x_1^\ast > x^* > x_1^\ast \) by the first part of (A7), \( C'(x_1^\ast) < C'(x^*) < C'(x_1^\ast) \). Taking into account (A2), we obtain \( P(x^*) - C'(x^*) > P(x_1^\ast) - C'(x_1^\ast) \). Hence we have \( \pi_1^\ast < \pi_1^\ast \) by (A9). Second, if \( \varphi_2^* > 1 \), then we have \( \pi_1^\ast < \pi_1^\ast \), \( \pi_1^\ast < \pi_1^\ast \), and \( \pi_1^\ast < \pi_1^\ast \) in like manner.

Consider Case (c) in Lemma 1. By the second part of (A7), since \( \varphi_2^* < -1 \), we see that \( x_1^\ast - x_1^\ast < x_1^\ast - x_1^\ast = \varphi_2(x_1^\ast) - \varphi_2(x_1^\ast) = (x_1^\ast - x_1^\ast) \varphi_2^*(x_1^\ast) \), and hence \( (x_1^\ast - x_1^\ast)^2 - \varphi_2^*(x_1^\ast) < 0 \), which implies that \( x_1^\ast < x_1^\ast \). Immediately, we have \( X^c = X^c = (x_1^\ast - x_1^\ast)(1 + \varphi_2^*(x_1^\ast)) > 0 \) by (A8) and \( x_1^\ast - x_1^\ast = (x_1^\ast - x_1^\ast) \varphi_2^*(x_1^\ast) > 0 \).

Then
\[
\pi_1^\ast = x_1^\ast P(x_1^\ast + x_1^\ast) - C(x_1^\ast)
\]
\[
< x_1^\ast P(x_1^\ast + x_1^\ast) - C(x_1^\ast) \quad \text{since } x_1^\ast - x_1^\ast = X^\ast = X^\ast + x_1^\ast \quad \text{by (A8)}
\]
\[
< x_1^\ast P(x_1^\ast + x_1^\ast) - C(x_1^\ast) = \pi_1^\ast
\]
where the last inequality holds since \( x_1 P(x_1 + x_1^\ast) - C(x_1) \) has a maximum at \( x_1 = x_1^\ast \), and
\[
\pi_1^\ast = x_1^\ast P(x_1^\ast + \varphi_2(x_1^\ast)) - C(x_1^\ast)
\]
\[
< x_1^\ast P(x_1^\ast + \varphi_2(x_1^\ast)) - C(x_1^\ast) \quad \text{since } \varphi_2(x_1^\ast) > \varphi_2(x_1^\ast) = x_1^\ast \quad \text{as } x_1^\ast < x_1^\ast
\]
\[
< x_1^\ast P(x_1^\ast + x_1^\ast) - C(x_1^\ast) = \pi_1^\ast
\]
where the last inequality holds since \( x_1 P(x_1 + x_1^\ast) - C(x_1) \) has a maximum at \( x_1 = x_1^\ast \). Since \( C^* > 0 \) and \( x_1^\ast < x_1^\ast \) by the second part of (A7), \( C'(x_1^\ast) > C'(x^*) > C'(x_1^\ast) \). Taking into account (A2) and (A3), we obtain \( P(x_1^\ast) - C'(x_1^\ast) > P(x_1^\ast) - C'(x^*) > P(x_1^\ast) - C'(x_1^\ast) \), where \( P(x_1^\ast) - C'(x_1^\ast) > 0 \) and \( P(x_1^\ast) - C'(x_1^\ast) < 0 \). Hence by (A9), we have \( \pi_1^\ast < \pi_1^\ast \) if \( P(x_1^\ast) - C'(x_1^\ast) > 0 \) and \( \pi_1^\ast > \pi_1^\ast \) if \( P(x_1^\ast) - C'(x_1^\ast) < 0 \).

In summary, we have the following result:

**Lemma 2.**

(a) In Case (a) in Lemma 1, \( x_1^\ast > x_1^\ast \) and \( \pi_1^\ast > \pi_1^\ast > \pi_1^\ast \).
(b) In Case (b) in Lemma 1, \( \pi_1^\ast > \pi_1^\ast > \pi_1^\ast \); \( x_1^\ast > x_1^\ast \) if \( 0 < \varphi_2^* < 1 \) and \( x_1^\ast > x_1^\ast \) if \( \varphi_2^* > 1 \).
(c) In Case (c) in Lemma 1, \( x_1^\ast > x_1^\ast \); \( \pi_1^\ast > \pi_1^\ast > \pi_1^\ast \) if \( P(x_1^\ast) - C'(x_1^\ast) > 0 \) and \( \pi_1^\ast > \pi_1^\ast > \pi_1^\ast \) otherwise.

where \( x^\ast \) is a number between \( x_1^\ast \) and \( x_1^\ast \) such that \( C(x_1^\ast) - C(x_1^\ast) = (x_1^\ast - x_1^\ast)C'(x_1^\ast) \).

We have the following lemma:

**Lemma 3.**

(a) In Case (a) in Lemma 1, \( X_1^\ast > X^c \).
(b) In Case (b) in Lemma 1, \( X_1^\ast < X^c \) if \( 0 < \varphi_2^* < 1 \) and \( X_1^\ast > X^c \) if \( \varphi_2^* > 1 \).
(c) In Case (c) in Lemma 1, \( X_1^\ast > X^c \).

**Proof.** Remember that \( -1 < \varphi_2^* < 0 \), \( \varphi_2^* > 0 \), and \( \varphi_2^* < -1 \) in Case (a), Case (b), and Case (c) in Lemma 1, respectively. Then the proof is immediate by (A8) and Lemma 2. ■
A.  Proof of Proposition 1 The proof is immediate from Lemma 2 since \(-1 < \varphi_2' < 0\), \(\varphi_2' > 0\), and \(\varphi_2 < -1\) in Case (a), Case (b), and Case (c) in Lemma 1, respectively. 

A2. Proof of Proposition 2 By the integral by parts we have \(\Gamma(X) = \int_0^y \{ -YP'(Y) \} dY > 0\). Note that \(\ket{\Gamma(X)} = -XP' > 0\). As for Part (a), since \(X^s > X^c\) by Lemma 3, \(-X^sP(X^c) < -X^cP(X^c)\). Hence \(I^s = \Gamma(X^c) > \Gamma(X^c) = I^c\). As for Part (b), \(X^s < X^c\) if \(0 < \varphi_2' < 1\) and \(X^s > X^c\) if \(\varphi_2' > 1\) by Lemma 3. Hence \(I^s < I^c\) if \(0 < \varphi_2' < 1\) and \(I^s > I^c\) if \(\varphi_2' > 1\). As for Part (c), since \(X^s > X^c\) by Lemma 3, \(-X^sP(X^c) > -X^cP(X^c)\). Hence \(I^s > I^c\), as desired. 

A3. Proof of Proposition 3 It follows that \(\Pi^s - \Pi^c = (\pi_1 - \pi_1^c) + (\pi_2 - \pi_2^c)\), where, by way of the Mean Value Theorem,  
\[
\pi_1 - \pi_1^c = P(X^c)x_1 - P(X)X^c - C(x_1) - C(X^c)
\]
\[
= (x_1 - x_1^c)(P(X^c) - C(x_1^c)) + x_1^c [P(X^c) - P(X^c)],
\]
where \(x^+\) is a number between \(x_1^c\) and \(x_1^c\) such that \(C(x_1) - C(x_1^c) = (x_1 - x_1^c)C(x^+),\) and
\[
\pi_2 - \pi_2^c = P(X^c)x_2 - P(X^c)x_2 - C(x_2) - C(x_2^c)
\]
\[
= (x_2 - x_2^c)(P(X^c) - C(x_2^c)) + x_2^c (P(X^c) - P(X^c))
\]
where \(x^{++}\) is a number between \(x_2^c\) and \(x_2^c\) such that \(C(x_2) - C(x_2^c) = (x_2 - x_2^c)C(x^{++}).\) By using \(P(X^s) - P(X^c) = (X^s - X^c)P'(X^u),\) where \(X^u\) is a number between \(X^s\) and \(X^c,\) together with \(X^s - X^c = (x_1 - x_1)\{1 + \varphi_2(x_2)\},\) we have
\[
\Pi^s - \Pi^c = (x_1 - x_1^c)[P(X^c) - C(x^+) + X^cP'(X^u) + \varphi_2(x_1)\{P(X^c) - C(x^{++}) + X^cP'(X^u)]].
\] (A18)

Remind that concerning the slope of the follower’s reaction function, \(-1 < \varphi_2' < 0\) in Part (a), \(\varphi_2' > 0\) in Part (b), and \(\varphi_2' < -1\) in Part (c) in Proposition 1.

As for Part (a) in Proposition 3, first note that \(x_1 > x_1^c,\) and hence \(X^s > X^0 (> X^c)\) by Lemma 3. If \(C^s \geq 0\) (i.e., \(\mu \geq 0\)) then, since \(x^1 < x^{++}\) and hence \(C(x^1 \leq C(x^{++}),\) we obtain
\[
P(X^c) - C(x^+) + X^cP'(X^u)
\]
\[
\leq P(X^c) - C(x_1^c) + X^cP'(X^u) = -x_1^cP'(X^u) + X^cP'(X^u) \text{ (by (A3))}
\]
\[
< -x_1^cP'(X^u) + X^cP'(X^u) \text{ if } P' > 0 \text{ (i.e., } \eta \leq -1/2)
\]
\[
= (x_1^c - x_1^c) + x_1^c P'(X^u) < 0.
\]
Therefore, since \(C^s \geq 0, \varphi_2' > -1,\) and \(x^+ > x^{++},\) we obtain
\[
P(X^c) - C'(x^+) + X^cP'(X^u) + \varphi_2'(x_1)\{P(X^c) - C'(x^{++}) + X^cP'(X^u)\}
\]
\[
< P(X^c) - C'(x_1^c) + X^cP'(X^u) - \{P(X^c) - C'(x^{++}) + X^cP'(X^u)\} = C'(x^{++}) - C'(x^+) < 0.
\]
Hence \(\Pi^s < \Pi^c\) by (A18).

As for Part (b), the proof is immediate from Proposition 1: \(\Pi^s = \pi_1^b + \pi_2^b > \Pi^c = \pi_1^c + \pi_2^c.\)

As for Part (c), first note that \(x_1 < x_1^c,\) and hence \(X^s > X^0 (> X^c).\) Since \(C^s < 0\) (i.e., \(\mu < 0\)), \(x_1^c < x^{++},\) and \(C(x_1^c) > C(x^{++}),\) we obtain
\[
P(X^c) - C(x^{++}) + X^cP'(X^u)
\]
\[
< P(X^c) - C'(x_1^c) + X^cP'(X^u) = -x_1^c\{1 + \varphi_2'(x_1^c)\}P'(X^u) + X^cP'(X^u) \text{ (by (A2))}
\]
Then we see that  

\[
-\chi^i_1(1 + \phi_i(x))P(X) + x^i_1 \phi_i(x)\r
\]

if \( P^* > 0 \) (i.e., \( \eta \leq -1/2 \))

\[
\{(x^i_1 - x^*_1) + x^i_1 \phi_i(x^*_1)\} P(X^0) < 0.
\]

Therefore, if \( x^i > x^* \) then, since \( C^* < 0 \) and \( \phi_i < -1 \), we obtain

\[
P(X^0) - C'(x^*) + X^i P(X^0) + \phi_i(x^0) \{ P(X^0) - C'(x^*) + X^i P(X^0) \}
\]

\[
> P(X^0) - C'(x^*) + X^i P(X^0) - \{ P(X^0) - C'(x^*) + X^i P(X^0) \} = C'(x^*) - C'(x^*).
\]

Hence \( II^* < II^* \) by (A18). This completes the proof of the proposition. \( \square \)

A4. Proof of Proposition 4 We can write total surplus as

\[
\mathcal{Q}(x_i) = \int P(Y) dY - C(x_i) - C(x_i) = 0 \]

where \( x^* \) is a number between \( x^*_1 \) and \( x^*_2 \) and

\[
\mathcal{Q}(x_i) = \{ P(x^i_1 + \phi_i(x^*_1)) \} + \{ P(x^i_2 + \phi_i(x^*_2)) \}.
\]

Note that

\[
\{ P(x^i_1 + \phi_i(x^*_1)) \} - C(x^*_1) = \phi_i(P^* - C^*) + P^* > 0 \] (resp. \( < 0 \)),

as (i) \( \phi_i < (\text{resp. } >) - P^*(P^* - C^*) \) if \( P^* - C^* < 0 \),

or (ii) \( \phi_i > (\text{resp. } <) - P^*(P^* - C^*) \) if \( P^* - C^* > 0 \),

\[-P^*(P^* - C^*) > (\text{resp. } <) - 1 \text{ as } C^* > 0 \] (resp. \( < 0 \)) if \( P^* - C^* < 0 \),

\[-P^*(P^* - C^*) > 0 \] if \( P^* - C^* > 0 \).

As for Part (a), first note that \( P^* - C^* < 0 \) and \( x^*_1 < x^* < x^*_2 \). If \( C^* \geq 0 \) and \( -1 \leq -P^*(P^* - C^*) < \phi_i \), then \( \{ P(x^i_1 + \phi_i(x^*_1)) \} = \phi_i(P^* - C^*) + P^* \) > 0 by (A3).

Then we see that

\[
\mathcal{Q}(x^* = \{ P(x^i_1 + \phi_i(x^*_1)) \} + \{ P(x^i_2 + \phi_i(x^*_2)) \} - C'(x^*),
\]

the last inequality of which is \( > 0 \) if \( \phi_i(x^*) > x^* \). On the other hand, if \( C^* < 0 \) and \( -P^*(P^* - C^*) < -1 < \phi_i \), then \( \{ P(x^i_1 + \phi_i(x^*_1)) \} = \phi_i(P^* - C^*) + P^* \) > 0 by (A3).

Then we see that

\[
\mathcal{Q}(x^* = \{ P(x^i_1 + \phi_i(x^*_1)) \} + \{ P(x^i_2 + \phi_i(x^*_2)) \} - C'(x^*),
\]

the last inequality of which is \( > 0 \) if \( \phi_i(x^*) < x^* \). If \( C^* \geq 0 \) and \( -1 < \phi_i < -P^*(P^* - C^*) \), then \( \{ P(x^i_1 + \phi_i(x^*_1)) \} = \phi_i(P^* - C^*) + P^* \) > 0 by (1). Then we see that

\[
\mathcal{Q}(x^* = \{ P(x^i_1 + \phi_i(x^*_1)) \} + \{ P(x^i_2 + \phi_i(x^*_2)) \} - C'(x^*),
\]

the last inequality of which is \( > 0 \) if \( \phi_i(x^*) > x^* \). In those three cases, we have \( \mathcal{Q} = \mathcal{Q}(x^*_1) > \mathcal{Q}(x^*_2) = \mathcal{Q}^C \) by (A19).

In like manner, as for Part (b), we have \( \mathcal{Q} < \mathcal{Q}^C \) in case \( 0 < \phi_i < 1 \) and \( \mathcal{Q} = \mathcal{Q}^C \) in case \( \phi_i > 1 \) by (A19) if \( C^* > 0 \), \( P^* - C^* < 0 \), and \( \phi_i(x^*) > x^* \), or if \( C^* < 0 \), \( P^* - C^* < 0 \), and \( \phi_i(x^*) < x^* \); as for Part (c), we
have $\Omega^i < \Omega^c$ by (A19) if $\varphi_2(x^*) < x^*$. This completes the proof of the proposition. ■

Remark. It follows by the Mean Value Theorem that $\varphi_2(x) = \varphi_2(0) + x \varphi_2'(x^*) - 1$, where $0 < x^* < x$. Hence $\varphi_2(x^*) > (\text{resp. } <) x^*$ as $\varphi_2'(x^*) > (\text{resp. } <) 1 + \{P(\varphi_2(0)) - C(\varphi_2(0))\}/x^*P'(\varphi_2(0))$. For example, we have $\varphi_2(x^*) > x^*$ if $\varphi_2' > 1$ and $\varphi_2(x^*) < x^*$ if $\varphi_2' < 1$ with $x^*$ sufficiently large.

REFERENCES


