

A Service of

ZBW

Leibniz-Informationszentrum Wirtschaft Leibniz Information Centre for Economics

Irle, Albrecht; Milaković, Mishael; Alfarano, Simone; Kauschke, Jonas

# Working Paper A Statistical Equilibrium Model of Competitive Firms

Economics Working Paper, No. 2008-10

**Provided in Cooperation with:** Christian-Albrechts-University of Kiel, Department of Economics

*Suggested Citation:* Irle, Albrecht; Milaković, Mishael; Alfarano, Simone; Kauschke, Jonas (2008) : A Statistical Equilibrium Model of Competitive Firms, Economics Working Paper, No. 2008-10, Kiel University, Department of Economics, Kiel

This Version is available at: https://hdl.handle.net/10419/22055

#### Standard-Nutzungsbedingungen:

Die Dokumente auf EconStor dürfen zu eigenen wissenschaftlichen Zwecken und zum Privatgebrauch gespeichert und kopiert werden.

Sie dürfen die Dokumente nicht für öffentliche oder kommerzielle Zwecke vervielfältigen, öffentlich ausstellen, öffentlich zugänglich machen, vertreiben oder anderweitig nutzen.

Sofern die Verfasser die Dokumente unter Open-Content-Lizenzen (insbesondere CC-Lizenzen) zur Verfügung gestellt haben sollten, gelten abweichend von diesen Nutzungsbedingungen die in der dort genannten Lizenz gewährten Nutzungsrechte.

#### Terms of use:

Documents in EconStor may be saved and copied for your personal and scholarly purposes.

You are not to copy documents for public or commercial purposes, to exhibit the documents publicly, to make them publicly available on the internet, or to distribute or otherwise use the documents in public.

If the documents have been made available under an Open Content Licence (especially Creative Commons Licences), you may exercise further usage rights as specified in the indicated licence.



# WWW.ECONSTOR.EU

# A Statistical Equilibrium Model of Competitive Firms

by Simone Alfarano, Mishael Milaković, Albrecht Irle and Jonas Kauschke



Christian-Albrechts-Universität Kiel

**Department of Economics** 

Economics Working Paper No 2008-10



# A Statistical Equilibrium Model of Competitive Firms \*

Simone Alfarano<sup>a,c</sup>, Mishael Milaković<sup>a,\*</sup>, Albrecht Irle<sup>b,c</sup> and Jonas Kauschke<sup>b</sup>

<sup>a</sup>Department of Economics, University of Kiel <sup>b</sup>Department of Mathematics, University of Kiel <sup>c</sup>Center for Numerical Simulation, University of Kiel

#### Abstract

We argue that the complex interactions of competitive heterogeneous firms lead to a statistical equilibrium distribution of firms' profit rates, which turns out to be an exponential power (or Subbotin) distribution. Moreover, we construct a diffusion process that has the Subbotin distribution as its stationary probability density, leading to a phenomenologically inspired interpretation of variations in the shape parameter of the statistical equilibrium distribution. Our main finding is that firms' idiosyncratic efforts and the tendency for competition to equalize profit rates are two sides of the same coin.

*Key words:* Statistical equilibrium, maximum entropy principle, diffusion process, stochastic differential equation, competition, profit rate, return on assets, Subbotin distribution, Laplace distribution.

JEL codes: C16, L10, D21, E10.

<sup>\*</sup> We gratefully acknowledge useful comments by Giulio Bottazzi and Thomas Lux, and by conference participants at the 2008 Complex Markets Meeting at Warwick Business School, the ESHIA/WEHIA 2008 Meeting in Warsaw, the workshop on the Relevance of Network and Complex Systems Theory for Technological Search and Diffusion in Rimini, and the 14th International Conference on Computing in Economics and Finance in Paris.

<sup>\*</sup> Corresponding author: milakovic@economics.uni-kiel.de, +49 431 880 3369.

# A Statistical Equilibrium Model of Competitive Firms

"Profit is so very fluctuating, that the person who carries on a particular trade, cannot always tell you himself what is the average of his annual profit. It is affected, not only by every variation of price in the commodities which he deals in, but by the good or bad fortune both of his rivals and of his customers, and by a thousand other accidents, to which goods, when carried either by sea or by land, or even when stored in a warehouse, are liable."

Adam Smith [16, p. 58]

## 1 Competition and Profitability

Competition comes in many forms and varieties, and it is certainly one of the most pervasive concepts in the history of economic thought [19,23]. The dominant strand of thought, following Cournot, associates (perfect) competition with a particular market form, and emphasizes the efficient allocation of resources at points where prices equal marginal costs [12].

Another important strand of thought originates with Adam Smith's notion of competition as a dynamic process that leads to a tendency for profit rate equalization, which we henceforth label as classical competition.<sup>1</sup> Classical competition essentially describes a negative feedback mechanism. Capital will seek out sectors or industries where the profit rate is higher than the economywide average, typically attracting labor, raising output, and reducing prices and profit rates, which in turn provides an incentive for capital to leave the sector, thereby leading to higher prices and profit rates for firms that remain in the sector [7]. As a result, classical competition tends to equalize profit rates, yet it simultaneously leads to perpetual changes in technologies and competitive practices. Coupled with continually changing tastes of consumers, and the entry and exit dynamics of rival firms, the very nature of (classical) competition renders a complete elimination of differences in and across sectoral profit rates improbable.

Modeling the process of competition is made all the more difficult by the interactions among firms, which in themselves create a complex environment that

<sup>&</sup>lt;sup>1</sup> Evolutionary theories of industrial dynamics [5] or Schumpeter's [14] theory of creative destruction, for instance, also highlight the intrinsically dynamic character of economic competition, and would be consistent with the notion of 'classical' competition from this viewpoint.

feeds back into the destinies of individual companies. One company's gain is often the loss of others, particularly in situations where resources are limited, for instance when it comes to the hiring of exceptional talent, the retainment and acquisition of clients, or the patenting of new technologies. Positive feedbacks, typically arising from symbiotic relationships and synergetic interactions, further increase the complexity of the competitive environment.<sup>2</sup>

The interactions of competitive firms and their idiosyncratic efforts to stay ahead of the game give rise to an enormous amount of information and complexity that is hard to approach from a deterministic viewpoint. In light of the intricate connections and interactions among business firms, our focus shifts accordingly from a fixed-point equilibrium to the notion of a *statistical equilibrium* in the spirit of Foley [6]. Formally, Foley's statistical equilibrium theory of markets revolves around the *maximum entropy principle* (MEP) of Jaynes [9]. After all, MEP derives the combinatorially most likely (or informationally least biased) distribution of a random variate subject to moment constraints. Thus, instead of considering competitive equilibrium as a situation in which all economic agents face an identical profit rate, our statistical equilibrium model emphasizes the *stationary distribution of profit rates*.

Approaching the profitability of business firms from a probabilistic perspective is of course not unique to statistical equilibrium modeling, but rather follows a long-standing tradition that stresses distributional regularities in a wide range of socio-economic variables [4,8,10,13,15,18]. In order to apply the maximum entropy formalism to any kind of economic phenomenon, one essentially needs to encode the economic content in terms of moment constraints [3,6,21]. Hence, modeling classical competition with the maximum entropy principle boils down to expressing competition in the form of moment constraints. We take the position that the average profit rate corresponds to a measure of central tendency, while the complex movements of capital in search of profit rate equalization and the resulting feedback mechanisms translate into a generic measure of dispersion around the average. When the number of competitive firms in a decentralized type of market organization is large, probabilistic factors can give rise to statistical regularities in the distribution of profit rates. The distribution of profit rates that can be achieved in the most evenly distributed number of ways under the dispersion constraint is then the statistical equilibrium or maximum entropy distribution of profit rates, and turns out to be an *exponential power* or *Subbotin* [22] distribution.

The Subbotin distribution has three parameters: a location, a scale, and a

 $<sup>^2</sup>$  An early description of positive economic feedbacks, probably ranking among the most well-known together with Young's [24] notion of increasing returns, is Smith's elaboration "That the Division of Labour is Limited by the Extent of the Market" [16, Book I, Chapter III].

shape parameter. Structural differences in the statistical equilibrium model stem from differences in the shape parameter, because operating on the location or scale parameter does not change the qualitative features of the Subbotin distribution. If the shape parameter is equal to two, the Subbotin distribution reduces to the Gaussian (normal) distribution, and if it is equal to unity, the Subbotin distribution reduces to the Laplace (double-exponential) distribution.

Interestingly, there is evidence that the cross-sectoral distribution of firm growth rates is Laplacian [17], as are many distributions on the sectoral level, although some deviations from the Laplace distribution do show up on the sectoral level as well [2]. In a first approximation that neglects real frictions and time-lag structures, profit and firm growth rates would appear as reasonable proxies, speaking in favor of the model's phenomenological relevance. To further emphasize the empirical relevance of the model, we briefly illustrate that the empirical density of profit rates is indeed reasonably described by a Laplace distribution. This prompts us to ask why the empirical shape parameter is close to unity, what this implies about the competitive environment that firms are facing, and whether variations in the shape parameter correspond to qualitative changes in the competitive environment.

Since the maximum entropy principle only informs us of the stationary distribution, it hardly provides answers to the above questions, and neither does it shed light on the *dynamics* that lead to the stationary distribution. In order to extend the model in a dynamic direction, we utilize a particular class of stochastic processes known as *diffusion processes*, and construct a diffusion process that has the Subbotin as its stationary density. The rationale for resorting to diffusion processes is twofold. First, the process is parsimoniously described by only two functions, the so-called *drift* and *diffusion function* and, second, a considerable analytical apparatus relating to diffusion processes is already in place. This diffusion process will be introduced heuristically at first, starting from the assumption that the Subbotin distribution is the stationary distribution. Moreover, since the arising drift function has a singularity at m, we shall also provide a rather careful mathematical treatment of this process in Appendix A.

Examination of the diffusion process extends the maximum entropy results in two important ways. First, it provides additional insights into variations of the shape parameter of the stationary distribution. We show that the benchmark Laplace case, where the shape parameter equals unity, corresponds to a drift term that is independent of the current state of the profit rate, implying that competition is a 'global' mechanism that acts with equal force on all companies, no matter how far their profitability deviates from the average rate of profit. Second, the diffusion process shows that the complex mechanisms of competition *simultaneously* generate (i) the fluctuations in the destinies of individual companies and (ii) the drift towards an average profit rate. Thus competition cannot be described by a deterministic skeleton with superimposed noise, because the drift function depends on the scale of fluctuations in the diffusion function. Put differently, switching off the noise in the diffusion process also eliminates the systematic drift towards the average rate of profit. Viewed from this perspective, classical competition becomes a truly stochastic phenomenon, where the fluctuations of individual destinies and the dissipation of profitable business opportunities are two sides of the same coin.

## 2 Maximum Entropy Distribution of Profit Rates

We view profit rates as an inherently stochastic phenomenon, and take the position that competition among firms disperses their profit rates, denoted x, around an exogenously given measure m of central tendency. More formally, we assume that dispersion is measured by the *standardized*  $\alpha$ -th moment,  $\sigma^{\alpha} = E|x - m|^{\alpha}$ , with  $x, m \in \mathbb{R}$  and  $\alpha, \sigma > 0$ . At first, the assumption that the complexities of economic competition disperse profit rates around some average rate does not seem to get us anywhere. But by further assuming that in the absence of further information all profit rate outcomes around m are most evenly distributed, MEP establishes a correspondence between the moment constraint and a statistical distribution [9].

Formally, MEP under a standardized  $\alpha$ -th moment constraint defines a variational problem that maximizes the entropy H[f(x)] of the profit rate density f(x), defined as

$$H[f(x)] \equiv -\int_{-\infty}^{+\infty} f(x) \log f(x) \, dx,\tag{1}$$

subject to the constraint on the standardized  $\alpha$ -th moment,

$$\int_{-\infty}^{+\infty} f(x) \left| \frac{x-m}{\sigma} \right|^{\alpha} dx = 1.$$
(2)

and subject to the natural constraint that normalizes the density,

$$\int_{-\infty}^{+\infty} f(x) \, dx = 1 \,. \tag{3}$$

**Proposition 1** The maximum entropy distribution of profit rates under the standardized  $\alpha$ -th moment constraint (2) is a Subbotin distribution,

$$f(x;m,\sigma,\alpha) = \frac{1}{2\sigma\alpha^{1/\alpha}\Gamma(1+1/\alpha)} \exp\left(-\frac{1}{\alpha} \left|\frac{x-m}{\sigma}\right|^{\alpha}\right).$$
 (4)

**PROOF.** The Lagrangian associated with the variational program (1)-(3) is

$$\mathcal{L} = H[f(x)] - \mu \left[ \int_{-\infty}^{+\infty} f(x) \, dx - 1 \right] - \lambda \left[ \int_{-\infty}^{+\infty} \left| \frac{x - m}{\sigma} \right|^{\alpha} f(x) \, dx - 1 \right],$$

where  $\mu$  and  $\lambda$  denote the multipliers. Letting  $\xi \equiv 1 + \mu$ , the first order condition implies that the solution will have the functional form

$$f(x) = \exp(-\xi) \cdot \exp\left(-\lambda \left|\frac{x-m}{\sigma}\right|^{\alpha}\right).$$
(5)

Integrating by substitution in order to invert the constraints, and using the definition of the gamma function, Eq. (3) yields the normalizing constant, or *partition function*,

$$\exp(-\xi) = \frac{1}{2\sigma} \frac{1}{\alpha^{1/\alpha} \Gamma(1+1/\alpha)},$$
(6)

and consequently Eq. (2) yields

$$\lambda = \frac{1}{\alpha}.\tag{7}$$

Since f(x) is a positive function,  $\partial^2 \mathcal{L} / \partial f(x)^2 = -1/f(x) < 0$ , and the solution is a maximum.  $\Box$ 

The Subbotin distribution (4), illustrated in Figure 1, is characterized by a location parameter m, a scale parameter  $\sigma > 0$ , and a shape parameter  $\alpha > 0$ . If  $\alpha$  is smaller (greater) than two, the distribution is leptokurtic (platykurtic). If  $\alpha = 1$  the Subbotin reduces to the Laplace distribution, if  $\alpha = 2$  it reduces to the Gaussian, and if  $\alpha \to \infty$  it tends to a uniform. If  $\alpha \to 0$ , the statistical equilibrium distribution turns into Dirac's  $\delta$ -distribution at m, including as a special case the more conventional competitive equilibrium concept of a situation in which each firm 'faces' an identical profit rate.<sup>3</sup>

From a methodological viewpoint, statistical equilibrium modeling is less ambitious than conventional Walrasian theory because it does not seek, nor is it able, to predict the actual profit rate outcome for each individual business firm. On the other hand, the statistical equilibrium approach is capable of translating a parsimonious description of the system, given by the dispersion constraint (2), into the distributional outcome (4). The distribution is a *stationary* or *statistical equilibrium outcome* in the sense that it measures the competitive tendency for profit rate equalization on a characteristic time scale that is large enough to accommodate the time scale of idiosyncratic shocks.

<sup>&</sup>lt;sup>3</sup> From the viewpoint of entropy maximization, this particular case is the most improbable of all feasible results because it has a multiplicity of unity, which generally applies to unique competitive Walrasian equilibria [6].

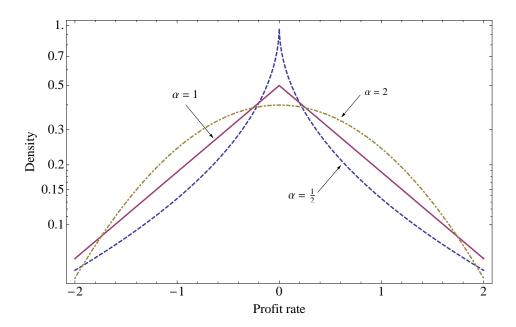


Fig. 1. Subbotin distribution with m = 0,  $\sigma = 1$ , and varying shape parameter  $\alpha$ . On semi-log scale, the Laplace distribution ( $\alpha = 1$ , solid curve) has linear slope while the Gaussian ( $\alpha = 2$ , dash-dotted curve) becomes a parabola.

Paraphrasing Foley's economic interpretation of MEP, the outcome of the particular maximum entropy program (1)-(3) corresponds to the profit rate distribution that arises from the most decentralized activity of competitive firms. Business firms typically engage in a plethora of competitive strategies that aim more or less directly at the maximization of profit, for instance by seeking increases in market share or revenues through product differentiation, price undercutting, advertising, customer relationship management, etc. In addition, firms might simultaneously or separately seek to reduce costs by downsizing operations, by exploiting increasing returns to scale, or by adopting or inventing cost-cutting technologies. It is exactly in the presence of such complex and multi-dimensional environments that MEP comes into its own. While MEP cannot identify the impact of particular competitive strategies, all such strategies, along with the ensuing complex feed-back mechanisms, are in principle included in the statistical equilibrium outcome of Proposition 1. The only prerequisite for interpreting the MEP distribution as the outcome of the most decentralized economic activity under the dispersion constraint (2), or as the outcome that can be achieved in the most evenly distributed number of ways under the dispersion constraint, is that the number of firms in the economy is large [6]. Statistical equilibrium modeling thus excludes situations of systemwide collusion, which in any case should become increasingly difficult to realize as the number of firms increases.

MEP cannot provide information about the individual destinies of companies, yet it manages to associate a distributional outcome with the dispersion constraint that presumably reflects the behavioral process of competition. In light

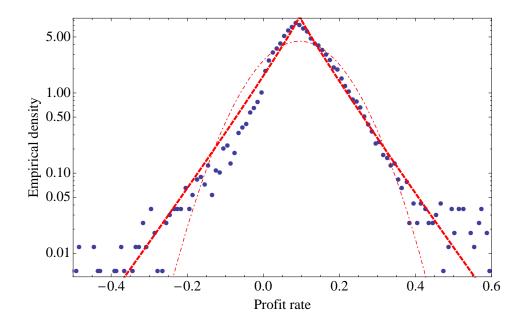


Fig. 2. Empirical density of annual profit rates (16956 pooled observations) for publicly traded non-bank companies in the United States. Profit rates (or ROAs) are calculated as the ratio of operating income to total assets for the 628 companies that are present during the period 1980-2006, corresponding to the time coverage of our data set from *Thomson Datastream*. These companies are operating in 36 sectors on a two-digit classification level, with a median profit rate of m = 9.5% over this time span. Maximum likelihood estimation of the Subbotin shape parameter yields  $\alpha = 0.94 \pm 0.02$  with a scale parameter  $\sigma = 0.057 \pm 0.001$ . The (thick) dashed curve illustrates the corresponding fit, while the (thin) dash-dotted curve shows a Gaussian fit using the sample mean and standard deviation. It is noteworthy that these are *raw* data that have not been standardized or normalized in any way.

of Figure 2, the Laplace distribution would appear to represent a reasonable benchmark case for the empirical density of profit rates, <sup>4</sup> begging the question what a shape parameter close to unity implies about the competitive environment in which firms are operating. More generally, what kind of qualitative changes in the competitive environment could be reflected in significant deviations of  $\alpha$  from unity? Such questions, however, are hard to answer with MEP because the principle offers little in the direction of economically interpreting the parameters  $\alpha$  and  $\sigma$ . Hence we extend the statistical equilibrium model into a dynamical setting by considering a diffusion process whose stationary distribution will be given by the Subbotin density.

<sup>&</sup>lt;sup>4</sup> Since our primary interest lies in the theoretical aspects of competition, Figure 2 is not intended as a conscientious econometric exercise, yet it illustrates that the statistical equilibrium model certainly has some phenomenological relevance.

#### 3 The Dynamic Evolution of Profit Rates

There are essentially three reasons why we take recourse to diffusion processes among the much broader class of stochastic processes to describe the dynamic evolution of profit rates  $\{X_t, t \ge 0\}$ . First, a diffusion is parsimoniously described by two functions, the *drift* and the *diffusion function*. Second, an analytical apparatus relating for instance to existence and uniqueness theorems is available for diffusions, and third, a simple closed-form solution for the stationary distribution turns out to exist in our case of interest.

We consider a *time-homogeneous diffusion* on the real line, which takes the general form

$$dX_t = A(X_t) dt + \sqrt{D(X_t)} dW_t , \qquad (8)$$

where A(x) and D(x) > 0 denote the drift and diffusion function, and  $dW_t$  denotes Wiener increments. A diffusion thus decomposes the profit rate increment  $dX_t$  into two factors: a random term governed by the diffusion function, and a systematic effect captured by the drift term, both of which are due to the complex and continually evolving environment that business firms create, as we will argue shortly. Finally, from an economic point of view, the assumption of a time-homogeneous diffusion implies that the nature of the underlying competitive mechanism is time invariant.

Our strategy is to heuristically construct a diffusion that has the Subbotin density as its stationary distribution, and to demonstrate subsequently with mathematical rigour that this indeed yields a regular diffusion on the real line. Regularity here means that from any starting point x any other real y is reached in finite time with positive probability. If a stationary distribution with density  $p_e(x)$  to the diffusion process (8) exists, <sup>5</sup> it obeys (in most cases of interest) the textbook formula

$$p_e(x) = \frac{\kappa}{D(x)} \exp\left(2\int_{x_0}^x \frac{A(y)}{D(y)}dy\right),\qquad(9)$$

where  $\kappa$  is the normalizing constant. We will subsequently show that this is indeed the case in our situation. Here  $x_0$  may be chosen freely and  $\kappa$  of course depends on  $x_0$ . Therefore, Eq. (9) serves to establish a relationship between our stationary distribution of interest, and the drift and diffusion function that we want to identify. Knowledge of the functional form of the stationary distribution is, however, not sufficient to uniquely characterize the diffusion process since there is still a degree of freedom. Following the principle of parsimony, we opt to exploit this degree of freedom in a simple manner by

<sup>&</sup>lt;sup>5</sup> The existence of a stationary distribution, in fact, implies additional conditions on the drift and diffusion, and a full characterization of the process at the boundaries for the different values of the underlying parameters, which we consider in Appendix A.

assuming a constant diffusion function D(x) = D, meaning that idiosyncratic shocks are independent of the current state of a firm's profit rate.<sup>6</sup> Then, straightforward manipulation of Eq. (9) uniquely expresses the drift A(x) as a function of the stationary distribution and its derivative  $p'_e(x)$ ,

$$A(x) = \frac{D}{2} \frac{p'_e(x)}{p_e(x)} \,. \tag{10}$$

Hence, utilizing the functional form of the Subbotin distribution (4) in Eq. (10), we obtain the drift function

$$A(x) = -\frac{D}{2\sigma} \operatorname{sgn}(x-m) \left| \frac{x-m}{\sigma} \right|^{\alpha-1} , \qquad (11)$$

where  $sgn(\cdot)$  denotes the signum function, and A(m) = 0. This result motivates the following proposition:

**Proposition 2** The stochastic differential equation

$$dX_t = -\frac{D}{2\sigma} \operatorname{sgn}(X_t - m) \left| \frac{X_t - m}{\sigma} \right|^{\alpha - 1} dt + \sqrt{D} \, dW_t \tag{12}$$

defines a regular diffusion on the real line for all  $\alpha, \sigma > 0$  and  $m \in \mathbb{R}$ , with a Subbotin stationary distribution given by (4).

# **PROOF.** See Appendix A.

Our economic interpretation of the dynamic evolution of profit rates rests on the assumption that all firms are subject to the same process (12), possibly with different diffusion constants, since  $p_e(x)$  is independent of D, but with identical parameters  $\alpha$ ,  $\sigma$  and m. Then each firm's destiny corresponds to a different realization of (12), such that the stationary distribution represents the cross-sectional statistical equilibrium outcome (4) arising from the interactions of competitive firms. Put differently, the diffusion process decomposes the complexities of a competitive environment into a drift and diffusion function, whereby the latter captures idiosyncratic factors, while the former describes the systematic tendency for competition to equalize profit rates. Figure 3 illustrates that this mean-reverting drift towards m is generally non-linear, and depends qualitatively on the value of  $\alpha$ .

Notably, an equilibrium Laplace distribution  $(\alpha = 1)$  is obtained from the diffusion

$$dX_t = -\frac{D}{2\sigma} \operatorname{sgn}(X_t - m) dt + \sqrt{D} dW_t , \qquad (13)$$

<sup>&</sup>lt;sup>6</sup> Alternatively one could, for instance, prescribe a linear drift term and then construct diffusion functions that yield particular stationary distributions of interest [1].

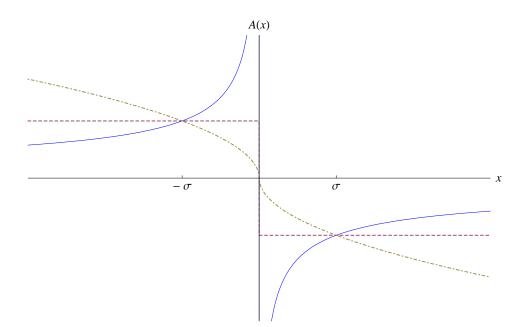


Fig. 3. The qualitative behavior of the drift function A(x), given by Eq. (11), depends on the parameter  $\alpha$ . The axes originate in (m, 0), and the curves are plotted for  $\alpha = 0.5$  (solid curve),  $\alpha = 1$  (dashed), and  $\alpha = 1.5$  (dash-dotted). The strength with which profit rates are pulled back towards m is equal for all parametrizations of  $\alpha > 0$  when  $x = \pm \sigma$ .

showing that the empirical benchmark case corresponds to a scenario in which the drift is constant, and therefore independent of a firm's current profit rate.

### 4 Diffusion, Dispersion, and the Process of Competition

Viewed from the perspective of the diffusion process, deviations of the empirical shape parameter from unity measure qualitative changes in the economic environment created by competitive firms. If  $\alpha > 1$ , the systematic force towards profit rate equalization becomes stronger the further profit rates deviate from m, and symmetrically, if  $\alpha < 1$ , this force becomes weaker the further profit rates deviate from m. In a more applied setting, it would probably pay off to study the defining characteristics of sectors that show deviations of  $\alpha$  in either direction in order to understand why certain industries are more or less prone to large deviations of profit rates from the average. A firm that operates in an environment where  $\alpha < 1$ , and succeeds in being very profitable at a given point in time, should look more optimistically into the future than a firm whose profitability is equally far from the average, but which operates in an environment where  $\alpha > 1$ . Looking at profitability from this angle suggests that  $\alpha$  is an aggregate measure of competitive pressures within and across industries. Furthermore, if  $\alpha = 0$  the diffusion turns into a particular case of a *Bessel* process, with an equilibrium  $\delta$ -distribution at m. Actually, Karlin and Taylor [11, Example 6, pp. 238–9] show that the point m then behaves as an exit boundary with total absorption in finite time. Here, the case  $\alpha = 0$  leads to a change in the nature of the diffusion's boundary condition, whereas MEP relates this case to an outcome with minimal multiplicity. None the less both, the diffusion and MEP, highlight the peculiarity of a situation in which all firms are equally profitable.

The most salient point of our model is that the level of idiosyncratic noise D turns up in the drift A(x), given by (11). Hence, our diffusion model decomposes the metaphor of competition into the *contemporaneous* presence of individual fluctuations and a systematic tendency towards profit rate equalization. Redefining the coefficients of the drift and diffusion as

$$\mu = \frac{D}{2\sigma^{\alpha}} \quad \text{and} \quad \lambda = \sqrt{D} ,$$
(14)

we obtain the fundamental relationship

$$\frac{\lambda^2}{2\mu} = \sigma^{\alpha} , \qquad (15)$$

which adeptly ties up the diffusion model with the entropy formalism, since the Subbotin distribution arises from MEP if we prescribe the dispersion

$$\sigma^{\alpha} = E \left| x - m \right|^{\alpha} \,. \tag{16}$$

It is the simultaneous and inseparable presence of individual fluctuations and a mean-reverting drift towards m that ultimately leads to the emergence of an equilibrium distribution. Strikingly, Eq. (15) reveals that the dispersion of profit rates measures the relative strength of one effect over the other.

Our pre-analytical vision of competition as a complex feed-back mechanism results in the diffusion (12), and as a consequence methodologically rules out a deterministic skeleton with some added noise on top of it. The introductory quote from Smith already illuminates the intrinsically random and interconnected nature of competition among economic agents, highlighting that the success of one firm cannot be attributed to its effort alone, but crucially depends on what other agents are doing as well. Therefore Eq. (12) does not represent the fate an atomistic firm might desire for itself, but rather demonstrates the impossibility of exactly such an endeavor in a competitive environment.

### 5 Conclusion

To capture the stochastic and intertwined aspects of competition, we have proposed a statistical equilibrium model that starts from a dispersion constraint, motivated by the notion of classical competition, which MEP translates into a Subbotin distribution of profit rates. Extending the statistical equilibrium model to a diffusion that has an equilibrium Subbotin distribution, we are then able to decompose the process of competition into two interdependent terms, the drift and diffusion function, which respectively capture the systematic tendency towards profit rate equalization on the one hand, and idiosyncratic factors on the other. As it turns out, dispersion measures the relative strength of these two effects.

Essentially, our model considers the distribution of profit rates as a statistical equilibrium outcome arising from the decentralized complex interactions of competitive firms, and the corresponding diffusion suggests that the empirical benchmark of a Laplace distribution represents a collection of firms whose interactions create a 'competitive field' that influences individual firms independently of their current profit rate.

Our model is, of course, far from being complete. By treating the average profit rate as an exogenous variable, we have effectively eliminated its determining factors from consideration. Nevertheless, from a methodological viewpoint, our diffusion model shows that the process of competition is an inherently stochastic phenomenon, because the level of idiosyncratic fluctuations enters the systematic tendency for profit rate equalization. Thus it is not possible to switch off the idiosyncratic noise without eliminating the systematic drift towards an average profit rate, casting some doubt on models that approach competition from a purely deterministic perspective.

### A Proof of Proposition 2

#### A.1 General considerations

We recall the definition of

$$A(x) = -\frac{D}{2\sigma}\operatorname{sgn}(x-m)\left|\frac{x-m}{\sigma}\right|^{\alpha-1}$$

with A(m) = 0. If  $\alpha = 2$ , then A(x) is Lipschitz continuous, which is the usual condition for the existence of a regular diffusion on the real line as a solution to the stochastic differential equation (12). The arising diffusion is the

well-known Ornstein-Uhlenbeck process. Lipschitz continuity no longer holds for  $\alpha \neq 2$ . The case  $0 < \alpha < 2$  is the more intricate one because there is a singularity at m for  $\alpha < 1$ , and we will consider it in detail in sections A.2 to A.6. We shortly remark on the case  $\alpha > 2$  in section A.7. For easier notation we henceforth use  $m = 0, \sigma = 1$ .

## A.2 The diffusion on $(0, \infty)$

First we obtain a solution to (12) on the positive half-line. For  $\alpha = 1, A(x)$  is constant on  $(0, \infty)$ . Hence, according to A.1, we obtain a diffusion on  $(0, \infty)$ that solves (12). For  $0 < \alpha < 2, \alpha \neq 1, A(x)$  is not Lipschitz continuous on  $(0, \infty)$  due to the behaviour in x = 0. To obtain a diffusion on  $(0, \infty)$  we apply the usual localization argument. For each  $n \in \mathbb{N}$  we choose a bounded Lipschitz continuous function  $A_n(x)$  on  $(0, \infty)$  such that  $A_n(x) = A(x)$  for  $x \in (\frac{1}{n}, \infty)$ . Then we solve (12) with  $A_n(x)$  instead of A(x). This yields a diffusion  $Y_t^n$ . Here  $Y_t^{n+1}$  extends  $Y_t^n$  in the way that they are equal (with probability one) up to the random time when one of them leaves the state space interval  $(\frac{1}{n}, \infty)$ . Hence they may be glued together to define a regular diffusion  $Y_t$  on  $(0, \infty)$  that solves (12). To extend this to a diffusion on the entire real line, it is necessary to investigate the boundary behaviour at 0 utilizing the scale and speed measure.

#### A.3 Scale and speed measure

In general, the scale function and scale measure are given by

$$S(x) = \int_{x_0}^x s(y) dy \text{ with } s(y) = \exp\left(-\int_1^y \frac{2A(z)}{D(z)} dz\right), \ x \in (0, \infty),$$
$$S[a, b] = S(b) - S(a), \ 0 < a < b < \infty.$$

Here any  $x_0 \in (0, \infty)$  may be inserted, and subsequently we will use  $x_0 = 1$ . The speed density and speed measure are given by

$$m(x) = \frac{1}{D(x)s(x)}, \ x \in (0,\infty), \ M[a,b] = \int_a^b m(y)dy, \ 0 < a < b < \infty.$$

For the boundary 0, we define

$$S(0,b] = \lim_{a \downarrow 0} S[a,b], \ M(0,b] = \lim_{a \downarrow 0} M[a,b].$$

Obviously  $0 < S[a, b] < \infty$ ,  $0 < M[a, b] < \infty$  for all  $0 < a < b < \infty$ , and we compute

$$s(y) = \exp\left(-\int_{1}^{y} (-1)z^{\alpha-1}dz\right) = \exp\left(\frac{y^{\alpha}}{\alpha} - \frac{1}{\alpha}\right),$$
  
$$S(0,1] = \int_{0}^{1} s(y)dy = \int_{0}^{1} \exp\left(\frac{y^{\alpha}}{\alpha} - \frac{1}{\alpha}\right)dy < \infty,$$

thus  $S(0, b] < \infty$  for all  $0 < b < \infty$ . Similarly,

$$m(y) = \frac{1}{D} \exp\left(-\frac{y^{\alpha}}{\alpha} + \frac{1}{\alpha}\right),$$

$$M(0,1] = \frac{1}{D} \int_0^1 \exp\left(-\frac{y^\alpha}{\alpha} + \frac{1}{\alpha}\right) dy < \infty,$$

hence  $M(0, b] < \infty$  for all  $0 < b < \infty$ . Furthermore,

$$S[a, \infty) = \lim_{b \uparrow \infty} S[a, b] = \infty, \ M[a, \infty) < \infty \text{ for all } 0 < a < \infty.$$

#### A.4 Boundary behaviour

For any arbitrarily chosen a > 0, let

$$\Sigma(0) = \int_0^a M[y, a] dS(y), \ N(0) = \int_0^a S[y, a] dM(y),$$
$$\Sigma(\infty) = \int_a^\infty M[a, y] dS(y), \ N(\infty) = \int_a^\infty S[a, y] dM(y).$$

Using [11, Lemma 6.3, Chapter 15], we obtain from A.3

 $\Sigma(0) < \infty, \ N(0) < \infty \text{ and } \Sigma(\infty) = \infty,$ 

and an easy argument shows that

$$N(\infty) = \int_{a}^{\infty} \int_{a}^{y} \frac{1}{D} \exp\left(\frac{z^{\alpha}}{\alpha} - \frac{1}{\alpha}\right) dz \exp\left(-\frac{y^{\alpha}}{\alpha} + \frac{1}{\alpha}\right) dy = \infty.$$

In the terminology of [11, p. 234],  $\infty$  is a natural boundary (as  $\infty$  is for Brownian motion) and can be omitted from the state space, whereas 0 is a regular boundary. A regular boundary can be added to the state space. To specify the behavior in 0, we set  $M(\{0\}) = 0$  which stands for instant reflection. So we have defined a diffusion  $Y_t$  with state space  $[0, \infty)$  that is a solution of (12) and is immediately reflected when it reaches 0. Using [11, pp. 192–197], one can show that  $Y_t$  reaches 0 with probability one in finite expected time from any starting point x.

### A.5 The diffusion on $(-\infty, \infty)$

Having defined  $Y_t$  as a diffusion on  $[0, \infty)$  that satisfies (12) with instant reflection, we have, with  $Y'_t = -Y_t$ , a diffusion on  $(-\infty, 0]$  which again satisfies (12) with instant reflection in 0, and is characterized by s'(y) = s(-y), S'[c,d] = S[-c,-d], m'(y) = m(-y), M'[c,d] = M[-c,-d]. These two may be glued together to define a diffusion  $X_t$  on  $(-\infty, \infty)$ . An informal way to describe this is the following: We use an independent randomization each time the process reaches the boundary zero. Using this randomization we let  $X_t = Y_t$  or  $X_t = Y'_t$ , each with probability  $\frac{1}{2}$ , up to the next time point when the process reaches the boundary zero. Starting the process with a symmetric distribution on  $(-\infty, \infty)$ , this defines a symmetric distribution on  $(-\infty, \infty)$ . More formally, we consider the functions  $\bar{s}, \bar{m}$  with  $\bar{s} = s(x), x > 0$ ,  $\bar{s} = -s(x), x < 0, \bar{m} = m(x), x > 0, \bar{m} = m(-x), x < 0$ , and define the corresponding scale measure  $\bar{S}$  and speed measure  $\bar{M}$  on  $(-\infty, \infty)$ . Then there exists a diffusion  $X_t$  on  $(-\infty, \infty)$  that has scale and speed measures corresponding to our informal construction; see e.g. [20].

#### A.6 The stationary distribution

Since the restoring force  $-\frac{D}{2} \operatorname{sgn}(x) |x|^{\alpha-1}$  is directed towards zero, the diffusion  $X_t$  is positive-recurrent because from any starting point x the point zero is reached in finite expected time according to A.4. Hence there exists a unique stationary distribution. Utilizing the scale function and speed density, this stationary distribution can be expressed as

$$p_e(x) = m(x)[K_1S(x) + K_2],$$

where  $K_1, K_2 > 0$  are normalizing constants, see [11, p. 221]. Recalling  $N(\infty) = \infty$  in A.4, we have in our case  $\int m(x)S(x)dx = \infty$ , and hence  $K_1 = 0$ . This yields

$$p_e(x) = \frac{\kappa}{D(x)} \exp\left(2\int_{x_0}^x \frac{A(y)}{D(y)}dy\right),$$

which is formula (9). So for any  $m \in \mathbb{R}, \sigma > 0$  we obtain

$$p_e(x) = \frac{\kappa}{D} \exp\left(\int_0^x -\frac{1}{\sigma} \operatorname{sgn}(y-m) \left|\frac{y-m}{\sigma}\right|^{\alpha-1} dy\right) = \frac{\kappa}{D} \exp\left(-\frac{1}{\alpha} \left|\frac{x-m}{\sigma}\right|^{\alpha}\right),$$

which proves formula (4).

#### A.7 The case $\alpha > 2$

For  $\alpha > 2$ , the function A(x) is not Lipschitz continuous on the entire real line, but on any interval [-n, n]. For any  $n \in \mathbb{N}$  we use a bounded Lipschitz continuous function  $A_n$  which is equal to A on [-n, n]. Similarly to (A.2), we obtain a diffusion on the real line which satisfies (12). As in the previous case, this diffusion has a unique stationary distribution with density given by (4).

#### **B** Simulation

We simulate the processes  $Y_t$  and  $X_t$  with the Euler-Maruyama method. Let  $X_0$  be normally distributed and  $Y_0 = |X_0|$ . Let  $\Delta t > 0$ . For all  $n \in \mathbb{N}$  we compute

$$Y_{n\Delta t} = Y_{(n-1)\Delta t} + A(Y_{(n-1)\Delta t})\Delta t + \sigma Z_n$$

where  $Z_n$  is normal distributed with mean 0 and variance  $\Delta t$ . Since  $\tilde{Y}_{n\Delta t}$  can become negative, we define  $Y_{n\Delta t} = \max\left(\tilde{Y}_{n\Delta t}, 0\right)$ . If  $X_{(n-1)\Delta t} \neq 0$  let  $X_{n\Delta t} = \operatorname{sgn}(X_{(n-1)\Delta t})Y_{n\Delta t}$ . If  $X_{(n-1)\Delta t} = 0$ , we set  $X_{n\Delta t}$  equal to  $Y_{n\Delta t}$  or  $-Y_{n\Delta t}$ , both with probability  $\frac{1}{2}$ .

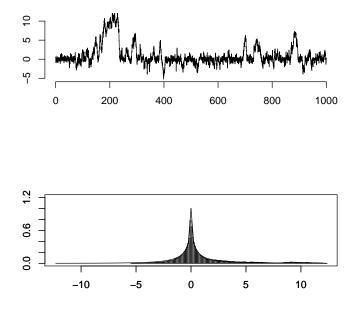


Fig. B.1. The simulated process  $X_t$  and the stationary distribution compared with the Subbotin distribution for  $m = 0, \sigma = 1$  and  $\alpha = 0.5$ .

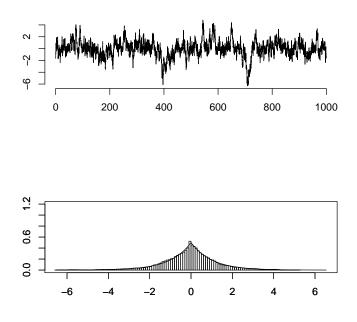


Fig. B.2. The simulated process  $X_t$  and the stationary distribution compared with the Subbotin distribution for  $m = 0, \sigma = 1$  and  $\alpha = 1$ .

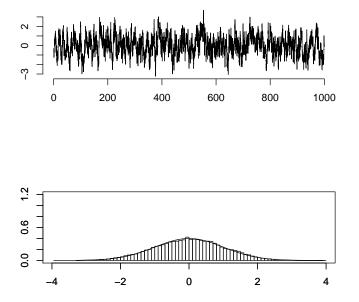


Fig. B.3. The simulated process  $X_t$  and the stationary distribution compared with the Subbotin distribution for  $m = 0, \sigma = 1$  and  $\alpha = 2$ .

#### References

- B. M. Bibby, I. M. Skovgaard, M. Sørensen, Diffusion-type models with given marginal and autocorrelation function, Bernoulli 11 (2005) 191–220.
- [2] G. Bottazzi, A. Secchi, Explaining the distribution of firm growth rates, RAND Journal of Economics 37 (2) (2006) 235–256.
- [3] C. Castaldi, M. Milaković, Turnover activity in wealth portfolios, Journal of Economic Behavior and Organization 63 (3) (2007) 537–552.
- [4] D. G. Champernowne, A model of income distribution, Economic Journal 63 (250) (1953) 318–351.
- [5] G. Dosi, R. R. Nelson, S. G. Winter (eds.), The Nature and Dynamics of Organizational Capabilities, Oxford University Press, New York, 2000.
- [6] D. K. Foley, A statistical equilibrium theory of markets, Journal of Economic Theory 62 (2) (1994) 321–345.
- [7] D. K. Foley, Adam's Fallacy, Harvard University Press, Cambridge, MA, 2006.
- [8] R. Gibrat, Les inégalités économiques, Recueil Sirey, Paris, 1931.
- [9] E. T. Jaynes, Where do we stand on maximum entropy?, in: R. D. Rosenkrantz (ed.), E. T. Jaynes: Papers on Probability, Statistics and Statistical Physics, Kluwer Academic Publishers, Dordrecht, Netherlands, 1978, pp. 210–314.
- [10] M. Kalecki, On the Gibrat distribution, Econometrica 13 (2) (1945) 161–170.
- [11] S. Karlin, H. M. Taylor, A Second Course in Stochastic Processes, Academic Press, San Diego, 1981.
- [12] P. J. McNulty, Economic theory and the meaning of competition, Quarterly Journal of Economics 82 (4) (1968) 639–656.
- [13] V. Pareto, Cours d'économie politique, vol. 2, Rouge, Lausanne, 1897.
- [14] J. A. Schumpeter, Capitalism, Socialism and Democracy, Harper, New York, 1950.
- [15] H. A. Simon, On a class of skew distribution functions, Biometrika 42 (34) (1955) 425–440.
- [16] A. Smith, An Inquiry into the Nature and Causes of The Wealth of Nations, Harriman House, Petersfield, England, 2007 (originally published in 1776).
- [17] M. H. Stanley, L. A. Amaral, S. V. Buldyrev, H. Leschhorn, P. Maass, M. A. Salinger, H. E. Stanley, Scaling behavior in the growth of companies, Nature 379 (1996) 804–806.
- [18] J. Steindl, Random Processes and the Growth of Firms, Griffin, London, 1965.

- [19] G. J. Stigler, Perfect competition, historically contemplated, Journal of Political Economy 65 (1) (1957) 1–17.
- [20] W. Stummer, The Novikov and entropy conditions of multidimensional diffusion processes with singular drift, Probability Theory and Related Fields 97 (4) (1993) 515–542.
- [21] M. J. Stutzer, A simple nonparametric approach to derivative security valuation, Journal of Finance 51 (5) (1996) 1633–1652.
- [22] M. F. Subbotin, On the law of frequency of errors, Matematicheskii Sbornik 31 (1923) 296–301.
- [23] J. Vickers, Concepts of competition, Oxford Economic Papers 47 (1) (1995) 1–23.
- [24] A. A. Young, Increasing returns and economic progress, Economic Journal 38 (152) (1928) 527–542.