

# Blockchain Disruption and Smart Contracts\*

Lin William Cong<sup>†</sup>    Zhiguo He<sup>‡</sup>    Jingtao Zheng<sup>§</sup>

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## Abstract

Distributed ledger technologies such as blockchains feature decentralized consensus as well as low-cost, tamper proof algorithmic executions, and consequently enlarge the contracting space and facilitate the creation of smart contracts. Meanwhile, the process of reaching decentralized consensus changes the informational environment. We analyze how these fundamental features reshape industry organization and the landscape of competition. Smart contracts can mitigate information asymmetry and deliver higher social welfare and consumer surplus through enhanced entry and competition, yet blockchain may also encourage collusion. In general, blockchain and smart contracts can sustain market equilibria with a larger range of economic outcomes. We further characterize smart contracts used in equilibrium and discuss anti-trust policy implications, such as injecting noise into certain consensus record and encouraging platform competition.

**Keywords: Competition, Distributed Ledger, FinTech, Incomplete Contracts, Collusion, Information, Security Design, Enforcement.**

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<sup>†</sup>University of Chicago Booth School of Business. Email: will.cong@chicagobooth.edu.

<sup>‡</sup>University of Chicago Booth School of Business; and NBER. Email: zhiguo.he@chicagobooth.edu.

<sup>§</sup>University of Chicago Booth School of Business and Economics Department.

# 1 Introduction

In the past few years, blockchain technology has taken the central stage in discussions on financial technology and in general media. It is believed to potentially disrupt business and the financial services in a way similar to how the internet disrupted offline commerce.<sup>1</sup> As shown in Figure 1, Google search in the past decades shows the rising popularity of the blockchain technology in the past half decade, and Figure 2 gives the recent trend in new open-source projects that are related to blockchain and smart contract.

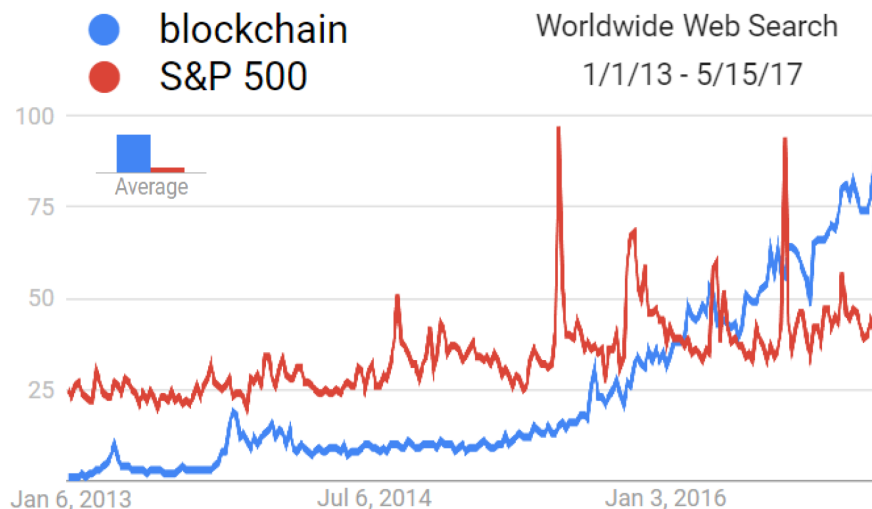


Figure 1: **Google Search for Blockchain.** We plot search interest relative to the highest point on the chart for the given region and time. A value of 100 is the peak popularity for the term; while 50 means that the term is half as popular. Likewise a score of 0 means the term was less than 1% as popular as the peak. The relative average is also displayed.

Through the use of distributed network and time-stamping of records, a blockchain is a distributed database and computing technology that is managed in a decentralized manner (often autonomously). It was first introduced as the technology behind the crypto-currency bitcoin in 2008, and has since emerged in various other forms subsequently, often allowing programs with logic and contingencies to be stored and automated to trigger further recording and transactions that all participants on the blockchain reach consensus on. This has given rise to applications such as smart contracts – digital contracts with consensus terms and are self-enforcing and tamper-proof through automated execution.

<sup>1</sup>Bloomberg Markets featured in its Oct 2015 cover “It’s all about the Blockchain.” The Economist ran a cover story around the same time “the Trust Machine” which argued that “the technology behind bitcoin could change how the economy works.” The financial services industry rebranded the blockchain more generally as a form of distributed ledger technology. Marc Andreessen, the cocreator of Netscape, even exclaimed “This is the thing! This is the distributed trust network that the Internet always needed and never had.”

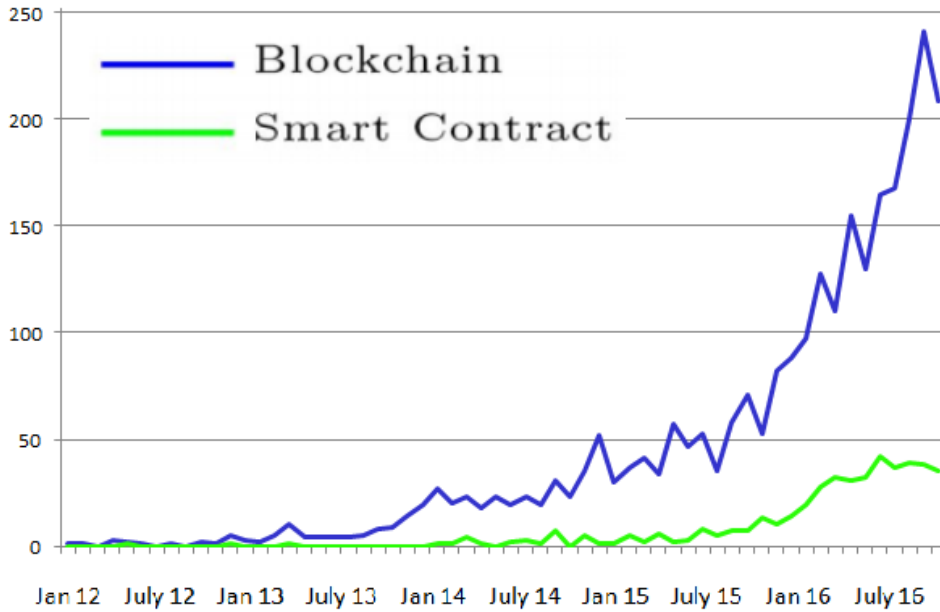


Figure 2: **Blockchain and Smart Contract Projects on GitHub.** Github is a major open-source development platform that hosts coding programs around the world. The metric indicates the number of blockchain and smart contract projects hosted. Since 2012, the number of Github projects related to blockchain and smart contracts has reached 2,715 and 445 units respectively, by the end of 2016.

In this paper, we argue that despite a plethora of definitions and descriptions of blockchain and decentralized ledger from a wide range of applications, the technology and its various incarnations—to varying degrees—are mainly defined by the ability to maintain a uniform view on the state of things and other events in an effective way. The backbone of the blockchain technology, from an economist’s perspective, can be described as a robust consensus that leads individuals and organizations with divergent perspectives and incentives to accept and act upon as if it is the “truth”. This consensus enables the self-execution of smart contracts, which we provide a sharp definition, and the greater distribution of information. For example, on the bitcoin blockchain, agents can check and verify transactions with one another, in order to eliminate “double-spending” the digital currency, and freeing everyone from the need of a centralized trustworthy arbitrator or third party.

Our analysis aims to demonstrate that blockchain and smart contracts are not merely database technology that reduces the cost of storing or sharing data, but have profound economic implications. We abstract away from the technical details of how various blockchains generate decentralized consensus, but point out two universal economic forces that naturally arise in this setting: first, greater decentralized consensus makes contracting on contingencies and enforcement easier; second, achieving such consensus requires distributing information to some degrees for verification.

Thus we emphasize that the increasingly popular blockchain technology features a fundamental tension between decentralized consensus and distributed information; the former enhances contractibility and hence is welfare improving, while the latter, depending on the economic environment, could be a potential detriment to the society. Armed with this insight, we then take as given these defining features of blockchain and smart contracts, and analyze in a theoretical model their impact on industrial organization, competition, and contracting.

By doing so, this paper is among the first to provide a conceptual description of blockchain and smart contracts from an economic and financial perspective. We not only propose a unified economic framework to think about the core features and functionality of decentralized ledger technology as represented by blockchain, but also model the impact of blockchain and smart contracts that potentially has profound implications on industrial organization, smart contract design, and anti-trust policy.

Our model is set in a dynamic, discrete-time, and risk-neutral world. There are two incumbent sellers known to be authentic, and an entrant who only has some probability of being authentic (otherwise he is fraudulent). Authentic sellers will deliver the goods, while the fraudulent ones cannot. In the baseline model, all sellers have publicly observable time-varying quality of service or goods that they can provide to buyers. In each period, buyers as a group show up with a constant probability, and shop the sellers to get price quotes to choose one seller for the transaction, then exit the economy. Each seller only observes whether customers come to her; she observes neither the price quotes other sellers offer, nor whether other sellers get customers. This captures in the spirit of Green and Porter (1984) imperfect monitoring in repeated games, but in a setting in which sellers compete on price rather than quantity.

In the traditional world without blockchain and smart contract, we assume sellers cannot offer prices contingent on the success or failure of delivering the goods. This could be due to contract incompleteness or heavy cost of enforcing the contract. Because of new entrant suffers from the lemons problem, entry is inefficient due to the asymmetric information on entrants authenticity. We also derive collusion equilibria between two incumbents. Because incumbent sellers cannot differentiate the event of no buyers showing up from the event of the other seller stealing his market share, aggressive price wars which are the perfect competitive strategy occur too often, making it relatively hard to sustain collusion among incumbent sellers.

Blockchain provides a decentralized consensus that enables agents to observe and contract on service outcome and aggregate service activity recorded on the blockchain (a reduced-form representation of the increased public information blockchain brings about). This has two important implications.

On the one hand, smart contracts with payment contingent on service outcomes allow the

authentic entrant to signal his authenticity fully and enter the market. This eliminates information asymmetry as an entry barrier, and the enhanced competition improves consumer (buyer) surplus and welfare.

On the other hand, sellers can also turn this expanded contractibility to their own favor to form a cartelism. Even if explicit smart contracts among sellers are infeasible (e.g., once it is deemed as violating anti-trust law), blockchain technology can still foster tacit collusion among sellers. This is because by observing the aggregate service activity on the blockchain, each seller now effectively knows whether buyers show up this period. Different from traditional world and the environment in Green and Porter (1984), now each seller can detect deviations perfectly in any collusive equilibrium, and hence as a group they are able to better coordinate punishment (which means reverting to playing the perfectly competitive strategy). Consistent with this intuition, we show that with only permissioned blockchain among the incumbents, there is always weakly more collusion equilibria than those that are sustainable in the traditional world.

What is the overall welfare effect of public blockchain which facilitates entry but also potentially fosters collusion? In our model, consumer surplus can be fully extracted with sellers' improved monitoring of deviations in a collusion enabled by blockchain, whereas it is always positive in the traditional world with imperfect monitoring in any collusive equilibria. This implies that blockchain disruption can harm consumer surplus. In general, there is a tradeoff between enhanced competition and the enlarged collusion equilibria of the economy. Under fairly weak conditions, with blockchain and smart contracts the set of possible dynamic equilibria is strictly bigger than that in a traditional world, leading to social welfare and consumer surplus that could be higher or lower than before.

There is a wide-spread concern that blockchains may jeopardize market competitiveness in a serious way; this concern becomes especially acute for permissioned blockchains like R3 Corda whose members are powerful financial institutions.<sup>2</sup> Our paper highlights one particular economic mechanism through which blockchain facilitates collusion, and we explore regulatory implications of the model that aims to improve consumer surplus. Injecting noise into the blockchain to mask certain information and encouraging platform competition potentially mitigate collusion. It is also beneficial to separate usage and consensus generation on blockchains, so that sellers cannot use the consensus-generating information for the purpose of sustaining collusion.

Finally We extend the analysis to a setting in which service qualities are privately known to the sellers, and show that the main result of blockchain and smart contracts mitigating information asymmetry extends. We further characterize the equilibrium, show that the smart contracts offered always deliver to buyers a payoff that is independent of sellers private

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<sup>2</sup>"Exposing the 'If we call it a blockchain, perhaps it won't be deemed a cartel?' tactic," by Izabella Kaminska, Financial times, May 11th, 2015.

types. The intuition mirrors that in auctions with security bids: better sellers use information insensitive securities to separate in a lemons market.

## Related Literature

Our paper adds to the emerging literature on blockchains. While existing studies typically lie in computer science, Harvey (2016) briefly surveys the mechanics of crypto-finance and a number of applications including Bitcoin. Catalini and Gans (2016) point out the blockchain technology can reduce the cost of verification and the cost of networking. Malinova and Park (2016) study the design of the mapping between identifiers and end-investors and the degree of transparency of holdings in a blockchain-based marketplace. Khapko and Zoican (2017) argue that blockchain allows for flexible settlement of trades, and the optimal time-to-settle trades off search costs and counter-party risk, creating vertical differentiation. Yermack (2017) evaluates the potential impacts of the blockchain technology on corporate governance: for managers, institutional investors, small shareholders, auditors, etc. Raskin and Yermack (2016) push further to envision that the central banks might use the technology to launch their own digital currencies. We add by examining arguably the most defining features of blockchain, and how they interact with information asymmetry and affect market competition – both are important, general issues in economics.

Related are studies on the underlying mechanism for generating decentralized consensus. Kroll, Davey, and Felten (2013) note that bitcoin miners are playing a strategic game and the “Longest Chain Rule” should be a Nash equilibrium. Biais, Bisiere, Bouvard, and Casamatta (2017) formalize this notion but show deviations from the rule can arise on the equilibrium path. Eyal and Sirer (2014) study “selfish mining” in bitcoin blockchain in which miners launch block-withholding attack. Nayak, Kumar, Miller, and Shi (2016) discuss “stubborn mining” that generalize and outperform “selfish mining” attacks. For challenges facing the incentive and governance issues of maintaining decentralized ledgers, see Evans (2014).

Along that line, several studies examine the organization and compensation of miners. Kiayias, Koutsoupias, Kyropoulou, and Tselekounis (2016) show that when the computational power of a miner is large, Nash equilibria different from the expected behavior of the bitcoin designer arise. This fundamental tension between concentration of computation power and system stability is also studied in Baldimtsi, Cong, He, and Li (2017), who theoretically and empirically analyze mining pool formation and compensation contracts in an attempt to shed new lights on the theory of firm.

Our paper differs in that we abstract from the underlying mechanics of blockchain and do not limit our attention to the bitcoin protocol. Instead, we analyze how the blockchain technology impacts the economy, highlighting how the decentralized consensus that the technology aims to provide mitigates information asymmetry, encourages entry and competition,

and yet at the same time can lead to greater cartelism and collusion. Our paper is also likely the first to rigorously define smart contracts and theoretical analyze their economic impact on market competition with informational asymmetry. As a complementary empirical study on smart contracts, Bartoletti and Pompianu (2017) document how they are interpreted and programmed on various blockchain platforms.

Our discussion on the application of blockchain and smart contract in financial services and transactions is broadly linked to the literature on financial technology and financial innovation. Philippon (2015) points out intermediation cost has been 1.5-2 percent of intermediated assets for a long time, despite dramatic technology improvement. Philippon (2016) confirms this statistic and uses it as evidence to show that the current financial system is rather inefficient.<sup>3</sup> We provide a cautionary tale that blockchain technology, while holding great potential in mitigating information asymmetry and encouraging entry, can also lead to greater collusive behavior.

Our analysis on collusion adds to the large literature on industrial organization and repeated games with monitoring. Earlier contributions include Friedman (1971), Osborne (1976) and Tirole (1988). See for example, Feuerstein (2005), for a survey. Our paper most closely relates to Porter (1983) and Green and Porter (1984), which study collusion in Cournot setting with imperfect public monitoring. Abreu, Pearce, and Stacchetti (1986) and Abreu (1987) generalize the results further to consider additional types of equilibria. Our analysis of sustainable equilibria is related to Fudenberg and Maskin (1986). Also related is Athey and Bagwell (2001) that studies optimal collusion with private information. Our paper examines Bertrand competition, and links the additional observable or contractible information to the type of monitoring in repeated games.

Finally, our paper is related to auctions and security design, for which Skrzypacz (2013) gives an overview. Our analysis on smart contract form follows DeMarzo, Kremer, and Skrzypacz (2005), which give an extensive exposition of security-bid auctions, showing “flatter” securities are used in equilibrium when an auctioneer cannot commit to security designs.

The rest of the paper is organized as follows: Section 2 provides institutional details on blockchain and smart contracts, and introduces key economic trade-offs; Section 3 lays out the modeling framework and analyzes dynamic equilibria in the traditional world; Section 4 demonstrates how blockchain facilitates entry and cartelism, and discuss policy implications; Section 5 generalizes the problem of informational asymmetry, and characterizes equilibrium smart contracts offers; Section 6 concludes.

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<sup>3</sup> He claims “welfare gains from improvement in financial services are technologically feasible but unlikely to happen without entry of new firms” and suggest a regulatory approach to “encourage entry and shape the development of new systems”.

## 2 Blockchain and Smart Contracts

After providing an overview of blockchain technology, we highlight the decentralized consensus which is the backbone of blockchain. We then formally define smart contracts based on decentralized consensus, and explain that it is not costless to reach such consensus. We then discuss the various real world business applications of smart contracts in financial industry.

### 2.1 Blockchain as Decentralized Consensus

The work on a cryptographically secured chain of blocks dates back to 1991 by Stuart Haber and W. Scott Stornetta, but it was only until 2008 that the first blockchain was conceptualized by Satoshi Nakamoto, and was implemented and popularized through the cryptocurrency, bitcoin (Nakamoto (2008)).<sup>4</sup> Its simplest form entails a distributed database that autonomously maintains a continuously growing list of public records in unit of “blocks”, secured from tampering and revision. Each block contains a timestamp and a link to a previous block. Other forms of blockchains emerged subsequently with different designs on exclusivity, transparency, and maintenance of the records.

All blockchains – with varying degrees – aim at creating a database system in which parties unknown to each other can jointly maintain and edit in a decentralized manner, with no individual party exercising central control. They are implementations of decentralized ledger.<sup>5</sup> One defining feature of blockchain architectures is thus their ability to maintain, in a relatively cheap way,<sup>6</sup> a uniform view on the state of things and the order of events – a consensus, a type of information that leads individuals or organizations with divergent perspectives and incentives to accept and act upon as if it is truth.<sup>7</sup>

The production of consensus is essential to many economic and social functions. Its benefits and empowerment for everyone sharing and trusting the same ledger are clear: settlements no longer take days, lemon’s markets and frauds disappear, and the list goes on. Traditionally, court, government, notary agencies, e.t.c., provide such consensus, but in a way that is labor-intensive, costly, tamper-prone, and local.

Blockchain disrupts the provision of consensus by reducing the risks and costs. First, it aims to produce decentralized consensus, a specific state or set of information to be agreed

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<sup>4</sup>Böhme, Christin, Edelman, and Moore (2015) surveys Bitcoin’s design principles and properties, risks, and regulation. Narayanan, Bonneau, Felten, Miller, and Goldfeder (2016) is an in-depth introduction for the technical details of Bitcoin blockchain.

<sup>5</sup>Technically speaking, blockchains are not the only way to implement decentralized ledger, but we are going to use them synonymously.

<sup>6</sup>Although mining to maintain consensus for Bitcoin is costly, going to court to reach consensus might still cost more for two parties involved in a dispute on payment.

<sup>7</sup>What we mean by consensus is alternatively called authority by programmer and blogger Steve Randy Waldman.



upon by all by rules and protocols, without the need to trust or rely upon a centralized authority.<sup>8</sup> This supposedly makes the consensus more secure. Second, it utilizes clever designs to reward a community for maintaining the consensus in a cost-effective way, allowing greater recording and processing power without incurring too much social cost.

In neither aspect is the technology in its current forms perfect, but it has improved quickly and substantially enough that the challenges are not insurmountable, and the basic functionality that blockchain provides is clear.<sup>9</sup> Rather than analyzing the technical details and refinements of various protocols, we identify two sets of questions that are economically important: first, how should we design the mechanism and informational environment for generating decentralized consensus? Second, how does decentralized consensus impact economic activities, taking as given the basic functions of blockchain – greater decentralized and tamper-proof consensus? We focus on the latter fundamental question.

For the remainder of the section, we elaborate the question further by first introducing smart contracts enabled by decentralized consensus, and highlighting the informational tradeoffs blockchain and smart contracts entail, before providing some real world examples.

## 2.2 Smart Contracts

In recent years, the development of blockchain technology has allowed customizable programming logic to be stored in a decentralized way. This course of development has revived the notion and facilitated the creation of smart contracts, originally envisioned by Szabo in 1994:

*“A smart contract is a computerized transaction protocol that executes the terms of a contract. The general objectives are to satisfy common contractual conditions (such as payment terms, liens, confidentiality, and even enforcement), minimize exceptions both malicious and accidental, and minimize the need for trusted intermediaries. Related economic goals include lowering fraud loss, arbitrations and enforcement costs, and other transaction costs.”*<sup>10</sup>

While a fully established definition for smart contracts has yet to be formed, it is apparent that its core notion lies in contracting on contingencies on a decentralized consensus, and on low-cost, algorithmic execution. To achieve decentralized consensus, a distributed ledger is

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<sup>8</sup>Even the change of rules requires some sort of voting. Decentralized consensus is not to be confused with “decentralized economy”.

<sup>9</sup>While there has been several hacking incident on blockchains (most notable one being the hack on the decentralized autonomous organization (DAO) on Ethereum blockchain) and bitcoin mining seems to waste electricity, those are the limitation to specific protocol designs. For example, Lightning, which builds on the Bitcoin blockchain, reduces the amount of information that has to be recorded on the blockchain to increase processing power. Phi from String Lab builds on Ethereum to ensure higher security and execution speed.

<sup>10</sup>See, for example, Tapscott and Tapscott (2016).

needed, which also has to be self-executing. Contingencies (including allocation of property and control rights) in a smart contract should be codified, so that automated execution is feasible, which reduces enforcement cost. Traditional resolutions by third parties such as the court or an arbitrator do not fit well as they involve high degrees of human intervention that are less algorithmic, and could be costly because the resolution are typically less deterministic and thus is costly to risk-averse agents. The low-cost requirements also rules out most centralized consensus, reason being that centralized consensus often entail huge bargaining power and monopoly by the party holding the centralized consensus (for example, a third party with data monopoly).

Given the aforementioned facts, we provider a sharper definition of smart contracts:

*Smart contracts are digital contracts allowing terms contingent on decentralized consensus and are self-enforcing and tamper-proof through automated execution.*

Our definition is consistent with and nests the definitions commonly seen in the legal circle (Lauslahti, Mattila, Seppälä, et al. (2016)), and in Szabo (1998) and Szabo (1997). It is important to note that smart contracts are not merely digital contracts (many of which rely on trusted authority for reaching consensus and execution), nor are they entailing artificial intelligence (they are rather robotic, on the contrary).

From our discussion thus far, it is clear that decentralized ledger technology as represented by blockchains naturally enables the use of smart contracts.<sup>11</sup> This in turn enables greater contractibility and enforceability in contingent contracts that facilitate exchanging money, property, shares, service, or anything of value in an algorithmically automated and conflict-free way.

The best way to describe smart contracts is to compare the technology to a vending machine. Ordinarily, one would go to a lawyer or a notary, pay them, and wait while you get the document. With smart contracts, one simply drops a coin into the vending machine (i.e. satisfies the contingency), and the escrow, drivers license, or money drops into one's account. More so, smart contracts not only define the rules and penalties around an agreement in the same way that a traditional contract does, but also automatically enforce those obligations. Many institutions, platforms, and governments around the world (including Georgia, Ghana, and Honduras), are already utilizing such smart contracts.<sup>12</sup>

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<sup>11</sup>Technically, the blockchain has to be Turing-complete in order to enable smart contracts with non-trivial logic and contingent statements. That said, smart contracts do not have to be implemented through blockchain, any decentralized consensus system would suffice. An interesting example suggested to us by Jiasun Li is metromile, a pay-per-mile car insurance company that aims to achieve consensus on miles driven using a device that synchronize data on driving.

<sup>12</sup>For an example of blockchain powered land services in Ghana, see <http://benben.com.gh/>

## 2.3 Information in Decentralized Consensus

As discussed, decentralized consensus on blockchain allows agents to enhance the contractibility in a significant way, hence greatly improving the efficiency for the parties involved in a transaction or contract agreement. However, the added contractibility comes with a natural cost that is interesting not only from a practical perspective but also from an angle of fundamental economic understanding.

This cost is associated with the fundamental issue of how participants reach decentralized consensus on blockchain. On Bitcoin, the consensus is reached and maintained through distributing all transaction information (with public-key-encrypted owner addresses) to the entire population on the blockchain, so every transaction details (except for identities) recorded on the consensus are, by definition, public information.

One obvious issue with distribution information that arises when pushing for real-world blockchain applications is the concern for business privacy. For instance, financial institutions are typically sensitive to let other parties who are not necessarily involved know the details the transaction. Similarly, traders on an exchange may want to hide their identities and trading, for example, to prevent front-running (Malinova and Park (2016)).

This reflects a fundamental trade-off: economic agents in real world demand privacy and confidentiality, while the decentralized consensus achieved on blockchain requires a certain degree of transparency and hence public information. As we will discuss shortly the real world examples of smart contract, one straightforward compromise is to only reach decentralized consensus on a subset of states of world which deems to be important. Nevertheless this subset is public. As such, the popular proposed solution is better encryption which effectively mask sensitive information while still maintain decentralized consensus.<sup>13</sup>

To that end, we highlight an important economic insight often overlooked by the practitioners: no news is news – even encrypted data are still data. Without distribution the details (such as identities or contingent terms) of a transaction, the mere act of verification request informs the validator something about the state of the world. Therefore, in a spirit akin to the Hershleifer effect, there could be many unintended consequences of this extra publicized information, in addition to the benefits consensus brings about. In our model we illustrate how decentralized consensus potentially hurts consumer surplus.

## 2.4 Applications in the Financial Industry

The applications of blockchain technology and smart contracts are broad. Because of the tamper-proof nature, and the ease to automate rule-based monetary transfers, smart

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<sup>13</sup>For example, Aune, O’Hara, and Slama (2017) discuss Directly related is the so-called “Zero Knowledge Proof” in computer science; in layman’s language, participants can agree on certain facts without revealing useful information.

contracts are especially appealing for financial services and trading.<sup>14</sup> It is also no surprise that the FinTech industry has been the biggest driver for blockchain innovation.

Here we outline some issues with financial services or transactions people face in the traditional world, and describe existing uses – and importantly, not merely proof of concept – of blockchain and smart contracts that can help. Throughout, we shall use the bold font to indicate start-ups and/or projects that have appeared in the real business world. Section 3 develops the model, keeping in mind applications in the financial industry.

## Trusted Payments

Suppose Alice in Chicago wants to make a payment to Bob in Africa but does not want Bob to cash it out immediately. She may have to go to a large bank and worry about issues such as whether Bob is the real Bob and the bank information he provides is accurate. The Society for Worldwide Interbank Financial Telecommunications (SWIFT) can mitigate the problem, but would require Bob’s bank to be in the society, and may take a long time to verify the bank has not turned fraudulent or bankrupt, and the bank has to do the same verifications on Bob’s account, before authorizing the transfer. If Alice is charged an unreasonably high exchange rate, or the transfer did not go through, resolving the issue may incur further cost and delay. This concern becomes even more severe with digital payments, where “double-spending” (spending the digital currency or using the credit more than once) issues abound.

**Bitcoins** as a form of cryptocurrency were first invented to offer a potential solution to the “double-spending” problem (Nakamoto (2008)). It enables peer-to-peer transactions recorded on the bitcoin blockchain that is secure and time-stamped to make it tamper-proof, and its public and distributed ledger provides real-time decentralized consensus on whether a transaction has taken place. If both Alice and Bob use bitcoins, they can make the transfer directly. Because to maintain the consensus record on Bitcoin blockchain requires solving difficult NP-complete computational problems (“proof-of-work”), it is costly and limited in capacity, making it unsuitable for large volumes of financial transactions. Subsequent platforms such as **Lightning** (build on the Bitcoin blockchain) and **Stellar** (separate blockchain) help improve the processing capacity through local channels and multisignature accounts so that unnecessary information does not have to be part of the decentralized consensus.<sup>15</sup>

That said, these blockchains’ scripting language is limited (basic arithmetic, logical, and

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<sup>14</sup>Bartoletti and Pompianu (2017) analyze 834 smart contracts from Bitcoin and Ethereum with 1,673,271 transactions. They find five main category of uses (financial, notary, games, wallet, and library), three of which are related to monetary transfers and transactions, with the remaining two related to recording consensus information. More than two-thirds of the uses are on managing, gathering, or distributing money.

<sup>15</sup>**Counterparty** also builds on the Bitcoin blockchain, but allow for more flexible smart contracts and maintains consensus through “proof-of-burn,” i.e., fees paid by clients are destroyed, and nodes are rewarded for validation from the inflation of the currency.

crypto operations such as hashing, verification of digital signatures), and only a small fraction of mining nodes can process more complex script by signature verification, making them less useful for general smart contracts. **Ethereum** – then second largest blockchain platform by market capitalization after the Bitcoin blockchain – allows the use of Turing-complete language and permits more complex contingent operations (primarily transactions in its native currency Ethers), providing the archetypal implementation of smart contracts (Buterin (2014)). All and only the valid updates to the contract states are recorded and ensured with automated execution. A group of voluntary participants maintain a decentralized consensus recording of the states, and other interacting parties utilize the consensus information to automate executions of contract terms. Additional applications such as **Monax** and **Phi (String Lab)** build on Ethereum to enrich and optimize its smart contract functionalities and processing power, just like websites build on the Internet protocol.

Traditional players in the financial industry are also actively adopting the blockchain technology to solve the payment problem. Originally known as Ripple Labs, **Ripple** was founded in 2012 to provide global financial transactions and real-time cross-border payments. It has since been increasingly adopted by major banks and payment networks as the settlement infrastructure technology. It achieves decentralized consensus using the Ripple transaction protocol RTXP (an iterative consensus process as an alternative to Proof-of-Work) and automated digital transfers through connecting electronically to bank accounts or using its native cryptocurrency Ripples (XRP). Now a system like Ripple, equipped with decentralized (and almost real-time) decentralized consensus, alleviates the concerns about Bob or Bob’s bank’s authenticity and functionality, and the use of contingent transfers ensures that if Bob violates the agreement, Alice’s fund is reverted back.

## Trade Finance

Another related and important application is trade finance, which accounts for more than USD 10 Trillion annually according to WTO report in 2015. Despite technological advent in many areas of financial services, trade finance remains a largely paper-based, manual process, involving multiple participants in various jurisdictions around the world, and prone to human error and delays along the supply chain.<sup>16</sup> An importer may fail to strike a deal because she cannot obtain a letter of credit, or the bank offering the letter of credit is not as well-known in the exporter’s country. An exporter may fail to get advanced financing

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<sup>16</sup>While a seller (or exporter) can require the purchaser (an importer) to prepay for goods shipped, the purchaser (importer) may wish to reduce risk by requiring the seller to document the goods that have been shipped. Typically, banks may assist by providing various forms of support. For example, the importer’s bank may provide a letter of credit to the exporter (or the exporter’s bank) providing for payment upon presentation of certain documents, such as a bill of lading. The exporter’s bank may make a loan (by advancing funds) to the exporter on the basis of the export contract. Small suppliers have to wait as long as 60 to 90 days to be paid for delivered goods, which hinders their access to working capital.

because the bank worries about whether the goods can be successfully and timely delivered and whether payments from the importer can be secured. Foreign exchange risks further exacerbate the situation.

It is clear that the blockchain technology can help alleviate (and to a large extent, resolve) the aforementioned frictions in trade finance. A decentralized ledger can better track goods during the process in which goods are shipped and delivered; by giving all parties equal access to the transaction record, it also facilitates faster verification and authentication, thereby reducing shipment and financial transaction times and uncertainties. Moreover, with the help of “oracles” – feeders of information from the offline world, smart contracts drastically reduce costs in executing transfers contingent on real outcomes such as a shipment’s having arrived at an intermediate port.

In 2016, **Barclays** and fintech start-up **Wave** claim to have become the first organization to complete a global trade transaction using distributed ledger/blockchain technology. The letter of credit (LC) transaction between Ornuia (formerly the Irish Dairy Board) and Seychelles Trading Company is the first to have trade documentation handled on the new Wave platform. Software giant **IBM** has also been spearheading the application of blockchain and smart contracts to trade finance, launching solutions for Indian Mahindra Group in December 2016, and in partnership with Danish shipping behemoth Maersk. In early 2017, IBM has ventured further by rolling out the **Yijian Blockchain Technology Application System** for the Chinese pharmaceutical sector. It has also collaborated with a group of companies to develop a blockchain-based crude oil trade finance platform.<sup>17</sup> Other blockchain-based platforms to support lending, issuing letters of credit, export credit and insurance include **HK Blockchain** for trade finance, **TradeSafe**, and **Digital Trade Chain (DTC)**.

## Exchanges and Trading

In addition to applications in payments and trade finance, smart contracts can also be used in exchanges and trading.<sup>18</sup> To that end, Nasdaq Inc launched in 2015 **LinQ** Platform for managing and exchanging pre-IPO shares, in early 2017, successfully completed a test using blockchain technology to run proxy voting on Estonian Tallinn Stock Exchange, the country’s only regulated secondary securities market. Korea Exchange (KRX) also launched a blockchain-based marketplace **Korean Startup Market (KSM)** where equity in startup companies can be traded. Smart contracts can enforce a standard transactional rule set for derivatives (a security with an asset-dependent price) to streamline Over-The-Counter

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<sup>17</sup><http://www.coindesk.com/ibm-blockchain-platform-oil-trade-finance/>

<sup>18</sup>The international management consulting firm Oliver Wyman, and the FinTech investment group Santander InnoVentures, estimate that the cost of clearing, settling, and managing the post-trade processes, formerly required when dealing in securities, ranges from US\$65 billion and US\$80 billion a year globally. Details can be found at <https://www.finextra.com/finextra-downloads/newsdocs/the%20fintech%20%20%20paper.pdf>.

(OTC) financial agreements. **Symbiont** offers product with a simple interface for specifying the terms and conditions when issuing smart securities, as well as integration with market data feeds.<sup>19</sup> Nasdaq has provided blockchain technology to run a new exchange – **The New York Interactive Advertising Exchange (NYIAX)** – to trade guaranteed advertising contracts.<sup>20</sup> Other efforts in applying blockchain and smart contracts to exchanges and trading include Digital Asset Holdings (DAH) backed by the Australian Securities Exchange (ASX) to upgrade post-trade services.

## Fundamental Tension in Blockchain Applications

In all the aforementioned applications, smart contracts have augmented contractibility and enforceability on certain contingencies, be it the lock-in requirement for Bob’s fund withdrawal, or the automated payment upon an importer’s successfully receiving the goods. Moreover, transaction and contingency information on the ledger is distributed and observable to many agents on the blockchains. For example, although the payment identity is confidential, transaction information is public on Ripple.<sup>21</sup> Trade finance blockchains typically require information from shipment ports to be distributed to get the whereabouts of shipments.

The concern about privacy is also voiced by practitioners, among which **R3 CEV** – an active blockchain consortium – has been outspoken.<sup>22</sup> R3’s **Corda** system sets out to tackle the challenge that the only parties who should have access to the details of a financial transaction are those parties themselves and others with a legitimate need to know.<sup>23</sup> Even with that, the request (thus a form of information) for proving transaction uniqueness is distributed to some independent observers, changing the information environment of this

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<sup>19</sup>Symbiont is a member of the **Hyperledger** project, a cross-industry, open-source, collaborative project led by the non-profit Linux Foundation to advance blockchain technology by coming up with common standards.

<sup>20</sup>Set to launch in the fourth quarter of 2017, NYIAX will provide an electronic marketplace for publishers, advertisers and media buyers to buy and sell future advertising inventory, global exchange operator Nasdaq and NYIAX said on Tuesday.

<sup>21</sup>Payment identity is not. Its thus difficult for anyone to associate transaction information with any specific user or corporation. See <https://ripple.com/insights/what-an-open-network-means-for-banks-market-makers-and-regulators/>.

<sup>22</sup>On blockchain, R3 has completed treasury bond trading (with eight member banks), completed a number of cloud-based ledger experiments on trading commercial papers (with 40 member banks), and designed and used so-called smart contracts to process accounts receivable (AR) purchase transactions, invoice financing or factoring, and letter of credit (LC) transactions (with fifteen of its consortium members including Barclays, UBS, and Wells Fargo). More details can be found at <https://www.finextra.com/blogposting/13209/blockchain-near-real-world-examples-and-collaboration-viable-approaches>

<sup>23</sup>Similar to many other blockchains, a transaction on Corda requires both validity and uniqueness. What is different is that consensus over the transaction validity is performed only by parties to the transaction in question. So we do not have consensus at the ledger level. Consensus over uniqueness is customizable and involve independent observers, typically random and pluggable.

economy at least partially.

Our economic analysis to follow focuses exactly on this tension highlighted in the current section: creating decentralized consensus leads to greater contractibility but necessitates greater information distribution.

### 3 Traditional World

We first describe the repeated games reflecting the dynamic economic environment in a world without decentralized consensus through blockchain (and smart contracts). In this benchmark setup, we characterize a large class of dynamic equilibria typically studied in the literature on dynamic games, and later compare them to those in a world with blockchain and smart contracts written on decentralized consensus.

#### 3.1 Model Setup

We consider a risk-neutral world in which time is infinite and discrete, and is indexed by  $t$ ,  $t = 1, 2, \dots$ . Every agent has a discount factor  $\delta$ .

In every period  $t \geq 0$ , with probability  $\lambda$  a unit measure of buyers show up, each demanding a unit of goods. Buyers (if present) only live for one period and exit the economy. We use  $\mathbb{I}_t$  to denote the aggregate event whether buyers show up in period  $t$ . Throughout, we use “buyers” and “customers” interchangeably.

There are three long-lived sellers who produce and sell the goods, and are either authentic or fraudulent. A fraudulent seller is unable to deliver the goods, while the authentic one always delivers. At the start of the game  $t = 0$ , two of them, A and B, are incumbents known to be authentic (who have already established a good reputation). There is also a new entrant C who privately knows her authenticity, but others only have the common prior belief that C is authentic with probability  $\pi$ . Later we refer to  $\pi$  as the seller C’s reputation.

In every period  $t \geq 0$ , each seller gets an i.i.d. draw of the quality  $q_i$ ,  $i \in \{A, B, C\}$  of the goods they offer, which is the expected utility a buyer can get conditional on delivery of the goods. A buyer gets zero utility otherwise. Denote the cumulative distribution function and probability density function of quality distribution by  $\phi(q)$  and  $\Phi(q)$ , and its support by  $[\underline{q}, \bar{q}]$ . It costs a seller  $k$  to produce the goods, where  $k < \underline{q}$  to reflect that transaction with an authentic seller is welfare-improving.

The quality profile  $\mathbf{q} = (q_A, q_B, q_C)$  is realized at the beginning of each period and is publicly observable, capturing temporal differences among sellers. We discuss the case when quality is the seller’s privately information in Section 5. For exposition, we denote the elements in  $\mathbf{q}$  in decreasing order by  $q^{(1)}$ ,  $q^{(2)}$ , and  $q^{(3)}$  respectively. Without loss of generality,



we treat  $q$  in the remainder of the paper as the probability of successful rendition of service by an authentic seller, which delivers unit utility to a buyer.

The potential entrant C can enter the market by paying an arbitrarily small cost of  $\epsilon > 0$ ; hence C enters only if he can ever make strictly positive profit in this market after entry.<sup>24</sup> This allows us to focus on information asymmetry of seller authenticity as the relevant entry barrier. We further assume that before getting customers the entrant has no loss-absorbing capacity, for example, due to endogenous borrowing capacity, so that potential entrants cannot take aggressive penetration pricing schemes.<sup>25</sup>

In the context of financial industry, one can think of the buyers as bank customers, and the goods demanded as a certain type of financial service. The incumbents then represent well-established financial institutions with high reputation, and the entrant represents new service providers such as PayPal in its early days. In this example,  $k$  represents the cost entailed in performing the service, and  $q$  the quality of service in terms of customer experience or speed or probability of completion conditional on seller's authenticity.

## Contracting Space and Information

We now give the key assumption on contracting space and information environment that are available in the traditional world.

**Assumption 1.** *In traditional world, no payment can be contingent on whether service delivery occurs or not. Each seller can only observe his own buyers and associated transaction information.*

The first part of Assumption 1 reflects certain contract incompleteness in real life; for a good reference on the costs of writing and enforcing complete contracts, see Tirole (1999). In our context, this implies that the sellers first quote price  $p_i(\mathbf{q})$  privately to buyers;<sup>26</sup> then, payoff-maximizing buyers choose one of the sellers, pay the offered price, and wait for the service to be delivered.

The second part of Assumption 1 implies that in the traditional world sellers do not observe others' price quotes. This assumption plays a role when we solve for the sellers' collusion equilibrium, and is similar to the assumption in Green and Porter (1984) and Porter (1983).

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<sup>24</sup>Whether the entry decision is made before the quality  $q_C$  realization or not is immaterial, given the arbitrary small entry cost.

<sup>25</sup>A sufficient condition to rule out aggressive penetration pricing (in which entrants suffer huge losses in order to enter). This is realistic because without accumulation of service profit over time, the entrant typically does not have large initial capital (deep pocket) to undercut price aggressively. In fact, all we need is that C's tolerance for loss,  $L$ , is no more than  $[q - \pi\bar{q}]^+$ .

<sup>26</sup>That sellers make offers is realistic in many applications where the customers or buyers are short-lived and dispersed. For example, banks typically quote the fee for making an international transfer, and customers can decide which bank to go to. Our main results are robust to this particular trading protocol.

## 3.2 Bertrand Competition and Entry

Let us first consider a competitive equilibrium, in which sellers will keep lowering their offered prices until their competitors quit. Suppose that C enters. If  $\pi q_C < \max\{q_A, q_B\}$ , at least one of the incumbents always competes to lower the price to  $k$  to get the customer this period and prevent the enhanced future competition they face had C entered in this period. Without a reputation of being authentic, C only stands a chance of getting a customer if buyers show up and  $\pi q_C \geq \max\{q_A, q_B\}$ .<sup>27</sup> The next proposition follows,

**Proposition 3.1.** *In a competitive equilibrium, the first time C can serve customers is in period  $\tau \equiv \min\{t \geq 0 \mid \pi q_{C,t} \geq \max\{q_{A,t}, q_{B,t}\}\}$  or later. Consequently, C never enters if  $\pi \bar{q} < \underline{q}$ .*

Basically, an entrant can get customers only when her perceived quality is higher than the incumbents. If she does not expect to get customers, she never enters.

In the remainder of the paper, we focus on the case  $\underline{q} > \pi \bar{q}$ ; in other words, the entrant C's reputation is sufficiently low that no entry ever occurs in the traditional world.<sup>28</sup> The discussion below clarifies that this inefficiency is rooted in the existence of fraudulent sellers in this market, and in traditional world the market relies on the seller's reputation, i.e., the probability of it being the authentic type, to mitigate the associated inefficiency. We shall show later that this problem can be fully resolved by smart contracts with blockchain technology.

**Remark: The Role of Reputation in Traditional World.** *In our setup, the incumbents enjoy the reputation of being authentic for sure, while the entrant has a lower reputation of being authentic only with probability  $\pi$ . To understand the role of reputation in our model, let us imagine a world with no distinction between incumbents and entrants, i.e., buyers perceive each seller to be authentic with probability  $\pi$ . Then, if  $\pi q_t^{(1)} < k$ , there is no transaction in equilibrium. Market breaks down even though a seller could be authentic; else if  $\pi q_t^{(1)} > k$ , there is always transaction but buyers sometimes choose a fraudulent seller. In either case, there is welfare loss and in the second case the buyer may incur a loss.*

*The above thought experiment highlights that the perfect reputation of incumbents in our model prevents market breakdown and the entry of new sellers with low reputation. Moreover, buyers would not pick a fraudulent type  $\pi q_C < \max\{q_A, q_B\}$ . That said, there is still room*

<sup>27</sup>Even so, C may not get a customer if the incumbents use predatory pricing. Note that when  $\pi \bar{q} < \underline{q}$ , no matter what  $\mathbf{q}$  is, C cannot enter even with penetration pricing because the maximum loss C can afford is less than  $\underline{q} - \pi \bar{q}$ .

<sup>28</sup>Together with  $\underline{q} > k$ , this case implies authenticity matters more than the dispersion in service quality: we would rather make an international transfer at reputable banks despite the differential customer service they have, than entrust the money to a random person on the street who is polite and offers to make the transfer for me.

for increase for welfare and consumer surplus, as we show later. In general, potentially authentic entrant still enters late (if at all): entry becomes a possibility only with sufficiently high entrant reputation  $\pi$ , and entry time  $\tau$  is increasing with reputation.

## Welfare and Consumer Surplus

With  $\underline{q} > \pi\bar{q}$ , C never enters. The expected future consumer (buyer) surplus and social welfare at any time  $s$  are, respectively,

$$\Pi_{buyer} = \mathbb{E}_s \left[ \sum_{t=s+1}^{\infty} \delta^{t-s} \mathbb{I}_t (\min\{q_{A_t}, q_{B_t}\} - k) \right] = \frac{\delta\lambda}{1-\delta} \mathbb{E} [\min\{q_A, q_B\} - k] \quad (1)$$

and

$$\Pi_{total} = \mathbb{E}_s \left[ \sum_{t=s+1}^{\infty} \delta^{t-s} \mathbb{I}_t \max\{q_{A_t}, q_{B_t}\} \right] = \frac{\delta\lambda}{1-\delta} \mathbb{E} [\max\{q_A, q_B\}]. \quad (2)$$

### 3.3 Collusive Equilibria

Besides the competitive equilibrium derived, there may exist collusive equilibria in this economy. Recall that sellers cannot make contingent contracts, and entrant cannot enter ( $\pi\bar{q} < k$ ); we thus examine potential tacit collusion among the incumbents.

We restrict each seller's strategies to the standard supergame strategies as discussed in, for example, Green and Porter (1984) and Friedman (1971). Specifically, consider the following strategy for A and B to collude. There are two phases:

1) *Collusion phase*: Every period, after the realization of types, A charges price  $q_A$  and B charges price  $q_B$ . A and B gets  $\mathbb{I}_t f(q_A, q_B)$  and  $f(q_B, q_A) = \mathbb{I}_t (1 - f(q_A, q_B))$  fractions of buyers, respectively. Here  $f(x, y) \in (0, 1)$  is the proposed anonymous allocation function, potentially as a function of realized types. For example, the sellers can split the total customers by setting quota on service to be delivered. This allocation function  $f$  includes the case where sellers always equally split buyers, and the case where buyers all go to the better seller.

2) *Punishment phase*: The punishment phase is triggered once one of the sellers does not have any buyers.<sup>29</sup> More specifically, the punishment phase can be triggered either by i) buyer not showing up this period or ii) one of the seller deviates by quoting a cheaper price to get all the buyers. Once triggered, A and B are engaged in Bertrand competition for a fixed  $T$  periods.

Recall that the sellers do not observe other sellers' price quotes, but observes their own customers. However, A and B's private signals are always correlated (i.e., observing either no

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<sup>29</sup>We could alternatively allow punishment to be triggered with some probability, which is similar to shortening the punishment phase. This does not affect our main results and is left out for exposition clarity.

customers or all customers), making this repeated game with private monitoring essentially a game with imperfect public monitoring. It is imperfect in the sense that punishment could be triggered even when no one deviates.<sup>30</sup>

A standard result in the literature of dynamic repeated games is that sustainable equilibria crucially depend on the discount factor  $\delta$ , with the Folk Theorem as the best-known example. We therefore proceed to find the lower bound of discount factor, denoted by  $\delta_{(T,f)}$ , above which an equilibrium with a specified  $T$  and  $f(x, y)$  exists.

**Lemma 3.2.** *A collusion strategy with  $(T, f)$  as described above is an equilibrium, if*

$$\frac{\lambda\delta(1-\delta^T)}{1-\lambda\delta-(1-\lambda)\delta^{T+1}} \geq \frac{M_3}{M_1-M_2} \quad (3)$$

where  $M_1 = E[f(q)(q-k)]$ ,  $M_2 = E[(q_i - q_{-i})^+]$ ,  $M_3 = \max_q\{(1-f(q))(q-k)\}$ ,  $f(q_i) = E_{q_{-i}}[f(q_i, q_{-i})]$ .

We note  $M_1$  is a seller's expected payoff in each stage game in the collusion phase,  $M_2$  is that in the punishment phase, and  $M_3$  is the maximum gain from deviating. To sustain a collusion, we basically need the incentive for one time deviation from collusion to be relatively small compared with the punishment going forward. Note that the LHS of (3) is increasing in  $\delta$  and in  $T$ . Therefore, there exists a  $\delta_{(T,f)}^{Traditional}$  above which the collusive equilibrium is sustained. Moreover,

**Proposition 3.3.** *The discount threshold  $\delta_o^{Traditional} \equiv \inf_f \frac{1}{\lambda} \frac{M_3}{M_1+M_3-M_2}$  is well-defined and positive. When  $\delta < \delta_o^{Traditional}$ , no collusion equilibrium exists for any  $(T, f)$ .*

With sufficiently small discount factor, no collusion can be sustained because sellers value future cost of punishment too lightly and prefer the one-time deviation gain in the current stage.

The welfare under  $(T, f)$  collusion is determined by  $f$ , and consumer surplus by both  $(T, f)$  and colluding price. One feature that stands out is that in the traditional world, the consumer surplus depends on the length of punishment period  $T$ . This is because buyers earn positive surplus only when the punishment phase is triggered due to absence of buyers in the economy (which occurs with probability  $1 - \lambda$  in each period).

Now consider a collusion where sellers charge a lower colluding price (less than  $q_i$ ), it easily follows that (3) is relaxed. Therefore if a collusive equilibrium extracting all rent in collusion phase is sustainable, an equilibrium with the safe  $(T, f)$  but lower colluding prices is also sustainable. This implies that equilibria with consumer surplus ranging from the competitive level and the  $(T, f)$  collusion level are all sustainable.

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<sup>30</sup>The equilibrium notion corresponding to the above strategies is thus akin to public perfect equilibrium.

## 4 World with Blockchain Disruption

The blockchain technology enables the consensus recording of success or failure of the service rendered. It does so by verifying and validating certain transactions, which, as we detail earlier, typically involves broadcasting or distributing information (potentially in encrypted and reduced form). Its algorithmic nature then enables certain transfers to be automated based on consensus, reducing enforcement costs. Blockchain and smart contracts thus drastically mitigate contract incompleteness.<sup>31</sup>

In the context of our model, the nature of blockchain and smart contracts has two implications: First, to the extent that contingent actions can be codified and automated, smart contracts can be written based on the decentralized consensus. Second, to reach decentralized consensus, some information has to be made observable to parties on the blockchain for validation or verification. For example, transaction amount is observable on Ripple network.

More concretely, in our model we assume that (1) there is consensus record on whether a particular service is successful between a seller and a buyer; (2) total amount of service activity is observable on the blockchain; (3) transfers contingent on consensus information can be arranged and automatically enforced among multiple parties that access the consensus information. For example, a bank can credibly offer a transfer between itself and a customer contingent on the service outcome. Two customers or two banks can arrange a credible transfer between them contingent on the number of customers serviced by all the banks. The list goes on.

The following assumption captures in reduced-form the functionality of blockchain and smart contracts, which is in sharp contrast to Assumption 1:

**Assumption 2.** *Blockchain enables decentralized consensus, and buyers and sellers can write smart contracts that are contingent on the service outcome associated with their own transaction. In order to reach decentralized consensus, aggregate service activities are publicly observable on blockchain.*

In the rest of this section, we will first demonstrate how blockchain and smart contracts can enhance entry and competition, then show the same technology can lead to greater collusive behavior.

### 4.1 Smart Contracts and Enhanced Entry

With blockchain, the entrant now can offer a price contingent on the success of service provision  $\mathbb{P} = (p^s, p^f)$ , where  $p^s$  and  $p^f$  are prices charged upon success and failure. An authentic entrant C can separate from his fraudulent peer by offering  $(p^s, -\epsilon)$ , where  $p^s > 0$

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<sup>31</sup>They still would not enable contracting on unforeseen contingencies, the third form of incompleteness in Tirole (1999).

and  $\epsilon$  is infinitesimal. The fraudulent type gains nothing from mimicking: he knows that he can never deliver the service and hence never receive the payment.

Let us first analyze the equilibrium without potential collusion. We have

**Proposition 4.1.** *With smart contracts, the entrant  $C$  enters almost surely, and first gets customers in period  $\tau = \min\{t \geq 0 | q_{C,t} \mathbb{I}_t \geq \max\{q_{A,t}, q_{B,t}\}\}$  or earlier.*

Smart contracts completely remove the reliance on sellers' reputation of being authentic, thus as long as the entrant's quality is higher than the incumbents, she can get customers. Thus she enters for sure.

In the world with blockchain and smart contracts, the expected future consumer surplus and total welfare at  $t = s$  under a competitive equilibrium are, respectively,

$$\Pi_{buyer} = \mathbb{E}_s \left[ \sum_{t=s+1}^{\infty} \delta^{t-s} \mathbb{I}_t (q^{(2)} - k) \right] = \frac{\delta \lambda}{1 - \delta} \mathbb{E} [q^{(2)} - k] \quad (4)$$

and

$$\Pi_{total} = \mathbb{E}_s \left[ \sum_{t=s+1}^{\infty} \delta^{t-s} \mathbb{I}_t q^{(1)} \right] = \frac{\delta \lambda}{1 - \delta} \mathbb{E} [q^{(1)}]. \quad (5)$$

Compared to (1) and (2), we see that with smart contracts that facilitates entry and hence enhance competition, the economy becomes more efficient. Both consumer surplus (linear in the second order statistic), and welfare (linear in first order statistic) improve. Therefore, we clearly see that smart contract can help improve consumer surplus and welfare. This welfare improvement due to enhanced entry is present in collusive equilibrium as well, as  $C$  always enters.

## 4.2 Enhanced Collusion under Permissioned Blockchain

While blockchain and smart contracts can improve both consumer surplus and welfare by encouraging entry and competition, they have a dark side and may result in dynamic equilibria with lower welfare or consumer surplus than in all the equilibria in the traditional world.

Specifically, we start by pointing out that smart contracts signed among sellers can allow greater collusive behavior compared to that feasible in the traditional world. We then move on to argue that, even without smart contracts among sellers, blockchain could still increase tacit collusion. This is because the information environment is different on blockchain. To the extent that information (even encrypted) has to be distributed for forming consensus, they can act as signals for coordination and detecting deviation, making the increase in tacit collusion (relative to the traditional world) irreducible.

To most clearly illustrate the collusion-enhancing effect of blockchain, we focus on permissioned blockchain for the incumbents which C cannot use to create smart contract to enter. Without the complicating factor of enhanced entry, collusive behavior becomes more sustainable.

#### 4.2.1 Collusion using Smart Contract

Before we move on to analyze how public information induced by decentralized consensus on blockchain may foster tacit collusions among sellers, it is immediate to see that the enlarged contingencies of smart contracts can be used among sellers as a device to facilitate their collusion. For example, the sellers can form a coalition and sign on to a smart contract, which essentially uses side payments contingent on the service outcome to punish deviation.

We illustrate this rather straightforward point through an example. Recall that Assumption 2 implies that the transaction information stored on the blockchain keeps the record of whether buyers show up, and if they show up, which sellers they chose. Although these detailed information might not be directly observable to the public (perhaps through encryption), sellers potentially can write and execute smart contract based on these contingencies.

Consider the following collusion with smart contract. All sellers collude to charge 1 dollar upon delivery, which effectively extract full rents from buyers. The sellers reach an agreement that they never serve all buyers (always leaving some strictly positive measure to other sellers); and if all the buyers go to seller  $i$ , which is a contractible contingency, then the smart contract automatically transfer all profit of seller  $i$  to other sellers. By imposing such automatic punishment upon deviation, the smart contract can potentially support any collusion, regardless of the discount factor.

#### 4.2.2 Tacit Collusion with Permissioned Blockchain

One may argue that explicit form of collusion using smart contracts is easy to detect and can be forbidden by anti-trust law. However, as we show next, even without explicit side payment through smart contracts, the blockchain improves publicly observable consensus, which also can facilitate greater collusion. This is the focus of our paper.<sup>32</sup>

This section considers a permissioned blockchain between the incumbents for which the entrant has no access. Consequently, authentic C cannot use smart contracts to attract any customer.

In this case, the collusion and punishment phases, as well as the allocation rule  $f$  are exactly the same as in the traditional world. The trigger for punishment phase, however, is

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<sup>32</sup>The fact that greater information may reduce competition is not new, see Dutta and Madhavan (1997) and Bloomfield and O'Hara (1999) for such discussions on information and dealer competition. What is novel is that decentralized consensus necessitates greater observability and information distribution.

different: instead of triggering it upon deviating or receiving no buyers, punishment in the world with blockchain can be further conditional on whether buyers show up (i.e. there is service activity on the blockchain). This is because the service outcome of each transaction is stored in the blockchain and gets decentralized consensus; though the information is usually encrypted, the mere fact of knowing transactions having taken place is useful information and can be used as a collusion device. In our model, knowing whether buyers show up allows the sellers to perfectly monitor deviation behavior by a colluding fellow.

Thanks to blockchain providing a consensus on whether buyers arrive in the period, the repeated game with imperfect public monitoring in the traditional world achieves perfect public monitoring as deviations can be accurately detected using blockchain.<sup>33</sup> And by targeting the punishment phase more accurately at true deviations, collusive equilibria become easier to sustain. Denote the threshold discount factor above which collusion is sustained with permissioned blockchain by  $\delta_{(T,f)}^{Blockchain2}$ , we have

**Proposition 4.2.** *Compare the thresholds above with the specified collusion strategy is an equilibrium. We have*

$$\delta_{(T,f)}^{Blockchain2} < \delta_{(T,f)}^{Traditional} \quad (6)$$

When the discount factor  $\delta \in [\delta_{(T,f)}^{Blockchain2}, \delta_{(T,f)}^{Traditional})$ , the consumer welfare under collusion with blockchain is lower than that under competitive market without blockchain. Furthermore, if  $f$  does not always allocate all customers to the better incumbent, welfare is also lower. In particular,

**Corollary 4.3.** *When  $\delta \in [\inf_f \{\delta_{(\infty,f)}^{Blockchain2}\}, \delta_o^{Traditional})$ , there cannot be collusion without blockchain, but there could be with blockchain.*

Importantly, for general  $\delta$ , any traditional collusion equilibrium with  $(T, f)$  has a corresponding sustainable blockchain collusion equilibrium with the same  $(T, f)$ , but the latter extracts greater rents for the sellers. We note that the sellers can always return the same rents to the buyers by lowering the colluding price, or activating punishment phase even when there is no buyers in the system at all. Hence if a dynamic equilibrium with a certain welfare and consumer surplus is sustainable in the traditional world, it is also sustainable with blockchain. Yet, as demonstrated earlier, there could be dynamic equilibria with additional welfare and consumer surplus outcomes sustained with blockchain.

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<sup>33</sup>With private monitoring with less correlated signals, to the extent that private signals are generated from a noisy signal of the true state of the world, having a consensus on the noisy signal increases private signals' correlation, which also makes the equilibrium more easily sustained (). This is beyond our current discussion but constitutes an interesting future work. For more discussion on private monitoring, see for example, Mailath and Morris (2002) and Hörner and Olszewski (2006).



### 4.3 Blockchain Disruption

While the permissioned blockchain does not facilitate entry, with public blockchain or a blockchain C can access, an authentic entrant can use smart contracts to separate from the fraudulent type (Section 4.1). Would the benefit of entry outweigh the cost of potential greater collusion? We now answer this question under the premise that there is a public blockchain that A, B, and C all have access to.

#### 4.3.1 Dynamic Equilibria with Public Blockchain

Recall that Section 4.1 has solved the competitive equilibrium. To characterize other collusive equilibria in this economy, consider the following collusion strategy:<sup>34</sup>

1) *Collusion phase*: Every period, after the realization of types, each seller  $i$  charges 1 dollar contingent on success. Let  $\hat{f}(q_i, q_j, q_k)$  be the fraction of the buyers that go to the seller with quality  $q_i$  where

2) *Punishment phase*: The punishment phase is triggered if one of the sellers does not have any buyers AND there are buyers showing up this period. In other words, the punishment phase is triggered only if there is some seller deviates. Once triggered, all sellers get involved in Bertrand competition for  $T$  periods.

Again, we discuss the conditions on the discount factor such that a collusion  $(T, \hat{f})$  can be sustained.

**Lemma 4.4.** *With blockchain and smart contract, the above strategy is an equilibrium if the parameters satisfies*

$$\frac{\delta\lambda(1-\delta^T)}{1-\delta} \geq \frac{\hat{M}_3}{\hat{M}_1 - \hat{M}_2} \quad (7)$$

where  $\hat{M}_1 = E[\hat{f}(q)(q-k)]$ ,  $\hat{M}_2 = E[(q_i - \max_{j \neq i} q_j)^+]$ ,  $\hat{M}_3 = \max_q \{(1 - \hat{f}(q))(q - k)\}$ .

The  $\hat{M}$ s have similar interpretations as in Lemma 3.2, but for three sellers instead of two. The LHS of equation 7 is also modified because with perfect public monitoring, the punishment is more accurately targeted.

#### 4.3.2 Welfare Effect of Blockchain Disruption

In a competitive equilibrium, blockchain improves welfare and consumer surplus. Is it possible that even with entry, blockchain reduces welfare and consumer surplus? The answer is largely “yes,” though the analysis needs extra care because with three sellers colluding,

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<sup>34</sup>Again it suffices to examine the collusive behaviors that allow the sellers full rent, any equilibrium with the same allocation but higher consumer surplus can be achieved by lowering the collusion price. Also, because the incumbents would not do better by colluding among themselves when C is competitive, than by colluding altogether with C, we only examine collusion of all three sellers — a more severe case of collusion.

the customer-splitting rule  $\hat{f}$  is necessarily different from  $f$  for the case of two incumbent sellers, making it inappropriate to directly compare thresholds  $\delta_{(T,f)}^{Traditional}$  and  $\delta_{(T,f)}^{Blockchain3}$ .<sup>35</sup> A series of formal results ensue.

**Proposition 4.5.** *The discount threshold  $\delta_o^{Blockchain3} \equiv \inf_{\hat{f}} \{\delta_{(\infty,\hat{f})}^{Blockchain3}\}$  is well-defined and satisfies  $\delta_o^{Blockchain3} < 1$ . For all  $\delta > \delta_o^{Blockchain3}$ , there exists a collusion equilibrium with blockchain such that the consumer surplus is lower than that in any equilibrium in the traditional world.*

This proposition gives a sufficient condition on the discount factor  $\delta$  so that even with entry, blockchain and smart contracts hurt consumers surplus.

**Proposition 4.6.** *For  $m \geq n \geq 2$ , if  $\lambda < \frac{n-1}{n}$ , then  $\delta_o^{Traditional,n} > \delta_o^{Blockchain,m}$ , where  $m$  and  $n$  indicate the number of colluding sellers with and without blockchain respectively. Consequently for all  $\delta \in [\delta_o^{Blockchain,m}, 1)$ , there is no collusion in the traditional world with  $n$  incumbents, while there can be collusion with blockchain with  $m$  sellers that reduces consumer surplus.*

This proposition highlights that the way blockchain disruption could potentially hurt the consumer surplus is through bringing in new entrant only to collude with those incumbents, whereas in the traditional world the incumbents cannot sustain any collusion.

**Theorem 4.7.** *The discount threshold  $\delta_a^{Blockchain3} \equiv \sup_f \{\delta_{(\infty,f)}^{Blockchain3}\}$  is well-defined and satisfies  $\delta_a^{Blockchain3} < 1$ . For all  $\delta > \delta_a^{Blockchain3}$ , any consumer surplus and welfare attainable in the traditional world can be attained with blockchain, and some additional equilibria with higher or lower consumer surplus or welfare can also be sustained.*

In this proposition, the subscript  $a$  in  $\delta_a^{Blockchain3}$  stands for “all”, indicating that if the discount factor is above  $\delta_a^{Blockchain3}$ , all collusion equilibria can be sustained. We hence obtain a general result that in terms of welfare and consumer surplus, the set of equilibrium outcomes with blockchain is a non-trivial superset of those in equilibria in the traditional world.

**Corollary 4.8.** *The most collusive equilibrium with blockchain, which generates the highest payoff to the sellers, improves social welfare but results in strictly lower consumer surplus, compared to any equilibrium outcome under the traditional world.*

Finally, this corollary implies that if the sellers can initially coordinate to pick their favorable equilibrium, welfare improves but buyers are worse off.

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<sup>35</sup>Blockchain3 indicates the public blockchain with all three sellers.

## 4.4 Measures to Reduce Collusion on Blockchain

There is a wide-spread concern that blockchains can jeopardize market competitiveness; this concern becomes especially acute for permissioned blockchains like R3 Corda whose members are powerful financial institutions. As put by a Financial Times article, “...the technology really facilitates is *cartel management* for groups that don’t trust each other but which still need to work together if they’re the value and stability of the markets they serve.”<sup>36</sup> Our paper highlights one particular economic mechanism through which blockchain hinders competition, and provides the rigorous analysis on why and how collusion could occur. We now explore regulatory and market solutions to curb collusive behaviors in our framework.

### Separation of Usage and Consensus Generation

In the model, the sellers can use the information on the blockchain to punish deviations from collusion in a more accurate way. They observe the information because the information is distributed and recorded on the blockchain during the process of consensus generation. From this perspective, one potential solution is to separate the players who help generate the decentralized consensus, from the users of that consensus. For example, if the sellers can only use the blockchain for signing smart contracts with buyers, then they no longer have access to the aggregate activity information that facilitates collusion.

### Blockchain Competition

Although we focus on the case of a single blockchain on which multiple sellers compete, in practice there are likely to be multiple blockchains which both sellers and buyers can choose. Suppose that sellers only participate a subset of blockchains in equilibrium; this can be justified by some fixed participation cost. Then the competition among blockchains seems to go against the collusive behaviors of sellers on one blockchain. It is because buyers can always pick the blockchain which offers the best price-adjusted service, which drives blockchains that are with a critical mass of sellers but are colluding out of market.

Of course, this discussion begs another question: Why it is more difficult for blockchains to collude, at least relative to sellers on the same blockchain? We believe it is indeed the case, as blockchains are decentralized with many players, and information is not shared across blockchains.

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<sup>36</sup>“Exposing the ‘If we call it a blockchain, perhaps it wont be deemed a cartel?’ tactic,” by Izabella Kaminska, Financial times, May 11th, 2015.

## Noise Injection

To prevent colluders' using the consensus on aggregate service activities on the blockchain to punish deviations from collusion in a more accurate way, regulators can pretend to be a seller that has customers to add noise to service activities. This reduces sellers' ability to use the information to sustain collusion.

In spirit, the added noise serves the role to make information disclosure less perfect, as in Dutta and Madhavan (1997) and Bloomfield and O'Hara (1999).

## 5 Information Asymmetry and Private Qualities

In our analysis so far,  $\mathbf{q}$  is publicly known, and many forms of smart contract can be used to solve the problem of inefficient entry (extensive margin of competition). This is obviously a strong assumption, without which the matching of consumers with incumbents could also be inefficient (intensive margin of competition). In this section we allow privately observed qualities. We characterize how smart contracts can help mitigate allocative inefficiency beyond entry, and derive the equilibrium form of smart contracts under market equilibrium.

### 5.1 Allocative Inefficiency in the Traditional World

Suppose that in addition to uncertainty on authenticity, quality  $q_i$  is also only privately known to seller  $i$ . Without smart contracts, the entrant would always claim it is authentic and has high quality (cheap talk), and incumbents cannot separate themselves either because both A and B can claim that it is of higher quality. Following the same logic before, the entrant does not enter because its perceived quality  $\pi\mathbb{E}[q_c]$  is below the incumbents' perceived quality  $\mathbb{E}[q_c]$ . In a competitive equilibrium among the incumbents, we have

**Lemma 5.1.** *In the traditional world, sellers post the same price  $p_i = k$ , and each buyer select (randomly) one of them. The expected buyer's surplus and social welfare per period is  $\mathbb{E}[q] - k$ .*

Lemma 5.1 shows that there is no separating equilibrium in this economy. The reason is simple. When payment cannot be made contingent on the whether the transaction succeeds or not, there is no cost of misreporting: seller can always misreport to get the highest (expected) upfront payment.

In the traditional world without smart contract, there are both welfare loss and market breakdown. In the case where  $k \leq \mathbb{E}[q]$ , there is social welfare loss since the transaction is implemented by a randomly selected seller instead of the highest type. With two incumbents, the consumer surplus is higher than the case with publicly-known  $\mathbf{q}$ , however, with more sellers, the mean is lower than the second order statistics and consumer surplus is lower

than the case with publicly-known  $\mathbf{q}$ . Therefore in general, information asymmetry on seller qualities leads to lower welfare and consumer surplus.

## 5.2 World with Blockchain and Equilibrium Smart Contracts

Smart contracts enlarge the space of price quotes sellers can use. In general, sellers can offer  $\mathbb{P} = (p^s, p^f)$ , and type  $q$  upon getting customers earns  $S_q(\mathbb{P}) = qp^s + (1 - q)p^f - k$  from each buyer who in return gets a utility  $B_q(\mathbb{P}) = q(1 - p^s) + (1 - q)(-p^f)$ , where  $1 - p^s$  is the unit utility from successful service lest the payment.

Sellers' flexibility in offering contingent prices implies that buyers' choice generally depends on their beliefs regarding the smart contracts that each seller type submits in equilibrium, making smart contract offering a signaling game.<sup>37</sup> We further impose that  $p^f \leq p^s$  so that  $\mathbb{P}$  is higher upon success, a standard assumption in the security design literature (see, e.g., Innes (1990), Hart and Moore (1995), and DeMarzo and Duffie (1999)).

Sellers may offer a large variety of smart contracts. We show that only one particular class of contracts emerges in equilibrium, which is further characterized by the following proposition.

**Proposition 5.2.** *There is a unique competitive equilibrium for the stage game, and sellers offer smart contracts of the form  $\mathbb{P}^* = (p, p - 1)$ . A seller of quality  $q$  offers  $(p_q, p_q - 1)$ , where*

$$p_q = 1 - q + k + \int_q^q \left[ \frac{\Phi(q')}{\Phi(q)} \right]^2 dq' \quad (8)$$

*which is decreasing in  $q$ . Buyers all go to the highest-quality seller.*

Recall that  $\Phi$  is the cdf of  $q$ . We note that such a contract means buyers get utility  $1 - p$  regardless of the service outcome. The conclusion mirrors the well-known result in the literature of security design that the sellers would offer the least information-sensitive security (“flattest” security in the language of security-bid auctions, e.g. DeMarzo, Kremer, and Skrzypacz (2005)).<sup>38</sup>

In a competitive equilibrium, we essentially have a cash auction in which a bidder with quality  $q$  has a private valuation of his/her service opportunity  $q - k$ , and bids  $p$ . In equilibrium, buyers choose the highest quality seller, who gets the second highest valuation

<sup>37</sup>Under a market mechanism where buyers shop sellers and choose the most favorable one, our setup has a natural reinterpretation under informal first-price auctions with security bids. See, for example, DeMarzo, Kremer, and Skrzypacz (2005) and Cong (2016).

<sup>38</sup>We further remark that the result is robust to a payment rule that depends on all price quotes (not only the winning seller's). To see this, any combinations of the smart contract bids are still in the same contract class whose convex hull is itself. Therefore the proof still applies. This implies no matter the sellers quote final prices (first-price auction) or gradually out-compete other sellers (English auction) or choose a third-price auction, sellers always use quality-insensitive contracts.

$\mathbb{E}[q^{(2)} - k]$  in each period the buyers arrive.<sup>39</sup> Notice that the economic outcomes are exactly the same as in the case where  $\mathbf{q}$  is public ((4) and (5)). Therefore we have,

**Corollary 5.3.** *Smart contracts fully resolve informational asymmetry in a competitive equilibrium, and welfare and consumer surplus are independent of whether seller qualities are private or not.*

### Collusion with Private Qualities

Fully characterizing the optimal collusions (full rent extraction in collusive stage games) is in general complicated and beyond the current discussion.<sup>40</sup> However, we can describe several large classes of equilibria. Unlike the case with publicly-known qualities where a collusion can maximize welfare yet fully extract rents, now there is a fundamental tension between allocative efficiency (increasing the total surplus) versus full rent extraction (how to split the total surplus).

To achieve full rent extraction, each type must be offering  $\mathbb{P} = (1, 0)$  in equilibrium. However, buyers would not be able to tell apart sellers' qualities, and therefore sellers gets  $\mathbb{E}[q] - k$  in each stage game.

To achieve allocative efficiency, the equilibrium has to be separating and  $q > \underline{q}$  gets positive rent. Therefore, any collusive equilibrium can be indexed by the payoff of  $\underline{q}$ , which is the markup each type adds to a competitive offer. The same argument for the unique equilibrium and smart contract form  $\mathbb{P} = (p, p - 1)$  also applies here, resulting in an equilibrium price offered by type  $q$  given by

$$p_q = m + 1 - q + k + \int_{\underline{q}}^q \left[ \frac{\Phi(q')}{\Phi(q)} \right]^2 dq' \quad (9)$$

where  $m$  is the markup subject to  $p_q \leq 1$  for all  $q$ . Given that the expression is decreasing in  $q$ , we only need to require  $m \leq \underline{q} - k - \int_{\underline{q}}^{\underline{q}} \left[ \frac{\Phi(q')}{\Phi(q)} \right]^2 dq'$ . As such, the buyers payoffs are positive.

The optimal collusion likely entails partial pooling, for example we can optimize the markup, allowing some types to be excluded from getting customers. However, for the part that is separating, the contract form remains.

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<sup>39</sup>We have used the revenue equivalence result between first-price and English auctions with independent private valuations.

<sup>40</sup>See, for example, Athey and Bagwell (2001).

## 6 Conclusion

In this paper we argue that decentralized ledger technologies such as blockchains feature decentralized consensus as well as low-cost, tamper proof algorithmic executions, and consequently enlarge the contracting space and facilitate the creation of smart contracts. However, the process of reaching decentralized consensus changes the information environment on blockchain.

We analyze how this fundamental tension can reshape industry organization and the landscape of competition; it can deliver higher social welfare and consumer surplus through enhanced entry and competition, yet may also lead to greater collusion. In general, blockchain and smart contracts can sustain market equilibria with a larger range of economic outcomes. We discuss regulatory and market solutions to further improve consumer surplus, such as injecting noise into certain consensus record and mandating the use of optimally designed smart contracts.

To focus on the impact of blockchain and smart contracts on the financial sector and the real economy, we have abstracted away from the underlying mechanics that allow blockchain to produce decentralized consensus. That said, we do highlight that any consensus-generating process requires distributing information. With this in mind, designing a robust consensus protocol and providing the right incentives for maintaining consensus constitute interesting future studies, which likely requires the joint effort of computer scientists and economists.

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## Appendix: Derivations and Proofs

### Proof of Proposition 3.1

*Proof.* In a competitive equilibrium, the sellers lower price until their competitors quit. If  $\pi q_C < \max\{q_A, q_B\}$ , at least one of the incumbents always competes to lower the price to  $k$  to get the customer this period and prevent the enhanced future competition they face had C entered in this period. Without a reputation of being authentic, C only stands a chance of getting a customer if buyers show up and  $\pi q_C \geq \max\{q_A, q_B\}$ .

Because C does not have a capacity to bear loss at the point of entry, C cannot charge a penetration price below production cost  $k$  and gets customers when  $\pi q_{C,t} \mathbb{1}_t < \max\{q_{A,t}, q_{B,t}\}$ . Even when  $\pi q_{C,t} \mathbb{1}_t \geq \max\{q_{A,t}, q_{B,t}\}$ , C may not be able to enter if the incumbents have deep pocket to do predatory pricing.  $\square$

### Proof of Proposition 3.2

*Proof.* Let  $V^+(q_i, q_{-i})$  be the present value of payoff to a seller with realized quality  $q_i$  in the collusion phase. In the collusion phase, buyers are indifferent between different sellers.

Let  $V^-$  be the present value of payoff to a seller before the realization of type in the first period of punishment phase. According to the collusion strategy, the continuation values satisfy:

$$V^+(q_i, q_{-i}) = \lambda(f(q_i, q_{-i})(q_i - k) + \delta V^+) + (1 - \lambda)\delta V^- \quad (10)$$

$$V^- = \lambda E[(q_i - \max_{j \neq i} q_j)^+] \frac{1 - \delta^T}{1 - \delta} + \delta^T V^+ \quad (11)$$

For the strategy to be an equilibrium, we need to verify, by one-shot deviation principal, that a seller does not have incentive to unilaterally deviate. This is obvious in the punishment phase, since it is Bertrand equilibrium. In the collusion phase, to prevent deviation, we need

$$\forall q, V^+(q) \geq \lambda((q - k) + \delta V^-) + (1 - \lambda)\delta V^- \quad (12)$$

Denote  $V^+(q_i) = E_{q_{-i}}[V^+(q_i, q_{-i})]$ ,  $f(q_i) = E_{q_{-i}}[f(q_i, q_{-i})]$ . Integrate (10), we have

$$V^+(q) = \lambda(f(q)(q - k) + \delta V^+) + (1 - \lambda)\delta V^- \quad (13)$$

$$V^+ = \lambda(E[f(q)(q - k)] + \delta V^+) + (1 - \lambda)\delta V^- \quad (14)$$

With (12) -(14), we have

$$\delta(V^+ - V^-) \geq (1 - f(q))(q - k), \forall q \in [\underline{q}, \bar{q}] \quad (15)$$

From (14) (11), we solve for  $(V^+ - V^-)$ , plug into the above equation, and get the range of discount factor to support the collusion strategy as an equilibrium:

$$\delta \lambda \frac{(1 - \delta^T)(M_1 - M_2)}{1 - \lambda \delta - (1 - \lambda)\delta^{T+1}} \geq M_3 \quad (16)$$

where  $M_1 = E[f(q)(q - k)]$ ,  $M_2 = E[(q_i - \max_{j \neq i} q_j)^+]$ ,  $M_3 = \max_q \{(1 - f(q))(q - k)\}$ .  $\square$

### Proof of Proposition 3.3

*Proof.* Since  $M_1$  is the expected stage game collusion rent to a seller, and  $M_2$  is her payoff in a competitive stage-game equilibrium, we have  $M_1 > M_2$ . Moreover,  $M_1 + M_3 > \mathbb{E}[q] - k$ , thus  $\frac{1}{\lambda} \frac{M_3}{M_1 + M_3 - M_2} > \frac{1}{\lambda} \frac{\mathbb{E}[q] - k - M_1}{\mathbb{E}[q] - k - M_2} > 0$ . By the least-upper-bound property (and its implied greatest-lower-bound property) holds, the infimum exists.  $\square$

### Proof of Proposition 4.1

*Proof.* Since the payment can be contingent on completion of service, the authentic type can be separated out from fraudulent type by the following smart contract: the buyer pays the seller  $p^s$  conditional on the

success of service, otherwise pays zero (or an infinitesimally small negative amount). The fraudulent type can ill-afford imitating the good type, since they cannot complete the service and get the payment anyway. So she does not enter and never gets any customer. For the authentic entrant to get buyers (if present), if  $q_C \geq \max\{q_A, q_B\}$ , he can charge payment  $p^s = \frac{k+(q_C-\max\{q_A, q_B\})}{q_C}$  contingent on completion of service, and  $-\epsilon$  upon failure, where  $\epsilon$  is infinitesimal just to break the fraudulent type's indifference (alternatively we can assume a tiny cost for offering the contract and the fraudulent type would not bother to offer since she gets no customer anyway).

Given the smart contract allows authentic C to costlessly separate. A, B, and C are basically competing based on  $\mathbf{q}$ . Any predatory behaviors would only incur losses for the current period without improving future continuation value as future  $\mathbf{q}$  is i.i.d.. Therefore there would not be any predatory (or penetration) pricing.

Finally for collusive equilibria, if A and B collude, they must be charging a weakly higher price, which enables C to first get customer earlier.

□

## Proof of Proposition 4.2 and Corollary 4.3

*Proof.* It is easy to derive,

$$V^+(q_i, q_{-i}) = \lambda(f(q_i, q_{-i})(q_i - k) + \delta V^+) + (1 - \lambda)\delta V^+ \quad (17)$$

$$V^+ = \lambda(E[f(q)(q - k)] + \delta V^+) + (1 - \lambda)\delta V^+ \quad (18)$$

$$V^- = \lambda E[(q_i - q_{-i})^+] \frac{1 - \delta^T}{1 - \delta} + \delta^T V^+ \quad (19)$$

$$\forall q, V^+(q) \geq \lambda((q - k) + \delta V^-) + (1 - \lambda)\delta V^+ \quad (20)$$

The collusion can be supported if

$$\frac{\delta \lambda (M_1 - M_2) (1 - \delta^T)}{1 - \delta} \geq M_3 \quad (21)$$

where  $M_1 = E[f(q)(q - k)]$ ,  $M_2 = E[(q_i - q_{-i})^+]$ ,  $M_3 = \max_q \{(1 - f(q))(q - k)\}$

Compared to tacit collusion without blockchain, the only difference in the above recursive equations is that the punishment phase is not triggered if the buyers do not show up, i.e., the corresponding part of the continuation value is  $(1 - \lambda)\delta V^+$  instead of  $(1 - \lambda)\delta V^-$ .

We show that whenever (3) is satisfied, so is (21).

This is equivalent to

$$1 - \lambda\delta - (1 - \lambda)\delta^{T+1} > 1 - \delta \quad (22)$$

which is equivalent to

$$\delta(1 - \delta^T)(1 - \lambda) > 0 \quad (23)$$

Now for the corollary, note that there cannot be collusion when  $\delta < \delta_o^{Traditional}$  is proven in Proposition 3.3.

To show there could be when  $\delta \geq \inf_f \{\delta_{(\infty, f)}^{Blockchain2}\}$ , we note again by the least upper bound property,  $\inf_f \{\delta_{(\infty, f)}^{Blockchain2}\}$  is well-defined and positive. To show one collusion equilibrium exists, we only need to

search within the class of  $f$  such that  $f(q)$  is continuous function, i.e.  $f \in \mathcal{C}([0, 1])$ . Because  $\mathcal{C}([0, 1])$  is a locally convex Hausdorff space that is complete, there exists a sequence of allocation functions that gets infinitely close to the infimum. This means for any  $\delta \geq \delta_o^{Blockchain2}$ , we can find a  $(T, f)$  that can be sustained. This holds true for our later discussions on infimum and supremum as well.  $\square$

## Proof of Lemma 4.4

*Proof.*

$$V^+(q_i, q_{-i}) = \lambda(\hat{f}(q_i, q_{-i})(q_i - k) + \delta V^+) + (1 - \lambda)\delta V^+ \quad (24)$$

$$V^+ = \lambda(E[\hat{f}(q)(q - k)] + \delta V^+) + (1 - \lambda)\delta V^+ \quad (25)$$

$$V^- = \lambda E[(q_i - \max_{j \neq i} q_j)^+] \frac{1 - \delta^T}{1 - \delta} + \delta^T V^+ \quad (26)$$

$$\forall q, V^+(q) \geq \lambda((q - k) + \delta V^-) + (1 - \lambda)\delta V^+ \quad (27)$$

$$\text{Note } V^+ - V^- = \frac{\lambda(\hat{M}_1 - \hat{M}_2)(1 - \delta^T)}{1 - \delta}. \quad \square$$

## Proof of Proposition 4.5

*Proof.* We note  $\hat{M}_2$  is simply the payoff to a seller in a competitive stage game, and is almost surely less than  $M_1$  which is the expected stage game payoff under collusion. Therefore,  $\inf_{\hat{f}} \{\delta_{(\infty, \hat{f})}^{Blockchain3}\} = \inf_{\hat{f}} \frac{\hat{M}_3}{\hat{M}_3 + \lambda(\hat{M}_1 - \hat{M}_2)}$ . But  $\frac{\hat{M}_3}{\hat{M}_3 + \lambda(\hat{M}_1 - \hat{M}_2)} \in (0, 1)$  for all  $\hat{f}$ . Again, by the greatest-lower bound property of real-numbered set, the threshold is well-defined and smaller than 1.

When  $\delta > \delta_o^{Blockchain3}$ , the blockchain can support at least one collusion that fully extracts consumer surplus (with no punishment phase on equilibrium path). This is so because, again, there is a sequence of allocation function  $\hat{f}$  within in the complete function space  $\mathcal{C}[0, 1]$  that arbitrarily approaches the infimum. Without blockchain, consumer surplus is never zero as competitive stage game is always on equilibrium path (even with collusion, there has to be punishment on equilibrium path), thus consumer surplus is always positive. The conclusion follows.  $\square$

## Proof of Proposition 4.6

*Proof.* For  $m > 2$  in general, the previous proposition's proof still applies and  $\delta_o^{Blockchain, m} < 1$ . For  $n \geq 2$ , when  $\lambda < \frac{n-1}{n}$ , we have  $\frac{1}{\lambda} \frac{M_3}{M_1 + M_3 - M_2} > \frac{1}{\lambda} \frac{\mathbb{E}[q] - k - M_1}{\mathbb{E}[q] - k - M_2} > \frac{1}{\lambda} \frac{\mathbb{E}[q] - k - \frac{1}{n}(\mathbb{E}[q] - k)}{\mathbb{E}[q] - k} > 1$ . Therefore there cannot be collusion with  $n \geq 2$  in the traditional world. The proposition follows.  $\square$

## Proof of Theorem 4.7 and Corollary 4.8

*Proof.* Again,  $\frac{\hat{M}_3}{\hat{M}_3 + \lambda(\hat{M}_1 - \hat{M}_2)} \in (0, 1)$  for all  $\hat{f}$ . Therefore by the least upper bound property,  $\sup_{\hat{f}} \{\delta_{(\infty, \hat{f})}^{Blockchain3}\}$  exists and is less than 1. When  $\delta > \sup_{\hat{f}} \{\delta_{(\infty, \hat{f})}^{Blockchain3}\}$ , any  $(\infty, \hat{f})$  can be sustained, including the one allocating buyers to the highest quality seller and the one allocating to the lowest-quality seller. Note that for any realization of seller qualities, the best-quality (worst-quality) seller with blockchain is better (worse) than the best-quality (worst-quality) incumbent, we could attain higher or lower welfare. Moreover, since competitive stage game is always on equilibrium path without blockchain, consumer surplus is positive. With blockchain we can extract full rent, so lower consumer surplus is attainable. Moreover, by introducing some

punishing on equilibrium path or lowering collusion price under blockchain, consumer surplus can be increased all the way to be higher than that in the traditional world (for example, under perfect competition). Thus consumer surplus thus can be higher too with blockchain.

Note for the corollary, the most collusive equilibria maximizes welfare but sellers fully extracts that. This equilibrium can be sustained and the results follows.  $\square$

## Proof of Lemma 5.1

*Proof.* The information asymmetry here is that the buyer does not know a seller's type. Therefore the buyer makes his decision based on his perception of the type  $\hat{q}_i$  and the price charged  $p_i$ . To be specific, the buyer maximizes his payoff by choosing the seller who can deliver the highest expected utility:

$$\max_i \hat{q}_i - p_i \tag{28}$$

If the payoff by choosing any seller is negative, the buyer will step out of the market.

Suppose there is a separating equilibrium where the pricing schedule is  $p(q)$  and the probability for a seller with type  $q$  to be chosen is  $f(q)$ . For a seller with type  $q$ , he can pretend to be type  $\tilde{q}$  by posting the price  $p(\tilde{q})$ . The seller's expected payoff by doing so is

$$f(\tilde{q})(p(\tilde{q}) - k) \tag{29}$$

Every seller will choose the same  $\tilde{q}$  to maximize (29), which does not depend on  $q$ . Therefore, the separating equilibrium does not exist.

Since there is no separating equilibrium, we consider the pooling equilibrium. Without a reputation system, the buyer's perception of each seller's type is the mean  $\mathbb{E}[q]$ .

This is similar to Bertrand competition. Suppose the lower price of the two firms is higher than  $k$ , say,  $p_1 > k$ . Consider the deviation for the second firm to the price  $p_2 = p_1 - \epsilon > k$ , which increases the profit of the second firm. Therefore, in equilibrium, we must have  $p_1 = p_2 = k$ . Since we always assume the buyer's decision rule is non-discriminating, the tie is broken randomly. Therefore the ex-ante consumer surplus and social welfare is  $\mathbb{E}[q_i u - k]$ , where the expectation is taken over the realization of  $q_i$ , which yields  $\mathbb{E}[q] - k$ . As a remark outside our parameter assumption, if the cost is so high that  $k > \mathbb{E}[q]$ , the ex-ante utility for buyer is negative, then the buyer will stay out of the market, i.e., the market breaks down.  $\square$

## Proof of Proposition 5.2

*Proof.* We first show that using  $\mathbb{P}^*$  is an equilibrium. We then prove that no other equilibrium exists. The proof resembles the argument in DeMarzo, Kremer, and Skrzypacz (2005) on how the flattest securities are always used in an equilibrium of informal auctions with security bids. However, because the sellers can always offer quality-insensitive smart contracts, we do not need to worry about equilibrium refinement. Readers who are familiar with DeMarzo, Kremer, and Skrzypacz (2005) should skip the detailed proof below.

With  $\mathbb{P}^*$ , buyers get utility  $1 - p$  regardless of the service outcome; in other words, the smart contract is quality-insensitive. Conversely, any quality-insensitive smart contract has to be of the form  $\mathbb{P}^*$ . Given that the buyer taking an offer  $(p, p - 1)$  gets  $1 - p$  utility, the setup is equivalent to a first-price auction where the buyers are the auctioneers who allocates business opportunity, and sellers are bidders who bid cash  $1 - p$ . The buyers go to the seller with the lowest  $p$ . We already know from the auction literature that a

unique symmetric equilibrium with cash bids exists. Therefore, there is a unique equilibrium when restricting smart contracts to  $\mathbb{P}^*$ , implying that there is no profitable deviation using quality-insensitive contracts. The equilibrium offer of type  $q$  follows the solution of symmetric equilibrium of first price auctions (Krishna (2009)), and is given by  $p_q$  that solves

$$1 - p_q = \mathbb{E}[q^{(1),N-1} - k | q^{(1),N-1} < q] = q - k - \int_{\underline{q}}^q \left[ \frac{\Phi(q')}{\Phi(q)} \right]^{N-1} dq' \quad (30)$$

where  $q^{(1),N-1}$  is the highest realized quality among other  $N - 1$  sellers. We note the expression is increasing in  $q$ , thus buyers all choose the highest-quality seller. Substituting in  $N = 3$  gives the expression in the proposition.

Now suppose this equilibrium breaks down when we allow for smart contracts beyond  $\mathbb{P}^*$ , then there must be a profitable deviation by a type  $q$  to a quality-sensitive smart contract  $\mathbb{P}_q$  such that  $Pr(B(\mathbb{P}_q))S_q(\mathbb{P}_q) > Pr(B_q(\mathbb{P}_q^*))S_q(\mathbb{P}_q^*)$ , where  $Pr(B)$  is the probability of getting customers when buyers believe that they can get utility  $B$ , and  $B(\mathbb{P}_q)$  is the buyers' perceived value of the deviation contract. Denote the set of types that find it profitable to deviate to  $\mathbb{P}_q$  by  $Q$ , then  $B(\mathbb{P}_q) \in B(\mathbb{P}_q(Q))$ . Therefore,  $\exists q' \in Q$  (possibly  $q$ ) such that  $q' - S_{q'}(\mathbb{P}_q) = B(\mathbb{P}_q(q')) > B(\mathbb{P}_q)$ . Consider the deviation by type  $q'$  to  $(p', p' - 1)$ , where  $p' = 1 - q' + S_{q'}(\mathbb{P}_q)$ . Then the probability of winning is higher than  $q'$  deviating to use  $\mathbb{P}_q$ , and the payoff conditional on getting customers are both  $S_{q'}(\mathbb{P}_q)$ , implying that if it is profitable for  $q'$  to deviate to  $\mathbb{P}_q$  (which is true since  $q' \in Q$ ), it is also profitable for  $q'$  to deviate to a quality-insensitive contract  $(p', p' - 1)$ . However this contradicts the fact that there is no profitable deviation using quality-insensitive contracts. Therefore we conclude that the equilibrium described in the previous paragraph is an equilibrium even when we allow general smart contract forms.

Next, we show that the above equilibrium is essentially unique for the game, i.e., all other symmetric equilibria have the same payoffs.

We first argue that if a smart contract  $\mathbb{P}$  is offered in an equilibrium and is quality-sensitive, then at most one type uses it. Suppose otherwise and more than one types use it. Let the lowest and highest types offering the smart contract be  $q_L$  and  $q_H$ , then  $B(\mathbb{P}) = B_{q^*}(\mathbb{P}_{q^*})$  for some  $q^* \in (q_L, q_H)$ . However,  $\mathbb{P}$  is increasing in quality because  $p^s > p^f$ ,  $q_L$  would find it profitable to deviate to offering  $(p, p - 1)$  where  $p = 1 - B(\mathbb{P})$ , contradicting that in equilibrium both  $q_L$  offers  $\mathbb{P}$ . Therefore, at most one type uses  $\mathbb{P}$ .

Let the type be  $q$ , then  $B(\mathbb{P}_q) = B_q(\mathbb{P}_q)$ . This implies the allocation and payoffs are unaltered if type  $q$  replaces the offer by  $(p_q, p_q - 1)$  where  $p_q = 1 - B(\mathbb{P}_q)$ . This is so because,  $S_q(\mathbb{P}_q) = q - B_q(\mathbb{P}_q) = q - (1 - p_q)$ .

Because each type  $q$  is solving the same optimization problem as in the case where we restrict to  $\mathbb{P}^*$ , we have shown that any unrestricted equilibrium are payoff equivalent to the unique and monotone equilibrium with restriction of smart contracts to  $\mathbb{P}^*$ .

Finally, the smart contract  $(p_q^s, p_q^f)$  used by type  $q$  in such an essentially unique equilibrium gives type  $q$  the same value as  $(p_q, p_q - 1)$ , i.e.  $qp_q^s + (1 - q)p_q^f = qp_q + (1 - q)p_q$ . Because in the equilibrium with  $\mathbb{P}^*$ , a seller's expected payoff is differentiable  $q$  for all  $q$ , by a standard envelope argument, taking derivatives in the unrestricted equilibrium yields  $p_q^s - p_q^f = 0$ . From this we conclude that all possible equilibria are payoff equivalent to the unique equilibrium when restricting smart contracts to  $\mathbb{P}^*$ , and the smart contracts used are also in  $\mathbb{P}^*$ . This basically means that no equilibrium exists other than the one described in the second paragraph of the proof. □