

**INTERIOR QUALITY EQUILIBRIUM
AND THE EFFECT OF A GOVERNMENT SUBSIDY**

by

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Abstract

I examine the existence of a subgame perfect equilibrium in a duopoly where the products are differentiated in quality, and derive the conditions under which an interior solution for the optimal qualities is obtained. The effect of government subsidy is investigated. I find that, in equilibrium, the subsidization of the high quality good may cause the quality of both products to fall, while subsidization of the low quality good unambiguously improves the quality of both products. If both products are subsidized, the effect is ambiguous.

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