

Topics in Microeconomics

INDUSTRIAL
ORGANIZATION,
AUCTIONS,
AND
INCENTIVES



ELMAR WOLFSTETTER

TOPICS IN MICROECONOMICS

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AND INCENTIVES**

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Preface

Purpose

The book is designed as a main textbook in *advanced undergraduate* courses on *microeconomics*, *information economics*, and *industrial organization* or as a supplementary textbook in the first-year *graduate course* on *microeconomic theory*.

The book distinguishes itself from other textbooks in that it focuses on an in-depth treatment of a few core topics, rather than on a complete self-contained overview of the entire field of microeconomics.

Another distinct feature is that the book breaks with tradition and completely ignores the standard competitive analysis, and instead focuses on the more modern themes of imperfect competition, uncertainty and incomplete information, auctions, and incentives.

Prerequisites

The core sections of the book should be accessible to students with a working knowledge of intermediate microeconomics. Mathematical prerequisites are at an introductory/intermediate level, though openness towards mathematical thinking is essential. Given these prerequisites, a good part of the book should be well suited as a main textbook in advanced microeconomics, industrial organization, or information economics.

In an advanced *undergraduate* class one would make a selection from the core material and stay away from supplementary and more demanding topics marked “*”. The variety of issues leaves the instructor with a wide range of choices. Of course, in a *graduate* class one should include the starred sections, which are a substantial part of the book, depending upon the instructor’s interests in the selection of topics.

By making different selections, the book can be used as textbook in *microeconomics* or in courses with an emphasis on *industrial organization*, *information economics*, *applications of game theory*, or *auctions and incentives*. THE book is also of potential interest to students and researchers who want to study certain topics independently, as an introduction to their research.

Outline of the Book

Chapter 1 (Monopoly) is ideally suited for the first sessions of the micro sequence because it starts with intermediate-level material that can be skimmed through quickly, and then gradually turns to more advanced topics and methods such as a simple version of the incomplete-information theory of price discrimination, the durable-goods monopoly problem, and bargaining. I usually start out the micro sequence with this material because students find it accessible from their undergraduate background and appealing to economic common sense.

Chapter 2 (Regulation of Monopoly) is a more specialized topic that one would not necessarily treat in the micro sequence. However, the sections on normative theories of regulation should be considered for inclusion because they offer a nice and simple introduction to the modern mechanism design approach.

Chapter 3 (Oligopoly and Industrial Organization) contains some core micro sequence material plus a great deal of supplementary material for use in a specialized course on industrial organization. In the micro sequence I use only the first two sections plus Section 3.5. However, in a course that emphasizes industrial organization one would cover also cover in detail Sections 3.3 and 3.6.

Chapters 4, 5, and 6 (Risk, Stochastic Dominance, and Risk Aversion) introduce basic concepts and results of stochastic dominance rankings of probability distributions and present the theory of comparative statics of risk. This material is useful in many decision problems under uncertainty, though some of details may be too involved for a standard micro sequence.

The exposition of the basic theory is followed by a sample of fully worked-out applications of the comparative statics of risk, drawn from various areas in economics – from portfolio selection to labor supply, entry in oligopolistic markets, auctions, and the ranking of income distributions.

In the micro sequence I usually go over most of Chapter 4, then select two or three applications from Chapter 5, and cover the core sections (without “*”) of Chapter 6. In a course on information economics, I cover Chapter 6 in full detail.

Chapter 7 (Matching: The Marriage Problem) opens the detailed coverage of incomplete information. The topic is two-sided matching of the members of two distinct groups, and the focus is on marriage.

In a standard micro sequence one will probably not use this material, and some people may find its inclusion a bit extravagant. However, in my own teaching I tend to use this brief chapter as “warm-up” material, ideally after a semester break. The topic is somewhat entertaining, and although the exposition is not loaded with technicalities, it has rigor and beauty.

Chapter 8 (Auctions) gives a comprehensive introduction to auction theory and surveys a great deal of the auction literature.¹ Auctions are increasingly important

¹ This chapter is an extended version of my survey, Wolfstetter (1996).

as a market mechanism, and auction theory is an ideal topic to exercise many of the tools and tricks of modern economic theory. This is why I strongly recommend it for inclusion in the micro sequence.

Many of the competing texts do not cover auctions at all or in sufficient detail. Of course, in the micro sequence one should not cover the entire chapter. One should use Sections 8.1–8.4 and 8.6, and leave the other material for a more specialized course.

Chapter 9 (Hidden Information and Averse Selection) surveys adverse-selection models and elaborates some standard applications, from insurance to labor, credit, price discrimination, and education. Most of the material is at a fairly elementary level, except the analysis of price discrimination. The latter generalizes the two-type model of hidden information and second-degree price discrimination in Chapter 1 to a continuum of types.

In the micro sequence I usually go quickly over the basic material, and then spend time exercising more advanced techniques using the example of price discrimination with a continuum of customer types.

Chapter 10 (Hidden Information and Signaling) surveys signaling models, using the famous education game, shows how signaling games are plagued by multiplicity-of-equilibria problems, and evaluates various proposed equilibrium refinements. Again, in the micro sequence I cover all core sections of this chapter.

Chapter 11 (Hidden Action and Moral Hazard) gives an introduction to the principal–agent problem and its various ramifications. Two basic models are distinguished: the *risk-vs.-incentives* model and the *limited-liability* model. The simplicity of the latter makes it a good framework for the analysis of the interrelationship between optimal contracts and optimal monitoring. Attention is also paid to the renegotiation problem and possible solutions to the disturbing lack of renegotiation-proofness of standard optimal contracts.

Nowadays, most micro courses include some coverage of the principal–agent problem. In an advanced undergraduate course one would probably only use the two-state, two-efforts models, whereas in a graduate course one should cover at least one of the generalizations, and possibly the analysis of optimal monitoring.

Chapter 12 (Rank-Order Tournaments) explains and debates incentive systems that are based on relative performance measures. This introduces the reader into the important area of principal–agent relationships between one principal and *many* agents.

Technical Supplements The book comes with several *technical supplements* (appendixes) that review basic concepts and results of *nonlinear optimization theory* (Appendixes A and B), *convexity and generalizations* (Appendix C), and *expected values and order statistics* (Appendix C). The emphasis is on basic concepts and results, mostly without proofs. These surveys should be useful for the working economist, even though the material is not required for the other parts of the book.

Most graduate programs have specialized math courses and assign one of the many excellent textbooks on optimization theory. The technical supplements included here are by no means a substitute for such a text.

Complementary Texts In recent years many good texts were published that one might combine with the present book. When I teach the graduate micro sequence, industrial organization, applied game theory, and auctions and incentives, I also assign parts of Fudenberg and Tirole (1991), Varian (1992), Kreps (1990), Tirole (1989), Milgrom and Roberts (1992), and Mas–Colell, Whinston, and Green (1995).

Why No Competitive Analysis? I close with a word of explanation for the absence of competitive analysis in this text. Over the years of teaching the micro sequence I found myself putting less and less emphasis on the relatively uninspiring competitive analysis, which is well covered in Varian (1992) and in other texts. This reflects not just my own preferences, but a general shift of emphasis in research. This fact, combined with the availability of good texts on competitive analysis, made me decide to put together a micro text that excludes competitive analysis altogether.

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Of course I appreciate being notified of errata. E-mail can be sent to: elmar.wolfstetter@rz.hu-berlin.de. Exercises to accompany each chapter of the book can be downloaded from: <http://www.wiwi.hu-berlin.de/wt1/topics>.

Contents

<i>Preface</i>	<i>page</i> xiii
<i>Acknowledgments</i>	xvii
I Imperfect Competition	1
1 Monopoly	3
1.1 Introduction	3
1.2 Cournot Monopoly – Weak Monopoly	5
1.2.1 Cournot Point	5
1.2.2 Deadweight Loss of Monopoly	14
1.2.3 Social Loss of Monopoly and Rent Seeking	16
1.2.4 Monopoly and Innovation	17
1.2.5 Monopoly and Product Quality	21
1.3 Price-Discriminating or Strong Monopoly	22
1.3.1 First-Degree Price Discrimination	23
1.3.2 Second-Degree Price Discrimination	24
1.3.3 Third-Degree Price Discrimination	24
1.3.4 Limits of Price Discrimination	26
1.4 Hidden Information and Price Discrimination	26
1.4.1 Solution of the Restricted Program	29
1.4.2 The Optimal Sales Plan	30
1.4.3 Why it Pays to “Distort” Efficiency	31
1.4.4 Sorting, Bunching, and Exclusion	32
1.5 Price Discrimination and Public Goods*	34
1.6 Intertemporal Price Discrimination	36
1.6.1 Durable-Goods Monopoly	37
1.6.2 Time-Inconsistency Problem	39
1.6.3 Optimal Time-Consistent Price Discrimination	40
1.6.4 Coase Conjecture	42
1.6.5 An Example Where the Coase Conjecture Fails*	42
1.7 Bilateral Monopoly and Bargaining*	43
1.7.1 A Finite-Horizon Bargaining Game	44
1.7.2 Infinite-Horizon Bargaining	45

1.8	Digression: The Case Against Microsoft	49
1.9	Concluding Remarks	50
1.10	Bibliographic Notes	50
2	Regulation of Monopoly	52
2.1	Introduction	52
2.2	Positive Theory: The Averch–Johnson Effect*	53
2.2.1	Assumptions	53
2.2.2	Effects of Regulation	54
2.2.3	Relation to Cost Minimization	55
2.2.4	Welfare Implication	56
2.3	Normative Theory: Two Almost Perfect Regulations	57
2.3.1	The Total Surplus Subsidy Mechanism	57
2.3.2	The Incremental Surplus Subsidy (ISS) Mechanism	58
2.4	Bibliographic Notes	63
3	Oligopoly and Industrial Organization	65
3.1	Introduction	65
3.1.1	Game-Theoretic Foundations	65
3.1.2	Historical Note	67
3.2	Three Perspectives	67
3.2.1	The Three Market Games	68
3.2.2	Cournot Competition	70
3.2.3	Bertrand Competition	72
3.2.4	Stackelberg Competition	74
3.2.5	Welfare Ranking	77
3.2.6	The Dual of Cournot Duopoly	77
3.2.7	Discussion	78
3.3	More on Stackelberg Competition	79
3.3.1	Criticism and Extensions	79
3.3.2	Managerial Incentives as Commitment Mechanism	80
3.3.3	Commitment and Observability	85
3.4	More on Cournot Competition	89
3.4.1	Existence and Uniqueness	89
3.4.2	Digression: A Prescription for Leviathan*	95
3.4.3	What Does a Cournot Equilibrium Maximize?*	97
3.4.4	What If Suppliers Form a Cartel?	98
3.4.5	Selten’s “Four Are Few and Six Are Many”	100
3.4.6	Are Mergers Profitable?	102
3.4.7	The Welfare Loss of Cournot Oligopoly	104
3.4.8	A Corrective Tax	105
3.4.9	The Generalized ISS Regulatory Mechanism*	106
3.4.10	Entry*	107
3.4.11	Exit*	111

3.5	More on Bertrand Competition	116
3.5.1	Capacity-Constrained Price Competition: An Example	117
3.5.2	An Alternative Rationing Rule	122
3.5.3	Generalizations	124
3.6	A Defense of Cournot Competition*	125
3.6.1	Benchmark Cournot Equilibrium	125
3.6.2	The Price-Competition Subgame	126
3.6.3	Equilibrium of the Overall Game	130
3.6.4	Excess Capacity and Collusion	131
3.6.5	Discussion	131
3.7	Bibliographic Notes	132
II	Risk, Stochastic Dominance, and Risk Aversion	133
4	Stochastic Dominance: Theory	135
4.1	Introduction	135
4.2	Assumptions and Definitions	136
4.3	First-Order Stochastic Dominance (FSD)	136
4.3.1	Main Results	137
4.3.2	FSD and the “Stochastically Larger” Relationship*	138
4.3.3	Relationship to Other Stochastic Orderings	139
4.4	Second-Order Stochastic Dominance	140
4.4.1	Main Results	141
4.4.2	SSD and the “Stochastically More Risky” Relationship*	142
4.5	An Invariance Property*	143
4.6	Ranking Transformations of Random Variables*	144
4.7	Comparative Statics of Risk	145
4.7.1	Framework	145
4.7.2	Key Issue	145
4.7.3	Summary Table	148
4.8	Bibliographic Notes	148
5	Stochastic Dominance: Applications	149
5.1	Introduction	149
5.2	Portfolio Selection I	149
5.3	The Competitive Firm under Price Uncertainty	150
5.4	Labor Supply	152
5.5	Entry in Cournot Oligopoly	153
5.6	Auctions	155
5.7	Portfolio Selection II*	155
5.8	Income Inequality*	157
5.9	Supplement: Variance-Minimizing Portfolios*	159
5.9.1	Portfolios	160
5.9.2	Conjectures	160
5.9.3	Outlook	160

5.9.4	Assumptions	161
5.9.5	A Lemma That Clears the Road	161
5.9.6	Main Result	162
5.9.7	Summary	163
5.9.8	Discussion	163
5.10	Bibliographic Notes	163
6	Risk Aversion	165
6.1	Introduction	165
6.2	Absolute and Relative Risk Aversion	165
6.2.1	Pratt's Theorem	166
6.2.2	An Incomplete-Insurance Puzzle	167
6.3	Strong Absolute Risk Aversion*	168
6.3.1	Ross's Theorem	169
6.3.2	A Portfolio Selection Puzzle	170
6.4	Wealth-Dependent Risk Aversion*	171
6.5	Bibliographic Notes	172
III	Incomplete Information and Incentives	173
7	Matching: The Marriage Problem*	175
7.1	Introduction	175
7.2	Notation and Basic Assumptions	175
7.3	Stable Two-Sided Matchings	176
7.4	Who Benefits from Which Procedure?	178
7.5	Strategic Issues	179
7.5.1	Two Impossibility Results	179
7.5.2	Stable Matchings?	180
7.6	Bibliographic Notes	181
8	Auctions	182
8.1	Introduction	182
8.1.1	Information Problem	182
8.1.2	Basic Assumptions	182
8.1.3	Cournot-Monopoly Approach	183
8.1.4	Auctions – What, Where, and Why	184
8.1.5	Popular Auctions	185
8.1.6	Early History of Auctions	186
8.2	The Basics of Private-Value Auctions	186
8.2.1	Some Basic Results on Dutch and English Auctions	186
8.2.2	Revenue Equivalence	187
8.2.3	Solution of Some Auction Games – Assuming Uniformly Distributed Valuations	188
8.2.4	An Alternative Solution Procedure*	195
8.2.5	General Solution of Symmetric Auction Games	196
8.2.6	Vickrey Auction as a Clarke–Groves Mechanism*	202

8.3	Robustness*	203
8.3.1	Introducing Numbers Uncertainty	204
8.3.2	Discrete Valuations	204
8.3.3	Removing Bidders' Risk Neutrality	205
8.3.4	Removing Independence: Correlated Beliefs	205
8.3.5	Removing Symmetry	206
8.3.6	Multiunit Auctions	207
8.3.7	Split-Award Auctions	208
8.3.8	Repeated Auctions	208
8.4	Auction Rings	209
8.5	Optimal Auctions	211
8.5.1	A Simplified Approach	212
8.5.2	The Mechanism-Design Approach	214
8.5.3	Secret Reservation Price?	221
8.5.4	Optimal Auctions with Stochastic Entry*	222
8.6	Common-Value Auctions and the Winner's Curse	225
8.6.1	An Example: The Wallet Auction	225
8.6.2	Some General Results	226
8.7	Affiliated Values*	229
8.7.1	Private and Common Value Generalized	229
8.7.2	Stochastic Similarity: Affiliation	230
8.7.3	Generalized Solution of the Vickrey Auction	230
8.7.4	Linkage Principle	232
8.7.5	Why the English Auction Benefits the Seller	233
8.7.6	Limits of the Linkage Principle	234
8.8	Further Applications*	235
8.8.1	Auctions and Oligopoly	235
8.8.2	Natural-Gas and Electric Power Auctions	238
8.8.3	Treasury-Bill Auctions	239
8.9	Bibliographic Notes	241
8.10	Appendix: Second-Order Conditions (Pseudoconcavity)	241
9	Hidden Information and Adverse Selection	243
9.1	Introduction	243
9.2	Adverse Selection	243
9.2.1	The Market for Lemons	244
9.2.2	Adverse Selection in Labor Markets	245
9.3	Positive Selection: Too Many Professors?	248
9.3.1	Assumptions	248
9.3.2	Occupational Choice	249
9.3.3	Positive vs. Adverse Selection	249
9.3.4	Subgame-Perfect Equilibrium	250
9.3.5	A Corrective Tax	250
9.4	Adverse Selection and Rationing	251

9.5	Adverse Selection and Screening	252
9.5.1	Screening in Insurance Markets	253
9.5.2	Screening in Labor and Credit Markets	258
9.5.3	Alternative Equilibrium Concepts	258
9.5.4	Limits of Screening	259
9.6	Screening without Competition*	259
9.6.1	Price Discrimination with a Continuum of Types	259
9.6.2	Implementation by Nonlinear Pricing	265
9.7	Bibliographic Notes	266
10	Hidden Information and Signaling	267
10.1	Introduction	267
10.2	The Education Game	268
10.2.1	Rules of the Game	268
10.2.2	Payoff Functions	269
10.2.3	Subgame	269
10.2.4	Sequential Equilibrium	269
10.3	Equilibrium – Embarrassment of Riches	270
10.4	Equilibrium Selection: Intuitive Criterion*	272
10.4.1	The Criterion When Type 2 Is Rare	273
10.4.2	The Criterion When Type 1 Is Rare	274
10.5	Screening vs. Signaling	275
10.6	Bibliographic Notes	276
11	Hidden Action and Moral Hazard	278
11.1	Introduction	278
11.2	Risk Aversion and Incentives	279
11.2.1	A Simple Model	279
11.2.2	Generalization	285
11.3	Limited Liability and Incentives	288
11.3.1	A Simple Model	289
11.3.2	Generalization	291
11.3.3	Monitoring and Incentives*	294
11.4	Renegotiation Problem	297
11.5	Bibliographic Notes	299
11.6	Appendix	300
12	Rank-Order Tournaments	302
12.1	Introduction	302
12.2	A Simple Model	302
12.2.1	First Best Effort and Wage	303
12.2.2	Tournament Game	304
12.3	Tournaments under Risk Neutrality	304
12.3.1	Tournament Subgame	304
12.3.2	Equilibrium Prizes	305

12.3.3	Two Illustrations	306
12.3.4	Discussion	307
12.4	Tournaments under Common Shocks	307
12.5	Bibliographic Notes	308
IV	Technical Supplements	309
A	Nonlinear Optimization: The Classical Approach	311
A.1	Introduction	311
A.2	Unconstrained Optimization	311
A.3	Equality-Constrained Optimization	314
A.4	Digression: Quadratic Forms	317
B	Inequality-Constrained Optimization	320
B.1	Introduction	320
B.2	The Problem	320
B.3	First-Order Necessary Conditions	321
B.4	Second-Order Conditions	323
C	Convexity and Generalizations	324
C.1	Introduction	324
C.2	Convex Sets	324
C.3	Convex Functions	325
C.4	Strongly Convex Functions	327
C.5	Convexity and Global Extreme Values	328
C.6	Generalized Convexity: Quasiconvexity	329
C.7	Convexity Properties of Composite Functions	333
C.8	Convexifiable Quasiconvex Programs	336
D	From Expected Values to Order Statistics	339
D.1	Introduction	339
D.2	Expected Value	339
D.3	Variance, Covariance, and Correlation	340
D.4	Rules to Remember	340
D.4.1	Expected Value	340
D.4.2	Variance, Covariance, Correlation	341
D.4.3	Expected Utility	342
D.4.4	Transformations of Random Variables	343
D.4.5	Order Statistics	344
D.5	Proofs	345
	<i>Bibliography</i>	351
	<i>Index</i>	365

Part I

Imperfect Competition

1

Monopoly

The best of all monopoly profits is a quiet life.
Sir John Hicks

1.1 Introduction

In this chapter we analyze the supply and pricing decisions of a pure, single-product monopolist facing a large number of price-taking buyers. We take the firm's choice of product as given and assume that consumers know all about product characteristics and quality. Moreover, we assume that the monopolist's market is sufficiently self-contained to allow us to neglect the strategic interdependency between markets. The strategic interdependency between markets is the subject matter of the theory of oligopoly with product differentiation.

Monopolies do exist. In the early days of photocopying, Rank Xerox was the exclusive supplier – some still use “xeroxing” as a synonym for “photocopying.” Postal and rail services are (or have been) monopolized (things are changing fast in these sectors), and so are public utilities (gas and electricity) and computer operating systems, to name just a few. One can even find inconspicuous products that are subject to monopolization. For example, in Germany matches were exclusively supplied by a single Swedish supplier who had acquired a monopoly license from the German government during World War I, when the German government was hard pressed for foreign currencies. Similarly, gambling licenses are often issued by states to raise revenue. Moreover, there are many local monopolies, like the single hardware store in a small community, the bus line exclusively served by Greyhound, or the flight route, say from Ithaca to New York City, served by a single airline.

As these examples suggest, monopolization has a lot to do with the size of a market, but also with licensing, patent protection, and regulation – supported by law. If entry into a monopolized market is not prohibited, a monopoly has little chance to survive unless the market is too small to support more than one firm. Monopoly profits attract new entrants. And even if entry is prohibited, eventually patent rights expire, or rival firms spend resources to develop similar products and technologies or even to gain political influence to raid the monopoly license. Therefore, a monopoly