Bidding adieu?

Auctions were going to revolutionise the price mechanism. Not yet

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NOT long ago, auctions were confined to the fringe: farmers hawking pork bellies in Chicago, say, or down-at-heel aristocrats selling family pictures at Sotheby's. Over the past decade, however, auctions have moved into the mainstream. Two things have helped to spread their use: the fashion for the sale of state assets and the rise of the Internet. Today, power plants, radio spectrum and even whole companies are sold by governments at auction. On the Internet, private buyers and sellers are put in touch over everything from Elvis memorabilia to airline seats. Perfectly efficient markets, you might think, have arrived at last.

Economists certainly love auctions, because they enable buyers and sellers to come together with full knowledge of supply and demand. Barriers to entry are minimal; an item simply goes to the buyer willing to pay the most for it. Raising the number of bidders, in theory, should result in higher demand and higher prices for a good. Increasing the supply of goods at auction lowers their price. Rationing goods at auction is silly, since it leaves money on the table.

Yet for all their promise, many auctions have strangely disappointed. For online auctioneers, a problem is that customers face costs in time spent bidding, and the risk of losing the auction. Fixed prices can work better if they reduce time spent buying and the risk of not getting what you want. This may explain why few auction websites—eBay is the notable exception—have prospered.

More complex problems bedevil auctions of dearer goods. Auctions for company shares—through initial public offerings (IPOs), for instance—have never taken off, a puzzle for some economists. Meanwhile, European government auctions of licences for third-generation mobile telephony caused controversy. Some governments raised fantastic sums, yet only at the cost of pushing buyers, who felt they had to win a licence or go out of business, into debts they now find hard to sustain. Other countries' auctions fetched lower prices than expected.

Raising the bids

Auctions, in other words, often produce results that seem to defy the simple laws of supply and demand. A new paper* by Jeremy Bulow of Stanford University and Paul Klemperer of Oxford University sheds light on such seemingly perverse outcomes. These, the authors suggest, may be more common than was thought.

When every bidder remains true to his personal reckoning of what something is worth, auctions do indeed obey the laws of economics. What somebody will pay, say, to own an unusual painting probably depends on his estimate of “private value”. Problems arise when bidders try to guess what competitors (who might have more information about the good)

will bid, and adjust their own bids to match. This is especially risky with financial or income-earning assets, such as company shares or an oil-field. If every bidder had perfect information about what is being sold, you might expect no variation in the bids for "common-value" assets. Yet in auctions of common-value assets, the traditional laws of economics are unlikely to work.

Chalk it up to the winner's curse: it is sometimes the most optimistic, and least well informed, bidder who wins at auction. If bidders are mindful of the curse, they may become more conservative as the number of rival bidders increases. Thus more bidders (ie, more demand) can actually lead to lower prices, since each bidder fears that a larger number of competitors might know more than he does. This might be one reason, say the authors, why a target company often accepts a takeover bid without courting the biggest number of acquirers. Increasing the number of bidders might make each too shy to bid up to the company's full value.

The winner's curse also helps to explain another snag with auctions. In America, auctions for a single mobile-phone licence in one city have yielded a lower price than an auction for two licences in another city of comparable size. An increase in the supply may actually bring higher prices, as bidders feel less worried about the winner's curse.

What of the market for public offerings of shares? IPOs have often been sold by underwriters for less than the prices at which shares changed hands on their first day of trading. That has led economists to argue that an auction would allocate shares more efficiently, raising more money for issuers. Auctions have been tried, but without much success. Here again, the winner's curse might explain why investors are so cautious.

The winner's curse is only one problem with recent auctions. A bigger one, which may be easier to fix, is auctioneers' overwhelming preference for one main style of auction, the ascending-bid auction. The auctioneers assume that this will yield the best prices. In theory, perhaps; but in the real world it turns out to be especially prone to collusion among bidders. In another paper**, Mr Klemperer reviews some lessons, and points to other bidding methods, such as sealed-bid and hybrid Anglo-Dutch auctions.

More broadly, he concludes that too little attention has been paid to basic competition policy. Eliminating collusion, and attracting the right number of bidders, would do more to boost efficiency than perfecting any theory of how idealised bidders might play.

**"Prices and The Winner's Curse", by Jeremy Bulow and Paul Klemperer. Rand Journal of Economics, Spring 2002. **"What Really Matters In Auction Design", by Paul Klemperer. Journal of Economic Perspectives, Winter 2002.*