

ECO426H1 Market Design: Auctions and Matching Markets

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February 17, 2020

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1 Private Value Auctions

1.1 Standard Auctions

Definition 1.1. An **auction** is an *informational environment* consisting of

- (i) **Bidding format rules:** the form of the bids, which can be price only, multi-attribute, price and quantity, or quantity only;
- (ii) **Bidding process rules:** Closing/timing rules, available information, rules for bid improvements/counter-bids, closing conditions;
- (iii) **Price and allocation rules:** final prices, quantities, winners.

Definition 1.2. A **market mechanism** uses prices to determine allocations.

Assumption 1.1. In this chapter, we shall impose the following assumption on bidders' valuations:

- (i) Each bidder's valuation is independently and identically distributed on some interval $[0, \omega]$ according to a distribution function F :

$$V_i \stackrel{i.i.d.}{\sim} F \text{ s.t. } \text{supp}(F) = \mathbb{R}_+ \quad (1.1)$$

- (ii) F belongs to the common knowledge in this system;
- (iii) Bidders' valuations have finite expectations:

$$\mathbb{E}[V_i] < \infty \quad (1.2)$$

Assumption 1.2. Moreover, we assume bidders' behaviours to satisfy the following properties:

- (i) Bidders are risk neutral, they are maximizing expected profits;
- (ii) Each bidder is both willing and able to pay up to his or her value.

Definition 1.3. A **strategy** of a bidder is a mapping from the space of his/her valuation to a bid:

$$s : [0, \omega] \rightarrow \mathbb{R}_+ \quad (1.3)$$

Definition 1.4. An equilibrium of auction is **symmetric** if all bidders are following the same bidding strategy s .

Proposition 1.1. In a symmetric equilibrium of the second-price auction, $s(v) = v$ is a weakly dominant strategy.

Proof. For a fixed valuation $v_i \in [0, \omega]$ of bidder i .

Let $p := \max_{j \neq i} b_j$ be highest bidding price by other bidders.

Let $\pi_i(b, p)$ denote bidder i 's profit when bidding b given the highest price from other bidders to be p .

Part 1: consider another bidding $z_i < v_i$, the following cases are possible:

- (i) $v_i < p \implies z_i < v_i < p \implies \pi_i(v_i, p) = \pi_i(z_i, p) = 0$ (bidder i losses anyway).
- (ii) $v_i = p \implies \pi_i(v_i, p) = \pi_i(z_i, p) = 0$ (bidder i is indifferent).
- (iii) $v_i > p$:

- (a) $v_i > z_i > p \implies \pi_i(v_i, p) = \pi_i(z_i, p) = v_i - p;$
- (b) $v_i > z_i = p \implies \pi_i(v_i, p) \geq \pi_i(z_i, p);$
- (c) $v_i > p > z_i \implies \pi_i(v_i, p) > \pi_i(z_i, p).$

Hence, bidding v_i weakly dominates bidding any value below it.

Part 2: for $z_i > v_i$, the following cases are possible:

(i) d

Therefore, bidding v_i weakly dominates bidding any other values. ■

Proposition 1.2. In a symmetric equilibrium of the first-price auction, equilibrium bidding strategies are given by

$$s(v_i) = \mathbb{E}[\max_{j \neq i} v_j | v_j \leq v_i] \quad (1.4)$$

which is the *expected second highest valuation conditional on v_i being the highest valuation*.

Proof. Let $s(v)$ denote an equilibrium strategy.

Lemma 1.1. For any agent, bidding more than $s(\omega)$ can never be optimal. Bidding $b > s(\omega)$ makes this agent win for sure. In such case, bidding $b' \in (s(\omega), b)$ strictly dominates bidding b .

Lemma 1.2. For any agent, $s(0) = 0$. Bidding any positive number would cause negative payoff with positive probability, and therefore, leads to a negative expected profit.

Lemma 1.3. Because s is monotonically increasing, therefore,

$$\max_{j \neq i} s(v_j) = s(\max_{j \neq i} v_j) \quad (1.5)$$

Let p denote the highest price among all other $N - 1$ bidders and let $F^{(N-1)}(x)$ denote the distribution of p .

The expected profit of bidder i by bidding an arbitrary $b \in \mathbb{R}_+$ is

$$\pi_i(b, v_i) = P(b > p)(v_i - s(v_i)) + P(b = p)(v_i - s(v_i)) + P(b < p)0 \quad (1.6)$$

Note that $b > p = s(\max_{j \neq i} v_j)$ if and only if $s^{-1}(b) > \max_{j \neq i} v_j$. It follows

$$P(b > p) = P(\max_{j \neq i} v_j < s^{-1}(b)) = F^{(N-1)}(s^{-1}(b)) \quad (1.7)$$

Therefore,

$$\pi_i(b, v_i) = F^{(N-1)}(s^{-1}(b))(v_i - b) \quad (1.8)$$

The first order condition implies

$$\frac{\partial \pi_i}{\partial b} \pi_i(b, v_i) = \frac{\partial \pi_i}{\partial b} F^{(N-1)}(s^{-1}(b))v_i - F^{(N-1)}(s^{-1}(b))b \quad (1.9)$$

$$= f^{(N-1)}(s^{-1}(b)) \frac{v_i - b}{s'(v_i)} - F^{(N-1)}(s^{-1}(b)) = 0 \quad (1.10)$$

For a symmetric equilibrium, all other bidders are following the same strategy s so that $s(v_i) = b$, therefore,

$$f^{(N-1)}(s^{-1}(b)) \frac{v_i - b}{s'(v_i)} - F^{(N-1)}(s^{-1}(b)) = 0 \quad (1.11)$$

$$\implies f^{(N-1)}(s^{-1}(b))(v_i - b) - F^{(N-1)}(s^{-1}(b))s'(v_i) = 0 \quad (1.12)$$

$$\implies f^{(N-1)}(s^{-1}(b))v_i = F^{(N-1)}(s^{-1}(b))s'(v_i) + f^{(N-1)}(s^{-1}(b))s(v_i) \quad (1.13)$$

$$\implies f^{(N-1)}(v_i)v_i = \frac{d}{dv_i} \left[F^{(N-1)}(v_i)s(v_i) \right] \quad (1.14)$$

$$\implies \int_0^{v_i} f^{(N-1)}(y)y \, dy = F^{(N-1)}(v_i)s(v_i) - F^{(N-1)}(0)s(0) \quad (1.15)$$

$$\implies F^{(N-1)}(v_i)s(v_i) = \int_0^{v_i} f^{(N-1)}(y)y \, dy \quad (1.16)$$

$$\implies s(v_i) = \frac{1}{F^{(N-1)}(v_i)} \int_0^{v_i} f^{(N-1)}(y)y \, dy \quad (1.17)$$

$$\implies s(v_i) = \mathbb{E} \left[\max_{j \neq i} v_j \mid \max_{j \neq i} v_j < v_i \right] \quad (1.18)$$

■