

Competitive markets for non-exclusive contracts with adverse selection: the role of entry fees

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Abstract

This paper studies competitive equilibria in economies characterized by the presence of asymmetric information, where non-exclusive contracts are traded in competitive markets and agents may be privately informed over contracts' payoffs. For such economies competitive equilibria may not exist when contracts trade at linear prices. We show that (non-trivial) competitive equilibria exist, under general conditions, when prices exhibit a minimal form of non-linearity (or, equivalently, a minimal requirement on the observability of agents' trades): the presence of two-part tariffs suffices, where the cost of trading each contract consists of an entry fee and a linear component in the quantity traded. The entry fee is determined at equilibrium and represents a measure of adverse selection in the economy.

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1. Introduction

This paper studies competitive equilibria in economies characterized by the presence of asymmetric information. We consider pure exchange economies where standardized, non-exclusive contracts are traded in competitive markets.

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Contracts are standardized as their terms (price and payoff specification) are independent of the identity of the agents entering the contract, and the same type of contract is available to many agents; they are non-exclusive as the terms of each contract do not depend on the transactions made by an agent in other markets (or even in the same market).¹ Contracts differ from securities as their payoff depends on the realization of the individual uncertainty affecting the agent entering the contract (as, for instance, in the case of an individual insurance contract). Hence contracts of the same type, when entered by different agents, are in effect different contracts as their return is contingent on the realization of different sources of uncertainty. To the eyes of the outside investors trading such contracts, however, they are indistinguishable; thus there is a single market—and price—for all contracts of the same type. To make explicit the role and activity of outside investors we assume that, in addition to consumers, there are competitive intermediaries who ‘make the market’ for contracts by compensating the buying and selling positions of the agents trading the contract.

We will examine situations where agents have some private information over the realization of their own individual risk. Since this risk only affects the payoff of the specific contracts an agent enters, and all contracts of the same type, but entered by different agents, trade at the same price, the trades of any agent are negligible with respect to the size of the market; hence we can argue that in this set-up asymmetric information is not incompatible with price taking behavior (see also Bisin et al., 1999). On the other hand, while with symmetric information the payoff distribution of contracts of the same type, at the time agents enter the contract, is the same for all of them, this is no longer true when agents have some private information. In that case the payoff distribution will be different for agents with different information. If these contracts are traded together in a single market at linear prices, (uninformed) intermediaries who ‘make the market’ may as a consequence end up having negative profits, whatever the price level. To insure that this does not happen, and hence the viability of markets and the existence of competitive equilibria in the presence of asymmetric information and informed traders, some degree of non-linearity of prices is needed; this provides in fact a mechanism according to which the losses intermediaries (outside investors) make by trading with agents with superior information can be recovered.

We are interested here in characterizing a minimal form of non-linearity of the pricing of contracts, which guarantees existence and can be implemented *with minimal requirements on the observability² of agents’ trades.³ In this paper we show that competitive equilibria*

¹ See Hellwig (1983), Arnott and Stiglitz (1993), Dubey et al. (1995), Bisin and Guaitoli (1995), Bisin and Gottardi (1999) and Kahn and Mookherjee (1998) for other analyses of economies where non-exclusive contracts are traded.

² Though no explicit assumption is made in the paper over the observability of agents’ trades, our analysis is particularly relevant in situations where the information available over agents’ trades is very limited (neither trades in the other markets nor even trades in the same market can be monitored by intermediaries). Thus contracts must trade at prices which are, essentially, linear.

³ When agents’ trades can be fully monitored, and hence exclusive contracts are available, the existence (and the efficiency) of competitive equilibria with moral hazard was shown by Prescott and Townsend (1984) (see also Bannardo (1997), Bannardo and Chiappori (1998), Citanna and Villanacci (1997), Kehoe et al. (1998), Lisboa (1997), Magill and Quinzii (1997)) and, more recently, by Bisin and Gottardi (2000) for adverse selection economies.

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