Partition Equilibria in a Japanese-English Auction with Discrete Bid Levels for the Wallet Game*

Ricardo Gonçalves† and Indrajit Ray‡

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Abstract

We consider the set-up of a Japanese-English auction with exogenously fixed discrete bid levels for the wallet game with two bidders, following Gonçalves and Ray (2017). We show that in this auction, *partition equilibria* exist that may be separating or pooling. We illustrate some separating and pooling equilibria with two and three discrete bid levels. We also compare the revenues of the seller from these equilibria and thereby find the optimal choices of bid levels for these cases.

Keywords: Japanese-English auctions, wallet game, discrete bids, partitions, pooling equilibrium, separating equilibrium.

JEL Classification Numbers: C72, D44.

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†Católica Porto Business School and CEGE, Universidade Católica Portuguesa, Rua Diogo Botelho, 1327, 4169-005 Porto, Portugal. E-mail: rgoncalves@porto.ucp.pt; Fax: +351.2261.96255.

‡*Author for Correspondences.* Economics Section, Cardiff Business School, Cardiff University, Colum Drive, Cardiff CF10 3EU, UK. E-mail: rayi1@cardiff.ac.uk; Fax: +44.2920.874419.

1 INTRODUCTION

Discrete bidding in English auctions is the norm in the real world, although substantial variations in the exact characteristics of these auctions are observed. In most English auctions, admittedly, the discrete bids are endogenous, possibly a function of several factors, including number of bidders, (expected) bidders' valuations, etc. In auctions at Sotheby's or Christie's, bidding usually advances between 5% and 10% of the current price level (Rothkopf and Harstad, 1994). However, there are many examples where the bids are exogenously given. Cassady (1967) gives examples of auctions in which the bid levels are known, such as the tobacco and livestock auctions in the USA. In wholesale fish markets, ascending or English (Graham, 1999, p. 181) and descending or Dutch (Guillotreau and Jimenez-Toribio, 2011) electronic auctions are commonly used, where the former (electronically) replicates the traditional oral ascending auctions; known discrete bid increments are a common feature in both these auction types (Carleton, 2000, pp. 10-11).

Milgrom and Weber (1982) analysed a particular version of the English auction, the so-called Japanese-English Auction (henceforth JEA), commonly known as clock auction, in which the price of the object increases continuously and the bidders decide to stay or drop out. In real world examples of JEA, the price actually increases in discrete increments. For example, in the Looe wholesale fish auction (UK), the increments are anywhere from 1p to 5p or 10p and sometimes different increments are used for different species during the same auction session. Online auction sites, such as eBay, use variants of such English auctions, adapted to the online world (Bajari and Hortaçsu, 2004), where bid increments are also discrete (and depend on the price level).

In order to incorporate this common feature of real world English auctions, the set-up in this paper (as originally presented in Gonçalves and Ray, 2017) is the same as the usual JEA except that the price goes up in discrete commonly known bid levels. In our game, as in the usual JEA, if a bidder wants to drop out, all he has to do is release the button. The final auction price is equal to the highest bid level at which at least one bidder was active. We use the so-called "wallet game" with two bidders (in which the common value of the good is simply the sum of two private signals, the amounts in the "wallets" of each bidder), introduced by Klemperer (1998), as our background common game to theoretically analyse a JEA with discrete bid levels. Klemperer (1998) illustrated that bidding twice the individual signal forms the unique symmetric (Bayesian-Nash) equilibrium in this game. However, with discrete bid levels, Gonçalves and Ray (2017) proved that one cannot construct a symmetric equilibrium using strategies analogous (in a discrete bids' environment) to bidding twice the private signal. Our aim here is thus to theoretically characterise the equilibria of a JEA in a common value environment with exogenously specified discrete bid levels.

There are real-life examples that (sort of) fit our model. In eBay, it is not all that rare to specify that bids cannot start below a given price, say, \$49, and must be a multiple of \$1 with the last digit 9; however, the assumption of a commonly known upper limit does not hold there.[1] Bidding at the online auction site QXL was also quite similar to our model: the price went up in predetermined increments and if bids were not a multiple of that increment, then the bid was rounded down to the closest multiple of the increment. QXL bidding increments depended on the bid value; for example, for bids in the $£2.50 - £9.99$ range, the bid increment was $£0.10$ while for bids in the $£10 - £99.99$, it was $£1.00$ and so on.

In the recent past, English auctions with predefined discrete bid levels have been analysed (Rothkopf and Harstad, 1994; Yu, 1999; Sinha and Greenleaf, 2000; Cheng, 2004; David *et al*, 2007; Isaac *et al*, 2007); for example, Yu (1999), in a private value setting with discrete bid increments, found multiple equilibria: depending on whether bidders' valuations are above (or below) certain thresholds, the bidders choose different (equilibrium) strategies. However, we note that the existing (above-mentioned) literature on discrete bids for single object auctions has focussed entirely on private value environments; virtually nothing has been done for the common value model. There is a vast literature on both multi-object and multi-unit auctions, some of which considers discrete bidding (see, for example, Brusco and Lopomo, 2002; Ausubel, 2004; Engelbrecht-Wiggans and Kahn, 2005). However, this literature also mainly refers to private values; for example, Ausubel (2004) modeled the auction increments through a price clock with either integer (steps) or continuous increases. Interestingly, and of relevance to our paper, Ausubel (2004) used discrete increments only in the private values case while the proposed (novel) ascending auction under an interdependent value formulation (a generalisation of both the private and common value models) is analysed under continuous bid increments.

Following the seminal experiment by Avery and Kagel (1997) on a continuous-bid JEA based on the wallet game, Gonçalves and Hey (2011) studied discrete bids in an experiment; however there has been no attempt to analyse the equilibria for this game theoretically apart from the recent contribution by Gonçalves and Ray (2017). Following their work, we are now taking the first step to fully characterise the set of equilibria for the wallet game in a JEA with discrete bids.

In this paper, we show that (symmetric) partition equilibria, involving weakly increasing strategies based on elements of a partition of the signal space, exist for the wallet game in a JEA with discrete bid levels. Such partition equilibria may be *pooling* or *separating* (depending on the number of partitions). We illustrate several such equilibria with only two or three discrete bid levels (with certain parametric restrictions). These equilibria, however, yield a lower expected revenue for the seller than in the case of a continuous JEA. Despite this, we further show that a revenue-maximising second best solution for this set-up exists; that is, the seller may choose these bid levels optimally to maximise the revenue.

These results are, in our opinion, interesting and novel from a theoretical viewpoint, but also are of

[1] We thank Ron Harstad for providing this example.

practical interest for real world auctions. First, our partition equilibria with discrete bid levels suggest that (expected) seller's revenue may be lower than in a continuous JEA. By adequately choosing both the number and the values of discrete bid levels, the seller may minimise this loss. Naturally, the seller also benefits from discrete bid levels in ways that our model does not capture. For instance, the auction-speed may be higher which is an important variable to consider when auctioning certain goods. In addition, by definition, JEA preclude the possibility of jump-bidding equilibria, which could hurt the auctioneer (Avery, 1998; Isaac *et al*, 2007).

Second, the (symmetric) partition equilibria that we find may appear to be complex in the way they are calculated, but they do point to very simple rule-of-thumb strategies that bidders may resort to: for example, with two discrete bid levels, if the signal is higher than a threshold, bid high; otherwise, bid low. The experimental literature on ascending auctions presents multiple (similar in nature) examples of simple strategies that are actually played (for instance, see Kagel, 1995; Kagel and Levin, 2016), although in most of those cases, such strategies are not equilibrium strategies, whilst our partition equilibria strategies would be. In that context, our results may, in a way, bridge the divide between theoretical and experimental work on ascending auctions.

2 MODEL

We consider the model originally presented in Gonçalves and Ray (2017).

2.1 Game (Gonçalves and Ray, 2017)

For the sake of completeness, we present the features of the game in Gonçalves and Ray (2017) in this subsection.

Consider the wallet game with two symmetric risk-neutral bidders $i \in \{1, 2\}$ bidding for one single good with common value, $\tilde{V}$. Each bidder receives an independent and uniformly distributed[2] private signal $x_i \sim U(0, 1)$, $i = 1, 2$. The (ex ante) unknown common value of the good is simply the sum of the two signals: $\tilde{V} = x_1 + x_2$.

We use the JEA with some exogenously fixed discrete bids that are the elements of the set $A = \{a_1, ..., a_k\}$, with $0 < a_1 < ... < a_k < 2$, $k \geq 2$ a finite integer; the set A is common knowledge to the bidders. We will denote a typical bid level by a_j, for $j = 1, ..., k$, with the implicit assumption that $a_0 = 0$ and $a_{k+1} = 2$, for notational convenience whenever required in this paper.

In the JEA we consider, the price goes up in discrete bid levels in the set A starting from a_1 and ending at a_k. The bidders have to keep pressing a button at each bid level to be actively bidding; a

[2] As in Gonçalves and Ray (2017), we take the uniform distribution as it is easier to analyse, however, any other specific distribution could have been considered.

bidder drops out of the auction at any stage by releasing the button. The final auction price is equal to the highest bid level in which at least one bidder was active. Therefore, for any $j = 1, ..., k-1$, if one bidder is active at a_j but not at a_{j+1} while his opponent is active at a_{j+1}, then the latter wins the auction and pays a price equal to a_{j+1}; if both bidders are active at a_j, but not at a_{j+1}, then the auction winner is decided at random with equal probabilities and the final price is a_j; finally, if both bidders are active at the last bid level a_k, the winner will be chosen at random with equal probabilities and will pay the price a_k. The net payoff to the (selected) winner in each of the above cases is the realised value of $x_1 + x_2$ minus the price to pay while the payoff to the loser is 0. If no bidder is active at a_1, then the auction ends immediately and the payoff to either bidder is 0.

A strategy in this Bayesian game is therefore to choose (as in Gonçalves and Ray, 2017) a drop out bid level as a function of the signal. Given a signal $x \in (0, 1)$, a bidding strategy for a player thus chooses 0 (which implies that the bidder is not active even at a_1) or a bid level a_j so that the bidder will be active at a_j but not at a_{j+1}, where $j = 1, ..., k$ (with $a_{k+1} = 2$). A typical strategy is denoted by σ that is a function $b(x) \in \{0, a_1, ..., a_k\}$ implying that the player with signal x is active until $b(x)$.

As in Gonçalves and Ray (2017), the above JEA for the wallet game with k bid levels $(a_1, .., a_k)$ will henceforth be called G_k.

2.2 Strategies

In this subsection, we look at possible strategies of G_k. The following definitions are new concepts (not present in Gonçalves and Ray, 2017) needed for the analysis in this paper.

Definition 1 *A strategy $\sigma = b(x)$ for G_k is weakly increasing (decreasing) if for all pair of signals x and y, $x > y$, $b(x) \geq (\leq)\ b(y)$.*

Theoretically, there are strategies that are neither weakly increasing nor weakly decreasing. For example, consider a strategy σ^{rat} for which $b(x) = a_m$, when x is a rational number and $b(x) = a_n$, otherwise for some m and n.

Understandably, bidders may not wish to use the strategy 0. Formally,

Definition 2 *A strategy is called active if it never chooses 0 for any signal, i.e., the bidder is active at least at a_1 for any signal x. A strategy is called inactive if it chooses 0 for at least one signal, i.e., the bidder is inactive even at a_1 for some signal x.*

A natural type of strategy one may think of is a strategy that divides the domain of the signal x, the interval $(0, 1)$, into $(l + 1)$ subintervals or elements of a partition using l (≥ 1) many cut-off signals. In the rest of the paper, we (ab)use the word "partitions" to mean "elements of a partition".

Definition 3 *A partition strategy for G_k is a strategy that uses l (≥ 1) cut-off points and thus $(l+1)$ partitions of the interval $(0,1)$, and chooses an element from the set $\{0, a_1, ..., a_k\}$ for each of these partitions.*

Note that $l = 0$, which implies no cut-off signal and therefore no partition, also generates a feasible strategy; in such a strategy, only one bid level is picked for the whole set of signals, the interval $(0,1)$.

Definition 4 *In G_k, a strategy is called a babbling strategy, if regardless of the signal, the bidder chooses either 0 or a particular bid level a_j, $j = 1, ..., k$, i.e., for any $x \in (0,1)$, $b(x) = c$ for some $c \in \{0, a_1, ..., a_k\}$. In an active babbling strategy, $b(x) = c$ for some $c \in \{a_1, ..., a_k\}$, for all $x \in (0,1)$. $b(x) = 0$, for all $x \in (0,1)$ is the inactive babbling strategy.*

Obviously, there are strategies that are not partition strategies; for example, the above mentioned σ^{rat} is not a partition strategy. Also, a partition strategy may be neither weakly increasing nor weakly decreasing. For example, consider G_2 with two bid levels, L and H and think of a strategy written using two cut-offs x^* and y^* as:

$$\sigma = \begin{cases} L \text{ if } x \leq x^* \\ H \text{ if } x^* < x \leq y^* \\ L \text{ if } x > y^* \end{cases}$$

We now focus on a specific subset of the strategy sets in G_k and make the following assumption.

Assumption 0. All the bidders use weakly increasing partition strategies only.

The JEA for the wallet game with k bid levels $(a_1, .., a_k)$ with weakly increasing partition strategies only is our baseline game and we henceforth call it G_k^0.

A non-babbling strategy in any G_k^0 can be written in terms of some cut-off signals x_c^*, $c = 1, ..., l$, where $0 < x_1^* < ... < x_l^* < 1$ and $l \leq k$ that divide the interval $(0,1)$ into $(l+1)$ partitions and associates an element of $\{0, a_1, ..., a_k\}$ to each partition in an increasing order. Such a non-babbling strategy, σ, can be easily associated with a certain probability distribution over the set $\{0, a_1, ..., a_k\}$, as determined by the partition(s). A babbling strategy is clearly associated with a degenerate distribution (probability 1 on one element of the set $\{0, a_1, ..., a_k\}$).

In the following subsection we formally define an equilibrium of the game G_k^0, with $k \geq 2$, using the standard notion of Bayesian-Nash equilibrium with usual expected payoffs.

2.3 Partition Equilibria

In this subsection, we characterise different kinds of equilibria using partition strategies. We further focus on active partition strategies to find equilibria in G_k^0, with $k \geq 2$. Clearly, using Definitions 1, 2 and 3, for any active weakly increasing partition strategy the number of cut-offs, l, must satisfy $l \leq k-1$.

Definition 5 *For any $k \geq 2$, an active weakly increasing partition strategy with l many cut-offs is called separating if $l = k - 1$,*

Clearly, for $k = 2$, an active weakly increasing partition strategy is either babbling or separating with a single cut-off.

Definition 6 *For $k > 2$, an active weakly increasing partition strategy with l many cut-offs is called pooling if $1 \leq l < k - 1$.*

Definition 7 *In G_k^0, where $k > 2$, a separating strategy is an active weakly increasing partition strategy that uses $k - 1$ cut-offs $(x_1^*, ..., x_{k-1}^*)$ and thereby k partitions; it can be written as:*

$$\sigma = \begin{cases} a_1 \text{ if } x \leq x_1^* \\ a_j \text{ if } x_{j-1}^* < x \leq x_j^*,\ j = 2, ..., k-1 \\ a_k \text{ if } x > x_{k-1}^* \end{cases}$$

In G_2^0, with 2 bid levels (a_1, a_2) and one cut-off x^*, a separating strategy σ can be written as: $\sigma = a_1$ if $x \leq x^*$ and a_2 otherwise.[3]

Similarly, one may also formally define and express any *pooling strategy*, in G_k^0, with $k > 2$, using l $(< k - 1)$ cut-offs.

As mentioned earlier, a non-babbling partition strategy, σ, can be interpreted as a probability distribution. For example, for $k > 2$, the separating strategy in Definition 5 above is a strategy in which the bidder chooses a_1 with probability x_1^*, a_j with probability $(x_j^* - x_{j-1}^*)$, $j = 2, ..., k-1$ and a_k with probability $\left(1 - \sum_{j=1}^{k-1} x_j^*\right)$. The probabilities for a pooling strategy can also be similarly identified.

We may now define a *partition equilibrium*, using the above partition strategies. As mentioned earlier, we are going to consider symmetric equilibria only. An equilibrium in symmetric partition (babbling) strategies is a strategy profile in which both bidders play the same partition (babbling) strategy.

A symmetric separating (pooling) partition equilibrium can be characterised by a separating (pooling) strategy with usual (Bayesian-Nash) equilibrium conditions. The equilibrium conditions are: *i.* indifference at the cut-offs, *ii.* incentive constraints for each partition, *iii.* activation constraint (active at a_1) which implies the participation constraint (at the beginning of the auction) and *iv.* feasibility constraints for the cut-off points. One can thus define and characterise such a partition equilibrium using these conditions.

Definition 8 *In G_k^0, a symmetric strategy profile (σ_1, σ_2) is called a separating equilibrium if each bidder i uses the same separating strategy σ_i with $k - 1$ cut-offs $(x_1^*, ..., x_{k-1}^*)$ with all of the following*

[3] In this definition, we have used, without any loss of generality, the weak inequality on the left hand side of the cut-off (as the signal is generated using a continuous distribution). One may define a partition strategy with the weak inequality on the right hand side of the cut-off in which case the following equilibrium analysis needs to be modified accordingly.

conditions satisfied.[4]

$u_1(a_j,\sigma_2)|_{x_1=x_j^*} = u_1(a_{j+1},\sigma_2)|_{x_1=x_j^*}$, $j = 1,...,k-1$ *[indifference conditions]*

$u_1(a_1,\sigma_2) > u_1(a_h,\sigma_2)$ *if* $x_1 \leq x_1^*$, $h > 1$ *[incentive constraint for the first partition]*

$u_1(a_k,\sigma_2) > u_1(a_h,\sigma_2)$ *if* $x_1 > x_{k-1}^*$, $h < k$ *[incentive constraint for the last partition]*

$u_1(a_j,\sigma_2) > u_1(a_h,\sigma_2)$ *if* $x_{j-1}^* < x_1 \leq x_j^*$, $j = 2,...,k-1$, $h \neq j$ *[incentive constraints for all other partitions, needed only for* $k > 2$*]*

$u_1(a_1,\sigma_2) \geq u_1(0,\sigma_2) = 0$ *if* $x_1 \leq x_1^*$ *[activation constraint] implying* $u_1(a_1,\sigma_2)|_{x_1=0} \geq 0$ *[participation constraint]*

$0 < x_1^* < ... < x_{k-1}^* < 1$ *[feasibility constraints]*

Similarly, one may write down the equilibrium conditions for a (symmetric) *pooling equilibrium*[5] or even a (symmetric) *babbling equilibrium*. The conditions for a babbling equilibrium clearly involve just the incentive constraint and the participation constraint.

3 RESULTS

We focus only on symmetric equilibria for the game G_k^0, with $k \geq 2$, in the rest of our paper. As it is well-known, the symmetric (Bayesian-Nash) equilibrium for the JEA with continuous bids is given by bid functions $b_i^*(x_i) = 2x_i$, $i = 1, 2$, as derived by Milgrom and Weber (1982), in a general model, and later specifically for the wallet game by Klemperer (1998) and Avery and Kagel (1997). Gonçalves and Ray (2017) proved that this "twice-signal bidding" strategy is not an equilibrium in G_k (and therefore not in G_k^0 either). Although twice-signal bidding is not an equilibrium G_k^0, we will show that other equilibria exist for our game in the next subsection.

Unfortunately, it is extremely difficult to analytically solve the above set of constraints (as in Definition 8) and thereby find all partition equilibria for G_k^0, particularly when k is not small. The analysis is understandably easier for G_2^0 or G_3^0. In the next subsection, we will consider G_2^0 and G_3^0 and show examples of symmetric partition equilibria in such games.

3.1 Separating Equilibrium in G_2^0

Consider any given G_2^0; let us denote the bid levels by L (low) and H (high); that is, $k = 2$ with $a_1 = L$ and $a_2 = H$.

Any separating strategy here can be written in terms of a cut-off signal x^*; a separating strategy for some x^*, $0 < x^* < 1$, is thus:

[4] Abusing notations for the expected payoff from a partition strategy.

[5] We do understand that our use of the phrase "pooling equilibrium" is not standard in the literature.

$$\sigma^{2S} = \begin{cases} L \text{ if } x \leq x^* \\ H \text{ if } x > x^* \end{cases}$$

In a symmetric separating equilibrium, each bidder thus plays L with probability x^* (the probability that $x \leq x^*$) and H with probability $(1 - x^*)$, that is, the strategy σ^{2S} can be associated with the distribution $(x^*; 1 - x^*)$ over L and H. Further, to construct an equilibrium, we make the following assumption on the values of L and H.

Assumption 1. $L < \frac{1}{2}$ and $L + \frac{1}{2} < H < \frac{3}{4} + \frac{L}{2}$.

Note that Assumption 1 in turn implies $H < 1$. We are now ready to present a separating equilibrium of this game.

Proposition 1 *Under Assumption* 1*, the separating strategy* $\sigma^{2S} = (x^*; 1 - x^*)$*, with* $x^* = \frac{2H-1}{2(1+L-H)}$*, constitutes a symmetric separating equilibrium of* G_2^0*.*

Proof. We first compute the (expected) payoffs for a bidder from the partition strategy profile; without loss of generality, we consider bidder 1. When bidder 2 has a signal $x_2 \leq x^*$ and bids L, using the uniform distribution, bidder 1 expects bidder 2 to have a signal realisation equal to $x^*/2$; similarly, when bidder 2 has a signal $x_2 > x^*$ and bids H, bidder 1 expects bidder 2 to have a signal realisation equal to $(1 + x^*)/2$.

Bidder 1's expected payoffs thus are given by: $u_1\left(L, \sigma^{2S}\right) = x^*.\frac{1}{2}(x_1 + \frac{x^*}{2} - L) + (1 - x^*).0$ and $u_1\left(H, \sigma^{2S}\right) = x^*.(x_1 + \frac{x^*}{2} - H) + (1 - x^*).\frac{1}{2}.(x_1 + \frac{1+x^*}{2} - H)$.

Setting the indifference condition (as in Definition 8) $u_1\left(L, \sigma^{2S}\right) = u_1\left(H, \sigma^{2S}\right)$, we get $x^* = \frac{2x_1+1-2H}{2(H-L)}$, which implies that when $x_1 = x^*$, $u_1\left(L, \sigma^{2S}\right) = u_1\left(H, \sigma^{2S}\right)$ provided $x^* = \frac{2H-1}{2(1+L-H)}$.

Substituting this cut-off x^* in the expected payoffs, we obtain

$u_1\left(L, \sigma^{2S}\right) - u_1\left(H, \sigma^{2S}\right) = \frac{1}{4}\frac{2H-1-2x_1(1+L-H)}{1+L-H} = \frac{1}{2}\left(x^* - x_1\right)$.

Hence, for bidder 1, if $x_1 > x^*$, we have $u_1\left(H, \sigma^{2S}\right) > u_1\left(L, \sigma^{2S}\right)$, that is, with a high signal realisation (above x^*), bidder 1 prefers to bid H, and when $x_1 \leq x^*$, we have $u_1\left(L, \sigma^{2S}\right) > u_1\left(H, \sigma^{2S}\right)$, that is, with a low signal realisation (below x^*), bidder 1 prefers to bid L, which confirms the desired equilibrium condition (incentive constraint as in Definition 8).

We now have to confirm the feasibility constraint that $x^* \in (0, 1)$; this is guaranteed by Assumption 1 as $x^* > 0 \Leftrightarrow H > 1/2$ and $x^* < 1 \Leftrightarrow H < \frac{3}{4} + \frac{L}{2}$.

Finally, we need to check the activation (and thus the participation) constraint that the payoffs cannot be negative (otherwise bidders would prefer not to be active) at L. As $u_1\left(L, \sigma^{2S}\right)$ is increasing in x_1, we just need to ensure that $u_1\left(L, \sigma^{2S}\right)\big|_{x_1=0} = \frac{(1-2H)(1+2L)(2L+1-H)}{16(H-L-1)^2} > 0$.

The above is indeed true; the denominator is always positive and for the numerator to be positive we must have either $H < 1/2$ and $H < L+1/2$, which we disregard because it would not yield a positive cut-off x^*, or we must have $H > 1/2$ and $H > L + 1/2$, which is guaranteed under Assumption 1. ■

It is also easy to show that the above partition equilibrium is indeed unique (in weakly increasing symmetric strategies). Clearly, there are only two potential candidate profiles which are based on two babbling strategies of staying active until L or H regardless of the signal. We denote these profiles by (L, L) and (H, H) respectively and prove that neither of them is an equilibrium.

Corollary 1 *Under Assumption* 1*, the separating strategy profile* $(\sigma^{2S}, \sigma^{2S})$*, where,* $\sigma^{2S} = (x^*; 1 - x^*)$*, with* $x^* = \frac{2H-1}{2(1+L-H)}$*, is the unique symmetric (Bayesian-Nash) equilibrium of* G_2^0*.*

Proof. To show uniqueness, we just need to prove that (L, L) and (H, H) cannot be an equilibrium. To prove that (L, L) cannot be an equilibrium, we note that there are realisations of x_1 for bidder 1 for which bidding L is not a best response against L. To see this, take $1 > x_1 > 1 - 2(\frac{3}{4} + \frac{L}{2} - H)$. In this case, $u_1(H, L) - u_1(L, L) = (x_1 + \frac{1}{2} - H) - \frac{1}{2}(x_1 + \frac{1}{2} - L) > 0$ (as, by Assumption 1, $1 - 2(\frac{3}{4} + \frac{L}{2} - H) < 1$). Similarly, we prove that (H, H) cannot be an equilibrium by showing that there are realisations of x_1 for bidder 1 for which bidding H is not a best response against H. To see this, take $0 < x_1 < H - 1/2$. Here, $u_1(L, H) - u_1(H, H) = \frac{1}{2}(H - \frac{1}{2} - x_1) > 0$. ■

The above results thus fully characterise the equilibrium of any G_2^0 satisfying Assumption 1, as the following example illustrates.

Example 1 *Consider two specific values for* L *and* H*, namely,* $L = 1/5$ *and* $H = 4/5$*, satisfying Assumption* 1*. In this case, from Proposition* 2*, we have* $x^* = 3/4$*. Hence, in the unique symmetric equilibrium of this game, a bidder is active at* L *(but not at* H*) if and only if the signal is less than or equal to* 3/4*. Bidder* i*'s payoff,* u_i*, from this equilibrium strategy profile is given by* $u_i = \frac{3}{8}x_i + \frac{21}{320}$ *if* $x_i \leq 3/4$ *(in which case bidder* i *plays* L*) and* $u_i = \frac{7}{8}x_i - \frac{99}{320}$ *if* $x_i > 3/4$ *(in which case bidder* i *plays* H*).*

3.2 Pooling Equilibria in G_3^0

Now we consider G_3^0 to provide some examples of pooling equilibria. Let us denote three bid levels by L (low), M (medium) and H (high); that is, $k = 3$ with $a_1 = L$, $a_2 = M$ and $a_3 = H$. We illustrate three different types of pooling equilibria with three bid levels in the following subsections.

3.2.1 Illustration 1

In this illustration, we use the parameter values from the previous subsection (G_2^0) and extend it to a specific G_3^0. We take any values of L and H satisfying Assumption 1 and call them L and M respectively (Assumption 1′ below) and make a further assumption (Assumption 2) on H as below, to construct a pooling equilibrium.

Assumption 1′. $L < \frac{1}{2}$ and $L + \frac{1}{2} < M < \frac{3}{4} + \frac{L}{2}$.

Assumption 2. $H > \frac{3}{4} + \frac{M}{2} + \frac{2M-1}{8(1+L-M)}$.

Clearly, Assumption $1^{'}$ is same as Assumption 1 with renamed parameters. We now construct a pooling equilibrium using the same cut-off as in Proposition 2. Let us consider the following partition strategy:

$$\sigma^{3P_1} = \begin{cases} L \text{ if } x \leq x^* \\ M \text{ if } x > x^* \end{cases}$$

Clearly the above strategy is a pooling strategy as the bid level H is not used. In a symmetric profile, each bidder plays L with probability x^* and M with probability $(1-x^*)$, that is, the strategy σ^{3P_1} can be associated with the distribution $(x^*; 1-x^*; 0)$ over L, M and H. We now prove that this strategy profile is an equilibrium for this game (following the proof of Proposition 2).

Proposition 2 *Under Assumptions* $1^{'}$ *and* 2*, the partition strategy* $\sigma^{3P_1} = (x^*; 1-x^*; 0)$*, with* $x^* = \frac{2M-1}{2(1+L-M)}$*, constitutes a symmetric pooling equilibrium of* G_3^0*.*

Proof. We first compute bidder 1's expected payoffs under this partition strategy profile which turns out to be:

$u_1\left(L, \sigma^{3P_1}\right) = x^* \frac{1}{2}\left(x_1 + \frac{x^*}{2} - L\right)$; $u_1\left(M, \sigma^{3P_1}\right) = x^*\left(x_1 + \frac{x^*}{2} - M\right) + (1-x^*)\frac{1}{2}\left(x_1 + \frac{1+x^*}{2} - M\right)$.

The indifference condition (as in Definition 8), $u_1\left(L, \sigma^{3P_1}\right) = u_1\left(M, \sigma^{3P_1}\right)$, is satisfied provided $x^* = \frac{2M-1}{2(1+L-M)}$.

Using this cut-off, we obtain $u_1\left(L, \sigma^{3P_1}\right) - u_1\left(M, \sigma^{3P_1}\right) = \frac{1}{2}(x^* - x_1)$; therefore the incentive constraints $u_1\left(L, \sigma^{3P_1}\right) > u_1\left(M, \sigma^{3P_1}\right)$ if $x_1 < x^*$ (and thus the constraint $u_1\left(L, \sigma^{3P_1}\right) > u_1\left(H, \sigma^{3P_1}\right)$ if $x_1 < x^*$) and $u_1\left(M, \sigma^{3P_1}\right) > u_1\left(L, \sigma^{3P_1}\right)$ if $x_1 > x^*$ are all satisfied.

Hence, we just need to prove that bidder 1 does not deviate and play H when $x_1 > x^*$, that is, we must have $u_1\left(H, \sigma^{3P_1}\right) - u_1\left(M, \sigma^{3P_1}\right) < 0$ if $x_1 > x^*$. Note that $u_1\left(H, \sigma^{3P_1}\right) - u_1\left(M, \sigma^{3P_1}\right) = \frac{1}{2}x_1 + \frac{1+x^*}{4} - H + \frac{M}{2}$. Substituting the value of x^* and setting $x_1 = 1$ (the highest possible signal), we confirm that this payoff difference is indeed negative under Assumption 2 (that is, $H > \frac{3}{4} + \frac{M}{2} + \frac{2M-1}{8(1+L-M)}$).

Finally, using the proof of Proposition 1, here as well we have the feasibility constraint and the activation (thus participation) constraint satisfied. ■

To illustrate the above, we may use the values in Example 1.

Example 2 *Take* $L = 1/5$, $M = 4/5$ *and* $H = 7/5$*, satisfying Assumptions* $1^{'}$ *and* 2*. As in Example* 1*, here as well, we have* $x^* = 3/4$*. Thus in this symmetric pooling equilibrium of this game, a bidder is active at* L *(but not at* M *or* H*) when the signal is less than or equal to* $3/4$ *and active at* M *(but not at* H*) when the signal is bigger than* $3/4$*. Bidder* i*'s payoff,* u_i*, from this equilibrium strategy profile is given by* $u_i = \frac{3}{8}x_i + \frac{21}{320}$ *if* $x_i \leq 3/4$ *(in which case bidder* i *plays* L*) and* $u_i = \frac{7}{8}x_i - \frac{99}{320}$ *if* $x_i > 3/4$ *(in which case bidder* i *plays* M*).*

3.2.2 Illustration 2

In this illustration, we will use different parameter values to construct another pooling equilibrium for any given G_3^0; we make the following assumptions.

Assumption 1$''$. $L < \frac{1}{2}$ and $2L < M < \frac{3}{4} + \frac{L}{2}$.

Assumption 3. $H = \frac{1}{2} + 2M - L$.

Let us consider the following partition strategy:

$$\sigma^{3P_2} = \begin{cases} L \text{ if } x \leq x^* \\ H \text{ if } x > x^* \end{cases}$$

In this pooling strategy the bid level M is not used. Here, the strategy σ^{3P_2} can be associated with the distribution $(x^*; 0; 1 - x^*)$ over L, M and H. We now prove our next result.

Proposition 3 *Under Assumptions* $1''$ *and* 3*, the partition strategy* $\sigma^{3P_2} = (x^*; 0; 1 - x^*)$*, with* $x^* = \frac{4}{3}M - \frac{2}{3}L$*, constitutes a symmetric pooling equilibrium of* G_3^0.

Proof. Following Definition 8, we need to show that the equilibrium conditions are satisfied at these parameter values.

The indifference condition is met when $x^* = \frac{4}{3}M - \frac{2}{3}L$ as $u_1\left(L, \sigma^{3P_2}\right)\big|_{x_1 = x^*} = u_1\left(H, \sigma^{3P_2}\right)\big|_{x_1 = x^*} = \frac{2(2M-L)(M-L)}{3}$.

The activation (and thus participation) constraint is satisfied by Assumption $1''$ as $u_1\left(L, \sigma^{3P_2}\right)\big|_{x_1 = 0} = \frac{2(2M-L)(M-2L)}{9} \geq 0$ when $M > 2L$.

Note that the feasibility constraint $0 < x^* = \frac{4}{3}M - \frac{2}{3}L < 1$ is satisfied under Assumption $1''$.

We now need to prove the incentive constraints for the two partitions below and above x^*.

To do this, take a small $\varepsilon > 0$ and x_1 such that $|x_1 - x^*| = \varepsilon$. It is easy to check that at x_1, $u_1\left(L, \sigma^{3P_2}\right) - u_1\left(H, \sigma^{3P_2}\right)$ is $\frac{\varepsilon}{2} > 0$, when $x_1 < x^*$ and is $-\frac{\varepsilon}{2} < 0$, when $x_1 > x^*$. Similarly, at x_1, $u_1\left(L, \sigma^{3P_2}\right) - u_1\left(M, \sigma^{3P_2}\right)$ is $\frac{(2M-L)\varepsilon}{3} > 0$, when $x_1 < x^*$ and is $\frac{(L-2M)\varepsilon}{3} < 0$, when $x_1 > x^*$ (by Assumption $1''$). Finally, when $x_1 > x^*$, at x_1, $u_1\left(H, \sigma^{3P_2}\right) - u_1\left(M, \sigma^{3P_2}\right) = \frac{(3-4M+2L)}{6}\varepsilon > 0$ (by Assumption $1''$). Thus all the incentive constraints are satisfied. ■

We may illustrate the above result now using some specific parameter values.

Example 3 *Take* $L = 1/5$*,* $M = 3/5$ *and* $H = 3/2$*, satisfying Assumptions* $1''$ *and* 3*. From Proposition 4, we have* $x^* = 2/3$*. Thus in this symmetric pooling equilibrium of this game, a bidder is active at L (but not at* M *or* H*) when the signal is less than or equal to* $2/3$ *and active at* H *when the signal is bigger than* $2/3$*. Bidder* i*'s payoff,* u_i*, from this equilibrium strategy profile is given by* $u_i = \frac{1}{3}x_i + \frac{2}{45}$ *if* $x_i \leq 2/3$ *(in which case bidder i plays L) and* $u_i = \frac{5}{6}x_i - \frac{13}{45}$ *if* $x_i > 2/3$ *(in which case bidder i plays* H*).*

3.2.3 Illustration 3

In this illustration, we make the following assumptions on the parameters.

Assumption 4. $M < \frac{1}{2}$.

Assumption 5. $H = M + \frac{1}{2}$.

Let us now consider the following partition strategy:

$$\sigma^{3P_3} = \begin{cases} M \text{ if } x \leq x^* \\ H \text{ if } x > x^* \end{cases}$$

In this pooling strategy the bid level L is not used. We may write the above strategy as $\sigma^{3P_3} = (0; x^*; 1 - x^*)$. We now prove that this strategy constitutes a symmetric equilibrium for this game.

Proposition 4 *Under Assumptions* 4 *and* 5*, the partition strategy* $\sigma^{3P_3} = (0; x^*; 1-x^*)$*, with* $x^* = 2M$*, constitutes a symmetric pooling partition equilibrium of* G_3^0*.*

Proof. Following Definition 8, we need to show that the equilibrium conditions are satisfied at these parameter values.

The indifference condition is satisfied at $x^* = 2M$, as $u_1 \left(M, \sigma^{3P_3}\right)\big|_{x_1 = x^*} = u_1 \left(H, \sigma^{3P_3}\right)\big|_{x_1 = x^*} = M^2$. The activation (and thus participation) constraint is trivially satisfied as $u_1 \left(M, \sigma^{3P_3}\right)\big|_{x_1 = 0} = 0$. The feasibility constraint $0 < x^* = 2M < 1$ is met by Assumption 4.

We now need to prove the incentive constraints for the two partitions below and above x^*. To do this, as in the proof of Proposition 4, we take a small $\varepsilon > 0$ and x_1 such that $|x_1 - x^*| = \varepsilon$. It is easy to check that at x_1, $u_1 \left(M, \sigma^{3P_3}\right) - u_1 \left(H, \sigma^{3P_3}\right)$ is $\frac{\varepsilon}{2} > 0$, when $x_1 < x^*$ and is $-\frac{\varepsilon}{2} < 0$, when $x_1 > x^*$. Similarly, whenever $x_1 < x^*$, at x_1, $u_1 \left(L, \sigma^{3P_3}\right) - u_1 \left(M, \sigma^{3P_3}\right) = -M \left(2M + \varepsilon\right) < 0$. Finally, whenever $x_1 > x^*$, at x_1, $u_1 \left(L, \sigma^{3P_3}\right) - u_1 \left(H, \sigma^{3P_3}\right) = -2M^2 - M\varepsilon - \frac{1}{2}\varepsilon < 0$. Thus all the incentive constraints are satisfied. ■

We may now illustrate the above result.

Example 4 *Take* $L = 1/10$*,* $M = 2/5$ *and* $H = 9/10$*, satisfying Assumptions* 4 *and* 5*. From Proposition* 5*, we have* $x^* = 4/5$*. Thus in this symmetric pooling equilibrium of this game, a bidder is active at* M *(but not at* H*) when the signal is less than or equal to* $4/5$ *and active at* H *when the signal is bigger than* $4/5$*. Bidder i's payoff,* u_i*, from this equilibrium strategy profile is given by* $u_i = \frac{2}{5}x_i$ *if* $x_i \leq 4/5$ *(in which case bidder i plays* M*) and* $u_i = \frac{9}{10}x_i - \frac{2}{5}$ *if* $x_i > 4/5$ *(in which case bidder i plays* H*).*

3.2.4 Multiple (Pooling) Equilibria

In this subsection, we show that there may exist two pooling equilibria in a given G_3^0 (for given values of the bid levels), using the illustrations in the previous subsection.

It is clear that one cannot find values of three bid levels so that both pooling equilibria $(\sigma^{3P_1}, \sigma^{3P_1})$ and $(\sigma^{3P_3}, \sigma^{3P_3})$ exist simultaneously (as Assumptions 1 and 4 for values of M are mutually exclusive). Similarly, one cannot find values of three bid levels for which both pooling equilibria $(\sigma^{3P_2}, \sigma^{3P_2})$ and $(\sigma^{3P_3}, \sigma^{3P_3})$ exist (as both Assumptions 3 and 5 cannot be satisfied by the same value of H).

However it is possible to find values of the bid levels such that both pooling equilibria $(\sigma^{3P_1}, \sigma^{3P_1})$ and $(\sigma^{3P_2}, \sigma^{3P_2})$ exist simultaneously.

Note that any values of L and M satisfying Assumption $1^{'}$ will also satisfy Assumption $1^{''}$ as for any $L < \frac{1}{2}$, $M > L + \frac{1}{2}$ implies $M > 2L$. Hence, we may find a set of numerical values for three bid levels for which two pooling equilibria exist as the following example (similar to Example 2) illustrates.

Example 5 *Take a G_3^0 with $L = 1/5$, $M = 4/5$ and $H = 19/10$, satisfying Assumption $1^{'}$ (and thereby Assumption $1^{''}$) and Assumptions 2 and 3. In this game, we have two different pooling equilibria, $(\sigma^{3P_1}, \sigma^{3P_1})$ and $(\sigma^{3P_2}, \sigma^{3P_2})$, characterised by two different cut-offs, respectively, $3/4$ and $14/15$. First, the symmetric pooling partition equilibria, $(\sigma^{3P_1}, \sigma^{3P_1})$ exists (as in Example 2) in which each bidder is active at L (but not at M or H) when the signal is less than or equal to $3/4$ and active at M when the signal is bigger than $3/4$. Bidder i's payoff, u_i, from this equilibrium strategy profile is given by $u_i = \frac{3}{8}x_i + \frac{21}{320}$ if $x_i \leq 3/4$ (in which case bidder i plays L) and $u_i = \frac{7}{8}x_i - \frac{99}{320}$ if $x_i > 3/4$ (in which case bidder i plays M). Second, the symmetric pooling partition equilibria, $(\sigma^{3P_2}, \sigma^{3P_2})$ exists in which each bidder is active at L (but not at M or H) when the signal is less than or equal to $14/15$ and active at H when the signal is bigger than $14/15$. Bidder i's payoff, u_i, from this equilibrium strategy profile is given by by $u_i = \frac{7}{15}x_i + \frac{28}{225}$ if $x_i \leq 14/15$ (in which case bidder i plays L) and $u_i = \frac{29}{30}x_i - \frac{77}{225}$ if $x_i > 14/15$ (in which case bidder i plays H). One may compare these two equilibria by their ex-ante expected payoffs (for each bidder i) that are respectively $\frac{43}{160}$ $(= 0.26875)$ for $(\sigma^{3P_1}, \sigma^{3P_1})$ and $\frac{323}{900}$ $(= 0.35889)$ for $(\sigma^{3P_2}, \sigma^{3P_2})$; hence, the equilibrium σ^{3P_2} is better for the bidders.*

3.3 Seller's Expected Revenue

We now focus on the seller's expected revenue from all the equilibria stated in the previous subsections.

3.3.1 Revenue in G_2^0

Consider the separating equilibrium $(\sigma^{2S}, \sigma^{2S})$ as presented in Proposition 1. The expected revenue for the seller from this equilibrium is given by L when both players play L (occurs with probability $(x^*)^2$) and H in all other cases (i.e., when at least one bidder bids H). Thus the seller's expected revenue (R^{2S}) is: $R^{2S} = (x^*)(x^*)L + (x^*)(1-x^*)H + (1-x^*)(x^*)H + (1-x^*)(1-x^*)H = \frac{L+4LH-4LH^2+3H-4H^2+4HL^2}{4(1+L-H)^2}$.

We observe that for all values of L and H satisfying our assumption, the seller's expected revenue is lower than in a JEA with continuous bids, $E\left[P^{JEA}\right] = 2/3$ (see Avery and Kagel, 1997). The following figure (Figure 1) displays this result, which is similar to that obtained by Rothkopf and Harstad (1994, Proposition, p. 575) in a private values setting (insofar as the revenue from a discrete bidding auction is lower than in its continuous counterpart).

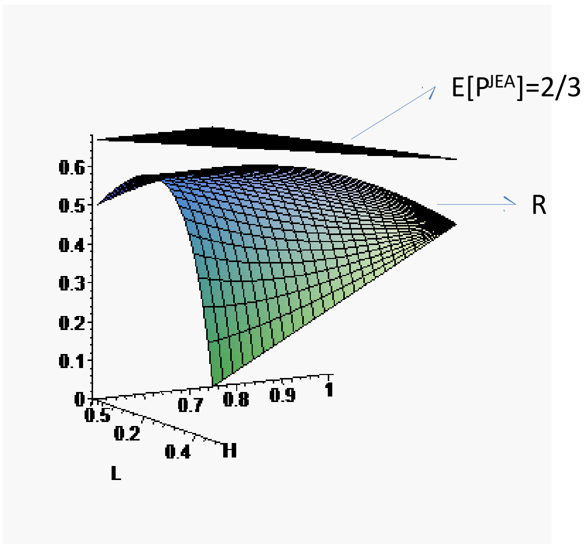

Figure 1: Seller's expected revenue for different bid levels

Although G_2^0 yields 'lost revenue' compared to the continuous case, it is possible to show that a second-best solution for the choice of L and H exists in this set-up.

Proposition 5 *In the equilibrium* $(\sigma^{2S}, \sigma^{2S})$ *as stated in Proposition* 1*, seller's expected revenue is maximised when* $L^* = 1/4$ *and* $H^* = 3/4$*, yielding* $x^* = 1/2$ *and* $R^{2S^*} = 5/8$*.*

Proof. In order to obtain the revenue-maximising values of L and H, we need to solve the following optimisation problem (rearranging the inequality restrictions):

$\max_{L,H} R^{2S} = \frac{L+4LH-4LH^2+3H-4H^2+4HL^2}{4(1+L-H)^2}$

subject to $1/2 - L \geq 0$, $H - L - 1/2 \geq 0$, $3/4 + L/2 - H \geq 0$, $L \geq 0$ and $H \geq 0$.

We set up the Lagrangian as below, where y_i are the multipliers:

$Z = \frac{L+4LH-4LH^2+3H-4H^2+4HL^2}{4(1+L-H)^2} + y_1 (1/2 - L) + y_2 (H - L - 1/2) + y_3 (3/4 + L/2 - H)$

We are now going to use the Kuhn-Tucker conditions for the above Langrangean. First, as we are looking for $L^* > 0$ and $H^* > 0$, we have $\frac{\partial Z}{\partial L} = 0$ and $\frac{\partial Z}{\partial H} = 0$. Now, when $\frac{\partial Z}{\partial y_2} = H - L - 1/2 = 0$

(that is, when $H = L + 1/2$), we have $y_2 > 0$ and the expected revenue is a concave function of L. This implies $\frac{\partial Z}{\partial y_1} = 1/2 - L > 0$ and also $\frac{\partial Z}{\partial y_3} = 3/4 + L/2 - H > 0$, thereby $y_1 = 0$ and $y_3 = 0$.

Thus we have three equations, namely, $\frac{\partial Z}{\partial L} = 0$, $\frac{\partial Z}{\partial H} = 0$ and $\frac{\partial Z}{\partial y_2} = 0$ that we can solve with respect to L, H and y_2. Solving these, we get $L^* = 1/4$ and $H^* = 3/4$ (with $y_2^* = 3/4$). For these optimal bid levels, $R^{2S^*} = 5/8$. ■

In the second best solution, "the loss of revenue" compared to the JEA with continuous bids is approximately 6.3%. It is, although significantly higher than zero, not very high in percentage terms.

3.3.2 Revenue in G_3^0

We now consider the seller's revenue for each of the three pooling equilibria for any given G_3^0 as described above. For each case, we find the best parameter values that maximise the corresponding seller's revenue.

First we consider the pooling equilibrium $(\sigma^{3P_1}, \sigma^{3P_1})$ for G_3^0 which is very similar to the separating equilibrium $(\sigma^{2S}, \sigma^{2S})$ for G_2^0. The seller's revenue from the equilibrium $(\sigma^{3P_1}, \sigma^{3P_1})$ is given by:

$R^{3P_1} = \frac{L+4LM-4LM^2+3M-4M^2+4ML^2}{4(1+L-M)^2}$.

It is obvious that we will have the same values for the parameters that maximise the seller's revenue here.

Corollary 2 *Seller's expected revenue from the equilibrium $(\sigma^{3P_1}, \sigma^{3P_1})$ is maximised when $L^* = 1/4$, $M^* = 3/4$ and $H^* = 5/4$, yielding $x^* = 1/2$ and $R^{3P_1^*} = 5/8$.*

Proof. The proof follows immediately from Proposition 5. Given the solutions of the Lagrangean (as in the proof of Proposition 5) $L^* = 1/4$ and $M^* = 3/4$, we obtain $H^* = \frac{3}{4} + \frac{M^*}{2} + \frac{2M^*-1}{8(1+L^*-M^*)} = 5/4$. For these bid levels, $x^* = 1/2$ and $R^{3P_1^*} = 5/8$. ■

Note that, not surprisingly, $R^{3P_1^*} = R^{2S^*}$.

We now consider the pooling equilibrium $(\sigma^{3P_2}, \sigma^{3P_2})$. The seller's revenue from the equilibrium $(\sigma^{3P_2}, \sigma^{3P_2})$ is given by:

$R^{3P_2} = \frac{28}{9}LM - \frac{16}{9}M^2 - \frac{1}{3}L + \frac{1}{2} + \frac{2}{3}M - \frac{10}{9}L^2$.

Proposition 6 *Seller's expected revenue from the equilibrium $(\sigma^{3P_2}, \sigma^{3P_2})$ is maximised when $L^* = 1/4$, $M^* = 1/2$ and $H^* = 5/4$, yielding $x^* = 1/2$ and $R^{3P_2^*} = 5/8$.*

Proof. The proof is similar to that of Proposition 5. Given the constrained maximisation problem, we write down the corresponding Lagrangean and use the Kuhn-Tucker conditions. Solving, we get $L^* = 1/4$ and $M^* = 1/2$. Hence, $H^* = \frac{1}{2} + 2M^* - L^* = 5/4$. For these bid levels, $x^* = \frac{4}{3}M^* - \frac{2}{3}L^* = 1/2$ and therefore $R^{3P_2^*} = 5/8$. ■

Finally, we consider the pooling equilibrium $(\sigma^{3P_3}, \sigma^{3P_3})$. The seller's revenue from the equilibrium $(\sigma^{3P_3}, \sigma^{3P_3})$ is given by:

$R^{3P_3} = M - 2M^2 + \frac{1}{2}$.

Proposition 7 *Seller's expected revenue from the equilibrium* $(\sigma^{3P_3}, \sigma^{3P_3})$ *is maximised at* $M^* = 1/4$ *and* $H^* = 3/4$*, with any* $L < 1/4$*, yielding* $x^* = 1/2$ *and* $R^{3P_3^*} = 5/8$*.*

Proof. The proof is straightforward. From the first order condition, we obtain $M^* = 1/4$, in which case $H^* = M^* + 1/2 = 3/4$. Any $L < M^* = 1/4$ will thus be revenue-maximizing. In this case, $x^* = 1/2$ and $R^{3P_3^*} = 5/8$. ■

Observe that $R^{3P_1^*} = R^{3P_2^*} = R^{3P_3^*} = R^{2S^*}$. It is not really surprising if we carefully look at the way the pooling strategies σ^{3P_1}, σ^{3P_2} and σ^{3P_3} have been constructed as extreme points of a separating equilibrium in a G_3^0 (discussed in the next subsection) and hence the corresponding equilibrium profiles $(\sigma^{3P_1}, \sigma^{3P_1})$, $(\sigma^{3P_2}, \sigma^{3P_2})$ and $(\sigma^{3P_3}, \sigma^{3P_3})$ have the same payoffs.

3.4 Separating Equilibrium in G_3^0: A Simulation

One may be interested in constructing a separating equilibrium for any given G_3^0. Following Definition 7, a separating strategy for G_3^0 with three bid levels, L, M and H can be written using two cut-offs x^* $(= x_1^*)$ and y^* $(= x_2^*)$ as:

$$\sigma^{3S} = \begin{cases} L \text{ if } x \leq x^* \\ M \text{ if } x^* < x \leq y^* \\ H \text{ if } x > y^* \end{cases}$$

From Definition 8, we can construct a symmetric separating equilibrium using the above strategy. The profile $(\sigma^{3S}, \sigma^{3S})$ is an equilibrium if the following conditions are met.

$u_1\left(L, \sigma^{3S}\right)\big|_{x_1=x^*} = u_1\left(M, \sigma^{3S}\right)\big|_{x_1=x^*}$ [indifference at x^*]

$u_1\left(M, \sigma^{3S}\right)\big|_{x_1=y^*} = u_1\left(H, \sigma^{3S}\right)\big|_{x_1=y^*}$ [indifference at y^*]

$u_1\left(L, \sigma^{3S}\right) > u_1\left(M, \sigma^{3S}\right)$ if $x_1 < x^*$ [incentive constraint for the first partition]

$u_1\left(M, \sigma^{3S}\right) > u_1\left(L, \sigma^{3S}\right)$ if $x^* < x_1 < y^*$ [first incentive constraint for the second partition]

$u_1\left(M, \sigma^{3S}\right) > u_1\left(H, \sigma^{3S}\right)$ if $x^* < x_1 < y^*$ [second incentive constraint for the second partition]

$u_1\left(H, \sigma^{3S}\right) > u_1\left(M, \sigma^{3S}\right)$ if $x_1 > y^*$ [incentive constraint for the third partition]

$u_1\left(L, \sigma^{3S}\right) \geq u_1(0, \sigma_2) = 0$ if $x_1 \leq x^*$ [activation constraint] implying $u_1\left(L, \sigma^{3S}\right)\big|_{x_1=0} \geq 0$ [participation constraint]

$0 < x^* < y^* < 1$ [feasibility constraint]

As mentioned earlier, it is difficult to analytically characterise such an equilibrium, that is, it is hard to find numerical values for x^* and y^* satisfying all the above constraints for any given values of L, M and H. We thus present a simulation to indicate the existence of such an equilibrium for a fixed set of values of L, M and H. We start off with $L = 1/4$ and $M = 3/4$; recall that these values maximise the seller's revenue from the equilibrium $(\sigma^{2S}, \sigma^{2S})$ with two bid levels. Coupled with these values, we take a range of values for H between 5/4 (= 1.25) and 7/4 (= 1.75). Note that, for the bid levels $L = 1/4$, $M = 3/4$, and $H = 5/4$, we have the pooling equilibrium $(\sigma^{3P_1}, \sigma^{3P_1})$ and for $L = 1/4$, $M = 3/4$, and $H = 7/4$, we have the pooling equilibrium $(\sigma^{3P_2}, \sigma^{3P_2})$. We vary the value of H and find values of x^* and y^* satisfying all the equilibrium conditions and thereby find a separating equilibrium in this case. The following figure (Figure 2) shows the cutoffs x^* and y^* in the separating equilibrium for different values of H (between 1.25 and 1.75 on the horizontal axis).

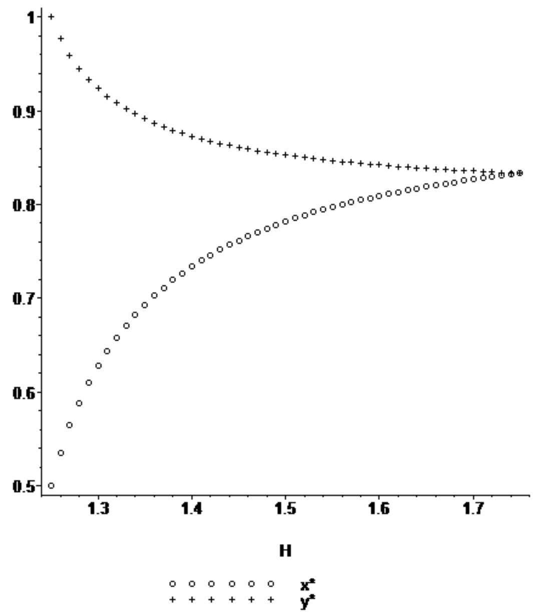

Figure 2: Cutoffs for separating equilibrium

In Figure 2, for each value of H (on the horizontal axis) we have two different dots: the lower curve is for x^* while the upper curve is for y^*. Take, for example, three different levels of H: $H = 7/5$, $H = 3/2$ and $H = 8/5$. The approximate numerical values are the following:

	$H = 7/5$	$H = 3/2$	$H = 8/5$
x^*	0.734	0.782	0.801
y^*	0.873	0.853	0.842
Seller's Revenue	0.514	0.476	0.453

Note that at the two boundaries of the values of H, we have the pooling equilibria $(\sigma^{3P_1}, \sigma^{3P_1})$ and $(\sigma^{3P_2}, \sigma^{3P_2})$ that can be interpreted as the two extremes of the separating equilibrium. The pooling equilibrium $(\sigma^{3P_1}, \sigma^{3P_1})$ is equivalent to a separating equilibrium with $x^* = 1/2$ and $y^* = 1$ in which H is not played. Similarly, the pooling equilibrium $(\sigma^{3P_2}, \sigma^{3P_2})$ is equivalent to a separating equilibrium with $x^* = y^* = 5/6$ in which M is not played.

We can find the seller's revenue from such a separating equilibrium, as displayed in Figure 3.

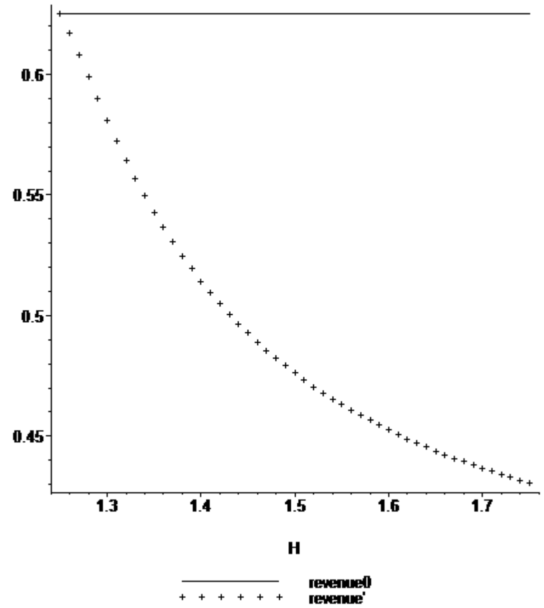

Figure 3: Seller's revenue in pooling and separating equilibrium

We observe that the revenue from any separating equilibrium here (revenue$'$ in Figure 3) is lower than that of the pooling equilibrium $(\sigma^{3P_1}, \sigma^{3P_1})$ which is equivalent to the equilibrium $(\sigma^{2S}, \sigma^{2S})$ with two bid levels (revenue0 in Figure 3). Thus, we note that in this example, the seller strictly prefers the pooling equilibrium $(\sigma^{3P_1}, \sigma^{3P_1})$ to be played rather than the separating equilibrium for any sufficiently high H where these two types of equilibria coexist. Also, by the same token, we observe that two bid levels are (weakly) better than three for the seller. However, it is important to note that if the seller had the choice of all three bid levels, $L = 1/4$, $M = 3/4$ and $H > 5/4$ would in all likelihood not be his revenue-maximising choices. But finding the optimal choice of L, M and H is not easy, even with simulations. We conjecture that perhaps the revenue from the equilibrium $(\sigma^{2S}, \sigma^{2S})$ in G_2^0 is (weakly) higher than that from any (pooling or separating) equilibrium in G_3^0.

4 CONCLUSION

In a JEA for the wallet game with continuous bid levels, we have shown that a partition equilibrium based on cut-offs in signals exists where the bidders use only weakly increasing partition strategies. We have characterised these equilibria that can be pooling or separating. We illustrated a few such equilibria with two and three discrete bid levels. Under our partition equilibrium, seller's expected revenue is strictly lower than that of the continuous JEA; the seller can, however, optimally choose the bid levels to maximise the expected revenue. In this second best solution, the 'loss of revenue' compared to the JEA with continuous bid increments is not very high in percentage terms. Our paper thus provides some understanding of how, once one fixes the number of bid levels, bid levels should be optimally chosen by the seller.

The rationale behind our result is relatively straightforward: given discrete bid levels, the partition equilibrium leads players to bid up to the lowest discrete bid level 'too' often, and that reduces the expected revenue compared to the continuous bidding JEA. With continuous bid levels the players can easily infer (from the equilibrium strategies) their opponent's signal and thus accurately calculate their payoff. However, with discrete bid levels, such an accurate inference is no longer possible and bidding up to the low bid level more often provides a 'safety net' under such "uncertainty".

Our construction of equilibrium is somewhat similar to the recent work by Ettinger and Michelucci (2016a) and Hernando-Veciana and Michelucci (2017) in a different environment: these results are all related to a type of bunching which is somehow endogenously determined (in their papers, by jump bids or by the choice of a 2-stage mechanism while in our work by the choice of the bid levels). Also, Ettinger and Michelucci (2016b) analyses a simple example in which partitions can be induced by jump bidding (Proposition 4 in their paper).

Needless to add, it is certainly an interesting question whether a general result for the set of equilibria can be obtained in the games analysed in this paper for more than three bid levels. Future research should characterise the set of all such partition equilibria for any number of discrete bids and other (non-partition) equilibria, if any.

JEA with discrete bids may present other advantages to the auctioneer or to the bidders, such as, reduced auction duration or an easier understanding of the rules that are particularly important issues in online auctions. Thus, it may very well be the case that it becomes an even more attractive auction format in the future, in which case more analysis should be devoted to this format than its continuous bid counterpart.

Our research points out what the implications are of using a specific set of bid levels and how a seller should optimally manipulate it. One may be interested in finding the optimal number of bid levels for such an auction. Our simulation on three bid levels suggests that the optimal number of bid levels (to maximise the seller's revenue) is perhaps small. One may also be interested in testing this hypothesis in a suitably designed experiment. In addition, whether our partition equilibria are played is also a question well suited for experimental testing. In the very simple set-up, with two or three discrete bid levels, although multiple (separating or pooling) equilibria exist, our analysis provides helpful indications regarding equilibrium selection. These are likely to be the next steps in our research.

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