Incomplete information bargaining with applications to mergers, investment, and vertical integration

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May 24, 2021

Abstract

We provide an incomplete information bargaining framework that captures the effects of differential bargaining power in markets with multiple buyers and multiple suppliers. The market is modeled as a mechanism that maximizes the expected weighted welfare of the agents, subject to the constraints of incentive compatibility, individual rationality, and no deficit. We show that, in this model, there is no basis for the presumption that vertical integration increases equally weighted social surplus, while it is possible that horizontal mergers that appropriately change bargaining weights increase social surplus. Moreover, efficient bargaining implies that in equilibrium noncontractible investments are efficient.

Keywords: bargaining power, countervailing power, vertical integration, investment

JEL Classification: D44, D82, L41

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*We are grateful to three anonymous reviewers and two editors of this journal, Liran Einav and Sylvain Chassang, whose comments and suggestions have helped us to improve the paper substantially. We also thank Matt Backus, Allan Collard-Wexler, Nitin Dua, Sean Ennis, Soheil Ghili, Brad Larsen, Robin Lee, Joao Monteiz, Rob Porter, Patrick Rey, George Rozanski, Glen Weyl, Matthijs Wildenbeest, Steve Williams, and seminar audiences at Bocconi University, Boston University, Columbia University, CREST/École Polytechnique, Harvard University, MIT, New York University, University of East Anglia, University of Melbourne, Australiasian Microeconomic Theory Seminars, Conference on Mechanism & Institution Design, Interactive Online IO Seminar, CEPR Virtual IO Seminar Series, 3rd BEET Workshop, 33rd Summer Conference on Industrial Organization: Advances in Competition Policy, 13th Annual Competition Law, Economics & Policy Conference in Pretoria, MACCI Workshop on Mergers and Antitrust, and 19th Annual IIOC for valuable discussions and comments. Edwin Chan, Toan Le and Bing Liu provided excellent research assistance. Financial support from the Samuel and June Hordern Endowment, European Research Council under the European Community’s Seventh Framework Programme (FP7/2007-2013) Grant Agreement 340903, University of Melbourne Faculty of Business & Economics Eminent Research Scholar Grant, and Australian Research Council Discovery Project Grant DP200103574 is also gratefully acknowledged.

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1 Introduction

Bargaining has come to the forefront in industrial organization and antitrust. It plays a prominent role in recent cases, including in health care, telecommunications, mass media, and patents. Common practice in modeling bargaining is to assume that the agents have complete information about each other’s values and costs and to adhere to axiomatic approaches based on Nash bargaining or the Shapley value according to which bargaining outcomes are efficient. Apart from bargaining losing “much of its interest” when information is complete (Fudenberg and Tirole [1991]), the complete information approach with efficient bargaining has the downside that shifts of bargaining power, perhaps due to a merger, or more generally changes in market structure, only affect the distribution of surplus and not its size since bargaining is, by assumption, efficient. Of course, the popularity of the complete information bargaining approach is in no small part due to the perceived challenges associated with the alternative of incomplete information bargaining, such as a lack of tractability of extensive-form representations and the dependence of bargaining outcomes on higher-order beliefs and assumptions of common knowledge of type distributions.

In this paper, we develop an incomplete information bargaining framework that sidesteps the lack of tractability of extensive-form games by taking an “as-if” approach in which allocations and transfers are on the Pareto frontier achievable through mediated mechanisms. Specifically, we stipulate that there is a market mechanism that, for given bargaining weights, maximizes the weighted sum of the agents’ surplus, subject to the constraints that the mechanism is incentive compatible and individually rational and does not run a deficit. For the case of one buyer and one supplier with equal bargaining weights, our model specializes to the bilateral trade problem of Myerson and Satterthwaite [1983].

We apply this framework to analyze several long-standing questions in antitrust. We show that with incomplete information bargaining, there is no basis for a presumption that vertical integration increases social surplus. The intuition is simple and related to the fact that whether incomplete information bargaining is efficient is endogenous. In a nutshell, vertical integration can create a Myerson-Satterthwaite problem by rendering hitherto efficient bargaining inefficient. More generally, because changes in bargaining weights and market structures have direct effects on the social surplus resulting from incomplete information

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The notion that vertical integration improves outcomes remains influential in antitrust. A case in point is the 2020 update of the U.S. DOJ and FTC’s Vertical Merger Guidelines, which after recognizing that “vertical mergers are not invariably innocuous” state that “vertical mergers often benefit consumers through the elimination of double marginalization, which tends to lessen the risks of competitive harm” and that “vertical mergers combine complementary economic functions and eliminate contracting frictions, and therefore have the capacity to create a range of potentially cognizable efficiencies that benefit competition and consumers” (U.S. DOJ and FTC, 2020, pp. 2, 11).
bargaining, the framework opens scope for a countervailing power defense of, say, horizontal mergers that appropriately shift bargaining powers, or more generally the analysis of policies that equalize bargaining powers. Although the concept that power on one side of a market could neutralize power on the other side of a market has been controversial since its inception,\footnote{Galbraith (1954, p. 1) saw “the neutralization of one position of power by another” as a mitigant of economic power of “substantial, and perhaps central, importance,” while Stigler (1954, p. 13) lamented the lack of any explanation for “why bilateral oligopoly should in general eliminate, and not merely redistribute, monopoly gains.” The controversy arises in no small part because formalizing notions of countervailing power has proven challenging and because “it is difficult to model bilateral monopoly or oligopoly, and there exists no single canonical model” (Snyder, 2008, p. 1188).} it has popular appeal and has influenced antitrust policies and regulation.\footnote{For example, OECD (2011, pp. 50–51) and OECD (2007, pp. 58–59) raise the possible role of collective negotiation and group boycotts for counterbalancing market power by providers of payment card services. Potential benefits from allowing physician network joint ventures are recognized by the U.S. DOJ and FTC’s 1996 “Statement of Antitrust Enforcement Policy in Health Care.”} Our paper thus provides a framework that permits the evaluation of arguments based on equalization of bargaining power.

The incomplete information bargaining framework also has the feature that when agents make noncontractible and nonobservable investments that improve their own type distributions, efficient incomplete information bargaining implies efficient equilibrium investments. Thereby, the model sheds new light on ongoing debates in industrial organization and antitrust in the wake of the Dow-DuPont merger decision on the interaction between market structure and investments. It also epitomizes the contrast to complete information models, which with incomplete contracting obtain inefficient investments because of hold up. With incomplete information, incentive compatibility protects the agents from hold up, and if bargaining is efficient, it perfectly aligns individuals’ investment incentives with the planner’s objective.

Our framework uses the Myersonian mechanism design approach (Myerson, 1981) to elicit agents’ private information and determine prices and builds on the bilateral trade model of Myerson and Satterthwaite (1983), augmented by bargaining weights and multiple buyers and suppliers. Thereby, it combines elements of Myerson and Satterthwaite (1983), Williams (1987), and Gresik and Satterthwaite (1989). Specifically, our model allows for multiple buyers and multiple suppliers without imposing restrictions on the supports of the buyers’ values and the suppliers’ costs other than assuming that all buyers’ value distributions have the same support and all suppliers’ cost distributions have the same support.\footnote{Gresik and Satterthwaite (1989) also allow for multiple suppliers and multiple buyers, but they restrict attention to identical value distributions, identical cost distributions, and all distributions with a common support. Our setup has similarities with the optimal auction setting of Myerson (1981), with the important difference that our setup has two-sided private information.} We generalize Williams’ approach of maximizing an objective that assigns differential weights...
in a bilateral trade problem by allowing for multiple agents. Put differently, our paper reinterprets Myerson and Satterthwaite (1983) as a bilateral monopoly problem, extends it to allow for bargaining weights and multiple agents on both sides of the market, and shows that it is tractable and has all the required features. In particular, inherent to the independent private values setting is the key economic tradeoff between rent extraction and social surplus. We defer further discussion of the literature to Section 8.

While our paper does, of course, not resolve the deep problems related to agents’ higher-order beliefs and common knowledge assumptions in economics, it seems fair to deflect criticism of incomplete information bargaining models based on these concerns by noting that assuming common knowledge of distributions is weaker than the assumption of complete information models that there is common knowledge of values and costs.

The remainder of the paper is structured as follows. Section 2 introduces the setup. In Section 3, we provide a model of incomplete information bargaining. Section 4 derives results pertaining to horizontal mergers, and Section 5 derives results for vertical integration. Section 6 analyzes investment incentives. We discuss extensions in Section 7 and related literature in Section 8. Section 9 concludes the paper. Formal mechanism design results and longer proofs are relegated to appendices.

2 Setup

We consider a pre-merger market with \( n^S \) suppliers and \( n^B \) buyers, denoting the sets of suppliers and buyers, respectively, by \( \mathcal{N}^S \equiv \{1, \ldots, n^S\} \) and \( \mathcal{N}^B \equiv \{1, \ldots, n^B\} \). Each supplier \( j \) has the capacity to produce \( k^S_j \) units of a good at a constant marginal cost, and each buyer \( i \) has constant marginal value for up to \( k^B_i \) units of the good, where \( k^S_j \) and \( k^B_i \) are positive integers. Total demand is \( K^B \equiv \sum_{i \in \mathcal{N}^B} k^B_i \), and total supply is \( K^S \equiv \sum_{j \in \mathcal{N}^S} k^S_j \), and we define \( K \equiv \min\{K^B, K^S\} \).

Supplier \( j \) draws its constant marginal cost \( c_j \) independently from distribution \( G_j \) with support \([\underline{c}, \bar{c}]\) and density \( g_j \) that is positive on the interior of the support. Buyer \( i \) draws its constant marginal value \( v_i \) independently from distribution \( F_i \) with support \([\underline{v}, \bar{v}]\) and density \( f_i \) that is positive on the interior of the support. The problem is trivial if \( \bar{v} \leq \underline{c} \) because then it is never ex post efficient to have any trade. Therefore, we assume that \( \bar{v} > \underline{c} \). We assume that \( G_1, \ldots, G_{n^S}, F_1, \ldots, F_{n^B}, k^S_1, \ldots, k^S_{n^S}, \) and \( k^B_1, \ldots, k^B_{n^B} \) are common knowledge, while the realized costs and values are the private information of the individual suppliers and buyers. To save on notation, we ignore ties among the agents’ costs and values. While

\[5\text{For experimental results consistent with the incomplete information bargaining, see Valley et al. (2002, Fig. 3.A). See Larsen (2021) on the first-best and second-best frontiers for wholesale used cars.}\]
we adhere to a setup with constant marginal costs and values, with additional structure, one can allow for decreasing marginal values and increasing marginal costs.

The suppliers and buyers have quasilinear preferences. The payoff of supplier $j$ with type $c_j$ when producing $q \in \{0, \ldots, k_j^S\}$ units of the good and receiving the monetary transfer $m$ is $m - c_j q$. The payoff of buyer $i$ with type $v_i$ when receiving $q \in \{0, \ldots, k_i^B\}$ units of the good and making the monetary payment $m$ is $v_i q - m$.

Because both the buyers’ values and the suppliers’ costs are random variables whose realizations are the agents’ private information, the setup is symmetric with respect to the privacy of information, with the important consequence that ex post efficiency need not be possible. Indeed, our setup encompasses the classic Myerson-Satterthwaite (1983) setting, where, as they show, for $n^S = n^B = 1$, ex post efficient trade is impossible if and only if $\underline{v} < \underline{c}$.

We refer to the case with $\underline{v} < \underline{c}$ as the case with overlapping supports and the case with $\underline{v} \geq \underline{c}$ as the case of nonoverlapping supports. Thus, with one supplier and one buyer, incomplete information prevents ex post efficient trade in the case of overlapping supports, but not in the case of nonoverlapping supports.

We denote supplier $j$’s virtual cost and buyer $i$’s virtual value function by

$$\Gamma_j(c) \equiv c + \frac{G_j(c)}{g_j(c)} \quad \text{and} \quad \Phi_i(v) \equiv v - \frac{1 - F_i(v)}{f_i(v)},$$

which we assume to be increasing. As observed by Mussa and Rosen (1978), virtual value functions can be interpreted as marginal revenue functions and, analogously, virtual cost functions can be interpreted as marginal cost functions. For $a \in [0, 1]$, we define the $a$-weighted virtual cost functions and the $a$-weighted virtual value functions by

$$\Gamma_j^a(c) \equiv c + (1-a) \frac{G_j(c)}{g_j(c)} \quad \text{and} \quad \Phi_i^a(v) \equiv v - (1-a) \frac{1 - F_i(v)}{f_i(v)}.$$

The monotonicity of $\Gamma_j(c)$ and $\Phi_i(v)$ implies that $\Gamma_j^a(c)$ and $\Phi_i^a(v)$ and are also monotone.

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6To avoid informed-principal problems, we model the mechanism-design problem as one in which a third party without private information—such as a broker or “the market”—or ganizes the exchange. Although our setup has properties that are sufficient for the informed-principal problem to have no material consequences (see Mylovanov and Töger 2014), it seems wise to circumvent the associated technicalities. Of course, by giving all the bargaining power to one agent, we still obtain the optimal mechanism for that agent, just as one would if we assumed that the agent with all the bargaining power organized the exchange.

7We provide a derivation of this result in Appendix A.

8If $g_j(\bar{v}) = 0$, then define $\Gamma_j(\bar{v}) \equiv \lim_{c \downarrow \bar{v}} \Gamma_j(c)$. If $g_j(\bar{c}) = 0$, then $\Gamma_j(\bar{c}) = \infty$. Likewise, if $f_i(\bar{v}) = 0$, then define $\Phi_i(\bar{v}) \equiv \lim_{c \uparrow \bar{v}} \Phi_i(c)$, if $f_i(\bar{c}) = 0$, then $\Phi_i(\bar{c}) = -\infty$.

9The assumption of increasing virtual type functions can be relaxed through the use of “ironing.”

10This departs from the more standard notation in that the coefficient on the hazard rate term is $1 - a$ rather than $a$, but because we will be introducing bargaining weights, this modification is useful.
3 Incomplete information bargaining

At the heart of any economic model of exchange with transfers are assumptions that govern the price-formation process. For example, oligopoly models specify a mapping from firms’ actions to prices, and models based on Nash bargaining specify a mapping from preferences to trades and transfer payments. Our model stays within this tradition and adds to it by introducing an incomplete information bargaining model that allows for heterogeneous bargaining weights. It has neither the shortcoming of standard oligopoly models that buyers are price takers nor the problem of Nash bargaining that outcomes are efficient by assumption.\footnote{For evaluating the merits of buyer power arguments, the standard oligopoly models of Cournot and Bertrand are “dead on arrival” because one side of the market—typically, buyers—is characterized by price-taking behavior and hence has no bargaining or market power. The assumption of efficiency embedded in generalized Nash bargaining preempts any social-surplus-increasing effects of changes in the bargaining weights because the outcome is efficient both before and after the change. As noted by Ausubel et al. \citeyear{Ausubel2002}, the results of \cite{Myerson1983} imply that the search for efficiency is “fruitless.” Indeed, axiomatic bargaining approaches that stipulate efficient bargaining rule out transaction costs by assumption. In light of the Coase Theorem, which puts the question of transaction costs on center stage in economics, this limits the value of the approach.}

For exposition, it is useful to think of incomplete information bargaining as what the market does and to contrast it with what society, represented by a planner, would choose, with the planner facing the same constraints as the market—incentive compatibility, individual rationality and no deficit—while giving equal weight to all agents.

3.1 Market mechanism

We model incomplete information bargaining as a direct mechanism \((Q, M)\) operated by the market, where the allocation rule, \(Q = (Q^S, Q^B)\) with \(Q_j^S : [\tilde{v}, \tilde{c}]^{nB} \times [v^S, c^S] \rightarrow \{0, \ldots, k_j^S\}\) and \(Q_i^B : [\tilde{v}, \tilde{c}]^{nB} \times [v^S, c^S] \rightarrow \{0, \ldots, k_i^B\}\), maps the agents’ types to the quantities provided by the suppliers and the quantities received by the buyers, and the payment rule, \(M = (M^S, M^B)\) with \(M^S : [\tilde{v}, \tilde{c}]^{nB} \times [v^S, c^S] \rightarrow \mathbb{R}^{nS}\) and \(M^B : [\tilde{v}, \tilde{c}]^{nB} \times [v^S, c^S] \rightarrow \mathbb{R}^{nB}\), maps types to the payments to the suppliers and the payments from the buyers.\footnote{Any model of trade maps agents’ types into quantities and payments, regardless of whether the model has complete or incomplete information. However, for complete information models, the dependence on agents’ types is often degenerate insofar as each agent has only one (known) type.}

Feasibility requires that for all type realizations, \(\sum_{j \in N^S} Q_j^S(v, c) \geq \sum_{i \in N^B} Q_i^B(v, c)\).

The mechanism is required to satisfy incentive compatibility, individual rationality, and no deficit. A direct mechanism is incentive compatible if it is in the best interest of every agent to report its type truthfully to the mechanism and is individually rational if each agent, for every possible type, is weakly better off participating in the mechanism than walking away, where we normalize the payoffs of not trading and of walking away—that is,
the value of the outside option—to zero. A direct mechanism has no deficit if the sum of the expected payments from the buyers is greater than or equal to the sum of the expected payments to the suppliers. For formal definitions, see Appendix A.

Fixing a mechanism \((Q, M)\), supplier \(j\)’s and buyer \(i\)’s ex post surpluses as a function of the type realizations are

\[
U_{j;Q,M}(v,c) \equiv M_j^S(v,c) - c_j Q_j^S(v,c),
\]

and

\[
U_{i;Q,M}(v,c) \equiv v_i Q_i^B(v,c) - M_i^B(v,c).
\]

The budget surplus generated by the mechanism is

\[
R_M(v,c) \equiv \sum_{i \in N^B} M_i^B(v,c) - \sum_{j \in N^S} M_j^S(v,c),
\]

and the welfare or social surplus generated by the mechanism is

\[
W_Q(v,c) \equiv \sum_{i \in N^B} v_i Q_i^B(v,c) - \sum_{j \in N^S} c_j Q_j^S(v,c).
\]

To capture bargaining power, we endow the agents with bargaining weights \(w = (w^S, w^B)\), where \(w_j^S \in [0,1]\) is supplier \(j\)’s bargaining weight and \(w_i^B \in [0,1]\) is buyer \(i\)’s bargaining weight. We assume that at least one agent’s bargaining weight is positive. We define weighted welfare with bargaining weights \(w\) to be

\[
W_{Q,M}^w(v,c) \equiv \sum_{i \in N^B} w_i^B U_{i;Q,M}(v,c) + \sum_{j \in N^S} w_j^S U_{j;Q,M}(v,c),
\]

and assume that the market maximizes \(E_{v,c}[W_{Q,M}^w(v,c)]\), subject to incentive compatibility, individual rationality, and the constraint of no deficit:

\[
E_{v,c}[R_M(v,c)] \geq 0.
\]

We let \(\mathcal{M}\) denote the set of incentive compatible, individually rational, no-deficit mechanisms. The payoff equivalence theorem (see, e.g., Myerson 1981, Krishna 2010, Börgers 13)

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\(^{13}\)In our independent private values setting, any Bayesian incentive compatible and interim individually rational mechanism can be implemented with dominant strategies and ex post individual rationality. By construction, it yields the same interim and hence ex ante expected payoffs and revenue. Thus, while we formally state our assumptions in Appendix A in terms of Bayesian incentive compatibility and interim individual rationality, one could also use the ex post versions of those constraints.
(2015) implies that, given \((Q, M) \in \mathcal{M}\), the expected payoff of an agent is pinned down by the allocation rule and incentive compatibility up to a constant that is equal to the interim expected payoff of the worst-off type for that agent, which by incentive compatibility is \(\bar{c}\) for a supplier and \(\bar{v}\) for a buyer (see Appendix A). Thus, we have

\[
\mathbb{E}_{v,c}[M_j^S(v, c)] = \mathbb{E}_{v,c} \left[ \Gamma_j(c_j)Q_j^S(v, c) \right] + \hat{u}_j^S(\bar{c})
\]

and

\[
\mathbb{E}_{v,c}[M_i^B(v, c)] = \mathbb{E}_{v,c} \left[ \Phi_i(v_i)Q_i^B(v, c) \right] - \hat{u}_i^B(\bar{v}),
\]

where \(\hat{u}_j^S(c) \equiv \mathbb{E}_{v,c}[U_j^S(Q_j, M(v, c))]\) and \(\hat{u}_i^B(v) \equiv \mathbb{E}_{v,c}[U_i^B(Q_i, M(v, c))]\).

It is possible that multiple agents have the maximum bargaining weight and that a mechanism exists that maximizes weighted welfare subject to incentive compatibility and individual rationality and satisfies the no-deficit constraint with slack. If this is the case, then the bargaining weights pin down the allocation rule but not the payments because the expected budget surplus can be allocated among any of the agents with the maximum bargaining weight as lump sum payments without affecting the value of the objective or the incentive constraints. Because a complete specification of the outcome of incomplete information bargaining needs to account for these eventualities, we assume that there are tie-breaking shares \((\eta^S, \eta^B) \in [0, 1]^{n^S+n^B}\) satisfying \(\eta_i^x = 0\) if \(w_i^x < \max w\) and \(\sum_{j \in N^S} \eta_j^S + \sum_{i \in N^B} \eta_i^B = 1\). The market then selects the mechanism in \(\mathcal{M}\) that maximizes expected weighted welfare and that distributes the budget surplus absent fixed payments among the agents according to their tie-breaking shares.\(^{14}\)

We define an incomplete information bargaining mechanism with bargaining weights \(w\) to be a mechanism that, among all mechanisms in \(\mathcal{M}\), maximizes expected weighted welfare, \(\mathbb{E}_{v,c}[W_{Q,M}^w(v, c)]\). Notice that, because we evaluate outcomes according to expected welfare \(\mathbb{E}_{v,c}[W_{Q}(v, c)]\), the bargaining weights \(w\) are indeed only bargaining weights, that is, they do not affect how outcomes are evaluated, although they do affect the distribution of social surplus and, as we will see, sometimes the size of social surplus.

An immediate implication of this approach is that with equal bargaining weights, incomplete information bargaining delivers the second-best allocation rule, which maximizes expected welfare subject to incentive compatibility, individual rationality, and no deficit. Depending on the specifics, the second-best allocation rule may differ from the first-best allocation rule that maximizes welfare ex post without accounting for the no-deficit con-

\(^{14}\)For example, one might apply equal sharing or distribute the surplus according to Nash bargaining weights. Like with Nash bargaining weights, the tie-breaking shares have no social surplus effects.
Another implication of our approach is that if a group of agents on one side of the market have all the bargaining power, e.g., each agent in the group has a bargaining weight of one while all other agents have a bargaining weight of zero, then the incomplete information bargaining outcome is the perfectly collusive outcome for the agents with all the bargaining weight. Although collusive outcomes are not necessarily inconsistent with large numbers of agents under the view that increasing competition on one side of the market reduces the bargaining power of those agents, one could, for example, fix a set of buyers with positive bargaining weight and assume that when there are \( n^S \) suppliers, each supplier has bargaining weight \( 1/n^S \), in which case we get the “usual” result that supplier power goes to zero as the number of suppliers increases.

### 3.2 Allocation rule for incomplete information bargaining

The Lagrangian associated with maximizing expected weighted welfare \( E[v, c] \) subject to the no-deficit constraint \( \text{(2)} \) can be written as \( E[v, c]\left[ W^w_{QM}(v, c) + \rho R_M(v, c) \right] \), where \( \rho \) is the Lagrange multiplier on the no-deficit constraint. Using \( \text{(3)} \) and \( \text{(4)} \), the Lagrangian can be rewritten as

\[
E[v, c]\left[ \sum_{i \in N^B} w^B_i (v_i - \Phi_i(v_i)) Q^B_i(v, c) + \sum_{j \in N^S} w^S_j (\Gamma_j(c_j) - c_j) Q^S_j(v, c) \right]
\]

\[
+ \rho \left( \sum_{i \in N^B} \Phi_i(v_i) Q^B_i(v, c) - \sum_{j \in N^S} \Gamma_j(c_j) Q^S_j(v, c) \right)
\]

plus the term \( \sum_{i \in N^B} (w^B_i - \rho)u^B_i(v) + \sum_{j \in N^S} (w^S_j - \rho)u^S_j(\tau) \), which can be treated parametrically\(^\text{18} \). The buyer, supplier, and budget surpluses identified in \( \text{(5)} \) are the parts of the

\(^{15}\)The first-best allocation rule is monotone and hence permits incentive compatible implementation. Without the no-deficit constraint, individual rationality is trivial to satisfy.

\(^{16}\)Hatfield et al. (forth.) show that collusion in syndicated markets may become easier as market concentration falls, and that market entry may facilitate collusion because firms can sustain collusion by refusing to syndicate with any firm that undercuts the collusive price.

\(^{17}\)While we do not pursue it here, our approach generalizes directly to the requirement that the mechanism needs to generate a budget surplus of \( \kappa \in \mathbb{R} \), which is not more than the maximum budget surplus that any incentive-compatible, individually-rational mechanism can generate.

\(^{18}\)Denoting by \( \hat{q}^B_i(z) \) and \( \hat{m}^B_i(z) \) the interim expected quantity and payment of agent \( i \) when its type is \( z \) for \( x \in \{B, S\} \), which are formally defined in \( \text{(13)} \) in Appendix A.1, we have \( \hat{u}^B_i(v) = \hat{q}^B_i(v)w - \hat{m}^B_i(v) \) and \( \hat{u}^S_j(\tau) = \hat{m}^S_j(\tau) - \hat{q}^S_j(\tau)\tau \). Consequently, no matter what the pointwise maximizer implies for \( \hat{q}^B_i(v) \) and \( \hat{q}^S_j(\tau) \), one can choose achieve any value for \( \hat{u}^B_i(v) \) and \( \hat{u}^S_j(\tau) \) by appropriately varying \( \hat{m}^B_i(v) \) and \( \hat{m}^S_j(\tau) \), respectively.
respective surpluses that vary with the allocation rule and exclude the fixed terms.

Given the Lagrange multiplier $\rho$, the allocation rule that maximizes [5] can be defined pointwise. For the case of one supplier with cost $c$ and one buyer with value $v$, it is straightforward to show that the optimum has $Q^S_1(v, c) = Q^B_1(v, c) = \min\{k^S_1, k^B_1\}$ if $\Gamma^w_1(v, c) \leq \Phi^w_1(v)$, and $Q^S_1(v, c) = Q^B_1(v, c) = 0$ otherwise. For the general case, this basic rule extends as one might expect, but requires some additional notation.

Let $\Gamma^a_i(c)$ denote the constant vector $(\Gamma^a_j(c))_{j \in N^S}$ the merged list of these weighted virtual costs. Analogously, let $\Phi^a_i(v)$ denote the constant vector $(\Phi^a_j(v))_{j \in N^a}$ the merged list of these weighted virtual values. For a given type vector $(v, c)$, bargaining weight vector $w$, and Lagrange multiplier $\rho$, the objective in [5] is maximized when the quantity traded $q^*(\rho)$ is the largest element of $\{0, 1, \ldots, K\}$ such that the $q^*(\rho)$ lowest elements of $\Gamma^w/\rho(c)$ are less than or equal to the $q^*(\rho)$ greatest elements of $\Phi^w/\rho(v)$ [19].

A pointwise for a given $\rho$. That allocation rule induces each supplier $j \in {\cal N}^S_I(\rho)$ to produce $k^S_j$ and each buyer $i \in {\cal N}^B_I(\rho)$ to obtain $k^B_i$ units. Ignoring ties among the weighted virtual types of different agents at these threshold values, which occur with probability zero, the “residual” quantity $q^*(\rho) - \sum_{j \in {\cal N}^S_I(\rho)} k^S_j$, is procured from the supplier whose weighted virtual cost is equal to $\Gamma^*(\rho)$, and quantity $q^*(\rho) - \sum_{i \in {\cal N}^B_I(\rho)} k^B_i$, is allocated to the buyer whose weighted virtual value is equal to $\Phi^*(\rho)$. We refer to this allocation rule as the pointwise maximizer given $\rho$.

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[19] We select, arbitrarily but without loss of generality, the largest quantity consistent with the virtual values associated with traded units being greater than or equal to the virtual costs associated with traded units.
It only remains to specify the solution value $\rho^w$ for the Lagrange multiplier $\rho$. Following the same arguments that were first developed in the working paper version of Gresik and Satterthwaite (1989) and that were first used in published form in Myerson and Satterthwaite (1983), $\rho^w$ is the smallest feasible value for $\rho$ such that the no-deficit constraint is satisfied by the pointwise maximizer given $\rho$. Because any budget surplus can be reallocated to the agents through fixed payments, and because $\rho^w$ is the shadow price of the no-deficit constraint, we have $\rho^w \geq \max w$. Thus, we can define as $\rho^w$ as the smallest value of $\rho$ greater than or equal to $\max w$. Thus, we have the following result:

**Lemma 1.** The allocation rule for incomplete information bargaining with bargaining weights $w$, $Q^w$, is defined by

$$Q^w_j(v, c) \equiv \begin{cases} k^S_j & \text{if } \Gamma^w_j\rho^w(c_j) < \Gamma^*(\rho^w), \\ q^*(\rho^w) - \sum_{\ell \in \mathcal{N}^S(\rho^w)} k^S_\ell & \text{if } \Gamma^w_j\rho^w(c_j) = \Gamma^*(\rho^w), \end{cases}$$

and $Q^w_j(v, c) \equiv 0$ otherwise, and

$$Q^w_i(v, c) \equiv \begin{cases} k^B_i & \text{if } \Phi^w_i\rho^w(v_i) > \Phi^*(\rho^w), \\ q^*(\rho^w) - \sum_{\ell \in \mathcal{N}^B(\rho^w)} k^B_\ell & \text{if } \Phi^w_i\rho^w(v_i) = \Phi^*(\rho^w), \end{cases}$$

and $Q^w_i(v, c) \equiv 0$ otherwise.

**Proof.** See Appendix B.

An immediate implication of Lemma 1 is that the total quantity traded in incomplete information bargaining never exceeds the first-best level. This follows from the observation made above that $\Phi^*(\rho)$ is weakly larger than the value and $\Gamma^*(\rho)$ is weakly less than the cost of the marginal agents who would trade under the first-best.

### 3.3 Payoffs under incomplete information bargaining

We are left to augment the allocation rule of Lemma 1 with a consistent payment rule. As described above, based on the payoff equivalence theorem, all that remains to be done is to define the fixed payments to the agents' worst-off types. Individual rationality is satisfied if and only if the fixed payment to each supplier is nonnegative and the fixed payment from

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20 In addition, because a positive expected budget surplus is always possible given our assumption that $v > c$, the shadow price is finite.
each buyer is nonpositive. The optimization of the weighted objective requires that no money
be left on the table. So, we first define the “money on the table” before fixed payments are
made, i.e., the budget surplus under the mechanism of Lemma 1, not including the fixed
payments, given by

\[ \pi^w \equiv \mathbb{E}_{v,c} \left[ \sum_{i \in \mathcal{N}^B} \Phi_i(v_i)Q^w_i(v,c) - \sum_{j \in \mathcal{N}^S} \Gamma_j(c_j)Q^w_j(v,c) \right]. \tag{6} \]

Because all expected budget surplus is distributed to the agents, it follows that

\[ \pi^w = \sum_{j \in \mathcal{N}^S} \hat{u}^S_j(\bar{v}) + \sum_{i \in \mathcal{N}^B} \hat{u}^B_i(\bar{v}). \]

Of course, if \( \rho^w > \max \mathbf{w} \), then the no-deficit constraint binds, implying that \( \pi^w = 0 \) and
that the question of how to allocate the budget surplus is moot. In contrast, if \( \rho^w = \max \mathbf{w} \),
then \( \pi^w \geq 0 \). In this case, weighted welfare is maximized when \( \pi^w \) is allocated among the
suppliers and buyers with bargaining weights equal to \( \max \mathbf{w} \), which is accomplished by
having interim expected payoffs to the agents’ worst-off types of

\[ \begin{align*}
\hat{u}^S_j(c; \mathbf{w}, \eta) &= \eta_j^S \pi^w \\
\hat{u}^B_i(v; \mathbf{w}, \eta) &= \eta_i^B \pi^w,
\end{align*} \tag{7} \]

where, as defined above, \( \eta_j^S = 0 \) and \( \eta_i^B = 0 \) for any supplier \( j \) and buyer \( i \) that does not
have the maximum bargaining weight.

The outcome of incomplete information bargaining with bargaining weights \( \mathbf{w} \) and tie-
breaking shares \( \eta \) is then given by the expected buyer and supplier payoffs implied by the
allocation rule \( Q^w \) given in Lemma 1 and interim expected payoffs to agents’ worst-off types
given by (7). Thus, we have:

**Proposition 1.** Incomplete information bargaining with bargaining weights \( \mathbf{w} \) and shares \( \eta \)
generates expected supplier payoffs for \( j \in \mathcal{N}^S \) of

\[ u^S_j(\mathbf{w}, \eta) \equiv \eta_j^S \pi^w + \mathbb{E}_{v,c} \left[ (\Gamma_j(c_j) - c_j)Q^w_j(v,c) \right], \]

and expected buyer payoffs for \( i \in \mathcal{N}^B \) of

\[ u^B_i(\mathbf{w}, \eta) \equiv \eta_i^B \pi^w + \mathbb{E}_{v,c} \left[ (v_i - \Phi_i(v_i))Q^w_i(v,c) \right]. \]

The outcomes from incomplete information bargaining given in Proposition 1 coincide
with the set of Pareto undominated payoffs associated with mechanisms in \( \mathcal{M} \). To see this,
first note that because no money is left on the table, any expected payoffs from incomplete information bargaining are Pareto undominated among payoffs resulting from mechanisms in $\mathcal{M}$. Conversely, given a vector of expected payoffs $\tilde{u}$ that is the outcome of $\langle \tilde{Q}, \tilde{M} \rangle \in \mathcal{M}$ and that is Pareto undominated in the set of expected payoff vectors that obtain from mechanisms in $\mathcal{M}$, the weights $w$ and shares $\eta$ that induce $\tilde{u}$ follow from the dual characterization of maximal elements (see, for example, Boyd and Vandenberghe (2004) and (18) in Appendix B).

**Proposition 2.** If expected payoff vector $\tilde{u}$ associated with $\langle \tilde{Q}, \tilde{M} \rangle \in \mathcal{M}$ is Pareto un-dominated among expected payoff vectors for mechanisms in $\mathcal{M}$, then there exist bargaining weights $w$ and shares $\eta$ such that $Q^w = \tilde{Q}$ and $(u^S(w, \eta), u^B(w, \eta)) = \tilde{u}$. Conversely, given bargaining weights $w$ and shares $\eta$, $(u^S(w, \eta), u^B(w, \eta))$ is Pareto undominated among expected payoff vectors for mechanisms in $\mathcal{M}$.

**Proof.** See Appendix B.

As we show in Appendix D, incomplete information bargaining includes the $k$-double auction of Chatterjee and Samuelson (1983) as a special case (when $n^S = n^B = 1$ and agents draw their types from the same uniform distribution). In incomplete information bargaining, just as in the $k$-double auction, equalization of bargaining power increases expected social surplus, which is what we turn to next.

### 3.4 Social-surplus-increasing equalization of bargaining weights

Despite the result of Proposition 2 that incomplete information bargaining is Pareto efficient, its outcome may differ from what the planner would choose. This creates potential for social-surplus-increasing *equalization of bargaining power*—by which we mean changing some asymmetric vector of bargaining weights $\tilde{w}$ to $w = (w, \ldots, w)$—and the possibility that the negative consequences of, say, a merger on social surplus might be reversed by an associated equalization of bargaining power.

In particular, denoting by $W^* \equiv \mathbb{E}_{v,c}[W_{Q^*}(v, c)]$ the value of the planner’s objective under the planner’s optimal allocation rule, which we denote by $Q^*$, and by $W^w \equiv \mathbb{E}_{v,c}[W_{Q^w}(v, c)]$ the value of the planner’s objective under the allocation rule chosen by the market, denoted $Q^w$, we have $W^w \leq W^*$ because the allocation rule $Q^w$ is available when the planner chooses $Q^*$. Notice also that $Q^* = Q^{(w, \ldots, w)}$ for any $w \in (0, 1)$.

To see this, note that

$$W_{Q^M}(v, c) = w(W_{Q}(v, c) - R_{M}(v, c)),$$

which is maximized, subject to no deficit, at $Q^*$. With symmetric bargaining weights, the weight $w$ has a multiplicative effect on the solution value of the Lagrange multiplier on the no-deficit constraint, but ultimately it has no effect on the allocation rule $Q^w$, which depends on $w$ divided by that multiplier.

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21To see this, note that $W^{(w, \ldots, w)}(v, c) = w(W_{Q}(v, c) - R_{M}(v, c))$, which is maximized, subject to no deficit, at $Q^*$. With symmetric bargaining weights, the weight $w$ has a multiplicative effect on the solution value of the Lagrange multiplier on the no-deficit constraint, but ultimately it has no effect on the allocation rule $Q^w$, which depends on $w$ divided by that multiplier.
Given a market with weights \( w \), we say that the planner prefers an equalization of bargaining weights if \( W^w < W^* \), or equivalently, \( Q^w(v, c) \neq Q^*(v, c) \) for all \((v, c)\) in an open subset of \([v, \overline{v}]^n_s \times [c, \overline{c}]^n_b\). As stated in the next proposition, specific conditions are required for the planner not to prefer an equalization of bargaining weights. Of course, the question of equalization of bargaining weights is moot when these weights are already all the same. But even when the weights differ, there may be no benefit to the planner if the market has full trade, that is, \[ \left( K\text{-th lowest of } \{\Gamma_j^{w^S} / \rho^w(\overline{v})\}_{j \in N^S} \right) \leq \left( K\text{-th highest of } \{\Phi_i^{w^B} / \rho^w(\overline{v})\}_{i \in N^B} \right), \] which implies that \( \rho^w = \max w \), and if there is sufficient symmetry among the agents that it is always the highest-value buyers and lowest-cost suppliers that trade. Specifically, the suppliers must have equal bargaining weights and the buyers must have equal bargaining weights, and if one side of the market has a lower bargaining weight, i.e., does not have weight equal to \( \max w \), then agents on that side must have symmetric distributions so that the ordering of virtual types matches the ordering of actual types.\(^{22}\)

**Proposition 3.** In a market with asymmetric bargaining weights \( w \), the planner prefers an equalization of bargaining weights unless all of the following conditions are satisfied:

(i) the full-trade condition \([8]\) holds;
(ii) for all \( j \in N^S \), \( w_j^S = w^S \), and for all \( i \in N^B \), \( w_i^B = w^B \);
(iii) if \( w^S < w^B \), then for all \( j \in N^S \), \( G_j = G \);
(iv) if \( w^B < w^S \), then for all \( i \in N^B \), \( F_i = F \).

**Proof.** See Appendix B.

Proposition 3 provides conditions on bargaining weights and primitives such that the planner does not benefit from an equalization of bargaining weights. That said, there exist asymmetric bargaining weights such that the planner benefits from an equalization of bargaining weights, i.e., there exist \( w \) such that \( W^w < W^* \), unless \( n^B = n^S = 1 \), \( \overline{v} \leq \Phi_1(\overline{v}) \), and \( \overline{v} \geq \Gamma_1(\overline{c}) \).\(^{23}\) This shows that, quite generally, equalization of bargaining power increases

\(^{22}\)That ex ante symmetry among agents implies that there is no inefficiency in production when the production decision is based on (equally weighted) virtual types rather than actual types hinges on the assumption that the virtual type functions are increasing. Without that assumption, the weighted virtual type functions would have to be replaced by their “ironed” counterparts (see Myerson, 1981), and the resulting allocation rules would induce inefficiency with positive probability because of randomness due to tie-breaking.

\(^{23}\)These distributional assumptions are restrictive in the sense that they are not satisfied if the supports of the buyer’s and supplier’s type distributions overlap because \( \Phi_1(v) < v \) for any \( v < \overline{v} \) and \( \Gamma_1(c) > c \).
social surplus. Some of the benefits that the planner obtains from more equal bargaining weights stem from an equalization of bargaining weights among agents on the same side of the market, which eliminates socially wasteful discrimination among the agents based on differently weighted virtual types. While this effect is integral to the incomplete information bargaining model that we study here, equalization of bargaining power on one side of the market is arguably not what competition authorities and practitioners, or for that matter, John Galbraith, have in mind when speaking of countervailing power, which refers to an equalization of bargaining power across the two sides of the market.

In light of this, we consider the frontier of total supplier and total buyer expected payoffs. Let \( \eta_w \) denote the tiebreaking shares that specify an equal division of any budget surplus among the agents with the maximum bargaining weight in \( w \) and define the minimum and maximum total supplier payoffs by

\[
\underline{u}_S \equiv \min_w \sum_{j \in N^S} u_j^S(w, \eta_w) \quad \text{and} \quad \overline{u}_S = \max_w \sum_{j \in N^S} u_j^S(w, \eta_w).
\]

For \( u \in [\underline{u}_S, \overline{u}_S] \), let

\[
\omega(u) \equiv \max_w \sum_{i \in N^B} u_i^B(w, \eta_w) \quad \text{subject to} \quad \sum_{j \in N^S} u_j^S(w, \eta_w) \geq u.
\]

In honor of [Williams (1987)](Williams1987), who first analyzed problems of this kind in a bilateral trade setting, we call

\[
F \equiv \{(u, \omega(u)) \mid u \in [\underline{u}_S, \overline{u}_S]\}
\]

the Williams frontier.

The following lemma shows that the Williams frontier is defined by payoffs associated with bargaining weights that are symmetric on each side of the market. Defining, for \( \Delta \in [0, 1] \), \( w_\Delta \) by \( w^S_\Delta \equiv (1 - \Delta, \ldots, 1 - \Delta) \) and \( w^B_\Delta \equiv (\Delta, \ldots, \Delta) \), and letting \( \tilde{u}_j^S(\Delta) \equiv u_j^S(w_\Delta, \eta_{w_\Delta}) \) and \( \tilde{u}_i^B(\Delta) \equiv u_i^B(w_\Delta, \eta_{w_\Delta}) \), we have:

**Lemma 2.** \( F = \left\{ \left( \sum_{j \in N^S} \tilde{u}_j^S(\Delta), \sum_{i \in N^B} \tilde{u}_i^B(\Delta) \right) \mid \Delta \in [0, 1] \right\} \).

**Proof.** See Appendix [B].

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24That is, for \( x \in \{B, S\} \), if \( w_x^* \neq \max w \), then \( \eta_{w,x}^* = 0 \), and otherwise \( \eta_{w,x}^*(w) \equiv 1/m \), where \( m \) is the number of elements of \( w \) that are equal to \( \max w \).
Using Lemma 2, we have the following characterization of the Williams frontier:

**Proposition 4.** The Williams frontier is concave to the origin and the frontier is strictly concave if and only if its intersection with the first-best frontier contains at most one point.

**Proof.** See Appendix B.

As shown in Proposition 4, the Williams frontier is strictly concave if and only if it coincides with the first-best frontier at most at one point. This occurs, for example if the supports of the suppliers’ and buyers’ type distributions coincide, that is, if \( v = c \) and \( \tau = \tau \), because in that case first-best is not possible.

A natural but somewhat elusive question is under what conditions on the primitives the first-best becomes possible for some bargaining weights. One might expect, for example, that the performance of the mechanism improves as the market becomes thicker in the sense that there are more ex ante identical buyers and sellers. While this has been shown to be true for the case with identical supports, single-unit traders, and identical distributions on each side of the market (see Gresik and Satterthwaite 1989), it follows from the above that the first-best remains elusive with identical supports irrespective of assumptions on distributions, maximum demands, and capacities.

Away from the assumption of nonoverlapping supports, which guarantees that the first-best is possible with equal bargaining weights, it is therefore difficult to formulate general conditions under which the first-best is achievable.

That said, if there is a gap between the supports, that is, \( v > \tau \), then the Williams frontier follows the first-best frontier for a range of bargaining weights that are sufficiently symmetric. Along that segment, it is only weakly concave. This is illustrated in Figure 1. As shown in panel (a), for the case of overlapping supports, the first-best cannot be achieved and the Williams frontier is strictly concave. In contrast, as shown in panel (b),

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25 With single-unit traders and identical distributions on each side of the market, this follows from Williams (1999). Away from identical distributions and single-unit traders, the impossibility of the first-best follows from the facts that with identical supports the lowest buyer and highest seller types never trade and that with multi-unit traders the deficit of the Vickrey-Clarke-Groves (VCG) mechanism is bounded below by the Walrasian price gap times the quantity traded (Loertscher and Mezzetti, 2019). By the payoff equivalence theorem, no efficient mechanism that satisfies incentive compatibility and individual rationality runs a smaller deficit in expectation than the VCG mechanism. As these arguments make clear, identical supports are only sufficient since \( v \leq c \) and \( \tau \leq \tau \) also implies that the least efficient types on each side never trade.

26 With nonidentical but overlapping supports, Williams (1999, Theorem 4 and Table 1) provides conditions under which the first-best is possible with single-unit traders and identical distributions on each side of the market. These conditions require that the number of agents on one side of the market is much larger than on the other. The nature of these conditions is captured in and around our Proposition on vertical integration.

27 Sufficiently symmetric bargaining weights are not required for the first-best. For example, in the bilateral trade setting in which the buyer has all the bargaining power, we get the first-best if \( v \geq \Gamma(\tau) \). This holds, for example, if the supplier’s cost is uniformly distributed on \([0, 1]\) and the buyer’s distribution has \( v \geq 2 \).
with nonoverlapping supports, the first-best is achieved for a range of $\Delta$ close to $1/2$ and in that range the frontier is linear. The reasons for the concavity of the Williams frontier are essentially the same as those invoked by Paul Samuelson to show that with constant returns to scale the production possibility frontier is concave: the convex combination between any two points on the frontier can be achieved by randomizing over the mechanisms associated with each of them. By reoptimizing, one may be able to do better. The linear segment of the frontier in Figure 1(b) is a case where reoptimizing cannot improve outcomes because at both endpoints of that segment, the mechanism is already first-best.

Another natural question is whether there is any empirical evidence in support of the Pareto efficiency of bargaining outcomes. The analysis in Larsen (2021), which is based on used-car transactions in a bilateral trade setup, shows that the Williams frontier is a reasonable albeit imperfect approximation to real-world bargaining outcomes. As mentioned in footnote 17, the incomplete information bargaining approach is amenable to the incorporation of additional transaction costs, which can be modeled by adding the constraint that the mechanism’s revenue be no less than some positive number. We do not pursue this farther here because of space constraints and because, without a specific application in mind, it is not clear what these additional transaction costs would be. Assumptions that imply that bargaining outcomes are Pareto efficient, subject to the constraints imposed by incomplete information, appear to be a good starting point as they are in line with those underlying the foundations of complete information bargaining.

Figure 1: Williams frontier $\mathcal{F}$ for the case of 1 single-unit buyer and 1 single-unit supplier. $FB$ denotes the first-best social surplus, and $SB$ denotes the second-best social surplus. All types are uniformly distributed. Panel (a) assumes that $[c, \bar{c}] = [v, \bar{v}] = [0, 1]$. Panel (b) assumes that $[c, \bar{c}] = [0, 1]$ and $[v, \bar{v}] = [1.1, 2.1]$, in which case first-best and second-best total surplus are the same.
Building on Proposition 4 and letting

\[ W(\Delta) \equiv \sum_{j \in N^S} \tilde{u}_j^S(\Delta) + \sum_{i \in N^B} \tilde{u}_i^B(\Delta) \]

the concavity of the Williams frontier has the following implication:

**Corollary 1.** Movement towards the equalization of buyer-side and supplier-side bargaining weights along the Williams frontier weakly increases social surplus, i.e., if \( \Delta' < \Delta \leq 1/2 \) or \( 1/2 \leq \Delta < \Delta' \), then \( W(\Delta') \leq W(\Delta) \leq W(1/2) \).

Corollary 1 has policy implications for settings in which competition authorities could allow actions that equalize bargaining power. For example, allowing merchants that purchase payment card services from powerful suppliers (e.g., Visa, Mastercard) to engage in group boycotts might improve social surplus by equalizing bargaining power.\(^{28}\) Considering bargaining between powerful insurance companies and doctors for the supply of health services, allowing physician joint ventures might equalize bargaining power and improve social surplus.\(^{29}\)

An effect similar to that described in Corollary 1 arises in the partnership literature, where social surplus is increased by equalizing *ownership shares* rather than by equalizing bargaining weights. For example, as first observed by Cramton et al. (1987), when all agents draw their values independently from the same distribution, ex post efficient reallocation is possible if all agents have equal shares, and is impossible if one agent has full ownership. However, the paths through which these gains in social surplus are achieved, and the gains themselves, are different in the two approaches. In the partnership literature, the allocation rule is kept fixed at the ex post efficient one, but agents’ ownership shares are allowed to change. The revenue of the mechanism increases as ownership shares (or, more generally, agents’ worst-off types) become more similar, eventually permitting the first-best without running a deficit.\(^{30}\) In contrast, in incomplete information bargaining with bargaining weights, the worst-off types of all agents are always the same (the lowest type for a buyer and the highest type for a supplier), and so is the revenue of the mechanism, which is zero. What changes as the bargaining weights change is the allocation rule, which transitions from, say, the buyer-optimal one via the second-best to the one that is optimal for the suppliers.

\(^{28}\)See footnote 3.

\(^{29}\)For example, the U.S. DOJ and FTC (1996) state: “The Agencies will not challenge, absent extraordinary circumstances, a non-exclusive physician network joint venture whose physician participants share substantial financial risk and constitute 30 percent or less of the physicians in each physician specialty with active hospital staff privileges who practice in the relevant geographic market” (p. 65). While the guidelines do not allow simple group negotiations over price, without some form of financial integration, under the theory that group negotiation would tend to raise prices, Corollary 1 finds benefits to group negotiation that equalizes bargaining weights even in the absence of financial integration.

\(^{30}\)With identical distributions, equal shares imply equal worst-off types, which somewhat camouflages the point that the driving force for possibility is the equalization of worst-off types; see, for example, Che (2006) for a proof that with equal worst-off types, ex post efficiency is possible.
Moreover, because, for example with identical supports, the second-best is different from first-best in the model with bargaining weights, equalization of bargaining weights yields, in general, less social surplus than equalization of ownership shares (or worst-off types) in a partnership model.

4 Horizontal mergers

In this section, we analyze horizontal mergers, including both the effects of a merger on the merging parties’ type distribution and the possibility of merger effects on the bargaining power of both the merging and nonmerging parties. We evaluate outcomes from an ex ante perspective, that is, before firms’ types are realized.

4.1 Modeling horizontal mergers

To model mergers within our constant-returns-to-scale setup, we assume that the merged entity draws its constant marginal type from a distribution that combines the distributions of the merging firms. Further, we assume that the capacity of the merged entity combines the capacities of the merging firms. For a merger of suppliers $i$ and $j$, we denote the merged entity’s cost distribution by $G_{i,j}$ and its capacity by $k_{i,j}^S$, and for a merger of buyers $i$ and $j$, we denote the merged entity’s value distribution by $F_{i,j}$ and its capacity by $k_{i,j}^B$. We assume that the merged entity’s virtual type function is increasing.

To model a merger, one needs to describe how a merger transforms the two pre-merger firms’ distributions and capacities into the distribution and capacity of the merged entity. The natural mapping from pre-merger to post-merger firms is clear for a merger of firms whose capacities are sufficiently large that each could individually serve the entire other side of the market. For example, suppose that suppliers 1 and 2 merge, where $k_1^S = k_2^S = K^B$. In this case, we model the merged entity as having a constant marginal cost for $K^B$ units that is drawn from the distribution of the minimum of a cost drawn from $G_1$ and a cost drawn from $G_2$, i.e., $G_{1,2}(c) = 1 - (1 - G_1(c))(1 - G_2(c))$. This has the natural interpretation of a merged entity that has two facilities, each with constant marginal cost for $K^B$ units, where the merged entity rationalizes its production by using only the facility with the lower marginal cost. In other words, in line with Farrell and Shapiro (1990), we assume that there are no synergies associated with a merger beyond the ability to rationalize production.

\[ \text{This is the approach also taken by, for example, Salant et al. (1983), Perry and Porter (1985), Waehrer (1999), Dalkir et al. (2000), and Loertscher and Marx (2019).} \]
or consumption between the component firms. Analogously, the merged entity created from the merger of buyers 1 and 2 with \( k_1^B = k_2^B = K^S \) would draw its constant marginal cost for \( K^S \) units from \( F_{1,2}(v) = F_1(v)F_2(v) \).

4.2 Mergers that do not affect the bargaining weights

As we now show, in the case of a merger of “large” firms modeled as described above, a merger that does not alter bargaining weights or shares weakly reduces expected weighted welfare, and strictly so if the merging firms do not have the maximum bargaining weight. Of course, a merger that creates a merged entity that can produce at least some units at a cost below that of the pre-merger firms could increase expected weighted welfare, but below we provide conditions on the relation between the pre-merger and post-merger firms’ type distributions and capacities such that a merger weakly reduces expected weighted welfare.

We say that a merger does not alter bargaining weights or shares if all nonmerging agents retain their pre-merger bargaining weights and shares in the post-merger market and the merging agents have the same bargaining weight in the pre-merger market, which is then inherited by the merged entity, and the share of the merged entity is equal to the sum of the shares of the merging agents.

**Proposition 5.** A horizontal merger that does not alter bargaining weights or shares, and that involves suppliers \( i \) and \( j \) with \( k_i^S = k_j^S = K^B \), weakly reduces expected weighted welfare (strictly if \( w_{i,j} < \max w \); and with equality for all agents if \( w_{-\{i,j\}} = 0 \)), and analogously for a merger of buyers \( i \) and \( j \) with \( k_i^B = k_j^B = K^S \).

**Proof.** See Appendix B.

A number of results follow from Proposition 5. It implies that a horizontal merger involving agents with maximum capacity reduces social surplus when all agents have the same bargaining weight and harms any nonmerging agent that has all the bargaining power. Further, the proposition implies that two maximum capacity agents on the same side of the market that are the only agents with bargaining power have no incentive to merge, which is an effect that is depicted in Figure 2 below. Proposition 5 generalizes the insights from Loertscher and Marx (2019) that a merger harms a powerful buyer to a setting in which incomplete information pertains to both sides of the market, there are multiple buyers and suppliers with multi-unit demand and supply, and bargaining power that is not restricted to be with the buyer. As in Loertscher and Marx (2019), a merger need not be profitable.

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32 Additional merger-related synergies can be incorporated along the lines laid out in Loertscher and Marx (2019).
for the merging suppliers—when the buyers have sufficient bargaining power, the resulting more aggressive behavior against the merged entity because of its stronger type distribution can outweigh the benefits to the merging suppliers from the elimination of competition.

Building on Proposition [5], we see that while antitrust authorities seem inclined to look more favorably upon a supplier merger when there are powerful buyers, in the absence of bargaining power effects, a merger of suppliers that face powerful buyers can actually be worse for social surplus than a merger of powerful suppliers:

**Proposition 6.** Consider a horizontal merger of suppliers $i$ and $j$ with $k_i^s = k_j^s = K^B$ that does not alter bargaining weights. If the pre-merger market is:

(i) efficient, then the merger decreases expected social surplus unless $w_i = w_j = \max w$;
(ii) inefficient and $G_i = G_j$, then the merger decreases expected social surplus by more if the buyers have all the bargaining power than if the merging suppliers have all the bargaining power.

*Proof.* See Appendix B.

Under the conditions of Proposition [6], concerns regarding the welfare consequences of a merger are heightened when merging suppliers face a powerful buyer.

### 4.3 Bargaining power effects of mergers

In addition to changing the type distribution of the merged entity compared to the merging firms, it is also conceivable that mergers alter firms’ bargaining powers. Indeed, the idea that a merger somehow “levels the playing field” in terms of bargaining power is based on this very conception. It finds support in the empirical literature (Ho and Lee, 2017; Bhattacharyya and Nain, 2011; Decarolis and Rovigatti, forth.) and features prominently in antitrust debates and cases. Nonetheless, a major obstacle to analyzing the effects of the equalization of bargaining power in existing modeling approaches is that these typically either assume efficient bargaining, where shifts in bargaining power have no social surplus consequences, or rely on oligopoly models in which agents on one side of the market (typically buyers) are assumed to be price-takers and so have no bargaining power.

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33 The Agencies consider the possibility that powerful buyers may constrain the ability of the merging parties to raise prices. ... However, the Agencies do not presume that the presence of powerful buyers alone forestalls adverse competitive effects flowing from the merger” (U.S. Guidelines, p. 27).

34 As a case in point, the Australian government’s 1999 (now superseded) guidelines stated: “If pre-merger prices are distorted from competitive levels by market power on the opposite side of the market, a merger may actually move prices closer to competitive levels and increase market efficiency. For example, a merger of buyers in a market may create countervailing power which can push prices down closer to competitive levels” (ACCC, 1999, para. 5.131).
In contrast, as stated in Corollary 1 with incomplete information, a change in bargaining weights has an impact on social surplus because the efficiency of the mechanism varies with bargaining weights. Consequently, a merger that results in buyer-side and supplier-side bargaining powers moving closer together increases social surplus if the bargaining-power effects outweigh the productive-power effects of consolidation. As an example, Figure 2(a) shows a case in which a merger of suppliers reduces social surplus if the buyer has all the bargaining power both before and after the merger, but a merger increases social surplus if the buyer and suppliers’ bargaining weights are equalized after the merger. Indeed, Figure 2(b) provides an example in which an equalization of bargaining power induces the first-best in the post-merger market—specifically, if the buyer has all the bargaining weight prior to the merger, then the pre-merger outcome is not the first-best, but with symmetric bargaining weights in the post-merger market, the outcome is the first-best. In addition, in the example of Figure 2(b), when the pre-merger market is efficient, a merger causes that market to become inefficient unless the post-merger market has symmetric bargaining weights—the post-merger Williams frontier touches the first-best frontier only when $\hat{\Delta} = 1/2$.

Transposing the roles of buyers and suppliers in Figure 2 provides an example of how consolidation among buyers that equalizes bargaining power between buyers and a dominant supplier can increase welfare. This is consistent with the empirical analysis of Decarolis and Rovigatti (forth.) showing that consolidation among online advertising intermediaries has increased their buyer power, countervailing Google’s significant market power in online search.

We summarize with the following result:

**Corollary 2.** A merger between two symmetric suppliers or two symmetric buyers that does not alter bargaining weights or shares and reduces social surplus is more harmful to social surplus than a merger between the same two agents that equalizes the bargaining weights between the two sides of the market. Moreover, the effects of equalizing bargaining weights associated with a merger can be so strong that the first-best is possible after the merger when it was not possible before the merger.

The above results, particularly Proposition 6 and Corollary 2, highlight the double-edged sword of allowing mergers of suppliers when buyers are powerful—there is the possibility that post-merger equalization of bargaining weights will increase social surplus, but if that does

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35 In the example of Figure 2(a), merger plus equalization of bargaining weights decreases buyer surplus by -0.028 and increases social surplus by 0.009, so for a competition authority to credit a countervailing power defense, it would need to place a weight of at least 75% on social surplus versus buyer surplus.

36 For other empirical work related to countervailing power, see Ellison and Snyder (2010) and the cites therein.
Figure 2: Williams frontier for the case of 1 pre-merger buyer and 2 symmetric pre-merger suppliers (blue), all with capacity of one, and the frontier following the merger of the two suppliers (orange). The pre-merger frontier is defined by \((w^S, w^B) = (1, 1, 1)\) and \(\Delta \in [0, 1]\), and the post-merger frontier is defined by \((\hat{w}^S, \hat{w}^B) = (1, 1)\) and \(\hat{\Delta} \in [0, 1]\). We assume equal tiebreaking shares among the agents with the maximum bargaining weight. Panel (a) assumes that the buyer’s and pre-merger suppliers’ types are uniformly distributed on \([0, 1]\). Panel (b) assumes that the pre-merger suppliers’ costs are uniformly distributed on \([0, 1]\) and that the buyer’s value is uniformly distributed on \([1, 2]\).

not occur, then the merger harms social surplus, including possibly harming the buyers and the merging suppliers.

A merger of suppliers that does not alter bargaining weights can either harm or benefit a nonmerging supplier, and the effect can vary with the nonmerging supplier’s bargaining weight. Further, even if a merger harms a nonmerging supplier when that nonmerging supplier has low bargaining weight, it might benefit the nonmerging supplier when the nonmerging supplier has high bargaining weight. Considering the equalization of bargaining weights, an increase in the bargaining weight of the merged entity harms the nonmerging suppliers, potentially reversing what would have been a beneficial effect of the merger on a nonmerging supplier. In addition, the benefits to social surplus associated with an increase in the bargaining weight for the merged entity (up to the level of the buyer’s bargaining weight) varies with the bargaining power of outside suppliers. For example, if the equalization of bargaining weights between the buyers and merging suppliers also equalizes their bargaining weights with those of the nonmerging suppliers, then the effect is stronger than if the nonmerging suppliers have a bargaining weight of zero.

Corollary 2 demonstrates that there is the possibility of defending a merger on grounds...
that it will equalize bargaining power because a merger that causes bargaining weights to shift in favor of the merging parties may improve expected social surplus despite the other adverse effects. Of course, a merger of, for example, suppliers that also induces an increase in suppliers’ bargaining power is bad for the buyers for two reasons: competition among suppliers is reduced and the remaining suppliers have increased bargaining power. Thus, the review of a supplier merger based on a buyer-surplus standard would never be swayed by claims of equalization of bargaining power. In contrast, merger review based on a social-surplus standard may well be. In the mirror setting with a powerful supplier and a merger among buyers with little bargaining power, the merger plus equalization of bargaining weights could increase social surplus and buyer surplus, to the comfort of a competition authority that weights buyer surplus. Indeed, consistent with this, Kirkwood (2012, p. 1523) argues that “neither courts nor enforcement agencies have ever objected to a buy-side merger on the ground that it would create countervailing power.”

Our analysis allows us to identify necessary conditions for a defense of a merger by suppliers based on the equalization of bargaining power. First, as just mentioned, the objective of the merger review would need to include the promotion of social surplus, and not just buyer surplus. Second, the side of the market on which the merger occurs would need to have less bargaining power than the other side, so that an increase in the merging parties’ bargaining power is a movement towards the equalization of bargaining power. Third, the side opposite the merger would need to retain at least some bargaining power following the merger—for example, following a supplier merger, buyer power would need to diminish, but not vanish—so that society is not simply trading dominant buyers for dominant suppliers.

This offers an interpretation of and rationale for the EC merger guidelines, which state that “it is not sufficient that buyer power exists prior to the merger, it must also exist and remain effective following the merger. This is because a merger of two suppliers may reduce buyer power if it thereby removes a credible alternative” (EC Guidelines, para. 67). Our conclusions are consistent with that view insofar as the buyers must have power before a supplier merger and retain at least some power after the merger in order for a defense based on the equalization of bargaining power to make economic sense.

The necessary conditions for a defense based on the equalization of bargaining power raise the question of how one would ascertain that an agent has bargaining power. Such an evaluation will depend on the specifics of the problem at hand. For example, if a market is characterized as a \(k\)-double auction, then evidence of buyer power would be that trans-

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37 The EC merger guidelines also state, “Countervailing buyer power in this context should be understood as the bargaining strength that the buyer has vis-à-vis the seller in commercial negotiations due to its size, its commercial significance to the seller and its ability to switch to alternative suppliers” (EC Guidelines, para. 64).
actions always occur at the buyer’s price. In the case of a procurement auction, evidence consistent with buyer power and inconsistent with its absence includes: (i) the buyer uses procurement methods that result in suppliers other than the lowest-cost supplier winning, such as handicaps or preferences; (ii) the distribution of reserve prices is different across the markets if the buyer purchases in separate markets; (iii) one observes with positive probability ties in procurement outcomes and randomization over winners. Analogous conditions apply for an analysis of supply power.

4.4 General conditions for weighted welfare reducing mergers

In general, a merger removes an independent agent and creates a merged entity that draws its type from a distribution that can differ from the distributions of the pre-merger firms. We now consider conditions on the merged entity’s type distribution that are sufficient for the result, as in Proposition 5 that a merger reduces expected weighted welfare. To develop intuition, consider the case of a supplier merger in which, as in Proposition 5, the merged entity draws its constant marginal cost from the distribution of the minimum of the two merging suppliers’ marginal costs. Then one can essentially transfer to the pre-merger market the allocation rule of any incentive compatible post-merger mechanism by replacing the type of a merged entity that combines suppliers \( i \) and \( j \) with \( \min\{c_i, c_j\} \) and allocating the merged entity’s quantity to the merging supplier \( i \) or \( j \) with the lower cost. Using threshold payments, the budget surplus, not accounting for fixed payments, is then greater in the pre-merger market because the competition between suppliers \( i \) and \( j \) reduces the threshold payments to those suppliers. This means that the post-merger incomplete information bargaining mechanism is feasible in the pre-merger market—indeed has strictly greater budget surplus not accounting for fixed payments. If it also gives (weakly) greater expected weighted welfare, then it follows by a form of revealed preference argument that expected weighted welfare under the (optimized) pre-merger mechanism is (weakly) greater.

\footnote{This property does not hinge on particular distributional assumptions. For \( k = 1 \), the buyer’s and supplier’s optimal bids are \( \Gamma_1^{-1}(v) \) and \( c \), respectively, while for \( k = 0 \), they are \( v \) and \( \Phi_1^{-1}(c_1) \). Hence, for \( k = 1 \) \( (k = 0) \) the \( k \)-double auction is the mechanism that is optimal for the buyer (supplier) for any distributions \( F_1 \) and \( G_1 \) with positive densities on their supports. (If \( \Phi_1 \) or \( \Gamma_1 \) is not monotone, one would replace the virtual type function with its ironed counterparts and the inverse with the generalized inverse \( Myerson, 1981 \).)}

\footnote{The background for these conditions is as follows: (i) a buyer with power discriminates among heterogeneous suppliers based on their virtual costs; (ii) a buyer without power would optimally set a reserve equal to \( \min\{v, \bar{c}\} \), so even if suppliers in the different markets draw their types from different distributions, the distribution of reserves would be the same across the markets as long as the buyer’s values for the goods in the markets are drawn from the same distribution and the suppliers’ supports do not vary; (iii) for a buyer with power, this outcome arises when suppliers draw their costs from distributions that are identical but do not satisfy regularity, that is, their virtual costs are not monotone and so the optimal mechanism involves “ironing,” while a buyer without power purchases from the lowest-cost supplier.}
than under the post-merger mechanism.\footnote{If the merging suppliers do not have the maximum bargaining weight, then pre-merger expected weighted welfare can be increased by distributing the savings from reduced payments to the merging suppliers to agents with higher bargaining weights, yielding the result that expected weighted welfare is greater pre-merger. If the merging suppliers have the maximum bargaining weight and all other agents have lower bargaining weights, then one can achieve the same expected weighted welfare in the pre-merger market, and potentially greater expected weighted welfare once the mechanism is optimized for the pre-merger market. If the merging suppliers have the maximum bargaining weight and all other agents have a bargaining weight of zero, then no further optimization is possible, and so the merger has no effect on expected weighted welfare.}

We provide general conditions for this argument to apply in the following lemma. As stated in the lemma, we require that the post-merger distribution, $G_{i,j}$ in the case of a supplier merger, is equal to the distribution of some nondecreasing function of $h$ the merging agents’ types, $c_i$ and $c_j$ for a supplier merger. The remaining conditions ensure that one can rank the threshold payments of the merging agents relative to the threshold payment of the merged entity.

**Lemma 3.** A merger of suppliers $i$ and $j$ that does not alter bargaining weights or shares weakly reduces expected weighted welfare if the merged entity’s cost distribution $G_{i,j}$ and capacity $k^S_{i,j}$ are such that there exists continuous, nondecreasing function $h : [c, \bar{c}]^2 \to [c, \bar{c}]$ satisfying: (i) for all $z \in [c, \bar{c}]$,

$$\Pr_{c_i, c_j}(h(c_i, c_j) \leq z) = G_{i,j}(z),$$

(ii) $\min\{c_1, c_2\} \leq h(c_i, c_j)$, (iii) $k^S_i < k^S_{i,j} \Rightarrow c_j \leq h(c_i, c_j)$, and (iv) $k^S_j < k^S_{i,j} \Rightarrow c_i \leq h(c_i, c_j)$; and analogously for a merger of buyers.

**Proof.** See Appendix B.

Condition (i) in Lemma 3 is sufficient to permit the construction of a mechanism in the pre-merger market that has the same interim expected allocations for the nonmerging firms as the post-merger incomplete information bargaining mechanism. Then, as long as $h(c_i, c_j) \geq c_i$ whenever agent $i$ trades, the sum of the pre-merger agents’ threshold payments is no greater than the threshold payment of the merged entity in the post-merger market. Conditions (ii)–(iv) guarantee this. Thus, under the conditions of Lemma 3, one can construct a pre-merger mechanism that mimics the post-merger allocation and payments, but with weakly lower payments to merging suppliers (weakly higher payments to merging buyers), resulting in an incentive compatible, individually rational, no-deficit mechanism for the pre-merger market that has the same or greater expected weighted welfare. Optimizing that mechanism for the pre-merger market only reinforces the result that expected weighted welfare is greater pre-merger than post merger.
5 Vertical integration

We now analyze vertical integration between a buyer and a supplier. We begin by highlighting the stark results that are available in specific settings and then analyze comparative statics for broader settings.

Throughout this section, to simplify the analysis, we consider settings in which the short side of the market has only one agent before integration, that is, \( \min\{n^B, n^S\} = 1 \), and all agents have single-unit demand and capacities. The assumption that \( \min\{n^B, n^S\} = 1 \) ensures that the trading position of the vertically integrated firm does not depend on type realizations. If \( n^B = 1 \), it can only buy, and if \( n^S = 1 \), it can only sell, provided that it trades.\footnote{This assumption substantially simplifies the derivation of, say, the second-best mechanism. Without it, the vertically integrated firm may, depending on type realizations, optimally sell, buy, or not trade at all. The analysis of problems of this kind is complicated by the fact that the integrated firm’s worst-off type becomes endogenous, requiring techniques such as those developed by Loertscher and Wasser (2019). While interesting and relevant, it seems best to leave this analysis for future work.}

Consequently, if buyer 1 and supplier 1 vertically integrate, then the integrated firm’s willingness to pay will be \( \min\{v_1, c_1\} \) if \( n^B = 1 \) and its cost for selling will be \( \max\{v_1, c_1\} \) if \( n^S = 1 \). We say that a market is one-to-one if \( \min\{n^B, n^S\} = \max\{n^B, n^S\} \) and one-to-many otherwise. We also assume that following vertical integration, the integrated entity can efficiently solve its internal agency problem, which is a standard assumption.\footnote{This assumption can be rationalized, for example, on the grounds that integration slackens the individual rationality constraints within the integrated firm. For an examination of incentive problems within an integrated firm, see Legros and Newman (2013).}

5.1 Efficiency rationales for vertical integration

Consider first a setting with overlapping supports pre-integration (i.e., \( v < \tau \)). Because the first-best is then impossible when there is only one buyer and one supplier, we have the following result:

**Proposition 7.** If supports overlap, then vertical integration increases social surplus when the number of agents is sufficiently small, regardless of bargaining weights.

As reflected in Proposition 7 in a one-to-one market, vertical integration increases social surplus and enables the first-best by essentially eliminating a Myerson-Satterthwaite problem. However, as we show next, vertical integration can also create a Myerson-Satterthwaite problem. In particular, if the pre-integration market has nonoverlapping supports, then the first-best is possible in the pre-integration market and, indeed, occurs if the pre-integration bargaining weights are symmetric. In that case, vertical integration cannot possibly increase social surplus. This leaves the question of whether vertical integration is always neutral. The
Proposition 8 shows that the answer is negative—in the post-integration market, the integrated firm sources internally for some type realizations when an outside supplier has a lower cost.

**Proposition 8.** Assume a one-to-many pre-integration market with \( n^B = 1 < n^S \) and \( v > c \) and symmetric bargaining weights pre-integration. If \( \bar{c} < \bar{v} \), then vertical integration cannot increase social surplus for \( v \) sufficiently large, regardless of post-integration bargaining weights. Similarly, if \( v > c \) and \( G_j = G \) for all \( j \in N^S \), then vertical integration cannot increase social surplus for \( n^S \) sufficiently large, regardless of post-integration bargaining weights.

**Proof.** See Appendix B.

Proposition 8 provides clear-cut conditions under which there is no efficiency rationale for vertical integration with equal bargaining weights before integration. If the buyer’s and the suppliers’ supports have sufficiently small overlap, that is, for \( \bar{c} < \bar{v} \) and \( v \) sufficiently large, then vertical integration cannot increase social surplus simply because the first-best is already achieved without integration. Likewise, with ex ante symmetric suppliers and \( v > c \), there is no efficiency rationale for vertical integration if the supply side is sufficiently competitive. The first part of Proposition 8 follows by setting \( v = \bar{c} \), the second from Williams (1999, Section 3). Varying the overlap of the supports by changing \( v \) is a way of capturing the somewhat loose notion of how much private information there is. Viewed from this angle, the first part of Proposition 8 says that if there is little private information, then there are no gains from vertical integration. Put differently, private information is necessary for an efficiency rationale for vertical integration. The second part says that vertical integration is less likely to increase social surplus in otherwise highly competitive environments, which resonates with intuition and insights from oligopoly models (see e.g. Riordan (1998), Loertscher and Reisinger (2014)). With little competition, rival suppliers have large markups and react to vertical integration by reducing markups and quantities. In contrast, with highly competitive markets, price is already close to marginal costs. Consequently, the outside suppliers can essentially only reduce their quantities. This leads to an increase in consumer price and thereby to the perhaps paradoxical result that vertical integration is anticompetitive in otherwise competitive environments.

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4 Riordan (1998) shows that vertical integration by a dominant firm that faces a competitive fringe is anticompetitive in that it raises the equilibrium price that downstream consumers face. Loertscher and Reisinger (2014) extend Riordan’s model by replacing the assumption of a competitive fringe with a Cournot oligopoly and show that vertical integration is more likely to be harmful the larger is the number of firms in the Cournot oligopoly.
Of course, with symmetric pre-integration bargaining weights analogous results hold for $n^S = 1 < n^B$, in which case $c < v$ and $\overline{c}$ sufficiently small imply that vertical integration decreases social surplus, regardless of post-integration bargaining weights, and if $F_i = F$ for all $i \in \mathcal{N}^B$ and $\overline{c} < \overline{v}$, then vertical integration cannot increase social surplus for $n^B$ sufficiently large.

Propositions 7 and 8 provide conditions under which vertical integration either always increases or always decreases social surplus. At the heart of both results is the fact that the efficiency of the price-formation process is endogenous in incomplete information bargaining. The elimination of a Myerson-Satterthwaite problem through vertical integration is the incomplete information analogue to the classic double mark-up problem. In contrast to the complete-information literature, however, there is now a new effect, namely that trade becomes less efficient for the nonintegrated agents. Further, it is possible for this latter effect to dominate so that the market as a whole is made less efficient as a result of vertical integration.\footnote{This occurs, for example, with $n^B = 1$, $n^S = 2$, and symmetric bargaining weights if $F$ is uniform on $[0,1]$ and for $j \in \{1,2\}$, $G_j(c) = c^{1/10}$, also with support $[0,1]$. Then vertical integration causes expected social surplus to decrease from 0.4827 to 0.4815.}

The results of Propositions 7 and 8 are robust in that they do not depend on specific assumptions about distributions or beliefs of agents. Indeed, because there is always a dominant strategy implementation of the incomplete information bargaining mechanism, beliefs play no role. Moreover, we obtain social surplus decreasing vertical integration without imposing any restrictions on the contracting space and without invoking exertion of market power by any player (above and beyond requiring individual-rationality and incentive-compatibility constraints to be satisfied). These are noticeable differences relative to the post-Chicago school literature on vertical contracting and integration, whose predictions rely on assumptions about beliefs, feasible contracts, and/or market power.\footnote{For an overview, see Riordan (2008). On the sensitivity of complete information vertical contracting results to assumptions of “symmetric,” “passive,” and “wary” beliefs see, e.g., McAfee and Schwartz (1994).}

Maybe more importantly, in our incomplete information setting, any benefits and costs of vertical integration are pinned to the primitives of the problem, which contrasts with complete information settings, where these hinge on restrictions on the contracting space. As argued persuasively by Choné et al. (2021), this is a matter of substance rather than taste.

Of course, our results do rely, inevitably, on support assumptions. Indeed, for $v \geq \overline{v}$ and equal bargaining weights pre-integration, vertical integration cannot possibly increase social surplus. This suggests that, as the overlap of supports becomes smaller, the social surplus gains from vertical integration may decrease as well. To formalize and substantiate this notion, fix $[c, \overline{c}] = [0,1]$ and $\overline{v} = 1$, and define the maximum gain from vertical integration

\[G_j(c) = \frac{c}{10},\]
associated with $v \in [0,1)$ by $G(v) \equiv (W^{FB}(v) - W^{SB}(v))/W^{FB}(v)$, where $W^{FB}(v)$ and $W^{SB}(v)$ denote first-best and second-best social surplus, respectively, as a function of $v$. The amount $G(v)$ provides only an upper bound for the gain from vertical integration because vertical integration does not necessarily make the first-best possible when it is not possible absent vertical integration. Then we have\footnote{Not surprisingly, a result analogous to Proposition \ref{prop:vertical_gains_decrease} obtains for the case of one single-unit supplier if one fixes the buyers’ support at $[0,1]$ and $c = 0$ and varies $\tau \in (0,1]$. In that case, the maximum gain from vertical integration is decreasing in $\tau$.}

**Proposition 9.** Assuming $n^B = 1$ and symmetric suppliers, $G(v)$ decreases in $v$ whenever $G(v) > 0$.

**Proof.** See Appendix B.

Proposition \ref{prop:vertical_gains_decrease} provides a monotonicity result relating differences in supports to the maximum gain from vertical integration. Reduced overlap of the supports reduces the maximum gain from vertical integration. Intuitively, the social benefit from vertical integration is reduced when gains from trade are more certain because then market-based transactions between nonintegrated firms work better.

### 5.2 Comparative statics for vertical integration

In this section, we begin by considering the possibility, captured by Proposition \ref{prop:vertical_gains} that with overlapping supports, the social surplus effects of vertical integration depend, in general, on the number of firms. Specifically, consider the case of one buyer and multiple suppliers, each of which draws it cost from the same distribution. We know from Williams (1999) that the first-best is possible if $v > c$ and $n^S$ is large enough.\footnote{See also Makowski and Mezzetti (1993).} Because vertical integration induces the buyer’s willingness to pay to be $y = \min\{v, c\}$, the support of $y$ is $\min\{v, c\}$, $c$]. The results of Williams (1999) for this case imply that the first-best is not possible. Hence, vertical integration is socially harmful whenever $n^S$ and the supports are such that the first-best is possible without vertical integration. When $c = v$ and $\tau = \bar{\tau}$, the first-best is not possible absent vertical integration, nor with vertical integration if $n^S > 1$ (see, e.g., Williams, 1999).

So the question arises whether vertical integration is more or less likely to be socially harmful if $n^S$ is larger. The intuition and insights from oligopoly models, discussed above, together with the point that the double markup under linear pricing in those models corresponds to having to pay information rents to both the buyer and the suppliers in incomplete information bargaining, suggests that vertical integration is more likely to be harmful the larger is $n^S$. However, establishing this in general is challenging and beyond the scope of
the present paper. That said, Figure 3(a) illustrates a case in which the oligopoly intuition carries over to our setup. In particular, in a one-to-many market with overlapping supports, vertical integration eliminates a double-markup (of information rents), but it also makes the outside market less competitive, and possibly less efficient, and affects the virtual type function of the integrated firm. As the number of nonintegrated suppliers grows large, the probability that the vertically integrated firm sources internally goes to zero, and the outside market is close to efficient (see Appendix E for details). Because all effects become small, it is hard to prove general results analytically. As shown in Figure 3(a), for the case of uniformly distributed types on \([0, 1]\), the change in social surplus due to vertical integration is nonmonotone in the number of outside suppliers and, in the limit, approaches zero from below.

![Figure 3(a) Social surplus effect of vertical integration](image)

![Figure 3(b) Social surplus effect of vertical integration](image)

Figure 3: Change in expected social surplus as a result of vertical integration in a market with one buyer and multiple suppliers with single-unit demand and supply, where \(n^S\) is the number of independent suppliers after vertical integration (i.e., the pre-integration market has \(n^S + 1\) suppliers). Pre-integration suppliers’ costs are uniformly distributed on \([c, \bar{c}] = [0, 1]\), the pre-integration buyer’s value is uniformly distributed on \([\bar{v}, \bar{v}]\), and bargaining weights are symmetric. In panel (a), \([\bar{v}, \bar{v}] = [0, 1]\), and in panel (b), \(\bar{v} = 1.2\) with \(\bar{v}\) varying as indicated.

We provide comparative statics related to Proposition 8 in Figure 3(b), where we illustrate that given \(\bar{c} < \bar{v}\), as \(\bar{v}\) increases, eventually vertical integration decreases expected social surplus (again, see Appendix E for details). While Proposition 8 is straightforward to prove by taking the case of \(\bar{v} = \bar{c}\), Figure 3 provides examples in which having as few as two independent suppliers in the post-integration market is sufficient for vertical integration to reduce social surplus even when \(\bar{v} = \bar{c}\). This emphasizes the salient possibility of anticompetitive vertical integration in a variety of settings.

Interesting and challenging (and still open) issues arise with vertical integration in many-
to-many settings. As discussed in and around footnote 41 in that case, the integrated firm may be a buyer or a supplier vis-à-vis the outside firms in the post-integration market, or not trade at all.

6 Investment

We now extend the model to allow for investment.

6.1 Setup and results

Investment incentives feature prominently, and at times controversially, in concurrent policy debates, and they have been at center stage in the theory of the firm since Grossman and Hart (1986) and Hart and Moore (1990) (G-H-M hereafter). To account for investment, we extend our model by adding investment as an action taken by each agent prior to the realization of private information, where investment improves an agent’s type distribution. We show that the results under incomplete information differ starkly from those obtained in the G-H-M literature. This literature stipulates complete information and efficient bargaining and, as a consequence, obtains hold-up and inefficient investment. In contrast, in our setting, incomplete information protects agents from hold-up, and investments are efficient if and, under additional assumptions, only if bargaining is efficient.

We extend the model to allow the suppliers and buyers to improve (or more generally change) their type distributions by investing. Investments do not change the supports of the distributions. Supplier \( j \in \mathcal{N}^S \) making investment \( e_j^S \) incurs cost \( \Psi_j^S(e_j^S) \), and buyer \( i \in \mathcal{N}^B \) making investment \( e_i^B \) incurs cost \( \Psi_i^B(e_i^B) \). Consistent with G-H-M, we assume that investments are not contractible. Thus, bargaining only depends on equilibrium investments and does not vary with off-the-equilibrium-path investments. One implication of this is that the interim expected payments to the worst-off types of agents are not affected by

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48 For example, related to the 2017 Dow-DuPont merger, the U.S. DOJ’s “Competitive Impact Statement” identifies reduced innovation as a key concern [https://www.justice.gov/atr/case-document/file/973951/download](https://www.justice.gov/atr/case-document/file/973951/download) pp. 2, 10, 15, 16). Interestingly, countervailing power was also an issue in the Dow-Dupont merger. The European Commission analyzed “whether significant buyer power exists to compensate for any potential added market power from the Parties” and the parties argued that they “face substantial countervailing bargaining power by their sophisticated customers, namely distributors and agricultural cooperatives,” but the EC concluded that “the limited countervailing buyer power would be insufficient to off-set the anticompetitive concerns raised by the Transaction given that non-large customers do not have buyer power” (EC CASE M.7932 – Dow/DuPont, [http://ec.europa.eu/competition/mergers/cases/decisions/m7932_13668_3.pdf](http://ec.europa.eu/competition/mergers/cases/decisions/m7932_13668_3.pdf) paras. 434, 528, 3565).

49 This assumption also prevents the mechanism from using harsh punishments for deviations from any prescribed investment level.
actual investments. We assume that the buyers and suppliers first simultaneously make their investments and then bargaining takes place.

We first consider the planner’s problem of determining investments when the allocation rule is first-best. Denote the first-best allocation for a given realization of types by $Q^{FB}(v, c)$. Then, for a given realization of types, first-best welfare is $W^{FB}(v, c) \equiv \sum_{i \in N^B} v_i Q^{FB,B}_i(v, c) - \sum_{j \in N^S} c_j Q^{FB,S}_j(v, c)$. We let $\bar{\epsilon}$ denote first-best investments, which are a solution to the planner’s first-best investment problem, given by $\max_{\epsilon} \mathbb{E}_{v, c|\epsilon} [W^{FB}(v, c)] - \sum_{i \in N^B} \Psi_i^B(\epsilon_i^B) - \sum_{j \in N^S} \Psi_j^S(\epsilon_j^S)$.

Now consider the agents’ incentives to invest when incomplete information bargaining is such that the first-best is possible (see, e.g., Proposition 3 for conditions under which this is the case without symmetric bargaining weights). By the payoff equivalence theorem, it follows that, up to a constant, any incentive compatible mechanism generates the same interim and consequently the same ex ante expected utility for every agent. Thus, for the case considered here in which the first-best is possible, we can, without loss of generality, focus on expected utilities for the Vickrey-Clarke-Groves (VCG) mechanism. Given a type realization $(v, c)$, supplier $i$’s VCG payoff is $W^{FB}(v, c) - W^{FB}(v, \bar{\epsilon}_i, c_{-i})$, plus possibly a constant. Likewise, the buyer $i$’s payoff is $W^{FB}(v, c) - W^{FB}(v, c_{-i}, c)$, plus possibly a constant.

Taking expectations over $(v, c)$, and noticing that $W^{FB}(v, \bar{\epsilon}, c_{-j})$ is independent of supplier $j$’s type and its distribution, and so independent of $e_j^S$, it follows that each supplier $j$’s problem at the investment stage, taking as given that the other agents choose investments $\bar{\epsilon}_{-j}$, is $\max_{e_j^S} \mathbb{E}_{v, c|e_j^S} [W^{FB}(v, c)] - \Psi_j^S(e_j^S)$. An analogous optimization problem applies to buyer $i$’s choice of $e_i^B$, noting that $W^{FB}(v, c_{-i})$ is independent of buyer $i$’s type and its distribution, and so independent of $e_i^B$. It then follows that the planner’s solution $\bar{\epsilon}$ is a Nash equilibrium if incomplete information bargaining permits the first-best. This proves the first part of Proposition 10 below.

Under additional conditions, the converse is also true, that is, $\bar{\epsilon}$ being a Nash equilibrium outcome in the game in which agents’ first-stage investments are followed by incomplete information bargaining implies that bargaining is efficient. Given investments $\epsilon$, for $j \in N^S$, let $G_j(\cdot; e_j^S)$ and for $i \in N^B$, let $F_i(\cdot; e_i^B)$ denote supplier $j$’s and buyer $i$’s type distributions, respectively, with virtual type functions assumed to be monotone. Sufficient conditions for the converse to hold are: for all $j \in N^S$ and $i \in N^B$,

$\Psi_j^{St}(0) = \Psi_i^{Bt}(0) = 0$, and for all $e > 0$, $\Psi_j^{St}(e), \Psi_i^{Bt}(e) > 0$ and $\Psi_j^{Stt}(e), \Psi_i^{Btt}(e) > 0$; \hspace{1cm} (9)
for all $c \in (c, \bar{c})$ and $v \in (v, \bar{v})$,
\[
\frac{\partial G_j(c; e)}{\partial e} > 0 \quad \text{and} \quad \frac{\partial F_i(v; e)}{\partial e} < 0; \quad (10)
\]
and either (i) the type distributions have overlapping supports, $v < c$, (ii) $K^B = K^S$, (iii) $K^B < K^S$ and for all $j \in N^S$ and $c \in [c, \bar{c}]$,
\[
G_j(c; \bar{c}_j^S) \equiv G(c), \quad (11)
\]
or (iv) $K^B > K^S$ and for all $i \in N^B$ and $v \in [v, \bar{v}]$,
\[
F_i(v; \bar{c}_i^B) \equiv F(v). \quad (12)
\]

Conditions (9)–(10) imply that the first-best investments $\bar{e}$ are positive and determined by first-order conditions. This allows one to show that when first-best investments are a Nash equilibrium, the total number of trades under incomplete information bargaining is the same as under the first-best. Given any one of the remaining conditions (i)–(iv), one can show further that it is the same set of buyers and suppliers that trade in the Nash equilibrium as under the first-best.\(^{50}\)

**Proposition 10.** First-best investments are a Nash equilibrium outcome of the simultaneous investment game if incomplete information bargaining is efficient. Conversely, assuming that (9)–(10) and at least one of (i)–(iv) above holds, if first-best investments are a Nash equilibrium outcome, then incomplete information bargaining is efficient.

*Proof.* See Appendix B.

As shown in Proposition 10 when incomplete information bargaining is efficient, the agents’ Nash equilibrium investment choices are first-best investments. Because private information protects agents from hold-up,\(^{51}\) efficient incomplete information bargaining implies efficient investments.\(^{52}\) Intuitively, given that the allocation rule is efficient, each agent is the

\(^{50}\)Proposition 10 connects to the equivalence result of Hatfield et al. (2018), which links efficient dominant-strategy mechanisms under incomplete information with efficient investments, and to earlier work by Milgrom (1987) and Rogerson (1992). A difference is that the no-deficit constraint in our setting may preclude the first-best.

\(^{51}\)Lauermann (2013) finds that private information protects against hold-up in a dynamic search model, finding that it is easier/possible to converge to Walrasian efficiency with private information, but otherwise hold up prevents convergence to efficiency. This is consistent with our results, interpreting search as investment.

\(^{52}\)In a setup where efficient bargaining is possible because of shared ownership (rather than the absence of any allocation-relevant private information), Schmitz (2002, p. 176) notes that “Intuitively, ... a party’s
residual claimant to the surplus that its investment generates. Anticipating that this will be the case once types are realized, each agent’s incentives are also aligned with the planner’s at the investment stage because each agent’s and the planner’s reward from investment are the same. Further, under additional conditions, any inefficiency in bargaining results in inefficient investments.

Combining Proposition 10 with Corollary 2 allows us to connect investment with the equalization of bargaining power. While the equalization of bargaining power can increase social surplus holding investments fixed, as in Corollary 2, Proposition 10 shows that it can also improve investments to the first-best level. Proposition 10 thus provides an additional channel—investments—through which change in bargaining power can increase social surplus.

While Proposition 10 focuses on investments that improve agents’ own types, the first part of Proposition 10 continues to hold if, for example, there is a single buyer and each supplier can invest in the “quality” of its product, thereby increasing the value of its product to the buyer. Our result does not hold if, for example, investment generates externalities, e.g., if there are technology spillovers across suppliers or if investment increases the buyer’s value regardless of its trading partner.

6.2 Investment and vertical integration

Using Proposition 10 we can connect investment with vertical integration. We assume that vertical integration does not affect the cost of investment for the integrated firm, so if buyer $i$ and supplier $j$ integrate and invest $e_i^B + e_j^S$, the cost of investment is $\Psi_i^B(e_i^B) + \Psi_j^S(e_j^S)$. With one buyer and one supplier in the pre-integration market and overlapping supports, incomplete information bargaining is inefficient, which under conditions (9) and (10), implies that equilibrium investments are inefficient. But, by assumption, the allocation is efficient after vertical integration, which by Proposition 10 implies that investments are efficient after vertical integration. Thus, with overlapping supports, vertical integration promotes efficient investment insofar as there is an equilibrium with efficient investments after integration but not before. In contrast, with, say, one buyer and two or more symmetric suppliers and nonoverlapping supports, incomplete information bargaining is efficient for some bargaining weights, including symmetric ones, without vertical integration, which implies that

\(^{53}\)This result contrasts with that of Che and Hausch (1999), who study a contracting setup in which investments by suppliers in cost reduction are efficient, but investments by suppliers that benefit the buyer need not be. Importantly, however, there is no incomplete information at the price-formation stage in their model.
investments are efficient without vertical integration. But following vertical integration, incomplete information bargaining is inefficient, and so, under (9) and (10), and investments are no longer efficient. In this case, vertical integration disrupts efficient investment insofar as there is no equilibrium with efficient investments after integration whereas there was one before integration.

**Corollary 3.** Assuming that (9) and (10) hold, for a one-to-one pre-integration market with overlapping supports, vertical integration promotes efficient investment; but for a one-to-many pre-integration market with nonoverlapping supports, if at least one of (ii)–(iv) above holds, then vertical integration disrupts efficient investment if bargaining is efficient prior to vertical integration (which occurs, for example, with symmetric bargaining weights).

### 6.3 Comparative statics for investment

We now analyze how equilibrium investments are affected by bargaining power and by the extent to which the supports of the value and cost distributions overlap. To analyze investment effects, we parameterize the agents’ type distributions and allow investment to affect the distributional parameter in a way that improves the distribution in a first-order stochastic dominance sense, where investment results in a dominating distribution for buyers and a dominated distribution for suppliers.

We consider a bilateral trade setup with linear virtual types. We hold fixed the support of the supplier’s distribution at [0, 1] and let the support of the buyer’s distribution be [v, v + 1], where we vary v from 0 to 1. Specifically, we fix X > 0 and consider a supplier type distribution of $G_{eS}(c) \equiv c^{X-eS}$ with support [0, 1], where $eS \in [0, X)$ is the supplier’s investment, and a buyer type distribution of $F_{eB}(v) \equiv 1 - (1+v-v)^{X-eB}$ with support [v, v + 1], where $eB \in [0, X)$ is the buyer’s investment. We assume that each agent’s investment e has cost $e^2/2$. Relegating the details to Appendix E, we illustrate the effects of bargaining power and the distributional supports on equilibrium investment in Figure 4.
Figure 4: Nash equilibrium investments with bargaining weights \((w^S, w^B) = (1-\Delta, \Delta)\) for buyer distributions with varying supports. Assumes the linear virtual type setup for bilateral trade with \(F(v) = 1 - (1 + v - v^{1.25-e_B})\), where \(e_B \in [0, 1.25]\) is the buyer’s investment, and \(G(c) = c^{1.25-e_S}\), where \(e_S \in [0, 1.25]\) is the supplier’s investment. Investment \(e\) has cost \(e^2/2\). When \(v = 1\), we obtain \(e^{FB} = e^{SB} = 0.25\), implying that first-best (and second-best) investment levels result in uniformly distributed types. For \(v = 1\), \(\rho^{NE} = \max\{w_S, w_B\}\) for all bargaining weights, and for \(v = 1/4\), \(\rho^{NE} > \max\{w_S, w_B\}\) for all bargaining weights.

As shown in Figure 4, each agent’s equilibrium investment is maximized away from extreme bargaining weights. This points to an additional benefit of the equalization of bargaining weights; namely, it has the potential to improve the efficiency of investment, in some cases to the first-best.

7 Extensions and discussion

The model presented here can accommodate a range of extensions. We first provide an extension to incorporate price-taking downstream consumers. Then we briefly discuss extensions that allow variation in agents’ outside options and that allow buyers to have preferences over suppliers, in which case bargaining externalities arise naturally, with details contained in Appendix C. Also in Appendix C, we show that one can use the results of Delacrétaz et al. (2019) to generalize the setup to allow buyers to have preferences over suppliers, which also naturally leads to bargaining externalities. Finally, we briefly discuss extensive-form and axiomatic foundations for incomplete information bargaining, with details contained in Appendix D.
7.1 Downstream consumers

Thus far, our model does not include a mass of downstream consumers beyond the buyers that participate in incomplete information bargaining. Because competition authorities commonly put weight on the welfare of final consumers, it seems important to extend the model to incorporate final consumers.

A natural and tractable way of doing this is to assume that each buyer in our model is a retailer that has exclusive access to a downstream market. (Whether it is the only supplier in that market does not matter for these purposes; to rule out externalities in the bargaining mechanism, what is important is that none of the other agents participating in the mechanism is active in this market.) The input that the buyers procure can be interpreted as reducing the marginal cost of production in that market or (by and large) equivalently as improving the quality of the product.

A natural and tractable model in which the buyer’s value and consumer surplus move in the same direction is one in which the buyer’s private information relates to the size of the market. Specifically, let $D_i(p)$ be the decreasing demand function in market $i$ when the mass of consumers is equal to 1, normalize units so that $D_i(0) = 1$, and assume that $D_i(p_i) = 0$ for some finite price $p_i$. If we assume that the buyer is a retailer that has constant marginal costs of production, which we normalize to zero without loss of generality, then it is optimal for the retailer to set a uniform price $p_i^*$, assuming each consumer is privately informed about its value and has single-unit demand, where $p_i^* \in \arg\max_p pD_i(p)$. Accordingly, consumer surplus in the market with a mass 1 of consumers and a good of quality 1 is $CS_i^* = \int_{p_i}^{p_i^*} D_i(p)dp - D_i(p_i^*)p_i^*$, and if the mass of consumers in the market is $\omega$, demand at price $p$ is $\omega D_i(p)$, implying that consumer surplus is $\omega CS_i^*$, while the retailer’s profit is $\omega p_i^* D_i(p_i^*)$. Letting $\gamma_i = \int_{p_i}^{p_i^*} D_i(p)dp/(p_i^* D_i(p_i^*)) - 1 > 0$, where the inequality follows because $D_i$ is decreasing, we have $CS_i^* = \omega \gamma_i p_i^* D_i(p_i^*)$. In words, $\gamma_i$ captures how much of retailer $i$’s profit is “passed through” to downstream consumers in market $i$.

If the quality of the retailer’s good improves by the commonly known parameter $\delta > 0$ when the retailer buys the input, then consumer surplus increases by $\omega \delta CS_i^*$ while the retailer’s willingness to pay for the quality increment is $v_i = \omega \delta p_i^* D(p_i^*)$ if the mass of consumers is $\omega$. Accordingly, the increase in consumer surplus in market $i$ if the retailer obtains the input is $\gamma_i v_i$. In other words, the larger is the buyer’s willingness to pay, the larger is the consumer surplus effect of this buyer obtaining the input.

\footnote{This practice has recently been challenged by Hemphill and Rose (2018), who argue that the mission of antitrust merger review is to protect the welfare of the merging firms’ trading partners, whether they are purchasers or sellers.}

\footnote{Alternatively, and largely equivalently, one could think of the input as decreasing the constant marginal cost of production from $c > 0$ to $c - \delta$ with $\delta < c$. As with the quality improvements, $\Delta CS^* = \gamma \Delta \Pi^*$ for}
With downstream consumers, both the social planner who aims at maximizing equally weight social surplus and an authority whose objective is consumer surplus will take the $\gamma_i$’s into account. The social planner will attach a weight of $\gamma_i + 1$ to buyer $i$’s value (and a weight of 1 to each supplier), so that the planner’s Lagrangian becomes

$$\mathbb{E}_{\mathbf{v}, \mathbf{c}} \left[ \sum_{i \in \mathcal{N}^B} (\gamma_i + 1)v_i Q^B_i (\mathbf{v}, \mathbf{c}) - \sum_{j \in \mathcal{N}^S} c_j Q^S_j (\mathbf{v}, \mathbf{c}) + (\rho - 1) \left( \sum_{i \in \mathcal{N}^B} \Phi_i(v_i)Q^B_i (\mathbf{v}, \mathbf{c}) - \sum_{j \in \mathcal{N}^S} \Gamma_j(c_j)Q^S_j (\mathbf{v}, \mathbf{c}) \right) \right]$$

plus $\sum_{i \in \mathcal{N}^B} (1 - \rho)\hat{u}_i^B (v) + \sum_{j \in \mathcal{N}^S} (1 - \rho)\hat{u}_j^S (\bar{c})$. This is the same as (5) with $\mathbf{w} = 1$ and the addition of the $\gamma_i$’s. By contrast, the Lagrangian for the authority with a consumer surplus objective is simply

$$\mathbb{E}_{\mathbf{v}, \mathbf{c}} \left[ \sum_{i \in \mathcal{N}^B} \gamma_i v_i Q^B_i (\mathbf{v}, \mathbf{c}) + \rho \left( \sum_{i \in \mathcal{N}^B} \Phi_i(v_i)Q^B_i (\mathbf{v}, \mathbf{c}) - \sum_{j \in \mathcal{N}^S} \Gamma_j(c_j)Q^S_j (\mathbf{v}, \mathbf{c}) \right) \right]$$

plus $\sum_{i \in \mathcal{N}^B} (1 - \rho)\hat{u}_i^B (v) + \sum_{j \in \mathcal{N}^S} (1 - \rho)\hat{u}_j^S (\bar{c})$.

If the “pass-through” of retailer’s profit to consumer surplus is the same across markets, that is, $\gamma_i = \gamma$ for all $i \in \mathcal{N}^B$, then neither the planner nor the authority will discriminate among buyers in the weights that they attach to them. In this case, any discrimination in their mechanisms will be due to the no-deficit constraint being binding, which implies that there is some discrimination based on virtual values, provided $F_i \neq F_h$ for some $i \neq h$ with $i, h \in \mathcal{N}^B$. Simply having a larger expected market is not a reason for discrimination in this case because $i$’s market being larger than $h$’s would be reflected in $F_i$ and $F_h$. In contrast, when $\gamma_i \neq \gamma_h$, then both the social planner and the authority would discriminate across downstream markets.\(^{56}\) This is true for the social planner even if the no-deficit constraint does not bind.\(^{57}\)

\(^{56}\) A simple specification that allows for the $\gamma_i$’s to vary across market is to assume that for all $i$, for $D_i(p) = (1 - p)^{a_i}$ for $p \in [0,1]$ with $a_i > 0$. This implies $p_i^* = \frac{1}{1 + a_i}$ and hence $D_i(p_i^*) = \left( \frac{a_i}{1 + a_i} \right)^{a_i}$. At $\omega = 1$, $v_i = \frac{1}{a_i} \left( \frac{a_i}{1 + a_i} \right)^{1 + a_i}$ while $CS_i^* = \int_0^1 (1 - p)^a dp - v_i = \frac{1}{1 + a_i} v_i$. Thus, $\gamma_i = \frac{1}{1 + a_i}$.

\(^{57}\) For the authority with a consumer surplus standard, the no-deficit constraint always binds because it does not put any weight on the buyers’ and the suppliers’ welfare.
7.2 Bargaining breakdown

A pervasive feature of real-world bargaining is that negotiations often break down. Anecdotal examples range from the U.S. government shut down, to the British coal miners’ and the U.S. air traffic controllers’ strikes in the 1980s, to failures to form coalition governments in countries with proportional representation. Providing systematic evidence of bargaining breakdown, Backus et al. (2020) analyze a data set covering 25 million observations of bilateral negotiations on eBay and find a breakdown probability of roughly 55 percent. More generally, when firms bargain over essential inputs, such as medical equipment for hospitals or computer chips for manufacturers, bargaining breakdown will typically not mean that the firms stop trading with each other, but rather that the latest, quality-improved version of the input is not traded.

Because with incomplete information, bargaining breakdown occurs on the equilibrium path, one can use observed bargaining breakdown frequencies as a moment to match in empirical research rather than as an error. While specifics will, of course, depend on the available data and on the econometric approach, we provide an illustration in Appendix E.

7.3 Variation in agents’ outside options

Our model is amenable to introducing variation in agents’ outside options, which occupy center stage in complete information bargaining. In the incomplete information setting, outside options can affect an agent’s cost of participating in the mechanism independently of whether the agent trades and can affect its value or cost distribution by shifting its support. We provide a brief discussion here, with details contained in Appendix C.

The comparative statics with respect to increasing an agent’s participation cost are intuitive and largely the same as in models with complete information because it increases the agent’s share of the surplus that is created; in contrast to complete information models, it may decrease expected social surplus because of distortions to the allocation rule required.

58 As described by Crawford (2014), there are regular blackouts of broadcast television stations on cable and satellite distribution platforms due to the breakdown of negotiations over the terms for retransmission of the broadcast signal.
59 With incomplete information, bilateral bargaining can break down on the equilibrium path for three reasons. First, it may be that the buyer’s value is below the supplier’s cost, but because of private information, the two parties do not know this before they sit down at the negotiating table, so bargaining begins but then breaks down. Second, with unequal bargaining power, incentives for rent extraction may lead more powerful agents to impose sufficiently aggressive thresholds for trade that breakdown results. Third, because of impossibility theorems, even if the buyer’s value exceeds the supplier’s cost, the constraints imposed by incentive compatibility, individual rationality, and no deficit may prevent ex post efficient trade from taking place.
60 Of course, to the extent that outside options affect bargaining weights, the comparative statics are those discussed above.
to cover larger outside options.

The effects of changing an agent’s production-relevant outside option are more nuanced. For example, as a supplier’s outside option improves, the support of its cost distribution shifts upwards by the amount of the improvement, with the result that higher costs become more likely. Hence, the supplier will tend to be less likely to trade. However, under the assumption of monotone hazard rates, this effect is partly (but not completely) offset because, for a given cost realization, the supplier’s weighted virtual cost is lower than before the increase in the outside option. This implies that, ex post, given the same cost realization, the supplier is treated more favorably after the outside option increases. This is in line with intuition gleaned from complete information models. But from an ex ante perspective, the increase in the outside option reduces the supplier’s expected payoff from incomplete information bargaining because overall it makes the supplier less likely to trade and thereby decreases the supplier’s ex ante expected payoff. Moreover, as a supplier’s cost distribution worsens, the revenue constraint faced by the mechanism becomes tighter, which further tends to worsen the agent’s bargaining outcome.

### 7.4 Implementation

In many cases, economists have achieved greater comfort with models of price-formation processes when the literature has shown that there exists a noncooperative game that, at least under some assumptions, has an equilibrium outcome that is the same as the outcome delivered by the model under consideration. Indeed, this comfort often extends well beyond the narrow confines of the foundational game. For example, the existence of microfoundations are regularly invoked to support empirical estimation of a model even when the data-generation process does not conform to the extensive-form game providing the microfoundation.

In light of this, it is perhaps useful to note that, as mentioned above and discussed in Appendix D.1, for the case of one supplier, one buyer, and uniformly distributed types, the $k$-double auction of Chatterjee and Samuelson (1983) provides an extensive-form game that delivers the same outcomes as incomplete information bargaining. In addition, as we show in Appendix D.2, our approach has axiomatic foundations analogous to those that underpin Nash bargaining. Further, intermediaries like eBay, Amazon, and Alibaba play a prominent trade in organizing markets and, as we show in Appendix D.3, provide micro-foundations for incomplete information bargaining. Specifically, building on the model of Loertscher and Niedermayer (2019), for general distributions, one buyer, and any number of suppliers, the incomplete information bargaining outcome arises in equilibrium in an extensive-form

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61For example, a model based on Nash bargaining might be estimated even when it is clear that alternating-offers bargaining is not a good description of the bargaining process used in reality.
game involving a buyer, suppliers, and a fee-setting broker. This is reminiscent of the role of intermediaries in the wholesale used car market as described by Larsen (2021). There, auction houses run auctions, facilitate further bargaining in the substantial number of cases in which the auction does not result in trade, and collect fees from traders.

8 Related literature

The independent-private-values setting with continuous distributions has the virtue that, for a given objective, the mechanism that maximizes this objective, subject to incentive-compatibility, individual-rationality, and no-deficit constraints, is well defined and pinned down (up to a constant in the payments) by the allocation rule, which is unique. Of particular interest to industrial organization and antitrust economics, it also has the feature that, quite generally, there is a tradeoff between allocating efficiently and extracting rents. This tradeoff is at the heart of both industrial organization and Myerson’s optimal auction. This tradeoff is the reason why the Williams frontier is typically not identical to the 45-degree line and, therefore, the basis from which the possibility of social-surplus-increasing equalization of bargaining power emerges. Moreover, the aforementioned assumptions are essentially the only assumptions that permit a tractable approach that maintain the basic tradeoff between profit and social surplus.

There has also been a recent upsurge of interest in bargaining (see, for example, Backus et al., 2020, 2019; Zhang et al., forth.; Larsen, 2021), and buyer power (see, for example, Snyder, 1996; Nocke and Thanassoulis, 2014; Caprice and Rey, 2015; Loertscher and Marx, 2019; Decarolis and Rovigatti, forth.). For example, the latter find empirical evidence that increased buyer power has reduced Google’s online search revenues.

62 Antitrust authorities regularly face the task of evaluating the competitive effects of mergers in settings in which the payments that merging firms receive for their products are determined through competitive procurements, exactly because buyers have incomplete information regarding the suppliers’ costs. The prevalence of procurement in business-to-business transactions provides clear motivation for tools that embrace the incomplete information that drives the price formation process in such markets. Further, the observance of bargaining breakdown in real-world settings is also consistent with the presence of asymmetric information as documented by Backus et al. (2020) and difficult to reconcile with complete information as is the case with the evidence discussed and presented by Backus et al. (2019).

63 Dropping the assumption of risk neutrality, Maskin and Riley (1984) and Matthews (1984) show that optimal mechanisms depend on the nature of risk aversion, are not easily characterized, and, among other things, may require payments to and/or from losers. Without independence, as foreshadowed by Myerson (1981), Crémer and McLean (1985, 1988) show that there is no tradeoff between profit and social surplus. Without private values, additional and, therefore, in some sense arbitrary, restrictions may be required to maintain tractability and/or the tradeoff between profit and social surplus (Mezzetti, 2004, 2007). Notwithstanding recent progress, with multi-dimensional private information and multiple agents, the optimal mechanism is not known (see, e.g., Daskalakis et al., 2017). With discrete types, there is no payoff equivalence theorem. In other words, the mechanism is not pinned down by the allocation rule.
emphasize the value in abstracting away from the rules or extensive form of a game and instead focusing on outcomes, e.g., allocations and transfers, to estimate bargaining weights and distributions that can then be used for the analysis of counterfactuals.\footnote{They provide conditions under which their estimation procedure works well, including a demonstration based on the }\footnote{While the empirical literature examining multilateral bargaining focuses on fixed quantities or linear tariffs,} Bargaining has also come to the forefront of the empirical IO literature, in particular in analyses of bundling and vertical integration such as \cite{Crawford:2012} and \cite{Crawford:2018}. \cite{Collard-Wexler:2019} and \cite{Rey:2019} provide recent theoretical foundations for the widely used Nash-in-Nash bargaining model.\footnote{As stated by \cite[p. 1809]{Holmstrom:1983}, \enquote{Some economists, following Coase have ... argued that we should expect to observe efficient allocations in any economy where there is complete information and bargaining costs are small. However, this positive aspect of efficiency does not extend to economies with incomplete information.\textquoteleft}} \cite{Ho:2017} apply this framework to the question of countervailing power by insurers when negotiating with hospitals and find evidence that consolidation among insurers improves their bargaining position vis-à-vis hospitals. Our paper contributes to this literature by showing, among other things, that in incomplete information models, bargaining breakdown occurs on the equilibrium path,\footnote{For an overview of the literature on the competitive effects of vertical integration, see \cite{Riordan:1995}. As described there, the literature takes the view that most vertical mergers lead to some efficiencies.} and that the probability of breakdown can, under suitable assumptions, be used to estimate distributions. \cite{Ausubel:2002} explicitly account for inefficiencies in bargaining and focus on the second-best mechanisms introduced by \cite{Myerson:1983}, as do we; however, they focus on the robustness of the Bayesian mechanism design setting in two-person bargaining, which appears not to be a central concern for applied work, given the frequent reliance on models based on Nash bargaining, in which agents literally know each other’s types.

Consistent with our results, the literature on vertical integration and foreclosure also notes that a vertical merger that eliminates internal frictions may create or exacerbate external ones for the case in which buyers are competing downstream intermediaries.\footnote{Ordover et al. (1990) and Salinger (1988) show that vertical integration leads to an increase in rivals’ (linear) prices and Hart and Tirole (1990) provide a similar insight in the context of secret contracting, without restriction to linear tariffs. Nocke and Rey (2018) and Rey and Vergé (2019), extend the latter insight to multiple strategic suppliers for Cournot and Bertrand downstream competition. Allain et al. (2016) show that, while vertical integration solves hold-up problems for the merging parties, it may also create or exacerbate problems for} Ordover et al. (1990) and Salinger (1988) show that vertical integration leads to an increase in rivals’ (linear) prices and Hart and Tirole (1990) provide a similar insight in the context of secret contracting, without restriction to linear tariffs. Nocke and Rey (2018) and Rey and Vergé (2019), extend the latter insight to multiple strategic suppliers for Cournot and Bertrand downstream competition. Allain et al. (2016) show that, while vertical integration solves hold-up problems for the merging parties, it may also create or exacerbate problems for
The incomplete information approach also has implications for two-stage models in which investments precede bargaining, which have been at the center of attention in incomplete contracting models in the tradition of Grossman and Hart (1986) and Hart and Moore (1990). As discussed, the predictions could hardly differ more starkly because with incomplete (complete) information efficient bargaining implies efficient (inefficient) investment. There has also been a recent upsurge of interest in industrial organization relating to market structure and the incentives to invest (see, e.g., Federico et al., 2017, 2018; Jullien and Lefouill, 2018; Loertscher and Marx, 2019), onto which our paper—in particular, the results pertaining to mergers and vertical integration—sheds new light as well.

9 Conclusions

We provide an incomplete information bargaining model suitable for analyzing a range of important issues in industrial organization. In a methodological contribution, we show how one can allow multiple buyers and multiple suppliers, with multi-unit demand and supply, while still maintaining the assumption of one-dimensional private information. In our setup, the social surplus increasing effect of an equalization of bargaining power arises naturally because of the inherent tradeoff between social surplus and rent extraction: with independent private values, neither the mechanism that is optimal for buyers nor the one that is optimal for the suppliers is efficient in general, which opens the scope for increasing social surplus by making bargaining powers more equal. We show that socially harmful vertical integration arises naturally in our setting. We also examine the relation between the efficiency of incomplete information bargaining and the incentives to invest, which differs fundamentally from what obtains in complete information models that are based on the assumption that efficient trade is always possible. In extensions, we show that one can incorporate effects on downstream consumers, that the effects of outside options can differ relative to complete information setups, and that bargaining externalities arise naturally.

Our paper shows that an economic agent’s strength or weakness has two dimensions that

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68 Nocke and Thanassoulis (2014) provide model within the paradigm of efficient, complete information bargaining in which bargaining power can mitigate frictions due to credit constraints.

69 The tight connection between incentives for efficient investment and efficient allocation in incomplete information models has its roots in the seminal works of Vickrey (1961), Clarke (1971), and Groves (1973) and the subsequent uniqueness results of Green and Laffont (1977) and Holmström (1979). Essentially, dominant strategy incentive compatibility under incomplete information requires each agent to be a price taker, and efficiency then further requires this price to be equal to the agent’s social marginal product (or cost). As demonstrated by Milgrom (1987), Rogerson (1992), Segal and Whinston (2011), Hatfield et al. (2018), and Loertscher and Riordan (2019), this is precisely the set of conditions that have to be satisfied for incentives for investment to be aligned with efficiency.
are, conceptually, independent. The first one reflects the agent’s productivity. Is the agent likely to have a high value if it is a buyer or a low cost if it is a supplier? The second dimension captures the agent’s bargaining power, that is, its ability (or inability) to affect bargaining in its favor. For example, consider a supplier whose bargaining power allows it to make a take-it-or-leave-it offer to a buyer that depends on the realization of the supplier’s cost. The supplier optimally customizes its offer to the productivity of the buyer, with a weaker buyer (in the sense of hazard rate dominance) receiving a lower offer on average. Such differences do not reflect differences in bargaining power as commonly understood. No one would explain that economy airfares are lower than business airfares because of economy customers’ greater bargaining power. What is indicative of the relative bargaining powers is then not so much the level of prices but rather the price-formation process itself. For example, in a bilateral trade setting, if the buyer (supplier) always makes the price offer, then one would conclude that the buyer (supplier) has all the bargaining power, indicating that there is scope for social benefits from an equalization of bargaining power. In contrast, if the buyer and supplier participate in a $k$-double auction with $k = 1/2$, then this may be indicative of equal bargaining powers, suggesting that there is no scope for equalization of bargaining power.

Avenues for future research are many. Among other things, developing a better understanding of what determines bargaining power would add considerable value. The distinction between productive strength and bargaining power brought to light in the present paper may prove useful in that regard.

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[7] Byrne et al. (2021) find evidence that bargained prices for retail electricity contracts are affected by an individual’s willingness to search and bargain and the extent to which they reveal that they are informed about market prices.
References


