

Auctions vs. Negotiations: The Case of Favoritism

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Abstract:

We consider a procurement setting in which price and quality matter. We then compare an optimal auction with publicly announced rules with a simple sequential negotiation mechanism which rules may be privately changed at any point of the execution. The designer of the procurement mechanism is an agent of the buyer who has private information about the buyer's preferences and may collude with one of the sellers. Contrary to common wisdom that transparency hinders favoritism, we show that the sequential negotiation yields a higher buyer surplus if the number of sellers is sufficiently large. This is due to the fact that in the auction mechanism the favorite seller has to decide whether to distort the mechanism before observing the offers of the other sellers. Hence, he always distorts the mechanism whenever the expected punishment is low. In the sequential mechanism it is optimal for the favorite seller to observe the bids of the other sellers before distorting the allocation rule. Hence, at some realizations of the cost parameters distorting the mechanism yield no advantage and the sequential mechanism allocates efficiently.