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The Law of One Price in Auctions with Outside Competition

J. Philipp Reiß (Karlsruhe Institute of Technology)

In this paper we theoretically and experimentally investigate price formation in the auction part of a hybrid market. All consumers are faced with unit demand for a single object that is offered by various sellers. Sellers utilize two different price-setting mechanisms. First, there is a single auction seller offering a single object for sale. Second, there is a vast market segment with posted prices where substitute objects are traded, however, prices are dispersed and consumers have to engage in costly search for them before any transaction. The timing in the hybrid market is sequential where the auction is held before any consumer can participate in the posted-prices market. To keep the setting as simple as possible, we employ a second-price auction and assume that consumers' values are independently distributed and their private information. We characterize equilibrium behavior in the hybrid market and use it to predict behavior in the experiment.

Theoretically we find that - depending on the demand structure - the price in the auction either is carried over from the vast posted-prices market to the auction, so that the law of one price holds for the auction, or equals a smaller bargain-price. Put differently, depending on demand, the model explains why rare bargain-prices in auctions can coexist with a series of identical higher prices with identical objects exchanged in the market. Experimentally we find that consumers behave myopically so that auction prices are higher than predicted, because the potential benefits derived from the opportunity of participating in the posted-prices market is not fully reflected in the bids submitted in the auction.