

## **MICROECONOMICS AT WORK EXERCISE**

### **THE PRICE MECHANISM AND AUCTIONS**

**REFERENCE:** ‘Bidding Adieu’, *The Economist*, 29 June 2002, p. 82.

**CHAPTERS RELEVANT TO THIS EXERCISE:** Chapters 2, 3 and 7.

### **OVERVIEW**

This article is a review of two recent articles about auctions as a mechanism for allowing the price system to work perfectly. Auctions have traditionally been thought of as a mechanism which allows markets to operate in their freest form. Buyers and sellers can come together with full knowledge of the supply and demand situation, with bids reflecting the utility, or value, that buyers place on a good.

It is pointed out, however, that in practice, for two particular reasons, auctions may not allow ‘perfect competition’ to work. First, buyers (bidders) do not necessarily have perfect information about the value of what it is they are bidding for – particularly if the ‘good’ is, say, an enterprise whose worth depends on buyers’ estimates of future returns. In such a case, their bids might be influenced by their guesses about what other bidders will bid, and adjusted accordingly. Second, there can be collusion between bidders. This raises the issue of the way in which the form (or design) of the auction influences how ‘perfectly’ the market works.

The point is that while the concept ‘perfect competition’ is a useful and valid approximation of the way that markets in practice work, we need to be aware of the ways in which markets can work ‘imperfectly’ in the real world – a caution made on page 149.

### **QUESTIONS**

1. Why are auctions generally thought to have been an ideal mechanism for allowing perfect competition to work?
  2. ‘When every bidder remains true to his personal reckoning of what something is worth, auctions do indeed obey the laws of economics’. But why might this not always be the case?
  3. What is the ‘winner’s curse’?
1. Explain how auctions may operate in different ways, and the significance of auction design.