

Endogenous Entry in Markets with Adverse Selection*

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Abstract

The implications of adverse selection due to asymmetric information about quality are well-understood. Given the negative implications for trading and welfare, however, the question arises of how such markets come into existence. We consider a market in which firms make observable investment/entry decisions that generate products of a quality that becomes known only to the firm. Entry has the tendency to lower prices, which may lead to adverse selection. The implied price collapse limits the amount of entry so that high prices are supported in the market equilibrium, which results in above normal profits.

While contributing to our understanding of markets with asymmetric information and adverse selection, the model may also provide insight into the question of why markets with adverse selection are empirically hard to identify. The analysis suggests that rather than observing the canonical market collapse, such markets may instead be characterized by less entry than would be empirically predicted and above normal profits even in markets with low measures of concentration.

Keywords: adverse selection, asymmetric information, quality, entry, entry barriers

JEL classification: D8 (Information, Knowledge, and Uncertainty), D4 (Market Structure and Pricing), L1 (Market Structure, Firm Strategy, and Market Performance)

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1 Introduction

The inefficiencies associated with adverse selection are well known. The basic idea, introduced in Akerlof's (1970) seminal paper, is familiar: There is a market in which products are differentiated only by their quality. If consumers cannot observe the quality of individual goods then by the law of one price all qualities are sold for the same price. If firms' costs are increasing in quality, then at that single price the highest quality products may not be offered, whereas lower quality ones are. Poor quality drives out good quality and the amount exchanged is inefficiently low, perhaps even zero. Since then there have been many applications and extensions of the basic work.¹

Notwithstanding this extensive literature, two issues concerning such markets remain. The first is theoretical in nature: Given that especially high quality firms suffer the consequences of adverse selection, the question arises of how—particularly in new products markets—high quality producers find themselves in such an unenviable situation. Equilibrium reasoning suggests that forward looking firms should be able to anticipate and avoid such unfavorable outcomes.

The second issue concerning adverse selection is an empirical one. As Riley (2002) notes, research seeking empirical support for the potential role of introductory prices, advertising or warranties in overcoming the adverse selection problem draw at best only mixed conclusions. These studies do, however, provide evidence for some of the underlying assumptions of the basic model, namely that even when products are differentiated by quality, they may be subject to the law of one price so that higher quality does not command a price-premium. Moreover, these findings also suggest that high quality is not actually driven off the market. Indeed, many studies seeking direct or indirect empirical verification for adverse selection in various settings have similarly found only relatively weak evidence.²

¹For some recent theoretical contributions in the area see, *e.g.*, Johnson and Waldman (2003), Hendel *et al.* (2005), Hörner and Vielle (2009), or Belleflamme and Peitz (2009).

²Studies showing lacking evidence of methods of overcoming adverse selection are Gerstner (1985), Hjorth-Andersen (1991), Caves and Greene (1996), or Akerberg (2003); for contrasting findings see Wiener (1985). Studies that fail to identify adverse selection directly or indirectly include, *e.g.*, Bond (1982), Lacko (1986), Genesove (1993), or Sultan (2008), but also see Dionne *et al.* (2009).

In this paper we address the first question directly by considering endogenous entry into the market. In doing so, we are able to shed some light on the second issue, showing that the two questions may actually be related. A two-stage game is used to model markets in which adverse selection can arise. In the first stage firms make an observable fixed investment in quality. Similar to the seminal work of Milgrom and Roberts (1986) and also Daughety and Reinganum (1995, 2005), the quality of the product resulting from the investment is random and unobservable to the consumers. However, unlike these models of monopoly, we consider entry so that firms who enter the market find themselves in the second stage competing in a market characterized by the salient features of adverse selection.

To fix ideas, consider viticulture: while land, grapes and other inputs (*e.g.*, casks) are verifiable, the quality of the resulting wine for most consumers is not.³ Other industries in which investment is verifiable, but quality not, range from the highly specialized, such as horse breeding (the stud and mother are verifiable investments); to broader markets such as secondary mortgage markets in which loan origination is observable, but loan quality is only imperfectly conveyed. Many trade associations and agencies also certify certain inputs or processes of production, but not the quality of the final product. This is the case historically, for instance, with purity laws, appellation or guilds' marks; today Underwriter Laboratories in the United States, the *Technischer Überwachungsverein* (TÜV) in Germany, and the International Organization for Standardization (ISO) perform similar accreditations.

We show that incremental entry may have substantial price effects if adverse selection takes hold and the market collapses with bad quality driving out good quality, resulting in dramatic implications for profitability. Indeed, this mechanism can be viewed as a possible manifestation of the notion of ruinous or destructive competition. While economic research in this area generally focuses on uncertain demand (see, *e.g.*, Deneckere *et al.*, 1997) some, including legal scholars and policy makers (for instance, OECD, 2008, or Hovenkamp, 1989), see ruinous competition tied specifically to a deterioration in quality. In anticipation of this,

³While we primarily have in mind small, new vineyards, Ashenfelter (2008) notes that even when examining the most famous and well known *châteaux* considerable uncertainty about quality in the market for new wines exists.

firms rationally refrain from entering so that adverse selection and the associated market collapse coupled with a deterioration of quality does not arise in the market.^{4,5}

When latent adverse selection manifests itself in this way it results in *ex ante* positive profits in the entry equilibrium.⁶ That is, the potential for adverse selection works as a barrier to entry. An implication of this is that it would be difficult to find direct empirical support for adverse selection, even though it is a salient feature of the market studied. Indeed, empirical support for the presence of latent adverse selection might be found in indirect evidence such as otherwise unexplained supra-normal profits or diminished investment/entry. Thus, the analysis suggests heretofore unrecognized factors in the empirical literature on how uncertainty affects investment/entry. For instance, in our model price-cost margins (*i.e.*, profitability) are not necessarily related to concentration, so the analysis may shed light on the apparent empirical contradiction that—on the one hand—uncertainty has been found to have a greater negative impact on investment as the price-cost-margin increases (*e.g.*, Guiso and Parigi, 1999); but—on the other hand—the inverse relationship between uncertainty and investment has been shown to be stronger for more competitive environments (Ghosal and Loungani, 2000).

The basic intuition for why latent adverse selection affects entry is straightforward as is illustrated in the following stylized example. There are ten price-taking firms each of which sells one indivisible unit. Firms possess a technology that either produces a high quality product at cost 2.20, or a low quality product at cost of 1.50. Demand for high quality goods is given by $\bar{P} = 7(1 - 0.05Q)$; for low quality goods it is $\underline{P} = 2(1 - 0.05Q)$. The quality

⁴As Hovenkamp (1989) notes, the role of dramatic quality deterioration has long been acknowledged (see, *e.g.*, Jenks, 1888, 1889 or Jones, 1914, 1920), but has, to our knowledge, not been formally modeled. An implication of our model is that under unforeseen negative demand shocks markets do experience dramatic crashes coupled with a deterioration of quality that can be interpreted as ruinous competition.

⁵Etro (2006) also notes the importance endogenous entry has in understanding the market equilibrium, in his case strategic substitutability no longer determines investment distortions.

⁶For a fixed market structure (*i.e.*, without entry) positive profit with asymmetric information can also arise, see for example, for the case of moral hazard Bernardo and Chiappori (2003), but also Klein and Leffler (1981), Creane (1994), and Dana (2001); and positive profit can persist even when entry is considered, when there is an exogenously given incumbent with advantages over potential entrants, see, *e.g.*, Schmalensee (1982), Farrell (1986), or Dell’Ariccia *et al.* (1999). More generally, on the importance of positive profit persistence when endogenizing entry, see Etro (2011).

of an individual firm's product is unobservable, but it is known that half of the firms offer high quality, so demand for goods of unknown quality is given by $\tilde{P} = (.5 \times 7 + .5 \times 2)(1 - 0.05Q) = 4.5(1 - 0.05Q)$. The equilibrium price for the goods of unobservable quality when all ten firms produce one unit each is $P^* = 4.5(1 - 0.05 \times 10) = 2.25$, which is sufficient to cover the cost of both low and high quality producers, yielding an expected profit of 0.40.

A potential entrant is contemplating this market. The quality of the entrant's product is equally likely to be high or low *ex ante* (e.g., this may be the result of R&D that is required to enter the industry) so its expected costs are $.5 \times 1.50 + .5 \times 2.20 = 1.85$. Should the firm enter this market? Remarkably, the answer is no.

Since the entrant's level of quality is unobservable, market demand is—as before—given by \tilde{P} . If the firm enters the market, the price with eleven units on offer in the market is thus $P^* = 4.5(1 - 0.05 \times 11) \approx 2.03$. While this price is above the firm's *ex ante* expected costs of 1.85, it is insufficient to cover a high quality firm's cost of 2.20. *Ceteris paribus*, this need not be of concern to the eleventh firm, as it might contemplate entry in anticipation of becoming a low-quality producer. However, upon entry *some* high quality firm is driven out of the market. As a result, the average quality of the remaining output is decreased. This implies a decrease of demand, reinforcing the reduction in price. In other words, adverse selection takes hold of the market and—as can readily be verified for our illustrative example—all high quality firms leave the market.⁷ With only low quality firms in the market demand is given by \underline{P} , and so the price is no greater than $P = 2(1 - 0.05 \times 5) = 1.50$,⁸ which is the cost of producing producing a unit of low quality. Consequently, low quality firms can at best only cover their costs and therefore make zero profit.

In sum, despite prices being well above cost in the ten-firm market, if an additional firm enters the market adverse selection sets in and the price plunges from 2.25 to 1.50. Hence, no investment made to enter the market—no matter how small—can be recovered. As a

⁷Consecutive market prices upon exit of 1, 2, 3, 4, 5 high-quality firms are approximately 2.13, 2.17, 2.14, 2.00, 1.69; none of which are sufficient to cover the costs of producing high quality.

⁸There are at least the original five, but possibly six low quality firms in the market depending on the investment outcome of the entrant.

consequence no entry takes place: the latent adverse selection in the market serves as an entry barrier protecting above normal profits and, in equilibrium, there is no adverse selection in the market: all firms—high and low quality alike—produce and sell their output.⁹

The underlying mechanism that generates the result is that prices are a function of both the quantity and the average quality sold in the market. Entry reduces prices due to increased quantity, but the price reduction triggers adverse selection, reducing average quality and further eroding profit, rendering initial entry costs unrecoverable. As a consequence, the entry equilibrium may result in positive profit, even with costless entry, while trade in the market does not exhibit adverse selection. That these insights are not merely a peculiarity of the illustrative example is demonstrated in the more general framework that is introduced after relating the main idea to recent work on adverse selection.

The general framework is introduced in Section 2, followed by the analysis of the equilibrium. Welfare and potential policy implications of the equilibrium are presented in Subsection 2.3, where it is shown that while the absence of adverse selection raises welfare compared to increased entry coupled with adverse selection, welfare still falls short of second-best levels. Subsection 2.4 concludes the basic analysis with some technical conditions that differentiate markets with the potential for milder forms of adverse selection. These technical conditions are used when we examine the robustness of the findings by considering alternative frameworks in Section 3. In particular, while for heuristical reasons the base model deals with binary quality distributions, we extend the main insights to generalized quality distributions in Subsection 3.1, and while the base model assumes price-taking behavior, we consider monopolistic firms in Subsection 3.2. Section 4 contains some concluding remarks, all proofs are collected in the Appendix.

⁹It should be noted that in keeping with our general set-up in the remainder of the paper, we have chosen the potential entrant's R&D efforts in the illustrative example to yield a stochastic quality outcome. However, the limited entry/positive profit equilibrium derived in the example holds even if the firm is known to produce high quality, provided that consumers cannot distinguish which firm produced which units in the market. Specifically, for the case that consumers anticipate an additional unit of high quality in the market, demand is given by $P = \left(\frac{6}{11}7 + \frac{5}{11}2\right)(1 - 0.05Q) = \frac{52}{11}(1 - 0.05Q)$, which with an output of 11 units in the market yields a price of approximately 2.13, *i.e.*, below the cost of high quality so that the potential entrant refrains from entry, *even if it is known that his product will raise the average quality in the market.*

2 Entry and Welfare in the Base Model

In this section we present the basic model with a binary distribution of quality. We consider the entry equilibrium, while distinguishing markets in which under adverse selection no high quality is traded (“classic” adverse selection) from those in which some high quality producers continue to sell (“mild” adverse selection). Thereafter we analyze the welfare properties of the equilibrium configurations and propose a revenue-neutral welfare enhancing tax-*cum*-subsidy scheme that results in the attainment of the second-best welfare optimum. We conclude with a discussion of technical conditions that differentiate markets in which mild adverse selection may occur from markets where this phenomenon does not arise. These technical conditions are then shown to hold with generalized (continuous) distributions of quality.

2.1 The Base Model

Consider a two-period model of a market for a good of which the quality characteristics are inherently unobservable to consumers. In the first period firms install a fixed level of capacity, normalized to 1, by making an investment outlay of $\iota \geq 0$. The investment cost may reflect discovery costs associated with securing requisite inputs or basic research and development outlays; or, for the case of our viticulture example, the acquisition of land to be cultivated or aged barrels to be employed, and for the case of mortgages the loan origination process. Similar to the seminal papers by Jovanovic (1982) and Hopenhayn (1992), the success of the initial investment outlay is unknown *ex ante*, but has a binomial distribution: there is a probability τ that a firm’s product is of high quality with unit cost of \bar{c} ; and $(1 - \tau)$ is the probability that it is of low quality, costing \underline{c} .¹⁰ At the end of the first period, the firm observes the quality that it can produce after its investment outlay of ι is sunk.¹¹

¹⁰Jovanovic (1982) and Hopenhayn (1992) consider *ex ante* unknown cost differences of firms entering a market. In contrast to our work, however, these studies consider industry dynamics assuming a homogeneous product of known quality.

¹¹As will become clear below when we discuss the equilibrium notion, whether or not the firm observes a rival’s quality-realization is not germane, nor, for that matter, is the exact assumption governing the

In the second period market exchange takes place. Since quality is unobservable to consumers, the market clears at one price, P . Firms act as price takers *vis-à-vis* that price and make a production decision that maximizes their market profit (gross of entry costs, which are sunk at this stage) $\pi := P - c$, given their costs $c \in \{\underline{c}, \bar{c}\}$, with $0 < \underline{c} < \bar{c}$. The augmented cost for a unit of high quality either represents a production cost or can be thought of as an opportunity cost, as is done, for example in Daughety and Reinganum (2005), *i.e.*, all firms have production costs of \underline{c} , but high quality producers have an outside option valued at \bar{c} . The latter interpretation is pertinent if, for instance, there is an alternative use for the product, as is the case in Akerlof's (1970) archetypal paper in which used car owners may choose to keep their cars, horse-breeders who choose to hold on to some yearlings (Chezum and Wimmer, 1997), lenders who keep mortgages rather than selling them in the secondary market;¹² or if high-quality products can be sold in an alternative market in which quality is independently verified—as is the case in viniculture with vintners who can sell their grapes to a *négociant*, rather than selling under their own label (Lonsford, 2002a,b, Heimoff, 2009), or electronics manufacturers who sell their products to name brands for retail (see, *e.g.*, Financial Times Information, 2000).¹³

Inverse demand for products of (known) high quality is given by $\bar{P}(Q)$, whereas demand for products of low quality is $\underline{P}(Q)$ ($< \bar{P}(Q), \forall Q$)—both twice continuously differentiable and strictly decreasing. While firms know the quality of their product, the quality characteristics of any given good on offer is unobservable to consumers. At the beginning of the second period, consumers know the number of firms that invested in order to sell in the market, but not each firm's output. Consumers also know the *ex ante* distribution of quality that

quality-determination process, provided that τ captures the expected quality across, but not necessarily within firms.

¹²The commercial mortgage-backed security (CMBS) market is subject to adverse selection at the margin between loans that are securitized in-house by the originator and loans sold to competing CMBS underwriters, see Chu (2011).

¹³The two interpretations of the the unit cost for high quality (*i.e.*, production costs or opportunity costs) are isomorphic whenever the investment outlay is not so low that firms invest solely in the hopes of obtaining high quality for the alternate use. Consequently, all the derived results continue to hold under the opportunity cost interpretation provided that the critical thresholds on ι derived in the paper are shifted by the amount of this added profit opportunity.

can be delivered, given by τ . On the basis of this, consumers form beliefs about the quality composition of overall market supply. Letting α denote the consumers' perception of the fraction of high quality products on offer (which can differ from τ , depending on firms' production choices), market demand is

$$P(Q, \alpha) := \alpha \bar{P}(Q) + (1 - \alpha) \underline{P}(Q). \quad (1)$$

Since both demand for high quality goods \bar{P} and demand for low quality goods \underline{P} are strictly decreasing, $P(Q, \alpha)$ is strictly decreasing in its first argument. And, since $\bar{P} > \underline{P}$, market demand is increasing in its second argument, reflecting the greater willingness to pay for higher quality. In equilibrium, consumers' beliefs about the expected (*i.e.*, average) quality on offer are consistent with firms' actions so that α correctly reflects the average quality of the goods in the market.

We assume that selling some high-quality goods is efficient, (*i.e.*, $\bar{c} < P(0, 1)$) and, in order to make entry attractive, that producing some low-quality goods is also efficient (*i.e.*, $\underline{c} < P(0, 0)$). As a result $Ec := \tau \bar{c} + (1 - \tau) \underline{c} < P(0, \tau)$ so that there is positive demand for at least some output, given the prior distribution on quality. Moreover, since we are interested in market constellations in which adverse selection may occur, we assume for convenience that when beliefs rule out the presence of high quality the market price is insufficient to cover the costs of producing high quality, *i.e.*, $P(0, 0) < \bar{c}$. Finally, we make the standard assumption that $\lim_{Q \rightarrow \infty} P(Q, \gamma) = 0$.

Our assumptions characterizing the market equilibrium are standard in the literature on adverse selection, yet these do not always identify a unique equilibrium. In particular, there is the possibility of a coordination failure in which high-quality firms under-produce for no reason other than consumers do not expect them to produce. In order to assure that firms' entry decisions are not driven by equilibrium selection, we use the Pareto selection criterion to eliminate all but one market equilibrium, whenever multiple equilibrium configurations exist. This means that we restrict attention to the equilibrium with the greatest average quality of output in the market.¹⁴ As a result of this assumption, for any number of firms in the market

¹⁴Wilson (1980) considers the possibility of multiple equilibrium configurations and notes that these can be

there is a unique equilibrium price $P^*(n)$, which implies a well-defined expectation of market profit for the n^{th} firm prior to entry, *i.e.*, $E\pi(n) = P^*(n) - Ec = P^*(n) - [\tau\bar{c} + (1 - \tau)\underline{c}]$.

For purposes of greater clarity, we treat the number of firms n as coming from a continuum. Consequently, any above-normal profit equilibrium is not due to the well-known integer constraint problem, but is a general characteristic of the equilibrium that occurs even when n is an integer. Moreover, for heuristic purposes, we characterize symmetric equilibrium configurations in which firms choose mixed strategies over binary production plans, *i.e.*, they choose a probability with which they either produce at full capacity, or shut down. Other equilibrium configurations, involving asymmetric pure strategies, or fractional capacity utilization rates, yield identical insights.

2.2 Endogenous Entry and Market Equilibrium

For expositional ease we consider sequential entry of firms so that the equilibrium is determined by the last firm that expects to recover its entry costs of ι upon entering the market (the equilibrium is qualitatively the same when assuming simultaneous entry decisions).¹⁵ Due to downward sloping demand for a given quality composition, as firms enter the market the increase in supply drives down the market price. Consequently firms' expected market profits are diminished upon entry. Entry continues up to the point where the marginal firm's expected market profit upon entering, $E\pi$, no longer exceeds its entry cost of ι . We consider how this process plays out in the equilibrium of the entry game, and what the implications of the entry equilibrium are on the market equilibrium.

We first consider high entry costs and demonstrate that in the resulting zero-profit entry equilibrium no adverse selection occurs in the market. Second, we consider lower entry costs (including the possibility of zero entry costs) and examine markets in which adverse

Pareto-ranked by increasing prices; Rose (1993), however, finds that generally a unique equilibrium emerges. In our model there is multiplicity, including the possibility of more than one equilibrium with the same price so that average quality, rather than price, yields the relevant Pareto-ranking.

¹⁵In the special case of costless entry, the Pareto criterion yields that a firm refrains from entering when it is indifferent between entering or not.

selection leads to all high quality being taken off the market so only low quality is traded.¹⁶ We refer to this market outcome as “classic” adverse selection, and show that the possibility of classic adverse selection may function as a barrier to entry so that the entry equilibrium is associated with positive profits and there is no adverse selection in the market.

We conclude this subsection by considering a milder form of adverse selection in which some, but not all high quality is taken off the market. We show that with small (possibly even zero) entry costs adverse selection may still function as an entry barrier, resulting in an entry equilibrium with positive expected profit in concurrence with mild adverse selection; while classic adverse selection is prevented from occurring in the market equilibrium. We leave for later a more technical discussion of the conditions on demand, costs, and quality that allow for mild adverse selection to occur.

2.2.1 High Entry Cost: Zero Profit and No Adverse Selection

The entry equilibrium is determined once the marginal firm is left without positive overall expected profit when contemplating incurring the investment outlay of ι given its expected market profit upon entering. Thus, if entry costs ι are large, a firm must expect high market profits upon entry in order to enter the market. Since expected costs of the firm are exogenous, the only way to support high expected profits is through a high market price. However, a price that is high enough to induce entry of the last firm, may be sufficiently high so that all firms in the market—regardless of their quality and cost characteristics—can cover their costs of production. Consequently, there is no adverse selection in the market when prices are sufficiently high. This leads to the first result, which is useful as a benchmark for later results because it establishes the conventional entry equilibrium outcome. Specifically, high entry costs imply a zero-profit entry condition and a market in which there is no adverse selection. Formally,

¹⁶Using the Pareto selection criterion in conjunction with our assumption that it is efficient to produce some low quality precludes a complete market collapse. However, these cases are easily subsumed in the current analysis.

Lemma 1 (High Entry Costs Prevent Adverse Selection) *There exists an investment cost $\bar{\iota}$ such that whenever $\iota \geq \bar{\iota}$,*

1. *if entry takes place, the equilibrium number of firms n^* is implied by the market price that is equal to the total expected cost of the firm, i.e., $P(n^*, \tau) = \iota + Ec$;*
2. *firms make zero expected profit, i.e., $E\pi - \iota = 0$; and*
3. *there is no adverse selection in the market, i.e., all high quality producers are active in the market and the average quality in the market is characterized by τ .*

In this equilibrium *ex ante* profits are zero and all firms produce at full capacity. It follows that under endogenous entry adverse selection is not observed when there are sufficiently high entry costs despite the salient features of adverse selection being present. To put this more succinctly: when entry costs are high, few firms enter. And when few firms enter, a high price is sustained. And when the price is high, all firms can cover their costs. Finally, when all firms can cover their costs there is no adverse selection.

The critical threshold of entry costs noted in the lemma is given by $\bar{\iota} = (1 - \tau)(\bar{c} - \underline{c})$. This threshold is exactly equal to the *ex ante* expected profit of a firm when the market price only just covers the cost of producing high quality, *i.e.*, when $P = \bar{c}$ so that only low quality producers obtain positive profit. We now turn to how endogenous entry affects markets when entry costs are lower.

2.2.2 Positive Profit and No Adverse Selection

In Proposition 1 entry costs are identified that are so high that entry into the market is restricted and only few firms enter. As a result of the small number of firms in the market, prices are sufficiently high to support full production by high quality producers so that adverse selection does not occur in the market. We now suppose that entry costs are below the threshold identified in Proposition 1 and show that the resulting increase in entry still need not result in adverse selection. Indeed, despite lower entry costs, latent adverse selection

can serve as an effective entry barrier under which no adverse selection occurs in the market and the entry equilibrium entails above normal profit (as is the case in the example in the introduction).

In order to demonstrate this, note first that for adverse selection to *not* occur all firms must be offering their output for sale. This only happens if the resulting market price is no lower than the cost of producing high quality. Let \bar{n} denote the largest number of firms that the market can sustain under full production without adverse selection setting in. It follows that \bar{n} is implicitly given by

$$P(\bar{n}, \tau) = \bar{c}. \quad (2)$$

Firms' expected market profits (*i.e.*, gross of entry costs ι , but before production costs are known) at \bar{n} are given by

$$E\pi(\bar{n}) = P(\bar{n}, \tau) - [\tau\bar{c} + (1 - \tau)\underline{c}] = (1 - \tau)(\bar{c} - \underline{c}). \quad (3)$$

This is the critical threshold on entry costs, identified in Proposition 1, above which entry falls short of levels that may trigger adverse selection. We now derive the entry equilibrium when entry costs are below this level of *ex ante* expected market profit. That is, we consider cases in which, in contrast to Proposition 1, $\iota < \bar{\iota}$.

As noted, if firms in excess of \bar{n} enter the market, then adverse selection occurs. In the current analysis we restrict attention to the classic case of adverse selection known from the literature in which high quality is driven out and only poor quality remains to be traded in the market.¹⁷

Proposition 1 (Adverse Selection as an Entry Barrier) *Suppose that for any amount of entry that induces a price below high quality cost when all entrants produce, i.e., $n > \bar{n}$, the market suffers from classic adverse selection and only low quality is traded in the market. Then there exists an investment cost $\underline{\iota} \in [0, \bar{\iota})$ such that for all $\iota \in [\underline{\iota}, \bar{\iota})$,*

1. *the equilibrium number of entrants results in an equilibrium price equal to high quality cost when all entrants produce so that $n^* = \bar{n}$;*

¹⁷Necessary and sufficient conditions for this case are given in Subsection 2.4.

2. *firms make positive expected profit, i.e., $E\pi - \iota > 0$; and*
3. *there is no adverse selection in the market, i.e., all high quality producers are active in the market and the average quality in the market is characterized by τ .*

Proposition 1 demonstrates that even with entry costs that do not limit entry to a zero-profit equilibrium, adverse selection need not occur in the market, as the potential for adverse selection itself can work as an effective entry barrier. Having assumed that it is efficient to produce some low quality, a complete collapse (*i.e.*, a no-trade equilibrium) as in Akerlof's (1970) paper does not occur (although we can easily also allow for this outcome, and the insights follow even more readily). Nevertheless, when $\underline{c} = 0$ entry is limited to $n^* = \bar{n}$, resulting in potentially substantial above-normal expected profit of $(1 - \tau)(\bar{c} - \underline{c})$ in the entry equilibrium even with costless entry.

Lemma 1 and Proposition 1 together suggest that when one considers entry in markets with the characteristic features of adverse selection, then adverse selection does not in fact take hold of the market whenever entry costs are above \underline{c} , where—depending on characteristics of demand, *ex ante* quality and costs— \underline{c} can be arbitrarily small, or even zero. If entry costs are high, then the entry equilibrium is characterized by the common zero-profit condition. However, if entry costs are low, the latent adverse selection leads to an entry equilibrium in which firms' average market profits are above the cost of entry. These results may provide an explanation for why empirical research frequently fails to uncover direct or indirect evidence of adverse selection. However, the propositions suggest alternative tests for these markets, namely either high entry costs serving as a barrier to entry which prevents adverse selection from taking hold of the market (Lemma 1); or above normal profit without additional entry (Proposition 1).

In the analysis thus far (in particular in Proposition 1) we have restricted attention to instances in which what we termed classic adverse selection may affect the market, namely that adverse selection implies that high quality producers shut down and only low quality is on offer in the market. We have characterized how such latent adverse selection serves as an

entry barrier that prevents adverse selection and preserves above normal profit in the entry equilibrium. If, instead, one considers milder forms of adverse selection that do not lead to market collapse, entry may take place beyond \bar{n} , and yet above-normal profit still remains a feature of the entry equilibrium. We now examine this case.

2.2.3 Positive Profit with Mild Adverse Selection

Proposition 1 is concerned with the case of classic adverse selection in which all high quality producers exit and only low quality producers remain, should adverse selection set in. However, recall that given our assumption of downward sloping demand prices are a function of not only the average quality in the market, but also of the quantity on offer in the market. And thus, firms shutting down and exiting has—all else equal—the tendency to increase prices in the market. Hence, if entry beyond \bar{n} takes place so that the price is insufficient to cover the expense of producing high quality when all firms produce, some high quality firms (albeit not necessarily all) opt out of production. As this reduces the quantity on offer in the market, the price tends to rise, possibly allowing those high quality firms that did not opt out of production to cover their production costs.

An illustration of this can be found with a minor modification of the example given in the introduction. If in that example the cost of producing high quality is lower, say, 2.10 rather than 2.20, then the eleventh firm will enter the market, knowing full well that if it obtains high quality either itself or a rival high quality firm will not produce, resulting in a price of about 2.13. However, entry of a twelfth firm would not take place, since this would surely trigger classic adverse selection and render any investment outlay unrecoverable, regardless of the firm's type. Hence the entry equilibrium would, once again, be characterized by classic adverse selection serving as an entry barrier that preserves above normal profit. And while mild adverse selection is a feature of the market equilibrium; classic adverse selection is not.

Whether such an adjustment can take place in any given market depends critically on how firms' choices affect the composition of quality and quantity in the market. To formalize this, recall market demand as a function of quantity and average quality, given in (1) and

reproduced here:

$$P(Q, \alpha) = \alpha \bar{P}(Q) + (1 - \alpha) \underline{P}(Q). \quad (4)$$

The proof of Proposition 1 relies on demand being increasing in its second argument. Specifically, notice that in markets that exhibit classic adverse selection with entry beyond \bar{n} , α takes on the value of either τ (no adverse selection) or 0 (classic adverse selection). This discontinuity (α switching from τ to 0) when adverse selection sets in is central to the positive profit result in Proposition 1. In departure from the previous analysis, we now consider situations in which both Q and α vary continuously as firms in the market alter their production plans continuously—potentially leading to mild adverse selection.

If entry beyond \bar{n} takes place and all firms in the market produce, then—by definition of \bar{n} —the price is below \bar{c} , so high quality producers make negative profit in the market. Consequently, at least some high quality producers will refrain from producing, which reduces market output. Since $P(Q, \alpha)$ is decreasing in its first argument, the reduction of output—all else equal—yields a higher market price. Note, however, that all else is not equal: as only high quality producers cease production the positive quantity effect is countered by a negative quality effect since the average quality of the goods on offer deteriorates. With this we formalize the notion of “mild” adverse selection.

Lemma 2 (Mild Adverse Selection) *A market has the potential for an equilibrium with mild adverse selection whenever for some $n > \bar{n}$ there exists $\kappa \in (0, 1)$ such that*

$$P \left((1 - \tau + \kappa\tau)n, \frac{\kappa\tau}{1 - \tau + \kappa\tau} \right) = \bar{c}; \quad (5)$$

in which case κ is the proportion of high quality firms in the market that produce.

While we leave a more technical and detailed discussion of the conditions for the existence of mild adverse selection to the end of this section, it is worth noting at this stage that if several values for κ exist that satisfy (5), then the Pareto equilibrium selection criterion eliminates all but the largest of these. However, it is important to note that mild adverse selection need not exist in a given market: While high quality producers are indifferent

between producing and not producing when the price is \bar{c} , their decisions affect average quality and thus consumers' willingness to pay. This, in turn, affects the market price for given market output and firms are no longer indifferent between producing or not at prices that are different from \bar{c} so that firms' production plans are adjusted. Thus, output and average quality must be determined simultaneously and must yield a price of \bar{c} . Such balancing is not always possible. Indeed, in the initial example used in the introduction to the paper no such balancing is possible so that mild adverse selection cannot occur.

Having formalized the condition for mild adverse selection, we now characterize the implications for entry when the condition holds.¹⁸

Proposition 2 (Mild Adverse Selection and Positive Profits) *Suppose that the market has the potential for mild adverse selection. Then there exists an investment cost $\underline{c}' \in [0, \bar{c})$ such that for all $\iota \in [\underline{c}', \bar{c})$,*

1. *the equilibrium number of entrants is greater than that which would result in an equilibrium price equal to high quality cost, i.e., $n^* > \bar{n}$;*
2. *firms make positive expected profit, i.e., $E\pi - \iota > 0$; and*
3. *there is mild adverse selection with a fraction $\kappa \in (0, 1)$ of high quality producers still operating in the market so that the fraction of high quality is $\alpha \in (0, \tau)$.*

When conditions on demand, the distribution of quality, and costs allow for mild adverse selection, this leads to entry beyond \bar{n} , whenever entry costs are not prohibitive, *i.e.*, they are not above \bar{c} . However, as some high quality firms opt not to produce, average quality in the market deteriorates upon entry beyond \bar{n} . At some point continued entry leads to such a deterioration of average quality of the goods on offer that consumers are no longer willing to pay a price that covers the costs of producing high quality, at which point further entry results in classic adverse selection in the market. That is, classic adverse selection still determines the equilibrium entry level.

¹⁸The analysis of high entry costs given in Proposition 1 is independent of whether the market has the potential for mild adverse selection.

A comparison between markets with the possibility of mild adverse selection with those where only classic adverse selection can occur is not directly possible, since these markets must differ in some aspects of demand, cost, or the exogenous quality parameter. However, it may nonetheless be worth noting that if the markets are sufficiently similar in the relevant aspects, then the threshold level identified under mild adverse selection, $\underline{\iota}'$, may be smaller than that under classic adverse selection, $\underline{\iota}$, since mild adverse selection permits entry beyond \bar{n} . In particular, if demand for low quality, the cost of producing low quality, and the exogenous probability of being of high quality are the same across markets and if demand for and costs of high quality are such that \bar{n} is the same in both markets, then $\underline{\iota}' \leq \underline{\iota}$ with equality only when $\underline{\iota}' = \underline{\iota} = 0$.

Thus, loosely speaking, while markets with mild adverse selection are more prone to exhibit adverse welfare effects of adverse selection, a complete market collapse—and hence the most drastic implication for welfare—is more likely to be deterred, since the critical threshold for entry costs is low. This observation naturally leads to a more detailed examination of welfare in these markets.

2.3 Welfare

The focus of the preceding analysis has been firms' forward looking decisions based on their profit considerations. In this subsection we assess overall equilibrium welfare under endogenous entry in markets with adverse selection. To this end, let $CS(n)$ denote consumer surplus in the (unique) market equilibrium with n firms and define $W(n) := CS(n) + nE\pi(n)$ as the total welfare in the market when n firms have entered.

To begin, an implication of Proposition 1 is that when entry costs are above $\bar{\iota}$ the entry equilibrium yields the maximum welfare. This follows, since there is no adverse selection in the market and so there is no welfare loss in the market; and given that firms' entry decisions yield zero expected profit, any increase in the welfare in the market upon entry is insufficient to offset additional entry costs. This insight does not apply to the cases of Propositions 1 and 2 since these equilibrium configurations are characterized by positive profits. However, as

these equilibrium configurations also do not exhibit classic adverse selection, positive profits need not imply welfare losses compared to increased entry. Indeed, limited entry not only protects the above normal profits, but also protects consumer surplus in the market that arises because high quality is traded. Formally,

Proposition 3 (Welfare Preservation) *When investment costs are in the intermediate range, i.e., $\iota \in (\underline{\iota}, \bar{\iota})$ so that latent adverse selection serves as an entry barrier and $n^* = \bar{n}$, overall welfare is greater compared to market settings with an increased number of firms entering.*

In other words, when entry costs are such that $\iota \in (\underline{\iota}, \bar{\iota})$ (for classic adverse selection and $\iota \in (\underline{\iota}', \bar{\iota})$ for mild adverse selection), entry beyond the entry equilibrium reduces market welfare, as the market collapses and classic adverse selection occurs. Hence, when endogenizing entry, the welfare losses associated with classic adverse selection are averted.

Nevertheless, the fact that profit is not competed away in the entry process suggests the potential for welfare improving policies. Indeed, it is still possible for a welfare-maximizing competition agency to raise welfare, even when the quality of the individual firms is also unobservable to the government (*i.e.*, second-best welfare maximization). To see this, note that while entry beyond \bar{n} necessarily (weakly) reduces the market price, incremental entry beyond \bar{n} coupled with a commitment to full production by all firms (including all high quality firms, who then produce at a loss) yields a price that is above expected production and entry costs (*i.e.*, $P(n + \epsilon, \tau) > \tau \bar{c} + (1 - \tau)\underline{c} + \iota$, with ϵ small, but positive). Such incremental entry increases welfare because the gain to consumers, due to increased production and increased average quality, is greater than the loss to high quality firms from producing without being able to cover production costs. Hence, the equilibrium entry level is less than the second best welfare optimum.

It may seem counter-intuitive that it is socially optimal to have a high quality firm sell in the market in which it earns negative economic profits, but the high quality firm creates a positive externality by increasing the average quality in the market. Thus, the constrained

welfare-optimal amount of entry, denoted by n^{**} , is obtained when entry costs are just offset by market profit under (forced) full production, *i.e.*, $P(n^{**}, \tau) = \tau\bar{c} + (1 - \tau)\underline{c} + \iota$.

Thus, while forward-looking firms refrain from entering and thereby prevent the welfare losses associated with adverse selection, the entry level is inefficient compared to the second-best welfare optimum. Despite investment-entry being socially insufficient, the traditional solution to increase entry—*i.e.*, subsidizing investment-entry—does not work. This is because the additional entry that the subsidy induces does not result in the positive market externality of high quality output, since at the point of the production decision, the subsidy is sunk and high quality producers are better off refraining from production. That is, the negative welfare effects of limited entry are not curbed by the introduction of an investment-entry subsidy. Indeed, this suggests a further indirect test for the presence of adverse selection in markets, namely that investment-entry subsidies (short of the remaining above-normal profit) do not affect the market equilibrium.

Although an investment-entry subsidy does not move the market towards the second-best welfare maximum, the classic solution of offering a production subsidy for firms in the market does so, provided that this policy is announced before investment-entry occurs. Specifically, a production subsidy that covers the high quality firm's short-fall of revenue over costs, *i.e.*, $\bar{c} - P(n^{**}, \tau)$, results in the second best welfare optimum: all high quality firms are able to cover their costs of production when n^{**} firms enter, as they sell their product at the price of $P(n^{**}, \tau)$ and obtain the subsidy. This outcome, however, continues to result in positive *ex ante* (expected) profits, since high quality firms break even and low quality firms make positive profit. Nevertheless, despite the positive profits at this new level of entry, additional firms do not enter, as otherwise this added entry again reduces prices to a level where adverse selection sets in, which renders investment costs unrecoverable.

It should be noted that the welfare-increasing policy can be made revenue-neutral. This is done by imposing an investment-entry tax in the first period equal to the value of the subsidy. With this tax and the production subsidy, expected profits for the n^{**} firms that enter are zero. Consequently, such a revenue neutral policy is welfare enhancing even if

the subsidy and tax fall short of the optimal level, since the increased entry coupled with the positive market externality from sustained production of high quality raises welfare. If, instead, the tax and subsidy is set above the optimum, then the optimal level of investment-entry (*i.e.*, n^{**}) followed by full production still results, because investment-entry greater than n^{**} generates negative profits and so entry beyond n^{**} does not occur. We summarize this discussion in the following proposition.

Proposition 4 (Revenue-Neutral Welfare Optimizing Policy) *The second best social welfare optimum can be achieved with a period-two production subsidy and a revenue-neutralizing period-one investment tax. Moreover, even if the government sets the wrong subsidy level, as long as there is a revenue-neutralizing investment tax, welfare increases.*

An advantage of such a combined policy in which firms are first taxed and later subsidized is that the policy is easy to implement. In contrast to previous suggestions that restrict the subsidy to high-quality producers, there is no need for the verification of a firm's quality as all firms receive the subsidy. Hence, firms need not worry about the possibility of an erroneous or faulty application of the subsidy rule, which otherwise might lead high-quality producers to refrain from producing.

Despite the fact that the proposed policy in Proposition 4 does not require verification of quality since the subsidy applies indiscriminately to all firms, the policy is costless due to its revenue-neutrality. Hence the government need not know if there is latent adverse selection, that is, if there is no latent adverse selection, then the investment-entry decision is unaffected. A final advantage of the proposed policy is that, since the policy is revenue neutral, an industry will only lobby for it when the policy increases overall welfare.

2.4 Conditions For Classic Adverse Selection

Since the notion of mild adverse selection is novel to this paper we briefly delineate when it can arise. The conditions obtained facilitate the analysis of the extensions and generalizations studied in the next section. As a matter of nomenclature, we refer to a market in which

classic adverse selection may occur, but mild adverse selection cannot happen, as a market with “classic adverse selection” (even though in equilibrium there is no adverse selection when $\iota > \underline{\iota}$). We otherwise speak of a market with “mild adverse selection” (even though this market exhibits classic adverse selection when $\iota < \underline{\iota}'$).

In line with Lemma 2 let κ denote the proportion of high quality firms in the market that actually produce (so that the proportion $(1 - \kappa)$ of high quality producers shut down). Then, for a given number of firms in the market n , market output is given by $Q(\kappa|n) := (1 - \tau + \kappa\tau)n$; and the proportion of high quality in the market is given by $\alpha(\kappa) := \frac{\kappa\tau}{1 - \tau + \kappa\tau}$. Define the market price (*i.e.*, a firm’s revenue) for given n and given κ by

$$\mathcal{P}(\kappa|n) := P(Q(\kappa|n), \alpha(\kappa)) = \alpha(\kappa)\bar{P}(Q(\kappa|n)) + (1 - \alpha(\kappa))\underline{P}(Q(\kappa|n)). \quad (6)$$

This representation allows one to consider how the market price varies with incremental changes in the proportion of high quality output in the market. In particular, it serves to show how the exit of a high quality firm has two countervailing effects on price. Thus,

$$\begin{aligned} \mathcal{P}'(\kappa|n) &= \frac{d\mathcal{P}}{d\kappa} = \frac{\partial P}{\partial Q} \frac{dQ}{d\kappa} + \frac{\partial P}{\partial \alpha} \frac{d\alpha}{d\kappa} \\ &= \underbrace{\left((1 - \alpha)\underline{P}' + \alpha\bar{P}' \right) \tau n}_{\text{Quantity Effect}} + \underbrace{(\bar{P} - \underline{P}) \frac{\tau(1 - \tau)}{(1 - \tau + \kappa\tau)^2}}_{\text{Quality Effect}}. \end{aligned}$$

When considering a reduction in κ , the first term is the slope of the demand curve for a given quality composition of output, so this term captures the positive price effect of a reduction in output (*cf.* Fig. 1). This term is weighted by τ , since only high quality firms have an incentive to reduce their output. The second term measures the (negative) effect on the price premium that consumers are willing to pay for high quality over low quality, weighted by the marginal impact of decreases in average quality, due to a reduction in κ (see Fig. 1). Whether these two effects can offset each other in such a way to establish a market price that leaves high quality firms indifferent about their production decision, *i.e.*, $\mathcal{P}(\kappa) = \bar{c}$, determines whether a market can exhibit “mild adverse selection” (see Lemma 2).

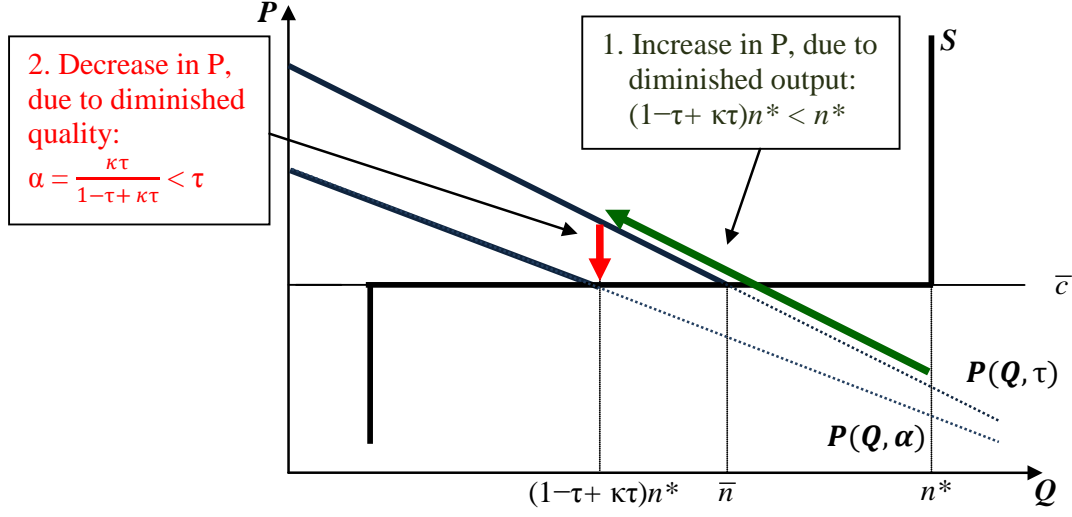


Figure 1: Two Effects of a Reduction in High-Quality Output

In particular then, a market cannot exhibit mild adverse selection whenever

$$\mathcal{P}(\kappa|n) < \mathcal{P}(1|\bar{n}) = \bar{c}, \quad \forall \kappa \in [0, 1] \text{ and } n > \bar{n}. \quad (7)$$

In order to better interpret the condition, consider a market in which there are currently \bar{n} firms so that the market price is just sufficient to cover the cost of high quality production, *i.e.*, $\mathcal{P}(1|\bar{n}) = P(\bar{n}) = \bar{c}$. At this point, for classic adverse selection to not occur, the negative price effects of incremental entry of average quality must be offset by the positive price effects of incremental exit of high quality, when taking account of the negative price effect of deterioration of quality in the market as average quality enters and high quality exits. Formally, suppose that $\mathcal{P}'(1|\bar{n}) < 0$ (which is a sufficient condition for a market with mild adverse selection). This states that a marginal reduction in high quality leads to an increase in the price when the market is at \bar{n} . Note that \mathcal{P}' is continuous in n . Therefore a marginal change in n does not change the sign of \mathcal{P}' , implying that an increase in price, due to incremental entry beyond \bar{n} , can be offset by an incremental reduction in high quality output. If this is not the case, then the possibility that an incremental reduction in high quality can yield mild adverse selection is precluded. This yields,

Lemma 3 (Necessary Condition for Classic Adverse Selection) *A necessary condi-*

tion for a market with classic adverse selection (i.e., no mild adverse selection) is that

$$\mathcal{P}'(1|\bar{n}) \geq 0.$$

The condition given in Lemma 3 is not sufficient to assure that (7) holds, since mild adverse selection need not be the result of a marginal adjustment process. In particular, there are market constellations in which upon incremental entry beyond \bar{n} mild adverse selection emerges due to a (potentially large) positive measure of high quality firms ceasing production. Indeed, in the example given in the introduction, if the cost of producing high quality is given by 2.15, rather than 2.20, then upon entry of the eleventh firm in the market, high quality cannot cover its cost even after the exit of one high-quality producer as the price drops to 2.13. However, if *two* high quality producers *simultaneously* exit, the price increases to 2.17, which is sufficient to cover high quality costs. That is, while a marginal reduction in high quality output may not suffice to restore an equilibrium, a large reduction (falling short of complete shut-down of high quality) may yield an equilibrium with mild adverse selection.

We now consider conditions that render Lemma 3 sufficient for a market with classic adverse selection.

Lemma 4 (Sufficient Condition for Classic Adverse Selection) *A sufficient condition for a market with classic adverse selection (given the condition in Lemma 3) is that*

$$\mathcal{P}''(\kappa|\bar{n}) \neq 0,$$

i.e., $\mathcal{P}(\kappa)$ is either strictly concave or strictly convex in κ when evaluated at \bar{n} .

Lemma 4 essentially imposes a regularity condition on the price adjustment process as quantity and quality vary. The condition can be made weaker, since high quality being driven entirely off the market only requires that once—for a fixed number of firms in the market—the price reaches an extremum under variation in the quality make-up of supply, then this extremum is not just local, but also global. For instance, either quasi-concavity or quasi-convexity of \mathcal{P} is also sufficient to guarantee the desired result.

We close this section with two final observations. First, while the primary argument made is applied to conditions when there are \bar{n} firms in the market, the proof of Lemma 4 establishes that mild adverse selection can be ruled out for measurable entry beyond \bar{n} (*i.e.*, a coordinated simultaneous entry of several firms). Second, it is straightforward to show that Lemma 4 always holds when demand is not too convex (*e.g.*, linear) and the price premium function (*viz.*, $\bar{P} - \underline{P}$) is either decreasing or elastic whenever it is increasing.

3 Robustness

In this section we offer some results on the robustness of the insights by considering a generalization and an extension. An obvious extension would be to allow for additional periods of trading so that learning can take place. Indeed, this allows high quality firms to reap profit in the future and therefore makes entry more attractive than in the base model. But this is qualitatively equivalent to simply assuming a lower cost for the production of high quality, and therefore such an extension results only in quantitative, but not qualitative differences compared to the preceding analysis.

A less obvious question is what role discrete quality levels play in the base model. Hence, we first consider a version of the model with a continuous distribution of types and derive similar insights to those already established. A second question concerns the role that the market structure has on the results. We address this by illustrating the main results by sketching how in monopoly settings the same underlying effect of diminished entry (*viz.* reduced capacity) also occurs when the firm invests in order to produce a good of uncertain quality.

3.1 Continuous Distribution of Quality

Though we considered discrete distributions of quality thus far, the results do not crucially depend on discreteness. Specifically, suppose that quality, which is indexed by s , is distributed *ex ante* according to the strictly increasing and twice differentiable distribution

function $F(s)$ on $[\underline{s}, \bar{s}]$. The cost associated with producing a unit of the good with quality index s is given by the strictly increasing twice differentiable function $C(s)$. Given the Pareto selection criterion in conjunction with the law of one price, if it is profitable for a firm of quality index $\sigma \in [\underline{s}, \bar{s}]$ to produce, it is also profitable for all firms with quality index $s \leq \sigma$ to produce. All other assumptions on firms remain the same. In particular, we consider a continuum of firms who each observe an independent draw from the distribution of quality parameters $F(s)$ upon entry. Consequently there is no aggregate uncertainty and the distribution of quality among the firms in the market is also characterized by $F(s)$.¹⁹

Demand for quality s is given by $p(Q, s)$, which is twice differentiable and decreasing in market output Q and increasing in quality s . Define demand for the case that σ is the highest level of quality on offer by $P(Q, \sigma) := \int_{\underline{s}}^{\sigma} \frac{p(Q, s)}{F(\sigma)} dF(s)$ and it follows that $P(Q, \sigma)$ is also twice differentiable, decreasing in Q , and increasing in σ . Assume that the lowest quality alone cannot support efficient market transactions, *i.e.*, $P(0, \underline{s}) \leq C(\underline{s})$; whereas there is potential for trade given the *ex ante* average quality, *i.e.*, $P(0, \bar{s}) > C(\bar{s})$. Assuming $\lim_{Q \rightarrow \infty} P(Q, \sigma) = 0$ yields that \bar{n} is implied by $P(\bar{n}, \bar{s}) = C(\bar{s})$.

It readily follows that the analogue to Proposition 1 holds with $\bar{\iota} = C(\bar{s}) - Ec$, where $Ec := \int_{\underline{s}}^{\bar{s}} C(y) dF(y)$ is the expected cost of a firm under the prior. For this case n^* is then implied by $P(n^*, \bar{s}) = \iota + Ec$ with $\iota \geq \bar{\iota}$.

In order to distinguish the cases of classic adverse selection from mild adverse selection define similarly to (6),

$$\mathcal{E}(\sigma|n) := P(nF(\sigma), \sigma) - C(\sigma). \quad (8)$$

That is, $\mathcal{E}(\sigma|n)$ is the equilibrium market profit (*i.e.*, earnings) of the marginal producer with quality index σ , given that n firms are in the market.²⁰

We define classic adverse selection in this context as a case where a marginal deterioration of quality leads to a market collapse, *i.e.*, a discrete drop in average quality and market price

¹⁹An implication of the continuous distribution of quality is that in contrast to the previous section the equilibrium entails pure strategies.

²⁰Because in the two-type case there is only one cost-type (the high cost firm) who makes the marginal decision on whether to produce, (6) does not contain an expression for costs, whereas here each firm has distinct costs which must be considered explicitly.

so that no firms continue to produce. In contrast, mild adverse selection entails marginal exit of high quality in such a way that prices adjust smoothly to the altered conditions in the composition of supply. Hence, analogous to (7), the condition that characterizes markets with classic adverse selection is given by

$$\mathcal{E}(\sigma|n) < \mathcal{E}(\bar{s}|\bar{n}) = 0, \quad \forall \sigma \in [\underline{s}, \bar{s}] \text{ and } n > \bar{n}.$$

The necessary and sufficient conditions for a market to exhibit classic adverse selection are derived analogous to Lemmata 3 and 4, yielding

$$\begin{aligned} \mathcal{E}'(\bar{s}|\bar{n}) &\geq 0, \\ \mathcal{E}''(\sigma|\bar{n}) &\neq 0. \end{aligned}$$

Intuitively speaking the necessary condition assures that if entry beyond \bar{n} takes place so that the price decreases due to the increased supply, profit of firms at the upper end of the quality support decrease, which implies that a positive measure of high quality firms must cease production. The sufficient condition then guarantees that not only do a positive measure of firms near the upper end of the quality support exit, but so do in fact firms of all quality types.

Given these conditions, the results of positive profits and no adverse selection in the market (Proposition 1) and positive profits with mild adverse selection (Proposition 2) carry over with only minor qualifications to the current setting as illustrated in the following two examples.

Example 1 (Positive Profits and No Adverse Selection) *Let quality be distributed uniformly on the unit interval, i.e., $F(s) = s$ on $[0, 1]$ and let costs be given by $C(s) = \sqrt{s}/3$. Demand for given quality is $p(Q, s) = s(1 - Q)$, so $P(Q, \sigma) = \int_0^\sigma \frac{s(1-Q)}{\sigma} ds = (\sigma/2)(1 - Q)$.*

Given these parameters, $\mathcal{E}(\sigma|n) = (\sigma/2)(1 - n\sigma) - \sqrt{\sigma}/3$ and $\mathcal{E}'(\sigma|n) = 1/2 - n\sigma - 1/6\sqrt{\sigma}$. The full production threshold \bar{n} is implied by $P(\bar{n}, 1) = C(1)$, i.e., $(1/2)(1 - \bar{n}) = 1/3$, so $\bar{n} = 1/3$. Thus, $\mathcal{E}'(\sigma = 1|n = 1/3) = 1/2 - 1/3 - 1/6 = 0$, so the necessary condition for classic adverse

selection is met. Note that when entry is at $\bar{n} = 1/3$ average market profits are given by $P(\bar{n}, \bar{s}) - \int_{\underline{s}}^{\bar{s}} C(s) dF(s) = P(1/3, 1) - \int_0^1 (\sqrt{s}/3) ds = (1/2)(1 - 1/3) - 2/9 = 1/9$. Hence, $\bar{t} = 1/9$.

Now consider $n > \bar{n} = 1/3$ and note that the highest quality producer's market profit must be zero. From (8) we have

$$\mathcal{E}(\sigma | n > \bar{n}) = P(nF(\sigma), \sigma) - C(\sigma) = \frac{\sigma}{2}(1 - n\sigma) - \frac{\sqrt{\sigma}}{3} = 0. \quad (9)$$

However, for all $n > \bar{n} = 1/3$, (9) does not have a non-negative root in σ so there exists no market equilibrium with production for $n > \bar{n}$ and therefore $\underline{t} = 0$, $n^* = \bar{n} = 1/3$ and in the entry equilibrium firms make an average profit of $1/9 - \iota > 0$.

Example 2 (Positive Profits with Mild Adverse Selection) Consider Example 1, now with costs given by $C(s) = \sqrt{s}/4$. Then $\bar{n} = 1/2$, since $(1/2)(1 - \bar{n}) = 1/4$; and $\mathcal{E}'(\sigma = 1 | n = 1/2) = 1/2 - 1/2 - 1/8 = -1/8 < 0$, so the necessary condition for classic adverse selection is violated (i.e., the sufficient condition for mild adverse selection is met).

Note that when $\bar{n} = 1/2$ firms enter, average market profits are $P(1/2, 1) - \int_0^1 (\sqrt{s}/4) ds = (1/2)(1 - 1/2) - 1/6 = 1/12$, so $\bar{t} = 1/12$.

Now, analogous to (9), the equilibrium condition for the highest level of quality for entry beyond $\bar{n} = 1/2$ is given by

$$\mathcal{E}(\sigma | n > \bar{n}) = \frac{\sigma}{2}(1 - n\sigma) - \frac{\sqrt{\sigma}}{4} = 0. \quad (10)$$

This equation does have a root in σ provided that $n \leq 16/27$, but not for entry beyond that, so $\bar{n}' = 16/27$. At \bar{n}' (10) reveals that $\sigma = 9/16$. A firm's expected market profit (after entry, but before quality and costs are realized) at this point is given by $F(\sigma)\mathcal{E}(\sigma | \bar{n}') = 9/256$. So for $\iota \in [0, 9/256)$, $n^* = 16/27$ and equilibrium profit is $9/256 - \iota > 0$.

The main distinction between Proposition 2 for the discrete case and Example 2 for a continuous distribution of quality concerns firms' profits under mild adverse selection. In particular, where in Proposition 2 firms retain positive profit for any entry cost between \underline{t}' and \bar{t} , this is not the case in Example 2. Specifically, the entry equilibrium configuration for

$\iota \in [9/256, 1/12 = \bar{\iota}]$ entails zero expected profit as firms enter beyond $\bar{n} = 1/2$ and quality gradually adjusts with the implied price decline. However, such gradual adjustment is not possible beyond $n^* = 16/27$ at which point a positive profit equilibrium emerges when entry costs are below $9/256$.

3.2 Monopolistic Markets

Having shown that limited entry and above normal profit can occur even under costless entry in Walrasian markets due to latent adverse selection, we briefly consider the case of monopolistic markets.²¹ As the monopoly market implies restricted entry, it is clear that profits are expected to occur in equilibrium and therefore the point of this section is to demonstrate that latent adverse selection nonetheless affects the market equilibrium. In particular, the potential for adverse selection still leads to “limited entry,” but now in terms of a reduced capacity choice by the monopolistic firm. Coupled with the result is, similar to the other models, that the market equilibrium exhibits no adverse selection.

Formally, we suppose that the firm incurs an investment outlay of ι in order to obtain an observable production capacity which, for purposes of congruence with the base model, we denote by n . After the capacity decision, the firm observes the quality of its product as being high with probability τ or otherwise low. In order to not distract from the point at hand, we preclude signalling equilibrium configurations by assuming that low quality alone cannot sustain sales, which implies that a low quality-producer will always mimic the strategy of the high-quality producer, thus, eliminating any separating equilibrium. Once the firm knows its quality and costs, it chooses a price and then produces output $Q \leq n$.

Example 3 (Reduced Capacity Choice) *Suppose $\tau = 2/3$; demand for known high quality is given by $\bar{P} = 6(1 - 0.05Q)$, whereas there is no demand for low quality. Hence demand for average quality is $P = 4(1 - 0.05Q)$. Unit cost of high quality is $\bar{c} = 3$ and $\underline{c} = 0$. Con-*

²¹Since Akerlof’s seminal paper much of the theoretical literature has actually departed from his analysis by focusing on monopoly settings (and thereby precluding entry). See, *e.g.*, Milgrom and Roberts (1986), Daughety and Reinganum (1995), but also the more recent work by Hendel and Lizzeri (2002) and Belleflamme and Peitz (2009).

sumers (rationally) anticipate that a high quality producer would leave capacity unused, if the price is below \bar{c} , since this price is below the unit cost of production. However, above this price, as either type would in fact sell (and the low quality producer would sell whatever the high quality producer sells at these prices), demand follows the demand for expected quality.

In sum

$$P = \begin{cases} 4(1 - 0.05Q) & \text{if } Q < 5 \\ 0 & \text{if } Q \geq 5. \end{cases}$$

Thus, the firm will only be able to sell when facing demand of $P = 4(1 - 0.05Q)$. If the firm has high costs, it produces $Q^* = 2.5$, which is also produced if the firm has low cost in order to mimic the high cost firm. Hence $n^* = 2.5$.

In contrast, if the firm were to be known to produce high quality its output is 5 and it is 0 if it is known to produce low quality, yielding an average output of $n^{FI} := (2/3)5 + (1/3)0 = 10/3 > 2.5 = n^*$. And optimal output under average quality produced at average costs is $n^{Ave} := 5 > 2.5 = n^*$. Thus, one obtains reduced capacity compared to either benchmark with $\iota = 0$.

Since positive profit naturally occurs in the monopolistic setting, this cannot be used to empirically detect the impact of the potential of adverse selection on the market. Notice, however, that if data can be obtained on the expectation of marginal costs, then if this average is below marginal revenue this is an empirical indication of lower than expected capacity, due to latent adverse selection.

4 Conclusion

In this paper we examine how markets with the salient features of adverse selection are affected when the heretofore exogenous number of firms is made endogenous. Firms enter through a fixed investment after which nature chooses the quality of the firm's product that is unobservable to consumers. It is found that the potential for adverse selection—low quality producers driving out high quality ones—affects the market even though adverse selection

does not arise in equilibrium. Indeed, such latent adverse selection leads to entry equilibrium configurations with positive profits, even under the assumption of costless entry.

Unobserved adverse selection in conjunction with positive profits is the result of the interaction of two classic mechanisms. First, as demand slopes downward less entry results in higher prices. Second, average quality is increasing in market prices so that if the market price is high enough, then high quality producers are willing to produce. Hence, zero profits may no longer define the entry equilibrium. Instead the entry equilibrium is defined by the greatest level of entry under which adverse selection does not occur *ex post*. That is, latent adverse selection is an entry barrier, and whenever it defines the entry equilibrium then equilibrium profits are positive even under costless entry.

While the primary derivation is performed for discrete quality distributions in Walrasian markets, we show that the insights—*viz.* limited entry, positive equilibrium profits that exceed entry costs, and the absence of observed adverse selection—hold for generalized (continuous) distributions and the result of latent adverse selection as an entry barrier carries over to the monopoly setting in the form of reduced capacity.

The theoretical analysis provides some additional insights. First, the role of downward sloping demand suggests it may play an important role in models of endogenous quality that heretofore have used unit demand—indeed, in our setting downward sloping demand gives rise to a form of “mild” adverse selection in which only some high quality producers exit the market. Secondly, it is found that the equilibrium outcome of limited entry prevents welfare losses stemming from adverse selection so that overall welfare is greater despite profits not dissipating. Nevertheless, welfare can be raised further through a revenue-neutral policy of an investment tax and a production subsidy. The revenue neutrality implies that even an incorrectly set tax and subsidy raises welfare.

As the model yields equilibrium configurations in which adverse selection is not an equilibrium phenomenon the insights may contribute to our understanding of why empirical evidence of adverse selection in markets is often lacking. In particular, the findings suggest that in industries with high entry costs one would not find either direct or indirect empirical

evidence of adverse selection, even though the market exhibits the characteristics for adverse selection. In cases of lower entry costs, indirect empirical evidence for latent adverse selection can be found in the absence of actual adverse selection coupled with positive profits that are not competed away. These observations taken together imply a negative correlation between entry costs and profitability, which may be a contributing explanation to the somewhat counter-intuitive empirical finding that entry is slow to react to high profits.²²

The insights and conclusions from the model may be particularly applicable in industries with frequent innovations, as in these instances the results of R&D are frequently not known with certainty *ex ante* and product life-cycles may be sufficiently short to result in frequent new ‘investment/entry’ even of previously existing firms (*e.g.*, consumer electronics). Similar situations may arise when output is tied to heterogenous inputs (*e.g.*, in order to diversify bottleneck risks many manufacturers multi-source their procurement which can result in non-uniform quality across suppliers and subsequent variations in the quality of the final product); and in high-end agricultural (*e.g.*, viticulture, where quality is subject to exogenous shocks such as weather) and animal breeding, which entails uncertain and hard-to-verify outcomes (*e.g.*, horse-breeding, where lineage does not guarantee winnings).

In addition to these applications, alternative interpretations of the model yield additional insight. One such possibility is to reinterpret n so that rather than considering *de novo* entry, one examines existing firms’ output decisions. For instance, a mortgage lender—who can only gauge the specific quality of a loan after it has originated—can decide to keep it, or sell it in the secondary market, where—as has become abundantly clear in the last years—quality has been proven hard to verify. Similarly car dealers must decide whether to keep trade-ins in their inventory or whether to sell them off to other markets.

Finally, while the exposition of the paper is in keeping with Akerlof’s original notion of adverse selection, the analysis is of course isomorphic for markets with experience or credence goods, including instances in which products are differentiated by production or distribution characteristics (*e.g.*, ‘sustainable,’ ‘fair trade’ and other attributes) that are unobservable

²²See, *e.g.*, Geroski’s widely cited review of the empirical literature on entry (Geroski, 1995, p. 427).

and hard to verify.

Appendix of Proofs

Proof of Proposition 1. Suppose first that no adverse selection occurs in the market. Then demand is given by $P(Q, \alpha) = P(n, \tau)$. Since $P(n, \tau)$ is decreasing in n , entry ceases once the price is just sufficient to cover the expected production cost Ec and the entry cost ι , *i.e.*, equilibrium entry is defined by $P(n^*, \tau) = \iota + Ec$, proving the first statement. At this price, expected market profits are $E\pi = P(n^*, \tau) - Ec = \iota$, proving the second statement. In order to confirm our initial supposition it must be that the price is sufficiently high to cover the costs of the high quality producer. That is, $P(n^*, \tau) = \iota + Ec = \iota + \tau\bar{c} + (1 - \tau)\underline{c} \geq \bar{c}$. Let $\bar{\iota} = (1 - \tau)(\bar{c} - \underline{c})$. □

Proof of Proposition 1. An implication of Lemma 1 is that since $\iota < \bar{\iota}$ entry assuredly takes place at least till \bar{n} . Beyond that, take the proposed entry equilibrium as given and consider the marginal firm at n^* . Since $n^* = \bar{n}$, incremental entry triggers adverse selection. Because the market then exhibits classic adverse selection, all high quality producers shut down. Thus, the only possibility of obtaining positive market profit for the marginal firm is if it is a low quality (and hence low cost) producer. Upon entry, if all low quality firms produce, the resulting market price is $P((1 - \tau)\bar{n}, 0)$. If $P((1 - \tau)\bar{n}, 0) \leq \underline{c}$, then firms make no profit so that incremental entry beyond $n^* = \bar{n}$ does not pay off, even under the assumption of costless entry. Hence, let $\underline{\iota} = 0$ and all three statements of the proposition follow readily.

Suppose instead that $P((1 - \tau)\bar{n}, 0) > \underline{c}$. Then, if the marginal firm enters and is a low quality producer, its profit is $P((1 - \tau)\bar{n}, 0) - \underline{c}$. Hence, the marginal firm's expected market profit prior to but conditioned on incremental entry is given by $(1 - \tau)(P((1 - \tau)\bar{n}, 0) - \underline{c})$. Let $\underline{\iota} = (1 - \tau)(P((1 - \tau)\bar{n}, 0) - \underline{c})$ and it is clear that entry beyond \bar{n} does not take place.

Note finally that since $P((1 - \tau)\bar{n}, 0) < P(0, 0) < \bar{c}$, it follows that $\underline{\iota} < \bar{\iota}$. This establishes that equilibrium profits are positive, since $E\pi(n^*) = E\pi(\bar{n}) = P(\bar{n}, \tau) - Ec =$

$$\bar{c} - (\tau\bar{c} + (1 - \tau)\underline{c}) = (1 - \tau)(\bar{c} - \underline{c}) = \bar{\iota} > \iota. \quad \square$$

Proof of Lemma 2. First, by definition of \bar{n} there exists a full-production equilibrium with no adverse selection for $n \leq \bar{n}$. Thus, given the Pareto equilibrium selection criterion, mild adverse selection cannot occur for any $n \leq \bar{n}$, so we require that $n > \bar{n}$ (which precludes $\kappa = 1$).

Second, note that $P < \bar{c}$ cannot be an equilibrium since it entails negative market profits for high quality producers, which are avoided by shutting down (implying $\kappa = 0$); and $P > \bar{c}$ cannot be an equilibrium as an idle high-quality producer increases profit by producing and selling a unit of the good. Hence, for an equilibrium with mild adverse selection to occur, it must be that $P = \bar{c}$.

At this price all low quality firms produce, yielding output of $(1 - \tau)n$. If a fraction κ of the τn high quality firms produce, market output is thus $(1 - \tau + \kappa\tau)n$ and the proportion of high quality is $\frac{\kappa\tau}{1 - \tau + \kappa\tau}$. Therefore the existence of a κ such that (5) holds for some $n > \bar{n}$ is a necessary and sufficient condition for the market to have an equilibrium with mild adverse selection. \square

Proof of Proposition 2. As in the proof to Proposition 1, note that an implication of Lemma 1 is that since $\iota < \bar{\iota}$ entry assuredly takes place at least till \bar{n} . However, unlike in the proof of Proposition 1, from Lemma 2, given mild adverse selection there exists $n > \bar{n}$ such that the expected market price is $P = \bar{c}$; and, therefore, entry continues beyond \bar{n} ; confirming the first claim in the proposition.

Now define \bar{n}' as the largest number of firms such that mild adverse selection can be sustained, *i.e.*, $P(\bar{n}') = \bar{c}$ and $P(n) < \bar{c}, \forall n > \bar{n}'$. Then the remainder of the proof follows the proof of Proposition 1 *mutatis mutandis* with \bar{n}' replacing \bar{n} . In particular, if $P((1 - \tau)\bar{n}', 0) \leq \underline{c}$, let $\underline{\iota}' = 0$; and if $P((1 - \tau)\bar{n}', 0) > \underline{c}$, let $\underline{\iota}' = (1 - \tau)(P((1 - \tau)\bar{n}', 0) - \underline{c})$. \square

Proof of Proposition 3. Note first that market welfare is increasing in n for $n \leq \bar{n}$. Consider now welfare for $n \geq \bar{n}$ and denote by κ the portion of high quality firms who produce in the market so that $\kappa = 0$ in markets with classic adverse selection and $\kappa \in (0, 1)$

in markets with mild adverse selection. Market output is thus given by $Q = (1 - \tau + \kappa\tau)n$ and the proportion of high quality in the market is given by $\alpha = \frac{\kappa\tau}{1-\tau+\kappa\tau} < \tau$.

Welfare at \bar{n} is given by

$$\begin{aligned} W(\bar{n}) &= CS(\bar{n}) + \bar{n} \times E\pi(\bar{n}) = \int_0^{\bar{n}} [\tau\bar{P} + (1 - \tau)\underline{P} - \bar{c}] dQ + \int_0^{\bar{n}} (1 - \tau)(\bar{c} - \underline{c})dQ \\ &= \int_0^{(1-\alpha)\bar{n}} [\tau\bar{P} + (1 - \tau)\underline{P} - \bar{c}] dQ + \int_{(1-\alpha)\bar{n}}^{\bar{n}} [\tau\bar{P} + (1 - \tau)\underline{P} - \bar{c}] dQ \\ &\quad + \int_0^{(1-\alpha)\bar{n}} (\bar{c} - \underline{c})dQ + \int_{(1-\alpha)\bar{n}}^{(1-\tau)\bar{n}} (\bar{c} - \underline{c})dQ. \end{aligned}$$

The second and fourth integral are both positive, let their sum be denoted by A ; and the first and third can be combined to yield

$$W(\bar{n}) = \int_0^{(1-\alpha)\bar{n}} [\tau\bar{P} + (1 - \tau)\underline{P} - \bar{c}] dQ + A.$$

When replacing τ with α in the integral, the integral itself is the market welfare under incremental entry beyond \bar{n} . However, as $\tau > \alpha$, $\bar{P} > \underline{P} > 0$ and $A > 0$, there is a discrete fall in welfare upon entry beyond \bar{n} . Note lastly that for entry beyond that welfare decreases as average profit weakly decreases and output and average quality also decrease; with another discrete fall in welfare at \bar{n}' in the case of markets with mild adverse selection. \square

Proof of Lemma 4. If $\mathcal{P}(\kappa|\bar{n})$ is convex, then it lies below any of its secant lines. Consider the secant line constructed from the points $\kappa = 0$ and $\kappa = 1$, *i.e.*, $\mathcal{S}(\kappa) := \mathcal{P}(0|\bar{n}) + [\mathcal{P}(1|\bar{n}) - \mathcal{P}(0|\bar{n})]\kappa$; or $\mathcal{S}(\kappa) = (1 - \kappa)P((1 - \tau)\bar{n}, 0) + \kappa\bar{c}$, since $\mathcal{P}(0|\bar{n}) = P((1 - \tau)\bar{n}, 0)$ and $\mathcal{P}(1|\bar{n}) = \bar{c}$. Notice that $P((1 - \tau)\bar{n}, 0) < P(0, 0)$, since P is decreasing in its first argument. Since $P(0, 0) < \bar{c}$, it follows that $\mathcal{P}(\kappa|\bar{n}) < \mathcal{S}(\kappa) < (1 - \kappa)P(0, 0) + \kappa\bar{c} < \bar{c}$, $\forall \kappa \in (0, 1)$.

Now suppose that $\mathcal{P}(\kappa|\bar{n})$ is concave. Then the function lies below any of its tangent lines. Since $\mathcal{P}'(1|\bar{n}) > 0$, it therefore follows that $\mathcal{P}(\kappa|\bar{n}) < \mathcal{P}(1|\bar{n}) = \bar{c}$, $\forall \kappa < 1$. Hence, regardless of whether $\mathcal{P}(\kappa|\bar{n})$ is concave or convex, $\mathcal{P}(\kappa|\bar{n}) < \bar{c}$, $\forall \kappa \in (0, 1)$ so that incremental entry beyond \bar{n} does not result in mild adverse selection.

Note finally that $\frac{d}{dn}\mathcal{P} = \left((1 - \alpha)\underline{P}' + \alpha\bar{P}' \right) (1 - \tau + \tau\kappa) < 0$ so that $\mathcal{P}(\kappa|n) < \bar{c}$, $\forall n > \bar{n}$, violating Lemma 2 and, thus, ruling out mild adverse selection for any $n \geq \bar{n}$. \square

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