Multiple bidding in auctions as bidders become confident of their private valuations

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Abstract

Bidders may increase their bids over the course of a multi-period, second-price auction if (1) they become more certain about their valuations over time, and (2) they cannot bid in the final auction period with positive probability.

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Introduction

In a standard second-price auction, it is optimal for a potential buyer to simply bid his private valuation for the item at any point during the auction (Vickrey, 1961). Such a strategy means the bidder always wins the item whenever it is sold for less than his valuation, and he never pays more than his valuation for it. However, in online second-price auctions, bidders often submit bids less than their valuations, and increase their bids over the course of the auction.

Why do bidders increase their bids over the course of an online auction? I show how such behavior can arise when a bidder becomes more certain about his valuation over the course of the auction, and when there is a positive probability a bidder is unable to return to the auction in a later period to submit a bid. Unlike other explanations of multiple-bidding, I do not require that bidders are naive about the second-price auction mechanism (e.g., Roth and Ockenfels, 2002;...

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Ockenfels and Roth, 2003), that learning one’s true valuation is costly (e.g., Rasmusen, 2006), that the item has a common value (e.g., Bajari and Hortaçsu, 2003), or even that bidders observe other players’ bids (e.g., Rasmusen, 2006).¹

This paper presents a simple model in which an auction lasts for two periods. In the first period, when a potential buyer first observes the item up for auction, he has expectations about his valuation for the item; however, he knows his expected valuation may change as he has more time to consider the item. Additionally, the potential bidder recognizes something may come up that prevents him from returning to the auction in the second period. I show that in equilibrium the buyer does bid in the first period of the auction, and his bid is less than his expected valuation. If he is able to return to the auction for the second period, and his realized valuation is higher than his previous bid, he will increase his bid, thus engaging in multiple bidding. Evidence from a classroom experiment supports the theoretical findings.

Model

There are $N+1$ bidders in a two-period, sealed-bid, second price auction. Each bidder $i \in \{1, ..., N+1\}$ has private valuation $V_i$ for the auctioned item, which is the independent realization of a random variable uniformly distributed on $[0, 1]$. To simplify the model, I assume $N$ of the bidders are certain regarding their valuations from the beginning of the game. The one other bidder is uncertain about his own valuation in the first period of the auction, but learns his valuation before the second period of the auction.² (One could imagine that the bidder spends time considering the benefit he will get from the item and his outside options between the time he first discovers the auction for the good, and the period in which the auction ends.)

With probability $\alpha \in (0, 1)$, a bidder is unable to participate in the second period of the auction. This could be because something comes up that results in the opportunity cost of returning to the auction being higher than the expected benefit of returning, or the bidder could have technical issues connecting to the internet or submitting a bid.

¹Rasmusen (2006, page 6) argues that multiple bidding occurs in any auction in which the bidders become more certain of their valuations over time. This is not entirely correct. If players are certain they can submit a bid in a future period of the auction, they should wait to submit a bid until after they learn their valuations. If they submit a bid before they are most certain of their valuation, they risk paying more for the item than their valuation.
²The results should not change if more than one bidder does not realize his valuation until after the first period of the auction.
The game takes place as follows:

1. Players 2, ..., N + 1 realize their valuations, and each player $i \in \{1, ..., N + 1\}$ can submit a first-period bid $B_{1i}$.

2. Player 1 realizes his valuation $V_1$. With probability $1 - \alpha$, a player can submit a second-period bid $B_{2i} > B_{1i}$.

3. All players $i$ such that $\max\{B_{1i}, B_{2i}\} \in \max\{B_{1j}, B_{2j}\}_{j=1}^{N+1}$ win the item with equal probability.

**Equilibrium and Results**

First, consider the strategies of players 2, ..., N + 1 who know their valuations in the first period. In equilibrium these players bid their valuations in period one. If they bid more than their valuations, they risk winning the item at a higher price than it is worth to them. If they bid less than their valuations, or do not submit bids in the first period, they risk not winning the good when they would benefit from doing so.

Given the equilibrium strategies of the other players, I consider the strategy of player 1. With probability $\alpha$, player 1 is unable to submit a bid in the second period. With probability $1 - \alpha$, player 1 is able to submit a bid in the second period. It is straightforward to see that if $B_{11} < V_1$, then $B_{21} = V_1$, and if $B_{11} \geq V_1$, then the player will not submit a bid in the second period, or $B_{21} = \emptyset$.

Now, consider player 1’s first-period bid. Without loss of generality, suppose player 2 has the highest realized valuation of the $N$ other bidders, and let $F$ define the distribution of $V_2$ (with density $f$). Since all valuations are drawn from a uniform distribution on the unit interval, it follows that $F(V) = V^N$; that is, the valuation of player 2 is less than V if and only if the valuations of all bidders except player 1 are less than V. Therefore, $f(V) = NV^{N-1}$.

Player 1 chooses his bid $B_{11}$ to maximize the following expression with respect to $b$

$$\alpha \int_0^{V_1} f_b \int_0^{V_2} NV_2^{N-1} (V_1 - V_2) dV_2 dV_1 + (1 - \alpha) \left( \int_0^{V_1} f_b \int_0^{V_2} NV_2^{N-1} (V_1 - V_2) dV_2 dV_1 + \int_b^{V_1} NV_2^{N-1} (V_1 - V_2) dV_2 dV_1 \right).$$
The first part of this expression is the expected payoff to player 1 when he is unable to submit a
bid in the second period. The second part of the expression is his expected payoff when he is able
to bid his valuation in the second period. The expression simplifies to

\[ \alpha \left( \frac{b^N}{2} - \frac{N b^{N+1}}{1+\frac{N}{N+1}} \right) + (1 - \alpha) \left( \frac{b^{N+2}(1-N)}{2(N+1)} + \frac{1-b^{N+2}}{(N+2)(N+1)} \right). \tag{1} \]

The first order conditions for equation 1 are

\[ \frac{1}{2} Nb^{N-1} (\alpha - 2b\alpha - b^2(1-\alpha)) = 0. \tag{2} \]

Solving equation 2 for \( b \), one finds player 1’s first period bid. This gives the first result.

**Lemma 1** In equilibrium,

\[ B_{11} = \frac{\sqrt{\alpha}}{1 + \sqrt{\alpha}}, \]

and, conditional of being able to bid in the second period, \( B_{21} = V_1 \) when \( V_1 > B_{11} \), and \( B_{21} = \emptyset \) when \( V_1 \leq B_{11} \).

The lemma follows immediately from the above analysis, and the fact that \( B_{11} \in (0, 1/2) \) is always feasible. Given player 1’s strategy and the distribution of his valuation, one can determine the probability the player increases his bid in the second period.

**Proposition 1** Player 1 engages in multiple bidding with ex ante probability \( 1 - \sqrt{\alpha} \).

For the player to engage in multiple bidding, he must be able to submit a bid in the second
period, and his valuation must be greater than his first-period bid. These conditions are met with
probability \( (1 - \alpha) \left( 1 - \frac{\sqrt{\alpha}}{1 + \sqrt{\alpha}} \right) \), which simplifies to \( 1 - \sqrt{\alpha} \).

When player 1 is able to submit a bid in the second auction (which happens with probability
\( 1 - \alpha \)), he is more likely than not to increase his bid. This is because his first period bid is strictly
less than his expected valuation, and therefore his realized valuation is greater than \( B_{11} \) more than
half the time. Furthermore, when a player becomes more certain about his own, private valuation
over time, increasing his bid over the course of the auction can be rational, even if his realized
valuation by the end of the auction is not greater than his expected valuation when he first bid. In
the above model, player 1 had first-period expectations $1/2$; however, so long as $V_1$ is greater than $rac{\sqrt{\alpha}}{1+\sqrt{\alpha}}$ (which is less than $1/2$), he will increase his bid in the second period, if he is able to.

**Experimental Evidence**

I conducted a two-period auction during a law school class at Cornell University. The findings of the experiment suggest that the behavior depicted by the model can happen in real life auctions.

Forty-seven students participated. It was a sealed-bid second-price auction, and the prize was a voucher for lunch buffets for two people at the Taverna Banfi Restaurant. The voucher included soup, salad, entree, and dessert buffets, as well as tax and gratuity, a $41 value. At the beginning of class, the auction and prize were described in detail, and the students were given an opportunity to submit bids. Then, at the end of the 1 hour 20 minute class, the students were given the opportunity to increase their bids or leave them unchanged. If the student did not submit a bid in the first round, he could submit any bid he wanted in the second round. Twenty-five percent of the second-period bids were randomly selected and ignored; it was announced to the students before class that this would happen. No bids were made public until after the final round of bidding.

Because only 75 percent of the second-period bids counted, students knew there was a positive probability they could not increase their bid in the future. Furthermore, the 1 hour 20 minute time delay between the first and second bids provided the students with an opportunity to consider using the prize and potentially change their valuations. During both bidding periods, each student reported on a scale of 1 to 10 his anticipated excitement from using the prize, which I loosely interpret as his valuation.

Of the 47 participants, 27 students reported the same valuation during both bidding periods. Of these 27 students, 8 (30%) of them increased their bids over the course of the auction. The behavior of these students is consistent with the equilibrium of the model, in which a bidder initially bids less than his expected valuation, then increases his bid during the second round even if his valuation remains unchanged. Additionally, 11 of the 47 students increased their reported valuations between periods, and 7 (64%) of these also increased their bids—behavior predicted by

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3 If the student did not submit a bid in the first round, he could submit any bid he wanted in the second round.

4 There are a number of possible explanations as to why 19 of the participants who reported no valuation change did not increase their bids. For example, the bidders may have been certain of their valuation from the first period, in which case they have no incentive to increase their bids in the second period. Alternatively, the bidders may have been budget constrained, or the “anticipated excitement” measure is an imperfect measure of one’s valuation. Also, bidders may not have had enough time to consider their optimal strategy in the game before submitting a first period bid; in which case, they may behave more in line with the model after gaining experience.
the model. Of the 9 students who decreased their reported valuation between periods, 2 of the 9 increased their bids.\(^5\) A total of 17 of the 47 participants (35\%) increased their bids over the course of the in-class auction in which they had time between bidding periods to consider using the prize, and in which they were unable to submit second-period bids with positive probability.\(^6\) In the language of this paper’s model, these 17 bidders engaged in multiple bidding.

**Closing Comments**

Although the paper only considers a very simple auction model, similar results should hold in a more complex setting. For example, more than one bidder may be uncertain about his valuation at the beginning of the auction; the game may involve more than two discrete periods; and valuations may be drawn from a more complicated distribution. None of these alterations should change the results.

Furthermore, I have said nothing about the phenomenon of sniping, or how bidders in online auctions often wait to submit a bid until the final moments of the auction. If a bidder learns about his valuation over time, he benefits from bidding immediately before the auction closes. However, it may not be reasonable to believe that a bidder learns a significant amount about his valuation during the final few minutes of an auction. Yet, bidders often wait until the closing seconds of an auction to bid. Therefore, other explanations of sniping may be more appropriate. Future research could incorporate this paper’s model into a game with simultaneous auctions or bidders who are susceptible to an endowment effect in order to simultaneously explain multiple-bidding and sniping.

**References**


\(^5\)Such behavior is supported by the model, so long as the decreases to the players’ valuations are relatively small.

\(^6\)Of the 47 participants, 2 students did not submit a bid in either period. Only 1 student submitted a second period bid after not bidding in the first period. The average first period bid was $22.60 across all students, and $16.82 across the 17 students that increased their bids between the two periods. Of the 17 participants to increase their bids, the average bid increase was $7.11. The winning bidder paid a price of $40 for the item.

