Hybrid All-Pay and Winner-Pay Contests

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Johan N. M. Lagerlöf
Dept. of Economics, U. of Copenhagen
Email: johan.lagerlof@econ.ku.dk
Website: www.johanlagerlof.com

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Introduction: What is a hybrid contest? (1/2)

- A **hybrid contest**:
  - In some economic, social, or political situation, each one of a number of economic agents try to win an indivisible prize.
  - To increase her probability of winning, each contestant makes both **all-pay investments** and **winner-pay investments**.
- Example: The competitive bidding to host the Olympic games.
  - *All-pay investments*: Candidate cities spend money upfront, with the goal of persuading members of the IOC.
  - *Winner-pay investments*: A city commits to build new stadia and invest in safety arrangements if being awarded the Games.
- To fix ideas, consider the following formalization:
  - Contestant i chooses $x_i \geq 0$ and $y_i \geq 0$ to maximize

$$\pi_i = (v_i - y_i)\, p_i\,(s_1, s_2, \ldots s_n) - x_i,$$

subject to $s_i = f\,(x_i, y_i)$.

Introduction: Other examples (2/2)

- Competition for a government contract or grant:
  - *All-pay investments*: Time/effort spent on preparing proposal.
  - *Winner-pay investments*: Commit to ambitious customer service.
- A political election:
  - *All-pay investments*: Campaign expenditures.
  - *Winner-pay investments*: Electoral promises (costly if they deviate from the politician's own ideal policy).
- Rent seeking to win monopoly rights of a regulated market:
  - *All-pay investments*: Ex ante bribes (how Tullock modeled it).
  - *Winner-pay investments*: Conditional bribes.
- Tullock's motivation:
  - Empirical studies in the 1950s: DWL appears to be tiny.
  - Tullock: Maybe a part of profits adds to the cost of monopoly.

Literature Review (1/2)

- Two earlier papers that model a hybrid contest:
  - **Haan and Schonbeek (2003)**.
    - They assume Cobb-Douglas—which here is quite restrictive.
  - **Melkoyan (2013)**.
    - CES but with $\sigma \geq 1$. Symmetric model. Hard to check SOC.
    - My analysis: (i) other approach which yields easy-to-check existence condition; (ii) assumes general production function and CSF; (iii) studies both symmetric and asymmetric models.
- Other contest models with more than one influence channel:
  - **Sabotage in contests** (improve own performance and sabotage the others performance): Konrad (2000), Chen (2003).
  - **War and conflict** (choice of production and appropriation): Hirschleifer (1991) and Skaperdas and Syroploulos (1997).
  - **Multiple all-pay "arms"** (maybe with different costs): Arbatskaya and Mialon (2010).

Literature Review (2/2)

- Multidimensional (procurement) auctions:
  - **Che (2003), Branck (1997), Asker and Cantillon (2008)**.
    - Firms bid on both price and (many dimensions of) quality.
    - The components of each bid jointly determine a score.
    - Auctioneer chooses bidder with highest score.
  - Differences:
    - In their models, not both all-pay and winner-pay ingredients.
    - Not a probabilistic CSF.

- Optimal design of a research contest: **Che and Gale (2003)**.
  - A principal wants to procure an innovation.
  - Fimrs choose both quality of innovation and the prize if winning.
  - Thus, effectively, both all-pay and winner-pay ingredients.
  - Differences: Not a probabilistic CSF (so mixed strategy eq.), linear production function, mechanism design approach.

A model of a hybrid contest (1/2)

- $n \geq 2$ contestants try to win an indivisible prize.
- Contestant i chooses $x_i \geq 0$ and $y_i \geq 0$ to maximize the following expected payoff:

$$\pi_i = (v_i - y_i)\, p_i(\mathbf{s}) - x_i, \qquad \text{subject to } s_i = f(x_i, y_i),$$

where $\mathbf{s} = (s_1, s_2, \ldots, s_n)$ and $s_i \geq 0$ is contestant i's *score*.

  - $v_i > 0$ is i's valuation of the prize.
  - $p_i(\mathbf{s})$ is i's prob. of winning (or contest success function, CSF).
  - x_i is the **all-pay investment**: paid whether i wins or not.
  - y_i is the **winner-pay investment**: paid i.f.f. i wins.

- It is a one-shot game where the contestants choose their investments (x_i, y_i) simultaneously with each other.

A model of a hybrid contest (2/2)

- Assumptions about $p_i(\mathbf{s})$:
  - Twice continuously differentiable in its arguments.
  - Strictly increasing and strictly concave in s_i.
  - Strictly decreasing in s_j for all $j \neq i$.
  - The contest is won by someone: $\sum_{j=1}^{n} p_j(\mathbf{s}) = 1$.
  - Later I assume that $p_i(\mathbf{s})$ is homogeneous in $\mathbf{s}$.
- Assumptions about $f(x_i, y_i)$:
  - Thrice continuously differentiable in its arguments.
  - Strictly increasing in each of its arguments.
  - Strictly quasiconcave.
  - Homogeneous of degree $t > 0$: $\forall k > 0 \; f(kx_i, ky_i) = k^t f(x_i, y_i)$.
  - Inada conditions to rule out $x_i = 0$ or $y_i = 0$.
- Examples:

$$p_i(\mathbf{s}) = \frac{w_i s_i^r}{\sum_{j=1}^{n} w_j s_j^r}, \qquad f(x_i, y_i) = \left[\alpha x^{\frac{\sigma-1}{\sigma}} + (1-\alpha) y^{\frac{\sigma-1}{\sigma}}\right]^{\frac{t\sigma}{\sigma-1}}$$

Analysis (1/7)

- One possible approach:
  - Plug the production function into the CSF.
  - Take FOCs w.r.t. x_i and y_i.
  - Used by Haan and Schoonbeek (2003) and Melkoyan (2013), assuming Cobb-Douglas and CES, respectively.
- My approach: Solve for contestant i's best reply in two steps:
  1. Compute the conditional factor demands.
     - That is, derive optimal x_i and y_i, given $\mathbf{s}$ (so also given s_i).
  2. Plug the factor demands into the payoff and then characterize contestant i's optimal score s_i (given $\mathbf{s_{-i}}$).
- Important advantage: a single choice variable at 2, so easier to determine what conditions are required for equilibrium existence.

- Contestant i solves (for fixed p_i): $\min_{x_i,y_i} p_i y_i + x_i$, subject to $f(x_i, y_i) = s_i$.
- The first-order conditions (λ_i is the Lagrange multiplier):

$$\frac{\partial \mathcal{L}_i}{\partial x_i} = 1 - \lambda_i f_1(x_i, y_i) = 0, \qquad \frac{\partial \mathcal{L}_i}{\partial y_i} = p_i - \lambda_i f_2(x_i, y_i) = 0.$$

- So, by combining the FOCs:

$$\frac{1}{p_i} = \frac{f_1(x_i, y_i)}{f_2(x_i, y_i)} \stackrel{\text{def}}{=} g\left(\frac{x_i}{y_i}\right) \Rightarrow x_i = y_i h\left(\frac{1}{p_i}\right),$$

  where h is the inverse of g (i.e., $h \stackrel{\text{def}}{=} g^{-1}$).
- By plugging back into $s_i = f(x_i, y_i)$ and rewriting, we obtain:

$$Y_i(s_i, p_i) = \left[\frac{s_i}{f(h(1/p_i), 1)}\right]^{\frac{1}{t}}, \quad X_i(s_i, p_i) = Y_i(s_i, p_i)\, h\left(\frac{1}{p_i}\right).$$

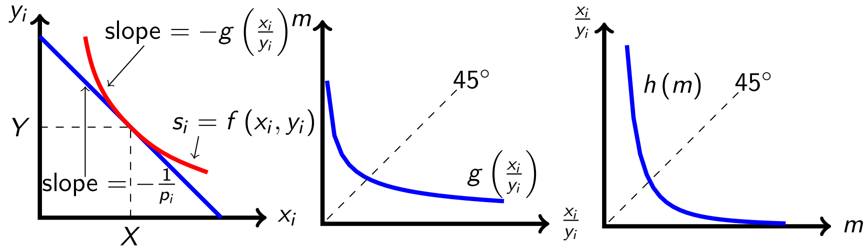
- Contestant i's payoff: $\pi_i(\mathbf{s}) = p_i(\mathbf{s}) v_i - C_i[s_i, p_i(\mathbf{s})]$, where

$$C_i[s_i, p_i(\mathbf{s})] \stackrel{\text{def}}{=} p_i(\mathbf{s})\, Y_i[s_i, p_i(\mathbf{s})] + X_i[s_i, p_i(\mathbf{s})].$$

- A Nash equilibrium of the hybrid contest:
  - A profile $\mathbf{s}^*$ such that $\pi_i(\mathbf{s}^*) \geq \pi_i\left(s_i, \mathbf{s}^*_{-\mathbf{i}}\right)$, all i and all $s_i \geq 0$.

Analysis (3/7)

The cost-minimization problem and the h function



(a) Cost minimization.

(b) Graph of the g function.

(c) Graph of the h function.

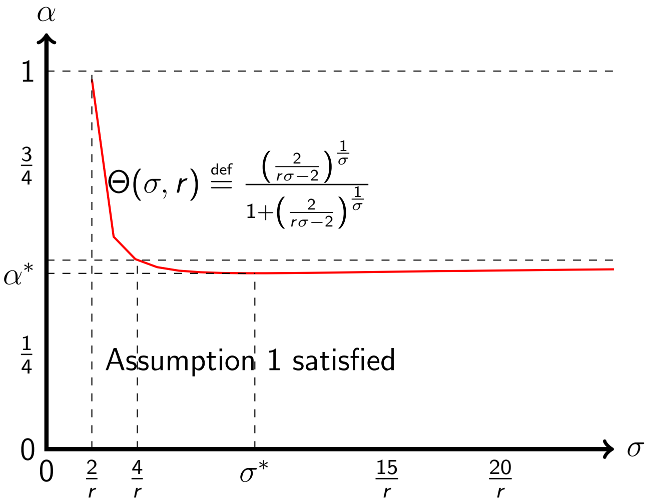
Equilibrium existence

Define the following elasticities:

- The elasticity of output w.r.t. x_i: $\eta\left(\frac{1}{p_i}\right) \stackrel{\text{def}}{=} \frac{f_1\left[h\left(\frac{1}{p_i}\right),1\right]h\left(\frac{1}{p_i}\right)}{f\left[h\left(\frac{1}{p_i}\right),1\right]}$.
- The elasticity of substitution: $\sigma\left(\frac{1}{p_i}\right) \stackrel{\text{def}}{=} -\frac{h'\left(\frac{1}{p_i}\right)\frac{1}{p_i}}{h\left(\frac{1}{p_i}\right)}$.
- The elasticity of the win probability w.r.t. s_i: $\varepsilon_i(\mathbf{s}) \stackrel{\text{def}}{=} \frac{\partial p_i}{\partial s_i}\frac{s_i}{p_i}$.
- We have that $\eta \in (0,t)$, $\sigma > 0$, and $\varepsilon_i \in (0,1)$.
- **Assumption 1.** The production function and the CSF satisfy:
  (i) $t \leq 1$ and $\varepsilon_i(\mathbf{s})\,\eta\left(\frac{1}{p_i}\right)\sigma\left(\frac{1}{p_i}\right) \leq 2$ (for all p_i and $\mathbf{s}$);
- **Proposition 1.** Suppose Assumption 1 is satisfied. Then there exists a pure strategy Nash equilibrium of the hybrid contest.

- Assume a CES production function, $t = 1$, $r \leq 1$, and

$$p_i(\mathbf{s}) = \frac{w_i s_i^r}{\sum_{j=1}^n w_j s_j^r} \quad \text{and} \quad p_i(0, \cdots, 0) = \frac{w_i}{\sum_{j=1}^n w_j}.$$



Analysis (6/7)

- To check the SOC with Melkoyan's analytical approach is cumbersome and in the end he relies on numerical simulations:

  [. . .] one can demonstrate, after a series of tedious algebraic manipulations, that a player's payoff function is locally concave at the symmetric equilibrium candidate in (7) if and only if [large mathematical expression]. [. . .] Numerical simulations indicate that this inequality is violated only for extreme values of the parameters [. . .]. In addition to verifying the local second-order conditions, I have used numerical simulations to verify that the global second-order conditions are satisfied under a wide range of scenarios.

Characterization of equilibrium

- Recall: $\pi_i(\mathbf{s}) = p_i(\mathbf{s})\, v_i - C_i[s_i, p_i(\mathbf{s})]$.
- The FOC (with an equality if $s_i > 0$):

$$\frac{\partial \pi_i(\mathbf{s})}{\partial s_i} = \frac{\partial p_i(\mathbf{s})}{\partial s_i} v_i - C_1(s_i, p_i) - C_2(s_i, p_i)\frac{\partial p_i(\mathbf{s})}{\partial s_i} \leq 0.$$

- Use Shephard's lemma, $C_2(s_i, p_i) = Y_i[s_i, p_i(\mathbf{s})]$:

$$[v_i - Y_i(s_i, p_i(\mathbf{s}))]\frac{\partial p_i(\mathbf{s})}{\partial s_i} \leq C_1(s_i, p_i), \quad (1)$$

  with an equality if $s_i > 0$.
- **Proposition 2.** Suppose Assumption 1 is satisfied. Then $\mathbf{s}^* = (s_1^*, \ldots, s_n^*)$ is a pure strategy Nash equilibrium of the hybrid contest if and only if condition (1) holds, with equality if $s_i^* > 0$, for each contestant i.

A Symmetric Hybrid Contest (1/4)

Assumption 2. The CSF is symmetric and homogeneous of degree 0.

- Note that, thanks to Assumption 2:

$$\frac{\partial p_i(s,s,\ldots,s)}{\partial s_i} = \frac{\widehat{\varepsilon}(n)}{ns}, \text{ where } \widehat{\varepsilon}(n) \stackrel{\text{def}}{=} \varepsilon_i(1,1,\ldots,1).$$

- Use this in the FOC and impose symmetry:

$$(v-y^*)\frac{\widehat{\varepsilon}(n)}{ns^*} = C_1\left[s^*,\frac{1}{n}\right] = \frac{1}{ts^*}C\left[s^*,\frac{1}{n}\right] = \frac{1}{ts^*}\left[\frac{y^*}{n}+x^*\right]$$

$\Leftrightarrow (v-y^*)\,t\widehat{\varepsilon}(n) = y^* + nx^*$. And from before, $x^* = h(n)y^*$.

- The last equalities are linear in x^* and y^*, so easy to solve.
- **Proposition 3.** Within the family of sym. eq., there is a unique pure strategy equilibrium: $s^* = f[h(n),1](y^*)^t$, $x^* = h(n)y^*$, and

$$y^* = \frac{t\widehat{\varepsilon}(n)v}{1+nh(n)+t\widehat{\varepsilon}(n)}.$$

- **Proposition 4.** Effect of more contestants on x^* and y^*:

$$\frac{\partial x^*}{\partial n} < 0 \Leftrightarrow \sigma(n) > -\frac{n(n-2)h(n)-1}{(n-1)[1+t\widehat{\varepsilon}(n)]},$$
$$\frac{\partial y^*}{\partial n} > 0 \Leftrightarrow \sigma(n) > \frac{n(n-2)h(n)-1}{(n-1)nh(n)};$$

  and if $\sigma(n) \geq 1$, then necessarily $\frac{\partial x^*}{\partial n} < 0$ and $\frac{\partial y^*}{\partial n} > 0$.
- In order to understand the above:
  - More contestants means a lower probability of winning.
  - This lowers the relative cost of investing in y_i.
  - So whenever $\sigma(n)$ is sufficiently large, $\frac{\partial y^*}{\partial n} > 0$ and $\frac{\partial x^*}{\partial n} < 0$.
  - But if $\sigma(n)$ small, the derivatives must have the same sign. For:

$$\frac{\partial y^*}{\partial n}\frac{n}{y^*} = \sigma(n) + \frac{\partial x^*}{\partial n}\frac{n}{x^*} \qquad \text{(follows from } x^* = h(n)y^*\text{)}.$$

  As $\sigma(n) \to 0$, the production function requires x_i and y_i to be used in fixed proportions (a Leontief production technology).

- The total amount of equilibrium expenditures in the symmetric hybrid model is defined as $R^{\mathrm{H}} \stackrel{\text{def}}{=} nC\left[s^{*}, \frac{1}{n}\right]$.
- The corresponding amount in the all-pay contest: $R^{\mathrm{A}} = t\widehat{\varepsilon}(n)v$.
- **Proposition 5, part (a).** In the symmetric model:

$$R^{\mathrm{H}} = (1 - \frac{y^{*}}{v})R^{\mathrm{A}} = \left[\frac{1}{v\left[1 + nh(n)\right]} + \frac{1}{R^{\mathrm{A}}}\right]^{-1}.$$

In particular, for any finite n, we have $R^{\mathrm{H}} < R^{\mathrm{A}}$.

  - The payoff suggests the intuition: $\pi_i = (v_i - y_i)\, p_i\,(\mathbf{s}) - x_i$.
- **Proposition 5, part (b).** In the symmetric model, suppose $p_i(\mathbf{s}) = \phi(s_i)/\sum_{j=1}^{n}\phi(s_j)$, where ϕ is a strictly increasing and concave function satisfying $\phi(0) = 0$.
  - Then R^{H} is weakly increasing in n if and only if: (i)

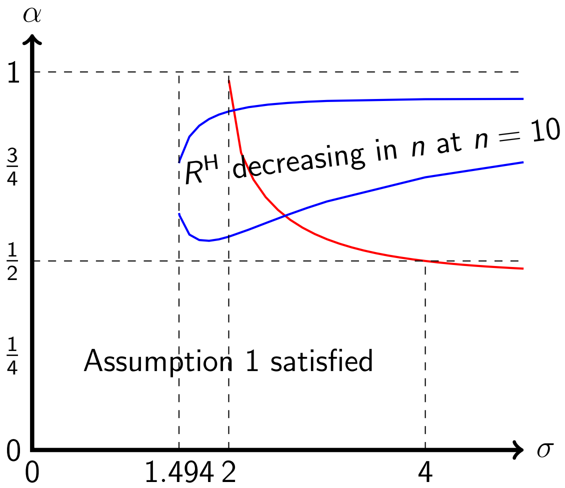
$$\sigma\,(n) \leq 1 + \frac{4n}{tr\,(n-1)^{2}}; \tag{2}$$

or (ii) inequality (2) is violated and $h\,(n) \notin (\Xi_L, \Xi_H)$. See figure!

A Symmetric Hybrid Contest (4/4)

Illustration of result (b)

- Assume CES, $t = 1$, and $n = 10$.



Asymmetric Hybrid Contests (1/2)

- I assume $n = 2$ and I study three models:
  - The CSF is biased in favor of one contestant.
  - One contestant has a higher valuation than the other.
  - I also endogenize the degree of bias.
- **Assumption 3.** The CSF is given by

$$p_i(\mathbf{s}) = \frac{w_i s_i^r}{w_1 s_1^r + w_2 s_2^r}.$$

- The following three equations define equilibrium values of p_1^*, y_1^*, and y_2^*:

$$y_i^* = \frac{rtp_i^*(1-p_i^*)v_i}{rtp_i^*(1-p_i^*) + p_i^* + h\left(\frac{1}{p_i^*}\right)}, \quad \text{for } i = 1,2, \text{ and } \Upsilon(p_1^*) = 0, \text{ where}$$

$$\Upsilon(p_1) \stackrel{\text{def}}{=} \frac{\frac{w_2 v_2^{rt}}{w_1 v_1^{rt}} p_1 f\left[h\left(\frac{1}{1-p_1}\right), 1\right]^r}{\left[rtp_1(1-p_1) + 1 - p_1 + h\left(\frac{1}{1-p_1}\right)\right]^{rt}} - \frac{(1-p_1) f\left[h\left(\frac{1}{p_1}\right), 1\right]^r}{\left[rtp_1(1-p_1) + p_1 + h\left(\frac{1}{p_1}\right)\right]^{rt}}.$$

- The equilibrium is unique if $r\eta\left(\frac{1}{p_i}\right)\sigma\left(\frac{1}{p_i}\right) \leq 1$.

Asymmetric Hybrid Contests (2/4)

A Biased decision process ($w_1 \neq w_2$ but $v_1 = v_2$)

- Among the results:
  - **(a)** $p_1^* > p_2^* \Leftrightarrow y_1^* < y_2^* \Leftrightarrow C(s_1^*, p_1^*) > C(s_2^*, p_2^*)$.
  - **(b)** Evaluated at symmetry ($w_1 = w_2$): $\frac{\partial p_1^*}{\partial w_1} > 0$,

$$\frac{\partial y_1^*}{\partial w_1} < 0, \quad \frac{\partial y_2^*}{\partial w_1} > 0, \quad \frac{\partial x_1^*}{\partial w_1} > 0 \Leftrightarrow \frac{\partial x_2^*}{\partial w_1} < 0 \Leftrightarrow \sigma(2) > \frac{2}{2+rt}.$$

Different valuations ($v_1 \neq v_2$ but $w_1 = w_2$)

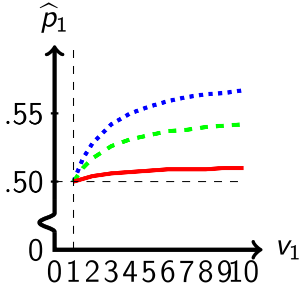
- Among the results:
  - **(a)** $p_1^* > p_2^* \Leftrightarrow \frac{y_1^*}{v_1} < \frac{y_2^*}{v_2}$.
  - **(b)** $v_1 - y_1^* > v_2 - y_2^* \Leftrightarrow C(s_1^*, p_1^*) > C(s_2^*, p_2^*)$.

An Endogenous Bias (w_1 chosen, but $v_1 \geq v_2$ and w_2 fixed)

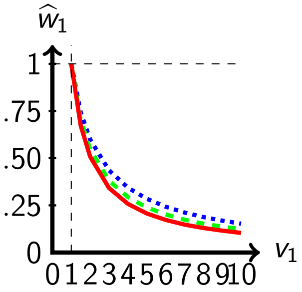
- Timing of events in the game:
  1. A principal chooses w_1 to maximize $R^H = C(s_1^*, p_1^*) + C(s_2^*, p_2^*)$.
  2. w_1 becomes common knowledge and the contestants interact as in the previous analysis.
- **Assumption 3.** The production function is of Cobb-Douglas form: $f(x_i, y_i) = x_i^\alpha y_i^\beta$, for $\alpha > 0$ and $\beta > 0$.
- Results: The equilibrium values of p_1 and w_1 satisfy:
  - If $v_1 = v_2$, then $\widehat{p}_1 = \frac{1}{2}$ and $\widehat{w}_1 = w_2$.
  - If $v_1 > v_2$, then $\widehat{p}_1 > \frac{1}{2}$.
  - If $v_1 > v_2$, then $\widehat{w}_1 < w_2$ at least if $|v_1 - v_2|$ is very small or big.
- My intuition for results:
  - Contestant 1 is more valuable as a contributor (as $v_1 > v_2$).
  - Hence, she should be encouraged to use x_1, as all-pay investments are more conducive to large expenditures.
  - This is achieved by making winner-pay inv. costly: $\widehat{p}_1 > \frac{1}{2}$.
  - To generate $\widehat{p}_1 > \frac{1}{2}$, $v_1 > v_2$ is more than enough, so bias can be in favor of Contestant 2.
    - Might not be robust.

Numerical example ($t = r = v_2 = w_2 = 1$)

- Plot of plot $\widehat{p}_1$ and $\widehat{w}_1$ against v_1 for three different values of α: 0.9 (the blue, dotted curve), 0.5 (the green, dashed curve), and 0.1 (the red, solid curve).



(a) The high-valuation contestant's probability of winning.



(b) The weight in the CSF that is assigned to the high-valuation contestant's score.

Main results and contributions: (1/1)

1. The analytical approach (borrowing from producer theory):
   - $\longrightarrow$ Generality, tractability, and an existence condition.

2. A larger n leads to substitution away from all-pay investments.
   - But only if the elasticity of substitution is large enough.

3. Total expenditures always lower in hybrid contest than in all-pay.

4. Total exp'tures can be decreasing in n (also shown by Melkoyan).

5. Asym. contests (in terms of valuations and bias): Sharp predictions about relative size of investm's and of expenditures.

6. Endogenous bias: High-valuation contestant more likely to win but the bias is against her (the latter might not be robust).

Possible avenues for future work (1/1)

1. Sequential moves: first (x_1, y_1), then (x_2, y_2).

2. Applying the producer theory approach to other contest models with multiple influence channels.

3. Experimental testing.
   - Relatively sharp predictions.
   - But risk neutrality might be an issue?

4. Further work on asymmetric contests.
   - More than two contestants.
   - Can a contestant be hurt by a bias in favor of her?
   - Can a contestant benefit from an increase in rival's valuation?

5. Contest design in broader settings.