

The Case for Auctioning Countermeasures in the WTO

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1. Introduction

A major accomplishment of the Uruguay Round of GATT negotiations in creating the World Trade Organization (WTO) was the introduction of new dispute settlement procedures. These procedures were intended to provide a significant step forward, relative to GATT, in the settling of trade disputes, in large part by ensuring that violations of WTO commitments would be met with swift retaliation (“suspension of concessions”) by the affected trading partners. While the dispute settlement procedures of the WTO indeed represent a considerable improvement over those in GATT, ten years of experience under the new procedures suggests that significant problems of enforcement remain in the WTO.

One prominent problem with the WTO dispute settlement procedures is the practical difficulty faced by small and developing countries in finding the capacity to effectively retaliate against trading partners that are in violation of their WTO commitments. The difficulty is that, even if a small or developing country wins a

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ruling against a trading partner under the WTO dispute settlement procedures, and is therefore authorized to retaliate in the event that the trading partner does not bring its policies into conformity with its WTO obligations, the country may have little ability to bring teeth to the ruling with effective retaliation. As a consequence, many small and developing countries voice frustration with their ability to negotiate meaningful commitments with trading partners in the WTO.¹

This problem persists from the GATT era. As Hudec (2000) details, the 1965 developing country proposals on remedies included a proposal for “collective retaliation” in cases where a large country violated its obligations to a developing country. Under this proposal, the retaliation threat would be more effective, since a large-country defendant would face the possibility that its exports would suffer a loss of access to markets in multiple countries. Developed countries objected to the proposal for collective retaliation, however, and it was not adopted.

More recently, the frustration of small and developing countries has been expressed with particular force by Mexico, which has proposed in the WTO (WTO, 2002) a number of changes to the dispute settlement procedures in order to address this problem. Among the changes proposed by Mexico is that the right of retaliation be made “tradeable.” The idea is that, if a country wins a ruling against a trading partner under the WTO dispute settlement procedures, and finds that it is unable or unwilling to retaliate itself, it should be able to trade that right to another country that would value and utilize the right of retaliation. In Mexico’s view, “...this concept might help address the specific problem facing Members that are unable to suspend concessions effectively.” (WTO, 2002, p. 6).

The problem confronting small and developing countries admits two interpretations. A first interpretation is dismissive. It emphasizes that many GATT/WTO obligations are reciprocal in nature. If a country received the benefit of a negotiated tariff reduction from its trading partner, then it may be expected that the country offered the benefit to its trading partner of a reduction in its own tariff. But if a country had the ability to offer such a benefit, then it likewise has the ability to achieve effective retaliation by withdrawing this benefit. According to this perspective, the problem of ineffective retaliation would arise only for those

¹Bown (2004a,b) reports empirical results that are consistent with the argument that retaliation is less effective for such countries. Likewise, in other work (Bagwell, Mavroidis and Staiger, 2006), we examine all disputes brought to the WTO since its inception (January 1, 1995) and report consistent evidence. For example, we do not find any dispute in which a developing country (defined here as a non-OECD member) has imposed countermeasures to induce compliance even when faced with non-implementation.

countries that anyway had little to offer in negotiations. A second interpretation is accommodative. It emphasizes that the welfare of small and developing countries may be of particular interest to the world community. It also stresses that small and developing countries may value heavily the growth of their export industries; consequently, such a country may be unable to use a retaliatory tariff increase to impose a reciprocal (i.e., commensurate) cost on a developed country, should the latter violate its GATT/WTO obligations and restrict access to its market.

We see merit in both interpretations and do not advocate one over the other. We do believe, however, that the accommodative interpretation is sufficiently compelling to motivate exploratory formal analyses of the proposed changes to dispute settlement procedures. In this regard, we note that Maggi (1999) has already provided a theoretical framework with which to understand the potential benefits of collective retaliation. He shows that governments may be better able to enforce efficiency-enhancing trade agreements, if a third country is allowed to retaliate when a trade dispute arises between two other countries. We are unaware, however, of any prior analysis of the recent proposal that retaliation rights be tradeable.

In this paper, we offer a first formal analysis of tradeable retaliation rights. In particular, we identify some potential benefits of tradeable retaliation rights, propose alternative structures for trading such rights, and then evaluate the proposed structures in terms of the identified potential benefits. Our work thus directly contributes to the ongoing policy discussions by providing a rigorous evaluation of the pros and cons of alternative structures for tradeable retaliation rights. We thereby also provide valuable formal input with regard to the larger question of whether tradeable retaliation rights is a good idea. We do not claim to provide an answer to this question, however.

What are the potential benefits of tradeable retaliation rights? The Mexican proposal highlights two such benefits. A first benefit is that such a system would facilitate the rebalancing of concessions, since the harmed country would then receive compensation in exchange for its rights to suspend. A second benefit is that the incentive for compliance would be improved, because the offending country is more inclined to bring its policies into conformity with its WTO obligations when it faces a more realistic possibility of effective retaliation. We suggest here a third potential benefit that also warrants consideration; namely, when retaliation rights are tradeable, an existing right of retaliation may be more efficiently allocated to the WTO member who values this right most highly.

How might trade in retaliation rights be structured? While the Mexican pro-

posal does not make any specific suggestions in this regard, a number of trading structures could be considered. One interesting possibility is that the right of retaliation might be auctioned. Alternatively, the harmed country might post a price at which it would be willing to sell its existing right of retaliation, or the harmed country might select a large country with which to bargain over the transfer of retaliation rights.

We explore here the case of auctioning countermeasures in the WTO. While other trading structures are also worthy of consideration, we focus on auctions since auction theory is well developed and has been of great practical use in other policy arenas. As we discuss below, we consider two auction structures, which differ with regard to whether the offending country is allowed to bid to retire the right of retaliation against it. The auction structures are readily evaluated in terms of the three potential benefits of tradeable retaliation rights listed above. In particular, we may gauge the rebalancing of concessions on the basis of the expected revenue received by the government running the auction, the incentive for compliance on the basis of the cost inflicted on the offending country, and efficiency in terms of the combined welfares of the affected governments.

This exploration is novel from the perspective of the theory of trade agreements, where threatened retaliation plays a central role in enforcement, but where auctioning retaliation rights has not been considered.² From the perspective of auction theory, retaliation rights within the WTO exhibit some novel features as well, because retaliation implies a rich pattern of both positive and negative externalities across trading partners. Recent work in the auction literature has focused on environments with externalities, and the case of auctioning countermeasures in the WTO can be viewed as a novel and interesting environment within which to extend the study of auctions with externalities.³

To undertake our analysis, we adopt a simple model in which two foreign countries import a common good from an exporting home country. We assume that each country has bound its tariffs in a previous GATT/WTO negotiation, that the home country has violated its WTO commitments, and that some other (unmodeled) country has been granted a right of retaliation against the home

²See, for example, Bagwell and Staiger (1990, 1997), Dixit (1987), Ederington (2001), Maggi (1999) and Limao (2005). Bagwell and Staiger (2002, Chapter 6) provide a recent review of the existing literature on enforcement of trade agreements.

³As discussed below, our formal analysis is most closely related to that of Jehiel and Moldovanu (2000). Other important contributions in this literature include Das Varma (2002), Ettinger (2002), Haile (2000) and Jehiel and Moldovanu (1996, 2001).

country but is unwilling or unable to exercise this right with a retaliatory tariff of its own. With this country as the “seller,” we then consider the implications of allowing the seller to sell the right of retaliation in a first-price sealed-bid auction. We consider two different auction structures. In our *basic auction*, we allow the two foreign countries to bid for the right to retaliate against the home country, but we do not allow the home country to bid to retire this right of retaliation. In our *extended auction*, we permit the home country to bid as well.

We assume that the two foreign countries experience privately observed political-economy shocks that determine their valuation of the right to impose a higher tariff. In our basic auction, the two foreign countries are the only bidders, and we observe that this is an auction with positive externalities: each foreign country would prefer that the other foreign country win the auction and retaliate against the home country over the alternative that no country wins the auction and no retaliation is imposed. Intuitively, both foreign countries enjoy a more favorable terms of trade (i.e., a reduced world price for the home-country export) when retaliation by either foreign country is imposed.⁴ We show further that whether a foreign country would in fact prefer to win the right of retaliation over the alternative that the other foreign country wins this right depends on the realization of its privately observed political-economy shock. Intuitively, the more favorable foreign terms of trade is enjoyed in either event, but the import-competing producers in the winning country enjoy as well the benefits of additional tariff protection at the expense of consumers in that country. Thus, a foreign country that is sufficiently politically motivated - and therefore values the implied redistribution from its consumers to its import-competing producers to a sufficient degree - prefers to win rather than lose to the other foreign country. Together, these features lead the basic auction to exhibit several unusual properties, including misallocation of the retaliation right across the foreign countries and even outright auction failure, in which no bids are made despite positive valuation by the bidders.

When we extend the basic auction to permit the home country to bid to retire the right of retaliation against it, we observe that both positive and negative externalities arise among bidders. While each foreign country continues to impose a positive externality on the other foreign country if it wins the auction, each foreign country imposes a negative externality on the home country if it wins. We show that in this extended auction there can be no auction failure, and indeed

⁴See Bown and Crowley (2004, forthcoming) and Chang and Winters (2001) for evidence consistent with the hypothesis that a tariff increase by one country may generate a positive terms-of-trade externality for another country that imports the relevant good.

the home country always wins and retires the retaliation right. Intuitively, the home country incurs the full cost of retaliation, while retaliation is a public good among the foreign countries; thus, the home country has the greatest incentive to win the auction.

Our analysis of the extended auction contributes to an ongoing policy debate about the role of monetary compensation in WTO dispute settlement procedures. In particular, it is sometimes argued that these procedures should be modified, so that retaliatory tariffs are not used and instead the violating country provides an appropriate cash payment to the harmed country.⁵ But it is not clear that monetary compensation would always be credible: What would happen if the harmed country is small and the violating country refuses to make the cash payment? Our analysis of the extended auction suggests that monetary compensation from the home (violating) country to the seller (the harmed country) becomes credible in this circumstance, when the seller offers the right of retaliation in an auction. Intuitively, the home country then understands that if it does not win the auction and make the corresponding cash payment, a (large) foreign country will win the auction and impose a tariff on home-country exports. Thus, the threat of a retaliatory foreign tariff induces the home country to offer actual cash compensation.

We next evaluate the two auction structures with respect to the three potential benefits listed above. First, we consider the extent to which the auctions facilitate the rebalancing of concessions. We show that this first criterion favors the extended auction, as the greatest expected revenue is generated when the home country is permitted to bid to retire the right of retaliation. Second, we explore the degrees to which the auctions encourage greater compliance and promote greater ex-ante efficiency, respectively. We demonstrate that the compliance and efficiency criteria favor the basic auction under some circumstances. A general implication of our analysis is thus that the ranking of different auction structures in the WTO-retaliation setting depends critically on the kind of benefits (re-balancing, compliance, efficiency) that are sought.

Our work thus provides a rigorous evaluation of the pros and cons of different structures for auctioning retaliation rights. It thereby also offers valuable formal input with regard to the larger question of whether the WTO dispute settlement system should be modified to include tradeable retaliation rights. We do not claim to answer this question, however, since auctioning retaliation rights in the WTO could also yield a number of important benefits and costs for the WTO system

⁵For further discussion of monetary compensation in the WTO, see Bronkers and van den Broek (2005), Davies (2006) and O'Connor and Djordjevic (2005).

that are not included in our formal analysis. For example, a potential benefit is that the prospect of auction revenue might enable a small developing country to attract and finance private legal support for WTO legal actions that it otherwise could not afford to initiate. An additional cost is that the revenue generated by auctions could result in excessive use of the WTO dispute settlement system. As well, when bilateral disputes take multilateral dimensions, tensions may grow across governments and frustrate future negotiations.

Finally, we note that our formal analysis is closely related to that of Jehiel and Moldovanu (2000). They consider second-price sealed-bid auctions with externalities and derive a number of interesting results. Among these, they construct an equilibrium for a general family of payoffs that exhibit positive externalities. In our analysis of the basic auction, we feature an analogous equilibrium.⁶ Our analysis has several important novel aspects, however. In particular, we characterize the necessary properties of equilibrium behavior and thereby establish that the constructed equilibrium is unique, analyze an extended auction wherein bidders are asymmetric and both positive and negative externalities exist, focus on first-price sealed-bid auctions, and develop a new trade-policy application.

The rest of the paper proceeds as follows. Section 2 lays out the economic model. The basic auction is defined in Section 3, and the equilibrium bids are characterized in Section 4. Section 5 defines the extended auction, and Section 6 characterizes the equilibrium bids in this extended auction. Section 7 compares the two auction structures from the perspective of expected revenue, compliance and ex-ante efficiency. Section 8 concludes.

2. Model

In this section, we develop the economic framework that underlies our analysis. We present a three-country model, in which two symmetric foreign countries (1 and 2) import a single good from Home. In subsequent sections, we analyze auctions in which the foreign countries bid for the right to retaliate against Home on this good;

⁶Haile (2000) considers a second-price sealed-bid auction with positive externalities, in which bidders have noisy signals of their private values at the time of the auction and the positive externalities are driven by resale opportunities. In this specific setting, he constructs the unique symmetric equilibrium for a range of binding reserve prices that lie sufficiently below the highest possible valuation. While the particular setting that we analyze is quite different, the equilibrium of our basic auction and that derived by Haile have analogous features, though our results apply to reserve prices up to the highest possible valuation.

therefore, we refer to this good as the “retaliation good.” Our goal in the present section is to develop an economic model of the retaliation-good sector, define the corresponding welfare functions for governments, and characterize best-response, Nash and efficient tariffs.

2.1. Economic Model

The economic model of the retaliation-good sector is simple. For each foreign country $j = 1, 2$, let demand and supply be given as $D(P^j) = 1 - P^j$ and $Q(P^j) = 1/4$, where P^j is the local price of the retaliation good in foreign country j . In the Home country, there is a larger endowment (supply) of this good, but no demand: $D^h(P) = 0$ and $Q^h(P) = 1/2$, where P is the local price of the retaliation good in the Home country. It is convenient to define foreign country j 's import demand function and Home's export supply function:

$$\begin{aligned} M(P^j) &\equiv D(P^j) - Q(P^j) = 3/4 - P^j \\ E(P) &\equiv Q^h(P) - D^h(P) = 1/2 \end{aligned} \tag{2.1}$$

Home exports $1/2$ units, regardless of the local price. Under free trade, the local price is $P^1 = P^2 = P = 1/2$, and each foreign country thus imports $1/4$ units.

We now allow that each foreign country imposes an import tariff. Let τ^j denote foreign country j 's specific tariff. For simplicity, we assume that Home has no export policy. Thus, the world price, P^w , for the retaliation good must agree with Home's local price: $P = P^w$. The local price in foreign country j , by contrast, is given as

$$P^j = P^w + \tau^j. \tag{2.2}$$

We require as well that the market for the retaliation good clears:

$$M(P^1) + M(P^2) = E(P^w). \tag{2.3}$$

Using (2.2), we may solve (2.3) for the equilibrium world price, $\tilde{P}^w(\tau^1, \tau^2)$, as

$$\tilde{P}^w(\tau^1, \tau^2) = \frac{1 - \tau^1 - \tau^2}{2}. \tag{2.4}$$

Using (2.2) and (2.4), we find that the equilibrium local price in foreign country j , which we denote as $\hat{P}^j(\tau^j, \tilde{P}^w)$, is given as

$$\hat{P}^j(\tau^j, \tilde{P}^w) \equiv \tilde{P}^w(\tau^1, \tau^2) + \tau^j = \frac{1 - \tau^i + \tau^j}{2}, \tag{2.5}$$

where $i, j = 1, 2$ and $i \neq j$. For simplicity, we assume throughout that $\tau^j \leq 1$.

2.2. Welfare Functions

We consider next the welfare functions of the governments of the various countries, with regard to trade in the retaliation-good sector. In line with recent work, we allow that a government is motivated by both national-income and political-economy (i.e., distributional) concerns.⁷ The latter concern may reflect, e.g., the lobbying activities of import-competing firms.

We represent the welfare function for the government of foreign country j as

$$W^j(\hat{P}^j, \tilde{P}^w) = \int_{\hat{P}^j}^1 (1 - P^j) dP^j + \zeta^j \Pi(\hat{P}^j) + [\hat{P}^j - \tilde{P}^w] M(\hat{P}^j) \quad (2.6)$$

where the first term is consumer surplus, the second term is profit weighted by a political-economy parameter, ζ^j , and the third term is tariff revenue. Foreign country j 's profit is defined as

$$\Pi(P^j) \equiv P^j(1/4). \quad (2.7)$$

As (2.6) reveals, the government of foreign country j experiences a welfare benefit from the world-price reduction (i.e., terms-of-trade improvement) that an increase in any import tariff implies. At the same time, a higher import tariff also affects welfare by changing the local price, \hat{P}^j , and thereby altering consumer surplus, profit and tariff revenue.

With respect to the political-economy parameter, we assume:

A1: For each $j \in \{1, 2\}$, $\zeta^j \in [1, 2]$.

The government of foreign country j maximizes national income when $\zeta^j = 1$. Otherwise, the government weighs the profit of import-competing firms above consumer surplus and tariff revenue.

Writing welfare as a function of prices, we find that

$$W^j(\hat{P}^j, \tilde{P}^w) = 1/2 + (1/4)\hat{P}^j[\zeta^j - 1] - (1/2)(\hat{P}^j)^2 - \tilde{P}^w(3/4 - \hat{P}^j). \quad (2.8)$$

Likewise, using (2.4) and (2.5), we find that welfare can be defined as a direct function of tariffs, $\hat{W}^j(\tau^j, \tau^i) \equiv W^j(\hat{P}^j(\tau^j, \tilde{P}^w(\tau^1, \tau^2)), \tilde{P}^w(\tau^1, \tau^2))$, and written

⁷For discussion of this literature, see Bagwell and Staiger (1999, 2002 Chapter 2). The formulation that we adopt here is analogous to those used by Bagwell and Staiger (2001) and Baldwin (1987).

as

$$\widehat{W}^j(\tau^j, \tau^i) = \frac{(1 + \zeta^j) + \zeta^j \tau^j - 3(\tau^j)^2 + 2\tau^i \tau^j + [2 - \zeta^j]\tau^i + (\tau^i)^2}{8}. \quad (2.9)$$

We consider next the welfare of Home. Letting ζ^h denote the political-economy parameter for Home, we represent Home's welfare as

$$W(\tilde{P}^w) = \zeta^h(1/2)\tilde{P}^w. \quad (2.10)$$

Thus, Home weighs the profit of its export sector, $(1/2)\tilde{P}^w$, by a political-economy parameter, ζ^h . Observe that Home suffers a welfare loss, when foreign tariffs are increased and the world price declines.

Maintaining symmetry with A1, we make the following assumption:

A2: $\zeta^h \in [1, 2]$.

This assumption plays no role in the analysis until Sections 5-7.

2.3. Best-Response and Nash Tariffs

With the foreign country welfare functions defined, we may now characterize best-response (optimal) and Nash tariffs. The best-response function can be found by using (2.8) and setting $W_{\tilde{P}^j}^j \frac{d\tilde{P}^j}{d\tau^j} + W_{\tilde{P}^w}^j \frac{\partial \tilde{P}^w}{\partial \tau^j} = 0$. Thus, when the government of foreign country j selects its optimal tariff, it considers the impact of the tariff on the local price and the world price. To find the best-response tariff, we may equivalently use (2.9) and set $\frac{\partial \widehat{W}^j}{\partial \tau^j} = 0$. We find that the best-response tariff function, $\tau_R^j(\tau^i)$, is given by $\tau_R^j(\tau^i) = \frac{\zeta^j + 2\tau^i}{6}$. The best-response function is upward sloping, since the foreign countries are competing importers: as the tariff of one foreign country rises, more volume is diverted to the other foreign country, and the latter country thus greets the higher volume with a greater tariff as it thereby achieves a large welfare gain from the consequent terms-of-trade improvement.⁸

We now characterize the Nash tariffs. The Nash equilibrium is a useful benchmark with which to identify the source of inefficiency in the absence of a trade agreement. Foreign country j 's Nash tariff, τ_N^j , is defined by $\tau_R^j(\tau_N^i) = \tau_N^j$. We find that $\tau_N^j = \frac{3\zeta^j + \zeta^i}{16}$ and observe that $\tau_N^j \leq 1/2$ under A1. It is interesting to

⁸Bagwell and Staiger (1997) examine a related "competing importer" model and likewise find that import tariffs are strategic complements. See also Maggi (1999).

observe further that $\tau_N^j - \tau_N^i = (1/8)[\zeta^j - \zeta^i]$. The foreign country with the higher political-economy parameter thus sets the higher Nash tariff, as it has greater incentive to raise the local price - and thus the profit of the import-competing sector. Figure 1 illustrates the best-response and Nash tariffs.

2.4. Efficient Tariffs

We now characterize efficient tariffs, where efficiency is measured relative to the welfare functions of the three governments.⁹ A simplifying feature of our economic model is that Home always exports 1/2 units. Thus, foreign tariffs do not restrict trade in an aggregate sense; rather, tariffs influence the allocation of the fixed volume of Home exports across the foreign countries. This structure is advantageous for two reasons. First, it serves to highlight the externality across foreign countries that is a primary focus of our auction analysis, because with this structure retaliation by one foreign country cannot destroy trade volume but rather only diverts it to the other foreign country. Second, while it is well understood that tariffs may impact efficiency by altering the overall volume of trade, it is less well appreciated that tariffs also may enhance efficiency by allocating a greater share of aggregate trade volume to the importing country whose government most values trade (i.e., to the foreign country whose government weighs least heavily the interests of import-competing firms). This latter role is most easily seen when there is a fixed volume of trade to allocate.¹⁰

To characterize the efficiency frontier, we begin by deriving the politically optimal tariffs. As discussed by Bagwell and Staiger (1999, 2001, 2002), a government's politically optimal tariff is that tariff which would be optimal, if governments were not motivated by the terms-of-trade implications of their trade policies. In other words, when a government chooses its politically optimal tariff, it achieves its preferred local price. Formally, the politically optimal tariff for foreign country j satisfies $W_{\hat{p}_j}^j = 0$. Using (2.5) and (2.8), we find that the politically

⁹The WTO is an agreement among governments, and we thus analyze the efficiency of this agreement relative to the preferences of governments. For further discussion, see Bagwell and Staiger (1999, 2001, 2002 Chapter 2).

¹⁰We emphasize, though, that the basic features of our auction analysis do not hinge on our assumption of fixed aggregate trade volume. In particular, the efficiency-enhancing role for tariffs that we identify here, and the externalities across bidders that we characterize below, would also arise in a more general model in which tariffs affect the aggregate volume of trade.

optimal tariff, τ_{PO}^j , is given by

$$\tau_{PO}^j = (1/4)[\zeta^j - 1]. \quad (2.11)$$

The politically optimal tariff is free trade when national income is maximized. Under A1, foreign country j 's Nash tariff exceeds its politically optimal tariff: $\tau_N^j > \tau_{PO}^j$. Intuitively, foreign country j is motivated as well by terms-of-trade considerations when setting its Nash tariff.

We turn now to the efficiency frontier. Define joint welfare by

$$J(\tau^1, \tau^2) \equiv W(\tilde{P}^w) + W^1(\hat{P}^1, \tilde{P}^w) + W^2(\hat{P}^2, \tilde{P}^w).$$

When $\zeta^h = 1$, the world price cancels from this sum, being entirely associated with the redistribution between Home export profit and foreign tariff revenue.¹¹ For our present purposes, it is sufficient to examine the efficiency frontier when $\zeta^h = 1$. Setting $\frac{\partial J}{\partial \tau^1} = 0$, we find that efficient tariffs, (τ_E^1, τ_E^2) , satisfy

$$\tau_E^1 - \tau_E^2 = (1/4)[\zeta^1 - \zeta^2]. \quad (2.12)$$

It may be confirmed that (2.12) also arises when J is maximized with respect to τ^2 . Thus, (2.12) characterizes the set of efficient tariffs when $\zeta^h = 1$. Notice that the politically optimal tariffs are efficient.

As Figure 2 illustrates, the efficiency frontier is upward sloping. Intuitively, efficiency in our model is all about the allocation of a fixed volume of trade across foreign countries. If foreign country 1 has a higher political-economy parameter than does foreign country 2 (i.e., if $\zeta^1 > \zeta^2$), then it is efficient for foreign country 1 to have a higher local price and thus greater profit in the import-competing sector. This is accomplished by allowing foreign country 1 to select a higher tariff, as (2.12) confirms.

Along the efficiency frontier, the foreign tariff differential is maintained. Of course, at higher tariff pairs along the frontier, the world price is lower, and so movements along the efficiency frontier correspond to redistributions from Home to the foreign countries. But how is the efficient tariff differential determined? At a given world price (i.e., for a given sum of tariffs, $\tau^1 + \tau^2$), efficiency requires that the particular tariffs (τ^1 and τ^2) maximize the joint welfare of the foreign

¹¹This conclusion follows from (2.1), (2.3), (2.6) and (2.10). If $\zeta^h \neq 1$, then the world price would again cancel from J , if Home had its own export policy, since the world price would then be associated with the redistribution of tariff revenue between Home and the foreign countries.

countries. This amounts to choosing the best local price pair (\hat{P}^1, \hat{P}^2) , given the fixed world price. This choice involves a tradeoff. First, as discussed above, when political-economy differences are present across foreign countries, the welfare benefit of greater profit in the import-competing sector is larger in the foreign country with the higher political-economy parameter. This force suggests that local prices should vary across foreign countries. Second, the joint consumer surplus and tariff revenue of foreign countries is maximized when local prices are equal across foreign countries. For a given world price, the efficient local price ratio thus represents a balance between the two considerations.

Why isn't the Nash equilibrium efficient? As Figure 2 illustrates, when $\zeta^j > \zeta^i$, the Nash equilibrium entails tariffs for which the tariff differential, $\tau^j - \tau^i$, is smaller than would be efficient. Intuitively, when foreign country i raises its tariff, it does not internalize the fact that a greater share of imports is then diverted to foreign country j , whose local price (and thus profit) falls as a result. When $\zeta^j > \zeta^i$, this leads foreign country i to “under-value” the redistributive effect (on profit, across foreign countries) of its tariff increase on foreign country welfare for any given world price. By contrast, when $\zeta^j = \zeta^i$, there is no efficiency basis to seek a redistribution of profit from one foreign country to another, and so the Nash equilibrium is efficient.

3. The Basic Auction: Definition and Payoffs

In this section, we define and interpret our basic auction. After identifying the different outcomes that may arise in this auction, we characterize and interpret the payoffs that are associated with these outcomes.

3.1. Definition

Our *basic auction* is a first-price sealed-bid auction, where the two foreign countries are the bidders. Each of the two foreign countries is privately informed of its political-economy parameter, where these parameters, ζ^1 and ζ^2 , are independently and identically distributed according to a well-behaved (twice-continuously differentiable) distribution function, $F(\zeta^j)$, over the support $[1, 2]$, with the density function given as F' . After observing ζ^j , foreign country j makes a monetary bid for the right to retaliate. The foreign countries select their bids simultaneously. The bids are selected from the set $\{N\} \cup [b_o, \infty)$, where N corresponds to a decision to “not bid” and $b_o \geq 0$ is the exogenous reserve price for the auction.

A case of particular interest is $b_o = 0$. If both countries make a bid (i.e., neither selects N), then the right of retaliation goes to the high bidder, with each foreign country having an equal chance of gaining the right of retaliation in a tie. If one foreign country makes a bid and the other does not, then the right of retaliation goes to the former. Finally, if neither foreign country makes a bid (i.e., both select N), then the right of retaliation is not assigned, and no retaliation occurs.

What does retaliation mean? As discussed in the Introduction, we imagine that Home has violated its WTO obligations against some country, but that this country elects not to retaliate on its own. Instead, the harmed country conducts an auction for the right to retaliate against Home. In our basic auction, we assume that two foreign countries bid for the right to retaliate against Home. We now suppose that, through prior negotiations with Home, the two foreign countries have agreed to set their tariffs on the retaliation good at $\tau_o \equiv \tau_o^1 = \tau_o^2 \geq 0$. If a foreign country obtains the right of retaliation, then it is permitted to raise its tariff on the retaliation good up to the higher value, $\tau_o + \Delta$, where $\Delta > 0$. The size of Δ is interpreted as reflecting the size of Home's original violation.¹² Here, we do not model the nature of Home's original violation, or the selection of the retaliation good, though these are obviously important subjects for discussion and future analysis.¹³ Given this focus and the assumed symmetry of the foreign

¹²Under GATT/WTO rules, when it is found that a country has violated its obligations (e.g., by selecting a tariff above the level to which it had agreed), if the offending and harmed countries cannot agree upon "compensation" (e.g., the offending country may offer tariff reductions on other goods that it imports), then the harmed country is authorized to retaliate (e.g., the harmed country may raise its own tariffs), where the permitted level of retaliation is determined as that which restores the original balance of concessions. Working with a general-equilibrium model, Bagwell and Staiger (1999, 2001, 2002) show that the balance of concessions is restored when the retaliatory action is of a magnitude that restores the offending country's original terms of trade (i.e., the ratio of the price of its export good to its import good on world markets). We consider here the possibility that the harmed country may hold an auction for retaliation of this size. GATT/WTO rules further provide that the retaliation must later be removed if the original violation is later removed, and so more generally we may think of the harmed country as auctioning the per-period rental of the right to retaliate.

¹³As shown just below, the assumption of a single retaliation good enables us to analyze a simple model in which positive externalities arise across bidders. An alternative model would allow that both foreign countries import goods 1 and 2 from Home but that only foreign country 1 (2) has import-competing firms that supply good 1 (2). Then, good 1 (2) would be the natural retaliation good for foreign country 1 (2). In this alternative model, positive externalities would still arise across bidders: a retaliatory tariff by foreign country i on good i would lower the world price of this good and thereby benefit consumers of good i in foreign country j while also increasing tariff revenue in foreign country j .

countries, we can regard Δ as an exogenous number that characterizes the extent of permitted retaliation by the winner (if any) of the auction.

We are interested in the case in which any winner of the auction would, in fact, choose to carry out the permitted level of retaliation. Intuitively, we may imagine that Home and the foreign countries have negotiated lower tariffs over time, with the status quo being that each now sets its tariff below its reaction curve. Each foreign country would thus enjoy a small tariff hike, if such a hike did not induce a higher Home tariff on some (unmodeled) good that the foreign country exports to Home.¹⁴ Our focus here is on the auction of retaliation rights, and so we do not put forth a repeated-game model with which to endogenize the status quo tariffs. Using A1, however, we do know that a small retaliation would be carried out if the initial tariffs entail free trade or are politically optimal, for example. More generally, we impose the following assumption:

A3: $\tau_o \geq 0$, $\Delta > 0$ and $\tau_o + \Delta < 1/6$.

This assumption implies that $\tau_o + \Delta$ is always below each foreign country's reaction curve, since under A1 we have that $1/6 \leq \zeta^j/6 = \min_{\tau^i} \tau_R^j(\tau^i)$. Thus, under A1 and A3, when a foreign country wins the right to retaliate, it will exercise this right in full, regardless of the current realization of its political-economy parameter.¹⁵

¹⁴Our model does not provide an efficiency rationale for an agreement between Home and the foreign countries to lower tariffs. First, we do not model the good (or goods) that the foreign countries export to Home. Second, with regard to the good that Home exports, we have assumed that the total export volume is fixed, so that efficiency concerns only the allocation of this volume across foreign countries. As Bagwell and Staiger (1999, 2001, 2002) show, however, in more general settings, efficiency enhancing trade agreements must entail reciprocal tariff reductions. Motivated by this general finding and by the actual nature of trade-policy negotiations, we thus assume that the initial tariffs are below the respective reaction curves, so that each foreign country would carry out a small retaliation.

¹⁵In the context of a larger game in which the status quo tariffs are endogenized, it is natural to associate our model with a later stage that follows the negotiation of the status quo tariffs. After this negotiation is completed, the respective countries may experience political-economy shocks. Such a shock may, for example, motivate Home to violate its agreement. Likewise, the foreign countries receive political-economy shocks that may alter the benefit of a unilateral tariff hike. From this perspective, A3 means that the political-economy parameter for a foreign country would never drop (as compared to its level at the time of the original negotiation) to such an extent that the appeal of a unilateral tariff hike would be lost. This discussion provides some additional context within which to consider our analysis, but we emphasize that such a game would require a separate analysis and is well beyond the reach of the present paper.

3.2. Payoffs

From foreign country j 's perspective, there are three possible outcomes: it may “win” the auction, in which case $\tau^j = \tau_o + \Delta$ and $\tau^i = \tau_o$; it may “lose” the auction to foreign country i , in which case $\tau^j = \tau_o$ and $\tau^i = \tau_o + \Delta$; or it may be that “nothing” happens (no country wins the auction), in which case $\tau^j = \tau^i = \tau_o$. The respective (gross) payoffs to foreign country j from these three outcomes are:

$$\begin{aligned}\omega(\zeta^j) &\equiv \widehat{W}^j(\tau_o + \Delta, \tau_o; \zeta^j) \\ \lambda(\zeta^j) &\equiv \widehat{W}^j(\tau_o, \tau_o + \Delta; \zeta^j) \\ \eta(\zeta^j) &\equiv \widehat{W}^j(\tau_o, \tau_o; \zeta^j),\end{aligned}\tag{3.1}$$

where we now explicitly represent the dependence of welfare on the political-economy parameter.

We now characterize these payoffs. Our first claim is that each foreign country prefers retaliation to nothing, whether that country wins or loses.

Lemma 3.1: $\omega(\zeta^j) > \eta(\zeta^j)$ and $\lambda(\zeta^j) > \eta(\zeta^j)$.

Proof: We find that

$$\begin{aligned}\omega(\zeta^j) - \eta(\zeta^j) &= \widehat{W}^j(\tau_o + \Delta, \tau_o; \zeta^j) - \widehat{W}^j(\tau_o, \tau_o; \zeta^j) \\ &= \frac{\Delta}{8} \{\zeta^j - 4\tau_o - 3\Delta\} > 0,\end{aligned}\tag{3.2}$$

where the inequality uses A1 ($\zeta^j \geq 1$) and A3 ($\Delta > 0, \tau_o + \Delta < 1/6$).

Likewise, we find that

$$\begin{aligned}\lambda(\zeta^j) - \eta(\zeta^j) &= \widehat{W}^j(\tau_o, \tau_o + \Delta; \zeta^j) - \widehat{W}^j(\tau_o, \tau_o; \zeta^j) \\ &= \frac{\Delta}{8} \{4\tau_o + 2 - \zeta^j + \Delta\} > 0,\end{aligned}\tag{3.3}$$

where the inequality uses A1 ($\zeta^j \leq 2$) and A3 ($\tau_o \geq 0, \Delta > 0$). **Q.E.D.**

Intuitively, provided that some foreign country wins the auction, retaliation will occur and the resulting reduction in the world price affords a terms-of-trade benefit to both foreign countries. The political-economy parameter cannot be too small (i.e., we use $\zeta^j \geq 1$), else the winning country might prefer the lower local price that comes with no retaliation; and the political-economy parameter also

cannot be too large (i.e., we use $\zeta^j \leq 2$), else the losing country might prefer no retaliation to the low local price that occurs upon losing and thus absorbing diverted trade volume. Under A1 and A3, however, there is no ambiguity: the foreign countries agree that someone should retaliate.

But might there be a free-riding problem? This seems plausible if a foreign country would rather lose than win. In this case, retaliation has the aspect of a public good among the foreign countries. Intuitively, whether a foreign country wins or loses, it obtains the benefit of a lower world price. The difference between the two outcomes rests with the local price. If foreign country j wins, then it imposes the retaliatory tariff and obtains a higher local price; whereas, if foreign country j loses, then it absorbs diverted trade volume, and its local price thus drops. Given that the world price is the same in either outcome, the comparison thus boils down to whether foreign country j prefers the higher local price that comes with winning or the lower local price that comes with losing. Now, foreign country j 's preferred local price comes about when its tariff is set at its politically optimal level, τ_{PO}^j . This discussion thus suggests that foreign country j prefers to win rather than lose if $\tau_o + \Delta$ is “closer” to τ_{PO}^j than is τ_o .

We now report our formal finding and then return to confirm its relationship to the intuitive discussion just presented.

Lemma 3.2: Let $\zeta_c \in (1, 2)$ be defined by

$$\zeta_c = 4[\tau_o + \frac{\Delta}{2}] + 1. \quad (3.4)$$

Then $\text{sign}\{\omega(\zeta^j) - \lambda(\zeta^j)\} = \text{sign}\{\zeta^j - \zeta_c\}$.

Proof: To establish this result, we use (3.2) and (3.3) and observe that

$$\frac{\omega(\zeta^j) - \lambda(\zeta^j)}{\Delta} = \frac{\zeta^j - 1}{4} - (\tau_o + \frac{\Delta}{2}). \quad (3.5)$$

The lemma now follows by simple rearrangement. **Q.E.D.**

We now consider further the relationship of this finding to the informal discussion above. We observe that τ_o is “closer” to τ_{PO}^j than is $\tau_o + \Delta$ when $\tau_{PO}^j - \tau_o < \tau_o + \Delta - \tau_{PO}^j$, which by (2.11) is in turn true if and only if $\zeta^j < \zeta_c$. Thus, our informal discussion indicates that when $\zeta^j < \zeta_c$, foreign country j would rather lose (select τ_o) than win (select $\tau_o + \Delta$). But of course this is just what our formal lemma says as well.

We now consider the relationships between the three payoffs in some further detail. Using (2.9) and (3.1), it is straightforward to confirm the following:

Lemma 3.3: The slopes of $\omega(\zeta^j)$, $\lambda(\zeta^j)$ and $\eta(\zeta^j)$ are positive and satisfy

$$\omega'(\zeta^j) = \frac{1 + \Delta}{8} > \eta'(\zeta^j) = \frac{1}{8} > \lambda'(\zeta^j) = \frac{1 - \Delta}{8}. \quad (3.6)$$

This lemma is illustrated in Figure 3 and captures a simple idea. When the foreign country wins, its local price is higher, and so its import-competing industry earns greater profit. This is especially valuable when the government places a greater welfare weight on these profits. Thus, $\omega(\zeta^j)$ increases swiftly with the political-economy parameter. By contrast, when the foreign country loses, the resulting reduction in the local price works to reduce profit in the import-competing industry and is thus particularly painful when the political-economy parameter is large. It follows that $\lambda(\zeta^j)$ increases slowly with the political-economy parameter. Finally, if no retaliation occurs, then the foreign country's payoff rises with the political-economy parameter at an intermediate speed, corresponding to the direct effect of a higher weight on profit.

The basic auction is an auction with positive externalities: by Lemma 3.1, any foreign country j prefers that foreign country i win the auction to the situation in which neither foreign country wins the auction (i.e., $\lambda(\zeta^j) > \eta(\zeta^j)$). This is because retaliation is a public good among the foreign countries. As we show in the next section, the presence of a positive externality across bidders has interesting implications for equilibrium bids and revenue.

4. The Basic Auction: Equilibrium Bids

In this section, we characterize the *symmetric (Bayes-Nash) equilibria* of the basic auction. Such an equilibrium is described by a bidding function, $b(\zeta^j)$, that maps from $[1, 2]$ into $\{N\} \cup [b_o, \infty)$. We begin by characterizing the necessary properties of a symmetric equilibrium. In the Appendix, we state and prove these properties through a series of lemmas. For expositional ease, in the text below, we offer an informal description of the main findings. With the necessary properties identified, we then establish the existence of a unique symmetric equilibrium.

Throughout, we maintain the assumption that b_o is sufficiently small:

A4: $\omega(2) - b_o > \lambda(2)$.

This assumption ensures that the net benefit of winning exceeds that of losing, at least for the highest type. Of course, A4 is satisfied when $b_o = 0$. We observe further that $\omega(1) - b_o > \eta(1)$ is sufficient for A4.¹⁶

Our analysis of the necessary properties of a symmetric equilibrium starts with two basic findings. The first finding is that the equilibrium bidding function must be “monotonic.” Specifically, in any symmetric equilibrium, if a type bids (i.e., does not select N), then any higher type must bid, too, and in fact the higher type must choose a weakly higher bid. The second finding is that “auction failure” is a feature of any symmetric equilibrium. In other words, in any symmetric equilibrium, the probability that any foreign country j does not bid (i.e., selects N) is greater than zero. It is thus possible that the auction will fail, in the sense that no foreign country makes a bid. This result holds even if $b_o = 0$. To see the intuition, suppose instead that all types bid. Foreign country j would then win with positive probability even when its type is low. Further, if foreign country j were to deviate and not bid (i.e., free ride), then it would enjoy the payoffs from losing (i.e., $\lambda(\zeta^j)$), since the other foreign country is sure to bid and thus win. But foreign country j would gain from such a deviation if its type were sufficiently low, because it then prefers losing to winning.

With these two basic findings in place, we next provide three further characterizations of symmetric equilibria. We first show that there must exist a critical low type $\zeta_L \in (1, 2)$ such that types below ζ_L do not bid while types above ζ_L do bid. Second, we characterize the form of the bidding function for types above ζ_L . We show that there must exist a critical high type $\zeta_H \in (\zeta_L, 2)$ such that the intermediate types pool at the reserve bid b_o (i.e., $b(\zeta^j) = b_o$ for all $\zeta^j \in (\zeta_L, \zeta_H)$) while types above ζ_H bid above the reserve bid. Finally, we further characterize the bidding behavior of the highest types. We show that the critical high type ζ_H joins the pool at the reserve bid (i.e., $b(\zeta_H) = b_o$) and that the bidding function rises continuously and strictly as the type rises above ζ_H .

At an intuitive level, the first and third characterizations are easily understood. The first characterization builds naturally from the monotonicity and auction-failure findings just described. The third characterization reflects the insight that higher types prefer winning to losing and thus bid aggressively. Over the range of higher types, the equilibrium bidding function is thus strictly increasing, just as it is in a standard first-price auction.

The second characterization is more subtle and reflects the following logic.

¹⁶If $\omega(1) - b_o > \eta(1)$, then using (3.5) and (3.2) we have $\omega(2) - \lambda(2) - b_o > (\omega(2) - \lambda(2)) - (\omega(1) - \eta(1)) = \frac{\Delta}{2} \{ \frac{1}{4} - \tau_o - \frac{\Delta}{4} \} > 0$.

First, we show that it is not possible for an interval of types to pool at any $\tilde{b} > b_o$. If such a pooling bid were posited, then all types on that interval could not be indifferent between winning and losing; thus, there would exist some type that prefers to deviate to a slightly higher or lower bid. By contrast, pooling at b_o is possible, since a slightly lower bid is then not possible. Second, we show that an interval of types, beginning at ζ_L , *must* pool at the bid b_o . Intuitively, if b were strictly increasing over $(\zeta_L, 2]$, then it would be necessary that type ζ_L is indifferent between bidding b_o and not bidding: $\omega(\zeta_L) - b_o = \eta(\zeta_L)$. But this implies that $\omega(\zeta_L) - b_o < \lambda(\zeta_L)$, and so types just above ζ_L would gain from deviating to a lower bid (such as b_o), since they then benefit by losing more often (and paying less when winning). Third, we show that the highest types are unwilling to pool at b_o , since under A4 such types would gain from deviating to a higher bid and winning more often.

The next step is to characterize the critical values, ζ_L and ζ_H , in terms of the parameters of the model. We show that $\zeta_H = \bar{\zeta}(b_o)$ and $\zeta_L = \tilde{\zeta}(b_o)$ in any symmetric equilibrium, where $\bar{\zeta}(b_o)$ and $\tilde{\zeta}(b_o)$ are defined as follows. The value $\bar{\zeta}(b_o)$ is defined as the solution to

$$\omega(\zeta^j) - \lambda(\zeta^j) = b_o. \quad (4.1)$$

Using (3.5) and A4, we may confirm that $\bar{\zeta}(b_o) = 1 + 4\tau_o + 2\Delta + \frac{4}{\Delta}b_o \in (1, 2)$. Given $\bar{\zeta} = \bar{\zeta}(b_o)$, we define $\tilde{\zeta}(b_o)$ as the solution to

$$(F(\bar{\zeta}) - F(\zeta^j)) \left[\frac{\lambda(\zeta^j) - (\omega(\zeta^j) - b_o)}{2} \right] = F(\zeta^j) [\omega(\zeta^j) - b_o - \eta(\zeta^j)]. \quad (4.2)$$

Using (3.6), (4.1) and A4, we may confirm that $\tilde{\zeta}(b_o)$ is uniquely defined, $\tilde{\zeta}(b_o) \in (1, \bar{\zeta}(b_o))$ and $\frac{d\tilde{\zeta}}{db_o} > 0$.¹⁷

To complete our characterization of the necessary features of a symmetric equilibrium, we derive the form that the bidding function takes over $\zeta^j \in [\zeta_H, 2]$. Fortunately, over this range of types, standard tools from auction theory can be used to derive the bidding function. Recalling that $\zeta_H = \bar{\zeta}$, we establish that, in any symmetric equilibrium, when foreign country j has type $\zeta^j \in [\bar{\zeta}, 2]$, it bids

$$b(\zeta^j) = \omega(\zeta^j) - \lambda(\zeta^j) - \frac{\Delta}{4} \frac{1}{F(\zeta^j)} \int_{\bar{\zeta}}^{\zeta^j} F(x) dx. \quad (4.3)$$

¹⁷For further details concerning these calculations, see Bagwell, Mavroidis and Staiger, 2003.

Intuitively, a bidder in a first-price auction “shades” the bid relative to the true valuation, where in the present context the bidder’s valuation over the range of focus corresponds to the value of winning relative to losing, $\omega(\zeta^j) - \lambda(\zeta^j)$.

We may now summarize the various findings above into a single proposition that states the necessary properties of a symmetric equilibrium:

Proposition 4.1: In any symmetric equilibrium,

- (i). for all $\zeta^j \in [1, \tilde{\zeta})$, $b(\zeta^j) = N$,
- (ii). for all $\zeta^j \in (\tilde{\zeta}, \bar{\zeta}]$, $b(\zeta^j) = b_o$, and
- (iii). for all $\zeta^j \in (\bar{\zeta}, 2]$, $b(\zeta^j)$ is strictly increasing and given by (4.3).

The values $\tilde{\zeta}$ and $\bar{\zeta}$ depend upon b_o and are defined by (4.2) and (4.1). They satisfy $\bar{\zeta} \in (1, 2)$ and $\tilde{\zeta} \in (1, \bar{\zeta})$.

Figure 4 illustrates the bidding function.

With the necessary features established, we now confirm that the stated bidding function indeed constitutes a symmetric equilibrium.

Proposition 4.2: The bidding function defined in Proposition 4.1 constitutes a symmetric equilibrium.

The proof is provided in the Appendix.

Together, Propositions 4.1 and 4.2 indicate that we have now characterized the unique symmetric equilibrium for our basic auction. Summarizing:

Corollary 4.1: For the basic auction, there exists a unique symmetric equilibrium. In this equilibrium, the governments of the foreign countries use the bidding function defined in Proposition 4.1.

In auctions without externalities, the first-price auction is allocatively efficient: the bidding function is strictly increasing, and so the highest-valuation bidder always obtains the item. In the setting considered here, however, positive externalities exist. We find that a first-price auction then no longer ensures that retaliation is efficiently allocated: auction failure may result, so that no bidder wins the right to retaliate; and even when bidding occurs, it may be that both foreign countries bid at the reserve price and the right of retaliation is misallocated. On the other hand, when at least one foreign country has a high political-economy parameter, then bidding is more aggressive and the auction allocates retaliation across the foreign countries in an efficient manner.

5. The Extended Auction: Definition and Payoffs

As discussed in the Introduction, an extended auction may facilitate a credible cash payment from Home (the violating country) to the seller (the harmed country). In this section, we begin our analysis of the extended auction. In particular, we define and interpret the extended auction, and we also characterize Home's payoffs for the extended auction. The equilibrium bids and expected revenue for the extended auction are analyzed in the subsequent section.

5.1. Definition

We now consider an *extended auction*, in which Home can bid to retire the right of retaliation. In particular, Home places a bid at the same time that the foreign countries make their respective bids, where the space of possible bids for each country is $\{N\} \cup [b_o, \infty)$. If no country bids at or above b_o , then no retaliation occurs and no auction revenue is received. If some country does bid b_o or more, then the highest bidder wins the auction. In the event of a tie, the auction treats foreign countries symmetrically, but we will allow that Home may be treated differently than the foreign countries. For example, Home may win all ties.¹⁸ In the event that Home wins, the right of retaliation is retired, and Home transfers its bid to the seller. By contrast, if a foreign country wins the auction, then, as in the basic auction, the winning foreign country retaliates and transfers its bid to the seller. To keep our analysis tractable, we assume that Home's political-economy type is publicly known and constant at some value $\zeta^h \in [1, 2]$. As in the basic auction, the foreign countries' respective types are privately known.

5.2. Payoffs

The payoffs to the foreign countries are defined as in the basic auction. We focus here on Home's payoff under the different outcomes (retaliation, no retaliation).

If Home does not face retaliation (whether because both foreign countries select N or Home bids more), we may use (2.4) to derive that the equilibrium world price is $\tilde{P}_{NR}^w \equiv \tilde{P}^w(\tau_o, \tau_o) = \frac{1}{2} - \tau_o$. Likewise, if Home does face retaliation, then the equilibrium world price is $\tilde{P}_R^w \equiv \tilde{P}^w(\tau_o + \Delta, \tau_o) = \frac{1}{2} - \tau_o - \frac{\Delta}{2}$. Now recall from

¹⁸Our results hold as well under the requirement that Home and foreign countries are treated symmetrically when ties occur. By allowing that Home is treated differently in ties, we are able to state a simple specification for equilibrium strategies.

(2.10) that Home's welfare is $W(\tilde{P}^w) = \zeta^h(1/2)\tilde{P}^w$, where $\zeta^h \in [1, 2]$ under A2. Thus, Home's (gross) payoff under no retaliation and retaliation is given as

$$W_{NR} \equiv \zeta^h(1/2)\tilde{P}_{NR}^w = \zeta^h(1/2)(\frac{1}{2} - \tau_o). \quad (5.1)$$

$$W_R \equiv \zeta^h(1/2)\tilde{P}_R^w = \zeta^h(1/2)(\frac{1}{2} - \tau_o - \frac{\Delta}{2}). \quad (5.2)$$

Using (5.1) and (5.2), we may thus define Home's "valuation" of no retaliation as

$$W_{NR} - W_R = \zeta^h \frac{\Delta}{4}. \quad (5.3)$$

We now recall A4, which ensures that the reserve bid is small relative to the value that a foreign country of the highest type places on winning versus losing. We now show that A4 also has implications for Home's willingness to bid.

Lemma 5.1: For any $\zeta^h \geq 1$, $W_{NR} - W_R > \omega(2) - \eta(2) > \omega(2) - \lambda(2) > b_o$.

Proof: Using (5.3), we find that

$$\begin{aligned} W_{NR} - W_R &= \zeta^h \frac{\Delta}{4} \geq \frac{\Delta}{4} > \frac{\Delta}{4} - \frac{\Delta}{8}[4\tau_o + 3\Delta] \\ &= \omega(2) - \eta(2) > \omega(2) - \lambda(2) > b_o, \end{aligned} \quad (5.4)$$

where the first inequality uses A2 ($\zeta^h \geq 1$), the second inequality uses A3, the subsequent equality uses (3.2), the next inequality uses (3.3), and the final inequality uses A4. **Q.E.D.**

As we will show, this lemma ensures that Home has the greatest incentive to win the auction. Intuitively, Home receives all of the cost of a reduction in the world price, while each foreign country enjoys only a share of the benefit.

A novel feature of our extended auction is that both positive and negative externalities are present. As in the basic auction, a positive externality arises across foreign countries: each foreign country prefers that the other foreign country win to the possibility that neither foreign country wins (i.e., $\lambda(\zeta^j) > \eta(\zeta^j)$). In the extended auction, however, Home is also a bidder, and a negative externality arises between Home and the foreign countries: Home prefers that no country win to the possibility that a foreign country wins, since retaliation is avoided only in the former case (i.e., $W_{NR} > W_R$).

6. The Extended Auction: Equilibrium Bids and Revenue

We again look for *symmetric equilibria*, where symmetry in the extended auction means that foreign countries adopt symmetric strategies. Home may adopt an asymmetric strategy, and recall, too, that the extended auction may treat Home differently than the foreign countries, in the event that Home ties with one or both foreign countries. As above, we focus on pure-strategy equilibria. Let $b^h \in \{N\} \cup [b_o, \infty)$ denote Home's bid.

Our first step is to determine whether a symmetric equilibrium exists in which Home *always loses* (i.e., a foreign country wins the right of retaliation with probability one). Our result is as follows:

Lemma 6.1: In any symmetric equilibrium of the extended auction, if b_o is sufficiently close to zero, then $b^h \neq N$ and Home cannot always lose.

Proof: Assume to the contrary that $b^h = N$. The foreign countries then bid as characterized above for the basic auction. Home's payoff from $b^h = N$ is thus $F^2(\tilde{\zeta})W_{NR} + [1 - F^2(\tilde{\zeta})]W_R$. If Home were to deviate and bid $b_o + \epsilon$, for $\epsilon > 0$ and small, then Home's payoff would be $F^2(\bar{\zeta})[W_{NR} - b_o] + [1 - F^2(\bar{\zeta})]W_R$, approximately. Thus, using (5.3), Home does better by deviating if and only if $[1 - \frac{F^2(\tilde{\zeta})}{F^2(\bar{\zeta})}][\zeta^H \frac{\Delta}{4}] > b_o$. Since $\bar{\zeta} > \tilde{\zeta}$ and $\zeta^h \frac{\Delta}{4} > b_o$ (by (5.4)), this inequality holds when b_o is sufficiently close to zero.

Next, we suppose that $b^h \neq N$ and yet Home always loses. This is possible only if $b^h \geq b_o$ and $b(\zeta^j) \geq b^h$ for all $\zeta^j \in [1, 2]$. In that event, though, a foreign country with type close to 1 wins with positive probability and would do better by deviating to N . The other foreign country would then win with probability one, and so the deviating foreign country would enjoy the payoff $\lambda(\zeta^j)$, which exceeds the value of the weighted sum of $\omega(\zeta^j) - b(\zeta^j)$ and $\lambda(\zeta^j)$ that it receives in the putative equilibrium.¹⁹ **Q.E.D.**

It is tempting to conjecture that this lemma holds for any b_o . One might argue that, if a foreign country is willing to bid, then surely Home would be willing to bid more. After all, as Lemma 5.1 establishes, Home gets more from stopping retaliation than any foreign country gains from having retaliation occur (whether as a winner or a loser). This argument, however, is incomplete, as it ignores the

¹⁹For further details, see the proof of Lemma 4.2 in the Appendix, where an analogous argument is made.

fact that Home may enjoy no retaliation even when not bidding. This happens when the foreign countries get stuck in an auction failure. Thus, it is not obvious that Home would always outbid the lowest type of foreign country. We show in the lemma, however, that Home will certainly do so if b_o is sufficiently small.

Our second step is to consider whether symmetric equilibria exist in which Home *always wins* (i.e., a foreign country wins the right to retaliate with probability zero). In fact, it is simple to construct equilibria of this kind.

Lemma 6.2: There exist symmetric equilibria of the extended auction in which Home always wins. One set of such equilibria is specified as follows:

$$\begin{aligned} b^h &\in [\omega(2) - \eta(2), \zeta^h \frac{\Delta}{4}] \\ b(\zeta^j) &= b^h, \text{ for all } \zeta^j \in [1, 2] \\ &\text{Home wins all ties.} \end{aligned} \tag{6.1}$$

In any equilibrium in which Home always wins, $b^h \in [\omega(2) - \eta(2), \zeta^h \frac{\Delta}{4}]$.

Proof: We begin by establishing existence. Consider Home. A higher bid is clearly not an attractive deviation. A lower bid is also an unattractive deviation. Such a bid ensures certain retaliation, which implies a loss for Home since $W_{NR} - b_h \geq W_{NR} - \zeta^h \frac{\Delta}{4} = W_R$. Consider next a foreign country. Of course, such a country is unable to gain from a lower bid, since then it would only continue to lose. A higher bid would be most attractive to a foreign country of type $\zeta^j = 2$. But if this type were to bid $b^h + \epsilon$, for $\epsilon > 0$ and small, then its payoff would be $\omega(2) - (b^h + \epsilon) < \omega(2) - b^h \leq \omega(2) - [\omega(2) - \eta(2)] = \eta(2)$, and so the deviation is less attractive than bidding b^h and losing to Home. Thus, the strategies specified in (6.1) constitute a symmetric equilibrium for the extended auction.

Next, we establish that any such equilibrium must have $b^h \in [\omega(2) - \eta(2), \zeta^h \frac{\Delta}{4}]$. Suppose Home always wins and $b^h < \omega(2) - \eta(2)$. Then when a foreign country has a type near 2, it would gain by deviating to $b^h + \epsilon$, for ϵ positive and small, as it thereby receives approximately $\omega(2) - b^h > \eta(2)$. Suppose next that Home always wins and $b^h > \zeta^h \frac{\Delta}{4}$. Then $W_{NR} - b^h < W_{NR} - \zeta^h \frac{\Delta}{4} = W_R$, and so Home would gain by deviating and selecting N , as it then either enjoys W_{NR} (in the event of auction failure) or W_R . **Q.E.D.**

An attractive feature of the specification in Lemma 6.2 is that the associated symmetric equilibrium exists without any further assumptions on the parameters

of the model. A potential objection to this specification, however, is that the foreign countries use dominated strategies. In particular, for a foreign country of type ζ^j , any bid b such that $b > \max\{\omega(\zeta^j) - \eta(\zeta^j), b_o\}$ is dominated by the alternative strategy of selecting N .²⁰ Thus, the specification used in (6.1) involves the use of a dominated strategy by all types of foreign country other than the type $\zeta^j = 2$.

This objection raises the issue of whether an equilibrium can be established without the use of dominated strategies. Home will resist cutting its bid from b^h if enough foreign types bid at or near b^h . Intuitively, when $b^h < \zeta^h \frac{\Delta}{4}$, a lower bid generates a higher Home payoff when Home wins, but reduces Home's payoff when Home loses. Thus, if Home faces a sufficient probability of losing when it shades its bid, then Home will not shade. For this to be true, it is not necessary that the foreign country types all bid b^h . It is necessary only that the probability is sufficiently high that a foreign country bid will fall at or just below b^h .

Fortunately, for a wide range of parameters, it is possible to construct symmetric equilibria in which Home always wins and foreign countries do not use dominated strategies. To illustrate, suppose b_o is small and consider the following specification: $b^h = \omega(2) - \eta(2)$ and $b(\zeta^j) = \omega(\zeta^j) - \eta(\zeta^j)$ for all $\zeta^j \in [1, 2]$. Under this specification, we can show that Home will resist cutting its bid from b^h if two conditions hold: (A) $F''(\zeta^j)F(\zeta^j) < 3(F'(\zeta^j))^2$ for all $\zeta^j \in (1, 2]$, and (B) $1/F'(2) \leq 4(\zeta^h - 1) + 8\tau_o + 6\Delta$.²¹ Condition A is implied if $F(\zeta^j)$ is log-concave and thus holds for many popular distributions. For example, it holds if $F(\zeta^j) = (\zeta^j - 1)^\alpha$ for any $\alpha > 0$. This family of power distributions includes the uniform distribution ($\alpha = 1$), convex distributions ($\alpha > 1$) and concave distributions ($\alpha < 1$). Condition A ensures that Home will not find a large bid reduction attractive, if it does not gain from a slight cut in its bid. Condition B then ensures that Home will not gain by shading its bid a slight amount. The latter condition is more restrictive, and it is more likely to hold when $F'(2)$ and ζ^h are

²⁰The selection of N yields payoff $\eta(\zeta^j)$ or $\lambda(\zeta^j)$, depending upon whether the other foreign country wins. The bid of b yields payoff $\omega(\zeta^j) - b < \eta(\zeta^j) < \lambda(\zeta^j)$ when b is the winning bid, yields the payoff $\lambda(\zeta^j)$ when the other foreign country wins, and yields the payoff $\eta(\zeta^j)$ otherwise. Thus, the strategy of selecting N yields a greater payoff than the strategy of selecting b whenever b would be the winning bid, and the strategy of selecting N yields the same payoff as the strategy of selecting b whenever b would not be the winning bid.

²¹Details are available from the authors upon request. The conclusions developed here also apply if the foreign bidding function is made slightly steeper while satisfying $b(2) = \omega(2) - \eta(2)$. For $\zeta^j < 2$, a winning bid by foreign country j could then provide a strictly higher payoff than not bidding.

large. Intuitively, Home is deterred from shading its bid slightly, if doing so would significantly increase its probability of losing (i.e., $F'(2)$ is large) and losing would be quite costly (i.e., ζ^h is large). If $F(\zeta^j)$ is a power distribution, then $F'(2) = \alpha$, and so Condition B is sure to hold if α is sufficiently large. Likewise, if $F(\zeta^j)$ is a power distribution and $\alpha \geq 1/4$, then Condition B must hold if $\zeta^h \in [\frac{1}{4\alpha} + 1, 2]$. Conditions A and B are thus satisfied in the case of a uniform distribution when A2 is strengthened slightly so that $\zeta^h \in [\frac{5}{4}, 2]$.

At the same time, it must be noted that it is sometimes impossible to construct a symmetric equilibrium in which Home always wins and foreign countries do not use dominated strategies. As we establish in Bagwell, Mavroidis and Staiger (2003), if the foreign countries do not use dominated strategies and $F'(2) < 3/16$, then there does not exist a symmetric equilibrium in which Home always wins. Intuitively, it is impossible to stop Home from slightly reducing its bid from $b^h = \omega(2) - \eta(2)$, if it is unlikely that a foreign country bids at or just below b^h . In turn, if there aren't too many foreign country types that are high (i.e., if $F'(2)$ is small) and if foreign countries do not use dominated strategies, then it is unlikely that a foreign country bids at or just below b^h .

For distribution functions that place sufficiently little weight on the highest types, the requirement that dominated strategies not be used can have important existence implications. As just noted, for such distributions, this requirement can preclude the existence of symmetric equilibria in which Home always wins. We show above that, when b_o is small, symmetric equilibria do not exist in which Home always loses, and we establish just below that symmetric equilibria then also fail to exist in which Home *sometimes wins* (i.e., a foreign country wins the right to retaliate with probability between zero and one). If a symmetric equilibrium exists when b_o is small, then it must involve Home always winning. Thus, if the distribution function is such that the highest types occur with very low probability, then existence of a symmetric equilibrium is not assured unless we allow that dominated strategies may be used.^{22,23}

²²Related issues arise in other games. Consider a Bertrand pricing game, in which firm 1's constant unit cost is known to take value 1 while firm 2's constant unit cost is distributed over $[1, 2]$. In any Nash equilibrium, firm 1 sets its price equal to 1 and wins all ties, while all types of firm 2 also select the price of 1 and lose the tie. (It can be shown that this conclusion holds also when it is allowed that firm 1 can use mixed strategies.) With the exception of the type for which cost equals 1, all types of firm 2 then use a dominated strategy. This equilibrium is analogous to that described in (6.1) for the auction game considered here.

²³Interestingly, the existence problem is absent in a second-price auction. In that case, if $b^h \geq \omega(2) - \eta(2)$ and $b(\zeta^j) = \omega(\zeta^j) - \eta(\zeta^j)$ for all $\zeta^j \in [1, 2]$, then Home has no incentive to

We now move to our third step and consider whether symmetric equilibria exist in which Home sometimes wins. Our finding is as follows:

Lemma 6.3: In any symmetric equilibrium of the extended auction, if b_o is sufficiently close to zero, then Home cannot sometimes win.

The proof is in the Appendix. We sketch here the basic argument, which involves three steps. First, we show that it is impossible to have a pooling region over which foreign countries sometimes or always win, given that Home is allowed to bid in the extended auction. Second, we show that Home sometimes wins only if there exists $\hat{\zeta} \in (1, 2)$ such that $b(\hat{\zeta}) = b^h$ and, for all $\zeta^j > \hat{\zeta}$, $b(\zeta^j) > b^h$ and b is strictly increasing. Third, we exploit the following tension. On the one hand, type $\hat{\zeta}$ (perhaps plus ϵ) has the option of mimicking lower types, and so must be indifferent between beating Home and not, indicating a relationship between $\omega(\hat{\zeta})$ and $\eta(\hat{\zeta})$. On the other hand, type $\hat{\zeta}$ has the option of mimicking higher types, and so must be indifferent between bidding its equilibrium bid and that assigned to a slightly higher type, indicating a relationship between $\omega(\hat{\zeta})$ and $\lambda(\hat{\zeta})$. In our basic auction, this tension is resolved with a pooling region at b_o . But in the extended auction, as established in the first step, we cannot have a pooling region over which foreign countries sometimes or always win. A contradiction is thus suggested.

We may now use Lemmas 6.1, 6.2 and 6.3 to conclude as follows:

Proposition 6.1: In any symmetric equilibrium of the extended auction, if b_o is sufficiently close to zero, then Home always wins and bids $b^h \in [\omega(2) - \eta(2), \zeta^h \frac{\Delta}{4}]$. Furthermore, the resulting expected revenue is strictly greater than in the equilibrium outcome that occurs in the basic auction (as described in Propositions 4.1 and 4.2).

shade its bid. In particular, a bid below $\omega(2) - \eta(2)$ would reduce Home's probability of winning and would not reduce the bid that it would pay in states where it wins. First- and second-price auctions are both interesting formats in which to study tradeable retaliation rights. These formats are of independent interest even in auctions without externalities, as they generate different expected revenues and payoffs once it is allowed that bidders may be risk averse, asymmetric or budget constrained. We focus here on first-price auctions for two main reasons. First, first-price auctions are more commonly used. Second, as Klemperer (2004) emphasizes, in terms of practical auction design, first-price auctions offer some important potential advantages: bidder collusion is very easy to enforce in second-price auctions (see also Robinson, 1985), and second-price auctions may discourage entry by bidders relative to first-price auctions.

Proof: We need only confirm that expected revenue is higher in any symmetric equilibrium of the extended auction than in the symmetric equilibrium outcome of the basic auction. This is trivial to see. When Home is allowed to bid, Home always wins and the seller thus *always* gets $b^h \geq \omega(2) - \eta(2)$. By contrast, in the basic auction wherein Home does not bid, the seller *sometimes* (i.e., when there is no auction failure) gets

$$b(\zeta^j) \leq b(2) = \omega(2) - \lambda(2) - \frac{\Delta}{4} \int_{\bar{\zeta}}^2 F(x) dx < \omega(2) - \lambda(2) < \omega(2) - \eta(2).$$

Thus, expected revenue is clearly higher when Home bids. **Q.E.D.**

The expected-revenue result is of particular importance. Intuitively, when b_o is small so that Home is sure to bid, expected revenue rises relative to that achieved in the basic auction, because (i) auction failure is avoided, *and* (ii) Home bids more than would any foreign country were Home not allowed to bid.

7. Policy: Revenue, Compliance and Efficiency Criteria

In this section, we present our normative analysis. As explained in the Introduction, the overall wisdom of a system of tradeable retaliation rights is difficult to assess and hinges on a variety of considerations. We thus are not able to resolve this issue here; however, we are able to provide valuable formal input by rigorously evaluating the pros and cons of two specific structures for auctioning retaliation rights. Specifically, we compare the basic and extended auctions under the criteria of expected revenue, compliance and ex-ante efficiency. We thereby formally explore the normative implications of permitting Home to bid to retire the right of retaliation.

7.1. Revenue

As discussed in the Introduction, in a system with tradeable retaliation rights, the harmed country may receive monetary compensation for its right to suspend; thus, a potential benefit of such a system is that it may facilitate the rebalancing of concessions. When retaliation rights are auctioned, we may associate this benefit with the expected revenue that is enjoyed by the seller. Expected revenue is thus a natural criterion for making normative comparisons across different auction

designs, and we now discuss the implications for expected revenue of permitting Home to bid to retire the right of retaliation.

If the desirability of permitting Home to bid is evaluated on the basis of expected revenue, Proposition 6.1 provides a clear normative conclusion: Home should be permitted to bid to retire the right of retaliation against it. This follows because, as Proposition 6.1 indicates, if b_o is sufficiently small, Home always wins and the seller thus *always* gets $b^h \geq \omega(2) - \eta(2)$. By contrast, in the basic auction, the seller never receives a bid this high, and sometimes receives no bid at all. Therefore, if b_o is sufficiently small, the seller's expected revenue is strictly higher when Home is allowed to bid.

7.2. Compliance

A second potential benefit of a system with tradeable retaliation rights is that the incentive for compliance may be improved. It is an unsettled matter among WTO members and legal scholars whether the central purpose of retaliation within the WTO is in fact to facilitate rebalancing or induce compliance.²⁴ Nevertheless, the differing compliance implications across the basic and extended auctions is bound to be an important feature of auction design regardless of one's position on this matter. We thus next discuss the implications for compliance of permitting Home to bid to retire the right of retaliation.

To assess the compliance implications of the basic and extended auctions, we consider the difference in the expected costs of non-compliance faced by the Home government under each auction. As we have observed, when Home is given the opportunity to bid in the extended auction it always wins and retires the right of retaliation. It might therefore be expected through the logic of revealed preference that the Home government must face higher expected costs of non-compliance under the basic auction where it is not permitted to bid, since in the extended auction Home could always choose not to bid but in fact bids aggressively. However, this reasoning is incomplete because, as our analysis of the extended auction confirms, the foreign governments bid more aggressively when the Home government is present (in the extended auction) than when the Home government is not present (in the basic auction). More specifically, as we have emphasized above, the positive externalities present in the basic auction lead the foreign governments to bid less aggressively than is efficient, and through this lead to the possibility of auction failure. This possibility is eliminated in the extended auction, where

²⁴See, for example, WTO (2004), Jackson (1997) and Sykes (2000).

the foreign governments are induced to bid more aggressively and the Home government always places the winning bid. But from the perspective of the Home government, auction failure is an attractive feature of the basic auction, and since this feature is absent from the extended auction the Home government may prefer the basic auction to the extended auction. In fact, as this discussion suggests, the relative compliance implications of the two auctions hinge critically on the probability of auction failure in the basic auction.

To formalize this observation, we denote by EW_B the expected welfare of the Home government under the basic auction, and by EW_E the expected welfare of the Home government under the extended auction. Observing that $F^2(\tilde{\zeta})$ gives the probability of auction failure in the basic auction, it follows that the expected welfare of the Home government under the basic auction is $EW_B = F^2(\tilde{\zeta})W_{NR} + [1 - F^2(\tilde{\zeta})]W_R$. On the other hand, as Proposition 6.1 demonstrates, in any symmetric equilibrium of the extended auction (for small b_o), Home always wins and bids $b^h \in [\omega(2) - \eta(2), \zeta^h \frac{\Delta}{4}]$. As a consequence, the expected welfare of the Home government under the extended auction is $EW_E = W_{NR} - b^h$. A measure of the difference in the expected costs of non-compliance faced by the Home government under the two auctions is then given by $EW_E - EW_B = [1 - F^2(\tilde{\zeta})](\zeta^h \frac{\Delta}{4}) - b^h$: we may interpret a positive (negative) value of $EW_E - EW_B$ as indicating that the cost of non-compliance to the Home government is higher (lower) under the basic auction than under the extended auction.

It may now be seen that the relative compliance implications of the two auctions hinge critically on the probability of auction failure in the basic auction. In particular, if the probability of auction failure in the basic auction ($F^2(\tilde{\zeta})$) is sufficiently high, then $EW_E - EW_B < 0$ indicating that the cost of non-compliance to the Home government is lower under the basic auction than under the extended auction. Intuitively, by free-riding on the prospect of auction failure, the Home government can expect under the basic auction to get away with non-compliance at relatively little cost in this case. On the other hand, if the probability of auction failure in the basic auction ($F^2(\tilde{\zeta})$) is sufficiently small, then $EW_E - EW_B > 0$ for at least some equilibria of the extended auction, indicating that the cost of non-compliance to the Home government is then higher under the basic auction than under the extended auction (for these equilibria). Intuitively, in this case as the prospect of auction failure is insignificant, the Home government can expect little chance to free ride under the basic auction in any event, and so is not much harmed by the absence of this possibility in the extended auction, where it then enjoys the added possibility of bidding to retire the retaliation right.

If the desirability of permitting Home to bid is evaluated on the basis of compliance, our discussion above then provides a clear normative conclusion (at least for b_o small): Home should not be permitted to bid to retire the right of retaliation against it unless the probability of auction failure in the basic auction is sufficiently high.

7.3. Efficiency

A third potential benefit of a system with tradeable retaliation rights is that such a system may enhance efficiency by appropriately allocating the right of retaliation. We thus next discuss the implications for ex-ante efficiency of permitting Home to bid to retire the right of retaliation, where ex-ante efficiency is measured relative to the objective functions of the affected governments. In choosing between the basic and extended auctions, the affected governments are the Home government, the two foreign governments, and the seller (the harmed government). In our quasi-linear setting, ex-ante efficiency is achieved when the expected joint welfare among the four governments is maximized. We thus adopt as our normative criterion in this subsection the expected joint welfare of the affected governments.

A first observation is that, under this criterion, the expected revenue generated by each auction is irrelevant. This is because the revenue paid by the winning bidder to the seller is a pure transfer from one government to another. Hence, when ex-ante efficiency is the criterion, expected revenue differences cannot be used to select among auction designs. Instead, differences in the allocation of the right of retaliation across auctions becomes the critical feature. Moreover, since the seller is only affected through the expected revenue, we may restrict our measure of joint welfare to the sum of the (gross) welfare levels of the Home and the two foreign governments.

In this regard, it might be thought that any retaliation would reduce efficiency. This perspective suggests that it is desirable under the ex-ante efficiency criterion to permit Home to bid. It must be remembered, however, that we have allowed governments to be motivated by political-economy concerns, and so if a foreign country experiences a sufficiently large political-economy shock it might be efficient to permit that country to raise its tariff level (i.e., retaliate to $\tau_o + \Delta$). Hence, to assess whether the basic auction – which results in retaliation unless there is auction failure – can lead to greater ex-ante efficiency than the extended auction – which never results in retaliation for sufficiently small b_o – we need to derive an expression for the expected joint welfare under each auction.

Consider first the extended auction. For sufficiently small b_o Home always makes the winning bid and retires the retaliation right. Hence, letting EJ_E denote the expected joint welfare under the extended auction, recalling the definition of joint welfare $J(\tau^1, \tau^2)$ for any two tariffs τ^1 and τ^2 , and letting $EJ(\tau_o, \tau_o)$ denote the expected joint welfare when there is no retaliation (i.e., when $\tau^1 \equiv \tau_o$ and $\tau^2 \equiv \tau_o$), we have that, for sufficiently small b_o , $EJ_E = EJ(\tau_o, \tau_o)$.

We now develop an analogous expression for the basic auction. Using (3.2), (3.3) and (5.3), we note that when foreign country 1 wins the right to retaliate, joint welfare is given by $J(\tau_o + \Delta, \tau_o) = J(\tau_o, \tau_o) + [\omega(\zeta^1) - \eta(\zeta^1) + \lambda(\zeta^2) - \eta(\zeta^2) + W_R - W_{NR}]$ and thus

$$J(\tau_o + \Delta, \tau_o) = J(\tau_o, \tau_o) + \frac{\Delta}{8}[2(1 - \zeta^h - \Delta) + (\zeta^1 - \zeta^2)]. \quad (7.1)$$

Similarly, when foreign country 2 wins, joint welfare is given by

$$J(\tau_o, \tau_o + \Delta) = J(\tau_o, \tau_o) + \frac{\Delta}{8}[2(1 - \zeta^h - \Delta) + (\zeta^2 - \zeta^1)]. \quad (7.2)$$

Finally, (7.1) and (7.2) imply that

$$\frac{1}{2}J(\tau_o + \Delta, \tau_o) + \frac{1}{2}J(\tau_o, \tau_o + \Delta) = J(\tau_o, \tau_o) + \frac{\Delta}{8}[2(1 - \zeta^h - \Delta)]. \quad (7.3)$$

Let EJ_B denote the expected joint welfare under the basic auction. Using (7.1), (7.2) and (7.3), and after some manipulation, we find that

$$\begin{aligned} EJ_B = EJ(\tau_o, \tau_o) + \frac{\Delta}{4}\{[1 - F^2(\tilde{\zeta})][1 - \zeta^h - \Delta] \\ + \int_{\tilde{\zeta}}^{\bar{\zeta}} \int_1^{\tilde{\zeta}} (\zeta - \zeta_o) F'(\zeta_o) d\zeta_o F'(\zeta) d\zeta + \int_{\tilde{\zeta}}^2 \int_1^{\zeta} (\zeta - \zeta_o) F'(\zeta_o) d\zeta_o F'(\zeta) d\zeta\}. \end{aligned}$$

Intuitively, the difference between the expected joint welfare under the basic auction (EJ_B) and the expected joint welfare when there is no retaliation ($EJ(\tau_o, \tau_o)$) is composed of the sum of three terms, which can be understood with the help of (7.1)-(7.3). A first term ($[1 - F^2(\tilde{\zeta})][1 - \zeta^h - \Delta]$) represents the “baseline” expected efficiency loss from protection with $\zeta^1 \equiv \zeta^2$. This term is strictly negative, and it appears in (7.1), (7.2) and (7.3), since some foreign country wins the right to retaliate in each expression. The second and third terms are each double integrals,

and these terms represent the expected efficiency gain from allocating retaliation to the high- ζ^i foreign country. These two terms are each strictly positive. The first double integral measures this expected gain when the high- ζ^i foreign country lies in the range $[\tilde{\zeta}, \bar{\zeta}]$ and the low- ζ^i foreign country lies in the range $[1, \tilde{\zeta}]$. Excluded from this double integral is the range of low- ζ^i realizations that lie above $\tilde{\zeta}$ but below the realization of the high- ζ^i foreign country. This is because there is pooling over this region in the basic auction, with each foreign country receiving the right of retaliation with probability $1/2$, and as indicated by (7.3) this pooling region adds no expected efficiency gain from allocating retaliation to the high- ζ^i foreign country. The second double integral measures this expected gain when the high- ζ^i foreign country lies in the range $[\bar{\zeta}, 2]$. There is no pooling in the basic auction when the high- ζ^i foreign country lies in this range, and so the range of low- ζ^i realizations runs from 1 up to the high- ζ^i foreign country realization.

With expressions for the expected joint welfare under the basic and extended auctions given by EJ_B and EJ_E , respectively, we may now state:

Proposition 7.1: If $1 - \zeta^h - \Delta$ is sufficiently close to zero, then $EJ_B > EJ_E$.

Proof: Under A4, $\bar{\zeta} < 2$. The proposition thus follows as a direct consequence of the expressions for EJ_B and EJ_E provided above. **Q.E.D.**

Under our maintained assumptions, this proposition describes a parameter region in which $\zeta^h \in [1, 2]$ is equal to or near unity, $\Delta > 0$ is near zero, and $b_o \geq 0$ is equal to or near zero (so that A4 holds, even though Δ is small). For example, our maintained assumptions and the additional assumption in Proposition 7.1 all hold if $\zeta^h = 1$, $b_o = 0$, and $\Delta > 0$ is sufficiently small.

According to Proposition 7.1, greater ex-ante efficiency is achieved under the basic auction than under the extended auction (for small b_o) if Home's political-economy weight is small (i.e. ζ^h is close to one) and the degree of retaliation being auctioned is small (i.e., Δ close to zero). Under these conditions, the expected benefit of allocating the retaliation right to the foreign country that experiences the biggest political-economy shock outweighs the expected cost imposed on the other two countries, and so expected joint welfare is higher under the basic auction than under the extended auction, where the right of retaliation is surely retired.

If the desirability of permitting Home to bid is evaluated on the basis of ex-ante efficiency, Proposition 7.1 then provides a clear normative conclusion (at least for b_o small): Home should not be permitted to bid to retire the right of retaliation

against it unless the political costs of retaliation against Home (ζ^h) and/or the size of the retaliation (Δ) are sufficiently large.

7.4. Discussion

Based on the above findings, it is evident that the merit of allowing the violating (Home) government to bid to retire the right of retaliation against it depends on the purpose that auctions are expected to serve in the WTO-retaliation setting. If the central purpose of the auction is to facilitate rebalancing by enhancing the ability of harmed countries to collect compensation from violating countries, then the violating government should be allowed to bid and the extended auction is thus preferable to the basic auction. On the other hand, a preference for the basic auction over the extended auction is indicated for the purpose of encouraging compliance with WTO obligations, unless the probability of auction failure in the basic auction is sufficiently great. Likewise, from the perspective of the goal of ex-ante efficiency, permitting the violating government to bid may not be advisable, and indeed the basic auction will be preferable to the extended auction unless the size of retaliation is sufficiently large and/or the violating government suffers a sufficiently great political cost if it faces retaliation. More broadly, these findings indicate the importance of understanding the purpose of introducing auctions in the WTO-retaliation setting for selecting the appropriate features of auction design.²⁵

²⁵A further consideration is how the WTO compensation provisions (see note 12) might alter the relative performance of the basic and extended auctions with respect to the three criteria we have identified. In our working paper (Bagwell, Mavroidis and Staiger, 2003) we show that the preference for the extended auction over the basic auction on the criterion of expected revenue is unaltered by this consideration. Intuitively, when Home can preemptively offer monetary compensation to the harmed country if the latter agrees not to hold a basic auction, Home offers the revenue that the harmed country expects under the basic auction and thereby prevents retaliation. The harmed country would expect a larger payment from Home, however, if an extended auction were used. The relative merits of the basic and extended auctions could be altered by this consideration, however, when the concern is with ex-ante efficiency. More generally, a systematic account of the possible interactions between existing WTO compensation mechanisms and the potential auctioning of WTO retaliatory rights is an important area for further study.

8. Conclusion

We offer a first formal analysis of the possibility that retaliation rights within the WTO system might be allocated through auctions. We focus here on first-price sealed-bid auctions. In our basic auction, two foreign countries bid for the right to retaliate against the home country. The basic auction is characterized by positive externalities, since retaliation by one foreign country improves the terms of trade for the other foreign country. We show that this auction exhibits some unusual properties: the retaliation right may be misallocated across the foreign countries, and it is also possible that auction failure occurs. We then consider an extended auction, in which the home country is also allowed to bid to retire the right of retaliation. The extended auction is again characterized by positive externalities between foreign countries. But the extended auction also features negative externalities, since the home country experiences a negative externality whenever a foreign country wins. In the extended auction, we find that auction failure does not occur; in fact, the home country always wins and the retaliation right is therefore always retired.

We also evaluate the different auction formats from a normative standpoint according to three criteria: compensation/rebalancing, compliance and efficiency. The extended auction generates greater expected revenue for the seller than does the basic auction, and so the extended auction would be preferred under the compensation/rebalancing criterion. On the other hand, the basic auction may be preferred on both efficiency and compliance grounds. As a general matter, our analysis thus suggests that the desirability of key auction design features may hinge on the purpose that auctions are expected to serve in the WTO-retaliation setting.

9. Appendix

Lemma 4.1: (Monotonicity) In any symmetric equilibrium, if $\zeta_B^j > \zeta_S^j$ and $b(\zeta_S^j) \neq N$, then (i). $b(\zeta_B^j) \neq N$ and (ii). $b(\zeta_B^j) \geq b(\zeta_S^j)$.

Proof: To prove this lemma, fix a symmetric equilibrium. Suppose that $\zeta_B^j > \zeta_S^j$ and $b(\zeta_S^j) \neq N$. Let $\rho(\zeta^j)$ denote the probability that foreign country j wins when it bids $b(\zeta^j)$. Let $\mathbf{B} \equiv \text{prob}\{b(\zeta^j) \neq N\}$.

We first show part (i). Given $b(\zeta_S^j) \neq N$, incentive compatibility implies

$$\rho(\zeta_S^j)[\omega(\zeta_S^j) - b(\zeta_S^j)] + (1 - \rho(\zeta_S^j))\lambda(\zeta_S^j) \geq \mathbf{B}\lambda(\zeta_S^j) + (\mathbf{1} - \mathbf{B})\eta(\zeta_S^j), \quad (9.1)$$

which is to say that type ζ_S^j must (weakly) prefer $b(\zeta_S^j)$ to N . Now, suppose to the contrary that $b(\zeta_B^j) = N$. Then type ζ_B^j must (weakly) prefer N to $b(\zeta_S^j)$:

$$\mathbf{B}\lambda(\zeta_B^j) + (\mathbf{1} - \mathbf{B})\eta(\zeta_B^j) \geq \rho(\zeta_S^j)[\omega(\zeta_B^j) - b(\zeta_S^j)] + (1 - \rho(\zeta_S^j))\lambda(\zeta_B^j). \quad (9.2)$$

Adding (9.1) and (9.2) gives

$$\begin{aligned} & \mathbf{B}[\lambda(\zeta_B^j) - \lambda(\zeta_S^j)] + (\mathbf{1} - \mathbf{B})[\eta(\zeta_B^j) - \eta(\zeta_S^j)] \\ & \geq \rho(\zeta_S^j)[\omega(\zeta_B^j) - \omega(\zeta_S^j)] + (1 - \rho(\zeta_S^j))[\lambda(\zeta_B^j) - \lambda(\zeta_S^j)]. \end{aligned} \quad (9.3)$$

Using (3.6), we may rewrite (9.3) as $\mathbf{B}[1 - \Delta] + (\mathbf{1} - \mathbf{B}) \geq \rho(\zeta_S^j)[1 + \Delta] + (1 - \rho(\zeta_S^j))[1 - \Delta]$, which in turn may be simplified as

$$\frac{1 - \mathbf{B}}{2} \geq \rho(\zeta_S^j). \quad (9.4)$$

Now, we also know that

$$\rho(\zeta_S^j) \geq 1 - \mathbf{B}, \quad (9.5)$$

since the probability of winning with $b(\zeta_S^j)$ is at least the probability that the rival foreign country does not bid (in which case a bid of $b(\zeta_S^j)$ certainly wins). Clearly, if $\mathbf{B} < \mathbf{1}$, then (9.4) and (9.5) are contradictory. Finally, if $\mathbf{B} = \mathbf{1}$, so that the set of non-bidding types is of measure zero, then (9.4) and (9.5) imply that type ζ_S^j must lose: $\rho(\zeta_S^j) = 0$. We thus may find a type $\zeta_M^j \in (\zeta_S^j, \zeta_B^j)$ that bids and sometimes wins: $\rho(\zeta_M^j) > 0$. Given that $b(\zeta_M^j) \neq N$, incentive compatibility implies that $\rho(\zeta_M^j)[\omega(\zeta_M^j) - b(\zeta_M^j)] + (1 - \rho(\zeta_M^j))\lambda(\zeta_M^j) \geq \mathbf{B}\lambda(\zeta_M^j) + (\mathbf{1} - \mathbf{B})\eta(\zeta_M^j)$. But $\mathbf{B} = \mathbf{1}$ and (3.6) then imply that $\rho(\zeta_M^j)[\omega(\zeta_B^j) - b(\zeta_M^j)] > \rho(\zeta_M^j)\lambda(\zeta_B^j)$, and thus type ζ_B^j strictly prefers $b(\zeta_M^j)$ to N , which is again a contradiction.

We now prove part (ii). Given that $\zeta_B^j > \zeta_S^j$ and $b(\zeta_S^j) \neq N$, we have from part (i) that $b(\zeta_B^j) \neq N$. Incentive compatibility thus implies

$$\begin{aligned} & \rho(\zeta_B^j)[\omega(\zeta_B^j) - b(\zeta_B^j)] + (1 - \rho(\zeta_B^j))\lambda(\zeta_B^j) \\ & \geq \rho(\zeta_S^j)[\omega(\zeta_B^j) - b(\zeta_S^j)] + (1 - \rho(\zeta_S^j))\lambda(\zeta_B^j), \text{ and} \end{aligned} \quad (9.6)$$

$$\begin{aligned} & \rho(\zeta_S^j)[\omega(\zeta_S^j) - b(\zeta_S^j)] + (1 - \rho(\zeta_S^j))\lambda(\zeta_S^j) \\ & \geq \rho(\zeta_B^j)[\omega(\zeta_S^j) - b(\zeta_B^j)] + (1 - \rho(\zeta_B^j))\lambda(\zeta_S^j). \end{aligned} \quad (9.7)$$

Adding (9.6) and (9.7), we obtain

$$[\rho(\zeta_B^j) - \rho(\zeta_S^j)][\omega(\zeta_B^j) - \lambda(\zeta_B^j)] \geq [\rho(\zeta_B^j) - \rho(\zeta_S^j)][\omega(\zeta_S^j) - \lambda(\zeta_S^j)]. \quad (9.8)$$

Since $\omega - \lambda$ is strictly increasing, it follows from (9.8) that $\rho(\zeta_B^j) \geq \rho(\zeta_S^j)$ and thus, equivalently, that $b(\zeta_B^j) \geq b(\zeta_S^j)$. **Q.E.D.**

Lemma 4.2: (Auction Failure) In any symmetric equilibrium, $\mathbf{B} < 1$, where $\mathbf{B} \equiv \text{prob}\{b(\zeta^j) \neq N\}$.

Proof: Fix a symmetric equilibrium. Suppose $\mathbf{B} = 1$. Let $\rho(\zeta^j)$ denote the probability that a foreign country of type ζ^j wins the auction with the bid $b(\zeta^j)$. By Lemma 4.1, the bid function is (weakly) increasing over the support $[1, 2]$. Consider a small interval I of types just above 1. For any $\zeta^j \in I$, $\rho(\zeta^j) > 0$. Thus, for any $\zeta^j \in I$, a strict gain could be achieved by deviating to N , since $\lambda(\zeta^j) > \rho(\zeta^j)[\omega(\zeta^j) - b(\zeta^j)] + (1 - \rho(\zeta^j))\lambda(\zeta^j)$ follows from $\rho(\zeta^j) > 0$, $\lambda(1) > \omega(1)$, and $b(\zeta^j) \geq b_o \geq 0$. This contradicts $\mathbf{B} = 1$. **Q.E.D.**

Lemma 4.3: In any symmetric equilibrium, there exists $\zeta_L \in (1, 2)$ such that $b(\zeta^j) = N$ for all $\zeta^j < \zeta_L$, and $b(\zeta^j) \neq N$ for all $\zeta^j > \zeta_L$.

Proof: By Lemma 4.2, we know that a positive measure of types do not bid. Using Lemma 4.1, we know further that the set of such types must take the form $[1, \zeta_L)$, since once active bidding begins it continues for all higher types. Thus, $\zeta_L > 1$. Now suppose that $\zeta_L = 2$, so that no types bid ($\mathbf{B} = 0$). In this case, using A4, a foreign country with type near $\zeta^j = 2$ would strictly gain by deviating and bidding b_o , since $\omega(2) - b_o > \lambda(2) > \eta(2)$. **Q.E.D.**

Lemma 4.4: In any symmetric equilibrium, there exists $\zeta_H \in (\zeta_L, 2)$ such that $b(\zeta^j) = b_o$ for all $\zeta^j \in (\zeta_L, \zeta_H)$ and $b(\zeta^j) > b_o$ for $\zeta^j > \zeta_H$.

Proof: We establish the lemma by proving a sequence of claims:

Claim 1: In any symmetric equilibrium, if $2 \geq \zeta_B^j > \zeta_S^j \geq 1$ and $b(\zeta^j) \equiv \tilde{b} \geq b_o$ for all $\zeta^j \in [\zeta_S^j, \zeta_B^j]$, then $\tilde{b} = b_o$.

To prove this claim, we suppose to the contrary that $b(\zeta^j) \equiv \tilde{b} > b_o$ for $\zeta^j \in [\zeta_S^j, \zeta_B^j]$, where $2 \geq \zeta_B^j > \zeta_S^j \geq 1$. There are two subcases.

First, suppose that $\omega(2) - \tilde{b} \leq \lambda(2)$. It then follows that $\omega(\zeta_S^j) - \tilde{b} < \lambda(\zeta_S^j)$. Hence, type ζ_S^j as well as an interval of types just above ζ_S^j would strictly gain from deviating to $\tilde{b} - \epsilon \geq b_o$, for ϵ positive and small. With positive probability, the other country bids \tilde{b} , and such a deviation then converts ties into losses, resulting in a strict gain. If the other country bids more than \tilde{b} , then the deviation is irrelevant.

Finally, if the other country bids less than \tilde{b} , then the deviation converts wins into losses (when the other country's bid falls between the deviant bid and \tilde{b}) or results in a win with a lower bid (when the other country's bid falls below the deviant bid). In either case, the deviation results in a strict gain.

Second, suppose that $\omega(2) - \tilde{b} > \lambda(2)$. Then there exists some value $\zeta_z^j \in (1, 2)$ such that $\omega(\zeta_z^j) - \tilde{b} = \lambda(\zeta_z^j)$. Of course, not every type in $[\zeta_S^j, \zeta_B^j]$ can be ζ_z^j ; thus, there exists a sub-interval of types, $(\underline{\zeta}_z^j, \bar{\zeta}_z^j) \subset [\zeta_S^j, \zeta_B^j]$ over which (i) $\omega(\zeta^j) - \tilde{b} > \lambda(\zeta^j)$ or (ii) $\omega(\zeta^j) - \tilde{b} < \lambda(\zeta^j)$. Consider case (i). Any type $\zeta^j \in (\underline{\zeta}_z^j, \bar{\zeta}_z^j)$ would then strictly gain by deviating to $\tilde{b} + \epsilon$, converting ties to wins. Likewise, in case (ii), such types would strictly gain by deviating to $\tilde{b} - \epsilon \geq b_o$, converting ties to losses. This proves Claim 1.

Claim 2: In any symmetric equilibrium, there exists $\bar{\epsilon} \in (0, 2 - \zeta_L]$ such that $b(\zeta^j) = b_o$ for all $\zeta^j \in (\zeta_L, \zeta_L + \bar{\epsilon}]$.

To prove this claim, we suppose to the contrary that b is strictly increasing at ζ_L . By Lemma 4.3, we know that $b(\zeta^j) \neq N$ for all $\zeta^j \in (\zeta_L, 2]$. Further, Lemma 4.1 indicates that b cannot decrease; thus, $b(\zeta^j) > b_o$ for all $\zeta^j \in (\zeta_L, 2]$. By Claim 1, it thus follows that pooling does not occur anywhere over $\zeta^j \in (\zeta_L, 2]$. Hence, b is strictly increasing over $\zeta^j \in (\zeta_L, 2]$.

For simplicity, let us assume that type ζ_L bids. Given that b is strictly increasing throughout the bidding region, type ζ_L wins only when the other country does not bid. It follows that $b(\zeta_L) = b_o$ is necessary. It is also necessary that type ζ_L is indifferent between bidding and not bidding; thus, it must be that $\mathbf{B}\lambda(\zeta_L) + (1 - \mathbf{B})[\omega(\zeta_L) - b_o] = \mathbf{B}\lambda(\zeta_L) + (1 - \mathbf{B})\eta(\zeta_L)$, or equivalently

$$\omega(\zeta_L) - b_o = \eta(\zeta_L), \quad (9.9)$$

since $\mathbf{B} < 1$ follows from Lemma 4.2.

Finally, it is also necessary that types higher than ζ_L are unable to gain through deviations. But (9.9) implies that

$$\omega(\zeta_L) - b_o < \lambda(\zeta_L). \quad (9.10)$$

Given that payoffs are continuous, it follows from (9.10) that $\omega(\zeta_L + \epsilon) - b_o < \lambda(\zeta_L + \epsilon)$, for ϵ positive and small. As $b(\zeta_L + \epsilon) > b_o$, it follows that $\omega(\zeta_L + \epsilon) - b(\zeta_L + \epsilon) < \lambda(\zeta_L + \epsilon)$. Thus, type $\zeta_L + \epsilon$ prefers losing to winning. As a consequence, it would strictly gain by deviating and bidding less.

We have now constructed an interval of types that would deviate and bid less. This is a contradiction, and so our supposition that b is strictly increasing at ζ_L must be false. Hence, a region of pooling must begin at ζ_L . By Claim 1, we know that pooling must occur at the reserve bid, b_o . This establishes Claim 2.

Claim 3: In any symmetric equilibrium, $b(2) > b_o$.

Suppose to the contrary that $b(2) = b_o$. By Claim 2, pooling occurs at b_o for all types $\zeta^j \in (\zeta_L, 2]$. Consider type $\zeta^j = 2$. This type receives payoff $[\frac{\mathbf{B}}{2} + 1 - \mathbf{B}](\omega(2) - b_o) + \frac{\mathbf{B}}{2}\lambda(2)$, where $\mathbf{B} = 1 - F(\zeta_L) \in (0, 1)$. If type $\zeta^j = 2$ were to deviate and bid $b_o + \epsilon$, for ϵ positive and small, it would receive payoff $\omega(2) - b_o - \epsilon$. The gain from this deviation is $\frac{\mathbf{B}}{2}[\omega(2) - b_o - \lambda(2)] - \epsilon > 0$, where the inequality follows for ϵ small, given A4 and $\mathbf{B} \in (0, 1)$. This proves Claim 3.

Together, the three claims establish that a region of pooling must begin at ζ_L . The pooling occurs at the reserve bid, b_o , and it does not include the highest types. Given that b is (weakly) increasing by Lemma 4.1, it follows that b exceeds b_o for higher types. The necessary existence of $\zeta_H \in (\zeta_L, 2)$ is thus established, and the lemma is proved. **Q.E.D.**

Lemma 4.5: In any symmetric equilibrium, $b(\zeta_H) = b_o$, $b(\zeta^j)$ is continuous over $\zeta^j \in [\zeta_H, 2]$, and $b(\zeta^j)$ is strictly increasing over $\zeta^j \in (\zeta_H, 2]$.

Proof: To prove this lemma, we recall from Lemma 4.4 that $b(\zeta^j) > b_o$ for $\zeta^j > \zeta_H$, where $\zeta_H \in (\zeta_L, 2)$. By Lemma 4.1 and Claim 1, b is strictly increasing for $\zeta^j > \zeta_H$. Suppose $b(\zeta_H) > b_o$. Then type ζ_H would strictly gain by deviating to $b' \in (b_o, b(\zeta_H))$, since it preserves its win-loss probabilities but now wins with a lower bid. Thus, it is necessary that $b(\zeta_H) = b_o$. Finally, suppose there is a discontinuity at some value $\zeta_d \in [\zeta_H, 2]$. For simplicity, suppose that b contains its upward jump, so that $\lim_{\epsilon \rightarrow 0} b(\zeta_d + \epsilon) = b(\zeta_d)$. Then type ζ_d would strictly gain from a deviation to a lower bid that rests in the gap, as it would thereby preserve its win-loss probabilities while winning with a lower bid. Thus, $b(\zeta^j)$ is continuous for $\zeta^j \geq \zeta_H$. **Q.E.D.**

Lemma 4.6: In any symmetric equilibrium, $\zeta_H = \bar{\zeta}(b_o)$ and $\zeta_L = \tilde{\zeta}(b_o)$.

Proof: Fix a symmetric equilibrium. Consider type ζ_H . This type could choose bid b_o and thus tie with an interval of the rival country's types. Alternatively, it could select bid $b_o + \epsilon$, thereby receiving essentially the same payoff when the rival

country bids above b_o or elects not to bid. With the latter choice, however, type ζ_H wins rather than ties when the rival country bids b_o . Given the continuity of the payoff functions, since types just below (above) ζ_H choose to bid b_o (just above b_o), type ζ_H must be indifferent between the alternatives. Thus, it is necessary that the payoff to type ζ_H from bidding b_o , $F(\zeta_L)(\omega(\zeta_H) - b_o) + \frac{F(\zeta_H) - F(\zeta_L)}{2}(\omega(\zeta_H) - b_o + \lambda(\zeta_H)) + (1 - F(\zeta_H))\lambda(\zeta_H)$, must be the same as the payoff to type ζ_H from bidding b_o plus an arbitrarily small increment, $F(\zeta_L)(\omega(\zeta_H) - b_o) + (F(\zeta_H) - F(\zeta_L))(\omega(\zeta_H) - b_o) + (1 - F(\zeta_H))\lambda(\zeta_H)$. Indifference is thus obtained if and only if $[\omega(\zeta_H) - b_o + \lambda(\zeta_H)]/2 = \omega(\zeta_H) - b_o$, or equivalently $\omega(\zeta_H) - \lambda(\zeta_H) = b_o$. By (4.1), $\zeta_H = \bar{\zeta}(b_o)$ is necessary.

Consider next type ζ_L . This type must be indifferent between not bidding and selecting the bid b_o . Thus, it is necessary that the payoff to type ζ_L of not bidding, $F(\zeta_L)\eta(\zeta_L) + (1 - F(\zeta_L))\lambda(\zeta_L)$, must equal the payoff to type ζ_L from bidding b_o , $F(\zeta_L)(\omega(\zeta_L) - b_o) + \frac{F(\zeta_H) - F(\zeta_L)}{2}(\omega(\zeta_L) - b_o + \lambda(\zeta_L)) + (1 - F(\zeta_H))\lambda(\zeta_L)$. Equating this expressions and simplifying, we obtain $(F(\zeta_H) - F(\zeta_L))[\frac{\lambda(\zeta_L) - (\omega(\zeta_L) - b_o)}{2}] = F(\zeta_L)[\omega(\zeta_L) - b_o - \eta(\zeta_L)]$. Next, we recall from above that $\zeta_H = \bar{\zeta}(b_o)$ is necessary. Referring to (4.2), we thus see that $\zeta_L = \tilde{\zeta}(b_o)$ is necessary. **Q.E.D.**

Lemma 4.7: In any symmetric equilibrium, when foreign country j has type $\zeta^j \in [\bar{\zeta}, 2]$, it bids

$$b(\zeta^j) = \omega(\zeta^j) - \lambda(\zeta^j) - \frac{\Delta}{4} \frac{1}{F(\zeta^j)} \int_{\bar{\zeta}}^{\zeta^j} F(x) dx.$$

Proof: Fix ζ^j and consider $\tilde{\zeta}^j \in [\zeta_H, 2]$. Suppose that foreign country j has type ζ^j and bids as if its type were $\tilde{\zeta}^j$. Given that the rival country uses the equilibrium bidding function, the payoff to foreign country j is then

$$U(\tilde{\zeta}^j, \zeta^j) \equiv F(\tilde{\zeta}^j)[\omega(\zeta^j) - b(\tilde{\zeta}^j)] + [1 - F(\tilde{\zeta}^j)]\lambda(\zeta^j). \quad (9.11)$$

With the monotonicity of b embedded, we observe this function satisfies the single-crossing condition:

$$U_{12}(\tilde{\zeta}^j, \zeta^j) = F'(\tilde{\zeta}^j)[\omega'(\zeta^j) - \lambda'(\zeta^j)] > 0. \quad (9.12)$$

For our present purposes, the important point is that a symmetric equilibrium exists only if the local incentive constraint is satisfied: for all $\zeta^j \in [\zeta_H, 2]$,

$$U_1(\tilde{\zeta}^j, \zeta^j) = 0 \text{ when } \tilde{\zeta}^j = \zeta^j. \quad (9.13)$$

Recalling from Lemma 4.6 that $\zeta_H = \bar{\zeta}$, it is now possible to use (9.13) to characterize the necessary features of the bidding function for $\zeta^j \in [\bar{\zeta}, 2]$.

To establish this lemma, we use (9.11) and (9.13) and rewrite the local incentive constraint as follows:

$$F'(\zeta^j)[\omega(\zeta^j) - \lambda(\zeta^j)] = \frac{d[F(\zeta^j)b(\zeta^j)]}{d\zeta^j}. \quad (9.14)$$

We follow standard arguments (see, e.g., Riley and Samuelson (1981)). We integrate both sides and rearrange terms, obtaining that the expected payment of type $\zeta^j \in [\zeta_H, 2]$ must be

$$F(\zeta^j)b(\zeta^j) = F(\bar{\zeta})b(\bar{\zeta}) + \int_{\bar{\zeta}}^{\zeta^j} F'(x)[\omega(x) - \lambda(x)]dx. \quad (9.15)$$

But we also know from Lemmas 4.5 and 4.6 that $b(\bar{\zeta}) = b_o$. Using $b(\bar{\zeta}) = b_o$, and integrating by parts and using (4.1), we obtain that, in any symmetric equilibrium, the expected payment of type $\zeta^j \in [\zeta_H, 2]$ must be

$$F(\zeta^j)b(\zeta^j) = F(\zeta^j)[\omega(\zeta^j) - \lambda(\zeta^j)] - \frac{\Delta}{4} \int_{\bar{\zeta}}^{\zeta^j} F(x)dx. \quad (9.16)$$

Solving (9.16) for $b(\zeta^j)$ then completes the proof. **Q.E.D.**

Proof of Proposition 4.2: Consider the bidding function defined in Proposition 4.1. Without loss of generality, suppose that $b(\tilde{\zeta}) = b_o$. We show that no type can gain from a deviation. Consider any type ζ^j . If this type were to select N , then it would receive payoff $F(\tilde{\zeta})\eta(\zeta^j) + (1 - F(\tilde{\zeta}))\lambda(\zeta^j)$. If instead it were to select b_o , then it would receive payoff $F(\tilde{\zeta})(\omega(\zeta^j) - b_o) + \frac{F(\bar{\zeta}) - F(\tilde{\zeta})}{2}(\omega(\zeta^j) - b_o + \lambda(\zeta^j)) + (1 - F(\tilde{\zeta}))\lambda(\zeta^j)$. Let $G_n(\zeta^j)$ represent the gain to type ζ^j from choosing N rather than b_o . Using (4.2), note that $G_n(\tilde{\zeta}) = 0$. Calculations give

$$G'_n(\zeta^j) = (F(\bar{\zeta}) - F(\tilde{\zeta})) \frac{\lambda'(\zeta^j) - \omega'(\zeta^j)}{2} - F(\tilde{\zeta})(\omega'(\zeta^j) - \eta'(\zeta^j)) < 0. \quad (9.17)$$

Thus, if $\zeta^j \in [1, \tilde{\zeta})$, then type ζ^j indeed prefers N to b_o . Similarly, if $\zeta^j \in (\tilde{\zeta}, 2]$, then it prefers b_o to N .

Next, consider any ζ_S^j and ζ_B^j drawn from the interval $[\bar{\zeta}, 2]$ with $\zeta_S^j < \zeta_B^j$. Referring to (9.11), (9.13) and (9.12), we may confirm that type ζ_B^j loses by deviating and selecting type ζ_S^j 's bid: $U(\zeta_B^j, \zeta_B^j) - U(\zeta_S^j, \zeta_B^j)$

$$= \int_{\zeta_S^j}^{\zeta_B^j} U_1(x, \zeta_B^j) dx = \int_{\zeta_S^j}^{\zeta_B^j} U_1(x, \zeta_B^j) - U_1(x, x) dx = \int_{\zeta_S^j}^{\zeta_B^j} \int_x^{\zeta_B^j} U_{12}(x, y) dy dx > 0.$$

Likewise, we may verify that type ζ_S^j loses by deviating and selecting type ζ_B^j 's bid. In short, over the region for which the bid function is strictly increasing, the single-crossing property holds, and so the necessary local incentive constraint implies as well that the global incentive constraint holds (over the region).

With these relationships in place, we show that no type can gain from a deviation. First, fix $\zeta^j \in [1, \tilde{\zeta})$. As established above, any such type prefers N to b_o , and it would thus lose by mimicking the bid of any type in the interval $[\tilde{\zeta}, \bar{\zeta}]$. It remains to show that ζ^j would lose by mimicking the bid of any type in the interval $[\bar{\zeta}, 2]$. Let $\hat{\zeta}^j \in [\bar{\zeta}, 2]$. Using (9.11), (9.13) and (9.12), observe that

$$U_1(\hat{\zeta}^j, \zeta^j) = U_1(\hat{\zeta}^j, \zeta^j) - U_1(\hat{\zeta}^j, \hat{\zeta}^j) = - \int_{\zeta^j}^{\hat{\zeta}^j} U_{12}(\hat{\zeta}^j, x) dx < 0,$$

and so type ζ^j is most tempted to mimic the bid of type $\bar{\zeta}$. But this type bids b_o , and we know type ζ^j prefers N to b_o .

Second, fix $\zeta^j \in [\tilde{\zeta}, \bar{\zeta}]$. As established above, $\zeta^j \in (\tilde{\zeta}, \bar{\zeta}]$ prefers b_o to N , while type $\tilde{\zeta}$ is indifferent. Thus, a type $\zeta^j \in [\tilde{\zeta}, \bar{\zeta}]$ does not gain from mimicking a type in the interval $[1, \tilde{\zeta})$. It remains to show that ζ^j would not gain by mimicking the bid of any type in the interval $[\bar{\zeta}, 2]$. Arguing as in the previous paragraph, it is straightforward to see that ζ^j is most tempted to mimic $\bar{\zeta}$. But this type bids b_o , just as does ζ^j , and so ζ^j does not gain from mimicking the bid of any type in $[\bar{\zeta}, 2]$.

Third, fix $\zeta^j \in [\bar{\zeta}, 2]$. As established above, a global incentive constraint is satisfied over this region, and so ζ^j loses by mimicking the bid of any other type in $[\bar{\zeta}, 2]$. In particular, $\zeta^j > \bar{\zeta}$ loses by deviating to $b(\bar{\zeta}) = b_o$. It remains to show that $\zeta^j \in [\bar{\zeta}, 2]$ would not gain by mimicking a type in the interval $[1, \tilde{\zeta})$ and selecting N . By (9.17), type $\zeta^j \in [\bar{\zeta}, 2]$ prefers b_o to N . Since $\zeta^j > \bar{\zeta}$ prefers its own bid to b_o , every type $\zeta^j \in [\bar{\zeta}, 2]$ loses by selecting N .

Finally, our proof relies on the function U , which presumes that b is strictly increasing for $\zeta^j > \bar{\zeta}$. To confirm this, we differentiate the bid function in Proposition 4.1 and find that $b'(\zeta^j) > 0$ ($b'(\zeta^j) = 0$) for $\zeta^j > \bar{\zeta}$ ($\zeta^j = \bar{\zeta}$). **Q.E.D.**

Proof of Lemma 6.3: With b_o sufficiently close to zero, we know from Lemma 6.1 that Home does not select $b^h = N$. Thus, it is not possible that Home sometimes wins, by not bidding and escaping retaliation sometimes when auction failures occur. At the other extreme, if $b^h \geq \omega(2) - \eta(2)$, then Home must always win. Therefore, if Home wins sometimes, then it must be that $b^h \in [b_o, \omega(2) - \eta(2))$. Hence, we assume that a symmetric equilibrium exists in which Home sometimes wins with $b^h \in [b_o, \omega(2) - \eta(2))$. We seek a contradiction.

Suppose that the foreign countries have a pooling region on which they always or sometimes win. Formally, suppose that there exists $[\zeta_1^j, \zeta_2^j]$ such that $\zeta_1^j < \zeta_2^j$ and $b(\zeta^j) = \bar{b} \geq b^h$ for all $\zeta^j \in [\zeta_1^j, \zeta_2^j]$, where Home does not always win a tie (when $\bar{b} = b^h$). If $\bar{b} = b^h$, then Home could raise its bid by ϵ and gain, since by (5.4) we know that $W_{NR} - W_R > \omega(2) - \lambda(2) > b^h$. If $\bar{b} > b^h$, then $\bar{b} > b_o$. As in the proof of Claim 1 in Lemma 4.4, either type ζ_1^j will gain from a lower bid or type ζ_2^j will gain from a higher bid. (The arguments are unaffected by b^h , since b^h is lower in this case than the relevant bids.) Thus, it is impossible that the foreign countries have a pooling region on which they always or sometimes win. In sum, if foreign countries use a pooling region, then on that region they must always lose: either $\bar{b} < b^h$, or $\bar{b} = b^h$ and Home always wins the tie.²⁶

Given our assumption that Home sometimes wins, it is necessary that there exists a positive measure of foreign types that win against Home. As just established, these types cannot pool anywhere, and so there must exist a positive measure of foreign types whose bids exceed b^h . Let ζ_B^j and ζ_S^j be two such types, with $\zeta_B^j > \zeta_S^j$. Arguing as in Lemma 4.1, with the definition of \mathbf{B} modified so that $\mathbf{B} \equiv \text{prob}\{b(\zeta^j) > b^h\}$, we may derive that all types in the interval $[\zeta_S^j, \zeta_B^j]$ bid above b^h and further that $b(\zeta_B^j) \geq b(\zeta_S^j)$. Since pooling regions are not possible for bids that exceed b^h , we know that $b(\zeta_B^j) > b(\zeta_S^j)$. It follows that there must exist $\hat{\zeta} \in (1, 2)$ such that, for all $\zeta^j > \hat{\zeta}$, $b(\zeta^j) > b^h$ and b is strictly increasing. Furthermore, if we let $\hat{\zeta}$ denote the lowest such value, then we know as well that $b(\hat{\zeta}) = b^h$. Otherwise, there would be a gap between $b(\hat{\zeta})$ and b^h , and in analogy with Lemma 4.5 this would give types near $\hat{\zeta}$ a strict benefit from deviating to a lower bid that rests in that gap.

²⁶This is consistent with the equilibrium in Lemma 6.2, in which Home always wins.

Therefore, we consider now the possibility that Home sometimes wins and there exists $\hat{\zeta} \in (1, 2)$ such that $b(\hat{\zeta}) = b^h$ and, for all $\zeta^j > \hat{\zeta}$, $b(\zeta^j) > b^h$ and b is strictly increasing. We propose to exploit the following tension. Looking toward lower types, type $\hat{\zeta}$ (perhaps plus ϵ) must be indifferent between beating Home and not, indicating a relationship between $\omega(\hat{\zeta})$ and $\eta(\hat{\zeta})$. Looking toward higher types, type $\hat{\zeta}$ (perhaps plus ϵ) must be indifferent between bidding its equilibrium bid and that assigned to a slightly higher type, indicating a relationship between $\omega(\hat{\zeta})$ and $\lambda(\hat{\zeta})$. In our basic auction, as Lemmas 4.4 and 4.7 indicate, this tension is resolved with a pooling region at b_o . But in the extended auction, as just discussed, we cannot have a pooling region over which foreign countries sometimes or always win. This suggests that a contradiction is inevitable.

To confirm this suggestion, we proceed as follows. We note first that type $\hat{\zeta}$ (perhaps plus ϵ) must be indifferent between beating Home with a bid at (or just above) b^h and losing to Home: $F(\hat{\zeta})[\omega(\hat{\zeta}) - b(\hat{\zeta})] + [1 - F(\hat{\zeta})]\lambda(\hat{\zeta}) = F(\hat{\zeta})\eta(\hat{\zeta}) + [1 - F(\hat{\zeta})]\lambda(\hat{\zeta})$. We thus conclude that

$$\omega(\hat{\zeta}) - b(\hat{\zeta}) = \eta(\hat{\zeta}). \quad (9.18)$$

This is the relationship between $\omega(\hat{\zeta})$ and $\eta(\hat{\zeta})$.

We note second that any type at or above $\hat{\zeta}$ must satisfy a local incentive compatibility condition, ensuring that no gain is possible by mimicking the behavior of a slightly higher type. Using (9.11) and (9.13), we may again derive (9.14), which now must hold for all $\zeta^j \in [\hat{\zeta}, 2]$. Taking (9.14) and integrating over the range $[\hat{\zeta}, \zeta^j]$, we derive an expression analogous to (9.15). In particular, we find that the expected payment of type $\zeta^j \geq \hat{\zeta}$ is

$$F(\zeta^j)b(\zeta^j) = F(\hat{\zeta})b(\hat{\zeta}) + \int_{\hat{\zeta}}^{\zeta^j} F'(x)[\omega(x) - \lambda(x)]dx. \quad (9.19)$$

Integrating by parts, we obtain that $F(\zeta^j)b(\zeta^j) =$

$$F(\hat{\zeta})b(\hat{\zeta}) - F(\hat{\zeta})[\omega(\hat{\zeta}) - \lambda(\hat{\zeta})] + F(\zeta^j)[\omega(\zeta^j) - \lambda(\zeta^j)] - \int_{\hat{\zeta}}^{\zeta^j} F(x)[\omega'(x) - \lambda'(x)]dx.$$

Solving for $b(\zeta^j)$ we obtain

$$b(\zeta^j) = \quad (9.20)$$

$$\frac{F(\widehat{\zeta})}{F(\zeta^j)}b(\widehat{\zeta}) - \frac{F(\widehat{\zeta})}{F(\zeta^j)}[\omega(\widehat{\zeta}) - \lambda(\widehat{\zeta})] + [\omega(\zeta^j) - \lambda(\zeta^j)] - \frac{1}{F(\zeta^j)} \int_{\widehat{\zeta}}^{\zeta^j} F(x)[\omega'(x) - \lambda'(x)]dx.$$

This equation indicates a relationship between $\omega(\widehat{\zeta})$ and $\lambda(\widehat{\zeta})$.

We next differentiate the bidding function in (9.20). We find that

$$b'(\zeta^j) = \frac{F'(\zeta^j)}{(F(\zeta^j))^2} \left[\begin{array}{c} -F(\widehat{\zeta})b(\widehat{\zeta}) + F(\widehat{\zeta})[\omega(\widehat{\zeta}) - \lambda(\widehat{\zeta})] \\ + \int_{\widehat{\zeta}}^{\zeta^j} F(x)[\omega'(x) - \lambda'(x)]dx \end{array} \right]. \quad (9.21)$$

Notice that, if

$$\omega(\widehat{\zeta}) - b(\widehat{\zeta}) = \lambda(\widehat{\zeta}), \quad (9.22)$$

so that type $\widehat{\zeta}$ were indifferent between trading (locally) winning and losing events, as was true in our equilibrium for $\bar{\zeta}$ in the basic auction, then the first two terms in (9.21) would cancel, and it would follow directly from (9.21) that $b' \geq 0$. But (9.22) does not hold here; rather, we have that $b(\widehat{\zeta})$ satisfies (9.18). Imposing (9.18), we use (9.21) to write

$$b'(\zeta^j) = \frac{F'(\zeta^j)}{(F(\zeta^j))^2} \{F(\widehat{\zeta})[\eta(\widehat{\zeta}) - \lambda(\widehat{\zeta})] + \int_{\widehat{\zeta}}^{\zeta^j} F(x)[\omega'(x) - \lambda'(x)]dx\}. \quad (9.23)$$

But using (9.23), we see that

$$b'(\widehat{\zeta}) = \frac{F'(\widehat{\zeta})}{F(\widehat{\zeta})}[\eta(\widehat{\zeta}) - \lambda(\widehat{\zeta})] < 0. \quad (9.24)$$

But (9.24) contradicts the possibility assumed above that $b(\widehat{\zeta}) = b^h$ and, for all $\zeta^j > \widehat{\zeta}$, $b(\zeta^j) > b^h$ and b is strictly increasing. **Q.E.D.**

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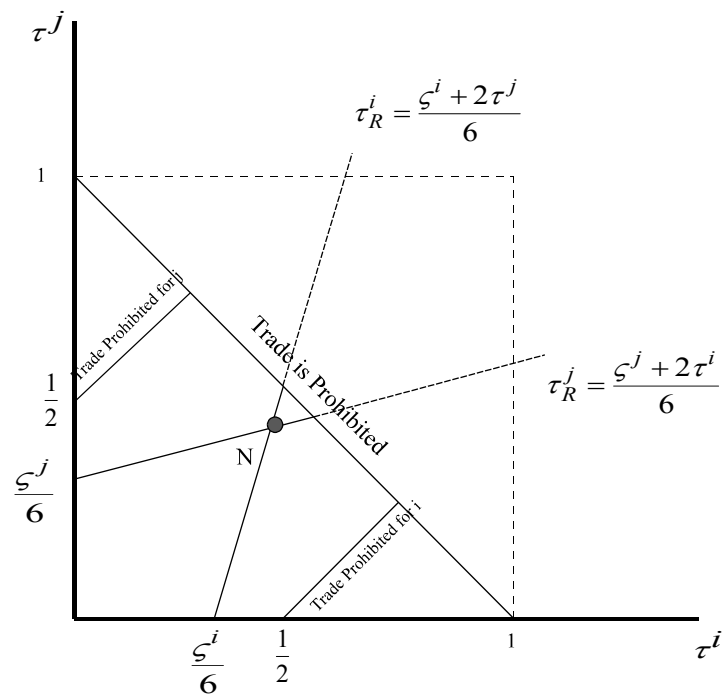


Figure 1

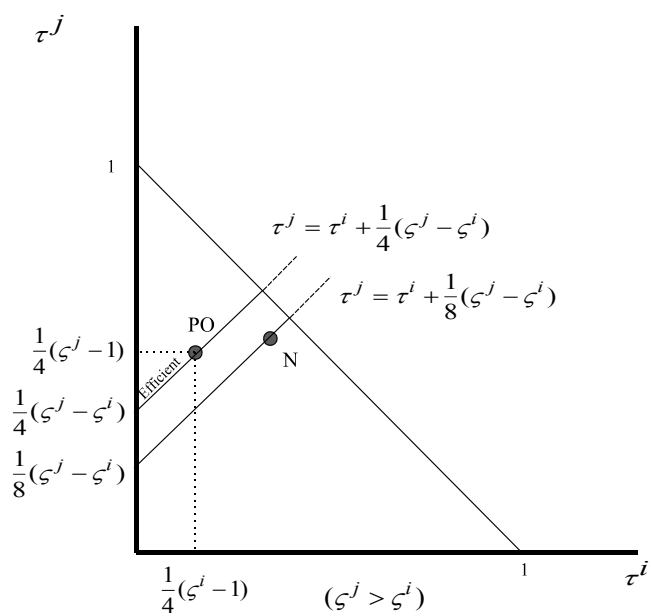


Figure 2

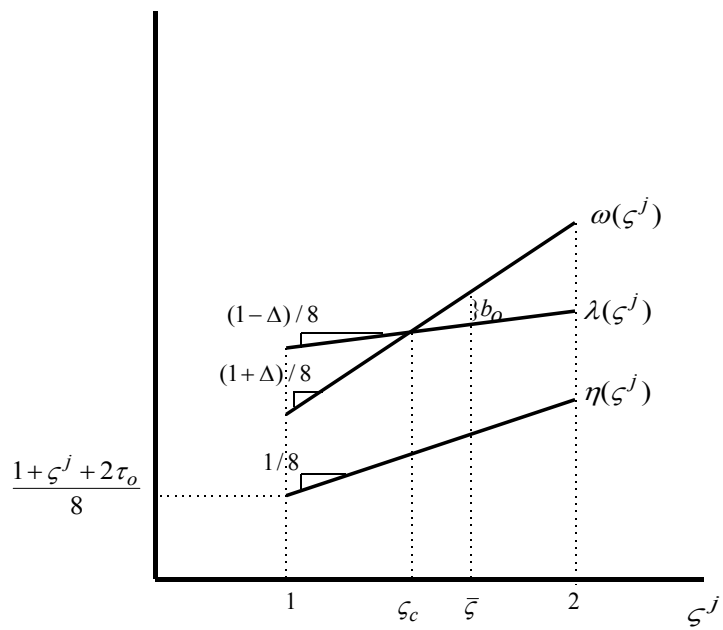


Figure 3

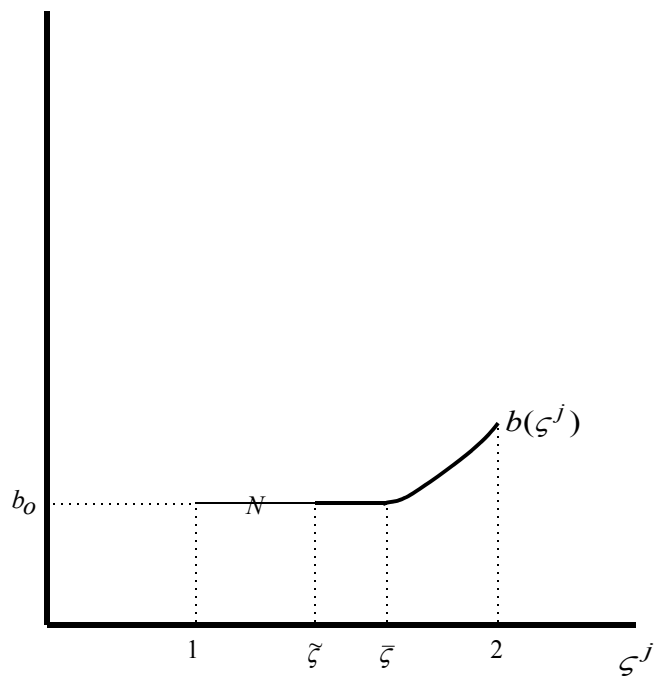


Figure 4