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Working Paper

Quality uncertainty with imperfect information acquisition

Center for Mathematical Economics Working Papers, No. 487

Provided in Cooperation with:

Center for Mathematical Economics (IMW), Bielefeld University

Suggested Citation: Gertz, Christopher (2013) : Quality uncertainty with imperfect information acquisition, Center for Mathematical Economics Working Papers, No. 487, Bielefeld University, Center for Mathematical Economics (IMW), Bielefeld

This Version is available at:

<https://hdl.handle.net/10419/97228>

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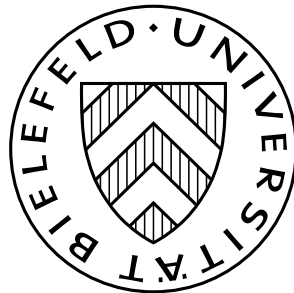
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September 2013

Quality Uncertainty with Imperfect Information Acquisition

Christopher Gertz



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This version: September 17, 2013

[Abstract:] I analyze a monopolistic model of quality uncertainty but with the possibility of information acquisition on the consumer side. Information is costly and its amount is chosen by the consumer. The analysis of Bayesian equilibria shows the possibility of three equilibrium classes, only one of which leaves positive utility to the consumer. The classic adverse selection results of these markets are weakened in this situation. I show that cheaper information does not necessarily benefit the consumer but can instead rule out the buyer-friendly and welfare maximizing equilibria. Moreover, making quality search arbitrarily efficient does not lead to sure selling of the high quality product. A sustainable adverse selection effect, though weaker than in the classical model, remains even in the limit.

1. Introduction

Along with the price, the quality of a product is one of the two major characteristics relevant to a purchase decision. While price information can be tricky to obtain in situations with negotiation possibilities or multiple resellers, it is usually even harder to get a good idea about the quality of a product. This phenomenon occurs not only in classical examples like second hand cars but is also present in almost every potential purchase for goods with which you do not have much experience. Whether you have not bought a TV for many years, want to buy wine in an unfamiliar supermarket, consider to buy an upgrade of the operating system on your computer or to invest in a financial product. You do not have full information about what you really get for your money if you are not an expert for these products or at least inform yourself prior to the purchase.

On the other hand, the seller of a product usually has much better information about the quality. A second hand car has been used by the owner for many years, giving him the knowledge of any accident, repair or defects that occurred over the last years and might still exist or be relevant. In the same way, a producer knows the characteristics and weaknesses of the product for sale. While positive qualities might be advertised or otherwise pointed out to the buyer, there is no incentive for the seller to do the same for bad qualities or missing features if not mandated by law. If the consumer wants this information, she usually has to acquire it on her own. And even the advertised positive qualities may be exaggerated, untrue or not relevant to the consumer. In the same way as for information about bad quality, the buyer must figure out how to deal with the information given by the seller.

This asymmetry of quality information has been present in the literature ever since George Akerlof's famous paper of 1970 and his previously mentioned second hand car example. The question of how such quality uncertainty influences the market outcome has since been discussed in many papers. There have been various attempts to mitigate between the extreme nature of Akerlof's model and the classical case of perfect information. To name just two of the most well-known works, Bagwell and Riordan (1991) introduce multiple periods in which firms can set different prices while Milgrom and Roberts (1986) allow the firms to give an additional, costly advertising signal to distinguish oneself and keep low quality sellers from imitating the high quality sellers' behavior.

While these examples follow the idea of giving high quality firms certain additional possibilities to signal their excellence, it is only natural to also look at the other side of the market, namely the consumer. In the Akerlof model buyers do not have any other possibility than either to trust the firms or not, their posterior beliefs about quality depending on the price and being determined by Bayes' law in an equilibrium. Having the examples of the first paragraph in mind, the idea of the consumer having no further information is obviously a very strong assumption and not true in most purchasing situations. A second hand car can be tested before buying, a bottle of wine can be bought and tried out before you decide to serve it at your dinner party and for most products you can find multiple tests, ratings and reviews online. Especially with the Internet, the amount of quality information available to consumers has dramatically increased over the last years.

With more and more people owning smartphones, this information is available and can be looked up even inside the shop.

Surprisingly few papers have so far considered to relax this part of Akerlof's model. Bester and Ritzberger (2001) let the consumer decide about buying a perfect quality signal and base their decision on the additional information. In Voorneveld and Weibull (2004) the buyer receives an additional, costless but noisy signal that is correlated to the true quality. One can interpret this as an independent, non-perfect test review that is observed by the consumer in any case. These two models of additional quality information do not quite capture the real life situations, as it is usually not costless (in terms of money or time) to acquire information and this information does not have to be perfect. Even if there are free tests and reviews on the Internet, one has to take the time and put effort in finding and reading these sources. These test, on the other hand, may not contain all relevant information and can be incorrect, biased or based on a faulty product. The same holds for the information from friends and experts. Testing a TV in the store can not fully simulate the home environment and how the TV works together with other devices, etc. All this adds some unreliability to the information acquisition procedure and suggests some probability of false information.

My paper simultaneously covers both ideas. The consumer is able to choose how much effort or costs she wants to invest in acquiring quality information and this will result in a quality signal. This signal, on the other hand, will be more precise when exerting more search effort to such an extend that one might even reach perfect information.

It is worth noting that the paper of Kihlstrom (1974) was motivated by the same ideas as this paper. His analysis, however, solely focuses on the consumer side (the market for information) and does not give any indication about the implications for market equilibria.

The analysis shows that in the market with imperfect information acquisition, different kinds of equilibria can occur. Under reasonable refinements, the most important two categories of equilibria are one in which the consumer does not spend effort on quality information and one in which she does. Only in the first type of these equilibria she has positive utility. Her ability to search, although not executed, lowers the price to below the expected quality. In equilibria with search, on the other hand, the price of the product is relatively high and all the consumer's possibility of acquiring information provides market power for the firm, not for the consumer.

Starting from these insights, I investigate how the existence and outcomes of these equilibria develop when information is available more easily. I find that a higher ability of acquiring quality information stops the existence of the consumer-friendly equilibrium and thus takes away all consumer utility.

At last, I investigate the limit behavior of the model in the case when quality information is very expensive or very cheap. Surprisingly, making information acquisition arbitrarily easy does not lead to convergence to the full information case in that the error probability of the signal stays bounded away from zero and a non-vanishing share of high quality products is not traded. Although the possibility of imperfect information acquisition

generally lowers adverse selection phenomena, it does not get rid of them even in the limit of perfect information. Making the information very expensive can lead to the outcomes of the classical models of quality uncertainty but often also, for a wide range of parameters, uniquely selects an equilibrium that was previously disregarded in the literature.

The paper is structured as follows. The first section describes the model of quality information acquisition and the market participants. I then proceed by analyzing the consumer behavior. This is embedded in a formally defined monopolistic market model and the rational Bayesian equilibria are analyzed. Finally, I compare outcomes of different levels of search efficiency to investigate the market impact of cheaper or more expensive quality information.

2. The Model

I consider a monopolistic market with one product and one potential consumer (or “buyer”)¹. The quality of the product can take two fixed values and is drawn by nature with a publicly known probability η of high quality. The realization is known only by the firm and will be denoted by its type $\theta \in \{H, L\}$.

A high quality firm faces production costs c^H while the low quality firm pays c^L for producing one unit of the product. This cost is only incurred when the good is actually sold. I assume $c^L < c^H$ so that high quality production is at least marginally more costly than for low quality. In particular, these costs can also be seen as losing an outside option. For example, the seller of a second hand car could also bring the vehicle to a professional dealer who would pay him the amount c^θ . When he makes the sale, he loses this outside option.

Firms are risk-neutral payoff maximizers. Selling one unit of the good for a price p with probability δ yields the payoff

$$\pi^\theta(p, \delta) = \delta \cdot (p - c^\theta), \quad \theta \in \{H, L\}.$$

Only observing the price p set by the firm, not the quality of the product, the risk-neutral consumer maximizes her expected gains from trade. After a purchase she learns her valuation; her utility from having bought a product of quality q for price p then is $q - p$.

I denote $q^H > q^L$ the consumer’s valuation for the high and the low quality product, respectively. To always ensure possible gains from trade, I assume $c^L < q^L$ and $c^H < q^H$.²

The buyer always has a certain, endogenous belief of the quality after observing a price. Fix a price p and let $\hat{\mu} \in [0, 1]$ be the conceived probability of facing a high type firm.

¹The analysis would not change if I assumed multiple, identical buyers. For simplicity, I only speak of one consumer.

²Adriani and Deidda (2009) focus on a case in which trade would not always be beneficial under full information. They show that this leads to market breakdown in their setting under the D1-Refinement of Cho and Kreps (1987).

Then the consumer's expected utility from buying the good is

$$u_b(p, \hat{\mu}) := \hat{\mu}q^H + (1 - \hat{\mu})q^L - p$$

while the utility from not buying the good is $u_n := 0$.

She faces a third option, namely to pay a cost (or to exert effort) of a chosen level $k \geq 0$ to then obtain a binary signal $s \in \{s^H, s^L\}$ about the product quality. This signal might be incorrect with an error probability of $\varepsilon(k) \in [0, \frac{1}{2}]$. Mathematically this means

$$P(s^H|\theta = L) = P(s^L|\theta = H) = \varepsilon(k).$$

The assumption of both error types being the same is certainly somehow restrictive but is not believed to have a qualitative impact on the result.³

The exogenously given error function ε satisfies the following assumptions.

- $\varepsilon : \mathbb{R}_+ \rightarrow [0, \frac{1}{2}]$ is continuous.
- $\varepsilon(0) = \frac{1}{2}$
- Denote $\bar{k} = \inf \{k \in \mathbb{R}_+ | \varepsilon(k) = 0\}$ the costs for a perfect signal where $\inf \emptyset := \infty$. Then ε is twice continuously differentiable on $(0, \bar{k})$.
- $\varepsilon'(k) < 0, \varepsilon''(k) > 0 \quad \forall k \in (0, \bar{k})$

While the first and third points are of technical nature, the second assumption says that the signal does not contain any information if the consumer exerts no effort. The last point ensures that higher effort always leads to a strictly higher signal precision while the marginal precision gain is diminishing. This accounts for the phenomenon that information acquisition, such as reading reviews, will often give redundant information and thus the amount of new information gained via a certain increase of search effort is decreasing. Due to the second point I can assume that the consumer also receives the (non-informative) signal when she chooses $k = 0$.

Note that I allow for obtaining a *perfect signal*, i.e. there may be a finite cost \bar{k} for which the error probability is zero. Depending on the error function, this value might also be infinity so that perfect information would not be achievable. I do not restrict attention to any of these cases.

By the last assumption the expression

$$\varepsilon'(0) := \lim_{\substack{k \rightarrow 0 \\ k \in (0, \bar{k})}} \varepsilon'(k) = \inf_{k \in (0, \bar{k})} \varepsilon'(k) \in [-\infty, 0)$$

is well-defined. This value is important in the analysis. For illustrating results, I use the simple function $\varepsilon(k) = \max \left\{ \frac{1}{2} - \sqrt{k}, 0 \right\}$ which satisfies the assumptions above.

The seller (or firm) makes a take-it-or-leave-it offer. Naturally, agents on this market do not act simultaneously. At the time when the consumer makes her decision, the price

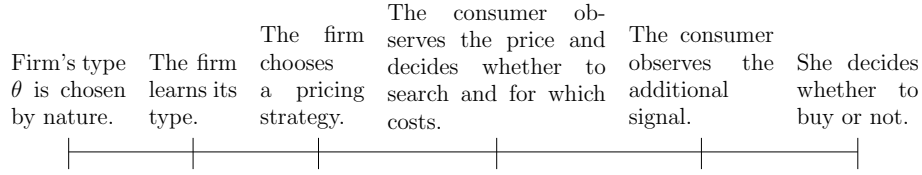


Figure 1: The timing of the market

was already set by the firm and this requires the quality level to already be realized. Figure 1 outlines the timing of the market.

The consumer holds a belief system $\mu : \mathbb{R}_+ \mapsto [0, 1]$, later determined by the equilibrium definition, which assigns to each possible price p a belief $\mu(p)$ about the probability that the product is of high quality conditional on the observed price. In the analysis it is sometimes useful to consider a fixed price p and a fixed corresponding posterior belief $\mu(p)$. In this case, I abbreviate the latter by writing $\hat{\mu}$ instead of $\mu(p)$. I define the expected quality based on such beliefs by

$$\bar{q}_{\hat{\mu}} := \hat{\mu}q^H + (1 - \hat{\mu})q^L.$$

In the same way, to avoid imprecisions, single values of other functions are denoted similarly. Note that the true a-priori probability of high quality is denoted by η while the expression μ is reserved for posterior belief values.

3. Consumer behavior

Since I analyze a multi-stage game, I proceed by backward induction, thus first dealing with the buyer's decision problem. As mentioned above, she observes a price $p \in \mathbb{R}_+$ and chooses a search effort $k \geq 0$ for an additional signal with error probability $\varepsilon(k)$. Having received all the information, she decides whether to buy the good or not. I allow for mixed strategies, so it is possible for the consumer to buy the good only with a certain probability. Remember that the two possible quality valuations q^L, q^H as well as the a priori probability η of facing a high type producer is known to the consumer.

This analysis can itself be divided in the decision before and after the additional signal is received. Again, I use a backward induction argument to separately deal with the two situations.

3.1. After receiving the signal

Assume for now that k has been chosen. Let $\hat{\varepsilon} := \varepsilon(k)$ be the corresponding error probability and $\mu(p) \in (0, 1)$ the posterior belief that a product with price p has quality

³See Martin (2012) for the use of a more complex information structure. In his analysis, however, the firm can choose only between two exogenously given prices.

q^H . In this section, p and $\mu(p)$ can be viewed as fixed so that I write $\hat{\mu}$ for the posterior belief.

Conditional on observing the high signal s^H , the probability of the quality being high is

$$\frac{(1 - \hat{\varepsilon})\hat{\mu}}{(1 - \hat{\varepsilon})\hat{\mu} + \hat{\varepsilon}(1 - \hat{\mu})}$$

which follows from Bayes' law.

The expected utility from buying (not taking into account the sunk cost k), given this situation is then

$$\frac{(1 - \hat{\varepsilon})\hat{\mu}}{(1 - \hat{\varepsilon})\hat{\mu} + \hat{\varepsilon}(1 - \hat{\mu})} q^H + \frac{\hat{\varepsilon}(1 - \hat{\mu})}{(1 - \hat{\varepsilon})\hat{\mu} + \hat{\varepsilon}(1 - \hat{\mu})} q^L - p.$$

Note that with $\hat{\varepsilon} = \frac{1}{2}$ this is the original utility from buying without the additional signal.

Remember that the search amount k was chosen by the rational consumer in an optimal way, keeping in mind these possible implications of receiving the high signal. It is obvious that she will not exert any search effort if $p \leq q^L$ or $p \geq q^H$. In the former case trade always gives a non-negative utility and thus buying without additional signal is always strictly preferred to paying a positive search cost. In the latter case buying the good can never yield strictly positive utility and hence any positive search effort will result in a negative utility that can be avoided by simply not buying.

On the other hand, if she decides to pay a positive cost for the signal precision, this should intuitively imply that the information of the signal has some value to her. The following observation shows that the implication of a positive search effort is even more extreme.

Lemma 3.1. *Let a price p with corresponding posterior belief $\hat{\mu}$ be given. If the consumer has optimally exerted positive search effort, then she buys if and only if she receives the signal s^H .*

This result may not come as a surprise. If it was optimal to ignore a signal, it would be pointless to pay for its precision. The lemma is in the same spirit as the corresponding statement in Bester and Ritzberger (2001). It shows that the two pieces of information, namely the inherent information of the price given by the corresponding posterior belief $\hat{\mu}$ and the additional signal, are essentially not considered simultaneously. The former is used to decide about how much search effort to exert and if zero effort is chosen, it is used to determine whether to buy the good or not. Once the consumer decides to pay for signal precision, the buying decision only depends on the signal, not on the value $\hat{\mu}$ of the posterior belief. This, of course, does not occur in situations where an additional, informative signal is received regardless of the decision of the consumer as in Voorneveld and Weibull (2011).

While this effect also arises in Bester and Ritzberger (2001), consumers in their model observe a perfect signal and it is natural to dismiss prior information after learning the

true state. In the situation at hand the reason is more subtle, basically lying in the backward induction argument. The probable implications of receiving various signals of a certain error probability are taken into account before the decision of costly acquiring the information is formed. Essentially, also the choice to buy only at a high signal is already made at that stage.

The proof of this lemma is straightforward. Like all others, it can be found in the appendix.

3.2. Choosing the optimal search effort

I proceed by determining the optimal search costs k . Assume therefore that the consumer pays a cost $k > 0$ for search and that this level is optimal. I know by the previous lemma that the only possible behavior after receiving the signal is to buy if and only if the signal is s^H , i.e. if the quality is high and the signal is correct or if the quality is low and the signal is wrong. Then the expected utility, given price p and posterior beliefs $\hat{\mu}$, is

$$u_s(p, \hat{\mu}, k) := \underbrace{\hat{\mu}(1 - \varepsilon(k))(q^H - p)}_{\text{correct high signal}} + \underbrace{(1 - \hat{\mu})\varepsilon(k)(q^L - p)}_{\text{false high signal}} - k.$$

This formula consists of three terms. The (possibly subjective) probability of facing a high good is $\hat{\mu}$. The consumer then buys if she receives a correct signal which has the probability $1 - \varepsilon(k)$. This yields the utility $q^H - p$. The second term of the formula reflects the possibility and consequences of buying a low quality product because of a false high signal. The search costs k have to be paid regardless of the quality and the buying decision.

I want to stress that this is the expected utility after observing the price and before receiving the signal, and only if the optimal search cost is positive. Lemma 3.1 allows me to ignore the updated beliefs after observing the additional quality information.

Maximizing this utility with respect to search costs, I get the first order condition

$$\begin{aligned} & \hat{\mu}(-\varepsilon'(k))(q^H - p) + (1 - \hat{\mu})\varepsilon'(k)(q^L - p) = 1 \\ \Leftrightarrow & \varepsilon'(k) = \frac{1}{-\hat{\mu}(q^H - p) + (1 - \hat{\mu})(q^L - p)} \\ & = \frac{-1}{\hat{\mu}(q^H - p) + (1 - \hat{\mu})(p - q^L)} =: d(p, \hat{\mu}) =: \hat{d}. \end{aligned}$$

The parameter \hat{d} depends both on the price p and the posterior belief $\hat{\mu}$ and is always negative in the relevant range of prices $[q^L, q^H]$ and when $\hat{\mu} \in (0, 1)$. Its value is an indicator of whether the price fits the expected valuation given by the belief. If p and $\hat{\mu}$ are both high or both low, ε must have an extreme slope and thus the optimal k is low. If there is a discrepancy between p and $\hat{\mu}$, \hat{d} is closer to zero and thus k is higher. This shows that search is used more extensively if the consumer has reason not to trust the price. Figure 2 depicts this effect.

Note that I can rewrite the utility in the form

$$u_s(p, \hat{\mu}, k) = [\hat{\mu}(q^H - p) + (1 - \hat{\mu})(p - q^L)](-\varepsilon(k)) - k + \hat{\mu}(q^H - p)$$

so that the function is always strictly concave in k for $\hat{\mu} \in (0, 1)$ and $p \in [q^L, q^H]$. The first order condition thus provides the interior solution if there is one in the range $(0, \bar{k})$.

It follows that the utility maximizing search cost for the consumer problem is

$$k^*(p, \hat{\mu}) := \begin{cases} 0 & \hat{d} \leq \varepsilon'(0) \\ (\varepsilon')^{-1}(\hat{d}) & \varepsilon'(0) < \hat{d} < \varepsilon'(\bar{k}) \\ \bar{k} & \hat{d} \geq \varepsilon'(\bar{k}). \end{cases} \quad (1)$$

This function is continuous and piecewise differentiable in both arguments. However, its form presents some problem for the analysis, namely that there is a saddle point at $(\frac{q^H - q^L}{2}, \frac{1}{2})$. Figure 2 shows an example of this function. It also shows the effect that search effort is high in the areas in which $\hat{\mu}$ and p do not correspond to each other.

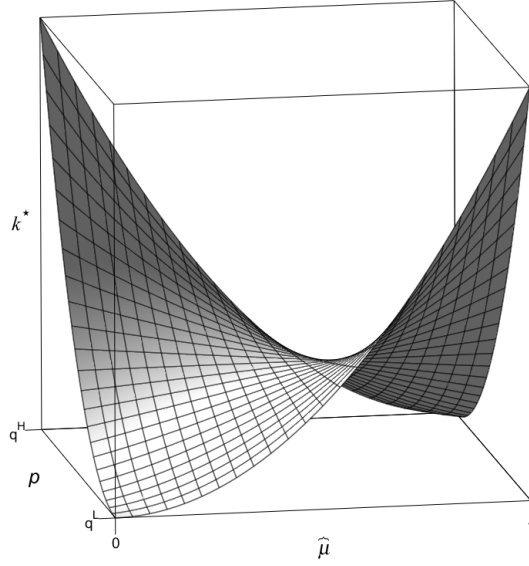


Figure 2: The function k^* for $\varepsilon(k) = \max \left\{ \frac{1}{2} - \sqrt{k}, 0 \right\}$.

As mentioned above, this analysis is based on Lemma 3.1 and thus gives a *necessary* condition. If the consumer pays a positive cost, it has to be given by the function k^* . To ensure that paying this cost and then acting in accordance to the signal (provided k^* is positive) is optimal, the corresponding error probability must be low enough to yield positive utility when the signal is s^H and negative utility in case of receiving s^L . I thus have to test whether k^* meets this condition. In general, this is not the case for all pairs $(p, \hat{\mu}) \in [q^L, q^H] \times (0, 1)$. The following lemma, however, shows that this is never an issue when utility implied by the optimal search behavior exceeds the one from not buying or from buying without extra information.

Definition 3.2. *Let*

$$u_s^*(p, \hat{\mu}) := u_s(p, \hat{\mu}, k^*(p, \hat{\mu}))$$

denote the maximal achievable utility if the consumer was committed to buy if and only if she receives signal s^H .

Lemma 3.3. *Let $(p, \hat{\mu}) \in [q^L, q^H] \times (0, 1)$ be given and denote $\hat{k}^* := k^*(p, \hat{\mu})$. Moreover, assume*

$$u_s^*(p, \hat{\mu}) > \max\{0, \bar{q}_{\hat{\mu}} - p\} = \max\{u_n, u_b(p, \hat{\mu})\}. \quad (2)$$

Then I have $\hat{k}^ > 0$ and the error probability $\varepsilon(\hat{k}^*)$ is low enough so that the consumer buys the product if and only if she receives the signal s^H .*

I denote the optimal utility, given a price p and a corresponding posterior belief $\hat{\mu}$ by

$$u^*(p, \hat{\mu}) := \max\{u_b(p, \hat{\mu}), u_n, u_s^*(p, \hat{\mu})\}.$$

Having the three options of searching, not buying and buying without search, the consumer acquires information if the condition (2) of the previous lemma is met (while there can be mixed strategies in case of equality). I continue by investigating when this is the case and when the consumer prefers either of the two other options, depending on the observed price p and the corresponding posterior belief $\hat{\mu}$. Note that due to the complicated behavior of the optimal search costs and hence the signal precision, the area in which positive search effort occurs is not trivially well-shaped.

Lemma 3.4. *For all $\hat{\mu} \in (0, 1)$ there are prices $\underline{p}_{\hat{\mu}}, \bar{p}_{\hat{\mu}}$ such that*

$$q^L < \underline{p}_{\hat{\mu}} \leq \bar{q}_{\hat{\mu}} \leq \bar{p}_{\hat{\mu}} < q^H$$

and the consumer strictly prefers buying without search whenever the price p is below $\underline{p}_{\hat{\mu}}$, she strictly prefers searching whenever $p \in (\underline{p}_{\hat{\mu}}, \bar{p}_{\hat{\mu}})$ and she strictly prefers not buying whenever $p > \bar{p}_{\hat{\mu}}$, provided that $\hat{\mu}$ is the corresponding posterior belief to p .

Figure 3 gives a graphical intuition for how the utility of each of the three options depends on p for a fixed value of $\hat{\mu}$. There is a counter-intuitive effect when $\hat{\mu} > \frac{1}{2}$. The optimal search effort k^* is then decreasing in the price and hence a price increase could have a positive effect for the consumer's utility. In the proof of Lemma 3.4 I show that this effect is, however, negligible such that I indeed always have a decreasing behavior of the search payoff in the price variable. The thicker line in the figure depicts the function u^* , the maximum utility value of all three options “search”, “buy” and “don't buy”. Note that u_s^* is not a linear function but the proof shows that its slope is always below zero and above the slope of u_b which leads to the result above.

Having this lemma, I am particularly interested in situations where the interval $(\underline{p}_{\hat{\mu}}, \bar{p}_{\hat{\mu}})$ is not empty. As it turns out, this is always the case as long as the marginal gain of signal precision from search effort is sufficiently high at zero.

Lemma 3.5. *For all $\hat{\mu} \in (0, 1)$, the strict inequality $\underline{p}_{\hat{\mu}} < \bar{p}_{\hat{\mu}}$ holds if and only if*

$$\varepsilon'(0) < \frac{-1}{2\hat{\mu}(1 - \hat{\mu})(q^H - q^L)}.$$

In this case, one even has $\underline{p}_{\hat{\mu}} < \bar{q}_{\hat{\mu}} < \bar{p}_{\hat{\mu}}$.

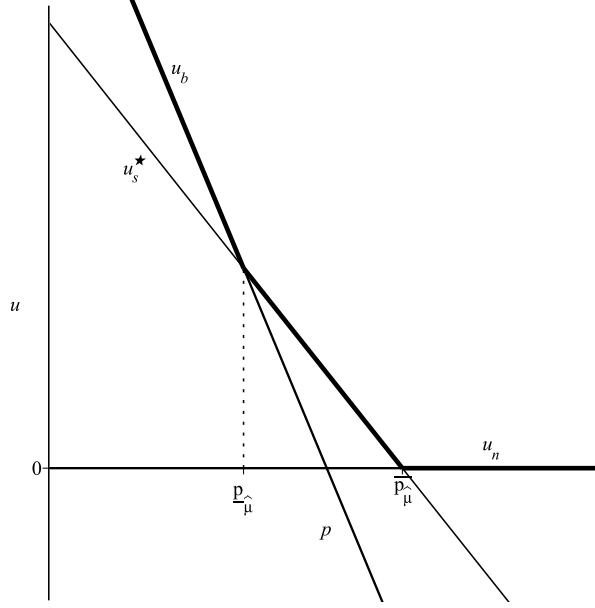


Figure 3: The utility development with p and determination of the prices $\underline{p}_{\hat{\mu}}$ and $\bar{p}_{\hat{\mu}}$ for fixed $\hat{\mu}$. The function u^* is given by the thick upper contour line.

In other words: Every non-degenerate posterior belief can lead to search behavior if the marginal benefit from search is sufficiently high.

Note that search and hence a positive probability of trade exists even with prices above expected quality $\bar{q}_{\hat{\mu}}$. It is of some importance for later analysis that the statement of this lemma is always true if I have $\varepsilon'(0) = -\infty$.

A similar result to Lemma 3.4 is true for the dependence of consumer's behavior on the posterior belief $\hat{\mu}$. This follows from the following, more important observation.

Lemma 3.6. *The values $\underline{p}_{\hat{\mu}}$ and $\bar{p}_{\hat{\mu}}$ are continuous and piecewise differentiable in $\hat{\mu}$. Moreover, I have*

$$\frac{\partial}{\partial \hat{\mu}} \underline{p}_{\hat{\mu}} > 0 \text{ and } \frac{\partial}{\partial \hat{\mu}} \bar{p}_{\hat{\mu}} > 0$$

for each point in which the respective function is differentiable and

$$\lim_{\hat{\mu} \rightarrow 0} \underline{p}_{\hat{\mu}} = \lim_{\hat{\mu} \rightarrow 0} \bar{p}_{\hat{\mu}} = q^L \quad \lim_{\hat{\mu} \rightarrow 1} \underline{p}_{\hat{\mu}} = \lim_{\hat{\mu} \rightarrow 1} \bar{p}_{\hat{\mu}} = q^H.$$

This relatively nice behavior of the lower and upper bound for prices for which search is optimal is somehow surprising when one considers the shape of the optimal search effort function. It is needless to say that these properties will facilitate the following equilibrium analysis.

To give a better feeling for how the three options of “search”, “buy” and “don’t buy” are distributed, I give a graphical example. Figure 4 shows the various areas for $q^H = 1, q^L = .5, \varepsilon(k) = \frac{1}{2} - \frac{3}{2}\sqrt{k}$. Note that this error function satisfies $\varepsilon'(0) = -\infty$ and hence for every non-degenerate value of $\hat{\mu}$ there is a price for which search is strictly optimal.

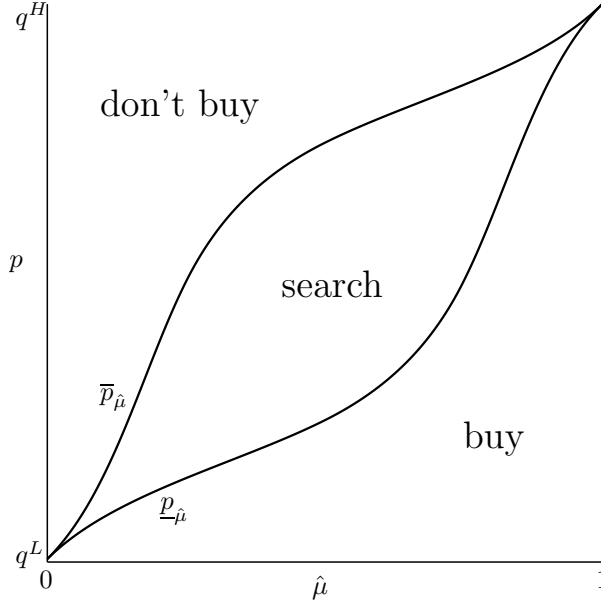


Figure 4: The areas of consumer behavior and the development of $\underline{p}_{\hat{\mu}}$ and $\bar{p}_{\hat{\mu}}$.

4. The market and equilibrium behavior

Having determined the behavior of the consumer, I investigate how this leads to various equilibria. I first need to formally define the game, i.e. the strategies and the equilibrium concept.

Definition 4.1. A consumer strategy is a function $b : \mathbb{R}_+ \rightarrow \mathbb{R}_+ \times [0, 1]^2$ where, for every price p , $b(p) = (k, \gamma^H, \gamma^L)$ denotes the amount of search effort k and the probabilities γ^H, γ^L of buying the product conditional on receiving the high or low signal.

A firm’s strategy $a : \{H, L\} \rightarrow \Delta(\mathbb{R}_+)$ is a mapping that maps each type to a probability distribution over the price space \mathbb{R}_+ .

I write a_H and a_L instead of $a(H)$ or $a(L)$. Using Lemma 3.1 of the previous section, I know that the consumer optimally either pays a positive search cost and then buys if and only if a positive signal arises or she does not search and buys with a certain probability $\gamma \in [0, 1]$ independent of the signal that does not convey any information. Based on this behavior, it is convenient to narrow down the set of possible consumer strategies.

Definition 4.2. A consistent consumer strategy is a strategy where for all $p \in \mathbb{R}_+$ I have $b(p) = (k, 1, 0)$ or $b(p) = (0, \gamma, \gamma)$ with $k > 0$ and $\gamma \in [0, 1]$.

Having this, I give the formal definition of an equilibrium in this setting.

Definition 4.3. Let (a, μ, b) be a tuple where a is the firm's strategy, $\mu : \mathbb{R}_+ \rightarrow [0, 1]$ is a posterior belief system of the consumer and b is a consistent consumer strategy. This tuple is an equilibrium if

- Every price in the support of a_H and a_L maximizes the profit of the respective type
- μ is determined by Bayes' law whenever possible⁴
- b maximizes the consumer's utility with respect to $\mu(p)$ for each prize p .

Note that this is similar to the classical weak Perfect Bayesian Equilibrium as used in the famous text book by Mas-Colell et al. (1995) but adapted to the general strategy space of this model. An equilibrium in which $a_H = a_L$ is called a *pooling equilibrium* while a *separating equilibrium* is one in which the supports of a_H and a_L have an empty intersection. I call any other equilibrium a *hybrid equilibrium*.

For an equilibrium $EQ = (a, \mu, b)$, any price p that is in at least one of the supports of a_L or a_H is called an *equilibrium price of EQ*. If additionally $b(p)$ has the form $(k, 1, 0)$, I call p a *search price* of EQ , otherwise a *no-search price*. Abusing notation, I denote $u(p, \mu(p), b(p))$ the consumer's expecting utility when observing a price p with corresponding posterior belief $\mu(p)$ and playing strategy $b(p)$. For each firm type θ I define the equilibrium profit $\pi^\theta(EQ)$ as the expected profit when setting a price in the support of a_θ . This value is well-defined by the first point in the equilibrium definition.

It is trivial to see that there can be a separating equilibrium in which the high type always sets price q^H , the low type sets the price q^L , the consumer has the belief system $\mu(p) = 1_{\{p=q^H\}}$ and only buys for prices smaller than or equal to q^L . For this to actually be an equilibrium, one must have $c^H \geq q^L$ so the high quality firm has no incentive to set the price q^L . This equilibrium would also occur if one did not allow for information acquisition and is present in many other models of markets with quality uncertainty. Note that high quality is not traded at all in this setting. I thus refer to this constellation as the *total adverse selection* (TAS) equilibrium.

To emphasize the relation to the classical model of quality uncertainty and the perfect information case, I briefly discuss these two cases.

With full information, the situation is quite obvious. Since the consumer always knows the type, the firm can always demand the true value q^θ and the buyer buys with proba-

⁴This point is often not formulated precisely in the literature. Formally, I apply the classic version of Bayes' law for every price p where $a_H(\{p\}) + a_L(\{p\}) > 0$. For prices that are in the support of exactly one of the two distributions, I assume that the posterior belief is either 1 or 0, according to the type that uses p . No restriction is made for prices that are in both supports but have probability 0.

bility one. Otherwise, any slightly lower price would lead to sure buying and thus causes the firm to deviate.

If the consumer had no possibility of obtaining information about the product quality, the described situation corresponds to a lemon market model in the spirit of Akerlof that is similar but not quite equal to the analysis of Ellingsen (1997)⁵. It appears as a special case of my model if I set $\varepsilon(k) = \frac{1}{2}$ for all k (which, of course, would not satisfy the assumptions). In his setting, if $c^H \leq \bar{q}_\eta$ ⁶, pooling equilibria exist for a price in $[\max\{q^L, c^H\}, \bar{q}_\eta]$ while separating equilibria with prices q^L and q^H always exist in which the low quality firm sells with probability one and the high quality firm with a probability in

$$\left[\max \left\{ 0, \frac{q^L - c^H}{q^H - c^H} \right\}, \frac{q^L - c^L}{q^H - c^L} \right].$$

In particular, the total adverse selection equilibrium exists if and only if $q^L \leq c^H$ as was already observed in the setting of this paper. There are other, hybrid equilibria in Ellingsen's setting. While they are disregarded due to his refinements and although his analysis is not completely applicable to my setting, such equilibria also appear here.

4.1. Equilibrium analysis

I start with observing some rather obvious and intuitive features that are quite standard and can be found in similar form in other models. They are nevertheless important for the analysis of equilibria.

Lemma 4.4. *In every equilibrium, the following statements hold.*

- i) *The support of a_L is a subset of $[q^L, q^H]$, the support of a_H is a subset of $[q^L, \infty)$.*
- ii) *The low type does not set the price q^H with positive probability.*
- iii) *The low type's profit is weakly larger than $q^L - c^L$.*
- iv) *Every price in (q^L, q^H) is either in both supports of a_L and a_H or in neither.*

These points are not surprising considering the nature of an equilibrium. Any price below q^L would induce sure buying and thus always yield a lower profit than a higher price with the same property. The low type thus always has the option to deviate to a price arbitrarily close to q^L and to receive a profit close to $q^L - c^L$ which shows iii). For the low type, setting a price q^H or higher with positive probability would lead to a posterior belief below 1 and hence the consumer does not buy. The resulting profit is zero and contradicts iii).

If a price is set by one type but not by the other, the equilibrium definition implies that the consumer knows the true quality. If it was a low type and the price was above q^L ,

⁵Ellingsen assumes equal differences between valuation and production costs for each type, thus corresponding to the case $q^H - c^H = q^L - c^L$.

⁶Although Ellingsen excludes this case in his paper, the set of pooling equilibria is easy to derive.

this would result in not buying at all, making it irrational for the low type to set this price. On the other hand, a price below q^H set by only the high firm would result in sure buying and this would attract the low quality firm to imitate that behavior. The formal versions of these arguments can be found in the appendix.

Since the consumer never buys a product for a price higher than q^H , every such strategy is at least weakly dominated by any price in $(c^H, q^H]$. I thus assume that also the high type does not set a price above q^H .

I now know that, apart from the prices q^L and q^H , every price is either in both types' support or in neither of them. However, there could in principal still be a large number of such prices, making further analysis even more complicated by adding measure theoretic obstacles. I show that this is in fact not the case and that there cannot be more than two such non-boundary prices played in equilibrium.

Lemma 4.5. *In an equilibrium, there are no two prices that are in both supports of a_L and a_H and for which the consumer searches.*

Lemma 4.6. *In an equilibrium, there cannot exist two different prices that are in both supports and for which the consumer does not search.*

For both of these lemmas, the first property of an equilibrium implies that both types must be indifferent between the prices in the support of their price distribution. In the proof, I show that this can not be the case for two search prices or two no-search prices. It is, however, possible that both types are indifferent between a search price and a no-search price.

These observations already significantly reduce the set of possible equilibrium strategies. Although I put no a-priori restrictions on the firm's price setting behavior, in equilibrium, each type does not play more than two prices in the set (q^L, q^H) .

If the error function ε satisfies an additional, Inada-like condition, I can rule out even more equilibria. As seen in Lemma 3.5, the value of $\varepsilon'(0)$ is of importance when it comes to determining the consumer reaction. It has to be low enough to ensure the existence of a search price for any given posterior belief $\hat{\mu} \in (0, 1)$. The bound itself depends on this belief and hence may vary between different equilibria or even between different equilibrium prices. It is hence convenient to define the following property.

Definition 4.7. *An error function ε satisfies the assumption (I) if*

$$\varepsilon'(0) = -\infty.$$

Having this, I can even go further in narrowing down the set of equilibria.

Lemma 4.8. *Assume that ε satisfies assumption (I) and let $p \in (q^L, q^H)$ be a no-search equilibrium price. Then $b(p) = (0, 1, 1)$ so that the consumer buys with probability one.*

This statement follows from Lemma 3.5. If the consumer buys with a probability in $(0, 1)$, she is indifferent between buying and not buying, hence $q_{\mu(p)} = p$. This price,

however, leads to search when $\varepsilon'(0)$ is low enough. Having $b(p) = (0, 0, 0)$ would give zero profit to both firms and thus violates Lemma 4.4 iii).

The previous lemmas now allow me to define quite precisely the form of possible equilibria in the model.

Proposition 4.9. *If assumption (I) is satisfied, in every equilibrium the inclusions*

$$\begin{aligned} \text{supp}(a_L) &\subset \{q^L, p_s\} & \text{supp}(a_H) &\subset \{p_s, q^H\} \\ \text{or } \text{supp}(a_L) &= \{p_1\} & \text{supp}(a_H) &\subset \{p_1, q^H\} \end{aligned}$$

hold where p_s is a search price, q^L and p_1 induce sure buying and if q^H is played, I have $b(q^H) = (0, \gamma, \gamma)$ with γ low enough to not attract the low type firm.

Summarized, these are the different types of equilibria in the model

- Separating adverse selection equilibria
- Pooling equilibria without search in which both types set the same price $p_1 \leq \underline{p}_\eta$
- Pooling equilibria with search and a price $p_s \in [\underline{p}_\eta, \bar{p}_\eta]$
- Hybrid equilibria in which the high type firm demands a high search price p_s and the low type plays $a_L(p_s) = \alpha$, $a_L(q^L) = 1 - \alpha$ for some $\alpha \in (0, 1)$.
- Other equilibria with $q^H \in \text{supp}(a_H)$ and $\gamma > 0$.

All these equilibria exist provided the buyer and the high type firm make non-negative profit and the low type earns at least $q^L - c^L$. I denote the pooling search equilibrium with the highest possible price \bar{p}_η as PE_s and the pooling no-search equilibrium with the price \underline{p}_η as PE_b . If at least one hybrid equilibrium exists, the one with the highest search price p_s is denoted as HE . These are the important equilibria due to the robustness check in the next subsection. The set of potential equilibria is significantly narrowed down but still too large to draw qualitative conclusions from the model. In what follows, I argue in which way some of these equilibria, and in particular the belief systems by which they can be supported, can be disregarded.

4.2. Selection of equilibria

There are various, well established refinements to eliminate implausible equilibria in signaling games. Bester and Ritzberger (2001) use a modification of the well-known Intuitive Criterion introduced by Cho and Kreps (1987). In my model, as well as in theirs, the original version of the Intuitive Criterion does not rule out any equilibria. The modification used by Bester and Ritzberger, however, is not well defined in my setting since the firms' profit functions are not monotone in beliefs. I thus follow another approach of arguing which consumer beliefs are unconvincing and hence rule out the equilibria supported by these beliefs.

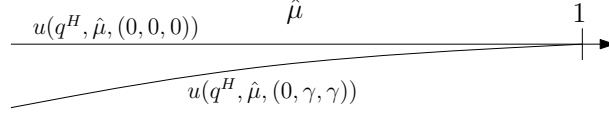


Figure 5: Buying for the price q^H leads to negative utility if $\hat{\mu} < 1$

To illustrate the idea of the following refinement, consider an adverse selection equilibrium in which the high type firm makes positive profit, i.e. a separating equilibrium in which the low type sets price q^L , the high type price q^H and the consumer buys the high quality product with some probability $\gamma > 0$. From the equilibrium property I must have $\mu(q^H) = 1$ so the consumer knows the quality when she sees the high price. Note that she is then indifferent between buying and not buying since the price matches her valuation. If she had any doubts about her posterior belief $\mu(q^H)$, i.e. if she admits that there is even the smallest possibility to be wrong about her belief, “not buying” would be strictly better than her strategy $b(q^H) = (0, \gamma, \gamma)$. Since “not buying” is optimal even for her rational belief $\hat{\mu} = 1$, her strategy is dominated in a certain sense. This idea is depicted in Figure 5 and formally written down in the following refinement.

Definition 4.10. *Let $p, \mu(p)$ be given. The action $b \in \mathbb{R}_+ \times [0, 1]^2$ is locally dominated in beliefs if there exists another action $b^* \in \mathbb{R}_+ \times [0, 1]^2$ and a $\delta > 0$ such that*

$$u(p, \hat{\mu}, b^*) \geq u(p, \hat{\mu}, b) \quad \forall \hat{\mu} \in (\mu(p) - \delta, \mu(p) + \delta) \cap [0, 1]$$

and the inequality is strict for $\hat{\mu} \neq \mu(p)$.

An equilibrium (a, μ, b) has belief-robust responses if for no price p and corresponding belief $\mu(p)$ the action $b(p)$ is dominated in beliefs.

This condition reflects some doubts about the posterior beliefs. A best response which violates this criterion is not a strict one, meaning that there is another best response b^* to $(p, \mu(p))$ that yields the same payoff. Moreover, this response is even strictly better if the buyer was only a little wrong about her posterior belief.

The criterion is one of local robustness of the strategy. Other criteria in the same spirit can be found in the literature, for example the *robust best reply* definition in Okada (1983).

Note that this condition does not in general rule out mixed strategies of the consumer. In this case, however, it leads to eliminating all equilibria in which the buyer plays a mixed strategy for the highest possible price q^H , including the classic adverse selection equilibria, mentioned above, in which the high type makes positive profits.

Lemma 4.11. *For an equilibrium, the following is equivalent.*

- i) *The equilibrium has belief-robust responses.*
- ii) *The price q^H is not in the support of a_H or the equilibrium is the separating equilibrium with total adverse selection.*

The reason why most adverse selection equilibria are ruled out is not specific to my setting. In fact, a similar refinement excludes these equilibria e.g. in Ellingsen (1997).⁷ In that paper, he uses another refinement under which only the separating equilibrium with the highest possible high type trade probability survives. While this is a legitimate approach, the richness of equilibria in my setting allows me to exclude these equilibria and still obtain interesting results.⁸

As one can see, a lot of the equilibria survive this refinement. This gives me the opportunity to address another issue of implausible consumer behavior, namely the possibility of extreme belief changes.

Imagine two situations in which the consumer observes a price p or a similar price that is very close to p . It does not seem intuitive that the posterior beliefs should differ too much, especially if I let the difference of the two prices be arbitrarily small. Even if one admits that real prices usually can not differ by less than one cent, posterior beliefs that assign $\mu(p) = 1$ and $\mu(p + 0.01) = 0$ seem quite extreme. In fact, marginal price changes are often due to reseller behavior and may not even be perfectly perceived by consumers.⁹ It thus seems more natural that the consumer would rather acknowledge the closeness of the prices by assigning a similar posterior belief. Formally, I postulate continuity of beliefs in those prices that actually occur in equilibrium.

Definition 4.12. *An equilibrium (a, μ, b) satisfies the locally continuous beliefs condition if for every equilibrium price p the function μ is continuous in p .*

Continuity is not a very strong assumption considering that it just excludes jumps in beliefs but still allows for arbitrarily strongly increasing or decreasing posteriors. The described behavior for the one-cent difference in the motivating example would actually still be possible under locally continuous beliefs. However, this slight step has a big impact on the number of equilibria.

Before I determine the consequences of this refinement, note that it usually¹⁰ rules out the pooling equilibrium without search (PE_b) if I have $\varepsilon(\underline{p}_\eta) = 0$ so that there is perfect search for the border case of a pooling equilibrium price in which “buy” and “search” yield the same outcome to the consumer. The reason for this is that, with continuous beliefs, the high quality firm would want to deviate to a slightly higher price than \underline{p}_η .

⁷Compare Proposition 5 of Ellingsen (1997). Note that elimination of strategies that are locally dominated in beliefs could be substituted by elimination of weakly dominated strategies in my paper without changing the results.

⁸Interestingly enough, Ellingsen justifies his new refinement by saying “in reality, a seller will typically not know exactly the buyer’s valuation” which is true. In the same spirit, however, the idea that the consumer might not be perfectly confident about her posterior beliefs should not be ignored. Ellingsen’s idea of “elastic demand” is incorporated in my next refinement and thus this approach covers both aspects of imperfections to some extent.

⁹See Zeithaml (1988) for an overview on perception of price and other product characteristics by consumers.

¹⁰There can be cases in which the pair $(\underline{p}_\eta, \eta)$ is exactly on the border defined by (1) so that there might be a continuous “path” $\mu(p)$ of posterior beliefs under which the PE_b equilibrium can be sustained. Since this is a non-generic case, I omit the detailed analysis and just write $\varepsilon(\underline{p}_\eta) > 0$ as condition for the stability of PE_b .

which, because the consumer receives a perfect signal, also yields a selling probability of one.

Proposition 4.13. *The strategies (a, b) can be supported by a posterior belief system that satisfies locally continuous beliefs and such that it has belief-robust responses if and only if they are the strategies of one of the following equilibria:*

- the pooling no-search equilibrium PE_b with price \underline{p}_η . This equilibrium exists if and only if $\underline{p}_\eta \geq c^H$ and $\varepsilon(\underline{p}_\eta) > 0$
- the pooling search equilibrium PE_s with price \bar{p}_η . It exists if and only if $\bar{p}_\eta \geq c^H$ and $\pi^L \geq q^L - c^L$
- hybrid equilibria in which the high quality firm sets a price $p = \bar{p}_{\hat{\mu}}$ and the low quality firm sets this price with probability $\alpha \in (0, 1)$ while setting q^L with probability $(1 - \alpha)$ and I have $\hat{\mu} = \mu(p) = \frac{\eta}{\eta + \alpha(1 - \eta)} > \eta$. This equilibrium exists if and only if $\bar{p}_{\hat{\mu}} \geq c^H$.
- the total adverse selection equilibrium (TAS). It exists if $c^H \geq q^L$.

While three of these equilibria are unique within their class if they exist, there may be multiple hybrid equilibria. Every value $\hat{\mu} > \eta$ for which the equation

$$\varepsilon(k^*(\bar{p}_{\hat{\mu}}, \hat{\mu})) \cdot (\bar{p}_{\hat{\mu}} - c^L) = q^L - c^L$$

holds yields such an equilibrium if c^H does not exceed the price $\bar{p}_{\hat{\mu}}$. The reason is that a low quality firm must be indifferent between the prices $\bar{p}_{\hat{\mu}}$ and q^L . Figure 6 shows such a constellation in which not only multiple hybrid equilibria but also the pooling search equilibrium PE_s exist at the same time.

To give an overview over the qualitative implications of these equilibria, their properties are summarized in the following table. The “ \gtrsim ” symbol indicates generic strict inequalities, i.e. the set of parameters for which equality occurs is a Lebesgue null set in the parameter space.¹¹

	π^H	π^L	consumer utility	existence condition
PE_b	$\gtrsim 0$	$> q^L - c^L$	> 0	$\underline{p}_\eta \geq c^H$ and $\varepsilon(\underline{p}_\eta) > 0$
PE_s	$\gtrsim 0$	$\gtrsim q^L - c^L$	0	$\bar{p}_\eta \geq c^H$ and $\pi^L \geq q^L - c^L$
hybrid	> 0	$q^L - c^L$	0	$\exists \hat{\mu} > \eta : \bar{p}_{\hat{\mu}} \geq c^H$ and $\pi^L = q^L - c^L$
TAS	0	$q^L - c^L$	0	$c^H \geq q^L$

Table 1: The properties of equilibria surviving the refinements

This table shows an interesting aspect especially about the consumer utility. There is only one equilibrium in which she has positive utility and this does not involve search.

¹¹For example, in the PE_s equilibrium if \bar{p}_η happens to be exactly c^H , the high type makes no profit.

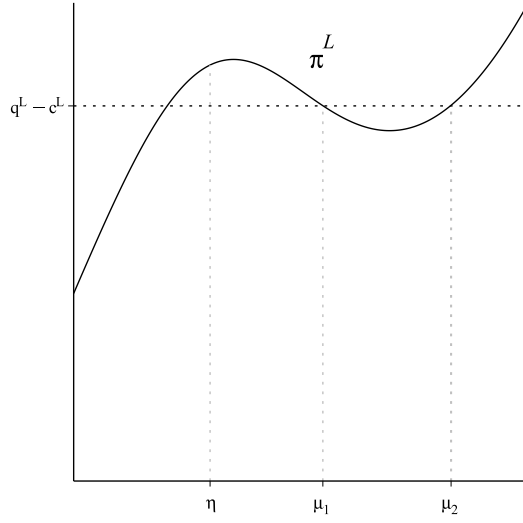


Figure 6: The coexistence of PE_s and multiple hybrid equilibria. The function depicts the low type profit for each $\hat{\mu}$ when setting the price $\bar{p}_{\hat{\mu}}$. The values μ_1 and μ_2 are the posterior beliefs of hybrid equilibria.

As stated earlier, the classical models do not leave any consumer utility in any refined equilibrium. Introducing search can benefit the consumer but only if she does not use this new “ability”. The possibility of search does not allow the PE_b equilibrium to have a higher price than \underline{p}_{η} . Remember that in the classic lemon market this price was equal to \bar{q}_{η} so that the consumer had zero expected utility. Naturally, this consumer friendly equilibrium only exists if the price is still high enough for a high quality firm to make positive profit. It also shows, however, that if the optimal search effort on the pooling price leads to perfect information, this equilibrium fails the refinements. In this case, the consumer’s ability to search destroys her only chance of having positive utility. I elaborate on this effect in the next section.

Quality uncertainty situations being famous for their adverse selection effects, I can now investigate how the model behaves in this regard. The following shows that introducing search, as one would assume, indeed reduces the advantage of low quality goods over high quality goods in terms of traded amount.

Observation 4.14. In PE_b and PE_s , a high quality firm has a weakly higher probability of selling the good than the low type. In any hybrid equilibrium, the probability for a high firm of selling the good is higher than in any separating adverse selection equilibrium.

Note that in a hybrid equilibrium, the low type firm can have a higher chance of selling its good than the other type. This value is $1 - \alpha + \alpha\hat{\varepsilon}$ where α is the share with which it sets the high search price and $\hat{\varepsilon}$ is the error probability of that price.

To go even further, observe that there is a partial ranking in Pareto dominance between the existing equilibria.

Definition 4.15. *An equilibrium (a, μ, b) Pareto dominates another equilibrium $(\tilde{a}, \tilde{\mu}, \tilde{b})$ if the equilibrium payoffs satisfy $\pi^H \geq \tilde{\pi}^H$, $\pi^L \geq \tilde{\pi}^L$ and $u^* \geq \tilde{u}^*$ and at least one of these inequalities is strict.*

This definition of Pareto dominance is taken after the quality of the firm is revealed, thus taking each type's profit into account separately. This gives a stricter version than an a-priori Pareto dominance in which one would only consider the expected profit before the firm learns its type. However, an interesting dominance ranking holds even with this condition.

Lemma 4.16. *The following items reflect the full Pareto dominance ranking between the equilibria of Proposition 4.13.*

- *If multiple hybrid equilibria exist, the one with the highest search price (HE) dominates the others.*
- *TAS is dominated by PE_b , PE_s and HE whenever one of these equilibria exists.*
- *PE_s and HE are dominated by PE_b if and only if $\pi^H(PE_s) \leq \pi^H(PE_b)$ or $\pi^H(PE_s) \leq \pi^H(HE)$, respectively.*

It is quite natural to observe that the equilibria PE_s and HE are somehow similar. In both equilibria, there is a search price on the upper border of the search area and the consumer has zero utility. Indeed, the coexistence of these equilibria is rare and does never occur if the probability of having high quality is sufficiently high.

Lemma 4.17. *Let $q^L - c^L < q^H - q^L$. There is a lower bound $\underline{\eta} < \frac{1}{2}$ such that whenever $\eta > \underline{\eta}$, there exists either PE_s or HE provided that the search price of one of these equilibria exceeds c^H .*

The reason for having this lower bound lies in the profit of the low quality type. It strictly increases when the posterior $\hat{\mu}$ goes from $\frac{1}{2}$ to 1 and the price is $\bar{p}_{\hat{\mu}}$. Thus, the PE_s condition $\pi^L \geq q^L - c^L$ implies that for all higher beliefs the low type's profit is even larger. In HE , however, the profit must exactly attain this bound. The situation in Figure 6 corresponds to a case in which $\eta < \underline{\eta}$. In this figure, $\underline{\eta}$ can be chosen to be μ_1 .

Notice also that the actual value of $\underline{\eta}$ might be zero so that the negative profit effect of losing customers never outweighs the positive effect of a higher price for the low type firm. The condition $q^L - c^L < q^H - q^L$ of the lemma follows from the existence condition of a hybrid equilibrium. If this is violated, a hybrid equilibrium can never exist.

The so far established results already shed some light on how the market outcome is influenced by introducing information acquisition costs in the classical model of quality uncertainty. It shows that if the cost for high quality production is low, a pooling

equilibrium without search exists. While this is also true in the classical model, there are qualitatively different aspects, namely that the actual price to pay in the pooling equilibrium is strictly below the average quality valuation and hence the consumer has strictly positive utility. On the other hand this effect is caused by the same issue that rules out these equilibria for high quality costs between \underline{p}_η and \bar{q}_η . In these cases, introducing the possibility of information acquisition leads to search behavior but does not help the consumer.

A different phenomenon can be observed in the PE_s and HE equilibria. They exist whenever \bar{p} is high enough. Since these equilibria contain search prices, they do not occur in the classical model but dominate and thus eliminate the otherwise existing separating equilibria. Although also the payoffs are different, the main contribution of these equilibria is the weakening or complete elimination of adverse selection phenomena.

5. Search efficiency

The previous section investigates a market in which the search possibility for the consumer is fixed by the function ε . As mentioned in the introduction, I am also interested in comparing situations in which consumer might have higher or lower costs for searching. Since the actual costs k are endogenously chosen by the consumer, I have to clarify what “lower search costs” means in this setting. It is rather to be viewed as higher “search efficiency” which means that the consumer gets a more precise signal for the same search effort. Think about someone who wants to buy a TV in 2013 or someone in the 1980s. Getting information about a certain product is much easier now than it was back then, due to the Internet, multiple test magazines and websites. It is safe to say that it is both less time consuming and cheaper to get the same amount of information now than it was back then.

To capture this efficiency in my model I introduce a parameter a to the function ε . The extended function satisfies the following properties.

- $\varepsilon : \mathbb{R}_+^2 \rightarrow [0, \frac{1}{2}]$, $(k, a) \mapsto \varepsilon(k, a)$ is continuous.
- For every $a > 0$, $\varepsilon(\cdot, a)$ satisfies the assumptions from section 2 on page 4 and assumption (I). Denote $\bar{k}(a)$ the perfect information cost for parameter a .
- The function is twice continuously differentiable on

$$K := \{(k, a) | 0 < k < \bar{k}(a)\} = \{(k, a) | 0 < \varepsilon(k, a) < \frac{1}{2}\},$$

the area in which information is neither perfect nor meaningless.

- $\varepsilon_a(k, a) := \frac{\partial}{\partial a} \varepsilon(k, a) < 0$ for all $(k, a) \in K$.
- For all $k > 0$ I have $\lim_{a \rightarrow \infty} \varepsilon(k, a) = 0$ and $\lim_{a \rightarrow 0} \varepsilon(k, a) = \frac{1}{2}$.

Having $\varepsilon(\cdot, a)$ satisfy the same conditions as before, one can use the results of the previous model and perform comparative statics by varying parameter a . The fourth

point ensures that for increasing a , the signal precision for the same search effort becomes higher. Finally, the last item ensures that in the pointwise limit, the error function reflects perfect information (for $a \rightarrow \infty$) or the classical lemon market without information acquisition (for $a \rightarrow 0$). Hence, it allows me to use the parameter as a mediator between these two widely acknowledged models. One simple example for such a function is

$$\varepsilon(k, a) = \max \left\{ \frac{1}{2} - a\sqrt{k}, 0 \right\}. \quad (3)$$

Most expressions of the previous sections now depend on the new parameter. I denote them in the same way but adding the value a as the last argument of every function.

The aim of this section is to compare the various types of equilibria and their level of price, consumer utility, average quality etc. under a change of search efficiency. It is also worth checking whether the limit behavior of the error probability function, when taking $a \rightarrow \infty$ or $a \rightarrow 0$, also leads to market behavior that converges to the equilibria of the classical lemon market or the perfect information case as discussed above.

This analysis is necessarily different from the one of Bester and Ritzberger (2001) since their cost had an exogenously given value and could thus just be directly increased or decreased. Here, the effort level is chosen by a rational consumer. A direct change of the costs can thus not be done. I rather facilitate the access to information by giving more signal precision for the same effort.

5.1. Analytical results

The first result analyzes the price behavior under pooling equilibria where no search occurs. Remember that the consumer is indifferent between *searching* and *buying without search* in the pooling price \underline{p}_η of these equilibria.

Proposition 5.1. *The price $\underline{p}_\eta(a)$ of the PE_b equilibrium is continuous, piecewise differentiable and non-increasing in a . Moreover,*

$$\lim_{a \rightarrow 0} \underline{p}_\eta(a) = \bar{q}_\eta \text{ and } \lim_{a \rightarrow \infty} \underline{p}_\eta(a) = q^L.$$

holds. If $q^L < c^H < \bar{q}_\eta$, there are values $0 < \underline{a} \leq \bar{a}$ such that the pooling no-search equilibrium PE_b exists if $a \leq \underline{a}$ and it does not exist for $a \geq \bar{a}$.

The reason why $\underline{a} \neq \bar{a}$ can not be excluded despite the monotonicity of the price in PE_b is that the condition $\hat{\varepsilon} > 0$ for PE_b to be an equilibrium might be violated for some lower a but be true for a higher search efficiency. This, however, appears for rather special parameters and is not further investigated. A direct consequence of this proposition is that the profit of both firms decreases with increasing search efficiency while the consumer's utility rises in the pooling equilibrium without search. This can be seen by just observing that neither the average quality nor the amount of trade is different between each of these equilibria.

Remember that in the end of the last section I conclude that the existence of PE_b is due to moderate production costs of high quality goods. The proposition provides a similar

statement in terms of search costs. Only when search costs are high, pooling no-search equilibria can exist. However, as long as $a < \underline{a}$, making search more efficient lets the equilibrium price decrease and thus gives a higher utility to the consumer. This supports the first intuition that a more efficient way of searching should increase the consumer's power and thus increases her surplus. Note, however, that no search occurs in these equilibria. Instead, all products are sold for a price that decreases with better search efficiency. Here, the possibility of search is rather used as a threat than as a tool.

One can observe a similar behavior for the upper bound \bar{p}_η of the consumer's search area.

Proposition 5.2. *For every $\hat{\mu} \in (0, 1)$ the function $\bar{p}_{\hat{\mu}}(a)$ is continuous, piecewise differentiable and non-decreasing in a . Moreover, I have*

$$\lim_{a \rightarrow 0} \bar{p}_{\hat{\mu}}(a) = \bar{q}_\eta \text{ and } \lim_{a \rightarrow \infty} \bar{p}_{\hat{\mu}}(a) = q^H.$$

Inferring to equilibrium behavior from this proposition is not as easy as it was before, since both PE_s and HE make use of search prices. It is not obvious which of these equilibria exist for a given a . However, noticing that the high price of HE is always higher than \bar{p}_η , it follows that the equilibrium search price behavior for $a \rightarrow \infty$ is not influenced by this question.

Corollary 5.3. *Let $c^H > q^L$ and $q^L - c^L < q^H - q^L$. For $a \rightarrow \infty$, all undominated equilibria converge to a separating state in which the high type sells with probability $1 - \frac{q^L - c^L}{q^H - c^L}$.*

If the condition $c^H > q^L$ was violated, the pooling equilibrium without search PE_b would exist for all a . The second condition ensures the existence of HE even for high values of a . Since every equilibrium in this setting has only a finite number of prices and I am not interested in the out-of-equilibrium beliefs, convergence of equilibria is just taken as convergence of the firms' actions.

This result is striking in that even though the information costs approach zero, the consumer still makes errors and does not get perfect information. The firm's behavior converges to the separating state that would appear in the perfect information case but the probability of selling does not approach one. Note that there is an important difference to the similar result by Bester and Ritzberger (2001). They show that in their setting, letting the information costs k approach zero, a non-vanishing share of consumers still acquires information but the high type still sells to all buyers that would by the product under perfect information. In contrast, the limit behavior at hand shows a sustainable loss in sales for the high quality type.

The analysis of equilibria in the other direction is quite tricky. When search becomes inefficient, the prices of PE_b and PE_s necessarily converge to \bar{q}_η and the question if this is an equilibrium depends on whether the high quality production costs exceed this value. If they do, PE_b and PE_s do not exist for low values of a but TAS does. In other words, these equilibria converge to the two possible classic lemon market equilibria with the exact same existence conditions. One might expect that this price convergence is

also true for HE since $\bar{p}_{\hat{\mu}}(a)$ is the high quality price. The issue here is that in HE , the posterior $\hat{\mu}$ for the search price itself depends on a so that the convergence result from Proposition 5.2 does not apply and may, in fact, not be true for the equilibrium price.

Observation 5.4. Let $\eta(q^H - q^L) < q^L - c^L < q^H - q^L$ and $c^H < 2q^L - c^L$. Then, for each value of a which is close enough to 0, HE exists and for $a \rightarrow 0$ these equilibria converge to a semi-separating state with the high type setting $\hat{p} := 2q^L - c^L$ while the low type mixes between this price and q^L .

The limit state of the HE equilibria involves a high price $\hat{p} = 2q^L - c^L$ and a posterior belief $\mu(\hat{p}) = \frac{q^L - c^L}{q^H - q^L}$ while the probability of selling is $\frac{1}{2}$. If $q^H - c^H = q^L - c^L$, this situation corresponds to one of the *semi-mixed equilibria* computed by Ellingsen (1997) in his model without information acquisition. There, this equilibrium exists with many others of a similar type and fails the D1 refinement by Cho and Kreps (1987). However, the behavior here shows that this equilibrium, if it exists, is robust with respect to costly information acquisition.

5.2. A numerical example

To increase the understanding of what happens with various levels of search efficiency, I continue with a concrete example. Even with a relatively simple error function satisfying the assumptions, the model is too complex to solve for explicit expressions of the various equilibria. I thus rely on numerical calculations to illustrate the results on the development of the model outcomes.

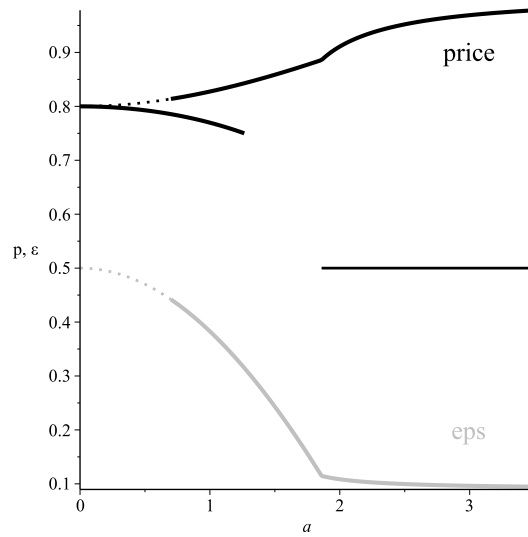


Figure 7: Price and error probability development for increasing search efficiency

For these calculations I choose the error function (3) and set $\eta = .6$, $q^H = 1$, $q^L = \frac{1}{2}$, $c^H = \frac{3}{4}$ and $c^L = .45$. Note that since $c^H < \bar{q}_\eta = .8$, the existence of pooling no-search

equilibria is possible for small values of a . Choosing $\eta \geq \frac{1}{2}$ ensures, using Lemma 4.17, that PE_s and HE do not exist at the same time to obtain clearer pictures. Corollary 5.3 is applicable to this setting but Observation 5.4 is not. I give a second example to illustrate its result.

Figure 7 depicts the development of the price and the corresponding error probability for the various search prices. The thin black line is the price q^L for the low quality in HE . To show the convergence even of the dominated pooling search equilibria, their values are displayed as dotted lines. One observes that for low values of a , the pooling no-search equilibrium exists and that its price is decreasing. While at first the other equilibrium is dominated, there is an interval of values of a in which both pooling equilibria exist at the same time until the lower price falls under the production costs of the high type. As search gets more efficient, the error probability decreases and converges to $\frac{q^L - c^L}{q^H - c^L} \approx 0,091$ as predicted by Corollary 5.3.

Figure 8 illustrates the profit development of the different types in these equilibria.

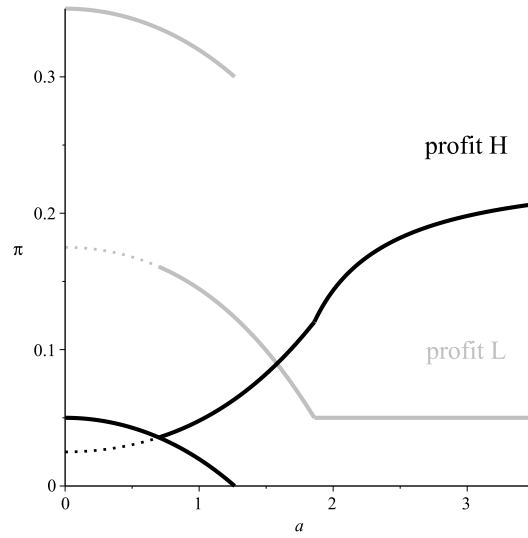


Figure 8: The profits of both types, depending on the search efficiency and the equilibrium

One can see very well how profits decrease in PE_b and how PE_s stops being Pareto dominated when its high type's profit catches up with the one from PE_b . The low type's profit never falls below $q^L - c^L = .05$ and attains this value in the hybrid equilibrium.

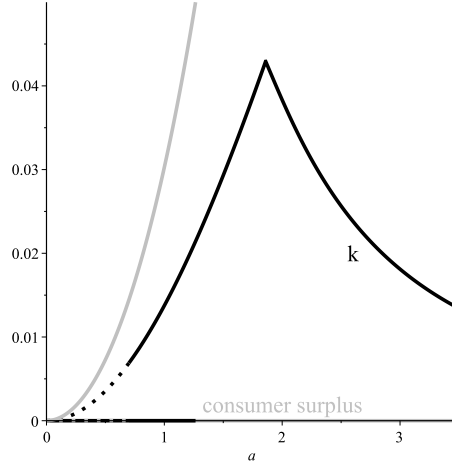


Figure 9: Utility and search effort of the consumer

I look at the consumer side of the market in Figure 9. The utility of the consumer behaves exactly as predicted. An interesting effect is observable for the search costs. Although search gets more efficient with increasing a , the absolute effort increases in the pooling search equilibrium. This effect has already been observed by Bester and Ritzberger (2001) and is reproduced here under a different model of search behavior. It shows how the power given to the consumer by allowing for information acquisition can be exploited by the high type to increase prices, search behavior and thus also the probability of selling the high quality product.

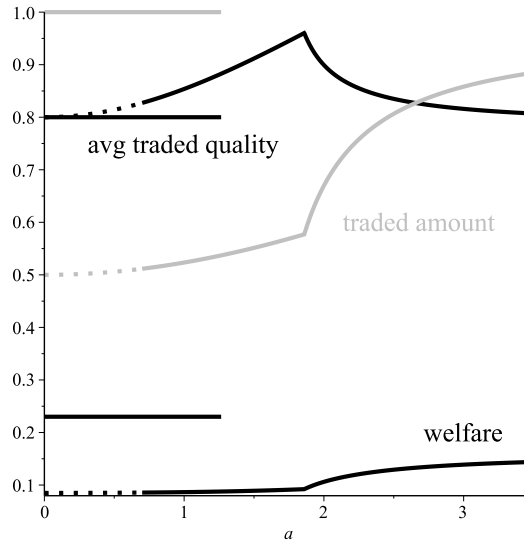


Figure 10: The development of various market characteristics

Finally, Figure 10 depicts the development of some market figures. Welfare here is simply computed as a sum of the firm's expected profit $\eta\pi^H + (1-\eta)\pi^L$ and the consumer utility. The high welfare value in PE_b stems not only from the higher consumer utility but mostly from the fact that all products are traded with probability one and no utility is "wasted" on search effort. All possible gains from trade are thus exploited and distributed among the market participants.

In contrast to markets with quality uncertainty being famous for their adverse selection phenomena, average traded quality in this setting is even higher than the offered one. This is of course due to the higher trade probabilities for the high type on search prices and thus occurs in PE_s and HE . As search gets more efficient, the low type shifts its price distribution more to q^L and hence sells with an overall higher probability which causes average traded quality to go down and, because of the not vanishing error probability, to go even below the a-priori expected quality.

To also give an example of Proposition 5.4, I consider the case where $q^H = 1, q^L = 0.5, c^H = 0.7, c^L = 0.2$ and $\eta = .35$. Note that this also implies that PE_b and PE_s do not exist if a is close to 0 because of their low price close to $\bar{q}_\eta = .675$. The values are explicitly chosen so that they fit the model of Ellingsen (1997) in which $q^H - c^H = q^L - c^L$. As mentioned before, his refinements forecast a separating equilibrium for this case without information acquisition. This result may serve as a hint that these equilibria might not be disregarded, after all.



Figure 11: The convergence of HE for vanishing search efficiency.

6. Conclusion and possible extensions

The paper shows the outcome of a monopolistic market with quality uncertainty in which the consumer has the possibility to costly acquire information about the product quality. This information could be perfect or imperfect, the exact precision depending on the endogenous search effort exerted by the consumer.

Given the optimal consumer behavior, the market offers many possible equilibria, some of which are already present in the classical model without information acquisition. After eliminating implausible and Pareto dominated equilibria, I am left with three main categories of market behavior. In pooling equilibria without search, the consumer has a positive profit and the highest possible welfare was reached. Equilibria that comprise search leave no utility to the consumer but, except for when information is cheap, have an average traded quality that is above the actual average and thus show the opposite effect to the classical adverse selection results on lemon markets. The third category of total adverse selection only occurs when high quality production costs are high and search is not efficient. The analysis shows that information acquisition possibilities only benefit the consumer if she does not acquire any information. If she can use her search abilities as a threat rather than actually acquire costly information, she can cause prices to be lower than the average quality and thus have positive utility. In contrast, actual quality search in equilibrium leads to a higher market power of the high type and thus to higher prices but also to higher average traded quality. The consumer's welfare is zero in these equilibria.

An important contribution of this paper is the comparison of situations with different search efficiencies. I show that an increase in efficiency can benefit or hurt the consumer and that the consumer's utility will with certainty drop to zero after a certain threshold of efficiency.

At last, the analysis shows that the case of perfect information is not the limit case of high search efficiency. Even when making information acquisition arbitrarily cheap, the probability of consumers receiving a false signal does not vanish. Moreover, this limit error level does not depend on the error function. Making information acquisition inefficient can lead to the same behavior as predicted in the classical models but for a wide range of parameters the limit equilibrium is one that was previously disregarded.

Starting from this model, certain extensions come to mind to enrich the analysis and lead to a more realistic behavior.

As most other papers in this field, this work does not incorporate competition between multiple firms. The consumer is always confronted with exactly one good and her only choices are on how much to search and if to buy the product. In the same way the firm does not have to worry about actual competition. The type of "rival" it faces exists only theoretically in the head of the consumer who has to figure out which type she is facing. Extending this setting to an oligopolistic market will certainly prove to be interesting.

I only look at one consumer. As I have pointed out, this could be extended to multiple identical consumers without changing the analysis and thus the outcome. In reality, this is not realistic. Besides different valuations or outside options that people might have,

the relative efficiency of today's quality information is mainly due to new technologies which in return can not be assumed to be accessible for everyone with the same efficiency. Some people are more adapt or have better access to these new technologies than others and this difference can be quite severe from one person to another. It is hence important to account for this in a more realistic model.

Other restrictive aspects of the model might be generalized such as the amount of quality levels and signals. Especially the former aspect is important to obtain meaningful results about the relationship between prices and quality in lemon markets with information acquisition.

A. Appendix

Proof of Lemma 3.1. Fix a price p and a corresponding posterior belief $\hat{\mu} \in (0, 1)$, assume that the consumer has paid a cost $k \geq 0$ for the signal precision and denote $\hat{\varepsilon} := \varepsilon(k)$ the error probability. Receiving the high signal s^H , the updated posterior belief is

$$\hat{\mu}_H := P(q^H | s^H) = \frac{\hat{\mu}(1 - \hat{\varepsilon})}{\hat{\mu}(1 - \hat{\varepsilon}) + (1 - \hat{\mu})\hat{\varepsilon}}$$

which is just Bayes' law applied.

The expected quality with respect to this information is then

$$\bar{q}_{\hat{\mu}_H} := \hat{\mu}_H q^H + (1 - \hat{\mu}_H) q^L.$$

With similar calculations, let $\bar{q}_{\hat{\mu}_L}$ be the expected quality on receiving a low signal. I have

$$\begin{aligned} \hat{\mu}_H - \hat{\mu}_L &= \frac{\hat{\mu}(1 - \hat{\varepsilon})(\hat{\mu}\varepsilon + (1 - \hat{\mu})(1 - \hat{\varepsilon})) - \hat{\mu}\varepsilon(\hat{\mu}(1 - \hat{\varepsilon}) + (1 - \hat{\mu})\hat{\varepsilon})}{(\hat{\mu}\varepsilon + (1 - \hat{\mu})(1 - \hat{\varepsilon}))(\hat{\mu}(1 - \hat{\varepsilon}) + (1 - \hat{\mu})\hat{\varepsilon})} \\ &= \frac{\hat{\mu}(1 - \hat{\mu})(1 - 2\hat{\varepsilon})}{(\hat{\mu}\varepsilon + (1 - \hat{\mu})(1 - \hat{\varepsilon}))(\hat{\mu}(1 - \hat{\varepsilon}) + (1 - \hat{\mu})\hat{\varepsilon})} \geq 0. \end{aligned}$$

The inequality follows from $\hat{\varepsilon} \in [0, \frac{1}{2}]$. Thus

$$\bar{q}_{\hat{\mu}_L} \leq \bar{q}_{\hat{\mu}_H}$$

where equality holds if and only if $\hat{\mu}_H = \hat{\mu}_L$ which is equivalent to $\hat{\varepsilon} = \frac{1}{2}$.

There are now three cases that can occur, regarding the level of the price p .

First case: $\bar{q}_{\hat{\mu}_L} < p < \bar{q}_{\hat{\mu}_H}$

This implies that $\hat{\varepsilon} < \frac{1}{2}$, $k > 0$ and that the consumer only buys if she receives the high signal.

Second case: $p \leq \bar{q}_{\hat{\mu}_L}$

The consumer would either buy with each signal or mix between "buying" and "not buying" in the case where $p = \bar{q}_{\hat{\mu}_L}$ and the low signal appears. In both cases, the payoff (with search costs and before observing s) is

$$\hat{\mu} q^H + (1 - \hat{\mu}) q^L - p - k$$

which clearly has a maximum at $k = 0$.

Third case: $p \geq \bar{q}_{\hat{\mu}_H}$

The consumer would not buy on any signal (while with equality she may buy on s^H but gets utility $\bar{q}_{\hat{\mu}_H} - p - k = -k$) so also here optimality implies $k = 0$.

\Rightarrow If $k > 0$, the consumer buys if and only if the signal is s^H . \square

Proof of Lemma 3.3. I write $\hat{k}^* := k^*(p, \hat{\mu})$ and $\hat{\varepsilon} := \varepsilon(\hat{k}^*)$. Note first that with $\hat{k}^* = 0$ I would have $\hat{\varepsilon} = \frac{1}{2}$ and thus

$$u_s^*(p, \hat{\mu}) = \frac{1}{2}\hat{\mu}(q^H - p) + \frac{1}{2}(1 - \hat{\mu})(q^L - p) = \frac{1}{2}u_b(p, \hat{\mu}) \leq \max\{u_b(p, \hat{\mu}), u_n\}$$

which contradicts the assumptions. Define

$$E_H := \frac{\hat{\mu}(1 - \hat{\varepsilon})}{\hat{\mu}(1 - \hat{\varepsilon}) + (1 - \hat{\mu})\hat{\varepsilon}}q^H + \frac{(1 - \hat{\mu})\hat{\varepsilon}}{\hat{\mu}(1 - \hat{\varepsilon}) + (1 - \hat{\mu})\hat{\varepsilon}}q^L - p \quad (4)$$

$$E_L := \frac{\hat{\mu}\hat{\varepsilon}}{\hat{\mu}\hat{\varepsilon} + (1 - \hat{\mu})(1 - \hat{\varepsilon})}q^H + \frac{(1 - \hat{\mu})(1 - \hat{\varepsilon})}{\hat{\mu}\hat{\varepsilon} + (1 - \hat{\mu})(1 - \hat{\varepsilon})}q^L - p \quad (5)$$

the expected utility from buying, disregarding the sunk search costs, when receiving a high signal or a low signal, respectively.

The following two important relations are immediate from these formulas.

$$\begin{aligned} u_s^*(p, \hat{\mu}) &= \hat{\mu}(1 - \hat{\varepsilon})(q^H - p) + (1 - \hat{\mu})\hat{\varepsilon}(q^L - p) - \hat{k}^* \\ &= \hat{\mu}(1 - \hat{\varepsilon})q^H + (1 - \hat{\mu})\hat{\varepsilon}q^L - (\hat{\mu}(1 - \hat{\varepsilon}) + (1 - \hat{\mu})\hat{\varepsilon})p - \hat{k}^* \\ &\stackrel{(4)}{=} (\hat{\mu}(1 - \hat{\varepsilon}) + (1 - \hat{\mu})\hat{\varepsilon})E_H - \hat{k}^* \end{aligned} \quad (6)$$

$$\begin{aligned} u_s^*(p, \hat{\mu}) &= \hat{\mu}(1 - \hat{\varepsilon})(q^H - p) + (1 - \hat{\mu})\hat{\varepsilon}(q^L - p) - \hat{k}^* \\ &= \hat{\mu}(q^H - p) + (1 - \hat{\mu})(q^L - p) - \hat{\mu}\hat{\varepsilon}(q^H - p) - (1 - \hat{\mu})(1 - \hat{\varepsilon})(q^L - p) - \hat{k}^* \\ &= \bar{q}_{\hat{\mu}} - p - [\hat{\mu}\hat{\varepsilon}q^H + (1 - \hat{\mu})(1 - \hat{\varepsilon})q^L - (\hat{\mu}\hat{\varepsilon} + (1 - \hat{\mu})(1 - \hat{\varepsilon}))p] - \hat{k}^* \\ &\stackrel{(5)}{=} \bar{q}_{\hat{\mu}} - p - (\hat{\mu}\hat{\varepsilon} + (1 - \hat{\mu})(1 - \hat{\varepsilon}))E_L - \hat{k}^* \end{aligned} \quad (7)$$

Assume that the signal is not precise enough in the sense of the lemma. This can have two reasons. Either the expected value from buying is below zero even when receiving a high signal ($E_H \leq 0$) or it is above zero even on receiving a low signal ($E_L \geq 0$).

In the first case, equation (6) implies $u_s^*(p, \hat{\mu}) < 0 = u_n$ which contradicts the conditions of the lemma.

In the second case, equation (7) implies

$$u_s^*(p, \hat{\mu}) = \bar{q}_{\hat{\mu}} - p - \underbrace{(\hat{\mu}\hat{\varepsilon} + (1 - \hat{\mu})(1 - \hat{\varepsilon}))E_L + \hat{k}^*}_{>0} < \bar{q}_{\hat{\mu}} - p = u_b(p, \hat{\mu})$$

which is a contradiction for the same reason. \square

Proof of Lemma 3.4. I begin by finding values $\underline{p}_{\hat{\mu}} \leq \bar{p}_{\hat{\mu}}$ such that the strict inequalities hold.

$$\begin{aligned} u_b(p_1, \hat{\mu}) &> \max\{u_n, u_s^*(p_1, \hat{\mu})\} & \forall p_1 \in [q^L, \underline{p}_{\hat{\mu}}) \\ u_s^*(p_2, \hat{\mu}) &> \max\{u_b(p_2, \hat{\mu}), u_n\} & \forall p_2 \in (\underline{p}_{\hat{\mu}}, \bar{p}_{\hat{\mu}}) \\ u_n &> \max\{u_b(p_3, \hat{\mu}), u_s^*(p_3, \hat{\mu})\} & \forall p_3 \in (\bar{p}_{\hat{\mu}}, q^H]. \end{aligned} \quad (8)$$

It is obvious that the first inequality is satisfied for $p_1 = q^L$ and the one inequality for $p_3 = q^H$. It is thus only left to show that there is monotonic behavior in p in the pairwise differences between $u_b(p, \hat{\mu})$, $u_s^*(p, \hat{\mu})$ and u_n . I show that the inequalities

$$\frac{\partial}{\partial p} u_b(p, \hat{\mu}) < \frac{\partial}{\partial p} u_s^*(p, \hat{\mu}) < \frac{\partial}{\partial p} u_n$$

hold on the interval (q^L, q^H) wherever k^* and thus u_s^* is differentiable in p . The left and right component of this expression are obvious from their definitions

$$\frac{\partial}{\partial p} u_b(p, \hat{\mu}) = \frac{\partial}{\partial p} (\hat{\mu} q^H + (1 - \hat{\mu}) q^L - p) = -1 \quad \frac{\partial}{\partial p} u_n = 0$$

By the shape of the function k^* (on page 8), I know that $u_s^*(p, \hat{\mu})$ is continuous and piecewise differentiable in p on some (possibly empty) intervals (q^L, p') , (p', p'') , (p'', q^H) and I have

$$u_s^*(p, \hat{\mu}) = \begin{cases} u_s(p, \hat{\mu}, 0) = \hat{\mu} \frac{1}{2} (q^H - p) + (1 - \hat{\mu}) \frac{1}{2} (q^L - p) & \text{if } p \in I_1 \\ u_s(p, \hat{\mu}, (\varepsilon')^{-1}(\hat{d})) & \text{if } p \in I_2 \\ u_s(p, \hat{\mu}, \bar{k}) = \hat{\mu} (q^H - p) - \bar{k} & \text{if } p \in I_3. \end{cases}$$

In this expression I have $I_2 = (p', p'')$ and I_1, I_3 are the sets $[q^L, p')$ and $(p'', q^H]$.¹²

While the first and third components are easy to differentiate, the middle one becomes

$$\begin{aligned} & \frac{\partial}{\partial p} u_s(p, \hat{\mu}, (\varepsilon')^{-1}(\hat{d})) \\ &= \frac{\partial}{\partial p} \left(\hat{\mu} (1 - \varepsilon(k^*)) (q^H - p) + (1 - \hat{\mu}) \varepsilon(k^*) (q^L - p) - k^* \right) \\ &= -\hat{\mu} (1 - \hat{\varepsilon}) - \hat{\mu} (q^H - p) \frac{\partial}{\partial p} \varepsilon(k^*) - (1 - \hat{\mu}) \hat{\varepsilon} + (1 - \hat{\mu}) (q^L - p) \frac{\partial}{\partial p} \varepsilon(k^*) - \frac{\partial}{\partial p} k^* \\ &= -\hat{\mu} (1 - \hat{\varepsilon}) - (1 - \hat{\mu}) \hat{\varepsilon} + \frac{1}{d} \frac{\partial}{\partial p} \varepsilon(k^*) - \frac{\partial}{\partial p} k^* \\ &= -\hat{\mu} (1 - \hat{\varepsilon}) - (1 - \hat{\mu}) \hat{\varepsilon} + \frac{1}{d} \varepsilon'(k^*) \frac{\partial}{\partial p} k^* - \frac{\partial}{\partial p} k^* \\ &= -\hat{\mu} (1 - \hat{\varepsilon}) - (1 - \hat{\mu}) \hat{\varepsilon} + \frac{1}{d} \hat{d} \frac{\partial}{\partial p} k^* - \frac{\partial}{\partial p} k^* \\ &= -\hat{\mu} (1 - \hat{\varepsilon}) - (1 - \hat{\mu}) \hat{\varepsilon} \in (\hat{\varepsilon} - 1, -\hat{\varepsilon}). \end{aligned}$$

¹²Their order depend on the value of $\hat{\mu}$ which determines whether search effort increases or decreases in p . For $\hat{\mu} = \frac{1}{2}$, search effort is constant and two of the intervals are empty.

Summarized, I end up with the following expression

$$\frac{\partial}{\partial p} u_s^*(p, \hat{\mu}) = \begin{cases} -\frac{1}{2} & \text{if } p \in I_1 \\ -\hat{\mu}(1 - \hat{\varepsilon}) - (1 - \hat{\mu})\hat{\varepsilon} & \text{if } p \in I_2 \\ -\hat{\mu} & \text{if } p \in I_3. \end{cases}$$

which is always strictly between -1 and 0 and even continuous.

It follows from Lemma 3.3 that the consumer really searches in the region $(\underline{p}_{\hat{\mu}}, \bar{p}_{\hat{\mu}})$. Finally, the price $p = \bar{q}_{\hat{\mu}}$ implies

$$u_n = u_b(p, \hat{\mu})$$

so that I must have $\underline{p}_{\hat{\mu}} \leq \bar{q}_{\hat{\mu}} \leq \bar{p}_{\hat{\mu}}$ for equation (8) to be true. \square

Proof of Lemma 3.5. Set $\hat{p} = \bar{q}_{\hat{\mu}}$. Clearly $u_b(\hat{p}, \hat{\mu}) := \bar{q}_{\hat{\mu}} - \hat{p} = 0 = u_s(\hat{p}, \hat{\mu}, 0)$ holds. Moreover, I have

$$\frac{\partial}{\partial k} u_s(\hat{p}, \hat{\mu}, k) = -\varepsilon'(k)\hat{\mu}(q^H - \hat{p}) + \varepsilon'(k)(1 - \hat{\mu})(q^L - \hat{p}) - 1$$

for all $k \in (0, \bar{k})$ and thus, taking the limit $k \rightarrow 0$

$$\begin{aligned} \frac{\partial}{\partial k} u_s(\hat{p}, \hat{\mu}, 0) &= -\varepsilon'(0)[\hat{\mu}(q^H - \hat{p}) + (1 - \hat{\mu})(\hat{p} - q^L)] - 1 \\ &\stackrel{\hat{p}=\bar{q}_{\hat{\mu}}}{=} -\varepsilon'(0)[\hat{\mu}(q^H - (\hat{\mu}q^H + (1 - \hat{\mu})q^L)) \\ &\quad + (1 - \hat{\mu})(\hat{\mu}q^H + (1 - \hat{\mu})q^L - q^L)] - 1 \\ &= -\varepsilon'(0)(2\hat{\mu}(1 - \hat{\mu})(q^H - q^L)) - 1. \end{aligned}$$

This is positive by the assumption. Hence, $u_s^*(\hat{p}, \hat{\mu}) > u_s(\hat{p}, \hat{\mu}, 0) = u_b(\hat{p}, \hat{\mu}) = u_n$ which proofs $\bar{q}_{\hat{\mu}} = \hat{p} \in (\underline{p}_{\hat{\mu}}, \bar{p}_{\hat{\mu}})$.

Assume now that the inequality stated in the lemma is not true. Then, by the calculations above and the strict concavity of ε , $u_s(\hat{p}, \hat{\mu}, k)$ is decreasing in k so that $u_s^*(\hat{p}, \hat{\mu}) = u_s(\hat{p}, \hat{\mu}, 0) = u_b(\hat{p}, \hat{\mu}) = u_n$.

With the same argument as in the proof of Lemma 3.4, I know that

$$\frac{\partial}{\partial p} u_b(p, \hat{\mu}) < \frac{\partial}{\partial p} u_s^*(p, \hat{\mu}) < \frac{\partial}{\partial p} u_n$$

for all $p \in (q^L, q^H)$ and thus $u_b(p, \hat{\mu}) > u_s^*(p, \hat{\mu})$ for all $p < \bar{q}_{\hat{\mu}}$ and $u_n > u_s^*(p, \hat{\mu})$ for all $p > \bar{q}_{\hat{\mu}}$. Hence I have $\underline{p}_{\hat{\mu}} = \bar{p}_{\hat{\mu}} = \bar{q}_{\hat{\mu}}$. \square

Proof of Lemma 3.6. I only show the claim for $\underline{p}_{\hat{\mu}}$ since the other part is basically the same proof. Note that, given $\hat{\mu} \in (0, 1)$, $\underline{p}_{\hat{\mu}}$ is uniquely determined¹³ by solving

$$\begin{aligned} u_b(p, \hat{\mu}) &= u_s^*(p, \hat{\mu}) \\ \Leftrightarrow \quad \hat{\mu}q^H + (1 - \hat{\mu})q^L - p &= \hat{\mu}(1 - \varepsilon)(q^H - p) + (1 - \hat{\mu})\varepsilon(q^L - p) - k^* \end{aligned} \quad (9)$$

¹³This is also true if $\underline{p}_{\hat{\mu}} = \bar{q}_{\hat{\mu}}$. From Lemma 3.4 it follows that in this case $k^*(p, \hat{\mu}) = 0, \varepsilon(k^*(p, \hat{\mu})) = \frac{1}{2}$ and the equation (9) holds.

and since these expressions are continuous and piecewise differentiable, the function $\underline{p}_{\hat{\mu}}$ also has these properties.

In the three areas of differentiability, I either have $k^*(p, \hat{\mu}) = 0$, $k^*(p, \hat{\mu}) = \bar{k}$ or $k^*(p, \hat{\mu}) = (\varepsilon')^{-1}(d(p, \hat{\mu}))$. In the first two cases, (9) yields

$$\underline{p}_{\hat{\mu}} = \bar{q}_{\hat{\mu}} \quad \text{or} \quad \underline{p}_{\hat{\mu}} = q^L + \frac{\bar{k}}{1 - \hat{\mu}}$$

which both induce a strictly positive derivative in $\hat{\mu}$.

In the third case, differentiating (9) with respect to $\hat{\mu}$ yields

$$\begin{aligned} q^H - q^L - \underline{p}'_{\hat{\mu}} &= (1 - \hat{\varepsilon})(q^H - \hat{p}) + \hat{\varepsilon}(\hat{p} - q^L) - \hat{\mu}(\frac{\partial}{\partial \hat{\mu}} \varepsilon)(q^H - \hat{p}) \\ &\quad + (1 - \hat{\mu})(\frac{\partial}{\partial \hat{\mu}} \varepsilon)(q^L - \hat{p}) - \underline{p}'_{\hat{\mu}}(\hat{\mu}(1 - \hat{\varepsilon}) + (1 - \hat{\mu})\hat{\varepsilon}) - \frac{\partial}{\partial \hat{\mu}} k^* \\ &= (1 - \hat{\varepsilon})(q^H - \hat{p}) + \hat{\varepsilon}(\hat{p} - q^L) + \frac{1}{\hat{d}}(\frac{\partial}{\partial \hat{\mu}} \varepsilon) \\ &\quad - \underline{p}'_{\hat{\mu}}(\hat{\mu}(1 - \hat{\varepsilon}) + (1 - \hat{\mu})\hat{\varepsilon}) - \frac{\partial}{\partial \hat{\mu}} k^* \end{aligned}$$

where I left out the arguments for d, ε and k^* and wrote $\hat{p} = \underline{p}_{\hat{\mu}}$, $\hat{\varepsilon} = \varepsilon(k^*(\hat{p}, \hat{\mu}))$.

Reordering this equation and using $\frac{\partial}{\partial \hat{\mu}} \varepsilon = \varepsilon'(\hat{k}^*) \frac{\partial}{\partial \hat{\mu}} k^* = \hat{d} \cdot \frac{\partial}{\partial \hat{\mu}} k^*$, I get

$$\underline{p}'_{\hat{\mu}} = \frac{\hat{\varepsilon}(q^H - \hat{p}) + (1 - \hat{\varepsilon})(\hat{p} - q^L)}{1 - \hat{\mu}(1 - \hat{\varepsilon}) - (1 - \hat{\mu})\hat{\varepsilon}} > 0.$$

The limit behavior $\lim_{\hat{\mu} \rightarrow 0} \underline{p}_{\hat{\mu}} = q^L$ is clear, since I have $q^L < \underline{p}_{\hat{\mu}} \leq \bar{q}_{\hat{\mu}}$ for all values $\hat{\mu} \in (0, 1)$.

For $\hat{\mu}$ going to one, note that the convergence of $\underline{p}_{\hat{\mu}}$ is guaranteed by the strict monotonicity. Since k^* can not be higher than q^H for the equation (9) to be true, it is bounded and hence there is an increasing sequence $(\hat{\mu}_n)$, converging to 1, for which $k^*(\underline{p}_{\hat{\mu}_n}, \hat{\mu}_n)$ converges to a value $\kappa \geq 0$. Take such a sequence and the limit $n \rightarrow \infty$ in (9). I then obtain

$$\begin{aligned} q^H - \lim_{\hat{\mu} \rightarrow 1} \underline{p}_{\hat{\mu}} &= (1 - \varepsilon(\kappa)) \left(q^H - \lim_{\hat{\mu} \rightarrow 1} \underline{p}_{\hat{\mu}} \right) - \kappa \\ \Leftrightarrow \quad \varepsilon(\kappa) \left(q^H - \lim_{\hat{\mu} \rightarrow 1} \underline{p}_{\hat{\mu}} \right) &= -\kappa \end{aligned}$$

which, since the left hand side is weakly positive, implies $\kappa = 0$, thus $\varepsilon(\kappa) = \frac{1}{2}$ and, more importantly,

$$\lim_{\hat{\mu} \rightarrow 1} \underline{p}_{\hat{\mu}} = q^H.$$

□

Proof of Lemma 4.4. As seen from section 3, the consumer would buy for any price below q^L . This shows that every such price p can not be part of an equilibrium because a deviation to any price in (p, q^L) would yield a higher payoff.

Assume that the equilibrium profit π^L for the low type is below $q^L - c^L$. A deviation to the price $q^L - \frac{q^L - c^L - \pi^L}{2}$ would then yield the profit

$$q^L - \frac{q^L - c^L - \pi^L}{2} - c^L = \frac{q^L - c^L}{2} + \frac{\pi^L}{2} > 2\frac{\pi^L}{2} = \pi^L.$$

Let $p \in (q^L, q^H)$ be a price that is in the support of a_L but not of a_H . By Bayes' law I must have $\mu(p) = 0$ so the consumer would know the true quality. Hence, he would not buy the product and the low type would make no profit which contradicts the previous point.

Assume now that $p \in (q^L, q^H)$ is a price in the support of a_H but not of a_L . Since $\mu(p) = 1$ and $p < q^H$, the consumer buys with probability 1. So there must be at least one price $p_L > p, p_L \in \text{supp}(a_L)$, otherwise the low type would deviate from any price to p .

1st case: $b(p_L) = (0, \gamma, \gamma), \gamma \in [0, 1]$

By optimality of the low type's strategy, this price satisfies

$$p - c^L \leq (p_L - c^L)\gamma. \quad (10)$$

That is, the low type must make at least as much profit with setting price p_L than with price p . By the previous part of the proof, p_L is in the support of a_H . Hence the high type must be indifferent between setting prices p or p_L .

$$\begin{aligned} p - c^H &= (p_L - c^H)\gamma \\ \stackrel{(10)}{\Rightarrow} & (p_L - c^L)\gamma + c^L - c^H \geq (p_L - c^H)\gamma \\ \Leftrightarrow & (1 - \gamma)c^L \geq (1 - \gamma)c^H \end{aligned}$$

which, since the first equation also implies $\gamma \neq 1$, is not compatible with the assumption $c^L < c^H$.

2nd case: $b(p_L) = (k, 1, 0), k > 0$

Let $\hat{\varepsilon} := \varepsilon(k)$ be the probability of a false signal. This equals the chance that the low type will sell her product. Again by optimality of the low type's choice the following inequality holds.

$$p - c^L \leq (p_L - c^L)\hat{\varepsilon} \quad (11)$$

Again, the price p_L must also be in the support of the high type. This yields

$$\begin{aligned} p - c^H &= (p_L - c^H)(1 - \hat{\varepsilon}) \\ \stackrel{(11)}{\Rightarrow} & (p_L - c^L)\hat{\varepsilon} + c^L - c^H \geq (p_L - c^H)(1 - \hat{\varepsilon}) \\ \Leftrightarrow & \hat{\varepsilon}(p_L - c^H) \geq (1 - \hat{\varepsilon})(p_L - c^L) \end{aligned}$$

which gives a contradiction for the same reason as before and using $\hat{\varepsilon} < 1 - \hat{\varepsilon}$. \square

Proof of Lemma 4.5. Let $p < p'$ be two such prices, $\hat{\varepsilon}, \hat{\varepsilon}'$ the corresponding error probabilities. For search to be possible, the prices have to be in both supports and hence, by the indifference principle for both types,

$$\begin{aligned}(p - c^H)(1 - \hat{\varepsilon}) &= (p' - c^H)(1 - \hat{\varepsilon}') \Rightarrow (1 - \hat{\varepsilon}) > (1 - \hat{\varepsilon}') \Leftrightarrow \hat{\varepsilon} < \hat{\varepsilon}' \\ (p - c^L)\hat{\varepsilon} &= (p' - c^L)\hat{\varepsilon}' \Rightarrow \hat{\varepsilon} > \hat{\varepsilon}'\end{aligned}$$

which gives a contradiction. \square

Proof of Lemma 4.6. Without search, there are two probabilities $\gamma, \gamma' \in [0, 1]$ of the consumer buying for the prices $p < p'$. By the optimality of the firm's strategy I have

$$\begin{aligned}(p - c^H)\gamma &= (p' - c^H)\gamma' \\ (p - c^L)\gamma &= (p' - c^L)\gamma' .\end{aligned}$$

Note that, since the low type always has positive profit, all of these factors must be strictly above zero. Reassembling these equations gives two different values for the ratio $\frac{\gamma}{\gamma'}$ since $p \neq p'$ and $c^L \neq c^H$. This is a contradiction. \square

Proof of Lemma 4.8. Assume such a price $p \in (q^L, q^H)$ exists. Then the consumer buys with probability $\gamma \in (0, 1)$. She is thus indifferent between buying without search and not buying. In this case $p = \bar{q}_{\mu(p)}$ holds. Since $\varepsilon'(0) = -\infty$, she would search on that price by Lemma 3.5. \square

Proof of Proposition 4.9. The previous lemmas already show that not more than two equilibrium prices can exist in (q^L, q^H) . I then show that there can not be a search price p_s and a no-search price p_1 played by both types. If this was the case, I must have $p_1 < p_s$ since otherwise there would be incentives to deviate from p_s to p_1 .

Let now be p_1 and p_s be played in an equilibrium by both types. Applying the indifference principle for both firms I get

$$\begin{aligned}p_1 - c^H &= (1 - \hat{\varepsilon})(p_s - c^H) \\ p_1 - c^L &= \hat{\varepsilon}(p_s - c^L)\end{aligned}$$

and thus

$$1 - \hat{\varepsilon} = \frac{p_1 - c^H}{p_s - c^H} \stackrel{p_1 < p_s}{\underset{c^H > c^L}{<}} \frac{p_1 - c^L}{p_s - c^L} = \hat{\varepsilon}$$

which contradicts $\hat{\varepsilon} \in [0, \frac{1}{2}]$.

Finally, note that if the price p_1 is played, it induces sure buying and is thus the lowest price in the equilibrium. Thus, $q^L \notin \text{supp}(a_L)$.

The statement about the low value of γ for $b(q^H) = (0, \gamma, \gamma)$ does not need prove. If we denote the low type's equilibrium profit by π^L , one upper bound for γ is $\frac{\pi^L}{q^H - c^L}$ which is strictly smaller than one. \square

Proof of Lemma 4.11. Let (a, μ, b) be an equilibrium in which q^H is played by the high firm and the consumer has strategy $b(q^H) = (0, \gamma, \gamma)$, $\gamma > 0$. This is a best response because of $\hat{\mu} := \mu(q^H) = 1$ and thus the consumer's utility

$$\gamma \cdot u_b(q^H, \hat{\mu}) + (1 - \gamma) \cdot \underbrace{u_n}_{=0} = \gamma(\hat{\mu}q^H + (1 - \hat{\mu})q^L - q^H) = \gamma(1 - \hat{\mu})(q^L - q^H)$$

attains its maximum in all values of γ . For slightly lower $\hat{\mu}$, however, this value has a unique maximum in $\gamma = 0$ and thus the original strategy $b(q^H)$ is locally dominated by $(0, 0, 0)$. On the other hand, the total adverse selection equilibrium does not have this problem since $(0, 0, 0)$ is the equilibrium strategy for q^H .

Every other equilibrium is either pooling on price p_s or p_1 or hybrid with prices q^L and p_s . I show that non of these prices is locally dominated in beliefs.

Let p_s be an equilibrium search price (implying that $\mu(p_s) \in (0, 1)$) with consumer behavior $b(p_s) = (k, 1, 0)$, $k > 0$. By the analysis of section 3, this strategy is the unique maximum over all search behaviors. The remaining candidates for domination are thus $(0, 0, 0)$ ("don't buy") and $(0, 1, 1)$ ("buy")¹⁴. If "don't buy" had the same utility, I had

$$u_s(p_s, \mu(p_s), k) = \mu(p_s)(1 - \varepsilon(k))(q^H - p_s) + (1 - \mu(p_s))\varepsilon(k)(q^L - p_s) - k = 0 = u_n.$$

Differentiating this with respect to the posterior belief, one sees that

$$\frac{\partial}{\partial m} u_s(p_s, m, k) = (1 - \varepsilon(k))(q^H - p_s) + \varepsilon(k)(p_s - q^L) > 0$$

such that I have $u_s(p_s, m, k) > u_n$ for all $m > \mu(p_s)$. The strategy $b(p_s)$ is thus not locally dominated by the strategy $(0, 0, 0)$.

If "buy" had the same utility as b , I had

$$\begin{aligned} u_s(p_s, \mu(p_s), k) &= \mu(p_s)(1 - \varepsilon(k))(q^H - p_s) + (1 - \mu(p_s))\varepsilon(k)(q^L - p_s) - k \\ &= \mu(p_s)q^H + (1 - \mu(p_s))q^L - p_s = u_b(p_s, \mu(p_s)). \end{aligned}$$

and the derivatives

$$\begin{aligned} \frac{\partial}{\partial m} u_s(p_s, m, k) &= (1 - \varepsilon(k))(q^H - p_s) + \varepsilon(k)(p_s - q^L) \\ &< \max\{q^H - p_s, p_s - q^L\} < q^H - q^L = \frac{\partial}{\partial m} u_b(p_s, m). \end{aligned} \tag{12}$$

This shows that $b(p_s)$ is strictly better than $(0, 1, 1)$ for any $m < \mu(p_s)$.

Now let $p_1 < q^H$ be an equilibrium price. If $b(p_1) = (0, 1, 1)$ is not a unique best response, there is a search strategy $(k, 1, 0)$ with the same payoff¹⁵. Using (12), I know that for any higher posterior belief, this search strategy is worse than "buy". Strategy $b(p_1)$ is thus not locally dominated.

¹⁴Note that their convex combinations can not be best responses in this case and thus are no candidates, as well.

¹⁵Lemma 3.5 rules out no-search strategies giving the same payoff.

The last price to check is q^L for which the equilibrium behavior $(0, 1, 1)$ is clearly the unique best response for any posterior belief $m > 0$ so that local domination is also excluded here. This also concludes the proof for showing that the total adverse selection equilibrium has belief-robust responses. \square

Proof of Proposition 4.13. Let (a, μ, b) be an equilibrium. I first show that there are no equilibrium prices p that differ from $q^L, q^H, \underline{p}_{\hat{\mu}}$ and $\bar{p}_{\hat{\mu}}$ where $\hat{\mu}$ is determined according to Bayes' law.

First, assume that there is an equilibrium no-search price p in (q^L, q^H) that is not equal to $\underline{p}_{\mu(p)}$. In this case, Lemma 3.4 shows that $u_b(p, \mu(p)) > u_s^*(p, \mu(p))$. Assuming that μ is continuous in p , the continuity of u_b and u_s^* implies that “buying” will still be better than “searching” for a marginal increase of the price. This is an incentive for both types to deviate which contradicts the equilibrium property.

Second, assume the existence of an equilibrium search price $p \neq \bar{p}_{\mu(p)}$. It follows again from Lemma 3.4 that I must have $u_s^*(p, \mu(p)) > u_n$. Again the continuity of these expressions implies that the consumer will also search for a marginal higher price, although the search effort and thus the error probability $\hat{\varepsilon}$ might change. Note that the profit of the firm, depending on the type, is $(p - c^H)(1 - \hat{\varepsilon})$ or $(p - c^L)\hat{\varepsilon}$ such that, for a higher price, at least one of these values will increase. This gives an incentive for at least one type to deviate.

These two arguments alone rule out all the equilibria from Proposition 4.9 that are not mentioned in Proposition 4.13. I thus only have to show that the rest of the equilibria can be supported by a locally continuous belief system.

Since all equilibria have a finite number of prices, these prices can be considered independently from each other by looking at non-intersecting environments of them. The price q^L can obviously be supported by $\mu(p) = 0$ in any environment of q^L . For the price q^H note that for all values of $\hat{\mu} = \mu(q^H)$ the interval $(\bar{p}_{\hat{\mu}}, q^H)$ is non-empty and decreasing (see Lemma 3.6) so that there is an invertible, continuous function $p(\hat{\mu})$ with $p(\hat{\mu}) \in (\bar{p}_{\hat{\mu}}, q^H)$ for all $\hat{\mu} \in (0, 1)$. By the definition of $\bar{p}_{\hat{\mu}}$, the inverse $\mu(p)$ of this function satisfies

$$u_n > \max\{u_b(p, \mu(p)), u_s^*(p, \mu(p))\} \quad \forall p \in (p(\frac{1}{2}), q^H)$$

so that the consumer would not buy with that belief system for any other price and hence there is no incentive for a deviation by any firm.

Let now \bar{p} be an equilibrium price on the upper line of the search area. That is

$$\bar{p} = \bar{p}_{\mu(\bar{p})}.$$

Keeping the function μ constant above \bar{p} leads to the consumer not buying for higher prices. For lower prices, I can use the same argument as before of $\bar{p}_{\hat{\mu}}$ being strictly increasing in $\hat{\mu}$ to show that there exists a continuous and even increasing belief system $\mu(p)$ for $p < \bar{p}$ for which the consumer does not buy on lower prices.

At last, assume $\underline{p} = \underline{p}_{\mu(\underline{p})}$ for a no-search price, implying that the consumer buys with probability one. Moreover, assume $\varepsilon(k^*(\underline{p}, \mu(\underline{p}))) < 1$. Independent of the belief system,

no firm would deviate to a lower price since the probability of selling can not grow. Keeping the posterior belief constant to $\mu(\underline{p})$ leads to search behavior for these prices. By continuity of $\varepsilon(k^*)$, I have

$$\lim_{\underline{p} \downarrow \underline{p}} (1 - \varepsilon(k^*(\underline{p}, \mu(\underline{p}))))(\underline{p} - c^H) = (1 - \varepsilon(k^*(\underline{p}, \mu(\underline{p}))))(\underline{p} - c^H) \stackrel{\text{ass.}}{<} \underline{p} - c^H$$

so that a high quality firm has a lower profit for slightly higher prices. It is straightforward to show the same for the low type. \square

Proof of Observation 4.14. In PE_b , both types trade for sure while in PE_s the high type firm has some trading probability $1 - \hat{\varepsilon} > \hat{\varepsilon}$. It suffices to show the observation for any hybrid equilibrium.

Remember that the existence of a hybrid equilibrium implies $q^L - c^L < q^H - q^L$. In this case, the selling probability for the price q^H in a separating equilibrium can not exceed

$$\frac{q^L - c^L}{q^H - c^L} = \frac{q^L - c^L}{q^H - q^L + q^L - c^L} < \frac{q^L - c^L}{q^L - c^L + q^L - c^L} = \frac{1}{2}.$$

to not make the low firm deviate to the higher price. The selling probability for a high quality firm in a hybrid equilibrium, however, is $1 - \hat{\varepsilon} > \frac{1}{2}$ which proofs the observation. \square

Proof of Lemma 4.16. If two or more hybrid equilibria exist, the consumer surplus and the low type's profit are both at their minimum. Observe that the latter implies that the search precision $\varepsilon(k^*(\bar{p}_\rho, \hat{\mu}))$ in these equilibria is higher if the price \bar{p}_ρ is higher. This also implies a higher chance of selling high quality goods and thus an overall strictly higher profit for the high type. Hence, HE dominates all other hybrid equilibria.

Let either of PE_b , PE_s or HE exist. I know that in all these equilibria I have $\pi^L \geq q^L - c^L$, $\pi^H \geq 0$ and $u^* \geq 0$ which are the payoffs of the TAS equilibrium. In PE_b , the consumer has positive utility while in PE_s and HE , the high type firm has positive profit. Hence TAS is dominated.

Now let EQ either denote PE_s or HE and denote \bar{p} and $\hat{\varepsilon}$ the search price and its corresponding signal imprecision in EQ . I know that the consumer is strictly better off in PE_b . Assume $\pi^H(PE_b) \geq \pi^H(EQ)$. It then follows, since $\bar{p} \geq \underline{p}_\eta$

$$\begin{aligned} \frac{\underline{p}_\eta - c^L}{\bar{p} - c^L} &\geq \frac{\underline{p}_\eta - c^H}{\bar{p} - c^H} = \frac{\pi^H(PE_b)}{\frac{1}{1-\hat{\varepsilon}}\pi^H(EQ)} \geq 1 - \hat{\varepsilon} > \hat{\varepsilon} \\ \Rightarrow \quad \pi^L(PE_b) &= \underline{p}_\eta - c^L > \hat{\varepsilon}(\bar{p} - c^L) = \pi^L(EQ). \end{aligned}$$

This shows that PE_b dominates EQ .

It is straightforward to show that other pairs of equilibria do not dominate each other. \square

Proof of Lemma 4.17. Note first that the existence of PE_s implies that the low type's profit $\hat{\varepsilon}(\bar{p}_\eta - c^L)$ is at least $q^L - c^L$. In the hybrid equilibrium, this bound must be

attained for the low type to justify playing both prices. I show that this condition can not be met in both equilibria.

Taking the derivative of $\pi_L(\bar{p}_{\hat{\mu}}, \hat{\mu})$ with respect to the posterior belief $\hat{\mu}$ (for values in which this is differentiable) yields

$$\begin{aligned}
& \frac{\partial}{\partial \hat{\mu}} \pi_L(\bar{p}_{\hat{\mu}}, \hat{\mu}) \\
&= \frac{\partial}{\partial \hat{\mu}} \varepsilon(k^*(\bar{p}_{\hat{\mu}}, \hat{\mu})) \cdot (\bar{p}_{\hat{\mu}} - c^L) \\
&= \left(\frac{\partial}{\partial \hat{\mu}} \varepsilon(k^*(\bar{p}_{\hat{\mu}}, \hat{\mu})) \right) (\bar{p}_{\hat{\mu}} - c^L) + \varepsilon' \bar{p}'_{\hat{\mu}} \\
&= \begin{cases} 0 & \text{if } \varepsilon = 0 \\ \varepsilon'(k^*) \left([(\varepsilon')^{-1}]' (\hat{d}) \frac{\partial}{\partial \hat{\mu}} d(\bar{p}_{\hat{\mu}}, \hat{\mu}) \right) (\bar{p}_{\hat{\mu}} - c^L) + \varepsilon' \bar{p}'_{\hat{\mu}} & \text{if } \varepsilon > 0 \end{cases} \\
&= \begin{cases} 0 & \text{if } \varepsilon = 0 \\ \varepsilon'(k^*) \frac{1}{\varepsilon''(k^*)} \hat{d}^2 \left(q^H - q^L - 2\bar{p}_{\hat{\mu}} + \bar{p}'_{\hat{\mu}}(1 - 2\hat{\mu}) \right) (\bar{p}_{\hat{\mu}} - c^L) + \varepsilon' \bar{p}'_{\hat{\mu}} & \text{if } \varepsilon > 0 \end{cases} .
\end{aligned}$$

While the right hand side of the lower term is always positive, the left hand side is positive if $\hat{\mu} \geq \frac{1}{2}$ and $\bar{p}_{\hat{\mu}} \geq \frac{q^H + q^L}{2}$. Note that the former condition implies the latter as I always have $\bar{p}_{\hat{\mu}} \geq \bar{q}_{\hat{\mu}}$. It is thus sufficient to have $\hat{\mu} \geq \frac{1}{2}$. Moreover, in an equilibrium where only the low type deviates from the search price, Bayes' law implies $\hat{\mu} \geq \eta$ on that price. The derivative of the low type's profit is thus always non-negative. It is even strictly positive for all beliefs in which $\varepsilon(\bar{p}_{\hat{\mu}}, \hat{\mu}) > 0$. This is true for $\hat{\mu} = \eta$ and thus also for all values above η .

By Lemma 3.6, this profit converges to $\frac{1}{2}(q^H - c^L)$ when taking $\hat{\mu} \rightarrow 1$ so that, using the condition $q^L - c^L < q^H - q^L$, it attains the value $q^L - c^L$ for exactly one $\hat{\mu}$. The hybrid equilibrium is thus unique.

I see that the conditions of the low type having a higher profit than $q^L - c^L$ in one equilibrium and exactly this profit in the other are mutually exclusive. By continuity, this extends to values below $\frac{1}{2}$ which proofs the existence of $\underline{\eta}$. \square

Proof of Proposition 5.1. Define

$$P := \{(p, a) | d(p, \eta) < \varepsilon_k(\bar{k}(a), a)\}$$

the open area for which $\varepsilon(k^*(p, \eta, a), a)$ is positive.

Note that $k^*(p, \eta, a)$ as defined by (1) is continuous¹⁶ and piecewise differentiable in (p, a) in P and its complement P^c . It thus also holds for the composition $\varepsilon(k^*, a)$. Hence $\underline{p}_{\eta}(a)$ has the same properties, being the unique implicit solution of the equation

$$\begin{aligned}
& u_b(p(a), \eta, a) = u_s^*(p(a), \eta, a) \\
& \bar{q}_{\eta} - p(a) = \eta(1 - \varepsilon(k^*, a))(q^H - p(a)) + (1 - \eta)\varepsilon(k^*, a)(q^L - p(a)) - k^* \quad (13)
\end{aligned}$$

¹⁶While \bar{k} can take the value ∞ , k^* can not. Since \bar{k} is continuous when restricted to the open set on which it is finite, k^* is continuous.

where I left out the arguments of k^* . Differentiating this expression with respect to a , in the areas where this is differentiable, yields

$$\begin{aligned}
-p_a &= \eta \left[\left(-\frac{\partial}{\partial a} \varepsilon \right) (q^H - p) + (1 - \varepsilon)(-p_a) \right] + (1 - \eta) \left[\left(\frac{\partial}{\partial a} \varepsilon \right) (q^L - p) + \varepsilon(-p_a) \right] - \frac{\partial}{\partial a} k^* \\
&= - \left(\eta(1 - \varepsilon) + (1 - \eta)\varepsilon \right) p_a - \left(\eta(q^H - p) + (1 - \eta)(p - q^L) \right) \frac{\partial}{\partial a} \varepsilon - \frac{\partial}{\partial a} k^* \\
&= - \left(\eta(1 - \varepsilon) + (1 - \eta)\varepsilon \right) p_a + \frac{1}{d(p, \eta)} \frac{\partial}{\partial a} \varepsilon - \frac{\partial}{\partial a} k^*
\end{aligned}$$

and

$$\begin{aligned}
\frac{\partial}{\partial a} \varepsilon &= \frac{\partial}{\partial a} \varepsilon(k^*, a) = \varepsilon_k(k^*, a) \frac{\partial}{\partial a} k^*(p(a), a) + \varepsilon_a(k^*, a) \\
&= \varepsilon_k \frac{\partial}{\partial a} k^* + \varepsilon_a \\
&= d(p, \eta) \frac{\partial}{\partial a} k^* + \varepsilon_a.
\end{aligned}$$

whenever $(p(a), a) \in P$ and

$$\frac{\partial}{\partial a} \varepsilon = \frac{\partial}{\partial a} 0 = 0$$

in every open subset of P^c . Combining these expressions and writing $p_a := \frac{\partial}{\partial a} p(a)$, I either get

$$\begin{aligned}
-p_a &= - \left(\eta(1 - \varepsilon) + (1 - \eta)\varepsilon \right) p_a + \frac{\varepsilon_a}{d} \\
\Leftrightarrow p_a &= \frac{\eta(q^H - p) + (1 - \eta)(p - q^L)}{1 - \eta(1 - \varepsilon) - (1 - \eta)\varepsilon} \varepsilon_a < 0
\end{aligned}$$

or

$$p_a = \frac{1}{1 - \eta(1 - \varepsilon) - (1 - \eta)\varepsilon} \frac{\partial}{\partial a} \bar{k}(a) \leq 0.$$

It is left to show the limit of $p(a)$ when I let a go to 0 or ∞ . I begin with the latter case which can be done in several steps.

First step: $\lim_{a \rightarrow \infty} k^*(\underline{p}_\eta(a), \eta, a) = 0$

Assume that $\limsup_{a \rightarrow \infty} k^*(\underline{p}_\eta(a), \eta, a) = \kappa > 0$. Then I have

$$\varepsilon(k^*(\underline{p}_\eta(a_n), \eta, a_n), a_n) \leq \varepsilon\left(\frac{\kappa}{2}, a_n\right)$$

for some sequence (a_n) going to ∞ with $\lim_{n \rightarrow \infty} k^*(\underline{p}_\eta(a_n), \eta, a_n) = \kappa$. Since the right hand side converges to zero, so does the left hand side so that I obtain from equation (13)

$$\begin{aligned}
\bar{q}_\eta - \lim_{n \rightarrow \infty} \underline{p}_\eta(a_n) &= \eta(q^H - \lim_{n \rightarrow \infty} \underline{p}_\eta(a_n)) - \kappa \\
\Rightarrow \lim_{n \rightarrow \infty} \underline{p}_\eta(a_n) &= q^L - \frac{\kappa}{1 - \eta}
\end{aligned}$$

which contradicts $\underline{p}_\eta(a) > q^L$ for all a .

Second step: $\lim_{a \rightarrow \infty} \varepsilon(k^*(\underline{p}_\eta(a), a), a) = 0$

Assume that $\limsup_{a \rightarrow \infty} \varepsilon(k^*(\underline{p}_\eta(a), a), a) = e > 0$. This also implies

$$\varepsilon'(k^*(a_n), a_n) = d(\underline{p}_\eta(a_n), \eta) \text{ and } \varepsilon(k^*(\underline{p}_\eta(a_n), a_n), a_n) > \frac{e}{2} \quad \forall n \in \mathbb{N}$$

for some sequence (a_n) going to infinity and having $\lim_{n \rightarrow \infty} \varepsilon(k^*(\underline{p}_\eta(a_n), a_n), a_n) = e$. Write $k^*(a_n) := k^*(\underline{p}_\eta(a_n), a_n)$. Since $\underline{p}_\eta(a_n)$ converges, so does $d(\underline{p}_\eta(a_n))$ and I have

$$\lim_{n \rightarrow \infty} \varepsilon'(k^*(a_n), a_n) = \lim_{n \rightarrow \infty} d(\underline{p}_\eta(a_n), \eta) =: \delta \leq \frac{-1}{\max\{\eta, 1 - \eta\}(q^H - q^L)} < 0$$

which implies $\varepsilon'(k^*(a_n), a_n) > 2\delta$ for large n .

Choose $k = -\frac{e}{8\delta}$ and n large enough such that this inequality holds and that $k^*(a_n) < k$.

This is possible due to the first step. I then have for all $n \in \mathbb{N}$

$$\begin{aligned} \varepsilon(k, a_n) &= \varepsilon(k^*(a_n), a_n) + \int_{k^*(a_n)}^k \underbrace{\varepsilon'(l, a_n)}_{\geq \varepsilon'(k^*(a_n), a_n) > 2\delta} dl > \frac{e}{2} + (k - k^*(a_n))2\delta \\ &\geq \frac{e}{2} + k2\delta = \frac{e}{2} - \frac{e}{4} = \frac{e}{4} > 0 \end{aligned}$$

which is a contradiction to $\lim_{n \rightarrow \infty} \varepsilon(k, a_n) = 0$.

From the second step, it now follows easily by equation (13) that

$$\begin{aligned} \bar{q}_\eta - \lim_{a \rightarrow \infty} \underline{p}_\eta(a) &= \eta(q^H - \lim_{a \rightarrow \infty} \underline{p}_\eta(a)) \\ \Rightarrow \lim_{a \rightarrow \infty} \underline{p}_\eta(a) &= q^L. \end{aligned}$$

This concludes the proof for the case $a \rightarrow \infty$.

The proof for $a \rightarrow 0$ is quite similar. I show that $\lim_{a \rightarrow 0} k^*(p(a), a) = 0$ (otherwise, $\varepsilon(k^*(p(a), a), a)$ goes to $\frac{1}{2}$ for some subsequence and this is not optimal in the limit), that $\lim_{a \rightarrow 0} \varepsilon(k^*(p(a), a), a) = \frac{1}{2}$ and hence the limit of equation (13) yields

$$\begin{aligned} \bar{q}_\eta - \lim_{a \rightarrow 0} \underline{p}_\eta(a) &= \frac{1}{2}\eta(q^H - \lim_{a \rightarrow 0} \underline{p}_\eta(a)) + \frac{1}{2}(1 - \eta)(q^L - \lim_{a \rightarrow 0} \underline{p}_\eta(a)) \\ \Rightarrow \bar{q}_\eta - \lim_{a \rightarrow 0} \underline{p}_\eta(a) &= \frac{1}{2}\bar{q}_\eta - \frac{1}{2}\lim_{a \rightarrow 0} \underline{p}_\eta(a) \\ \Rightarrow \lim_{a \rightarrow 0} \underline{p}_\eta(a) &= \bar{q}_\eta \end{aligned}$$

The last part of the proposition follows directly from this convergence of \underline{p}_η and $\lim_{a \rightarrow 0} \hat{\varepsilon} = \frac{1}{2} > 0$. \square

Proof of Proposition 5.2. The arguments here are basically the same as in the previous proof, using that $\bar{p}_\eta(a)$ is implicitly defined by the equation

$$u_n = u_s^*(p(a), \eta, a)$$

$$0 = \eta(1 - \varepsilon(k^*, a))(q^H - p(a)) + (1 - \eta)\varepsilon(k^*, a)(q^L - p(a)) - k^*.$$

The derivative is thus either

$$\frac{\eta(q^H - p) + (1 - \eta)(p - q^L)}{-\eta(1 - \varepsilon) - (1 - \eta)\varepsilon} \varepsilon_a > 0 \text{ or } \frac{1}{-\eta(1 - \varepsilon) - (1 - \eta)\varepsilon} \frac{\partial}{\partial a} \bar{k}(a) \geq 0.$$

The arguments for the convergence to \bar{q}_η and q^H are again very similar to the previous proof and are thus omitted. \square

Proof of Corollary 5.3. It follows from the convergence of $\underline{p}_\eta(a)$ that PE_b does not exist for high values of a , since its price must be lower than the high quality production costs c^H from some point on. Both, the search price p_s of PE_s and HE converge to q^H . The proof of Proposition 5.2 shows that for PE_s , the corresponding signal error $\varepsilon(k^*(\bar{p}_\eta(a), \eta))$ converges to 0 when a goes to infinity. Thus for high values of a we have

$$\varepsilon(k^*(\bar{p}_\eta(a), \eta))(\bar{p}_\eta(a) - c^L) < q^L - c^L \quad (14)$$

so that PE_s does not exist. The convergence of $\bar{p}_\eta(a)$ to q^H also shows that for high values of a we must have $\bar{p}_\eta(a) > c^H$. For each of these values of a , since the left hand side of (14) converges to $\frac{1}{2}(q^H - c^L) > q^L - c^L$ when η goes to one, there exists $\hat{\mu} \in (\eta, 1)$ so that

$$\varepsilon(k^*(\bar{p}_{\hat{\mu}}(a), \hat{\mu}))(\bar{p}_{\hat{\mu}}(a) - c^L) = q^L - c^L.$$

This constitutes the existence of a hybrid equilibrium and thus of HE .

The above condition combined with the limit behavior

$$q^H \geq \bar{p}_{\hat{\mu}}(a) \geq \bar{p}_\eta(a) \rightarrow q^H, \quad a \rightarrow \infty$$

implies the convergence of $\varepsilon(k^*(\bar{p}_{\hat{\mu}}(a), \hat{\mu}))$ to $\frac{q^L - c^L}{q^H - c^L}$. \square

Proof of Proposition 5.4. From the proof of Proposition 5.1 I know that $\lim_{a \rightarrow 0} \bar{p}_\eta(a) = \bar{q}_\eta$, $\lim_{a \rightarrow 0} k^*(\bar{p}_\eta(a), \eta, a) = 0$ and $\lim_{a \rightarrow 0} \varepsilon(k^*(\bar{p}_\eta(a), \eta, a), a) = \frac{1}{2}$. The low type profit in PE_s thus converges to

$$\begin{aligned} \lim_{a \rightarrow 0} \varepsilon(k^*(\bar{p}_\eta(a), \eta, a), a)(\bar{p}_\eta(a) - c^L) &= \frac{1}{2}(\bar{q}_\eta - c^L) \\ &= \frac{1}{2}(\eta q^H + (1 - \eta)q^L - c^L) \\ &= \frac{1}{2}(\underbrace{\eta(q^H - q^L)}_{< q^L - c^L} + q^L - c^L) \\ &< q^L - c^L \end{aligned}$$

which shows that for low a this equilibrium type does not exist. It follows from Lemma 3.6 that for each such a there is at least one belief $\hat{\mu}(a) > \eta$ for which the low type exactly attains the profit $q^L - c^L$ at price $\hat{p}(a) := \bar{p}_{\hat{\mu}(a)}(a)$ if the consumer behaves optimally. Writing $\hat{k}^*(a) := k^*(\hat{p}(a), \hat{\mu}(a), a)$, this means

$$\varepsilon(\hat{k}^*(a), a)$$

I use a similar argument to the one in the proof of Proposition 5.2 to show that $\lim_{a \rightarrow 0} \hat{k}^*(a) = 0$ and $\lim_{a \rightarrow 0} \hat{\varepsilon}(a) = \frac{1}{2}$. The above equality then dictates that $\lim_{a \rightarrow 0} \hat{p}(a) = 2q^L - c^L$ and, since the posterior belief satisfies

$$\hat{\mu}(a)(1 - \hat{\varepsilon}(a))(q^H - \hat{p}(a)) + (1 - \hat{\mu}(a))\hat{\varepsilon}(a)(q^L - \hat{p}(a)) - \hat{k}^*(a) = 0$$

for all a , taking the limit and applying the result yields $\lim_{a \rightarrow 0} \hat{\mu}(a) = \frac{q^L - c^L}{q^H - q^L}$.

Finally, the condition $c^H < 2q^L - c^L = \lim_{a \rightarrow 0} \hat{p}(a)$ ensures that these prices indeed form hybrid equilibria for low values of a . \square

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