Competition Policy in Selection Markets

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I. INTRODUCTION

One of the oldest arguments against both competition and the policies promoting it is the problem of cream-skimming. In selection markets, like insurance and finance, where some customers are cheaper to serve than others, competitors have an incentive to poach the most lucrative customers from their rivals, the "cream." As Rothschild & Stiglitz[2] and de Meza & Webb[3] famously showed, this form of competition often causes severe problems, as competing firms distort their product quality or price in order to attract the cream. Such concerns were a leading part of debates over public utility regulation and the antitrust defense of AT&T, as highlighted by Faulhaber,[4] and have been well known in economics since the work of Rothschild and Stiglitz. However, cream-skimming has never made it into the models economists use to evaluate mergers and other competition policy issues.

This article reviews a pair of recent papers (Mahoney & Weyl[5]; Veiga & Weyl[6]) in which we have begun to fill this lacuna. In particular, we have found that in many realistic cases there can be too much competition in selection market. [(,)-865( )]TJec

be insurance if it did not indemnify individuals against their future costs, but in doing so it makes unhealthy consumers more expensive to cover. Other examples of selection markets include:

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function of a market power parameter à (x-axis), where 0 represents perfect competition and 1 monopoly. The value à = 0.2 is a useful benchmark: with symmetric Cournot firms it corresponds to an Herfindahl-Hirschman Index of 2,000, just above the threshold the Department of Justice uses to define markets as highly concentrated.

The figure indicates that, in this case, the marginal borrower is subsidized by $4,462 or 41 percent of the price of the car. The marginal borrower receives a subsidy whenever à < 0.5, which corresponds to a symmetric Cournot duopoly, indicating that higher levels of concentration may be desirable. While our analysis should be interpreted with caution, implicit subsidies of this magnitude could easily reverse standard prescriptions for competition policy and the design of pro-competitive financial deregulations that do not consider selection.

III. ADVERSE SELECTION AND STINGY INSURANCE