Racing to the Bottom: Competition and quality*

Limor Golan† Christine A. Parlour‡ Uday Rajan§

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Abstract

We model competition between risk-neutral principals who hire weakly risk-averse agents to produce a good of variable quality. The agent can increase the likelihood of producing a high-quality good by providing costly effort. We demonstrate that the cost of providing incentives increases in the number of other firms competing. We characterize conditions under which the first-best outcome involves each firm inducing high effort. If the market is competitive, we characterize when firms induce high effort in the short run and low effort in the long run, and also when the competitive outcome deviates from first best. The more-risk averse the agent, the sooner the divergence from first best. Increased competition thus leads to a “race to the bottom” in quality.

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†limor@andrew.cmu.edu
‡parlour@haas.berkeley.edu
§urajan@umich.edu
1 Introduction

Should social policy encourage competition in service industries? The answer appears to be “yes,” judging from the deregulation of financial markets (the National Market System), competitive provision of directory assistance in the UK or the plethora of subprime mortgage brokers. However, is there an economic basis for this argument? The standard argument in favor of competition is that, fixing a production technology and factor prices, free entry drives firms to produce at the minimum of the long run cost curve which is socially efficient.

In service industries, the good being produced is typically intangible and depends on the interaction of agents. Indeed, there is no reason to view the “production function” as invariant to market structure, an idea fundamental to the efficiency of competitive equilibrium. Specifically, contracts in service industries are flexible and can easily be changed as the industry structure changes. In this way, competition can change the cost of producing high quality services, rendering the notion of “the minimum of the long run average cost curve” specious. Understanding if competitive forces lead to socially efficient outcomes is of immediate importance because the service industry is so large: In the United States, it accounts for approximately two thirds of domestic production. To examine this question, we consider the effect of competition on competing firms’ incentives to provide high quality services. Given how services are produced, to what outcomes will competition lead and will they be socially efficient?

We present a simple model of an industry in which risk neutral principals offer incentive contracts to agents. If an agent puts in high effort, then the good is more likely to be of high quality, and less likely to be of low quality. A monopsonist consumer observes the quality offered by each firm. She then chooses a firm to patronize and buys a fixed amount. In our model there are therefore two contractible states. We derive the optimal contract between the principal and the agent, solve for a principal’s equilibrium effort choice, and compare the results of competition to the first best.

We consider two types of competitive equilibria — short run and long run. The difference between them is that, in long run equilibrium, firms make close to zero profits (modulo an integer number of entrants). We focus on the case in which all firms optimally induce high effort in the short run. As the number of firms in the industry increases, the incentive (in terms of an increase in expected revenue) to incurring costly effort decreases. Further, if the agent is risk averse, the cost to providing incentives increases. This is because competition can make the contracting problem between the principal and agent more noisy: An agent can fail to make a sale either because he shirked or because he faced an aggressive competitor. Both of these effects go in the same direction; eventually the average quality of services
produced in the industry degenerates. We compare this outcome to the first best in which each firm induces high effort and find that, the more risk-averse the agent (so the more severe the incentive problem), the sooner competitive forces drive the economy away from the first best.

Our model is appropriate for service industries. First, we assume that firms’ choice of quality is not fixed. Therefore, while we do not specifically model the evolution of the industry, it is consistent with flexible quality choice: It is more difficult to upgrade a car factory than it is to change a compensation contract. Second, only the consumer knows the quality of the good. This is consistent with services, which are experience goods: It is easier to measure a car’s attributes than to determine if a waiter was polite. Thirdly, we do not explicitly consider price competition. Unlike the market for widgets, decreasing price in services industries does not automatically lead to increased market share. Finally, the production function itself depends on the degree of the competition in the industry: agents’ incentives to provide costly effort depend on the contracts offered to them by the principal.

Our stylized model relates to the literature on the effect of product market competition on managerial incentives. A few distinct features separate it from the previous literature. First, effort exerted by an employee affects the quality of the service and thus the demand for it. Previous literature has focussed on managerial actions that reduce the cost of production for a good. By contrast, in our model the production cost is the cost of providing incentives to the agent and is thus fully endogenous. Second, we provide a precise definition of first best and therefore can define “slack.” Finally, while competing firms affect the contracting relationship between the principal and each agent, the industrial structure (that is one principal matched with one agent) is not inefficient per se: while a monopolist might internalize the market revenue externality we present, it could not arrange production more cheaply than a series of isolated principal agent pairs.

A principal may elicit higher effort either because the benefit is higher or the cost is lower. Previous literature has considered how competition affects both of these. The earliest literature on competition between principals is due to Fershtman and Judd (1987). In their framework, observable contracts are a way of committing to specific production plans and hence changing the one-shot oligopoly game output. We also consider the effect of competition on the desire to induce effort. We interpret this as a statement that competition can change the production function of a firm.

This paper is closely related to those by Raith (2003) and Schmidt (1997). Raith (2003) models entry and exit of firms on a circle. Each firm consists of a risk neutral principal and a risk averse agent. Production costs are decreasing in the unobservable effort exerted by an agent. However, as Raith assumes that realized costs are directly contractible and are
directly affected by the actions of the employee and noise which is independent across firms, the cost of providing incentives is fixed and independent of the competition. Rather, it is the benefit to inducing a particular level of effort that changes with changes in competition. By contrast, we find that the cost of inducing a particular quality level in the optimal contract depends on the market structure. Indeed, the cost of inducing high effort is increasing in the number of competing firms.

Schmidt (1997) considers the effect of competition on managerial incentives to reduce costs. Specifically, increased competition makes it more likely that a company will go bankrupt and so the manager works harder to reduce costs, as this will allow him to keep his job. However, the reduced profits that accompany increased competition decrease the marginal benefit of a cost reduction and so he may not be offered a contract that ensures maximum cost reducing effort. In his model, if a manager is not paid a wage in excess of his reservation wage (i.e., if managers in a competitive industry are not “scarce”) then increased competition unambiguously leads to cost reduction. In our model, the participation constraint always binds as employees are not scarce, and we obtain the opposite result: that competition increases the cost of providing incentives. Further, we directly model the effect of competition (i.e., all firms in our industry optimally choose their quality level).

There is a literature on the information content of an industry and how that is affected by competition. Specifically, if there are common shocks to an industry then there may, collectively, be more information in an oligopoly than in a monopoly. (Holmstrom (1982) and Nalebuff and Stiglitz, 1983.) Hart (1983) shows that competition reduces managerial slack. Scharfstein (1988) demonstrates that the effect can be ambiguous. This literature suggests that the efficient mode of production would be to have multiple agents working for one firm (to generate more information). In our model, as the quality distribution for each agent depends on his action alone (the quality draws are independent) pairing one principal with one agent is a technologically efficient mode of production. An endogenous information externality arises from the purchasing behavior of the consumer.

Hermalin (1992) considers a manager offering a contract to shareholders (therefore the manager’s participation constraint does not bind). He demonstrates that competition has an ambiguous effect on managerial incentives: Competition may change the relative payoff of actions, and may induce the manager to consume different amounts of perquisites. He also identifies a “risk-adjustment” effect that arises because competition may change the informativeness of the agent’s action. In our model, increased competition decreases the informativeness of an agent’s action, which therefore requires a risk premium. This increased cost to the competing principals affects their equilibrium quality choice.

We briefly outline our model in Section 2. We present the optimal contract and expected...
cost of inducing high effort to the principal in Section 3. It is there that we demonstrate that the cost of inducing high effort is increasing in the number of other competing firms. We establish a benchmark, first best in Section 4. The effects of competition both long and short run are enumerated in Section 5. We establish conditions under which long run competition (with free entry) deviates from first best and discuss our results.

2 Model

An industry with \( n \geq 1 \) firms provides a service that can be of variable quality. Each firm is owned by a risk-neutral principal who contracts with an agent (an employee) to produce the service. The employee chooses effort \( e \in \{e_h, e_\ell\} \). The quality of the service offered depends on the effort level: high effort yields high quality with probability \( q \), while low effort yields high quality with probability \( 1 - q \), where \( q > \frac{1}{2} \). Agents are all identical. Each agent is weakly risk-averse with a utility function over wealth denoted by \( u(\cdot) \). The agent has a reservation wage \( w_0 \) that gives rise to a reservation utility \( u_0 = u(w_0) \). His utility is separable in wealth and the cost of effort. Let \( g(\cdot) \) denote the inverse function of \( u(\cdot) \).

If \( e_0 \) denotes the monetary cost to the agent of high effort, and (with a slight abuse of notation) \( e_h^n \) denotes the agent’s disutility of exerting high effort, then, \( e_h^n = u(w_0 + e_0) - u(w_0) \). Low effort entails zero cost, and generates no disutility.

The service is purchased by a representative customer. She observes the quality of the good offered by each firm, and spends \( y \) at one randomly chosen high-quality firm.\(^1\) The principal cannot observe the quality of the service experienced by each customer, but does observe the sales revenue generated by her employee. There are two possible revenue states that the principal can observe: a high outcome, \( y \), or a low one, \( 0 \). Corresponding to these two states, there are two wage levels she optimally offers, designated as \( w_h \) and \( w_\ell \) respectively. Thus, the contract offered by the principal is defined by \( (w_h, w_\ell) \). We assume that \( w_0, e_0 > 0 \), and \( w_0 + e_0 \leq qy \), so that a monopolist facing no incentive problem has a non-negative expected profit if it induces high effort.

Let \( p_h \) denote the probability of achieving high revenue (\( y \)) when the agent puts in a high effort, and \( p_\ell \) the corresponding probability when he chooses low effort. That is, \( p_h = \Pr(y \mid e_h) \), and \( p_\ell = \Pr(y \mid e_\ell) \). From the viewpoint of a single firm, \( p_h \) and \( p_\ell \) are exogenous. However, the probabilities depend on the quality choices of the other firms.

To see this, consider an arbitrary firm \( i \), and suppose that the industry consists of \( n_h \)

\(^1\)A constant revenue is consistent with a game in which the consumer has beliefs on quality given prices, coupled with arbitrary small costs of sequential searching. Her optimal strategy is as follows: If a price signals low quality, she moves on and buys from the first high quality firm she finds. Firms then have no incentive to reduce price.
other firms (i.e., not including firm \( i \)) that provide high effort, and \( n_{\ell} \) other firms that produce low effort. Suppose that firm \( i \) provides high effort. The consumer will purchase from a firm only if it produces high quality. She randomizes with equal probability across all high-quality firms. If firm \( i \) has high effort, it produces high quality with probability \( q \). Suppose exactly \( k \) of the other \( n_h + n_{\ell} \) firms in the industry also produce high quality. The event that exactly \( k \) of the other \( n_h + n_{\ell} \) firms have high quality has probability

\[
\psi(k \mid n_h, n_{\ell}) = \sum_{j=\max\{k-n_h,0\}}^{\min\{k,n_{\ell}\}} \binom{n_h}{k-j} q^{k-j} (1-q)^{n_h-(k-j)} \binom{n_{\ell}}{j} (1-q)^j q^{n_{\ell}-j}.
\]

Further, if firm \( i \) generates high quality and exactly \( k \) of the remaining firms also generate high quality, the consumer buys from firm \( i \) with probability \( \frac{1}{k+1} \). Thus, the overall probability that firm \( i \) generates revenue \( y \) when it induces high effort is

\[
p_h(n_h, n_{\ell}) = q \sum_{k=0}^{n_h+n_{\ell}} \psi(k \mid n_h, n_{\ell}) \frac{1}{k+1}.
\]

If, instead, firm \( i \) provides low effort, it generates high quality with a lower probability, \( 1-q \). However, the probability distribution over the information that the consumer gets from the other \( n_h + n_{\ell} \) firms is independent of the effort of firm \( i \). Therefore,

\[
p_{\ell}(n_h, n_{\ell}) = (1-q) \sum_{k=0}^{n_h+n_{\ell}} \psi(k \mid n_h, n_{\ell}) \frac{1}{k+1} = \frac{1-q}{q} p_h(n_h, n_{\ell}).
\]

Notice that, if there are no other firms in the industry, \( p_h(0, 0) = q \) and \( p_{\ell}(0, 0) = 1-q \).

The expected revenue of firm \( i \) is \( p_h(n_h, n_{\ell})y \) if it has high effort and \( p_{\ell}(n_h, n_{\ell})y \) if it has low effort. We show that (as is intuitive), the expected revenue declines as the industry grows more competitive via the entry of either high or low effort firms. That is, the probability that firm \( i \) earns a high revenue declines in both \( n_h \) and \( n_{\ell} \). Importantly, the difference between \( p_h \) and \( p_{\ell} \), which represents the marginal benefit to firm \( i \) of inducing high effort, also declines as the industry becomes more competitive.

**Lemma 1** The probabilities \( p_h(n_h, n_{\ell}) \) and \( p_{\ell}(n_h, n_{\ell}) \) are both strictly decreasing in \( n_h \) and \( n_{\ell} \), as is the difference \( p_h(n_h, n_{\ell}) - p_{\ell}(n_h, n_{\ell}) \).

We now turn to an examination of industry structure on the cost to a firm of inducing high effort.
3 Cost of High Effort and the Employee Risk Premium

Suppose that the principal wishes to induce low effort. Then, she must pay the agent enough for him to achieve the reservation utility $u_0$. Since the principal is risk-neutral, risk-sharing is not beneficial. Thus, an optimal low-effort contract has the agent earning the wage $w_0$ in both states. If the agent is strictly risk-averse, this is the unique optimal contract when low effort is induced.

By contrast, suppose the principal wishes to induce high effort. The optimal contract minimizes the cost of doing so, and specifies a wage in the high revenue state, $w_h$, and the low, $w_\ell$, that are the solution to the problem:

$$\min_{w_h, w_\ell} \ p_h w_h + (1 - p_h) w_\ell$$

subject to:

$$p_h u(w_h) + (1 - p_h) u(w_\ell) - e_h^u \geq p_\ell u(w_h) + (1 - p_\ell) u(w_\ell) \quad (1)$$

$$p_h u(w_h) + (1 - p_h) u(w_\ell) - e_\ell^u \geq u_0, \quad (2)$$

where (1) is the incentive compatibility constraint, and (2) is the participation constraint.

Define $u_h = u(w_h)$ and $u_\ell = u(w_\ell)$. That is, $u_h$ is the utility induced by the high wage and $u_\ell$ is the that generated by the low wage. Recall that $g(\cdot)$ denotes $u^{-1}(\cdot)$. Then, we can write the problem with agent utilities $u_h, u_\ell$ rather than wages as the choice variables:

$$\min_{u_h, u_\ell} \ p_h g(u_h) + (1 - p_h) g(u_\ell)$$

subject to:

$$\text{(IC)} \quad (p_h - p_\ell)(u_h - u_\ell) \geq e_h^u$$

$$\text{(PC)} \quad u_\ell + p_h (u_h - u_\ell) \geq u_0 + e_\ell^u.$$ 

It is immediate that the participation constraint (PC) must bind at the optimum. If not, $u_\ell$ and $u_h$ can both be reduced by the same amount, leaving the incentive compatibility constraint (IC) unaffected. Further, if the agent is strictly risk-averse, the solution to the above problem is unique, with both the (IC) and (PC) constraints binding. If the agent is also risk-neutral, there is a continuum of optimal contracts each satisfying (PC) with equality. For ease of comparison to the risk-averse case, when the agent is risk-neutral, we select the contract which also satisfies (IC) with equality.

Given an optimal high-effort contract $(u_h^*, u_\ell^*)$, the cost to the firm of eliciting high effort is just the expected wage, $p_h g(u_h^*) + (1 - p_h) g(u_\ell^*)$. Since the firm takes $p_h$ and $p_\ell$ as given, we write $c(p_h, p_\ell)$ to denote the cost to the firm when it wishes to induce high effort.

Lemma 2 The optimal contract that elicits high effort satisfies $u_\ell = u_0 - \frac{p_\ell e_h^u}{(p_h - p_\ell)}$ and $u_h = u_0 + \frac{(1 - p_\ell) e_h^u}{(p_h - p_\ell)}$. The cost to the firm when high effort is elicited is therefore

$$c(p_h, p_\ell) = p_h g(u_0 + \frac{(1 - p_\ell) e_h^u}{(p_h - p_\ell)}) + (1 - p_h) g(u_0 - \frac{p_\ell e_h^u}{(p_h - p_\ell)}).$$

6
In the special case of a risk-neutral agent, so \( g(u) = u \), the cost of inducing high effort is readily obtained to be \( w_0 + e_0 \). In particular, the cost is independent of \( p_h \) and \( p_\ell \), and is therefore invariant to the structure of the industry.

When the agent is risk-averse, however, the cost of inducing high effort depends on \( p_h \) and \( p_\ell \). In turn, \( p_h \) and \( p_\ell \) depend on the number of other firms in the market. Thus, the cost of inducing high effort if the agent is risk-averse depends critically on the industrial structure. With a slight abuse of notation, we refer to \( c(n_h, n_\ell) \) as the cost to an arbitrary firm \( i \) of inducing high effort, when there are \( n_h \) other firms in the industry providing high effort and \( n_\ell \) firms in the industry providing low effort.

We show that the cost of effort is increasing in the number of both high and low quality firms in the industry. The intuition for this result is as follows: As the number of firms in the industry increases, the likelihood that the agent loses the sale is higher even if he puts in high effort. As a result, his wage when revenue is high must increase, else he will earn less than his reservation utility. However, the increased difference in the wages in the high and low revenue states exposes the agent to increased risk. If he is risk-neutral, this increase in risk is irrelevant. However, if he is strictly risk-averse, he must be further compensated for bearing extra risk. In this way, the “production” of effort becomes more costly as the industry grows more competitive.

**Proposition 1** Suppose the agent is strictly risk-averse; that is, \( u'' < 0 \). Then, the cost of inducing high effort, \( c(\cdot) \), strictly increases in each of \( n_h \) and \( n_\ell \).

The excess cost of inducing high effort, \( c(n_h, n_\ell) - [w_0 + e_0] \), may also be interpreted as the risk-premium that must be provided to the agent to induce him to participate in the contract. Since quality is stochastic, high effort necessarily leads to uncertainty in outcomes. A risk-averse agent must be compensated for the extra uncertainty. Of particular interest to us going forward is the risk-premium that a monopolist must provide, or \( c(0, 0) - [w_0 + e_0] \).

Suppose, for example, the agent has CARA utility, so that \( u(w) = -\exp(-\rho w) \), where \( \rho \) is the coefficient of absolute risk aversion. Then, \( g(u) = \frac{1}{\rho}(-\ln(-u)) \). Suppose \( w_0 \) and \( e_0 \) are held constant, with \( e_0^u = u(w_0 + e_0) - u(w_0) \) varying as \( \rho \) changes. In this case, \( c(0, 0) \) is increasing in the risk aversion coefficient \( \rho \), as is the marginal cost of effort, \( c(0, 0) - w_0 \). Finally, as observed earlier, with a risk-neutral agent, \( c(\cdot) = w_0 + e_0 \) in all cases.

The overall decision to provide high effort, of course, depends on both the benefit and cost of high effort. In the next section, we consider the first-best structure of the industry, in which a planner who does not face incentive issues chooses the optimal industry struc-
ture, and turn to the competitive structure in Section 5. In the latter, each firm decides independently whether to enter the industry, and, if so, which effort level to provide.

4 First-Best Industry Structure

In the first-best structure, there is no incentive problem: a planner wishing to induce high effort merely needs to compensate agents for the marginal disutility of high effort, \( e^u_h \) (the cash equivalent of which is \( e_0 \)). In addition, the planner chooses the number of high and low effort firms, \( n_h \) and \( n_\ell \) to maximize social welfare. For convenience, we assume consumer surplus to be zero, so that overall welfare is then equal to the aggregate industry profit.\(^2\)

The consumer buys if she believes that the service will be of high quality, therefore a sale occurs as long as at least one firm produces high quality. If there are \( n_h \) firms inducing high quality and \( n_\ell \) firms inducing low quality, then the event that every firm produces low quality has probability \( (1 - q)^{n_\ell} q^{n_h} \). Thus, with probability \( 1 - (1 - q)^{n_\ell} q^{n_h} \), at least one firm produces high quality. Further, the cost to the planner is \( w_0 \) for each low-effort firm and \( w_0 + e_0 \) for each high-effort firm. Thus, the aggregate industry profit is given by

\[
\Pi(n_h, n_\ell) = [1 - q^{n_\ell} (1 - q)^{n_h}] y - (n_h + n_\ell) w_0 - n_h e_0.
\]

By definition, an industry structure with \( n_h \) firms eliciting high effort and \( n_\ell \) firms eliciting low effort is first-best if aggregate industry profit cannot be improved by changing either the number of high-effort or the number of low-effort firms; that is, if

\[
\Pi(n_h, n_\ell) \geq \Pi(\tilde{n}_h, \tilde{n}_\ell) \quad \text{for any } \tilde{n}_h, \tilde{n}_\ell \geq 0.
\]

It is intuitive that, if \( e_0 \) is sufficiently high (as an extreme case, consider \( e_0 \geq y \)), the first-best allocation would have no high-effort firms. This case is uninteresting, since when \( e_0 \) is sufficiently high, no firm in competition will choose to supply high effort. Therefore, to highlight the difference between the competitive and first-best structures, we consider a situation under which \( e_0 \) is sufficiently low so that the first-best structure entails only high-effort firms.

Consider a planner who is offering high quality services in an \( n - 1 \) firm industry. If he adds one more agent, he is faced with an increased wage bill of \( w_0 + e_0 \). The chance that the consumer buys the good (but did not before) is \( q (1 - q)^{n-1} \), namely, the chance that the firm produces high quality when all else fails. Define \( \tilde{n}^f \) as the largest integer \( n \) for which

\[
q (1 - q)^{n-1} \geq \frac{w_0 + e_0}{y}.
\]

\(^2\)It is straightforward to generalize to the case in which the consumer obtains a utility \( \hat{y} > y \) from consuming the good, with a consumer surplus \( \hat{y} - y \).
That is, if there are \( \hat{n} \) high-effort firms in the market, adding an extra high-effort firm results in all \( \hat{n} + 1 \) firms making a loss. Clearly, a planner will never wish to have more than \( \hat{n} \) high-effort firms. In Proposition 2 below, we identify a condition under which it is optimal for a planner to have exactly \( \hat{n} \) firms in the industry, each incurring high effort.

Given our assumption that \( q \geq w_0 + e_0 \), inequality (3) that defines \( \hat{n} \) is satisfied for \( n = 1 \). Further, the left-hand side decreases to zero as \( n \) gets large. Thus, a unique \( \hat{n} \) exists, and is at least 1. Notice, also that \( \hat{n} \) is increasing in \( y \), the per customer revenue.

Ensuring that it is optimal to supply effort will frequently result in comparing the payoff to a firm that induces high effort to a firm that induces low. Define

\[
B = \frac{2q - 1}{1 - q}.
\]

Since \( 2q - 1 = q - (1 - q) \), \( B \) is the probability that high effort generates high quality minus the probability that low effort generates high quality, divided by the probability of high quality given low effort. It summarizes the benefit to a firm (in terms of increased likelihood of high quality) of inducing high effort.

**Proposition 2** Suppose that the agent's cost of disutility is sufficiently low so that \( e_0 \leq B w_0 \). Then, the first-best allocation has \( \hat{n} \) firms in the industry, and each firm provides high effort.

The condition on \( e_0 \) is intuitive: To ensure that all firms producing high quality is first best, it must be the case that for an industry of size \( \hat{n} \), it is not in the central planner’s best interest to convert a worker’s contract to one that induces low effort. If the central planner does so, then he saves the effort cost, \( e_0 \), but changes the failure probability. This effect is captured by the \( B \) term, which relates to the marginal benefit (in terms of higher probability) of inducing high effort.

### 5 Racing to the Bottom

Do market forces “work” in service industries? If the first-best industry structure entails only high-effort firms, will competition lead to the same outcome? There are two aspects of competition that are pertinent. In the short-run, every firm in the industry must earn a non-negative profit, and must be satisfied with its own effort (i.e., it should not be able to increase its expected profit by switching effort). However, new firms cannot enter the market, so that firms in the industry may earn positive profits. In the long-run, no firm must be willing to enter the market at either effort level. In other words, existing firms
must make close to zero profits. In this framework, \( w_0 > 0 \) acts as a fixed cost and ensures a finite number of firms in the market. Recall, that the profit of an individual firm in an industry with \( n_h + n_\ell + 1 \) firms is

\[
\pi_i(n_h, n_\ell) = \begin{cases} 
    p_h(n_h, n_\ell) y - c(n_h, n_\ell) & \text{if firm } i \text{ provides high effort} \\
    p_\ell(n_h, n_\ell) y - w_0 & \text{if firm } i \text{ provides low effort.}
\end{cases}
\]

**Definition 1** In a short-run industry equilibrium with \( n_h \) firms inducing high effort and \( n_\ell \) firms inducing low effort then

(i) No high effort firm wishes to either switch to low effort or to exit: If \( n_h \geq 1 \), then

\[
p_h(n_h - 1, n_\ell) y - c(n_h - 1, n_\ell) \geq \max\{p_\ell(n_h - 1, n_\ell) y - w_0, 0\}.
\]

(ii) No low quality firm wishes to either switch to high quality or to exit: If \( n_\ell \geq 1 \), then

\[
p_\ell(n_h, n_\ell - 1) y - w_0 \geq \max\{p_h(n_h 1, n_\ell - 1) y - c(n_h, n_\ell - 1), 0\}.
\]

Next, consider long-run equilibrium. In the long run, there are no barriers to entry, and firms can continue to enter as long as positive profits are available.

**Definition 2** A long-run equilibrium with \( n_h \) firms inducing high effort and \( n_\ell \) firms inducing low is a short-run equilibrium with the additional provision that no new firm wishes to enter the market at either effort level:

\[
p_h(n_h, n_\ell) y - c(n_h, n_\ell) \leq 0 \quad \text{and} \quad p_\ell(n_h, n_\ell) y - w_0 \leq 0.
\]

Our goal here is not to characterize all equilibria of the game, but rather to consider situations under which competitive equilibria do not implement the first best. We therefore identify sufficient conditions under which competition leads to all firms producing high quality in the short run, but following the entry of new firms, the industry is of low quality in long run equilibrium. In this case, firm entry directly reduces the quality of the industry.

First, consider the short run. If competing firms produce high quality, then the industry size must be sufficiently small. We identify a threshold number of firms such that each firm in the industry supplies high effort if the short-run number of firms is less than the threshold. Define \( \hat{n}_c \) as the largest integer \( n \) to satisfy

\[
p_h(n - 1, 0) \geq \max\left\{ \frac{q}{(1-q)B \left( \frac{c(n - 1, 0) - w_0}{y} \right)} , \frac{c(n - 1, 0)}{y} \right\} \tag{4}
\]

An integer number of firms may preclude exactly zero profits for industry participants.
The two parts of the RHS come from the joint requirements that firms producing high quality do not switch to low quality and secondly, do not exit. From Lemma 1, we know that the LHS of (4) is declining in \( n \), and it goes to zero as \( n \) gets large. From Proposition 1, the RHS is increasing in \( n \). Thus, if the condition is satisfied at \( n = 1 \), there exists a unique \( \hat{n}_c \) greater than or equal to one. Further, the condition is also satisfied by all \( n < \hat{n}_c \).

Notice also that the more risk-averse the agent, the faster the RHS of (4) increases. Thus, increasing risk aversion on the part of the agent leads to a weakly lower \( \hat{n}_c \).

The maximum number of firms that the industry can sustain is determined by a zero profit condition. In the long-run, if the industry has \( \hat{n}_c \) firms and each firm supplies low effort, and no new firms wish to enter then \( \hat{n}_c \) is the largest integer that satisfies

\[
p(0,n-1) \geq \frac{w_0}{y}.
\]

Note that the left-hand side is declining in \( n \). Thus, if there are \( \hat{n}_c \) low-effort firms in the industry, and an extra low effort firm were to enter, each firm would make a loss, since \( p_{\ell}(0,n) < w_0 \).

**Proposition 3** Suppose that (i) \( \frac{c(0,0) - w_0}{y} \in \left[ \frac{(1-q^2)B}{2}, (1-q)B \right] \),

(ii) \( \frac{w_n}{y} \leq \frac{1-q^2}{2} \), and

(iii) \( \frac{c(0,0)}{y} \leq q \). Then, if the number of firms in short run equilibrium is no greater than \( \hat{n}_c \) each firm supplies high effort. However, there is a long-run equilibrium with \( \hat{n}_c > \hat{n}_c \) firms, each supplying low effort.

Each firm compares the incremental profit from high effort with the associated increase in cost. The expression \( \frac{c(0,0) - w_0}{y} \) in condition (i) measures the extra cost to a monopolist of providing incentives per unit revenue. This must be small enough so that the firm wishes to induce high effort in the short run, yet large enough that in the long run, firms will induce low effort. The lower bound in condition (i) is conservative. As we show in the proof of the Proposition, the exact condition is \( \frac{c(\hat{n}_c - 1,0) - w_0}{y} \geq B \frac{1-q^2}{\hat{n}_c} \). A sufficient condition is found by requiring the inequality to hold at \( \hat{n}_c = 2 \), and considering \( c(0,0) \) rather than \( c(\hat{n}_c - 1,0) \) on the left-hand side. The upper bound of (i) ensures that a monopolist earns a higher profit from high effort, as compared to low effort. The second condition guarantees enough entry so that firms’ best response is to elicit low effort. The third condition is the requirement that a monopolist serving the market earns a weakly positive profit from inducing high effort. If this does not hold, then no firm in competition would provide high quality.

The conditions presented in Propositions (3) and (2) are somewhat different. Under which conditions do the first-best solution and the competitive outcome diverge? We iden-
tify conditions under which Proposition 2 holds, and yet in long-run equilibrium all firms supply low effort. As with Proposition 3, condition (i) is conservative. The exact condition is 
\[ \frac{c(0,0) - w_0}{y} \geq \frac{(1-q^{\hat{n}}^e)B}{n^e}. \]

**Proposition 4** Suppose (i) \( \frac{c(0,0) - w_0}{y} \geq \frac{(1-q^2)B}{2} \), and (ii) \( e_0 \leq w_0B \). Then, the first-best solution has \( \hat{n}^f \) firms, each providing high effort. However, there exists a long-run equilibrium that has \( \hat{n}^c \) firms, each providing low effort.

There are thus two effects that cause competition to diverge from the first best. First, suppose the agent is risk-neutral, so that the principal can costlessly align the agent’s incentives. Then, condition (i) in the Proposition reduces to \( \frac{e_0}{y} \geq \frac{(1-q^2)B}{2} \) (as mentioned after Proposition 4, this condition is conservative). With a risk-neutral agent, the race to lower effort occurs entirely due to a reduction in the benefit of high effort, analogous to the “business stealing” effect identified by Raith (2003). As the number of firms increases, the benefit accruing to a firm of inducing effort decreases. If all other firms produce high quality then each firm’s revenue will be proportional to \( \frac{1}{n} \). Therefore, for fixed costs, the benefit of high effort declines and free entry drives firms to produce low quality because of declining expected benefit.

However, in addition to this revenue effect, we identify a cost externality: With a risk-averse agent, increasing the number of competitors increases the cost to each firm of providing incentives, by reducing the likelihood of achieving a high revenue. This cost is important, because it determines how “quickly” the industry diverges from first best. In Section 5.1, we provide an example to illustrate both the revenue and cost effects of competition.

To emphasize the effect of agent risk-aversion, we explicitly consider a situation in which, with a risk-neutral agent, there exists a long-run equilibrium with all firms providing high effort. However, with sufficiently risk-averse agents, there is a long-run equilibrium with each firm providing low effort.

Define \( \hat{n}^h \) to be the largest integer that satisfies
\[ \left[ \frac{1 - (1-q)^n}{n} \right] y \geq w_0 + e_0. \]  \( (6) \)

Since \( qy > w_0 + e_0 \) by assumption, \( \hat{n}^h \) exists and weakly exceeds one.

If \( e_0 \) is sufficiently low, there exists a long-run equilibrium with \( \hat{n}^h \) firms in the market, each supplying high effort. However, even at the low cost of effort in a world with certainty, if the agent is sufficiently risk-averse, there is a long-run equilibrium in which each firm supplies low effort.
Proposition 5 There exists an $\bar{e} > 0$ such that, if $\frac{e_0}{y} \leq \bar{e}$ and the agent is risk-neutral, it is a long-run equilibrium for there to be $n^h$ firms in the market, each supplying high effort. However, if $\frac{\theta_q - w_0}{y} \geq \frac{(1-q^2)B}{2}$, it is a long-run equilibrium for there to be $n^s$ firms in the market, each supplying low quality.

It is intuitive that when $e_0$ (the cost of effort to a firm employing a risk-neutral agent) is low, an equilibrium will entail high-effort firms. As mentioned in Section 3, the quantity $[c(0,0) - w_0]y$ represents the marginal cost to a monopolist of inducing high effort, and increases in the risk-aversion of the agent. Of course, this quantity depends on $e_0$ as well. Suppose the agent has CARA utility. For any fixed $e_0$ that satisfies the first part of the proposition, if the coefficient of risk aversion is sufficiently high, there will be a long-run equilibrium with only low-effort firms. Indeed, in the next section, we demonstrate an example in which even with risk-neutral agents, there exists a long-run equilibrium with low-effort firms, along with a long-run equilibrium with high-effort firms. When the agent is sufficiently risk-averse, the high-effort equilibrium no longer exists.

5.1 Example

To illustrate our results, we consider the following numeric example. Let $q = 0.7$, $y = 1$, $w_0 = 0.08$, and $e_0 = 0.11$. At these parameter values, $\hat{n}^f = 2$ and $\hat{n}^c = 12$.

Notice that $\frac{\theta_q}{y} = 0.11 > w_0B = 0.1067$, so the condition of Proposition 2 is not satisfied. However, as mentioned, this condition represents a loose upper bound; the exact condition is $\frac{\theta_q}{y} \leq (2q - 1)(1-q)\hat{n}^f - 1 = 0.12$, which is satisfied. Therefore, the first-best outcome entails two high-effort firms in the industry, and no low-effort firms.

The optimality of two high-effort firms when there is no incentive problem may be checked directly. The industry profit in the first-best case is given by $[1 - (1-q)^2]y - 2(w_0 + e_0) = 0.53$. Switching one firm to low-effort yields a profit $[1 - q(1-q)]y - 2w_0 - e_0 = 0.52$. Removing one firm entirely yields a profit $qv - (w_0 + e_0) = 0.51$. Adding a third high-effort firm yields $[1 - (1-q)^3]y - 3(w_0 + e_0) = 0.40$. Finally, adding a third firm that provides low-effort yields a profit $[1 - 3(1-q)]y - 3w_0 - 2e_0 = 0.48$. Thus, it is optimal to have two high-effort firms, and no low-effort firms.

Now, suppose the agent is risk-neutral. Then, from condition (4), $\hat{n}^s = 4$. Note that condition (i) of Proposition 3 is violated, since $\frac{\theta_q}{y} = 0.11 < \frac{(1-q^2)B}{2} = 0.34$. However, as mentioned in the text, the right-hand side of the condition represents a loose lower bound for $e_0$. The exact condition in the risk-neutral case is $\frac{\theta_q}{y} \geq \frac{1-q^{\hat{n}^s}}{\hat{n}^c} B = 0.1096$. Thus, there is a long-run equilibrium with 12 low-effort firms and no high-effort firms in the market.

Next, suppose the agent has CARA utility with risk-aversion coefficient $-1$. That is, her utility over consumption is defined by $u(w) = -e^{-w}$. Now, the marginal cost of high
effort exceeds $e_0$ at each industry configuration, reducing the profit from providing high effort. Thus, $\hat{n}_c$ falls to 3. The long-run equilibrium in which all firms provide low-effort is unaffected.

These results are illustrated in Figure 1, which plots the profit of firm $i$ when all other firms in the industry are providing high effort (left-hand panel) and low effort (right-hand panel).

Consider the left-hand panel of Figure 1 first. If all other firms in the industry are providing high effort, and the agent is risk-neutral, it is a best response for firm $i$ to also provide high effort as long as the number of other firms in the industry is 4 or less. When there are 5 other firms in the industry, firm $i$ makes a loss regardless of the effort level it provides. Thus, it is a long-run equilibrium for there to be exactly 5 high-effort firms in the industry. Conversely, if the agent is risk-averse as described above, the profit from high effort is lower: now, high effort is a best response only if the number of other firms in the industry is 2 or lower.

Next, consider the right-hand panel. If all other firms in the industry provide low effort, and the agent is risk-neutral, it is a best response for firm $i$ to provide high effort if there are 10 or fewer other firms, but to switch to low effort when there are 11 other firms. Thus, it is a long-run equilibrium for there to be 12 low-effort firms in the market. Therefore, when
the agent is risk-neutral, there exist multiple long-run equilibria: one in which all firms provide high effort, and another in which all firms provide low effort. In the short-run, if 6 or fewer other firms provide low effort, it is a best response to provide high effort.

Therefore, in this example:

- The first-best outcome has 2 high-effort firms.
- There is a long-run equilibrium with 12 low-effort firms.
- When the agent is risk-neutral, there is a long-run equilibrium with 5 high-effort firms, and short-run equilibria with 5 or fewer high-effort firms.
- When the agent is risk-averse with CARA coefficient 1, there are short-run equilibria with 3 or fewer high-effort firms.

6 Conclusion

Competition in this environment can induce a race to the bottom, and thus have a negative effect on welfare. At some point competitive forces encourage too much entry which leads to a lower average industry quality. As firms enter the market, they reduce the incentives of existing firms to produce high quality and also are more likely to introduce low quality goods.

That competition in service industries has pernicious effects has a number of policy implications. First, barriers to entry may be a good thing. Specifically trade restrictions or professional accreditations that act as barriers to entry may result in higher quality. Since effort is positively correlated with quality, the implication of Proposition 3 is that, if the marginal cost of high effort is sufficiently high (but not high enough to entirely preclude provision of effort), the average quality of the service offered will be low in long-run equilibrium, but may be high in the short-run. Thus, in sectors identifiable with costly effort, prevention of entry may preserve a high average quality across firms. For example, industry associations in professions such as accountancy, law, and medicine, are often accused of erecting barriers to entry in an effort to keep supply low. Our model provides a justification for such barriers: in their absence, the average quality of the service would plummet.

Second, the proponents of government “outsourcing” argue that opening up competition in the provision of services generates service provision at a lower cost. This model suggests that there is another externality at work, namely that an increase in competition in a service industry may actually decrease the quality of the good. If quality is difficult to measure it suggests that monopoly or restricted provision may be optimal if quality is an issue.
Finally, the health care market is one service industry that has befuddled most high income countries. Aside from anecdotal evidence, there is some indication that increased competition has generated worse outcomes. Propper, Burgess and Gossage (2003) examine the reforms of the National Health Service in the UK. Using quality measures (such as mortality) they find a negative relationship between quality and the degree of competition.

This is a very stylized model, but the intuition that competing firms can make it more expensive to elicit high effort in service industries is robust. Whether that results in equilibrium lower effort levels depends, of course on the benefit to the principal in so doing. Previous versions of this paper let the revenue generated by a transaction depend on the number of firms in the industry. The results go through (albeit with more parameter restrictions). In sum, increased competition in any industry with risk averse employees offering services may not generate the anticipated beneficial effects.

7 Appendix: Proofs

Proof of Lemma 1

Recall that \( p_h \) is defined as 
\[
p_h(n_h, n_\ell) = q \sum_{k=0}^{n_h+n_\ell} \psi(k \mid n_h, n_\ell) \frac{1}{k+1}.
\]
Therefore, \( p_h(\cdot) \) is the expectation of a random variable which takes on values in the set with \( \{ \frac{1}{n_h+n_\ell+1}, \frac{1}{n_h+n_\ell+2}, \ldots, 1 \} \), and the density at \( \frac{1}{k+1} \) is given by \( \psi(k \mid n_h, n_\ell) \).

We will show that the distribution generated by \( \psi(\cdot \mid \tilde{n}_h, \tilde{n}_\ell) \) first-order stochastically dominates the distribution generated by \( \psi(\cdot \mid n_h, n_\ell) \) whenever either \( \tilde{n}_h < n_h \) or \( \tilde{n}_\ell < n_\ell \), or both.

First, consider the binomial distribution over \( \{0, \ldots, n\} \), with success probability \( p \). Let \( \phi(k \mid n,p) = \binom{n}{k} p^k (1-p)^{n-k} \) denote the density at \( k \) and let \( \Phi(\cdot \mid n,p) \) denote the associated distribution.

Consider any \( k \in \{0,1,2,\ldots,n\} \). Then, \( \Phi(k \mid n,p) = \sum_{i=0}^{k} \binom{n}{i} p^i (1-p)^{n-i} \). Hence, \( \Phi(k \mid n+1,p) = \sum_{i=0}^{k} \binom{n+1}{i} p^i (1-p)^{n-i+1} \). Now, \( \binom{n}{i} + \binom{n+1}{i+1} = \binom{n+1}{i+1} \) whenever \( n \geq i + 1 \). Therefore,
\[
\Phi(k \mid n+1,p) = \sum_{i=0}^{k} \binom{n}{i} p^i (1-p)^{n-i+1} + \sum_{i=0}^{k-1} \binom{n}{i+1} p^{i+1} (1-p)^{n-i+1}.
\]

We can now write
\[
\Phi(k \mid n,p) - \Phi(k \mid n+1,p) = \sum_{i=0}^{k} \binom{n}{i} p^i (1-p)^{n-i} [1 - (1-p)] - \sum_{i=0}^{k-1} \binom{n}{i+1} p^{i+1} (1-p)^{n-i+1} = \sum_{i=0}^{k} \binom{n}{i} p^i (1-p)^{n-i} - \sum_{i=1}^{k} \binom{n}{i} p^{i+1} (1-p)^{n-i} = p(1-p)^n > 0.
\]
Therefore, the distribution $\Phi(\cdot | n+1, p)$ first-order stochastically dominates by $\Phi(\cdot | n, p)$.

Now, notice that $\psi(k | n_h, n_\ell) = \sum_{j=\max(k-n_h, 0)}^{\min(k, n_\ell)} \phi(k-j | n_h, q) \phi(j | n_\ell, (1-q))$. Let $\Psi(k | n_h, n_\ell) = \sum_{i=0}^{k} \psi(i | n_h, n_\ell)$ be the probability that at least $k$ of the remaining firms are high quality.

Suppose one additional high-effort firm enters the market, so that the number of high-effort firms (other than firm $i$, which we are interested in) increases from $n_h$ to $n_h+1$, while the number of other low quality firms remains fixed at $n_\ell$. Note that $\phi(\cdot | n_\ell, (1-q))$ is unchanged, whereas $\Phi(k-j | n_h+1, q) < \Phi(k-j | n_h, q)$ for all $(k-j) \in \{0, \ldots, n_h\}$. Since the last inequality holds for all $j \in \{\max(0, k-n_h), \ldots, \min(k, n_\ell)\}$, it follows that $\Psi(k | n_h+1, n_\ell) < \Psi(k | n_h, n_\ell)$ for all $k \in \{0, \ldots, n_h+n_\ell\}$. It follows immediately that $p_h(\cdot)$ is strictly decreasing in $n_h$.

A similar argument shows that $p_h(\cdot)$ is strictly decreasing in $n_\ell$.

Now, $p_e(n_h, n_\ell) = \frac{1-q}{q} p_h(n_h, n_\ell)$, and $p_h(n_h, n_\ell) - p_e(n_h, n_\ell) = (2 - \frac{1}{q}) p_h(n_h, n_\ell)$. Since $p_h(\cdot)$ is strictly decreasing in $n_h$ and $n_\ell$, so are $p_e$ and $p_h - p_e$.

**Proof of Lemma 2**

First, suppose the agent is strictly risk-averse. Then, the objective function $p_h g(u_h) + (1-p_h) g(u_e)$ is strictly convex. From the arguments in the text, the participation constraint (PC) must bind. If the IC does not bind, the first-order conditions imply that $g'(u_h) = g'(u_e)$, or $u_h = u_e$. However, a constant wage will violate the IC constraint. Therefore, the IC constraint must bind.

Next, suppose the agent is risk-neutral. Then, any $u_h, u_e$ which Then, any $u_e, u_h$ that exactly satisfy the PC result in the same cost ($u_0$). Thus, any pair $(u_h, u_e)$ that exactly satisfy the PC and weakly satisfy the IC represent an optimal contract. In particular, the solution obtained when both constraints bind is optimal.

When both IC and PC bind, solving the two equations simultaneously yields the utilities exhibited in the statement of the Lemma. The expected cost to the firm is the expected wage, and is given by

$$c(p_h, p_e) = p_h g(u_0) + \left(1-p_e\right) e_h^u \left(\frac{p_h}{p_h - p_e}\right) + (1-p_h) g(u_0) - \left(\frac{p_e e_h^u}{p_h - p_e}\right).$$

**Proof of Proposition 1**

The cost of inducing high effort is

$$c(n_h, n_\ell) = p_h g(u_0) + \left(1-p_e\right) e_h^u \left(\frac{p_h}{p_h - p_e}\right) + (1-p_h) g(u_0) - \left(\frac{p_e e_h^u}{p_h - p_e}\right),$$

where $p_h, p_e$ are functions of $n_h$ and $n_\ell$. 

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Since \( p_\ell(n_h, n_\ell) = \frac{1-q}{q} p_h(n_h, n_\ell) \) for every pair \( (n_h, n_\ell) \) it follows that \( p_h - p_\ell = \frac{2q-1}{q} p_h \) and \( (1 - p_\ell) = \frac{q - (1-q)p_h}{q} \), where we suppress the dependence on \( n_h, n_\ell \) for brevity. Substituting these expressions into (7),

\[
c(n_h, n_\ell) = p_h g \left( u_0 + \frac{(q - (1-q)p_h) e^u_h}{(2q-1)p_h} \right) + (1 - p_h) g \left( u_0 - \frac{(1-q)e^u_h}{2q-1} \right).
\]

Let \( u_h = u_0 + \frac{(q - (1-q)p_h) e^u_h}{(2q-1)p_h} \) and \( u_\ell = u_0 - \frac{(1-q)e^u_h}{2q-1} \). Then,

\[
\frac{\partial c(n_h, n_\ell)}{\partial p_h} = g(u_h) - g(u_\ell) + p_h g'(u_h) \frac{\partial u_h}{\partial p_h} = g(u_h) - g(u_\ell) - \frac{(2q-1)p_h}{p_h - p_\ell} e^u_h,
\]

Further, \( u_h - u_\ell = \frac{e^u_h}{p_h - p_\ell} \), so that

\[
\frac{\partial c(n_h, n_\ell)}{\partial p_h} = g(u_h) - g(u_\ell) - g'(u_h)(u_h - u_\ell).
\]

Now, given \( g(u(w)) = w \) for every \( w \), it follows that \( g'(u(w))u'(w) = 1 \). Since \( u'(\cdot) > 0 \), it further follows that \( g'(\cdot) > 0 \).

Further, \( g''(u')^2 + g' u'' = 0 \), or \( g''(u') = \frac{-g'(u(w))u''(w)}{(u(w))'} \) for every \( u \). Now, since \( g'(\cdot) > 0 \), \( u''(\cdot) < 0 \), and \( u'(\cdot) > 0 \), it must be that \( g''(\cdot) > 0 \), or \( g \) is strictly convex. Therefore,

\[
g'(u_h) > \frac{g(u_h) - g(u_\ell)}{u_h - u_\ell}, \text{ or } g(u_\ell) > g(u_h) - g'(u_h)(u_h - u_\ell).
\]

Therefore, \( \frac{\partial c(n_h, n_\ell)}{\partial p_h} < 0 \).

Now, from Lemma 1, \( p_h \) is strictly decreasing in \( n_h \) and \( n_\ell \). Thus, \( c(\cdot) \) is strictly increasing in each of \( n_h \) and \( n_\ell \).

**Proof of Proposition 2**

Notice that the aggregate industry profit is concave in \( n_h \) and \( n_\ell \). Thus, it is sufficient to consider a situation in which all firms are producing high effort, and show that local changes in the number of high and low effort firms do not increase profit.

Suppose, therefore, that the first-best industry structure consists of \( n \) firms, each producing high effort. Then, the following four conditions must hold:

(i) Increasing the number of high effort firms to \( n + 1 \) must not increase profit. That is,

\[
[1 - (1-q)^n]y - n(w_0 + e_0) \geq [1 - (1-q)^{n+1}]y - (n+1)(w_0 + e_0),
\]

or,

\[
q(1-q)^n y \leq w_0 + e_0. \tag{8}
\]
Now, $n_f$ is defined as the largest integer $n$ for which $q(1 - q)^{n-1} \geq \frac{w_0 + \epsilon_0}{y}$. Thus, if there are $n_f$ firms in the industry, $q(1 - q)^n y < w_0 + \epsilon_0$, so that (8) holds.

(ii) Reducing the number of high effort firms to $n - 1$ must not increase profit. That is,

$$[1 - (1 - q)^n] y - n(w_0 + \epsilon_0) \geq [1 - (1 - q)^{n-1}] y - (n - 1)(w_0 + \epsilon_0),$$
or,

$$q(1 - q)^{n-1} y \geq w_0 + \epsilon_0,$$

which holds at $n = n_f$, given the definition of $n_f$.

(iii) Switching a high effort firm to a low effort firm does not improve profit. That is,

$$[1 - (1 - q)^n] y - n(w_0 + \epsilon_0) \geq [1 - q(1 - q)^{n-1}] y - (n - 1)(w_0 + \epsilon_0) - w_0,$$
or,

$$(2q - 1)(1 - q)^{n-1} y \geq \epsilon_0,$$

We have assumed that $\epsilon_0 \leq \frac{2q-1}{1-q} w_0$, which is equivalent to the inequality $\frac{w_0}{\epsilon_0} \geq \frac{1-q}{2q-1}$, and hence to $\frac{\epsilon_0 + w_0}{\epsilon_0} \geq \frac{q}{2q-1}$, or $\frac{\epsilon_0 + w_0}{\epsilon_0} \geq \frac{\epsilon_0}{2q-1}$.

Further, by definition of $n_f$,

$$q(1 - q)^{n_f-1} y \geq \epsilon_0 + w_0,$$
or $(1 - q)^{n_f-1} y \geq \frac{\epsilon_0 + w_0}{\epsilon_0}$. Since $\frac{\epsilon_0 + w_0}{\epsilon_0} \geq \frac{\epsilon_0}{2q-1}$, it follows that $(1 - q)^{n_f-1} y \geq \frac{\epsilon_0}{2q-1}$, so that condition (10) holds.

(iv) Adding a low effort firm does not improve profit. That is,

$$[1 - (1 - q)^n] y - n(w_0 + \epsilon_0) \geq [1 - q(1 - q)^n] y - n(w_0 + \epsilon_0) - w_0,$$
or,

$$(1 - q)^{n+1} y \leq w_0.$$

We show that (11) is satisfied, given (8) and (10). Multiply (10) by $-1$ and add to (8). This directly yields (11), which is therefore satisfied.

Thus, if there are exactly $n_f$ high-effort firms and zero low-effort firms in the industry, a local change in either the number of high or low effort firms does not increase profit. Since the aggregate industry profit is concave in $n_h, n_\ell$, the first-best solution has $n_f$ firms in the industry, each producing high effort.

**Proof of Proposition 3**

First, we show that it is a long-run equilibrium for $n_c$ firms in the market to each supply low effort. By definition of $n_c$, no new firm wishes to enter the market and supply low effort.
Also, by definition of \( \hat{n}_e \), no firm wishes to exit the market, since each firm earns a weakly positive profit.

Thus, we need to check the following two conditions:

(i) No firm in the industry wishes to switch from low to high effort. No firm will switch in this manner if

\[
p_h(0, \hat{n}_e - 1)y - c(0, \hat{n}_e - 1) \leq p_\ell(0, \hat{n}_e - 1)y - w_0. \tag{12}
\]

Since \( p_h(0, \hat{n}_e - 1) = \frac{q}{1-q} p_\ell(0, \hat{n}_e - 1) \), the above inequality can be re-written as

\[
\frac{2q-1}{1-q} p_\ell(0, \hat{n}_e - 1)y \leq c(0, \hat{n}_e - 1) - w_0. \]

Now, note that \( p_\ell(0, \hat{n}_e - 1) = \frac{1-q^{\hat{n}_e}}{c} \), and (from Proposition 1)

\[
c(0, \hat{n}_e - 1) \geq c(0, 0). \]

Thus, (12) is satisfied if

\[
c(0, 0) - w_0 \geq \frac{2q-1}{1-q} \left( \frac{1-q^{\hat{n}_e}}{\hat{n}_e} \right) y, \tag{13}
\]

It is straightforward to see that, for \( n \geq 1 \), the expression \( \frac{1-q^n}{n} \) is decreasing in \( n \). Hence, if condition (13) is satisfied for \( \hat{n}_e = 2 \), it is satisfied for all higher \( \hat{n}_e \). When \( \hat{n}_e = 2 \), the condition reduces to \( c(0, 0) - w_0 \geq \frac{(2q-1)(1+q)}{2} y \), or \( \frac{c(0,0) - w_0}{y} \geq \frac{(1-q)B}{2} \), which is assumed in the statement of the Proposition.

(ii) No firm wishes to enter and supply high effort. That is,

\[
p_h(0, \hat{n}_e)y - c(0, \hat{n}_e) \leq 0. \tag{14}
\]

Note that (12) can be written as

\[
[p_h(0, \hat{n}_e - 1) - p_\ell(0, \hat{n}_e - 1)]y \leq c(0, \hat{n}_e - 1) - w_0.
\]

Since \([p_h(\cdot) - p_\ell(\cdot)]\) is decreasing in both arguments and \(c(\cdot)\) is increasing in both arguments, it follows that

\[
[p_h(0, \hat{n}_e) - p_\ell(0, \hat{n}_e)]y \leq c(0, \hat{n}_e) - w_0. \tag{15}
\]

Further, \( p_\ell(0, \hat{n}_e)y < w_0 \) by definition of \( \hat{n}_e \). Add this last inequality to (15), and we obtain (14). Therefore, no firm wishes to enter and supply high effort.

Hence, there exists a long-run equilibrium with \( \hat{n}_e \) firms in the market, each supplying low effort. Notice that the argument above implies that a sufficient condition for there to exist a long-run equilibrium with \( \hat{n}_e \) firms, each supplying low effort, is

\[
\frac{c(0,0) - w_0}{y} \leq \frac{(1-q^2)B}{2}.
\]

Next, we show that if there are \( n \leq \hat{n}_e \) in the market in the short-run, each firm will supply high effort. There are two conditions we need to check:

(i) No firm wishes to switch from high to low quality; that is,

\[
p_h(n-1, 0)y - c(n-1, 0) \geq p_\ell(n-1, 0)y - w_0.
\]
This last condition reduces to \( \frac{2q-1}{q}p_h(n-1,0)y \geq c(n-1,0) - w_0 \), which is satisfied by definition of \( \hat{n}_s^c \). For \( \hat{n}_s^c \) to weakly exceed one, the condition must be satisfied at \( n = 1 \). Since \( p_h(0,0) = q \), this requires \( c(0,0) - w_0 \leq (2q-1)y \), or \( \frac{c(0,0)-w_0}{y} \leq (1-q)B \), which has been assumed.

(ii) No firm wishes to exit the market; that is,

\[
p_h(n-1,0)y \geq c(n-1,0)
\]

This condition is again satisfied by definition of \( \hat{n}_s^c \). For \( \hat{n}_s^c \) to weakly exceed one, the condition must be satisfied at \( n = 1 \), which implies that \( c(0,0) \leq qy \).

Finally, we show that \( \hat{n}_s^c < \hat{n}_s^c \). For this to hold, it is sufficient that, if there are \( \hat{n}_s^c \) firms in the industry each supplying high effort, each firm makes a loss; that is, \( p_h(\hat{n}_s^c - 1,0) < \frac{c(\hat{n}_s^c - 1,0)}{y} \). Now, \( p(\hat{n}_s^c - 1,0) = \frac{1}{1-(1-q)\hat{n}_s^c} \). Thus, a sufficient condition for \( \hat{n}_s^c \) to be strictly less than \( \hat{n}_s^c \) is \( \frac{1}{1-(1-q)\hat{n}_s^c} < \frac{c(\hat{n}_s^c - 1,0)}{y} \). Since \( c(\cdot) \) is strictly increasing in both arguments (from Proposition 1), it is sufficient that

\[
\frac{1 - (1-q)\hat{n}_s^c}{\hat{n}_s^c} < \frac{c(0,0)}{y}
\]

Further, from the definition of \( \hat{n}_s^c \), it must be that \( p(0, \hat{n}_s^c - 1) \geq \frac{w_0}{y} \), or \( \frac{1-q\hat{n}_s^c}{\hat{n}_s^c} \geq \frac{w_0}{y} \). Multiply both sides by \(-1\) and add to (17). This yields

\[
\frac{c(0,0) - w_0}{y} > \frac{q\hat{n}_s^c - (1-q)\hat{n}_s^c}{\hat{n}_s^c}.
\]

The RHS is declining in \( \hat{n}_s^c \), so it is sufficient if the RHS holds at \( \hat{n}_s^c = 2 \), which yields \( \frac{c(0,0) - w_0}{y} > 2q^{-1} \). However, by assumption \( \frac{c(0,0) - w_0}{y} > (1+q) 2q^{-1} > 2q^{-1} \). Hence, \( \hat{n}_s^c < \hat{n}_s^c \).

**Proof of Proposition 4**

As shown in the proof of Proposition 2, the condition \( \frac{w_0}{y} \leq w_0B \) is sufficient for the first-best to have \( \hat{n}_f \) high-effort firms and no low-effort firms.

Further, as shown in the proof of Proposition 3, a sufficient condition for there to exist a long-run equilibrium with only low-effort firms is \( \frac{c(0,0) - w_0}{y} \geq \frac{(1-q\hat{n}_s^c)B}{\hat{n}_s^c} \). Since the right-hand side of this last inequality is decreasing in \( \hat{n}_s^c \), it is satisfied when \( \frac{c(0,0) - w_0}{y} \geq \frac{(1-q^2)B}{2} \), provided that \( \hat{n}_s^c \geq 2 \). Condition (ii) in the statement of the Proposition ensures that \( \hat{n}_s^c \geq 2 \): Since \( \frac{1-q^2}{2} = p(0,1) \), the condition implies that \( p(0,1)y \geq w_0 \).

**Proof of Proposition 5**
In the proof of Proposition 3, we show that the condition \( c(0,0) - w_0 \geq \frac{(1-q^2)}{2} B \) is sufficient for there to exist a long-run equilibrium with \( \hat{n}_L \) firms, each supplying low effort. Thus, what remains to be proved is the first part of the Proposition.

Suppose the agent is risk-neutral. Note that \( \hat{n}_H \) may also be defined as the largest integer \( n \) for which

\[
p_h(n-1,0)y \geq w_0 + e_0.
\]

Thus, it follows that

\[
p_h(\hat{n}_H - 1,0)y - (w_0 + e_0) \geq 0 \geq p_h(\hat{n}_H,0)y - (w_0 + e_0).
\]

Therefore, if there are \( \hat{n}_H \) firms in the industry, each supplying high effort, no existing firm has an incentive to leave the industry, and no new firm has an incentive to enter and supply high effort.

We therefore need to check that no existing firm wishes to switch to low effort, and no new firm wishes to enter and supply low effort. We check each of these in turn.

(i) If an existing firm switches to low effort, its profit is \( p_\ell(\hat{n}_H - 1,0)y - w_0 = \frac{1-q}{q^2} p_h(\hat{n}_H - 1,0)y - w_0 \). For such a deviation to be ruled out, we need

\[
p_\ell(\hat{n}_H - 1,0)y - w_0 \leq p_h(\hat{n}_H - 1,0)y - (w_0 + e_0),
\]

or,

\[
\frac{e_0}{y} \leq p_h(\hat{n}_H - 1,0) - p_\ell(\hat{n}_H - 1,0).
\]

Define

\[
\bar{e} = [p_h(\hat{n}_H,0) - p_\ell(\hat{n}_H,0)] = \frac{2q - 1}{q} \left[ \frac{1 - (1-q)(\hat{n}_H+1)}{\hat{n}_H + 1} \right]
\]

Since the term \([p_h(\cdot) - p_\ell(\cdot)]\) is strictly decreasing in both arguments (Lemma 1), it follows that \( \bar{e} < p_h(\hat{n}_H - 1,0) - p_\ell(\hat{n}_H - 1,0) \). Thus, if \( \frac{e_0}{y} \leq \bar{e} \), condition (19) is satisfied, and no existing firm has an incentive to switch to low effort.

(ii) Suppose \( \frac{e_0}{y} \leq \bar{e} \); that is,

\[
e_0 \leq [p_h(\hat{n}_H,0) - p_\ell(\hat{n}_H,0)]y.
\]

In addition, from the definition of \( \hat{n}_H \),

\[
w_0 + e_0 > p_\ell(\hat{n}_H,0)y.
\]

Multiply (20) by \(-1\) and add to (21), to obtain

\[
w_0 > p_\ell(\hat{n}_H,0)y.
\]

That is, no new firm can enter with low effort and earn a non-negative profit.

Therefore, if \( \frac{e_0}{y} < \bar{e} \) and the agent is risk-neutral, it is a long-run equilibrium for there to be \( \hat{n}_H \) firms in the industry, each supplying high effort.
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