OLIVER FABEL* AND ERIK LEHMANN*

Adverse Selection and the Economic Limits of Market Substitution: An Application to E-Commerce and Traditional Trade in Used Cars

*University of Konstanz, Faculty of Law, Economics, and Public Administration;
Department of Economics, Chair of Management, in particular Firm Policy Formation,
BOX D-144, 78457 Konstanz, Germany

e-mail: <firstname.name>@uni-konstanz.de

Abstract

Adverse selection induces economic limits to market substitution. If quality uncertainty persists in both internet and traditional marketplaces, a second-best equilibrium with parallel market segments may arise. Positive trade in parallel segments implies that the information cost advantage of one marketplace is exactly offset by a more severe adverse selection problem associated with non-observable quality variables. The electronic marketplace providing dominant search means contains all segments. The traditional market then lacks segments characterized by low quality expectations given the vector of advertised quality signals. The analytic results are confirmed by an empirical investigation of used-car trade.

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