Abstract

The theoretical properties of the auction for Medicare Durable Medical Equipment are examined. Two unique features of the Medicare auction are (1) winners are paid the median winning bid and (2) bids are nonbinding. It is shown that median pricing results in allocation inefficiencies as some high-cost firms potentially displace low-cost firms as winners. Further, the auction may leave demand unfulfilled as some winners refuse to supply because the price is set below their cost. A model of non-binding bids that establishes the rationality of a lowball bid strategy is also introduced. Such a strategy was employed by many bidders in the actual Medicare auctions and recently replicated in Caltech experiments. The median-price auction and the standard clearing-price auction where each firm bids true costs as a dominant strategy are contrasted.