Chapter 15

Confronting the Challenges of Asymmetry of Information and Competition: The Rise of eBay

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ABSTRACT

During its history, the largest U.S. consumer-to-consumer online platform, eBay, had to overcome two major obstacles: Asymmetry of information and competition from Yahoo Auctions. This chapter examines two of the mechanisms used by eBay that may account for the company’s success story: the seller’s rating mechanism and the insertion fee structure. The first of these mechanisms seems to have played an important role in addressing the problem of asymmetry of information in consumer-to-consumer online commerce. In addition, the eBay rating may have served as a barrier to entry for competing platforms in the consumer-to-consumer online commerce. The second mechanism appears to have aided eBay in its competition with Yahoo Auctions in the U.S. online auction market.

INTRODUCTION

Online Auctions and Importance of eBay

Online commerce (often referred to as ecommerce) is a relatively young phenomenon that developed in the 1990’s and fortified its position in the first decade of the XXI century. Despite its short history, e-commerce has already produced its own well-known brand names. One such widely recognized name is eBay. In the U.S., online auctions have effectively become synonymous with the eBay brand. The ease of adaptability of auctions to online commerce further contributed to the growing popularity of eBay. However, the history of online auctions has not been free of competition, and serious competitive battles indeed took place before eBay became synonymous with online auctions in the U.S. market. In fact, it was following the closing of Yahoo Auctions in the summer of 2007, that eBay’s hegemony over the

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U.S. online auction market was finally sealed. In addition to competition, online businesses operating in the consumer-to-consumer space also faced other challenges that included asymmetry of information. The industry and particularly eBay were successfully able to overcome this challenge and turn it into a shield against potential competitors.

Much like all online commerce, eBay is a relatively young firm, making its success story even more exciting. Indeed, eBay has come a long way since its debut on Labor Day of 1995. In 2013, eBay reported that the total volume of merchandise sales on its U.S. website (excluding vehicles) reached $30.403 billion a year (eBay, 2014). For comparison, according to the most recent estimates by the U.S. Census, the size of the U.S. online retail sales in 2011, the last year for which the data is currently available, was around $193.904 billion (U.S. Census, 2013). A mere comparison between these numbers highlights the relative importance of eBay.

Although eBay is associated with online auctions, the company does not act as the seller in any auctions listed on its website, but merely serves as a platform for its users. Its customers are the individuals and businesses who wish to sell their items on eBay. In turn, eBay serves as a platform in consumer-to-consumer and business-to-consumer ecommerce.

In its short history, eBay has had to overcome two important obstacles: asymmetry of information and competition with Yahoo. These two obstacles received significant attention in economic literature. The proceeding discussion examines each of these two aspects of eBay’s experience and highlights the unique and creative ways in which eBay has met these challenges.

BACKGROUND

Asymmetry of Information

Online commerce differs from the traditional brick and mortar setting in the way the interaction between buyers and sellers is conducted. In online commerce, this interaction does not need to take place in person. Transactions may involve participants who not only never meet face to face, but may even reside in different countries. In such a setting, trust inevitably becomes an integral part of any transaction, making asymmetry of information a serious challenge for any online business. In the context of eBay, where sellers are individuals or businesses, the asymmetry of information problem has two characteristics: the accuracy of the description of the item being offered for sale and the reliability of the seller in complying with the terms of the transaction.

Over time, ecommerce developed a number of mechanisms aimed at reducing the risks arising from asymmetry of information. Online payment methods, buyer protection, insurance, escrow accounts, etc. all constitute examples of the mechanisms that help facilitate online transactions and reduce the problem of asymmetry of information today. However, in the 1990s, during the rise of eBay, such mechanisms did not exist.

From the start, eBay came up with a simple mechanism to address the problem of asymmetry of information – rating. The eBay rating mechanism is an ingenious solution to a complex issue. It is simple to understand and interpret, making it an easily adaptable tool for all users. It represents a measure of reputation a user has on eBay, and as such, it can serve as a signal about the reliability of that user. This signaling property helps reduce the problem of asymmetry of information. In the design of the rating mechanism, eBay limited the possibility of manipulating one’s rating value by creating multiple