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All-units Discounts and Double Moral Hazard

Daniel P. O'Brien¹

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Abstract

An *all-units discount* is a price reduction applied to all units purchased if the customer's total purchases equal or exceed a given quantity threshold. Since the discount is paid on all units rather than marginal units, the tariff is discontinuous and exhibits a negative marginal price ("cliff") at the threshold that triggers the discount. This paper shows that all-units discounts arise in optimal agency contracts between upstream and downstream firms that face double moral hazard. I present conditions under which all-units discounts dominate two-part tariffs and other continuous tariffs. I also examine these tariffs when the upstream market faces a threat of entry. In the case considered, all-units discounts deter entry by less efficient rivals without distorting price and investment, whereas continuous tariffs either accommodate such entry or deter it by distorting price and investment.

Keywords: All-units discounts, retroactive rebates, double marginalization, double moral hazard, principal-agent, partnerships, teams

JEL Classifications: D42, D86, L12, L42

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