A Supplier’s Optimal Quantity Discount Policy Under Asymmetric Information

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In the supply-chain literature, an increasing body of work studies how suppliers can use incentive schemes such as quantity discounts to influence buyers’ ordering behaviour, thus reducing the supplier’s (and the total supply chain’s) costs. Various functional forms for such incentive schemes have been proposed, but a critical assumption always made is that the supplier has full information about the buyer’s cost structure. We derive the optimal quantity discount policy under asymmetric information and compare it to the situation where the supplier has full information.

(Supply Contracts; Coordination; Lot Sizing; Quantity Discounts; Asymmetric Information)

1. Introduction

The most well-established framework for studying coordination in supply chains is perhaps that of choosing lot sizes in a tightly coupled system with lot-for-lot production. Imagine a single supplier with high setup costs shipping to a single buyer with low setup costs, where the supplier’s production lot size is equal to the lot size shipped to the buyer. Clearly, letting either party determine lot size independently would lead to inefficient outcomes. Starting with (among others) Goyal (1976), Monahan (1984), and Lee and Rosenblatt (1986), the joint economic lot-sizing literature has examined the case where the supplier wishes to induce the buyer to choose a higher lot size than she would of her own accord. Reviews by Goyal and Gupta (1989) and Weng (1995) show how coordination can be achieved in integrated lot-sizing models with deterministic demand. Their work and that of others provides valuable insights into how and when quantity discount schemes can be used to achieve jointly optimal outcomes. Weng (1995) shows that, as long as the quantity discount offered does not affect demand, a quantity discount scheme can indeed yield jointly optimal lot sizes. Several different types of quantity discount schemes have been proposed in the literature, including all-units and incremental discounts, and with a variety of functional forms. Appropriately designed, any of these schemes can lead the buyer to choose the jointly optimal lot size and make both parties better off than without any form of coordination.

A critical assumption made throughout this literature, though, is that the supplier has full information, and can design the quantity discount scheme accordingly; this rarely will be true in practice. In this paper we drop that full information assumption and derive the supplier’s optimal quantity discount scheme when the buyer holds private information about her cost structure. Specifically, imagine that a supplier and buyer are about to start doing business together, and that the supplier’s setup costs are (considerably) larger than the buyer’s. We examine the lot-for-lot production system that is traditional in this context, so the supplier’s production lot size equals the transfer lot size. The simplest mode of operating would be to agree on a price and let the buyer order as frequently as she wishes; clearly this will lead to a much higher order frequency than the supplier would like. The
supplier wants to induce the buyer to order less frequently, realizing she will be reluctant to do so, but, as he cannot observe the buyer’s cost structure, he does not know how “reluctant” she truly is. The supplier needs to design an incentive mechanism to overcome this. The buyer’s reluctance can stem from several causes and is often not easily quantifiable even to the buyer; from the supplier’s standpoint, the buyer’s “holding costs” are anything but known. (One could perform the analyses in this paper with information asymmetry about the buyer’s setup costs, but, as these are generally assumed to be far less than the supplier’s, this case is less interesting.)

In this paper we compare two contracts: the supplier’s optimal contract under full information (case FI) and under asymmetric information (case AI). The asymmetric information case can also be interpreted as the optimal contract to offer to a group of heterogeneous buyers when the supplier cannot price-discriminate. Lal and Staelin (1984) were unable to obtain a closed-form solution to a closely related problem: Given $N$ groups of buyers of different sizes, with holding costs, order costs, and demand rates varying between groups but not within groups, what is the optimal pricing policy? Our analysis is a partial solution to their problem: we only vary the buyer’s holding costs, but derive the optimal quantity discount policy for an arbitrary continuum of buyer types. In §2, we develop the basic model under full information. Section 3 derives the optimal contract under asymmetric information. We compare the performance of both schemes in §4; conclusions and further research are discussed in §5.

2. The Basic Model: Full Information in a Lot-for-Lot System

Let $k_i$ and $k_s$ denote the setup costs incurred by the supplier and buyer respectively and let $h_i$ denote the buyer’s unit holding cost per unit time. (All notation is summarized in Table 1.) We assume $k_i$ and $k_s$ are constant and common knowledge. Two decisions are considered: order lot size, $Q$, and the contract specifying the quantity discount $P(Q)$ per unit time from supplier to buyer. The buyer’s operating cost is $C_i(h_i, Q) = (k_i d/Q) + (h_i/2)Q; Q_i(h_i) = \sqrt{2k_i d/h_i}$ is the lot size that minimizes $C_i(h_i, Q)$. We assume that supplier and buyer work under a lot-for-lot system, as is common in literature on integrated buyer-supplier lot sizing. (This assumption is relaxed in Corbett and de Groote 1997). Under lot-for-lot, the supplier’s cost function is $C_s(Q) = k_d Q$ so that his individual optimum $Q_s$ is the largest allowable lot size. The system (or joint) operating cost is $C_s(h_i, Q) = C_s(h_i, Q) + C_i(Q) = [(k_i + k_s)d/Q] + \frac{1}{2}h_iQ$ and the corresponding jointly optimal lot size is $Q_j(h_i) = \sqrt{2(k_i + k_s)d/h_i}$. The assumption that the supplier has the larger setup cost, i.e. $k_i \geq k_s$, is the starting point for the joint economic lot sizing literature.

Assuming that trade takes place, the supplier’s and buyer’s total or net costs are their operating costs net of the discount $P(Q)$, so that $TC_s(Q) := C_s(Q) + P(Q)$ and $TC_i(h_i, Q) := C_i(h_i, Q) - P(Q)$. If no trade takes place, their total costs are equal to their reservation net cost levels $TC^+_s$ and $TC^+_i$, respectively: They will choose not to trade with each other if the net costs (after discount) of doing so would exceed these reservation values. These could be the costs of the market

<table>
<thead>
<tr>
<th>Table 1</th>
<th>Notation</th>
</tr>
</thead>
<tbody>
<tr>
<td>i = FI, AI</td>
<td>cases considered</td>
</tr>
<tr>
<td>FI</td>
<td>full information</td>
</tr>
<tr>
<td>AI</td>
<td>asymmetric information with revelation</td>
</tr>
<tr>
<td>$k_i$, $k_s$</td>
<td>buyer’s and supplier’s setup costs</td>
</tr>
<tr>
<td>$h_i$</td>
<td>buyer’s unit holding costs per period</td>
</tr>
<tr>
<td>$h_s$</td>
<td>range of buyer holding cost $h_s$</td>
</tr>
<tr>
<td>$Q_i$, $h_i$</td>
<td>supplier’s prior distribution and density over $h_i$</td>
</tr>
<tr>
<td>$E[X]$</td>
<td>expectation of a random variable $X$</td>
</tr>
<tr>
<td>$d$</td>
<td>demand per period</td>
</tr>
<tr>
<td>$C_s$, $C_i$, $C_j$</td>
<td>buyer, supplier, and joint cost function (excluding discount)</td>
</tr>
<tr>
<td>$Q$</td>
<td>lot size</td>
</tr>
<tr>
<td>$Q_s$, $Q_i$, $Q_j$</td>
<td>buyer’s, supplier’s, and jointly optimal lot size (without contracting)</td>
</tr>
<tr>
<td>$P(h_i)$</td>
<td>payment from supplier to buyer, as a function of $h_i$, under contract $i$</td>
</tr>
<tr>
<td>$\hat{p}(h_i) = D_i P(h_i)$</td>
<td>partial derivative of $P(h_i)$ with respect to $h_i$</td>
</tr>
<tr>
<td>$TC^+_i$, $TC^+_s$, $TC^+_j$</td>
<td>maximum (net) cost level acceptable to buyer and supplier</td>
</tr>
<tr>
<td>$TC_{hi}$, $TC_{si}$, $TC_{ji}$</td>
<td>buyer, supplier, and joint net cost function in case $i$, after discount</td>
</tr>
</tbody>
</table>
alternatives or, if there are none, $TC^*_s$ could be the cost of the market opportunity the buyer forgoes by not trading with the supplier, and $TC^*_b$ could be the cost to the supplier of converting the process to supply a different market altogether. If their joint costs under $Q$ exceed $TC^*_s + TC^*_b$, they will definitely not trade; this gives the condition that \( \sqrt{2d(k_b + k_s)h^*_s} \leq TC^*_s + TC^*_b \). Only the buyer knows $h^*_b$. This condition can be rewritten to give an upper bound $h^*_b$ where

$$h^*_b \leq \frac{(TC^*_s + TC^*_b)^2}{2d(k_b + k_s)}.$$  

(1)

If (1) is met under full information, mutually beneficial trade can always take place. Under asymmetric information, however, (1) is necessary but not sufficient. Below, we let the supplier choose a cut-off point $h^*_s$ such that he will choose not to trade with buyers with $h^*_s > h^*_b$, as the supplier’s total costs would then exceed $TC^*_s$. Assume that the supplier holds a prior distribution $F(h_s)$ over $h^*_s$ with support $[h^*_b, h^*_s]$. Demand per unit time $d$ is known and constant. In particular it is not affected by the lot sizing or contracting decisions. The supplier has the initiative to propose contracts but the buyer may refuse them. This corresponds to a principal-agent framework with supplier as principal and buyer as agent with “adverse selection” (ex ante information asymmetry) but no “moral hazard” (unobservability of effort); see Laffont and Tirole (1993) for more on these concepts.

The need to coordinate stems from the fact that the buyer, in optimizing her own costs, does not consider the cost impact for the supplier, leading to $Q_s < Q_j < Q_i$. The supplier can influence the buyer’s choice of $Q$ by specification of the contract $P(Q)$, leading the buyer to minimize her net costs $TC_j(h_s, Q) = C_j(h_s, Q) - P(Q)$. By doing so, he can induce the buyer to choose a $Q$ that reduces his operating cost $C_j(Q)$ and the total system cost $TC_j(h_s, Q)$. However, this is done at the expense of the discount $P(Q)$. In designing a contract, the supplier must therefore trade off the efficiency of the outcome against the sharing of the resulting efficiency gains between the two parties. It is easy for the supplier to induce efficiency by passing on his setup cost, charging the buyer $k_s$ for each delivery, thus making the buyer internalize all variable costs (the “individually rational and responsible decision” (IRRD) approach suggested by Joglekar and Tharthare 1990). The buyer will then choose the jointly optimal lot size $Q_j$. To make this contract palatable to the buyer (regardless of $h^*_b$) the supplier must offer a high discount; this approach is therefore efficient but the resulting cost sharing is unattractive for the supplier.

In the principal-agent framework, the supplier first proposes a “menu of contracts” or discount scheme, specifying the discount $P(q)$ offered for any lot size $q$. The buyer decides whether or not to accept the contract and, if she accepts, chooses some order lot size $Q$. The supplier gives the buyer a discount of $P(Q)$. The supplier’s problem can be formalized as follows:

$$\forall \text{ min } E[TC_j(Q)] = E[P(Q) + C_j(Q)] \quad (2)$$

subject to

**IC:** $Q = \arg \min_q \{TC_j(h_s, q)\}$

$$= \arg \min_q \{C_j(h_s, q) - P(q)\} \quad \forall \text{ } h^*_s \in [h^*_b, h^*_s] \quad (3)$$

**IRb:** $TC_j(h_s, Q) = C_j(h_s, Q) - P(Q) \leq TC^*_j$ 

$$\forall \text{ } h^*_s \in [h^*_b, h^*_s] \quad (4)$$

**IRs:** $TC_j(Q) = C_j(Q) + P(Q) \leq TC^*_j$.  

(5)

The expectation in (2) will be defined more precisely below. The supplier minimizes his expected total cost taking into account the buyer’s reaction to the contract as expressed in the two constraints. Equation (3) is the incentive-compatibility (IC) constraint, and accounts for the buyer’s selection of a lot size that minimizes her net costs including the discount. Equation (4) is the buyer’s individual-rationality (IRb) constraint, and ensures the buyer’s participation: The net costs incurred by the buyer (again after discount) must be at most equal to the reservation costs $TC^*_j$. If we were to omit IRb, the supplier could set $P(Q)$ arbitrarily negative. No buyer would ever wish to contract with such a supplier, hence the need to restrict the supplier’s behavior by including IRb. Equation (5) is the equivalent condition for the supplier, and ensures that he
will not end up worse off from the contracting process than from the outside alternative. The range over which IRs must hold is defined below.

In this case $h_b$ is observed by the supplier. The optimal contract is equivalent to the selection of the joint economic lot size $Q(h_b)$, as in Goyal (1976), Banerjee (1986), and others, leaving all efficiency gains to the supplier. This outcome can be implemented with the contract

$$P_f(h_b, Q) = \begin{cases} 
  \frac{C_s(h_b, Q(h_b))}{h_b} - TC_b^+ & \text{if } Q \geq Q(h_b) = \sqrt{\frac{2(k_s + k_b)d}{h_b}}.
  \\
  -TC_b^+ & \text{otherwise}
\end{cases}$$

(6)

The buyer will choose $Q(h_b)$, resulting in net costs

$$TC_{b,f}(h_b) = TC_b^+$$

(7)

$$TC_{s,f}(h_b) = C_s(h_b, Q(h_b)) - TC_b^+ = \sqrt{\frac{2(k_s + k_b)d h_b}{h_b}} - TC_b^+.$$  

(8)

This is known as the first-best solution. Condition (1) guarantees that $TC_{s,f}(h_b) \leq TC_b^+$ for all $h_b \in [h_{b,l}, h_{b,u}]$. Below we evaluate contracts when the supplier has no information about $h_b$ other than the range $[h_{b,l}, h_{b,u}]$ and a prior distribution $F(h_b)$.

3. Optimal Contract Under Asymmetric Information (Case AI)

The approach we take here relies on the revelation principle (explained below) and closely follows Laffont and Tirole (1993) and Corbett (1997). We reformulate the problem as a direct revelation game and use optimal control theory to derive the supplier’s optimal contract. A common assumption needed here is the following:

Assumption 1. Decreasing reverse hazard rate: $D_{h_b}[f(h_b)/F(h_b)] \leq 0$.

Many common distributions satisfy Assumption 1, including uniform, normal, logistic, chi-squared, and exponential; see Shaked and Shanthikumar (1994, p. 24) for more on the reverse hazard rate. If $f(x)$ defined on any (possibly infinite) interval $[l, u]$ satisfies Assumption 1, its truncation $f_{\cdot}(x)$ to the interval $[h_{b,l}, h_{b,u}]$, defined by $f_{\cdot}(x) = f(x)/F(h_{b,u}) - F(h_{b,l})$ does too. See Bagnoli and Bergstrom (1989) for an extensive discussion of the related condition of log-concavity and distributions which meet these conditions. Distributions with thin tails cause problems; to rule these out, we use an additional assumption to guarantee incentive-compatibility:

Assumption 2. $F(h_{b})/f(h_{b}) \leq (k_s/k_b)$ for all $h_b$.

Neither of these assumptions (1 and 2) on $F(h_b)$ are in fact necessary conditions.

Instead of proposing a single contract $P(Q)$ as in the full-information case, the supplier now offers a menu of contracts $\{Q, P(Q)\}$, letting the buyer choose a specific $(Q, P(Q))$-pair from the menu. We parameterize $Q$ and $P$ on $h_b$, offering a $(Q(h_b), P(h_b))$ menu equivalent to a $(Q, P(Q))$ menu, though that equivalence relation need not exist in closed form. Whether or not contracting is explicitly based on $h_b$, the supplier can always infer $h_b$ after the fact from the buyer’s selection of $(Q, P(Q))$. The contracting procedure is then as follows. At the outset, the buyer knows $h_b$, unobserved by the supplier. The supplier offers a menu $\{Q(h_b), P(h_b)\}$, linking lot size $Q(h_b)$ to the discount $P(h_b)$ for any $h_b \in [h_{b,l}, h_{b,u}]$ the buyer announces. The buyer chooses lot size $Q(h_b)$ and discount $P(h_b)$, effectively announcing $h_b$. After contracting, lot size is fixed (forever) at $Q(h_b)$, and the buyer receives a per-period discount of $P(h_b)$. Buyer and supplier incur net costs per period of $C_s(h_{b,l}, Q(h_{b})) - P(h_b)$ and $C_s(Q(h_{b})) + P(h_b)$, respectively. Later we see that, under the supplier’s optimal menu of contracts, if constraint IRb is satisfied for some $h_b^*$, it will also be satisfied for all $h_b \leq h_b^*$. For large values of $h_b$, though, constraint IRs may not hold. To ensure that both players’ individual-rationality constraints are satisfied, the supplier can set $h_b^*$ such that IRb and IRs are met for all $h_b \leq h_b^*$ and such that both parties will revert to their outside alternatives whenever $h_b > h_b^*$. This is explained more formally below.

The revelation principle (Laffont and Tirole 1993, p.
120) states that if there is an optimal contract for the supplier, then there exists an optimal contract under which the buyer will truthfully reveal her holding cost. This allows us to restrict our attention to such revelation mechanisms. Intuitively, this is easy to see: the supplier can predict exactly how a buyer with holding cost \( h_b \) would behave, and therefore what \( \hat{h}_b \) she would announce when faced with any given quantity discount scheme. Therefore, he can construct a mapping \( \hat{h}_b(h_b) \) and use this in designing the discount scheme \( \{Q(h_b), P(h_b)\} \). The revelation principle allows us to formulate an incentive-compatibility constraint on \( P_{AI}(h_b) \), which requires that it is optimal for a buyer with holding cost \( h_b \) to indeed reveal \( h_b = \hat{h}_b \). Write the derivative \( D_{h_b} \) option to refuse to trade with buyers with \( h_b \). We relax this requirement, and give the supplier the constraint on \( PAI \) allows us to formulate an incentive-compatibility constraint:

\[
\min_{\hat{h}_b} \left\{ \frac{k_d}{Q_{AI}(\hat{h}_b)} - \frac{h_b}{2} Q_{AI}(\hat{h}_b) - P_{AI}(\hat{h}_b) \right\}.
\]  

(9)

Taking the first-order condition with respect to \( \hat{h}_b \) and requiring it be satisfied at \( \hat{h}_b = h_b \) yields the incentive-compatibility constraint:

\[
P_{AI}(h_b) = \left( \frac{h_b}{2} - \frac{k_d}{Q_{AI}(h_b)} \right) Q_{AI}(h_b).
\]  

(10)

The common formulation of the buyer’s individual-rationality constraint \( IRb \) requires that the contract is acceptable to any buyer, regardless of \( h_b \):

\[
TC_b \geq TC_{b'}(h_b, Q(h_b))
\]

\[
= C_b(Q(h_b)) - P(h_b) \quad \forall \ h_b \in [\bar{h}_b, \tilde{h}_b].
\]  

(11)

We relax this requirement, and give the supplier the option to refuse to trade with buyers with \( h_b > \hat{h}_b^* \). By default, \( IRb \) is then met for any \( h_b > \hat{h}_b^* \) and for \( h_b \leq \hat{h}_b^* \) \( IRb \) becomes

\[
TC_b \geq TC_{b'}(h_b, Q(h_b))
\]

\[
= C_b(Q(h_b)) - P(h_b) \quad \forall \ h_b \in [\bar{h}_b, \hat{h}_b^*].
\]  

(12)

Of course, if \( \hat{h}_b^* \geq \bar{h} \), the two are equivalent. To find the optimal menu of contracts, the supplier solves the optimal control problem:

\[
F_{AI} \min_{Q(h_b), P(h_b), h_b \in [\bar{h}_b, \tilde{h}_b]} E_{h_b}\left[ TC_s(h_b) \right]
\]

\[
= E_{h_b \leq h_b^*} \left[ \frac{k_d}{Q(h_b)} + P(h_b) \right] + E_{h_b > h_b^*} \left[ TC_s^* \right]
\]  

(13)

subject to the incentive-compatibility and individual-rationality constraints. More details on how to solve this problem are provided in Corbett and de Groote (1997).

**Proposition 1.** In the optimal discount scheme under asymmetric information, the supplier will only trade with buyers with \( h_b \leq \hat{h}_b^* \) where \( \hat{h}_b^* \) is the solution to

\[
TC_s^* = \frac{k_d}{Q_{AI}(\hat{h}_b^*)} + P_{AI}(\hat{h}_b^*),
\]  

(14)

and \( \hat{h}_b^* \) is increasing in \( TC_s^* \). For \( h_b \in [\hat{h}_b^*, \tilde{h}_b] \), the lot size and discount scheme are given by

\[
Q_{AI}(h_b) = \sqrt{\frac{2(k_s + k_b)d}{h_b + f(h_b)}}
\]  

(15)

\[
P_{AI}(h_b) = \left( \frac{h_b}{2} - \frac{k_d}{Q_{AI}(h_b)^2} \right) Q_{AI}(h_b).
\]  

(16)

For \( h_b \in [\hat{h}_b^*, \tilde{h}_b] \), no trade takes place and both players revert to their outside alternatives, incurring costs \( TC_s^+ \) and \( TC_s^- \), respectively. When the prior \( F(h_b) \) is uniform, the optimal policy and corresponding cost levels for \( h_b \in [\hat{h}_b^*, \tilde{h}_b] \) are:

\[
Q_{AI}(h_b) = \sqrt{\frac{2(k_s + k_b)d}{2h_b - \bar{h}_b}}
\]  

(17)

\[
P_{AI}(Q) = \frac{h_bQ}{4} - \frac{(k_s - k_b)d}{2Q} + \frac{1}{2} \sqrt{2(k_s + k_b)(2h_b - \bar{h}_{s})d}
\]

\[- TC_s^-
\]  

(18)

\[
TC_{b, AI}(h_b) = TC_b^+ - \frac{1}{2} \sqrt{2(k_s + k_b)d \left( \sqrt{2h_b - \bar{h}_b} \right.}
\]

\[- \sqrt{2h_b - \bar{h}_b} \]

(19)

\[
TC_{s, AI}(h_b) = \frac{1}{2} \sqrt{(k_s + k_b)d \left( \sqrt{2h_b - \bar{h}_b} + \sqrt{2h_b - \hat{h}_b^*} \right.}
\]

\[- \left( \hat{h}_b - \bar{h}_b \right) Q_{AI}(h_b) - TC_s^-
\]  

(20)

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The efficiency is reduced by information asymmetry but contracting is more efficient than no form of coordination:

\[ TC_{b} \geq TC_{s,Al} \geq TC_{j,Fl} = TC_{j,i} \quad \forall \ h_b \in [h_{b}, \tilde{h}_b]. \] (23)

The supplier’s expected net costs increase under information asymmetry:

\[ TC^+_s \geq E_{h_b}[TC_{s,Fl}] \geq E_{h_b}[TC_{s,Fl}]. \] (24)

The buyer’s net costs decrease when she has private information:

\[ TC_b^+ = TC_{b,Fl}(h_b, Q_{Fl}(h_b)) \]
\[ \geq TC_{b,Al}(h_b, Q_{Al}(h_b)) \quad \forall \ h_b \in [h_{b}, \tilde{h}_b]. \] (25)

The first inequality in (22) follows from Assumption 2; the second follows directly from the definition of \( Q_{Al} \) and \( Q_{Fl} \). One cannot meaningfully compare \( TC_{b,h} \) with \( TC_{b,Fl} \) and \( TC_{s,Al} \) or \( TC_{s,b} \) with \( TC_{s,Fl} \) and \( TC_{s,Fl} \) as this would require additional assumptions about payment flows before contracting; these assumptions would then drive the resulting comparisons.

5. Conclusions and Future Research

This paper has derived the optimal quantity discount scheme for the joint economic lot-sizing problem under asymmetric information. Strictly speaking, to implement a quantity discount scheme as a reduction of unit price, one would have to look into the impact on the holding cost structure. One could also combine this with letting total demand vary with the discount offered, as in Weng (1995). Such extensions should not materially alter the key qualitative insights of the current work. One can easily redo this analysis with uncertainty about the buyer’s setup cost; this leads to similar qualitative results. Allowing uncertainty on several dimensions independently, e.g. following Lal and Staelin’s (1984) model of heterogeneous buyer groups, does not seem manageable with current techniques. Finally, we need to further explore how else one might model the presence of outside alternatives rather than through the individual-rationality constraint commonly used in the economics literature.
either using the relaxation proposed here or in some other way.¹

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