Marketing Colloquia

Thursday, September 26, 2013
Where: 741 JMHH
When: 3:00 PM to 4:20 PM

So-Eun Park

University of California at Berkeley

Consumer Surplus Moderated Price Competition

ABSTRACT: Standard models of price competition assume that firms are pure profit maximizers. With no direct government intervention in a market, this assumption is sensible and empirically useful in inferring the product markups. However, in markets for essential goods such as food and healthcare, a government may wish to address its consumer surplus concerns by imposing regulatory constraints or actively participating as a player in the market. As a consequence, some firms may have objectives beyond profit maximization and standard models may induce systematic biases in empirical estimation.

This paper develops the structural model of price competition where some firms have consumer surplus concerns. Our model is applied in order to understand demand and supply behaviors in a retail grocery market where the dominant retailer publicly declares its consumer surplus objective. Our estimation results show that the observed low prices of this retailer arise indeed as a consequence of its consumer surplus concerns instead of its low marginal costs. The estimated degree of consumer surplus concerns suggests that the dominant retailer weighs consumer surplus to profit in a 1 to 7 ratio. The counterfactual analysis reveals that if the dominant retailer were to be profit maximizing as in the standard model, its prices would increase by 6.09% on average. As a consequence, its profit would increase by 1.16% and total consumer surplus would decrease by 7.18%. To the contrary, competitors lower their prices in response to the dominant retailer's increased prices, i.e., become less aggressive as if they are strategic substitutes. Interestingly, even though profit of all firms increases, total social surplus would decrease by 3.21% suggesting that profit maximization by all firms induces an inefficient outcome for the market.