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WELFARE EFFECTS OF PRICE-MATCHING POLICIES IN A DIFFERENTIATED PRODUCT MARKET

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This paper analyzes the social welfare effects of the application of price-matching policies in a model of maximum product differentiation. In this framework the changes in the prices charged have no direct effects on social welfare if the market is covered (all consumers buy the good) and consumers have rectangular demands. The effects on social welfare derived from applying the clause are given by an increase in production costs which is partially outweighed by a reduction in transportation costs; as a result, the application of the clause reduces social welfare.

Keywords: Facilitating practices, guaranteed lowest prices.

(*JEL* D43, L13)

1. Introduction

It is frequently observed that rms openly announce that they are committed to matching the prices of their competitors if they are lower than the prices charged by the rm. This price-matching policy is offered by a great spread of sellers such as supermarkets, toy businesses, photograph or video dealers and banks.[1]

This common practice generally gives rise to a question: Is the price-matching commitment interesting from the consumers point of view? If the application of the clause did not affect the prices charged by the rms, some consumers would bene t from learning about lower

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[1]As an example, the commitment has been offered by supermarkets as PRYCA, toyshops as TOYS R US, the shops of the group Image Center (photograph and video products) or banks as Credit Lyonnais.

prices. But if a rm is ready to match his rival s prices: Why should the rivals charge low prices? It is far better to adopt the commitment and to raise prices. When rms apply the clause they are protecting themselves against a price reduction by other rivals. For this reason, the literature on facilitating practices has analyzed the application of the clause as a useful device to charge higher prices.

The main objective of this paper is to show the effects that the application of the clause has on social welfare. This is done in a setting where the highest prices do not have a direct effect on social welfare. As a result, we compare the results under a situation in which the application of the clause is not allowed against the situation in which rms can make use of the commitment, if they consider it to be interesting. In our model there is maximum product differentiation (when rms are located within the city) and the rivals have different production costs. When products are differentiated by location, if the quantity sold does not diminish when the prices rise, the highest prices do not directly reduce social welfare. There is only a transfer of surplus from the consumers to the rms. But the application of the clause has indirect effects which affect social welfare. For example, given that the nal prices charged by the rms are equal, this affects consumers transportation costs and rms production costs (this occurs as the market is shared equally by the rms). From the point of view of social welfare, the negative effect due to the increase in the market share of the high-cost rm outweighs the reduction of consumers transportation costs, as a result total welfare decreases.

The preceding effects have not been analyzed in detail in the previous literature on price-matching because the location models applied to analyze the use of the clause assume that rms incur identical and constant unit costs. Location models are suitable for analyzing the impact of price-matching policies due to the product homogeneity that is required to apply the commitment. Further, they allow product differentiation through location.[2]

[2]Firms do not accept differences in design, quality or product presentation. The only difference they accept when applying the clause refers to the place in which the product is sold and, even than, it sometimes has certain restrictions. Some exceptions to the limited use of location models to analyze the impact of the use of the commitment are Levy and Gerlowski (1991), who study the effects of the application of the clause in a model in which rms advertise their products; Zhang (1995), who studies the effects of the application of the clause on the degree of product differentiation when rms have identical production costs; and Casado-

The standard literature, analyzing the effects of the clause, focuses on the anti-competitive effects of the commitment. Papers by Lin (1988), Doyle (1988), Logan and Lutter (1989) or Png and Hirshleifer (1987) address this issue. Corts (1996) on the other hand, shows that the application of the clause may also have competitive effects when there exist two types of consumers in the market: The sophisticated population who buy at the lowest nal price comparing prices and price-matching policies; and the unsophisticated consumers who never seek the bene ts of the price-matching policy.

The effects of price-matching clauses on social welfare have not been analyzed in a systematic way.[3] Possibly, this is due to the existence of unambiguous negative effects. As the present paper shows, there exists a positive effect in a simple model with product differentiation. Other positive effects are described by Salop (1986). For example, the clause allows the consumers to buy the good before completing the search process. In this case reduction in the delay time may bene t both the buyer and the seller. Moreover, rms may practice price discrimination when applying the clause, and this may bene t some consumers, but harm others. Casado-Izaga (1998) shows that the application of the clause may have positive effects from the social welfare s point of view, when the rms apply the clause in order to transmit information on the costs of the rms established in the market. This may therefore allow the entry of low-cost rms or avoid the entry of high-cost producers.

The paper is organized as follows: First, the model is presented in section 2. Section 3 studies equilibrium and social welfare. Section 4 concludes and all the propositions are relegated to the appendix.

2. The Model

Buyers are uniformly distributed with unitary density along a linear city of length one. Each consumer has the same gross valuation, $\bar{s}$, for the good and it does not depend on the location from where consumers buy the product. Purchases are transported home at a linear cost (td) which depends on the distance travelled (d). The consumers buy only

Izaga (1999), who analyzes the social welfare effects of the application of the clause in a free-entry model.

[3]Recently, Edlin and Emch (1999) compare price-matching markets with entry to monopoly and price-matching markets without entry, and nd that price matching with entry creates greater welfare losses than monopoly in markets with a low ratio of xed to marginal cost.

one unit of the good at the lowest delivered price, considered as the mill price plus transportation cost, if it does not exceed their gross surplus. The good is acquired in the shop in which the delivered price is the lowest. Consumers are thus modelled *à la* Hotelling (1929), taking into account that in this paper the consumers gross valuation of the good has an upper limit.

The rms are located on the two extremes of the linear city, rm A on the left border (0) and the rival, B, on the right border (1). Then, maximal differentiation (within the city) is exogenously imposed. The rms A and B have unitary constant costs of production c_a y c_b, respectively, with $c_a > c_b$. For the sake of simplicity, and without loss of generality, it is considered that A is the high cost rm. Its production costs will be denoted by $c > 0$, with $c = c_a - c_b$. On the basis of this assumption, which simpli es calculations, rm B s production cost is zero.

The timing of the game is as follows: In the rst stage of the game both rms simultaneously choose whether they commit themselves to a price-matching policy. In the second stage, once the rms observe their rivals rst period action, both rms simultaneously choose prices. The consumers have perfect information about price-matching policies and prices, and choose the rm in which they buy the product as a function of the nal prices of each rm. This depends on the rms commitments in the rst stage and the transportation costs from their own shop.

We will use the following assumptions to get the results in a simple way:

$$A1 \quad : \quad \bar{s} > \frac{3t}{2} + c$$
$$A2 \quad : \quad c < 3t$$

These assumptions guarantee that the market is covered (all consumers buy the good) when rms do not apply the price-matching policy, and that both rms have a positive market share in this situation. Assumption A1 allows us to focus on the welfare problem in a simple way, but conceals some interesting results from the point of view of the incentives of the high-cost rm to apply the commitment. Some of them will be discussed later.

3. Results

First the equilibrium analysis and then the welfare results are presented in this section.

3.1 Equilibrium Analysis

The game is solved by backward induction from the last stage. Let p_i^{jk} be the price charged by rm $A(i=a)$ or $B(i=b)$ if rm A does not apply the clause $(j=N)$, or if it does $(j=Y)$, and if rm B does not commit itself $(k=N)$, or if it does $(k=Y)$. The following lemma shows the nal equilibrium prices in the four subgames in the second stage of the game.

LEMMA 1 *The nal equilibrium prices in the second stage of the game are:*

(i) If both rms do not offer the clause: $p_a^{NN}=t+\frac{2c}{3}; p_b^{NN}=t+\frac{c}{3}$.

(ii) If rm A does not offer the clause and B does: $p_a^{NY}=t+\frac{2c}{3}; p_b^{NY}=t+\frac{c}{3}$.

(iii) If rm B does not offer the clause and A does: $p_a^{YN}=p_b^{YN}\in[t,t+c]$.

(iv) If both rms offer the clause: [4] $p_a^{YY}=p_b^{YY}\in\left[0,\bar{s}-\frac{t}{2}\right]$.

In the cases in which the high-cost rm commits ((iii) and (iv)), the iterative elimination of weakly dominated strategies selects a unique equilibrium price, which is the highest price in the interval.

This lemma shows that when rms have different costs the high-cost rm must commit itself to a price-matching policy in order to obtain a change in the equilibrium prices with respect to the prices that exist when the rms do not commit themselves. If the rms production costs were the same, the commitment would only lead to changes in prices when both rms apply the commitment, with respect to the prices charged when the rms do not apply the clause. When there exist differences in production costs, the clause affects prices when applied by the high-cost rm.

[4]These equilibrium prices and those of the case (iii) are the nal prices and may make the consumer ask for the commitment. Then there exist other equilibrium posted prices. For example, in case (iv) the following posted prices are equilibrium prices: $p_a^{YY}=\bar{s}-\frac{t}{2}; p_b^{YY}\in\left[\bar{s}-\frac{t}{2},\infty\right]$. In this case, the consumers ask the high-price rm for the guarantee.

The equilibrium prices in case (ii) do not change with respect to those obtained in case (i) because the rm committing itself is the rm charging the lowest price in the preceding equilibrium. In case (iii) when rm A commits itself and B does not, rm B charges higher prices than those of A if these are lower than t. From the point of view of A, it has the commitment to match B s prices if these are lower than $t + c$, but it prefers to reduce B s higher prices. Then, the nal equilibrium prices are in the interval $[t, t + c]$. In case (iv) the best response a rm can give to a rival s price which is not higher than $\bar{s} - \frac{t}{2}$ is not to reduce it. Moreover, no rm wants to charge a price higher than $\bar{s} - \frac{t}{2}$, because it is weakly dominated by $\bar{s} - \frac{t}{2}$. Then, the nal equilibrium prices are in the interval $\left[0, \bar{s} - \frac{t}{2}\right]$. In this case, the highest price charged by the rms is the maximum amount that the consumer located in the middle of the market is willing to pay. For this reason, we need to set bounds to the consumer gross surplus ($\bar{s}$) as is usual in the analysis of location models.

The simplest resolution of the game requires the selection of a unique equilibrium price in the last stage, in the subgames in which the equilibrium price is not unique. The iterative elimination of weakly dominated strategies selects a unique equilibrium price, the highest in the corresponding interval. This criterion is usual in this literature (see, e.g., Zhang, 1995).

On the basis of the preceding lemma we can state proposition 1. It determines that under assumptions A1 and A2 both rms offer the clause in the rst stage of the game, and then charge the highest price which the consumer located in the center of the linear city is willing to pay.

PROPOSITION 1 *There exists a subgame perfect Nash equilibrium in which both rms simultaneously commit themselves to the price-matching policy in the rst stage of the game and then simultaneously charge* $p_a^{YY} = p_b^{YY} = \bar{s} - \frac{t}{2}$.

Proposition 1 shows that when the consumers gross surplus ($\bar{s}$) is high enough both rms are interested in committing themselves to a price-matching policy. In any case, this result depends on assumption A1. It can be shown that if $\bar{s}$ is lower, the high-cost rm may not be interested in committing itself[5]. The reason is that in this case the high-cost rm would have to sell the good to consumers who are very

[5]This happens, for example, if $\bar{s} \leq \frac{3}{2}t + c, \bar{s} > \frac{3}{2}t + \frac{c}{2}$ and $\bar{s} < \frac{3}{2}t + \frac{c}{3} + \frac{c^2}{9t}$.

far from its location, and it would be better to charge a high price and to focus on the nearest consumers. This reason explains why the clause is not offered by the high-cost rms in markets in which the differences in production costs are great and buyers do not have a high valuation of the good. Finally, given A1 and A2, both rms have higher pro ts and charge higher prices when both apply the clause, compared with the case in which the application of the commitment is not allowed.

3.2 Social Welfare Analysis

Given that under assumptions A1 and A2 both rms offer the clause and that it increases the prices nally charged, though in a way in which both rms charge the same nal price, the effects of the application of the clause on social welfare (SW) only depend on the changes in the consumers transportation costs and the rms production costs. It must be pointed out that what leads to the results on social welfare is the impossibility of price differences under price-matching policies. When the clause is applied, the market is equally shared between the two rms, thus increasing production costs, because when rms are not allowed to apply the clause the low-cost rm has a higher market share than the rival. But when the clause is applied there is a positive effect from the point of view of social welfare. Buyers buy the good in the nearest shop, thus reducing transportation costs. The market is always covered and then the higher prices do not produce the usual Harberger deadweight loss triangle. Proposition 2 shows that the application of the clause leads to a reduction in social welfare.

PROPOSITION 2 *Under assumptions A1 and A2, social welfare is lower when rms are allowed to apply the price-matching policy. Under commitment, the change in social welfare is* $\Delta SW = -\frac{5c^2}{36t}$. *Consumer surplus also decreases.*

In order to understand why social welfare diminishes, the problem of the social planner, whose objective is to maximize social welfare, has to be solved. If the social planner covers the market,[6] he gives rm A a share x^p, and rm B a share $1 - x^p$, so as to maximize: $\bar{s} - cx^p - t\int_0^{x^p} x \; dx - t\int_0^{1-x^p} x dx$. The problem amounts to minimizing $cx^p + t(x^p)^2 - tx^p + \frac{t}{2}$. The solution is: $x^p = \frac{t-c}{2t}$. If this value is negative, the whole market is for rm B. It can be shown that the value of x^p which minimizes costs, allows rm A a market share which is lower

[6] In this model the social planner is always interested in serving all the consumers.

than the one corresponding to the situation in which both rms are not allowed to apply the clause $(x^c) : x^p < x^c; \frac{t-c}{2t} < \frac{1}{2} - \frac{c}{6t}$. Then, the higher social welfare loss derived from applying the clause is due to the fact that rm A s market share is further from the optimal when the rms commit themselves to matching their rivals prices.

From the point of view of consumer surplus, under assumption A1, all the consumers have a lower surplus when rms are allowed to commit. If the reservation value were lower than $\frac{3}{2}t + \frac{2}{3}c$, the consumers buying from the high-cost rm when the application of the clause is not allowed would bene t from the clause, because they all pay lower prices; and some consumers who change from rm B to rm A bene t from the reduction in transportation cost which outweighs the higher prices they now pay the high-cost rm.

4. Conclusions

When rms apply a price-matching policy their rivals cannot beat their nal prices and equilibrium prices increase when consumer gross surplus is high enough. From the point of view of social welfare the price rise does not have a direct effect, because the market is covered and demands are inelastic over the relevant range. The important point from the point of view of social welfare, if we compare the cases in which the application of the clause is allowed and those in which it is not, is that nal prices are the same for both rms when they commit themselves. Then, consumers buy in the nearest shop and this produces an increase in production costs as the high-cost rm increases its market share. This negative effect outweighs the positive effect owing to the reduction of consumer transportation costs and thus the application of the clause reduces social welfare.

The effects of the application of the clause on social welfare do not substantially change if the market is not covered when rms do not adopt the commitment, and both rms charge the monopoly price; or when only one rm sells to all consumers. In the rst case the high-cost rm does not grant the guarantee and, therefore, it has no effects. In the second case, if only one rm covers the market, it is due to the existence of high costs differences. Then, the application of the clause by the less efficient rm would reinforce the negative effects described before.

Finally, the results on social welfare remain the same if consumers transportation costs are quadratic. Each firm's demand remains the same with linear or quadratic transportation costs, because the market is covered and the firms are located on the borders. The welfare loss remains the same as with linear costs because the increase in the production costs and the reduction of transportation costs are the same.

Appendix 1

A1.1 Proof of Lemma 1

(i) When the firms do not apply the clause, A and B choose the prices that maximize, respectively:

$$
\begin{aligned}
&Max(p_a - c)\left(\frac{p_b - p_a}{2t} + \frac{1}{2}\right),\\
&Max\, p_b\left(\frac{p_a - p_b}{2t} + \frac{1}{2}\right).
\end{aligned}
$$

The first order conditions provide the respective reaction functions of firm A and B:[7]

$$
\begin{aligned}
p_a &= \frac{p_b}{2} + \frac{t+c}{2},\\
p_b &= \frac{p_a}{2} + \frac{t}{2}.
\end{aligned}
$$

Then, we have the equilibrium prices (p_a^{NN}, p_b^{NN}), demands $(x^{NN}, 1-x^{NN})$ and profits (π_a^{NN}, π_b^{NN}) of firm A and B:

$$
\begin{aligned}
p_a^{NN} &= t + \frac{2c}{3}; p_b^{NN} = t + \frac{c}{3}; x^{NN} = \frac{1}{2} - \frac{c}{6t}; 1 - x^{NN} = \frac{1}{2} + \frac{c}{6t};\\
\pi_a^{NN} &= \frac{t}{2} - \frac{c}{3} + \frac{c^2}{18t}; \pi_b^{NN} = \frac{t}{2} + \frac{c}{3} + \frac{c^2}{18t}.
\end{aligned}
$$

(ii) When only firm B offers the guarantee, the solution is the same as before because the firm committed to charge the lowest price really does it. In order to understand why, note that the reaction function of firm A changes because of the application of the clause by the rival. A will never be interested in charging a lower price than the price charged by B. Then, A's reaction function around the equilibrium is $p_a = Max\left(\frac{p_b}{2} + \frac{t+c}{2}, p_b\right)$. Similarly, the price effectively charged by B cannot be higher than the price charged by A.

[7] The second order conditions are satisfied. It must be noted that the reaction functions may have other different shapes in other ranges; for example, if firm B's prices are high enough, but they do not affect the resolution of the problem because they are not in the relevant range.

Then, the effective price that B charges is $p_b = Min\left(p_a, \frac{p_a}{2} + \frac{t}{2}\right)$. It is straightforward to obtain the equilibrium results:

$$\begin{aligned} p_a^{NY} &= t + \frac{2c}{3}; p_b^{NY} = t + \frac{c}{3}; x^{NY} = \frac{1}{2} - \frac{c}{6t}; 1 - x^{NY} = \frac{1}{2} + \frac{c}{6t}; \\ \pi_a^{NY} &= \frac{t}{2} - \frac{c}{3} + \frac{c^2}{18t}; \pi_b^{NY} = \frac{t}{2} + \frac{c}{3} + \frac{c^2}{18t}. \end{aligned}$$

(iii) In this case the iterative elimination of weakly dominated strategies selects a unique equilibrium price, the highest in the interval. Then, we have the following results:

$$\begin{aligned} p_a^{YN} &= t + c; p_b^{YN} = t + c; x^{YN} = \frac{1}{2}; \\ 1 - x^{YN} &= \frac{1}{2}; \pi_a^{YN} = \frac{t}{2}; \pi_b^{YN} = \frac{t+c}{2}. \end{aligned}$$

When rm A offers the clause, and following a similar reasoning to the one followed in case (ii), we have that the price nally charged by rm A is: $p_a = Min\left(p_b, \frac{p_b}{2} + \frac{t+c}{2}\right)$. Then, B will nally charge a price such that: $p_b = Max\left(\frac{p_a}{2} + \frac{t}{2}, p_a\right)$ if $Max\left(\frac{p_a}{2} + \frac{t}{2}, p_a\right) \leq \bar{s} - \frac{t}{2}$ and $p_b = \bar{s} - \frac{t}{2}$ if $Max\left(\frac{p_a}{2} + \frac{t}{2}, p_a\right) > \bar{s} - \frac{t}{2}$. B is aware that A will match his offer and reacts by charging no lower prices than A.

In this case the nal equilibrium prices are in the interval $[t, t + c]$. The iterative elimination of weakly dominated strategies selects a unique nal equilibrium price, the highest in the interval. Then, $p_a^{YN} = p_b^{YN} = t + c$.

(iv) When both rms adopt the commitment:

$$\begin{aligned} p_a^{YY} &= p_b^{YY} = \bar{s} - \frac{t}{2}; x^{YY} = \frac{1}{2}; \\ 1 - x^{YY} &= \frac{1}{2}; \pi_a^{YY} = \frac{\bar{s}}{2} - \frac{t}{4} - \frac{c}{2}; \pi_b^{YY} = \frac{\bar{s}}{2} - \frac{t}{4}. \end{aligned}$$

In this case the best response a rm can give to a price in $\left[0, \bar{s} - \frac{t}{2}\right]$ is to match it or to charge a higher price, and rm B is not interested in charging a price higher than $\bar{s} - \frac{t}{2}$. The equilibrium prices are nally: $p_a^{YY} = p_b^{YY} \in \left[0, \bar{s} - \frac{t}{2}\right]$. It is straightforward to verify that the iterative elimination of weakly dominated strategies selects a unique nal equilibrium price, the highest in the interval. Q.E.D.

A1.2. Proof of Proposition 1

From the point of view of A, given A1 and A2: $\pi_a^{YN} > \pi_a^{NN}$ and $\pi_a^{YY} > \pi_a^{NY}$.

From the point of view of B: $\pi_b^{NN} = \pi_b^{NY}$. Given A1: $\pi_b^{YN} < \pi_b^{YY}$. Q.E.D.

A1.3. Proof of Proposition 2

When both rms do not offer the price-matching policy rm A has a market share equal to: $x = \frac{1}{2} - \frac{c}{6t}$. If rms are allowed to apply the commitment they apply it, nal prices are equal, and the A has a market share of $\frac{1}{2}$. Then, when the rms apply the clause there is an increase in the production costs which negatively affects social welfare:

$$\Delta PC = \left(\frac{1}{2} - \frac{1}{2} + \frac{c}{6t}\right) c = \frac{c^2}{6t} > 0.$$

The application of the clause has a positive effect on social welfare, because the consumers buy the good to the closest seller and then they travel less. The change in transportation cost is:

$$\Delta TC = \int_{\frac{1}{2}-\frac{c}{6t}}^{\frac{1}{2}} tx\,dx - \int_{\frac{1}{2}}^{\frac{1}{2}+\frac{c}{6t}} tx\,dx =$$
$$\frac{t}{2}\left(x^2 \Big|_{\frac{1}{2}-\frac{c}{6t}}^{\frac{1}{2}} - x^2 \Big|_{\frac{1}{2}}^{\frac{1}{2}+\frac{c}{6t}} \right) = -\frac{c^2}{36t} < 0.$$

From the point of view of social welfare there are no more effects, because the highest prices are simply a transfer from the consumers to the producers, without deadweight loss. Then, when rms are allowed to apply the clause social welfare (SW) diminishes with respect to the situation in which the application of the commitment is not allowed:

$$\Delta SW = -\Delta PC - \Delta TC = -\frac{c^2}{6t} + \frac{c^2}{36t} = -\frac{5c^2}{36t} < 0.$$

Consumer surplus also diminishes when rms are allowed to apply the commitment:

$$\begin{aligned} \Delta CS &= \Delta SW - \Delta(\pi_a + \pi_b) = -\frac{5c^2}{36t} - \left(\bar{s} - \frac{3}{2}t - \frac{c}{2} - \frac{c^2}{9t}\right) \\ &= -\bar{s} + \frac{3}{2}t + \frac{c}{2} - \frac{c^2}{36t} < 0. \quad \text{Q.E.D.} \end{aligned}$$

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Abstract

Este trabajo analiza el impacto que tiene el uso de la garantía de mejor precio sobre el bienestar social en un marco de máxima diferenciación de producto. En este contexto los cambios en precios no tienen un efecto directo sobre el bienestar cuando el mercado está cubierto y los consumidores tienen demandas rectangulares. Los efectos sobre el bienestar social derivados del uso de la cláusula se asocian a un aumento de los costes de producción compensado parcialmente por la reducción de los costes de transporte, con lo que el efecto neto es negativo.

Palabras clave: Prácticas restrictivas de la competencia, mejor precio garantizado.

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