Research Note: Consumer Heterogeneity and Competitive Price-Matching Guarantees

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Abstract
Price-matching guarantees are widely used in consumer and industrial markets. Previous studies argue that they are a marketing tactic that facilitates implicit price collusion. This is because once a store adopts this marketing tactic, its rivals can no longer steal its customers by undercutting its price, and hence they have little incentive to initiate price cuts. While a store with price-matching guarantees has no fear of losing customers to rivals’ price cuts, it has every incentive to raise its own price to charge a higher price to its loyal consumers. A growing body of legal literature uses this argument today to justify calls for antitrust actions against stores employing this marketing tactic.

However, this theoretical conclusion baffles practitioners and industry experts. In practice, sellers typically embrace this marketing tactic in response to heavier competition and a growing bargain consciousness among shoppers. The introduction of price-matching guarantees by a store is frequently interpreted by industry observers as the initiation of a price war rather than a signal of price collusion. This assertion is supported in many instances by the fact that stores that introduce price-matching guarantees also roll back their prices and typically suffer subsequent loss of profits. Most ironically, the favorite examples used by researchers to illustrate how price-matching guarantees can enforce price collusion, Crazy Eddie and “Nobody Beats the Wiz,” have subsequently either gone bankrupt or filed for federal bankruptcy protection.

In this study we show that price-matching guarantees can indeed facilitate competition: The expected prices and profits can be strictly lower when all stores adopt price-matching guarantees than when they are not allowed to. This is because the adoption of price-matching guarantees generates not only a competition-dampening effect, which has been recognized in the literature, but also a competition-enhancing effect. This latter effect comes from the fact that price-matching guarantees encourage price search by those consumers who prefer to shop at a particular store but are mindful of saving opportunities. These consumers will have incentives to obtain the rival store’s price when their favorite store offers price-matching guarantees to avail themselves of the lowest possible price at their favorite store. As a result, price-matching guarantees reduce the number of purchases at the store from those consumers who would have paid the full price and thus prompt a store to price more aggressively to bid for more incremental sales. This competition-enhancing effect can more than offset the competition-dampening effect in markets where consumers differ in their price search costs and store loyalty. Thus, our study casts doubt on the advisability of blanket prohibition on price-matching guarantees.

Our argument relies only on consumer segmentation and on the phenomenon of periodic sales, both of which are common in retail markets. We arrive at our conclusion by incorporating bargain shoppers and opportunistic loyalists into the standard sales-promotion models. In contrast, the past literature on price-matching guarantees ignores the ubiquitous phenomenon of sales in retail markets and overlooks those consumers who prefer to shop at a particular store, but are alert to saving opportunities. As a result, it is troubled by two awkward conclusions. On the one hand, price-matching guarantees simply remove rivals’ incentives to undercut in price and, hence, also their incentives to run sales. This implies that the adoption of price-matching guarantees in a market will eliminate the phenomenon of sales, which is obviously counterfactual. On the other hand, in equilibrium no consumer actually invokes price-matching guarantees, as each player has incentives to close any price gap in the market. This is obviously false, based on our casual observations and our conversations with store managers.

Theoretical research on the subject thus far has been overwhelmingly one-sided, and empirical or experimental studies are conspicuously lacking. We hope that our conclusion will spark further research in both directions. A healthy debate will broaden our perspective on an issue of great importance in formulating public policies and in managerial decision making.

(Price Guarantees; Price Promotions; Competitive Strategy)

1. Introduction
Many manufacturers and retailers today promise to match the lowest advertised price their customers can