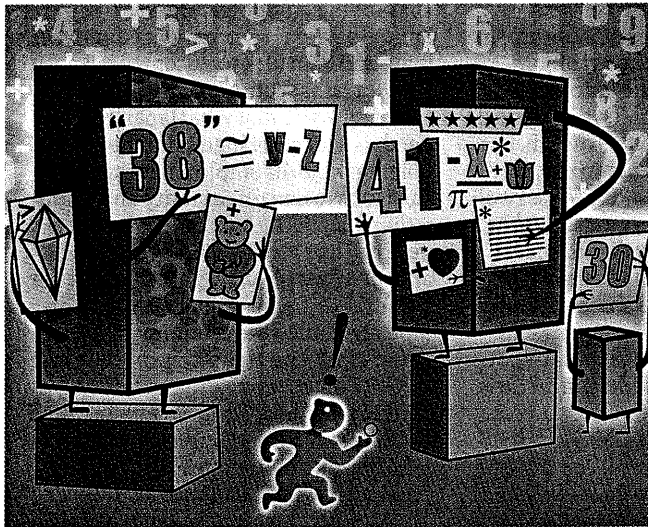


Free exchange | Guaranteed profits



Price-match guarantees prevent rather than provoke price wars



“YOUR shopping would have been cheaper elsewhere, so here’s a voucher for the difference.” Anyone who has recently visited a British supermarket will be familiar with such seemingly generous deals, typically extended to shoppers after they pay. The four biggest British supermarket chains all offer some form of price-match guarantee, promising that their customers could not save any money by shopping elsewhere. On the face of it, they seem like a good thing: a sign that fierce competition is lowering prices. But economists have long been suspicious of such promises, which can leave consumers worse off.

The problem is that price-match guarantees can blunt the logic of competition. Suppose a car dealership worries about a rival undercutting its prices and stealing customers. Even if the dealership can respond by cutting its prices too, it might lose sales in the interim. A price-match guarantee offers a pre-emptive defence. By promising to match any discounts, the dealership can persuade its customers that they need not shop around: they will always pay the lowest price available.

As a result, cutting prices no longer wins the competitor new business; buyers stay loyal and invoke the guarantee instead of switching. All that price cuts achieve for the competitor is the erosion of profits on existing sales. It will probably conclude that prices—and margins—are better left high. The result is “tacit collusion”: the maintenance of high prices, without any explicit communication between firms. Consumers end up suffering due to a guarantee that at first glance seems good for them.

There is no evidence that Britain’s current crop of price-match guarantees has hurt consumers. However, researchers have linked similar promises elsewhere to sustained high prices for groceries, tyres and even shares.* *Wonks* have confirmed the finding in the laboratory, too. In an experiment conducted in 2003, Shakun Datta of the University of Richmond and Jennifer Offenber of Loyola Marymount University paired subjects at random and asked them to play two versions of a computerised price-setting game—one in which players could offer price-match guarantees and another in which they could not. Participants got to keep any profits they made, and were repeatedly reshuffled to prevent any other price-fixing tactics from arising during multiple interactions with the same partner. When the guarantee was pos-

sible, it was deployed 94% of the time and as a result, prices rose by an average of 36%. Even when one player had much lower costs than the other, prices still rose, albeit by less.

Price-matching need not always be a con: guarantees can be constructed in ways that work against tacit collusion. Most relate only to another store’s advertised prices, not to the sum that it would actually charge after applying its own price-matching offers. This creates a loophole which a clever upstart could exploit. Suppose an incumbent supermarket charges £4 for a steak and offers a price-match guarantee. The savvy entrant could advertise a higher price of £5, while promising not just to match any lower price, but to refund twice the difference. Net of the resulting £2 rebate, the upstart’s steak would cost just £3. Yet the advertised price of £5 would not trigger the incumbent’s own price-matching guarantee. Customers might still be tempted to switch by price cuts structured in this way.

That may be too clever by half, but there are other reasons why guarantees might be harmless, or even welcome. One relates to their complexity. At British supermarkets, refunds usually come in the form of a discount on the next shop; to take advantage, a customer must return with the voucher. Remembering to do so takes effort, as anyone with a stack of unused gift vouchers knows. This gives a price-cutting rival an opening. Although any discounts it offers will be matched by the first supermarket in the form of vouchers, customers may value the straightforward price cut more highly, since taking advantage of it is less of a hassle. If enough customers think this way, the result would be a genuine price war—although some might find switching stores more of a chore than remembering to bring their vouchers with them.

Match points

Another mooted justification for the guarantees is price discrimination: selling to different types of consumers at different prices. For instance, if some customers are too busy to shop around, a firm can sell to them at a high price while using a guarantee to attract more price-sensitive, hassle-tolerating customers. This is great for profits, but sometimes benefits consumers too.

Finally, a price-guarantee may be an attempt to signal genuinely lower prices and thus stand out from the crowd. That is probably how most consumers interpret them. This works only if there is a genuine difference in efficiency between rival stores, such that only one can afford to sell on the cheap. Then, the nimble firm might want a price war in order to speed the lumbering one’s demise. In such circumstances, any attempt by the lumbering firm to collude tacitly is futile; if it offers a guarantee, its bluff will be called. So when low-cost firms make such promises, consumers can take them as a sign of a competitive offering.

This does not seem to be what is happening in Britain, however. There, it is the more expensive supermarkets that are promising to match each others’ prices. Only one has pledged to match the deals on offer at Aldi and Lidl, nimble low-cost rivals that are making inroads into the market.

One British supermarket proclaims to its customers that, thanks to its guarantee, they “don’t have to shop around”. On close examination, that sounds like an effort to abate a price war, not start one. ■

*Studies cited in this article can be found at www.economist.com/pricematching15