

Competition and Price Informativeness: An Experiment

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Abstract

Consumers often rely on price as a guide to the quality of a product. If consumers are unable to observe quality directly, price might not perfectly communicate product quality. In this context, competition might increase or decrease the informativeness of prices. I study how competition impacts the informativeness of prices theoretically and in a lab experiment. While theory leaves the question open, I find in the experiment that competition leads both high- and low-quality firms to decrease prices, but the price reduction is larger for high-quality firms who are more likely to price high in the absence of competition. Thus, prices become a less reliable guide to quality when there are more sellers in the market.