Reputation and Competition in a Market for Differentiated Products

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March 2009

Abstract

This paper shows how the presence of uninformed consumers in a market for differentiated products induces firms to exert costly effort. Product quality observed (privately) by a consumer depends both on firms' effort levels and her type, which is a number in the unit interval. If all consumers are informed about their type, high effort provision is an equilibrium outcome only if a positive mass of consumers has exactly the same type. This assumption is usually not fulfilled in models of product differentiation. Uninformed consumers, who only know a distribution over their possible types, may be willing to switch firms after observing bad quality. Given that some consumers are uninformed, firms provide high effort in each period of an equilibrium even if the distribution over types is continuous. Thus, uninformed consumers exert a positive externality on informed ones. Furthermore, we show that the same result may obtain if consumers behave non-strategically, i.e. if they only compare prices and expected payoffs without paying attention to the incentive problem.

Keywords: Repeated Games, Imperfect Private Monitoring, Product Differentiation

JEL classification codes: C73, D82, L15