The Non-Shopper Problem

In a few high-profile markets, prices seem to stay *far* above average cost even though there are *tons* of competitors. There are thousands of credit card issuers, but the average interest rate is 18.26%. There are over 100,000 real estate brokerage firms, but the default commission remains 6%. Sure, unsecured credit has a high default risk, but high enough to justify an 18.26% rate? And why on Earth would it cost *$60,000* to sell a million-dollar home?

From the standpoint of economic theory, such industries are deeply puzzling. In monopoly models, prices stay above average cost forever, but calling an industry with thousands of competitors a "monopoly" seems absurd. In oligopoly and monopolistic competition models, prices stay above *marginal* cost forever, but entry should still drive prices down to average costs.

My UT friends John Hatfield and Richard Lowery (plus Scott Kominers) have a model where realtors are basically a giant cartel that crushes price competition with the threat of ferocious retaliation. (More elaboration here and here). The HKL math is impressive, but ultimately it's an incredible conspiracy theory. What evidence is there that realtors really are unleashing hell on price-cutters? I see cut-rate realtors in my neighborhood all the time. And the same is even clearer for credit cards. Zero-interest offers show up in my mailbox on a regular basis.

What's really going on? I propose a much simpler model than HKL. Namely: In some industries, many consumers foolishly fail to shop around. Maybe they're lazy. Maybe they're fatalistic. Maybe they don't want to look cheap. Maybe they don't want to look weird. Whatever the non-shoppers' motivation, however, the result is the same. If firms know that many consumers don't shop around, then one profit-maximizing business model is simply to charge a high price and see how many suckers come along.

Sure, rival firms will compete for the price-sensitive consumers. Or maybe each firm will charge an easy-to-see high price for suckers and a (slightly) harder-to-see low price for bargain-hunters. Either way, however, we'll see a long-run equilibrium where a lot of people pay prices that far exceed average cost. Indefinitely.

Why is my model better than HKL? Because it explains the same facts – lots of firms persistently charging above average cost – without straining credulity.

Look around with your own eyes. Don't you see lots of people who stubbornly fail to shop around, even though shopping around totally works? I sure do. For virtually any major purchase, I ask the vendor, "Can you do any better?" And guess what? They cut my price two-thirds of the time. Everyone else pays full price.

The same goes for realtors. Discount realtors advertise publicly. And several of my friends have negotiated commission cuts with “full-price” firms. A little self-advocacy can easily yield $10k in savings. For credit cards, I know grad students who did 0% balance transfers over and over, receiving many thousands of dollars of unsecured credit for negative real interest rates despite their very low income. All fueled by the power of gumption and frugality.

As a classic Payless commercial from the 80s remarks, “You could pay more, but why?”

Should we deem this situation a “market failure”? Only if you hold markets to impossibly high standards. If consumers pay high prices because they refuse to shop around, many businesses will naturally charge high prices.   But in such scenarios, it makes far more sense to say that it is not the market, but the consumers, who have failed.