RESEARCH INSIGHTS

How does increased competition impact prices and quality in the retail sector?

- A *conditional cash transfer* program in the Dominican Republic offered an opportunity to randomize the entry of 61 firms into 72 markets and study the effects of increased competition on prices and service quality for the beneficiaries of the program.
- Six months after the intervention, entry into the market led to reductions in prices and an improvement of self-reported service quality among consumers.
- Prices dropped more in areas where the number of entrants was larger. Competition seems to have driven part of the clientele away from incumbent retailers.

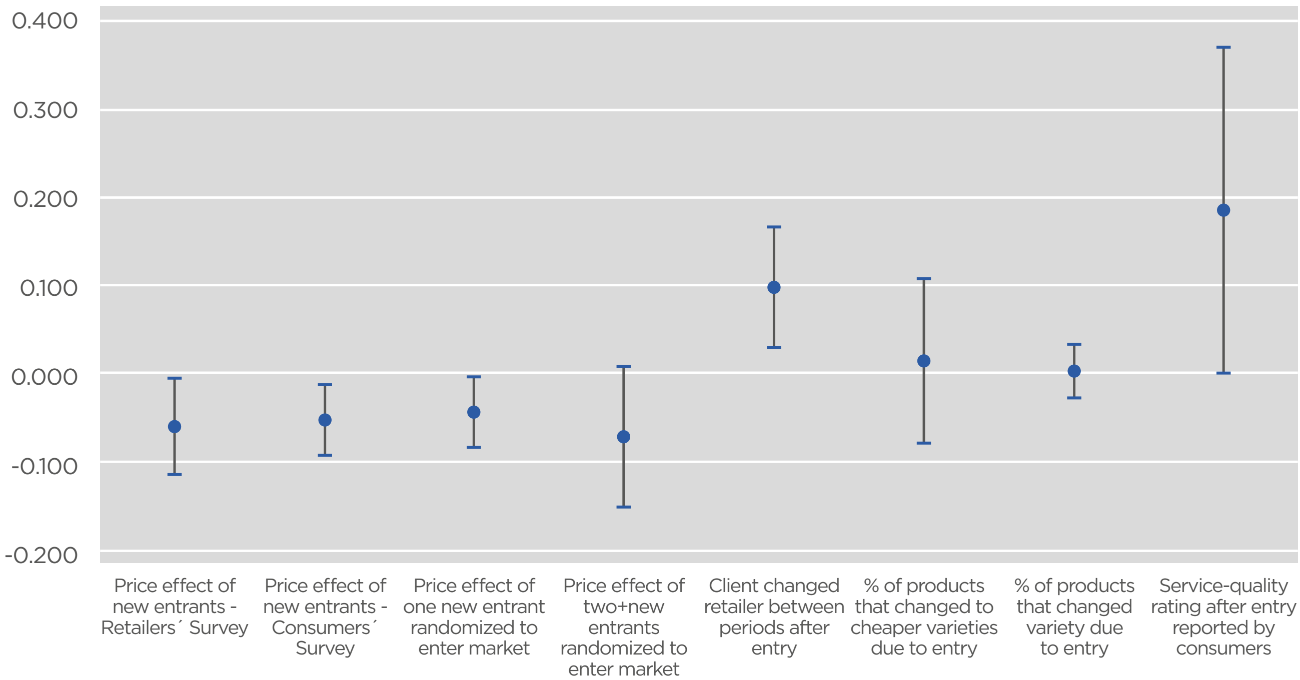
CONTEXT

Competition policies matter. Economists have extensively studied the effect of competition on prices and quality in the retail sector, which accounts for 20 percent of global GDP. However, most research has focused on market entry of large retailers. Much less attention has been paid to small firms. Competition helps consumers even when many firms are already operating in a market. It also helps governments, which can procure public services and achieve lower prices without sacrificing quality—provided they can ensure enough competition among potential providers.

THE PROJECT

This research project was undertaken in the context of a cash transfer program in the Dominican Republic. The program provides monetary transfers to families that can only be used in affiliated grocery stores. Since entry into this market was restricted by program design, these retailers could potentially wield market power. A *randomized controlled trial* was designed around how many new stores started operating in each of 72 districts—between zero and three, for a total of 61 new stores in all districts. In treated areas, this led to a 26 percent increase in the number of stores consumers could visit to use their monetary transfers.

Average Treatment Effects of Increased Competition



RESULTS

Theory predicts that firms with market power may exploit their position to reduce quality and raise prices. In practice, entry of new firms leads to price reductions by increasing competitive pressure on incumbents. Effects on quality have been less clear-cut, as they ultimately depend on the extent to which consumers perceive and value quality.

1. The average treatment effect of entry led to reductions in prices ranging from 2 to 6 percent. Even where markets were already served by as many as five incumbent retailers, prices dropped as a result of greater competition.

2. Prices dropped more in areas with a larger number of new stores, since both incumbents and entrants faced increasing competition.

3. The probability of consumers changing to an entrant retailer increased, so competition seems to have driven part of the clientele away from incumbent retailers. This may explain the results found in price changes. Incumbents and entrants must compete more fiercely through price drops in order to keep their clientele.

4. The entrance of new retail stores does not seem to influence product quality, since there appear to be no effects on cheaper varieties of the same product.

5. Consumers report that the quality of service improves after entry, which can also be part of the incumbents and entrants' strategy to keep their clientele.

6. The entry of small retailers has price effects similar to those reported in existing literature for market entry of large retail chains.

POLICY IMPLICATIONS

This study has obvious implications for competition policy. It also explores conditions that render contracting out public services to the private sector an efficient strategy for governments—with the following conclusions:

1. 1When governments outsource service delivery to the private sector, they should foster competition to reduce prices without diminishing quality.

2. A lack of competition in a *conditional cash transfer* program can result in transfers from consumers to producers. With little competition, producers might wield enough market power to increase prices, thereby extracting additional income from consumers and diminishing or even voiding the intended benefits of the program.

3. The results of our study indicate that greater competition provides an effective means of avoiding rent-seeking by suppliers. Since cash transfers may impact market dynamics, governments should aim to maximize supplier numbers and ensure maximum competition in markets. This can be achieved through a large pool of affiliated retail stores and enough supply to ensure no retailer wields market power.

THE IDB AND CONDITIONAL CASH TRANSFERS

For decades, Latin America and the Caribbean has been using *conditional cash transfers* as a tool to assist families living in poverty. The IDB has long supported countries in these efforts and is constantly searching for new ways to apply them. This research project was undertaken in collaboration with the IDB's Social Protection and Health Division.

FULL STUDY

Busso, M. and S. Galiani. 2019. The Causal Effect of Competition on Prices and Quality: Evidence from a Field Experiment. American Economic Journal: Applied Economics 11(1): 33-56

Key concept

CONDITIONAL CASH TRANSFERS

A type of social program that provides money to recipients contingent upon verifiable actions.

Key concept

RANDOMIZED CONTROLLED TRIAL

A type of experiment aiming to reduce bias by randomly assigning subjects to either a treatment group that receives an intervention or a control group with no intervention.

DEPARTMENT OF RESEARCH AND CHIEF ECONOMIST

The Department of Research and Chief Economist generates new ideas to enrich the knowledge base that supports the policy agenda of the Inter-American Development Bank (IDB) and its member countries for achieving sustainable and equitable development in the region. To maximize the impact of its research, the Research Department carries out activities that serve as inputs to other IDB departments, governments, the academic community and public opinion in the region.

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