Leveraging of Reputation through Umbrella Branding with and without Market Power , May 17, 2012 2009

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ABSTRACT. The Klein-Leffler model explains how the benefit of future reputation can induce firms to produce high quality experience goods, either in a monopoly or an industry with competing firms. We show that reputation can be leveraged across products, but only by a firm with a monopoly on at least one product. Such a firm, however, may be able to capture the market for a competitive product by using umbrella pricing to make higher quality more credible than for firms without a monopoly base. Such monopoly extension increases social welfare, and can even benefit consumers, despite the increase in price. The expanding monopolist does not need to use bundling, and consumers are left better off, but otherwise this looks like classic monopoly leverage.

THE MODEL. Firms produce a single good of low or high quality. Each firm chooses its own quality anew each period. All firms have a marginal cost of c for low quality and $(1+\gamma)c$ for high quality, with $\gamma > 0$.

Consumers lie on a continuum of length x. Consumers are identical. Each wishes to buy one unit of the good and is willing to pay up to v for low quality or $(1+\theta)v$ for high quality, with $\theta > \gamma$. The discount rate is r and there are an infinite number of periods. If $v > c$ we will say that low quality is viable: it is more efficient for consumers to buy low quality than not to buy at all.

Proposition 1: Whenever parameter values make high quality viable under competition they also make it viable under monopoly.

Observation 1. Suppose a competitive market is viable for low quality but not for high quality. If the the low-quality product becomes worse (v falls) while the high-quality product does not ($(1+\theta)v$ stays the same) social welfare can rise because high quality may become viable.

Observation 2. If the monopolized market is unviable for high quality, the monopolist may be able to profitably make it viable by allowing free entry into production of the low-quality good.

Proposition 2: A monopoly selling two products can for some parameter values maintain high quality for each when two monopolies each selling one product cannot.

Proposition 3: A competitive industry made up of firms selling two products cannot maintain high quality if an industry of firms selling one product each could not.

Proposition 4: Suppose one product can be produced by only one firm but a second product can be produced by many firms. If the monopoly is allowed to produce both products, it will capture both markets. If a firm with a monopoly on some third product also tries to sell in the competitive market, competition between the two monopolies will result in monopoly leveraging that helps consumers.

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