

Market Frictions: A Unified Model of Search and Switching Costs

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CCP Policy Briefing

BACKGROUND

- In many markets, consumers' choices are constrained by different forms of market friction. Example markets include bank accounts, mortgages and computer software. Consumers' ability to change suppliers is often restricted by both the costs of collecting information about alternative options and the costs of organising or adjusting to an actual changeover.
- Despite this, the two vast literatures on search costs and switching costs have remained largely independent of each other. Indeed, very little is known about the potential differences or interactions between the costs and, worse, the two frictions are often referred to synonymously.

SUMMARY

- This paper demonstrates the benefits of examining the two frictions in unison.
- First, the paper shows how subtle distinctions between the two costs can provide important differences in their effects upon consumer behaviour and market prices.
- Second, the paper illustrates a simple methodology for estimating the magnitude of both costs while demonstrating the potential bias that can arise from a single-cost approach.
- Definitions employed in the paper are:

Search costs are the costs incurred by a consumer in identifying a firm's or set of firms' product and price offerings, regardless of whether the consumer then buys the product from the searched firm(s) or not.

Switching costs are the costs incurred by a consumer in changing suppliers that do not act to improve the consumer's information.

KEY FINDINGS

- The mechanisms by which the two costs affect competition have some important differences.
 - Search costs weaken the incentive for firms to cut prices by reducing the willingness of consumers to start searching and by decreasing the extensiveness of any search activity across multiple firms.

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- Switching costs also deter initial search activity but they do not affect the extensiveness of any search because they cannot be incurred across multiple firms. However, because switching costs can still be incurred by fully informed consumers, they also enhance the loyalty of consumers that have searched the entire market.
- As a result, parameters can be selected such that either cost can have the larger marginal impact on equilibrium prices. Nevertheless, the paper shows that in many cases, search costs may generate the larger anti-competitive effect. This is because search costs are found to have the stronger effect in deterring initial search activity.
- Drawing on the model developed in the paper and on data from a consumer survey, the paper demonstrates the potential importance of accounting for both frictions. It is shown that by incorrectly attributing all imperfections to only one cost, a single-cost model methodology can exhibit an upward bias.

POLICY ISSUES

- Within the context of the model developed in this paper, an authority may often wish to reduce search costs by improving consumers' access to information, rather than taking actions to regulate or ease consumers' costs of switching.
- The paper provides an initial framework for estimating search and switching costs separately using simple consumer survey data.

THE CCP

The ESRC Centre for Competition Policy (CCP), at the University of East Anglia, undertakes competition policy research, incorporating economic, legal, management and political science perspectives, that has real-world policy relevance without compromising academic rigour.

FOR MORE INFORMATION

The full working paper (CCP Working Paper 09-3) and more information about CCP and its research is available from our website: www.ccp.uea.ac.uk

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