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This is an excellent paper, which contains a trove of interesting data on prices and costs. The thorough comparison between retail and wholesale prices of both nationally advertised brands and comparable products sold under private labels that the authors carry out turns out to convey important lessons for many issues in economics.

The authors focus on a very important magnitude, which they call the “ideal” markup. This is the ratio of the price paid by consumers for a nationally advertised good and the marginal cost of both producing the good and delivering it to the consumer. The gap between this price and this marginal cost gives the answer to a standard microeconomics question. This is the extent to which the sum of consumer and producer surplus increases when the final price is reduced sufficiently that the quantity sold increases by one unit. This magnitude is also a critical ingredient in macroeconomics because it answers the question of whether producers would continue to be willing to sell and distribute their goods if, either because prices are rigid or for some other reason, price falls by some percentage relative to this marginal cost.

Once one has the retail price of a good, one can obtain this gap if one knows how much it costs to produce an additional unit and how much it costs to deliver it to a customer. The paper’s solution to these hard measurement problems is attractive on a number of counts. The authors suppose that Dominick’s acquisition price of a private-label good that is similar to a nationally branded good is generally no smaller than the marginal cost of producing and delivering to the supermarket an additional unit of the branded good. They also suppose that the supermarket’s margin between the price it pays for the branded good and the price at which it sells the good is no smaller than the supermarket’s own marginal cost of distributing the good. Thus, the sum of the private label’s wholesale price and the margin on branded goods is an underestimate of the full marginal cost of delivering an additional unit to the consumer, and the ratio of the price to this sum is an underestimate of the markup they seek to measure.

Although no assumption that simplifies calculations so much can be valid 100 percent of the time, I find this approach very compelling. Although one might initially suspect that private-label goods are cheaper to manufacture than branded goods so that their low wholesale price is not informative, many of Dominick’s private-label goods proudly proclaim in their package their similarity in content and appearance to well-publicized branded goods. Indeed, one thing I would have liked to see is more soft information from the authors about the relative appearances of the pairs of goods they consider. Broad surveys that show that good private-label goods

are quite often of high quality and not cheap to manufacture are in some ways less compelling than particular comparisons for the goods in their sample because private-label goods vary a great deal in quality.

Interestingly, the magnitude that seems harder to measure in this study is the price paid by consumers, because the retail price the authors measure does not include coupons and rebates. Still, it is quite clear that some consumers pay the full retail price for branded goods at least some of the time, so that the authors have a valid measurement of a particular ratio between price and marginal cost. What is less clear is the fraction of the economy that involves the high markups they find in their analysis because, even within this sector, many transactions involve smaller markups.

For macroeconomics, the ratios they consider matter because they measure how much price can be squeezed relative to marginal cost while maintaining an incentive to sell. The authors' calculation essentially supposes that the retail margin cannot be squeezed, so that the entire ability to absorb lower prices falls on the manufacturer. I see the ratio of wholesale prices charged by branded goods and private-label goods as, in some ways, a more direct measurement of the extent to which manufacturers of branded goods would continue to deliver products even if their prices fell. It is thus good to see these numbers reported as well, and it is interesting that they are similar to those of their ideal markup.

Let me close by offering some thoughts on the microeconomic implications of this paper's findings. The first is that it is far from clear that the ideal markup the authors compute says much about the extent to which branded goods' prices are too high from a social point of view. It is true that lower prices would increase producer and consumer surplus, if advertising and research and development (R&D) expenditures were held constant. However, firms would almost certainly not hold these expenditures constant if they were forced by an omniscient planner to lower their prices. It is more likely that such a squeezing of margins would lower the manufacturer's incentive to carry out R&D and advertising. The resulting fall in R&D could be costly, particularly because the fact that private labels free-ride on branded products by copying their designs suggests that the incentives for R&D in this industry may actually be too low. If advertising expenditures are socially useful—as they can be, for example, in the model of Becker and Murphy (1993)—reductions in these expenditures could be deleterious as well.

Once one focuses on R&D and advertising expenditures, the natural question that poses itself is whether the ratio of these expenditures to other costs is of the same order of magnitude as the ratio of branded wholesale prices to private-label wholesale prices. If this is the case, one could conclude that these high markups are simply necessary to cover these additional costs. This in no way reduces the interest in the paper's finding that these markups are high, although it would suggest that rents in these industries are dissipated in a relatively straightforward way.

The paper also contains a second set of fascinating facts that raise important microeconomics issues. In particular, the paper shows that the ratios of the four prices considered here for each pair of goods (i.e., the retail and wholesale prices for both members of each pair) vary quite dramatically across goods, even within narrow product categories. Trying to understand some of these variations seems extremely worthwhile. Indeed, some of the relative prices reported here seem to cry out for explanation. This seems particularly true of the “negative” margin between the retail and the wholesale price of certain soft drinks. This almost makes one worry about the authors’ ability to measure the amount that Dominick’s actually paid for its products.

One source of variation in the ratio of branded to private-label retail prices is obviously the extent to which branded products are seen as superior by customers (and this may explain the huge markups in toothbrushes). Open questions fall into two categories, however. The first is whether other ratios, such as the ratios of wholesale prices or the difference in branded and private-label retail margins, are also explainable in these terms or whether they hinge on variables related to the manufacturing industry’s structure. The other is whether any of these ratios, including the ratio between the retail prices of the products in each pair, are related to the extent to which there is price discrimination in each product.

Reference

Becker, Gary S., and Kevin M. Murphy. 1993. A simple theory of advertising as a good or bad. *The Quarterly Journal of Economics* 108 (4): 941–64.