The information highway is a dead end for bargain hunters



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Shopping online actually tilts the balance back in favour of the seller

IT MIGHT not do your washing and sort out your love life, but at least the internet will mean you end up paying lower prices. Online shopping makes it easier to compare prices charged by different vendors, and the increased competition is bringing prices down across the board. This, at least, has been the assumption, and there do seem to be some signs in practice that it is true. For example, prices for books and CDs, common online purchases, have been falling in the US. And recent price cuts announced by car manufacturers, notably Ford last week, are often attributed to the wide publicity gained by internet car retailing.

Does online shopping spell lower prices across the board, however? One of the Government's advisers on the hugely successful spectrum auction for third-generation mobile phones thinks not. In a new paper* Paul Klemperer argues that increased price transparency over the internet might just be bad for consumers.

Some consumer gains are very clear and not in dispute. It is certainly easier to make price comparisons, so that reduces the amount of time a customer has to spend shopping around. In fact, such comparisons are getting easier all the time with the development of 'bots' that look at a wide range of different websites and can calculate and compare prices including delivery charges. The more sophisticated are even getting on to pricing bundles of goods, such as a list of 10 books.

There is also at least the potential to cut out costs such as car dealership networks, or large chains of retail stores or bank branches, savings which could also reduce prices to consumers.

On the other hand, Professor Klemperer notes that transparency goes both ways. Competitors can easily see how much their rivals are charging different sorts of customers. He argues this makes shopping on the internet similar to a reverse auction.

In an "ascending bid" auction the price of the item being auctioned rises until all but one bidder is left. In online car sales, the price a consumer faces falls until all but one company quits bidding to sell.

In the conventional car sale, competing dealers cannot observe what other offers each potential customer has. It is more like a "sealed bid" auction, where not knowing what the competing bids are creates an incentive to bid more aggressively and collusion is impossible.

Selling online, on the other hand, lifts their veil of ignorance about the competition. This allows them to send tacit signals to each other about when to stop cutting their prices. If you think of the deal as a contest between buyer and seller, the car buyer will be in a better position to bluff in the showroom about having a better price offer from another car dealer.

But shopping online actually tilts the balance back in favour of the seller. "Selling over the internet probably makes it easier for firms to collude," the paper concludes.

What's more, the transparency of pricing could have an additional impact over time by discouraging new competitors from entering the market. Unless they have a clear cost advantage over others selling cars, it will be obvious they should not bother. When it is not so obvious, or in other words, when it is harder to observe what prices everybody else is charging, such newcomers might enter the market, boosting competition to the benefit of consumers. And a little extra competition can lower prices substantially. Concern about the incentives created for new entry has been one of the key concerns in auction design.

Other economists, such as Hal Varian and Carl Shapiro in their excellent book *Information Rules*, have pointed out that the internet makes it easier for companies to charge different prices to different groups of consumers. The improved scope for price discrimination can boost profits rather than leaving more money in the pockets of consumers.

Airline seats are a good example of a product with a huge range of prices, from the business class passenger with complete flexibility about travel times to the last-minute seat on a particular flight sold through a bucket shop.

With online sales spreading to other goods, increased price dispersion is more evident than big price falls. For instance software is often sold in different versions, one for leisure use at home, and a faster or more complex version for businesses, with a wide difference in price for products whose production cost is essentially the same. Early upgrades can command a premium price. Many software companies give away part of their product to entice customers on to more expensive options. A hugely successful example is Adobe Acrobat, which can be freely downloaded for reading documents on the internet but must be bought in order to publish documents. Making the software free for one purpose established its market dominance for others.

So while the internet is reducing some prices thanks to the additional competition, with other products and services it is not at all clear what the effect on the average price level will be. It is not even clear how to compare a very low price with a much higher price paid for a product tailored more closely to buyers' needs or greater convenience. What is clear, however, is that it would be wrong to leap to the obvious conclusion that the growing popularity of online shopping is bound to reduce prices.

Varian and Shapiro offer the following advice to businesses: "Personalise your product and personalise your pricing. This is easier to do on the internet than virtually any other medium since you communicate with your customers on a one-to-one basis."

They go on to explain that while physical stores know little about their customers, retailers selling mail order can at least partially tailor their prices and offers as they know your address and buying history; but e-tailers know what you are buying right now, and are not stuck with an expensive print-run of catalogues with particular styles and prices. Selling online makes it easy to set different prices for different groups of customers, different versions of products or even individual customers.

* *Why every economist should learn some auction theory*, Paul Klemperer, Centre for Economic Policy Research discussion paper no. 2572, www.cepr.org

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