Two at the Top: Quality Differentiation in Markets with Switching Costs

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We explore the effects of switching costs on the subgame perfect quality decisions of oligopolists with repeated price competition. We establish a strong strategic quality premium. We show that competition for the establishment of customer relationships will eliminate low-quality firms in period 1 and that low-quality firms can survive only based on poaching profits. The equilibrium configuration is characterized by an agglomeration of two providers of top-quality as soon as switching cost heterogeneity is sufficiently significant. We demonstrate a finiteness property, according to which the two top-quality firms dominate the market with a joint market share exceeding 50%.

Keywords: quality choice, switching costs, poaching, natural oligopoly.

JEL-classification: D43, L15

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