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Consumer Stickiness: A Sign of Healthy Competition

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There has been concern expressed recently about the presence of consumer stickiness in both the homeowners' insurance and retail electric markets. Some have used this as an excuse to call for increased government regulation to alleviate the problems caused by this "market failure," whereby too many consumers fail to make an "affirmative choice" and switch to a new provider. However, the truth is that consumer stickiness is an integral part of the market process based on individual preferences.

The myth that consumer stickiness represents a market failure stems from the theoretical construct by economists known as "perfect competition," something that is completely unlike competition in the real world.[1] This state is characterized by numerous producers of similar size producing similar products that are difficult to differentiate from each other. Both consumers and producers have perfect knowledge of the market. Thus, it is impossible for any company to gain an advantage in market share over another, because changes in pricing, service or quality are immediately transmitted through the entire marketplace. For many, since this market represents perfect competition, then anything less, i.e., actual market conditions, is imperfect, and in need of government regulation.[2]

Market critics point to various examples of consumer stickiness where allegedly inferior products triumph over allegedly superior products, thereby proving their point about the imperfect nature of real world markets. These include the QWERTY vs. the Dvorak keyboards, Windows vs. Macintosh, VHS vs. Beta, etc. All of these show, it is said, that the market is incapable on its own of overcoming certain costs of switching that prevent the selection of superior products and therefore the efficient allocation of resources.

However, judging actual markets based on theoretical models discounts the importance of individual preference. By accounting for individual preference, or consumer choice, one can then understand that a genuine marketplace is one where "business organizations of various sizes continually strive to discover which products and services consumers desire, and at what prices, and continually strive to supply those products and services at a profit to themselves and at the lowest cost."[3] Products and companies succeed because they are the most efficient at meeting the preferences of the individual consumer. Consumer stickiness is bad and markets are inefficient only in the eyes of the critics who have substituted their own preferences for those of consumers. This is certainly the case in Texas today with calls for government regulation in the electricity and homeowners' insurance markets.

If competition was working in these markets, critics contend, more people would have left the larger providers and chosen providers who offered lower prices. The existence of consumers sticking with higher prices is proof that consumer choice is not readily available; thus consumers need protection from the larger companies who are profiting at their expense. Of course, no standard is offered for how much business the firms should lose before competition is considered to be optimal.

Although the economic model of perfect competition suggests that switching should increase as the costs of doing so are lessened, research examining online consumer stickiness shows this not to be the case. Even though the Internet allows consumers to search and frequently switch to alternative providers, Brynjolfsson and Smith found "that while there is lower friction in many dimensions of Internet competition, branding, awareness, and trust" mean that consumers are still willing to pay higher prices to retailers that they have previously dealt with.[4]

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Kim and Kim summarize other studies on this subject:

> Another study (Johnson et al. 2004) showed that 70 percent of the CD and book shoppers are locked-in to just one site and consumers tend to search fewer sites as they become more experienced with online shopping. Consumers may be locked in to the initial choice mainly because switching behavior is not only economic in nature (Morgan and Hunt 1994) but also can be psychological and emotional (Sharma and Patterson 2000).[5]

In other words, a high level of consumer stickiness could well indicate the presence of a very efficient market in which consumers can more readily confirm the validity of the choices they have made—choices based not only on cost, but on multiple factors that lead to the satisfaction of individual consumer preference.

Consumer stickiness is also the key market characteristic that provides an incentive for companies to innovate. In order to capture and retain market share, companies invest their capital to improve their products and services. This entrepreneurial competition for market share drives the American economy. Without the possibility of building and maintaining a loyal customer base, capital investment, innovation and productivity would wither away.

Staying the course with deregulation is also supported by significant evidence that it has fostered efficient and healthy retail markets for homeowners' insurance and electricity. The Texas Public Utility Commission just released a report showing that the deregulation of the retail electric markets has provided service options for customers "at prices that are significantly below the estimated rates that would have been in effect if regulation had continued."[6] It also reports that there are "benefits of competition beyond lower prices for electricity, such as a variety of service and pricing options and efficient mechanisms for promoting renewable energy and energy efficiency."[7]

Today's Texas homeowners' insurance market is also more competitive after the introduction of free market reforms in 2002-2003. The Herfindahl Index, a scale economists use to measure market concentration, decreased from 1,636 in 2000 to 1,388 in 2003, indicating that competitiveness in the Texas market has improved.[8] A greater variety of prices and coverage being offered to Texas consumers. Homeowners are getting bombarded by mailings and advertisements by companies trying to attract their business. Consumers can go to the TDI web site and compare prices and coverage from dozens of insurers.

In both of these markets, the presence of a variety of different providers of different sizes with loyal, i.e., sticky, customers is a sign of healthy competition. Deregulation is allowing the complicated yet vital process of matching producers and consumers to be worked out in the most efficient manner. Every time consumers send a check to their electric provider or insurance company they signal they have made an affirmative choice that satisfies their individual preferences. Texas policymakers should trust the judgment of their constituents and support competition in these markets.

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[1]George Reisman, "Platonic Competition," http://www.mises.org/story/1988 (Dec. 2005).
[2]Walter Block, "Value Freedom In Economics," http://www.mises.org/etexts/valuefreedom.pdf (2001).
[3]Dominick T. Armentano, *Antitrust: The Case for Repeal*, The Ludwig von Mises Institute (1999) 34.
[4]E. Brynjolfsson and M. D. Smith, "Frictionless commerce? A comparison of Internet and conventional retailers," *Management Science*, 46(4), (2000).
[5]Hye-Young Kim* and Youn-Kyung Kim, "Escapism, Consumer Lock-In, Attitude, and Purchase: An Illustration from an Online Shopping Context," *Journal of Shopping Center Research, 12-2* (2005) 112.
[6]Public Utility Commission, "Electricity Pricing in Competitive Retail Markets in Texas," (Feb. 2006) 1.
[7]Ibid., 1.
[8]Patrick Brockett and Patricia Arnold, *Deregulation, Pricing, and Availability Issues in the Texas Homeowners' Insurance Market*, Texas Public Policy Foundation (Dec. 2004) 22.

This *Policy Brief* was prepared by Bill Peacock, director of the Center for Economic Freedom.