Consumer benefits differ for changing product sizes in a specialty coffee market

October 2 2008

When consumers hold private information about their tastes, companies can use nonlinear pricing as a screening mechanism to induce different types of customers to buy different products. Screening incentives may lead a firm to make a small version of its product "too small" in order to collect more profit from consumers who purchase the larger version. A study in the *RAND Journal of Economics* shows that firms distort the products.

Brian McManus of the University of North Carolina at Chapel Hill used data from a specialty coffee market near the University of Virginia , where coffee shops follow the common practice that larger drinks have lower per-ounce prices than smaller drinks. McManus constructed a utility model to compare consumers' benefits and the shops' costs for an additional ounce of a drink. This provides an estimate of the average distortion in product size for consumers who self-select into each purchasing option.

Design distortions decrease with drink size for products with the largest profit margins. Product sizes are close to efficient for the largest, most expensive espresso drinks; this mirrors the "no distortion at the top" result of price discrimination theory. Distortions exist for the other drinks – these products are generally too small.

Source: Wiley