Abstract

Retailer Competition and Assortment Differentiation: Causal Evidence from Entry Lotteries

This paper studies how and to what extent retailers strategically alter their product assortments to differentiate themselves from local competitors and weaken price competition. In the context of the legalized cannabis industry in Washington, we exploit the random variation in local competition resulting from the use of a lottery system to allocate licenses to retailers. We document that (i) an increase in downstream competition leads to lower retailers’ markups, (ii) an increase in downstream competition incentivizes retailer to increase differentiation in their product offerings, and (iii) this type of strategic differentiation softens price competition. The strategic differentiation by retailers leads to higher prices in the market and higher variety, with ambiguous effects for consumers and producers. Next, we use a structural model of demand and supply allows us to quantify the effects of product differentiation on prices, profits, and welfare.