Abstract

We analyze a model where firms compete with prices and qualities in markets consisting of consumers with heterogeneous cost characteristics. Consumers demand two goods, which can be supplied jointly or separately by firms. We consider two sets of strategies for firms: uniform price-quality pairs, and screening price-quality menus. For each strategy regime, we compare the equilibria under integration (when each firm supplies both goods) and separation (when each firm supplies only one good). Separating markets often enhances quality efficiencies, and we characterize these conditions. The theory is used to model a variety of phenomena such as payers of health care contracting specialty managed-care firms to administer separately mental health and substance abuse coverage and cream-skimming for the lowest cost students in locales where school choices are possible.

Keywords: Price and quality competition, integration, separation, screening, adverse selection, correlation

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