Refree Report for the paper "Reexamining the Schmalensee Effect," by Jeong-Yoo Kim

Summary

This paper studies a signaling model in which a high quality product can be signaled by a lower price. The paper considers a model where a firm has private information about the quality of the good, which is either H or L. The novelty of the model is to allow the firm to make a cost-saving R&D investment in the beginning stage. In this case the high quality firm has more incentives to lower its marginal cost of production, and as a result, the marginal cost of the high quality firm can be lower than that of the low quality firm. This is the reason why a lower price can be chosen by the high quality firm in a separating equilibrium.

Comments

- The paper is simple and clearly written. Its contribution to the price signaling literature is to consider how a cost-saving R&D investment changes the separating equilibrium.
- A similar idea has been extensively studied with a screening model in the literature of contract theory. See Lewis and Sappington (1989, JET) and Maggi and Rodriguez-Clare (1995, JET). These papers consider the firm's fixed costs to reduce its marginal cost of production and investigate how countervainling incentives arise. The distortion of efficiency from countervailing incentives can come out in the opposite way than would happen without the option to reduce the marginal cost. This is a mirror image of the main result of this paper. I wonder if the author can discuss this point briefly in the introduction.
- Equation (4) can be rewritten in a more friendly way for readers as follows:

$$\frac{dp}{dr} = -\frac{\overbrace{D_2}^{+} - c'\frac{\partial K^*}{\partial r}D_1}{\underbrace{2D_1 + (p - c(K(R)))D_{12}}}$$