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ANGER AND REGULATION

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### **ABSTRACT**

We propose a model where voters experience an emotional cost when they observe a firm that has displayed insufficient concern for other people's welfare (altruism) in the process of making high profits. Even with few truly altruistic firms, an equilibrium may emerge where all firms pretend to be kind and refrain from charging "abusive" prices to their customers. Our main result is that, as competition decreases, the set of parameters for which such pooling equilibria exist becomes smaller and firms are more likely to anger consumers. Regulation can increase welfare, for example, through fines (even if there are no changes in prices). We illustrate these gains in a monopoly setting, where regulation affects welfare through 3 channels (i) a reduction in monopoly price leads to the production of units that cost less than their value to consumers (standard channel); (ii) regulation calms down existing consumers because a reduction in the profits of an "unkind" firm increases total welfare by reducing consumer anger (anger channel); and (iii) individuals who were out of the market when they were excessively angry in the unregulated market, decide to purchase once the firm is regulated, reducing the standard distortions described in the first channel (mixed channel).

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# 1 Introduction

Governments routinely regulate markets, particularly those where there is a tendency towards little competition. One possible explanation is that such regulation improves efficiency. Indeed, economists have developed normative theories of regulation, explaining how social welfare increases when such regulation adopts a particular form. For example, forcing a monopoly to increase output might be desirable because in a monopoly equilibrium the cost to the firm of an extra unit is less than the value given to it by the consumer (see, Pigou, 1938, Baron and Myerson, 1982, Laffont and Tirole, 1991, *inter alia*).

Given how far the logic used in this explanation is from anything that voters voice when they demand changes in regulation, it is useful to develop alternative theories of the regulation of business.<sup>1</sup> In particular, it would be valuable to develop a normative theory of regulation that would have some connection with the rhetoric of regulation, or that at least gives some weight to public opinion in the determination of regulation policy. Although most existing models do not focus on such “populist dynamics”, they are central to our paper, which emphasizes the role of emotions in the motivation of consumers (as distinct from a material motive). Thus, we assume that a consumer’s experience and decisions can be understood by studying total utility, constructed as the sum of a material payoff and an emotional payoff. Psychologists and some economists have gathered evidence on several emotions that are candidates to be part of the second term. One that appears to be particularly relevant for the setting we seek to describe, whereby a monopoly might “abuse” its market position and set “exploitation” prices, is consumer anger.

There are several episodes where consumers appear to react with anger in the face of price increases. The title of a recent article in a British newspaper describes one such emotional reaction: “Fare increases of up to 15% anger rail passengers”.<sup>2</sup> In some cases,

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<sup>1</sup>Actual regulation mentions fairness, but economists interpret its contents as preoccupied with direct efficiency gains and potential efficiency gains from curtailing abuse of power. For example, the two key articles on competition policy in the treaty establishing the European Community focus on anti-competitive agreements and concerted practices (article 81) and on abuse of a dominant position (Article 82) often mention “fairness” elements that are easier to interpret in our model than in a standard model concerned only on efficiency (e.g., article 82 prohibits abuse by “directly or indirectly imposing unfair purchase or selling prices or other unfair trading conditions”). Several authors have argued economics has difficulties in providing a comprehensive theory of regulation (descriptive or normative). For an interesting general discussion making this point with emphasis on contract law, see Posner (2002), who argues that the failure originates in the difficulties in defining the concept of transaction cost.

<sup>2</sup>See, *The Guardian*, Tuesday, January 1, 2008. According to the article “passengers and rail user watchdogs reacted angrily yesterday to ‘outrageous’ new year price increases which will see the cost of some train tickets rise by almost 15%. The new prices were also described as “unjustified and unfair”. It also reports that one Gerry Doherty, leader of the TSSA (the union for people in transport and travel) described the increases as “outrageous”.

such reactions appear to have led to violence. For example, riots and widespread anger have been linked to price increases in Bolivia during January-April 2000, when the city of Cochabamba witnessed a popular revolt after the newly privatized water company increased the tariffs. Protests included the occupation of the city's main square on February 4 in an incident that left 22 people wounded and 135 under arrest (See, Darocca Oller, 2004).<sup>3</sup> In the US, the era of the big trusts is frequently described as a period in history where consumers experienced emotional reactions to business activities, leading to the rise of regulation.<sup>4</sup> There are several other episodes where emotions are central in the process whereby some form of regulation or punishment of business is put into place, including the 2008-9 subprime crisis in the US, although economists typically dismiss them as populist episodes and often involve indignation at actions that may be broader than price increases. The purpose of our paper is to develop a model where we can understand the causes of these populist forces and how regulation might help contain them.

Psychologists have investigated several characteristics of angry emotional reactions, gathering evidence capable of distinguishing anger from other negative emotions, such as sadness or shame. For example, anger is correlated with the belief that redress is still possible and that remedy requires (perhaps indirectly) the intervention of the self. It also indicates that others (as opposed to the situation, or the self) were responsible for the negative event (see, for example, Ellsworth and Smith, 1985, and Lazarus, 1991, as well as the review of Lerner and Tiedens, 2006).<sup>5</sup> An important finding for our purposes is reported in Lerner and Tiedens (2006), whereby anger makes people indiscriminately punitive (and optimistic about their own chances of success). There is also some evidence that anger does not seem to reflect only a fixed personality trait of left-leaning individuals (who are often angry with no connection to the stimulus), as in some experiments people can be induced to feel angry (and sometimes even provide what is the typical right wing answer). For example, Small and Lerner (2005) found that individuals induced to feel anger choose to provide less public assistance to welfare recipients than those induced to feel other emotions, while Bodenhausen

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<sup>3</sup>Conditions do not seem to have improved as a result. A report explains that "people of this high Andean city were ecstatic when they won the "water war." . . . After days of protests and martial law, Bechtel - the American multinational that had increased rates when it began running the waterworks - was forced out. . . . Today, five years later, water is again as cheap as ever, and a group of community leaders runs the water utility, Semapa. But half of Cochabamba's 600,000 people remain without water, and those who do have service have it only intermittently - for some, as little as two hours a day, for the fortunate, no more than 14." See Forero (2005).

<sup>4</sup>It is remembered in these terms: the review of the book "The Muckrakers", in *Time Magazine* on Friday, December 21st, 1966 was titled "A Time for Anger". Archives of Time Magazine, accessed October 28th 2008.

<sup>5</sup>Other negative emotions follow alternative appraisals: sadness (rather than anger) follows negative events that are blamed on situational forces whereas shame follows personal responsibility.

et al (1994) found them to engage in more stereotyping. Less of this research has concerned itself with emotional reactions following price increases, although Tyran and Engelmann (2005) were able to generate experimental evidence on boycotts following increases in prices in the lab.

We study a model where an individual's experience as a client of a monopolistic firm improves when the price paid falls and the profits of those firms perceived as unkind go down.<sup>6</sup> The first of these two terms –the material payoff– is standard in economics, while the second term –the emotional payoff– captures the demand for fairness that has been analyzed in several well-known models in economics such as Rabin (1993), Fehr and Schmidt (1999), Falk and Fischbacher (2006), *inter alia*.<sup>7</sup> In particular, we follow Levine (1998) and Rotemberg (2008) and assume an individual's kindness towards others depends on their estimation of how kind others have been in relationships with them.<sup>8</sup> This allows these authors to have agents who are “spiteful” towards those that are perceived to have behaved unkindly to the decision maker, a feature that plays a key role in our theory of regulation of monopolists. Note that this specification naturally leads to a signaling game, since an individual's actions can reveal how altruistic they are. Thus, it does not require that there be a large fraction of truly altruistic firms for the equilibrium to be heavily influenced by altruism. Finally, part of the attraction in applying these preferences to the demand for regulation is that it may help explain both the amount of regulation, as well as some instances of redistributive regulation (such as when fines are applied by “populist” governments) and of “inefficient” regulation (i.e. types of regulation may not be optimal from a standard economic efficiency perspective).<sup>9</sup>

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<sup>6</sup>Anecdotal evidence suggests that anger often arises at the announcements of high profits by firms that are under scrutiny. See, for example, “Railtrack profits spark anger”, reported on *BBCNews* online, Thursday, November 4, 1999. <http://news.bbc.co.uk/2/hi/business/504329.stm>. Accessed Tuesday October 28th, 2008.

<sup>7</sup>Jolls, Sunstein and Thaler (1998) provide an early discussion of how law and economics might incorporate agents that have bounded rationality and bounded self-interest. See also the contributions in Sunstein (2000) as well as the observations in Posner (1998).

<sup>8</sup>Although there are differences (Levine's preferences are linear) in our context they lead to similar implications. One reason is that, although in Rotemberg the individual is angry or not whereas in Levine the “anger” is continuous, the tradeoffs in Levine are linear, so the optimal amounts of regulation (or of punishment) are corner solutions: the individual wants either no punishment or as large a punishment as possible. Rotemberg (2008) explains how the “minimal altruism” preference relations he defines explain a wide range of behavior in ultimatum and dictator games.

<sup>9</sup>Another instance where anger may be the driver of regulation is the rise of political pressure on CEO pay following the 2008-9 financial crisis. A report in the *Financial Times* explains “Gordon Brown, the prime minister, has said he would use the government's banking aid package to clamp down on compensation, adding ‘the days of big bonuses are over’”. And then describes how the actions of the Financial Services Authority reflected this heightened pressure. For example it states “The letter does not have the status of mandatory guidance, but the FSA has said it would increase the regulatory capital requirements for banks

We develop a model of price competition along the lines of Salop (1979), but where consumers react with anger when they conclude that the firm has shown low levels of altruism towards them. Given the strength of consumer reactions to high prices by monopolistic competitors, there is a signaling game where it often pays for firms to act as if they were kind. This leads to a set of pooling equilibria, where prices are relatively low and consumers are not angry. The main result of the paper is that when competition decreases and the number of firms falls, the set of prices for which a pooling equilibrium can be sustained is smaller. That is, as competition decreases, consumers are more likely to experience anger leading to higher welfare losses. In this context, regulation might increase welfare through three different channels. First, there is the standard channel whereby a reduction in monopoly price leads to the production of units that cost less than their value to consumers. Second, regulation calms down existing consumers: a reduction in the profits of a firm viewed as excessively selfish increases total welfare by reducing consumer anger. Finally, there is a third (mixed) channel arising because individuals who were out of the market when they were excessively angry in the unregulated market, decide to purchase once the firm is regulated, reducing the standard distortions described in the first channel. Note that one of the most visible ways that regulation affects firm profits is by regulating prices, but the mechanism also allows fines (when their imposition is credible) to play a similar role. Our theory connects the public's appreciation of firms with the extent of competition, noting that positive appraisals of big monopolies would be harder to maintain. This connection is emphasized in the literature on the history of public relations of large American corporations. For example, Marchand (1998) states "The crisis of legitimacy that major American corporations began to face in the 1890's had everything to do with their size, with the startling disparities of scale." (Marchand, 1998, p. 3). Indeed, it is possible to argue that there is a parallel between our paper's focus on the concept of commercial legitimacy and the concept of State legitimacy in political science.

Closest to our paper are two studies of the determination of prices when consumers' utility functions display psychologically realistic features. The first is by Heidhues and Kőszegi (2008), who study the role of competition when consumers are loss averse and discuss the emergence of focal points and price rigidity. The second study is by Rotemberg (2005), who assumes a similar set of preferences as we do (consumers get angry when firm's display insufficient levels of altruism), developing a new model with price rigidity and applies it to the

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that do not sufficiently link pay with risk." See *Financial Times*, Monday October 13, 2008. With respect to the forms of regulation, we note that previous work has tried to explain variations over time. For example, the growth in the size of the market plays a key role in the explanations for why private litigation is substituted by ex-ante regulation during the progressive era in Glaeser and Shleifer (2003). Previous work has also tried to clarify why the particular forms observed differ from what economists would expect: Rotemberg (2003) is able to explain the choice of commercial policy (tariff vs quotas) using altruistic preferences.

analysis of monetary policy. Our model, which extends their analysis of realistic preferences to the context of regulation, is related to theories of exploitation by big firms. Marxist theories emphasize how capitalist institutions (including private ownership of the means of production and an accomplice State) lead workers/consumers to pay “surplus value” (see Brewer, 1987, *inter alia*). In our theory, consumers have a simple approach to deciding when such exploitation takes place (they measure firm altruism), and are not alienated nor passive (they get angry). The problem with monopoly in our model is that consumers cannot go to other firms when these misbehave, and because of this, firms are more likely to do so.

Interestingly, our approach to regulation and emotions is connected to capture theory. The Chicago and Virginia schools argue that regulations are the product of interest group activity (see, for example, Stigler, 1971, Peltzman, 1976, Buchanan, 1976, Djankov *et al*, 2002, *inter alia*). The basic idea is that regulations are correlated with profits across industries and that this could reflect the interaction of groups in society, with different costs and benefits of organizing to obtain favorable regulations. Indeed, noting that “the Civil Aeronautics Board has not allowed a single new trunk line to be launched since it was created in 1938” and other examples where the regulatory actions appear to benefit firms, Stigler (1971) concludes that the most plausible explanation is firm demand for protection and regulation. Such demand for regulation on the part of firms and other interest groups has occupied the majority of positive theories of regulation. Whereas the public could in principle be treated as an interest group, as in the generalizations of the theory (see, for example, Becker, 1983, Baron, 1994, Grossman and Helpman, 1994, *inter alia*), the emphasis there is on material payoffs and the public typically ends up with a low influence on the final outcome given the well known problems of free riding in voting.<sup>10</sup>

In section II, we introduce the basic model, while in Section III we characterize the equilibrium in oligopoly. The main result is derived, showing that the set of pooling prices is smaller when there are fewer firms, so that anger is more likely as competition decreases. In Section IV we study the welfare gains from regulation. Given that regulation has often been discussed in situations of monopoly, we analyze the monopoly equilibrium and describe 3 channels through which regulation might increase consumer welfare. Section V, presents a discussion, while Section VI concludes.

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<sup>10</sup>Rotemberg (2006) shows how altruistic preferences are helpful in explaining turnout by voters who expect to be pivotal with very low probability. Note that Stigler himself refers to the public’s demand for regulation, but it seems that he believed that it could not be modeled. When explaining the existence of regulations that harm social welfare, he states “the second view is that the political process defies rational explanation: “politics” is an imponderable, a constantly and unpredictably shifting mixture of forces of the most diverse nature, comprehending acts of great moral virtue (the emancipation of slaves) and of the most vulgar venality (the congressman feathering his own nest)”. Our theory of regulation focuses on fairness (and anger) and thus is capable of explaining the type of regulatory phenomena Stigler is concerned about.

## 2 The model

There are  $n$  consumers, each characterized by a parameter  $x$  interpreted, as in Salop (1979), as either a “preferred variety” or as a “location parameter”. For each consumer, his location is drawn from a uniform distribution on the circle of circumference 1. There are  $m$  evenly distributed firms along the circle (there are  $m$  firms, but we use  $b = 1/m$  as the relevant parameter).

Firms are of one of two types, altruistic or selfish; the prior probability that a firm is altruistic is  $q$ . Firm  $i$  chooses a price  $p_i$ , and has a cost  $c$ , so when demand for its product is  $D_i$ , its profits are  $(p_i - c) D_i$ . If the firm is selfish, that is the firm’s objective (its utility). If the firm is altruistic, its utility is profits plus a term that depends on the utility of the consumer. The altruistic firm has a cost of  $\alpha$  if consumer utility is lower than a certain threshold (this level is exogenous for this model, but in a richer model it could be derived from learning, adaptation, history, etc). We call the threshold  $\tau$ , and set it to be the utility the consumer would obtain in a “fairly competitive” industry (see Proposition 4 and the Appendix for two examples).

Consumers want to buy (at most) one unit of the good, for which they would obtain a gross surplus of  $s$  (gross of price and transport costs). If they have to travel a distance  $x$ , and then pay a price of  $p_i$ , their net surplus is  $s - tx - p_i$  (i.e. they have a transport cost of  $t$  per unit of distance traveled). In addition the consumer derives  $\lambda_c(\widehat{\lambda}_f)(\pi + p - c)$  from consuming where  $p$  is the price he is paying to the firm,  $c$  is the firm’s marginal cost, and  $\pi$  is the profit the firm obtains from other customers. The individual’s altruism is denoted  $\lambda_c$ , which is assumed to depend on its estimate of the firm’s altruism,  $\widehat{\lambda}_f$ . The individual’s altruism is assumed to be non-negative when he thinks he is interacting with a “kind” firm, which is a firm that is altruistic towards consumers (i.e., experiences an increase in utility when its customers are happier). And it is assumed to be negative when consumers conclude that the firm they are dealing with is “unkind”, which is assumed to mean a firm that is not altruistic. In what follows,  $\lambda_c(\widehat{\lambda}_f)$  will be either a fixed number  $\lambda > 0$  or 0, depending on whether the consumer has rejected that the firm is altruistic, or not. These preferences have been studied by Levine (1998) and Rotemberg (2008), who explain how they can account for the experimental results of ultimatum and dictator games.<sup>11</sup> The main feature of these preferences for our purposes is that consumers can get angry, that this anger is triggered by the behavior of the firm, and that angry consumers dislike firms making a profit (and he is angrier when he contributes to those profits).

In what follows, and without loss of generality, we normalize  $t = 1$  (so all other parameters

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<sup>11</sup>In the setting we discuss, Rotemberg and Levine’s preferences are observationally equivalent as the “jumps” observed when Rotemberg’s agents reject the hypothesis that they face an agent that is not “minimally altruistic” can also be observed when preferences are linear and pooling equilibria break up.



are just normalized by  $t$ ). We also assume (without loss of generality) that the number of consumers is  $n = 1$ .<sup>12</sup> Also, we assume:  $s \leq c + 1$ , which ensures that in a monopoly not all consumers are served; and  $s - c - \frac{3b}{2} \geq 0$  for all  $b \leq \frac{1}{2}$ , or  $s \geq c + \frac{3}{4}$ , which ensures that in an oligopoly, the market is covered (since otherwise an oligopoly behaves just like a group of local monopolies). Finally, we assume that the proportion of altruistic firms in the market is such that based solely on this prior, the individual does not reject that the firm he is facing is altruistic. That is, if the individual is faced with a random firm, and has no information on which to update his prior, he doesn't get angry at the firm.

## 2.1 Equilibrium

We will analyze a signalling game, in which firms choose a price which signals their type. An equilibrium in this setting is a triplet  $[a(p, x; \mu), p(\theta); \mu(p)]$  where:

- $a(\cdot)$  is an “acquisition” decision strategy (the same for all consumers; we are looking at symmetric equilibria) as a function of price, tastes  $x$  (or distance) and beliefs  $\mu$  (of whether the firm is altruistic or not) into  $\{0, 1\}$ , where  $a = 1$  means “buy” and  $a = 0$  means “don't buy”;
- $p(\cdot)$  is a function that maps types into prices (one price for each type; the same function for all firms);
- $\mu(\cdot)$  is a function that maps prices into  $[0, 1]$ , such that  $\mu(p)$  is a number that represents the probability that the consumer assigns to the firm being altruistic.
- $a$  is optimal given  $x, p$  and  $\mu$ ;  $p$  is optimal given  $a$  (and other firms playing  $p$ );  $\mu$  is consistent (it is derived from Bayes' rule whenever possible).

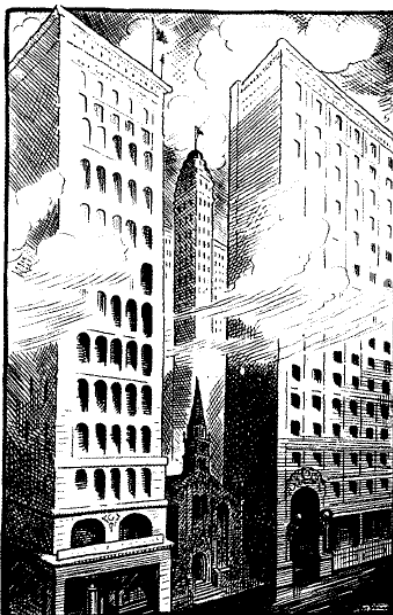
We focus on equilibria (pooling or separating) where beliefs are of the sort “*I reject the firm is altruistic if and only if its price  $p$  is such that  $p > \bar{p}$* ” where  $\bar{p}$  is the equilibrium pooling price, or the equilibrium price of the altruistic firm in a separating equilibrium (that is,  $\bar{p} = p(\theta_a)$  for  $\theta_a$  the altruistic type).<sup>13</sup>

<sup>12</sup>Our formulation with  $n$  consumers is not equivalent to a formulation where there is a continuum of consumers of mass  $n$  (the standard assumption). In the continuum formulation, a consumer's purchase does not affect the firm's profits, and so anger is not relevant.

<sup>13</sup>We are ruling out (for example) equilibria in which the consumer rejects that the firm is altruistic if the firm charges a price  $p < \bar{p}$  (i.e. the consumer comes to believe the firm is selfish even if it is charging a price below the “target” price); in standard signalling models, beliefs like these may still be part of an equilibrium, because in equilibrium one does not observe prices  $p < \bar{p}$  and so the consistency condition (that beliefs be derived from Bayes rule) places no constraints on beliefs. We are also ruling out equilibria in which the consumer rejects that a firm is altruistic iff its price is  $p > \bar{p}$ , and in equilibrium the altruistic firm charges a price  $p(\theta_a) < \bar{p}$ .

### 3 Anger and Competition in Oligopoly

In this section we study the connection between concentration and anger. We start by characterizing the symmetric pooling equilibria in an oligopoly where both types of firm charge the same price. Of course, there may be separating equilibria too. But we focus our analysis on pooling equilibria because we know that in a pooling equilibrium there is no anger, while in a separating equilibrium there is some anger (amongst consumers served by selfish firms). Thus, a simple way to establish a connection between an increase in anger and a more concentrated market structure (and, eventually, monopoly) would be to show that as the number of firms fall pooling equilibria are harder to sustain. Of course, there may be other ways to connect anger and concentration, and these may even explain a large part of this correlation. But the channel we study has the considerable advantage of being both simple and tractable, as well as consistent with elements of the historical experience in the US, where public preoccupation with the increased size of corporations gave rise to the regulatory movement. Figure 1, is a graphic illustration of this fear (taken from Marchand, 1998).



Nearer. My God To Thee

Figure 1

It presents a cartoon from 1913 emphasizing the large size of corporations dwarfing Trinity Church in New York City, highlighting the changes in values and possibilities of large corporations at that particular time in history (this is the phenomenon emphasized in Glaeser and Shleifer, 2003).

The first step is to find necessary conditions under which a price  $p^\circ$  is part of a pooling equilibrium in which consumers attain their target level of utility (the case of consumers with low utility is qualitatively similar).

Consider a firm who maximizes profits in a deviation from a pooling equilibrium with price  $p^\circ$  (we are not including a utility cost of the deviating firm, since we assume for the time being that the equilibrium is such that consumers attain their target utility level  $\tau$ ). If the firm lowers its price, consumers won't be angry. In that case, demand is given by the sum of all (unit) demands of consumers who are closer to the deviating firm than the two consumers (one to each side) who are indifferent:<sup>14</sup>

$$s - p - x = s - p^\circ - (b - x) \Leftrightarrow D = 2x = p^\circ - p + b$$

Profits are then

$$(p - c)(p^\circ - p + b).$$

When the firm maximizes this expression, we obtain an optimal price of

$$p = \frac{p^\circ + b + c}{2}.$$

For the firm not to want to deviate from  $p^\circ$ , it must be the case that this optimal price is larger than  $p^\circ$ , or equivalently

$$b + c \geq p^\circ. \tag{1}$$

In words, if the oligopoly price is too large, the firms are better off lowering their price, and the consumers will not punish them (by getting angry).

If the firm raises its price, consumers become angry, and demand is given by the condition that

$$s - p - x - \lambda(p - c) = s - p^\circ - (b - x) \Leftrightarrow D = p^\circ - (1 + \lambda)p + b + \lambda c. \tag{2}$$

In that case, profits are

$$(p - c)(p^\circ - (1 + \lambda)p + b + \lambda c).$$

For the firm not to want to deviate and charge the optimal price

$$p = \frac{p^\circ + b + c(1 + 2\lambda)}{2(\lambda + 1)} \Rightarrow \pi = \frac{(p^\circ - c + b)^2}{4(1 + \lambda)} \tag{3}$$

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<sup>14</sup>Recall that we have assumed that there are  $n$  consumers, and we have normalized  $n = 1$ . We have argued that this is not the same as the assumption that there is a continuum of mass 1 of consumers. Still, when calculating demand, and elsewhere, the intuitions for the results will be conveyed "as if" we had assumed the continuum version, since it is easier to explain equations that way. For example, in this case, the explanation with 1 consumer would be: "In that case, demand is given by the probability that the consumer is located closer to the deviating firm than the locations that would leave him indifferent between purchasing from the deviating firm and its neighbors."

it must be the case that profits in the equilibrium are larger than these deviation profits.<sup>15</sup> Formally,

$$(p^o - c) b \geq \frac{(p^o - c + b)^2}{4(1 + \lambda)} \Rightarrow p^o \geq c + b \left[ 1 + 2\lambda - 2\sqrt{\lambda(1 + \lambda)} \right]. \quad (4)$$

Notice that combining (1) and (4) when  $\lambda = 0$  (the standard Salop case), we obtain

$$p^o = b + c. \quad (5)$$

An additional restriction is that for a given  $\tau$ , as we decrease the number of firms the price must also decrease to achieve the target utility. Consumer utility (in a pooling equilibrium with price  $p^o$ ) is the number of firms,  $1/b$ , times the total utility of consumers served by each firm (the 2 in the equation below is because each firm serves consumers to both sides)<sup>16</sup>:

$$\frac{2}{b} \int_0^{\frac{b}{2}} (s - p^o - x) dx = s - p^o - \frac{b}{4}. \quad (6)$$

This utility is larger than  $\tau$  if and only if

$$s - p^o - \frac{b}{4} \geq \tau \Leftrightarrow s - \tau - \frac{b}{4} \geq p^o. \quad (7)$$

We now present an important result: as competition decreases (enough), anger is more likely. The proposition shows that as competition decreases, a pooling equilibrium is less likely. But since pooling equilibria have no anger, and separating equilibria do (in expected terms there will be some selfish firms), when pooling equilibria disappear, anger appears.

**Proposition 1** *There is a critical  $n^c$  such that for all  $n^c \geq n' > n$ , the set of pooling prices is smaller when there are  $n$  firms than when there are  $n'$ . That is, as competition decreases, anger is more likely.*

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<sup>15</sup>It could happen that the firm considers raising its price and discovers that the optimal price in the deviation with angry consumers is lower than  $p^o$  (this happens if  $p^o$  is larger than the optimal price, given in the previous equation). If that happens, the firm is better off not raising its price. Hence, our assumption that the optimal price in a deviation is achieved (with angry consumers) is justified.

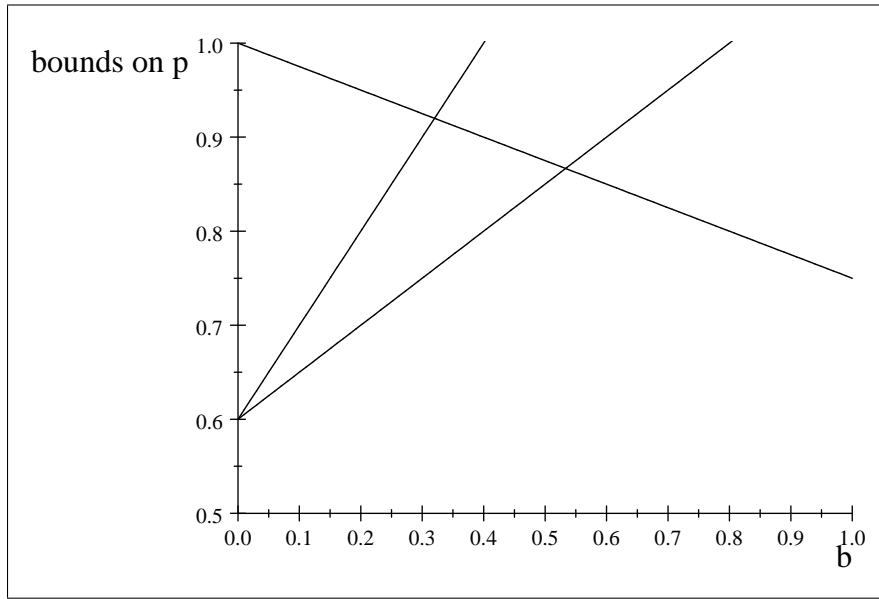
<sup>16</sup>Here the definition of what utility to consider (for consumers) is not obvious. Why consider total utility of all consumers? Maybe firm 1 is behaving really badly and slaughtering its consumers, but still total utility is large in the market, and so firm 1 experiences no utility cost of having a high price. In equilibrium this will make no difference (if firm 1 is treating its consumers badly, all firms are doing the same), but it matters in a deviation. In the set of questions we will analyze in this paper, this makes no difference, but in general it would seem more “psychologically plausible” that the firm cares about how it treats its consumers, and not about “average utility in the market (including the welfare of other firms’ consumers)”.

**Proof.** We have  $b + c \leq s - \tau - \frac{b}{4}$  for all

$$b \leq \frac{4}{5}(s - c - \tau) \equiv b^c = 1/n^c, \quad (8)$$

so that the constraint in equation (7) is not binding, because the constraint in equation (1) is tighter. For  $b > b^c$ , the situation is reversed, and equation (7) is binding but (1) is not. Starting at  $b^*$ , increasing  $b$  (lowering competition) lowers the upper bound on  $p^o$  (the derivative of  $s - \tau - \frac{b}{4}$  with respect to  $b$  is negative) and increases the lower bound since the derivative of the bound in equation (4) is positive:  $1 + 2\lambda - 2\sqrt{\lambda(1 + \lambda)}$ . ■

The plot below illustrates the three constraints on  $p^o$ . The price  $p^o$  must lie between the two loci with positive slopes (the steeper one is equation (1) and the flatter, (4)) which arise from the firms' incentives not to deviate. The price must also lie below the negatively sloped constraint (equation (7)) that arises from the condition that fewer firms imply lower prices (if consumers are to obtain their target utilities).



Two related results can be derived. The first connects the cost structure of firms and the rise in anger. Potentially, this link could explain why less developed economies are more regulated in practice (see Djankov et al 2002) under the assumption that in poor countries costs are higher (perhaps because of smaller markets or higher inefficiencies) or more volatile (perhaps because of macro instability). It would also explain why there is more demand for regulation in poor than in rich countries, or more broadly, why capitalists and capitalism are not popular in less developed countries (see Di Tella and MacCulloch, 2002).

**Proposition 2** *When costs increase, or when they become more volatile, anger is more likely.*

**Proof.** When costs increase, the two loci of equations (1) and (4) move upwards by the amount of the increase in costs. Since equation (7) is unchanged, the set of  $(b, p)$  pairs for which a pooling equilibrium exists shrinks. More importantly, if for a given  $b$  there was a pooling equilibrium, there is an increase in costs that makes that pooling equilibrium impossible.

Symmetrically, when costs fall, the set of pooling equilibrium prices increases. But a larger volatility in costs makes it more likely that a high (pooling-breaking) cost will happen, and then the selfish firms will reveal themselves as such and anger will arise. ■

The second illustrates another straightforward feature of the model: when for some exogenous reason consumers become “captive” of one particular firm, anger is more likely. When consumer’s elasticity of demand decreases, local monopolies have an incentive to increase prices. The temptation may be large enough that an anger-triggering price increase may be profitable. The motivation for this result is the “raising prices in a snow storm” scenario considered in the classic paper on fairness by Kahneman, Knetsch and Thaler (1986).<sup>17</sup> We model this increase in captivity by changing the transport cost of consumers going to rivals, while keeping rival’s prices fixed.<sup>18</sup>

**Proposition 3** *Assume that for a given parameter configuration, there is a pooling equilibrium with a price of  $p^o$ . If the cost of transportation to firms  $i - 1$  or  $i + 1$  increases from 1 to  $t > 1$ , but the cost of getting to firm  $i$  remains constant, the firm’s incentives to increase price increase. There is a threshold  $t^*$  such that if  $t \geq t^*$  firm  $i$  raises its price and consumers become angry.*

**Proof.** When the cost of getting to firms  $i - 1$  and  $i + 1$  increases to  $t$ , the demand faced by firm  $i$  (after an increase in price) and its profits, are

$$D = 2 \frac{p^o - p + \lambda(c - p) + bt}{t + 1} \quad \pi = (p - c) 2 \frac{p^o - p + \lambda(c - p) + bt}{t + 1}$$

and the optimal price and profit are

$$p = \frac{c + p^o + 2c\lambda + bt}{2\lambda + 2} \Rightarrow \pi = \frac{(p^o - c + bt)^2}{2(\lambda + 1)(1 + t)}.$$

For large enough  $t$ , these profits exceed the oligopoly profit, and the firm raises its price, causing anger. ■

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<sup>17</sup>They ask “A hardware store has been selling snow shovels for \$15. The morning after a large snowstorm, the store raises the price to \$20. Please rate this action as: Completely Fair, Acceptable, Unfair or Very Unfair.” Almost 82 percent of respondents considered it unfair for the hardware store to take advantage of the short-run increase in demand associated with a blizzard.

<sup>18</sup>This keeps competition constant for the firm being analyzed. An equivalent way of modeling this is assuming that the two neighbors of the firm being analyzed move farther away, as if there had been a decrease in the number of firms.

This result assumes that consumers continue to make inferences based on the equilibrium prior to the shock. Although one could argue that a new equilibrium (one with fewer firms) should be the benchmark, we believe that keeping the old equilibrium beliefs is also plausible. In addition, note that the case of fewer firms also leads to more anger, as established by Proposition 1.

We note that any price  $p^o$  in the range determined by equations (1) and (4) can be part of a pooling equilibrium if we choose  $\tau$  or  $\alpha$  appropriately.<sup>19</sup>

*Reference Utility and the “Disciplined Approach” (see Kőszegi and Rabin, 2006)*

Models concerned with reference points (including fairness models) have to decide how to model it in a way that is appealing (non arbitrary) and consistent with the evidence. It is also helpful if it is straightforward how to track the proposed deviation from standard economic models. For example Heidhues and Kőszegi (2008) use a disciplined approach introduced by Kőszegi and Rabin (2006), basing the reference-dependent preferences on classical models of intrinsic utility taken straight from Salop (1979). Importantly, they endogenize the reference point as lagged rational expectations, in a way that if there is no loss aversion, their theory reduces to Salop’s. Likewise, we base our model in Salop (1979) and endogenize the “target” level of utility as the utility that can be obtained in a reasonably competitive model with selfish firms. When there is no anger (at insufficiently altruistic firms), our model reduces to Salop’s.

In particular, we can observe the consequences of using the “disciplined approach” by showing that the number of firms associated to the target level of utility is connected to the critical number of firms below which increases in concentration are more likely to lead to consumer anger. To compute what would consumer utility be in some market, so that we can set the “target” level of utility  $\tau$  at some “reasonable” level, we need to choose one of the possible equilibrium prices. For the purposes of “benchmarking” consumer utility in each market, we set  $p^o = b + c$ , which is the price in the standard Salop case. We then have the following result, which tells us what the critical  $n^c$  of Proposition 1 is.

**Proposition 4** *If  $\tau$  is the utility of the consumers in a market with  $n^*$  firms, and the price is the one that would prevail in the standard Salop model,  $p^o = c + 1/n^*$ , then for all  $n^* \geq n' > n$ , the set of pooling prices is smaller when there are  $n$  firms than when there are  $n'$ . That is, as competition decreases, anger is more likely. In particular, the threshold  $n^c$  of Proposition 1 is  $n^c = n^*$ .*

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<sup>19</sup>Note that if the firm is altruistic and it raises its price enough, there could be a utility cost of providing consumers with a very low level of utility. Since we found necessary conditions, we focused only on the incentives of the selfish firm. When we want to build an equilibrium with a price  $p^o$  within the range we have just identified, we need to take into account this utility cost for the altruistic firm. But choosing  $\tau$  or  $\alpha$  low enough, any one of these prices is an equilibrium.

**Proof.** Consumer utility is as in equation (6) with  $p^o = c + b$

$$\frac{2}{b} \int_0^{\frac{b}{2}} (s - b - c - x) dx = s - c - \frac{5}{4}b$$

so setting  $\tau$  to be the utility in a market with  $n^*$  firms, we get  $\tau = s - c - \frac{5}{4}b = s - c - \frac{5}{4n^*}$ . Then, from equation (8)

$$\frac{1}{n^c} = \frac{4}{5} (s - c - \tau) = \frac{4}{5} \left( s - c - \left( s - c - \frac{5}{4n^*} \right) \right) = \frac{1}{n^*}$$

as was to be shown. ■

## 4 Regulation and Welfare

It is possible to analyze the welfare gains from regulation in this setting (where consumers get angry when firms display insufficient altruism towards consumers). We focus on a monopoly setting to simplify the exposition and the contrast with the gains from regulation in the standard model. Note that both pooling and separating equilibria are possible (in principle) in a monopoly. Anger will only arise in a separating equilibrium, so that is the main focus of this section. For reference, however, we start by characterizing the conditions for a pooling equilibrium in a monopoly setting.

### 4.1 Pooling in Monopoly

For the selfish firm, it must be the case that sticking with the equilibrium  $p^m$  is better than deviating, angering consumers, and getting  $(p - c)D$ , where  $D = 2x$  for  $x$  such that

$$s - p - x - \lambda(p - c) = 0 \Leftrightarrow x = s - p(1 + \lambda) + \lambda c.$$

Of course, it must also be the case that  $x \leq 1/2$  (otherwise,  $D = 1$ ). For that to be the case, we must have

$$p \geq \frac{s + c\lambda - \frac{1}{2}}{\lambda + 1}$$

(in the standard case, with  $\lambda = 0$ , this just says that the individual located at  $x = 1/2$  has negative net surplus from buying the good).

Hence, profits for the selfish monopolist who deviates are

$$(p - c) 2 (s - p(1 + \lambda) + \lambda c) \Rightarrow p = \frac{c(1 + 2\lambda) + s}{2(1 + \lambda)} \Leftrightarrow \pi^{dev} = \frac{(c - s)^2}{2(1 + \lambda)}. \quad (9)$$



So the condition on parameters for  $p^m$  to be an equilibrium is that the equilibrium profits,  $2(p^m - c)(s - p^m)$ , are larger than  $\pi^{dev}$ :

$$2(p^m - c)(s - p^m) \geq \frac{(c - s)^2}{2(1 + \lambda)} \Rightarrow p^m \geq \frac{c + s}{2} - \frac{s - c}{2} \sqrt{\frac{\lambda}{\lambda + 1}}. \quad (10)$$

Note that consumer anger has two different effects on demand. First, it reduces demand:

$$\frac{d(2(s - p(1 + \lambda) + \lambda c))}{d\lambda} = 2(c - p) < 0.$$

The second is less direct and involves the effect on the incentives of the firm (that is, the effects on marginal revenue). In this setting, price as a function of  $Q$  is

$$Q = D = 2(s - p(1 + \lambda) + \lambda c) \Leftrightarrow p = \frac{(2s - Q + 2c\lambda)}{2(1 + \lambda)}$$

which implies that marginal revenue is

$$pQ = \frac{(2s - Q + 2c\lambda)}{2(1 + \lambda)}Q \Rightarrow MgR = \frac{s - Q + c\lambda}{\lambda + 1}.$$

Notice that in the standard model (with  $\lambda = 0$ ), marginal revenue equal marginal cost implies that  $Q^* = s - c$ . As  $\lambda$  increases (from 0), the effect on marginal revenue is given by

$$\frac{dMgR}{d\lambda} = \frac{Q - (s - c)}{(\lambda + 1)^2}$$

which is negative for  $Q < Q^* = s - c$  and positive for  $Q > Q^*$ . Hence, for  $Q < Q^*$ , the monopolist facing angry consumers has a smaller incentive to increase  $Q$  (quantity demanded is more sensitive to price, so increasing quantity on the margin, requires a bigger drop in price than otherwise -i.e., when  $\lambda$  was 0). Similarly, for  $Q > Q^*$  the monopolist facing angry consumers has a smaller incentive to decrease  $Q$ . But since the sign of  $MgR - c$  is the same as before the change in  $\lambda$ , the optimal quantity is the same as in the standard model:

$$Q^\lambda = 2(s - p^m(1 + \lambda) + \lambda c) = 2\left(s - \frac{c(1 + 2\lambda) + s}{2(1 + \lambda)}(1 + \lambda) + \lambda c\right) = s - c.$$

#### *Consumers with high utility*

For the altruistic firm, utility in the equilibrium is  $2(p^m - c)(s - p^m)$  (we don't subtract  $\alpha$  because we are looking for a pooling equilibrium in which the consumer gets at least the threshold utility level) and utility from the deviation is, for  $\pi^{dev}$  as defined in equation (9),  $\pi^{dev} - \alpha$ . So  $p^m$  can be maintained as a pooling equilibrium iff

$$2(p^m - c)(s - p^m) \geq \frac{(c - s)^2}{2(1 + \lambda)} - \alpha \Rightarrow p^m \geq \frac{s + c}{2} - \frac{1}{2} \sqrt{\frac{\lambda}{\lambda + 1} (c - s)^2 + 2\alpha} \quad (11)$$

Total consumer utility for a price  $p^m$  is then

$$2 \int_0^{s-p^m} (s - p^m - x) dx = (s - p^m)^2 \quad (12)$$

*Consumers with low utility*

For the altruistic firm, utility in the equilibrium is  $2(p^m - c)(s - p^m) - \alpha$ . The firm has, in principle, three alternatives.

The first involves maintaining the equilibrium monopoly price, which yields  $2(p^m - c)(s - p^m) - \alpha$ .

The second, involves deviating and charging consumers the optimal price. This raises the question of whether the firm's optimal price is above or below the price that would anger consumers and whether it is above or below the price that would give consumers their threshold utility. Note, first that the equilibrium monopoly price is  $p^m \leq p^*$  (the optimal price of the altruistic firm). This is always the case, since if the equilibrium monopoly price was higher than  $p^*$ , then the altruistic firm could lower its price without being punished. Hence a deviation to the optimal price must be with a higher price. Second, given this, we conclude that the equilibrium price must be the largest price for which consumers don't reject that the firm is altruistic.<sup>20</sup> Third, as a consequence of the first two points, since the deviation is with a higher price, it must still leave consumers with a low (below threshold) utility. These three points ensure that an altruistic firm who deviates angers consumers, and still pays the utility cost  $\alpha$ . The firm's utility is then  $\frac{(c-s)^2}{2(1+\lambda)} - \alpha$ .

The third involves lowering its price enough to give consumers their threshold utility. Utility from the deviation is, for the maximum  $p$  that yields the threshold utility,  $2(p - c)(s - p)$ . This maximum price is defined by consumer utility (as in equation 12) equal  $\tau$  :

$$(s - p)^2 = \tau \Leftrightarrow p = s - \sqrt{\tau} \quad (13)$$

Then, the altruistic firm's utility is

$$2(p - c)(s - p) = 2(s - \sqrt{\tau} - c)(s - s + \sqrt{\tau}) = 2\sqrt{\tau}(s - c - \sqrt{\tau}). \quad (14)$$

and the condition for a pooling equilibrium in which the consumer gets low utility is that

$$2(p^m - c)(s - p^m) - \alpha \geq 2\sqrt{\tau}(s - c - \sqrt{\tau}) \Rightarrow p^m \geq \frac{c + s}{2} - \frac{1}{2}\sqrt{(s - c - 2\sqrt{\tau})^2 - 2\alpha}$$

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<sup>20</sup>Otherwise the firms could have increased their prices without being punished, and this price increase wouldn't do any additional harm in terms of worsening the altruistic firm's utility cost of consumers not achieving their target utilities, since the firm is already paying that cost with the "low" initial price.

## 4.2 Separating Equilibrium in a Monopoly (Regulation)

We now study the welfare effects of regulating a monopoly. As explained, in order to evaluate the gains and losses to consumers and the firm, we must first characterize the equilibrium that would give rise to regulation. That is, we must characterize separating equilibria when there is only one firm.

The initial situation is one in which there is a separating equilibrium; the type of equilibrium we focus on is one in which beliefs are “don’t reject that the firm is altruistic iff  $p \leq \bar{p}$ ” for some price  $\bar{p}$ . Two cases can arise: for the altruistic firm the consumer’s utility is above the threshold, or it is below.

If the consumer’s utility is below the threshold for the price of the altruistic firm in some equilibrium, then both firms face the same incentives, and that can’t be a separating equilibrium (not a strict one at least<sup>21</sup>). The same is true if the consumer’s utility is above the threshold for both prices. Therefore, we will only focus on separating equilibria in which the high price yields a utility below the threshold, and the low price a utility above the threshold. That is, in the equilibria we analyze, we will have  $p_a \leq p^\tau$ , for  $p_a$  the price of the altruistic firm in equilibrium, and  $p^\tau$  be the highest price that gives consumers their target utility when they are not angry (as defined in equation 13),  $p^\tau = s - \sqrt{\tau}$ .

**Lemma 1** *In a separating equilibrium, the only possible price for the selfish firm is the price that maximizes profits when consumers are angry:*

$$p_s = \frac{c(1 + 2\lambda) + s}{2(1 + \lambda)} \Leftrightarrow \pi_s = \frac{(c - s)^2}{2(1 + \lambda)}. \quad (15)$$

**Proof.** Suppose  $p_s$  is not as in equation (15). Since  $p_s$  is a (separating) equilibrium price, consumers will know that the firm is selfish and will therefore be angry. Hence, playing  $p_s$  must be better than playing any price  $p$  for which consumers have rejected that the firm is altruistic:  $(p_s - c)2(s - p_s(1 + \lambda) + \lambda c) \geq (p - c)2(s - p(1 + \lambda) + \lambda c)$ . But the right hand side has a unique maximizer given by equation (15), so we obtain a contradiction. ■

We now find the range of prices for the altruistic firm that can be part of a separating equilibrium.

**Lemma 2** *In a separating equilibrium the price  $p_a$  of the altruistic firm must satisfy*

$$\frac{c + s}{2} - \frac{s - c}{2} \sqrt{\frac{\lambda}{\lambda + 1}} \geq p_a \geq \frac{s + c}{2} - \frac{1}{2} \sqrt{\frac{\lambda}{\lambda + 1} (c - s)^2 + 2\alpha}. \quad (16)$$

*Moreover, any price in that range can be sustained as a separating equilibrium, as long as it gives consumers their target level of utility.*

<sup>21</sup>The firm charging the high price would make “more profits” out of the larger price, but “less” from the punishment, than the firm charging the low price. The two effects would net out.

**Proof. Necessity.** For the altruistic firm not to want to deviate (upwards) and charge its optimal price (the optimal price is the same as for the selfish firm) we must have (as in the analysis prior to equation 11),

$$2(p_a - c)(s - p_a) \geq \frac{(c - s)^2}{2(1 + \lambda)} - \alpha \Rightarrow p_a \geq \frac{s + c}{2} - \frac{1}{2} \sqrt{\frac{\lambda}{\lambda + 1} (c - s)^2 + 2\alpha}.$$

Similarly, the selfish firm must want to charge its equilibrium price, and not the maximum price for which consumers are not angry,  $\bar{p}$ . To connect this relationship with an upper bound on  $p_a$ , notice that we must have  $p_a = \min\{\bar{p}, p^\tau\}$ . This is so, first, because we must have  $p_a \leq \min\{\bar{p}, p^\tau\}$  for beliefs to be consistent, and for consumers to obtain their target utility. Second, if we had  $p_a < \min\{\bar{p}, p^\tau\}$ , the altruistic firm could increase its price towards its optimal price (without anger)  $\frac{c+s}{2}$ ; since

$$\frac{c + s}{2} > \frac{c(1 + 2\lambda) + s}{2(1 + \lambda)} > \bar{p} \geq \min\{\bar{p}, p^\tau\} > p_a$$

such a price increase would strictly increase its profits without lowering consumer utility below  $\tau$ .

For the selfish firm not to want to deviate to  $\bar{p}$ , we must have

$$2(\bar{p} - c)(s - \bar{p}) \leq \frac{(c - s)^2}{2(1 + \lambda)} \Rightarrow p_a \leq \bar{p} \leq \frac{c + s}{2} - \frac{s - c}{2} \sqrt{\frac{\lambda}{\lambda + 1}}$$

and this establishes the upper bound for  $p_a$ .

**Sufficiency.** It is straightforward to check that for any  $p_a \leq p^\tau$ , and  $p_a$  in the range defined by equation (16), there is an equilibrium with  $\bar{p} = p_a$ . This condition defines  $\mu$  as

$$\mu(p) = \begin{cases} 1 & p \leq \bar{p} \\ 0 & p > \bar{p} \end{cases}.$$

Given this, the selfish firm optimally charges  $p_s$  as in equation (15), the altruistic firm optimally charges  $p_a = \bar{p}$ , beliefs are consistent, and consumer's acquisition decisions are optimal given their beliefs and tastes. ■

For an equilibrium with  $p_a \leq p^\tau$  to exist, we must have of course  $p^\tau \geq \frac{s+c}{2} - \frac{1}{2} \sqrt{\frac{\lambda}{\lambda+1} (c-s)^2 + 2\alpha}$  (otherwise the range is empty). If we continue with the assumption that  $\tau$  is consumer utility in some oligopoly with  $m = 1/b$  firms, so that  $\tau = s - c - \frac{5}{4}b$ , the condition for existence of a separating equilibrium becomes

$$p^\tau = s - \sqrt{s - c - \frac{5}{4}b} \geq \frac{s + c}{2} - \frac{1}{2} \sqrt{\frac{\lambda}{\lambda + 1} (c - s)^2 + 2\alpha}.$$

Although, as usual, the set of equilibria is large, the Cho and Kreps "Intuitive criterion" refinement in this context yields that the price is as large as possible in the range determined

by Lemma 2:

$$p_a = \frac{c+s}{2} - \frac{s-c}{2} \sqrt{\frac{\lambda}{\lambda+1}}.$$

Recall that we have assumed  $s \leq c+1$ , which was the condition for the market not to be fully served by a monopoly. We compare two types of regulatory policies: mandated prices for the firms, and subsidies.

Consider a situation where there was a separating equilibrium and the firm is perceived to be a selfish firm (a possible example is US railroads at the time of the Sherman Act). What is total welfare? Consumer utility is, using  $p_s$  from equation 9,

$$2 \int_0^{s-p-\lambda(p-c)} (s-p-\lambda(p-c)-x) dx \Big|_{p=p_s} = \frac{(s-c)^2}{4}.$$

Notice that consumer welfare is exactly the same as in the case where the consumer's utility is standard: the expression of consumer welfare is independent of  $\lambda$ . The reason is that, while for each price less consumers would purchase because anger diminishes the incentives to purchase, the monopolist lowers his price so that exactly the same number of consumers as before purchases:

$$\frac{D}{2} = s - \lambda(p_s - c) - p_s = s - \lambda \left( \frac{c(1+2\lambda) + s}{2(1+\lambda)} - c \right) - \frac{c(1+2\lambda) + s}{2(1+\lambda)} = \frac{s-c}{2}.$$

In order for the marginal consumer to be the same (with  $\lambda > 0$  or  $\lambda = 0$ ) the price decrease must exactly offset anger; indeed, an increase in  $\lambda$  decreases price  $p_s$

$$\frac{dp_s}{d\lambda} = \frac{c-s}{2(\lambda+1)^2} < 0.$$

Since transportation cost (or taste)  $x$  is additive, the effect on every other consumer is exactly the same as with the marginal consumer, and therefore total utility is the same.

In brief, the reason for the price decrease is that demand becomes more elastic when  $\lambda$  grows. This lower optimal price leads to a decrease (relative to the standard case) of the welfare of the firm:

$$(p-c) D \Big|_{p=p_s} = (p-c) 2(s-\lambda(p-c)-p) \Big|_{p=p_s} = \frac{(s-c)^2}{2(1+\lambda)}.$$

We now calculate the welfare in six cases: standard and anger model, crossed with 3 policies; laissez faire, regulated price  $p = c$  and a subsidy under which  $p = c$  and the monopolist gets  $p_s - c$  per unit from the government, as an incentive to lower prices to consumers. For these calculations we assume that even for  $p = c$ , not all consumers are served.

In the standard model, as has been argued, the firm maximizes  $(p - c) 2 (s - p)$ , charges an optimal price of  $p^* = \frac{c+s}{2}$  and obtains profits of  $\pi^* = \frac{(c-s)^2}{2}$ . The rest of the cases are given by:

Firm's Profits in Standard and Anger Models		
Policy↓	Standard Model	Anger Model
Laissez Faire	$\frac{(c-s)^2}{2}$	$\frac{(s-c)^2}{2(1+\lambda)}$
Regul.	0	0
Subsidy	$(p^* - c) 2 (s - c) = (c - s)^2$	$(p^s - c) 2 (s + \lambda (c - p^s) - c) = \frac{(\lambda+2)(c-s)^2}{2(\lambda+1)^2}$

Consumer welfare is given by

Consumer Welfare in Standard and Anger Models		
Policy↓	Standard Model	Anger Model
Laissez	$2 \int_0^{s-\frac{c+s}{2}} (s - \frac{c+s}{2} - x) dx = \frac{(c-s)^2}{4}$	$2 \int_0^{s+\lambda(c-p_s)-p_s} (s + \lambda (c - p_s) - p_s - x) dx = \frac{(c-s)^2}{4}$
Regul.	$2 \int_0^{s-c} (s - c - x) dx = (c - s)^2$	$2 \int_0^{s+\lambda(c-c)-c} (s + \lambda (c - c) - c - x) dx = (c - s)^2$
Subsidy	$2 \int_0^{s-c} (s - c - x) dx = (c - s)^2$	$2 \int_0^{s+\lambda(c-p_s)-c} (s + \lambda (c - p_s) - c - x) dx = \frac{(\lambda+2)^2(c-s)^2}{4(\lambda+1)^2}$

Note that in the anger model, the consumer cares not only about how much he pays, but also about how much the firm receives. In calculating the subsidy, we assume that the firm gets  $p_s$ , the price in the absence of regulation. Note that the consumer welfare is the same in the absence of regulation; not only that, the consumer who is indifferent between buying and not buying is also the same individual; the price reduction, that the monopolist must make in the anger model, leaves the welfare of each consumer intact.

Then, total welfare in all scenarios is

Total Welfare in Standard and Anger Models		
Policy↓	Standard Model	Anger Model
Laissez	$\frac{(c-s)^2}{4} + \frac{(c-s)^2}{2} = \frac{3(c-s)^2}{4}$	$\frac{(c-s)^2}{4} + \frac{(s-c)^2}{2(1+\lambda)} = \frac{(\lambda+3)(c-s)^2}{4(\lambda+1)}$
Regul.	$(c - s)^2 + 0$	$(c - s)^2 + 0$
Subsidy	$(c - s)^2 + (c - s)^2 = 2 (c - s)^2$	$\frac{(\lambda+2)^2(c-s)^2}{4(\lambda+1)^2} + \frac{(\lambda+2)(c-s)^2}{2(\lambda+1)^2} = \frac{(c-s)^2(\lambda^2+6\lambda+8)}{4(\lambda+1)^2}$

Since consumer welfare with and without anger is the same, and the profits of the monopolist are lower with anger, total welfare in the economy is lower in the anger model.

The following table shows the gains to regulation: total welfare after regulation, minus total welfare before regulation. An obvious point that we haven't addressed yet is where is the money for subsidies coming from? How is it counted in total welfare. We will address this issue shortly.

Benefits of Interventions in Standard and Anger Models		
Policy↓	Standard Model	Anger Model
Regul.	$(c - s)^2 - \frac{3(c-s)^2}{4} = \frac{(c-s)^2}{4}$	$(c - s)^2 - \frac{(\lambda+3)(c-s)^2}{4(\lambda+1)} = \frac{(c-s)^2(3\lambda+1)}{4(\lambda+1)}$
Subsidy	$2(c - s)^2 - \frac{3(c-s)^2}{4} = \frac{5(c-s)^2}{4}$	$\frac{(c-s)^2(\lambda^2+6\lambda+8)}{4(\lambda+1)^2} - \frac{(\lambda+3)(c-s)^2}{4(\lambda+1)} = \frac{(c-s)^2(2\lambda+5)}{4(\lambda+1)^2}$

In both the standard and in the anger models the government subsidy equals the firm's profit:  $T_A = \frac{(\lambda+2)(c-s)^2}{2(\lambda+1)^2}$  is the transfer in the anger case and  $T_S = (c - s)^2$  in the standard case. It is easy to check that the subsidy is always larger in the standard case; yet, as we now show, it is not the extra subsidy in the standard case that make subsidies less attractive in the anger model. Let  $\Delta_{St.}^{S-R}$  be the difference in welfare between Subsidies and Regulation in the standard model (by how much more do subsidies increase welfare); similarly, let  $\Delta_{Ang.}^{S-R}$  be the difference in welfare between Subsidies and Regulation in the anger model. We have that

$$\begin{aligned} \Delta_{St.}^{S-R} - \Delta_{Ang.}^{S-R} &= (c - s)^2 - \frac{(c - s)^2 (4 - 3\lambda^2 - 2\lambda)}{4(\lambda + 1)^2} = \frac{1}{4} \frac{\lambda (c - s)^2 (7\lambda + 10)}{(\lambda + 1)^2} \\ &> (c - s)^2 - \frac{(\lambda + 2)(c - s)^2}{2(\lambda + 1)^2} = T_S - T_A \end{aligned}$$

Hence, imagine that due to the costs of raising the money (or the political economy costs) the regulator was indifferent between the two policies when he thought the economy was a standard one. If he learns that consumer preferences include the anger term that we study in this paper, he would favor regulation without subsidies.

Although subsidies are less attractive than in the standard model, good old fashioned price setting by the regulator is better in the model with anger:

$$\frac{(c - s)^2 (3\lambda + 1)}{4(\lambda + 1)} - \frac{(c - s)^2}{4} = \frac{1}{2} \frac{\lambda}{\lambda + 1} (c - s)^2 > 0$$

### 4.3 Three channels in the Regulation of Monopoly

To summarize: there are three channels through which regulation can potentially increase welfare in our model where consumers react with anger at prices they consider to be unfair.

1. There is a standard channel whereby a reduction in price from above marginal costs increases total welfare by getting a good of cost  $c$  to be produced and transferred to a consumer who values it at  $s$ .
2. For each consumer, who was purchasing and was angry, a reduction in price increases total welfare by reducing his anger (because the firm is making lower profits).

3. Finally, any channel that reduces anger (whether it reduces price or not) induces people who were out of the market to start buying the good, and that also increases total welfare. Imagine for example a policy that kept the price fixed, but “expropriated” the profits from the firm. In that case, in the standard model, welfare would be unchanged. In the current model welfare increases for two reasons: first, each consumer who was purchasing before, is happier. But also, some consumers who were not purchasing, will now become customers.

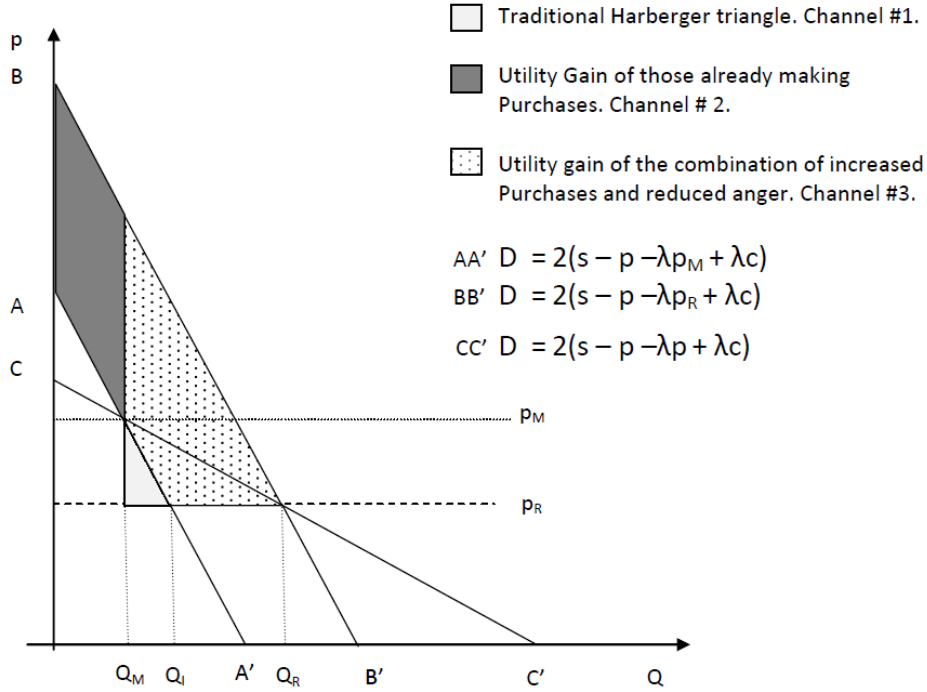


Figure 2. Three Channels through which a reduction in price from the monopoly price  $p_M$  to the regulated price  $p_R$  increases welfare.

Figure 2 depicts the three channels described above, which go beyond the standard Kaldor-Hicks potential efficiency gains.<sup>22</sup> Consider a regulator who induces a change in the price from the monopoly price  $p_M$  to  $p_R$ . Assume he does so in two (imaginary) steps: he first reduces the price paid by the consumer, while keeping the price received by the monopoly at  $p_M$ ; in the second (imaginary) stage, the regulator reduces the price received by the monopoly from  $p_M$  to  $p_R$ . The locus  $AA'$  depicts demand when the price paid by the consumer varies, but the price received by the firm is fixed at  $p_M$ ,  $D = 2(s - p + \lambda p_M + \lambda c)$ . In that case, when the price paid by the consumer is changed by the regulator to  $p_R$ , the demand function

<sup>22</sup>Trivially, they are Kaldor-Hicks gains when consumers maximize an objective that has a fairness component. An interesting extension of our model is to consider the possibility of an emotional cost to those that are the target of anger, as firms might want to be popular with consumers (particularly when the owner has to live in the same community as consumers) and regulation introduces other welfare terms.



is fixed, and the quantity demanded changes to  $Q_I = 2(s - p_R + \lambda p_M + \lambda c)$ . At that stage, welfare has increased only through the first channel, the traditional Harberger triangle (light gray in Figure 2). Then, when the regulator changes the price received by the firm, the new demand curve is the locus  $BB'$ ,  $D = 2(s - p + \lambda p_R + \lambda c)$ . Consumers who were already purchasing  $Q_M$  units, will increase their welfare due to the reduced anger; this is the dark gray area in Figure 2, which corresponds to the second channel. Finally, the change in the price received by the monopoly induces additional purchases of  $Q_R - Q_I$  from individuals for whom the reduction in anger makes the purchases worthwhile. These new sales generate additional welfare through the first (traditional) channel, since units that cost less than what consumers value them are being exchanged. This combination is the third channel, the dotted trapezoid in Figure 2. The demand function when the price changes are not broken down in the two imaginary steps is given by  $D = 2(s - p + \lambda p + \lambda c)$  and is locus  $CC'$  in the figure above.

## 5 Discussion

*Our Results:* The starting point of the paper is our assumption that total utility is made up of a material payoff and an emotional payoff. While the former is standard, the emotional payoff is assumed to become negative when agents that are perceived to be unkind do well, or more precisely, when a firm that has charged “excessive” prices makes positive profits. While other specifications for these emotional reactions might also be natural, this one is sufficient for our purposes: firms in our model are extremely interested in appearing to behave altruistically and often, though not always, charge relatively low prices so as not to irritate consumers. Indeed in competitive markets (i.e., when there are still enough competitors in the market so that it pays for a selfish firm to pretend to be altruistic) the introduction of an emotional payoff makes demand more elastic.<sup>23</sup>

It is worth pointing out that, in principle, the emphasis on emotions triggered by high prices introduces more discipline on firms. Interestingly, however, this does not mean that there are lower welfare gains from regulation. Indeed, when we study reductions in the numbers of competitors, we note that when emotions matter, the increase in prices can be considerably higher than when emotions don’t affect total utility. Put differently, when there are few competitors, consumers have a higher cost of “punishing” any particular firm that has misbehaved (by charging them high prices) by withdrawing their purchases. This introduces

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<sup>23</sup>Interestingly, Supreme Court judge Stephen Breyer mentions that an additional justification for regulation (beyond efficiency) is fairness, by which he means that competition prevents firms from “arbitrary or unjustifiably discriminatory exercise of personal power” and that a monopolist might be able to get away with discriminating or more generally “treating a customer unfairly”. See Breyer (1982).

a bigger role for regulation. More generally, given our assumption that emotional payoffs play a role, the optimal reaction to small restrictions in output under monopoly (a small “Harberger triangle”) and high bureaucratic costs of setting up regulatory agencies may still be to regulate. This fits well with the fact that we often wish to regulate utilities (like Water and Sewage), even though it is clear that high prices bring about small reductions in output. Given this, some authors have opted for introducing a weight in the social welfare function that can yield a small influence of firm profits on regulated price (see, for example, Laffont and Tirole, 1993). The results in this paper could be used to formally justify the inclusion of such low weight on profits, perhaps providing some guide on how to estimate them through experimental methods.

*Relationship to Other Work:* Our paper is related to previous research emphasizing the fact that one important attribute that people look to see in prices is their fairness. In an important paper, for example, Kahneman, Knetsch and Thaler (1986) noted a remarkable degree of agreement amongst survey respondents in what changes in prices they considered fair and which ones they did not. A growing literature in economics has studied the theoretical implications of assuming consumers’ preferences display a concern for fairness, including Rabin (1993), Fehr and Schmidt (1999), Bolton and Ockenfelds (2000), *inter alia*. Of particular interest for our purposes are Levine (1998) and Rotemberg (2005, 2008), who assume that a person’s altruism towards others depends on his/her estimation of how altruistic others are in return. Introducing heterogeneity in agent’s preferences allows them to explain a wide range of phenomena observed in dictator and ultimatum experiments. Using their specification of consumer preferences allows us to introduce a feature that is relevant to the regulation of monopoly: high prices sometimes anger consumers, so there is a cost of monopoly that is closer to the informal descriptions of “exploitation” and “abuse” observed in the anecdotal evidence. Regulation and anti-trust actions can then be interpreted as addressing primarily these emotional costs of monopoly.<sup>24</sup>

Rotemberg (2005) describes how altruistic preferences can give rise to price rigidity. In his model, missing on a good deal gives rise to regret, and facing a price that is unjustifiably high induces customer anger. He observes that the frequency of price adjustment can depend on economy-wide variables observed by consumers and derives implications for the effects of monetary policy. While our specification of preferences is very much related, he does not analyze how equilibrium outcomes depend on the level of competition, the main purpose of our paper. Heidhues and Köszegi (2008) on the other hand describe a market equilibrium

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<sup>24</sup>See also the reactions to the 2009 subprime crisis, in particular the public fallout after it was disclosed that some of the troubled firms had paid bonuses to their executives. One example is “The Outrage Factor: Do populist outbursts like the one sparked by the AIG bonuses represent a threat to capitalism -or an opportunity? Our essayists on populism and its discontents”, cover story in *Newsweek*, March 30, 2009.

closely related to our paper (as it is also based on Salop, 1979). They also introduce a realistic assumption of consumer preferences (in their case consumers have loss aversion, and so a price increase is worse than a price decrease of the same magnitude). One difficulty in applying their model to the study of monopolies (in terms of the interpretation) is that it does not incorporate the anger feature that we believe is important in the rise of regulation. Another difficulty (in terms of the modeling approach), is that consumers who do not purchase do not experience disutility. In contrast, in the monopoly setting it seems important that models allow for the possibility that bystanders can get upset even when they are not themselves the victims of “exploitative” prices. Heidhues and Kőszegi (2008) develop a “disciplined approach” where the behavioral model is based on the classic (intrinsic utility) model of Salop, and fully endogenize the reference point (as the lagged rational expectations point). In our model, the predictions also reduce to Salop’s when there are no psychologically realistic features and the “fair” outcome is defined within the model (the outcome for the consumer when there is a reasonable amount of competition). For a discussion of how a behavioral model becomes generally applicable when it is based on a “disciplined approach”, see also Kőszegi and Rabin (2006).

*Relationship to Public Relations (the Practice and the particular Instruments used):* Given that the public is keen to find out which type of firms they face, there is ample room for firms to try and influence these perceptions. For simplicity, we only allow firms in our model to signal their type through their choice of prices. But firms, in practice, employ a variety of strategies to influence the perceptions of potential clients. For example, one interpretation of the large amounts of money spent in “public relations” is that they are an attempt to signal a “kind” type by other (presumably cheaper) means than lowering prices.<sup>25</sup> Similarly, it is possible to interpret the particular form that such public relations efforts take in terms of our model. For example, publicizing charitable actions (by the firm as a whole or by its founder or main shareholders) cannot be easily interpreted when consumers care only about their material payoffs. A simpler explanation is that it is an attempt to influence the perception of the type of firm.<sup>26</sup>

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<sup>25</sup>See, for example, Boyd (2000), Metzler (2001) and the discussion in Patel *et al* (2005). On the role of status and how legitimacy confers power but depends on the support of stakeholders, see Pfeffer and Salancik (1978) and Suchman (1995).

<sup>26</sup>One of the first and most famous of the public relations practitioners was Ivy Ledbetter Lee, who had the Rockefeller family as a client. After the so-called Ludlow Massacre in 1913 (where striking miners and children were eventually killed), Lee advised John D. Rockefeller to visit the mines personally and to advertise his philanthropic activities (which had been secret up to then). See, for example, Bates (2002). Note that even if potential clients were just altruistic towards the beneficiaries of the firm’s charitable giving it is unlikely that (in the absence of the signalling role of donations) they would favor the firm’s publicizing their largesse. The reason is that the publicity might crowd out other donors (unless they think that this publicity will now re-direct further giving by others, perhaps by raising awareness of the “worthiness” of

Another particular form of public relations that is consistent with our approach is that firms often “humanize corporations”, emphasizing the identity of the founder or main shareholder. One interpretation of this relatively common form of marketing is that by doing so a firm is more likely to be perceived to have the attributes of humans (such as kindness) than of “soul-less” corporations that “only care about profits”. Again, such language is unlikely to make sense in a world where customers only care about material payoffs. Figure 3 is taken from Marchand (1998), who studies the role of corporate imagery in the creation (and maintenance) of the perception that corporations in America have a “soul” (interpreted by the author as forms of kindness, tolerance and other positive human attributes).

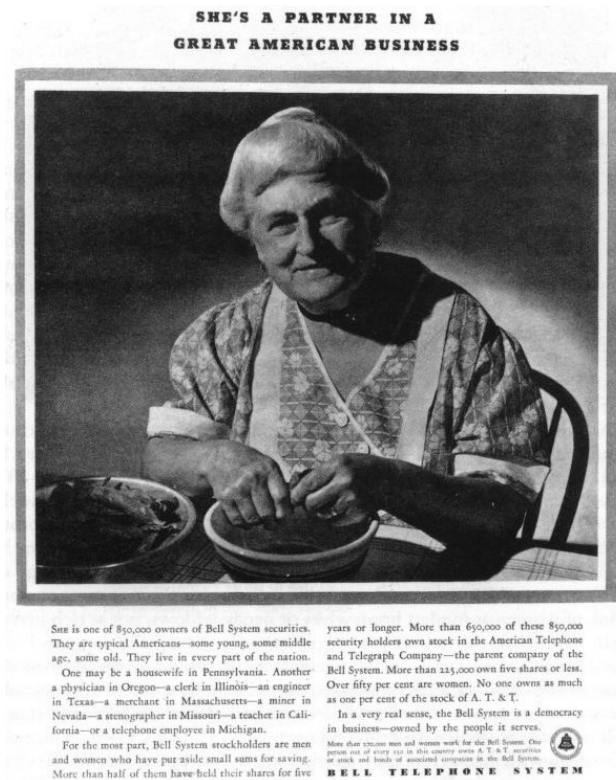


Figure 3. An ad in the campaign by Bell Telephone System to humanize the corporation.

It depicts an elderly lady cooking and describes her as one of the many shareholders of the telephone company. It also emphasizes that these are neither exceptional nor sophisticated investors (occupations mentioned include housewife, miner, clerk, teacher), are not opportunistic investors who prioritize short run profits (more than half “have held their shares for five years or longer”), approximately half are women, and often hold what appears as a small amount (a large number of them “own 5 shares or less”) for saving purposes (instead of speculation). In terms of our model, we note that it is harder to get angry at higher prices (this cause). It seems implausible that this is the primary logic that is triggered by the publicity of a firm’s charitable giving.

when these are ultimately benefiting a gentle-looking, cooking grandmother than when the beneficiary is a rich capitalist. Interestingly, Marchand (1998) also mentions that it is related to an attempt to appear democratic at a time when the big companies are perceived to have grown dramatically in size relative to traditional institutions (the advertisement mentions that the Bell company is a democracy run by the people it serves).

Note that it is unlikely that the public has good information about the structure of costs faced by the firm. In that case a firm that is perceived as kind will be granted more tolerance and allowed to charge relatively higher prices than an unkind firm in similar circumstances without triggering consumer anger.<sup>27</sup>

*Positive Theories of Regulation:* Finally, the model also has some implications for a positive theory of regulation. Most models emphasize the role of interest groups in lobbying and bribing their way to favorable regulation, as in Stigler (1971). Our paper is complementary in the sense that we give a role to the demand for regulation on the part of the public (rather than on the part of firms) and the mechanisms we describe may also give rise to the set up of regulatory bodies that are not carefully designed by benevolent policymakers (for example, it may not consider the firms' welfare as part of the objective function). In these models, causality goes from corruption to regulation.

It is worth emphasizing that the evidence available also suggests the opposite causal link (broadly, from corruption to regulation). For example, within a country, individuals who perceive lots of corruption in the country are precisely those who declare to want more regulation; and that this demand is stronger when big companies are thought to be involved. Even over time, regulation bursts seem to follow corruption scandals (see, for example, Di Tella and MacCulloch, 2002).<sup>28</sup>

This is consistent with the model we present: when capitalists are perceived to be corrupt and unkind, voters demand regulation. Of course, in sophisticated legal systems, more efficient punishment directed only at those that are perceived to be breaking the rules might be available. In such cases, a descent into distrust and a regulated economy might be avoided by "moral crusaders", who often explicitly frame their campaigns as a benefit to capitalism.<sup>29</sup>

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<sup>27</sup>This may be the consequence of a purely rational Bayesian calculation in which the prior belief shifts "upwards" towards higher (better or nicer) types, but it can also be the consequence of basic psychological mechanisms ("nice people don't do this kind of thing")

<sup>28</sup>Anecdotal evidence is consistent with this interpretation: after the Enron scandal in 2002 there was heightened regulation even though a Republican administration was in place (including additional funding for the Securities and Exchange Commission, Sarbanes-Oxley legislation, etc). Note that authors who see these reforms as insufficient, like Conrad (2004), discuss how policymakers undercut pressures for more reforms during this period.

<sup>29</sup>Eliot Spitzer, the former governor of New York, is a recent example of a tradition that goes back at least to Teddy Roosevelt. In one speech, he stated this view: "... even though those who pretend to speak for the free market kick vigorously against us when we reveal these problems, . . . the reality is that the market

More broadly, we give a central role to the interaction between the legal system and regulation as both are seen as limiting and punishing deviant business actions.

There are several episodes where regulation is put into place as a result of considerable public anxiety. The classic case is the Sherman Act of 1890, which laid the basis of the regulation of big business in America. Our reading of this episode is that the political support for regulation originated in perceptions of corporate “abuse” rather than the possibility that monopolies would introduce inefficiencies in the economy (by restricting trade). One example is John D. Rockefeller’s Standard Oil trust. Various practices that reinforced an ability to charge high prices made the concern the target for attacks. These were discussed in the press and the muckrakers’ writings, including Ida Tarbell’s 1902 popular series on Standard Oil in McClure’s Magazine (later compiled in the well known book “History of Standard Oil Company”). Starting in 1904, the States filed a series of lawsuits (13 in 1906 alone) which ended in a Federal district court decision to break up the Standard Oil Company into its component companies. Although doubts remain as to the impact of the separation on its conduct, it is clear that the motivation for regulation in this case is unlikely to have been a preoccupation with efficiency (particularly when there are efficiencies to be gained on the cost side as scale is increased). Wildavsky and Tenenbaum (1981) describe this and other episodes where high prices led to widespread mistrust between the public (and politicians) and the oil industry. In particular, it describes the public reactions to the first oil shock and the subsequent debates over how much of these increases could be justified by dwindling oil and gas reserves (versus taking advantage of the increases engineered by the OPEC cartel).

## 6 Conclusions

We present a model where the need to regulate a firm arises because consumers sometimes have adverse emotional reactions to high prices. The root assumption is that consumers get angry when they think that a firm is charging “abusive” or “exploitative” prices. We model this by assuming that consumers experience utility from consumption at low prices (a standard material payoff) and disutility from observing high profits in the hands of firms that have displayed low levels of altruism towards their clients (an emotional payoff). In the context of a simple monopolistic competition model along the lines of Salop (1979), this implies that firms experience large drops in demand when their activities (e.g., price selections) irritate consumers. We show that market equilibrium in these circumstances displays a series of interesting properties. For example, the client of a firm who discovers

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*survives only because we reveal these problems, make them eminently clear, and try to confront them in a very real way”* (Spitzer, 2005). On the interaction between beliefs and punishment, see Di Tella and Dubra (2008).

that the owner is (say) a criminal experiences a utility loss (no such loss is present in standard economic models).<sup>30</sup> Moreover, in some circumstances, even with a very low proportion of truly altruistic firms, most firms in the market charge a low price in order to appear to be kind.

The main result of the paper is that, under a reasonable set of circumstances, anger is more likely as the number of firms falls and competition decreases. This happens because a feature of the equilibrium is that, as the number of firms in the market drops, switching to a firm who has not raised prices becomes more costly to the consumer, and the threat to punish unkind firms by not purchasing from them becomes less credible. This leads to price increases by firms, which in turn leads to anger. This phenomenon introduces a new potential justification for regulation: by reducing the profits of firms revealed to be unkind, anger of captive consumers (and of the public that is witness to the “abuses”) falls and consumer welfare is increased.

The second contribution of the paper is to illustrate these gains from regulation in the context of monopoly. There are three channels: regulation helps through the standard channels (increasing output when it is valuable), through a purely emotional channel (captive consumers are less angry as unkind firms earn less in profits), and through a mixed channel (individuals who were out of the market as they were too angry in the unregulated market, decide to purchase and reduce the standard distortions described in the first channel). The anger mechanism emphasized here suggests that firms will invest resources in trying to appear kind, perhaps developing professionals devoted to “public relations”, or by advertising campaigns emphasizing the founder’s identity (in contrast to the anonymous set of shareholders) or through philanthropy (see, for example, the evidence collected in Marchand, 1998). The mechanism also suggests that regulation may also have value when it reassures consumers that any observed increase in prices is justifiable (for example because costs are higher, rather than because there was an increase in the “unkindness” -or greediness- of the firm).

Fairness has been the focus of a growing literature in economics. Our paper’s contribution is to lay out a simple framework to discuss how such considerations may help understand better the benefits of regulating monopolies. Specifically, we show how anger and competition are connected and how the anger/fairness objective modifies the simple Kaldor-Hicks criteria (based only on efficiency considerations) yielding three channels through which monopolies affect welfare. The framework can also be applied to help explain the choice between different regulatory approaches, such as anti-trust versus regulatory agencies or between regulatory instruments, such as fines versus price regulation.

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<sup>30</sup>This is consistent with retail firms charging high prices and claiming that the extra money goes to foreign Aid (e.g., the “Red” campaign by *The Gap* and singer activist Bono).

## 7 Appendix

In this appendix we present an example in which, for a given set of parameters, there is a pooling equilibrium (without anger) in a duopoly but no such equilibrium in a monopoly. Proposition 1 showed that, always within oligopoly, decreases in competition make anger more likely. One of the points of this example is to “generalize” this observation to encompass a reduction in competition that leads from a duopoly (a form of oligopoly) to a monopoly: a reduction in competition that leads to the rise in anger.

We now show that if  $\tau$  is the utility with 3 firms, for some parameter configurations there is a pooling equilibrium in which both types of firms choose the same price (resulting in no anger, and consumers obtaining a “high” utility from consumption,  $u \geq \tau$ ) with 2 firms. At the same time, there is no pooling equilibrium when there is a monopoly. This results in consumers being angry if the monopolist happens to be of the selfish type. The point of this example is to show:

1. That anger is more likely in a monopoly, so the monopoly is the right model to look at when focusing on anger.<sup>31</sup> This is so, because the only equilibria without anger are pooling equilibria (in any separating equilibrium, in expected terms there will be some selfish firms, and so long as they charge a price larger than marginal cost, there will be anger; and price equal to marginal cost is never optimal).
2. That there is some distance between assumptions and results. If we had chosen  $\tau$  to be the utility attained by consumers in a duopoly and shown that there is no pooling equilibrium in a monopoly, one could suspect that the “no pooling” result was the consequence of focusing on a market structure different from the one used to calculate the benchmark utility  $\tau$ . The example shows that that is not the case: the benchmark utility is with 3 firms; one can still obtain that utility and a pooling equilibrium with a different (more concentrated) market, in particular in a duopoly; the pooling only breaks when moving to a monopoly.

Suppose  $\lambda = \frac{1}{15}$ ,  $s = 1$ ,  $c = 0$ ,  $\alpha = \frac{7}{50}$  and  $\tau = \frac{7}{12}$ , corresponding to the utility of the consumer in a market with 3 firms. Note that  $\alpha = \frac{7}{50} = 0.14$  is fairly small, relative to the profits (maximum profits are:  $1/2$  in a monopoly with these parameters; and  $1/4$  for each firm in a duopoly). We say that the altruistic motive is “fairly small” in the sense that it is not larger than total firm profits in either the monopoly or duopoly (if it were, one could argue that the altruistic motive is driving “everything”; we have that  $\alpha$  is not too large, and we obtain differential behavior in the case of the monopoly vis a vis the duopoly)

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<sup>31</sup>For different parameter configurations one can obtain anger also in an oligopoly; anger is not “proprietary” of markets with a monopoly.



## 7.1 No pooling in monopoly with high utility for consumers

The price in the monopoly situation must be, from equation (10),

$$p^m \geq \frac{c+s}{2} - \frac{s-c}{2} \sqrt{\frac{\lambda}{\lambda+1}} = \frac{3}{8}$$

for the selfish firm to want to pool. But such a price yields a consumer utility of  $\frac{25}{64} < \frac{7}{12} = \tau$ .

## 7.2 No pooling in monopoly with low utility for consumers

For the altruistic firm, the alternatives are

1. charging the equilibrium monopoly price and getting  $2(p^m - c)(s - p^m) - \alpha$ ,
2. charging its optimal price  $p^* > p^m$  (leaving consumers angry and still with a low utility), which yields  $\frac{(c-s)^2}{2(1+\lambda)} - \alpha$ .
3. lowering its price enough to satisfy consumers, which yields a utility given by equation (14),  $2\sqrt{\tau}(s - c - \sqrt{\tau})$ .

But (1) is better than (3) iff  $p^m(1 - p^m) \geq \sqrt{\frac{7}{12}} \left(1 - \sqrt{\frac{7}{12}}\right) + \frac{7}{100} = 0.25043$  which is impossible. We conclude that there's no pooling, because the altruistic firm always wants to lower its price and satisfy consumers. (even though  $\alpha$  is relatively small).

## 7.3 Pooling in duo

We consider a pooling equilibrium in which the price charged guarantees consumers their acceptable utility level of  $\frac{7}{12}$ . Total utility of consumers for a price of  $p$  in a duopoly is:

$$4 \int_0^{\frac{1}{2}} (s - p - x) dx = 4 \int_0^{\frac{1}{2}} (1 - p - x) dx = \frac{3 - 4p}{2} \geq \frac{7}{12} \Rightarrow p \leq \frac{11}{24}.$$

We will show that  $p^* = \frac{11}{24}$  is indeed part of a pooling equilibrium. Profits for both types of firm in the equilibrium are price times demand (half the market for each firm):  $\pi^* = \frac{11}{48}$ .

Faced with this price, neither the altruistic nor the selfish firm wants to deviate by decreasing its price. For both firms, the alternative is choosing  $p$  to maximize its profits in a situation where consumers are angry and demand is given by the following condition

$$s - p(1 + \lambda) - x = s - p^* - \left(\frac{1}{2} - x\right) \Leftrightarrow D = p^* - p(\lambda + 1) + \frac{1}{2} = \frac{23}{24} - p(\lambda + 1).$$

Profits  $pD$  are maximized for

$$p = \frac{23}{48(\lambda + 1)} = \frac{115}{256} \Rightarrow \pi^{dev} = \frac{2645}{12288} < \frac{11}{48} = \pi^*$$

and the altruistic firm has an extra utility cost of  $\alpha$ . Both firms are then happy to choose the equilibrium price  $p^*$ .

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