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Quality differentiation and firms' choices between online and physical markets

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Highlights

- We develop a theoretical framework to study firms' choices between online and physical markets with respect to product quality and competition.
- A pooling effect suggests that information asymmetry attracts low-quality products to the online market.
- A differentiation effect indicates that a firm with a lower-quality product may prefer to reveal its product quality in the physical market because quality differentiation helps alleviate price competition.
- In an entrant-incumbent model, the entrant with product quality lower than that of the offline incumbent may choose the physical market.
- In a simultaneous-move model, the two contrasting effects give rise to a wide range of product quality—from low-end to high-end—in both the online and offline markets.

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