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The reputational costs of business pricing decisions

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The authors base their analysis on transaction- and establishment-level data from the Yelp Transactions Platform, which allows customers to place orders at local restaurants and then leave a review and a star rating (a proxy for reputation) on the Yelp website. Looking first at star-rating distributions by restaurant price level, Luca and Reshef observe similar ratings across variously priced establishments (3.4 stars for the cheapest category and 3.6 stars for the priciest), suggesting that a restaurant's reputation is influenced by both quality and price. To isolate the causal effect of price levels, the authors conduct a within-case longitudinal analysis, controlling for fixed effects and adopting two specifications: one tracking changes in customer ratings in the few days before and the few days after an item's price change, and another doing the same but focusing on a shorter time window immediately before and after the price-change decision.

The results from these analyses point to prices having a sizable and statistically significant reputational effect. The authors report that, for the average restaurant, a price increase of 1 percent is followed by a ratings drop of 2.5–5 percent, a large effect given that price increases average between 3 and 9 percent. Further, more granular analyses presented in the article show that the negative reputational effect of higher prices is stronger among first-time customers. In Luca and Reshef's interpretation, this result implies both that consumer responses are nonretaliatory but price driven, presumably because new customers have no prior knowledge of the establishment they are rating, and that price levels condition consumer expectations about product quality, with lower initial ratings indicating perceived incongruity between price and quality.

While the authors are unable to pinpoint a single mechanism through which higher prices hurt reputation, they suggest that a mixture of causal chains is likely at play, whereby customers rate a business on the basis of differences between, on the one hand, quality and price (net utility) and, on the other, value and prior expectations (deviations from expectations). Overall, Luca and Reshef conclude that their results "point to a tradeoff: price increases not just reduce present demand, but can potentially harm future demand by decreasing firm reputation."