Pricing under Fairness Concerns

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Abstract
This paper proposes a theory of pricing premised upon the assumptions that customers dislike unfair prices—those marked up steeply over cost—and that firms take these concerns into account when setting prices. Since they do not observe firms’ costs, customers must extract costs from prices. The theory assumes that customers infer less than rationally: when a price rises due to a cost increase, customers partially misattribute the higher price to a higher markup—which they find unfair. Firms anticipate this response and trim their price increases, which drives the passthrough of costs into prices below one: prices are somewhat rigid. Embedded in a New Keynesian model as a replacement for the usual pricing frictions, our theory produces monetary nonneutrality: when monetary policy loosens and inflation rises, customers misperceive markups as higher and feel unfairly treated; firms mitigate this perceived unfairness by reducing their markups; in general equilibrium, employment rises. The theory also features a hybrid short-run Phillips curve, realistic impulse responses of output and employment to monetary and technology shocks, and an upward-sloping long-run Phillips curve. (JEL: L11, E31, D91, E71)

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