Bocconi

Università Commerciale Luigi Bocconi

Department of Decision Sciences **Department of Economics**

Economic Theory, Decision Theory and Experimental Economics Seminar

The Market for Deceptive Products

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Abstract

We analyze conditions facilitating profitable deception and incentives for innovation in a competitive market for potentially deceptive products. Firms selling homogenous products simultaneously set a transparent "up-front price" and an "additional price," and decide whether to shroud the additional price from naive consumers. To model especially financial products such as banking and credit-card services, actively managed mutual funds, and non-traditional mortgages, we assume that there is a binding floor on the product's up-front price. In a market with a single socially valuable product and sufficiently many firms, at least one firm is willing to unshroud, so a deceptive equilibrium does not exist. But perversely, if the product is socially wasteful, unshrouding would eliminate the industry, so in this case a profitable deceptive equilibrium always exists. In a market with multiple products, since a superior product both diverts sophisticated consumers and renders an inferior product socially wasteful in comparison, it guarantees that firms can profitably sell the inferior product by deceiving consumers. Regarding innovation decisions, because learning ways to charge higher additional prices increases the profits from shrouding and thereby lowers the motive to unshroud, a firm may have a strong incentive to make such exploitative innovations and have competitors copy them. In contrast, the incentive to make innovations that increase the product's value to consumers is zero or negative if other firms can copy the innovation, and even otherwise is strong only if the product is socially wasteful.

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