The Market for Deceptive Products*

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Abstract

We develop a model of price competition in a homogenous product that has an "additional price" firms can shroud from consumers, and there is a floor on the product's transparent up-front price. Then, the incentive to unshroud the additional prices is limited by the consideration that it lowers demand by revealing to consumers that the product is expensive, so that a profitable deceptive equilibrium can often be maintained by firms. Furthermore, because learning ways to charge consumers higher additional prices lowers the incentive to unshroud, a firm may have a motive to make such exploitative innovations *and* pass them to its competitors. The more firms there are in the industry, the likelier it is that at least one is willing to unshroud, eliminating the deceptive equilibrium. But perversely, if the product is socially wasteful, unshrouding would eliminate the industry, so in this case a profitable deceptive equilibrium always exists. Because a superior transparent product both diverts sophisticated consumers and renders the deceptive product socially wasteful, it guarantees that there is a profitable equilibrium in which naive consumers are exploited. We also discuss possible microfoundations for our key assumption of a price floor, and identify some policy implications of our findings.

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