

**Communicating Quality: A Unified Model of Disclosure and Signaling\***

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### **ABSTRACT**

Firms communicate product quality attributes to consumers through a variety of channels, such as pricing, advertising, releases of research reports and test results, or warranties and returns policies. The conceptualization of the economics of such communication is that it takes on one of two alternative forms when quality is exogenous: 1) *disclosure* of quality through a credible direct claim; 2) *signaling* of quality via producer actions that influence buyers' beliefs about quality. In general, these two literatures have ignored one-another. In this paper we argue that disclosure and signaling are two sides of a coin and that firms should be viewed as choosing which means of communication they will employ. Moreover, we show that integration of these two alternatives leads to a number of new implications about disclosure, signaling, firm preferences over type, and the social efficiency of the channel of communication employed.

## 1. Introduction

For many products, consumers are unable to observe quality directly prior to purchase, but a firm knows the quality of the product it provides (its “type”). Firms communicate product quality attributes to consumers through a variety of channels, such as pricing, advertising, releases of research reports and test results, or warranties and returns policies. The conceptualization of the economics of such communication is that it takes on one of two alternative forms when quality is exogenous:<sup>1</sup> 1) *disclosure* of quality through a credible direct claim; 2) *signaling* of quality via producer actions that influence buyers’ beliefs about quality. Examples of the first form of communication would involve disclosure via the use of an independent (possibly costly) auditing process with public announcements of what quality was found to exist, or advertising in the presence of truth-in-advertising laws with high penalties for misrepresentation. Examples of the second form of communication include posting prices that consumers might use to infer quality, or advertising in unregulated environments where lost future sales due to misrepresentation can provide incentives for truthfulness.

Both approaches have generated extensive literatures that deal with firms selling products whose quality is determined exogenously, known to the firms themselves, but not observable to consumers prior to purchase. Remarkably, there has been little communication *between* these two approaches and yet they are intimately related. In this paper we argue that disclosure and signaling

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<sup>1</sup> A third distinct approach to unobservable quality involves the idea of a “quality-guaranteeing price” (beginning with Klein and Leffler, 1981; see Bester, 1998, for a recent example and further references). In this literature, quality is endogenously-chosen by the firm after it posts its price. A firm that dilutes its quality will lose future sales, and a firm that charges too low a price will have an incentive to subsequently dilute quality. Understanding this, consumers will not buy at such prices. Instead, there is a threshold price that is high enough to make it optimal for the firm subsequently to provide high quality rather than to cash in now and forego future sales. Consumers will only be willing to buy at prices at or above this quality-guaranteeing price.

are two sides of a coin and that a firm should be viewed as choosing which means of communication it will employ. Moreover, we show that integration of these two alternatives leads to a number of new implications about disclosure, signaling, firm preferences over type, and the social efficiency of the channel of communication employed.

Why have these approaches remained so distinct? The disclosure literature invariably assumes that marginal cost is independent of quality, which renders separation via signaling impossible. Thus, for these models, non-disclosure is consistent with all non-disclosing types charging the same price; these types pool.<sup>2</sup> On the other hand, few signaling models of product quality assume that products of different quality are equally costly to produce.<sup>3</sup> Most signaling models assume that higher-quality products are more costly to produce,<sup>4</sup> though some are agnostic on the issue, allowing higher-quality products to be either more or less costly.<sup>5</sup> This difference in costs typically allows the price chosen by the firm to reveal its product's quality.

We argue that the alternative to disclosure should not be viewed as “non-disclosure,” but rather as revealing type via other channels such as price; this modification of perspective alters a number of previously-developed results. We focus on the case wherein higher quality is associated

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<sup>2</sup> For examples of models which involve a single firm (or can be viewed as such due to a lack of strategic interaction), see Viscusi (1978), Grossman (1981), Milgrom (1981), Jovanovic (1982), Matthews and Postlewaite (1985), Milgrom and Roberts (1986b), and Polinsky and Shavell (2006). For examples involving multiple firms, see Board (2003), Cheong and Kim (2004), Levin, Peck and Ye (2005), and Hotz and Xiao (2005).

<sup>3</sup> But see Hertzendorf and Overgaard (2001a,b) for models that do make this assumption.

<sup>4</sup> Examples include Bagwell and Riordan (1991), Bagwell (1993), Shieh (1993), Fluet and Garella (2002), and Daughety and Reinganum (forthcoming, 2008a).

<sup>5</sup> Examples include Milgrom and Roberts (1986a) and Daughety and Reinganum (1995, 2005a).

with higher marginal costs of production, and we analyze a continuum-type model.<sup>6</sup> We show that, in equilibrium, a firm with the lowest-quality product will not disclose for any positive disclosure cost, since it obtains its full-information profits in a separating signaling equilibrium. A firm with a higher-quality product will typically need to distort its price in order to signal its true quality (and this distortion increases with an increase in the true quality of the product) and thus, in a separating equilibrium, its signaling equilibrium profits will be less than those under full information. We then show that there is a level of the cost of disclosure that induces a sufficiently high-quality firm to choose disclosure over signaling. Therefore, for this intermediate level of disclosure cost, some types reveal quality via disclosure while other types reveal quality via signaling. We show that overall profits, as a function of type, are “U-shaped” in that both the lowest-quality and highest-quality types of firm have higher profits than those for intermediate types. Moreover, if disclosure costs are “moderate” (to be made precise below), then the highest-quality types make the highest profits; this partly resolves a dilemma in much of the price-quality signaling literature wherein higher profits are associated with lower quality, suggesting that firms would prefer to produce lower-quality products.<sup>7</sup>

A welfare analysis of voluntary disclosure therefore focuses *not* on how much information is ultimately revealed, *but whether it is revealed through the socially-optimal channel*. In a separating signaling equilibrium each type of firm (except the lowest) charges a higher price and

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<sup>6</sup> In a companion paper focused on safety and legal liability considerations (Daughety and Reinganum, forthcoming, 2008b), we examine a two-type model in which marginal costs may be increasing or decreasing with safety, depending upon the liability regime.

<sup>7</sup> See, for example, Bagwell and Riordan (1991), Bagwell (1993), and Daughety and Reinganum (1995; forthcoming, 2008a).

sells less output than it would under full information (*a fortiori*, this is less than the socially-optimal output). Since the firm considers its own profit increase from disclosure, but not the value of the additional output to consumers, there will be a range of disclosure costs for which the firm inefficiently chooses to signal rather than disclose. A mandatory disclosure rule may be surplus-increasing as it results in a price reduction and an increase in output produced. However, a more nuanced approach is possible. We describe a simple, decentralized subsidy policy that induces socially-efficient disclosure (given equilibrium pricing). Finally, while the monopolist in our analysis engages in insufficient disclosure, the classical disclosure analysis finds that the monopolist engages in excessive disclosure. Our model allows us to understand what assumptions drive this result.

### *Related Literature*

In this subsection, we briefly describe how this paper relates to its closest antecedents.<sup>8</sup> Several previous papers develop models in which price signals product quality; such a model will appear as part of our analysis, but it will be augmented with a disclosure decision. Bagwell and Riordan (1991) provide a two-type monopoly model wherein high quality is more costly to produce.<sup>9</sup> The signaling portion of our current paper is based on the model in Daughety and Reinganum (1995), which linked liability considerations to the relationship between a firm's full marginal cost

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<sup>8</sup> More distant literature includes papers using as signaling instruments: 1) advertising, such as Kihlstrom and Riordan (1984), Milgrom and Roberts (1986a), Hertzendorf and Overgaard (2001b), and Fluet and Garella (2002); and 2) warranties, such as Spence (1977), Gal-Or (1989) and Lutz (1989).

<sup>9</sup> Daughety and Reinganum (2007; forthcoming, 2008a) employ a two-type model to analyze price-quality signaling in oligopolies under the assumption that marginal cost is increasing in quality.

(i.e., production plus liability costs) and safety. Daughety and Reinganum (2005) provide a model with a continuum of types, unit demand and marginal costs that increase in quality; in that paper, the firm can commit to a disclosure policy before it learns its type, but cannot not make a disclosure after learning its type (it signals quality via price). In the current paper, we model the disclosure decision as occurring after the firm has learned its type, consistent with the usual timing in the disclosure literature.<sup>10</sup>

Some of the earliest product-quality disclosure literature (e.g., Grossman, 1981; and Milgrom, 1981) assumed that disclosure was costless. In this case the unique equilibrium involves complete disclosure. To see why, notice that incomplete disclosure pools multiple firm types, and consequently consumers' willingness to pay is based on the average quality in the pool. If disclosure is costless, then the highest-quality type in the pool can increase consumers' willingness to pay, and hence its profits, by defecting to disclosure; this thought experiment continues until all types are disclosed (this is often referred to as "unraveling"). Other models (e.g., Viscusi, 1978; Jovanovic, 1982; and Levin, Peck and Ye, 2005) have assumed positive disclosure costs. These models find that high-quality types engage in disclosure, as do we. However, in these models disclosure is typically socially excessive, while we find that voluntary disclosure is insufficient.

One reason that the classical disclosure models find excessive disclosure is because those models assume that consumers have unit demand with a common (and known) reservation price, in which case disclosure is essentially redistributive; while there may be a private value associated with disclosure, there is no social value. In Section 5, we compute a version of our model in which costs

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<sup>10</sup> One exception is Levin, Peck and Ye (2005), who consider both alternatives: (1) the disclosure decision is made before the firm learns its product quality; and (2) the disclosure decision is made after the firm learns its product quality.

are unresponsive to quality (so that only a pooling equilibrium exists among non-disclosing firms) in order to determine circumstances under which disclosure is socially excessive or insufficient. When demand is downward-sloping and costs are unresponsive to quality, then non-disclosing firms charge a common “pooled” price. Disclosure by a firm with relatively high quality would expand that firm’s demand (for any given price) and allow it to raise both its price and its output. This is privately beneficial, but it need not be socially beneficial, for two reasons. First, consumer’s surplus may fall; second, those firm types remaining in the pool are adversely affected by the consumer’s revised beliefs about the expected quality in the pool. We show that the combination of pooling and reduced demand elasticity leads to an increase in the set of disclosure costs that result in excessive disclosure; the classical model’s assumptions of pooling and inelastic demand therefore assure that disclosure will be excessive. In our main model, with downward-sloping demand and quality-sensitive costs, disclosure by a relatively high-quality type allows that type to lower its price and expand its output without affecting the non-disclosing types’ profits. Since the social gain from this increase in output exceeds the private gain, some types inefficiently fail to disclose.

The only published<sup>11</sup> paper of which we are aware that involves both disclosure and signaling of quality is Fishman and Hagerty (2003). However, in their model disclosure and signaling are not substitutes (as they are in our model), but rather are complements due to an externality between

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<sup>11</sup> Since completing this paper, we have become aware of a working paper by Caldieraro, Shin and Stivers (2007) that assumes one high-quality and one low-quality firm (firms know each others’ qualities; consumers cannot observe quality directly but know there is one firm of each type). After firms individually choose whether or not to disclose, only some consumers observe the disclosure, leading to both disclosure and signaling by the firms. However, to simplify the analysis, this paper imposes exogenous restrictions on the consumer belief structure. These restrictions may select among equilibria (as is typical of equilibrium refinement arguments that restrict out-of-equilibrium beliefs) but imposing restrictions on the belief structure itself may also create equilibria which would not exist absent these restrictions.



different types of consumers. Thus, signaling does not accompany non-disclosure in their model (because they maintain the crucial assumption that marginal costs are the same for high- and low-quality products); it can only accompany disclosure.<sup>12</sup> Our model is very different from that of Fishman and Hagerty (2003) in that we assume only one type of consumer (all of our consumers become informed about quality when the firm discloses it); moreover, our consumers have downward-sloping demand. Our firm has a marginal cost that is increasing in quality. Thus, if a firm does not disclose its quality directly, it reveals it through its price: disclosure and signaling are substitutes.

Two papers that are more tangentially-related than those discussed above also address the choice of signaling versus disclosure. In Cai, Riley and Ye (2007) a seller with private information regarding her own valuation auctions an item to multiple potential buyers, whose valuations are positively-correlated with that of the seller. The seller's reserve price signals her value to the buyers but signaling involves distortion. In the working paper version, the authors briefly discuss an application involving costly external value certification. In their model, higher seller types make higher profits under signaling (the opposite is true in our model), but they too find that higher-valuation sellers will certify while lower-valuation sellers will signal. In Bernhardt and Leblanc (1995) a firm with an investment project can either signal its value to the capital market through its debt contract or disclose this value directly. However, disclosure is assumed to reveal not just the

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<sup>12</sup> They assume two different types of (unit demand) consumer; one type becomes “informed” about quality when a disclosure is made, while the other remains “uninformed” about actual quality, but is aware that a disclosure has been made. Suppose that most consumers are capable of becoming “informed.” Then a firm which makes a disclosure and charges a high price will only do so if it is a high-quality firm, for if it were a low-quality firm charging a high price, it would alienate all of the informed consumers. So an uninformed consumer who knows that a disclosure was made (but not its content) can infer high quality from a high price.

project's value, but sufficient information for a competitor to enter the relevant market and undermine the project's value to the disclosing firm. In a three-type model, they find that the "bad" type will never disclose; the "medium" type will engage in partial or no disclosure; and the "good" type will engage in full, partial, or no disclosure, depending on the parameters of the problem.

In our model, we adhere closely to the classical price-quality signaling and disclosure models, in which, respectively, no consumer is informed *ex ante* about quality and a consumer learns product quality with certainty from a firm's disclosure. However, other "hybrid" models are possible. For instance, instead of modeling disclosure as a perfect signal of quality, it could be a "noisy" signal. A noisy signal which simply allows a consumer to update the distribution of quality, while maintaining the same support, would have no effect on the separating signaling equilibrium (which depends only on the support and not on the distribution over that support). Thus, no firm type would be willing to pay a positive amount for this kind of noisy signal. A noisy signal that excludes some types from the support could be valuable; our model can be viewed as a special case wherein all false types are excluded. Lizzeri (1999) examines the case of a strategic intermediary who can observe a seller's quality (type) costlessly. The (sole) intermediary commits to a fee and a disclosure policy. The seller's type is fixed, but unobservable to buyers. Moreover, the seller cannot signal quality through his price because all seller types have the same reservation value (zero). When trade is always efficient, the equilibrium involves the intermediary disclosing nothing, and charging the seller the difference between the average price based on the prior type distribution and the worst type's full-information price; all seller types use the intermediary. Thus the

intermediary provides no information but appropriates all the information rents.<sup>13</sup> However, if there are many competing intermediaries, then intermediaries set fees to just cover their costs and adopt a policy of full disclosure. Since our goal is to integrate the traditional disclosure model (wherein quality is disclosed truthfully) with the potential for price signaling that arises with quality-dependent costs, we abstract here from strategic intermediaries with market power.

Another variation could include a fraction of consumers who are informed *ex ante* about quality, as in Bagwell and Riordan (1991). If this fraction is small the firm still engages in signaling but if this fraction is sufficiently large, then the firm abandons signaling and prices at its full-information monopoly price. Finally, one could assume that not all consumers are informed by a firm's disclosure as in Caldieraro, Shin and Stivers (2007). This would result in a signaling subgame like that of Bagwell and Riordan (1991), since *ex post* of disclosure there will be a fraction of informed consumers and a fraction who remain uninformed. While our model could be modified to accommodate some of these features, this would detract from our main focus of comparing, contrasting, and combining the classical signaling and disclosure models.

### *Plan of the Paper*

In Section 2, we describe the notation and provide the results of the analysis when firms can choose between disclosure via a (costly) credible statement and signaling via pricing. We also show that the firm with access to both disclosure and signaling has “U-shaped” profits with respect to its type, and discuss the implications of this result. In Section 3 we characterize socially-optimal

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<sup>13</sup> When trade with some seller types is inefficient, the intermediary discloses only whether or not trade is efficient and only efficient seller types seek certification. Albano and Lizzeri (2001) re-examine the behavior of a strategic intermediary under the assumption that the seller chooses the quality of his product.

disclosure, assuming the firm retains control of the pricing decision; in general, the socially efficient amount of disclosure does not occur in equilibrium. Section 4 details a decentralized subsidy scheme that induces socially efficient use of communication channels by the firm, but leaves the firm's payoff unchanged. Section 5 employs our model to show that the classical disclosure literature's excessive-disclosure result occurs because of a combination of two assumptions: 1) that the marginal cost of production is independent of the level of quality and 2) that demand is modeled as inelastic (i.e., unit demand). Section 6 summarizes our results and suggests extensions. The Appendix addresses a technical issue concerning the belief function used in the main text.

## 2. Equilibrium Disclosure and Signaling

### Model setup

#### *Quality*

We assume that a single firm produces a product whose quality,  $\theta$ , is unobservable to consumers prior to purchase. Quality here is the probability that the consumer is completely satisfied with a unit of the product. We capture this by assuming that  $\theta \in [\underline{\theta}, \bar{\theta}]$ , with  $0 < \underline{\theta} < \bar{\theta} < 1$ ; thus, the lowest type is  $\underline{\theta}$  while the highest type is  $\bar{\theta}$ . Further, assume that the consumer's prior belief about  $\theta$  is that it is distributed according to a continuously differentiable distribution function,  $G(\bullet)$ , with positive density,  $g(\bullet)$ , on the interval  $[\underline{\theta}, \bar{\theta}]$ . Thus, any type of product may be completely satisfactory in a given instance of its consumption, but any type of product may also disappoint in a given instance; the key attribute is that higher-quality products are more likely to be satisfactory. This "consumer satisfaction" interpretation of quality is useful in that "satisfaction" is non-verifiable, and thus the firm cannot offer a warranty of the form: "your money will be refunded if you are not

completely satisfied with the product,” as this would introduce moral hazard on the part of the consumer, who would always claim, *ex post* of consuming the product, that she was disappointed.<sup>14</sup>

### *Consumers*

All types of product provide utility to the consumer, but a unit that is completely satisfactory provides greater utility. In particular, we assume that the consumer’s utility is quadratic in the quantity consumed of the product of interest, with the coefficient on the quadratic term denoted  $\beta$ , and the coefficient on the linear term denoted  $\alpha$  in the case of a satisfactory unit and  $\alpha - \delta$  in the case of a disappointing unit, where  $\beta > 0$  and  $\alpha > \delta > 0$ . The consumer is unable to observe directly the product’s quality before purchase. Let the perceived quality of the good be denoted  $\tilde{\theta}$ . If the firm discloses the quality before purchase, then  $\tilde{\theta} = \theta$ ; on the other hand, if the product’s quality is not disclosed, then these perceptions will be determined as part of a perfect Bayesian equilibrium wherein the firm’s strategy is its price.

The consumer’s utility function is quasi-linear in all other goods; thus, if the price of the product is  $p$ , the consumer’s income is  $I$ , and she consumes  $q$  units of perceived quality  $\tilde{\theta}$ , then her utility is given by:

$$U(p, q, \tilde{\theta}) \equiv (\alpha - (1 - \tilde{\theta})\delta)q - \beta(q)^2/2 + I - pq.$$

Thus, the consumer’s demand for the product of perceived quality  $\tilde{\theta}$  is given by:

$$q(p, \tilde{\theta}) = (\alpha - (1 - \tilde{\theta})\delta - p)/\beta.$$

Our model assumes that consumers purchase multiple units of the good, each unit of which fails or succeeds independently, but with the same probability. Thus, sampling one unit and

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<sup>14</sup> We trace this interpretation of quality, and the argument that no such warranty can be offered, to Milgrom and Roberts (1986a); this interpretation is also used in Shieh (1993).

observing its success or failure does not imply uniform success or failure for all units, though it would permit some updating. Due to fixed costs of shopping, it is likely that the cost-savings associated with buying multiple units on one trip outweigh the value of updating associated with experimentation with individual units. Examples of goods with these features include light bulbs, courses in a restaurant meal, food items such as melons or meats, clothing items, wine, and investment recommendations from a financial advisor.

Alternatively, a downward-sloping demand curve can also be generated by accumulating unit demand functions of consumers with heterogeneous reservation prices. To see this, assume that there is a continuum of heterogeneous consumers of measure  $N$ , each with unit demand, but with reservation prices distributed uniformly on  $[0, V]$ . A consumer with reservation price  $v$  will buy the product if  $v \geq p + (1 - \tilde{\theta})\delta$ . Thus aggregate demand can be written as  $Q(p, \tilde{\theta}) = (N/V)(V - (1 - \tilde{\theta})\delta - p)$ , which is exactly of the same form as that derived for the representative consumer above. Thus a demand model as shown above (either characterizing a representative buyer or an aggregate of individuals) reasonably captures the essence of the problem at hand.

### *The Firm*

The firm of type  $\theta$  manufactures units of the product at a constant unit cost of  $k\theta$ , with  $k > 0$ , so that marginal cost is increasing in  $\theta$ . The gross profits for the firm depend on its true price-cost margin and consumer demand, which depends on perceived quality:

$$\pi(p, \theta, \tilde{\theta}) \equiv (p - k\theta) (\alpha - (1 - \tilde{\theta})\delta - p)/\beta.$$

The firm of type  $\theta$  can affect its perceived quality in two ways, through its disclosure policy and through its price. We model the choice of disclosure policy and price as being simultaneous, once the firm has learned its true type. Further, we assume that disclosure requires an expenditure of the

amount  $D > 0$  and that if the firm elects to disclose its quality then, in keeping with the disclosure literature, the disclosure is truthful so that  $\tilde{\theta} = \theta$ . As an example of this expenditure,  $D$  might reflect the cost of obtaining, from an independent third party, a verification of the firm's type (for instance, this could be achieved by testing a sample of units).<sup>15</sup> Note that we are assuming that it is the firm's type which is verifiable at a cost, not the consumer's satisfaction with an individual unit of the product. If the firm elects not to disclose its quality, consumers will base their perceptions of quality on the posted price.

Finally, the following parameter restrictions will be maintained throughout the paper.

Assumption 1.  $\alpha - (1 - \theta)\delta - k\theta$  is increasing in  $\theta$ .

Assumption 2.  $\alpha - (1 - \underline{\theta})\delta > k\bar{\theta}$ .

Assumption 1 implies that higher-quality products are socially preferred to lower-quality products (even though the high-quality product is more costly to produce). This reduces to the assumption that  $\delta > k$ : the marginal gain in reduced consumer dissatisfaction exceeds the marginal cost of its provision. Assumption 2 implies that there is a price in the interval  $(k\bar{\theta}, \alpha - (1 - \underline{\theta})\delta)$  at which any firm type will have positive demand and a positive price-cost margin, thereby guaranteeing that each type can make positive profits whether they are correctly-perceived or mis-perceived as the worst possible type. Another implication of Assumption 2 is that, while consumers might (in principle) over-pay for a unit, no product type generates negative surplus overall.

### Analysis of Equilibrium Pricing

We first characterize the equilibrium pricing behavior that accompanies a decision to

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<sup>15</sup> As indicated earlier, we assume the firm has access to a competitive market of credible auditors.

disclose quality directly. Next, we characterize equilibrium pricing behavior when the disclosure cost  $D$  is prohibitively high; this involves solving a relatively straightforward signaling model in which price reveals quality. Finally, we lower the disclosure cost to determine which types, if any, will defect from signaling to the outside option of direct disclosure.

Note that any firm type that discloses can (and will) charge its full-information monopoly price (that is, the price it would charge if consumers could observe quality directly). Let  $P^f(\theta)$  denote the full-information monopoly price for a firm producing a product of type  $\theta$ , and let  $\Pi^f(\theta)$  denote the corresponding full-information monopoly profits; then  $P^f(\theta) = (\alpha - (1 - \theta)\delta + k\theta)/2$  and  $\Pi^f(\theta) = (\alpha - (1 - \theta)\delta - k\theta)^2/4\beta$ . Since disclosure is costly, but the pricing game accompanying disclosure is one of full information, the equilibrium price and payoff for a disclosing firm of type  $\theta$  are simply  $P^f(\theta)$  and  $\Pi^f(\theta) - D$  for  $\theta \in [\underline{\theta}, \bar{\theta}]$ .

Now suppose that the disclosure cost  $D$  is prohibitively high, so it is common knowledge that no firm will choose disclosure. Then consumers will try to infer product quality from the price that is being charged. We characterize a separating perfect Bayesian equilibrium in which price serves as a signal of quality.<sup>16</sup> Let  $B(p)$  be the belief function that relates the firm's price to the consumer's perceived quality; thus, if the firm charges the price  $p$ , then it is inferred to have quality  $B(p) \in [\underline{\theta}, \bar{\theta}]$ . A firm charging price  $p$ , with true quality  $\theta$  and perceived quality  $\tilde{\theta} = B(p)$ , obtains a profit of:

$$\pi(p, \theta, B(p)) \equiv (p - k\theta)(\alpha - (1 - B(p))\delta - p)/\beta.$$

In addition to incentive compatibility constraints that ensure separation, a separating perfect

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<sup>16</sup> We focus on separating equilibria in this paper. In two-type models of this sort, refinement using the Intuitive Criterion or D1 (Cho and Kreps, 1987) eliminates pooling equilibria.



Bayesian equilibrium requires that consumers infer correctly the firm's type from its price; that is, the beliefs must be consistent with equilibrium play. This is formalized in the following definition.

Definition 1. Suppose that  $D$  is prohibitively high, so no firm type discloses. A separating perfect Bayesian equilibrium in prices consists of a price function,  $P^s(\theta)$ , and beliefs,  $B^*(p)$ , such that for all  $\theta \in [\underline{\theta}, \bar{\theta}]$ :

$$(i) \quad \pi(P^s(\theta), \theta, \theta) \geq \max_p \pi(p, \theta, B^*(p)); \quad (IC)$$

$$(ii) \quad B^*(P^s(\theta)) = \theta. \quad (\text{Consistency})$$

In a separating equilibrium,  $P^s(\theta)$  must be either everywhere increasing or everywhere decreasing in  $\theta$ . Furthermore, the equilibrium price function  $P^s(\theta)$  must be continuous on  $[\underline{\theta}, \bar{\theta}]$ . This follows because, in a separating equilibrium, the payoff for type  $\theta$  is  $\pi(P^s(\theta), \theta, \theta)$ , which is continuous in all of its arguments, so that if  $P^s(\theta)$  were discontinuous then two arbitrarily-close types would make distinctly different profits, causing one of them to defect and pool with the other. Let  $\underline{P}$  and  $\bar{P}$  denote the minimum and maximum prices in the separating equilibrium. In what follows, we will assume that the beliefs  $B(p)$  are monotonic for all  $p$ , continuous on  $[\underline{P}, \bar{P}]$  and twice differentiable on  $(\underline{P}, \bar{P})$  with  $B'(p) \neq 0$  on the same open interval; we will refer to such beliefs as *regular* beliefs (see the Appendix for a more technical discussion that relaxes these assumptions). Under these assumptions, the function  $\pi(p, \theta, B(p))$  is twice differentiable in  $p$ , and we will be able to represent the equilibrium price function as the solution of a differential equation. Totally differentiating the function  $\pi(p, \theta, B(p))$  with respect to  $p$  yields the first-order condition:

$$d\pi/dp \equiv \pi_p = (\alpha - (1 - B(p))\delta - p) + (p - k\theta)(B'(p)\delta - 1) = 0. \quad (1)$$

We note for future reference that since the price-cost margin,  $(p - k\theta)$ , and the quantity demanded,

$(\alpha - (1 - B(p))\delta - p)$ , are positive, equation (1) implies that  $B'(p)\delta - 1 < 0$ . Substituting  $B'(p) = 1/p'(\theta)$  and  $B(p(\theta)) = \theta$  (consistency of beliefs), equation (1) can be re-written as the following ordinary differential equation:

$$dp/d\theta = \delta(p - \theta k)/(2p - (\alpha - (1 - \theta)\delta) - \theta k). \quad (2)$$

Notice that the numerator is positive, while the denominator is positive if and only if  $p > P^f(\theta) = (\alpha - (1 - \theta)\delta + k\theta)/2$ . Thus, the solution of this ordinary differential equation that maximizes profit is either an increasing function of  $\theta$  that lies above the full-information price function, or a decreasing function of  $\theta$  that lies below the full-information price function. It is straightforward to show that the second-order condition selects the first version: higher quality is associated with a higher price, and quality is signaled with a price that is upward-distorted relative to the full-information price.<sup>17</sup> Furthermore, since  $B'(p) = 1/p'(\theta)$ , then  $B'(p)\delta - 1 < 0$  is equivalent to  $p'(\theta) > \delta$ . The relevant boundary condition for this problem is that there is no need for the lowest type to distort in a separating equilibrium, so that at  $\underline{\theta}$ ,  $P^s(\underline{\theta}) = P^f(\underline{\theta})$ .

The solution  $P^s(\theta)$  to equation (2) that maximizes profit is described (implicitly) by:<sup>18</sup>

$$(\alpha - (1 - \theta)\delta - p)^{(\delta - k)}(2p - k\theta + k(\alpha - \delta)/(\delta - k))^\delta = K, \quad (3)$$

where  $K$  is a constant found by using the boundary condition in equation (3) above. As was

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<sup>17</sup> Recall that  $B'(p)\delta - 1 < 0$ . The second-order condition is that  $d^2\pi/dp^2 \equiv \pi_{pp} = 2(B'(p)\delta - 1) + (p - k\theta)(B''(p)\delta) < 0$ . Moreover, since equation (1) is a differential equation, it must hold for all  $(p, \theta)$ . Thus,  $\pi_{pp}dp + \pi_{p\theta}d\theta = 0$ , which implies that  $dp/d\theta = -\pi_{p\theta}/\pi_{pp} = k(B'(p)\delta - 1)/\pi_{pp}$ . Since both the numerator and denominator are negative, we conclude that  $dp/d\theta > 0$ .

<sup>18</sup> This solution is found by reducing equation (2) first to a homogeneous equation and then to a separable equation via changes in variables, solving the resulting ordinary differential equation, and then using the earlier substitutions to recover the solution to equation (2) (for these general procedures, see, for example, Hildebrand, 1962, p. 37).

discussed in a related version of this problem<sup>19</sup> in Daughety and Reinganum (1995), the solution to the implicit representation (3) is a hyperbola in  $(p, \theta)$ -space; this holds because equation (3) is multiplicatively separable into two linear functions of  $p$  and  $\theta$ . Therefore the relevant portion is strictly increasing and concave. Since this is the unique solution to the differential equation that maximizes profit, we have the following proposition; Figure 1 illustrates the signaling and full-information price functions.

Proposition 1. There is a unique separating perfect Bayesian equilibrium with regular beliefs.

- (i) The lowest-type firm always charges its full-information price:  $P^s(\underline{\theta}) = P^f(\underline{\theta})$ .
- (ii)  $P^s(\theta)$ ,  $\theta \in [\underline{\theta}, \bar{\theta}]$  is the solution to the implicit equation (3) using the boundary condition from part (i).  $P^s(\theta) > P^f(\theta)$  for all  $\theta \in (\underline{\theta}, \bar{\theta}]$  and  $P^s(\theta)$  is strictly increasing and concave on this interval.
- (iii)  $B^*(p) = (P^s)^{-1}(p)$  for  $p \in [P^s(\underline{\theta}), P^s(\bar{\theta})]$ ,  $B^*(p) = \underline{\theta}$  for  $p < P^s(\underline{\theta})$ , and  $B^*(p) = \bar{\theta}$  for  $p > P^s(\bar{\theta})$ .

To see how firm profits in the signaling equilibrium depend upon  $\theta$ , substitute the solution from equation (3) into the profit function, to obtain the reduced-form profits:

$$\Pi^s(\theta) \equiv \pi(P^s(\theta), \theta, B^*(P^s(\theta))) \equiv (P^s(\theta) - k\theta) (\alpha - (1 - B^*(P^s(\theta)))\delta - P^s(\theta))/\beta.$$

Differentiating with respect to  $\theta$ , employing the envelope theorem and the earlier-stated requirement that beliefs are correct in equilibrium, provides the following:

$$d\Pi^s(\theta)/d\theta = -k(\alpha - (1 - \theta)\delta - P^s(\theta))/\beta, \text{ for all } \theta \in [\underline{\theta}, \bar{\theta}]. \quad (4)$$

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<sup>19</sup> There liability was of interest, but the same general differential equation arises, and the structure of the equilibrium signaling function is found in exactly the same manner as is discussed therein.

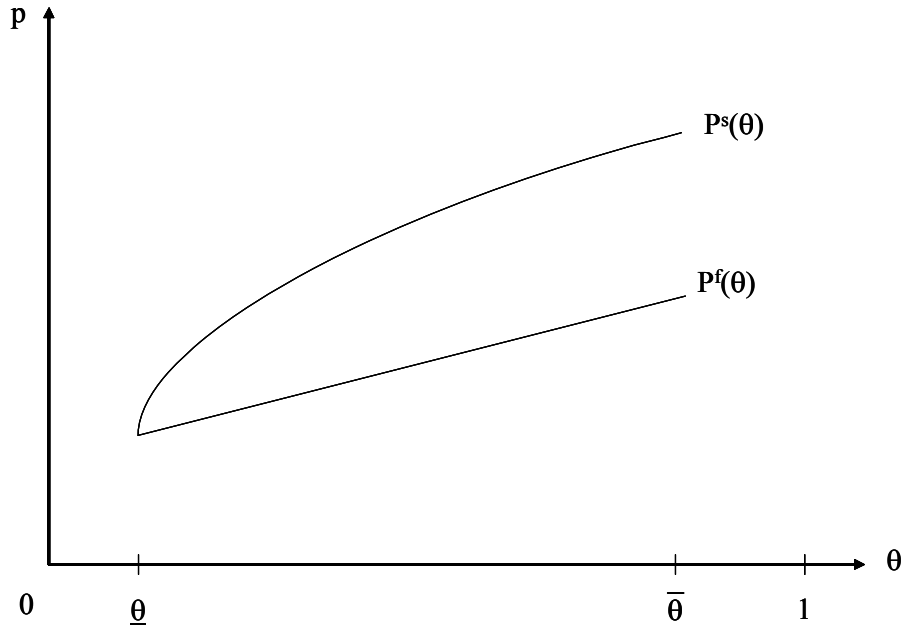


Figure 1: Pricing Under Signaling and Under Full Information

This derivative is strictly negative since  $(\alpha - (1 - \theta)\delta - P^s(\theta))/\beta$  is simply the quantity demanded at price  $P^s(\theta)$  and, by Assumption 2, there is always a price at which any firm type can obtain positive demand (and therefore it does so at its equilibrium price). This means that (in the signaling equilibrium) profits are declining in quality; this is due to the need to distort price.

Proposition 2. Properties of Signaling and Full-Information Profits as a Function of Quality.

- i)  $\Pi^s(\theta)$ , the reduced-form profit function in the signaling equilibrium, is strictly decreasing in  $\theta$  for all  $\theta \in [\underline{\theta}, \bar{\theta}]$ ;
- ii)  $\Pi^f(\theta)$ , the full-information profit function, is strictly increasing in  $\theta$  for all  $\theta \in [\underline{\theta}, \bar{\theta}]$ ;
- iii) since  $P^s(\underline{\theta}) = P^f(\underline{\theta})$ , then  $\Pi^s(\underline{\theta}) = \Pi^f(\underline{\theta})$ , and the difference in profits,  $\Pi^f(\theta) - \Pi^s(\theta)$ , is strictly increasing in  $\theta$  for all  $\theta \in [\underline{\theta}, \bar{\theta}]$ .

*Private Incentives for Voluntarily Disclosure.*

Proposition 2 implies that there exists a range of disclosure costs,  $D$ , such that some types

will signal and others will disclose. That is, for  $D$  such that  $0 < D < \Pi^f(\bar{\theta}) - \Pi^s(\bar{\theta})$ , there is a marginal voluntarily-disclosing type  $\theta^V \in (\underline{\theta}, \bar{\theta})$  with the property that:

$$\Pi^f(\theta) - D \begin{cases} > \\ = \\ < \end{cases} \Pi^s(\theta) \text{ as } \theta \begin{cases} > \\ = \\ < \end{cases} \theta^V.$$

Those types below  $\theta^V$  choose to signal, while those types above  $\theta^V$  choose to disclose. The marginal type,  $\theta^V$ , is indifferent between signaling and disclosing; we take this type as disclosing so as to be consistent with the classical disclosure literature wherein the lowest type discloses when  $D = 0$ .

This produces a pricing function as shown in Figure 2 below. When  $D > \Pi^f(\bar{\theta}) - \Pi^s(\bar{\theta})$ , then signaling is the least-costly means of communicating quality, while if  $D = 0$ , then all types can credibly disclose and are able to avoid using distortionary pricing as a means for signaling quality. On the other hand, when  $0 < D < \Pi^f(\bar{\theta}) - \Pi^s(\bar{\theta})$ , then disclosure is “from above;” that is, the higher quality types, who have much to gain from switching from signaling to disclosing, pay the cost  $D$

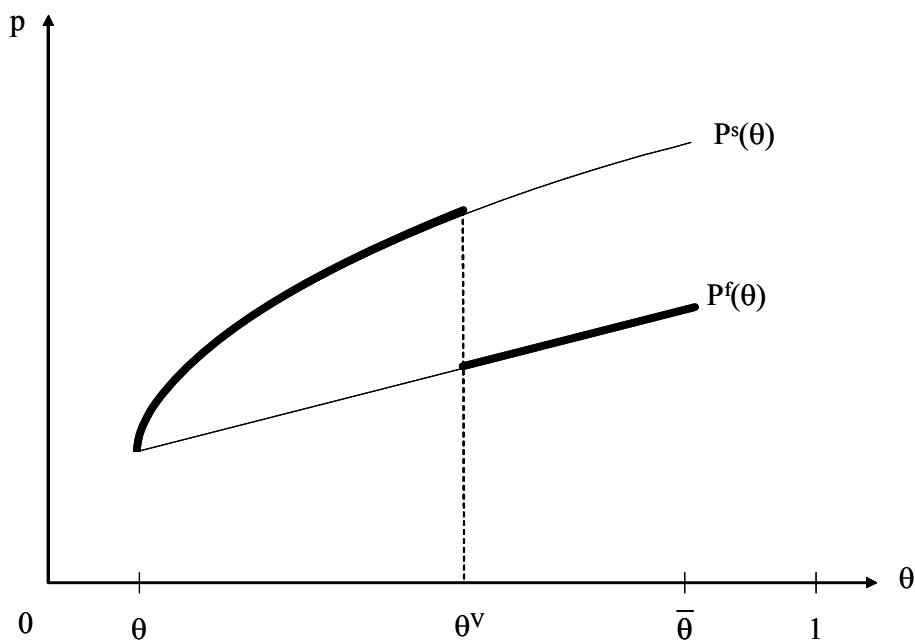


Figure 2: Pricing with an Intermediate Disclosure Cost

and credibly disclose their types. This allows them to lower their prices from the (distorted) monopoly signaling prices to the (undistorted) monopoly full-information prices, thereby increasing their profits. As the gap between the full-information and signaling profits declines, we find the marginal type that is disclosing voluntarily; all types below this marginal type would obtain full information profits (net of disclosure costs) that are below what they can achieve via signaling, so they choose to communicate quality via a distorted price. Notice that non-disclosure accompanied by a price  $p > P^s(\theta^V)$  is an out-of-equilibrium event; we assume that consumers treat such a price as coming from the type  $B^*(p) > \theta^V$  (as described in Proposition 1). That is, the consumer responds as if type  $B^*(p)$ , who should have disclosed in equilibrium, “trembled” and signaled instead. The incentive compatibility constraints guarantee that the resulting profit along the signaling price line would be no greater than what the non-disclosing type would have obtained if it had correctly signaled its type, which (for types above  $\theta^V$ ) is lower than the full-information profit minus the disclosure cost. Thus, the beliefs specified in Proposition 1 are enough to deter this sort of defection.<sup>20</sup>

Denote the overall equilibrium profits incorporating the disclosure-signaling choice as  $\Pi(\theta)$ , so that  $\Pi(\theta) = \Pi^s(\theta)$  for  $\theta \in [\underline{\theta}, \theta^V)$  and  $\Pi(\theta) = \Pi^f(\theta) - D$  for  $\theta \in [\theta^V, \bar{\theta}]$ . By construction,  $\Pi(\theta)$  is continuous and twice differentiable everywhere except at  $\theta^V$ . From equation (4) and from the earlier discussion that  $\delta < dP^s/d\theta$ , it follows that  $\partial^2\Pi^s(\theta)/\partial\theta^2 = -k(\delta - dP^s/d\theta)/\beta > 0$ . It is also straightforward to show that  $\Pi^f(\theta)$  is strictly increasing and convex in  $\theta$ . Thus, Figure 3 illustrates

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<sup>20</sup> Harsher out-of-equilibrium beliefs, that is  $B(p) < B^*(p)$ , would also support this signaling and disclosure equilibrium. Such harsher beliefs would arise if the consumer believes that an out-of-equilibrium price is coming from a type in  $[\underline{\theta}, \theta^V)$ , who made the correct disclosure decision but trembled on the price.

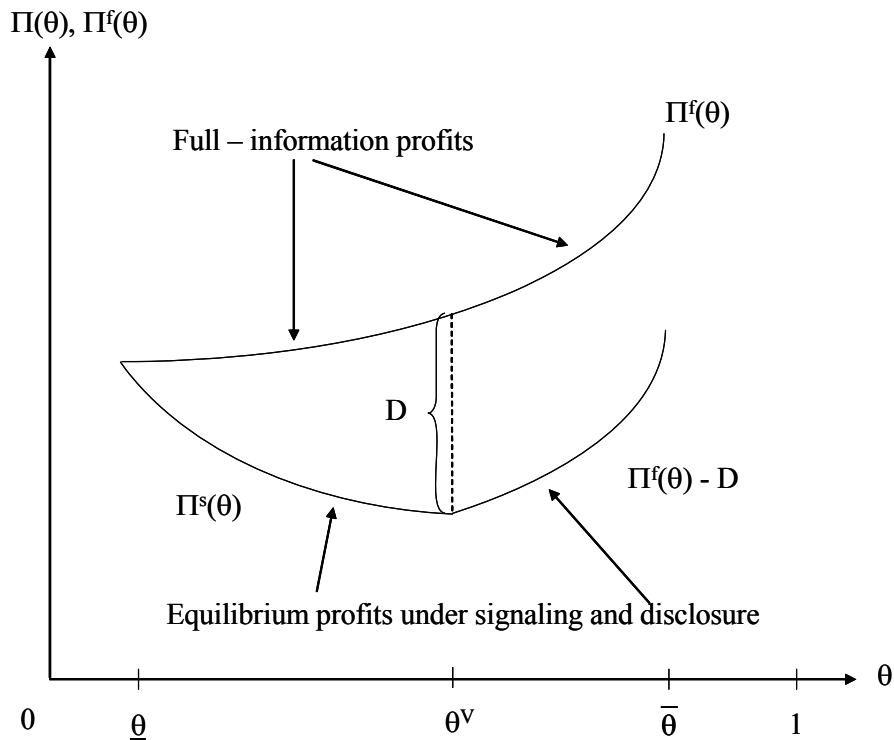


Figure 3: Payoff Relationships with Voluntary Disclosure

the case of greatest interest, wherein  $0 < D < \Pi^f(\bar{\theta}) - \Pi^s(\bar{\theta})$ .

The equilibrium profit function,  $\Pi(\theta)$ , is “U-shaped” (with a kink at the bottom) but a little more can be observed. Let  $D^{\text{mod}} \equiv \Pi^f(\bar{\theta}) - \Pi^f(\underline{\theta})$ , something that is very easy to compute;  $(0, D^{\text{mod}})$  defines a set of “moderate” disclosure costs. If  $0 < D < D^{\text{mod}}$  (that is, if the disclosure cost is moderate in magnitude), then  $\Pi(\bar{\theta}) > \Pi(\underline{\theta})$ , so that the “U-shape” of  $\Pi(\theta)$  involves the right end being higher than the left end; it is better to be a high-quality producer than a low-quality producer, when disclosure is incorporated in the equilibrium. In this case, the firm most prefers to be a high-quality producer, next prefers to be a low-quality producer, and least-prefers to be a producer of middle-quality products. Alternatively, for  $D^{\text{mod}} < D < \Pi^f(\bar{\theta}) - \Pi^s(\bar{\theta})$ , some types disclose, but now  $\Pi(\bar{\theta}) < \Pi(\underline{\theta})$ , so it is better to be a low-quality producer than a high-quality producer.

Thus, the opportunity to disclose at a cost that is moderate ( $D$  such that  $0 < D < D^{\text{mod}}$ ) partly resolves a problem endemic to many price-quality signaling models: since it is the higher-quality types that must distort their strategies the most so as to separate, it is not unusual that the high-quality types have reduced-form profits that are less than those of the low-quality firms. Here, disclosure at moderate cost changes this picture as it results in the highest-quality types achieving payoffs higher than those of the lowest-quality types.

In this paper, the firm's type space  $[\underline{\theta}, \bar{\theta}]$  is given exogenously, but previous work allows us to speculate intelligently about what would happen in an extension wherein the firm first engages in R&D in order to influence its type and then either discloses or signals as discussed above. In Daughety and Reinganum (1995) we model the R&D process as sequential sampling from a distribution defined over  $[\underline{\theta}, \bar{\theta}]$ . That is, a firm pays a sampling cost and draws a quality level from  $[\underline{\theta}, \bar{\theta}]$ ; it then decides whether to stop sampling and produce this quality of product, or pay another sampling cost and take another draw. The firm's problem is one of optimal stopping, and there will be a subset of  $[\underline{\theta}, \bar{\theta}]$  such that the firm will stop if it draws a quality level from within this set, and will otherwise sample again. Assuming the consumer knows the firm's sampling cost then, in equilibrium, the consumer correctly conjectures the stopping set. Therefore the firm's ultimate "type space" is determined endogenously as a subset of  $[\underline{\theta}, \bar{\theta}]$ .

We can speculate about the results of doing this same exercise in the current model, which allows the firm to choose between signaling and disclosure. When disclosure costs are very high, then only signaling will occur; since signaling profits are decreasing in quality, the firm will stop sampling when it obtains a sufficiently low level of quality; the endogenously-determined type space will be of the form  $[\underline{\theta}, \theta_L]$ , with  $\theta_L < \bar{\theta}$ . When disclosure costs are negligible, then almost all firm



types will engage in disclosure; since full-information profits are increasing in quality, the firm will stop sampling when it obtains a sufficiently high level of quality; the endogenously-determined type space will be of the form  $[\theta_H, \bar{\theta}]$ , with  $\theta_H > \underline{\theta}$ . Finally, when disclosure costs are neither very high nor very low, then some firm types will signal and others will disclose, resulting in overall firm profits that are U-shaped. In this case, there will be an intermediate range of disclosure costs for which the firm's optimal stopping set will be the union of two disconnected intervals; the firm will stop sampling either when it draws a sufficiently low quality level or a sufficiently high quality level, but it will reject intermediate levels of quality in favor of sampling again. Here the endogenously-determined type space will be of the form  $[\underline{\theta}, \theta_L] \cup [\theta_H, \bar{\theta}]$ , with  $\underline{\theta} < \theta_L < \theta_H < \bar{\theta}$ .

### 3. Disclosure, Signaling, and Social Efficiency

Since the firm only considers its profit when making a decision to disclose, the decision to disclose or to signal is socially inefficient. To see this we construct total surplus and therefore require consumer's surplus to be added to profits. Let  $CS^i(\theta) \equiv (\alpha - (1 - \theta)\delta - P^i(\theta))^2/2\beta$ ,  $i = f, s$ , be the consumer's surplus enjoyed from a transaction at price  $P^i(\theta)$ ; here, as usual, the superscript  $s$  indicates signaling and the superscript  $f$  indicates full-information. The following proposition is straightforward to verify.

Proposition 3. Properties of Consumer's Surplus as a Function of Quality.

- (i)  $CS^s(\underline{\theta}) = CS^f(\underline{\theta})$ ;
- (ii)  $CS^f(\theta)$  is strictly increasing in  $\theta$ , for  $\underline{\theta} \leq \theta \leq \bar{\theta}$ ;
- (iii)  $CS^s(\theta)$  is strictly decreasing in  $\theta$ , for  $\underline{\theta} \leq \theta \leq \bar{\theta}$ ;
- (iv)  $CS^f(\theta) - CS^s(\theta)$  is strictly increasing in  $\theta$ , for  $\underline{\theta} \leq \theta \leq \bar{\theta}$ .

Item (i) follows directly from the fact that the lowest-quality type always signals type without distorting its price. Item (ii) is straightforward to derive via employing the full-information price function. Item (iii) follows by differentiating  $CS^s(\theta)$  and recalling that  $\delta < dP^s/d\theta$ ; item (iv) follows immediately from items (ii) and (iii).

Now let  $W(\hat{\theta})$  be the total surplus associated with any policy wherein types in  $[\underline{\theta}, \hat{\theta})$  employ signaling while types in  $[\hat{\theta}, \bar{\theta}]$  pay the disclosure cost  $D$ , disclose type, and use the appropriate full-information price; we assume that  $D \in (0, \Pi^f(\bar{\theta}) - \Pi^s(\bar{\theta}))$ , so at least some types would disclose voluntarily.<sup>21</sup> Then total surplus is:

$$W(\hat{\theta}) \equiv \int_A (CS^s(\theta) + \Pi^s(\theta))dG(\theta) + \int_B (CS^f(\theta) + \Pi^f(\theta) - D)dG(\theta), \quad (5)$$

where  $A \equiv [\underline{\theta}, \hat{\theta})$  and  $B \equiv [\hat{\theta}, \bar{\theta}]$ . Notice that:

$$W'(\hat{\theta}) = [CS^s(\hat{\theta}) + \Pi^s(\hat{\theta}) - CS^f(\hat{\theta}) - \Pi^f(\hat{\theta}) + D]g(\hat{\theta}). \quad (6)$$

Observe that the term in brackets is positive at  $\underline{\theta}$  (since it reduces to simply  $D$ ) and negative at  $\theta^V$  (where it reduces to  $CS^s(\theta^V) - CS^f(\theta^V) < 0$ ). Moreover, using Propositions 2 and 3, the term in brackets is decreasing in  $\hat{\theta}$ . Thus there is a unique  $\hat{\theta}$  in the interval  $(\underline{\theta}, \theta^V)$ , which we denote as  $\theta^W$ , which maximizes  $W(\hat{\theta})$  over  $\hat{\theta} \in [\underline{\theta}, \bar{\theta}]$ . In other words, the equilibrium level of disclosure is socially inefficient, as social optimality would entail disclosure by all types in the interval  $[\theta^W, \bar{\theta}]$ , but the firm only discloses for types in the interval  $[\theta^V, \bar{\theta}]$ , where  $\theta^W < \theta^V$ .

### *Mandatory Disclosure*

Figure 2 makes the effect of mandatory disclosure clear: all types disclose, but now those below  $\theta^V$  all bear the cost of disclosure while some (those in  $[\underline{\theta}, \theta^W)$ ) should not. Of course,

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<sup>21</sup> For  $D \in [\Pi^f(\bar{\theta}) - \Pi^s(\bar{\theta}), CS^s(\bar{\theta}) + \Pi^s(\bar{\theta}) - CS^f(\bar{\theta}) - \Pi^f(\bar{\theta})]$  no type would disclose voluntarily but social optimality requires that some types do disclose. Considering this case adds complexity (boundary considerations) without adding insight, so we abstract from it.

mandatory disclosure yields a benefit to consumers, since the price falls to the full-information line from the price-signaling line.

#### 4. Subsidy-augmented Disclosure

As a more-nuanced alternative to mandatory disclosure, we now consider a subsidy scheme that induces voluntary disclosure only by those types for whom disclosure is socially efficient. Furthermore, we will see that this subsidy scheme leaves the firm's overall profits unchanged and therefore results in the same U-shaped overall profits for the firm as indicated in the discussion above, with the highest-quality firms making the highest profits if disclosure costs are moderate.

Consider the following subsidy function:

$$s(\theta; D) = \Pi^s(\theta) - (\Pi^f(\theta) - D) \text{ for } \theta \text{ in } [\theta^W, \theta^V] \text{ and zero elsewhere.}$$

From the discussion in Section 2, it is straightforward to find the following properties of  $s(\theta; D)$ .

Proposition 4. Properties of the Subsidy Function.

- (i)  $s(\theta^W; D) = CS^f(\theta^W) - CS^s(\theta^W) > 0$ ;
- (ii)  $s(\theta^V; D) = 0$ ;
- (iii)  $s(\theta; D)$  is decreasing in  $\theta$  for  $\theta^W \leq \theta < \theta^V$ ;
- (iv)  $s(\theta; D)$  is increasing in  $D$  for  $\theta^W \leq \theta < \theta^V$ .

Item (i) is due to equation (6) where  $W'(\theta^W) = 0$ ; item (ii) is from the definition of  $\theta^V$ ; item (iii) follows from Proposition 2(iii) and item (iv) is straightforward.

Now consider a social planner who chooses to make this subsidy available to any type that discloses. Those types at  $\theta^V$  and above do not actually receive any subsidy, but they voluntarily disclose quality as discussed earlier. Furthermore, types below  $\theta^W$  do not qualify for the subsidy,

so they continue to signal type via their prices. Finally, the subsidy function makes all types in the interval  $[\theta^W, \theta^V]$  indifferent between disclosing and signaling, which we heretofore assumed resulted in disclosure. Thus, under the subsidy function, disclosure and signaling cause all types to be revealed, some via one channel and some via the other channel, but now the efficient channel is always employed voluntarily. This is summarized in Proposition 5.

Proposition 5. Equilibrium Subsidy Payments and Resulting Overall Profits.

(i) The subsidy received by type  $\theta$  is:

- a) 0 for  $\theta \in [\underline{\theta}, \theta^W]$ ;
- b)  $\Pi^s(\theta) - \Pi^f(\theta) + D$  for  $\theta \in [\theta^W, \theta^V]$ ;
- c) 0 for  $\theta \in [\theta^V, \bar{\theta}]$ ;

(ii) Using the subsidy function, the overall equilibrium profits,  $\Pi(\theta)$ , and the disclosure-signaling choices are as follows:

- a)  $\Pi(\theta) = \Pi^s(\theta)$  (signaling) for  $\theta \in [\underline{\theta}, \theta^W]$  ;
- b)  $\Pi(\theta) = \Pi^s(\theta)$  (disclosure) for  $\theta \in [\theta^W, \theta^V]$ ;
- c)  $\Pi(\theta) = \Pi^f(\theta) - D$  (disclosure) for  $\theta \in (\theta^V, \bar{\theta}]$ .

All the gains in surplus from inducing additional disclosure accrue to the consumers. The expected payments under the subsidy policy are:

$$\int_{B1} (s(\theta; D)) dG(\theta),$$

where  $B1 \equiv [\theta^W, \theta^V]$ , which we assume comes from general tax revenues for the economy. The foregoing subsidy function allows for a decentralized scheme, wherein the planner simply announces the policy and any firm that seeks the subsidy must credibly disclose its type.

## 5. Why Voluntary Disclosure is Excessive in the Classical Disclosure Analysis

In Section 3 we found that  $\theta^W < \theta^V$ : voluntary disclosure is socially insufficient. However, to our knowledge, the classical model in the disclosure literature finds that there is too much disclosure by the monopolist. Is this difference between the two analyses a result of the use of pooling as the result of non-disclosure in those models and signaling in our model? We see below that this only partly explains the welfare result; the rest of the explanation appears to emanate from the assumption by the classical models of unit demand with common (and known) reservation price for the product.

We modify the model presented above by assuming that  $k = 0$ , making the cost of production the same for all  $\theta \in [\underline{\theta}, \bar{\theta}]$ . Now if  $D$  is positive but not too large,<sup>22</sup> then pooling results from non-disclosure (as in the classical disclosure analysis): there will be some marginal type,  $\theta^P$ , such that all types less than this type do not disclose and all charge the same price. To make things computable, assume that  $[\underline{\theta}, \bar{\theta}] = [0, 1]$ , and that  $G$ , the distribution over types, is the uniform distribution. Then  $E[\theta | \theta < \theta^P] = \theta^P/2$ : each type in the pool is treated as the mean of the types in the pool. In what follows we will use a superscript  $P$  to denote any pooling results, such as prices or profits. Thus, the types that pool set a price  $P^P(\theta^P) = P^f(\theta^P/2)$  and make profits  $\Pi^P(\theta^P) = \Pi^f(\theta^P/2)$ , so the equilibrium marginal type that voluntarily discloses when the disclosure cost is  $D$ , denoted as  $\theta^{PV}$ , is found by solving  $\Pi^P(\theta^{PV}) = \Pi^f(\theta^{PV}) - D$ . Now the socially efficient marginal type,  $\theta^{PW}$ , is found by maximizing:

$$\int_A (U(P^P(\theta^P), q(P^P(\theta^P), \theta^P), \theta) + \Pi^P(\theta^P)) dG(\theta) + \int_B (CS^f(\theta) + \Pi^f(\theta) - D) dG(\theta),$$

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<sup>22</sup> In order for there to be an interior marginal type, we need  $0 < D < \Pi^f(\bar{\theta}) - \Pi^P(\bar{\theta})$ .

where  $A \equiv [\underline{\theta}, \theta^P)$  and  $B \equiv [\theta^P, \bar{\theta}]$ .<sup>23</sup> Using similar methods to those employed in Section 3 above, it is straightforward to prove the following proposition.

**Proposition 6.** Voluntary v. Socially Efficient Levels of Disclosure for the Pooling Version.

Assume that  $0 \leq D < \Pi^f(1) - \Pi^P(1)$ , so that there is an interior type  $\theta_V^P$ .

a)  $D = 0$  implies that  $\theta^{PV} = \theta^{PW}$  (optimal disclosure if disclosure cost is zero).

b)  $D > 0$  implies that  $\theta^{PV} \gtrless \theta^{PW}$  as  $D \gtrless 2(\alpha - \delta)^2/3\beta$ .

Thus, if  $D$  is “low” ( $0 < D < \min \{2(\alpha - \delta)^2/3\beta, \Pi^f(1) - \Pi^P(1)\}$ ) then there is excessive disclosure; this is because  $\theta^{PV}$  is to the left of  $\theta^{PW}$ . If  $D$  is “high” (that is,  $2(\alpha - \delta)^2/3\beta < D < \Pi^f(1) - \Pi^P(1)$ ) then there will be insufficient disclosure, since now  $\theta^{PV}$  is to the right of  $\theta^{PW}$ . Finally, notice that if  $2(\alpha - \delta)^2/3\beta > \Pi^f(1) - \Pi^P(1)$ , then there are no values of  $D$  that yield insufficient disclosure. Thus, while pooling does imply ranges of disclosure costs that will result in excessive disclosure for the monopolist, for some parameters there are sufficiently high values of  $D$  such that disclosure is insufficient.

However, notice that if  $\alpha$  is increased, then the set of disclosure costs that result in excessive disclosure increases, since both parts of  $\min \{2(\alpha - \delta)^2/3\beta, \Pi^f(1) - \Pi^P(1)\}$  are increasing in  $\alpha$ . It is straightforward to show that the own-price elasticity of demand for our model is  $-p/(\alpha - (1 - \theta)\delta - p)$ , and that increasing  $\alpha$  makes the demand curve more inelastic, so that a more inelastic demand function is associated with an increase in the set of  $D$ -values that result in excessive disclosure. This suggests that the other key assumption of the classical disclosure model that leads to the excessive-disclosure result is that demand is fully inelastic (via the unit-demand assumption).

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<sup>23</sup> Note that  $CS^f(\theta) = U(P^f(\theta), q(P^f(\theta), \theta), \theta)$ .

## 6. Summary and Conclusions

In this paper we model the firm as being able to choose either to signal quality (via price) or to disclose quality (via paying a cost that guarantees credible disclosure; e.g., by employing an outside auditor). If the disclosure cost is sufficiently high the firm will always signal the quality of the product via the price it sets; in the unique separating equilibrium, consumers use the price to infer the quality of the product and buy accordingly. If the cost of disclosure were zero, then all types of the firm would choose to disclose, and the firm would post its type-specific full-information price. Again, consumers would react to the price, knowing the quality of the product, and buy accordingly. We show that full-information profits are increasing in quality, but signaling profits are decreasing in quality, and the lowest possible type's profits are the same in the two informational settings. Thus, the gap between full-information and signaling profits is increasing in quality. Therefore, for disclosure costs that are positive but not prohibitively high, there is a marginal type of firm that is just indifferent between disclosing and signaling; all types below choose to signal and all types above choose to disclose. We then show that the overall profits of the firm (as a function of quality) are first decreasing (due to signaling) and then increasing (due to disclosure), so that these profits are "U-shaped." If disclosure costs are moderate then this means that profits for the firm are highest for the highest-quality type, lower for the lowest-quality type and lower yet for types "in the middle." This, in turn, affects a firm's incentives to invest so as to influence its quality.

Information about quality is always revealed, but this may involve the use by the firm of an inefficient means of revelation. Since the firm's choice between signaling and disclosure is based on its profits under signaling versus the full-information profits net of the disclosure cost, some types will inefficiently choose to signal when social welfare would be maximized by those types

disclosing instead, as the ensuing reduction in price and expansion in output increase overall surplus.

We provide a subsidy scheme that addresses this inefficiency, with the subsidy generated from the overall tax base. The subsidy function specifies a payment based on the firm having elected to pay the disclosure cost and disclose type; it is made available to all types of firm but is positive only for those who would otherwise inefficiently choose to signal. This subsidy scheme results in each type of firm choosing the socially-efficient channel through which to communicate quality to consumers and maintains the same overall profits as would arise without the subsidy.

Finally, our model finds that voluntary disclosure is socially insufficient while the classical analysis finds that disclosure is socially excessive. We modify our model to examine this contrast by making production cost independent of quality, which means that non-disclosure involves pooling. We characterize the disclosure/non-disclosure decision again and find that now there is a range of the disclosure cost wherein disclosure is socially excessive, and that this range increases as the demand function becomes more inelastic. However, there do exist values of the parameters  $\alpha$  and  $\delta$ , and the disclosure cost, for which voluntary disclosure is insufficient.

Our model allows only one instrument through which the firm could signal quality: price. As indicated in Section 1, a number of other signaling instruments have been investigated, sometimes in lieu of price but sometimes in conjunction with price (see, for example, Milgrom and Roberts, 1986a, wherein advertising augments price as a signal of quality). Expanding the model to allow for a richer strategy space in this sense would likely lead to a relaxation of Assumption 2 and may readily improve the profits of a firm engaged in signaling, thereby increasing the portion of the overall parameter space wherein a separating equilibrium can exist. Note also that strategies that might augment price and result in increased signaling profits will result in an increase in the



marginal disclosing type ( $\theta^V$ ).

Our model considers a monopolist; the extension to multiple firms is important but quite complex. The complexity arises due to the fact that the incentive compatibility constraints for each firm also are best response functions with respect to the expected price of the firm's rival (see Daughety and Reinganum, 2007 and forthcoming, 2008a, for examples in the pure signaling context with two types for each firm). This means that the price-signaling function also must satisfy a fixed-point property (so that best responses yield an equilibrium), which makes the analysis considerably more difficult. In the case at hand, one would further need to allow each firm to choose whether to signal or to disclose, and this would also influence the overall pricing equilibrium. The payoff to this exercise would be a better understanding of equilibrium pricing and profits in an oligopoly setting when both signaling and disclosure are possible firm strategies.

### Appendix

Claim. Assume that a separating equilibrium exists with beliefs  $B(p)$ , where  $B(p)$  is monotonic for prices not in  $[\underline{P}, \bar{P}]$ . Then the separating equilibrium beliefs satisfy the rest of the regularity requirements; that is,  $B(p)$  is monotonic for all  $p$ , continuous on  $[\underline{P}, \bar{P}]$  and twice differentiable on  $(\underline{P}, \bar{P})$  with  $B'(p) \neq 0$  on the same open interval.

Proof. We argued in the text that, in a separating equilibrium,  $P^s(\theta)$  must be either everywhere increasing or everywhere decreasing in  $\theta$ , and  $P^s(\theta)$  must be continuous on  $[\underline{\theta}, \bar{\theta}]$ . Then the function  $P^s(\theta)$  on  $[\underline{\theta}, \bar{\theta}]$  is invertible to obtain  $B(p)$  on  $[\underline{P}, \bar{P}]$ , and the resulting  $B(p)$  is continuous and monotonic on  $[\underline{P}, \bar{P}]$ . Therefore  $B(p)$  is differentiable almost everywhere on  $[\underline{P}, \bar{P}]$ , as is  $\pi(p, \theta, B(p))$ . Totally differentiating the function  $\pi(p, \theta, B(p))$  with respect to  $p$  yields the first-order condition that appears as equation (1) in the text:  $(\alpha - (1 - B(p))\delta - p) + (p - k\theta)(B'(p)\delta - 1) = 0$ . Substituting  $\theta = B(p)$  (consistency of beliefs), equation (1) can be re-written as an ordinary differential equation,  $(\alpha - (1 - B(p))\delta - p) + (p - kB(p))(B'(p)\delta - 1) = 0$ , which holds almost everywhere on  $[\underline{P}, \bar{P}]$  (that is, wherever  $B(p)$  is differentiable). The solution to this equation is given by

$$(\alpha - (1 - B)\delta - p)^{(\delta - k)}(2p - kB + k(\alpha - \delta)/(\delta - k))^\delta = K, \quad (3')$$

where  $K$  is a constant found by using the appropriate boundary condition in equation (3') above. Notice that equation (3') is a well-behaved function of  $p$  and  $B$ , so the two candidate belief functions  $B(p)$  that it defines implicitly (one increasing in  $p$  and one decreasing in  $p$ ) are twice differentiable on  $(\underline{P}, \bar{P})$  with  $B'(p) \neq 0$  on the same open interval. By an argument analogous to that in footnote 17, the candidate which is increasing in  $p$  provides the separating equilibrium beliefs, and its inverse provides the separating equilibrium price function. Thus, the relevant boundary condition is  $B(\underline{P}) = \underline{\theta}$ . Therefore, the only regularity assumption on beliefs that does not follow from the hypothesis of a separating equilibrium is that  $B(p)$  is monotonic outside the equilibrium price interval  $[\underline{P}, \bar{P}]$ . Even this is not strictly necessary, but the resulting out-of-equilibrium beliefs are sufficient to support the separating equilibrium. QED.

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