

Inderst and Ottaviani
“How (not) to Pay for Advice”

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Agent incentives

What do agents do?

- Work hard to figure out if product is well suited to consumer
- Recommend one product or other on the basis of information that they've generated

Trade-offs involved

- In recommendation: reputational cost associated with recommending a bad match against higher commission on one of the products
- In information gathering: *useful* information (how useful depends on recommendation strategy) against cost of information gathering

Moving around incentives

- Consumer has no ability to influence incentives
 - Fee is ex-ante sunk cost
 - In principle reputation cost?
 - Different notion of naivety: don't know they could have got better?
Policy recommendation teach them so they know to complain?
- Seller can influence incentives through commission
 - No “first best” solution since only one lever (commission) affects **both** recommendation incentives and effort incentives
 - Fixed component transfers surplus but has no affect on incentives
- If all consumers sophisticated then second best outcome
 - Surplus transferred through fixed fees
 - So just maximize surplus (as a planner would)

Naïve consumers

- Naïve consumers believe that agents recommend if and only if match is expected to be good and only effort incentives come from avoiding the reputation cost of recommending a bad match
- More optimistic than they should be about a recommended product
- So higher surplus for firm+agent through higher commission for agent (which in turn requires higher price and so also lower fee to keep customer interested as will never buy product unless going through agent)

Results

- Naïve consumer end up suffering for their naivety
- Prices higher than would otherwise be, and fee at zero

Discussion

- Effect of competition?
 - Among firms
 - Among agents
- What affects “reputation” cost?
 - Weak advice?
 - Another policy tool
- Consumer information gathering
 - Real incentive role for fee contingent only on completion?
 - More distinction between weak/strong advice?
 - Less stark view of naivety?
 - Can even allow for a continuum of naivety in the extent to which agent’s signal shifts your prior?

Bottom line

- First order question of considerable interest to policy makers that has not been much explored (though see also Inderst and Ottaviana 2008a, b and 2009!)
- Useful and clear identification of some key themes and forces