

Abstract (long) of  
**“Cheap Talk with Outside Options.”**  
(with Kaiwen Leong)

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It is about how the presence of an outside option affects communications via cheap talk.

Cheap Talk is a particular type of communication game formalized by Crawford and Sobel in 1982. <sup>(\*)</sup> Cheap Talk is widely applied to many fields such as managers’ organizational design and policy makers’ selection of their experts. The model’s main message is that conflict of interest always hurts communication. My paper adds an outside option to the standard cheap talk model; this simple and realistic assumption leads to a different conclusion, namely that conflict of interest can sometimes facilitate communication.

I will illustrate my conclusion by using an example. Consider a product manager who is going to decide whether to start a new product line or to continue with business as usual. If the manager starts a new product line, he will also have to decide how much he will invest in it. There is an expert on the new business. The expert knows technology which determines the firm’s optimal investment (or a state); but the manager does not have such information. In other words, the expert knows each player’s gain from every potential investment decision. On the other hand, each player’s gain from business as usual is fixed (or state independent) and already known to both players. So, the manager asks the expert for advice about his optimal investment before making a decision.

The expert’s optimal investment is larger than the manager’s optimal investment by fixed amount, say positive real number  $b$ , which measures conflicts of interest. For example, the manager’s only goal is to maximize the firm’s profit. But, the expert benefits not only from the firm’s profit but also from being involved in a large project for his future career concern.

How does the conflict  $b$  affect quality of communication? My paper suggests that if the manager definitely starts a new product line, the smaller conflict  $b$  is better for communication. But, interestingly, if there is the possibility that the manager selects business as usual without starting a new product line, the larger conflict sometimes results in more informative communication. The mechanism is as follows.

In the first case which is equivalent to the standard cheap talk model, the manager will definitely make a new investment. So, the expert always has an incentive to deviate upward and recommend a larger investment. And, conflicts exacerbate the upward deviation. Thus, conflicts always hurt communication.

In the second case, the business as usual is a realistic and profitable option for the manager. The manager

does not want to make a large investment, for example, because it is risky. The manager selects business as usual if the expert reports that the manager's optimal investment is very large. But, business as usual may be bad for the expert. Interestingly, this effectively introduces a new form of the expert's potential deviation, which is not observed in the standard cheap talk model. The expert may want to deviate downward. Then, the expert is affected by two types of potential deviation, downward deviation and upward deviation. In other words, when the manager's optimal investment is small, the expert may want to deviate upward to increase investment. On the other hand, when the manager's optimal investment is large, the expert may want to deviate downward to avoid business as usual. Conflicts of interest exacerbate the upward deviation but also mitigate the downward deviation. The relation between conflicts of interest and informativeness of communication is not monotonic any more.

Therefore, in the presence of an outside option, my paper comes to a different conclusion from Crawford and Sobel's, namely that conflict of interest can sometimes facilitate communication.

(\*1) In the cheap talk model, there is a perfectly informed speaker and an uninformed decision maker. The decision maker asks the speaker for advice before making a decision. The decision affects both players' payoffs. The speaker's message may or may not be true, does not bind the decision maker's decision and does not directly affect either player's payoffs. So, the talk is cheap.