Seller Information about Consumer Naivete Lowers Welfare

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Abstract

Hypothesizing that recent improvements in information about consumers likely allows (or will soon allow) firms to better distinguish naive and sophisticated consumers, we analyze the welfare effects of such a development using a reduced-form contracting model in which firms can introduce fees that naive consumers ignore. Our formulation subsumes many markets that have been invoked as potentially conducive to consumer naivete, including those for credit, printers, hotels, gambling, and mobile phones. When firms know more about whether a consumer is naive, they respond by increasing the distortionary exploitation of consumers more likely to be naive and decreasing the distortionary exploitation of consumers more likely to be sophisticated. We show that—because an increase in a pre-existing distortion is more harmful than a similar decrease is beneficial—under weak conditions information about consumer naivete lowers social welfare. In addition, we derive conditions under which information about consumer naivete benefits sophisticated or naive consumers; in many cases, however, such information harms both types. We also investigate a privacy regime in which firms need a consumer's consent to access naivete-relevant information. We establish that in equilibrium consumers consent for free, and sophisticated consumers' welfare is higher while naive consumers' welfare is lower than when no consent is required.