

How firms take advantage of naive consumers with hyperbolic discounting

- hyperbolic discounting leads to particular “efficient contracts”
- naivete leads to some inefficiency
- particular contract structures predicted

- is there naivete? do firms structure themselves to take advantage of it?
- surely – as anyone has purchased a car can attest
- many people make small mistakes, some people make large mistakes – lots of evidence
- models of quantal response equilibrium, self-confirming, etc.
- this is a model of homogeneous naivete that discards the traditional tools of economic theory

Larger problems in conventional theory

- risk in aversion in the small and large
- common knowledge (quantal response? self-confirming?)
- preferences too dependent on current endowment (market frictions? habit formation?)

can model “errors” and naivete using private information

- firm gets signal of consumer preferences not shared by consumer
- runs into problems with common knowledge
- quantal response equilibrium? self-confirming equilibrium?

This paper deals with the “small anomaly in markets” problem

- providing “rational explanations” of these anomalies used to be very popular in the Chicago crowd
- Barro and Romer model of ski-lifts

some key explanatory elements missing here:

- uncertainty, esp. about future preferences
- externalities
- private information
- costly information

importance of *quantitative* explanations

Some statements the Chicago crowd might not like

- “deviation from marginal cost pricing...reduce firm profits when consumers are time consistent” (p. 4)

monopolies generally price above marginal cost

- “given the competitiveness of the industry, we expect the clubs to offer contracts that are approximately profit maximizing”

How much of a puzzle is there?

- the underlying evidence on hyperbolic discounting is explained quite well by the fact the present is more certain than the future (Villaverde and Mukherji [2001]) who also give experimental evidence against the desire for advance commitment
- positive externalities: frequent health club users look healthier attracting other people to the club...so they should be discriminated in favor of
- “Customers who want to quit are typically required to mail a cancellation letter or to cancel in person, even though firms could make cancellation as easy as sending an email or giving a phone call;” cancellation is expensive for the firm (paper work)...so regardless of consumer preferences they would want to discourage it
- UCLA withholding – how does UCLA benefit?
- need for naive consumers to explain rising unit costs? consistent with introductory pricing under uncertainty; fixed cost of switching

Block pricing

- internet connections, for example
- usage fees are very unpopular with consumers; very popular with firms
- fixed fee reduces uncertainty of payment and the transaction cost of worrying about how much it costs to be using the system
- problem of fraud?
- similarly renewal cost may have to do primarily with the fact it is costly to reconsider contracts all the time

Welfare

- not strongly pushed in the paper
- welfare calculated under the assumption that consumers are mistaken about the utility they will receive – not an obvious choice
- If people are different people at different points in time, it is hard to see how we can use a particular set of welfare weights to compare their utility
- problem of “expert” groups deciding what is best for other people – “the road to hell is paved with good intentions...”