

Exploiting Naive Consumers with Limited Willpower

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This paper studies the optimal contract with consumers who has only limited willpower so cannot always stick with the initially desirable alternative when facing a tempting option. Assuming that consumers are unaware of their dynamic inconsistent choice at the time of committing to interact with the monopolist, we characterize the optimal menu for the monopolist. Unless the consumer's willpower is very strong, the optimal menu includes three options, (i) one he believes he will choose, (ii) one that is less desirable but tempting and prevents him from choosing the first alternative and (iii) one that is between the first two alternatives in terms of both desirability and temptation. Our result illustrates that the monopolist designs a contract that actually induces the compromise effect due to the limited willpower.

Key words: Willpower, Bounded Rationality, Contract, Compromise effect, Dynamic Inconsistency

The latest version the paper can be downloaded from:
<http://www-personal.umich.edu/~ndaisuke/papers.html>