Naivete-Based Discrimination*

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March 4, 2015

Abstract

We initiate the study of naivete-based discrimination, the practice of conditioning offers on external information about a consumer's naivete. We identify a broad class of situations in which such discrimination typically lowers social welfare. In our primary example, a credit market with time-inconsistent borrowers, improving lenders' information about borrowers' short-run taste for immediate gratification (β) or naivete about this taste ($\hat{\beta}$) always lowers welfare. To take advantage of non-sophisticated borrowers' underestimation of their willingness to pay interest on a loan, firms raise lending above optimal. Information about consumers leads firms to (inefficiently) differentiate the amount of lending according to naivete, while (also inefficiently) raising total lending. Because the overlending distortion is the same whether or not firms observe beliefs, information about a consumer's beliefs has at most distributional implications, but information about naivete given beliefs always strictly decreases total welfare, while information about tastes is neither necessary nor sufficient to decrease welfare. We show that the logic of our results extends to other markets, such as bank accounts or mobile phones, where consumer naivete may play a role and the distortion from exploiting naivete falls on both types of consumers. We also point out important settings outside this class, and identify the effect of information about naivete in those cases.

Keywords: sophistication, naivete, first-degree price discrimination, third-degree price discrimination

*We thank Dan Benjamin, Fabian Herweg, Michael Grubb, and Takeshi Murooka, as well as numerous seminar and conference audiences for helpful comments. Financial support from the European Research Council (Starting Grant #313341) is also gratefully acknowledged. Part of the research on this project was carried out while Heidhues visited the Institute for Advanced Studies at CEU, whose hospitality he gratefully acknowledges.