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Contract Design and Self-Control: Theory and Evidence

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Abstract

How do rational firms respond to consumer biases? In this paper we analyze the profit-maximizing contract design of firms if consumers have time-

inconsistent preferences and are partially naive about it. We consider markets for two types of goods: goods with immediate costs and delayed benefits (investment goods) such as health club attendance, and goods with immediate benefits and delayed costs (leisure goods) such as credit card-financed consumption. We establish three features of the profit-maximizing contract design with partially naive time-inconsistent consumers. First, firms price investment goods below marginal cost. Second, firms price leisure goods above marginal cost. Third, for all types of goods firms introduce switching costs and charge back-loaded fees. The contractual design targets consumer misperception of future consumption and underestimation of the renewal probability. The predictions of the theory match the empirical contract design in the credit card, gambling, health club, life insurance, mail order, mobile phone, and vacation time-sharing industries. We also show that time inconsistency has adverse effects on consumer welfare only if consumers are naive.

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