Author's Accepted Manuscript

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PII: S1090-9443(15)00030-7
DOI: http://dx.doi.org/10.1016/j.rie.2015.05.002
Reference: YREEC622

To appear in: *Research in Economics*

Received date: 24 November 2014
Revised date: 14 May 2015
Accepted date: 18 May 2015

Cite this article as: Oktay Sürücü, Welfare Improving Discrimination based on Cognitive Limitations, *Research in Economics,* http://dx.doi.org/10.1016/j.rie.2015.05.002

Welfare Improving Discrimination based on Cognitive Limitations

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Abstract

This paper is concerned with the situation in which a profit-maximizing monopolist faces consumers that are heterogeneous in two dimensions: their taste for quality and their level of cognitive limitations. The behavioral phenomenon considered here is the attraction effect when choices are made across categories. Using the standard second-degree price discrimination model, the optimal menu of contracts is characterized. Discriminating consumers based on their taste and cognitive limitations allows the monopolist to partially relax the incentive compatibility constraints. The decrease in distortion caused by the reduction of information rents moves the economy towards the efficient outcome. The optimal contract does not only increase the monopolist's profit but also improves the aggregate welfare of the economy. Furthermore, it provides a possible explanation for the apparent puzzle why one may observe that the same quality products are priced differently under different labels.

Keywords: bounded rationality, attraction effect, contract design, welfare

JEL Classification Numbers: D03, D42, D60, D82, D86.

1. Introduction

The growing literature initiated by Amos Tversky, Daniel Kahneman, and their collaborators presents a large body of experimental evidence demonstrating that human beings depart systematically from rationality due to their cognitive imperfections. The prevalence of behavioral anomalies has motivated the emergence of a literature strand that integrates insights gained from experimental studies into economical models. The present paper contributes to this body of work by exploring

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[1] I am most grateful to Federico Etro and two anonymous referees for helping me improve this paper. I also thank Marco LiCalzi for helpful comments.