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# Informing Consumers about their own Preferences\*

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## Abstract

We analyze a model of monopolistic price discrimination where only some consumers are originally sufficiently informed about their preferences, e.g., about their future demand for a utility such as electricity or telecommunication. When more consumers become informed, we show that this benefits also those consumers who remain uninformed, as it reduces the firm's incentives to extract information rent. By reducing the costs of information acquisition or forcing firms to supply consumers with the respective information about past usage, policy can further improve welfare, as contracts become more efficient. The last observation stands in contrast to earlier findings by Crémer and Khalil (American Economic Review 1992), where all consumers are uninformed.

**Keywords:** Nonlinear pricing; price discrimination; monopolistic screening; information acquisition.

**JEL-classification:** D42, D82, L12

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# 1 Introduction

We consider subscribers' choice between different service plans when at least some of them do not yet know their future demand or can only learn it at a cost. Consumers may be choosing between different fixed or mobile telephone call plans or between contracts for the supply of electricity or other utilities. At the time that consumers choose a particular contract, some may be well informed about their future usage. For other consumers, future demand may be less predictable; for example, they may have little recollection of their past usage of the service, or they may be subscribing for the first time.

Our first step in the analysis is to solve for the optimal contracts offered by a monopolistic provider. If all consumers were *ex-ante* uninformed about their future demand, a monopolist's optimal menu would specify first-best consumption levels and would allow the firm to extract all consumer rent. As a second benchmark, if initially all consumers knew their demand type, the consumption level of consumers with low demand would be distorted downwards, provided that low-type consumers were served at all—this is the standard screening benchmark. When both informed and uninformed consumers are present, as in our model, we find that contracts for all low-demand consumers are (weakly) more distorted compared to these two benchmark cases: Contracts for uninformed low-demand consumers are distorted compared to the efficient outcome where all consumers are uninformed; and contracts for informed low-demand consumers are more distorted compared to the already distorted outcome in the standard screening benchmark.

The fact that some consumers are perfectly informed about their consumption, while others are not, gives rise to different contractual forms that are signed in equilibrium. Uninformed consumers still face uncertainty about their future demand, and the respective tariff is more flexible in this sense.<sup>1</sup> Our simple setup with only two (low- and high-valuation) demand types, allows us to undertake various comparative statics analyses. In particular, we find that uninformed consumers benefit from the presence of informed consumers, even though information helps to predict only a consumer's own demand.<sup>2</sup> This has interesting policy implications.

Policies intended to assist consumers in making better-informed decisions may benefit *all* consumers, including those who stay uninformed. This holds even though such information relates only to a consumer's own demand schedule. Interestingly, an increase in the fraction of informed consumers *always* benefits uninformed consumers in our model. When the fraction of informed consumers increases, we show that the firm's optimal offer allows uninformed consumers to extract a higher "information rent." As with all our results, the impact of policy is thus tightly related to the presence of market power, which the firm uses to make discriminatory ("screening") offers to uninformed and informed consumers alike.

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<sup>1</sup>For evidence that firms offer a variety of subscription plans, offering different degrees of flexibility, see, for instance, Lambrecht et al. (2007) or Narayanan et al. (2007).

<sup>2</sup>The fact that some consumers are perfectly informed about their consumption allows us also to distinguish between "simple tariffs" and "flexible tariffs," where the latter allow consumers to adjust the consumed quantity. As evidence from the marketing literature shows (e.g., Lambrecht et al. 2007; Narayanan et al. 2007), for different subscription services, firms' range of offers seems to indeed take into account that only some consumers sufficiently value such flexibility.

With the deregulation of many utilities, including fixed-line telephony, electricity, or gas, public agencies have set up internet services to assist households with their decision making. For instance, they may provide “calculators” that force households to key in an expected demand profile and, thereby, calculate their expected bill for a given tariff. Moreover, consumers may become better informed about their *future* consumption pattern when they have more accurate and readily available information about their *past* consumption. When firms have an obligation to provide such information to their past consumers, this should also make more consumers informed.

Our results show how such policies benefit even consumers who do not take advantage and remain uninformed. However, we show as well that, at least in our context of a model of monopolistic screening, more information and, thereby, a lower fraction of uninformed consumers may lead to lower welfare, though it benefits consumers. Note also that the considered policy may not only increase the fraction of consumers who are (better) informed about their own preferences and future consumption profiles, but that it also reduces the costs of becoming informed for consumers who ultimately may then decide against spending the respective time and effort to do so. We analyze this channel in the second part of the paper.

If costs of information acquisition are low, this additionally constrains the firm’s offers. Intuitively, as costs become smaller, contracts designed for informed and uninformed consumers become more similar. Our analysis with the possibility of endogenous information acquisition follows the seminal paper by Crémer and Khalil (1992),<sup>3</sup> though there all consumers are ex-ante homogeneous. As we show, the simultaneous presence of both informed and uninformed consumers leads to strikingly different welfare results. To see this, suppose first that there were only uninformed consumers, as in Crémer and Khalil (1992). Then, welfare is strictly lower as costs of information acquisition decrease, given that contracts are then less efficient. While results are generally ambiguous in our model, where consumers differ in their information, for a (standard) linear-quadratic functional specification, which allows us to obtain explicit solutions, we show that the opposite holds: Welfare is higher as costs of information acquisition decrease. Hence, even though the (potentially “subsidized”) option of information acquisition may not be used by some consumers in equilibrium, we find that the constraint that it imposes on the firm’s price discriminating offer may enhance welfare. This observation further strenghtens the case for policy interference aimed at making consumers more informed about their own preferences and future demand.

Taken together, our model thus reveals two channels through which public policy that aims to increase consumer knowledge can enhance consumer surplus or welfare in the presence of a service provider who can practice price discrimination. If such a policy turns uninformed into informed consumers, then this increases the “information rent” that these

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<sup>3</sup>See, also, Matthews and Persico (2007), where, through its refund policy, the firm can affect consumers’ incentives to ex-ante acquire information. Also compare, more generally, the literature on mechanism design with endogenous information acquisition, as surveyed in Bergemann and Välimäki (2006). Finally, there is also a strand of the literature in which the *principal* (i.e., the firm in our model) has information or can, at a cost, acquire information about the characteristics of the good and must decide whether to share this with the agents (i.e., the consumers in our model). See, in particular, Lewis and Sappington (1994) and Johnson and Myatt (2006).

consumers can realize (in expectation) and, as we show, it can also raise the utility of those consumers who are still uninformed. In addition, even if (some) consumers do not become informed but could do so at lower cost after policy intervention, this can make contracts more efficient.

This paper contributes to the growing literature on sequential screening models. Perhaps the most distinctive feature of our setting compared to recent approaches such as Courty and Li (2000) or Miravete (2005) is the specification of informed and uninformed consumers. This together with our restriction to only low- and high-type demand (cf. also the discussion in Section 2) allows us to conduct a comparative analysis for policy evaluation.<sup>4</sup>

While in Lewis and Sappington (1997) there are also both informed and uninformed agents, the focus there is on how to get the informed agent to exert (more) effort into acquiring information that is valuable to the principal. Somewhat more closely related, in Dai, Lewis, and Lopomo (2006), agents differ initially in the precision with which they can forecast their costs of production. In our setting, however, the better information that some agents have *ex-ante* also creates *ex-ante* heterogeneity in a second dimension: low- and high-demand types. Consequently, in our model, offers to both informed and uninformed agents will be distorted, while in their model, only the menu offered to the less knowledgeable agent is inefficient.

Finally, there is also a small but growing literature that combines demand uncertainty with non-standard utilities incorporating overconfidence, procrastination, or projection bias. In particular, in Grubb (2009) consumers systematically underestimate the variability of their future demand.<sup>5</sup> His main objective is to explain the three-part tariff structure that seems to prevail, in particular, in some contracts for mobile telephone network usage.

The rest of this paper is organized as follows. In Section 2, we set up the model. Section 3 contains the analysis with informed and uninformed consumers who may have low or high demand. Section 4 provides some results on comparative statics, while Section 5 extends the analysis by allowing uninformed consumers to acquire information, albeit at a cost, before choosing from the offered contracts. Section 6 concludes. All proofs are relegated to the Appendix.

## 2 The Model

Consider a monopolistic firm offering a long-term service contract to consumers. The firm has constant marginal cost  $\tilde{c}$ . A consumer of (real-valued) demand type  $\theta$ , which can be

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<sup>4</sup>Though Courty and Li (2000) consider only single-unit purchases, Rochet and Stole (2003) have shown how their results can be re-interpreted with multi-unit purchases, as well as with decreasing marginal values. Earlier papers include Baron and Besanko (1984), Riordan and Sappington (1987), and Miravete (1996, 2005). Miravete (1996) is of particular interest, as this paper also considers non-linear pricing: Consumers have *ex-ante* knowledge about their demand function, which together with some additional “shock” generates their willingness to pay at the time of consumption. Also Clay et al. (1992) introduce *ex-ante* uncertainty into a model of price discrimination, though their analysis is restricted to a comparison of two particular tariff structures.

<sup>5</sup>In Eliaz and Spiegler (2008) and Uthemann (2005), consumers have biased priors about having low or high demand later.

low or high with  $0 < \theta_l < \theta_h$ , derives gross utility  $\theta\tilde{u}(q)$  from consuming  $q$  "units" (e.g., minutes) of the particular service. Here, the continuously differentiable function  $\tilde{u}(q)$  is assumed to be strictly increasing and concave with  $\tilde{u}(0) = 0$ . It is convenient to additionally invoke the (standard) boundary conditions  $\lim_{q \downarrow 0} \tilde{u}'(q) = \infty$  and  $\lim_{q \rightarrow \infty} \tilde{u}'(q) = 0$ , which together imply that the first-best level of service will be both finite and strictly positive for any choice  $\theta > 0$  and  $\tilde{c}$ . We also suppose that  $\tilde{u}$  is twice continuously differentiable.

Our choice of specification derives from the main motivating examples in the Introduction, where the assumption of constant marginal cost is probably realistic. Before describing the model, however, it is useful to rephrase the consumer's choice problem. Instead of choosing quantity  $q$ , we suppose that the consumer selects a certain level of gross "base utility"  $u = \tilde{u}(q)$ . Since  $\tilde{u}$  can be inverted, we define  $C(u) := \tilde{c}\tilde{u}^{-1}(u) = \tilde{c}q$ . That is, to generate consumer utility of  $\theta u$ , the firm must incur the cost  $C(u)$ . The invoked properties of  $\tilde{u}(q)$  imply that  $C(u)$  is strictly increasing and strictly convex with  $C'(0) = \lim_{u \downarrow 0} C'(u) = 0$ . Denote total surplus by  $s(u; \theta) := \theta u - C(u)$ , which for  $\theta_i$  is uniquely maximized by some bounded and strictly positive value  $u_i^{FB}$ ,  $i = h, l$ . Note that  $0 < u_l^{FB} < u_h^{FB}$ .

Suppose that there is mass one of consumers. The *ex-ante* probability with which an individual consumer ultimately has high demand is given by  $\mu \in (0, 1)$ . However, only the fraction  $\pi$  of consumers initially know their type. Later, at the stage of consumption, all consumers become informed about their type. (In Section 5, an uninformed consumer may also learn his type early, albeit only at a cost.) A consumer's knowledge is his private information.

Without loss of generality, we can restrict consideration to the following set of offers. For *ex-Ante* informed consumers, the firm designates, at most, two different consumption profiles  $u_{A,i}$  and respective transfers  $t_{A,i}$ , where  $i = l, h$ . For only *ex-Post* informed consumers, the firm specifies, instead, a menu of two options:  $\{(u_{P,i}, t_{P,i})\}_{i=l,h}$ . Each consumer decides which, if any, contract to sign. Note that while contracts  $(u_{A,i}, t_{A,i})$  specify a fixed allowance, the menu  $\{(u_{P,i}, t_{P,i})\}_{i=l,h}$  still allows for flexibility: The consumer pays  $t_{P,l}$  for an allowance up to  $u_{P,l}$ , while if she wants to consume more, she can purchase the additional allowance  $u_{P,h} - u_{P,l}$  at an incremental price of  $t_{P,h} - t_{P,l}$ .<sup>6</sup>

To summarize the contractual game, we thus have the following sequence of moves. Initially, at some period  $\tau = 1$ , nature chooses the type of each consumer, but only a fraction  $\pi$  is informed about this. At  $\tau = 2$ , the firm offers a menu of three tariffs, comprising  $(u_{A,i}, t_{A,i})$  with  $i = l$  and  $i = h$  and  $\{(u_{P,i}, t_{P,i})\}_{i=l,h}$ . A consumer can then choose, in  $\tau = 3$ , the preferred tariff or not to sign a contract at all. When a contract was signed, in  $\tau = 4$  also the previously uninformed consumers perfectly learn their demand type. Finally, in  $\tau = 5$  all consumers who have signed a contract realize the respective quantities and make the respective payments.

As noted in the Introduction, the framework with only two possible demand types and where consumers are either fully informed or not informed is chosen so as to focus on the comparative analysis and, thereby, on policy evaluation. Still, a restriction to a finite and possibly very limited number of contracts is clearly realistic in most markets. As noted previously, in our model there are three types of contracts, and one allows for additional

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<sup>6</sup>This contract is, thus, similar to a "three-part tariff" contract.

flexibility once the consumer has subsequently learnt his type. Firms also tend to segment the market by creating a very limited number of categories, such as low- and high-usage consumers in our model. And consumers may also think in similar, simplified "brackets" regarding their own consumption type. As noted above, our initial specification of constant marginal cost  $\tilde{c}$  of producing the respective service should also fit well the various key applications mentioned in the Introduction, namely to utilities such as electricity or telecommunication call plans. These are also markets where the subsequently discussed policies of making consumers more informed seem particularly relevant in practice (cf. also the Introduction).

### 3 Analysis of the Optimal Contract

#### 3.1 Benchmarks

**Only Informed Consumers.** With only informed consumers, the firm would face a standard screening problem to choose contracts  $(u_{A,i}, t_{A,i})$ . With net utility levels  $V_{A,i} := \theta_i u_{A,i} - t_{A,i}$ , the incentive constraint of the high-demand type,  $IC_{A,h}$ , becomes  $V_{A,h} \geq \theta_h u_{A,l} - t_{A,l}$ ; the individual rationality constraint of the low-demand type,  $IR_{A,l}$ , becomes  $V_{A,l} \geq 0$ . It is well known that both constraints bind at the optimal offer. Moreover, all other constraints can be ignored, while the high type consumes the first-best service level,  $u_{A,h} = u_h^{FB}$ . High-demand consumers realize a rent equal to  $u_{A,l}(\theta_h - \theta_l)$ , where the optimal service level for low-demand consumers,  $u_{A,l} = u_l^S$ , solves

$$s'(u_l^S; \theta_l) = \frac{\mu}{1 - \mu}(\theta_h - \theta_l) \quad (1)$$

whenever this is positive, while otherwise  $u_l^S = 0$ . Substituting  $C'(0) = 0$  such that  $s'(0; \theta_l) = \theta_l$ , we have from (1) that  $u_l^S > 0$  holds strictly if and only if  $\mu < \theta_l/\theta_h$ .

**Only Uninformed Consumers.** As a second benchmark, suppose that all consumers are uninformed ( $\pi = 0$ ). In this case, consumers' individual rationality constraint need only be satisfied in expectation:  $IR_P$  with  $\mu V_{P,h} + (1 - \mu)V_{P,l} \geq 0$ , where  $V_{P,i} := \theta_i u_{P,i} - t_{P,i}$ . By optimality for the firm,  $IR_P$  binds and both consumption profiles are efficient,  $u_{P,i} = u_i^{FB}$ . Finally, with discrete types, there is some freedom in specifying the optimal transfers, which have to satisfy  $IR_P$  as well as both *ex-post* incentive-compatibility constraints:  $IC_{P,i}$  with  $V_{P,i} \geq \theta_i u_{P,j} - t_{P,j}$ . For instance, one possibility is to choose transfers that reflect incremental costs:  $t_{P,h} - t_{P,l} = C(u_h^{FB}) - C(u_l^{FB})$ .

#### 3.2 The Firm's Program with Informed and Uninformed Consumers

**Constraints.** With both informed and uninformed consumers present, the firm faces in addition to the constraints spelled out in the two benchmarks additional incentive-compatibility constraints *across* the respective offers, which we denoted by subscripts  $A$

(for the *ex-ante* informed consumers) and  $P$  (for the only *ex-post* informed consumers). We will show that we can ignore the possibility of informed low-demand consumers mimicking uninformed consumers, while we refer to the respective ("cross") constraint of informed high-demand consumers,  $V_{A,h} \geq V_{P,h}$ , as  $ICC_{A,h}$ . Next, for an uninformed consumer, who is supposed to pick the menu  $\{(u_{P,i}, t_{P,i})\}_{i=l,h}$ , we suppose first that only the option to mimic the informed low-demand type may become attractive. We refer to this ("cross") constraint as  $ICC_P$ :

$$\mu V_{P,h} + (1 - \mu)V_{P,l} \geq \mu(\theta_h u_{A,l} - t_{A,l}) + (1 - \mu)V_{A,l}.$$

As is usual, we will later show that the solution to the "relaxed program" satisfies all neglected constraints, including the constraint that the uninformed consumer may want to mimic the informed high-demand consumer.

**Firm's Program.** Summing up, with both informed and uninformed consumers present, the firm faces the following (relaxed) program. The firm chooses contracts to maximize expected profits

$$\begin{aligned} & \pi \{ \mu [t_{A,h} - C(u_{A,h})] + (1 - \mu) [t_{A,l} - C(u_{A,l})] \} \\ & + (1 - \pi) \{ \mu [t_{P,h} - C(u_{P,h})] + (1 - \mu) [t_{P,l} - C(u_{P,l})] \} \end{aligned}$$

subject to the following set of constraints: (i) The downward incentive-compatibility constraints for both informed and uninformed consumers  $IC_{A,h}$  and  $IC_{P,h}$  (as introduced in the benchmarks of Section 3.1); (ii) the individual rationality constraints for the informed low-type consumer  $IR_{A,l}$  and the uninformed consumer  $IR_P$  (as also introduced in Section 3.1); and (iii) the two "cross" incentive-compatibility constraints, namely for the uninformed consumer  $ICC_P$  and the informed high-type consumer  $ICC_{A,h}$ . In addition, note that all  $u$  must be non-negative.<sup>7</sup>

**Solution Procedure.** We characterize the optimal contract in several steps. We first solve the firm's program under the assumption that all consumers purchase a positive level of services so that  $u_{,i} > 0$ . Here, we encounter two cases, which we refer to as Cases 1 and 2. Subsequently, we show that there are two more cases possible, Cases 3 and 4, in which not all consumers are served. Finally, we derive conditions for when Cases 1-4 apply.

To characterize the outcome, we will have to establish which constraints bind (and when). Though in our model, consumers differ along two dimensions—i.e., whether they have high or low demand and whether they are initially informed or uninformed—from an *ex-ante* perspective, there are only three distinct types, which may be ordered in one

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<sup>7</sup>To save space, we have chosen not to first write out the full program explicitly. Note, however, that in the relaxed program, the following constraints are ignored: the upward incentive-compatibility constraints; the individual rationality constraint for the high type; the constraint that an informed low type does not want to mimic an uninformed low type; the constraint that an uninformed consumer does not want to mimic the informed high type; the constraint that an informed low type does not want to mimic an uninformed high type; and the constraint that an informed high type does not want to mimic an uninformed low type.



dimension, namely through their prior beliefs of whether they have high or low valuation.<sup>8</sup> As we argue below, this allows us to reinterpret some of our results in the language of a more standard, one-dimensional screening problem. Still, the procedure that we adopt will be particularly helpful in extending our results to the case where uninformed consumers can acquire information, albeit at a cost.

### 3.3 Preliminary Results

**No Exclusion.** Suppose first that all consumers purchase a strictly positive level of services. We are particularly interested in the *allocation* of consumption levels  $u_{A,l}$ ,  $u_{A,h}$ ,  $u_{P,l}$ ,  $u_{P,h}$ . They are characterized as follows:

**Proposition 1** *Suppose that according to the optimal offer all consumers purchase a positive level of services. This offer has the following properties:*

*Case 1) If  $\pi \geq \frac{1}{2-\mu}$ , informed and uninformed consumers obtain the same allocations:  $u_{.,h} = u_h^{FB}$  and  $u_{.,l} = u_l^S$ .*

*Case 2) If  $\pi < \frac{1}{2-\mu}$ , only high-demand consumers obtain the same allocation regardless of whether or not they are informed—i.e.,  $u_{P,h} = u_{A,h} = u_h^{FB}$ . The allocation of the informed low type is more distorted than that of the uninformed low type—i.e.,  $u_{A,l} < u_l^S < u_{P,l} < u_l^{FB}$ .*

Recall, for Case 2, that  $u_l^S$  denotes the distorted consumption level for low-demand types under a "standard screening" contract (cf. in Section 3.1, the case with  $\pi = 1$ ). The key for Proposition 1 are the two "cross" constraints. To see this, we first compare the characterization in Proposition 1 with the outcome of the two benchmark cases with only uninformed consumers ( $\pi = 0$ ) or only informed consumers ( $\pi = 1$ ). For  $\pi = 0$  the first-best allocation results, but in the presence of both informed and uninformed consumers, the distortion of  $u_{P,l}$  follows from the constraint  $ICC_{A,h}$ , which requires that an informed high-demand consumer does not want to mimic an uninformed consumer. Compared to the case with  $\pi = 1$ , where there are only informed consumers,  $u_{A,l}$  becomes even further distorted in Case 2 of Proposition 1, in which the two incentive constraints across informed and uninformed consumers,  $ICC_{A,h}$  and  $ICC_P$ , bind.

Next, we provide more details. If the uninformed consumer picks the informed low-type consumer's contract, thus violating  $ICC_P$ , she realizes a rent of  $(\theta_h - \theta_l)u_{A,l}$  in case she ultimately turns out to have high demand. The level of  $u_{A,l}$  also determines the rent of an informed high-type consumer. In Case 2, however, this does not follow from the ("standard") constraint  $IC_{A,h}$ , which remains slack, but instead more indirectly, as both  $ICC_{A,h}$  and  $ICC_P$ , bind.

Put differently, in this case it is particularly helpful to think of the three initial types of consumers as being ordered according to their ex-ante expected valuation, that is with the informed low-demand consumer at the bottom and the informed high-demand consumer at the top. In Case 2, all downwards incentive compatibility constraints are binding and the derived contracts are globally incentive compatible (cf. also the discussion below after

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<sup>8</sup>Instead, see for multi-dimensional screening problems, e.g. Armstrong and Rochet (1999).

Corollary 3). Each tariff, i.e.,  $(u_{A,i}, t_{A,i})$  for the informed consumers  $i = l$  and  $i = h$  and the menu  $\{(u_{P,i}, t_{P,i})\}_{i=l,h}$  for the uninformed consumers are then derived from the same principle, namely to trade off the objective to minimize the information rent for all "higher-type" consumers with the objective to maximize the respective surplus. For the "highest type", the informed  $\theta = h$  consumers, this obtains efficiency, while there is inefficiency for all "lower types". (That being said, for the "middle type", namely the ex-ante uninformed consumer, the efficiency shows up only when they turn out to have low demand, while  $u_{P,h} = u_{A,h} = u_h^{FB}$ .) In particular, for the type at the bottom, the informed low-demand consumer, the proof of Proposition 1 shows that  $u_{A,l}$  solves

$$s'(u_{A,l}; \theta_l) = \frac{\mu}{1-\mu} \frac{1-\pi+\pi\mu}{\pi} (\theta_h - \theta_l). \quad (2)$$

Comparing this to (1) confirms  $u_{A,l} < u_l^S$  for Case 2, where  $\pi < \frac{1}{2-\mu}$ . The respective trade-off for the "middle type" is next as follows. Recall that it is through the binding constraint  $ICC_P$  that a higher level of  $u_{P,l}$  allows informed high-type consumers to extract a higher rent when an uninformed consumer realizes a higher utility. Taking this into account,  $u_{P,l}$  optimally trades off surplus maximization with rent extraction if

$$s'(u_{P,l}; \theta_l) = \mu \frac{\pi}{1-\pi} (\theta_h - \theta_l). \quad (3)$$

Comparing this to (1) confirms  $u_{P,l} > u_l^S$  for Case 2.

**Exclusion.** We suppose next that not all consumers are served. Here, we have to distinguish between two cases: In Case 3, *all* low-type consumers are excluded, whereas in Case 4, only those who are also informed are excluded.

**Proposition 2** *If not all consumers are served under the optimal offer, all high-demand consumers purchase the first-best level of services,  $u_{,h} = u_h^{FB}$ . For low-demand consumers, the following cases are possible:*

*Case 3) All low-demand consumers are excluded.*

*Case 4) Only informed low-demand consumers are excluded, while uninformed low-demand consumers purchase an inefficiently low level of services,  $0 < u_{P,l} < u_l^{FB}$ .*

Of particular interest is Case 4 in Proposition 2. There, by no longer serving informed low-type consumers, the firm can extract all consumer surplus from uninformed consumers. The optimal choice of  $u_{P,l}$  for low-demand uninformed consumer trades off surplus maximization with rent extraction from informed high-demand consumers. This is the same trade-off as in Case 2 of Proposition 1, which is why  $u_{P,l}$  is again determined from the first-order condition (3).

### 3.4 Solution to the Firm's Problem

Which of the different cases in Propositions 1 and 2 applies depends on the fractions of the different types of consumers.

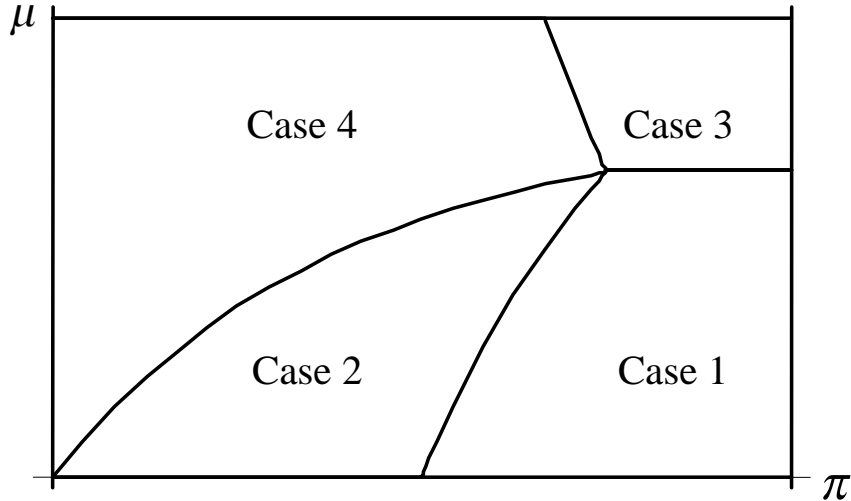


Figure 1: Optimal contracts for  $\theta_h = 3/4$  and  $\theta_l = 1/2$ .

**Proposition 3** Which of the characterized four cases applies depends, as follows, on the fractions of the different consumer types:

i) Suppose that the fraction of high-demand consumers is low with  $\mu < \theta_l/\theta_h$ : In this case, uninformed low-type consumers always purchase a positive quantity. If, for given  $\mu$ , the fraction of informed consumers  $\pi$  is low, then informed low-demand consumers are excluded (Case 4). Otherwise, all consumers are served, with Case 1 applying for high values of  $\pi$  and Case 2 for intermediate values.

ii) Suppose, instead, that  $\mu \geq \theta_l/\theta_h$ : Then, for given  $\mu$ , all low-type consumers are excluded if  $\pi$  is sufficiently high (Case 3). For lower values of  $\pi$ , however, only informed low-demand consumers are excluded (Case 4).

We illustrate this in Figure 1 (which is drawn for the particular values  $\theta_h = 3/4$  and  $\theta_l = 1/2$ ). Furthermore, the respective thresholds for  $\mu$  and  $\pi$  that determine which of the four cases apply are given explicitly in the proof of Proposition 3. We now provide more intuition for the case distinction in Proposition 3.

The role of the fraction  $\mu$  of high-demand consumers is intuitive and standard: As there are more consumers with high demand, it becomes more likely that low-demand types are excluded so that the firm can extract more rents from high-demand types. Hence, when moving upwards in Figure 1, we move from Cases 1 and 2 to Cases 3 and 4, respectively. Next, if  $\mu$  is high but also  $\pi$  low, implying that there altogether few informed consumers, it is intuitive that only informed low types, but not uninformed low types, are excluded. Hence, as we move to the left in the upper part of Figure 1 we move from Case 3 to Case 4, implying that fewer types are excluded. Interestingly, the opposite holds in the lower part of Figure 1—i.e., for relatively low values of  $\mu$ . There, with few high-type consumers, as there are more uninformed consumers (lower  $\pi$ ), the offer made to informed low-demand consumers becomes increasingly distorted in an attempt to extract more rents

from uninformed consumers. Ultimately, as  $\pi$  becomes too low, informed low-demand consumers no longer purchase a positive quantity—i.e., we move from Case 2 to Case 4. At this point, there is a discrete jump up in the number of excluded consumers. As  $\pi$  decreases further, the number of excluded consumers declines.

For simplicity, Proposition 3 was phrased mainly in terms of high or low values of  $\pi$ . To see how the respective boundaries that separate the four cases change in both parameters  $\pi$  and  $\mu$ , it is again instructive to consult Figure 1: As is shown in the proof of Proposition 3, the respective monotonicity of the boundaries displayed in Figure 1 holds generally. Before further discussing the solution to the firm’s program in the following section, the rest of this section offers a more formal discussion of how the boundaries of the cases behave.

Recall first that in the standard screening problem, a horizontal line with  $\mu = \theta_l/\theta_h$  separates the case where all consumers are served from that where only high-demand consumers are served. This line separates Cases 1 and 3 in Figure 1. From Proposition 1, we have next that Cases 1 and 2 are separated by a function that we denote by  $\tilde{\pi}_{12} = 1/(2 - \mu)$ . Applying a similar notation, we have that  $\tilde{\pi}_{24}$  separates Cases 2 and 4, while  $\tilde{\pi}_{34}$  separates Cases 3 and 4. Note that  $\tilde{\pi}_{24}$  is determined from the requirement that  $u_{A,l} = 0$  holds in Case 2, where  $u_{A,l}$  is strictly decreasing in  $\mu$  but strictly increasing in  $\pi$ . This implies that  $\tilde{\pi}_{24}$  is indeed upward-sloping as a function of  $\mu$ , as depicted in Figure 1. Finally, the boundary between Cases 3 and 4,  $\tilde{\pi}_{34}$ , is obtained from setting  $u_{P,l} = 0$  in Case 4. As  $u_{P,l}$  becomes more distorted as there are more informed consumers and more high-type consumers,  $\tilde{\pi}_{34}$  is strictly decreasing in  $\mu$ .

### 3.5 Further Discussion

Serving informed consumers with low demand comes with high opportunity costs to the firm in terms of lost profits with *both* informed high-demand consumers and uninformed consumers. Optimally, the firm makes the corresponding “basic” contract  $(u_{A,l}, t_{A,l})$  relatively unattractive, in particular, if the fraction of uninformed consumers or that of high-demand consumers is relatively high.

**Corollary 1** *Suppose that Cases 2 or 4 apply. Then, as the fraction of uninformed consumers or of high-demand consumers increases (lower  $\pi$  or higher  $\mu$ , respectively), the more unattractive becomes the “basic” tariff, which is offered to informed low-demand consumers. This results first in a lower level of  $u_{A,l}$  and, ultimately, in the exclusion of these consumers (corresponding to  $u_{A,l} = 0$ ).*

Recall now our previous discussion of reinterpreting our results in terms of a more standard one-dimensional screening problem. From an *ex-ante* perspective, informed low-demand types then represent the “bottom type,” while uninformed consumers and high-demand informed consumers represent the respective “adjacent higher” types. As all “adjacent downwards” incentive-compatibility constraints bind in the presently considered cases, it is intuitive that the distortion “at the bottom” increases as the probabilities of the “higher types” increase (specifically, through an increase in  $\mu$  or  $\pi$ ).

For what follows, note further that an uninformed consumer generates (weakly) higher revenues for the firm compared to an informed consumer.

**Corollary 2** *Suppose that Cases 2 or 4 apply. Then, the firm always realizes strictly higher revenues from an uninformed consumer than from an informed consumer, both in expectation (over high- and low-demand types) and when considering only low-demand consumers.*

From the consumer's side, it is immediate that an informed consumer is better off (strictly for Cases 2 and 4). In particular, note that uninformed low-demand consumers end up realizing strictly negative utility:  $V_{P,l} < 0$ .<sup>9</sup> Clearly, from an *ex-post* perspective, uninformed low-demand consumers would have been better off purchasing the "basic" tariff  $(u_{A,l}, t_{A,l})$  instead. However, given their own initial demand uncertainty, the offer designed for uninformed consumers was equally attractive, as it also contained the option to make use of an additional allowance  $u_h^{FB} - u_{P,l} > 0$  at an incremental price  $t_{P,h} - t_{P,l}$  that is smaller than the respective utility increment  $\theta_h(u_h^{FB} - u_{P,l})$ .

## 4 Comparative Analysis

Given the explicitly characterized solution to the firm's program in Propositions 1, 2, and 3, the present model lends itself to comparative analysis. This section conducts such an analysis in terms of an increase in the share of informed consumers  $\pi$ .

This analysis seems interesting for the following reasons. First, in light of the results from other models, which we review below, it is interesting to analyze how the presence of (more) informed consumers affects the utility of those who are less informed (though they do not suffer from any other, exploitable behavioral biases). Second, as noted in the Introduction, public policy in some recently deregulated industries aims to encourage consumers to become more knowledgeable, including about their own demand profile.<sup>10</sup> In the extreme, firms may be forced to apply the contract that turns out to be, *ex post*, the most favorable for any given consumer—the introduction of such a policy corresponds to a discrete jump to  $\pi = 1$ . The comparative analysis in  $\pi$  may help to shed more light on the implications of such policies.

**Impact of  $\pi$  on Uninformed Consumers' Surplus.** From implicitly differentiating (3) for  $u_{P,l}$  and using  $u_{P,h} = u_h^{FB}$ , it follows that the expected service level of uninformed consumers decreases as there are more informed consumers (higher  $\pi$ ). Still, it turns out that uninformed consumers are better off. This holds strictly for Case 2, where it follows immediately from the proof of Proposition 1. Precisely, this holds as the lowest service level  $u_{A,l}$  increases in  $\pi$ , which, through the binding ("cross") constraint  $ICC_P$ , leads to a

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<sup>9</sup>Cf. also Miravete (1996).

<sup>10</sup>In our monopolistic setting, we can abstract from other, more well-known implications of such policies, which serve to induce more effective competition by reducing search (and/or switching) costs (cf. the literature discussed below).

higher rent for uninformed consumers. (For all other cases uninformed consumers' utility is constant in  $\pi$ .<sup>11</sup>)

**Corollary 3** *As the fraction of informed consumers increases (higher  $\pi$ ), uninformed consumers' utility increases.*

Note that a consumer's information is only with respect to her *own* demand type. Still, as more of the uninformed consumers become informed, this increases not only their own utility but also that of consumers who still remain uninformed. The mechanism through which the presence of informed consumers benefits those who are uninformed differs from the mechanism that is at work in models with search and shopping costs, where the presence of consumers who are better informed about rivals' offers brings down expected prices (cf. Varian 1980; or, more recently, Janssen and Moraga-González 2004).<sup>12</sup>

Formally, the result from Corollary 3 can be also restated in the following way. Recall that once the way incentive constraints in Case 2 bind has been worked out, uninformed consumers represent the "intermediate type" in a standard screening model, with informed low- and high-demand types representing the "top" and "bottom types", respectively. The respective *ex-ante* probabilities of these "types" are  $(1 - \mu)\pi$  ("bottom"),  $1 - \pi$  ("intermediate"), and  $\mu\pi$  ("top"). As  $\pi$  increases, the rent of uninformed consumers is affected in the following way through the chosen service level "at the bottom,"  $u_{A,l}$ . First, as the probability of the "bottom type" increases, the distortion "at the bottom" is optimally decreased, resulting in more rent for all "higher types." Second, as the probability of the "intermediate type" decreases, this reduces the firm's benefits from extracting rent, which further pushes up  $u_{A,l}$ . The third effect, however, goes in the opposite direction: As a higher  $\pi$  increases the probability of the "top type," this increases the benefits from rent extraction "at the top," which pushes down  $u_{A,l}$  (next to  $u_{P,l}$ ). Corollary 3 shows that the first two effects together dominate.

Corollary 3 may also be interesting in light of claims that more-informed or sophisticated consumers are cross-subsidized at the expense of less-informed consumers. For instance, in Gabaix and Laibson (2006), this holds, albeit under competition, if only some consumers are knowledgeable about their future demand of an "add-on service," while other consumers are "naïvely" unaware of this. In a monopolistic context and with perfectly rational consumers, Corollary 3 provides a different benchmark, where the presence of informed consumers benefits uninformed consumers.<sup>13</sup>

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<sup>11</sup>Recall that Case 2 applies for intermediate values of  $\pi$ , provided that  $\mu$  is not too high. (Cf. also Figure 1.) For low values of  $\pi$ , where Case 4 applies instead, uninformed consumers realize zero rent, while for high  $\pi$ , where Case 1 applies and uninformed consumers realize the highest rent, we know that a further increase in  $\pi$  does not affect contracts and, thus, utilities. Finally, for high  $\mu$ , where only Cases 3 and 4 apply as  $\pi$  changes, uninformed consumers always realize zero utility.

<sup>12</sup>Interestingly, in Anderson and Renault (2000), where consumers may lack information about "match value," which is again specific, a greater share of informed consumers has a *negative* externality through increasing the prevailing price.

<sup>13</sup>With perfect competition, all contracts would be undistorted in our model, while high- and low-demand types would realize the same surplus irrespective of whether they are initially informed or not. From the arguments in Armstrong and Vickers (2001) and Rochet and Stole (2002), it could be conjectured that as long as the market remains fully covered and as long as horizontal differentiation is "type-independent"

**Impact of  $\pi$  on Informed Consumers' Surplus.** The present comparative analysis still ignores the impact of a change in  $\pi$  on all (other) informed consumers. This is generally ambiguous. To explore this, note first that in Cases 1 and 3,  $\pi$  has no effect on contracts and, thus, utilities. Next, in Case 4, in which only informed low-demand consumers are excluded, the impact of a higher  $\pi$  on informed high-demand consumers is unambiguous: As their fraction increases (higher  $\pi$ ), the firm optimally extracts more rent (at the cost of a lower surplus realized with uninformed consumers). Finally, in the Case 2, all consumers are served. Here, the utility of informed high-demand consumers,  $V_{A,h}$ , depends (positively) on both  $u_{A,l}$  and  $u_{P,l}$  through the binding constraints  $ICC_P$  (the "cross" constraint to the uninformed consumers's menu),  $IC_{P,l}$  (the constraint in the menu), and  $ICC_{A,h}$  (the "cross" constraint for uninformed consumers). Precisely, from the proof of Proposition 1, we have

$$V_{A,h} = \mu(\theta_h - \theta_l)u_{A,l} + (1 - \mu)(\theta_h - \theta_l)u_{P,l}. \quad (4)$$

Results are now ambiguous, as we already know that a change in  $\pi$  has the opposite effect on  $u_{A,l}$  and  $u_{P,l}$ . In fact, the proof of Corollary 4 shows that the set of parameters for which the overall effect on  $V_{A,h}$  is positive and where it is negative are both generally non-empty.

We can make further progress by requiring that  $C'''$  is zero.<sup>14</sup> With this specification, contracts in Case 2 stipulate

$$\begin{aligned} u_{A,l} &= \frac{1}{2c} \left[ \theta_l - \left( \frac{\mu}{1 - \mu} \right) \left( \frac{1 - \pi + \pi\mu}{\pi} \right) (\theta_h - \theta_l) \right], \\ u_{P,l} &= \frac{1}{2c} \left[ \theta_l - \mu \left( \frac{\pi}{1 - \pi} \right) (\theta_h - \theta_l) \right]. \end{aligned}$$

Substituting these contracts into (4),  $dV_{A,h}/d\pi > 0$  holds if and only if

$$\pi < \hat{\pi} := \frac{\sqrt{\mu}}{1 + \sqrt{\mu} - \mu}. \quad (5)$$

This threshold may or may not fall into the area that is covered by Case 2—i.e., the interval  $(\pi_{24}, \pi_{12})$ , where both boundaries also depend on  $\mu$  (cf. Figure 1). As shown in the proof of Corollary 4,  $\hat{\pi} \in (\pi_{24}, \pi_{12})$  holds only if  $\mu$  is not too large.

**Corollary 4** *As the fraction of informed consumers increases (higher  $\pi$ ), the impact on the utility of informed consumers is generally ambiguous: It is strictly negative in Case 4 and may be positive or negative in Case 2. With  $C''' = 0$ , the impact is strictly positive if and only if both  $\pi$  and  $\mu$  are sufficiently low.*

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(i.e., additive), price differences only reflect cost differences. However, if these two conditions do not jointly hold, then under imperfect competition, there remains scope for profitable price discrimination (cf. also Stole 1995 and Inderst 2004.) An analysis of imperfect competition in this sense is beyond the scope of the paper.

<sup>14</sup>Recall that  $C$  specifies costs as a function of the delivered "base utility,"  $\tilde{u}(q)$ , where  $q$  denotes quantity and where the ultimate utility is given by  $\theta\tilde{u}(q)$  for a customer of type  $\theta$ . In terms of the model's primitives, stipulating that  $C''' = 0$  is then equivalent to specifying some utility function  $\tilde{u}(q) = \sqrt{q/\gamma}$  (together with marginal cost  $\tilde{c}$ ), where  $\gamma > 0$ . (We use here, also, that  $C(0) = 0$  and  $C'(0) = 0$ . and note that  $C'''(u) = \tilde{c}\gamma$ .)

For the case with  $C''' = 0$ , Corollary 4 and its proof explicitly delineate a parameter region for which, together with Corollary 3, *all* consumers are better off as  $\pi$  increases. From Corollary 4, this is the case if the probability of the "top type,"  $\pi\mu$ , is not too high.

**Impact on Welfare.** As there are more informed consumers, the impact on welfare is also generally ambiguous. While in Cases 1 and 3, contracts are not affected, in Case 4, where only informed low-demand consumers are excluded, an increase in  $\pi$  leads to a reduction in welfare on two counts: First, it reduces the service level  $u_{P,l}$ ; second, it increases the fraction of excluded consumers. For Case 2, instead, we have shown in a previous version of this paper that there is still always a non-empty set of parameters for which total welfare strictly increases with  $\pi$ . In this case, the positive effect that this has on  $u_{A,l}$  is sufficiently strong, compensating for the two negative effects on welfare, which arise from a reduction in  $u_{P,l}$  and from the fact that the newly informed low-demand consumers now consume a strictly lower service level  $u_{A,l}$  instead of  $u_{P,l}$ .

## 5 Information Acquisition

Consumers who are initially uninformed about their future demand (type) may be able to acquire additional information before signing a contract. For instance, a consumer may be able to go through the records of her past consumption of the respective service—e.g., her past phone bills—to better estimate her future demand. To allow for this possibility, we stipulate in what follows that at the contracting stage, uninformed consumers also can observe their demand type, albeit only after incurring private disutility  $k > 0$ . Precisely, in terms of the model's timing, in  $\tau = 3$ , where consumers can make their choice between contracts, there is now also the possibility for uninformed consumers to first learn their demand type, at cost  $k$ .

In terms of the firm's program, the possibility of information acquisition requires that the incentive-compatibility constraint for an uninformed consumer be modified. Her alternatives, in addition to accepting the designated offer  $\{(u_{P,i}, t_{P,i})\}_{i=l,h}$ , are now threefold: first, to reject all offers, as captured by the individual rationality constraint  $IR_P$ ; second, to stay uninformed and pick a contract designed for an informed consumer; and third to become informed and subsequently make the *best* choice among all possible options, namely to either reject all contracts on offer or to accept one of them.

In what follows, for brevity's sake, we restrict consideration to the case where the firm's offer is acceptable to all types. Moreover, while the full program is solved in the proof of the subsequent Proposition 4, in the main text, we address only the most salient issues.

### 5.1 Solution

If the uninformed consumers did acquire information, the firm would face only informed consumers and thus a standard screening problem. The resulting optimal offer would



then clearly deprive consumers of the incentives to acquire information.<sup>15</sup> Recall from our analysis that, without the option of information acquisition, for high  $\pi$  the standard screening solution was still optimal (Case 1 in Proposition 1). Intuitively, in this case, the option to acquire information has no impact. The remaining case is that of Case 2, where  $\pi$  is sufficiently low and where previously (cf. Proposition 1) the offer designated for informed low-demand consumers was more distorted:  $u_{A,l} < u_{P,l}$ .

Given the additional option to acquire information, the uninformed consumers' incentive-compatibility constraint becomes now (cf. the proof of Proposition 4)

$$\mu V_h + (1 - \mu)V_{P,l} \geq \max \{(\theta_h - \theta_l)u_{A,l}, \mu V_h - k\}, \quad (6)$$

where it has already been used that  $V_{A,h} = V_{P,h} = V_h$ . The first term on the right-hand side of (6) arises again from the option to mimic informed low-demand consumers. As  $V_{A,l} = 0$ , the uninformed consumer would then only realize a positive rent, namely of  $(\theta_h - \theta_l)u_{A,l}$ , if she turns out to have high demand. The second term on the right-hand side of (6) captures the new option to become informed at cost  $k$ . In this case, the consumer will instead realize utility  $V_h$  when being of the high-demand type.

Now, take the values for  $u_{A,l}$  and  $u_{P,l}$  as obtained in Proposition 1. Once we substitute for  $V_h$ , we can show that under the previously derived offer, the option to acquire information does *not* become sufficiently attractive for uninformed consumers whenever

$$k \geq \mu(1 - \mu)(\theta_h - \theta_l)(u_{P,l} - u_{A,l}) \quad (7)$$

holds. Note that this is trivially the case if  $\pi \geq \frac{1}{2-\mu}$ , where  $u_{P,l} = u_{A,l} = u_l^S$  (Case 1), which confirms our previous observation. On the other hand, if  $\pi < \frac{1}{2-\mu}$  holds, then (7) defines an upper boundary on  $k$  such that we can ignore the new constraint that arises from the possibility of information acquisition if the respective costs  $k$  are sufficiently high. Otherwise, the firm has to adjust its offer. (Note that, as in the analysis of Crémer and Khalil (1992), where there are only uninformed types, in equilibrium there is no information acquisition.)

**Proposition 4** *Suppose that uninformed consumers can become informed at cost  $k > 0$ . If, under the firm's optimal offer, all consumers purchase a positive level of services, the following characterization applies:*

*Case 1) If  $\pi \geq \frac{1}{2-\mu}$ , Case 1 of Proposition 1 applies.*

*Case 2a) If  $\pi < \frac{1}{2-\mu}$  and  $k$  is sufficiently large such that it satisfies (7), then the contract specified in Case 2 is optimal.*

*Case 2b) If  $\pi < \frac{1}{2-\mu}$  and  $k$  is small such that it violates (7), then the optimal offer still has the property  $u_{A,l} < u_l^S < u_{P,l} < u_l^{FB}$  as in Case 2 of Proposition 1, albeit  $u_{P,l}$  is now smaller and  $u_{A,l}$  larger compared to the characterization there.*

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<sup>15</sup>As the consumer's indifference can be broken by a marginal adjustment of contracts, it is straightforward to also rule out the case where the uninformed consumer would mix between acquiring information or not.

## 5.2 Comparative Analysis

In Case 2b of Proposition 4, it is optimal for the firm to distort the informed low-type contract *less* and the uninformed low-type contract *more* compared to the characterization in Case 2 of Proposition 1. In fact, the difference between the respective values  $u_{P,l} > u_{A,l}$  is then pinned down by the binding condition (7), which becomes

$$u_{P,l} - u_{A,l} = \frac{k}{\mu(1 - \mu)(\theta_h - \theta_l)}. \quad (8)$$

This implies, in particular, that for  $k \rightarrow 0$ , both offers become the same. Intuitively, as uninformed consumers can become informed at (almost) zero costs, the firm's problem reduces to a standard screening problem:  $u_{.,l} \rightarrow u_l^S$ . More generally speaking, as  $k$  becomes smaller, the firm's ability to price discriminate between informed and uninformed consumers shrinks, which undermines a key reason why the firm previously made the (most basic) offer  $u_{A,l}$  so unattractively low. This leads us to the following Corollary.

**Corollary 5** *Suppose that  $\pi < \frac{1}{2-\mu}$  and  $k$  small such that it violates (7). As the costs of information acquisition  $k$  decrease, the difference in the allocation for informed and uninformed consumers,  $u_{A,l} - u_{P,l} > 0$ , decreases according to (8). For  $k \rightarrow 0$  we have that  $u_{.,l} \rightarrow u_l^S$ .*

From Corollary 5, contracts for informed consumers become more efficient and contracts for uninformed consumers less efficient as  $k$  decreases. To conclude this section, we ask—in analogy to the comparative analysis in  $\pi$  from Section 4—how changes in  $k$  affect consumers and welfare. As with changes in  $\pi$ , this may also be of interest for policy, provided that it aims to aid consumers in becoming more informed.

Intuitively, even though in the present model uninformed consumers do not become more or less informed as  $k$  decreases (see, however, the concluding remarks in Section 6), their expected utility increases. (This holds strictly in Case 2b—i.e., whenever both  $\pi$  and  $k$  are not too high.) The effect that this has on informed consumers, however, is generally ambiguous—as is the effect on welfare. To make further progress, as in Section 6, suppose that  $C''' = 0$ .

**Corollary 6** *Uninformed consumers benefit from a reduction in their own costs of information acquisition,  $k$ , while the impact on informed consumers and welfare is generally ambiguous. With  $C''' = 0$ , we have that (i) informed consumers benefit if and only if  $\pi$  is sufficiently small and that (ii) welfare always increases.*

Thus, for  $C''' = 0$ , a reduction in the costs of information acquisition benefits all consumers if the fraction of informed consumers is not too large. Otherwise, in case this is the result of a policy measure, this measure has distributional consequences: Uninformed consumers benefit, while those consumers who are already informed are hurt.

Interestingly, however, for  $C''' = 0$ , we find that the impact on welfare is always strictly positive. As noted in the Introduction, this provides a striking contrast to the result in Crémer and Khalil (1992), where in the presence of *only* uninformed consumers, a reduction in  $k$  always decreases welfare. This difference follows from the fact that, in their case, the positive impact (in terms of efficiency) on informed consumers' offers is absent.

## 6 Concluding Remarks

For many subscription services, tariff choice and consumption decisions are made at different points in time. Thus, when signing a contract, a share of consumers are still uncertain about their future level of demand. This paper considers the contract-design problem of a monopolist facing both uninformed consumers and consumers who, at the contracting stage, are already informed about their demand (type). In an extension, we also allow for the possibility that uninformed consumers can acquire information at a cost.

Initially, the firm faces both informed and uninformed consumers, as well as informed consumers with high or low demand. The respective share of informed vs. uninformed and high- vs. low-demand types determines the prevailing distortion of contracts and whether all consumers are served in the first place. The restrictions to only two types and fully revealing signals allow us to make this case distinction explicit and simple. In the comparative analysis, we found that the presence of informed consumers benefits uninformed consumers, even though information is only about a consumer's own demand. In particular, in the present model, there is thus no "free-riding" of informed consumers (through being "cross-subsidized") on uninformed consumers. We used this result to argue how policy intervention that helps consumers to obtain more knowledge about their own demand (type) could be justified, also given the resulting externality. In an extension we analyze the situation where policy intervention may reduce the costs of information acquisition, albeit in equilibrium the firm adjusts the offer so that this option is actually not used. For a tractable specification we found that policy intervention increases welfare, in striking contrast to the case where all consumers are ex-ante uninformed.

The tractable framework that this paper introduces may allow for several extensions and applications in future work. It could be interesting to endogenize the differential information that consumers possess at the contracting stage. If consumers have different costs of acquiring information, those with low costs should become informed, while those with higher costs should stay uninformed. The firm's design of the price-discriminating offer would then determine also the fraction of consumers who are informed, while public policy could more generally affect the costs of information acquisition.<sup>16</sup>

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<sup>16</sup>In related work, Bar-Isaac et al. (2010) analyze the decision of the firm to facilitate information acquisition for consumers with heterogeneous preferences.

## Appendix: Proofs

**Proof of Proposition 1.** The proof proceeds in several steps.

**Step 1:** If the optimal contract menu has the property that all consumers take contracts with strictly positive quantities, then we show next the following: (i)  $u_{A,h} = u_h^{FB}$ ; (ii)  $u_{P,h} = u_h^{FB}$ ; (iii)  $V_{A,l} = 0$ ; and (iv) that the constraint  $ICC_P$  is binding.

To see this, note first that if (i) does not hold, then we can adjust  $u_{A,h}$  and  $t_{A,h}$  so as to keep  $V_{A,h}$  constant, while increasing the surplus and thus the firm's profits. This is possible since in the relaxed program there are no constraints to mimic the informed high type. If (ii) does not hold, we can adjust  $u_{P,h}$  and  $t_{P,h}$  to increase the surplus, while leaving  $V_{P,h}$  constant and thus also  $ICC_{A,h}$  satisfied. Regarding assertion (iii), we only have to note that in the relaxed program there is no incentive constraint for the informed low type. Finally, assertion (iv) trivially holds in the relaxed program as, otherwise, one can adjust  $t_{P,i}$  downwards, while still satisfying all remaining constraints.

**Step 2:** Next, if all consumers are served, we show that  $ICC_{A,h}$  must be binding, i.e., that  $V_{A,h} = V_{P,h}$ . To show this, suppose by contradiction that  $ICC_{A,h}$  is not binding. Then the firm optimally raises  $t_{A,h}$  until  $IC_{A,h}$  binds. It is trivial that in this case  $u_{A,l} > 0$  must hold (so that  $V_{A,h} > 0$ ). Note next that if  $ICC_{A,h}$  does not bind, then  $u_{P,l}$  is optimally chosen so as to maximize surplus:  $u_{P,l} = u_l^{FB}$ . Substituting next the binding  $IC_{A,h}$  into the binding  $ICC_P$ , we have the requirement that  $\mu V_{P,h} + (1 - \mu)V_{P,l} = \mu(\theta_h u_{A,l} - t_{A,l}) = \mu V_{A,h}$ . As from  $ICC_{A,h}$  we have  $V_{A,h} \geq V_{P,h}$ , this requires that  $V_{P,l} \geq 0$ . If we substitute all of this into the firm's program, then the remaining consumption profile to specify is  $u_{A,l}$ . For this note that the expected surplus with this type of consumers is  $\pi(1 - \mu)s(u_{A,l}; \theta_l)$ , while the information rent for the informed high type is  $\pi\mu(\theta_h - \theta_l)u_{A,l}$ . Moreover, from the binding constraints  $IC_{A,h}$  and  $IR_{A,l}$  it follows that the utility of an uninformed high type equals  $(\theta_h - \theta_l)u_{A,l}$ , which in expected terms (for the firm) equals  $(1 - \pi)\mu(\theta_h - \theta_l)u_{A,l}$ . As a consequence, we must clearly have that  $u_{A,l} < u_l^{FB}$ .

We argue now that, contrary to the assumption,  $ICC_{A,h}$  is violated as the derived contract implies, in fact, that  $V_{A,h} < V_{P,h}$ . This follows from two observations: (i)  $V_{P,l} \geq 0$  and  $u_{P,l} = u_l^{FB}$  imply together with  $IC_{P,h}$  that  $V_{P,h} \geq (\theta_h - \theta_l)u_l^{FB}$ ; and (ii)  $V_{A,l} = 0$  and the binding  $IC_{A,h}$  imply  $V_{A,h} = (\theta_h - \theta_l)u_{A,l}$ . Since  $u_{A,l} < u_l^{FB}$ , this gives  $V_{A,h} = (\theta_h - \theta_l)u_{A,l} < (\theta_h - \theta_l)u_l^{FB} \leq V_{P,h}$ , which is a contradiction.

**Step 3:** We now first solve the remaining program under the hypothesis that  $IC_{A,h}$  does *not* bind. Hence, because of Step 2 we consider the situation in which  $ICC_{A,h}$  binds but not  $IC_{A,h}$ . It is then immediate that  $IC_{P,h}$  must bind. Together with  $V_{A,h} = V_{P,h} \equiv V_h$  we have  $V_h = \theta_h u_{p,l} - t_{p,l} = V_{P,l} + (\theta_h - \theta_l)u_{p,l}$ . The firm then obtains all expected surplus minus "rents" that are obtained by all uninformed and informed high-type consumers. The former group obtains in expectation  $\mu(\theta_h - \theta_l)u_{A,l}$ , the latter simply  $V_h$ .

To determine  $V_h$ , we proceed as follows. From  $ICC_P$  the expected surplus of an uninformed consumer is  $\mu V_h + (1 - \mu)V_{P,l} = \mu(\theta_h - \theta_l)u_{A,l}$ . As from  $IC_{P,h}$  we have  $V_{P,l} = V_h - (\theta_h - \theta_l)u_{p,l}$ , it also holds that  $\mu V_h + (1 - \mu)(V_h - (\theta_h - \theta_l)u_{p,l}) = \mu(\theta_h - \theta_l)u_{A,l}$ ,

such that jointly this implies that

$$V_h = \mu(\theta_h - \theta_l)u_{A,l} + (1 - \mu)(\theta_h - \theta_l)u_{P,l}. \quad (9)$$

Therefore, the total expected rent that goes to consumers is

$$(1 - \pi)\mu(\theta_h - \theta_l)u_{A,l} + \pi\mu[\mu(\theta_h - \theta_l)u_{A,l} + (1 - \mu)(\theta_h - \theta_l)u_{P,l}],$$

implying that

$$u_{P,l} = \arg \max_u (1 - \mu)[(1 - \pi)s(u; \theta_l) - \pi\mu(\theta_h - \theta_l)u], \quad (10)$$

while

$$u_{A,l} = \arg \max_u \pi(1 - \mu)s(u; \theta_l) - (1 - \pi)\mu(\theta_h - \theta_l)u - \pi\mu\mu(\theta_h - \theta_l)u. \quad (11)$$

**Step 4:** We now establish a condition that the constraint  $IC_{A,h}$  is indeed slack, as claimed in the previous step. For  $IC_{A,h}$  slack—i.e.,  $V_h > (\theta_h - \theta_l)u_{A,l}$ —equation (9) holds. Thus the condition for slackness is

$$\mu(\theta_h - \theta_l)u_{A,l} + (1 - \mu)(\theta_h - \theta_l)u_{P,l} > (\theta_h - \theta_l)u_{A,l},$$

which is equivalent to  $u_{A,l} < u_{P,l}$ . Whenever  $IC_{A,h}$  is slack, it follows from step 3 that we obtain  $u_{P,l}$  and  $u_{A,l}$  as (10) and (11), respectively. After setting up the first-order conditions and rearranging terms, we have that  $u_{A,l} < u_{P,l}$  holds if and only if

$$\frac{\pi\mu}{1 - \pi} < \frac{(1 - \pi)\mu + \pi\mu\mu}{\pi(1 - \mu)}$$

which is equivalent to  $\pi < \frac{1}{2-\mu}$ . Note that, at  $\pi = \frac{1}{2-\mu}$ , we have  $u_{A,l} = u_{P,l} = u_l^S$ . Hence, we have established that  $IC_{A,h}$  can indeed be ignored when solving the program if and only if condition  $\pi \leq \frac{1}{2-\mu}$  holds (at least weakly), while otherwise the constraint must bind.

**Step 5:** Suppose now that the converse of this condition holds, so that  $\pi > \frac{1}{2-\mu}$ . The argument in Step 4 implies that then  $IC_{A,h}$  must bind. Note also that by Step 2 also condition  $ICC_{A,h}$  must bind by optimality. Taken together, it then holds that  $\mu V_{P,h} + (1 - \mu)V_{P,l} = \mu(\theta_h u_{A,l} - t_{A,l}) = \mu V_{A,h}$  and thus that  $V_{P,l} = 0$ . Note first that it is not feasible to have  $u_{A,l} < u_{P,l}$ , given  $IC_{P,h}$ ,  $V_{A,h} = V_{P,h}$ , and as by assumption  $IC_{A,h}$  binds. While it could be feasible that  $u_{P,l} < u_{A,l}$ , it is easily shown from  $u_{A,l} < u_l^{FB}$  that this is not optimal. With  $u_{A,l} = u_{P,l}$  we then have the standard screening program and thus  $u_{A,l} = u_{P,l} = u_l^S$ .

**Step 6:** Finally, note that the solution to the relaxed program satisfies the neglected constraints. In fact, the only case where this is not immediately obvious is that were the informed low type would want to mimic an uninformed consumer. Since  $IC_{P,h}$  is binding, we only have to exclude the option to ultimately select  $(u_{P,l}, t_{P,l})$ . This is, however, strictly unprofitable as we obtain

$$V_{P,l} = \mu(\theta_h - \theta_l)(u_{A,l} - u_{P,l}) < 0.$$

**Q.E.D. (of Proposition 1)**

**Proof of Proposition 2.** To see first that it cannot be the case that *only* uninformed low-type consumers have a zero level of services, implying  $u_{A,l} > u_{P,l} = 0$ , recall from the proof of Proposition 1, which solves the relaxed program, that in fact  $u_{A,l} \leq u_{P,l}$ . Next, if the firm only serves high-demand consumers, then it is immediate that  $u_{\cdot,h} = u_h^{FB}$  and  $t_{\cdot,h} = \theta_h u_h^{FB}$  (Case 4). This leaves us with only one remaining case: Case 3, where only informed low-type consumers are excluded.

Note next that  $ICC_P$  becomes irrelevant, but that now the *ex ante* individual rationality constraint  $IR_P$  becomes binding:  $\mu V_{P,h} + (1 - \mu)V_{P,l} = 0$ . We show that  $ICC_{A,h}$  is binding. Suppose otherwise. Then the firm would propose a contract with  $V_{A,h} = 0$ . In order not to violate  $ICC_{A,h}$  we must have that  $V_{P,h} \leq 0$ . Because of individual rationality this requires that  $V_{P,l} \geq 0$ . But in this case the uninformed high-type consumer would profit from (later) choosing  $(u_{P,l}, t_{P,l})$  such that  $IC_{P,h}$  would be violated. This establishes that  $ICC_{A,h}$  is indeed binding such that  $V_{A,h} = V_{P,h}$ . For Case 3 note finally that  $IC_{P,h}$  is always binding. Otherwise, the firm could increase  $t_{P,h}$ , while simultaneously decreasing  $t_{P,l}$  so as to still satisfy  $IR_P$ , which would be profitable as it allows also to increase  $t_{A,h}$ .

Having thus established which constraints must be binding in Case 3, note that the rent of the informed high type is given by  $V_{P,l} + (\theta_h - \theta_l)u_{P,l}$ , which after substituting  $V_{P,l} = -\mu(\theta_h - \theta_l)u_{P,l}$  from  $IR_P$  becomes  $(1 - \mu)(\theta_h - \theta_l)u_{P,l}$ . This shows finally that  $u_{P,l}$  maximizes again (10). **Q.E.D. (of Proposition 2)**

**Proof of Proposition 3.** Using Proposition 1, define the function  $\tilde{\pi}_{12} := \frac{1}{2-\mu}$  to separate Case 1 from Case 2. Recall next that if informed and uninformed types obtain the same ("standard screening") contract, then only high-demand consumers are served if  $\mu > \theta_l/\theta_h$ , which separates Cases 1 and 3. To separate Cases 2 and 4, we use  $C'(0) = 0$  together with  $u_{A,l} = 0$  to solve from (2) for a function

$$\tilde{\pi}_{24}(\mu) := \frac{(\theta_h - \theta_l)\mu}{(1 - \mu)[\theta_l + (\theta_h - \theta_l)\mu]}$$

such that Case 2 only applies if  $\pi \geq \tilde{\pi}_{24}(\mu)$ . Note here that  $\tilde{\pi}_{24}(0) = 0$ ,  $\tilde{\pi}'_{24}(0) = (\theta_h - \theta_l)/\theta_l$ , and  $\tilde{\pi}'_{24}(\mu) > 0$ . Separating Cases 3 and 4, we proceed likewise and use  $C'(0) = 0$  next to  $u_{P,l} = 0$  to obtain from (3) that

$$\tilde{\pi}_{34}(\mu) := \frac{\theta_l}{\theta_l + (\theta_h - \theta_l)\mu},$$

which is strictly decreasing in  $\mu$ .

The assertions in Proposition 3 follow then immediately from applying the derived boundaries for the different cases. Note here, in particular, that all three boundaries ( $\tilde{\pi}_{12}$ ,  $\tilde{\pi}_{24}$ , and  $\tilde{\pi}_{34}$ ) together with the horizontal line  $\mu = \theta_l/\theta_h$  intersect at a single point:  $\mu = \theta_l/\theta_h$  and  $\pi = \frac{\theta_h}{2\theta_h - \theta_l}$ . **Q.E.D. (of Proposition 3)**

**Proof of Corollary 4.** Implicit differentiation of (2) and (3) yields

$$\begin{aligned}\frac{du_{A,l}}{d\pi} &= -\frac{\theta_h - \theta_l}{s''(u_{A,l}; \theta_l)} \frac{\mu}{1 - \mu} \frac{1}{\pi^2}, \\ \frac{du_{P,l}}{d\pi} &= \frac{\theta_h - \theta_l}{s''(u_{P,l}; \theta_l)} \mu \frac{1}{(1 - \pi)^2},\end{aligned}$$

such that  $dV_{A,h}/d\pi > 0$  holds if and only if

$$\frac{s''(u_{A,l}; \theta_l)}{s''(u_{P,l}; \theta_l)} < \frac{\mu}{(1 - \mu)^2} \frac{(1 - \pi)^2}{\pi^2}. \quad (12)$$

To show that generally the set of parameters for which (12) holds is non-empty, as well as the set for which the converse holds strictly, we consider parameters at the boundaries of Case 2. First, for  $\pi$  close to  $1/(2 - \mu)$ , (12) does not hold, given that in this case the right-hand side of (12) exceeds one, while as  $u_{A,l}$  and  $u_{P,l}$  become close to  $u_{S,l}$  the left-hand side of (12) converges to one. Second, when  $\pi$  is close to  $\tilde{\pi}_{24}$ , (12) holds at least for sufficiently small  $\mu$ . More formally, at the boundary  $\pi = \tilde{\pi}_{24}(\mu)$  the right-hand side of (12) becomes  $\frac{1}{\mu} \left( \frac{\theta_l}{\theta_h - \theta_l} + \frac{\mu(1-2\mu)}{1-\mu} \right)^2$  and thus tends to infinity as  $\mu \rightarrow 0$ .

Next, for  $C''' = 0$  condition (12) transforms to (5). Note next that  $\hat{\pi} < \tilde{\pi}_{12}$  holds if

$$\frac{\sqrt{\mu}}{1 + \sqrt{\mu} - \mu} < \frac{1}{2 - \mu},$$

which is always satisfied. After substitution into  $\hat{\pi} > \tilde{\pi}_{24}$  and some transformations, this condition becomes

$$\frac{\theta_l}{\theta_h - \theta_l} > \frac{\sqrt{\mu} - \mu\sqrt{\mu} + \mu^2}{1 - \mu},$$

which holds for  $\mu = 0$  but is violated close to the upper boundary  $\mu \rightarrow \theta_l/\theta_h$ . As the numerator on the right-hand side is increasing in  $\mu$  and the denominator is decreasing, this implies existence of an interior threshold such that the condition holds if and only if  $\mu$  is sufficiently small. **Q.E.D. (of Corollary 4)**

**Proof of Proposition 4.** The firm's offer must satisfy the new incentive compatibility constraint

$$\mu V_{P,h} + (1 - \mu)V_{P,l} \geq \mu V_{A,h} + (1 - \mu) \max\{V_{A,l}, V_{P,l}\} - k, \quad (13)$$

where we already used that  $V_{A,h} \geq V_{P,h}$  from  $ICC_{A,h}$  as well as  $V_{A,h} \geq 0$  from  $IR_{A,h}$ . We refer to (13) as  $ICC'_P$ . We characterize now stepwise the solution to the firm's new program.

**Step 1:** We first show that we can ignore the additional constraint  $ICC'_P$  in case the solution to the relaxed program (see Proposition 1) satisfies (7). Take thus the solution to the relaxed program (i.e., with  $k = \infty$ ). Recall from the proof of Proposition 1 that in this case  $ICC_P$  binds such that  $\mu V_{P,h} + (1 - \mu)V_{P,l}$  equals  $(\theta_h - \theta_l)u_{A,l}$ , while also

$V_{A,l} = 0$ ,  $V_{P,l} \leq 0$ , and  $V_{A,h} = V_{P,h} = V_h$  satisfies  $V_h = \mu(\theta_h - \theta_l)u_{A,l} + (1 - \mu)(\theta_h - \theta_l)u_{P,l}$ . Substituting these expressions into (13), we obtain

$$k \geq \mu(1 - \mu)(\theta_h - \theta_l)(u_{P,l} - u_{A,l}) - (1 - \mu)(\theta_h - \theta_l)u_{A,l},$$

implying that  $ICC'_P$  holds from (7).

In what follows we can thus focus on the case where condition (7) does not hold such that  $ICC'_P$  must bind.<sup>17</sup>

**Step 2:** Note that from the same arguments as in the proof of Proposition 1 it holds that  $u_{.,h} = u_h^{FB}$  and  $V_{A,l} = 0$ .

**Step 3:** We claim that if  $ICC'_P$  binds, then also  $ICC_{A,h}$  must bind such that  $V_{A,h} = V_{P,h} = V_h$ . We prove this by contradiction and suppose that  $V_{A,h} > V_{P,h}$ . Clearly, as the firm optimally increases  $t_{A,h}$  as much as possible and as  $ICC_{A,h}$  does not bind by assumption, the constraint  $IC_{A,h}$  must bind such that  $V_{A,h} = (\theta_h - \theta_l)u_{A,l}$ .

We next determine  $u_{A,l}$  and  $u_{P,l}$ . As  $ICC_{A,h}$  is supposed not to bind, it is immediate that optimally  $u_{P,l} = u_l^{FB}$ . To determine  $u_{A,l}$  note that from  $V_{A,h} > V_{P,h}$  and from the binding  $ICC'_P$  a reduction  $dt_{A,h} < 0$  increases the utility of the uninformed consumer by  $-\mu dt_{A,h}$ . Recall also that  $IC_{A,h}$  is binding. Consequently, the choice of  $u_{A,l}$  optimally trades off the maximization of the surplus  $s(u_{A,l}; \theta_l)$  with the reduction of the rent  $(\theta_h - \theta_l)u_{A,l}(1 - \pi + \pi\mu)$ . As we assume that the firm serves all consumers, we thus have that  $u_{A,l}$  solves

$$s'(u_{A,l}; \theta_l) = \frac{1 - \pi + \pi\mu}{\pi(1 - \mu)}(\theta_h - \theta_l). \quad (14)$$

Note that the resulting value of  $u_{A,l}$  is thus strictly *smaller* than that determined for Case 2 in (2). As also  $u_{P,l} = u_l^{FB}$  is strictly larger than the respective value in Case 2, we thus have that the difference  $u_{P,l} - u_{A,l}$  is strictly larger than the respective difference for the solution in Case 2. Consequently, as by assumption (7) was not satisfied for the solution to the original program (Case 2), where  $u_{P,l} - u_{A,l}$  was smaller, it must hold *a fortiori* that now

$$k < \mu(1 - \mu)(\theta_h - \theta_l)(u_{P,l} - u_{A,l}). \quad (15)$$

Note next that  $V_{A,h} = (\theta_h - \theta_l)u_{A,l}$ , while from  $IC_{P,h}$  we have that  $V_{P,h} \geq V_{P,l} + (\theta_h - \theta_l)u_{P,l}$ . Substituting into  $V_{A,h} > V_{P,h}$ , which holds by assumption, we have that  $(\theta_h - \theta_l)u_{A,l} > V_{P,h} \geq V_{P,l} + (\theta_h - \theta_l)u_{P,l}$ . It follows that

$$(\theta_h - \theta_l)(u_{P,l} - u_{A,l}) < -V_{P,l}. \quad (16)$$

As we have from the binding  $ICC'_P$  in (13) that  $-(1 - \mu)V_{P,l} = k - \mu(V_{A,h} - V_{P,h})$ , together with (16) this yields the requirement

$$k > (1 - \mu)(\theta_h - \theta_l)(u_{P,l} - u_{A,l}) + \mu(V_{A,h} - V_{P,h}), \quad (17)$$

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<sup>17</sup>Note that we can rule out the case where  $ICC'_P$  constrains the firm's choice *without* being binding at the optimal offer. If (7) does not hold, then the firm's expected profits are strictly decreasing in  $\mu V_{P,h} + (1 - \mu)V_{P,l}$  and thus in the "slack" that would arise when  $ICC'_P$  did not hold with equality.



contradicting (15).

**Step 4:** Substituting  $V_{.,h} = V_h$  into the binding  $ICC'_P$ , we have that (13) becomes

$$(1 - \mu)V_{P,l} = (1 - \mu) \max \{V_{A,l}, V_{P,l}\} - k,$$

which clearly requires  $V_{P,l} < 0$  and which from  $V_{A,l} = 0$  thus yields that

$$V_{P,l} = -\frac{k}{1 - \mu}. \quad (18)$$

**Step 5:** We next claim that if  $ICC'_P$  binds, then also  $ICC_P$  must bind. Substituting for  $\mu V_{P,h} + (1 - \mu)V_{P,l}$  from the binding  $ICC'_P$  and from (18) (together also with  $V_{.,h} = V_h$ ), note that  $ICC_P$  becomes

$$\mu V_h - k \geq \mu(\theta_h - \theta_l)u_{A,l}. \quad (19)$$

Suppose, by contradiction, that  $ICC_P$  does not bind. Then in the optimal contract it must clearly hold that  $IC_{A,h}$  or  $IC_{P,h}$  (possibly both) must bind. We argue now that  $IC_{A,h}$  must bind. If only  $IC_{P,h}$  binds, then note first that  $V_h = -k/(1 - \mu) + (\theta_h - \theta_l)u_{P,l}$ , while an uninformed consumer realizes  $\mu V_h - k$ . It is immediate that the optimal offer must satisfy  $u_{P,l} < u_{A,l} = u_l^{FB}$ . As then  $V_{A,h} \geq (\theta_h - \theta_l)u_l^{FB}$ , while  $V_{P,h} = V_{P,l} + (\theta_h - \theta_l)u_{P,l}$  with  $V_{P,l} < 0$  and  $u_{P,l} < u_A^{FB}$ , we have  $V_{A,l} > V_{P,l}$ . This contradicts that  $ICC_{A,h}$  must be binding (as proved in step 3).

As  $IC_{A,h}$  must thus bind, we have that  $V_h = (\theta_h - \theta_l)u_{A,l}$ . Substituting this into  $ICC_P$  in (19) yields then the requirement  $\mu(\theta_h - \theta_l)u_{A,l} - k \geq \mu(\theta_h - \theta_l)u_{A,l}$ , which clearly can not hold.

**Step 6:** We claim that if  $ICC'_P$  binds, then  $IC_{P,h}$  is binding but not  $IC_{A,h}$ . To prove this claim, we first argue that we can ignore the constraint  $IC_{A,h}$ . This follows immediately as by combining the binding constraints  $ICC_P$  and  $ICC'_P$  (using step 5) we have that

$$V_h = (\theta_h - \theta_l)u_{A,l} + \frac{k}{\mu}. \quad (20)$$

If  $IC_{P,h}$  was *also* not binding, then the firm could benefit from simply reducing  $V_h = V_{.,h}$  (by increasing the transfer). Consequently,  $IC_{P,h}$  must bind.

**Step 7:** Note next that, as in the proof of Proposition 1, we have from the binding constraints  $IC_{P,h}$  and  $ICC_P$  that  $V_h$  is given by (9). Together with the binding constraint  $ICC'_P$  this implies condition (8) for the difference  $u_{P,l} - u_{A,l}$ .

We turn now to the determination of  $u_{A,l}$  and  $u_{P,l}$ . Note that, expressed solely as a function of  $u_{A,l}$ , we have for the informed high type  $V_h = \frac{k}{\mu} + (\theta_h - \theta_l)u_{A,l}$  and for the uninformed consumer the expected utility  $\mu(\theta_h - \theta_l)u_{A,l}$ . Hence, trading off surplus maximization with consumer rent extraction, the optimal choice of  $u_{A,l}$  maximizes

$$\pi(1 - \mu)s(u_{A,l}; \theta_l) + (1 - \pi)(1 - \mu)s(u_{P,l}; \theta_l) - \mu(\theta_h - \theta_l)u_{A,l},$$

where  $u_{P,l}$  depends on  $u_{A,l}$  according to (8) (i.e.,  $du_{P,l}/du_{A,l} = 1$ ). Given that we focus on the case where it is optimal for the firm that all consumers purchase a positive level  $u_{.,i} > 0$ , this yields the first-order condition

$$\pi(1 - \mu)s'(u_{A,l}; \theta_l) + (1 - \pi)(1 - \mu)s'(u_{P,l}; \theta_l) = \mu(\theta_h - \theta_l). \quad (21)$$

**Step 8:** We claim the following: If the solution in Case 2 of Proposition 1 does not satisfy (7), then equations (21) and (8) pin down a unique solution  $u_{A,l} < u_{P,l} < u_l^{FB}$  such that  $u_{A,l}$  is larger and  $u_{P,l}$  smaller than in the offer of Case 2.

To prove this claim it is convenient to consider  $u_{P,l}$  as the remaining variable, with  $u_{A,l}$  determined by (8). We argue first that when setting  $u_{P,l} = u_l^{FB}$  and the corresponding value  $u_{A,l} = u_{P,l} - y$  with  $y := \frac{k}{\mu(1-\mu)(\theta_h - \theta_l)}$ , then the left-hand side of (21) is strictly lower than the right-hand side. To see this, note that the left-hand side of (21) then becomes  $\pi(1 - \mu)s'(u_{A,l}; \theta_l)$ . Take now as a comparison the solution  $u_{A,l}$  in Case 2 as given by (14), which as we know must clearly be strictly lower. The assertion follows then as at this lower value of  $u_{A,l}$  we have that  $\pi(1 - \mu)s'(u_{A,l}; \theta_l)$  equals  $(1 - \pi + \pi\mu)(\theta_h - \theta_l)$ , which is in turn strictly lower than the right-hand side  $\mu(\theta_h - \theta_l)$  of (21). As a final note, observe that using  $du_{A,l}/du_{P,l} = 1$  uniqueness of  $u_{A,l}$  follows from strict concavity of the surplus function, implying that the left-hand side of (21) is strictly monotonic.

**Step 9:** For a comparison with Case 2 at the upper boundary for  $k$ , recall first that from the characterization in Case 1 we have that  $\pi(1 - \mu)s'(u_{A,l}; \theta_l) = (\mu(1 - \pi + \pi\mu)(\theta_h - \theta_l)$  and that  $(1 - \pi)(1 - \mu)s'(u_{P,l}; \theta_l) = \pi\mu(1 - \mu)(\theta_h - \theta_l)$ . Adding up the right-hand sides yields exactly  $(\theta_h - \theta_l)\mu$ . Hence, the solutions for  $u_{A,l}$  and  $u_{P,l}$  satisfy (21). Moreover, by definition we have that at the upper boundary of  $k$ , where  $ICCP'$  just starts to bind, (7) is satisfied with equality, yielding condition (8). **Q.E.D (of Proposition 4.)**

**Proof of Corollary 5.** We claim that  $u_{A,l}$  is strictly decreasing and  $u_{P,l}$  strictly increasing in  $k$ , where also  $u_{.,l} \rightarrow u_l^S$  for  $k \rightarrow 0$  and where at  $k$  satisfying (7) there is continuity with respect to the offers of Case 2. Using the derivations in the proof of Proposition 4, monotonicity in  $k$  follows immediately from implicit differentiation of (21), which establishes that

$$\frac{du_{P,l}}{dy} = \frac{\pi s''(u_{A,l}; \theta_l)}{\pi s''(u_{A,l}; \theta_l) + (1 - \pi)s''(u_{P,l}; \theta_l)} > 0$$

and

$$\frac{du_{A,l}}{dy} = -\frac{(1 - \pi)s''(u_{P,l}; \theta_l)}{\pi s''(u_{A,l}; \theta_l) + (1 - \pi)s''(u_{P,l}; \theta_l)} < 0. \quad (22)$$

For the convergence (and continuity) results, note that we can substitute  $y = 0$  for the case of  $k = 0$ . **Q.E.D (of Corollary 5.)**

**Proof of Corollary 6.** To show that uninformed consumers benefit from a reduction in information acquisition costs, recall first that condition (7) just binds in Case 2b. There, where offers satisfy (8), an uninformed consumer becomes indifferent between her two options for a deviation: the option of acquiring information and mimicking the respective,

preferred informed type and the option of mimicking an informed low-type consumer without acquiring information. From the latter option, and as the incentive constraint binds, an uninformed consumer realizes  $\mu(\theta_h - \theta_l)u_{A,h}$  (cf. also equation (6)). As, from Corollary 5,  $u_{A,l}$  increases in response to a decrease in  $k$ , the uninformed consumer's expected utility thus indeed strictly increases.

Next, for Case 2b we know from Proposition 4 that informed consumers obtain the utility  $V_h = \frac{k}{\mu} + (\theta_h - \theta_l)u_{A,l}$ . Hence, using (22) we have

$$\frac{dV_h}{dk} = \frac{1}{\mu} - \frac{1}{\mu(1-\mu)} \frac{(1-\pi)s''(u_{P,l}; \theta_l)}{\pi s''(u_{A,l}; \theta_l) + (1-\pi)s''(u_{P,l}; \theta_l)}.$$

This derivative is, in general, of ambiguous sign. In the special case that  $C'''$  is zero, this reduces to

$$\frac{dV_h}{dk} = \frac{1}{\mu} \left( 1 - \frac{1-\pi}{1-\mu} \right),$$

which is negative if and only if  $\mu > \pi$ .

Finally, using the derivations in the proof of Proposition 4, the impact on welfare from a change in  $k$  can be determined from

$$\pi(1-\mu)s'(u_{A,l}; \theta_l) \frac{du_{A,l}}{dy} + (1-\pi)(1-\mu)s'(u_{P,l}; \theta_l) \frac{du_{P,l}}{dy},$$

where we use  $y := \frac{k}{\mu(1-\mu)(\theta_h - \theta_l)}$ . Substituting for  $\frac{du_{P,l}}{dy}$  and  $\frac{du_{A,l}}{dy}$ , the term is strictly negative whenever

$$\pi(1-\pi)(1-\mu)^2 s'(u_{P,l}; \theta_l) |s''(u_{A,l}; \theta_l)| < \pi(1-\pi)(1-\mu)^2 s'(u_{A,l}; \theta_l) (1-\mu) |s''(u_{P,l}; \theta_l)|,$$

which reduces to

$$\frac{s'(u_{P,l}; \theta_l)}{|s''(u_{P,l}; \theta_l)|} < \frac{s'(u_{A,l}; \theta_l)}{|s''(u_{A,l}; \theta_l)|}.$$

This is always satisfied if  $C'''$  is zero since  $u_{P,l} > u_{A,l}$ . **Q.E.D. (of Corollary 6)**

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