Investments and privacy when consumers pay with personal data*

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Abstract

We study a content platform that can commercialize user data through personalized advertising. It chooses advertising over pure content provision if data generated by content consumption are sufficiently informative. Advertising then is excessive. The platform may want to subsidize participation and consumption. However, money-motivated users generate noise which may constrain the profit-maximizing tariff at zero. Consumers paying for content entirely with personal data optimally trade off improvements in user experience against losses in privacy rent. Yet, privacy is inefficient by the platform's distorted incentives to invest in artificial intelligence to improve analytical power and in quality to stimulate content consumption.

Keywords: Artificial intelligence, content platform, personalized advertising, privacy, quality

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> Consumers use search engines that produce incredibly accurate results. Social networks let people keep in touch with friends, wherever they are in the world. And they don't pay a single penny for those services. Instead, they pay with their data. That doesn't have to be a problem, as long as people are happy that the data they share is a fair price to pay for the services they get in return. Personal data has become a valuable commodity.
>
> Margrethe Vestager, EU Commissioner for Competition.[1]

1 Introduction

Search engines, social media and many other digital platforms earn their revenue mainly by commercializing data collected from users. This business model challenges our valuation of consumer privacy, and has attracted the attention of competition authorities and the concern of policy makers. For instance, the German Competition Authority conducted an investigation into Facebook's practice of compiling data from third-party websites. They decided to restrict external data collection by requiring that Facebook only do so subject to users' individual consent.[2] At a European level, Regulation 2016/679, better known as the General Data Protection Regulation (GDPR), contains rules to protect individuals within the European Union with regard to the processing and movement of personal data. The United States, in contrast, has not established a unified framework for regulating commercial use of personal data.[3] Yet, survey evidence suggests that data privacy is a main concern of US citizens (Drenik, 2023).

Applications of increasingly powerful prediction tools built on artificial intelligence (AI) have been instrumental in increasing the commercial value of data. Recent progress in generative AI has accelerated privacy concerns, with calls being made to halt further development and use of such tools. Yet, despite the prominence of these phenomena in daily life and policy debates, the discourse lacks coherent frameworks to understand markets where customers buy services with their personal data and where firms invest in analysing such data.

We develop a model where a monopoly platform invests in AI to improve data analysis and in quality to attract consumers and increase content consumption. The platform profits from information through an improved ability to target users with personalized

[1] ec.europa.eu/commission/commissioners/2014-2019/vestager/announcements/making-data-work-us_en

[2] bundeskartellamt.de/SharedDocs/Meldung/EN/Pressemitteilungen/2019/07-02-2019-Facebook.html

[3] The US has a mix of state-level privacy laws, and federal laws targeting specific data types. California's Consumer Privacy Act from 2018, updated with the Privacy Rights Act effective from 2023, is currently the strictest data privacy law in the US.

advertising. On the demand side, agents choose whether to participate on the platform, how much content to consume, and whether to buy products advertised on the platform. Content consumption generates productive user data that reveal information about the individual. A key aspect of our model is that users can apply "bots" to generate additional non-productive "fake" user data through insincere platform usage. This limits both the firm's ability to attract users and to stimulate content consumption through subsidies.[4] The platform may then fail to internalize economic effects of data collection and analysis through its platform tariff. Our results deliver insights into four related policy questions.

How does investment in AI affect privacy and efficiency? To analyze technology investment in relation to privacy issues, we distinguish between data and information. Information is the output obtained by the firm after feeding user data into a prediction machine (Agrawal et al., 2018). Better AI technology improves the platform's information for any given quantity of user data by increasing the power of the prediction machine. Hence, a user may experience a *loss in information privacy* (which occurs when the firm knows more about the user) as a consequence of AI investment, which is distinct from that individual's *loss in data privacy* (which occurs when the firm collects more user data).[5] The distinction matters because an individual has some control over own data provision through individual platform usage, but has no influence over how the platform processes this information. A user may benefit from giving up some privacy because more precise information about user preferences improves the individual user experience on the platform. However, better information enables the firm to extract more consumer rent through better targeted ads. The platform ignores both effects under a zero platform tariff. We establish necessary and sufficient conditions for overinvestment in AI to occur. This equilibrium has too little information privacy in the sense that information extraction by the platform is excessive.

Do platforms have distorted incentives to invest in quality? The platform invests in quality to stimulate participation and content consumption. Increased participation is valuable because of the advertising profit additional consumers bring in. Increased content consumption is valuable because it generates additional user data which the platform can analyze to improve advertising. Still, the platform underinvests in quality under a zero platform tariff because it does not account for the positive effect of increased quality on

[4] The social media platform *X* has announced a plan to charge all participants for platform usage. The main purpose is to get rid of bots and fake accounts on the platform, according to the owner, Elon Musk; see bbc.com/news/technology-66850821.

[5] An individual concerned with data privacy dislikes sharing of personal data. Somebody who values information privacy is concerned about the consequences of sharing data regarding the information these data reveal and how information might affect him or her. The former is sometimes referred to as an intrinsic and the latter as an instrumental preference for privacy; see for instance Lin (2022) and Acemoglu (2024).

infra-marginal users.

Will platform usage and data collection be inefficient in equilibrium? The platform tariff affects participation on the extensive margin and platform usage on the intensive margin. It would like to subsidize participation and content consumption if users and the information generated by content consumption are very valuable. But subsidies would attract opportunists and trigger insincere platform use, both of which are worthless to the platform. To avoid freeriding, the equilibrium tariff has a particular structure which encompasses many commonly observed tariffs as special cases: Users pay a non-negative subscription fee for accessing the platform in return for a free user allowance. The platform may charge an overage fee to limit platform usage. From a consumer perspective, free access and free usage maximize expected utility in the set of non-negative platform tariffs. It follows that participation and content consumption are efficient if the zero tariff maximizes platform profit. Data privacy is efficient in this case because content consumption is efficient. Instead, participation, content consumption and data generation are inefficiently low if the equilibrium platform tariff is positive or the user allowance is limited.

Is advertising excessive? The platform engages in advertising if and only if information about consumer preferences is sufficiently precise. The firm is a pure content provider otherwise. Advertising, if it occurs, will be excessive for two reasons. First, the platform disregards the nuisance cost of advertising because advertising is chosen after the consumer has joined the platform. Second, the platform assesses the impact on the marginal instead of the average consumer when choosing advertising intensity, measured by the number of different varieties advertised on the platform. The benefit to the marginal consumer of an increase in product variety is larger than the benefit to the average consumer constituting the appropriate efficiency benchmark. This distortion causes too much product variety and thereby too much advertising in equilibrium.

We proceed as follows. Section 2 places our paper in the literature. We present our model in Section 3. It is solved by backward induction by first analyzing personalized advertising in Section 4, consumers' optimal platform participation and usage in Section 5, and the profit-maximizing platform tariff in Section 6. Section 7 considers AI investment, and Section 8 analyzes investment in quality. We conclude in Section 9. The Appendix contains proofs of some of the formal statements in the main text.

2 Contributions to the literature

Extensive research has been devoted to understanding markets for information; see Bergemann and Bonatti (2019) for a survey. Many papers analyze the downstream side of the market where an intermediary, a platform in our case, sells user data to advertisers or data brokers. A main issue is imperfect competition in this market. Trade of information raises additional questions about privacy protection that these papers often leave aside.[6] Privacy is of key concern to an evolving literature analyzing the upstream relationship between users and the intermediary (e.g. Bergemann and Bonatti, 2019; Jones and Tonetti, 2020; Ichihashi, 2021; Bergemann et al., 2022 and Acemoglu et al., 2022). An interesting question is whether allocation of data property rights can resolve privacy concerns through the pricing mechanism. Results show that outcomes in the data market typically are inefficient, particularly in the presence of data externalities that arise when one individual's data provide information about other users.

We consider the upstream relationship between users and the platform. Downstream inefficiencies are ignored by an assumption that advertising profit measures the full producer surplus associated with goods advertised on the platform. For instance, advertising could be the outcome of efficient bargaining between the platform and advertisers.[7] This simplification facilitates analysis of a fundamental aspect of information markets generally disregarded by the previous literature. Instead of data being exogenously given quantities, we treat data generation as an endogenous outcome of participation and usage decisions by agents. We incorporate an additional important aspect of content platforms: They provide an infrastructure through which (information about) goods can reach potential customers, as emphasized by Aguiar et al. (2024) and Bergemann and Bonatti (2024). Advertising on the platform affects the perceived benefits and costs of joining and using the platform, which has consequences for the quantity and quality of user data the platform will be able to collect. Our model captures this inter-dependency. It encapsulates the possibility of data trade between users and the platform through the nonlinear platform tariff, which formally allows subsidization of platform usage. Data markets turn out to be nonviable in our framework because the buyer (the platform) cannot distinguish between productive and non-productive data offered by a seller (consumer) just by examination of the data.

Armstrong (2006) provides the standard argument why access would be free for consumers on a two-sided platform. The access fee for users on one side of the platform are smaller in equilibrium if the externalities they exert on users on the other side are more positive. By implication, consumers pay a non-positive fee if they are sufficiently valuable to advertisers. That contribution and most others in the field, see Jullien et al. (2021) for

[6] An exception is de Corniere and de Nijs (2016) who examine incentives for a platform to disclose individual user data to advertisers who use these data to infer demand. Disclosure improves the match between products and consumers, which particularly benefits the industry through higher prices of advertised goods.

[7] Hagiu and Wright (2015) perform an interesting analysis of a platform's choice between vertical integration and "two-sidedness" where contracting is decentralized to buyers and sellers. Efficient contracting between platform and advertisers implies that the platform in our context is not two-sided according to their characterization.

a comprehensive survey, assume that an individual's only decision is whether to join the platform. Gans (2021) argues that free disposal of goods would generate a mass point of demand at a retail price equal to zero. In this spirit, agents have free disposal of platform participation in our model by the possibility to create a fake user profile at no cost and free disposal of platform usage by the possibility to program a bot at no cost. The latter feature is also highlighted by Corrao et al. (2023) who study optimal nonlinear pricing when there is free disposal and usage generates revenues to the seller, yielding a zero marginal price as in our model.

Unlike these studies, we analyze both platform participation on the extensive margin and content consumption on the intensive margin, with a detailed model of how platform usage generates revenues through advertising at a later stage. This allows us to go beyond studying the optimal tariff structure in itself, and address our four interconnected questions about AI and privacy, platform quality, data collection, and advertising.

The content platform in our context shares common features with a media platform generating business by connecting advertisers and subscribers; see Anderson and Jullien (2015) for a survey. The media platform must provide content to attract users who dislike advertising. In the seminal contribution by Anderson and Coate (2005) and the extension by de Corniere and Taylor (2023), the media platform has exogenous information about consumer preferences. A main question in this literature is whether advertising levels are efficient, with effects typically being ambiguous. Most studies assume that individuals only decide whether to join the platform. An exception is Reisinger (2012) who establishes circumstances with over- or under-provision of advertising under the assumption of endogenous platform usage and a zero platform tariff.

In our model, information about consumer preferences is endogenous and more precise when content consumption increases. We analyze both the decision to engage in advertising and how many varieties to advertise depending on this information. Our main result in this context is that advertising is excessive when it occurs. Moreover, our model highlights the feedback between advertising and the firm's pricing of content consumption.

A small number of papers incorporate privacy issues in the economic analysis of platforms; see Acquisti et al. (2016) for a survey of the economics of privacy. In Kox et al. (2017), competing platforms compile personal information from their subscribers. Distortions occur if individuals are unable to detect whether platforms collect personal information. Under complete information, platforms implement efficient data privacy. In Dimakopoulos and Sudaric (2018), platforms impose a minimal data requirement for granting access to the platform. Data collection is inefficient because platforms ignore infra-marginal consumers' value of privacy under a zero tariff. An access fee would restore efficiency by enabling platforms to fully internalize consumers' value of privacy. In Choi et al. (2019), data collection from platform users reduces the privacy of *non-users* because of a data externality. Data collection is excessive even in an equilibrium with full market coverage because reduced privacy diminishes the value of the non-user outside option and thereby enables the platform to extract more rent through a higher subscription fee.

In our framework, the profit-maximizing platform tariff can lead to inefficient data collection even under complete information and absent any data externalities. Some of our results are consistent with Lefez (2024) who analyzes a platform that collects information from buyers and transmits it to sellers. He finds that the platform collects too little information if it charges both sellers and buyers for access. We complement the previous literature by incorporating non-price strategies into the analysis, in terms of investment in AI and quality. Our paper adds to an emerging literature emphasizing consequences of AI for privacy. Acemoglu (2024) builds on Acemoglu et al. (2022) to argue that AI can be harmful because of data externalities across consumers. We derive circumstances when AI is harmful even absent data externalities because of excessive incentives to extract information from consumers by investment in AI. In an extension we introduce data externalities, and find that their presence may exacerbate or ameliorate distortions in AI investment incentives.

3 The model

This section describes the general properties of our model. The demand side consists of agents who choose whether to participate on a content platform, how much content to consume, and whether to purchase advertised products. On the supply side, a monopoly invests in AI and in quality, sets a platform tariff, and decides about advertising on the platform. Section 3.1 presents general expressions for the agents' utility functions, Section 3.2 the platform's profit function, and Section 3.3 the joint welfare function. The timing of the game is described in Section 3.4. Presentation of the specific model of personalized advertising is deferred to Section 4.

3.1 Agents

Two types of agents might participate on the platform. A consumer is valuable to the platform, but an opportunist is not.

Consumers. There is one representative consumer who derives utility from consuming content and therefore may have a willingness to pay for access to and use of the platform. This consumer also has a willingness to pay for goods advertised on the platform. The net surplus from using the platform and purchasing advertised goods is $y + V(q) - T(d)$. Here, y is an exogenous value of participating on the platform regardless of platform usage, $V(q)$ is the consumer's gross utility of content consumption $q \geq 0$, and $T(d)$ is a nonlinear platform tariff that depends on the total quantity $d \geq 0$ of platform usage. Content consumption is not the only way to use the platform, as we discuss below. The outside option of not participating on the platform is worth zero.

The exogenous valuation y is private information to the consumer, but it is common knowledge that $y \in [-\underline{y}, \bar{y}] = \mathcal{Y}$ with cumulative distribution function $G(y)$ and density function $g(y)$. We impose the monotone hazard rate property that $\frac{g(y)}{1-G(y)}$ is non-decreasing. The hazard rate is a measure of the semi-elasticity of participation demand, in absolute value terms. Participation demand is more elastic the larger is the hazard rate. We assume $\underline{y} > \max_{q \geq 0} V(q)$, so that the consumer opts out if the valuation y is sufficiently low and the platform tariff is non-negative. We also assume $\bar{y} > -\min_{q \geq 0} V(q)$, so that the consumer opts in if the valuation y is sufficiently large and the platform tariff is zero or negative.

The gross utility of content consumption consists of three additively separable terms

$$V(q) \;=\; \underbrace{U(q) - hN(\Phi(q))}_{\text{User experience}} + \underbrace{CS(\Phi(q))}_{\text{Privacy rent}}. \tag{1}$$

$U(q)$ measures the direct utility from consuming platform content in quantity q. This utility is continuous and strictly quasi-concave, with a bliss point $b > 0$. Additional consumption above b reduces utility. This makes sense if, for instance, q measures the time spent on the platform, and there is an opportunity cost of time that may dominate the direct utility of using the platform. Another interpretation is that the consumer experiences a disutility of giving up privacy which is embedded in the utility function $U(q)$. The privacy effect dominates for sufficiently large q, in which case additional content consumption reduces direct utility. $N(\Phi(q))$ is the advertising intensity on the platform, and $h > 0$ is the marginal disutility or nuisance that the consumer experiences from additional advertising. The nuisance cost arises whether or not the consumer buys any advertised product. Advertising intensity depends on content consumption indirectly through the function $\Phi(q)$. As will become clear in Section 4, $\Phi(q)$ measures the precision of the platform's information about the consumer obtained by analysing user data derived from content consumption. We assume that the advertising intensity is strictly decreasing in content consumption because the platform can better target the consumer if it has more precise information. We define the *user experience* in (1) as the direct utility of content consumption minus the nuisance cost of advertising. The function $CS(\Phi(q))$ measures the consumer's expected value of purchasing goods advertised on the platform. This consumer surplus depends on content consumption indirectly through the information it reveals about the consumer. We also refer to $CS(\Phi(q))$ as the consumer's *privacy rent.* This privacy rent is decreasing in content consumption because the platform can exploit better information about the consumer to extract rent.

The consumer can engage in insincere activities in quantity $q_0 \geq 0$, in addition to consuming content. The total platform usage amounts to $d = q + q_0$. Insincere platform usage neither has any intrinsic benefit nor cost from the viewpoint of the consumer. Think of it as a bot that randomly browses content on the platform. Insincere platform usage limits the platform's gains from stimulating content consumption through the platform tariff. We assume that the consumer does not engage in insincere activities unless there is a strict benefit from doing so.

Opportunists. There exists a measure $\rho \geq 0$ of opportunists, indexed by superscript o. An opportunist derives no exogenous value of being on the platform, no direct utility from consuming platform content, has no disutility of receiving advertising, nor any willingness to pay for goods advertised on the platform. Hence, $y^o = 0$ and $V^o(q^o) = 0$ for all $q^o \geq 0$. However, an opportunist will participate on the platform if paid to do so, that is, if $T(d) < 0$ for some $d \geq 0$. The opportunist will then generate platform usage by engaging in insincere activities in quantity $q_0^o \geq 0$ to minimize $T(d)$. An example of such behavior would be to construct a fake user profile on the content platform with a bot to randomly engage on the platform. We assume that opportunists opt out if the platform tariff is non-negative for all $d \geq 0$. Opportunists represent an obstacle to attracting consumers through platform subsidies, as will be clear below.

3.2 The monopoly content platform

The platform supplies content and may engage in advertising directed towards its users. The total profit of attracting the representative consumer (not an opportunist) to the platform equals $\Pi(q) - cq_0 + T(d)$, where

$$\Pi(q) = \underbrace{R(\Phi(q))}_{\text{Advertising revenue}} - \underbrace{fN(\Phi(q))}_{\text{Advertising cost}} - \underbrace{cq}_{\text{Data cost}} \tag{2}$$

represents the profit associated with the consumption of platform content in quantity q. The advertising revenue is what the platform expects to earn on selling goods advertised on the platform. This revenue depends on content consumption indirectly through the information $\Phi(q)$ it reveals about the consumer and is an increasing function of q. Advertising is costly, and we assume that the advertising cost scales linearly with advertising intensity, where the unit cost of advertising equals $f > 0$. This cost represents not only the production of actual ads, but also the cost of obtaining and possibly holding inventories of the different varieties. The parameter $c \geq 0$ measures the constant unit cost of handling data. We assume that the advertising revenue is sufficiently high for $\Pi(q)$ to be non-negative in the relevant domain. The profit function $\Pi(q)$ is strictly concave by assumption. The total profit of attracting the consumer is reduced by an additional data cost cq_0 if the consumer generates non-productive data $q_0 > 0$.

The purpose of collecting user data is to obtain consumer information. We assume a one-for-one relationship between content consumption and generation of *productive data*; q measures the quantity of productive data collected from the consumer. Insincere platform usage generates additional *non-productive data* in quantity q_0. The platform cannot tell the difference between productive and non-productive data. Instead, it feeds all collected data $d = q + q_0$ into an AI algorithm, a *prediction machine*, that delivers information $\Phi(d) \geq 1$ about the consumer. Specifically, $\Phi(d) = \Phi(q)$ for all $q_0 \geq 0$ so that non-productive data contain no information about the consumer. We let $\Phi(q)$ be a strictly increasing function so that more content consumption provides more information. For technical reasons, we also assume that $\Phi^{-\frac{1}{2}}(q)$ is convex.[8] An opportunist only engages in insincere activities on the platform, $d^o = q_0^o$, thus generating information $\Phi(q_0^o) = \Phi(0) = 1$. Non-separability of q from q_0 implies that the monopoly charges a nonlinear fee $T(d)$ that only depends on total platform usage.[9]

The monopoly can make two types of investments. It can invest in improved AI to enhance the power of its prediction machine. We parameterize the power of the AI by $\theta \in [0, \bar{\theta}]$, so that the output of the machine is $\Phi(q, \theta)$, which is increasing in θ for all $q > 0$. The platform can also invest in improving the quality of the platform service. This could for instance involve production of content by the platform. We parameterize this component by s, so that the consumer's direct utility of using the platform is $U(q, s)$. In particular, the total and marginal utility of using the platform are both increasing in s. The cost $\Psi(\theta)$ of AI is an increasing function of θ, and the cost $\Upsilon(s)$ of quality is an increasing function of s.

3.3 Welfare of content consumption

Adding up the gross utility in (1) and the profit associated with consumption of platform content in (2) produces the welfare of content consumption:

$$W(q) = V(q) + \Pi(q) = U(q) - cq + S(\Phi(q)). \tag{3}$$

[8]This condition is satisfied, for instance, by the constant elasticity function $\Phi(q) = (1 + q)^\theta$, $\theta > 0$, and the exponential function $\Phi(q) = e^{\theta q}, \theta > 0$.

[9]The consumer is privately informed about its preference y for participating on the platform, so the firm might consider offering a mechanism specifying platform usage $d(y)$ and a non-linear tariff $T(y)$ as functions of the possible types of the consumer. The consumer would self-select among the menu of contracts offered on the platform. Additive separability between the preference y and the gross utility $V(q)$ of using the platform strongly limits the ability to screen among consumer types through contracting. The monopoly can do no better than to offer one single type-independent contract.

It consists of the consumer's direct utility $U(q)$ of content consumption minus the platform's data cost cq plus the total advertising surplus

$$S(\Phi(q)) = CS(\Phi(q)) + R(\Phi(q)) - (h+f)N(\Phi(q)) \tag{4}$$

defined as the sum of the consumer surplus of purchasing goods on the platform and the advertising revenue minus the sum of the nuisance and advertising cost. We assume that $S(\Phi(q))$ is strictly concave.

3.4 Timing

The model has four stages with the following timing:

1. The monopoly invests in AI and quality.
2. The monopoly commits to a non-linear platform tariff.
3. The agents decide whether to participate on the platform and how to use the platform in that case. Participants pay the platform tariff as a function of their usage.
4. The monopoly analyzes user data. It then decides how many (if any) varieties of a product to advertise to each individual participant, the characteristics of those varieties, and their prices. Participants make their purchase decisions.

We solve for sub-game perfect equilibrium by backward induction.

4 Personalized advertising

This section analyses stage four of the game in which the platform decides on advertising. The presentation is heuristic, emphasizing how information affects advertising intensity, profit and consumer surplus, how these quantities relate to one another, and whether advertising is efficient. The full analysis of personalized advertising is provided in an online appendix (Natvik and Tangeras, 2024).

The model. The representative consumer is of type i located on a circle $\mathcal{I}$ with unit circumference. The type determines the consumer's preferences over differentiated goods also located on the circle. The consumer derives utility $\bar{v} - p_n - \frac{1}{\sigma}|i - l_n|$ from purchasing one unit of variety n located at $l_n \in \mathcal{I}$ when the price of that variety is p_n. The parameter $\bar{v} > 0$ represents the maximal willingness to pay for any good on the platform. The parameter $\sigma > 0$ is a measure of horizontal product differentiation, a higher σ meaning less differentiation. The consumer buys at most one variety if there are multiple varieties to choose from, and at most one unit of the good. The utility of not buying any item is zero.

The platform has prior knowledge that i is uniformly distributed on $\mathcal{I}$, but the actual type is the consumer's private information. Platform usage generates data the platform can analyse to retrieve information about i. A consumer of type i transmits a signal to the platform that he or she is of type $z \in \mathcal{I}$. The conditional density function $m(z|i)$ of the signal is uniform, $m(z|i) = \phi$ for all signals $z \in [i - \frac{1}{2\phi}, i + \frac{1}{2\phi}]$, and $m(z|i) = 0$ otherwise. The model links productive data to information through an assumption that $\phi = \Phi(q)$. An increase in q increases the precision of the signal z through an increase in ϕ.

The output $z \in \mathcal{I}$ and $\phi \geq 1$ of the prediction machine returns a posterior density function $m(i|z, \phi)$ of the consumer's type i characterized by $m(i|z, \phi) = \phi$ for all $i \in [z - \frac{1}{2\phi}, z + \frac{1}{2\phi}]$, and $m(i|z, \phi) = 0$ for all types outside this interval. The variable z represents the expected type of the consumer, and ϕ measures the precision with which the type is observed.

The firm wants to avoid advertising to opportunists because they have no willingness to pay for products, and advertising is costly. By an assumption that opportunists do not send any signal about their type, $z^o \in \emptyset$, the firm can always tell a consumer from an opportunist based on information produced from user data. Hence, the discussion below only concerns personalized advertising directed towards the representative consumer.

Profit-maximizing personalized advertising. The platform must decide how many different varieties $N \geq 0$ to advertise to the user, the location $l_n \in \mathcal{I}$ in product space and the price $p_n \geq 0$ of each variety n. We assume that the production cost of advertised goods is zero.[10]

The N varieties offered to the consumer span an interval $[z - \frac{1}{2K}, z + \frac{1}{2K}]$ of possible consumer types. The platform could increase the probability of selling goods by moving varieties uniformly towards z if the distribution of varieties was non-convex. The distribution is symmetric around z because i is uniformly distributed around z. $K \geq \phi$ because there is no point in advertising goods attractive to non-existent user types. Placing all varieties at the same distance from each other minimizes the consumer's "transportation cost" and maximizes the price the platform can charge.

By linearity, the price is the same for all varieties and set at the point where a consumer type placed at maximal distance from one variety is indifferent between buying a good or not:

$$\bar{v} - P - \frac{1}{\sigma}\frac{1}{2NK} = 0 \Leftrightarrow P(NK) = \bar{v} - \frac{1}{2\sigma NK}.$$

The platform maximizes the expected advertising profit

[10] An equivalent assumption would be that the unit production cost γ is the same for all goods and arises after the consumer has submitted the purchase order. One can subtract γ from the consumer's gross valuation $\tilde{v}$ to get the net valuation $\bar{v} = \tilde{v} - \gamma$ and proceed as in the main text.

$$\int_{z-\frac{1}{2K}}^{z+\frac{1}{2K}} P(NK)\phi dx - fN = (\bar{v} - \frac{1}{2\sigma NK})\frac{\phi}{K} - fN$$

over the degree K of product variety and the number N of products.

For analytical reasons, we treat the platform's profit-maximizing *advertising intensity* $N(\phi)$ as a continuous function of signal precision. This advertising intensity is nonlinear. For $\phi < \frac{2f}{\sigma\bar{v}^2}$, the signal is so imprecise relative to the advertising cost that it is not worthwhile for the monopoly to advertise any products. The platform is a *pure content provider* in this case. Above the threshold, the monopoly has sufficiently precise information about the consumer to engage in advertising on the platform. The platform offers enough product variety to ensure that every possible consumer type buys a product, $K = \phi$, and advertises with intensity

$$N(\phi) = \frac{1}{\sqrt{2\sigma\phi f}}. \tag{5}$$

The advertising intensity decreases as precision improves because the platform then can target the user more efficiently with ads.

By $K = \phi$ and expression (5), advertising revenue becomes

$$R(\phi) = \int_{z-\frac{1}{2\phi}}^{z+\frac{1}{2\phi}} P(N(\phi)\phi)\phi dx = \bar{v} - \sqrt{\frac{f}{2\sigma\phi}}. \tag{6}$$

$R(\phi)$ also measures the price of one unit of the good because the platform always sells one variety of the good, all varieties have the same price, and the consumer buys one unit. The advertising revenue is an increasing function of ϕ because increased precision enables the monopoly to offer better targeted products for which it can charge higher prices.

We now calculate the expected consumer surplus $CS(\phi)$ of purchasing goods advertised on the platform. The consumer buys one variety regardless of its type i. The price of all varieties is the same and equal to $R(\phi)$. The consumer surplus of a consumer of type i then depends on the distance to the closest variety offered on the platform. These varieties are uniformly distributed around the consumer's type. Hence,

$$CS(\phi) = 2N(\phi)\int_0^{\frac{1}{2N(\phi)\phi}} [\bar{v} - R(\phi) - \frac{1}{\sigma}(\frac{1}{2N(\phi)\phi} - z)]\phi dz = \frac{1}{2}\sqrt{\frac{f}{2\sigma\phi}} > 0. \tag{7}$$

The consumer surplus is positive, unlike in many other models of advertising which assume full surplus extraction (see for instance, Anderson and Coate, 2005). To some extent, the user benefits from an increase in signal precision because better targeted products reduces the average transportation cost. But the platform charges higher prices for those products, and the overall effect is a reduction in consumer surplus. In the limit as $\phi \to \infty$, the platform extracts the full surplus of advertised products. This is the case of perfect price discrimination.

The consumer surplus plus the advertising revenue minus the nuisance and advertising cost jointly yield the total advertising surplus

$$S(\phi) = CS(\phi) + R(\phi) - (h+f)N(\phi) = \bar{v} - \frac{3f+2h}{2f}\sqrt{\frac{f}{2\sigma\phi}}.$$

This surplus is strictly increasing in signal precision ϕ.[11]

Inefficiencies of personalized advertising. A social planner would spread the N varieties symmetrically across the interval $[z - \frac{1}{2K}, z + \frac{1}{2K}]$, $K \geq \phi$, to minimize transportation cost and maximize advertising welfare

$$2N \int_0^{\frac{1}{2NK}} [\bar{v} - \frac{1}{\sigma}(\frac{1}{2NK} - z)]\phi dz - (h+f)N = (\bar{v} - \frac{1}{4\sigma NK})\frac{\phi}{K} - (h+f)N$$

over K and N. Advertising is inefficient if signal precision is low relative to the social marginal cost of advertising, $\phi < \frac{h+f}{\sigma\bar{v}^2}$. Otherwise, the social planner offers enough product variety that every possible consumer type buys a product, $K = \phi$, and selects the corresponding advertising intensity

$$N^*(\phi) = \frac{1}{\sqrt{4\sigma\phi(h+f)}}.$$

that maximizes advertising welfare.

Proposition 1. *A monopoly engaging in personalized advertising does so excessively, $N(\phi) > 0$ implies $N(\phi) > N^*(\phi)$.*

Proof. Advertising is trivially excessive if $N(\phi) > 0 = N^*(\phi)$. If $N(\phi) > 0$ and $N^*(\phi) > 0$, then $\frac{N(\phi)}{N^*(\phi)} = \sqrt{2\frac{h+f}{f}} > 1$. □

There are two explanations for this inefficiency. First, the platform fails to internalize the consumer's nuisance cost hN of advertising because advertising intensity is chosen after agents have joined the platform. If advertising instead was set in advance of the participation decision, then the nuisance cost would be internalized in the platform tariff. In other words, there is a time-inconsistency problem as the platform cannot commit to (low) advertising before collecting data. Second, the platform targets the *marginal* instead of the *average* consumer when deciding on personalized advertising. The profit-maximizing product price extracts the full surplus of the marginal consumer, whose willingness to pay

[11] Based on the above expressions, the advertising profit $R(\Phi(q)) - fN(\Phi(q))$ and the total advertising surplus $S(\Phi(q))$ are concave functions by convexity of $\Phi^{-\frac{1}{2}}(q)$.

for the product is $\bar{v} - \frac{1}{2N\sigma\phi}$. In contrast, the relevant efficiency benchmark is the expected consumer's willingness to pay for an item, namely $\bar{v} - \frac{1}{4N\sigma\phi}$. The effect on the product price of a marginal increase in advertising intensity N is larger than the increase in the expected consumer's willingness to pay. These two effects both contribute to excessive advertising in equilibrium.

Under certain circumstances, the firm fails to engage in advertising even if advertising is efficient, $N(\phi) = 0 < N^*(\phi)$. This happens over an intermediate range of ϕ if $h < f$. From now on we assume that the platform always advertises.[12]

5 Participation and usage from a consumer perspective

This section analyses stage three of the game, where agents decide on platform participation and usage. Assume for now that platform usage is free and unlimited. Then, maximization of the gross utility $V(q)$ of content consumption characterized in (1) trades off the marginal improvement in user experience against the marginal loss in privacy rent

$$V'(q) = \underbrace{U'(q) - hN'(\Phi(q))\Phi'(q)}_{\text{Marginal improvement in user experience}} + \underbrace{CS'(\Phi(q))\Phi'(q)}_{\text{Marginal loss in privacy rent}}. \quad (8)$$

Advertising intensity decreases when content consumption increases, and therefore the nuisance cost of being on the platform is lower when the subscriber consumes more content. However, the privacy rent is also lower because better information about the consumer's type enables the platform to extract relatively more of the advertising surplus. We assume that $V(q)$ has a unique and positive optimum and denote this quantity of content consumption by $q^u > 0$.

The platform cannot distinguish between content consumption q and insincere platform usage q_0. Only the total quantity $d = q + q_0$ of platform usage by the consumer is verifiable. The consumer's possibility to generate non-productive data through insincere platform usage limits how much productive data the platform tariff can motivate the user to provide through consumption of platform content. In fact, the monopoly can at most implement content consumption q^u regardless of the platform tariff $T(d)$. For any ambition to implement $\hat{q} > q^u$ and $\hat{q}_0 \geq 0$, the consumer can consume content in quantity q^u and achieve total platform usage $\hat{d} = \hat{q} + \hat{q}_0$ through insincere platform usage $q_0 = \hat{q}_0 + \hat{q} - q^u > \hat{q}_0$.

Lemma 1. *The platform can implement content consumption $\hat{q}$ only if $\hat{q} \in [0, q^u]$ and*

[12] A sufficient condition for $N(\phi) > 0$ for all $\phi \geq 1$ is $\bar{v}^2\sigma \geq 2f$ because the firm advertises if and only if $\phi \geq \frac{2f}{\bar{v}^2\sigma}$.

$V(\hat{q}) \geq V(q)$ for all $q \in [0, \hat{q}]$.

Proof. See Appendix A. □

The gross utility function $V(q)$ does not have to be quasi-concave, so the monopoly may not be able to implement all content consumption in $[0, q^u]$. Let $\mathcal{Q}$ be the implementable set of content consumption.[13]

Turning to the extensive margin, the consumer has total utility $y + V(\hat{q}) - \hat{T}(\hat{q} + \hat{q}_0)$ of participating on the platform if the platform tariff $\hat{T}(d)$ implements platform usage $\{\hat{q}; \hat{q}_0\}$, where y is the exogenous value of participating on the platform as explained in Section 3.1. The value of the consumer's outside option is normalized to zero. Hence, the consumer joins the platform if and only if y exceeds the *participation threshold* $\hat{y} = \hat{T}(\hat{q} + \hat{q}_0) - V(\hat{q})$.

6 The profit-maximizing platform tariff

This section analyses the second stage of the game in which the monopoly chooses its platform tariff to maximize expected profit. A tariff $\hat{T}(d)$ that implements platform usage $\{\hat{q}, \hat{q}_0\}$ and a participation threshold $\hat{y}$ by the consumer, yields expected monopoly profit

$$\underbrace{[1 - G(\hat{y})][\Pi(\hat{q}) - c\hat{q}_0 + \hat{T}(\hat{q} + \hat{q}_0)]}_{\text{Expected profit from consumer}} + \underbrace{\rho[\min\{\hat{T}(\hat{q}_0^o); 0\} - c\hat{q}_0^o]}_{\text{Expected loss from opportunists}}. \tag{9}$$

In this expression, $1 - G(\hat{y})$ measures the probability that the consumer joins the platform.

A profit-maximizing tariff structure. We previously showed that the possibility to generate non-productive data through insincere platform usage q_0, restricted how much content consumption q the monopoly could implement through its platform tariff. This constraint has strong implications for the profit-maximizing platform tariff structure.

Lemma 2. *To maximize profit, it is sufficient to implement platform tariff structure*

$$T(d) = \begin{cases} F & \forall\ d \in [0, \hat{d}] \\ F + t \times (d - \hat{d}), \ \text{where } t \geq 0, & \forall\ d > \hat{d}. \end{cases} \tag{10}$$

The consumption of platform content is at most $\hat{d}$, and no participant engages in insincere platform usage under this tariff.

Proof. See Appendix B. □

[13] Formally, $\mathcal{Q} = \{q \in [0, q^u] \mid V(q) \geq V(\tilde{q})\ \forall \tilde{q} \in [0, q]\}$.

The platform tariff in Lemma 2 entails a fixed subscription fee F that allows free usage of the platform, possibly up to a limit $\hat{d}$. The monopoly levies an overage charge t for all platform usage in excess of this limit. This tariff structure encompasses many actual platform tariffs as special cases. Search engines and social media platforms typically allow free access to and unlimited free usage of the platform ($F = t = 0$). Media platforms offer digital subscriptions with unlimited free usage against a subscription fee ($F > 0 = t$). Streaming platforms often offer subscriptions with free access and user limitations ($F = 0 < t$).

The platform tariff works as follows. The monopoly can never implement content consumption above q^u by Lemma 1. The easiest way to accomplish q^u is to allow free unlimited usage of the platform. If the platform instead wants to limit consumption of platform content to $\hat{q} < q^u$, where $\hat{q} \in \mathcal{Q}$, then it can incentivize the subscriber by setting overage charge t at such a level that it becomes too expensive for the subscriber to consume content above $\hat{q}$. Consumption of platform content in any quantity $q \in [0, \hat{q}]$ is free. Therefore, the consumer optimally chooses $q = \hat{q}$ since $V(\hat{q}) \geq V(q)$ for all $q \in [0, \hat{q}]$; see Lemma 1. The monopoly attracts the desired amount of consumers by varying the subscription fee F.

The optimality of (10) depends crucially on the platform only being able to offer a platform tariff that depends on the consumer's total usage $d = q + q_0$. If instead q and q_0 were separately verifiable, then the platform could eliminate insincere platform usage by implementing an overage charge on such behavior. The platform could implement any content consumption $\hat{q} \geq 0$ through an appropriate marginal usage price which could be negative.

The platform never collects any overage charges because participants' (consumers and opportunists) platform usage never exceeds $\hat{d}$ in (10). The monopoly only has two sources of revenue, the subscription fee F and the advertising revenue $R(\Phi(q))$. If the subscription fee is zero or if the monopoly subsidizes participation on the platform, so that $F \leq 0$, then the advertising revenue represents the monopoly's sole source of income. The consumer pays entirely with personal data in this case.

Having shown that the tariff structure in (10) maximizes expected profit, the next question is how many participants to attract and how much content consumption to stimulate. The first issue we address is subsidization of platform participation through a negative subscription fee.

Can it be profitable to subsidize participation? The platform can implement content consumption $\hat{q} \in \mathcal{Q}$ by an overage charge t for data usage d in excess of $\hat{q}$. It can implement participation $\hat{y} \in \mathcal{Y}$ by a subscription fee equal to $F = \hat{y} + V(\hat{q})$. Substituting the simplified platform fee (10) into expression (9) returns the expected platform profit

$$\Pi^e(\hat{y}, \hat{q}) = [1 - G(\hat{y})][\hat{y} + W(\hat{q})] + \rho \min\{\hat{y} + V(\hat{q}); 0\} \tag{11}$$

purely as a function of the consumer's participation threshold $\hat{y}$ and consumption $\hat{q}$ of platform content, where $W(q)$ measures the welfare of content consumption q defined in (3).

The expected profit from consumers may increase by subsidizing access to the platform through a negative subscription fee. Subsidization is particularly profitable if the welfare of content consumption is high. However, subsidization will also attract opportunists who represent a cost to the monopoly. This cost is larger if there are more opportunists.

Lemma 3. *The platform does not subsidize subscriptions for any content consumption $q \in \mathcal{Q}$ if the share ρ of opportunists is sufficiently high.*

Proof. See Appendix C. □

We assume from now on that Lemma 3 holds, i.e. the share of opportunists is so high that the profit-maximizing subscription fee is non-negative.

When is the profit-maximizing platform tariff zero? The monopoly maximizes the expected profit $\Pi^e(y, q)$ over $y \in \mathcal{Y}$ and $q \in \mathcal{Q}$ subject to the non-negativity constraint $y + V(q) \geq 0$ on the subscription fee. Our next result characterizes the profit-maximizing platform tariff.

Proposition 2. *The platform allows free access to and free unlimited use of the platform, so that the consumer entirely pays with personal data, if and only if:*

1. *The profit-maximising content consumption on the intensive margin exceeds q^u:*

$$\Pi'(q^u) \geq 0. \tag{12}$$

2. *The extensive margin participation semi-elasticity is high:*

$$\frac{1 - G(-V(q^u))}{g(-V(q^u))} \leq \Pi(q^u). \tag{13}$$

If the inequality in condition (13) *is strictly reversed while* (12) *holds, then the monopoly charges a positive subscription fee while still permitting free unlimited use of the platform. If inequality* (12) *is strictly reversed, then the platform implements $\hat{q} \in \mathcal{Q}$ by offering free platform usage up to $\hat{q}$, and an overage charge, $t > 0$, on usage thereafter. Any strictly positive profit-maximizing subscription fee $\hat{F}$ is characterized by*

$$\frac{1 - G(\hat{F} - V(\hat{q}))}{g(\hat{F} - V(\hat{q}))} = \Pi(\hat{q}) + \hat{F}. \tag{14}$$

Proof. See Appendix D. □

On the intensive margin, higher content consumption increases the advertising revenue and reduces the advertising cost because the resulting increase in productive data improves the platform's ability to predict the consumer's type. However, increased content consumption also increases the platform's data cost. Differentiation of the profit function $\Pi(q)$ characterized in (2) yields the marginal profit

$$\Pi'(q^u) = \underbrace{R'(\Phi(q^u))\Phi'(q^u)}_{\text{Marginal advertising revenue}} - \underbrace{fN'(\Phi(q^u))\Phi'(q^u)}_{\text{Marginal advertising cost}} - \underbrace{c}_{\text{Marginal data cost}} \tag{15}$$

evaluated at the consumer's most preferred level of content consumption. Under condition (12), the marginal increase in advertising revenue and the marginal reduction in advertising cost are so large relative to the marginal increase in the data cost that the platform would prefer content consumption equal to or above q^u. However, it is impossible to induce content consumption beyond q^u because any attempt to do so would only generate non-productive user data through insincere platform usage. The platform instead maximizes the feasible content consumption, which is accomplished by allowing unlimited free platform usage.

The platform wants to reduce platform usage below q^u if the marginal advertising revenue and the marginal reduction in advertising cost are small relative to the marginal data cost. In that case, the platform offers free platform usage up to its preferred level of content consumption $\hat{q}$, after which consumers are penalized for any excess usage.

On the extensive margin, a higher subscription fee increases the profit $\Pi(q^u) + F$ on any consumer the platform manages to attract to the platform. However, a higher subscription fee also deters potential consumers from joining the platform. By how much, depends on the semi-elasticity of participation demand $\frac{g(y)}{1-G(y)}$. If inequality (13) is met, then participation demand is so elastic relative to the profit per user that the monopoly wants to maximize participation. The platform achieves this objective by setting the subscription fee to zero. Instead of paying with money, consumers pay entirely with their personal data.

In an interior optimum, the profit-maximizing subscription fee balances the marginal benefit of extracting rent from infra-marginal consumers through a higher subscription fee against the marginal loss associated with having fewer subscribers on the platform. The associated optimality condition (14) is very similar to the condition in Armstrong (2006) for the profit-maximizing user price in a two-sided market. The main difference is that the subscription fee is adjusted by the profit of content consumption in our context, whereas the user price is adjusted by the economic magnitude of the cross-group externality in the two-sided market.

Corrao et al. (2023) analyze a model of nonlinear pricing in which the seller cannot enforce consumption above q^u, but any consumption $q \leq q^u$. The marginal utility of consumption depends on the buyer's type, which is private information. The seller can subsidize participation without attracting opportunists. The profit-maximizing tariff either involves the buyer consuming q^u or the second-best welfare-maximizing quantity depending on the buyer's type. Below, we establish circumstances under which the platform allows free usage in our context.

To better understand the underlying characteristics that drive Proposition 2, we can substitute the marginal advertising intensity $N'(\phi)$ derived from (5) and the marginal advertising revenue $R'(\phi)$ derived from (6) into $\Pi'(q^u)$ identified in (15) to obtain the marginal profit expression

$$\Pi'(q^u) + c = \sqrt{\frac{f}{2\sigma\Phi(q^u)}} \frac{\Phi'(q^u)}{\Phi(q^u)} > 0.$$

The consumer's most-preferred content consumption q^u is independent of the platform's marginal data cost c, which implies that condition (12) is satisfied if c is sufficiently small. Other plausible characteristics also generate positive marginal profit. Substitute the marginal advertising intensity and the marginal consumer surplus $CS'(\phi)$ derived from (7) into $V'(q)$ from (8) to get the marginal utility

$$V'(q) = U'(q) - \sqrt{\frac{f}{2\sigma\Phi(q)}} \frac{\Phi'(q)}{\Phi(q)} \frac{f - 2h}{4f}$$

of content consumption. Observe in particular that this marginal utility is strictly negative for all content consumption q above the bliss point b if the marginal marketing cost f is sufficiently high relative to the marginal nuisance cost h. In this case, the marginal loss in privacy rent associated with content consumption is so high relative to the reduction in the nuisance cost that the consumer prefers content consumption $q^u \leq b$. By strict concavity of the profit function,

$$\Pi'(q^u) \geq \Pi'(b) = \sqrt{\frac{f}{2\sigma\Phi(b)}} \frac{\Phi'(b)}{\Phi(b)} - c.$$

The right-hand side of this expression is strictly positive if f is large or σ is sufficiently small so that the consumer values product characteristics highly in the decision whether to purchase products advertised on the platform. We conclude that free unlimited platform usage represents a profit-maximizing strategy under robust circumstances where, for instance, the marginal data cost is low, the marginal marketing cost is large, or product differentiation in the advertisement market is high.

It is also plausibly the case that the platform prefers to limit content consumption below

q^u. This occurs, for instance, if the marginal data cost c is large, or if the marginal advertising cost is small, $f < 2h$, and products are relatively homogeneous in the sense that σ is large. As for the subscription fee, q^u is independent of the maximal willingness $\bar{v}$ to pay for advertised products. Any increase in $\bar{v}$ instead goes to the platform as a one-for-one increase in advertising revenue; see (6). Hence, (13) is met and the profit-maximizing subscription fee is zero if consumers' willingness to pay for advertised products is sufficiently high.

The monopoly may want to subsidize participation if demand on the extensive margin is highly elastic. However, a monetary subsidy would be prohibitively costly by attracting a large share of opportunists. One way to circumvent this problem could be a contingent subsidy that only has value if used within the context of the platform. For instance, agents who sign up for the platform could receive a coupon which entitles the agent to a discount B on any purchased good advertised on the platform. This coupon would be equivalent to a monetary subsidy in amount B for the consumer, but worthless to an opportunist without any willingness to pay for goods advertised on the platform. In similar spirit, Amelio and Jullien (2012) analyze how a platform may sell a bundled good at a discount as an implicit subsidy to induce platform participation. We discuss implications of contingent subsidies below.

Does the platform tariff distort data privacy? To evaluate the effects of the platform tariff on data privacy and efficiency, we assume that the monopoly decides on advertising efforts after agents have joined and used the platform, also in the derivation of the welfare maximizing participation threshold $\hat{y}^*$ and content consumption $\hat{q}^*$. Conditional on the marketing intensity $N(\phi)$, a social planner maximizes expected welfare

$$W^e(y, q) = \int_y^{\bar{y}} [\tilde{y} + W(q)] g(\tilde{y}) d\tilde{y}. \tag{16}$$

Even the social planner is limited to selecting q from the set $\mathcal{Q}$ because non-verifiability of insincere platform usage makes it impossible to implement content consumption $q \notin \mathcal{Q}$. Implementation of participation threshold $y < -V(q)$ would imply that a subset of consumer types were strictly better off by not joining the platform. We therefore constrain the social planner to implement $y + V(q) \geq 0$. That is, our efficiency benchmark subjects the social planner to the same incentive compatibility and participation constraints as the monopoly faces.

The main difference between maximization of the profit function (11) and the welfare function (16) lies in the determination of the level of consumer participation on the extensive margin. Reducing participation through a larger subscription fee can be profitable to the monopoly because of increased rent extraction from infra-marginal consumer types. Such rent extraction represents pure redistribution between the firm and the consumer, while the social planner only cares about the marginal effect

$$W_y^e(y,q) = -[y + W(q)]g(y) < 0 \; \forall y > -V(q) \tag{17}$$

of reduced participation on expected welfare. The welfare on the platform is so high that the social planner maximizes participation. In a welfare-maximizing tariff structure, the subscription fee would be zero.

The social planner maximizes expected welfare

$$W^e(-V(q),q) = \int_{-V(q)}^{\bar{y}} [y + V(q)]g(y)dy + \Pi^e(-V(q),q)$$

over $q \in \mathcal{Q}$ if the subscription fee is zero and thereby uses the allowance both to increase the welfare associated with content consumption on the intensive margin and to increase participation on the extensive margin. The monopoly tends to use the allowance to increase welfare on the intensive margin, and the subscription fee to attract consumers on the extensive margin. Content consumption is downward distorted in this case because the monopoly fails to internalize the welfare benefit on the extensive margin of attracting consumers to the platform through a larger allowance. However, there is too little content consumption in equilibrium even if the subscription fee is zero so that the monopoly allows free access to the platform. The problem is that the monopoly fails to internalize the welfare benefit of a larger allowance on content consumption on the intensive margin. The welfare effect of a marginal increase in content consumption equals the sum of the effects on the consumer and the monopoly,

$$\frac{d}{dq}W^e(-V(q),q) = [1 - G(-V(q))]V'(q) + \frac{d}{dq}\Pi^e(-V(q),q),$$

but the monopoly only accounts for the latter effect. By the direct relationship between content consumption and generation of productive data:

Proposition 3. *The profit-maximizing platform tariff generally reduces participation ($\hat{y} \geq \hat{y}^*$) on the extensive margin and reduces content consumption ($\hat{q} \leq \hat{q}^*$) on the intensive margin relative to the social optimum. Platform usage generates too little productive data and therefore excessive data privacy in equilibrium. An exception occurs if free access and free unlimited usage maximize the platform's expected profit. Participation, content consumption and data generation then maximize expected welfare so that data privacy is efficient in equilibrium.*

Proof. See Appendix E. □

Platform participation and content consumption generally tend to be downward distorted in equilibrium, but an exception arises at the corner solution where the monopoly charges zero for both access and usage of the platform. The zero tariff maximizes the expected utility of the consumer in the class of non-negative platform tariffs. This tariff therefore maximizes welfare if it also maximizes monopoly profit.

The distortion of content consumption stems fundamentally from the assumption that it is prohibitively costly to subsidize participation. Suppose instead the monopoly and the social planner can attract the desired amount of consumers and simultaneously avoid opportunists, for instance by use of a conditional subsidy $B = -(y + V(q))$ as discussed above. By inspection of the marginal expected welfare expression (17), we see that the welfare maximizing participation threshold equals $-\max\{W(q); \underline{y}\}$. The social planner then maximizes the expected welfare

$$W^*(q) = \int_{-\max\{W(q);\underline{y}\}}^{\bar{y}} [\tilde{y} + W(q)] g(\tilde{y}) d\tilde{y}.$$

over $q \in \mathcal{Q}$. The solution to this problem is to maximize welfare $W(q)$ of content consumption, which is exactly the same as the platform would do. Participation would still be downward-distorted.[14]

From a general policy viewpoint, our model implies that competition authorities are rightfully concerned about the tariffs applied by content platforms: They have an incentive to reduce participation by charging excessive subscription fees, and to limit usage of the platform by overly restrictive usage allowances. Such tariffs reduce generation of productive data below the efficient level. However, free access to and free unlimited usage of the platform is not a source of policy concern as far as efficient platform tariffs are concerned. Paying exclusively with personal data in fact maximizes the expected utility of the consumer compared to all other non-negative tariff structures by the platform. Data generation then is efficient.

7 Too much AI?

We now enter the first stage of the game where the platform invests in AI to increase the precision of the prediction machine it employs to extract information about the subscriber from the analysis of user data. We describe AI as a variable θ that increases $\phi = \Phi(q, \theta)$.

We first assume that the platform allows free access to and free usage of the platform. Necessary and sufficient conditions for when a zero tariff maximizes the expected platform

[14] Assume that $W(\hat{q}) = \max_{q \in \mathcal{Q}} W(q)$. The welfare optimal participation level is then given by $\hat{y}^* = -\max\{W(\hat{q}); \underline{y}\}$. If $W(\hat{q}) < \underline{y}$, then the profit-maximizing threshold $\hat{y}$ directly satisfies $\hat{y} \geq -\underline{y} = \hat{y}^*$. Consider the alternative possibility $W(\hat{q}) \geq \underline{y}$. The platform maximizes $\Pi^e(y, \hat{q})$ over y, where $\rho = 0$. Strict quasi-concavity of $\Pi^e(y, q)$ in y and $\Pi^e_y(\hat{y}^*, \hat{q}) = 1 - G(\hat{y}^*) > 0$ imply $\hat{y} > \hat{y}^*$.

profit were established in Proposition 2. We also showed that the zero platform tariff was efficient conditional on the underlying technology. The question is whether this property is sufficient to generate efficient investment incentives.

A subscriber with free unlimited access to the platform chooses content consumption $q \geq 0$ to maximize gross utility

$$V(q, \theta) = U(q) - hN(\Phi(q, \theta)) + CS(\Phi(q, \theta)). \tag{18}$$

We denote the solution to this problem by $q^u(\theta)$, and let $v(\theta) = V(q^u(\theta), \theta)$ be the consumer's indirect utility of AI technology θ. The platform profit contingent on the AI technology θ equals $\pi(\theta) = \Pi(q^u(\theta), \theta)$, where

$$\Pi(q, \theta) = R(\Phi(q, \theta)) - fN(\Phi(q, \theta)) - cq$$

measures the platform profit as a function of the consumption q of platform content and the direct effect of the AI technology.

The platform selects the AI technology $\theta \in [0, \bar{\theta}]$ that maximizes its expected platform profit

$$\pi^e(\theta) = [1 - G(-v(\theta))]\pi(\theta) - \Psi(\theta).$$

AI has a direct effect on the consumer and the platform because of the direct effect on the prediction $\Phi(q, \theta)$ about the consumer's type. It also has an indirect effect through the consumption $q^u(\theta)$ of content and the consumer's participation threshold $-v(\theta)$. The platform's marginal profit of investing in AI therefore equals

$$\pi^e_\theta(\theta) = [1 - G(-v(\theta))][\Pi_\theta + \Pi_q q^u_\theta] + g(-v(\theta))\pi(\theta)V_\theta - \Psi'(\theta).$$

The marginal direct effect of investing in AI on platform profit, Π_θ, is positive because more precise information about the consumer's type increases the advertising revenue and simultaneously reduces advertising costs. The marginal indirect effects are positive if better AI increases content consumption and consumer participation, but goes in the opposite direction if better AI reduces content consumption and participation. Assume that the profit-maximizing investment is strictly positive and unique so that the equilibrium power of the AI satisfies $\hat{\theta} > 0$.

Consider the welfare-maximizing investment in AI. The social planner chooses AI to maximize expected welfare $w^e(\theta) = v^e(\theta) + \pi^e(\theta)$, where

$$v^e(\theta) = \int_{-v(\theta)}^{\bar{y}} [y + v(\theta)]g(y)dy$$

measures the consumer's expected utility of the AI technology. The difference between the social planner and the profit-maximizing platform is that the former accounts for the effect

$$v^e_\theta(\theta) = [1 - G(-v(\theta)]V_\theta(q^u(\theta), \theta)$$

of a marginal improvement in AI on the surplus of consumer types on the intensive margin, whereas the platform ignores this effect. AI investment will generally be distorted because of this externality.

The sign of this externality is generally ambiguous because improved AI has both positive and negative effects on the consumer:

$$V_\theta(q, \theta) = -hN'(\phi)\Phi_\theta + CS'(\phi)\Phi_\theta = \sqrt{\frac{f}{2\sigma\Phi}}\frac{2h-f}{4f}\frac{\Phi_\theta}{\Phi} \gtreqless 0. \tag{19}$$

On the one hand, better AI improves the user experience by exposing the consumer to less advertising when the platform has more precise information. This is the first marginal effect. On the other hand, there is a loss in privacy rent because the platform can better tailor its advertising efforts with more precise information about the consumer's type. This is the second marginal effect. Applying the advertising model in Section 4 enables us to scrutinize this trade-off.

Substitution of the marginal marketing intensity, $N'(\phi) < 0$, derived from (5) and the marginal consumer surplus, $CS'(\phi) < 0$, derived from (7), delivers the rightmost expression in (19). Either of the two marginal effects can dominate, depending on the magnitudes of underlying parameters. The marginal improvement in user experience dominates the marginal privacy loss if the marginal nuisance cost is sufficiently high relative to the marginal advertising cost, $2h > f$. The consumer prefers more to less AI in this case. The opposite is true if the marginal advertising cost is high relative to the marginal nuisance cost, $f > 2h$. The consumer is indifferent in the knife-edge case $2h = f$. Based on these results about the consumer externality, the following statements summarize the welfare effects of AI.

Proposition 4. *A monopoly that allows free access to and free unlimited usage of the platform invests too much in AI from a joint welfare perspective if the marginal nuisance cost of advertising is small relative to the marginal advertising cost, $2h < f$. The consumer's loss of privacy rent then dominates the improved user experience associated with more AI. There is underinvestment in AI in the opposite case, $2h > f$.*

Proof. Let θ^* maximize the expected welfare $w^e(\theta)$. The welfare difference between $\hat{\theta}$ and some arbitrary θ can be written as

$$w^e(\hat{\theta}) - w^e(\theta) = -\int_{\hat{\theta}}^{\theta} v^e_\theta(x)dx + \pi^e(\hat{\theta}) - \pi^e(\theta).$$

If $f > 2h$, then the first term on the right-hand side is strictly positive for all $\theta > \hat{\theta}$ by $v^e_\theta < 0$. Moreover, $\pi^e(\hat{\theta}) \geq \pi^e(\theta)$ for all θ since $\hat{\theta}$ maximizes the expected platform profit. Hence, $f > 2h$ implies $\theta^* \leq \hat{\theta}$. The inequality is strict because $w^e_\theta(\hat{\theta}) = v^e_\theta(\hat{\theta}) + \pi^e_\theta(\hat{\theta}) = v^e_\theta(\hat{\theta}) < 0$. If $2h > f$, then the first term on the right-hand side is strictly positive for all $\theta < \hat{\theta}$ by $v^e_\theta > 0$. Hence, $\theta^* \geq \hat{\theta}$. The inequality is strict by $w^e_\theta(\hat{\theta}) = v^e_\theta(\hat{\theta}) > 0$. □

The underlying logic is that investment in AI has an effect on the utility of consumers on the intensive margin that the platform fails to internalize because it cannot extract this rent through the platform tariff. The consumer gross utility can increase or decrease in the power of the prediction machine, which implies that AI investment can be too high or too low. Notice also that data privacy is efficient for all levels θ of AI since content consumption $q^u(\theta)$, and therefore data provision, maximizes the consumer's utility. Yet, information privacy, measured as $\Phi(q^u(\theta), \theta)$, is distorted because AI investment is inefficient.

Constrained advertising. Underinvestment in AI occurs in our model if the marginal cost of advertising is small relative to the consumer's marginal nuisance cost of being exposed to advertising. Advertising intensity goes to infinity when f approaches zero; see expression (5). Presumably there is an upper bound on the amount of advertising the platform can expose a consumer to. For instance, the attention span may limit the amount of advertising a consumer can digest. Advertising could also be constrained by a regulatory mandate. A constraint on advertising may substantially affect the incentives to invest in AI.

Impose an advertising constraint $N \leq \bar{N}$, where $\bar{N} \geq \frac{1}{\bar{v}\sigma}$. If this constraint is binding, then the advertising revenue becomes

$$R(\phi, \bar{N}) = \int_{z-\frac{1}{2\phi}}^{z+\frac{1}{2\phi}} P(\bar{N}\phi) = \bar{v} - \frac{1}{2\sigma\bar{N}\phi}.$$

Substituting the price $R(\phi, \bar{N})$ and advertising intensity $\bar{N}$ into (7), yields consumer surplus

$$CS(\phi, \bar{N}) = \frac{1}{4\sigma\bar{N}\phi}$$

under constrained advertising. The total advertising surplus becomes

$$S(\phi, \bar{N}) = CS(\phi, \bar{N}) + R(\phi, \bar{N}) - (h + f)\bar{N} = \bar{v} - \frac{1}{4\sigma\bar{N}\phi} - (h + f)\bar{N}.$$

These expressions have the same qualitative properties as under unconstrained advertising. In particular, advertising revenue and total marketing surplus are both increasing functions of precision ϕ, whereas the consumer surplus is smaller when ϕ is larger. A constraint on advertising has no bearing on the qualitative results in the second and the third stage of the game, but has implications for AI investment.

The gross utility of platform usage equals

$$V(q,\theta,\bar{N}) = U(q) - h\bar{N} + CS(\Phi(q,\theta),\bar{N}) = U(q) - h\bar{N} + \frac{1}{4\sigma\bar{N}\Phi(q,\theta)}$$

under constrained advertising, $N = \bar{N}$ as a function of content consumption q and the power θ of AI. Investment in AI exerts an unambiguously negative externality on consumers, $V_\theta < 0$, through a reduction in privacy rent without any associated reduction in advertising intensity. The following result is immediate and therefore stated without proof:

Proposition 5. *A monopoly that allows free access to and free unlimited usage of the platform invests too much in AI from a joint welfare perspective if advertising on the platform is constrained by* $\bar{N} \geq \frac{1}{\bar{v}\sigma}$ *and the marginal advertising cost* f *is sufficiently small.*

Overinvestment in AI does not have to be conditional on a high monetary advertising cost if advertising is constrained in other dimensions.

Subsidization of platform participation. Suppose the platform and social planner can subsidize consumer participation without simultaneously attracting opportunists to the platform, so that neither is constrained by $y + V(q) \geq 0$. An example could be a contingent bonus that can be used to buy goods advertised on the platform. Then the monopoly platform and social planner alike implement the content consumption $\hat{q}(\theta)$ that maximizes welfare $W(q,\theta)$ over the feasible subset $\mathcal{Q}$.

The monopoly invests in AI to maximize expected profit

$$\pi^*(\theta) = [1 - G(\hat{y}(\theta))][\hat{y}(\theta) + W(\hat{q}(\theta),\theta)] - \Psi(\theta).$$

In this expression, $\hat{y}(\theta)$ characterizes the participation threshold that maximizes the expected monopoly profit given the AI technology θ. The marginal effect of AI investment equals

$$\pi^*_\theta(\theta) = [1 - G(\hat{y}(\theta))]W_\theta(\hat{q}(\theta),\theta) - \Psi'(\theta).$$

Investing in AI is beneficial by increasing the total advertising surplus on the intensive margin, $W_\theta = S'(\phi)\Phi_\theta > 0$, which enables the monopoly to extract more rent from the consumer. The indirect effects working through content consumption $\hat{q}(\theta)$ and platform participation $\hat{y}(\theta)$ are of second-order importance to the monopoly in this case.

The social planner allows more participation than the platform and values also the utility of infra-marginal consumer types, so that the expected welfare of AI with power θ becomes

$$w^*(\theta) = \int_{-\max\{W(\hat{q}(\theta),\theta);\underline{y}\}}^{\bar{y}} [y + W(\hat{q}(\theta),\theta)] - \Psi(\theta).$$

The marginal net benefit

$$w^*_\theta(\theta) = [1 - G(-\max\{W(\hat{q}(\theta), \theta); \underline{y}\})]W_\theta(\hat{q}(\theta), \theta) - \Psi'(\theta) \geq \pi^*_\theta(\theta)$$

on expected welfare of investing in AI is weakly larger than the marginal net benefit for the monopoly because platform participation is weakly higher at the social optimum than in equilibrium, $\hat{y}(\theta) \geq -\max\{W(\hat{q}(\theta), \theta); \underline{y}\}$. The inequalities are strict if and only if there is incomplete participation in equilibrium, $\hat{y}(\theta) > \underline{y}$. We state the following result without proof.

Proposition 6. *The monopoly underinvests in AI from a joint welfare perspective if unconstrained subsidization of consumer participation is possible without simultaneously attracting opportunists to the platform.*

A comparison of Proposition 4 and Proposition 6 shows that the qualitative properties of the inefficiencies associated with AI investment depend crucially on the platform tariffs applied by the monopoly to incentivize participation and usage.

Data externalities. We now extend the analysis of AI investment to $I \geq 2$ consumers in which case the information the platform obtains about individual users depends on productive data collected from *all* consumers. Will such *data externalities* distort AI investments further?

The prediction machine delivers a signal $\phi_i = \Phi(q_i, Q_i, \theta)$ about consumer i, where q_i is the quantity of productive data collected from i, and $Q_i = \sum_{j \neq i} q_j$ measures the quantity of productive data collected from all consumers on the platform other than i. We assume that this production function is increasing in all arguments.

To emphasize data externalities, we set the platform tariff to zero and assume that the exogenous utility y of subscribing to the platform is so large that each consumer participates on the platform if it expects all other consumers to do so. Consumer i then maximizes

$$V(q_i, Q_{-i}, \theta) \;=\; U(q_i) - hN(\Phi(q_i, Q_{-i}, \theta)) + CS(\Phi(q_i, Q_{-i}, \theta))$$

over content consumption $q_i \geq 0$, treating Q_i as exogenous. The data externality from other users on individual i is captured by V_Q.

An interior symmetric equilibrium $q^u(\theta)$ solves the first-order condition $V_q(q^u, (I-1)q^u, \theta) = 0$. The effect on content consumption of a marginal improvement in AI is characterized by

$$q^u_\theta \;=\; \frac{-V_{q\theta}}{V_{qq} + (I-1)V_{qQ}}.$$

Under the standard stability condition $V_{qq} + (I-1)V_{qQ} < 0$, content consumption is increasing in θ if and only if the individual consumer's marginal utility of content consumption is increasing in θ.

AI investment will be distorted because the platform fails to take into account the effect on the consumer utility $v(\theta) = V(q^u(\theta), (I-1)q^u(\theta), \theta)$ under a zero platform tariff. The marginal effect on the consumer equals

$$v_\theta = V_\theta + V_Q(I-1)q^u_\theta = V_\theta - \frac{(I-1)V_Q V_{q\theta}}{V_{qq} + (I-1)V_{qQ}}.$$

The first term on the right-hand side is the direct marginal AI externality we have previously discussed. The second term is an indirect effect that arises because AI investment affects content consumption by the other consumers on the platform and thereby the information that the platform extracts from each individual consumer. The marginal effect of AI on the data externality is the product of how individual utility is affected by an increase in data from other users, V_Q, and how AI affects the quantity of productive data collected from other users, $(I-1)q^u_\theta$. From the functional form expressions from Section 4, the product

$$V_Q V_{q\theta} = [hN'(\Phi) - CS'(\Phi)]^2 \Phi_Q [\Phi_{q\theta} - \frac{3}{2}\frac{\Phi_q \Phi_\theta}{\Phi}]$$

can be positive or negative. The constant elasticity of marketing intensity $N(\phi)$ and consumer surplus $CS(\phi)$ with respect to signal precision ϕ implies that the sign is independent of the strength of the opposing effects in the consumer's utility function, but only depends on the properties of the prediction machine, $\Phi(q_i, Q_{-i}, \theta)$.

There are two effects of AI. One measures how AI affects information precision Φ. The other is how AI affects the marginal effect on precision of an increase in individual data, Φ_q. The effect of AI via the data externality is negative, $V_Q V_{q\theta} < 0$, if and only if the elasticity of information precision with respect to AI, $\frac{\Phi_\theta \theta}{\Phi}$, is sufficiently high compared to the elasticity of the marginal information precision of individual data with respect to AI, $\frac{\Phi_{q\theta}\theta}{\Phi_q}$.[15] The following result is immediate:

Proposition 7. *Data externalities can either distort or improve AI investment incentives, depending on the elasticity of information precision with respect to AI versus the elasticity of marginal information precision of individual user data with respect to AI, ($\frac{\Phi_\theta \theta}{\Phi} \gtrless \frac{2}{3}\frac{\Phi_{q\theta}\theta}{\Phi_q}$). Negative data externalities exacerbate an already existing overinvestment problem in AI ($V_\theta < 0$), but mitigate an underinvestment problem ($V_\theta > 0$).*

Negative data externalities mean that individuals suffer from others' platform use. But

[15]This condition is met if the marginal information value of individual data is non-increasing in the power of AI, $\Phi_{q\theta} \leq 0$. Another example is when precision is iso-elastic in individual data, $\Phi(q, Q, \theta) = q^\alpha H(Q, \theta)$ where $\alpha > 0$, and $H(Q, \theta) > 0$ is increasing in both arguments. In this second case, $\Phi_{q\theta}\Phi = \Phi_q \Phi_\theta$.

even so, their presence can increase efficiency in AI investment. Vice versa, positive data externalities can reduce efficiency in AI investment. This occurs if the direct AI externality is positive so that the platform would invest too little in AI absent the data externalities.

8 Too little quality?

We now consider quality investment in the first stage of the game. Investing in quality s increases both the consumer's direct utility $U(q, s)$ and marginal utility $U_q(q, s)$ of content consumption. We assume that the consumer has free access to and free unlimited usage of the platform also in this case, although this does not matter for the results.

The gross utility of content consumption is

$$V(q, s) = U(q, s) - hN(\Phi(q)) + CS(\Phi(q)),$$

as a function of quality s of the platform service and the quantity q of content consumption. The content consumption $q^u(s)$ that maximizes consumer gross utility increases in quality by the assumption that $U_{qs}(q, s) > 0$. We denote by $v(s) = V(q^u(s), s)$ the consumer's indirect utility of quality s. Higher quality increases participation since $v'(s) = U_s(q^u(s), s) > 0$.

The expected monopoly profit of offering quality s equals

$$\pi^e(s) = [1 - G(-v(s))]\Pi(q^u(s)) - \Upsilon(s).$$

Let the profit-maximizing choice $\hat{s}$ of quality be unique and positive.

The social planner chooses quality to maximize expected welfare $w^e(s) = v^e(s) + \pi^e(s)$, where

$$v^e(s) = \int_{-v(s)}^{\bar{y}} [y + v(s)]g(y)dy.$$

measures the consumer's expected utility of quality s. Investment is distorted because the platform ignores the marginal expected benefit

$$v^e_s(s) = [1 - G(-v(s))]U_s(q^u(s), s) > 0$$

on consumer surplus on the intensive margin of an increase in quality.

Proposition 8. *A monopoly that allows free access to and free unlimited usage of the platform invests too little in quality from a joint welfare perspective.*

Proof. Let s^* maximize the expected welfare $w^e(s)$. The welfare difference between $\hat{s}$ and arbitrary $s < \hat{s}$ can be written as

$$w^e(\hat{s}) - w^e(s) = \int_s^{\hat{s}} v_s^e(x)dx + \pi^e(\hat{s}) - \pi^e(s) > 0$$

by way of $v_s^e(s) > 0$ and $\pi^e(\hat{s}) \geq \pi^e(s)$. Hence, $s^* \geq \hat{s}$. The inequality is strict because $w_s^e(\hat{s}) = v_s^e(\hat{s}) + \pi_s^e(\hat{s}) = v_s^e(\hat{s}) > 0$. □

Investment in quality has a positive effect on infra-marginal consumer types that the platform fails to internalize because it only cares about the effect on the marginal consumer in the choice of quality.

9 Concluding remarks

The dominance of individual search engines, social media and streaming platforms has raised concerns about privacy protection in markets where collection and analysis of large quantities of personal data generate platforms' main source of income. These concerns have been accentuated by the accelerating development of analytical tools built on artificial intelligence (AI) to utilize data.

Our study offers a framework for examining the potential sources of inefficiency and conflicts of interest that arise in such digital markets. A distinguishing feature of this framework is to treat main choices of consumers and firms as endogenous and mutually dependent. Equilibrium choices include participation, content consumption and responses to advertising on the consumer side, and platform tariffs, advertising, AI and content quality investment on the platform side.

A main finding is that for a given technology, data collection will be efficient if the profit-maximizing platform tariff features free access and unlimited usage. We label this outcome efficient data privacy. Under a zero platform tariff, users consume content and generate user data in a quantity that for them strikes an optimal balance between the marginal improvement in user experience and the marginal loss in privacy rent. Thus, a business model in which users pay only with personal data for platform access and content consumption does not entail any direct welfare loss. The result suggests that a zero platform tariff in itself need not cause any economic harm to users that regulators should be concerned about.

Yet, consumer privacy will be inefficient because the platform has distorted incentives to invest in AI to analyze data. Under plausible assumptions, the monopoly firm over-invests and consequently extracts too much information about users. This happens when potentially insincere platform use and entry of 'bots' constrain the platform from subsidizing content consumption. Under a zero platform tariff, the platform fails to internalize the negative effect of the compiled information on users along the intensive margin. While data privacy is efficient, information privacy is inefficient. This result indicates that policies to restrict the utilization of AI technology on zero-tariff digital platforms could be warranted.

The platform generally under-invests in quality under a zero platform tariff because the platform fails to internalize the value of improved quality on infra-marginal consumers.

Our analysis builds on the assumption that users rationally foresee the personal consequences of their platform use and associated provision of individual user data. The key friction is that a content platform cannot distinguish sincere from insincere platform use. Acemoglu et al. (2023) study a model where users are unable to foresee the consequences of providing individual data to the platform. Extending our model in this direction would be interesting, and we surmise that such a friction will distort investments in AI and quality further.

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Appendices

A Proof of Lemma 1

Suppose the tariff $\hat{T}(d)$ implements $\{\hat{q}; \hat{q}_0\}$, where $\hat{q} > q^u$ and $\hat{q}_0 \geq 0$. The consumer could then consume platform content in quantity $q = q^u$ and engage in insincere platform usage $q_0 = \hat{q} - q^u + \hat{q}_0 > \hat{q}_0$ and achieve strictly higher utility under $\{q; q_0\}$ compared to $\{\hat{q}; \hat{q}_0\}$,

$$y + V(q) - \hat{T}(q + q_0) = y + V(q^u) - \hat{T}(\hat{q} + \hat{q}_0) > y + V(\hat{q}) - \hat{T}(\hat{q} + \hat{q}_0),$$

in contradiction to the assumed implementability of $\{\hat{q}; \hat{q}_0\}$ by $\hat{T}(d)$. By a similar argument, the monopoly cannot implement $\{\hat{q}; \hat{q}_0\}$, where $\hat{q} \in [0, q^u]$ and $\hat{q}_0 \geq 0$, for any $\hat{T}(d)$ if $V(q) > V(\hat{q})$ for some $q \in [0, \hat{q})$ The consumer could then reduce the consumption of platform content to q and increase insincere platform usage to $q_0 = \hat{q} - q + \hat{q}_0 > \hat{q}_0$ and achieve strictly higher utility than under $\{\hat{q}, \hat{q}_0\}$.$\square$

B Proof of Lemma 2

We do the proof in reverse order by first showing that no participant can strictly profit from engaging in insincere platform usage under the platform tariff $T(d)$ characterized in eq. (10). Assume that the consumer consumes platform content in quantity q and engages in insincere platform usage in quantity q_0. We obtain

$$y + V(q) - F - t \times \max\{q + q_0 - \hat{d}; 0\} \leq y + V(q) - F - t \times \max\{q - \hat{d}; 0\},$$

where the left-hand side of the inequality is the consumer utility of platform usage $\{q; q_0\}$ and the right-hand side is the consumer utility of $\{q; 0\}$. Hence, the consumer optimally sets $q_0 = 0$. If an opportunist engages in insincere platform usage in quantity q_0^o, then

$$-F - t \times \max\{q_0^o - \hat{d}; 0\} \leq -F$$

where the left-hand side of the inequality is the opportunist's utility of insincere platform usage q_0^o and the right-hand side is the utility of zero platform usage. Hence, the opportunist optimally sets $q_0^o = 0$.

We next show that the consumption of platform content never exceeds $\hat{d}$ subject to an appropriate choice of t. Let

$$t = \max\{\max_{q \in [0, q^u]} V'(q); 0\}.$$

The consumer utility equals $y + V(q) - F - t \times (q - \hat{d})$ for any $q > \hat{d}$. The consumer would never choose $q > \max\{\hat{d}; q^u\}$ because this would strictly reduce $V(q)$ and weakly increase the platform fee relative to content consumption q^u. This part of the proof is done if $\hat{d} \geq q^u$. Assume therefore that $\hat{d} < q^u$ and consider $q \in (\hat{d}, q^u]$. The difference between this strategy and $q = \hat{d}$ can be written as

$$y + V(q) - F - t \times (q - \hat{d}) - [y + V(\hat{d}) - F] = \int_{\hat{d}}^{q} (V'(x) - t)dx \leq 0$$

for all $q \in (\hat{d}, q^u]$ by the definition of t. Hence, $T(d)$ implements content consumption smaller than or equal to $\hat{d}$. The consumer chooses $q \in [0, \hat{d}]$ to maximize $y + V(q) - F$. Let $Q(\hat{d})$ be the maximal solution to this problem. For instance, $Q(\hat{d}) = \hat{d}$ if $\hat{d} \in \mathcal{Q}$ by Lemma 1.

To find an expression for the expected monopoly profit under $T(d)$, denote the participation threshold by $Y(\hat{d}, F)$. Specifically, $Y(\hat{d}, F) = \bar{y}$ if $\bar{y} + V(Q(\hat{d})) \leq F$ because the subscription fee is so high in this case that no consumer type wants to join the platform. At the other polar extreme, $Y(\hat{d}, F) = -\underline{y}$ if $-\underline{y} + V(Q(\hat{d})) \geq F$ because the subscription fee then is so small that all consumer types want to join the platform. For intermediary subscription fees it follows that $Y(\hat{d}, F) = F - V(Q(\hat{d}))$. We can then write the platform's expected profit as

$$[1 - G(Y(\hat{d}, F))][\Pi(Q(\hat{d})) + F] + \rho \min\{F; 0\}. \tag{20}$$

There are no costs of insincere platform usage in this expression.

The final step of the proof is to show that a tariff structure $T(d)$ characterized by (10) maximizes profit. To do so, consider an arbitrary platform tariff $\hat{T}(d)$ that implements consumer platform usage $\{\hat{q}; \hat{q}_0\}$, where $\hat{q} \in \mathcal{Q}$ and $\hat{q}_0 \geq 0$, and a consumer participation threshold $\hat{y} \in \mathcal{Y}$. Assume also that opportunists generate quantity $\hat{q}_0^o \geq$ of non-productive data. The expected platform profit is then given by expression (9). Consider now $T(d)$ of the form (10), where $\hat{d} = \hat{q}$ and $F = \hat{T}(\hat{q} + \hat{q}_0)$. This platform tariff implements content consumption $Q(\hat{q}) = \hat{q}$ since $\hat{q} \in \mathcal{Q}$. The consumer's utility of participating on the platform equals

$$y + V(Q(\hat{q})) - F = y + V(\hat{q}) - \hat{T}(\hat{q} + \hat{q}_0),$$

which is exactly the same as under $\hat{T}(d)$. Hence, $Y(\hat{q}, \hat{T}(\hat{q} + \hat{q}_0)) = \hat{y}$. Inserting this participation threshold and $Q(\hat{q}) = \hat{q}$ into (20) returns the expected profit

$$[1 - G(\hat{y})][\Pi(\hat{q}) + \hat{T}(\hat{q} + \hat{q}_0)] + \rho \min\{\hat{T}(\hat{q} + \hat{q}_0); 0\}$$

of non-linear tariff $T(d)$ where $\hat{d} = \hat{q}$ and $F = \hat{T}(\hat{q} + \hat{q}_0)$. This profit is at least as large as the expected platform profit (9) because there is no insincere platform usage, $q_0 = q_0^o = 0$, under the platform tariff $T(d)$, and the monopoly subsidizes opportunists by a relatively smaller amount, $\min\{\hat{T}(\hat{q}+\hat{q}_0);0\} \geq \min\{\hat{T}(\hat{q}_0^o);0\}$.□

C Proof of Lemma 3

Holding q fixed, $\hat{y} = -V(q)$ maximizes $\Pi^e(y,q)$ over $y \in [-\underline{y}, -V(q)]$ if and only if

$$[1-G(y)][y+W(q)] + \rho[y+V(q)] \leq [1-G(-V(q))]\Pi(q) \ \forall y \in [-\underline{y}, -V(q)),$$

which is equivalent to

$$\rho \geq \tilde{\Omega}(y,q) = G(y) - 1 + \frac{G(y) - G(-V(q))}{y+V(q)}\Pi(q) \ \forall y \in [-\underline{y}, -V(q)).$$

Define $\Omega(q) = \sup_{y\in[-\underline{y},-V(q))} \tilde{\Omega}(y,q)$. The monopoly then does not want to set $y < -V(q)$ for any $q \in \mathcal{Q}$ if $\rho \geq \max_{q\in[0,q^u]} \Omega(q)$. We conclude that the profit-maximizing subscription fee is non-negative for all $q \in \mathcal{Q}$ if ρ is sufficiently large.□

D Proof of Proposition 2

We show that $T(d) = 0$ for all $d \geq 0$ is a profit-maximizing tariff if and only if conditions (12) and (13) are both met.

(i) Necessity of (12). Suppose the monopoly charges $T(d) = 0$ for all $d \geq 0$, but $\Pi'(q^u) < 0$. The expected profit of the monopoly equals

$$\Pi^e(-V(q^u), q^u) = [1-G(-V(q^u))]\Pi(q^u)$$

under the zero tariff. Observe that $V(q) \geq V(q')$ for all $q' \in [0,q]$ and all q in a neighborhood of q^u because q^u would not be a strict maximum of $V(\cdot)$ otherwise. By implication, $q \in \mathcal{Q}$ for all q in a non-degenerate interval $[\tilde{q}, q^u]$. Consider a deviation to the tariff (10) with zero subscription fee, $F = 0$, but a user limit $\hat{d} \in [\tilde{q}, q^u)$ and a prohibitive marginal tariff $t > 0$ for all platform usage $d > \hat{d}$. This tariff yields expected profit

$$\Pi^e(-V(\hat{d}), \hat{d}) = [1-G(-V(\hat{d}))]\Pi(\hat{d})$$

Seeing as

$$\lim_{\hat{d}\to q^u-} \frac{d}{d\hat{d}}\Pi^e(-V(\hat{d}), \hat{d}) = [1-G(-V(q^u))]\Pi'(q^u) < 0$$

by $V'(q^u) = 0$ and the assumption that $\Pi'(q^u) < 0$, a strictly profitable deviation from the zero tariff then exists.

(ii) Necessity of (13). Suppose the monopoly charges $T(d) = 0$ for all $d \geq 0$, but (13) is strictly violated. Consider a deviation to the tariff (10) with positive subscription fee,

$F > 0$, and zero marginal tariff, $t = 0$. This tariff yields expected profit

$$\Pi^e(F - V(q^u), q^u) = [1 - G(F - V(q^u))][F + \Pi(q^u)] \tag{21}$$

Seeing as

$$\lim_{F \to 0^+} \frac{d}{dF} \Pi^e(F - V(q^u), q^u) = 1 - G(-V(q^u)) - g(-V(q^u))]\Pi(q^u) < 0$$

by the assumption that (13) is strictly violated, a strictly profitable deviation from the zero tariff then exists.

(*iii*) A zero marginal tariff, $t = 0$, is part of a profit-maximizing tariff under assumption (12). Assume that the profit-maximizing tariff (10) features subscription fee $\hat{F} \geq 0$, implements platform usage $\hat{q} \in \mathcal{Q}$ and participation threshold $\hat{y} = \hat{F} - V(\hat{q}) \in \mathcal{Y}$. This tariff yields expected profit

$$\Pi^e(\hat{y}, \hat{q}) = [1 - G(\hat{y})][\hat{y} + W(\hat{q})]$$

where, recall, $W(q) = V(q) + \Pi(q)$ characterizes ex-post welfare of content consumption. Consider now the alternative tariff (10) with subscription fee $F = V(q^u) - V(\hat{q}) + \hat{F} \geq \hat{F}$ and where $t = 0$ so that all platform usage is free and unlimited. The consumer consequently chooses content consumption q^u. The utility of participating on the platform conditional on optimal content consumption becomes

$$y + V(q^u) - F = y + V(\hat{q}) - \hat{F} = y - \hat{y}.$$

Hence, the alternative tariff implements participation threshold $\hat{y}$. The tariff thus generates expected profit

$$\Pi^e(\hat{y}, q^u) = [1 - G(\hat{y})][\hat{y} + W(q^u)] \geq \Pi^e(\hat{y}, \hat{q}).$$

$W(q^u)$ is at least as large as $W(\hat{q})$ because q^u maximizes $V(q)$ and $\Pi(q^u) \geq \Pi(q)$ for all $q \leq q^u$ by strict concavity of $\Pi(q)$ and the assumption that $\Pi'(q^u) \geq 0$.

(*iv*) Zero subscription fee, $\hat{F} = 0$, is part of a profit-maximizing tariff if $t = 0$ and assumption (12) holds. A tariff (10) with subscription fee $F \in [0, \bar{y} + V(q^u)]$ and marginal tariff $t = 0$ generates expected profit (21). This profit function is strictly quasi-concave in F by the monotone hazard rate property of $G(y)$. Under assumption (12), $\lim_{F \to 0} \frac{d}{dF} \Pi^e(F - V(q^u), q^u) \leq 0$, in which case $\hat{F} = 0$ maximizes (21) in the domain $F \geq 0$.

If the inequality in condition (13) is strictly reversed while (12) holds, then we know from (*iii*) that a zero marginal tariff maximizes profit and from (*ii*) that the profit-maximizing subscription fee is positive. If inequality (12) is strictly reversed, then we know from (*i*) that profit-maximizing content consumption $\hat{q} \in \mathcal{Q}$ satisfies $\hat{q} < q^u$. The platform can implement $\hat{q}$ by offering free platform usage up to $\hat{q}$, and charging a positive marginal fee, $t > 0$, on usage thereafter. Any strictly positive profit-maximizing subscription fee $\hat{F}$ is characterized by the solution (14) to the platform's first-order condition $\Pi^e_F(\hat{F} - V(\hat{q}), \hat{q}) = 0$ for profit maximization with respect to the subscription fee.

We can combine the first-order condition $V'(q^u) = 0$ for the consumer's optimal content consumption, where $V'(q)$ was characterized in (8), with the platform's marginal profit expression $\Pi'(q^u)$ identified in (15) and the marginal effects, $R'(\phi)$, $N'(\phi)$ and $CS'(\phi)$, from the model of personalized advertising in Section 4 to get

$$\begin{aligned}(\frac{f-2h}{4f})^2(\Pi'(q^u)+c) &= \frac{f-2h}{4f}U'(q^u) \\ &= (\frac{f-2h}{4f})^2\sqrt{\frac{f}{2\sigma\Phi(q^u)}\frac{\Phi'(q^u)}{\Phi(q^u)}} > 0,\ f \neq 2h,\end{aligned}$$

after simplification. Content consumption q^u is independent of the marginal data cost, so that condition (12) is satisfied if and only if c is sufficiently small. Content consumption q^u becomes very small or very large, depending on the sign of $f - 2h$, if σ goes to zero so that product differentiation in the advertising market becomes very large. Either way, the left-hand side of the above expression becomes very large. Based on these comparative statics results, we conclude that the profit-maximizing tariff features free unlimited data usage for instance if the marginal data cost is small or product differentiation in the advertisement market is large. □

E Proof of Proposition 3

The expected welfare $W^e(y, q)$ is strictly decreasing in y. Hence, $y = -V(q)$. The social planner then maximizes $W^e(-V(q), q)$ over $q \in \mathcal{Q}$ to derive the ex ante efficient platform usage $\hat{q}^*$. The corresponding efficient participation threshold is $\hat{y}^* = -V(\hat{q}^*)$.

Compare the efficient allocation $\{\hat{y}^*; \hat{q}^*\}$ to the allocation $\{\hat{y}; \hat{q}\}$ that maximizes $\Pi^e(y, q)$ over $y \in \mathcal{Y}$ and $q \in \mathcal{Q}$, subject to $y + V(q) \geq 0$. We first show that $\hat{q} \leq \hat{q}^*$. The chain of inequalities, $\hat{y} \geq -V(\hat{q}) \geq -V(\hat{q}^*) = \hat{y}^*$, then imply $\hat{y} \geq \hat{y}^*$. Assume first that $\hat{y} + V(\hat{q}) > 0$. In this case,

$$\begin{aligned}W^e(-V(\hat{q}), \hat{q}) - W^e(-V(q), q) = &\int_{-V(\hat{q})}^{-V(q)} [y + W(\hat{q})]g(y)dy \\ &+ [1 - G(-V(q))][W(\hat{q}) - W(q)] \geq 0\end{aligned}$$

for all $q \in \mathcal{Q}$ such that $q < \hat{q}$. The first expression is non-negative because $V(\hat{q}) \geq V(q)$ for all $(q, \hat{q}) \in \mathcal{Q}^2$ such that $\hat{q} > q$ and because

$$y + W(\hat{q}) > -V(\hat{q}) + W(\hat{q}) = \Pi(\hat{q}) \geq 0 \ \forall y > -V(\hat{q}).$$

The second expression is non-negative because $\hat{q} \in \arg\max_{q \in \mathcal{Q}} W(q)$ if $\hat{y} > -V(\hat{q})$. We conclude that $\hat{q}^* \geq \hat{q}$ if $\hat{y} + V(\hat{q}) > 0$.

Assume next that $\hat{y} + V(\hat{q}) = 0$. The difference

$$\begin{aligned} W^e(-V(\hat{q}), \hat{q}) - W^e(-V(q), q) = & \, V^e(-V(\hat{q}), \hat{q}) - V^e(-V(q), q) \\ & + \Pi^e(-V(\hat{q}), \hat{q}) - \Pi^e(-V(q), q) \end{aligned}$$

in expected welfare between $\hat{q}$ and $q < \hat{q}$, where $q \in \mathcal{Q}$, is non-negative if $V^e(-V(\hat{q}), \hat{q}) \geq V^e(-V(q), q)$ because $\Pi^e(-V(\hat{q}), \hat{q}) \geq \Pi^e(-V(q), q)$ by the assumption that $\hat{y} = -V(\hat{q})$ and $\hat{q}$ maximize the platform's expected profit. Seeing as

$$\begin{aligned} V^e(-V(\hat{q}), \hat{q}) - V^e(-V(q), q) = & \int_{-V(\hat{q})}^{-V(q)} [y + V(\hat{q})] g(y) dy \\ & + [1 - G(-V(q))][V(\hat{q}) - V(q)] \geq 0 \end{aligned}$$

by $V(\hat{q}) \geq V(q)$ for all $(q, \hat{q}) \in \mathcal{Q}^2$ such that $\hat{q} > q$, we conclude that $\hat{q}^* \geq \hat{q}$ even if $\hat{y} + V(\hat{q}) = 0$.

If free access and free unlimited usage maximize the platform's expected profit, then $\hat{q} = \hat{q}^* = q^u$ by $\hat{q} \leq \hat{q}^* \leq q^u$ and $\hat{q} = q^u$. Moreover, $\hat{y} = -V(\hat{q}) = -V(\hat{q}^*) = \hat{y}^*$.

The consumer would like to set the subscription fee as low as possible for any q to obtain expected utility $V^e(-V(q), q)$. The expected utility is non-decreasing in $q \in \mathcal{Q}$, so the consumer would like to implement q^u. As expected, the consumer prefers zero subscription fee and unlimited free access in the class of non-negative platform tariffs.□