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October 25, 2023

Price Discrimination

ECO 304K

Charging different prices to different people isn't automatically a bad thing.

Two-tiered pricing usually works to the advantage of people who need a financial break, and in the big picture there are net social benefits, in the form of greater market efficiency. Here's a rundown of companies that will give you a price break if you can prove you're a student:

- Clothing retailers like J. Crew, Eastern Mountain Sports, and TopShop
- Tech companies such as Apple, Microsoft, Adobe, and MathWorks (makers of MATLAB)
- Entertainment companies such as Cinemark, Major League Baseball, museums, and most ski resorts and amusement parks
- Travel and transportation companies such as Greyhound and Amtrak, many hotel brand and some air carriers
- Your favorite news publications like the New York Times or the Economist (!)
- Auto insurance (if you have any good grades)
- All the major cell phone carriers
- Many national restaurant chains and almost all local restaurants

In this chapter, we examine many real-life pricing situations and how businesses can make additional profits if they charge different price to different groups of customers. The study of ***price discrimination*** adds a layer of complexity to the simple models of perfect competition and monopoly. A thorough understanding of how price discrimination works is especially useful as we complete our study of market structure with monopolistic competition and oligopoly in the next two chapters.

Big questions

- **What is price discrimination?**

- **How is price discrimination practiced?**

What is price discrimination?

Price discrimination occurs when a firm sells the same good or service at different prices to different groups of customers. The difference in price is not related to differences in cost. Although "price discrimination " sound like something illegal, in fact is it beneficial to both sellers and buyers. When a firm can charge more than one price, markets work more efficiently; because price-discriminating firms typically charge a "high" and a "low" price, she consumers are able to buy the product at a low price. Of course, firms are not in business to provide goods at low prices; they want to make a profit. Price discrimination enables them to make more money to dividing their customers into at least two groups: those who get a discount and other who pay more.

We have seen that in competitive markets, firms are ***price takers***. If a competitive firm attempts to charge a higher price, its customers will likely buy elsewhere. To practice price discrimination, a firm must be a ***price maker***; it must have some market power before it can charge more than one price. Both monopolies and non-monopolistic companies use price discrimination to earn higher profits.

Conditions for Price Discrimination

For price discrimination to take place, two conditions must be met. First, there must be at least two different types of buyers; second, the firm must be able to prevent resale of the product or service.

Distinguishing groups of buyers

To price-discriminate, a firm must be able to distinguish groups of buyers with different price elasticities of demand. Under those conditions, the firm faces a downward-sloping demand curve for its product instead of a horizontal one. This gives the firm market power; firms can generate additional revenue by charging more to customers with inelastic demand and less to customers with elastic demand.

Preventing resale

For price discrimination to be a viable strategy, a firm must be also be able to prevent resale of the product or service; in some cases, preventing resale is easy.

One Price vs. Price Discrimination

A business that practices price discrimination would prefer to differentiate every customer by selling the same good or service at a price unique to that customer—a situation known as **perfect price discrimination.** To achieve this result, a business would have to know exactly what any particular customer would be willing to pay and charge him or her exactly that price. In practice, perfect price discrimination is hard to implement, so many firms instead settle for charging two or three prices based on sorting customers into a few easily identified groups.

Price discrimination boosts profits under normal circumstances, but it also gives a firm more flexibility when things get crazy.

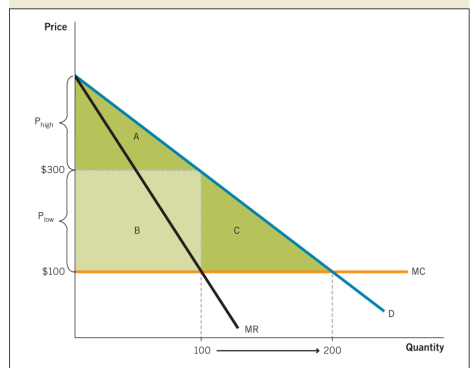
The Welfare Effects of Price Discrimination

Price discrimination is profitable for the companies that practice it; but it also increases the welfare of society. How, you might ask, can companies make more profit and also benefit consumers? The answer: because a price discriminator charges a high price to some and a low price to others, more consumers are able to buy the good.

FIGURE 11.2

Perfect Price Discrimination

If the firm charges one price, the most it can earn is the profit in the light green rectangle. However, if a firm is able to perfectly price-discriminate, it can pick up the additional profit represented by the green triangles.



First, in the long run, a perfectly competitive firm would charge a price just equal to the marginal cost. Second, this outcome mirrors the result of a government-regulated monopolist that uses the marginal cost pricing rule, $P =$ MC, to enhance social welfare. This strategy provides the firm with the opportunity to convert the area consisting of the two green triangles into more profit. In other words, the process maximizes the quantity sold; the efficiency of the market improves, and the firm generates more profit.

Comparing perfect price discrimination with perfect competition and monopoly

To understand the welfare effects of perfect price discrimination, we can compare the consumer and producer surplus in three scenarios: a competitive market, a market in which a monopolist charges a single price, and a market characterized by perfect price discrimination.

In a perfectly competitive market, there are no barriers to entry and no firm has market power. In the long run, the price will be equal to the marginal cost. Under perfect competition, the market structure clearly favors consumers.

A monopoly holds substantial market power, so the firm in this scenario sets a price using the profit-maximizing rule, $MR = MC$, without having to worry about competition driving the price down to marginal cost.

Conclusion

The word “discrimination” has negative connotations, but not when combined with the word “price”. Charging different prices to different groups of customers results in more economic activity and is more economic activity and is more efficient than charging a single price across the board. Under price discrimination, many customers pay less than they would if a firm had charged a single price, while other consumers will pay more because their demand is more inelastic; but overall, total social welfare increases, and the amount of deadweight loss in society is reduced.

Price discrimination also helps us understand how many markets actually function, because instances of perfectly competitive markets and monopoly are rare.