There's one born every minute: Two ways to find him

The first is what economists call "first degree price discrimination," but we could call it the "unique target" strategy: to evaluate each customer as an individual and charge according to how much he or she is willing to pay. This is the strategy of the used-car salesman or the real estate agent. It usually takes skill and a lot of effort; hardly surprising, then, that it is most often seen for items that have a high value relative to the retailer's time—cars and houses, of course, but also souvenirs in African street stalls, where the impoverished merchant will find it worth bargaining for some time to gain an extra dollar.

Now, however, companies are trying to automate the process of evaluating individual customers to reduce the time it takes. For instance, supermarkets accumulate evidence of what you're willing to pay by giving you "discount cards," which are needed to take advantage of sale prices. In return for getting a lower price on certain items, you allow the stores to keep records of what you buy, and then in turn offer you coupons for discounts on products. It doesn't work perfectly, because supermarkets can only send "money off" coupons, not "money on" coupons. "Money on" coupons have never been a success.

When technology allows, firms with scarcity power may use highly sophisticated methods to target customers. It's no secret anymore that Internet retailers such as Amazon can identify each customer by putting a tracing device called a "cookie" on her computer. Amazon used to tailor their prices based on their records of individual customers. The company really was able to offer "money on" vouchers: two readers buying exactly the same book would be offered a different price based on tendencies shown in previous purchases. Even though it would be more difficult than for on-line sales, supermarkets could, with the right technology do the same thing—each customer could have an identity tag, and price labels would change according to who was looking at them.

Of course, the "unique target" approach is unpopular. In Amazon's case, customers started to realize that if they deleted the cookies on their computers, they were offered different, often lower prices. And when they found out what the company was doing, there was an outcry. Like Costa, Amazon has promised not to do it any more.

Interestingly, people tend not to object nearly so much to the second approach, the "group target" strategy, which is to offer different prices to members of distinct groups. Who could complain about reduced bus fares for children and the elderly? Surely it must be reasonable for coffee shops to offer a discount to people who work nearby, and for tourist attractions to let locals in for a lower rate? It often *seems* reasonable because people in groups who pay more are usually people who can afford more, and that's because people who can afford more are usually people who care less about price. But we shouldn't forget that this is a convenient coincidence. Companies trying to increase their profits and get the maximum value out of their scarcity are interested in who is *willing* to pay more, rather than who can *afford* to pay more.

For instance, when Disney World in Florida offers admission discounts of over 50 percent to locals, they're not making a statement about the grinding poverty of the Sunshine State. They simply know that for a reduced price, locals are more likely to come regularly. But tourists will probably come once, and once only, whether it is cheap or expensive.

This example gets to the heart of things and tells us what we really mean by "price sensitivity" or "being lavish" or "being cavalier about prices." The important concept is this: when I raise the price, how much do my sales fall? And when I cut the price, how much do my sales rise? Economists tend to call this "own-price elasticity." Personally I think "price sensitivity" is a bit more descriptive.

Tourists visiting Florida are less price-sensitive than locals, which means that if Disney World raises its prices, locals are more likely to skip a day at the park. By the same token, if the admission price falls, locals may make repeat visits in a way that tourists probably won't. Being rich is sometimes connected with being insensitive to prices, but not always. Business-class air travel is expensive, because companies are willing to pay, and airlines have the scarcity power to take advantage of that fact. Business telephone calls are inexpensive, because although companies would be willing to pay, there is too much competition around for any phone company to force them to.

The same is true of discounts at coffee bars for local workers. The AMT coffee bar in Waterloo station in London will knock 10 percent off the cost of your coffee if you work locally. This isn't because the local workers are poor; they include top government officials and the extravagantly remunerated employees of the gigantic oil company Shell. The discount reflects the fact that local workers are price-sensitive despite being rich. Commuters who pass through Waterloo in a hurry see only one or two coffee bars and are willing to pay high prices for convenience. Local workers pop out of the office at 11 am for coffee and could walk in any direction. They can buy from several cafes, all equally convenient, all of which they will have had a chance to sample. They are bound to be more price-sensitive, even if they are rich.

The "individual target" strategy is difficult, partly because it requires a lot of information and partly because it tends to be very unpopular. Despite the difficulties, however, it's so profitable that companies always explore new ways to do it. The "group target" strategy of discounts for students or locals is less effective but easier to put into action, and it's usually socially acceptable, even welcomed. Either will deliver more profits than simply treating all customers as a homogenous mass.

The first "leak" in a price-targeting strategy, then, is that rich customers may buy cheap products, unless the products are deliberately sabotaged. The second "leak" is a particularly difficult one for companies using a group-target strategy to plug: their products may leak from one group to another. The risk is that the customers who are being offered a discount buy the product and then resell it at a profit to the customers who are being charged a higher price. Up until now, we've mostly been discussing services that can't be resold (like a bus trip or a visit to Disney World) or products that are probably too much hassle to resell (such as a sandwich or a cup of coffee). That's not coincidence. Services and convenience products are the most fertile grounds for price-targeting strategies, because they don't leak. The really great pricing tricks take place on airlines, in restaurants and cocktail bars (not many bookstores have a "happy hour"), in supermarkets, and at tourist attractions.

In contrast, some products are inherently leaky: they're expensive, easy to transport, and nonperishable. The obvious examples are digital media (CDs, DVDs, and software) and pharmaceuticals. Companies go to tremendous lengths to plug leaks, which in an age where Internet shopping allows us to order products from anywhere in the world are becoming increasingly difficult to prevent. For instance, the DVD industry agreed on a system of regional coding so that DVDs bought in the United States would not work in Europe. But that system is being circumvented by an alliance of customers and DVD-machine suppliers who willingly equip machines to read a DVD from anywhere in the world.

If your instincts are anything like mine, it all seems like a pretty shabby trick. But the same popular opinion that despises the DVD industry for trying to sell their products at different prices in different markets also believes that the big pharmaceutical companies should supply drugs to poor countries at discounted prices. Confusingly, our moral intuitions seem to be sending us contradictory messages.

Maybe the story is as simple as this: when it's an important product like a treatment for HIV/AIDS, the most important thing is to get it to the poor; when it's as trivial as a DVD, our irritation at being ripped off is the dominant emotion. But that doesn't quite add up: DVDs make it to very poor areas, and surely we should be at least somewhat pleased that the poor get to watch movies in bars and village halls across the developing world? Or, conversely, shouldn't we be even more outraged that the pharmaceutical companies are overcharging for crucial treatments in the developed world? An economist cannot solve these ethical conundrums, but economics can unwrap them so that at least the ethical question becomes clearer.