What is price discrimination and its effect on economies

Introduction

Price discrimination is the practice of one retailer, wholesaler or manufacturer charging different prices for the same items to different customers. This is a widespread practice that does not necessarily imply negative discrimination. In an economic term, price discrimination is the ratio of price to marginal cost that differs for similar products. The practice of price discrimination is not an isolated event. It occurs in many familiar situations but this practice is often highly controversial in terms of its impact on both consumers and rivals. Price discrimination is mainly for markets that are monopolistic or oligopolistic.

In these kinds of markets the firm has to decrease price in order to sell more of the good because they are the only supplier. Because of this marginal revenue is derived from the demand but the profit maximization condition is still marginal cost equals marginal benefits but marginal benefits does not equal the demand curve.

Role and Prevalence

Whenever we travel, because we are interested in economics we are probably conscious that we are being charged a different price for our journey than some other persons travelling with us. A rail journey is cheaper in the middle of the day than it is in rush hour. However, even at the same time of day a range of prices is being charged. For example, some have rail cards entitling them to discounts; others do not. Children often travel at half price. It is cheaper for people who book in advance. If we travel by air the price of the ticket probably varies hugely between types of traveler. These variations occur not just for different airlines and different flight times but people travelling on the same aircraft have bought tickets for very different prices. Some will have paid no money at all if they have collected enough `air miles'. These price differences are not confined to the transport industry. The rates charged at hotels vary between customers even for the same quality of room on the same night. Doctors in the private sector charge different amounts to different patients for the treatment of the same condition

Role and Prevalence

Price discrimination is one of the basic concepts in microeconomics. Price discrimination plays a major role in the privacy which is much debated and one of the many privacy puzzles is that even though the public shows intense concerns about loss of privacy, they are not doing much to protect themselves. Privacy-protecting technologies have not fared well in the marketplace, and very minor rewards are enough to persuade people to sign up for grocery store loyalty programs. Another puzzle is that so many commercial organizations are actively working to erode privacy. Governments often decrease privacy in attempting to combat terrorism, or tax evasion, or to increase their political control. Criminals invade privacy to make money by using other people's credit cards. Employers monitor their employees to increase productivity. And ordinary citizens, armed with an array of increasingly powerful and versatile tools, such as cameras in cell phones, are beginning to collect massive amounts of information that, if combined and analyzed, could lead to dramatic decreases in privacy. However, most of the data collection efforts so far have come from private enterprises, and are the ones that attract most of the concern and publicity. These efforts are often extremely intrusive, and are extremely widespread. Moreover, they persist in spite of intense public opposition, even though there have not been too many commercially successful exploitations of the information that is gathered.

Most of the privacy issues discussed above are related to price discrimination in one or other way. But it is not always true that price discrimination is bad for public even though the privacy is compromised. We are able to see best products and services for the price we pay today. It would not have been possible if the commercial organizations or the sellers have not continually researched to make their products and services to make it more customized to their customers by analyzing their behavior in different ways. Price discrimination plays very important role for both the survival of the commercial business and to the public to get the best out of the price they pay.

Price Discrimination Does Not Explain Everything

Price discrimination by word meaning looks like it is like unfair pricing to customers. But when are discuss from the viewpoint of seller or the manufacturers it is totally different and sounds very reasonable. Stores must sell their goods at prices that cover the wholesale cost of the individual goods as well as the overhead costs of the store, like labor and the building lease. The amount of additional price that must be charged for each good to cover overhead costs is a function of the average turnover of the goods sold. The faster a store can sell its goods, the lower the average overhead costs of each good, and thus the less that must charge to cover the stores average total costs. If a store sells three times as much on Black Friday than they normally do, then the overhead costs are three times as small.

Types of price discrimination

First degree price discrimination

First degree price discrimination is more theoretical as it requires the seller to have knowledge of absolute maximum price for the goods and services that the buyers are willing to pay. As the seller has the knowledge of maximum price that the buyers are willing, they are able to earn the maximum profit from the transaction. This assumes that the consumer passively reacts to the price set by the seller, and that the seller knows the demand curve of the customer. In practice however there is a bargaining situation, which is more complex: the customer may try to influence the price, such as by pretending to like the product less than he or she really does or by threatening not to buy it.

Second degree price discrimination

In second degree price discrimination price varies according to quantity sold. So when large number of quantity is sold then the unit price of the product is low and if less number of quantities is sold then unit price is higher for the same quality of the products and services.

Second degree price discrimination is more practical in nature and is widely used in the general market, mostly in industrial sector. Buyers who are buying in bulk enjoy the discounts than the one who buys individual items. In reality, different pricing may apply to differences in product quality as well as quantity. For example, airlines often offer multiple classes of seats on flights, such as first class and economy class. This is a way to differentiate consumers based on preference, and therefore allows the airline to capture more consumers' surplus.

Third degree price discrimination

In third degree price discrimination customers are segregated into different markets and charged different prices in each of them. Segmentation can be based on any characteristic such as age, geographic location, gender, income and many others according to the nature of the products and services.

Necessary Conditions for Price Discrimination

The firm must operate in imperfect competition; it must be a price maker with a downwardly sloping demand curve. For example, airlines routinely engage in price discrimination by charging high prices for customers with relatively inelastic demand such as business travelers and discount prices for tourist who have relatively elastic demand. The airlines enforce the scheme by making the tickets non-transferable thus preventing a tourist from buying a ticket at a discounted price and selling it to a business traveler.

The firm must be able to separate markets and prevent resale. Example of stopping an adult using a child ticket. The firm must be able to prevent " market seepage" or " consumer switching" which is the process whereby consumers who have purchased a good or service at a lower price are able to re-sell it to those consumers who would have normally paid the expensive price. This can be done in a number of ways, and is probably easier to achieve with the provision of a unique service such as a haircut rather than with the exchange of tangible goods. Seepage might be prevented by selling a product to consumers at unique and different points in time – for example with the use of time specific airline tickets that cannot be resold under any circumstances.

Different consumer groups must have elasticity of demand. E. g. students with low income will be more price elastic. There must be a different price elasticity of demand from each group of consumers. The firm is then able to charge a higher price to the group with a more price inelastic demand and a relatively lower price to the group with a more elastic demand. By adopting such a strategy, the firm can increase its total revenue and profits (i. e. achieve a higher level of producer surplus). To profit maximize, the firm will seek to set marginal revenue = to marginal cost in each separate (segmented) market.

Advantages and Disadvantages

Advantages

Firms will be able to increase revenue. This will enable some firms to stay in business who otherwise would have made a loss. For example price discrimination is important for train companies who offer different prices for peak and off peak.

Geographic price discrimination is used when a firm wishes to sell a product at different prices in different member states. Typically, this requires some measures in order to prevent trade between the member states from eliminating the price differentials.

By getting more money out of people who are willing and able to pay more than what would be the market equilibrium price you can provide your service to people who aren't able to pay the market price.

Increased revenues can be used for research and development which benefit consumers

Some consumers will benefit from lower fares. E. G. old people benefit from lower train companies; old people are more likely to be poor.

Disadvantages:

Some consumers will end up paying higher prices. These higher prices are likely to be allocatively inefficient because P> MC.

Businesses don't know what people are really willing and able to pay for your service so you might lose out on some money if you underestimate what someone is willing to pay or overestimate what someone is able to pay.

Decline in consumer surplus.

Those who pay higher prices may not be the poorest. E. g. adults could be unemployed, OAPs well off.

There may be administration costs in separating the markets.

Profits from price discrimination could be used to finance predatory pricing.

Conclusion:

Price discrimination is one of the major issues around the world and it will remain for coming years as well. The incentives towards price discrimination and the ability to price discriminate will be growing in the coming years as sellers will be increasingly tempted to engage in differential pricing. Internet have played a crucial role in helping general public to get best out of the price discrimination due to information of products and services easily available in the Web and ease of buying from any supplier. Therefore the stress is likely to be on different ways to hide price discrimination. Sellers are always tracking every moment of their customers to best fit their needs or to attract them to their products in the form of loyalty card, security camera, coupons, store credit card and many other forms of incentives. However, privacy concerns have always hit back to the sellers as it is very important topic going on in this Information Technology world. Since intimate knowledge of consumer preferences and willingness to pay will be of advantage in creating customized packages for the targeted group of people, and will often provide crucial competitive advantage to sellers governments are likely to play an increasing role in pricing.

Governments and others non-profit organizations are also likely to continue playing an important role, in order to protect the welfare of the general public without hurting the businesses. We as a general public should also be self conscious about the price discrimination and should accept if reasonable or look for best option if available and protect our privacy to the extent which is within our control.

Role and Prevalence

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Advantages and Disadvantages

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