**Price discrimination**

***Author****:* [*Geoff Riley*](http://www.tutor2u.net/blog/index.php/site/author/3/)***Last updated:*** *Sunday 23 September, 2012*

**Introduction to price discrimination**

In our study of the theory of the firm we have assumed so far that a business charges a single price for its products, naturally the reality is different!

Most businesses charge different prices to different groups of consumers for the same good or service! Businesses could make more money if they treated everyone as individuals and charged them the price they are willing to pay. But doing this involves a cost – so they have to find the right [pricing](http://www.tutor2u.net/blog/index.php/business-studies/tagged/tag/pricing/) strategy for each part of the market they serve – their revenues should rise, but marketing costs will also increase.

It is important that you understand what price discrimination is, the conditions required for it to happen and also some of the economic and social consequences of this type of pricing tactic.

**What is price discrimination?**

[**Price discrimination**](http://www.tutor2u.net/blog/index.php/economics/C181/) occurs when a business charges a **different price to different groups of consumers** for the same good or service, for reasons not associated with costs.

It is important to stress that charging different prices for similar goods is not pure price discrimination. **Product differentiation** – gives a supplier greater control over price and the potential to charge consumers a **premium price** because of actual or perceived differences in the quality or performance of a good or service.

**Conditions necessary for price discrimination to work**

Essentially there are **two main conditions** required for discriminatory pricing:

* **Differences in price elasticity of demand:** There must be a different price elasticity of demand for 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 lower price to the group with a more elastic demand. By adopting such a strategy, the firm can increase **total revenue** and **profits** (i.e. achieve a higher level of producer surplus). To profit maximise, the firm will seek to set marginal revenue = to marginal cost in each separate (segmented) market.
* **Barriers to prevent consumers switching from one supplier to another:** The firm must be able to **prevent “consumer switching”** – a process whereby consumers who have purchased a product at a lower price are able to re-sell it to those consumers who would have otherwise 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, dental treatment or a consultation with a doctor rather than with the exchange of tangible goods such as a meal in a restaurant.
  + Switching might be prevented by selling a product to consumers at unique **moments in time** – for example with the use of airline tickets for a specific flight that cannot be resold under any circumstances or cheaper rail tickets that are valid for a specific rail service.
  + Software businesses such as Microsoft often offer heavy price discounts for educational users. Office 2007 for example was made available at a 90% discount for students in the summer of 2009. But educational purchasers must provide evidence that they are students

**Examples of** [**price discrimination**](http://www.tutor2u.net/blog/index.php/economics/C181/)

**Perfect Price Discrimination –** *or charging whatever the market will bear*

Sometimes known as **optimal pricing**, with perfect price discrimination, the firm separates the market into each individual consumer and charges them the price they are willing and able to pay. If successful, the firm can extract the entire consumer surplus that lies underneath the demand curve and turn it into extra revenue or producer surplus. This is hard to achieve unless a business has full information on every **consumer’s individual preferences and willingness to pay**. The **transactions costs** involved in finding out through market research what each buyer is prepared to pay is the main barrier to a business’s engaging in this form of price discrimination.

If the monopolist can **perfectly segment the market**, then the average revenue curve becomes the marginal revenue curve for the firm. The monopolist will continue to sell extra units as long as the extra revenue exceeds the marginal cost of production.

In reality, most suppliers and consumers prefer to work with **price lists** and **menus** from which trade can take place rather than having to negotiate a price for each unit bought and sold.

**Second Degree Price Discrimination**

This involves businesses selling off **packages or blocks of a product** deemed to be **surplus capacity** at lower prices than the previously published or advertised price. Price tends to fall as the quantity bought increases.

Examples of this can be found in the hotel industry where spare rooms are sold on a last minute **standby basis**. In these types of industry, the **fixed costs** of production are high. At the same time the **marginal or variable costs** are small and predictable. If there are unsold rooms, it is often in the hotel’s best interest to **offload any spare capacity** at a **discount prices**, providing that the cheaper price that adds to revenue at least covers the marginal cost of each unit.

There is nearly always some **supplementary profit** to be made. Firms may be quite happy to accept a smaller profit margin if it means that they manage to steal an advantage on their rival firms.

**Early-bird discounts – extra cash flow**

Customers booking early with carriers such as EasyJet or RyanAir will normally find lower prices if they are prepared to book early. This gives the airline the advantage of knowing how full their flights are likely to be and is a **source of cash flow** prior to the flight taking off. Closer to the time of the scheduled service the price rises, on the justification that consumer’s demand for a flight becomes inelastic. People who book late often regard travel to their intended destination as a necessity and they are likely to be willing and able to pay a much higher price.

**Peak and Off-Peak Pricing**

* Peak and off-peak pricing and is common in the telecommunications industry, leisure retailing and in the travel sector.
* For example, telephone and electricity companies separate markets by time: There are three rates for telephone calls: a daytime peak rate, and an off peak evening rate and a cheaper weekend rate. Electricity suppliers also offer cheaper off-peak electricity during the night.
* At **off-peak times**, there is **plenty of spare capacity** and marginal costs of production are low (the supply curve is elastic)
* At **peak times** when demand is high, short run supply becomes relatively inelastic as the supplier reaches **capacity constraints**. A combination of higher demand and rising costs forces up the profit maximising price.