David Youngberg

Econ 280—Bethany College

**Lecture 05: Price Discrimination I**

1. Why do we have coupons? Why not just have sales?
   1. Do a particular type of person use coupons?
   2. Coupons are an example of *price discrimination*—when a seller charges different prices of the same good or service
2. Price discrimination requirements
   1. *Price setting power*: a firm will not discriminate in a perfectly competitive market because it will be undercut.
   2. *Distinguishable units*: there must have a way to determine which person or amount should be charged which price.
   3. *Prevention of resale*: the product cannot be easily resold; otherwise the discounted customers will turn around and sell it to others at a profit.
      1. *Arbitrage*—buying low and then selling high—prevents price discrimination from working.
   4. *Uniform cost*: the cost to bring the item to market cannot change; otherwise it’s just two different prices for two different products.
3. Three types of price discrimination
   1. *First-degree*—this is when the seller charges each customer their unique reservation price, allowing the seller to convert the entire consumer surplus into producer surplus. This obviously requires gathering a lot of information on each potential buyer and is rarely done. (Though as the Information Age continues to accelerate, first degree price discrimination is more likely.) This price discrimination is also called perfect price discrimination.
      1. Examples: mechanics, car salesmen
   2. *Second-degree*—this is when the seller charges lower prices for each additional unit a consumer buys. Unlike first-degree, this degree has a fixed pay schedule for everyone. It approximates first-degree, however, by charging more for the first few units, then a little less than that for the next few units, etc. Here, “distinguishable units” occurs automatically: because of diminishing marginal utility, the first unit will be more valuable than the second or third unit.
      1. Examples: electricity, “buy one get one free”
   3. *Third-degree*—this is when the seller charges different prices to customers based on a group they belong to. Certain customers are more sensitive to prices than others. Third-degree price discrimination relies heavily on taking advantage of how elasticity impacts revenue—charging more sensitive customers less—and generally has interesting ways to separate people into different groups.
      1. Examples: senior discounts, women’s haircuts
4. Price discrimination is everywhere
   1. Price discrimination is *incredibly* common. So common, some economists argue that price-setting (or monopoly) power is not really required. If it was required, then why are airlines struggling to survive? Where are the monopoly profits?
   2. At the same time, recall that every firm’s unique. Even if the industry is very, very competitive, there is still a role for *monopolistic competition*.
   3. Examples
      1. Coupons
      2. Five dollar foot-longs
      3. Bank loans
      4. Airplane tickets
      5. AIDs medication
5. Efficiency and price discrimination
   1. Part of price discrimination is a transfer payment (from consumer to producer surplus). This sounds bad, but a transfer payment is neutral. From an efficiency standpoint, everyone is treated equally.
   2. But if price discrimination reduces output, then you get some deadweight loss.
   3. *However*, if it increases output (assuming no deadweight loss as a result), then it is good for economic efficiency. Price discrimination increases firm revenue which is sometimes needed to induce entry into product.
      1. Is it better to have a rare disease or a common one?
      2. The role of market size. PD allows an increase in market size, and thus of revenue. PD helps cover fixed costs.