Price Discrimination

What is Price Discrimination?

When the same goods or services are sold to different consumers (in different markets) at varying ratios between marginal cost and price/the price difference is not due to a difference in the cost of production.

Conditions necessary for Price Discrimination

- **Monopoly Power**
  - If freedom of entry existed into the industry, competitors would enter where the firm was charging the higher price and earning SNP and this would continue until only normal profit was being earned.
- **Separation of markets**
  - This is, so that the good bought in the low priced market cannot be offered for resale in the higher priced market. If it was not possible to separate the markets then the above would occur until no price difference existed.
- **Different consumer elasticities of demand**
  - So that consumers with the high price elasticity of demand are charged the lower prices for their goods e.g. students are assumed to have lower incomes and so are not in the position to pay the full price for certain goods and services.
- **Consumer Indifference**
  - The difference in price may be so small that consumers are indifferent and so don't mind paying the slightly higher price.
- **Lack of awareness by consumers**
  - Consumers may be simply unaware that the good is available elsewhere at a lower price.
- **Consumer attitudes to the goods**
  - A consumer may be willing to pay a higher price for a good which they consider to be in fashion/provide status e.g. young people and their desire for 'branded' products.

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Degrees/Types of Price Discrimination

- 1st Degree
  - A monopolist attempts to remove consumer surplus.
  - A monopolist identifies those consumers who are prepared to pay a higher price and consequently charges them that higher price.
  - This type of price discrimination can occur in one-to-one confidential services. Visiting a medical consultant / solicitor
- 2nd Degree
  - A monopolist gives discounts for bulk buying. Night Saver Electricity, Magazine subscriptions, 3 for 2 offers
- 3rd Degree
  - Consumers have different price elasticities of demand.

- Consumers with inelastic demand pay a higher price than consumers with elastic demand. Business air travel vs. leisure air travel, Special rates / prices for students and old age pensioners.

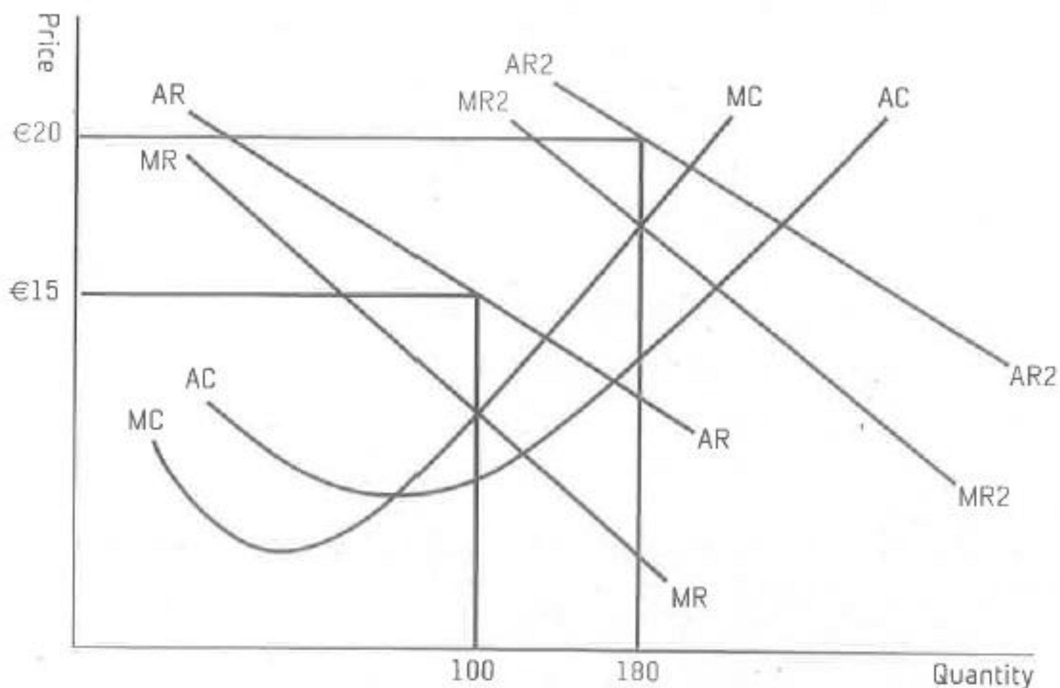
Monopoly that Price Discriminates into another market

If a firm can find a new, separate market for its product and charge this market a higher price for every quantity over and above the original quantity then it can afford to increase its production.

This is done in a situation where the producer identifies that some consumers will benefit from a consumer surplus if the product is sold to them at a lower price.

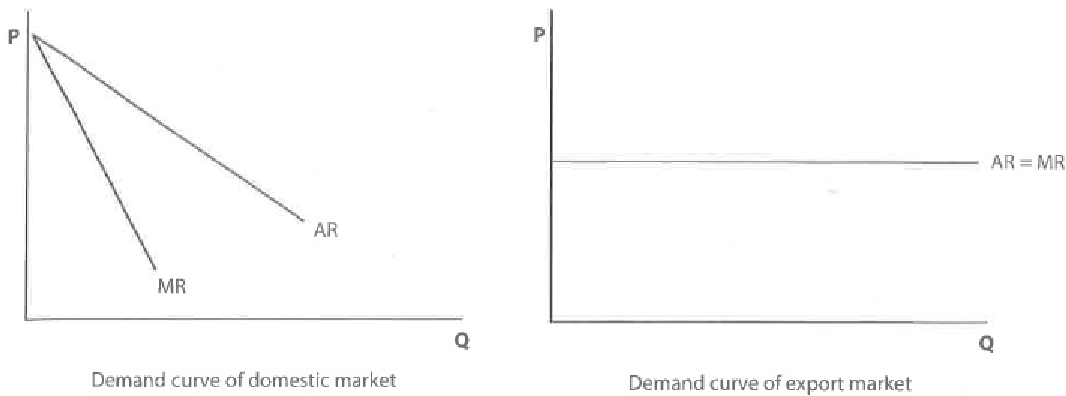
We assume that the markets are separate from each other and that consumers cannot transfer to other segments of the market.

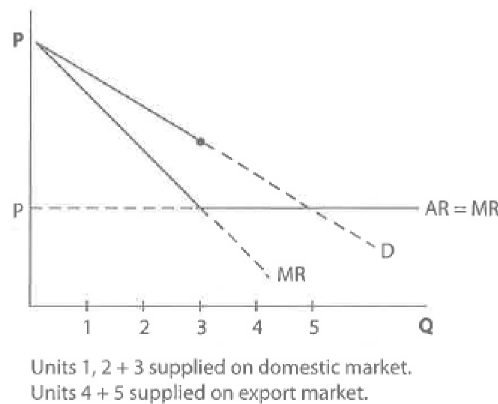
Because the firm now has a second market with a higher price for every quantity it will also have a new set of revenue curves for this market (represented by AR2/MR2 below)



Between 100 units and 180 units MR2>MC therefore the firm will increase its production up to 180 unites where MR2=MC and sell this extra 80 units into the second market at a price of €20. This adds to profit earned from the first market.

Monopoly (domestic) that Price Discriminates into Perfectly Competitive market (export)





Units 1, 2 + 3 supplied on domestic market.
Units 4 + 5 supplied on export market.

If the firm produced just two units, both would be supplied to the domestic market, as MR is greater. After three units the monopolist will supply in the following way:

- Quantities 1, 2 and 3 would be supplied on the home market, as MR is higher.
- Quantities 4 and 5 would be supplied on the export market, as MR is now higher.

In this way, total revenue is maximised, i.e. MR (home market) = MR (export market).

The dotted lines in the figure above show that portion of the demand curves for the individual markets which the producer will *not* be prepared to supply because by doing so they would reduce their revenue.

Where will the price discriminating monopolist earn maximum profits as opposed to maximum revenue? This always occurs where MC = MR.

We can now say that operating in two distinct markets, the firm will operate where MC = MR on the export market and where MC = MR on the home market, i.e. MC = MR (home market) = MR (export market), as the diagram below illustrates.

A Price - Discriminating Monopolist Operating in Two Markets

Explanation:

- Equilibrium occurs at point X. The firm will produce OB. This is where MC = MR (home market) = MR (export market).
- It will sell OA at home because the MR here is greater than the MR on the export market.
- It will sell AB on the export market because MR here is greater than MR on the home market.