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Topic: Price discrimination

Introduction

In monopoly, there is a single seller of a product called monopolist. The monopolist has control over pricing, demand, and supply decisions, thus, sets prices in a way, so that maximum profit can be earned.

The monopolist often charges different prices from different consumers for the same product. This practice of charging different prices for identical product is called price discrimination.

According to Robinson, "Price discrimination is charging different prices for the same product or same price for the differentiated product."

According to Stigler, "Price discrimination is the sale of various products at prices which are not proportional to their marginal costs."

In the words of Dooley, "Discriminatory monopoly means charging different rates from different customers for the same good or service."

According to J.S. Bains, "Price discrimination refers strictly to the practice by a seller to charging different prices from different buyers for the same good."

Let us learn different types of price discrimination.

Types of Price Discrimination:

Price discrimination is a common pricing strategy' used by a monopolist having discretionary pricing power. This strategy is practiced by the monopolist to gain market advantage or to capture market position.

There are three types of price discrimination, which are shown in Figure-13:

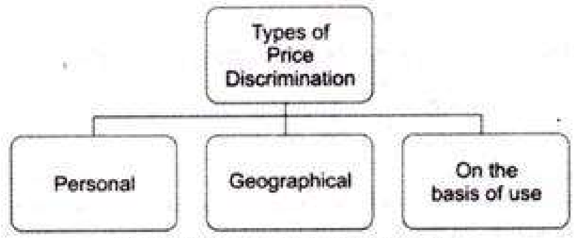


Figure-13: Price Discrimination

The different types of price discrimination (as shown in Figure-13) are explained as follows:

i. Personal:

Refers to price discrimination when different prices are charged from different individuals. The different prices are charged according to the level of income of consumers as well as their willingness to purchase a product. For example, a doctor charges different fees from poor and rich patients.

ii. Geographical:

Refers to price discrimination when the monopolist charges different prices at different places for the same product. This type of discrimination is also called dumping.

iii. On the basis of use:

Occurs when different prices are charged according to the use of a product. For instance, an electricity supply board charges lower rates for domestic consumption of electricity and higher rates for commercial consumption.

Degrees of Price Discrimination:

Price discrimination has become widespread in almost every market. In economic jargon, price discrimination is also called monopoly price discrimination or yield management. The degree of price discrimination vanes in different markets.

Figure-14 shows the degrees of price discrimination:

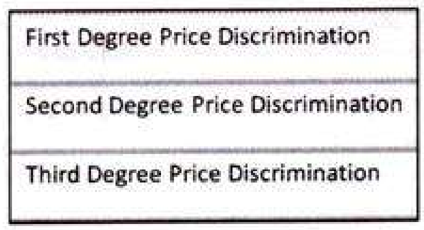


Figure-14: Degrees of Price Discrimination

These three degrees of price discrimination (as shown in Figure-14) are explained as follows:

i. <u>First-degree Price Discrimination:</u>

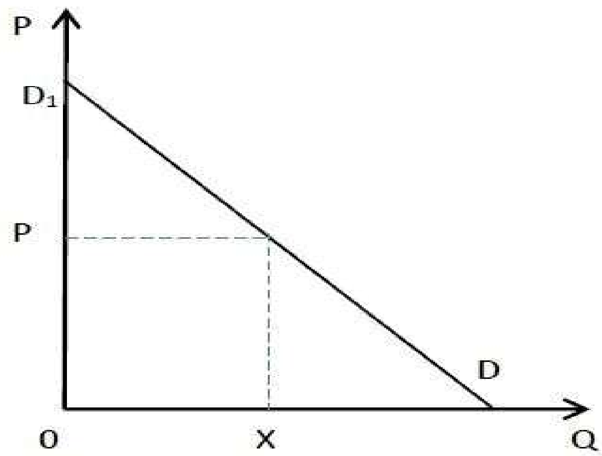
Refers to a price discrimination in which a monopolist charges the maximum price that each buyer is willing to pay. This is also known as perfect price discrimination as it involves maximum exploitation of consumers. In this, consumers fail to enjoy any consumer surplus. First degree is practiced by lawyers and doctors.

If the firm can negotiate with each buyer individually and sell each unit of output at different prices, which are higher than the equilibrium price, the firm can extract the entire consumer surplus and increase its profit.

This policy is called **first-degree price discrimination** or as '***take-it-or-leave-it price discrimination***'. (See Figure 1)

This is because in negotiating with each buyer the firm charges the maximum price that the buyer is willing to pay by threatening of denying selling any quantity to him.

First degree price discrimination graph : Figure 1

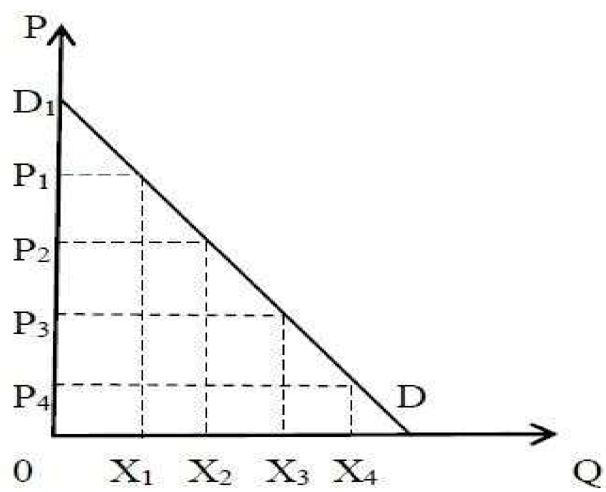


ii. Second-degree Price Discrimination:

Refers to a price discrimination in which buyers are divided into different groups and different prices are charged from these groups depending upon what they are willing to pay. Railways and airlines practice this type of price discrimination.

If the firm can negotiate with buyers and sell its output at more than two prices, which is higher than the equilibrium price it can extract still a large part of the consumer surplus and increases its profit. This action is called **second-degree price discrimination**. (See Figure 2)

Second degree price discrimination graph : Figure 2



iii. Third-degree Price Discrimination:

Refers to a price discrimination in which the monopolist divides the entire market into submarkets and different prices are charged in each submarket. Therefore, third-degree price discrimination is also termed as market segmentation.

In this type of price discrimination, the monopolist is required to segment market in a manner, so that products sold in one market cannot be resold in another market. Moreover, he/she should identify the price elasticity of demand of different submarkets. The groups are divided according to age, sex, and location. For instance, railways charge lower fares from senior citizens. Students get discount in cinemas, museums, and historical monuments.

If the firm sells its output in two different markets for two different prices called the '**third-degree** price discrimination'. (See Figure 3)

The equilibrium price is P2 and the firm produces 0-X2 unit of X. Total revenue of the firm is equal to the area of 0P2CX2 and the consumer surplus is equal to the area of P2CD1.

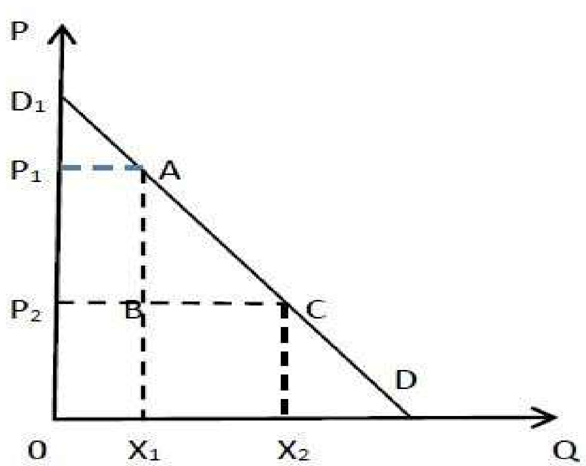
Suppose that the firm decided to sell its output in two markets.

- 0-X1 of X at price P1in the first market
- X1-X2 amount at price P2 in the second market

Now his total revenue is,
0P1AX1 + BCX2X1 = 0P2CX2 + P1P2AB

This indicates that the firm has extracted the part P1P2AB from the consumer surplus as profit.

Third degree price discrimination graph: Figure 3



The monopolist can earn higher revenue as such higher profit through price discrimination than selling all output at a single price. From the buyer's point of view, they are all subjected to extraction according to their income or purchasing power, or other differences.