

The Price is Right



How much would you like to pay for that _____ ?

One “Econ 101” assumption is that unless a firm has considerable market power, the price paid by the consumer equals approximately the cost of supplying that good or service. Thus the underlying beauty of Adam Smith’s “invisible hand,” coupled with the absence of barriers that could block competitors from entering the industry and driving down prices.

In many instances a buyer might actually be willing to pay more than the “sticker” or market price, but firms often have difficulty teasing that out, and the consumer’s anonymity in not salivating in front of the display case of new sweaters is a huge advantage. But in some instances firms are able to discern who might be willing to pay more, and this opens up the possibility of price discrimination, a term not as nefarious as it might otherwise connote.

Price discrimination is the practice of selling the same good or service at different prices to different buyers or groups. It is a rational profit-maximizing strategy, but the firm faces some obstacles. First, it must be able to identify us according to our willingness to pay; second, it must be able to prevent resales (arbitrage in economics or finance lingo – buying in one market at a lower price and reselling in another at a higher one).

BY ALLEN R. SANDERSON

Airlines charge more for a first-class ticket than for one in the economy section of the plane, but that is not price discrimination. Neither is when the Bears sell seats on the 50-yard line for more than in the upper deck. In both instances the products are not identical.

But airlines do price discriminate by separating business customers, who are likely to be less price sensitive, from leisure travelers. How do they do it? One metric is how long in advance you purchased the ticket. Another: Are you willing to stay over a Saturday night? (Airlines have actually benefited indirectly from terrorism: that threat means you have to show up at the airport with a photo ID and a matching ticket; otherwise ticket holders could resell to each other in private transactions.)

Movie theaters charge adults more for admission than children or senior citizens. Not because cineplexes love children and have a

warm spot in their hearts for the elderly, but because of a perceived difference in willingness to pay. But they don’t price discriminate on concessions; if they attempted to charge adults more for popcorn, a parent could just have the son or daughter buy it for them (and an entrepreneurial youngster could buy a dozen tubs and then resell to non-children in the auditorium).

Private colleges and universities require that applicants submit family income information, which they then use as a proxy for willingness to pay in making financial aid—or “net tuition”—decisions. Because it’s hard to sell your letter of admission on eBay, arbitrage is difficult.

The production cost of a hardcover book is only about \$2 more than the paperback version, but the \$10 price differential is to separate those who must have the latest John Grisham legal thriller right now from those who are perfectly content to read it in paperback at the beach next summer.

Why are our outlet malls 40 miles away instead of on North Michigan Avenue? Why are gym memberships and magazine subscription prices lower for new customers than for renewals? Why do you only get 50% off the second item once you have purchased the first one? What is the purpose of those little two-for-the-price-of-one grocery coupons in Sunday newspapers? Starting to catch on?

Price discrimination is not to be confused with dynamic pricing—varying the price of Cubs’ tickets by opponent, day v. night game, and month—nor surge pricing, a more controversial form of altering the price by time of day or perceived shortage. (Yes, Uber, I mean you!) Think snow shovels after a big snowstorm, bottled water in southern Florida after Hurricane Maria, the city raising parking rates around Wrigley Field during Cubs’ games, or the price of hotel rooms in South Bend on Notre Dame football weekends. People seem to resent more price increases that are the result of increased demand than triggered by increased costs.

In terms of role reversal, during job searches and interviews a firm will ask you for your salary requirements or to list your employment history and salaries on its application form. That is not an innocent exercise but rather an attempt at wage discrimination—how little can we offer and still entice you to work here? Don’t do it! As the Miranda warning has it, “Anything you say can and will be used against you.” □