Answer on Question #56787, Economics, Economics of Enterprise Completed

Question

Explain why a monopolist can increase profits by practising price discrimination compared with using a single price to maximize profits? What are the different kinds of price discrimination? What are the necessary conditions required for a monopolist to be able to practice each kind? Provide one example of each of the different types of price discrimination. You may use graphs to illustrate.

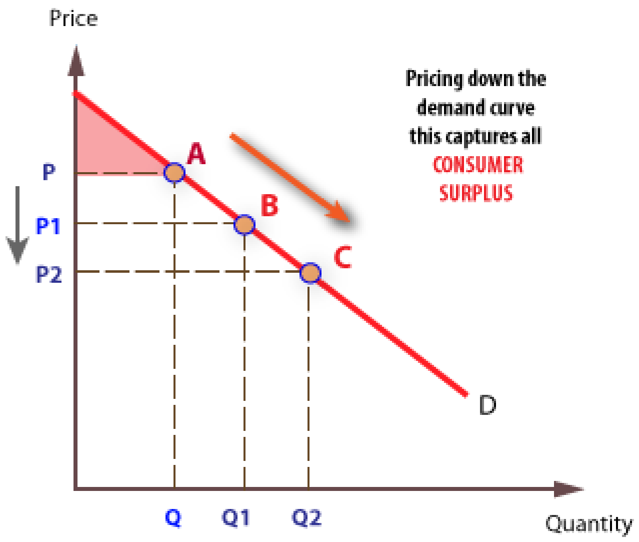
Answer

Price discrimination is the practice of charging a different price for the same good or service. There are three types of price discrimination – first-degree, second-degree, and third-degree price discrimination.

First-degree price discrimination

First-degree price discrimination occurs when a firm charges a different price for every unit consumed. It is alternatively known as perfect price discrimination.

Necessary condition – the firm is able to charge the maximum possible price for each unit which enables the firm to capture all available consumer surplus for itself. In practice, first-degree discrimination is rare.



Examples: used-car dealer is, or to profile your customers and offer personalized prices based on past performance.

Second-degree price discrimination

Second-degree price discrimination means charging a different price for different quantities, such as quantity discounts for bulk purchases.

Examples: buy-two-get-one-free offers, special pricing for bulk purchases and premium packages are second-degree promotions.

Third-degree price discrimination

Third-degree price discrimination means charging a different price to different consumer groups. Third-degree discrimination is the commonest type.

Examples: rail and tube travelers can be subdivided into commuter and casual travelers, and cinema goers can be subdivide into adults and children. Splitting the market into peak and off peak use is very common and occurs with gas, electricity, and telephone supply, as well as gym membership and parking charges, special discounts to members of certain groups, such as students, seniors or military personnel.

Price discrimination can only occur if certain conditions are met:

- The firm must be able to identify different market segments, such as domestic users and industrial users;
- Different segments must have different price elasticities (PEDs);
- Markets must be kept separate, either by time, physical distance and nature of use, such as Microsoft Office 'Schools' edition which is only available to educational institutions, at a lower price;
- There must be no seepage between the two markets, which means that a consumer cannot purchase at the low price in the elastic sub-market, and then re-sell to other consumers in the inelastic sub-market, at a higher price;
- The firm must have some degree of monopoly power.