Lectures Notes for Price Discrimination

Price Discrimination - Occurs when the seller charges different prices for the product it sells, and the price differences do not reflect cost differences.

A. Examples in Different Industries:
   - Hotel
   - Airlines
   - Movies
   - Computers
   - Higher Education
   - Prescription Drugs
   - Grocery Stores

B. Three Conditions Required for Price Discrimination to Occur:
   1) The seller must exercise some price control (downward sloping demand curve).
   2) Seller must be able to distinguish among customers who are willing to pay different prices.
   3) It must be impossible or too costly for one buyer to resell the good to other buyers (ie can't arbitrage).

What actions do firms take to prevent resale or make resale more “costly”?
C. Three Types of Price Discrimination:

i) Perfect Price Discrimination - Occurs when the seller charges the highest price each consumer would be willing to pay for the product (consumer's reservation values) rather than go without it.

ii) Third-Degree Price Discrimination - Occurs when the seller charges different prices in different markets, or charges a different price to different segments of the buying population.

iii) Second-Degree Price Discrimination - Occurs when the seller charges a uniform price per unit for one specific quantity, a lower price for an additional quantity, and so on. EXAMPLES: QUANTITY DISCOUNTS through 2-part pricing or block

II. Bundling

A. Cases of bundling:

1) Restaurants
2) Selling stereos
3) Cars with options
4) Celebrity Endorsements
B. Example 1 for Restaurants: Bundling Appetizers and Entrees

Suppose there are 10 type 1 individuals and 10 type 2 individuals. Also, assume there are no costs.

i) Valuations for Appetizer and Entree for Type 1 and Type 2 individuals.

<table>
<thead>
<tr>
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<th>Type 1</th>
<th>Type 2</th>
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<tbody>
<tr>
<td>Appetizer</td>
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<td>8</td>
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<tr>
<td>Entree</td>
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No bundling/ Sell separately

Bundling

ii) Valuations for Appetizer and Entree for Type 1 and Type 2 individuals.

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Bundling
iii) Valuations for Appetizer and Entree for Type 1 and Type 2 individuals.

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No bundling/ Sell separately

Bundling

Mixed Bundling

iv) Valuations for Appetizer and Entree for Type 1 and Type 2 individuals.

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No bundling/ Sell separately

Bundling

Mixed Bundling
C. Example 2 for Restaurants: Bundling Appetizers and Entrees

Now consider when there are costs. Marginal cost of an appetizer is $5 and marginal cost of an entree is $10.

i) Valuations for Appetizer and Entree for Type 1 and Type 2 individuals.

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No bundling/ Sell separately

Bundling

IV. Coupons
Firm Can Identify Individual of Type A and Individual of Type B

Individual A (8)  Individual B (1)
Third-Degree Price Discrimination

Student

Non-Student

MC=AVC

MC=AVC

D_{S}

D_{NS}

q_{S}

q_{NS}
Second-Degree Price Discrimination

(Two-Part Pricing)
Firm Cannot Identify Individual of Type A and Individual of Type B

Individual A (8)  

Individual B (1)  

Graphs showing individual demand curves for Individual A and Individual B.
Let the MC be constant at .50 and TFC=75.

a) Assume the opportunity cost of cutting a coupon is $0 for Type A individuals and $1.50 for Type B individuals.

b) Assume the opportunity cost of cutting a coupon is $.25 for Type A individuals and $1.50 for Type B individuals.

c) Assume the opportunity cost of cutting a coupon is $.75 for Type A individuals and $1.50 for Type B individuals.