Andrew Makabo Munyasia

Economics

8th August 2023

How Price Discrimination Affects Consumers and Producers

Introduction

. From an economic perspective, price discrimination is when two similar products, which have the same marginal cost to produce, are sold by a firm at different prices. While price discrimination can be frustrating for the purchaser and feel unfair, these are not reasons to use competition law to address it. It is better to use other tools to address cases that policymakers decide require fixing.

From an economic perspective, price discrimination is when two similar products, which have the same marginal cost to produce, are sold by a firm at different prices. A key characteristic is that the price that is charged is based partly on the value of the good to the customer, rather than just on the cost of producing the good. There are a number of different ways that firms can price discriminate, for example it can be based on the characteristics of the buyer (referred to as group pricing or third-degree discrimination), the behavior of the buyer (behavior-based discrimination), or the characteristics of the product (versioning or second-degree discrimination).

Buyers can often feel that price discrimination is frustrating and unfair, particularly when it is clear that they are paying a higher price than others. Policymakers can address those cases that they consider unfair using anti-discrimination or consumer protection laws. For example, anti-discrimination laws often specify that discrimination on the grounds of

In contrast, competition law focuses on the impact on consumers. Price discrimination can benefit consumers by reducing prices for some and by increasing the number of consumers that are served. However, it can also have an adverse impact on consumers. For clarity of enforcement of competition law, it is useful to distinguish three different effects: a) it can exclude rivals and thereby lead to the exploitation of consumers; b) it can exploit consumers, and, c) in upstream markets, it can exploit intermediate customers and create distortionary effects that harm consumers in downstream markets. In each case, it is the effect on consumers, and not the fairness of the discrimination, that determines the acceptability of the discrimination.

Effect of Price Discrimination on Consumers and Producers

If competition authorities find that a price discrimination scheme is exploitative and has an adverse effect on consumers, they should first consider whether the market is likely to solve the problem. If not, and the problem is persistent, the discrimination might be a good indication that the market is not functioning effectively, and a market study may help identify the features of the market that cause this harm. Where an authority believes the cause is a firm's restrictive conduct, it might want to investigate whether the conduct constitutes an abuse of dominance. In any case, the dynamic effects of the discrimination need to be considered.

Price discrimination can be harmful if it is costly to impose and reduces consumer surplus in the short run without a sufficient compensating effect. Such compensating effects might include expanding the market, intensifying competition, preventing commitment to maintain high prices, or incentivising innovation.

If on the other hand price discrimination is persistently harmful and unlikely to be resolved by the market then this might be a symptom of a malfunctioning market. In these circumstances, a market study can provide a comprehensive and holistic examination of the market, the different reasons why the market is not working effectively, and the relative magnitude of those different problems. For example, these may include problems of excessive concentration, tacit coordination, barriers to entry, behavioral biases on the demand side, and regulatory restrictions. Abuse by a dominant firm would therefore be just one of the possible causes and perhaps a rare one.

Evidence of exploitative discrimination would need to include not just market power and a lack of output expansion, though these would suggest that the discrimination is harmful to static welfare. It would also need to address the impact of the discrimination on dynamic welfare. For example, did the prospect of future profits earned through price discrimination incentivise sunk investment or innovation to earn market power (e.g. pharmaceutical firms might expect in business cases for R&D to be able to charge different prices in different countries for the products of their research) or did it lead to rent-seeking investments. Finally, it would need to establish that it was the firm’s market power, and not another common factor that creates the discrimination. If, for example, non-dominant firms in the market are also price discriminating, this might suggest that the discrimination is in fact determined by a third factor rather than specifically resulting from the firm’s market power.

Where an upstream firm (e.g. a manufacturer) profit-maximizes it may charge different prices to different downstream buyers (e.g. retailers) without seeking to exclude an upstream rival. The different prices may simply reflect the downstream buyers' different valuation of the good or service (or differing levels of buyer power). However, in certain circumstances, the difference may nevertheless distort competition between retailers in the downstream market, and this may have an adverse effect on consumers. For example, if a more efficient retailer has less elastic demand for an input they might be charged a higher price by a manufacturer with market power than other less efficient rivals. This may increase its costs, and lead it to produce less than it otherwise would, or even to exit.

A manufacturer might be relied upon to guard against discriminating in a way that increases its average margin but reduces downstream volumes to such a degree that it reduces its profits. For example, it typically benefits upstream firms to have a competitive downstream market. However, where it can increase its margin by discriminating without losing much volume downstream it may be indifferent to the downstream distortion that is created. Alternatively, there might be a non-financial explanation, such as the nationality of the favored buyer. To identify a harmful distortion would therefore require an explanation of the manufacturer's reasoning. It would also require that the un-favoured retailer would otherwise have imposed a competitive constraint upon the favored retailer. For instance, if despite the distortion, the downstream market remains competitive then no such competitive constraint will have been lost.

Work cited

DAF/COMP/M(2016)2/ANN5