Monopoly Behavior
or
Price Discrimination
Chapter 25
Monopoly Pricing

- Uniform pricing: charging the same price to every customer
- Competitive firms are *price takers*, suffer losses if they don’t charge the one, uniform market price
- We’ve been thinking about the behavior of a monopolist charging a uniform price
- But, a monopolist is a *price maker*, free to set price, including non-uniformly
- Today: non-uniform pricing, especially price discrimination
- Price discrimination: different prices for different people
- Other non-uniform pricing schemes: two-part tariffs, bundling, tie-ins
Non-uniform Pricing

Price-discrimination earns a monopoly higher profits

- Non-discriminating firm faces tradeoff:
  - Charge high price for customers with high WTP
  - Charge low price and sell more units to more customers
  - Optimum typically involves compromise

- Price-discriminating firm avoids this tradeoff:
  - Charges higher price to those with high WTP *capturing their consumer surplus*
  - Charges lower price to those with less WTP generating *extra sales*
Example

• Movie theater, $MC = 0$: everyone fits, showing movie is costless, so $\pi = \text{revenue}$

• Potential audience: 10 college students WTP $10, 20$ senior citizens WTP $5$

• Uniform price = $5 \implies \pi = 5 \cdot 10 + 5 \cdot 20 = 50 + 100 = 150$

• Uniform price = $10 \implies \pi = 10 \cdot 10 + 10 \cdot 0 = 100 = 100$

• Price discriminate $\implies \pi = 10 \cdot 10 + 5 \cdot 20 = 100 + 100 = 200$
Intuition: why non-uniform pricing works in general

- Firm faces a profit-maximization problem
- Uniform prices is one tool to solve the problem
- Non-uniform pricing allows other, multiple tools
- This can only help solve the problem, at worst the extra tools are useless and you can choose not to use them
Conditions for Price Discrimination

- Firm has market power
- Consumers have different demand elasticities, firm can identify them
- Firm can prevent/limit resales from low-paying to high-paying customers
  - Resales difficult for services, when transaction costs are high
  - E.g. show student ID when buying student software, mail in class schedule
Three Types of Price Discrimination

- **Perfect price discrimination** (first-degree): sell each unit for consumer’s full reservation price; prices differ across buyers

- **Quantity discrimination** (second-degree): different price for larger quantities (bulk discounts); prices same for all buyers

- **Multimarket price discrimination** (third-degree): prices same within group, but different groups/markets are charged different prices
Perfect Price Discrimination

• All-knowing monopoly sells each unit at reservation price, height of demand curve
• Monopolist reaps all possible gains-from-trade, leaves buyers with zero surplus
• However, monopolist supplies efficient level of output, outcome is Pareto efficient
Quantity Discrimination

- Hard to determine individual reservation prices
- But easy to know that most customers are willing to pay more for first unit than second (demand slopes down)
- Firm varies prices with number of units purchased
- E.g. utility block pricing, bulk discounts
Multimarket Price Discrimination

- Firm only knows which group/market is likely to have higher reservation prices
- Different prices for different groups
- E.g. theater example, airline classes, software pricing, coupons
Multimarket Price Discrimination

How does the monopolist maximize profits across markets?

• Choosing price for each market $\iff$ choosing quantity for each market

• $\pi(y_1, y_2) = p_1(y_1)y_1 + p_2(y_2)y_2 - c(y_1 + y_2)$

• Profit maximizing condition:

\[
MR_1(y_1) = MR_2(y_2) = MC(y_1 + y_2)
\]

• Equate MR across markets to $MC$

• If one market generated more marginal revenue than the other, could increase profits be shifting production to that market
\[ MR_1(y_1) = MR_2(y_2) = MC(y_1 + y_2) \]

- Demand differs across markets, so price will be different
- Where is price higher?
  - In the market with a higher markup
  - Markup = \( \frac{1}{1 + \frac{1}{\epsilon}} \)
  - I.e. in market with less elastic demand
Multimarket Price Discrimination

\[ MR_1(y_1) = MR_2(y_2) = MC(y_1 + y_2) \]
Multimarket Price Discrimination

Welfare effects:

• Inefficient production & consumption

• Lower welfare than under PC or perfect price discrimination

• Welfare may be higher or lower than in single-price monopoly
Other Kinds of Non-uniform Pricing

- Two-part tariffs: lump-sum fee + constant price per unit
- Tie-in sales: can buy one product only if you buy another one as well
  - Requirement tie-in
  - Bundling (or package tie-in)
- Can think of these as a form of quantity (2nd degree) discrimination, where the average price per unit varies with the number of units purchased
Two-part Tariffs

- Lump-sum fee + per unit price
- E.g. telephone service (connection fee + per minute rate); club cover charges; NFL personal seat license
- Because of fixed fee, average price per unit is higher the fewer units you buy
- Uniform pricing: raise $p$ above $MC \implies$ earn more per unit, but lower CS
- Two-part tariff (ideal): capture each customer’s max potential CS by charging different lump-sum fees, then set $p = MC$
- Like with first degree PD, there is no inefficiency
- But monopolist reaps all gains-from-trade, so equity suffers
Tie-in Sales

• Requirement tie-in:
  • E.g. Printer + ink/toner cartridges, razors + blades
  • Helps firm identify heavy users, i.e. those with high WTP

• Bundling:
  • E.g. Software such as Microsoft Windows + Internet Explorer, internet & cable service, preseason & regular season tickets, service + parts
  • Allows firms that can’t price discriminate to charge different people different prices
  • Profitability depends on tastes (negatively correlated demand for the two goods) and the ability to prevent resale