

The Ethics of Price Discrimination

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ABSTRACT

Price discrimination is the practice of charging different customers different prices for the same product or service. The ethical status of price discrimination is ambiguous: while many people intuitively consider it unfair, economists argue that in many cases the practice is likely to lead to higher welfare than the uniform pricing alternative—in some cases for each and every party to the transaction.

This paper argues that in itself the fact that people are treated differently does not make a practice necessarily unethical. It also shows that there are many situations in which i) it is necessary to engage in differential pricing in order to make the provision of some product or service possible; and ii) in many such situations the seller does not obtain an above-average rate of return, and concludes that price discrimination is not inherently exploitative. Even when conditions i) and/or ii) do not obtain, the paper contends that price discrimination will not be necessarily unethical, as the key requirement for a price to be fair is that a commensurate value be given for the price charged. In so far as this condition is met, the fact that some people get an even better deal than others do does not mean that the latter are wronged.

The paper concludes by arguing that the real ethical issue in cases of price discrimination is that the practice is often used as a way to take advantage of the situation of special need or the ignorance of some customers, and that this is what makes the practice unethical in such cases, not price discrimination as such.

INTRODUCTION

Price discrimination is the practice of charging different customers different prices for the same product or service. So-called dynamic pricing or smart pricing are modern terms for variants of the same basic practice.

It has often been said that the easiest way to spoil a plane trip is to ask your neighbour how much she paid for her ticket. You may easily find that while you (or your employer) have paid \$1,200, she may be doing the same trip in the same comfort for only \$180. You may also find that if you are trying to buy a laptop computer in the manufacturer's website and you enter the information that you are a small business owner, you will be informed that the price is, say, \$1,600. However, if you were to visit the same manufacturer's site under different identities, you could also find the price of the same system for health care organizations is \$1,450, while for local governments is only \$1,350. These are not isolated examples. Price discrimination—although often in slightly disguised forms—is a pervasive phenomenon which affects a wide variety of products (For simplicity, I will use the term “product” in this article to refer to goods *and services*).

Many business firms practice price discrimination for the simple reason that it can have a large impact on a company's profits. To understand why, reflect a moment on the laptop example I just offered. Laptops are nowadays a low-margin product in which there is keen competition. For a company which has to make do with average margins of 3%, being able to obtain additional margins of between 3% and 12% from a substantial proportion of its customers is certain to have a considerable impact on its bottom line. And many other businesses such as book publishers, air carriers and hotels in which the

price differences between very similar products are much larger can get additional margins of 300%-1000% rather than of 3%-12%.

These days price discrimination is acquiring an added importance because modern technology makes it possible to practice it in ever more refined ways (Grewal and Compeau, 1999; Sinha, 2000). For a businessperson to practice successfully price discrimination she needs to have an accurate knowledge of her customers. Modern information technology is making great progress in helping marketers to efficiently acquire, store, sort and deploy that information. Modern technology makes it also possible to change the prices of products as conditions change and new information about costumers is acquired, even if the products a company markets are counted in hundreds of thousands, the customers in millions, and changes of prices have to be made several times per day. But while modern information technology makes it easier to practice price discrimination, that same technology also allows customers to collect up to date information about the prices, and variations in them, demanded by different firms. If customers feel bad about price discrimination, they are able to complain about it at the speed of light, and modern technology also enables them to make their complaints heard much further than used to be the case (Sinha, 2000).

Almost 90 years ago Pigou (1920) devised a typology of price discrimination which is still widely used today. He spoke of First Degree, Second Degree and Third Degree price discrimination. There has been inconsistency in the usage of these terms and here I follow Shapiro and Varian (1999).

First Degree price discrimination obtains when each buyer is charged the maximum amount he is willing to pay. Of course, in practice it is impossible to reach this ideal, but a real-life approximation to it is the case of the lawyer or mechanic who tries to determine for each client the maximum amount he will be ready to pay on the basis of his way of dressing, the car he drives, the firm he works for, his profession, and any other information he can get about him.

Another example of this type of discrimination is the practice of American colleges to grant different financial aid to different students according to the financial position of their families (McPherson & Schapiro, 1998). This results in different effective prices for different students.

As I suggested above, improvements in information technology are making possible ever closer approximations to the ideal of First Degree price discrimination.

Second Degree price discrimination obtains when a producer offers different versions of a product which are designed in such a way that the more expensive ones will be attractive to those customers who have a greater willingness to pay higher prices. The guiding policy, as Varian has observed, is to try to get the customers to sort themselves according to their willingness to pay by offering them different versions of the product which are designed to give them incentives to do exactly that.

Book publishers, for instance, first release a high-price hardcover version of a new book and only some months later release a cheaper paperback version. Those readers who are especially eager to read the book and can afford to pay the higher price will buy the hardcover version while those other readers who are not ready to pay the higher price (whether for lack of sufficient interest or lack of means) will buy later the paperback edition (Clerides, 2004).

Of course, this may raise the issue of whether the hardback and paperback versions of a book are essentially the same product or two different products. Stigler (1987) has proposed a practical way of dealing with this issue by stipulating that price discrimination exists when the ratio of the prices of two similar products is different to the ratio of their marginal costs. By this test there is no doubt that in a great majority of cases the difference in prices between hardcover and paperback versions of the same book often constitutes price discrimination.¹ As Krugman (2000) has colourfully put it: “The paperback is cheaper to produce; but mainly its lower price is a way of pulling in price-sensitive customers after the juice has been squeezed out of the well heeled and impatient.”

It is also of interest to observe that publishers delay the publication of the paperback version (that is, they make this version less attractive than they could make it) precisely in order to make sure that interested readers of means have maximum incentive to buy the hardcover version of the book.

Other examples of Second Degree price discrimination include offering cheaper airline tickets if the stayover includes a Saturday (business passengers, who have a higher willingness to pay, are typically loath to stay an additional week-end away from their families if they do not absolutely have to) or the ticket has been bought well in advance; charging a very high price during the introductory period of a product and then dropping significantly the price (Apple reduced the price of the iPhone from \$599 to \$399 within two months of the product’s launch) (Casale, Esola and Wojcik, 2007); charging higher rates for peak-time electricity or use of mobile phones; regular periodic sales in stores (less price sensitive customers prefer not to wait until the next sale) (Varian, 1980); and offering coupons or rebates (poorer customers are ready to take the extra trouble involved in redeeming the coupons or claiming the rebates; wealthier customers typically do not bother) (Narasinham, 1984; Howell, 1991; Chen, Moorthy and Zhang, 2005).

Third Degree price discrimination occurs when identifiable groups of customers are charged different prices. Examples are different prices of laptops for small businesses, health organizations and local governments (McWilliams, 2001); discounts in many services for students and senior citizens; different prices of software for personal or business use (Grewal and Compeau, 1999); different prices for male or female haircuts, even in cases in which the haircut is practically identical (City of New York, Department of Consumer Affairs, 1992; Liston-Heyes and Neokleous, 2000); different subscription

¹ It follows from this definition that when cost differences justify differences in the prices of apparently similar products, one should not speak of price discrimination. This is important because frequently cases of apparent price discrimination can be explained by cost differentials (Lott and Roberts, 1991).

rates to academic journals for libraries and individual subscribers (Rosenbaum and Ye, 1997); different prices for the same drug in different countries (Frank, 2001); different freight rates in railroads for different freight classes (Odlyzko, 2004); and granting higher discounts to new buyers of enterprise software than to older customers who are upgrading their product (older customers tend to have been locked-in by having incurred very significant training and implementation costs and therefore are ready to pay higher prices) (Larkin, 2008).

Most people instinctively dislike price discrimination, especially when it results in their paying higher prices than others. Therefore, it should come as no surprise that some mighty scandals have ensued when cases of price discrimination have come to the attention of the public.

Some years ago it was claimed that Amazon had been charging different prices to different customers for the same DVDs. Allegedly this was done by quoting the same basic price to everybody but offering different discounts to different customers. Amazon came under very heavy criticism both in newspapers and in the Internet. Many of its critics accused the online retailer of tailoring its different offers on the basis of the information it had accumulated about each customer by keeping track of their previous transactions. On its part, Amazon insisted that the price differentials were random and constituted a way of testing the reactions of customers to different offers. In any case, the retailer discontinued the practice, promised that it would never engage again in it, and offered refunds to customers who had paid higher prices (Turow, 2005).

However, the condemnation of price discrimination is not universal. Economists often defend it, and it seems that many ordinary people can eventually reconcile themselves to differential pricing; most customers are aware of the widespread use of dynamic pricing by airlines but, as many of them have learned to play the discounted fares game, the practice does not seem to evoke anymore the outrage it used to.

So, we are faced with a practice which is common in the business world and is likely to become more so, and about which people have conflicting reactions. It would seem an issue ripe for ethical analysis, but curiously enough, outside some special niches, ethicists have done very little systematic work on it. The purpose of this article is precisely to fill that gap by trying to study the practice systematically from an ethical point of view.

ECONOMIC UNDERSTANDING OF PRICE DISCRIMINATION

While students of business ethics have failed to give to price discrimination the attention it deserves, the same cannot be said of economists. There is a very large economic literature devoted to the study of this practice and it will be useful to review here some of the main conclusions which economists have reached, especially on those points that are more relevant to an ethical assessment of the practice.

Basic economic concepts can help us achieve a better understanding of price discrimination. The maximum price that somebody is ready to pay for a given product is called her reservation price. The reservation price for a product of the immense majority of consumers who actually buy it will exceed the price which they actually have to pay for it and therefore such customers will be made better off by acquiring it; they derive from the transaction what is called a consumer surplus. The surplus is precisely the difference between the value to them of that product (measured by the highest amount they would be ready to pay for it) and the amount they actually pay for it.

Price discrimination can be understood as an attempt by the seller to get each consumer to pay for the product the highest price he is willing to pay (or to come as close to this as practicable). If price discrimination were to be fully successful the seller would appropriate fully the consumer surplus that buyers get under a uniform pricing regime.

For price discrimination to be possible, some conditions have to obtain (Stole, 2007):

1. The producer must be able to identify the reservation price of each consumer or group of consumers, or at least have reliable indicators of what that reservation price is.
2. There must not be significant price competition from rival firms. Otherwise competitors could target the segments that are being charged higher prices by the price discriminator and offer them more attractive deals. The effect of that competition would be to drive all prices towards the marginal cost and make price discrimination impossible.
3. Arbitrage must not be possible; that is to say, those consumers who have bought the product at a low price must not be able to resell it at a higher price to those who are willing to pay more for it. Insofar as arbitrage is possible the low price buyers will have a strong incentive to compete with the original supplier and undercut its business with those consumers who have a higher reservation price

Phlips (1983, 1) summarises the typical economist's view of price discrimination when he states that "[g]enerally, discriminatory prices [are] required for an optimal allocation of resources in real life situations."

This statement may seem surprising as conventional economic analysis argues that normally competition should make prices equal marginal costs and that this will maximize welfare. However, under contemporary "real life situations" many industries such as—among others—pharmaceuticals, telecommunications and software face very high fixed costs and very low marginal costs. In such situations, while setting prices at the level of marginal costs would make it impossible to recoup the original investment (and therefore would result in no new products), discrimination may easily result in better outcomes for everyone.

Thus, while the costs of developing a new piece of software can be extremely high, the costs of producing an additional copy of that software are insignificant. In such case, even if a group of consumers (say, businesses) are made to pay ten times more than

another group (say, students), for so long as the second group is paying more than the additional cost of producing the units that are sold to them, they will be contributing to covering some of the costs of developing the software and making it possible for the first group to be charged a price lower than what they would have had to pay otherwise.

More generally, using fairly general assumptions (that the relevant demand curves be downward sloping, that is to say, that customers be price-sensitive) Varian (1985, 1992, 1996) has shown that price discrimination is likely to lead to higher welfare than the uniform pricing alternative provided that the output sold using price discrimination is larger than that which can be sold at a uniform price.

Economists have also studied the distributional effects of price discrimination. It sometimes happens that price discrimination results in higher prices for the poor (Baker, 1994; Grewal and Compeau, 1999; Huang, 2005). However, as price discrimination redistributes income from less price sensitive to more price sensitive groups and as the latter are often the richer consumers, in many occasions price discrimination will have positive distributional effects (Tirole, 1989).

ETHICAL ISSUES ON PRICE DISCRIMINATION

Preliminary matters

We now have to face squarely the issue: Do we have reasons to believe that engaging in price discrimination is unethical? In my experience most people react negatively to price discrimination, especially when it results in their being charged higher prices. This article investigates whether that negative reaction can be justified critically.

It may be useful to first discuss briefly two preliminary points. The first arises from the fact that some types of price discrimination are illegal in a number of countries. Does this fact have any implications for an assessment of the ethical status of this practice?

Both in the UK (under the Competition Act 1980) and in the US (under the Robinson-Patman Act 1936) price discrimination is unlawful *when it substantially lessens competition or tends to create a monopoly*. This may easily happen, for instance, when a manufacturer or a wholesaler offer lower prices to some retailers, as this puts other retailers at a disadvantage. As a matter of fact the Robinson-Patman Act has come under intense criticism from legal scholars as tending to protect competitors rather than competition and as constituting a stumbling block on price reductions. Be that as it may, what the law in the two countries mentioned and in many others typically tries to promote is competition in the market rather than uniform prices for all customers. From this one cannot draw even a *prima facie* inference that price discrimination as applied to customers may be unethical

A second preliminary point derives from some studies (e.g., Ayres, 1991; Ayres and Siegelman, 1995) which have presented evidence that women and blacks are

systematically quoted higher prices than white males in car dealerships in the US. Obviously if this were a way to express contempt or dislike for blacks and women it would constitute an especially odious unethical malpractice. However, Ayres and Siegelman (1995) present evidence that tends to show that this is not the case. Whatever is the case, for my present purposes the important point is that if price discrimination constitutes a way of expressing contempt or dislike for a class of individuals (and this may well be the case in some situations), of course, it will be unethical. But the reason for this will be independent of there being anything inherently wrong in price discrimination itself, but the fact that intending to slight a group of human beings as such (whether based on racial, ethnic, linguistic, religious, gender or any other factors) is in itself wrong. It is possible to use a smile as a means to insult somebody, but we do not conclude from this that there might be something wrong with smiling; it is simply that insulting people is wrong, however innocent the means chosen to do this might be in themselves.

Price discrimination considered in itself

Moving now to a consideration of price consideration in itself, it seems clear that a blanket condemnation of it, in all circumstances and under all guises, cannot be sustained. Consider first a well-worn example:

A young doctor in a developing country is looking for ways to establish a medical practice in the rural community in which he was born, but cannot find a way to make the practice economically viable. He can see, on average, 400 patients per month. So, in order to cover his costs of \$4,000 per month (which include his own very modest salary) he should charge on average at least \$10 per visit. However, most of the people in his community can at most afford to pay \$5 per visit. An economist friend suggests to him to charge ninety per cent of his patients only \$5 per visit, but charge \$55 per visit to the ten per cent of his patients who can afford to pay this amount. In this way he would be able to cover all his costs and the rural practice would be viable.

Of course, the poor patients like this solution. The rich patients also like it: they would rather pay \$55 per visit than have to travel by bad roads to the nearest hospital which is 40 km away; and they would also like to get the added bonus of having a doctor close at hand in case of emergency. And the doctor also is happy: this solution would allow him to practice medicine in his own community.

The example is contrived, but it illustrates a common situation. Whenever the available alternatives are only price discrimination or no product at all, all those potential customers whose reservation price is above the price they are asked to pay will be better off under the price discrimination alternative. And often, as the example also indicates, price discrimination does not result in extraordinary profits for the seller (competition takes care of that); it just makes the provision of the product economically feasible.

Is the fact that the patients in the above example pay different fees enough to make it wrong to adopt the solution suggested by the economist? The solution makes everybody

better off than the alternative of not establishing the rural practice. The discrimination in fees in no way indicates less concern or respect for anybody; it is simply a way in which the members of the community secure a common good (the availability of medical services in the community) by contributing in proportion to their possibilities. Even the doctor is not making extraordinary profits: most probably he could make more money if he were to practice in a larger city. What is not to like about this solution?

And yet... Some people may still be made uncomfortable by the fact that some patients, just because they are more prosperous, are being made to pay more than their neighbours for exactly the same service. Are they not failing to receive the equal treatment to which they are entitled? As the recent Nobel laureate Paul Krugman (2000) put it in an article he published shortly after the Amazon scandal, “[d]ynamic pricing is ... undeniably unfair: some people pay more just because of who they are.”

At this point we are entering into deep philosophical waters. While, given the scope of this article and the space available, there is no way we can treat in sufficient depth the complex and contested philosophical and political implications of the ideas of equality and discrimination, we can at least provide some context.

It may be useful to start by confronting head on Krugman’s contention, just quoted, to the effect that it is unfair to treat people differently “just because of who they are.” Boxill (1992), for instance, has argued cogently that in many situations it is justifiable to treat people differently on the basis of their personal characteristics, even when they are beyond their control. Among many other examples, he offers that of denying blind people a driving licence.

The right to freedom from discrimination is listed in the Universal Declaration of Human Rights (1948) and in subsequent treaties such as the International Convention on the Elimination of All Forms of Racial Discrimination (1965), the International Covenant on Civil and Political Rights (1966) and the Convention on the Elimination of All Forms of Discrimination Against Women (1979). However, in the context of fundamental human rights documents, the proscription of discrimination refers always to differential treatment *in the enjoyment of basic rights* on the basis that one *belongs to some specific class* (as by race, sex, ethnicity, nationality, sexuality, religion and so on), not to a general right to be treated in exactly the same way as everybody else in all respects.

In recent decades equality has received much attention from philosophers. There is wide agreement among them that, in the expression of Dworkin (1977:370), all human beings should be treated with “equal concern and respect.” Beyond this basic idea, there is also very general agreement that there should be equality in regard to fundamental legal rights and freedoms, to possibilities of political participation, and to social opportunity (Gosepath, 2007). By contrast how far, if at all, equality of economic and social outcomes should be considered a worthy ideal, and whether, and to what extent, the state should take steps to establish it, remain keenly contested issues. However, even in the context of wide differences of views on this issue, there is a very general consensus that strict equality in this area is undesirable.

Even more fundamentally, leading philosophers of widely differing persuasions such as Nozick (1974), Walzer (1983), Raz (1986), Frankfurt (1997), Parfit (1998) and Anderson (1999) argued that we should not grant a compelling value to equality *as such*. In different ways they have contended that we should not strive for equality in itself, but for objectives that advance human fulfillment such as health, justice, and knowledge, and for the resources needed to attain these objectives. If somebody is hungry he should be helped because that is not a proper situation for a human being to be in, and not because of how his situation compares to that of anybody else. Of course, when that is done it will often turn out that there is now greater equality compared to the previous situation; still, what is valuable after the hungry person has been fed is not that there is now greater equality but that there is greater satisfaction of human needs. As Frankfurt puts it: “It is whether people have good lives, and not how their lives compare with the lives of others” (1997: 6).

Addressing more specifically the issue that interests us here, if somebody insists that for him equal treatment is the supreme consideration, there is very little I can do except reply that while I agree that I am entitled to be as respected as anybody else (and the same applies to everybody else), I do not agree that I (or anybody else) am entitled to be as well treated *in all matters* as everybody else and by everybody. In some respects (notably in relation to the political rights I enjoy) I am so entitled, but in other matters I simply recognize that you can and do love other people more than me and therefore you are going to treat them better than me. I do not find it difficult to grant this as, in order to deny it fairly, I would also have to deny myself the freedom to love some people more than others and to treat them differently. At this point—I already said that we are here very near rock bottom—all I can add is that, as far as I can see, a world in which I could in no way give preferential treatment to those who are especially near and dear to me, and in which the very fact of having some people who are especially near and dear would already constitute an offence to others, does not attract me at all.

I do not pretend to have provided a knock down argument against those who demand equal treatment at all costs. I have just done my best to indicate the ultimate reasons why I do not think that such extreme equal treatment is worth demanding and in the process I have tried to shed some light on my intuitive judgment, which I find I share with many people, that the arrangement in the example above is not objectionable. It follows that I, and all those who share that judgment, cannot automatically consider wrong all instances of price discrimination. At least in those cases in which the available alternatives are only price discrimination or no product at all, and price discrimination does not result in extraordinary profits to the producer, I cannot see that price discrimination is in any way unethical.

Relaxing the conditions

What then of those instances of price discrimination which cannot be justified on the basis that they are *necessary*, even if only to some extent, in order to make the provision

of some product of service possible and in which, moreover, the producer gets above-average rates of return?

It will be better to be explicit at this point. As we saw in our discussion of the economics of price discrimination, a producer can only engage in price discrimination if he has a measure of monopoly power. In marketing terms, he must offer a product or service that is differentiated to some extent. In a mature economy in which there are institutional devices to promote and protect competition, normally this will be the result of some innovation, at least relative to the conditions of a given market. The issue we are now facing can therefore be posed in the following terms: Imagine a firm which as a result of innovating in some aspect of its business enjoys for the time being some degree of pricing power. Imagine further that that business could be profitable, even very profitable, by selling its product at a uniform price. However, in order to be even more profitable, it is considering charging some of its customers a higher price. Is there anything unethical in this?

In order to make the issue more concrete, consider the following fanciful example:

A firm in the US has just developed a product that increases a car's petrol mileage, saving \$100 in petrol per can of the product. Initially the product will be marketed only in Florida and California. The Chief Marketing Officer has recommended to the CEO a retail price of \$60 per can for Florida and \$75 per can for California. The reason for the difference in prices is that market research indicates that Californian customers are more eager to try new products and more willing to pay for them. Studies indicate that significant volumes of the product can be sold quite profitably in the two markets at those prices.

This scenario is useful for our purposes here because it simplifies drastically the issue of value for the buyer. When the value of a product lies in its enabling users to reduce their costs, as is the case in this example, then the value the product provides to the buyers is exactly the money it saves them, in this case \$100 per can.

The firm of the scenario could be quite profitable if were to charge a uniform price of \$60 per can of the product and even if the product were to be sold only in either California or Florida. Therefore the scenario does not fall under any of the situations in which we have already argued that price discrimination will be unobjectionable. Now, assuming that the plan proposed by the Chief Marketing Officer makes sense from the perspective of optimizing returns to the firm, would there be any ethical reason for the CEO to insist in charging the same prices for the product in California and Florida?

I have argued elsewhere (Elegido, 2009) that it would not be unethical to sell the product at \$60 or even \$99 per can (though the latter most likely would not be wise from a marketing point of view) and take that position for granted in the remainder of this article. Therefore I will address here only the issue of price discrimination.

It may be helpful if before trying to answer the question posed by the preceding scenario, we consider another one:

Imagine that currently the exchange rate €/€ is 1.4. Today is my birthday and, being in a good mood, I offer to sell to a young man €10 for only \$5. To a second person I offer €10 for \$7 and to a third one €10 for \$10. All three are familiar with current €/€ exchange rates and they accept eagerly.

Were these unethical exchanges? Did I wrong in any way any of these people? As I see it the answer is clearly negative. In fact, what I have done is to make gifts of \$9 (to the first young man), \$7 (to the second person) and \$ 4 (to the third). Granted, I have not given the same gift to each of them, but am I not free to make differences in the gifts I give? To me it is obvious that I am, and I offered above some reasons to back this belief.

In Matthew´s Gospel Jesus tells the parable of the householder that goes out to hire labourers for his vineyard. Some of them he hires early in the day, and agrees to pay them a denarius a day. He keeps hiring groups of labourers at later times in the day, at the third, sixth, ninth and eleventh hours. When the time comes to pay them, those who have worked least got a denarius. The ones who have worked since early in the day expected to get more, but also received a denarius and they complained. The parable concludes with the householder addressing one of the disappointed workers:

“Friend, I am doing you no wrong; did you not agree with me for a denarius? Take what belongs to you and go; I choose to give to this last as I give to you. Am I not allowed to do what I choose with what belongs to me? Or do you begrudge my generosity?” (Matt.20:13-15, RSV)

I am not offering this text as a religious authority for the view that “salary discrimination” (i.e., “price-of-labour discrimination”) is ethically acceptable. Most exegetes agree that each of the parables in the gospels typically tries to make a very specific point and should not be taken to be arguing for any other positions depicted or implied in it. Here I just want to draw attention to how the narrative ends by making the point—as something so clear that it should clinch the argument without need for further explanation—that once the landlord has paid the proper salary (the “price” of their labour) to each of the workers, he is free to be more generous to some of them without having to offer any explanations for his conduct.

In this light, the point of the \$10 bills scenario is that, as I have contended elsewhere (Elegido, 2009), the essential condition for a price to be fair is that fair value be given for the amount charged. In so far as this condition is met, as in the \$10 bills scenario it obviously is, the fact that somebody else got an even better deal than I did does not mean that I was wronged. If I complain the seller could always retort: “I have given you good value for your money; what is it to you if I decided to give an even better deal to somebody else?”

And, of course, if this line of argument is correct in relation to the \$10 bills, it should also apply to the scenario of the petrol additive. Also there, if the Californians are getting a good deal, as they clearly are, they should have no business complaining that the Floridians are getting an even better one. Of course, all of us can sympathize with somebody who is feeling the pangs of envy; after all, we have all been there. But this is no reason for agreeing with him, once we have had the opportunity to consider the matter critically.

The above scenarios make the point clearly because in both of them what is the value of a product is very clear and this gives us direct access to “seeing” that in both cases the exchanges give good value for money. The issue of what is the value of most products or services is more complex and there is no way I can do justice to it here as a subsidiary topic in this article. I have discussed this matter at length in another paper (Elegido, 2009) and I concluded there that the best indicator of value for a differentiated product or service is the price it can fetch in an open market.

In order not to give to my defense of price discrimination a wider scope than I intend, we should remember at this point that I opened this section by situating the discussion in relation to firms which have obtained a degree of pricing power *by bringing to market an innovative product or service*. As I pointed out in my discussion on the economic understanding of price discrimination, in the absence of a degree of pricing power price discrimination is simply impossible.

But pricing power can be obtained in different ways, not only by being innovative. If a given country does not have a sound competition legislation, or the legislation is not enforced aggressively enough, there will be ways for business organizations to gain monopoly power in markets in which perhaps there obtained before a degree of competition. A strategy of winning monopoly power in such a situation and then proceeding to apply a policy of price discrimination as a way, perhaps among others, of extracting higher prices from some segments of the market would be ethically suspect in many ways and nothing that I have said before would justify it.

Deliberate reduction of quality

As I explained above, many cases of price discrimination involve offering different versions of a product or service. Versioning, as this practice is called, often involves making the cheaper versions of the product worse than they could be in order to encourage as many potential customers as possible to opt for the more expensive alternatives.

Thus, the main reason why paperback editions of books come to the market six months or one year later than the hardback version is to make sure that as many people as possible among those who are eager to buy that book buy the hardback version which, of course, is more profitable for the publisher.

Similar tactics had already been observed by the middle of the nineteenth century in relation to railways. As Dupuit (1849) wrote over a hundred and sixty years ago:

It is not because of the few thousand francs which would have to be spent to put a roof over the third-class carriages or to upholster the third-class seats that some company or other has open carriages with wooden benches. What the company is striving to do is to prevent the passengers who can pay the second class fare from travelling third class; it hits the poor, not because it wants to hurt them, but to frighten the rich. And it is again for the same reason that the companies having proved almost cruel to the third-class passengers and mean to the second-class ones, become lavish in dealing with first-class passengers. Having refused the poor what is necessary, they give the rich what is superfluous.

I am sure that modern-day flyers have no problem understanding Dupuit's point.

Actually 19th Century railways went further still. As Odlyzko has observed, "[t]hey even put third class carriages in front of the train. The expectation was that anyone willing to deal with cinders in his hair and eyes was indeed so desperately poor that he could not be induced to pay more than third-class fare" (2003, 8).

Most people find the idea of deliberately reducing quality shocking. Is it not unethical intentionally giving customers a product worse than one could profitably give them?

However, leaving aside for the time being the practice of subjecting passengers to a dusting of cinders when this could easily be avoided, on analysis the situation is not as bad as it looks. Let us remember, first of all, that as we observed when discussing the conclusions of economists on price discrimination, in the absence of price discrimination it may often be impossible to make the product or service available at all and that in other cases, by making larger the total pool of customers, price discrimination makes it possible to offer *to all the customers* a better and/or cheaper service.

Keeping that in mind, there is an even more basic point to which we should address our attention. While many people will agree that sellers should engage in mutually beneficial relationships with their customers ("win-win" is the popular term), it would be very difficult to argue that they have a positive obligation to give their customers *the very best deal possible*, even to the point of cutting to the bone their own profits, and even when acting in this way would force them to sacrifice other legitimate interests. Examples of such other interests are being able to offer their product (or a better or cheaper product) to other customers, or being able to get a profit commensurate with the value they create for customers. Provided that the basic test of giving more than commensurate value for the money charged is satisfied, and that offering even higher value would result in the seller not being able to serve other legitimate interests of his, I do not see that there is anything unethical with not giving the very best service that ideally could be offered. Of course, and for the avoidance of doubt, this argument, if correct, justifies not giving the best possible service, not creating positive inconveniences for one's customers, such as deliberately arranging for them to be pelted with cinders.

CONCLUDING THOUGHTS

The implications of the preceding analyses may perhaps become clearer through one last example:

You arrive in a city late at night and move into a hotel. On checking in you are informed that the rate per night is \$300. You find it steep, but it is late, you are tired and outside it is raining heavily, so you accept and move into your room. The following morning, while having breakfast, you strike a casual conversation with a fellow guest and during it you learn that she had made her reservation online and is only paying \$80 per night.

One more case of price discrimination and if this had happened to you and you are at all typical, you would be feeling very upset. Still, the issue of immediate interest is: Would you be justified in feeling wronged by the hotel?

Going by the standard I have argued for in this article, it depends.

If, on investigation, it turned out that in fact very few people ever paid the \$300 rate and that those who did were people who found themselves in a situation of special need (people like you, who arrived late in an unknown city in a bad-weather day) or people who were not familiar with hotel rates and hotel practices, and that in fact the \$300 rate was only announced as a reference to make people feel good for the discounts they succeed in “winning” from the hotel, then it is clear that you would have been taken advantage of. But, if you accept the line of argument offered in this paper, the ground of your complaint should not be the bare fact that you had paid a different price from other people. The real issue that merited complaint is that you had paid \$300 for a service which, by general consent, was worth much less than that.

On the other hand, if it were the case that the hotel charged a substantial proportion of guests the same \$300 rate it had charged you, even if it discounted that rate heavily to many other guests—even to, say, 70% of them—that would tend to show that many people thought that \$300 per night was worth paying for the service the hotel offered. If this had been happening for some time, it would be a very good indication that that was actually the case. In fact we do not have a better one. That being so, the situation is appropriately described by saying that the hotel, in offering discounted rates to many guests, had only responded to a difficult competitive environment; the way in which they did so did not imply in anyway disrespect or lack of concern for you; and in no way did they take advantage of you: by the common consent of many experienced travelers who were voting with their money (or were the employees of experienced companies who also were voting with their money), the service the hotel gave you was worth the money you paid for it. It would still be understandable if you felt unhappy about the experience, but that would be more appropriately described as the unhappiness of somebody who realized that he could have been smarter (and who perhaps then resolved to look more carefully in

future for available discounts) rather than the unhappiness of the person who had been wronged.

The overall conclusion I draw from the preceding analyses and arguments on the ethics of price discrimination is that ultimately there is no independent ethics of price discrimination. Provided that the price a buyer pays is lower than the value of the product or service he buys, as established by actual demand in an open market, that price will not be unjust (though of course the overall transaction might contain some other objectionable aspects such as deception or an expression of lack of respect). Whether or not there is price discrimination is simply irrelevant to the justice of a price.

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