What is price discrimination? Explain the degree of price Discriminations.

Price discrimination is a selling strategy that charges customers different prices for the same product or service based on what the seller thinks they can get the customer to agree to. In pure price discrimination, the seller charges each customer the maximum price they will pay. In more common forms of price discrimination, the seller places customers in groups based on certain attributes and charges each group a different price.

There are three most common types of price discrimination: first-, second-, and third-degree discrimination.

First-Degree Price Discrimination

In a perfect business world, companies would be able to eliminate all consumer surplus through first-degree price discrimination. Also called personalized pricing or perfect price discrimination, this strategy occurs when businesses can accurately determine what each customer will pay for a specific product or service and then sell it for that price.

An expectation to negotiate the final purchase price is part of the buying process in some industries, such as the used automobile industry. The company selling the used car can gather information through data mining relating to each buyer's past purchase habits, income, budget, and maximum available output to determine what to charge for each car sold.

This pricing strategy is well-suited for businesses and industries with high fixed costs as it allows the seller to capture the highest amount of available profit for each sale. It can only work if a company is able to segment or separate the market. It must also be able to stop the customer from selling the product or service to someone else at a higher price.

One of the drawbacks to first-degree price discrimination is that it is time-consuming and difficult to perfect for most businesses. It's not a process that many businesses can execute—especially large companies that have many customers.

Product differentiation is another competitive practice that businesses use. In this case, a business seeks to distinguish its product from a competing product to make it more attractive to a specific target market.

Second-Degree Price Discrimination

In second-degree price discrimination, the ability to gather information on every potential buyer is not present. Instead, companies price products or services differently based on the preferences of various groups of consumers. Put simply, companies price based on how much they can sell.

Second-degree price discrimination, which is also called product versioning or menu pricing, is normally applied through:

- Quantity discounts, such as special offers to customers who buy in bulk over those who buy a single product
- Buy-two-get-one offers
- Coupons
- Loyalty and rewards cards for frequent customers

This strategy is used by warehouse retailers, such as Costco or Sam's Club.12 It can also be seen in phone plans that charge more for additional minutes above a set limit.

Second-degree price discrimination does not eliminate consumer surplus altogether, but it does allow a company to increase its profit margin on a subset of its consumer base. It's also a very easy strategy to execute since it doesn't take a lot of effort to attract and segment the consumer base.

Third-Degree Price Discrimination

Third-degree price discrimination occurs when companies price products and services differently based on the unique demographics of subsets of their consumer base, such as students, military personnel, or older adults. As such, it's commonly called group pricing.

This type of pricing strategy in movie theater ticket sales, admission prices to amusement parks, and restaurant offers. The travel and tourism industry also uses third-degree price discrimination for those who book on a last-minute basis. Consumer groups that may otherwise not be able or willing to purchase a product due to their lower-income can be captured by this pricing strategy, thus increasing company profits.

Companies can understand the broad characteristics of consumers more easily than the buying preferences of individual buyers. Third-degree price discrimination provides a way to reduce consumer surplus by catering to the price elasticity of demand of specific consumer subsets. In order to be effective, companies must be able to ensure that customers don't sell these cheaper products and services to others.