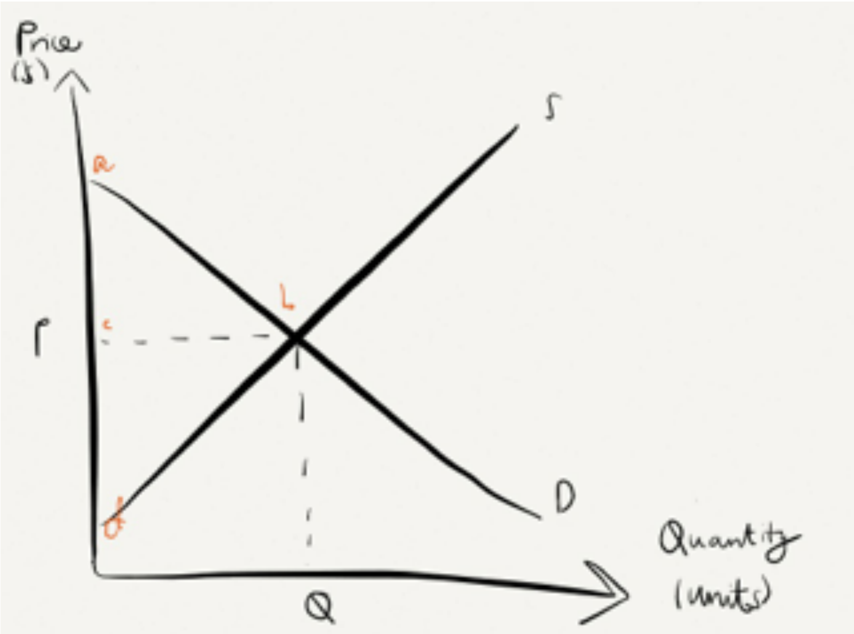
EXPLAIN THE NECESSARY CONDITIONS FOR PRICE DISCRIMINATION TO TAKE PLACE.

Price discrimination is where firms charge different prices to different consumer groups for the same product, where the difference in price is not justified by differences in cost. There are several conditions necessary for price discrimination to take place: 1) the firm must have sufficient market power to set the price (this is illustrated by a downwards sloping demand curve on the diagram below); 2) there must be different segments/ consumer groups distinguished by their differences in elasticities of demand (more/less willing to buy the product), and 3) there must be limited chance for resale or arbitrage. Examples of price discrimination include airlines charging different ticket prices for flights during different times of the year (charging more during periods where there are public or school holidays), or charging different prices for economy, business, or first class (charging different prices to consumers of different incomes).

There are different degrees of price discrimination. First degree prices discrimination is where a firm charges each consumer a unique price based on what they are willing to pay, taking away all consumer surplus as shown on the diagram below.



Without price discrimination, the firm charges the product at price P with quantity Q, and there is a consumer surplus of Δabc and a producer surplus of Δbcd. With price discrimination, the consumer surplus is eliminated and the producer surplus increases to Δabd. This price discrimination can only occur if the consumers can charge different prices and the consumers that receive their good for a lower price cannot sell it off to other buyers.

Second degree price discrimination is when firms discount either in terms of size or on a 'last minute' - for example bulk buying or last minute concert discounts, and third degree price discrimination can only take place when different groups of consumers are identified and the firm charges higher prices to the group with more inelastic price demand.