INTRODUCTION

If pollsters set out to identify ethical issues receiving the most attention from business leaders today, price discrimination would probably rank far behind sexual harassment, securities manipulation, banking fraud, drug testing, or a number of other current topics. Yet price discrimination has ethical dimensions that deserve to be explored. First, price discrimination is a common practice; and hence it may too easily be considered justified on that account. Second, businesspeople may simply accept the legal parameters on competition as sufficient to settle the ethical question. Third, price discrimination can either increase or decrease what economists call social welfare. Fourth, the very word “discrimination” suggests some lack of fairness or equity, which may or may not be the case.

These four reasons for exploring the ethics of price discrimination will also serve as a general outline for this Essay. In Part I, price discrimination will be defined and some examples provided to illustrate how widespread the practice is. In Part II, a brief history of antitrust legislation and some key legal cases concerning price discrimination will be followed by some norms that describe the American ideal of competition in the marketplace. Part III will indicate how neoclassical economic theory uses social welfare to evaluate the practice. Part IV will suggest how the ethical concept and virtue of justice can be used to evaluate the equity or fairness of price discrimination. Finally, a summary of this Essay will be Part V.

The purpose and scope of the following Essay is both practical
and modest. Studies have indicated little, if any, ethical improve-
ment among businesspersons over the years, and one reason sug-
gested is that ethicists have not provided them with "useful and
usable moral guidelines for their actions and decisions." This Essay
is a step in that direction on the topic of price discrimination, but the
essay is not a definitive treatment of competition in the marketplace
today. This Essay does suggest, however, that questions about the
widespread practice of price discrimination may be raised from legal,
economic, and ethical viewpoints.

I. PRICE DISCRIMINATION: CONDITIONS AND DEFINITION

Price discrimination can be defined briefly as the sale of differ-
ent units of the same product or service at prices not proportional to
the cost of supply. This definition, however, is too simple to use in
understanding the complexity of the actual practice of price discrimi-
nation. A more complete understanding requires some knowledge of
the nature of markets in which price discrimination occurs and ex-
amples of different forms of the practice.

For a business to be able to employ discrimination as a pricing
policy, "three conditions must be satisfied." First, the business must
have some ability to set price, that is, some monopoly power. A
purely competitive seller who must accept the market price, for ex-
ample, the farmer with #2 yellow corn for sale, cannot practice price
discrimination because he or she has no control over price. Second,
the business must be able to segment the market for the product or
service in question. That is, the business must be able to identify
different customers or groups of customers who are willing and able
to pay different prices for the same product or service. Third, it must
be impractical for customers to practice arbitrage. That is, little op-
portunity must exist for customers in a low-price market segment to
gain from resale of the product to customers in a high-price market
segment.

the Future, 40 REV. SOC. ECON. 454, 455 (1982).
2. The need to bring economics and ethics closer together again (economics was
once part of "moral philosophy") has been expressed by many from various view-
points. See, e.g., K. KOFORD & J. MILLER, SOCIAL NORMS AND ECONOMIC
INSTITUTIONS (1991); A. SEN, ON ETHICS AND ECONOMICS (1987); Weisso
kof, The Moral Predicament of the Market Economy, reprinted in G. DWORKIN,
3. F. SCHERER, INDUSTRIAL MARKET STRUCTURE AND ECONOMIC PERFORMANCE
315 (1980).
4. Id. at 15.
5. Id.
6. Id.
7. Id.
If these three conditions are present, then business firms may find opportunities for profit enhanced by practicing one or more of three types of price discrimination. These types, first identified by the British economist, A.C. Pigou, are denominated: first-degree price discrimination, second-degree price discrimination, and third-degree price discrimination.\(^8\)

First-degree price discrimination, sometimes called personal price discrimination, occurs when the seller manages to charge each buyer his or her reservation price, the maximum price the buyer is willing to pay for each unit of product sold. While few sellers may implement this pricing policy to perfection, examples of attempts can be found on new and used car lots, at garage sales, and in any market in which considerable bargaining occurs before the sale is completed.

Because bargaining with every customer can be expensive, many monopolists practice second-degree price discrimination. Second-degree price discrimination is like discrimination of the first degree in that reservation prices are determined; but it is different in that reservation prices are determined for groups and not for individuals. Groups of customers are often identified and segregated on the basis of the number of units of product purchased. Prices are uniform within the group but differ among groups. Economist Heinz Kohler notes that pricing of natural gas, electricity, water, telephone service, credit card loans, and magazines often follow this strategy.\(^9\) Buyers are charged one rate for the first 500 kilowatts, 1000 cubic feet, 3 minutes of conversation, $500 worth of credit, or first twelve months of subscription, and then charged different rates for additional blocks of service. Generally speaking, any type of quantity discount would be considered second-degree price discrimination provided, of course, the discount was not proportional to the cost of supply.

Third-degree price discrimination, thought to be the most common of the three types, is quite different from the other two. This pricing policy involves no attempt to identify the reservation prices of individual customers or groups of customers in what is seen as a single market. Rather, third-degree price discrimination partitions customers into two or more markets distinguished from each other by location, real or perceived differences in essentially similar products, demographic characteristics, time of day or year, or any number of other ways in which people can be grouped by eagerness to buy.

Once partitioning is completed, all buyers in the same market are charged the same price regardless of their reservation prices, but different prices are charged in different markets. Some examples in-

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clude in-state and out-of-state tuition differentials at state universities, absorption of freight rates to customers at varying locations from point of shipment, grocery price differentials at suburban and inner city supermarkets, price differentials between brand-name and private-label products or between standard and deluxe models of the same product, senior citizen discounts, off-season discounts offered by resorts and airlines, twilight tickets at the movies, and nighttime long-distance rates.

II. THE LAW AND COMPETITION

As noted above, the practice of price discrimination cannot occur in markets that are competitive in the strictest sense of the word, but different levels of competition exist. Price discriminators can choose to compete in ways that allow competitive responses from rivals, in ways that limit the ability of rivals to respond, or in ways that drive rivals out of business.

An example of price discrimination that allows a competitive response from rivals might occur in those industries in which rival firms tend to charge identical prices. In this instance, one rival seeking advantage over others may make an exception to the industry price for an important customer. But if word of this concession spreads, then discounts for other customers and by other rivals are likely. As a result, the industry's uniform price structure of the industry may collapse to the benefit of all buyers.

However, price discrimination can also be used to limit the entry or expansion of rival firms or to drive rival firms from the market to the detriment of rivals and customers alike. For example, a firm selling multiple products or selling at multiple locations may accept low margins or even losses when it faces competition and sustain its operations with profits from product markets or geographic markets where it faces little or no competition. One motivation for such a pricing strategy might be the hope of driving rival firms out of business so that prices could later be raised and profits increased. Another less predatory motivation might be to keep rivals weak so that they would not be able to expand into markets where profits are being made for lack of competition. In either case, the practice of price discrimination would put firms with more limited product lines and geographic coverage at a disadvantage and deny customers the benefits of buying in markets where competition keeps quality high and prices low.

Attempts to control this latter species of price discrimination in the United States illustrate a clash of two values basic to the American business culture, freedom of enterprise and equality. Gerald
Cavanagh, a prominent ethicist, describes freedom and its commercial extension, freedom of enterprise, as bedrock values of our economic system.\textsuperscript{10} Freedom of enterprise allows competition, and competition is valued because it promotes efficiency, another important value. Competition promotes efficiency because only the most efficient firms survive its rigors. But if only the most efficient survive, then some will fail. These divergent outcomes, however, conflict with another important cultural value, equality. To avoid moral schizophrenia, compromise is required.

In the United States, the legal system has been asked to maintain this compromise by policing competition. Competition must be vigorous enough to produce efficiency; yet, competition must not be so vigorous that some competitors are denied a fair chance to compete. To clarify the quality of competition required to maintain this compromise, this Essay first examines the history of events that led to the passage of the Robinson-Patman Antidiscrimination Act,\textsuperscript{11} the federal antitrust statute that most directly addresses price discrimination.

A. HISTORY LEADING TO ROBINSON-PATMAN ANTIDISCRIMINATION ACT

Anticompetitive price discrimination became commonplace in the United States after the Civil War as large multi-product, multi-market firms began to emerge from the chaos of the industrial revolution in an economy informed with the moral values of laissez-faire capitalism. Railroads were among the first of these newly evolved corporate giants to provoke the public's wrath with their discriminatory pricing policies. Railroads typically discriminated against farmers and other small businesses in favor of big businesses, a practice which made it difficult for small enterprises to market their goods at a profit and limited their ability to compete with large firms. The resulting political outcry led, in 1887, to the passage of the Interstate Commerce Act, the first federal statute limiting the practice of price discrimination.\textsuperscript{12}

But as Martin Schnitzer, American business scholar, notes, railroads were not the only practitioners of price discrimination.\textsuperscript{13} Other industrial monopolies aroused the anger of the public with misdeeds

\textsuperscript{10} G. CAVANAGH, AMERICAN BUSINESS VALUES 1-26 (1984).
like those described by antitrust economist, F.M. Scherer. The trusts, as monopolistic enterprises came to be called, were said to have driven small firms out of business by using predatory pricing and to have engaged in local and personal price discrimination by extracting high prices from communities and individuals who lacked competitive alternatives. These pricing strategies created great wealth for a few and dissatisfaction for the many who believed they had been treated unfairly. Monopoly was seen to be the source of this lack of equality, and competition came to be valued as a process capable of creating equality.

The political protest aroused by this dissatisfaction resulted in the enactment of the Sherman Antitrust Act of 1890, which was written to extend federal restraints on anticompetitive practices beyond the railroad industry with general prohibitions of trade restraints, monopolies, and attempts to monopolize. But, according to H. Craig Peterson, an economist, enforcement of the Sherman Act was weak, and the trusts generally continued to abuse their market power. A number of reasons were advanced for the Sherman Act's lack of effectiveness, among them its failure to prohibit specific anti-competitive practices.

Public sentiment reached a peak during the 1912 presidential elections, and Woodrow Wilson, who favored legislation prohibiting specific anti-competitive practices, was elected. Wilson's election set the stage for the passage, in 1914, of the Clayton Anti-trust Act, the first federal law applicable to industries other than transportation that specifically addressed the practice of price discrimination.

Section two of the Clayton Act prohibited price discrimination that substantially lessened competition or tended to create a monopoly. Quantity discounts, however, were allowed. This exemption proved to be especially troublesome to small business because of the growth of chain stores like A&P during the 1920s and 1930s. Independent groceries, drug stores, and their suppliers claimed that they could not compete against the chains because the chains were able to secure large discounts from suppliers. The lobbying power of these independents, combined with the general distrust of the value of competition brought on by the Depression, led to the passage of a tougher anti-price-discrimination law, the Robinson-Patman Act.

The Robinson-Patman Antidiscrimination Act, which became law in 1936, has been described by legal scholar, Irwin Stelzer, and

other commentators as one of the most complex and controversial of the nation's antitrust statutes. Yet, the Robinson-Patman Act reflected a change in the attitude of the public toward the moral value of competition. The Robinson-Patman Act views competition with suspicion. The competitive process, as policed by the Sherman and Clayton Acts, had not provided small business with an opportunity equal to that of big business to exercise its right of freedom of enterprise. In the words of Wright Patman, co-sponsor of the bill, the purpose of the Robinson-Patman Act was "to give little business fellows a square deal."20

Section 2a of the Robinson-Patman Act contains the basic prohibition of price discrimination.21 The section prohibits selling goods of like grade or quality at different prices to different purchasers when the effect "may be substantially to lessen competition or tend to create a monopoly in any line of commerce or to injure, destroy, or prevent competition with any person who grants or knowingly receives the benefit of such discrimination, or with customers of either of them."22 This statement extends the protection of the law to three levels of competition, primary line, secondary line, and tertiary line. However, definition of the requisite injury to competition required to make discrimination actionable is left to the courts; and the standard of injury applied by the courts has varied with the level of competition and with time.

B. PRIMARY-LINE CASES

Primary-line competition refers to competition with firms that are direct rivals to the firm practicing discrimination. The judicial threshold of actionable injury to primary-line competition has varied over the years. Discussion of three cases will provide some idea of the conditions under which the courts have found competition injured and, thus, some indication of the meaning of competition used in the statute. In the first case, Anheuser-Busch, Inc. v. FTC,23 the court seemed to be struggling to protect a competition that is a fair contest among rival firms.24 In Utah Pie Co. v. Continental Baking Co.,25 the Supreme Court sought to protect the small competitor.26

23. 289 F.2d 835 (7th Cir. 1961).
24. Id. at 840.
26. Id. at 698-700.
In the last case, *Matsushita Electric Industrial Co. v. Zenith Radio Corp.*\(^\text{27}\) the Supreme Court appeared to have dropped its concern about the rules of the contest and the small firm and to have come to view any form of price discrimination as acceptable so long as high monopolistic prices do not result.\(^\text{28}\)

In the first case, the United States Court of Appeals for the Seventh Circuit absolved Anheuser-Busch of wrong-doing because it had refrained from predatory misconduct, conduct intended to drive rivals out of the market, even though Anheuser-Busch had discriminated in its pricing of beer sold in St. Louis for fifteen months.\(^\text{29}\) According to the court, the law was not concerned with shifts in business among competitors.\(^\text{30}\) Though producers of other beers had lost market share during the Anheuser-Busch price cuts, loss of market share was not in itself sufficient injury. The court held that Anheuser-Busch was only exercising its right to compete vigorously.\(^\text{31}\)

Later, in *Utah Pie Co.*, the United States Supreme Court ruled that Continental Baking, Pet Milk, and Carnation, all large corporations with nationwide markets, had competed too vigorously by cutting prices below costs on frozen pies sold in Salt Lake, Utah.\(^\text{32}\) Utah Pie, the victim of this discrimination, was a local firm that had provoked what the Court considered to be a predatory response from the large concerns by entering the market after them and gaining a sixty-seven percent market share.\(^\text{33}\) It mattered little that Utah's market share never fell below thirty-four percent, that Utah made price cuts of its own, and that it operated at a profit throughout the episode.\(^\text{34}\) The Court found sales below cost, statements by Pet Milk management describing Utah Pie as a threat, and Pet Milk sending a spy into the Utah Pie plant to check for quality deficiencies to be actions that seriously threatened competition, even though Utah Pie continued to be a viable competitor.\(^\text{35}\) This decision was widely criticized as providing too much protection for the small competitor.\(^\text{36}\)

Subsequently, the Supreme Court has come to doubt that price

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\(^\text{27}\). 475 U.S. 574 (1986).
\(^\text{28}\). Id. at 576-98.
\(^\text{29}\). *Anheuser-Busch, Inc.*, 289 F.2d at 843.
\(^\text{30}\). Id. at 840-41.
\(^\text{31}\). Id. at 840.
\(^\text{32}\). *Utah Pie Co.*, 386 U.S. at 702-03.
\(^\text{33}\). Id. at 689, 691 n.7.
\(^\text{34}\). Id. at 699-700.
\(^\text{35}\). Id. at 696-97.
cutting like that condemned in the *Utah Pie* case is predatory. Injury standards under the Robinson-Patman Act have come to conform with standards set for judging predatory pricing conduct under the Sherman Act. The *Matsushita Electric Industrial Co.* case is an example. In that case, the United States Supreme Court ruled that even though Japanese television manufacturers had sold below average total cost in the United States and even though a number of United States manufacturers had abandoned television production after incurring large losses, such sales could not be predatory because the Japanese firms had not been able to raise prices to exploit the monopoly power, which is the only rational goal of predatory price discrimination. The Japanese were judged to be competing fairly because consumers in the United States were paying low prices, and little prospect existed that those prices would rise to monopolistic levels.

C. SECONDARY- AND TERTIARY-LINE CASES

Standards for judging injury in secondary- and tertiary-line competition cases, however, continue to be more concerned with protecting small firms and less concerned with vigorous competition of the kind that promotes efficiency and low prices. Secondary-line competition refers to firms competing with buyers when the buyers may have been granted discriminatory price concessions. Tertiary-line competition refers to firms competing with the customers of buyers when the buyers may have been granted a discriminatory price concession.

The United States Supreme Court, in *FTC v. Morton Salt Co.*, has set the standard for injury to competition at secondary and tertiary levels. Morton granted quantity discounts on its table salt, which allowed large buyers to set retail salt prices lower than smaller buyers. The Supreme Court found illegal injury to competition on this basis, noting that Congress was especially concerned with protecting small businesses unable to buy in large quantities. Reaffirming this standard of injury more recently in a tertiary-line case, the Supreme Court found that injury to competition was "more than established" when a brewer sold beer at lower prices to a Kentucky wholesaler

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38. *Id.*
40. *Id.* at 41.
41. *Id.* at 42-43, 46-47.
than to an Indiana wholesaler.\textsuperscript{42} The injury occurred when Indiana beer buyers bought their beer in Kentucky to take advantage of lower retail prices in Kentucky, lower retail prices made possible by the lower prices charged the Kentucky wholesaler by the brewer.\textsuperscript{43}

In light of this analysis, it can be said that federal price-discrimination law as currently applied has struck one compromise between freedom and equality in primary-line cases and another compromise for secondary- and tertiary-line cases. Freedom is favored where primary-line competition is involved. Equality or, more precisely, equal opportunity for small business is favored where secondary- and tertiary-line competition is the concern.

D. THE LAW AND COMPETITION: THE COMPETITIVE IDEAL

Discovering some basic ethical principles that underlie both traditional laws governing business competition (such as those outlined above) and American notions of fair competition is the goal of Lynn Sharp Paine, Professor at Harvard Business School.\textsuperscript{44} She suggests five principles that reflect the meaning of competitive activity as well as the law of unfair competition. They include the principles of (1) independent initiative, (2) constructive effort, (3) respect for the rules, (4) the level playing field, and (5) respect for officiating parties.\textsuperscript{45} She explains each of these and then focuses on practices associated with gathering commercial intelligence.

Her second principle of constructive effort is most relevant to price discrimination.\textsuperscript{46} The main point of the principle is that competitors who succeed by their own positive efforts are admired more than those who subvert their competitors.\textsuperscript{47} What the principle calls for on the part of all competitors is an attitude of respect for one another as they each strive after a common goal (for example, winning a ball game, an election, gaining market share).\textsuperscript{48}

It is difficult to enforce attitude and motivation through the law, but certain business practices that are normally acceptable have been deemed illegal if it can be shown that the purpose of the practice was to harm another competitor. Examples include selling product below cost, refusing to deal, or even setting up a firm simply to drive some-

\begin{itemize}
  \item \textsuperscript{43} Id. at 431-33.
  \item \textsuperscript{44} See Paine, Ideals of Competition and Today's Marketplace, reprinted in C. Walton, Enriching Business Ethics 91-112 (1990).
  \item \textsuperscript{45} Id. at 95-96.
  \item \textsuperscript{46} Id. at 100-02. She notes that she owes this term to R. Callmann, The Law of Unfair Competition, Trademarks & Monopolies (4th ed. 1981). Id. at 111 n.23.
  \item \textsuperscript{47} Paine, supra note 44 at 100.
  \item \textsuperscript{48} Id.
\end{itemize}
one else out of business. Antitrust law is designed to protect competition, not competitors, and hence actions that harm a competitor or create "public injury" may not be actionable as antitrust violations but rather as violating other principles of unfair competition.49

As Paine observes, respecting one's competitors conforms with the traditional ethical prescription of respecting other persons, an elementary form of justice.50 In addition, as the following section confirms, the principle of constructive effort also makes "economic sense," because it prohibits less successful firms from sabotaging better ones and thereby decreasing society's net welfare.51 Utilizing resources to destroy another rather than to improve one's own performance increases opportunity costs, and such costs could become significant if negative competition became widespread.52

III. ECONOMICS AND SOCIAL WELFARE

Mainstream normative economics uses the criterion of social welfare to evaluate the various forms of price discrimination. As philosopher Allen Buchanan notes, this approach is strictly utilitarian: a good action is the one which maximizes net social benefit.53

Social welfare, the excess of the benefits to society of a product or service over its costs, is maximized in purely competitive markets, markets where buyers and sellers are many and have no influence on price. In the real world, however, few markets are purely competitive. In such an environment, price discrimination may be a second-best substitute for competition. Where it is, it would be judged morally acceptable by utilitarian standards. Where it is not, that is, where a monopolistic seller practicing price discrimination produces less social welfare than if he or she charged a uniform price, price discrimination would not be judged acceptable by utilitarian standards.

To distinguish between these two cases, we turn to an economic analysis of the three types of price discrimination defined in Part I.54 The analysis proceeds in three steps. Step one explains a geometric representation of social welfare, first in a purely competitive market, and then in a monopolistic market. Step two applies this visual model to an analysis of first- and second-degree price discrimination. Step three applies the model to third-degree price discrimination.

49. Id. at 101, 111 n.30, 31.
50. See id. at 100.
51. Id. at 101.
52. Opportunity costs are the output foregone as the result of a decision to perform one action rather than another.
54. See supra Part I.
A. Step One: Competitive and Monopolistic Markets

In Figure 1a, product demand is represented by the downward sloping line, D. The height of D represents the value buyers attach to incremental units of product; thus, it also represents the price buyers are willing and able to pay. The height of the horizontal line, MC, represents marginal costs, the costs of all resources engaged in producing incremental units of product including a normal profit to the producer, the minimum return required to keep him or her producing this particular product rather than some other.

![Figure 1a](image)

In a purely competitive market, MC will be as low as possible, as individual producers will seek to gain advantage over other producers by introducing the latest technology and the best management techniques. Furthermore, the price, P, in a purely competitive market will be bid down to equal MC, because if any producer tries to charge

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55. The economic analysis conducted using Figures 1 and 2 makes a number of assumptions to simplify the presentation but which should not alter the conclusions. Costs are assumed to be constant. Costs and demand are assumed to reflect the full costs and full benefits to society; that is, externalities are assumed to be non-existent. The analysis also assumes the absence of an income effect associated with changes in prices. A final assumption that may alter conclusions about the effects of monopolistic pricing on social welfare should be discussed briefly. The conclusions made about the social welfare effects of monopolistic pricing policies, setting prices above marginal cost, are valid if the product or service in this analysis has no good substitutes or useful complements. If the product or service has good substitutes or useful complements, then the conclusions made will still be valid if those substitutes or complements are sold in markets that are purely competitive. If markets for substitutes or complements are monopolistic, then some degree of monopoly pricing, that is, pricing above marginal cost, may be required to maximize social welfare. Relaxation of this assumption would clearly complicate the analysis attempted in Figures 1 and 2 and adds further indication of the difficulties associated with using normative economic analysis to evaluate business pricing decisions. For additional discussion of this last assumption, see Scherer, supra note 3, at 24-29.
a higher price, buyers can always find another producer willing to sell a little more at MC, a price covering all expenses and providing a normal profit. At that price, buyers will be willing to buy a total of $Q^*$ units of the product.

The cost to society of $Q^*$ is represented by the rectangle marked “cost”; but since the value of the product is determined by demand, the benefits to society exceed “cost.” This excess, called social welfare, is represented by the shaded triangle. Social welfare is maximized at $Q^*$. Any quantity to the left of $Q^*$ would reduce the size of the shaded area. Any quantity to the right of $Q^*$ would impose costs in excess of benefits, a deficit partially offsetting social welfare accumulated in the shaded area.

A purely competitive market like that represented in Figure 1a will maximize social welfare. But few markets are purely competitive. Sellers may be few and thus have some control over price. In such a market, pictured in Figure 1b, a seller may choose to continue to produce at $Q^*$ and earn a normal profit or the seller may choose to restrict output in order to increase price and earn increased profits. Such a seller need not be the classic monopolist of robber-baron days. Nor must such a seller have violated any antitrust laws. Such a seller need only be a businessperson whose location, product, or service is so convenient or appealing to some buyers that they are reluctant to shop elsewhere. With customers like these, the seller can increase profits by restricting output so that price can be raised above cost.

If this monopolistic seller wishes to maximize profits, he or she will be guided by marginal revenue. In Figure 1b, it is assumed that our monopolist must sell at the same price to all buyers. Under this assumption, marginal revenue is represented by the downward slop-
ing line MR. MR lies below D, which charts the prices buyers will pay, because as output increases the seller not only sells the incremental output at a lower price but all output at a lower price.

The seller will find, as careful inspection of Figure 1b will reveal, that profits are maximized at Q, the output corresponding to the intersection of marginal cost and marginal revenue. Profits will be maximized at that point because the area of the rectangle, MP (monopoly profit), bounded at its top by the monopolistic price, P₁, will be greatest at that point.

Because the profit-maximizing monopolist will choose to sell only Q rather than Q*, social welfare, again represented by the shaded area, will be reduced relative to the purely competitive market. Thus, by utilitarian standards, the monopolist has not acted ethically. It is also worth noting that our monopolistic seller has appropriated part of that social welfare in the form of monopoly profits, a return in excess of normal profits. This return, extracted from buyers willing and able to pay the higher price, P₁, constitutes a redistribution of income, which has ethical implications of its own that will be discussed in the last section of this paper.

B. STEP TWO: FIRST- AND SECOND-DEGREE PRICE DISCRIMINATION

But if the monopolist is able to practice first- or second-degree price discrimination, profit maximization becomes compatible with utilitarian ethical norms because the discriminating producer restores the social welfare enjoyed in a purely competitive market by increasing output to Q*. In Figure 1c, it is first assumed that the monopolist is able to practice first-degree (personal) price discrimination. To use the figure to analyze the effects of that assumption, the step-like line beneath D should be ignored. Under that assumption every unit sold is sold at its reservation price so that every unit sold returns a per-unit monopoly profit equal to the vertical distance between D and MC. With the incentive of these monopoly gains, the price discriminator will expand output to Q*, achieving the same level of social welfare produced in a purely competitive market but capturing all of it as monopoly profit.
When we assume the monopolist practices second-degree (group) price discrimination, the step-like line becomes relevant to the analysis. In this case, we assume that the market has been segmented into four user groups and that the monopolist has approximated the reservation prices of each group, P1, P2, P3, and P4, at levels represented by the tread of each step. Once again, the discriminating monopolist will produce \( Q^* \), earning normal profits on sales to the customer group with the lowest reservation price and successively higher monopoly profits, denoted by the shaded area, on sales to customer groups with successively higher reservation prices. Because output reaches \( Q^* \), second-degree price discrimination, like first-degree price discrimination, can achieve levels of social welfare comparable to purely competitive markets.

From this analysis, it can be seen that monopolists who successfully practice first- or second-degree price discrimination and maximize their profits will also maximize social welfare. Their self-interest pricing policies happily conform to utilitarian ethical norms. Under these conditions, price discrimination resolves the utilitarian objection to profit maximization by monopolists. An analysis of conditions associated with third-degree price discrimination, however, is not so clear.

C. Step Three: Third-degree Price Discrimination

Pricing policies implementing third-degree discrimination partition customers into separate markets, each with its own demand and marginal revenue. Figure 2 assumes there are just two markets and that demand and marginal revenue are linear. The Figure has three sections. The section on the left represents one market for the monopolist’s product. If our monopolist operates a movie theater, then
the market on the left might be movies in the evening. The section in
the center represents another market, movies in the afternoon. Each
of these markets has its own demand and marginal revenue as indi-
cated. The section on the right contains a representation of the
movie theater's aggregate demand, the downward sloping kinked de-
mand, D. Just below is aggregate marginal revenue, MR. D and MR
are the horizontal summation of demand and marginal revenue from
each of the markets. Marginal cost per moviegoer, the same in each
market as it is overall, is the horizontal line MC. Because MR and
MC for the theater intersect at Q, Q is the overall quantity of tickets
that will maximize profits.

The uniform ticket price that would maximize profits is P, the
price that would bring a total of Q customers to the theater, Q" in
the evening and Q' in the afternoon. When Q" attend in the evening,
social welfare in the evening market is represented by the shaded
area in the left section of the figure. When Q' attend in the after-
noon, that market enjoys the social welfare represented by the
shaded area in the center section of the Figure.

The theater, however, can increase its profits by adjusting price
and quantity in each of the markets so that the marginal revenue
earned in each market is equal. Because marginal cost is constant in
this example, marginal revenues can be equalized at their intersec-
tion with marginal cost. In the evening, marginal revenue can be
equated with marginal cost by raising ticket prices to PE, an action
that will reduce the number of tickets sold to QE. The increase in
monopoly profits in the evening can be seen by comparing the gains,
represented by the rectangle above P, with the losses, represented by
the rectangle to the right of QE between P and MC. In the after-
noon, marginal revenue can be equated with marginal cost by lower-
ing ticket prices to PA, an action which will increase the number of
tickets sold to QA. The increase in monopoly profits in the afternoon
can be seen by comparing the gains, represented by the rectangle to
the right of Q' between PA and MC, with the losses, represented by
the rectangle above PA.

While the effect of price discrimination on the theater's profits is
beneficial, the effect on social welfare is adverse. There has been a
loss of social welfare in the evening market, a loss represented by the
shaded area between QE and Q". There has been a gain in social wel-
fare in the afternoon market, a gain represented by the area between
Q' and QA above MC but below demand. The net change, however,
is negative; for the loss in the evening exceeds the gain in the after-
noon. Thus, the pursuit of profit maximization through third-degree
price discrimination under market conditions illustrated in Figure 2
is not compatible with utilitarian ethical standards.
As previously noted, however, the analysis in Figure 2 assumes that demand is linear. This assumption is significant because the shape of demand determines whether or not third-degree price discrimination increases or decreases social welfare. Because as a practical matter, the pattern of demand is generally not known, problems in applying the social welfare criterion to evaluate third-degree price discrimination immediately become apparent. Focusing on changes in output relative to the output that would be produced if the monopolist charged a single price provides a partial solution to this problem. Figure 2 illustrates that third-degree price discrimination resulting in no output change has adverse effects on social welfare. Pricing policies resulting in output reductions would have even more adverse welfare effects. Third-degree price discriminators whose policies increase output, especially if the increase is large relative to a single-price monopoly pricing policy, may—but not necessarily will—improve social welfare.

These ambiguities suggest a need for the application of some moral principles beyond those contemplated by utilitarian ethical analysis when evaluating business policies involving price discrimination. Some principles of justice may be appropriate, for price discrimination cannot occur unless the seller has some monopoly power, and a seller with monopoly power can choose to raise prices and redistribute income to himself or herself.

IV. JUSTICE AND PRICE DISCRIMINATION

A. TYPES OF JUSTICE

Theories of (and controversies about) justice abound, but the following discussion will assume there are three major sets of relationships that need to be considered when deciding what actions or policies are "just" or "due" between certain parties. The first is the relationship between individuals that is called exchange (or commutative) justice, and it is best exemplified in competitive markets where buyers and sellers both receive in direct proportion to their contribution. A motto that captures the spirit is, "You get what you pay for."

57. For further discussion see Smith & Formby, Output Changes under Third-Degree Price Discrimination: A Reexamination, 48 S. Econ. J. 164-71 (1981).

The second is the relationship of individuals to the group(s) they belong to: their firm, organizations, community, or society as a whole. The individual's obligation to contribute to these larger entities (that also support the individual) is called contributive (or legal) justice. Here the community is uppermost, and its rights make claims on the individuals who compose it; hence the latter may be required to pay taxes or to fulfill certain criteria in order to vote, all in the name of the "general welfare" or common good.

The third and most controversial relationship is the duty of the group (firm, organization, community, or society) to distribute benefits and burdens equitably among its members, and it is called distributive (or social) justice. The general principle here is, to treat equals equally and unequals unequally.\textsuperscript{59} For example, people should receive equal pay for equal work, but those whose work is unequal (for example, it involves greater risk of harm) may properly be paid more for the risks or hardships they endure.

The calculations that can be made in the case of exchange justice to decide what is owed to (or owed by) the various parties are not possible in the case of distributive justice. For in the latter case, the responsibility of deciding what is due an individual falls on one in authority, and the obligation here is not paid (as in a quid pro quo situation), but allotted according to some proportion.\textsuperscript{60}

B. COMPETITION, PRICING, AND JUSTICE

Traditional Catholic moral theology has generally held that prices set in a competitive market may also be presumed to be just prices.\textsuperscript{61} Individual buyers and sellers may therefore accept as a rule of thumb that "market price" can serve as a criterion for price justice. The key, obviously, is how "competitive" the particular market is.\textsuperscript{62} On the part of sellers, this position presumes that declining production costs will lead them to lower their selling prices or to increase services to the consumer. Some short-term price maintenance may be justifiable if it helps offset other negative effects (for instance, laying off workers).

\textsuperscript{60} Walton, supra note 58, at 137, 249 n.53. Walton has an interesting discussion on the emergence of "social justice" as an "effort to get beyond the idea of comparative justice and to the idea of noncomparative justice, that is, what a person is entitled to by virtue of his or her humanity." Id. (citing J. Feinberg, Rights, Justice and the Bounds of Liberty: Essay in Social Philosophy 265-85 (1980)).
\textsuperscript{61} See H. Wirtz, Morality and Business 144-51 (1962).
\textsuperscript{62} See Clark, Toward a Concept of Workable Competition 30 Am. Econ. Rev. 241-56 (1940); Sohnick, A Critique of Concepts of Workable Competition 72 Q. J. Econ. 380-423 (1958) (showing economic perspectives on markets sufficiently competitive to result in prices which might be presumed to be just prices).
Issues of distributive (social) justice also arise, for individual prices are subject to the whole price structure and the conditions prevailing in the respective markets for goods and services. If the price structures are distorted in favor of particularly strong actors, then the ensuing prices may be somewhat unjust since the conditions for a competitive market are being violated. Government can exercise its responsibility for the general welfare by controlling this monopoly power.

Moral theologians recognize the complexity of price discrimination, and they offer no general condemnations of the practice. In third-degree price discrimination, for example, if the markets are distinct from one another, then the morality of the price in each market needs to be determined. If each market is sufficiently competitive and the prices in each reflect a general consensus of buyers and sellers as to what is a just price, then there is no injustice simply because the prices differ. What the moralists do condemn are “cases in which the seller exploits the buyer’s special need for a good and charges an exorbitant price simply because he has this particular purchaser at his mercy.”

Richard T. DeGeorge, a respected philosopher and ethicist, expresses a similar position on the justice of competition and pricing in his recent text on business ethics. Assuming that fair competition is part of our free-enterprise system, and that it best respects all parties and maximizes consumer welfare, then practices that are intended to undermine competition are not morally justifiable, even if they are not illegal. These practices may include creating a monopoly or overpricing. DeGeorge’s main objection to both practices is that they involve coercion of the other firms or consumers. Driving other firms out of business to create a monopoly clearly violates the freedom of other businesspeople to compete in the marketplace, and overpricing works only because the seller is able to take advantage of the buyer’s ignorance or weaker position (for example, inability to travel to another store). Insofar as price discrimination is based on a similar taking advantage of the buyer’s condition of ignorance or weakness, it is subject to the same moral objections.

C. A Recent Study of Discrimination in Pricing

As the preceding paragraphs indicate, the morality or ethics of

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63. H. Wirtenberger, supra note 61, at 169.
64. R. DeGeorge, BUSINESS ETHICS 218-21 (3d ed. 1990). See M. Velasquez, supra note 59, at 179-205 (arguing for a like position on “ethics in the marketplace,” and the ethical values of competitive markets over those skewed by oligopoly or monopoly power).
any particular case of price discrimination depends on many variables, and the complexity is best illustrated by pointing to Ian Ayres’ recent study of discrimination in retail car sales. He sent out testers to auto dealers in the Chicago area, and while the testers were all in the same age range and used the same bargaining tactics, they differed in race and gender. The results of the tests showed that white males received much better prices than did blacks or women. Ayres found that “white women had to pay forty percent higher markups than white men; black men had to pay more than twice the markup, and black women had to pay more than three times the markup of white male testers.”

On the face of it, this appears to be a clear case of “animus-based” discrimination, where the sellers simply disliked certain groups of people (women and blacks), and hence charged them more. But Ayres’ analysis of the methodology and results does not support this preliminary judgment. He believes that his results are best interpreted using a statistical theory of discrimination.

The latter falls into two major types: cost-based and revenue-based discrimination. Cost-based discrimination would argue that some stores or firms must charge higher prices because certain types of customers raise the seller’s costs. An example would be a store in the inner-city that argues that its prices are higher than similar stores in the suburbs because it incurs higher costs for security or insurance. If that is indeed the case, then as long as the higher prices are proportional to this seller’s higher costs, there is no injustice.

Revenue-based discrimination occurs when sellers charge higher prices to certain persons or groups because those customers are judged willing or able to pay a higher price. Businesspeople, for example, who fly on weekdays are charged higher prices than others who stay over a weekend, presumably because the business travelers value weekday travel more than others do.

As Ayres’ study points out, however, one has to make a further distinction between a consumer’s general willingness to pay (reservation price) and the consumer’s willingness to pay at a specific dealer-

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67. Id. at 819.
68. Id. at 849.
69. R. DEGEORGE, supra note 64, at 220.
70. The phenomenon of “cost-shifting” in hospitals, for example, is well-known: the patients with money and good insurance coverage are charged more in order to cover the hospital’s losses from patients who are indigent or whose bills are paid only by such government programs as Medicare and Medicaid. This practice involves too many issues for resolution here. For one viewpoint, see Marchasin, Cost Shifting: How One Hospital Does It, Wall St. J., Dec. 9, 1991, at A12.
ship. The latter, the consumer's "firm-specific reservation price," is revealed to be the key variable for auto dealers.

Thus, revenue-side statistical discrimination seeks to discover not the consumer's general valuation of a car, but how much he or she would be willing to pay a particular dealership. If a dealership can infer that a black or a woman is less likely to search at other dealerships, then the dealership may rationally attempt to charge him or her more. If a consumer's cost of searching at more than one dealership is prohibitively expensive, then the dealership may realize that, as far as that consumer is concerned, it has a virtual monopoly. Thus, profit-maximizing dealers may rationally make not only higher initial offers, but also lower concessions when bargaining against members of consumer groups who the dealer believes cannot afford to shop elsewhere.

If Ayres' analysis of the auto dealers' behavior is correct, and he admits that his explanation is tentative, then the sellers in his sample would be exemplifying the use of monopoly power to take advantage of the buyers' perceived situation.

Ayres' focus is on the legal dimension, in that his findings "constitute compelling evidence of unlawful racial and gender discrimination under both the civil rights and consumer protection laws." This does not mean that the sellers disliked blacks or women (animus), but only that the sellers took the race and gender of their customers into account when adopting a bargaining strategy.

His study is significant for this Essay in that it elaborates possible ethical implications of both first- and second-degree price discrimination: first-degree in its bargaining with individual buyers, but also second-degree in considering women and blacks as distinct groups from white males. It exemplifies injustice on the level of exchange between the individual sellers and buyers, since the various prices did not stem from differences in production costs, but rather from the seller's perception of the buyer's condition. On the level of distributive or social justice, Ayres points out that current legislation forbidding discrimination on the basis of race or gender does not cover all market transactions, but only selected ones like housing or hiring. His study adds auto dealerships to other markets where similar discrimination occurs.

71. Ayres, 104 HARV. L. REV. at 844.
72. Id. at 845.
73. Id. at 857.
74. See id. at 818 n.4 (citing dry cleaners (who charged more for women's blouses than for men's shirts) and a beauty salon hairdresser (who refused to serve a black woman) as current examples of continuing discrimination).
D. THE VIRTUE OF JUSTICE

Contemporary philosophers and theologians have begun to retrieve an insight that goes back at least as far as Aristotle: namely, that morally good actions usually come from people who are morally good.\footnote{5} In other words, ethical theories about justice and legislation to protect people's rights are no substitute for just citizens, those who habitually desire to "render everyone his rights."\footnote{6}

If some of the preceding suggestions about the "competitive ideal" and the ethics of the marketplace seem too far removed from actual practice to be realistic, then questions need to be raised not only about the structure of market prices and the possibility of government intervention, but also about the lived values of those whose choices ultimately determine prices, and that includes all of us. For while "[m]arket prices can certainly be a just measure of . . . exchange value . . . their justice ultimately rests on the virtuous inclination of the whole community of persons who collectively make up the market. . . . Ultimately, the justice of prices rests on the justice of persons."\footnote{7}

Some economists are also recognizing that in addition to the external rewards of the marketplace, business activity also offers internal incentives such as loyalty, duty, pursuit of excellence, love and compassion. A fully humane society and its marketplace will reflect not only self-interest but also civic virtue and concern for others.\footnote{8}

V. REVIEW AND SUMMARY

The intent of the preceding essay was to provide business managers and their advisors with some usable moral guidelines for making pricing decisions in competitive markets where price discrimination is common practice. The guidelines proposed were not definitive but were submitted as offerings for further discussion with the hope of contributing to the development of a system of values that can inform a more fully humane contemporary marketplace. These guidelines were drawn from reflections on the different types of price discrimination, on the response of the legal system to the practice of

price discrimination in the American economy, on an economic analysis of the practice, and on an evaluation of the practice in the context of justice.

Part I provided a standard economic definition of price discrimination and identified the market conditions that permit its practice. Three different types of price discrimination were noted, first-, second-, and third-degree. These distinctions are important because they point out the complexity of the practice and help clarify the economic and ethical analyses which followed in Parts III and IV.

United States antitrust law, reviewed briefly in Part II, has not concerned itself with the tripartite taxonomy of price discrimination developed by economists but has tried to identify when price discrimination is compatible with both freedom of enterprise and equality of economic opportunity, important values which sometimes conflict. To resolve this conflict, the American legal system, through the Robinson-Patman Act and its judicial interpretations, has attempted to conform to the traditional ethical prescription of respecting other persons while maximizing society's net welfare as it has sought to define when price discrimination was an acceptable competitive practice and when it was not. Hence, the law has sought simultaneous conformity with both of the major approaches to ethical theory: the deontological morality of justice and the teleological morality of utilitarian economics.

Economics has been less concerned with the quality of competitive practice than it has with the effects of competition on the welfare of society. Part III furnished a summary economic evaluation of price discrimination. First- and second-degree price discrimination were found to increase social welfare. The impact of third-degree price discrimination on social welfare was found to be mixed, suggesting the need to look beyond normative economics for usable moral guidelines.

To supplement the legal and economic guidelines already provided, Part IV concluded the Essay by referring the reader to the theory and practice of justice. Justice, simply put, requires that a seller not take undue advantage of the buyer. The meaning of undue advantage was clarified by a case study that suggested that first- and second-degree price discrimination might, under some conditions, violate the theory of justice. But justice in the abstract, laws on the books, and economic analyses are no substitute for buyers and sellers who habitually practice the virtue of justice. Only if the virtue of justice informs the actions of everyone who trades in the marketplace will that marketplace and the society it serves become fully humane.