# Unbundling the Confusion over Declining Marginal Cost Pricing

by Braden Cox

A controversy is brewing, pitting business realists against legal idealists—directly affecting consumer welfare. The debate centers around what economists call "declining cost industries." Burdened with such economic concepts as "marginal costs" and "price discrimination" and generally played out in arcane antitrust enforcement actions, a sexy policy debate this is not. Yet comprehending the pricing methodologies of declining cost industries is a must if policy makers are to properly understand 21st century business.

A declining cost industry is one characterized by the selling of a good or service whose average production costs decrease with each new unit produced. Let's say that I create a product that required lots of up front investment with high research and development costs. Despite all the initial costs, once I have perfected the product, the cost of reproducing another product—my "marginal cost"—is miniscule. So what is the best way to price my product?

It's easy, right? Just factor into the price the cost of development along with production costs. Wrong. Determining how much to charge over marginal cost is extremely difficult in practice, which makes charging a flat price impractical. Instead, businesses have found that they can best recoup their massive up front costs by charging a price based on what various buyers are willing and able to pay.

A pricing practice that differentiates based on the characteristics of the buyer may seem fishy to some. After all, this is discrimination! But what is good for sellers isn't necessarily bad for buyers, as both parties benefit from voluntary transactions. Indeed, price diversity in declining cost industries is socially efficient precisely because it extracts more value from those who are willing to pay more.

### Fighting for Survival – Declining Cost Industries

Declining average costs are not a new phenomenon. Yet they remain a widely misunderstood but pervasive economic reality.

Many economists incorrectly equate a firm's ability to price discriminate with its having monopoly or undue market power. Most economists argue that a perfectly competitive market pushes price toward marginal cost—and it is only an occasional aberration where some allowance is required for up front capital costs. Too often this mantra finds its way into regulatory policy—especially antitrust law. Antitrust regulators view with suspicion what they consider undue deviations from marginal cost pricing.

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Yet many important industries operate within a market characterized by declining average costs—including airlines, entertainment, pharmaceuticals, software, and telecommunications. In all of these industries, the challenge is similar: The amount one must charge to pay for overhead is small compared to the amount one must charge to remain viable.

The risk is that government regulators or the public at large will misconstrue the cost recovery strategies employed by declining cost industries as harmful to consumers. Pursuing regulation or litigation would drive prices below those needed to ensure dynamic, creative change. As a result, we would benefit from one generation of "cheap" goods or services but nothing thereafter.

### An Unheralded Economic Freedom – The Freedom to Price

If declining costs are the problem, then diversity in pricing is the answer. Derided by economists and antitrust lawyers as "price discrimination" or "price differentiation," this simply entails a firm charging different customers diverse prices for an identical product or service. The practice is actually quite common. Bulk discounts—such as for large quantities of copy paper or for "family size" restaurant meals—are one common form of price diversity.

As Economics Nobel Laureate Ronald Coase of the University of Chicago long ago noted, in his 1946 article, "The Marginal Cost Controversy," a declining cost industry must find some way to finance itself. He explained that there are two main ways to achieve the necessary level of revenue—via creative multipart pricing or through some form of government subsidy. The government subsidy approach inevitably entails government regulatory and/or price controls, as there are no "free" subsidies. So how can we let the market work?

A market solution requires for the seller to be able to distinguish between those buyers who are willing to pay a high price from those who are not. A seller must also be able to keep low-price buyers from reselling to those willing to buy at a higher price. This necessarily involves price diversification and contractual terms or technological barriers.

Thus, allowing the market to work means that laws under the rubric of

"privacy" should not prevent consumers from voluntarily sharing personal information with sellers, or prevent sellers from collecting consumer data. In addition, the legal system should enforce contractual obligations governing subsequent resale.

### Price Diversity is Consumer Friendly

It is easy to find examples of how price diversity helps consumers and maximizes resources that benefit all of society. Movie theaters have lower prices for matinees and restaurants have child menus to attract families who are, on average, more sensitive to prices than patrons without children. People who clip coupons are rewarded at grocery stores with a lower price. Senior citizens' strong price sensitivity provides the rationale for discounts at museums, drugstores, and even Broadway plays.

Bundling different goods together is another form of price diversity. For example, package deals from travel agents and online travel sites often provide consumers great savings. Hotel rooms and airline seats adhere to declining cost economics—the fixed cost of the building and airplane are large, but the cost of cleaning one extra room or flying one extra passenger is negligible. Product bundling allows hotels and airlines to fill excess inventory at a price that won't compete with its regular fares but will still allow it to make a profit.

There are those in government—particularly state tax regulators—who argue that consumers must be able to see the price of each component of their purchased item. But this is one instance where business "transparency" would hurt consumers because business would stop offering lower prices if it would undercut sales at its regular prices.

Declining cost businesses must have ways to engage in price diversity experimentation. Unfortunately, too many view any difference in price as anti-consumer or even unlawful. The reality is that "price discrimination" is a market solution that even the most ardent consumer advocate should embrace.

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## Meet CEI's Experts
## Ben Lieberman

*Ben Lieberman is Director of Air Quality Policy and Associate Counsel at CEI. His most recent work on energy prices has appeared in publications including the* New York Post, Chicago Sun Times, Weekly Standard, *and others. He received his J.D. from the George Washington University. He recently told* Monthly Planet *about himself.*

**You've written extensively on the Clean Air Act. How did you become interested in this issue?**

My father was an engineer with a strong science background, and I remember how he complained that federal environmental policy lacked a reliable scientific foundation. In law school, I took courses in environmental law, and realized how right he was. This sparked my interest in environmental policy, and it led me to CEI.

When I first came to CEI, I worked on the issue of stratospheric ozone depletion, but then branched into other issues covered by the Clean Air Act, and into the subject of air quality. I've since come to believe that the only good part of the Clean Air Act is its title—who can be against clean air?—but the statute itself is fraught with poorly designed and outdated provisions.

**What are the most common misperceptions you encounter held by people regarding public policy?**

When I started work at CEI, I assumed that policy analysts conducted research and wrote long policy papers. I quickly learned that research and writing are only part of the overall strategy for advancing policy. I have written not only monographs, but also op eds and magazine articles to influence public opinion. And my giving print, radio, and television interviews has also proven important in advancing our message. Another thing I did not expect was having to file comments and participate in agency-level meetings in the hopes of convincing regulators to see things from our perspective.

**Could you comment on the *Granholm v. Heald* Supreme Court case dealing with interstate wine sales?**

*Granholm v. Heald,* heard by the Supreme Court on December 7, involves challenges to two state laws that restrict direct-to-consumer wine sales from out-of-state wineries. This, of course, effectively bans a form of internet commerce that offers wine lovers more product choice and lower prices. But the alcoholic beverage wholesalers and distributors, who enjoy very high markups, do not want consumers to be able to bypass them, so they prevailed upon states to create these protectionist laws. But since these laws exempt in-state wines, they discriminate against out-of-state commerce and run afoul of the Constitution's commerce clause. This case is the first challenge to e-commerce to reach the Supreme Court, so the decision could set a precedent for other products sold online.