

# The economics behind Uber's new pricing model

May 25 2017, by Jordi Mckenzie

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Uber [is changing the way it calculates fares](#), moving to a system that charges what customers are "willing to pay", based on factors like whether you are travelling to a wealthy suburb. But while this change has been met with [mild outrage](#), it is actually a very common practice called "price discrimination."

Price discrimination is a firm's attempt to capture the difference between the value a consumer puts on a product and how much they actually pay. Firms do this by charging different [prices](#) to different [consumers](#) and exploiting differences in willingness to pay.

While this sounds like it comes at the expense of consumers, economic theory shows that [society as a whole can benefit](#) if certain conditions are met. For example, if Uber's new pricing means it can enter new markets or reduce customer waiting times, price discrimination could increase society's overall welfare.

Price discrimination takes many forms, such as Coca-Cola's infamous vending machines that increase soft drink prices [as the outside temperature increases](#), or charging more for pink razors.

[Cheap movie tickets on Tuesdays](#) are another example of price discrimination, as are the different priced tickets [at the theatre](#) and [concerts](#). Pharmaceutical companies [charge different prices in different countries](#), and car dealers [negotiate and give out discounts](#).

The airline industry is often regarded as the champion of price discrimination. [It price discriminates](#) on almost every aspect of a fare - from the time a booking is made to the type of seat booked, and, of course, the actual route flown.

The only surprise is that Uber hasn't implemented such a system before now. Its success has, in large part, been driven by a business model that so cleverly mimics a free-functioning market, notably with its "[surge pricing](#)."

## **What is price discrimination?**

Price discrimination is the practice of charging different "types" of

consumers different prices for the same product or service.

Broadly, "type" might be based on an observable characteristic (age, gender or residency status for example) or some unobservable characteristic that is revealed through the consumer's actions or preferences (coupon discounts, early bird specials, happy hour deals and so on).

Regardless of the mechanism, the objective is to exploit the different "willingness to pay" (WTP) between consumers and thereby increase profits. WTP describes the maximum amount a consumer *would* pay for a particular product or service. Given consumers differ in incomes and other circumstances, this presents an opportunity that firms may exploit through price discrimination.

Economists generally refer to three types of price discrimination – first degree, second degree, and third degree.

First degree generates the most profit. It involves each consumer paying the maximum price they are willing to pay and the firm extracting all of their WTP.

With the exception of some [internet auctions](#), pure first degree price discrimination isn't very common. But we can see versions of it where consumers pay a fixed fee in addition to ongoing fees (such as residential water pricing), and where a single price covers both access and (limited) consumption (such as internet services with data limits). If properly designed, these alternative pricing systems mimic first degree price discrimination by capturing the maximum profit available.

Second degree price discrimination involves providing discounts for bulk purchases. While generally not achieving the same level of profits as first degree, the profits from second degree price discrimination still

dominate over simple uniform pricing (where one price is charged to all consumers).

This type of pricing doesn't require a consumer to necessarily be identified by an observable characteristic, rather they reveal their "type" through their purchases. For example, a consumer who buys a 24-pack of [soft drink](#) cans at the supermarket generally receives a discount (per can) over the shopper who buys a single can.

Third degree price discrimination involves selling the same good or service to different segments of a market, based on willingness to pay. This is implemented using some identifiable consumer attribute, such as geography or age. An example would be train operators charging different prices to adults and students.

## **Price discrimination based on geography**

It is this third type of price discrimination that Uber is adopting. Although some customers will object to paying different amounts for the same distance travelled, Uber is certainly not the first company to exploit a geographic dimension when it comes to pricing decisions.

Many other businesses similarly base pricing decisions on location and (implicitly) the WTP of consumers in the markets they serve. For example, cafes, restaurants and bars operating in popular tourist destinations often charge substantially more than similar venues in neighbourhood locations. Although this may, to some extent, reflect higher costs, that typically doesn't explain the entire difference.

The subtle point is what economists refer to as "[net prices](#)", which occur only when price differences for different versions of the same good are not reflected in different costs.

So is Uber's plan to charge prices according to the customers' locations something that should cause users to take to the streets in mass protest, or at the very least raise concerns of regulators? Probably not. After all, it isn't as if Uber is itself a monopoly. There are always taxis as an alternative. But, of course, the taxi industry has always been partial to a little price [discrimination](#) itself. It just isn't as good at it.

This article was originally published on [The Conversation](#). Read the [original article](#).

Provided by The Conversation

Citation: The economics behind Uber's new pricing model (2017, May 25) retrieved 20 March 2024 from <https://phys.org/news/2017-05-economics-uber-pricing.html>

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