

WHY DIFFERENTIAL PRICING HELPS THE POOR

By Dr. Merrill Matthews Jr.

When consumers find out that a restaurant gives seniors a 10 percent discount off their tabs, the under-age-65 customers don't complain that they are "subsidizing" seniors — being charged more so that seniors can be charged less. Nor do they complain that if the restaurant can charge seniors less, it can afford to charge *everyone* less. People seem to understand that many seniors are on fixed incomes and may not be able to afford as much as those under age 65.

And when parents taking their children to an amusement park pay half the adult price for a child's ticket, those patrons buying adult tickets don't demand the same discount, claiming it is unfair to charge adults more so that children can be charged less. Indeed, they seem to sympathize with the parents.

It's called "differential pricing," and it is widely accepted in just about every sector of the economy — except in the market for prescription drugs.

What Is Differential Pricing? Differential pricing is the practice of charging some customers or clients more, while charging others less, for the same product or service. Virtually every industry and most companies engage in some form of differential pricing.

For example, the airlines have a range of fares they charge customers based on when and how they make their reservation, whether they want to fly first or business class or coach, or whether they are willing to stay over a Saturday night. And many passengers fly free by using frequent flier miles.

Health care providers historically have also engaged in differential pricing. Doctors charged most patients their standard fee for care, but poor patients often paid a reduced amount — if they paid anything at all. Such doctors weren't criticized but commended for their charity and public service because they — not the patients paying full price — were perceived as bearing the loss.

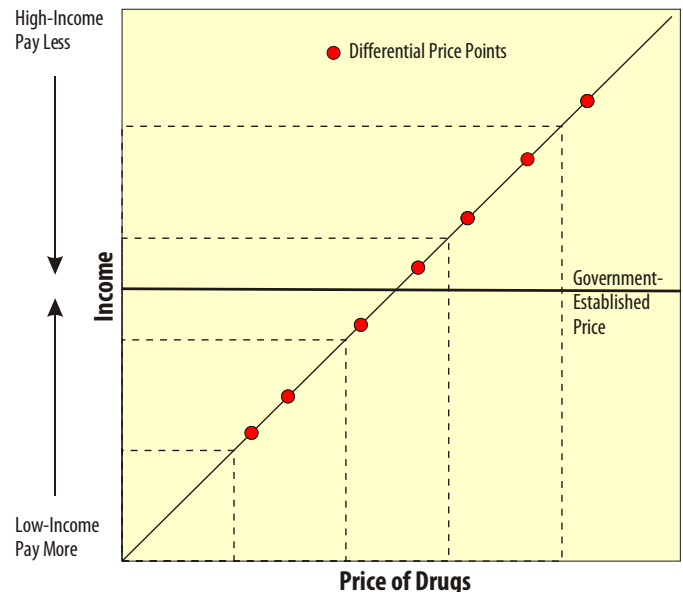
Why Do Companies Practice Differential Pricing?

Economists argue that companies engage in differential pricing in order to maximize sales and thus profits. First a company establishes a business model that anticipates a standard price for the product or service that should result in a profit if sales goals are met.

The question then arises, "Are there those outside the business model who might purchase the product if it cost less?" The answer is almost always yes, and so the company begins to look for ways to reach those individuals.

It's the market's way of ensuring that more consumers get products and services at lower prices and companies make higher profits — a win-win for both companies and consumers — unless, of course, you manufacture and sell a product that is politically sensitive, such as brand-name prescription drugs. For instance, the media, many politicians and special interest groups have come

DIFFERENTIAL PRICING MEANS POOR PAY LESS But Under a Gov't-Set Price...



to believe that differential pricing helps the drug companies while hurting the poor. In fact, eliminating differential pricing in prescription drugs would only hurt the poor.

Differential Pricing as a Social Benefit. Differential pricing permits companies and individuals to make their products or services available to people in a wider range of incomes.

Case Study: Airlines. The airlines want to sell as many tickets to as many people as possible. Their most lucrative business model is to sell rather expensive tickets to business travelers who expense the costs and so are less sensitive to the price. But many people without such expense accounts are not willing to pay that price. Since the plane is making the trip anyway and the “marginal cost” of adding more passengers is virtually zero, the airlines devised a way to identify pleasure travelers by requiring a Saturday night stay — which many business travelers don’t want to do — thus allowing millions of people with lower incomes or no expense account to travel to see family and friends.

Pharmaceuticals and Differential Pricing. Like most industries, pharmaceutical manufacturers engage in differential pricing. And like most industries, differential pricing has allowed lower-income people, both here and abroad, to have access to drugs they never would have gotten otherwise.

In this country, drug manufacturers provide billions of dollars in free or drastically discounted brand-name drugs to states and programs that seek to provide care to the poor and indigent. In addition, several drug companies have implemented discount cards for qualified low-income seniors. Pfizer and Eli Lilly went a step further by allowing all qualified low-income seniors to purchase any drug they sell for \$15 and \$12 per month, respectively. By identifying low-income seniors, drug companies are able to segment those who need help the most.

Differential Pricing and Other Countries. Drug companies are often criticized for selling bulk quantities of prescription drugs to foreign governments, especially Canada and Mexico, for prices lower than many Americans can purchase them.

However, such practices are common and well-accepted in other industries, and make sense from an economic standpoint. Canada’s per capita GDP is about two-thirds that of the U.S. — \$19,170 vs. \$29,240 (1998, U.S. dollars). Mexico’s is a mere \$3,840.

Even automakers sometimes sell their cars for less in Canada, and some Americans have been crossing the border to buy those cheaper cars — spurring a backlash from U.S. auto dealers who lose sales as a result.

But when drug companies discount their products or give them to impoverished countries, critics claim that such practices *prove* the companies are charging Americans too much and so they clamor for price controls.

They ignore the fact that the only reason doctors can afford to provide free services to some low-income people is that many others are willing to pay the full price. If no one pays the full price, no one can get a deeply discounted price.

Who Does Differential Pricing Help? If a company that sells a product for several different prices were told by the government it could only sell at one price, the company likely would no longer be able to sell the product for the current lowest price. As the figure on the previous page shows, higher-income people who are willing and able to pay more would pay lower prices. And lower-income people would be forced to pay more — precisely the opposite of what lawmakers intend by single-price legislation.

Differential pricing helps low-income people get a product they could not otherwise afford. If Congress were to do away with differential pricing in the market for prescription drugs — for example, by forcing a drug company to sell to every purchaser at the lowest price paid by any purchaser (a provision that recently passed the U.S. Senate) — it would ensure that low-income people all over the world would pay more or could no longer get the drugs they need.

Conclusion. Providing the widest possible access to a product means permitting — even encouraging — differential pricing. Eliminating differential pricing ensures that low-income people will have little or no access to the newest, life-saving drugs. It’s a death warrant masquerading as social do-goodism.

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