

Chapter 8: Auctions – Back to the Bazaar?

Several high profile Internet companies, such as Ebay and Priceline have pioneered a movement where consumers bid for products at auction, a trend soon followed by other Internet companies. Priceline, which began by selling airline tickets, had a market capitalization greater than all the major airlines together, seeming to indicate that auctions were a preferable way to sell these products. In fact, Ebay's success is not due to the use of auctions, and Priceline's model is doomed for failure.

The success of companies sponsoring auctions, such as Ebay, Yahoo, and Priceline, have caused some commentators to suggest that auctions are going to be playing an increasing role in future sales. For example, Clay Shirky, a professor of media studies at Hunter College recently opined in the pages of the Wall Street Journal that “the real importance of the name-your-price model.. [is that it is] a harbinger of a revolution being wrought by the information economy: the disappearance of fixed retail prices.”⁸¹

This is **myth number 5**. In fact, the Internet is going to have the exact opposite effect. Instead of charging different prices to each customer, Internet retailing is going to reduce the current variability in prices.

Again, too little respect is paid to the more ‘traditional’ pricing methods. These methods did not arise by happenstance. Instead they evolved and changed as the economy and society changed.

A. The evolution of the current pricing system

Did you ever wonder why tourists in third world countries encounter bazaars and shops where bargaining is considered the norm and yet it is so very rare in most western shopping centers? Why are the prices are simply posted on the isle at your local mall and grocery store?

It isn't a cultural difference.

Historically, bargaining was common until the very modern period. Bargaining worked to the seller's advantage. The high cost of time and low cost of information made it uneconomic for sellers in modern economies to engage in price negotiations, except for the most expensive items, such as automobiles. The Internet is not going to send us back to the Bazaar.

⁸¹ “Haggling Goes High-Tech,” April 10, 2000, Wall Street Journal.

For one thing, there are many more items to be purchased today than was the case in the previous century in Western societies, and we are much more less self sufficient. At one time it was common for families, the majority of whom lived an agrarian existence, to produce much of their own food and simple goods. As incomes and progress raced ahead, specialization in production became more and more common, requiring more and more reliance on market transactions to purchase items that previously had been hand made.

We also have much more disposable income with which to purchase the products that are available in our markets. Higher disposable income not only increases the number of items we tend to purchase, but it also makes leisure time more valuable since it is during our leisure time that we get to consume the products that we have purchased. What has happened is that the cost of time has become much higher, and haggling over the price of many items would be very inconvenient for most individuals.

Imagine, if you will, haggling with the checkout clerk over the prices of the items in your supermarket basket. Checkout clerks, for one, would need far more sophistication than they typically do, and also a different form of payment, otherwise they wouldn't have the proper incentive to try to get the highest price. \$6 to \$8 per hour will not provide sufficient incentive for hardy negotiations. And the process would be very time consuming. It would make getting stuck in line behind someone with lots of manufacturers coupons (and paying by check) seem like a cakewalk. Customers, particularly in those colorful locals, such as Brooklyn, New York, would likely riot.

Now duplicate this experience in drugstores, restaurants, department stores, and gas stations and you can quickly see that haggling over price would just be insane. Society, because of the higher cost of time, has moved in the exact opposite direction. We have drive-throughs for almost everything. Don't bother getting out of your car. Get your coffee, your lunch, your photographs and your dry-cleaning, all without leaving your car. The *raison d'etre* of all these drive-throughs was not to avoid breathing the outside air, but instead it was *to save time*.

Posting fixed prices achieves the same end. No negotiations. No concern that you might not get the product, as long as it is in stock. Posted prices are functional, from a time saving point of view. They are not ideal, however, from the sellers point of view.

B. The Concept of Price Discrimination

Haggling allows sellers to size up the buyer. Since sellers normally spend more time selling than buyers do buying, sellers will tend to have an experience advantage when haggling. The most common example of haggling still found in modern society is the automobile dealer.

Automobile salesmen get paid as a function of how high a price they can get consumers to pay for their cars. Making the sale, at a low price, is not the goal. Making a sale at a high price is. Automobile salesmen use various tactics to convince consumers that the one car with the ideal color and perfect options for the consumer is not likely to last, and certainly not at the attractive price that the salesman is offering, much to the putative chagrin of his supervisor, who often will stage a meeting with the salesmen where the consumers will hear the salesman being chewed out for giving the car away. The process is so time consuming and annoying (at least to many consumers) that they try to avoid these situations like the plague.

But this activity serves the interests of the automobile dealer, and perhaps even of society. That is because the dealer is engaging in what economists call 'price discrimination'. This just means that they are charging different prices to different customers, and if they are getting it right, they are charging higher prices to the customers who are willing to pay more.⁸² This is a well-worn subject that can be found in virtually any microeconomics text.

Price discrimination allows the seller to earn greater profits than would be possible if only the same single price were charged to all customers. Even though the price discriminator makes more money, not all customers are harmed, however. Those customers who are unwilling to pay a high price often would be priced out of the market if only a single price were offered to all consumers. After all, even if the price that this consumer would pay is greater than the production cost, potentially leading to a profitable sale, the seller will not charge this price if there are many customers willing to pay a higher price so that allowing them to pay a lower price would decrease profits by more than the gain from the low-price customers who only make purchases at a low prices. The single price that maximizes price by balancing the new low price customers against the lost profit from high priced customers is known as the profit maximizing price. This is a fundamental concept in introductory economics, although students often get confused by the mathematics.

⁸² Of course, no one *wants* to pay a higher price, but we each have was is called a 'reservation' price, which is the highest price we are willing to pay, and those with high reservation prices are the ones who pay higher prices if the seller engages in successful price discrimination.

When different prices can be charged, however, the seller doesn't lose money from the high-price customers since he can charge lower prices to only the individuals that he so chooses to sell the low price items. That is why price discrimination can increase his profits. It also allows low-price customers into the market, and the net result may well be beneficial if it leads to greater total output being sold.⁸³

Price discrimination is illegal under certain circumstances, but only if the customers are businesses that compete with one another. Sellers of final goods to regular consumers can price discriminate to their heart's content. What's the difference between these two instances of price discrimination? No economic difference at all. It is a political decision—business customers have more political clout than ordinary consumers do.

The point is that haggling allows price discrimination and it should prove profitable for the seller, everything else equal. But haggling is expensive, not just for the buyer, but also for the seller, who needs a staff of trained and motivated vipers, if the haggling is to prove successful in raising revenues. For almost all products in the US, the extra costs are greater than the additional revenues that would be generated, so haggling has largely disappeared. It exists in the case of automobiles because the items are very expensive and each automobile tends to have a somewhat unique set of options, making it difficult for the high-price customers to realize that they overpaid, an important precondition of price discrimination is to be truly successful.⁸⁴ Posted prices are a very cheap way of selling products, and this is now dominant. It all makes sense.

So what is the meaning of online auctions? Is it a form of price discrimination? Does it benefit sellers or buyers? Why does it exist on the Internet, but not in brick-and-mortar markets?

C. What do Auctions Do for Buyers and Sellers?

Sellers, on the other hand, will only wish to engage in auctions if they can receive a higher price than is available elsewhere. Sellers, therefore, will have to receive a price as least as high as is available through traditional outlets. But buyers, being aware of the lower prices elsewhere will not pay higher prices in auctions. This will keep auctions from becoming a dominant

⁸³ Actually, economists are interested in efficiency, measured in this simple case by the quantity of output sold. Price discrimination usually increases efficiency, so defined, even if consumers are made worse off. Economics doesn't take sides between consumers and producers and transfers from one group to the other are not considered relevant from an efficiency point of view, which is the view of economics..

⁸⁴ In the economics literature price discrimination can only succeed when 'arbitrage' is impossible, meaning that middlemen cannot arise to purchase the low priced items and resell them to the high-price individuals. Keeping consumers in the dark about prices makes arbitrage less likely.

retailing format unless the entertainment value of auctions is such that consumers are willing to pay a higher price.

Interestingly, in the current excitement brought about by auctions, buyers have been paying more for a large percentage of auctioned products (though less than half) than they would have paid purchasing the identical items sold at retail. However, as this information becomes more readily known (through outlets such as Consumer Reports), consumers will become more wary of auctions, and auctions are likely to be relegated to those items for which auctions make the most sense.

The increased availability of price information made possible by the Internet should make it increasingly difficult to sell new, homogeneous products at differential prices. It will just be too easy for consumers to compare prices, and to know what is the best available price for a product.

Auctions are a good way to sell out-of-season, clearance, and one-of-a-kind merchandise, and for these reasons may largely replace brick-and-mortar discounters who have tended to specialize in such merchandise. Net auctions are also likely to displace the classified advertising market since the Internet allows easy searching and is national or international in scope. Markets that were too thin at local geographic levels (meaning that too few buyers or sellers existed to ensure that the price went to a reasonable level) can function more efficiently on the Internet.

D. Ebay and Priceline

There is one huge success known as Ebay and one minor success, known as Priceline. Each of these companies has succeeded for a different reason. Ebay has powerful network effects in a market well suited to the Internet. Its success is not, I argue, due to its pricing, or in this case, auction policy. Priceline, on the other hand, has few network effects, and is not in a position to keep imitators from eating its lunch. It does depend on this concept of price discrimination for its success, and I do not believe that there is a great deal of room for growth.