PART I

BACKGROUND

CHAPTER 1

Introduction

"PLAY FAIR OR I QUIT!"

On a road near me, there are three gas stations, all on the same side of the road. One station consistently undercuts the other two by $.01 to $.03 a gallon. Drivers line up for this station, clogging the road in both directions. Customers wait to save, on average, $.02 a gallon. For a 20-gallon tank, that is $.40. If they wait six minutes each time, that is equivalent to $4 an hour. Hardly a minimum wage. Hardly rational behavior.

Gasoline consumers act irrationally because they are mad. They are mad because the price of gasoline is unfair. They perceive the price to be unfair not only because it is high, having recently gone over $3 a gallon, but also because they think the oil industry is acting unfairly.

OPEC exerts unfair power over oil supply: it now controls some 40 percent of oil production and over 60 percent of crude oil reserves. The oil companies make unfair profits: ExxonMobil has posted the highest profits ever recorded by a company. Oil company executives receive unfair compensation: the ExxonMobil CEO is paid over $144,000 a day. Gasoline wholesalers price unfairly: they use some sort of secret "zone" pricing so that some neighborhoods can be charged as much as $.50 a gallon more than others. And at the pump, customers are charged unfairly: they get less for their money on hot days because the gasoline expands.

Consumers react to what they perceive to be unfairness by punishing the oil companies in the only way they can: by demonstrating their anger at the pump. Each one acting individually, consumers wage lonely battles against unfair gasoline prices. But their concerted force is formidable.

Companies can be slow to recognize the force of perceived unfairness. For example, the president of the Western States Petroleum Association, when defending the practices of zone pricing, said "it is a perfectly acceptable form of pricing . . . a way for companies to price fairly in different areas."[1] Consumers disagree. They think it is wrong. And some companies are catching on.

For example, in a recent advertisement for the Sprint™ mobile phone service, there is a photo of some children forlornly reading a sign outside a playground. The sign gives the playground rules. The first two are:

1. "You have to guess how many minutes you're going to use your ball—for the next two years. Don't guess too high or too low, or you'll be sorry."
2. "Whoever is new on the playground is more special. It's just a fact. Therefore, new kids get the new things. Old ones don't."

The Sprint advertisement then points out the unfairness of mobile phone pricing: extra charges for estimating your usage too high or too low, and lower charges for new customers. It could also mention unfair extra charges for "regulatory issues" and unfair confusion caused by multiple plans and indecipherable billing.

The advertisement explains that Sprint is now rewriting the rules "to make things fair." Sprint has been driven to change their policies due to the public's quiet but effective response to the unfair pricing practices of the mobile phone industry. The company evidently gets it that fairness matters.

It also seems that airlines might be getting it. Since the innovation by American Airlines in 1985 of what is called "yield pricing," the airlines have patted themselves on the back for "skimming the consumer surplus," getting each customer to pay the maximum amount that each one is willing to pay.

The problem has been that one passenger could pay only $150 for a flight from New York to Los Angeles while another passenger on the same plane had to pay $1,500. The passengers paying $1,500 were the business-class passengers who did not make their reservations until the last minute and did not stay over Saturday night. To some extent this was accepted; business-class passengers did, after all, receive upgraded service. But was it 10 times better?

The difference in prices paid for the same flight was only part of the problem. The other part was that no one could figure out how prices were determined. The prices did not make sense. They seemed to change by the hour. Customers were left in the dark, and they rebelled. Again, as with gasoline and mobile phones, the revolt was quiet and steady.

Finally, at least one airline responded. Delta reduced its fare choices to just eight and eliminated the requirement of Saturday night stay-overs. The *Star Tribune* reported an airline analyst predicting that the industry was "heading toward a more consistent and fair pricing scheme."[2]

It was, unfortunately for Delta, too little, too late. The public was never made aware of its gesture toward price fairness. The company went into bankruptcy and has only recently emerged.

Printer ink cartridges are still a third example of where a company has responded to the consumers' concern for fairness. Ink cartridges have been priced like razor blades: charge next to nothing for the razor but charge up the wazoo for the blades—or in this case, the ink.[3] Because the company's own ink cartridges are the only ones that work in their printer, the customer had no choice. Customers thought this was unfair.

As a result, court cases were instigated.[4] The media pointed out that printing ink costs more per liter than vintage champagne.[5] Bloggers wrote reams of complaints.

Until recently, however, the printing ink companies have persisted in their pricing strategy. But now the fight for fair prices has been taken up by a competitor: Kodak has produced a printer that may cost more but whose ink costs less than half as much as others.[6] The company is charging customers for what they get. That is fair. And charging a fair price is giving the company a competitive edge.

In addition to gasoline, mobile phones, airlines, and printing ink cartridges, similar battles against unfair prices are being fought in many industries. Sometimes the battle is swift, like the quashing of Amazon's attempt to charge different amounts for the same MP3 player to different customers: some people were charged $233.95, while others were charged $182.95. Due to customer anger, Amazon quickly stopped and offered a refund to anyone who had paid the higher price.

Sometimes the battle is relentless, like the hackers who justify their attack on Microsoft software because they think Microsoft's profits are too high. In the summer of 2003, when they launched an attack of viruses and worms on Windows software, one worm left the message: "Billy Gates, why do you make this possible? Stop making money and fix your software."

Sometimes the combatants are organized, like the elderly who go to Canada to buy drugs because they cost 30 to 50 percent less there than in the United States. Sometimes the results are even lethal. Four people in South Africa died during a riot over the mixed-race community's paying for electricity based on meter readings, while others were paying a small fixed fee.[7]

And sometimes the battle is lost, as in the case of the Victoria's Secret catalog.[8] The company offered males a $25 discount on any $75 purchase, whereas females were offered only $10. The court dismissed the case, but the reason was not that sex discrimination was accepted, but that the case was based on racketeering charges under the RICO statute. The judge found that an irrelevant argument.

A Fair Price

The evidence shows that if sellers do not play fair, consumers will quit. But what is a fair price?

"Fair" has two separate meanings: "acceptable" and "just."[9] Acceptable implies that a fair price is satisfactory. Fair in this sense is a preference as in a "fair maid," "fair weather," or "fair sailing."

A "just" price, on the other hand, is a judgment that the price has been "justified," that it is "free of favoritism or bias; impartial . . . just to all parties; equitable . . . consistent with rules, logic or ethics."

This dual meaning of fair is demonstrated by the two words needed to translate *fair* into many foreign languages. For example, in German one translation of fair is *angemessen* meaning "satisfactory" or "appropriate" and the other is *gerecht* meaning "just."

The difference between an "acceptable" fair price and a "just" fair price is the difference between what is here called *personal* and *social fairness.* It is the difference between a price you prefer because it meets your own personal standards and a price you judge acceptable because it meets society's standards.

A personally fair price is one that is low enough to meet your expectations. In many cases, customers consider a price fair simply because it less than anticipated. As a researcher has commented, “Saying a price is fair may be another way of saying it is lower.”[10]

A socially fair price is one that is the same for everyone, does not give the seller unreasonably high profits, does not take advantage of consumers’ demand, and so on. Gasoline prices over $3 a gallon are personally unfair; zone pricing of gasoline—where some people have to pay more than others—is socially unfair.

When describing an unfair price, personal and social fairness are often presented in tandem. Pharmaceutical prices are considered unfair both because they are so high *and* because they are more expensive here than in Canada. Textbook prices are unfair both because they are so high *and* because students are forced to make the purchase. Sales taxes are unfair both because they are so high *and* because the poor pay a proportionally higher amount.

The Social Norms

Personal and social fairness is determined by the adherence to *social norms*. These norms are the consensual rules of a society. They apply to every aspect of economic exchange: not only the price itself, but also what is priced, who sets the price, what people get price exceptions, what price information is provided, what is included in the price, and so on.

Social norms are often just tacitly understood. We do not even notice them unless they happen to be violated. They do not dictate behavior but act as commonly accepted guides to what is appropriate.

Some examples of the norms of pricing are given in Table 1.1. The reaction to these examples can be “Of course! That’s just how things are.” Of course, restaurants are paid to prepare meals and spouses are not. That is obvious. But the social norms are not as obvious as they appear. Just consider the possibilities:

Suppose restaurants charged extra for condiments. Suppose nurses had to be tipped for service. Suppose brunettes and blondes had to pay a surcharge.

You might respond that these things would never happen. But in Slovakia, some restaurants charge tourists extra for mustard and catsup. In India, some nurses demand a tip to bring new babies to

Table 1.1. Examples of Social Norms of Pricing

Scope of Social Norms of Pricing	Examples of Social Norms of Pricing
What is priced	Restaurants should be paid to prepare meals, but spouses should not.
Who sets the price	Sellers should set prices in retail stores, but not in auctions.
What is basis for price	Train prices should vary by age, but not by weight.
What people get price exceptions	Movie prices should be lower for the low-income elderly but not the low-income poor.
Where prices are different	Higher price should be charged for beer in hotels than in grocery stores.
What people get paid more/less	Higher salaries should be paid to physicians than to equally essential school bus drivers.
What is priced higher/lower	Higher prices should be charged for diamond crystals than for salt crystals.
How price is charged	Gasoline charges should include an extra nine-tenths of a cent, but grocery prices should not.
What price information is provided	Prices should be tagged in retail stores but not in flea markets.
What is included in price	Elevator service should be included in the price of offices, but curtains should not.
When price can change	Price increases should be based on increased cost, not increased demand.

their mothers. Foreigners in India are charged more for entry into the Taj Mahal than natives are. To Americans, these charges seem wrong. They are deemed unfair.

There are different social norms of pricing for personal fairness and social fairness. The norms of personal fairness are *descriptive norms*. They stipulate what can be expected based on what has been customary in the past. They indicate what is generally considered to be normal behavior, like driving on the right-hand side of the road.

Descriptive norms of pricing include charging the same amount to mail a letter no matter where it is going, including tires in the price of a car, adding nine-tenths of a cent onto gasoline prices. When these descriptive norms are violated, it is perceived to be personally unfair.

The social norms of social fairness are *prescriptive norms*. They stipulate how people should behave based on society's values. Prescriptive norms are consensually agreed upon rules of society.

Examples of prescriptive norms of pricing include charging all customers the same price, not sneaking in hidden surcharges, not exploiting customers in need. When these prescriptive norms are violated, it is not just personally but socially unfair.

An Emotional Response

When a price is personally or socially unfair, people get an emotional rush. But the intensity of emotion differs depending on the kind of unfairness. The reaction to personal unfairness is mild. The violation of a descriptive norm, such as the expectation of a low price, results in dissatisfaction. An extra charge for bread in a restaurant results in mild annoyance and displeasure.

But in contrast to the relatively mild distress caused by personal unfairness, the reaction to social unfairness is ferocious. When a price is thought to be socially unfair, consumers feel an irrational desire to "get back" at the seller, even if it takes more effort than the money involved. They will argue endlessly with the store manager to get a $5 refund on a defective product. They will drive five minutes longer to avoid a pharmacy that prices unfairly.

Recent studies suggest that the emotional response to fairness is innate. Female brown capuchin monkeys that have been trained to use tokens for money are incensed when the exchange is not fair.[11] This was demonstrated by the actions of the capuchins when separated into adjacent cages where they could observe each other's behavior.

If the first trained monkey received a grape (a treasured reward) without having to pay the usual token, but the second monkey had to pay a token for only a cucumber (a less valuable reward), the second monkey either threw her own token away or refused to accept the cucumber. Just having a grape in the first monkey's empty cage was enough to make the second monkey sulk. "The researchers suggest that capuchin monkeys, like humans, are guided by social emotions."[12]

Fairness, in effect, is the emotional part of economic decision making. Neurological research shows that without this emotional component, consumers cannot make a decision to buy.[13] It is the emotions that generate a fast, convincing belief as to whether a price is acceptable or unacceptable, good or bad, right or wrong. Fairness is an emotional “yes” or “no.”

In Sum . . .

A fair price is one that is emotionally okay. It is acceptable and just. It has passed the test of personal and social fairness by adhering to the social norms. But when the norms are violated and the price is judged personally and socially unfair, watch out! Emotions intensify. Tempers flair. Consumers say, “Play fair or I quit!” And companies had better take heed.

To explain fair prices, this book calls on all kinds of evidence: anecdotal, theoretic, and experimental. It incorporates personal experiences, reports from news magazines and web sites, and opinions from bloggers. The underlying belief is that all sources of data are valuable—anything that can help us understand the slippery idea of price fairness.

The organization of the book is in three parts: background, model, and applications of the model in practice. The “background” section comprises this chapter and the following one on the history of a “just” price.

The “model” section explains how personal and social fairness lead to escalating emotions and retributions. Each element in the model is then explained further in subsequent chapters. These chapters show how judgments of price fairness can both increase trust and are supported by trust but can be quickly destroyed by the imposition of seller power. Each chapter includes an inset defining the concepts, which are collected at the end in a Glossary.

In the section on “applications,” the model is applied to specific instances of price fairness: tipping, price discrimination, negotiations, taxes, and across cultures. This section addresses why it is the norm not to stiff the waiter, why we care about what other people pay, and why the best tax is an old tax.

Although the first 18 chapters look at price fairness from the consumers’ viewpoint, the final chapter considers price fairness from the viewpoint of the seller. Chapter 19 shows how to avoid having customers say, “The price is wrong! And that’s not fair!”

Definitions

Personal fairness: Preference for what is considered acceptable outcomes and procedures based on the legitimate expectations of descriptive norms.

Social fairness: Judgment that outcomes and procedures are "just" based on the standards of prescriptive norms.

Social norms: Tacitly understood and consensually agreed-upon rules of a society.

Descriptive norms: Consensual rules of expected actions and outcomes based on custom and tradition.

Prescriptive norms: Consensual rules of appropriate actions and outcomes based on community values.