Market Segmentation and Economic Discrimination: Why Markets Deliver Unequal Outcomes

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The neo-liberal rationale for deregulation and privatization is to promote the welfare of society through promoting consumer sovereignty, freedom of choice, service flexibility, productive efficiency and allocative efficiency (Webber and Ernst 1998). Markets and competition in short are the best means of creating wealth and eliminating poverty. When concessions have to be made, neo-liberals insist that social support be funded directly by government and means tested. In this article I argue that contemporary income support as envisaged by neo-liberals (and indeed many Third Way proponents) ignore the negative consequences of market power. It is my contention that contemporary market segmentation of essential service consumers indicates the presence of market power. This market power manifests as economic discrimination because segmentation is a response to inequality.

Segmentation formally allocates status and treatment according to specific economic attributes. Income support therefore in a market society needs to overcome two deficits if it is to be serious about addressing disadvantage: lack of purchasing power, and lack of market power. The problem for market enthusiasts is that market segmentation demonstrates why markets in essential services such as energy, water, telecommunications, insurance, health and education etc do not eliminate poverty.

In Australia, the neo-liberal concept of 'community service obligations' (CSO) has largely replaced universal service as a means of social protection. CSOs are associated with markets, and universal service with monopolies and regulation. CSOs are defined as the delivery of a non-commercial service associated with a social purpose that is identified and mandated by government. The National Competition Council, for example, defined CSOs as:

- goods or services that governments require specific government businesses (and sometimes specific private enterprises) to provide to sections of the community and that would not be provided under commercial arrangements (Trembath 2002: 32).

The Industry commission argued:

- Cross-subsidies result in allocative inefficiency. Those whose consumption is taxed restrict their usage of the product, even though they may value the consumption of additional units more than the cost of producing them. Consequently, there is a welfare loss. Conversely, those who are subsidised are encouraged to expand their use of the product beyond the point where the value they derive from the good is equal to its cost of production. Again, there is a welfare loss (Industry Commission 1991: 120).

Yet beyond these apparently persuasive arguments there remain unanswered issues regarding the efficacy of CSOs in overcoming market failure when the service in question is an essential one. Martin (1995: 116) has argued:

- yet even while neo-liberals argue that CSOs function as income security, they acknowledge position in the market as being a significant factor for how customers are treated.

The broad aim of the CSO approach is that the services provided by GTEs, and purchased by the Budget sector, should be provided under commercial contracts. Commercial contracts change CSO clients from a charitable drain on the GTE's earnings from other clients, to valued customers who attract additional earnings for the GTE. This change in the status of CSO clients should also improve the manner in which they are serviced and their complaints handled (Allan 1994: 124).

This argument assumes that the CSO will be equal to any previous subsidies. But it is also an argument that points to a completely different dynamic that will impact upon the value of the transfer. The argument implicitly concedes that customers without market power (insufficient purchasing power) receive different treatment in a market. Poor customers, Allan is suggesting, are unattractive to commercially focused enterprises. They need to gain equal status (purchasing power) with attractive customers within a commercial environment before they will be treated in a non-discriminatory manner. This argument unintentionally acknowledges that it is not merely the characteristics of poor customers but the operation of the market itself that acts to disadvantage such customers. The subsidy (the cost of 'equalising' such customers) therefore needs to overcome two 'deficits': the customer's connected to affordability. Colton (1998) states:

- 'affordability' includes both an 'absolute' (‘to have enough or the means for’) and a ‘relative’ (‘to bear the cost of without serious detriment’) component. According to the FCC (Federal Communications Commission), both the absolute and relative components must be considered in making the affordability determination... service cannot be considered to be ‘universal’ if customers who are succeeding in paying for that service nonetheless cannot pay for it ‘without serious detriment’.

...
lack of purchasing power, and the consequences of differential treatment by competing providers. These deficits reflect two different types of market failure. CSOs however currently only address one of these.

A deficit CSOs need to overcome in a market is the differential treatment of customer by competing providers. A key observation of mass markets where consumption is largely non-discretionary is that suppliers engage in market segmentation in order to improve profitability. Companies want to attract and retain the most valuable customers, to increase the ‘share of wallet’ they receive from these customers, and to rid themselves of customers who are unprofitable (Fair Isaac 2003).

New information technology permits sophisticated application of market segmentation strategies (Alwitt and Donley 1996, Hallberg 1995, Berry and Linoff 1997, Grey 2002, Peace 2003). Competition benefits attractive customers but it also follows that some customers will be excluded from the market, and others will be subject to economic exploitation arising from their lack of market power.

Knights, Sturdy and Morgan (1994: 46) argue regulatory changes to stimulate competition, and changes to the socio-economic profile of the population, were two crucial elements promoting market segmentation of deregulated UK financial markets. They observed that ‘market saturation of certain core products’ arising out of increased personal incomes in the 1980s initially encouraged segmentation, and this was followed by economic recession and the housing crisis that

two crucial elements promoting market segmentation arising from their lack of market power. Competition, and changes to the socio-economic profile of the population, were two crucial elements promoting market segmentation of deregulated UK financial markets. They observed that ‘market saturation of certain core products’ arising out of increased personal incomes in the 1980s initially encouraged segmentation, and this was followed by economic recession and the housing crisis that

the market separates into a ‘sink’ sub-sector of under-performing suppliers located in disadvantaged areas unable to attract good staff and for which there are falling levels of consumer demand and no competition between consumers for access, and an ‘elite’ sub-sector of high performing suppliers located in wealthy, leafy areas able to attract good staff, with high levels of application, where there is congestion, and where in effect the suppliers choose the consumers’ (Perri 6: 2003: 252, my emphasis).

The separation of sub-sectors Perri 6 (2003: 259) described as ‘polarisation’ and he noted that ‘polarisation limits competition, unless regulation limits its effects’.

Leyshon and Thrift (1998) and Fowers (2001) have recognised the use of telecommunications and information technology as tools for attracting or avoiding customers in the banking industry. Incoming telephone calls are screened in relation to area codes. Customers from “bad” localities simply do not get through. ‘Good’ customers receive faster connection to an operator and

their loyalty is rewarded. In Australia, attractive banking and telecommunications customers have become known as HVCs (high-value customers), and unattractive ones as transactors, value dilutors, barriers or bozos (‘brings only zero outcomes’). Bozos are frequently discussed in terms of requiring ‘terminating’ (Cornell 2003). Bozos are customers who are vulnerable to exclusion from the market. Industry however is less explicit about the power they have over customers who have no choice but to purchase. These customers are vulnerable to being assigned into what I call the ‘residual market’.

Residual markets are that segment of the market that services customers whose consumption is non-discretionary and who have no market power. Stutz, quoted in Colton (1983: 38), warns that small customers face the risk of ‘cost shifting and lack of market power [that] will result in small captive customer rates increasing’. Rosen, Sverrisson and Stutz (2000: 55–7) argue:

When price discrimination is not based on the willingness to pay but, rather, on the consumers’ inability to negotiate the terms of the sales contract, or some other manifestations of market power that turns a particular customer class into price takers, particularly for a necessity of life, then it is clear that price discrimination has taken a negative turn. It is also clear that such price discrimination is likely to hurt small customers, while large customers are likely to benefit.

While it may be the case there is a multitude of suppliers, such as appears to be the case with payday lenders (short-term, unsecured lending), there is a severely asymmetrical relationship between buyers and sellers that favours the sellers. Liberalisation of markets may increase competitive pressure but it also seems to produce in essential services areas a situation of simultaneous competition and monopoly. The issue is not so much the number of buyers and sellers in the market but market power they hold. The capacity to economically exploit residual market customers raises the possibility that competition for attractive customers may involve cross-subsidisation from the residual market.

Speaking of telecommunications, Yarrow argues:

Relief of poverty and public provision for special needs are much better handled by the Department of Social Security (DSS), which can look at the position of the relevant individuals and groups in their entirety, and not just at their positions as buyers in the market (Yarrow 1996).

Selective or targeted assistance can also comprise a component of universal service. The distinction is that universal service the assistance is in addition to benefits arising out of the industry’s structure. For example a customer may receive income support on top of a price that is underpinned by a
Selective assistance, in the form of cash rebates such as a CSO can provide the recipient with additional purchasing power in the market, and this can make them somewhat more attractive to suppliers as Allan suggests. If recipients are assigned into a residual market, however, the question is whether or not the CSO compensates for the increased costs they face. The oversight made by reformers such as Yarrow (1996) is that each individual is a buyer in the market. Traditionally, government provision of selective assistance has been determined in relation to the recipient's income (the means test). Income tests assess only income, not position in the market. Markets reflect costs, but they also reflect market power and this seems to be forgotten or ignored.

Segmentation means that assistance should also take account of market position because it has a material bearing on the cost faced by the customer. In contrast, under universal service regimes, the end-cost of the service to each customer is the same for each member of that tariff class.

It is sharp economic differences between customers that make CSOs necessary but the same inequality also encourages market segmentation. In market societies that are characterised by inequality of wealth any transfers (CSOs) would need to be substantial to discourage segmentation and rise of a residual market. Perri (2003) found that where vouchers (a type of CSO) were made available to British schools in the “sub-sink” segment, the assistance did not necessarily compensate for the disadvantage associated with the segmentation effect he observed. Leyshon and Thrift (1999) also observed that the market functioned to increase the relative level of disadvantage. Transfer payments that compensated for the disadvantages of market segmentation therefore would potentially need to be larger than traditional income supplements provided through universal service. In addition, payments may be needed for a larger group. This arises because in a segmented market, market power provides an opportunity to extract economic rents. Proponents of markets would argue that excessive profiteering would attract new entrants who would then compete and bring prices down, but this is exactly what older forms of segmentation such as “redlining” in the US and more recent experience of financial deregulation contra-indicates. It is not only difficult to imagine that governments would increase funding to compensate individuals in residual markets; if they were to do so they would, in effect, be rewarding the sellers profiting from market abuse.

The Future...

In truly liberalised essential services, customers are assigned to one of several segments. The most disadvantaged, the BOZOs find that they excluded from the market altogether. Those who are economically marginal find their lack of market power results in them being assigned to the residual market where they are exploited. Attractive customers are lauded and benefit from cross-subsidies following from the residual market. Profit results improve in the short term but economic efficiency does not actually increase. Policy makers eventually find that to avoid systemic disadvantage, the value of rebates needed for income support to equalise customers in the market needs to be so great that markets seem to be counter-productive. They start wondering how they could avoid abuse of market power when someone mentioned universal service...

References are available on the CHP website: www.chp.org.au/parity