

GENERAL CONSIDERATIONS ON THE INFLUENCE OF PRICES ON BUSINESS

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Abstract: *In most companies, there is an ongoing conflict between managers in charge of covering costs (finance and accounting) and managers in charge of satisfying customers (marketing and sales). Accounting journals warn on prices that fail to cover full costs, while marketing journals argue that customer willingness to pay must be the sole driver of prices. The conflict between these views wastes company resources and leads to pricing decisions that are imperfect compromises. Profitable pricing involves an integration of costs and customer value. To achieve that integration, however, both need to let go of misleading ideas and to form a common vision of what profitability means.*

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1. INTRODUCTION

The concept of economic value assumes not only that customers are aware of alternatives but that they can accurately evaluate what the alternative suppliers have to offer. In fact, it is often quite difficult to determine the true attributes of a product or service prior to purchase. For example, consumers suffering from a headache may be aware of many alternative pain relievers that are cheaper than their usual brand and that claim to be equally effective, but if they are unsure that a cheaper brand is as effective or as free of unwanted side effects as the one they usually buy, they will consider it an inferior substitute even though it could be chemically identical. Most customers will continue paying a higher price for the assurance that their regular brand offers what the substitutes do not: the confidence accumulated from past experience that their brand can do what the others only promise to do.

Even price itself can be difficult to compare across brands, thus reducing price sensitivity. Catalog and Internet retailers often divide their prices into two parts: one part for the items plus a fixed or variable charge for “shipping and handling”. Research shows a wide variance among customers in their ability to make accurate comparisons with the single prices offered by traditional stores. Similarly, branded grocery products are often packaged in odd shapes and sizes, making price comparisons with cheaper brands difficult. When, however, stores offer unit pricing, grocery shoppers can identify the cheaper brands. In one study of unit pricing, the market shares of cheaper brands increased substantially after stores ranked brands by their unit prices.

Companies with new products for which they are trying to build cash flow often make the mistake of building the start-up cost of acquiring and servicing a new customer into a large, up-front fee. Because high uncertainty undermines perceived value, such companies lose potential sales and win sales only at lower prices than they otherwise could. By absorbing the up-front cost in higher monthly fees, the seller communicates confidence that customers will be satisfied and enables customers to pay as they enjoy a known value from product usage. Consequently, the seller should close more sales and, assuming that the product or service delivers the promised value so that the customer continues to buy it, the seller can ultimately expect a greater cash flow and a higher net present value (NPV) per customer acquired.

2. Switching Cost Effect

The greater the added cost (both monetary and non-monetary) switching suppliers, the less sensitive buyers are to the price of a product. The reason for this effect is that many products require that the buyer make product-specific investments to use them. If those investments do not need to be repeated when buying from the current supplier, but do when buying from a new supplier, that difference is a switching cost that limits interbrand price sensitivity.

This is the *switching cost effect*: The greater the product-specific investment that a buyer must make to switch suppliers, the less price sensitive that buyer is when choosing between alternatives. Since this effect is often attributed simply to consumer “inertia”, it is easy to underestimate its predictability and manageability.

Aspiring suppliers often absorb part of the switching cost in order to eliminate this effect. They should not do this simply by offering a lower price; however, since then they must give the discount even to previous customers who are not incurring a switching cost. The key is to target the discount selectively to new customers without lowering the price expectation. New suppliers do this by

providing free training, by giving generous “trade-in allowances” to customers who replace competitive equipment, or by giving a discount on the first order placed under a long-term contract.

3. Price-Quality Effect

Generally, price represents nothing more than the money a buyer must give to a seller as part of a purchase agreement. For a few products, however, price means much more. Such products fall into three categories: image products, exclusive products, and products without any other cues to their relative quality. In these cases, price is more than just a burden; it is also a signal of the value a buyer can expect to receive. In such cases, price sensitivity is influenced by the *price-quality effect*, which states that buyers are less sensitive to a product’s price to the extent that a higher price signals better quality.

Often, the perception of higher quality at higher prices reduces price sensitivity *even when* consumers seek *neither* prestige nor exclusivity. This *occurs* when potential buyers cannot ascertain the objective quality of a product before purchase *and* lack other cues, such as a known brand name, a country of origin, or a trusted endorsement to guide their decision for example, the name of a restaurant in a strange location, a folk artist at a fair, or a totally new brand with which the buyer has no prior experience. In such cases, consumers will rely somewhat on relative price as a cue to a product’s relative quality, apparently assuming that the higher price is probably justified by corresponding higher value.

As an illustration of how strong this effect can be, researchers have reported cases where a new synthetic car wax faced strong consumer resistance until its price was raised. Similarly, sales of new creamy-style cheesecake were poor until the company raised the price to equal that of its heavy (and more costly to produce) regular-style cheesecake. Buyers could not judge the quality of either product before purchase. Consequently, buyers played it safe by avoiding cheap products that they believed were more likely to be inferior.

Extreme cases such as these, where sales respond positively to a higher price, are admittedly rare. They lead one to expect, however, that in other cases sales simply respond less negatively to a higher price than they would if buyers did not associate a higher price with higher expected quality. Numerous studies have shown that, even when the objective quality of a brand is unaffected by its price, consumers use price as a quality cue to the degree that:

1. they believe qualities differ among brands within the product class.
2. they perceive that low quality imposes the risk of a large loss.

3. they lack other information (such as a known brand name) enabling them to evaluate quality before purchase.

The more consumers must rely on price to judge quality, the fewer prices sensitive they will be. For most purchase decisions, consumers can either examine a product before purchase or infer its quality from past experience with the brand (the difficult comparison effect). Studies indicate that under these conditions, price is not used as a quality cue. Nevertheless, the conditions for using price as a quality cue occur in one very important case: when new products are first offered to a market.

4. Expenditure Effect

A buyer's willingness to evaluate alternatives depends also on how large the expenditure is relative to the effort necessary to reduce it. For businesses, this effect is determined by the absolute size of the expenditure; for households, it is determined by the size of the expenditure relative to the available income. The *expenditure effect* states that buyers are more price sensitive when the expenditure is larger, either in dollar terms or as a percentage of household income. The more a buyer spends, the greater the gain from carefully evaluating the expenditure and attempting to find a better deal. This explains why the same person will sometimes shop at an expensive convenience store (for a small purchase) but be very sensitive to price when deciding where to go for the weekly shopping excursion. This partially explains why heating insulation costs much more when sold to maintenance men in lots of twenty-five feet than when sold to building contractors by truckloads of tens of thousands of feet. At the other extreme, small "impulse purchases" are simply not worth any effort to ensure that the price is a good deal. Consequently, percentage price differences across suppliers are often very large.

The effect of the expenditure size on price sensitivity is confounded in consumer markets by the effect of income. A family with five children may spend substantially more on food than a smaller family, yet still be less price sensitive if the cost of food accounts for a smaller portion of the large family's higher income. This relationship between a buyer's price sensitivity and the percentage of income devoted to the product results from the trade-off buyers must make between conserving their limited income and conserving the limited time they have to shop. Higher-income buyers can afford a wider variety of goods but cannot always afford more time to shop for them. Consequently, they cannot afford to shop as carefully as lower-income buyers, and so they accept higher prices as a substitute for time spent shopping.

The expenditure size relative to income is also a constraint on both a business's and a household's primary demand for a product. A young man may long

for a sports car, believing that a Porsche clearly has differentiating attributes that justify its premium price relative to similar cars. An economic value estimation of sports cars would reveal his decided preference and belief that the Porsche offers a “good value” relative to other sports cars. At his low income, however, he is not making purchase decisions among competing sports cars. Expenditures in other purchase categories (housing, food, and education) are of higher importance than a sports car, and those categories currently consume his income. Until his income rises, or the price of sports cars becomes much less, his brand preference within the category is not relevant.

5. End-Benefit Effect

An individual purchase is often one of many that a buyer makes to achieve a single benefit. Cream cheese is one of several products that a cook must buy to make a cheesecake. Software is just one component of a computer system, the cost of which may be minor compared to the cost of processor, modem, data storage, etc. The relationship of a purchase to a larger benefit is the basis of the *end benefit effect*, which can be divided into two parts: the derived demand and the price proportion. *Derived demand* is the relationship between a desired end benefit and the buyer’s price sensitivity for one of the products that contributes toward achieving that end benefit. The more sensitive buyers are to the cost of the end benefit, the more sensitive they will be to the price of products that contribute to that end benefit. In the examples above, the more price sensitive the buyer is about the decision to make a cheesecake or build a computer system, the more price sensitive she will be to the cost of cream cheese or disk storage devices. *Price proportion cost* refers to the percent of the total cost of the end benefit accounted for by the product’s price. The smaller the proportionate share accounted for, the less sensitive the customer will be to price differences.

Derived demand is most obvious in business markets. The more (less) price sensitive is the demand for a company’s own product, the more (less) price sensitive that company will be when purchasing supplies. A manufacturer of office furniture purchases sheet steel to make desks. The more desks it can sell the more steel it will buy. If desk buyers were highly price sensitive, any attempt to pass on steel price increases to the price of desks would cause a large reduction in sales. Consequently, the high price sensitivity of desk buyers would force the desk manufacturer to be highly sensitive to the cost of its desks and, therefore, to the price of steel.

Imagine how the manufacturer’s purchase behavior would change, however, if booming demand were to cause an order backlog to lengthen and customers to lose leverage in negotiating desk prices. Since the manufacturer could now more easily pass on added costs to the customer, its goal in purchasing would become less

to save money on supplies and more to ensure on-time and defect-free deliveries to keep the manufacturing process running smoothly. It is essential for salespeople in business markets to understand the end benefit that drives a customer's purchase decision (is it cost minimization, maximum output, quality improvement, civic mindedness) in order to infer the importance of price in the purchase decision.

The relationship between price sensitivity for a product and for the end benefit to which it contributes is not simply an economic phenomenon. There is a strong psychological component that depends on how a buyer perceives the absolute price, or price difference, in proportion to the total cost of the end benefit.

To fully appreciate the marketing implications of the end-benefit effect, managers need to recognize that it is both an economic and a psychological phenomenon. Consider how you would react if, after celebrating a very special occasion at a nice restaurant, your beloved paid for it with a two-for-one discount coupon. Unless you are an economist, this action would probably be seen as rather unromantic. Most people think it tacky to make choices based on price when an end benefit is emotionally important to them. Moreover, one must also recognize that the "total cost" of the end benefit need not be only monetary. Dieters are less sensitive to price than non-dieters when treating themselves to chocolates or ice cream because the dollar expenditure is only a small part of the total cost (both monetary and non-monetary) that they pay for this treat. The psychological aspects of this effect make it an excellent target for promotional activity. Once a brand is established in customers' minds as somehow "better", advertisers can increase the value of that perceived difference by relating it to end benefits to which the customer already attaches a high value.

6. Shared-cost Effect

Although the portion of the benefit accounted for by the product's price is an important determinant of price sensitivity, so also is the portion of that price actually paid by the buyer. People purchase many products that are actually paid for in whole or in part by someone else. Insurance covers a share of the buyer's cost of a doctor's visit or a prescription drug. Tax deductions cover a share of the cost of publications, educational seminars, and travel related to one's profession. Businesses usually compensate employee travelers for all or part of their travel and entertainment expenses.

Fairness Effect The concept of a "fair price" has bedeviled marketers for centuries. In the Dark Ages, merchants were put to death for exceeding public norms regarding the "just price". In the more recent dark history of Communism, those who "profiteered" by charging more than the official prices those very prices at

which the state was unable to meet demand-were regarded as criminals. Even in modern market economies, “price gougers” are often criticized in the press, hassled by regulators, and boycotted by the public. Consequently, it is well worth a marketer’s time to understand and attempt to manage this phenomenon.

Buyers are more sensitive to a product’s price when it is outside the range that they perceive as “fair” or “reasonable” given the purchase context. But what is fair? Managers should note that the concept of fairness appears to be totally unrelated to issues of supply and demand. It is related to perceptions of the seller’s profit, but not entirely. Oil companies have often been accused of gouging, even when their profits are below average. In contrast, popular forms of entertainment (for example, Disney World, state lotteries) are very profitable and expensive, yet their pricing escapes widespread criticism. Recent research seems to indicate that perceptions of fairness are more subjective, and therefore more manageable, than one might otherwise have thought. Buyers apparently begin by making an inference about the seller’s likely margin relative to what they expect the seller earned in the past, or relative to what others earn in similar purchase contexts. The effect of margin on fairness is strongly mitigated, however, by another factor: the inferred motive of the seller. Explaining the action with a “good” motive makes the price more acceptable than a “bad” motive. Finally, the research indicates that companies with good reputations are much more likely to be given the benefit of the doubt that their pricing decisions have good underlying motives, while those with unpopular reputations are likely to find their motives suspect.

7. The Framing Effect

The preceding discussion about prices and price increases being more objectionable for “necessities” follows from a stream of research called *prospect theory*, which has many important implications for managing price sensitivity. The essential idea of prospect theory is that people “frame” purchase decisions in their minds as a bundle of gains and losses. Moreover, how they frame those decisions affects how attractive they perceive a choice to be. The *framing effect* states that buyers are more price sensitive when they perceive the price as a “loss” rather than as a forgone “gain,” and that they are more price sensitive when the price is paid separately rather than as part of a bundle.

Many marketing implications of prospect theory have been suggested that seem consistent with both common observation and controlled research:

- To make prices less objectionable, make them opportunity costs (gains forgone) rather than out-of-pocket costs. Banks often waive fees for checking accounts in return for maintaining a minimum balance. Even when the interest forgone on the funds in the account exceeds the charge for checking, most people choose the minimum balance option.
- When your product is priced differently to different customers and at different times, set the list price at the highest level and give most people discounts. This type of pricing is so common that we take it for granted. Colleges, for example, charge only a small portion of customers the list price and give everyone else discounts (a.k.a. scholarships). To those who pay at or near the full price, the failure to receive more of a discount (a gain forgone) is much less objectionable than if they were asked to pay a premium because they are not star students, athletes, or good negotiators.
- Unbundle gains, bundle losses. Many companies sell offerings that consist of many individual products and services. For example, a printing company not only prints brochures but helps design the job, matches colors, schedules the job to meet the buyer's time requirements, etc. To maximize the perceived value, the seller should identify each of these as a separate product and identify the value of each one separately (unbundle the gains). However, rather than asking the buyer to make individual expenditure decisions, the seller should identify the customer's needs and offer a package price to meet them (bundle the loss). If the buyer objects to the price, the seller can take away a service, which will then make the service feel like a stand-alone "loss" that will be hard to give up.

Anyone who thinks only in terms of objective economic values will consider these principles far-fetched. One might argue that buyers in these cases could easily think of the same choices as entirely different combinations of "gains" and "losses". That is precisely the point that prospect theorists make. There are many different ways to frame the same transactions, and each way implies somewhat different behavior. Researchers have presented research subjects with many objectively identical choices, changing only the framing of the presentation. They have found that changing how people think about the choice in terms of "gains" and "losses" consistently and predictably changes the choices they make.

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