

Economic theory essay examples

[Business](#), [Customers](#)



Introduction

Airline companies charge different prices for different classes of passengers. A passenger who wishes to have higher quality services during the flight must pay a higher price for their tickets than those who travel in a different class. The airlines differentiate the prices of customers by having different features in the categories. However, there are other instances when the customers' ability to travel in the business class is limited by their level of income. Pricing is one of the strategies used in maximizing revenues for the airline companies. The companies, therefore, must take into account the factors that affect demand for the airline such as price, quality of services and the level of income. The major factors that affect the demand for the tickets are the price, time, and income elasticity. The airlines, therefore, must do thorough research on the factors that affect the responsiveness of demand in relation to the demand for the tickets.

Determination of Prices

The process of price setting, updating and evaluation differs from one industry to another. A significant element in airline pricing is the extent to which the demand changes in response to change in prices. The airlines use two types of classes; that is, business class and leisure class. Passengers who choose to use business class have to pay higher tickets for the additional services they get. Airlines aim at getting the largest market share in the market thus they have to set competitive prices. Charging very high prices above the competitors drives away customers who prefer paying less for a commodity since an increase in price decreases the demanded

quantity. Further the departure and frequency of flights, quality of services offered and price levels relative to other airlines. Passengers prefer a combination of product quality, flight schedules and prices that maximize their utility. For a product to be efficient in economic terms it must be able to make the consumer better off but this should not affect another consumer by making them worse off (Starkie 2008). The airline ticket is designed in a way that the consumers purchase the business or leisure tickets depending on their preferences.

Price Discrimination

There are instances where a commodity is sold at different prices to different customers. Price determination in air tickets depends on factors such as the class that the client prefers. Different customers in the flights have varying levels of willingness to pay thus it is possible to segment the prices. The prices are set according to observable characteristics such as income, thus the willingness to pay for the products. Prices are categorized into low and high elasticity submarkets and then each submarket is charged differently (Özer & Phillips 2012). In airline pricing, conditions are attached to different tickets thus giving the consumers the freedom to choose the class that best suits their taste and preferences. The consumers have to make sound decisions on the best air flight taking into consideration the quality of services offered, the price they pay for the tickets and the opportunity cost of using a different airline or a different class.

Airlines use the second-degree price differentiation mechanism. In this type of price discrimination, it is not possible for the sellers to differentiate between different types of customers. They achieve their pricing by

providing incentives and consequently the customers differentiate themselves in accordance with their preferences. By using non-linear pricing or discounts, the airlines can classify the customers according to classes. Each class is then assigned its price limit. By offering different seats for different classes, the airlines can capture more customer surplus.

Consumer Behavior

Understanding consumer behavior is very crucial in deciding the types of products to design and the prices to be charged. The general law of demand holds that when the prices of commodities increase the consumers purchase less quantity of a given commodity while other factors are held constant. The airlines must be very careful when coming up with the price levels for the tickets since if they increase the prices too high they may risk losing passengers to their competitors. The concept of utility is very important in studying consumer behavior. The demand of particular goods or service by the passengers is dependent on various factors such as their tastes, income level, quality, and price. Some passengers cannot afford to purchase business class tickets due to their low income levels. This increases the demand for leisure tickets by the consumers even though they may prefer the quality of services offered at the business class. The passengers who pay more for the tickets must feel that the foregone alternative was not better off (Casson 2003). A consumer's choice on the type of ticket to buy does not make the other consumers worse off. The marginal cost that the consumer incurs in purchasing the ticket must be equal to their ability to pay for a particular product. Marginal willingness to pay implies that the consumers willing to pay for an incremental unit of the good, in this case increased

satisfaction from the quality of services provided in the two classes. The close substitutes in air travel decreases as the distance increases thus passengers traveling for long distances will most probably prefer taking a flight to other means of transport.

Consumer Utility

The concept of utility is very vital in the choice of the type of classes the passengers are willing to pay. Total utility refers to the satisfaction that a consumer derives from consumption of a product. However, utility varies from one person to another depending on their tastes and preferences, time and place. In air travel, a passenger may prefer to use business class over leisure class due to the utility they derive from the additional services they get in the business class which they would not get if they decided to purchase leisure class ticket. Other passengers may prefer the leisure class in circumstances where they do not need to get to their destinations sooner (Besanko and Gibbs 2011).

The passengers' choice of the type of tickets to buy depends on their preferences. In economic theory, consumers' decision to purchase a product is determined by the expected level of utility. The idea of marginal utility and marginal cost is very significant in explaining consumer behavior. A consumer attains marginal utility from the additional satisfaction they get from consuming an additional unit of a given commodity. The passenger's decision to purchase a business class ticket is mainly driven by the guarantee that they will get additional comfort as compared to the leisure class. A consumer's demand curve is equal to their marginal value curve.

Marginal value can be defined as the additional worth of a good that one enjoys in terms of other goods.

Price Elasticity of Demand

Price elasticity of demand is one factor that the airlines use in determining the different prices to use for different class of passengers to maximize profits. They have to consider the percentage change in the demand for the tickets as a result of a percentage increase in the prices. The price elasticity of leisure and business classes of passengers in airline travel is different. The elasticity of price in business air travel is inelastic, implying that the volume of air tickets demanded does not change with an increase or decrease in price. The airlines are thus able to charge their clients differently since the change in prices does not affect the demand of their services (Belobaba et. al. 2009). The low sensitivity of airline demand to price change enables the airlines to maximize their revenue by increasing prices.

Time Elasticity of Demand

Time elasticity of demand also plays an important part in the determination in the sense that the percentage change in time taken for a trip affects the demand for the airline tickets. The demand for business air travel is usually more time elastic implying that more business class passengers will be willing to pay higher to have total trip time reduced. The demand elasticity for the leisure class, on the other hand, is inelastic because the passengers do not mind having longer total trip times. Time elasticity of demand concept is used in decisions on airline scheduling. This is because the leisure passengers respond less to the time elasticity as compared to the response

of business class passengers. The increase in frequency of departure is important for airlines in trying to reduce the schedule displacement time and in determining the total travel time for business class in the short-run. The different flight schedules require that the consumers choose to travel in higher priced options with high quality of service and fewer restrictions or lower priced class with many restrictions and poorer quality of services.

Income Elasticity of Demand

A comprehensive analysis of income elasticity of demand would enable the airline companies to make accurate adjustments on their price in relation to an increase in the income of the passengers. The services offered by the different classes of airlines are considered to be inferior goods since they are not affected by the change in consumer income. When the level of income rises, passengers who previously used other means of transport for shorter distance switch to the air transport. On the other hand, when the amount of passenger incomes fall, the airlines are still able to make profits since the demand for leisure class tickets increase (Boyd 2007).

Airline companies need to monitor the prices of their competitors and the income levels for the different classes and also they should consider the quality of services the competitors offer. Further, it is crucial to consider the economic situation in a given country in their pricing strategies.

Conclusion

The cost of purchasing a particular ticket for airline passengers is dependent on a number of factors including their financial capability, their preferences and the elasticity of demand. The airline companies must consider a number

of factors in their pricing strategies such as the consumer behavior and the utility that the different classes of consumers derive from their products and services. The passengers should feel that the cost of the foregone alternative is less than the benefit they get from the services of the airline.

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