

Main factors that determine business pricing decisions



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“ Anyone who has bought or sold something knows that in reality prices are set by buyers and sellers and that it costs time and money to calculate the right price of any product, or to work out how prices should respond to a change in the market” (Hall et al. 1997, p. 7). Price-setting decisions may seem rather simple for small bargaining transactions involving two or few parties. However, a number of influencing factors can lead to the determination of any price. These factors become more relevant and perhaps more easily observable on a larger, business scale, where there are significantly more parties involved and usually more products to price.. The aim of this essay is to discuss the main factors which determine pricing decisions in businesses, and to assess the relative importance of these factors.

Firstly, it is useful to outline why price setting is important. There are several different reasons. On the macroeconomic scope, price setting is important because it determines the effects of monetary policy decisions (regarding money, inflation and interest rates) on the economy (Hall et al. 1997). This is because of price rigidities (or ‘ sticky’ prices), which arise as a result of some of the factors determining business pricing decisions which will be discussed. With price rigidities, monetary policy has real effects on the macroeconomy, at least in the short- to medium-term. Also, nominal changes in prices can have effects on real output and employment in the short-term (Hall et al. 1997). On the microeconomic scope, price setting behaviour is of critical importance for businesses to meet their objectives. These objectives can vary depending on the individual firm’s strategy, but tend towards long-run profit maximisation - therefore business pricing decisions are also important

for businesses to maximise profits. And changes in prices affect profitability by a greater proportion than any other variable which a firm can change directly (BusinessWeek 2006).

So how do firms actually decide what prices to charge for their products? This will largely depend on the market structure where the firm is operating. Perfect competition is a theoretical market structure in which there is a very large number of buyers and sellers, who produce a homogeneous product and count with perfect information and perfect factor mobility. Given these circumstances, each individual firm acts as a price-taker, with no price-setting power. Therefore, under perfect competition, business pricing decisions do not exist, and prices are set by the industry forces of supply and demand. The nearest real examples of perfect competition industries are certain agricultural industries, where producers, or farmers, have no say over the price of their product. Moving towards imperfect market structures, monopolistic competition is a structure in which there is also a large number of buyers and sellers, but they produce a differentiated product and do not count with perfect information or perfect factor mobility. Further down the imperfect competition road is oligopoly, an industry structure characterised by a small number of sellers and high market concentration (or high market power). Finally there is monopoly, a structure with one seller and multiple buyers, so that the individual producer dominates the market entirely and is the sole price-setter. Economic theory explains that a monopolist produce a quantity where marginal revenue, MR, equals marginal cost, MC (the profit-maximising condition), and will charge a price where the demand curve meets this quantity, as illustrated below:

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Figure 1 – Monopoly price-setting:

Monopolistic competition and oligopoly price setting are generally predicted to fall somewhere between the perfect competition and the monopoly outcomes. That is, firms in monopolistic competition and oligopoly have some, but not absolute, price-setting power. There will be factors affecting pricing decisions which are outside the firm's control, at least at the time of setting or changing prices. Then there will be certain internal factors such as the firm's cost structure, and there will be the firm's pricing strategy, which is largely a way of responding to the previously mentioned factors. First let us look at the firm's external factors. This includes, of course, the market structure in which the firm operates, and there can be important differences even within the same theoretical structure. For example, some oligopolies can behave as a monopoly while others can have the same outcome as perfect competition. Focusing on imperfect competition, a main external factor affecting business pricing decisions is, broadly, the competition. This can be divided into several important factors: the availability of substitutes and level of product differentiation, cross-price elasticity of demand, market shares, and of course the rivals' prices. The availability of substitutes is important because a high availability means that if a firm increases its prices, its customers can more easily switch to a rival product. This is partly determined by the level of product differentiation and is captured by the cross-price elasticity of demand. Rivals' prices need to be considered, as customers will make price comparisons in the market. High product differentiation gives firms more power to charge price mark-ups above the cost of production, thereby making a supernormal profit (Tucker 2008).

Another external factor is the regulatory framework and any possible government interventions in the price-setting behaviour, such as price ceilings and subsidies. These are artificially imposed factors and, where present, can be of high relative importance because they offer direct incentives or barriers for a firm to undertake certain pricing decisions. For instance, a subsidy may allow a firm to charge lower prices where it would be otherwise impossible without incurring a loss. An example is the widespread production of biofuel from corn in the US (FT 2007). And a price ceiling makes it impossible for a firm to charge a price above a certain government-imposed level. Typically, price-ceilings have been imposed on basic necessity products and especially those where the seller would otherwise have a high share of bargaining power – such as residential rent.

Moreover, characteristics related to the customer-base of the business are an important external factor. The income level of customers will partly determine the demand curve faced by the producer, which is central to determining prices and is thus of high importance relative to several other factors. Certain psychological features are also taken into account, such as customers' perceptions of prices. For example, many firms may charge a price of £9.99 rather than £10.00, because, although the real difference is minimal, customers may perceive a large difference between one integer and the next (Tutor2u 2010). However, since this type of factor only determines such a minimal difference in actual prices, it is of very low importance relative to other factors.

The main internal factor affecting business pricing decisions is the firm's cost structure. Given the profit motive, the firm will seek to exceed its costs to <https://assignbuster.com/main-factors-that-determine-business-pricing-decisions/>

make a profit, and pricing is central to achieving this goal. In the long-run, firms are expected to produce on the profit-maximising condition where $MC=MR$, so the shape of the marginal cost curve will be very important to the pricing decisions. If a firm is experiencing economies of scale, it may be able to benefit from lowering prices to attain a higher market share and exploit the average cost reductions. Hall et al. (1997) make a distinction between two important cost-related factors for business pricing decisions: direct cost plus variable mark-up and direct cost plus fixed mark-up. This simply refers to how some firms specify a fixed, or target, percentage mark-up over costs.

Overall, the study by Hall et al. (1997) finds, from a survey of 659 UK firms, that market conditions (an external factor) were the most important factor in price-setting behaviour, with 40 percent of firms setting prices at the “highest level that the market could bear” (p. 12). Within market conditions, the most important is how the own firm’s prices (or potential prices) compares to competitors’ prices. This was especially true for retailing and manufacturing companies and firms in more concentrated markets. Internal, or company-specific, factors, were also found to be highly important. 20 percent of respondents stated that prices were determined by direct costs plus a variable mark-up and 17 percent said they were determined with a fixed mark-up. In either case, cost is of course an essential factor for price-setting behaviour. The cost/mark-up rule applies more closely to small companies, presumably because they cannot afford such extensive market research to obtain information on external factors. Finally, external factors related to customers were the least important as reported by respondents.

Given these direct factors, a firm can make more or less use of each one and can determine its price differently as a response to these factors, depending on the firm's pricing strategy. One pricing strategy category is differential pricing, based on consumer heterogeneity in three areas: transaction costs (giving rise to discounts on second markets), demand which incentivises the use of periodic discounting, and search costs, which incentivise random discounting (Tellis 1986). In other words, the firm can use a strategy of price discrimination, which consists of charging different prices for the same product under different circumstances or to different customers.

Another type of price-setting strategy category is competitive pricing, which includes a number of pricing strategies aimed at improving a firm's competitive position. Penetration pricing is the strategy of charging below-market prices to attract a larger market share and thus exploit economies of scale. This is related to both cost and market factors. Predatory pricing is a strategy of charging low prices with the aim of establishing and/or maintaining barriers to entry and expansion, to then later on increase prices again. Geographic pricing, another form of competitive pricing, is a strategy between second market discounting and predatory pricing (Tellis 1986).

Furthermore, there is the category of product line pricing strategies, which are based on taking account of a set (or line) of products when making pricing decisions. One strategy is price bundling, where the firm faces heterogeneous demand for perishable products which are non-substitutes.

The firm may have an incentive to charge the highest price which some consumers are willing to pay for each product, which means overall the

product line will be more expensive. Firms may use a premium pricing
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strategy when they face heterogeneous demand for substitute products which have joint economies of scale. A common example is when a firm can produce a superior version of a product but still faces demand at a lower price for the inferior version. The firm would charge a premium on its superior version, even if the costs of production are the same, in order to “subsidise” the lower-priced sales of the inferior version. This strategy may often mean that “relative to its costs, the firm takes a premium on its higher priced version and a loss on its lower priced version” (Tellis 1986, p. 155). Other product line pricing strategies include image pricing, where the firm launches an identical product under a different name and at a higher price to signal quality, and complementary pricing.

The existence of different pricing policies or strategies suggests that business pricing decisions can be affected more or less heavily by the different influencing factors discussed. These include external factors, such as market structure and consumer willingness to pay, and internal or firm-specific factors, such as the firm’s cost structure and the pricing strategy. The different types of pricing strategy show how different firms may respond in different ways to the same factors. This means it is difficult to objectively assess the relative importance of each factor as it may differ from firm to firm. However, there is empirical evidence to support that the most important factor are the market conditions in which the firm operates, an external factor, followed by the firm’s cost plus mark-up structure, an internal factor. Other factors, such as customer willingness to pay and regulatory structure are also considered, but on average are not as important to firms in their pricing decisions. Still, it is worth considering that

certain extreme regulatory structures such as price ceilings and heavy subsidies (or taxes) would be very important factors, either directly or indirectly through influence over the firm's cost structure and/or market structure.