Hetesi, E. – Kürtösi, Zs. (eds) 2011: The diversity of research at the Szeged Institute of Business Studies. JATEPress, Szeged, pp. 13–22.

The increasing importance of pricing

Gábor Rekettye

There are clear economic and managerial trends which have a great influence on the pricing policy of companies in the emerging millennium. Variances can be found in the upper limit and lower limit of possible pricing decisions which move in opposite directions, giving a broader field for price considerations. Consideration should be taken with the possible distribution of this incremental value. In the latter part of this research paper, research gives insight on some new pricing techniques like: product line pricing, pricing of services, and the decreasing differences in international pricing. As a conclusion, it is recommended that company managers should dispense from using the old formula of "cost-plus-profit" pricing in favour of more profitable techniques.

Key words: price, pricing policy, customer value, costs, product line pricing, pricing of services, international pricing

1. Introduction

Prices play an important role in the functioning of market economies by providing a link between supply and demand of products and services (Emmond 1993). There is no doubt that pricing has also great importance in the operation of companies. Company revenue (and profit) is generated through prices, while all other functions produce costs (Kotler 1998). On the other hand, the price of a product is a major determinant of the buyers' purchasing decision. As a consequence, its level, compared to the products' performance and to the offering of competitors, influences the demand for and the sale of the given product or service. This contradicting feature is the reason why pricing may be one of the managers' biggest headaches (Dolan 1995). In spite of its high importance, pricing is surprisingly underrepresented in the management literature. Price theory is extensively discussed in the economic literature with lots of mathematics (Hirshleifer 1984, Wilson 1993, McEachern 1988, and others), which company managers mainly do not understand. Conversely, price application is usually only handled by one or two chapters of marketing text books typically only touching the surface of the subject. These may be part of the reasons why company managers' knowledge of pricing is rather low and prices have usually been set either by rule of thumb or by the old, and so many times criticized, formula of "cost-plus-mark-ups". The objective of this paper is to summarize those trends of the world economy and business life which create new price pressures. Understanding these tendencies and applying them in the pricing policy can strengthen companies' sustainable competitive advantage. Furthermore, ignoring these tendencies can result in a decrease of market shares and eventually force these companies to exit the market.

2. The broadening zone of pricing decisions

In the value structure of a product or service, three important parts can clearly be differentiated: (1) the total customer value, (2) the price the customers have to pay for it, and (3) the costs of its production (Shapiro 1998). According to this anatomy of value, the zone of possible pricing decisions is defined by the upper and lower limits i.e., the perceived customer value at the top end and the cost of manufacturing at the lower end of the scale. It is obvious that customers are not willing to pay more than the perceived value, and their willingness to buy grows parallel with the distance between the perceived value and perceived price. Conversely, manufacturing companies want to make profits, which are according to this scheme, the difference between the price and the total cost of manufacturing. Their endeavour is to maximize profit, i.e. to set price as far as possible from the total costs. The anatomy is not yet complete. By companies, it is meant those organizations that produce products or services. In most cases, these companies do not sell directly to their customers; intermediaries, traders, wholesalers, retailers and other members of the sales channels are included in the process. They also want to have their piece of the pie. For the sake of simplicity, analysis of the government is not included, who also mandates having a piece of pie by levying taxes and duties on products and companies.

2.1. The upper limit: the perceived customer value

A major tendency of current times is that in most cases the upper limit of pricing decisions by the perceived customer value is gradually and continuously moving upwards. Customer value is the complete set of benefits the product or service is offering to the customers. Customer value can be divided into four sub-components: (1) the performance value i.e., how the actual product is performing the core benefit it is used for. (2) The added value, which consists mainly of the augmentation of the core product, services and other additional benefits surrounding the product. (3) Distribution value, which is the measure of how easily customers can access the given product or service on the market, and (4) the emotional (image) value, which is created by branding and other forms of marketing communication.

Now, looking at the vast selection of products and services offered to market, it can be concluded that their value has significantly increased during the last decades. Technological development, new operational methods like flexible manufacturing, JIT, kanban system, lean production and other techniques have made it possible to increase the technical quality of products and, at the same time, they can combine mass production with customization (Krajewsky–Ritzman 1999). A good example is the car industry. If a car of the same category produced at the end of the century is compared with that same type car produced 20 years earlier, it can be observed that the newer one is offers a lot of new or upgraded features like: ABS, DSA, higher safety, lower gas-mileage, etc.

The same is true for the other sub-components of customer value: marketers always try to enhance their offering with additional services to gain momentum in the fierce competition (Levitt 1980). To stay in the car market, it is observed that car manufacturers are gradually prolonging the time of guaranty, and they are also offering upgraded after-sale services.

Distribution has changed a lot in the past decades. New forms of distribution have emerged offering to consumers either cheaper or more efficient access to the options. It is enough to refer to the mass-retailers, or to the newly opened distribution channel of the Internet.

Emotional value is also becoming more important. The increasing number of products, as well as the amount of information carried by each of them, can overload and confuse consumers, who protect themselves against it by relying more and more on the image value of the brands. Successful companies try to reduce the number of brands and focus their marketing efforts to create and enhance the image value of their offering. The notion of mass-production and mass-customization is also applicable to the market communication process.

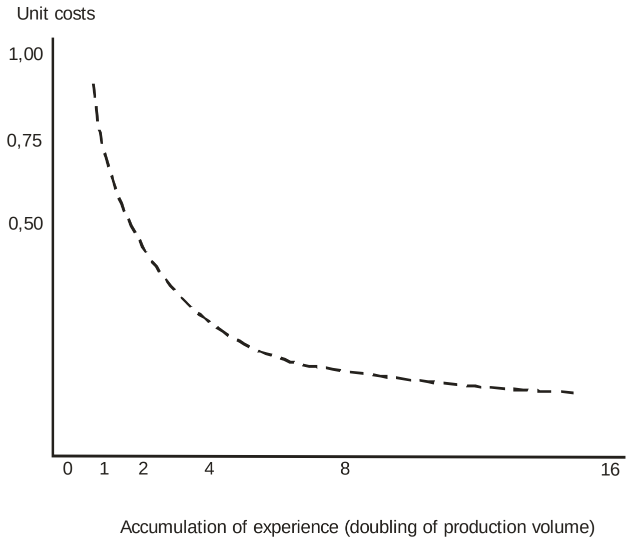
2.2. The lower limit: the changing cost structures

The prior paragraph clearly established that the upper limit of the zone of pricing decisions, i.e., the customer value has been moving upwards. In contrast, it is also determined that the lower limit, i.e., the costs of creating the customer value has moved in the opposite direction; it is going gradually and continuously downward. The reasons for this downward movement may be found: in the globalized competition, in the increasing efficiency of production, in the appearance of the cheap labour emerging countries, and in the falling raw material prices in the long run.

– As local competition is gradually transforming into global companies with entirely different cost structures, they meet each other face-to-face at the same marketplace. In this setting, customers obviously do not care about the individual cost structures. What they care about is the “best value for money”. They have developed a new buyer behaviour called “smart shoppers”. In the face-to-face competition of different cost structures, the winners are those who can reduce their unit costs and those who cannot, are forced to get out of the market.
– In this New World Order, a drastic improvement is witnessed in cost efficiency during production. This is especially true in the technology-

intensive sectors of the economy. As a result of economies of scale, the learning curve, and the experience curve to the unit cost of the products is decreasing. The effects of the experience curve are shown in Figure 1.

Figure 1. The effects of the experience curve



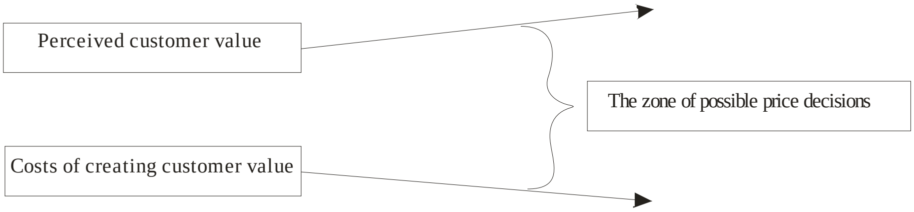
Source: own construction

– This tendency is strengthened by the fact that the prices of raw materials have shown a decreasing trend in the long run. (The price index of the basic raw materials – registered by the Economist – in 1990s was at 30 % level that of the starting base of 1840–1850.)

To prove the tendency of the declining prices, three comparable items were selected from the Hungarian price statistics: a color TV, an automatic washing machine, and synthetic washing powder. The retail prices of these items in 1998 were, calculated in real terms, compared to the prices of 1990, at 32.5 %, 52.9 % and at 77.4 % (Rekettye 1999, p. 94.).

By summarizing findings, it can be stated that the gap between costs and perceived value is gradually and continuously enlarging as shown in Figure 2.

Figure 2. The zone of possible price decisions



Source: Rekettye (1999, p. 89.)

2.3. Who are the beneficiaries of the broadening zone?

Theoretically, three parties can benefit from the broadening gap between the levels of customer value and costs: customers, trading companies and producing companies. The problem of actual distribution of this incremental value may be framed as a societal and a managerial question as well. In developed societies having good working market competition and well-articulated customer protection and customer movements, there is no doubt that final customers may be major beneficiaries. In a healthy economy, however, it will leave room also for companies to benefit from this improvement. Problems may arise in case if market structure is not well balanced, having one or the other parties a dominant power in the market. Monopolies or cooperating oligopolies may hurt the even distribution of this incremental value.

In transition economies like Hungary, two tendencies hurt the even (fair) distribution:

- Multinational manufacturers, entering these economies with FDI benefiting from the relative low-cost production resources, sometimes do not share the additional value with their partners.
- Multinational wholesalers and retailers (mass retailers) also moved in. On first observation, they offer a cheaper and more efficient channel for customers. Experiences of Western European countries (United Kingdom, first of all) warn, however, that after settling down, they will soon gain a dominant market share. After demolishing small competitors, they will be price leaders (forcing their business policies and trading conditions on manufacturers and consumers, as well) and will have an unbalanced bigger share from the broadening gap.

3. Some other tendencies and challenges of pricing policy in the New Millennium

In the latter part of this paper, attention is drawn to some important tendencies which impose challenges to company pricing policy. These are:

- Proliferation of product structures → importance of product line concept → importance of product line pricing
- Services → the new age of pricing
- Globalization → decreasing differences in international pricing.

Proliferation of product structure → the importance of product line concept → complicated price structures

Companies seldom produce or offer only one or a couple of products. Only small and some medium-sized companies can be listed as examples for such limited product mix. The product mix of the majority of organizations, especially medium and larger sized companies, consists of a larger number of products and/or services, which have either stronger or looser connection to each other. In the overall tendency of product structure proliferation, two major tendencies seem to emerge:

1) The emergence of a clear product line concept. Companies categorize their products into product lines. They develop special core competencies for each product lines. The same or similar engineering, production and marketing principles characterize the product line competence. In this new concept, the product lines, rather than the individual products, differentiate companies from competitors. The products belonging to the same line have similar design, features, etc. that add up to a distinguished, and differentiating line identity. Product lines are becoming more and more the centre of product development, and product management as well.
2) After the wave of diversification in the sixties and seventies, when huge company-empires with much diversified profiles were established, the end of the twentieth century is characterized by the endeavour to create company profiles based on consistency. The consistent company profile has favourable, synergy effects on the efficiency of product design, product development, manufacturing and marketing. Furthermore, a strong and clear corporate identity can be based on the consistency of similar product lines.

All of these tendencies impose strong requirement towards the price policy. The unique corporate identity and product line image must be reflected in their price structure as well. Special emphasis must be laid on the harmony of the quality and price level of product lines. Determining the differences between product lines, between items, and options within the product line, their expression in the pricing requires a very sophisticated price management. New methods are used: price segmentation, price discrimination, determination of price thresholds, price-differential threshold, and price-bundling, different pricing methods for competitive, complementary, and substitute items of the product lines, etc. Modern computing technology helps a lot in supporting the price-decisions, and in maintaining and controlling the price application. This sophisticated price management would not be possible without the use of IT.

3.1. Services → the new age of pricing

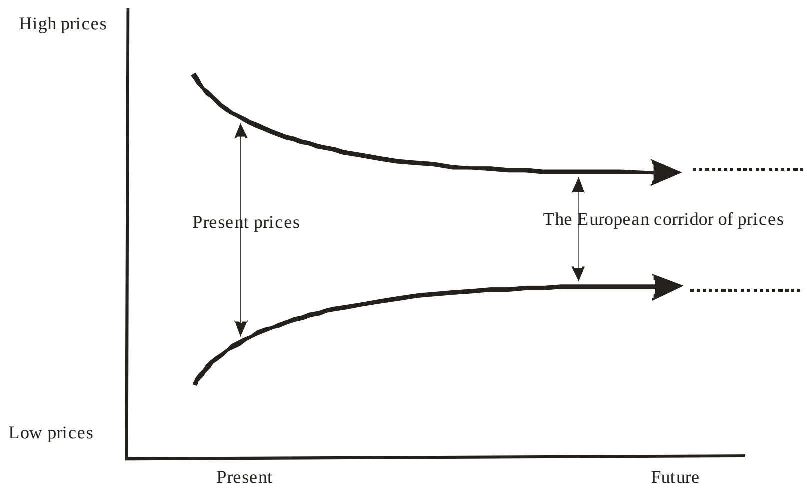
The contribution of services to GDP in most advanced countries exceeds the share of primary and processing industries. It has been so for many years. At the end of the twentieth century, nevertheless, there are some new tendencies that revolutionize the service sector and at the same time they influence all the economic activity including pricing:

- At the end of the twentieth century, a strong deregulation of major services was witnessed in almost all countries (banking, air industry, public utilities). Deregulation has been accompanied by privatization of these state-owned services. (Silverman 1994) Privatization and deregulation has brought about local, and soon after, international competition in the field of these formal monopolies. Prices have become the focus of the new competitions. Service providers soon realized that cost efficiency and market expansion are vital factors in acquiring sustainable competitive advantage. To maintain or expand market share, they needed to make market (and price) segmentation and needed to adjust their price policy accordingly. They invented new methods of price differentiation like nonlinear pricing, price bundling, one or two-tier block tariffs, bonus programs, yield management, etc. They were able to serve customers of different price sensitivity.
- At the end of the century, there was a definite shift from variable to fixed costs. Traditionally services, like hotel businesses, passenger transport, etc., have always been fix cost sensitive. The newly emerging and dominating sectors like telecommunication and other information-related services, however, are characterized by huge fix cost investments and by marginal costs sometimes nearing to zero. This radical shift in the cost structure makes it possible for the service providers to implement a very sophisticated and complicated price-customization. It is enough to refer to the price structure of a telephone company. It is already so complicated that most customers do not even have the time and energy to understand it.
- The new pricing practice of these modern services has a visible influence on pricing of tangible products as well (non-linear pricing, different discounts, bundling, etc.).

3.2. Globalization → decreasing differences in international pricing

Another major tendency of our times is the decrease of price level difference in international perspective. This is also a result of the intensified globalization. The world is getting “smaller” or as Ohmae (1991) said, it is getting “borderless”. Transportation costs are falling, tariff levels are decreasing, and information is available instantly all over the world. The tendency is especially true for an economic integration. European Union is a good example. There are no tariffs in the way of trade among member countries, tax levels are getting similar, and the monetary unit is getting the same. There is no economic rationale behind big price differences. Locally produced and culturally motivated products and services may make the exception. The tendency is well illustrated in Figure 3 (Simon–Wiese 1992). The decreasing price difference does not mean that company managers have to carry out the same price policy everywhere. Managers that use international pricing strategies must have a comprehensive understanding of the differences between customers from one country to another. This includes the culture, the legal regulations, and the structure of the economy, the competitive environment, the political structure, and the inflation/deflation trends in each market.

Figure 3. The decreasing difference in international price levels



Source: Simon–Wiese (1992)

4. Conclusions

The tendencies described suggest that companies must depart from the cost-oriented pricing approach that has been used in the twentieth century in many industries. The cost-oriented pricing has been popular for the following reasons: (1) the "cost-plus-mark-up" pricing was rather simple. It involved the calculation of all the costs that could be attributed to a product, and then adding to this figure a desirable mark-up, as determined by the management (Hanna–Dodge 1995). (2) Because of its simplicity, the price function could be easily delegated to lower levels of company organization. (3) Beside its simplicity, this method has been socially considered as a fair practice since price differences have been justified by the cost differences. In the new pricing environment, these reasons will lose their importance as it was discussed in this paper. Companies insisting to the old formula "cost-plus-profit" under these new conditions may make wrong pricing decisions. In the new millennium, it is an imperative for them to change thinking from the cost-oriented formula of "Costs > Profit > Price > Value > Customers" to the market-driven formula of "Customers > Value > Price > Costs > Profit".

References

Dolan, R. J. 1995: How Do You Know When the Price is Right? *Harvard Business Review*, Sept–Oct., pp. 4–11.

Emmond, W. 1993: *Note on Pricing and Public Policy, Order*. Harvard Business School, pp. 1–15.

Hanna, N. – Dodge, R. 1995: *Pricing - Policies and Procedures.* Macmillan Business.

Hirschleifer, J. 1984: *Price Theory and Application.* Prentice-Hall, Inc., Englewood Cliffs, New York.

Kotler, Ph. 1998: *Marketing Management*, Ninth Edition, Prentice-Hall, Inc., Englewood Cliffs, New York.

Krajevsky, L. J. – Ritzman, L. P. 1999: *Operations Management.* Fifth edition, Reading, MA., Addison-Wesley.

Levitt, Th., 1980: Marketing success through differentiation - of anything. *Harvard Business Review*, January–February, pp. 83–92.

McEachern, W. A. 1988: *Economics.* South-Western Publishing Co., Cincinatti, Ohio.

Ohmae, K. 1991: *The Borderless World*. New York, Harper Periennial.

Rekettye, G. 1999: *Az ár a marketingben. (Pricing in Marketing).* Műszaki Könyvkiadó, Budapest.

Shapiro, B. P. 1998: *Precision Pricing for Profit in the New World Order*. Harvard Business School, pp. 1–23.

Silverman, K. P. 1994: Electric power - the next generation. *The McKinsey Quarterly*, No. 3., pp. 57–61.

Simon, H. – Wiese, C. 1992: “Europäische Preismanagement. *Marketing*, 14. Jahrgang, No. 4., pp. 246–257.

Wilson, R. B. 1993: Nonlinear Pricing. *Oxford University Press.*