

# Determinants of Price

## The Demand Determinant of Price

After marketing managers set pricing goals, specific pricing should be set to reach these goals. The price they set for each product depends largely on two factors: the demand for the product or service and the cost to the seller for that product or service. When pricing targets are primarily sales-oriented, demand considerations generally dominate. Other factors, such as distribution and promotion strategies, perceived quality, demand from large customers, the Internet and the product lifecycle stage, can also influence price.

## The Nature of Demand

Demand is the amount of a product that will be sold on the market at various prices during a specific period. The amount of a product that people will buy depends on its price. The higher the price, the fewer products or services consumers will request. Conversely, the lower the price, the more products or services they will request.

One reason it sells more at lower than high prices is that lower ones attract new buyers. This fact may not be as obvious with fruit smoothies, but consider the example of a steak. As the price of this decreases more and more, some people who haven't been eating steak may start buying it instead of a burger. With each price reduction, existing customers can also purchase additional quantities.

Similarly, if the price of smoothies drops enough, some people will buy more than they have bought in the past.

# Determinants of Price

The offer is the quantity of a product that will be offered to the market by a supplier or several suppliers at different prices for a specific period.

At higher prices, smoothie makers will get more resources (apples, peaches, strawberries) and make more smoothies. If the price consumers are willing to pay for smoothies increases, producers can afford to buy more ingredients.

Production tends to increase at higher prices because a smoothie shop can sell more of them and get higher profits.

## How Demand and Supply Establish Prices

Let's combine demand and supply concepts to see how prices are determined in competitive markets. So far, the premise is that if the price is  $X$ , then consumers will buy the  $Y$  amount of smoothies. How high or low will prices really get? How many drinks will be produced? How many will be consumed? The demand curve cannot predict consumption, nor can it only forecast production. Instead, we need to look at what happens when supply and demand interact.

For example, at the price of \$3, the public would ask for only 35 shakes. However, suppliers are ready to place 140 shakes on the market at this price (bid and demand program data). If they do, they'd create a surplus of 105 smoothies. How does a marketer eliminate a surplus?

# Determinants of Price

## Reducing the Price

At the price of \$1.00, 120 shakes would be ordered, but only 25 would be placed on the market. A shortage of 95 units would be created. If a product's offering is limited and consumers ask for it, how do they induce the seller to dispose of a unit? They offer more money; i.e. they pay a higher price.

Now let's analyze at a price of \$1.50. At this price, 85 shakes are ordered. When demand and supply are equal, a state called "price balancing" is achieved. A temporary price below balance, say \$1, results in a shortage, because at that price the demand for fruit smoothies is greater than the supply available. Missing ones exert upward pressure on the price. However, as long as demand and supply remain the same, increases or temporary price decreases tend to return to a balance. In balance, there is no propensity for prices to rise or fall.

An equilibrium price may not be reached all at once. Prices can fluctuate during a trial and error period while the market for a product or service shifts toward balance. Sooner or later, however, supply and demand are set in the right balance.

## Elasticity of Demand

To appreciate demand analysis, you must understand the concept of elasticity. Demand elasticity refers to consumer responsiveness or sensitivity to price changes. Elastic demand occurs when consumers buy significantly more or less of a product when the price varies. Conversely, an inelastic demand means that an increase or decrease in price will not significantly affect product demand.

# Determinants of Price

Elasticity in the demand curve range can be measured using this formula:

$$E_p = \text{Var. \% Q} / \text{Var. \% P}$$

Elasticity (E)

Percentage change in the quantity requested from product A.

Percentage change in the price of product A.

If E is greater than 1, demand is elastic.

If E is less than 1, the demand is inelastic.

If E is equal to 1, the demand is unitary.

Unit elasticity means that an increase in sales significantly offsets a decrease in prices, so total revenue remains the same.

Elasticity can be measured by observing these changes in total revenue:

- If the price drops and revenues rise, demand is elastic.
- If both the price and revenue fall, demand is inelastic.
- If both the price and revenue rise, demand is inelastic.
- If the price rises and the income drops, demand is elastic.
- If the price increases or decreases and the revenue remains the same, the elasticity is unitary.

# Determinants of Price

## Inelastic Demand

For example, the initial decrease in the price of Spring Break tanning lotion, from \$5 to \$2.25, results in a decrease in the total income of \$969 (\$5 075 to \$4 106). When the price and total revenue decreases, demand is inelastic. The decrease in price is much greater than the increase in tanning lotion sales (810 bottles). Therefore, demand is not very flexible in the price range of \$5.00 to \$2.25.

When demand is inelastic, sellers can raise prices and increase total revenue. Often, items that are relatively inexpensive but convenient, tend to exhibit inelastic demand.

## Elastic Demand

In the example of the Spring Break tanning lotion when the price drops from \$2.25 to \$1.00, total revenue increases by \$679 (\$4 785 to \$4 106). An increase in total revenue when the price decreases, indicates that demand is elastic.

## Factors that Affect Elasticity

Several factors affect demand elasticity, including:

- **Availability of substitutes:** when many substitute products are available, the consumer can easily switch between products, making demand elastic. The same is true in reverse: a person with total kidney failure will pay for what they are charged for a kidney transplant because there is no replacement. It is interesting to note that the Bose stereo equipment is priced from 300% to

# Determinants of Price

500% higher than other brands. However, consumers are willing to pay the price because they perceive the equipment as far superior to other brands and that there is no acceptable substitute.

- **Price relative to purchasing power:** if a price is so low that it is an inconsequential part of an individual's budget, demand will be inelastic. For example, if the price of salt doubles, consumers will not stop adding salt to their food, because salt is cheap anyway.
- **Product durability:** consumers often have the option to repair durable products rather than replace them, extending their lifespan. If a person plans to buy a new car and prices suddenly start to rise, they could choose to fix the old car and drive it for another year. In other words, people are sensitive to rising prices and, in this case, demand is elastic.
- **Other uses of a product:** the higher the number of different uses of a product, the more elastic the demand tends to be. If a product has only one application, as it may be in the case of a new drug, the quantity purchased may not change when the price varies. A person will consume only the prescribed amount, regardless of the price. Conversely, a product like steel has greater applications. As the price decreases, steel becomes more economically feasible in a wider variety of uses, making demand relatively elastic.
- **Rate of inflation:** recent research has revealed that when a country's inflation rate (the rate at which the price level rises) is high, demand becomes more elastic. In other words, increasing price levels makes consumers more price-sensitive. The research also found that during inflationary periods, consumers base their choice at the right time (when to buy) and their decisions about the amount in price promotions. This suggests that a brand gains additional sales or market share if the

# Determinants of Price

product is effectively promoted, or if the marketing manager keeps the brand's price increases below the inflation rate.

Examples of elastic and inelastic demand abound in daily life. Recently, fans opposed to high prices for concerts. The promoters lost money and some shows, including some of many famous artists like Christina Aguilera and Marc Anthony, which were canceled. This is the price elasticity in action. On the other hand, the demand for some tickets was very inelastic. Rolling Stones concert tickets have sold out with prices of up to \$400 per ticket.

## Pricing power

For many companies, most of the pricing power faded long ago. The lack of pricing power means that when a company tries to increase its prices, it loses purchase volume while customers switch to low-cost competitors or find a substitute product. Finally, many of these companies have had to reduce their prices again (sometimes to do so even more than they were before trying to raise prices) in an attempt to recoup lost participation.

## REFERENCE:

Lamb, C., Hair, J. and McDaniel, C. (2011). Marketing. Ohio: Cengage Learning.