

Pricing Decisions, Policies and Practices

13.1 INTRODUCTION

Price-fixation is an important managerial function in all business enterprises. If the price set is quite high, the seller may not find enough number of consumers to buy his product. If the price fixed is too low, the seller may not be able to cover his cost. Thus, **fixing appropriate price is a major decision-making function of any enterprise. Price- decisions, no doubt, need to be reviewed from time to time.**

As per the traditional Economic Theory price is determined by the interaction of demand and supply. Thus, the buyers and sellers determine the price. However, in practice some other parties and several other factors are involved in fixation of the price. The two main parties are the Competitors and the Government. Competitors are in the form of potential rivals who manufacture and sell related products; these may be in the form of close substitutes. In such cases the price fixed by one producer may influence the price fixation policy of the other. The Government influences prices through the imposition of taxes or providing subsidies and also through measures of direct controls.

Determinants of price of a commodity:

1. Cost of production
2. The demand for the product
3. Its elasticity of demand
4. The objective or the goal of the producer
5. The nature of competition in market (market structure) and
6. Government policy pertaining to the product.

Pricing under different objectives

Pursuit of different objectives will lead to different pricing decisions. Traditional Economic Theory assumes that a firm sets the price and quantity of its product so as to maximize its current profit. **Baumol** argued that the objective of the firm is to maximize sales in money terms subject to a profit constraint. The objective of some other firms is to provide useful service to the customers by charging reasonable price. Some firms would like to take care of the goodwill of the company and hence will charge fair price etc.

Pricing under different market structures

A firm operates in a market and not in isolation. We have earlier elaborately discussed the Theory of Price Mechanism and Price Determination under different market categories. Under **Perfect Competition** price is determined by the forces of demand and supply. The point of intersection between demand and supply curves is the point of equilibrium which determines the equilibrium price. Each firm under perfect competition is a price taker and not a price maker. The Average Revenue Curve of a firm under perfect competition is horizontal and that **AR = MR**. Further there is always a tendency towards the prevalence of only one price under Perfect Competition; the respective changes in the forces of demand and supply alone influence the price.

In case of **Monopoly** the situation is slightly different. A monopolist can be a price maker. He can fix the price of his product, initially through a process of trial and error, by balancing losses and gains. He is in equilibrium at a point where **MR = MC** and corresponding point on the Average Revenue Curve determines the price that he would charge so as to earn maximum profit. As there are barriers to entry and no close substitutes, the monopolist will charge a high price and subsequently enjoy monopoly profits.

The monopolist may also practice **price-discrimination** i.e. he may charge different prices to different buyers and in different regions for the same product depending upon the elasticity of demand for the product. In case of dumping also different prices will be charged for the same product. In fact selling his product in foreign market at a price lower than his own market is itself referred to as Dumping.

In case of, **Monopolistic Competition** each producer is a monopolist of his product and a group of producers producing same, though not identical product compete with each other in the market. They differentiate their product and instead of having a price war with each other they practice product-differentiation. However, the prices charged are quite competitive in nature.

Under **Oligopoly** there are few sellers competing in the market. They may be rivals or may form collusion. The price policy of one producer is affected by the price policy of the others. Each producer before he fixes the prices of his product tries to understand the price behavior of other producer in the

market. For instance producer A thinks that if he lowers the price of his product and others don't then, he will be able to capture wider market, But it may so happen that if he lowers the price of his product and others also lower their prices then he will not be able to get more buyers and therefore all the producers may subsequently suffer. On the other hand, he may feel that if he raises the price of his product and others also raise their prices he may not loose out on many customers but it may so happen that when he raises his price and others don't raise their prices, then demand for his product will go down. Therefore under Oligopoly there prevails the phenomenon of price rigidity. They may prefer to resort to non-price competition leaving each other to follow their own policies.

13.2 PRICING METHODS IN PRACTICE

1. FULL COST PRICING

This method is also known as **Cost Plus Pricing**. In this method the producer calculates per unit cost of production and adds a margin of profit to it, which he considers fair and thereby arrives at a price which is acceptable to the consumer. In fixing the price, the firm calculates the average variable cost, adds to it the average fixed cost and to that adds the amount of fair profit. Fair profit is normally taken as 10% to 15% of the cost.

Price = Average Variable Cost + Net Profit Margin + Average Fixed Cost

The rationale of Full Cost Pricing lies in its simplicity and apparent fairness. It appears reasonable that price based on cost is a just price.

Limitations of the Full Cost Pricing

1. The main criticism against Full Cost Pricing is that it disregards demand, as also the purchasing power of the buyers.
2. One of the weaknesses of the full cost pricing is that it tends to diminish the interest of the sellers in cost control i.e. the seller will not make any effort to minimize cost because the price fixed will automatically cover the cost.
3. In such pricing, historical cost is considered. This leads to over-pricing under decreasing cost and under-pricing under increasing cost conditions.

4. Such type of pricing is difficult in case of wide fluctuations in variable cost.
5. It does not take account of the forces of competition.

In a dynamic market situation characterized by change and uncertainty, full cost pricing is not a sound policy. It may be a useful starting point provided the sellers are willing to deviate over a period of time.

2. MARGINAL COST PRICING

In case of Marginal Cost Pricing we have to consider the **incremental cost of production**. Fixed cost is not taken into consideration. Marginal cost is the additional cost for producing additional unit of output. In this method the price is related to marginal cost. The main difference between Full Cost Pricing and Marginal Cost Pricing is that in Marginal Cost Pricing the fixed cost component is not included. The Marginal Cost Pricing is useful in the short period whereas Full Cost Pricing is mainly for the long period. As long as the marginal cost is covered there is a sort of guarantee that the firm will not shut down.

Advantages:

1. It encourages aggressive price policy.
2. To keep the prices low the firm is encouraged to keep down the marginal cost.
3. Under Marginal Cost Pricing the competitive price is maintained.
4. It is useful for multi-product, multi-process and multi-market firm.
5. This method of pricing is useful for pricing over the lifecycle of the product.

The firm generally follows Marginal Cost Pricing when it enters into a new market, when the firm is having unutilized capacity and when there is high degree of competition in the market.

Limitations:

1. This policy is useful only in the short-period and does not provide a long-run stable price policy.

2. Under increasing cost conditions it may lead to higher price and under decreasing cost conditions it will lead to lower price.
3. It may lead to frequent price changes which are not liked by the consumers. The buyers prefer stable prices and not erratic price fluctuations.

It needs to be noted that the Marginal Cost Pricing provides the upper and lower limits of prices whereas Full Cost Pricing clings to the middle points. In fact while fixing the price both the theories should be taken into account as both the systems of pricing reinforce each other.

3. MULTI PRODUCT PRICING

Often we find that firms produce more than one product. Even the specialized firms produce different sizes, models and styles of the product. The products are so differentiated that the consumers look upon them to be separate products. The multiproduct firms may produce joint products. For example soap manufacturing company may be producing also glycerin, cosmetics etc. Some firms may produce related products such as a ready-made garment manufacturing company. Some firms may produce unrelated products. For example soaps, powder, steel cupboards, lockers, refrigerators etc. While determining prices such firms have to consider whether the products are complimentary or substitutes, whether production functions are fixed proportion or variable proportion and whether there exists unutilized capacity in the firm. In most of these cases the fixed costs can get distributed over the nature of the product.

Following factors may be considered while pricing in a multi-product firm:

1. If the products are totally independent pricing is like single product pricing.
2. If a firm is engaged in production of joint product the pricing principle should be that total cost must be covered by pricing of the main and the by-product taken together.
3. When a firm is producing substitutes the market gets separated on the basis of degree of elasticity of demand.
4. A multi-product firm is more like a discriminating monopolist fixing prices of different products on the basis of their respective elasticities of demand.

4. PRICING OF A NEW PRODUCT

The new product may be either an entirely new one or it is one of the varieties of the existing products. If there are many substitutes for the new product in the market then competitive price will be charged. If the product is entirely new then through the process of trial and error the price will be fixed not only to cover the cost of production but also to cover the cost of promotional strategy. Two types of pricing methods are adopted in pricing of a new product.

i) Skimming Price

ii) Penetration Price

i) **Skimming Price:** In case of Skimming Price the producer makes an effort to fix the price in such a way to skim away the consumers' surplus i.e. the firm learns about the maximum possible price which the consumer will be prepared to pay, rather than go without the commodity, and then quotes the price accordingly. This price may be much above the cost of production. The high price is accompanied by heavy sales promotion practices. Gradually the firm brings down this price. The time and size of the price reduction has to be proper. As long as the product is able to maintain its distinctiveness the firm continues with the Skimming Price policy. This policy is successful because in the initial stages when the new product is introduced in the market the demand for it is relatively inelastic and therefore the firm resorts to Skimming Price.

ii) **Penetration Price:** Penetration Price policy implies that the objective of the firm is to get into the market as early as possible even when there are other substitutes and therefore considerably low price is charged. When the product is able to acquire greater demand and capture bigger markets then the prices will be gradually raised.

5. PRICING OF EXPORTS

Pricing of export-oriented product is perhaps more complicated than pricing of the product which remains in the domestic market. When it comes to export many more considerations are involved besides merely the cost of transporting of the product. The producer has to consider the following aspects:

- i) The nature of demand for his product in the foreign market.
- ii) The degree of competition depending on the quality of the product.
- iii) The differences in the technology employed by producers in other countries thereby affecting costs.
- iv) The availability of substitutes.
- v) Governments' policy for promoting exports through providing subsidies, duties imposed by the foreign Government on inflow of our product, the commission by the middlemen and the brokers.
- vi) The regularity or irregularity regarding the demand.
- vii) The conditions for delivering of the goods in the foreign markets.

On the basis of these considerations, the following Export Pricing Strategies can be developed.

- i) Penetration pricing to capture the foreign market.
- ii) Skimming price for maximizing profit.
- iii) Dumping i.e. the price charged in foreign market is lower than the price at which product is sold in domestic market.
- iv) Competitive pricing.
- v) Standard world wide price for all the buyers in all the markets based on average cost of production.
- vi) Dual pricing based on cost plus or marginal cost method.
- vii) Escalation pricing i.e. export price is higher than the domestic price.
- viii) Follow the leader pricing i.e. the price fixed is the same as the price charged by the leading competitor in the foreign market.
- ix) Probe pricing is a policy of trial and error, balancing losses and gains in fixing the price. Initially some price is charged and then on getting the feedback the price gets adjusted.

13.3 A VARIETY OF APPROACHES IN SETTING PRICES:

A variety of approaches are employed by businessmen in setting prices. These approaches are not mutually exclusive but sometimes they complement or supplement one another.

1. **Intuitive Pricing:** It is a psychological method of pricing in which prices are based on the 'feel of the market'. The system is more subjective rather than objective in nature. Initially the price is estimated on the basis of cost plus method with flexible mark-up pricing. This method is fairly common.
2. **Experimental Pricing:** It is a trial and error method of pricing. This method is widely used in pricing of new products especially at retail level.
3. **Initiative Pricing:** In this method a firm decides to follow a price fixing policy of a price leader.
4. **Backward Cost Pricing:** Certain industries target price as the starting point for strategic calculations. The selling price is determined first and by working backwards the firm arrives at a product design.
5. **Odd Number and Critical Number Pricing:** Many firms believe that consumers have strong price sensitivity at certain critical points. This is particularly noticeable in the retail trade. It is very commonly believed that odd numbers are more attractive to the buyers than the even numbers. The problem of the management is to determine that number which has the greatest appeal.
6. **Double Pricing:** Double pricing is a technique in which two prices are shown on the price tag or on the pack of the article. The original price is usually crossed out and substituted by a new price at a lower level.
7. **Prestige Pricing:** Buyers are often price-conscious. There is some sort of price illusion. The buyers often feel that higher the price, the more prestigious is the product and therefore greater the demand for it. Some type of social scaling exerts a powerful influence on the pricing behavior.
8. **Multiple Pricing/ Collective Pricing:** Retail prices are usually expressed in terms of one unit. Experience often reveals that sales can be increased if more units are offered for a price. This technique of pricing is known as Multiple Pricing. The Multiple Pricing must offer small saving to the consumer.

9. **Peak-Load Pricing:** Pricing done on the basis of the peak period demand and off peak period demand is called Peak-Load Pricing. Higher prices are charged in the peak period and lower prices are charged in the off-peak period.

From the above discussion we observe that various pricing methods and pricing approaches prevail in domestic and export market. The choice of pricing method eventually depends on the objectives of the firm.

13.4 ADMINISTERED PRICES AND PRICE CONTROL

The concept of Administered Price was first introduced by Keynes for the prices charged by a monopolist. A monopolist can be a price maker and he consciously administered the price of his product irrespective of the cost of production. Competitive prices are determined by the interplay of forces of demand and supply in the market whereas administered prices according to Keynes were associated with monopolists' decision regarding price fixation irrespective of the market forces of demand and supply.

However, in India the meaning of Administered Price has been quite different. **In India, Administered Prices refer to prices which are fixed and enforced by the Government.** They acquire a statutory nature. They are the outcome of the price policy of the Government. The Government interferes in the price mechanism and fixes minimum and maximum prices of various commodities in the agricultural and non- agricultural sectors.

Following are the **reasons for the Government interference in price regulation**:

1. **To prevent exploitation of consumers** by certain producers who charge high prices just to maximize their profits.
2. Administered prices aim at **providing stable and assured income to the farmers** especially under the unfavorable climatic conditions. Administered prices also aim at protecting the interest of weaker sections of society.
3. The Government resorts to administered pricing for **discouraging or encouraging the consumption of** certain commodities. By raising the prices of certain commodities the purpose of the Government may be to put a check on their consumption. Similarly to encourage consumption of certain commodities their prices may be lowered for certain section of the people.
4. Administered prices are introduced for **encountering inflationary pressures**. The administered prices ensure that the free play of market forces does not lead to malallocation of resources.

In fact, Administered Prices are the result of the policy of the Price Control resorted to by the Government for an efficient management of the economy. **Price control refers to a direct measure on the part of the Government in fixing the prices for achieving certain macro economic goals like**

social welfare, efficient resource allocation, prevention of exploitation of the consumers etc.

The Price Control may be informal or formal. In case of **informal price control** the producers voluntarily agree to regulate the prices which are within limits suggested by the Government whereas under **formal price control**, the prices are statutorily fixed by the Government and have to be accepted by the producers.

Price Control may be total or partial. In case of total price control the price of the entire stock of output is enforced and administered by the Government through a Public Distribution System. For example: In case of any particular drug produced by a private sector the price control is total. This is also referred to as **monopricing** of the commodity. In case of **partial price control**, the Government directly fixes the price of a part of the production of a commodity and arranges for its distribution may be through fair price shops or via the systems of rationing. The rest of the stock is allowed to be sold in open market at any price which is determined by the free play of market mechanism. Partial

control therefore acquires the form of **dual pricing**.

The Government has from time to time introduced **price control for necessities** of various kinds. For example: edible oils, drugs, sugar, textiles and also for **certain intermediate inputs** such as cement, steel etc. In the case of agriculture the Government had appointed the **Agricultural Prices Commission** to enquire into prices of agricultural commodities and suggest suitable policy for prices of agricultural products. This commission recommended certain **minimum Procurement Prices** to safeguard the interest of the farmers assuring them of some minimum returns for their produce. Similarly **Issue prices** were also fixed to take care of the consumers of agricultural commodities. Later the **Agricultural Price Commission** was substituted by the **Commission for Agricultural Costs and Prices (CACP)**. Similarly **Price Stabilization Board, Price Intelligence Division, Cabinet Committee on Prices (CCP), The High Powered Price Monitoring Board (HPPMB)** have been set up. The **Tariff Commission of India and The Bureau of Industrial Costs and Prices** have been involved in determining fair prices of commodities.