3-2 Prices and Consumer Choices

GOALS

- Describe three methods of setting prices in a market economy.
- Explain how consumers' buying strategies affect demand and prices in a market economy.

KEY TERMS

- normal profit, p. 86
- cost-recovery pricing, p. 87
- cost-plus pricing, p. 87
- markup, p. 87
- value-based pricing, p. 87
- market-based pricing, p. 87
- rational buying, p. 88
- emotional buying, p. 88
- impulse buying, p. 88
- economizing, p. 89
- optimizing, p. 89

Why must businesses be careful when setting prices?

How Are Prices Set in a Market Economy?

In a market economy, prices are affected by a number of factors. Some factors are controlled by producers, such as their desired profit. Consumers' actions also affect prices in the marketplace. For example, if consumers are willing and able to buy a product, this will cause its price to rise. If consumer demand for a product is low, prices may fall and/or the manufacturer may stop producing it.

Sellers must be careful in setting a price for their product. If the price is too high, consumers may not buy the product. They may not be able to afford the price, or they may simply think the price is too high for the value received. If the price is set too low, consumers may perceive the product as cheap or of low value, causing demand for the product to be low. Also, if the price is too low, the company may not make any profit on the sale of the product. Businesses need a normal profit in order to stay in business. A **normal profit** allows a business to survive as well as grow.

Setting the right price for a product can be tricky. Having products available at the right price is critical to business success. Companies use different methods to set prices. Sometimes more than one method is considered when setting a price. Sellers want to set a price that will support the greatest demand and will be profitable. Some methods of setting prices are discussed in the following sections.

COST-RECOVERY PRICING

normal profit a profit that allows a business to survive and grow

In some cases, the business has invested large sums of money to develop a new product. *Research and development (R&D)* costs can be in the millions or even billions of dollars. Thus, when a product is first introduced, the price will be set high in order to recover the R&D costs. This is known as **cost-recovery pricing**. Because the price is high, it will invite competition, often in the form of *generics*, which are inexpensive substitutes.

cost-recovery pricing setting an introductory price high to recover the R&D costs

COST-PLUS PRICING

Another way that sellers set prices is called **cost-plus pricing**, which involves computing the per-unit cost of producing a product and then adding a percentage of that amount, called a **markup**, to obtain the price. The markup is also called the *profit margin* or *gross profit*. Using this method ensures that the company will make a certain profit if the product sells successfully. An example of cost-plus pricing for a piece of furniture is shown below.

cost-plus pricing setting a price based on production cost plus markup

markup the percentage amount added to production cost to obtain the price of an item

Item	Cost/Unit
Wood, 6 board feet, \$3.96 per foot	\$23.76
Labor, 2 hours at \$10 per hour	20.00
Paint, varnish, nails, and glue	1.24
Indirect costs (workers' benefits, rent, insurance, depreciation, overhead, etc.)	12.00
Total cost	\$57.00
Markup (40% × \$57.00)	22.80
Price	\$79.80

VALUE-BASED PRICING

Using **value-based pricing**, the seller tries to determine how much consumers are willing to pay for the product. In other words, it will be sold for the highest price that the market (consumers) will bear. If consumers value the product or service, they will pay whatever price is set, within reasonable limits. This is especially true of new, high-tech, and fad items. Consumers are willing to pay high prices because there are no less-expensive choices.

value-based pricing setting prices based on how much consumers are willing to pay

Companies may do market research to determine what the demand for a product will be. They also want to learn how much consumers will be willing to pay for the product. Perhaps you have been asked to complete a market survey while shopping at a mall. Telephone and Internet surveys are other popular ways that companies learn about consumers' wants and needs.

MARKET-BASED PRICING

With **market-based pricing**, the price is set to be competitive with prices of similar products currently being sold. If one business charges more than others do for a similar product, consumers are likely to buy from the other businesses to get the lower price. The manufacturer or retailer decides whether or not it can provide the product or service at that existing price and still make a profit. This is the easiest form of setting a price. It helps producers or sellers decide what products to include

market-based pricing setting prices to be competitive with prices of similar products currently being sold


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How can a business differentiate its product or service from others on the market?

in their marketing mix. *The marketing mix* is the group of products or services offered for sale by a business at any point in time. Clearly, what customers want (and are willing to pay to get it) will influence the products offered by sellers.

Sellers who have a similar product to others may try to market their product as different from or better than the other products. This strategy is known as *product differentiation*. For example, a seller offering a new cell phone might cite the phone's small size, Internet capabilities, or other unique features. These features are advertised in a way that makes the new cell phone seem more desirable than the other cell phones on the market. The seller may use these new features to justify charging a higher price. This strategy is not always successful. Consumers may not think the new features are useful or worth the higher price.

CHECKPOINT ▸ ▸ ▸

Name four methods sellers use to price products.

How Do Buying Strategies Affect Prices?

rational buying process of selecting goods and services based on need, want, and logical choices

emotional buying process of purchasing products based on desire rather than logic

impulse buying purchasing something on the spur of the moment without any planning

Consumers play a vital role in setting prices in a market economy. When consumers act in their own best self-interests, they are engaging in rational buying. **Rational buying** is the process of selecting goods and services based on need, want, and logical choices. Sometimes consumers engage in **emotional buying**, which is the process of purchasing products based on desire rather than logic. When you are feeling sad, angry, lonely, or some other emotion, you may make unwise purchases, using your emotions rather than logic to drive the choices. **Impulse buying** happens when people buy something on the spur of the moment without thinking it through or planning the purchase. You might see something in the store and grab it on impulse. Merchants display typical impulse items at key points, such as center aisles, the ends of aisles, and checkout areas. They are hoping the items will catch your eye and prompt you to buy without thinking. Emotional and impulse buying often lead to *buyer's remorse* when you later realize that you made a poor buying decision. In such a case, you may (or may not) be able to return the merchandise for a refund or credit.

There are two basic strategies for rational buying of goods and services: economizing and optimizing. Consumers can use the strategy that best fits their needs for different goods and services. They should also use the strategy that best fits the state of the economy or their bank account at the time. Using both economizing and optimizing strategies at the proper times is the best solution for most people.

ECONOMIZING

Consumers are **economizing** when they are saving as much as possible and spending money only when necessary. Using this approach, consumers wait until it is necessary to buy a product. Then they buy as little as possible and at the lowest price they can find. They do not buy large quantities or more than is currently needed. They simply try to spend as little money as they can for the needed product.

economizing saving as much as possible and spending money only when necessary

Most people go through periods of time when they economize. Others follow this spending pattern all the time. Economizing has its advantages. For example, delaying the purchase of something may result in not buying it at all. Economizing can lead to savings and better buying habits.

For some people, economizing is the only plan that allows them to meet their basic needs. For other people, economizing is a strategy used during certain times as a way to save money for later spending or investing. When economizing, people may spend little or no money on luxuries. People may also spend less on items for basic needs, such as food or clothing. Lower demand for products may lead to lower prices.

OPTIMIZING

Another spending strategy is called optimizing. **Optimizing** is getting the highest value for the money spent. High value may come in the form of purchasing in large quantities or purchasing high-quality products or services.

optimizing getting the highest value for the money spent

For example, if a product that is used often is on sale and stores well, a large quantity can be purchased to take advantage of discount pricing. When items are packaged and sold in large quantities, the cost per item is usually lower than when the item is sold individually.

How can buying in large quantities save money?

Success Skills
TIME MANAGEMENT

Consumers often buy things when they are in a hurry. Those purchase decisions are sometimes not the best decisions. Through *time management*, a person can make better decisions because she or he has planned the purchase and has had sufficient time to make a good choice. Using time-management strategies such as the following can help a person be more productive in school, work, and personal activities.

- Be aware of how you are using your time. This is the first step toward managing your activities in a way that makes the best use of your time.
- Identify *peak performance times*, when you are most productive during the day, and *weak performance times*, when you are the least productive. Schedule activities that involve decision making (such as shopping) at peak performance times.
- Use a daily or weekly planner to keep track of important dates and times.
- Keep a to-do list; mark off items as they are completed.
- Prioritize your activities so that you get the important ones done first.
- Break large projects or tasks into smaller parts, and plan time for completing each part.
- Save some time for doing things you enjoy.
- Do not rush or be pressured for time when making important decisions, such as major purchasing decisions.

Try It Out

Practice your time-management skills by preparing a shopping list for things you would like to buy in the next month. Prioritize the list, putting the items in order of importance. Comparison shop on the Internet. List three locations where you can buy the products on your list, along with the prices at each location. Describe how time management can improve your shopping experiences.

When consumers are optimizing, demand is higher when prices are lower. Customers will buy more of a product to take advantage of lower prices. Consumers should be careful not to let optimizing lead to overspending. Shoppers may buy items they do not need simply because the items are a bargain. Those who stock up on an item may be tempted to use it more frequently because they have a large quantity of it. Then consumers have to buy the item more often to replenish their stock, leading to more overspending.

Overspending can also lead to credit problems. Consumers who want to take advantage of lower prices, may make purchases using a credit card or loan.

When consumers shop carefully and wisely, they help keep prices low. When consumers do not buy wisely, they are part of the problem. Their actions lead to higher prices because of increased demand.

CHECKPOINT ▸ ▸ ▸

How is economizing different from optimizing?