Managerial Economics

M.Com. IV Sem.
Mr. Abhi Dutt Sharma
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Pricing Strategies

Pricing is the process of determining what a company will receive in exchange for its product or service. A business can use a variety of pricing strategies when selling a product or service. The
price can be set to maximize profitability for each unit sold or from the market overall. It can be used to defend an existing market from new entrants, to increase market share within a market or
to enter a new market.
There is a need to follow certain guidelines in pricing of the new product.
Following are the common pricing strategies −

Pricing a New Product

Most companies do not consider pricing strategies in a major way, on a day-today basis. The
marketing of a new product poses a problem because new products have no past information.
Fixing the first price of the product is a major decision. The future of the company depends on the
soundness of the initial pricing decision of the product. In large multidivisional companies, top
management needs to establish specific criteria for acceptance of new product ideas.
The price fixed for the new product must have completed the advanced research and
development, satisfy public criteria such as consumer safety and

earn good profits.
In pricing a new product, below mentioned two types of pricing can be selected −

Skimming Price

Skimming price is known as short period device for pricing. Here, companies tend to charge higher price in initial stages. Initial high helps to Skim the Cream of the market as the demand for new product is likely to be less price elastic in the early stages.

Penetration Price

Penetration price is also referred as stay out price policy since it prevents competition to a great extent. In penetration pricing lowest price for the new product is charged. This helps in prompt sales and keeping the competitors away from the market. It is a long term pricing strategy and should be adopted with great caution.

Multiple Products

As the name indicates multiple products signifies production of more than one product. The traditional theory of price determination assumes that a firm produces a single homogenous product. But firms in reality usually produce more than one product and then there exists interrelationships between those products. Such products are joint products or multiproducts. In joint products the inputs are common in the production process and in multi-products the inputs are independent but have common overhead expenses.
Following are the pricing methods followed −

Full Cost Pricing Method

Full cost plus pricing is a price-setting method under which you add together the direct material cost, direct labor cost, selling and administrative cost, and overhead costs for a product and add to

it a markup percentage in order to derive the price of the product. The pricing formula is –

Pricing formula =

Total production costs — Selling and administration costs — Markup / Number of units expected to sell

This method is most commonly used in situations where products and services are provided based on the specific requirements of the customer. Thus, there is reduced competitive pressure and no standardized product being provided. The method may also be used to set long-term prices that are sufficiently high to ensure a profit after all costs have been incurred.

Marginal Cost Pricing Method

The practice of setting the price of a product to equal the extra cost of producing an extra unit of output is called marginal pricing in economics. By this policy, a producer charges for each product unit sold, only the addition to total cost resulting from materials and direct labor. Businesses often set prices close to marginal cost during periods of poor sales.
For example, an item has a marginal cost of 2.00 and a normal selling price is 3.00 , the firm selling the item might wish to lower the price to $2.10 if demand has waned. The business would choose this approach because the incremental profit of 10 cents from the transaction is better than no sale at all.

Transfer Pricing

Transfer Pricing relates to international transactions performed between related parties and covers all sorts of transactions.
The most common being distributorship, R&D, marketing, manufacturing, loans, management fees, and IP licensing.
All intercompany transactions must be regulated in accordance with

applicable law and comply with the "arm's length" principle which requires holding an updated transfer pricing study and an intercompany agreement based upon the study.
Some corporations perform their intercompany transactions based upon previously issued studies or an ill advice they have received, to work at a cost plus X%. This is not sufficient, such a decision has to be supported in terms of methodology and the amount of overhead by a proper transfer pricing study and it has to be updated each financial year.

Dual Pricing

In simple words, different prices offered for the same product in different markets is dual pricing.
Different prices for same product are basically known as dual pricing. The objective of dual pricing is to enter different markets or a new market with one product offering lower prices in foreign county.
There are industry specific laws or norms which are needed to be followed for dual pricing. Dual pricing strategy does not involve arbitrage. It is quite commonly followed in developing countries where local citizens are offered the same products at a lower price for which foreigners are paid more.
Airline Industry could be considered as a prime example of Dual Pricing. Companies offer lower prices if tickets are booked well in advance. The demand of this category of customers is elastic and varies inversely with price.
As the time passes the flight fares start increasing to get high prices from the customers whose demands are inelastic. This is how companies charge different fare for the same flight tickets. The differentiating factor here is the time of booking and not nationality.

Price Effect

Price effect is the change in demand in accordance to the change in price, other things remaining constant. Other things include − Taste

and preference of the consumer, income of the consumer,
price of other goods which are assumed to be constant. Following is the formula for price effect –

Price Effect =
Proportionate change in quantity demanded of X / Proportionate change in price of X

Price effect is the summation of two effects, substitution effect and income effect
Price effect = Substitution effect – Income effect

Substitution Effect

In this effect the consumer is compelled to choose a product that is less expensive so that his satisfaction is maximized, as the normal income of the consumer is fixed. It can be explained with
the below examples –
Consumers will buy less expensive foods such as vegetables over meat.
Consumers could buy less amount of meat to keep expenses in control.

Income Effect

Change in demand of goods based on the change in consumers discretionary income. Income effect comprises of two types of commodities or products –

Normal goods –

If there is a price fall, demand increases as real income increases and vice versa.

Inferior goods –

In case of inferior goods, demand increases due to an increase in

the real income.