The Psychology of Pricing

Establishing a pricing policy can only be enhanced by an understanding of the psychological dynamics that occur every time consumer and product price meet. Certainly one element that must always be present is a perception of value, meaning that whatever the price is, the consumer sees it as worthwhile. The creation of this sense of worthiness is what allows some companies to demand much higher prices for products that essentially perform the same functions as much less expensive alternatives.

Establishing a perception of value is a branding and marketing function that is driven by a company's strategic decision to target a higher pricing position. The psychology of pricing is, in many cases, the backdrop to this decision. This article aims to share some of these insights.

Positioning Options

Not surprisingly, there are three pricing position options available, marking the high end, the low end, and the middle ground. Each one of these has their advantages and disadvantages, and selecting one has as much to do with cost structures and target market as it does with the image you are trying to present. Naturally, you cannot attempt to deny the reality of your situation, lest you are certain to be met with failure. By this we mean that you cannot attempt to be low end if your cost structure is high, and probably should not try to be high end if your cost structure is very low (because your quality probably won't support it). Some psychological elements you might be able to use to support your pricing position include:

- High End – exotic or elaborate atmosphere, sophisticated packaging, certificates of authenticity, high end distribution channels, high profile customer profiles, and some manifestations of exclusivity.
- Middle of the Road – use pricing as a "beside-the-point" and instead focus on elements like selection, service, and location.
- Low End – an emphasis on value, a sense of offering a bargain, showing comparative prices on similar products, and an appeal to the "smart shopper" in all of us.

What is a Fair Price, Anyway?

A key psychological aspect of pricing is the concept of fair. Certainly "fair" is an aspect of our perception of value, meaning that we view a product as worthwhile versus its price if we believe the price is reflective of the value being offered (which makes it a fair price). There are, of course, two perspectives on what constitutes a fair price; that of the consumer and that of the merchant. Let's look at each:

- The Consumer's View – Fair to the consumer is a balance between what is being received and the price that is being demanded for it. For example, fair in an upscale establishment might not be realized if the service was not superior and the quality superb. Conversely, in a low end enterprise, fair might be missed if the price was not sufficiently lower, justifying the consumer's willingness to forego service and quality.

- The Merchant's View – Fair to the merchant is a price that enables the continued operation of the establishment in a manner that supports all the operating costs and permits the desired profits.

These two perspectives may not always meet, and when they do not, the merchant is the one to suffer. (This is why, establishment of position is so important).

On Demand

There are two types of demand that influence the way consumers view merchants. These are:

- Elastic Demand – when consumers perceive merchants in the same category as being devoid of much distinction. Examples of this might be gas stations, supermarkets and home improvement stores. The need for the products offered is constant, yet consumers select for reasons other than price alone. This can include convenience (proximity), special sales, and other temporary incentives.
- Inelastic Demand – when consumers perceive merchants in the same category to be distinct. Examples of this can be clothing shops and restaurants. The perceived differences may lie in product assortment, service levels, and even locations.

These two levels of demand are both affected by price. The similar pricing policies of merchants in the elastic demand category serve to minimize even price as a point of distinction. On the other hand, companies in the inelastic category most likely use price to distinguish themselves in some way.

Understanding how consumers interact with price and what their motivations are can also help a company determine where on the price scale they prefer to operate. For example, some "feelings" price helps us achieve include:

- Exclusivity – the price is so high not everyone can afford it
- Smart – the price was too low for the product and a bargain was found
- Satisfaction – the price was fair

What you do not want are negative emotions, such as:

- Extortion – the price was set way too high because the product is somehow required.
- Petty – the price was an add-on that was unnecessary and somehow offset the perception of fair.

Prices can drive sales or lead them to collapse. Understanding what the price means to people is an essential part of establishing a pricing strategy.