Elasticity of Demand and Pricing

A major application of price elasticity of demand is how to set prices. As discussed earlier, firms that face a highly elastic demand must consider reducing prices to increase revenue while those whose products have an inelastic demand have more pricing power and this can increase prices to increase revenue. But it doesn't stop there. What if you can separate your customers into different groups, each with their own elasticity of demand? Suppose one group that buys a product has an inelastic demand while another group that buys the same product has an elastic demand - how would that affect your pricing? Which group is more willing to pay a higher price for the product? Also, suppose one product offered by your company is only purchased when people really need the service while another isn't essential - how can you price the respective products.

For example, suppose there is a lawn care service that offers quarterly service (fertilizing and weed control) as well as special treatments for chinch bugs. The cost of providing each service is similar. How can they price the services? Chances are, many people who obtain the quarterly service have a limit as to how much they are willing to pay. On the other hand, a person with a severe chinch bug problem would probably be willing to pay more, given that they may perceive it as an emergency. Similarly, auto repair shops may charge very little for oil changes, but charge much higher prices for certain types of repairs.

Another example is the airline industry. As we all know, most airlines now charge for luggage and many charge for choosing seats in advance. Why? Who would be willing to pay an extra fee for reserving a specific seat? Someone who really needs to secure the seat (and thus has an inelastic demand). Thus, airlines have found new ways for charging different prices to different customers based on their different elasticities of demand.

How about an industry that asks its customers how much they are able to pay for a product prior to setting the price? They may ask for customers to complete a form and include information about income, assets and even include tax returns. Once they review the information, they inform the customer about the price to be paid. Does this happen in the real world? Colleges require students to submit FAFSA before deciding how much financial aid they receive (and this how much they have to pay).

STOP AND THINK: How are the following examples of price discrimination (charging different prices to different customers for the same product):

- charging a high price when a new product is first introduced followed by reducing prices over time
- Black Friday
- coupons