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SMART PRICING

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Introduction: Fingerprints of the Invisible Hand

After a long season of back-breaking labor seeding, feeding, and growing a crop, a farmer would never say, "Time to harvest—let's take it easy." If anything, the farmer would get up even earlier and go to bed even later to make sure that every last grain was harvested. Yet supposedly sophisticated companies, run by some of the best-educated people in the world, neglect what peasants have known by instinct for thousands of years. They work hard thinking about, growing, and finding markets for their product but then pay scant attention to the decision that determines what all that hard work yields the company: setting the price.

Despite the critical function prices play in corporate profitability, we find that managers with pricing responsibilities do not usually think systematically about their pricing strategies. Most pricing decision makers never look for a strategy that could yield their product's maximum value. According to one study, only a tiny number of firms have "both a pricing strategy and research to support it." When it comes to pricing, some estimated that only about 8% of American businesses can be considered "sophisticated players."[1]

Oddly, nobody seems bothered by this state of affairs. Many executives we talk to about prices say, "We don't set prices. The market does!" As economists, we are not sure what this statement means. "Who is the market, then?" we press them.

To our mind, this is a reasonable question. Price setting is a tangible process with a tangible outcome—a dollar figure. The process of arriving at that number might not be tidy, but it cannot be so mysterious that it does not involve any human intervention. Someone, somewhere must make a concrete, numerical decision about the price of a product or service. Yet managers often give us a bewildered or indignant look when we ask this question and act as if the question itself were frivolous or rude. The way the managers talk about it, setting the price for a product or service is an almost automatic process, outside anyone's control. Occasionally, we get the more profound-sounding answer that "the invisible hand" sets the price—a misapplication of the famous macroeconomic observation of Adam Smith, the great Eighteenth Century Scottish economist and philosopher, on microeconomic circumstance.

Thinking of price-setting as being similar to time or the tide is a comforting idea, given how many company activities require conscious thought. But it's not actually true. When you take a closer look, the hands that set the price are almost always visible. They might not be very nimble, but they can clearly be seen in each of the four most common methods of price setting. Among the least sophisticated companies we have encountered over the years, setting a price sometimes involves not much more work than selecting a lottery number: Pick what comes to mind, say a prayer, and hope for the best. More sophisticated companies don't always do much better. They often take simplistic, ad hoc approaches, such as cost-plus pricing, competition-based pricing, or consumer-based pricing. Each of these approaches requires human intervention, and each is overly simplistic.

Cost-Plus Pricing

An overwhelming majority of U.S. companies use the cost-plus approach to set their prices. This practice also appears to be popular in other markets, even in fast-growing countries such as China and India. To use cost-plus pricing, a firm first determines its sales target and then figures out the average cost it will incur based on the sales target. The price for the product is set by taking the average cost plus a markup. For example, if the sales of Apple's iPod are 2 million units, the average cost at that output level might be $100 per iPod. Assuming that the normal markup at the company is 70%, Apple's selling price for an iPod would be $170. The size of the markup is determined either by the company's targeted internal rate of return on investment or by some vaguely defined "industry convention."

The enduring appeal of the cost-plus approach is threefold. First, it is simple. The manager does not need to look outside the company's own ledger to determine the price for a product. A casual familiarity with arithmetic is sufficient for anyone to come up with a price. Second, it is fair, or appears so. Indeed, cost-plus pricing is said to date back to medieval times when churches were involved in regulating commerce and allowed merchants to make only a fair living, not a killing. Third, many practitioners will tell you that cost-plus pricing is financially prudent because it ensures profitable sales. This guarantee of prudence is a reassuring way to dodge the high pressure involved in making a pricing decision. Such pressure can be nerve-racking at times because the effects of a pricing decision, unlike many other decisions in a corporation, are typically immediate and conspicuous.

However, none of these three reasons is sufficient justification for adopting a conventional cost-plus strategy. First, why is simple better? A quick counterexample suggests otherwise. When a consumer in China purchases a beautiful silk scarf, does she know or care about the cost of making the scarf? Most likely, she does not. In fact, manufacturers themselves might not even know the costs of their products with any degree of precision. In that case, why should a silk manufacturer set its price solely based on its costs?

A Chinese silk manufacturer we know tried this simple approach. The company set a low price of 200–300 yuan for its scarves. Its cost of production was so low that even 200 yuan would still yield a decent margin. This low price was also extremely competitive, compared to the high price of 2,000–3,000 yuan set by a French company in China selling similar scarves sourced—you guessed it—from this very manufacturer. On paper, the Chinese company looked as if it should be very competitive in the marketplace, given its huge price advantage. Yet somehow the French company still outsold the Chinese manufacturer by a big margin, even with an identical product that cost ten times as much.

The difference was so great that branding alone could not explain the outcome, a fact that baffled company strategists. Later, it dawned on the executives that the low price itself might be the problem. Most of the manufacturer's customers purchased a silk scarf not for their own use, but as an elegant gift to the wives of their bosses or *guanxi* (connections). Potential customers looked at the 200–300 yuan price tag and decided it was simply not substantial enough to be the kind of door-opening gift they had in mind. Many forgone sales later, the manufacturer learned to look beyond its cost and set its prices based on a better understanding of its customers and the market.

The second advantage touted for cost-plus pricing is its supposed fairness. But we think this often is not true, either. For example, if a utility company is regulated such that it can charge a rate based only on its average cost plus a fair return on investment, many economic studies have shown that the utility company will have little incentive to minimize its costs, and the rate will drift up unnecessarily in the long run. For the same reason, if other kinds of firms always succeed in passing their costs on to consumers in this way, they have no incentive to minimize their costs. Finally, if the cost of serving customers is the same, is it fair to charge all customers the same price, even if they have varying incomes and need for the product? Perhaps the answer will vary, depending on your political convictions and economic circumstances, but a little thinking makes it clear that in many situations "fair" cost-plus accounting could lead to an unfair result.

Consider an example from the pharmaceutical industry. If a drug is cheap to develop and manufacture, should it always be sold cheaply? Is a 10% markup on some cheap ingredients really a fair return on intellectual property that reduced doctor visits, hospital stays, and employee absenteeism for thousands of people?

Perhaps it would be more fair for society to reward the innovator. It might even be socially beneficial in the long run to allow a higher price as an incentive to encourage others to try to solve similar problems.

Consumers, interestingly, have a surprisingly nuanced view of fairness in cost-plus pricing. If cost-plus pricing is a fair way to set the price, then if a firm's unit cost decreases by $10, the absolutely fair thing to do would be to lower the product's price by $10 plus the markup on the cost. However, studies have shown that the fairness standard people apply to price changes is far more favorable to a firm than the cost-plus pricing rule would suggest, even when they know the precise magnitude of the cost change. In one survey, half of the respondents agreed with the statement that "fairness does not require the firm to pass on any part of its savings."[2] However, in that same survey, consumers also believed that more cost savings should be passed on to consumers if the cost savings are the result of a reduction of input costs instead of an efficiency gain: If the price of jet fuel goes down, I want a discount on my ticket, but if you build a better airplane, you can keep the difference. By applying this fixed cost-plus rule, a firm forgoes its chance of achieving any gains from efficiency improvements, although its customers would not have minded.

Nor does cost plus-pricing mean that every sale is automatically profitable. Cost is often partly a function of the sales target. If sales fall short of the target, the actual cost might be higher than projected. In that case, the price could turn out to be too low. Such a shortfall is always possible because the people responsible for sales normally make the sales projection, and they have an intrinsic interest in engineering a lower price to boost sales or to make their selling job easier.

Even if the sales target is met or exceeded, we don't know whether the initial price is a good price or one that a company can improve for its own financial benefit. Regardless of actual sales, cost-plus pricing does not ensure or even encourage financial prudence.

Finally, as the Chinese scarf example suggests, the biggest problem with cost-plus pricing is that it is an inward-looking approach that tends to distract a company from its customer orientation and obscure the importance of detailed market research. A corporation that develops an entrenched culture in price setting based on cost-plus pricing encourages *ad hoc* pricing decisions and overlooks many opportunities for price improvements. Indeed, cost-plus pricing sometimes leads companies to set consistently sub-par prices. When sales are brisk, a company will lower its price as its average costs go down, but when sales are sluggish, it raises its price to "cover" its higher average cost.

Competition-Based Pricing

Competition-based pricing is the second-most-popular price-setting approach. Managers sometimes refer to this approach as strategic pricing, although it's not particularly strategic. When taking this approach, a firm simply checks out its competition's price and then sets the price of its own product at about the same level, plus or minus a few percent. Once again, this approach has the virtue of being simple: It's an easy way to make a pricing decision without having to conduct any thorough market research. It also seems relatively safe: By setting a price close to the rival's and adjusting with it, a firm does not risk losing its market share to the competition.

However, setting one's own price solely on the basis of competition's price can cause two problems, either of which can cost a company dearly.

The worst risk is that competition-based pricing lulls the price setter into passivity. Managers can be so taken by this pricing approach that they lose sight of their own pricing responsibilities. To them, pricing involves nothing more than monitoring competitors' prices and making some timely adjustments on their own price based on the competition's price. Maybe this is what managers mean when they say the invisible hand sets their prices. This might seem like a low-risk strategy, but unfortunately sometimes the competition decides to set its prices the same way. When this kind of double-mirroring occurs, prices not just for the company but for the entire industry can easily fall out of sync with current demand.

Other times, price-matching can lead to a game of chicken. Everyone knows that setting a low price is the easiest, fastest way to gain market share. The trouble is that one rarely encounters a company that does not want a larger market share: In any given industry, if you added up all the market share targets of each company, the sum would most likely far exceed 100%. Obviously, something has to give. If all the firms in an industry become overzealous about meeting their market share targets, prices can easily slip into a downward spiral that can hurt not just the company but the industry as a whole. The competition for market share between the two aerospace giants Boeing and Airbus in the mid- and late 1990s offers an example of this risk. At the time, Airbus was consistently gaining market share and had surpassed its self-determined "survival threshold" of 30% of new global commercial airplane orders. Boeing decided to respond. It would "beat back Airbus and retain supremacy in the commercial-jetliner industry,"[3] and fearlessly guard its 60% market share. Boeing and Airbus began competing vigorously, "making every bid a battleground." Each would slash its price by at least 20% off the list price to grab an order. For example, to bid for ValueJet's order of 50 100-passenger airplanes in 1995, Boeing reportedly brought its price for Boeing 737s down from the list of $35 million, below its rock-bottom price of $22 million, all the way to $19 million.[4]

The outcome was quite predictable: huge losses all around. Boeing temporarily won the share battle for new airplane orders.

However, the victory came at a horrendous cost. Boeing suffered its first annual loss in 50 years in 1997, and by the following year, the company was forced to take more than $3 billion of pretax charges for the foul-up. Between 1996 and 1998, the profit margin of Boeing's commercial jetliners fell from 10% to less than 1%—a lower margin than a corner grocery store.

We are not suggesting that firms should never compete on price to gain market share. As we show in Chapter 3, "The Art of Price Wars," price wars are a legitimate strategy. However, we are suggesting—and advocating throughout this book—that firms should learn how to compete as intelligently on price as they do on every other aspect of their business. Adam Smith's invisible hand works only if the economic agents in the market are driven by their own enlightened self-interest to pursue their own maximum economic gain. Boeing's decision to build extraordinarily complex aerospace vehicles at a lower margin than a corner grocer was not enlightened self-interest.

Consumer-Based Pricing

Consumer-based pricing is the third common approach firms use to set their prices. In this case, the firm first sizes up its customers to determine how much each customer is willing to pay for its product or service and then charges the price each customer is willing to bear. Car dealers often take this approach.[5] A dealer typically displays a high sticker price for a car, which is nothing more than a wished-for price intended to frame the value of the car for the customer. Then a salesperson takes the prospective buyer out for a test drive. In the process, the salesperson gathers information about the customer's job, hobbies, family, and so on to help size up how serious the shopper is about the car and how price-sensitive he might be. When the salesperson senses that price is not a primary concern or that the customer is not a deft haggler, he will typically give all kinds of reasons for not being able to bring down the list price much. However, if the salesperson senses that the price is the obstacle to closing the deal, the salesperson will offer a better discount—but only after securing the "reluctant" approval of a mysterious boss behind a closed door and shaded windows.

Customer-based pricing gives the company the flexibility to charge different prices to different customers, rising or falling to match the size of the customer's wallet. Theoretically, the firm can achieve a high volume of sales at the best possible margins. However, an obvious problem with this pricing approach is that it inevitably alienates those customers who end up paying more than the successful hagglers. In the case of car purchases, many economic studies have shown that minority men and women have to pay up to $1,060 more than white males for the same car.[6] The backlash against this discriminatory practice contributed to the enormous success of GM's no-hassle, no-haggle sales policy on its Saturn line in the 1990s.

In business-to-business markets, discriminatory pricing can also easily alienate a firm's best customers, with detrimental long-term consequences. The worst is that over time, discriminatory pricing can train the customers to become aggressive bargainers. In the industrial markets, a professional buyer fears a high relative price more than a high price. A high price is a problem for the industry. A high relative price is a problem for the buyer personally. No one wants to think of himself as a sucker, but for a professional buyer, the damage wrought by overpaying isn't only to his pride; it can also hurt his career. He may suffer professionally if he is exposed as less skillful than his peers. Consequently, if the buyer suspects price discrimination, he will do everything possible to exploit a seller's pricing flexibility to secure the lowest price.

Ultimately, this kind of strategy can train good customers to behave badly. If a buyer knows the price she will pay depends on her perceived willingness to pay, she certainly does not have any incentive to dwell on how good and how valuable the seller's products and services are. Nor can she afford to appear interested in the seller's value propositions. The potential buyer might also try to withhold useful information from the seller, just to conceal her hand. She might even take pains to act as if the seller's products and services are no better, if not worse, than anyone else's—a hint that the buyer is perfectly willing to walk away if the seller's price is not competitive. Frequently, the concealment comes at the cost of depriving the seller of the kind of information that would help the seller serve the buyer better, both now and in the future.

This behavior also encourages more comparison shopping. To ensure a rock-bottom deal, the buyer will look to gain an upper hand in sales negotiations by entertaining competitive offers, even if the buyer does not intend to switch suppliers. Collecting competitive bids gives the buyer a decisive advantage. A seller risks legal perils if he talks to other suppliers about pricing, but a buyer is free to solicit competing price quotes. The buyer can then use the quotes as a lever to gain concessions from the seller. Knowing that the seller's salespeople have some pricing discretion, the buyer will try every means, both carrots and sticks, to make sure that the seller doesn't hold anything back.

For example, it is not uncommon for the buyer to embellish price quotes a little to gain a larger price concession. Sometimes those quotes don't even need to be explicit. A former Merrill Lynch chief information officer is famed for having a million-dollar coffee mug: "When an IBM salesman came calling, the CIO would put a coffee mug from a competitor on his desk. The salesman would immediately cut $1 million off the price of each mainframe, for fear of having Merrill take its huge business elsewhere."[7]

This kind of aggressive negotiation leads both buyer and seller to focus on transactions instead of building a relationship and to channel creative energy into devising ways to win more or less money instead of forging a long-term, win-win partnership. Facing such a buyer, the seller's choice is limited, especially in a buyer's market. You can refuse to budge on the buyer's price demand and try to sell based on a value proposition. In that case, you risk losing a big customer. Or you can compromise, bring the price down promptly, and close the deal. For most commissioned salespeople, such as the IBM salesman facing Merrill's mug of doom, a lower margin is always more appealing than no deal.

The game leaves both sides less happy than they might be. The buyer won't be happy, even if she receives the full discount for which she asked, simply because she can never be certain about whether she could have won an even lower price—so the next time, she will ask for a little more. For the seller, every order costs a little more price integrity. Sometimes this reluctant price discounting can even evolve into an arms race between competitors. Buyers become more demanding, and salespeople ask for more pricing discretion. The salespeople have a good chance of getting such price cuts because they supposedly know customers and competitive situations in the marketplace firsthand. And when they have the price cuts, they will use them more freely, forcing the producer to cut costs.

In this kind of pricing environment, the seller has little incentive to invest in the customer relationship or additional services, and cost cutting becomes the paramount imperative. What typically follows can be best described as a kind of service version of Gresham's law: Bad service companies drive out good. If no buyer seems to care about or wants to pay for customer services, then no seller wants to spend money to provide them. As customer service deteriorates in an industry, product differentiation declines, a new round of downward pricing pressure gains momentum, and the product moves another step closer toward being a commodity. Put it all together, and the industry enters a downward spiral, with the buyers paying less and getting less, and the sellers getting less and giving less. It's a good topic to reflect on during your next long-distance flight—over your lunch of peanuts and soda pop.

From this brief tour of how firms set their prices, we can come to two conclusions. First, the market does not set prices. Marketers do. All the prices we observe in the marketplace do not just spring out of an autonomous, impersonal market. The managers' hands in setting those prices are entirely "visible," regardless of whether such interventions are acts of expediency or strategy. Second, cost-plus pricing, competition-based pricing, consumer-based pricing, and even "lottery" pricing are not necessarily the best ways to price a product or service. In many cases, they are nothing but shortcuts managers use to cope with the weight of their decision-making responsibility.

Unfortunately, ignorance of the power of pricing can have huge consequences. Your company's survival may even depend on your pricing strategies. If you are a retailer, you must pay attention to Wal-Mart's price-dominance strategy. Either find a way to cope with it or be steamrolled, as many have been. If you are a manufacturer in the United States, whether you are in textiles, steel, or consumer electronics, you must heed "the China price"—the price quotes from China that are typically 30–50% lower than state-side manufacturing.[8] If you are a financial service company, you must navigate the new reality of deregulations and discount brokerage, both online and offline. Even if you are a high-tech company, you might find yourself in a situation where you no longer enjoy a comfortable lead in technology and you must compete directly or indirectly with companies from South Korea, Taiwan, India, and China—almost always on price and always against a player with a lower cost structure.

Competitors are not the only risk for sellers. Buyers are not as docile as they once were, either. In the consumer market, the Internet has changed the way in which price information is disseminated in the marketplace. A consumer shopping for a car is no longer in the dark about prices. She can easily find information online about the prices different dealers charge for the same car. If she is diligent, she can even find a dealer's invoice price for a car and the amount of the manufacturer's ongoing coupon or rebate promotions on the car. Armed with the price information, the customer might travel hundreds of miles for a lower price and save hundreds or even thousands of dollars on a car purchase. In the industrial market, the Internet plays a similar role in increasing price transparency and expanding the geographical range in which a firm can source its suppliers. As a buyer, when you have extensive price information and a larger set of choices, you become more sophisticated in using that information and choosier in your buying decisions. When you have those savvy buyers in a market, the overall price becomes even more critical for the company.

Price is also becoming more important because product differentiation is harder to achieve in many industries. For example, most desktop or laptop computers have "Intel Inside" and run Microsoft Windows. In the service industries, which now account for more than two-thirds of U.S. gross domestic product (GDP), companies cannot patent their service designs in the same way manufacturers patent their product designs. The resulting lack of product differentiation, either real or perceived, and the new ease of comparison shopping inevitably make price a bigger factor in customer buying decisions.

But at the same time technology is changing cost structures and pricing pressures, it is also giving many companies a whole new set of pricing opportunities. Many industries now have a high fixed cost, typically in development, and a low variable cost in production. In the software industry, for example, a huge cost must be incurred up front to develop the first copy of a program, but the cost of replicating the software is nearly zero. The same is true for many other digital technology–based industries such as music, movies, and information, and, to a lesser extent, for service industries such as airlines and hotels.

In these kinds of industries, pricing can play a considerable role because of a low variable cost and a wide dispersion in the consumer's willingness to pay. Companies with this kind of cost structure can set prices in ways that either harm profitability or enhance it. An undisciplined manager might seek a quick "high" in volume through an unsustainably low price. On the other hand, a more sophisticated manager might take advantage of the situation by designing a creative pricing structure to attract a certain kind of profitable customer. In either case, the price is now becoming an increasingly important differentiator.

The Four Levers

A manager can pull only four levers to increase a firm's profitability: sales, variable costs, fixed costs, and price. When a manager bumps up his firm's advertising budget to gain a larger market share, he's pulling the sales lever. If he has found a cheaper way to source raw materials, he is pulling a variable cost lever. If he tries to reduce his firm's overhead, he is pulling the fixed cost lever. Yet for some reason, not all these levers are treated equally. Price, in particular, is neglected. This is peculiar because a number of studies have found that although rarely pulled, the price lever is the most efficient way to increase a firm's profitability.[9] We updated these studies by applying the same methodology to the most recent company data available through Wharton Research Data Services (WRDS), as shown in Figure I.1.

As Figure I.1 shows, our analysis essentially reconfirms previous studies. We find that if a firm can cut its fixed costs by 1% without affecting its operations, its profitability can increase, on average, by 2.45%. Similarly, if a firm can increase its sales by 1% without changing its cost structure or price, the firm's profitability can rise by 3.28%. The effect of lowering the variable cost by 1% is larger: Profitability can increase 6.52%. However, the effect of improving a firm's price by 1% is the largest of all: 10.29%. Remarkably, as Figure I.2 shows, this effectiveness ranking order holds for each of the eight industry groups using the standard industry classification (SIC) scheme.

A pessimist might conclude from these numbers that price isn't a lever that one should pull lightly: If the upside benefit of pulling that lever is high, the downside risk or the difficulty involved in pulling that lever must be substantial, too. Otherwise, why wouldn't firms pull that lever more often? Indeed, some managers would quickly add that it's not practical. "It is one thing to cut costs by 1% without affecting everything else, but it is entirely something else to improve your pricing by 1% without changing anything else. For one thing, sales will drop!" For that reason, the pessimist might see the promised double-digit increase in profits as a dangerous illusion. It might seem far more prudent to pull the other three levers instead of risking everything on a single number.

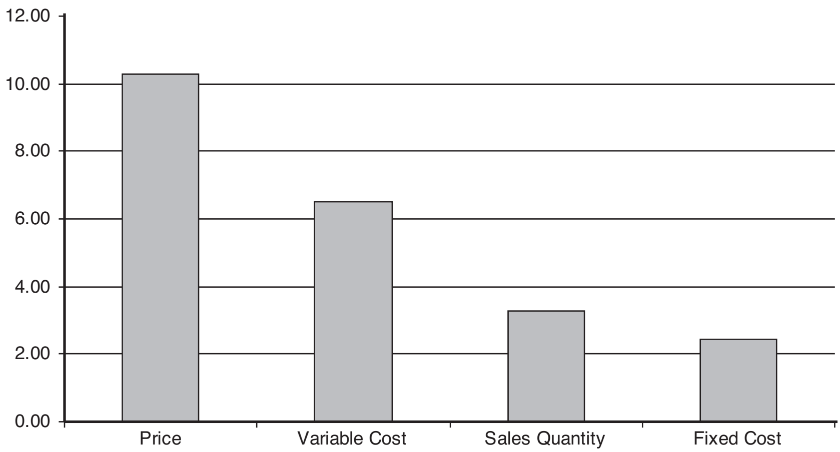

Figure I.1 Impact of profit levers in U.S. in 2004

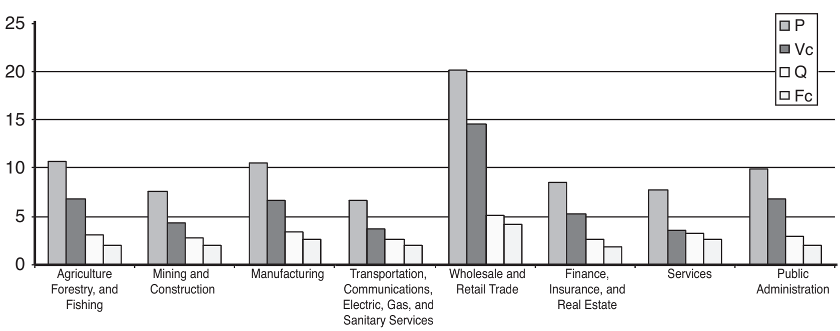

Figure I.2 Impact of profit levers in U S. by industry (2004)

However, an optimist would see from these tantalizing numbers a holy grail for profitability. How often could one identify and work with something that can lead to a double-digit increase in a firm's profitability by just changing a few numbers? The fact that a firm is not pulling the price lever only means that it is missing a big opportunity. After years of diminishing returns with the other three levers, the price lever might just be the best bet. In any case, it's certainly the easiest: Companies can make price changes quickly—hashed out over a bottle of Bud, then approved at the stroke of a pen.

When it comes to the potential of pricing, both the optimist and the pessimist have valid points. However, we believe the optimists have the edge. No strategy is risk-free, but after years of teaching pricing to our MBA students and executives and consulting to pricing managers all over the world, we believe companies willing to pull the price lever face more promise than risk.

Conclusion

Farmers do not take it easy at harvest time. Nor should firms. In our mind, it is simply an untenable management strategy to focus on value creation without thinking about how that value will be captured. The sooner firms recognize this, the sooner they will be on their way to bringing in a bumper crop.

We're not saying that pulling the price lever is a cinch. You must know what you are doing before you even think about pulling that lever. Once pulled, everything can change. Profits either rise spectacularly or fall in a traumatic, humiliating way. Whether you succeed or fail, the effect of your "hand" will be very "visible." Clearly, pricing is not a game for the fainthearted or someone with a trembling hand. But that doesn't mean you should not try. Risks and difficulty are inherent in any important corporate decision. They have not stopped managers from making those decisions and pulling the costs and sales levers in the past. They should not stop managers from facing up to their responsibility to examine the price lever now.

However, pricing is an unfamiliar subject for most managers. Until recently, pricing was scarcely taught except as a unit of microeconomics and a subtopic of marketing. For the longest time, business education everywhere focused primarily on the other three profit levers. Business students learned that in a competitive market, prices should be set so that marginal revenue matches marginal costs. They also learned that competing on price is generally a last resort and probably a bad idea. Unfortunately, neither precept offers much guidance to pricing managers. For these managers, they need more actionable pricing knowledge.

Over the past decade, nearly a dozen books have been published on pricing to help disseminate that knowledge, but most are quite specific, lacking general interests. In this book, we aim to make pricing knowledge more tangible, concrete, and fun by showing how innovative pricing strategies have helped leading companies create and capture value as well as new customers. We visit restaurants where the customer sets the price and see a famous rock band that made money by giving away its album for free. We look at how Google and other high-tech companies have used pricing to remake whole industries, and at China, where executives have made an art out of initiating and fighting price wars—in spite of the conventional Western wisdom that price wars are risky, stupid, and sometimes even fatal.

From these stories and many others, you will see that companies price their products in many different ways—through high prices, low prices, even no price—and you will learn how, why, and when each method works. We hope that as you read these stories, you will learn something not just about how to set prices, but about the importance of thinking about prices. We believe you will agree with us that the possibilities of pricing are endless, limited only by the need to retain some value for future harvest and the bounds of creativity.

Our experience has taught us that pulling the price lever demands courage and confidence, the kind best built on your knowledge about what pricing can do, how you can price your goods or services, and how consumers and your competition might react to your pricing decisions. If this book helps you gain more confidence in pulling the price lever and perhaps sparks an idea about an innovative way to price your own product or service, we will have achieved our main objective.

Endnotes

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Smart Pricing

How Google, Priceline, and Leading Businesses Use Pricing Innovation for Profitability

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"Pay As You Wish" Pricing

"If it's good enough, people will put a penny in the pot."
Chris Hufford, manager, Radiohead

On October 9, 2007, the English alternative rock band Radiohead began an experiment: Instead of pricing its music the conventional way, the band would let its fans pay whatever they wanted to download its latest 10-song album, *In Rainbows.* At the checkout page of the inrainbows.com website, visitors came to an empty price box. When they clicked on the box, a message appeared that said, "It's up to you." On the next page, another message appeared that said, "No, really, it's up to you."

Radiohead's decision to leave pricing to its fans came after years of frustration with traditional distribution. The Oxfordshire-bred band had decided not to renew its contract with its old record label, EMI, after their agreement ended in 2003. Although the five-member band had sold more than 20 million records through conventional channels, with more music being swapped or downloaded in pirated versions on the Internet, the idea of working with a traditional record label that sold albums for a fixed price "felt like chaining ourselves to a dinosaur," says Colin Greenwood, the band's bass player.[1]

Then manager Chris Hufford had an idea: Let the fans pay whatever they wanted for a download. "We all thought he was barmy," confessed singer Thom Yorke. "As we were putting up the site, we were still saying, 'Are you sure about this?'"[2]

Radiohead's pricing strategy set off a fierce debate in the music business, "as though a grenade had been lobbed into a record industry already in disarray," as one music writer put it.[3] On one side stood those who saw the technique as an important experiment in an industry profoundly shaken by the shift from physical to virtual delivery. On the other side, traditionalists who saw "pay as you wish," or what the English call "honor box" payment, as capitulation to the pirates—the beginning of another chapter in the decline and fall of the music business.

By the time the program ended on October 29, 2007, Radiohead had clearly won its bet that "virtual busking," as Hufford called it, could beat conventional pricing and distribution.[4] More than 1.8 million people downloaded the album, and although 60% did not pay, 40% did, which was enough to make the album a success for Radiohead.

Radiohead customers paid $2.26 per album on average, probably generating more cash for the band than if it had sold the album through layers of middlemen using conventional pricing, according to a survey by Comscore, a U.S. e-commerce survey company. (The band's managers disavowed Comscore's estimate but declined to supply an alternative set of numbers.)[5] "In terms of digital income, we've made more money out of this record than out of all the other Radiohead albums put together, forever," says Radiohead singer Thom Yorke.[6]

Some fans claimed to have paid even more than they would have for a conventional album: $20–$30 or more—money they would not have paid under a conventional pricing scheme. Consider Jason Raney of Sacramento, California, who said he planned to pay "a hundred dollars American" for his download of *In Rainbows*.[7]

Why Pay More?

At first glance, "pay as you wish" pricing doesn't seem to make much sense: Why would anyone pay something for a product if they had the choice to pay nothing? To anyone used to modern shopping, where most products are sold at a set price, "pay as you wish" seems like a utopian rocker's fantasy ("Dude, let's just, like, *ask* them to pay what they want.")—a good idea for a song, maybe, but not necessarily for a purchasing system.

In certain circumstances, however, "pay as you wish" can be very successful. For decades, theaters in the United States and England have offered "pay what you can" performances on certain nights. Several restaurants and cafés across the United States operate on a similar self-determined pricing model in which customers determine the prices. One World Café in Salt Lake City, Utah, is one such restaurant. As *TIME* wrote, "Attorneys and CEOs, students, seniors, and soccer moms, as well as those down on their luck are among the 150–200 customers that dine daily at One World."[8] Although no customer is required to pay, One World Café is still a thriving business. *The Wall Street Journal* reported that the business has been profitable since 2005 and projects revenues of $350,000 this year, with about a 5% profit margin,[9] not out of line with the 4%–6% profit margins typical of small restaurants.[10]

"Pay as you wish" is less impractical than it sounds because it eliminates many of the disadvantages of set pricing. For the seller, a set price requires figuring out what the price should be, which is typically a difficult and time-consuming process: What is this product worth to my customers? What price will enable me to make the most profit, given the fact that, except for certain kinds of luxury goods, a trade-off always occurs between price and volume? The trade-off arises because set pricing typically charges everyone the same price, regardless of whether one is willing to pay more or less. As a result, the seller is always torn between a better margin and a higher volume, as a better margin always results in a lower volume. The only latitude is the capability to adjust the set price over time. However, even with that little latitude, the vexing question for the seller is always "When should I raise or lower my price next?" The costs associated with this kind of activity aren't insignificant. As much as 1.93% of GDP is eaten up setting and resetting retail prices, an activity that economists call the "menu cost."[11]

For buyers, set pricing also requires answering some difficult questions: How much is this product really worth? Is the price I see on the box the right price for this product? This can be especially tricky when the product is something consumers could never manufacture for themselves, such as a digital camera. Even if buyers have all those questions figured out, they might still wonder if they could get a better price somewhere else.

Set pricing makes every transaction an adversarial encounter, a conflict in which neither the seller nor the buyer ever leaves completely satisfied. The seller must be forever uncertain about whether he set the price too low and left money on the table or whether he set the price too high and lost some potentially profitable customers. At the same time, the buyer will never be absolutely sure the deal he received is the best possible deal he might have found if he had kept shopping.

"Pay as you wish" sidesteps all these issues. In a way, it's the fulfillment of a marketer's dream: The seller gets the best offer from every possible buyer, with no chance that the buyer will leave feeling that he overpaid. Instead of choosing a single price that will be either lower or higher than the potential customer is willing to pay, "pay as you wish," creates a market in which the seller can sell to every possible customer at exactly the price the customer is willing to pay, theoretically expanding the market to the broadest possible size without giving too much of a break to those who are happy to pay a higher price.

Although "pay as you wish" pricing has always existed on the margins of the service economy—think of bellhops or street performers—awareness of its possibilities now seems to be spreading. The rise of more products that are entirely intellectual property with very little physical cost, such as software, and the growth of the service economy are making "pay as you wish" an increasingly practical alternative.

It's even making some inroads into academia. One Columbia Business School marketing professor recently experimented with "pay as you wish" pricing for his new textbook.

Noel Capon likens the textbook industry to the cartel price structure U.S. airlines enjoyed in the 1960s, in which the airlines competed on service but never on price. A "cozy oligopoly" of publishers he says, keeps prices high and encourages the publishers to compete for authors and compete over quality but never price. Incensed by the high price of college textbooks, Capon decided that instead of working with a conventional publisher, he would allow students free online access to his new tome.[12]

By copying the Radiohead model for his new marketing book, Capon hopes to force traditional publishers to lower the prices of their textbooks, playing a role analogous to the one low-cost Southwest Airlines played in revolutionizing airline pricing.

The marketing professor also hopes that the ability to read the book with no obligation to buy will prove a good way to boost demand. "It's a way of getting my book into the hands of as many people as possible," he explains. "The major barrier I've had to overcome is the reluctance of instructors to switch books. By taking the price of the online version to zero, instructors who weren't interested at the old price are going to have to give my book a serious thought."[13] (One problem with the theory, however, is that Professor Capon is assuming that instructors care about the price students pay for a textbook—a questionable assertion.

This might not always be the case, in the same way doctors might not care about the price patients pay for prescription drugs.)

For Radiohead, "pay as you wish" had a number of special advantages, too, some unique to the music industry. First, Radiohead's decision to let the public set the price of its product was big news, not only to Radiohead fans, but also to the general public. Choosing this innovative pricing model generated a lot of free publicity, which enabled the band to cut through the clutter of all bands trying to sell music the conventional way.

The notoriety seems to have helped generate a high enough profile for the album that, despite 1.8 million downloads, the "free" album still succeeded as a teaser for a deluxe boxed set (which included a bonus disc with eight additional songs) priced at £40. The boxed set soared to the top of British pop charts on release in December 2007 and sold 95,000 copies by March 2008.[14] In the end, a year after the experiment, Warner/Chappell, Radiohead's publisher, said that the group earned more money on the online downloads of *In Rainbows* than it had from the total sales of its previous album, *Hail to the Thief*. All told, 3 million copies of *In Rainbows* were downloaded or sold. Nor do physical sales seem to have been cannibalized: As of October 2008, a year after the release, CD sales had reached 1.75 million, a few thousand less than the total cumulative sales of its 2001 and 2003 albums combined.[15]

Interestingly, Capon's textbook sale also sought to capture different ends of the demand curve by differentiating the product itself. He offered "pay as you wish" access for a copy, but readers could access it only online. Students whose budget permitted could buy a printed version for $45 or download a portable document format (PDF) for $25.

This capability to structure multiple tiers of demand for the same product is an important feature of many "pay as you wish" programs. Charities and nonprofit groups have long known the advantages of "pay as you wish" pricing: Many of the 5 million visitors a year to the Metropolitan Museum of Art in New York pay $20 a person to enter, despite a sign that clearly specifies that the price is a "suggested donation." Even political marketers have learned the advantages of "pay as you wish": They can make a good case that President Obama's biggest fund-raising innovation wasn't the use of the Internet as a sales channel, but the ability to reach hundreds of thousands of small donors with a "pay as you wish" proposition in a market that, until recently, targeted only institutions and wealthy individuals.

Don't underestimate the value of such exposure in cross-selling. For many bands, recorded music is becoming more important as a way to drive ticket sales for concert tours than a revenue stream in its own right. The reason selling thousands of tickets is better than selling millions of albums right now is because the top performer typically receives up to 90% of the ticket price, as opposed to a much lower share of the price of an album.[16] For example, pop star Justin Timberlake earned $70.6 million on a 2007 tour in North America, even as his albums earned only $20.8 million.[17]

This isn't an isolated case. "Artists have found that their prime income stream is coming from touring," says one music industry analyst. "Twenty years ago, artists toured to promote an album. Today artists tour because there is a demand to see them live and that's how they make their money."[18] One measure of the success of touring today is that some music labels are reportedly trying to sign artists to "360" contracts, which give the company a share not just of the music revenue, but also of the revenue from T-shirts, concert tickets, ring tones, and other products related to the music.

Looked at in this light, even giving the music away can be a winning strategy. For example, Prince did not earn a profit on the nearly three million *Planet Earth* CDs sent out with the London *Daily Mail* newspaper this spring, but partly on the strength of that promotion, he was able to sell out 21 London concerts.[19] His "loss" with the album clearly sparked interest in his live performances, likely earning him more than the reported $500,000 plus 10% royalty he would have made on the sale of each CD distributed by conventional means.[20]

Many people, particularly college students, already pay nothing for their music and grow their music collection by downloading pirated versions. Instead of extracting nothing, as often happens in the current system of music distribution, Radiohead probably converted some of those online freeloaders to paying customers: A quarter might not be much, but it's better than nothing.

Although media would seem like a very special case, other kinds of businesses—even restaurants, as mentioned earlier—have also adopted "pay what you wish" pricing. Terra Bite Lounge, a coffee shop located in Kirkland, a suburb of Seattle, Washington, is one case in which the benefits of this alternative pricing method are not clear-cut. The café does not list its prices. Customers pay whatever they wish and drop their payments in a locked metal box on the counter, discreetly labeled "All payments and tips here, please." According to *The Wall Street Journal,* Terra Bite serves an average of 200 customers per day, who each pay on average $2 to $3. Ervin Peretz, one of the owners, says Terra Bite's per-food item revenue is substantially less than other coffee shops. At the moment, Terra Bite is a financially viable business and has more than broke even operationally since it opened in November 2007, but its unique pricing policy might put it in a precarious situation.[21] Serving an average of 80 customers per day at $3 per transaction is barely the break-even point, especially considering its rent of $4,000 per month.[22] However, others have done much better. At one café in Kettering, Ohio, the owner switched to "pay as you wish" pricing in 2008 as a way to respond to the recession. The result: Since he switched to that pricing method, sales and customer head count are up 50%–100%, and he's thinking of adding more staff.[23] And he's not alone: The upscale Just Around the Corner restaurant in London is now in its twenty-second year of operation using "pay as you wish" pricing, and it's still apparently successful.

So why take the risk? "When you give people good food and good service, they leave bigger tips," explains Vasos Michael, owner of Just Around the Corner. "So I said to myself, 'Let's leave the bill up to them, too.'"[24]

Typically, sellers turn to "pay as you wish" pricing because either they believe the product will drive business for a higher margin product, or they believe that "pay as you wish" pricing can yield more than conventional pricing—or both, for Radiohead.

Others, particularly some restaurants, price on this basis as a political statement, which can yield noneconomic benefits to the owners and perhaps yield some reputational gains in the community as well.

It might even improve the product by encouraging the waiter to provide excellent service. After all, the entire check, not just the tip, will be paid at the discretion of the customer. One consultant has described the business model as "an in-built quality control system."[25] Apparently, it's still working at Just Around the Corner: One recent reviewer of the restaurant noted that he has seen the same waitress at the restaurant for three years, which he says "must be a record in London."[26]

A final important element of some "pay as you wish" strategies, particularly in the music industry and perhaps in the emerging e-book industry, is the way it changes the cost structure. Refusing to set prices often cuts out a number of middlemen. For example, because publishers typically earn only 50% on the retail price of a book, voluntary payments by readers of a downloaded e-book produced at near-zero marginal cost don't need to be that high to generate a profit. For authors, who earn only 5% of a retail sale, the economics might be even more favorable.

Companies can also use such downloads to create a marketing buzz around a book. For example, Faber, a U.K. publisher, recently made historian Ben Wilson's book *What Price Liberty?* available for a free download six weeks before its paper publication—an experiment that Faber marketers believed would grow the audience for the book without cannibalizing hard-copy sales.[27]

In the textbook business, a "pay as you wish" model might have another advantage: It reduces the number of copies available for resale. A large percentage of textbooks students buy are used copies that the publisher and author earn no royalty on. As a result, a 100% "pay as you wish" model would help replace that profitless secondary market with one in which users would pay the publisher on an ongoing basis.

That's the theory. Whether a "pay as you wish" pricing strategy actually succeeds is another matter. In the music world, Radiohead members themselves have said that they don't believe "pay as you wish" pricing is something that could work for every group. They say that their success was primarily possible because they already had a large and established base of devoted fans. Similar experiments by lesser-known artists suggest that they might be right. Harvey Danger, a lesser-known band than Radiohead that still enjoys some fan recognition, released its album in 2005 under the same format as Radiohead. Fans downloaded the album 190,000 times, but only 1% of people paid something for it. Although the average donation (for those who donated) was $8.34, Harvey Danger's guitarist Jeff Lin says that it was "certainly not the runaway, huge financial bonanza some people thought it would be."[28]

However, other artists have experienced more success with "pay as you wish" pricing. In 2005, Canadian singer-songwriter Jane Siberry instituted what she referred to as "self-determined pricing" for her music downloads. At checkout, customers were given four options: pick a price, pay later after downloading the song, pay the standard 99¢, or "gift from Jane," which meant the customer did not have to pay.[29]

In the end, "pay as you wish" pricing may be an especially good way to price music and other experiential goods by focusing customers not on the price they will pay, but on the level of enjoyment they get from the song, book, or movie. Our colleague Peter Fader, a marketing professor at The Wharton School, argues that focusing consumers on the price of an experiential good such as music ultimately pushes down the perceived value of the experience. "If you boil it down to what is this song worth, you don't want people to be thinking about that. This is one of the problems with the whole iTunes business model, i.e., is it worth 99¢ or not? Music, being a holistic good and an experiential good, is worth more than just the bits that you are acquiring."[30]

Certainly, restaurateur Michael would agree with Fader that not focusing customers on the price provides a greater potential upside than conventional pricing. At Around the Corner, he said four American businessmen once came in for dinner and decided to leave £600 on the table when they left (nearly $1200 at the time). "They asked if it was okay," the owner recalls. He answered, "'Of course.' If that's what they thought it was worth, then fine!"[31]

The First Five Notes

Although music is a very risky business, we found that Radiohead's *In Rainbows* campaign shares the same five key qualities as any successful "pay as you wish" pricing program:

1. A product with a low marginal cost
2. A fair-minded customer
3. A product that can be sold credibly at a wide range of prices
4. A strong relationship between buyer and seller
5. A very competitive marketplace

A Low Marginal-Cost Product

Shortly after the release of *In Rainbows,* Radiohead guitarist Jonny Greenwood lost the password of some music software he uses, and he e-mailed the developers to ask for a new password. "They wrote back, 'Why don't you pay us what you think it's worth?'" Greenwood said.[32]

As Radiohead learned, software is also a good candidate for "pay as you wish" pricing. Our research suggests that any project with a low marginal cost—a high fixed cost for the first copy and low costs for each additional copy—is fair game.

For example, a dealership couldn't sell a car on a "pay as you wish" basis because the cost of a single nonpayment would outweigh the profit earned from dozens of buyers. Grocery stores would also not be good bets because most costs are marginal production costs. But software, music, and many other kinds of media and intellectual property typically have a low marginal cost. As the costs of these products are mostly fixed, the cost of selling an additional copy is quite low and often nearly zero online.

However, this does not mean that the marginal cost must be near zero for "pay as you wish" pricing mechanism to be viable. Restaurants have a substantial marginal cost, although fixed costs such as salaries and space leases are typically much greater than the marginal costs of food. At Around the Corner, the four American businessmen we mentioned earlier might have ordered a bottle of Château Mouton Rothschild Pauillac 2003, which may have cost £200, and yet in that instance "pay as you wish" still worked.

A Fair-Minded Customer

In the case of Radiohead, the success of *In Rainbows* relied on the fair-mindedness of the group's many dedicated fans. For a devotee of the band who has followed the band's development during the past 15 years, downloading without paying might be psychologically difficult.

Radiohead fans are apparently not alone in being fair-minded. Richard Thaler, a professor at the University of Chicago and a pioneering behavioral economist, has noted that by thinking of people as selfish, rational actors, classic economic theory has tended to overlook the fact that human beings actually often respond according to how they are treated. Many researchers have discovered that people tend to reciprocate "kindness with kindness, cooperation with cooperation, hostility with hostility, and defection with defection," Thaler says.[33]

Thaler also notes that people often act altruistically even without an economic incentive to do so. Even Adam Smith, the first modern theorist of capitalism, noted as far back as the Eighteenth Century:

> [H]ow selfish soever man may be supposed to be, there are evidently some principles in his nature, which interest him in the fate of others, and render their happiness necessary to him, though he derive nothing from it, except the pleasure of seeing it.[34]

"Pay as you wish" sellers seem to try to invoke this sense of fairness in their customers. For example, Radiohead forced buyers to enter an amount they wanted to pay before the download. Potential freeloaders had to enter £0 if they wanted to pay nothing. That action could trigger the fairness reflex: Is it fair of me to not pay anything for someone else's labor?

When a transaction occurs in a social setting, such as a restaurant, the fairness reflex can be encouraged by creating a situation in which it is difficult for customers to not pay anything without some damage to their reputation—a process Erica Okada, assistant professor of marketing at the Michael G. Foster School of Business, calls "social monitoring."[35] For example, at the Ten Thousand Buddha House, a successful "pay as you wish" restaurant in Hong Kong, all diners must make reservations in advance, reducing the sense of anonymity.[36] Whoever is paying the bill won't want to lose face by looking cheap in front of others at their table—or even strangers in the restaurant.

Sometimes organizations that use "pay as you wish" pricing further discourage underpayment by trying to add to the payer's embarrassment. Just Around the Corner discourages underpayment by shaming the under-payer. "With these people who pay a silly amount, we give them their money back," says owner Michael.[37] Technically, the customer can get away with paying nothing, but for most people, a free meal at the cost of public humiliation is too expensive. Such episodes are a one-time loss for the restaurant and normally a one-time lesson for the customer. The deadbeat customer either writes a larger check and pays more at subsequent visits, or he never returns.

This kind of confrontation seems common to "pay as you wish" businesses. Sam Lippert, owner of the "pay as you wish" Java Street Café in Kettering, Ohio, makes customers pay him directly. "Well, you know, they have to look me in the eye and say that that's what they think is fair. And, you know, that's a big incentive. When someone's at the counter and you say, 'You get to pay what you think is fair,' very few people are going to take advantage of that situation," he says—"especially if you know them by their first name."[38]

Businesses use other mechanisms to make it easier for customers to follow their own best instincts. Farmers around Ithaca, New York, often leave tables filled with produce on the side of the road, along with a cash box. They reduce their customers' temptation to run off with the money by making it difficult to remove the box or to take money out of the box's narrow piggy-bank slit. The behavioral economists who wrote about their business model note that they think the farmers have human nature figured out: "They feel that enough people will volunteer to pay for the fresh corn to make it worthwhile to put it out there. The farmers also know that if it were easy enough to take the money, someone would do so."[39] As an old Chinese saying goes, the lock on a door is meant to prevent the theft by a gentleman, not by a thief.

A strong sense of community among customers seems to help build this sense of social pressure as well. During the October downloads, many Radiohead fans reportedly asked each other how much they paid for their "free" downloads. The fact that "pay as you wish" restaurants have done well both in upscale urban neighborhoods and rural coffee shops suggests that "pay as you wish" pricing might be most effective in places with a strong sense of community.

But even in more hectic, impersonal situations, social monitoring seems to have some effect. For example, paying nothing at the Metropolitan Museum requires "buying" a lapel button directly from a museum employee, creating an uncomfortable social context for the visitor—in addition to the real or imagined social pressure exerted by others who have paid and, perhaps, by their own family.

New ways to create social pressure online may develop in the future as well. Wessex Press, the publishing house that publishes Capon's textbook, *Managing Marketing in the 21st Century,* tells customers that they can download the book for free, but they must "agree to receive an e-mail from Wessex in a few months' time encouraging you to pay what *Managing Marketing in the 21st Century* was worth to you."[40]

Far from underpaying, certain "pay as you wish" situations lead customers to err on the high side. For example, people at Just Around the Corner in London reportedly pay 10%–20% more than they normally would for an equivalent meal. When a pricing mechanism appeals to customers' good side, it can bring the best out of the customers.

A Wide Distribution in the Amount Customers Are Willing to Pay for a Product

The fact that some people care about Radiohead more than others was another reason for the campaign's success. If a product's perceived value doesn't vary much, encouraging customers to set their own prices might not be profitable. Much of the profit in "pay as you wish" pricing lies in the wide distribution of customers who don't know the underlying cost structure and overestimate the actual cost. A wide distribution of willingness to pay also makes it more profitable to charge different customers different prices. "Pay as you wish" pricing enables the seller to achieve price discrimination tailored to individual customers.

A Strong Relationship Between Buyer and Seller

After people have established a relationship, whether it is a one-sided relationship with a group such as Radiohead or a more mutual relationship with a salesperson, they often feel a need to reciprocate their kindness. Many businesses with conventional pricing have incorporated this tendency into their customer service practices—from Nordstrom, the high-end U.S. department store famed for providing extraordinary levels of service, such as gift-wrapping packages bought at other stores, to Wal-Mart, the low-price zealot that installs a person at every entrance, often a friendly old lady. Whether the idea is called "aggressive hospitality," as Wal-Mart founder Sam Walton branded his approach to customer service,[41] or an injunction to their employees to "think like the customer," the underlying idea is the same.[42] And in the case of the Wal-Mart greeter, the aim is not only to encourage loyalty, but also to discourage theft.[43]

The same principle may be even more important in "pay as you wish" pricing because the decision to leave anything is a voluntary act. If a waiter has been kind and helpful, it's difficult to walk away from a meal without tipping, although diners aren't legally obligated to leave anything.

Framing devices, such as the general custom in the United States of tipping 15% or the Metropolitan's posted notice about a suggested donation for admission, also add pressure to pay more than a token amount. Such frames might be a useful tool in "pay as you wish" pricing, which otherwise forces consumers to do more of the work involved in setting the price.

Getting to know how customers decide what to pay can also help a seller effectively implement "pay as you wish" pricing. Most consumer behavior studies suggest that buyers use three ways to decide the price they are willing to pay: anchor pricing, value pricing, and fair pricing.

When customers use anchor pricing (sometimes called reference pricing), they compare the price of similar goods to determine a price.

For example, users might note that CDs on iTunes sell for an average of $13 or recall that the price of a previous Radiohead CD is $15, which sets an upward boundary for the price they will pay. They might reason that if a CD downloaded from iTunes costs $13, and perhaps $9 ends up going to the label, Apple, and other marketing expenses, the artist might end up with $4.[44] As Radiohead doesn't have a label or other marketing expenses, they might conclude that $4 would be a fair price for their new CD.

A second common strategy customers use is value pricing—deciding the value the album represents to them and then using that as the maximum price they would be willing to pay to own the CD. For example, on Salon.com, user Sponte comments, "[I paid] £10...so, roughly $20 U.S.—since it's whatever I want to pay and that I value Radiohead as an artist and applaud this experiment...."[45]

In the third strategy, fair pricing, customers try to determine what they consider a "fair" price, their intuitive idea of what sounds like a fair return for the seller. Consider what these users at Salon.com say they paid for *In Rainbows:*

> "I decided to pay £5. I think $10 sounds about fair for a record these days."—User Ozoneon
>
> "I am preordering the album for £3. Sounds fair to me."—User edsohsmith[46]

Each of these methods relies to an extent on preexisting knowledge or sentiments to help anchor the price, which suggests that a radically new product might be difficult to sell using "pay as you wish." Knowing that the going rate for downloading a song is 99¢, or that a cup of coffee is generally a dollar or two, informs the customer's understanding of what an item is "supposed" to cost. Without an anchor price or a clear understanding of the value of a product's advantages, a customer would likely have a hard time deciding what the "fair price" should be.

A Competitive Marketplace

The music industry is very competitive, not only because of the number of bands that compete for young fans' devotion, but also because of piracy that tempts those young fans not to pay anything for songs. In this marketplace, given the alternative of a band setting a fixed price and seeing only a few people buying, "pay as you wish" can be a superior pricing mechanism even if the band's objective is to maximize its profitability.

Indeed, in a very competitive marketplace anywhere, "pay as you wish" may very well be an effective way for competing firms to avoid ruinous price competition. When consumers pay what they wish, prices in the market become autonomous, and competing firms no longer set any prices. When they do not set prices, they cannot and will not compete on prices!

Conclusion

"Pay as you wish" pricing probably goes back to the roots of trade, to the days when value was even more difficult to assign than it is in today's cash economy. Then, as now, "pay as you wish" pricing served as a good way not only to transfer goods and services, but also to build a stronger sense of community. It's easy to imagine within a family or a village that such large webs of mutual obligation could end up feeling virtually indistinguishable from good deeds.

As the collective wisdom of many cultures suggests—from the English proverb that "the giving hand, gets" to the Chinese injunction that if "if somebody gives you one drop of benefit, you should repay it with a spring of kindness"—human beings seem hard-wired for positive reciprocity. In the end, it's possible that "pay as you wish" may sometimes be not only a convenient process for exchanging goods and services, but also an elemental way in which communities are built or strengthened.

Certainly, Radiohead seems to have experienced the sales of its album this way—as a kind of affirmation from its fans. "It released us from something," says Yorke, the band's leader. "It wasn't nihilistic, implying that the music's not worth anything at all. It was the total opposite. And people took it as it was meant. Maybe that's just people having a little faith in what we're doing."[47]

Or as Hufford, the band's manager, put it, "People made their choice to actually pay money. It's people saying, 'We want to be part of this thing.' If it's good enough, people will put a penny in the pot."[48]

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