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WILLINGNESS TO PAY: WHAT IT IS & HOW TO CALCULATE

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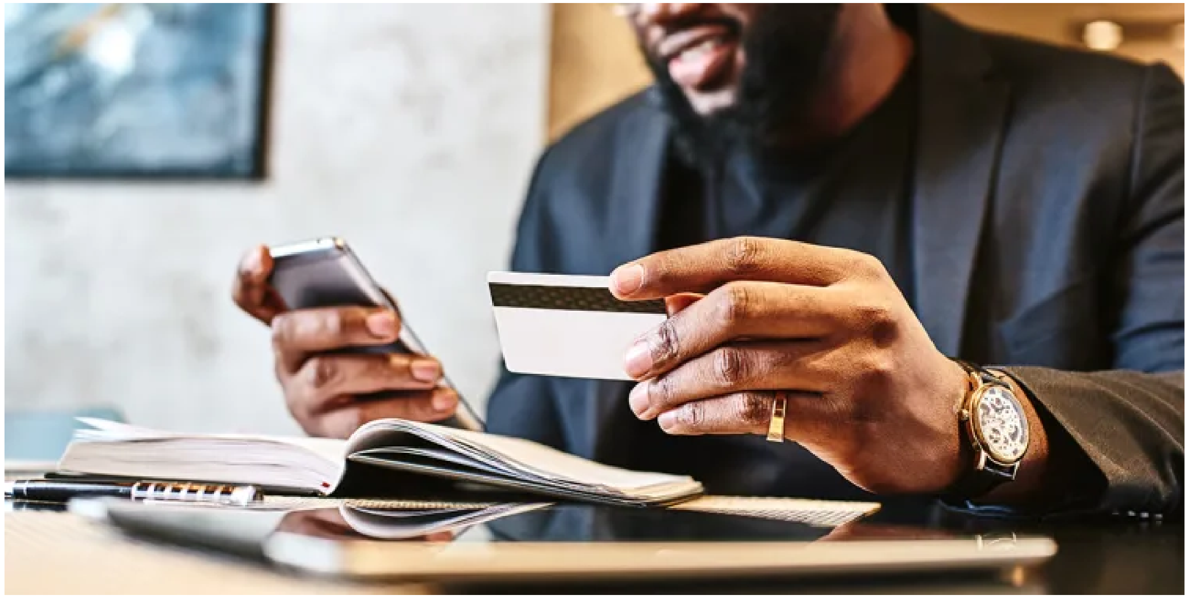

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Economics for Managers, Strategy

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Few factors are more important in business than ensuring your products and services are appropriately priced. Charge too little, and you leave revenue on the table—money you could use to expand your team, refine your offerings, and grow your business. Charge too much, and you might alienate and send potential customers to your competitors.

Whether you're a professional responsible for determining your company's pricing strategy or an entrepreneur on the verge of launching a new product or service, it's vital to understand how much your customers are willing to pay. Below is an overview of the willingness to pay concept and strategies you can use to estimate this crucial metric.

WHAT IS WILLINGNESS TO PAY?

Willingness to pay, sometimes abbreviated as **WTP**, is the maximum price a customer is willing to pay for a product or service. It's typically represented by a dollar figure or, in some cases, a price range. While potential customers are likely willing to pay less than this threshold, it's important to understand that, in most cases, they won't pay a higher price.

"What the concept of 'willingness to pay' is telling us is that whatever your willingness to pay for a product might be, and wherever it comes from, you're just not going to pay more than that [amount] for it," says Harvard Business School Professor Bharat Anand in the online course Economics for Managers.

Willingness to pay can vary significantly from customer to customer. This variance is often caused by differences in the customer population, typically classified as either extrinsic or intrinsic.

Extrinsic differences are observable. They're factors you can generally determine about a person without needing to ask them directly. A customer's age, gender, income, education, and where they live can all be extrinsic differences that impact their willingness to pay.

Intrinsic differences, on the other hand, are a person's characteristics you wouldn't know about without asking them directly. They're hard to observe and often called "unobserved differences." An individual's risk tolerance, desire to fit in with others, and level of passion about a given subject are all examples of intrinsic differences that can impact their willingness to pay.

OTHER FACTORS AFFECTING A CUSTOMER'S WILLINGNESS TO PAY

It's important to note that your customers' willingness to pay a certain price for your product or service isn't static. In addition to extrinsic and intrinsic differences, numerous factors can cause a customer's willingness to pay to rise or fall.

"We often wonder why people might be willing to pay for a product when another seemingly identical one was available for a cheaper price or free," Anand says in Economics for Managers. "That shouldn't be surprising. Price isn't the only feature that matters to customers. For example, legality, packaging, and brand name might matter as well."

When a customer has an urgent need that your product or service can address, they may be willing to pay a higher price than when their need is less urgent. Similarly, an actual or perceived shortage in supply could make them more willing to pay a higher price than when there's a surplus.

Conversely, a customer's willingness to pay may fall due to the emergence of a new competitor with stronger brand recognition or the perception that your product or service is outdated. This is especially true in the tech space.

HOW TO DETERMINE YOUR CUSTOMERS' WILLINGNESS TO PAY

By determining customers' willingness to pay, a company can set its prices at a level that allows it to maximize profits and customer satisfaction.

“You often see companies and managers immediately honing in on the question of ‘Where should we price?’” Anand says in Economics for Managers. “But it's often far more useful to start by thinking about customers' willingness to pay and how that's different for your product than for others.”

With this understanding, a business can work backward to determine the appropriate price that maximizes profits without alienating customers. Here are four methods you can use to estimate and calculate your customers’ willingness to pay for your products or services.

1. Surveys and Focus Groups

One of the surest ways of determining your customers’ willingness to pay is to ask them. While surveys tend to be more affordable than focus groups, both are an excellent way of doing so. Surveys typically collect a large amount of quantifiable data, while focus groups often result in more nuanced, qualitative information.

Relying on surveys and focus groups can come with challenges. If they’re not designed in a way that encourages respondents to answer truthfully, or if they rely on a poor sampling of consumers, they can result in erroneous data. This can have adverse effects on your ability to make business decisions.

2. Conjoint Analysis

Conjoint analysis is a specialized type of survey, in which respondents are asked to rank different bundled features. The responses are then used to assign a numerical value to each feature (called a “part-worth”) to determine consumers’ preferences.

The values can then be used to predict how a consumer will react to a given product and help determine which features make it into the end result.

3. Auctions

Auctions are often a more effective means of eliciting a consumer's true willingness to pay because they tie the act of revealing one's preference for a product or service to the probability of obtaining it. Although auctions can be useful tools for a seller with little to no information about consumers' willingness to pay, they can result in uncertainty for consumers. This uncertainty and delay can cause some consumers to prefer fixed prices.

There are several auction types that can help reveal willingness to pay. Some of the most common include:

- **Open outcry auction (English auction):** In this type of auction, a pool of potential buyers submit increasing bids. The consumer with the highest willingness to pay wins the auction, most typically by bidding (and therefore paying) an amount just above what the consumer with the second-highest willingness to pay bids.
- **Sealed second-price auction (Vickrey auction):** In this type of auction, a pool of potential buyers submits sealed bids. The individual who submits the highest bid wins the auction but pays the second-highest bid. Bidders are motivated to bid their exact willingness to pay to maximize their chance of winning while minimizing the risk of overpaying.
- **Sealed first-price auction:** Bidding works the same way as in Vickrey auctions, but the highest bidder pays the price they bid (as opposed to the second-highest bid). In this type of auction, bidders are often motivated to bid below their exact willingness to pay so they can capture some value if they win.

4. Experiments and Revealed Preference

It's increasingly possible to use data about consumers' past choices to determine their true willingness to pay. This is known as revealed preference because the insight is based on what the consumer does instead of what they say. A challenge of this approach lies in the possibility that missing variables might confound the interpretation of data.

One solution to this challenge is to run experiments designed to determine consumers' willingness to pay. For example, you might adjust prices to see how sales are impacted. By randomizing treatments and using control groups, you can avoid the problem of confounding variables.

THE IMPORTANCE OF GETTING IT RIGHT

Businesses have an incentive to determine consumers' willingness to pay for their products or services. By estimating WTP and working backward to determine price, firms can confidently maximize profit margin while capturing as much value as possible from the consumer.

Of course, this is just one aspect of what it takes to manage a business properly. Other economic principles should be used in conjunction with willingness to pay to set prices and make other business decisions. While trial and error can be an effective means of learning these skills and principles, taking an economics course is a way of doing so much more quickly.

Are you interested in deepening your understanding of how to calculate your customers' willingness to pay and use other key frameworks? Explore our eight-week course Economics for Managers and other strategy courses to learn more about how to develop effective pricing strategies. Download the free flowchart to find the best strategy course for you and your goals.

About the Author

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