The Philosophy of Price

by Hermann Simon

From ancient times through today, philosophers have contributed valuable insights on pricing. Astute pricers should keep their eyes wide open. Pricing is not a narrow discipline. It benefits from deep, almost philosophical thinking and understanding, as the author explains. Hermann Simon is the founder and honorary chairman of Simon-Kucher & Partners. Ranked on the Thinkers50 list of the most influential international management thinkers, he is considered the world's leading authority on pricing. He can be reached at hermann.simon@simon-kucher.com.

Prices are the central hinges of a market economy. As consumers, we pay them many times a day. As managers, we have to make price decisions all the time. But we hardly ever link our price-related activities to philosophy. What does philosophy have to do with price? Why should we look at something as ubiquitous and mundane as price from a philosophical standpoint?

It turns out that viewing price through the lens of classical philosophy reveals some very practical insights which can prevent us from making mistakes, both as buyers and sellers. What I refer to as the "philosophy of price" can …

- deepen our understanding of price and its effects,
- keep us humble (many seemingly modern pricing concepts were first articulated by ancient philosophers), and
- help us to solve difficult ethical pricing issues, such as in health care.

In this article, I offer insights drawn from classical philosophy which remain surprisingly relevant for 21st century price decisions. I have devoted my life to pricing and describe the journey through the land of price in my book *Confessions of the Pricing Man*.[1] In the first 20 years of my career, I worked as an academic. For the next two decades, I did real-world work as a price consultant. Along the way, my associates and I built the world's leading price consultancy. Simon-Kucher & Partners currently employs more than 1,200 people in 38 offices on six continents.

On Price and Value

There is one question I have been asked thousands of times during my career: "What is the most important aspect in pricing?"

My evergreen answer has always been "value" or "value-to-customer." To be even more precise, the best answer is "perceived value-to-customer." Why do I say that? The customer's willingness to pay a price and, thus, the opportunity for the seller to obtain that price, is nothing but the reflection of the value perceived by the customer.

This simple insight, however, is not new. It is derived from Latin, which uses the same word, *pretium*, interchangeably for value and for price.

Value = Pretium = Price

Languages contain a lot of philosophical wisdom. This linguistic truth from Latin is the eternal equation of pricing. Value and price must always be balanced. Businesspeople who adhere to this simple equation avoid making big mistakes in setting their prices. The equation also applies to the buyer, who as the saying goes, "gets what they pay for."

The concept of "value equals price" is so fundamental and universal that I would call it a philosophical equation. It tells us that pricing should not be primarily concerned with price as such, but instead concerned with value. It also teaches us that understanding, creating, and communicating value is the key challenge in pricing.

Lesson 1: The most important aspect of price and pricing is value. The essential and eternal equation in pricing is "value = pretium = price." Understanding, creating, and communicating value is the key challenge for a business.

On "Value-in-Use" and the Sharing Economy

This eternal equation begs the question: "What is value?" One of the first known answers to this question comes from the Greek philosopher Socrates (469-399 BC) who said that "happiness does not come from ownership, but from the use of a product." In contemporary terminology, we speak of "value-in-use."[3] We can therefore consider Socrates to be the father of a very modern concept: the sharing economy.[4] In the sharing economy, one does not own a car, a bicycle, or an apartment; one uses it, often only for a defined period. The increasingly widespread implementation of the sharing economy is radically transforming entire industries.

Why was this revolutionary Socratic idea not implemented earlier? The answer is obvious. Transaction costs of sharing were too high prior to the arrival of the internet. Selling a car at $30,000 is one transaction. Sharing it in hourly increments means thousands of transactions over the life of a car. Offering a car on a per-hour basis or a bicycle on a per-minute basis requires an extremely efficient transaction process and the ability to bring together a critical mass of buyers and sellers. Neither is possible without the internet.

At the same time, Socrates denied the value of ownership. I consider this a flaw. Ownership can have intrinsic value in addition to or even without "value-in-use." Think of a Ferrari displayed in front of its owner's house but never driven. Does the owner derive value from that car? Of course! There are two reasons for this. First, owning something is likely to convey more status than sharing something. In his famous classic *The Theory of the Leisure Class*, published in 1898, Thorstein Veblen described this phenomenon, which is also called "snob effect."[5] A second, very modern argument is that sharing is always based on an "incomplete contract." This concept goes back to Nobel laureate Ronald Coase, who explained why firms exist and own their assets.[6] Coase said that within a firm, transaction costs can be lower, and that sharing, renting, or leasing is always based on an incomplete contract. Only ownership grants you the right to do anything with the object in question. You cannot repaint a leased car or an Airbnb apartment, nor can you sell it. But if you own it, you can tear it down, repaint it, sell it, dismantle it, or whatever. Ownership has a higher value than anything based on an incomplete contract. The issue of incomplete contracts gains new importance with so-called "smart contracts" and blockchain technology.

Can the value of ownership vs. the value of sharing/renting/leasing be observed in real life? I think so. Here is a current case. The "ownership price" of a given BMW 7 Series car is €110,510, while the leasing price per month is €1,231 for a leasing period of three years. Thus, in three years the consumer pays a total of €44,316. Without financing costs, the payback period amounts to 89 months or 7.5 years. If you add financing costs, there is hardly a way for the seller to get the "ownership price" through leasing. A possible explanation is that ownership plus value-in-use create higher perceived value than mere value-in-use, and that certain consumers are willing to pay the higher ownership price. Socrates may have missed this aspect.

Lesson 2: The basic idea of the sharing economy goes back to Socrates, who said that value does not come from ownership, but from the use of a product ("value-in-use"). While this may be generally true, ownership can also have intrinsic value, resulting from Veblen ("snob") effects or from complete contracts. The observation of higher ownership prices relative to sharing prices is consistent with this notion. Only the internet has made large scale application of the sharing economy possible thanks to radically lower transaction and controlling costs.

On Value Differentiation

We owe many of the more sophisticated insights on value and price to the Greek philosopher Aristotle (384-322 BC). He observed that value-in-use can vary among individuals. This is the basis for the ubiquitous price differentiation or price discrimination we experience today.[7] Aristotle also noted that the value-in-use declines as the quantity of goods increases. This fundamental law is now known as Gossen's Second Law, formulated in 1854 by Hermann Heinrich Gossen (1810-1857).[8] This law is the foundation for non-linear pricing.[9]

Aristotle also mentions that the value of a product can depend on the use of another product. This insight provides a rationale for multi-product pricing and for so-called price bundling. He also observed that the value-in-use will increase if the good can be consumed conspicuously, which leads us back to the snob or Veblen effect. Finally, one can draw a direct line of reasoning between Aristotle and Karl Marx. Aristotle stated that labor as a commodity has value, but does not create value. This essentially contradicts Marx's labor value theory, which we will discuss later.

Lesson 3: Many modern pricing concepts, such as price differentiation, non-linear pricing, and price bundling, are rooted in ancient philosophy and can be traced back to Aristotle. Even today, his ideas help us to comprehend the underlying logic behind certain pricing tactics.

On "Just Price"

The concept of "just price" dates back to Thomas Aquinas (1225-1274).[10] Today we use the term "fair price" in a similar sense. Aquinas looked at pricing from an economic and an ethical perspective. His ideas were strongly influenced by the Christian tradition against usury and against interest in general. To raise prices in response to increasing demand was theft in his view. Aquinas also explicitly stated that charging higher prices in the wake of natural disasters is unethical.

This latter topic is highly relevant today, as illustrated by the report "Price Gouging After Hurricane Sandy: Immoral or Law of Supply and Demand."[11] It concerns the pricing for power generators during and after a 2012 hurricane in the US. Should the seller raise the price after a disaster? If the price is kept constant, the first buyers will buy several generators and resell them at a higher price. Is this just?

We can also look at the case of Uber after a terrorist attack in Australia in 2014. The demand for cars surged, and the Uber program automatically increased the surcharge.[12] This makes economic sense, because the higher fees attract more cars to the site from which people want to flee. Uber got a very negative media response to that action, however. Uber now applies manual intervention if demand rises suddenly and sharply.[13] In the case of a London terror attack in 2017, Uber refunded the passengers who had paid the surcharge.[14]

Very innovative life-saving drugs are another example. Kymriah, a gene-based therapy offered by Novartis, heals a certain type of leukemia with one injection. What is a just price for this product? In the

US, an application of this drug costs up to $475,000. In the UK, the National Health Service covers a price of 220,000 British pounds, but only for children. In Germany the price is €320,000. Novartis chairman Dr. Joerg Reinhardt defends these prices: "We firmly believe that therapies should be paid for on the basis of their value. We are determined to set our prices according to this principle. In the future, costs for a genetic therapy will be justified by their value for the individual patient."[15] Even higher values and prices can be seen on the horizon. Spark Therapeutics, which offers a new gene therapy against a gene defect which leads to blindness in children, "has said it plans to sell Luxurna in the US at a cost of $850,000 a patient, but it wants to offer partial refund if patients don't meet recovery targets."[16] The most recent addition of this kind of product is Zolgensma, which was approved by the American FDA in May 2019. It heals spinal muscle atrophy, a disastrous disease affecting babies, with a single injection. The price is $2.1 million. The value of this revolutionary innovation of Novartis has been estimated by a British institute at $4 million.[17]

Would a different price system be more just? One idea brought into the discussion is a refund if the treatment does not yield the promised effect. An alternative could be a price scheme where patients pay 50% of their annual income. A patient who earns $100,000 per year would pay $50,000. A patient who makes $2 million a year would pay $1 million. While such a system seems unrealistic at first glance, it is actually the basis for income taxes, which one can consider to be the price for government services. For public goods, theory suggests that the price paid by a customer should be equal to the marginal utility of that customer.[18] The income percentage can be considered as a proxy for the marginal utility. Is such a life-saving drug a public good?

The concept of "just price" was later discarded by Spanish scholars and replaced by a more market-oriented approach.[19]

Lesson 4: The concept of "just price," which dates back to Thomas Aquinas, is considered obsolete today, at least for competitive markets. But the problem remains in certain cases, such as monopolies, extreme demand, or very high value products or services such as for life-saving drugs. We have no clue what is just in such situations.

On Marxian Pricing

Are you a Marxist? You are likely to answer "no." So my next question is: "OK, if you are not a Marxist, why is your pricing Marxian?" While Marx's labor theory is totally rejected today, it has survived in pricing. What a strange phenomenon! Let me explain why that is the case.

The most important contribution of Karl Marx (1818-1883) was his labor theory of value, according to which only labor creates value. He writes that the "prices of goods are determined by wages."[20] Marx allows for differences in productivity and qualifications of workers, and thus for different values per unit of time. But the core of his theory is that only labor creates value. Consequently, labor costs are the sole base for price calculations.

Karl Marx's labor value theory is considered completely obsolete. Nevertheless, cost-plus pricing, which is nothing but Marxian pricing, predominates.

In modern terminology we call this method "cost-plus pricing." Based on my decades of observations around the world, I would claim that 80% of all prices in today's markets are primarily determined on the basis of costs. And all costs are labor costs. Lawyers, consultants, and most other service providers charge prices for their time (hourly, daily, monthly rates). If an automotive company buys parts from a supplier, these parts carry labor costs up the value chain.

Lesson 5: Karl Marx's labor value theory is considered completely obsolete. Nevertheless, cost-plus pricing, which is nothing but Marxian pricing, predominates. If one doesn't believe in Marxism, one should get rid of Marxian pricing. Perhaps calling it Marxian will accelerate the eradication of cost-plus pricing.

On Subjective Value

The so-called subjective value theory, which is generally but not universally accepted, could be expressed as "value is in the eye of the beholder."[21] This is also not new. Publilius Syrus, who lived in the 1st century BC, said: "Everything is worth what a purchaser will pay for it." What is this theory's implication for pricing? It is "value extraction" or, in the modern internet vernacular, "monetization."[22] These terms encompass all variants of price differentiation or price discrimination, across customers, across product variants, across space and time.[23] The internet has radically improved the opportunities for price differentiation due to much better data and much lower implementations costs.

However, there is a strong and increasing opposition against "value extraction." Mariana Mazzucato from the London School of Economics is one of the outspoken critics. "Things are only getting worse," she writes. "'Rent seeking' refers to the attempt to generate income, not by producing anything, but by overcharging above the 'competitive price,' and undercutting competition by exploiting particular advantages, or blocking other companies from entering an industry, thereby retaining a monopoly advantage."[24]

Her views are seconded by Nobel laureate Joseph Stiglitz, who blames weak regulation and monopolistic practices for "rent extraction."

A related key question is whether there is a level playing field between consumers and increasingly sophisticated sellers. I think there is. The reason lies in the much higher price and value transparency the internet provides. Today's consumers have all kinds of price comparisons at their fingertips. The same increasingly applies to value transparency thanks to widely-used customer feedback mechanisms. Marshall McLuhan's "global village," first described in 1962, has become reality. Understanding value creation and delivery on the one side and value extraction (or monetization) on the other side becomes critical for buyers and sellers. This applies to B2C markets as well as to B2B markets.

Lesson 6: According to the subjective value theory, value is in the eye of the beholder. Aristotle recognized that values are differentiated and offer opportunities for value extraction and systematic price differentiation. Modern information technology has pushed this trend to such an extreme and thus provoked a backlash against "value extraction." This opposition suggests that companies should not overdo it with respect to price discrimination. On the other hand, increasing price transparency and value transparency contribute to a level playing field between sellers and buyers.

Society and Price

A journey through philosophy yields many additional insights on the role of prices in society. I highlight several of them in this last section.

On price and quality

Baltasar Gracian (1601-1658), a Spanish philosopher and Jesuit, said: "It is better to be cheated in the price than in the quality."[25] The same idea resonates in the French proverb: "Le prix s'oublie, la qualité reste."[26] The English social reformer and philosopher John Ruskin (1819-1900) expressed a similar thought: "It is unwise to pay too much, but it is worse to pay too little. When you pay too much, you lose a little money – that is all. When you pay too little, you sometimes lose everything because the thing you bought was incapable of doing the thing you bought it to do. The common law of business balance prohibits paying a little and getting a lot – it cannot be done. If you deal with the lowest bidder, it is well to add something for the risk you run, and if you do that you will have enough to pay for something better."[27]

Price as truce

The French philosopher Gabriel Tardé (1834-1904) interpreted price negotiations as war and the price as truce. Labor union strikes fall clearly into this pattern. But it also describes modern price conflicts such as the recent "war" over prices between Nestlé, the world's largest food producer, and Edeka, Europe's largest grocery retailer.

Limits of price

The American philosopher Michael J. Sandel asserts in his book *What Money Can't Buy: The Moral Limits of the Markets* that prices have begun to penetrate many sectors of our personal lives. For a price of $85 for a five-year membership, travelers can join Pre-Check, a program of the Transportation Security Administration (TSA) in the United States, and take advantage of an expedited security line at airports. Today more than five million people have registered, more than 200 US airports and 42 airlines participate, and 94 percent of the TSA Pre-Check waiting times are less than five minutes.

Entering the United States from abroad costs $14, the fee for an entry into ESTA (Electronic System for Travel Authorization). In Afghanistan, mercenaries from private firms earn between $250 and $1,000 per day to fight. The price depends on the person's qualifications, experience, and citizenship. In Iraq and Afghanistan, there were at times more active personnel from private security companies than soldiers from the U.S. Army. For $6,250, one can hire a surrogate mother from India to carry an embryo. A flat rate for unlimited surrogate mothers in India plus extra arrangements for twins or triplets would cost $60,000. One can purchase the right to immigrate to the United States for $500,000. Smoking is forbidden in most U.S. hotels and motels. Some facilities charge a fine of $200 or more for violating this rule. One can consider that fine as the price a guest must pay to buy the "privilege" to smoke in the room.

More and more we are seeing price stickers on everything, as market and price mechanisms reach deeper into our day-to-day lives. This invasion of pricing into areas historically organized outside of market norms is one of the remarkable changes of our times. Sandel comments on this trend: "When we decide that certain goods may be bought and sold, then we decide – at least implicitly – that it is appropriate to treat them as commodities, as instruments of profit and use. But not all goods are properly valued in this way. The most obvious example is human beings."[28]

Prices, information, and God

Who makes prices? According to the book *The Mantle of the Prophet* the following applies: "Information about prices is the quickening breath that sustains the life of the bazaar, and the mechanism by which these prices adjust to new information on supply and demand is so refined as to seem almost divine. 'God sets prices,' according to a saying ascribed to the Prophet Mohammed, and most Islamic jurists agreed that an unseen hand that operated with such efficiency must be the hand of God."[29] This statement recalls Adam Smith's invisible hand.

Lesson 7: From ancient times through today, philosophers have contributed valuable insights on pricing. Astute pricers should keep their eyes wide open. Pricing is not a narrow discipline. It benefits from deep, almost philosophical thinking and understanding.

Summary

Philosophy helps both buyers and sellers to better understand pricing challenges. Many concepts which seem current and modern actually have ancient philosophical roots. But their implementation has only become possible thanks to modern information technology and big data analysis.

The eternal equation of pricing will always remain "Value = Pretium = Price," an insight already expressed in Latin 2000 years ago. While some theories of value and price such as the "just price" are generally ignored today, they still apply to certain situations. We don't have solutions for some ethical issues. The widely accepted subjective value theory advocates differentiated value extraction, but increasing opposition suggests that sellers should not overdo price discrimination.

This article provides only a very selective and limited review of the philosophy of price. It is by no means comprehensive. It would be easy to write a lengthy book on this topic. Nonetheless, buyers and sellers ignore the philosophy of price at their own peril. ❖

Endnotes

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