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The Origin and History of Value-Based Pricing

by: Stephan M. Liozu, Ph.D.

Value-based pricing is not a new concept; its principles have been in practice for centuries. By understanding the historical evolution of value-based pricing, businesses can better appreciate its significance and apply these timeless principles to their pricing strategies.

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We live in times of fake news, exaggerated claims, and organization myths. With the combination of abundance of information and subpar education levels, we succumb to these myths and consider them as truths. Pricing is not immune to this phenomenon. I work with many organizations on pricing and value transformation and, sometimes what I hear from leaders makes my eyes roll all the way to the back of my head. It is surreal at times.

For many business leaders, pricing, and value-based pricing in particular, is an innovation. It is new to them, which means they do not know the first thing about it. I often hear statements like "value-based pricing is a shiny concept that never works" or "value-based strategies are a waste of time - they never work" or "value-based pricing was invented by marketers to make customers pay a premium." What is even more surprising is that some pricing experts or so-called pricing "thought leaders" make these statements.

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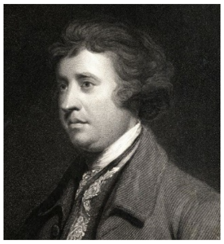
Let me make a bold statement. Pricing comes from economics. It is not new. Value-based pricing was not invented some decades ago. It has been around for centuries. Whether you call it value-based pricing, differentiation, or price utility, merchants, traders, and financiers understood that commodities have a price and that some prices might be higher based on preference and supply scarcity. Consider the following quote by Edmund Burke: **"It is not the necessity of the seller, but the necessity of the buyer, that determines the price."** This quote is from Burke's work ***Thoughts and Details on Scarcity***, written in 1795. In this document, Burke discusses economic principles and reflects on issues related to scarcity and the pricing of commodities, emphasizing how market prices are influenced by the needs and demands of buyers rather than sellers.



Edmund Burke

Value-based pricing is a strategy where prices are set primarily based on the perceived value to the customer rather than on the cost of the product or historical prices. As mentioned earlier, this approach is not a modern invention; its principles have been in practice for centuries. Let us explore the origins and evolution of value-based pricing, examining key concepts such as willingness to pay, differentiation, and perceived value through various historical periods.

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Ancient and Medieval Periods

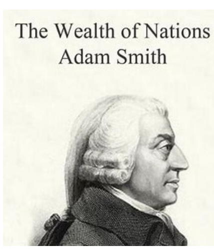
The concept of value-based pricing can be traced back to ancient civilizations. In ancient marketplaces, traders often set prices based on what they believed buyers were willing to pay. This practice was evident in the barter systems of Mesopotamia and ancient Egypt, where the value of goods was determined by their perceived utility and desirability. Buyers and sellers understood the value of goods, which is essential in bartering mechanisms. For example, a bushel of wheat might be traded for a certain number of fish, with the exchange rate reflecting the relative value of the goods based on their necessity, availability, and utility

During the medieval period, the notion of value-based pricing was further refined. Medieval merchants understood that the value of goods could vary significantly based on factors such as rarity, quality, and the buyer's need. For instance, spices from the East were highly valued in Europe not only for their culinary uses but also for their origin, rarity, and the prestige associated with them. This differentiation allowed merchants to command higher prices.

Also, during the medieval period, the notion of "just price" emerged, which was influenced by the teachings of the Catholic Church and philosophers like Thomas Aquinas. The "just price" was supposed to reflect the fair value of a good or service, considering its utility, the cost of production, and the common good. Aquinas argued, **"The just price is the price that is required for the preservation of equality of exchange, which is necessary for the common good"** (Summa Theologica).

The Renaissance and Early Modern Period

The Renaissance period marked a significant shift in economic thought, with a growing emphasis on individualism and the subjective nature of value. The works of early economists like Adam Smith laid the groundwork for modern economic theories.



Adam Smith, in his seminal work ***The Wealth of Nations*** (1776), acknowledged that the value of goods could be influenced by their utility to the consumer, stating, **"The real price of everything, what everything really costs to the man who wants to acquire it, is the toil and trouble of acquiring it."** Although Smith primarily focused on labor and production costs, he recognized that consumer perception of value played a role in pricing.

The Industrial Revolution

The Industrial Revolution brought about significant changes in production and consumption patterns. Mass production techniques lowered the cost of goods, but the principles of value-based pricing remained relevant. The industrial revolution brought about mass production and standardization of goods, which shifted the focus to cost-plus pricing. However, as markets became more competitive, businesses began to recognize the importance of differentiating their products based on perceived value. They began to recognize the importance of branding and differentiating to move away from competitive pressure.

The Austrian School of economics, particularly Carl Menger and Eugen von Böhm-Bawerk, introduced the concept of marginal utility in the late 19th century. This theory posited that the value of a good is determined by the additional satisfaction or utility that it provides to the consumer. Böhm-Bawerk stated, **"The value of a good is determined by the importance**

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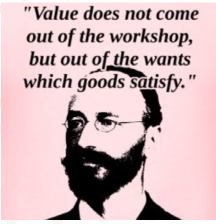


Eugen von Böhm-Bawerk

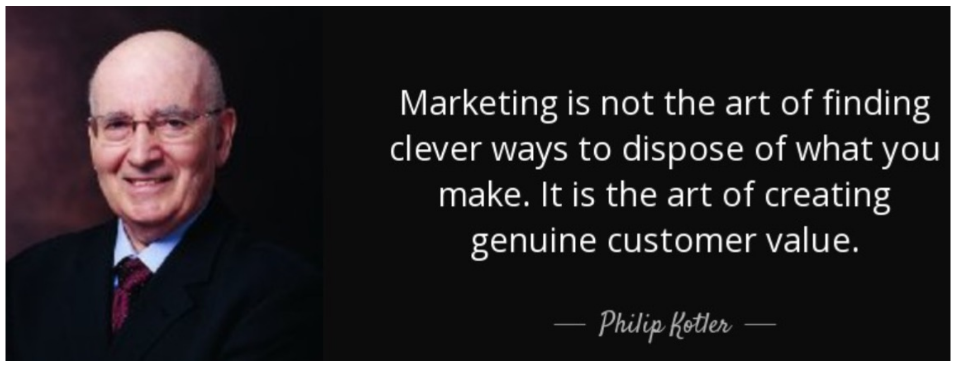
of the satisfaction it assures us compared with that of the satisfaction which we could obtain through the next best use of the same means,” ***Capital and Interest*** (1884), while Menger posited that **“the value of goods arises from their relationship to our needs and the utility they provide”** ***Principles of Economics*** (1871).

One notable example is the luxury goods market. Companies like Tiffany & Co., established in the 19th century, leveraged the perceived value of their products to command premium prices. The brand’s association with quality, exclusivity, and prestige allowed it to implement a value-based pricing strategy effectively.

The 20th Century: Formalization of Value-Based Pricing

The 20th century saw the formalization of value-based pricing as a distinct strategy. The rise of marketing as a discipline brought a deeper understanding of consumer behavior and the factors influencing perceived value. The concept of “willingness to pay” became central to pricing strategies. In the 1950s, economist Joel Dean introduced the idea of price discrimination, where businesses charge different prices to different customers based on their willingness to pay. This concept is closely related to value-based pricing, as it involves setting prices based on the perceived value to different customer segments.

The mid-20th century saw the formalization of value-based pricing principles, especially with the rise of marketing as a distinct business function. Companies began to invest heavily in understanding consumer behavior and preferences, leading to the development of sophisticated pricing strategies that considered consumer perception of value. In 1960, the concept of the “marketing mix” was introduced by E. Jerome McCarthy, which included price as one of the four Ps (Product, Price, Place, Promotion). This framework highlighted the importance of aligning pricing strategies with consumer value perception, laying the groundwork for value-based pricing. Philip Kotler, a prominent marketing scholar, contributed to the popularization of value-based pricing through his influential textbooks and articles, emphasizing that customer perception of value includes both tangible and intangible factors. He stated: **“Value is the sum of the perceived tangible and intangible benefits and costs to customers”** ***Marketing Management*** (1967).



The 1980s and 1990s saw the proliferation of value-based pricing in various industries, particularly in technology and pharmaceuticals. The term “value-based pricing” became more formally recognized in the business and marketing literature during the 1980s. This period saw the publication of several influential books and articles that discussed pricing strategies focused on customer value.

For example, IBM shifted its pricing strategy to focus on the value delivered to customers through its innovative products. As Samuel J. Palmisano, former CEO of IBM, put it, **“You have to recognize that customers are in control. You have to understand what they value, and you have to deliver that,”** ***Harvard Business Review*** (2004).

By the 1990s, value-based pricing had become a mainstream concept in both academic and business circles. It was widely adopted in various industries, especially in sectors where differentiation and perceived value were critical, such as technology, pharmaceuticals, and luxury goods. Robert Dolan and Hermann Simon were among the notable scholars and practitioners who advanced the understanding and application of value-based pricing during this period. Simon’s work, in particular, provided detailed frameworks and case studies on implementing value-based pricing strategies.

The term “value-based pricing” was created to describe a pricing strategy that focuses on setting prices primarily based on the perceived or estimated value of a product or service to the customer, rather than on the cost of production or historical prices. This approach aims to align prices with the benefits and utility ▶ CONTINUED ON PAGE 4

that customers derive from the product or service.

During this period of the late 1990s and early 2000s, some of the best quotes regarding value and value-based pricing were created. Most of them are still used today in pricing and marketing presentation.

"People don't want to buy a quarter-inch drill, they want a quarter-inch hole." Ted Levitt, "Marketing Myopia," ***Harvard Business Review*** (1960), republished frequently during the 2000s.

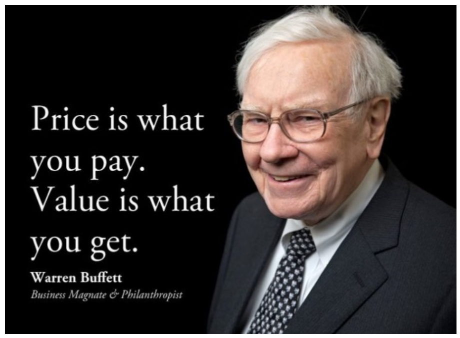
"Companies that understand value-based pricing will outperform their competitors." Michael V. Marn and Robert L. Rosiello, "Managing Price, Gaining Profit," ***Harvard Business Review*** (1992).

"In many cases, companies set prices reactively rather than proactively, missing the opportunity to capture value." Robert J. Dolan and Hermann Simon, "Power Pricing: How Managing Price Transforms the Bottom Line," ***The Free Press*** (1996).

"Buyers' perceptions of value - not sellers' costs - should determine prices." Kent B. Monroe, ***Pricing: Making Profitable Decisions***, 3rd Edition, McGraw-Hill (2003).

"A price is not just a number. It is a mechanism for allocating value." Or **"Companies that get pricing right have a significant competitive advantage."** Thomas T. Nagle, ***The Strategy and Tactics of Pricing***, 4th Edition, Prentice Hall (2006).

"Price is what you pay. Value is what you get." ***Berkshire Hathaway Annual Report*** (2008).



"In the end, price is a reflection of the value a customer is willing to pay. The better a company can measure and convey this value, the more successful its pricing strategy will be." Hermann Simon, ***Confessions of the Pricing Man: How Price Affects Everything***, Springer (2015).

The Digital Age and Modern Applications

The advent of the digital age has further transformed value-based pricing. The internet and big data analytics have provided businesses with unprecedented insights into consumer behavior and preferences. Companies can now gather detailed data on customers' willingness to pay and tailor their pricing strategies accordingly.

One of the most prominent examples of value-based pricing in the digital age is the software industry. Companies like Adobe and Microsoft have shifted from traditional pricing models to subscription-based models, where prices are set based on the perceived value of continuous updates and support. This approach aligns with the principles of value-based pricing, as it focuses on the ongoing value provided to the customer.

E-commerce platforms like Amazon also use dynamic pricing algorithms that adjust prices in real-time based on factors such as demand, competition, and customer behavior. This dynamic approach to value-based pricing allows businesses to maximize revenue by capturing the maximum willingness to pay from different customer segments.

The future of value-based pricing methodology will be characterized by a more sophisticated, AI-driven approach that leverages advanced technologies, enhanced customer insights, and transparent practices. Businesses that can adapt to these changes and effectively align their pricing strategies with the perceived value delivered to customers will be well positioned for success in an increasingly competitive and dynamic market landscape.

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Conclusion

The history of value-based pricing reflects a gradual shift from simplistic cost-plus pricing models to more sophisticated strategies that consider consumer perception and utility. From ancient bartering systems to modern data-driven approaches, the evolution of value-based pricing underscores the fundamental economic principle that value is ultimately determined by the needs and preferences of consumers.

Value-based pricing is **not** a new concept; its principles have been in practice for centuries. From ancient marketplaces to modern digital platforms, the idea that prices should reflect the perceived value to the customer has remained a constant. By understanding the historical evolution of value-based pricing, businesses can better appreciate its significance and apply these timeless principles to their pricing strategies.

The journey of value-based pricing through history highlights the importance of differentiation, willingness to pay, and perceived value in pricing decisions. As businesses continue to navigate an increasingly complex and competitive marketplace, the lessons from the past can provide valuable insights for future success.

Now, you know more about the origin and history of value-based pricing. It is time for all of us to make history and to advance the field for the future generations. It is ok to learn from the past. It is more fun to invent the future!

Pricing Excellence for Software Solutions

by: Danilo Zatta, Ph.D., MBA

The current economic environment is forcing software companies to focus on managing their profitability. But pricing software correctly is not a trivial endeavor. In this article, the author discusses the need to go beyond traditional pricing approaches and explores how to craft an optimal pricing strategy. Dan Zatta (danilo.zatta@valcon.com) is a globally recognized management advisor and the author of several books including ***The Pricing Model Revolution*** and ***The 10 Rules of Highly Effective Pricing***. He also coauthored the books ***At The Heart of Leadership*** and ***Pricing Decoded***. He has been recognized as one of the "Global Top 50 Marketing and Sales Thought Leaders." Zatta will lead a workshop on "10 Rules for Effective Pricing" at the PPS 19th Annual Conference in Berlin on November 20.

In today's fast-paced digital landscape, software has become an integral part of our lives, powering everything from basic communication to complex business operations. Unsurprisingly, the software market has therefore experienced robust growth rates over the past years.

Despite this growth, several software companies did not achieve satisfactory profitability levels. With the previous dictum of growth coming to a stall, software companies are now forced to focus on managing their profitability. In this new reality, pricing decisions for software products and services have become an even more critical business consideration – not least because pricing is the most effective profit lever. Leaders of software enterprises now understand how effective pricing strategies play a vital role in determining a company's revenue model, market positioning, and customer relationships. But doing pricing right is a non-trivial endeavor.

1. The need to move beyond traditional pricing strategies

Given the dynamic landscape of the software industry, traditional pricing models are incapable of capturing business value. These conventional strategies often hinge on fixed product features and consistent cost structures, making them ill-suited for a sector that is defined by rapid technological evolution. Furthermore, the intangible nature of the value of software solutions complicates the application of conventional cost-plus or competitor-based pricing models, as these fail to capture the real value perceived by users. A meaningful starting point for understanding why it is essential to move beyond ineffective traditional pricing models it is to investigate the market conditions that render them inadequate.

2. Industry challenges that require strategic pricing solutions

The competitive landscape in the software industry has added a layer of complexity to the business pricing endeavors.

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