# Prices as Signals and Incentives

## OBJECTIVES

In Section 2, you will
- analyze how the price system works
- explain how prices provide information about markets
- describe how prices act as incentives to producers

## KEY TERMS

- competitive pricing, p. 174
- incentive, p. 176

## TAKING NOTES

As you read Section 2, complete a chart like the one shown to keep track of how each key concept affects producers and consumers. Use the Graphic Organizer at [Interactive Review @ ClassZone.com](https://www.classzone.com).

<table>
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<th>Competitive pricing</th>
<th>Producers</th>
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## How the Price System Works

### KEY CONCEPTS

To better understand how price works in the market, let’s look at how one kind of change in supply affects the equilibrium price. More producers in a market increase supply, which leads to increased competition and a lower equilibrium price. **Competitive pricing** occurs when producers sell goods and services at prices that best balance the twin desires of making the highest profit and luring customers away from rival producers. By entering a market at a lower price, a new supplier can add to its customer base while it maintains overall profits by selling more units.

### EXAMPLE Competitive Pricing

Let’s look at an example of competitive pricing. As winter approaches, Elm Street Hardware prices its snow shovels at $20. But Uptown Automotive sees an opportunity to take some customers (mostly for tools, which both stores sell) from Elm Street. Uptown enters the snow shovel market, raising the overall supply. It also prices the shovels at $13. Uptown has a lower profit margin per shovel, but hopes to sell hundreds of them in order to maintain overall profit. Elm Street can choose to lower its prices as well or risk losing customers.
EXAMPLE Characteristics of the Price System

In a market economy, the price system has four characteristics.

1. **It is neutral.** Prices do not favor either the producer or consumer because both make choices that help to determine the equilibrium price. The free interactions of consumers (who favor lower prices) and producers (who favor higher prices) determines the equilibrium price in the market.

2. **It is market driven.** Market forces, not central planning, determine prices, so the system has no oversight or administration costs. In other words, the price system runs itself.

3. **It is flexible.** When market conditions change, prices are able to change quickly in response. Surpluses and shortages motivate producers to change prices to reach equilibrium.

4. **It is efficient.** Prices will adjust until the maximum number of goods and services are sold. Producers choose to use their resources to produce certain goods and services based on the profit they can make by doing so.

APPLICATION Analyzing and Interpreting Data

A. If Karen sold 25 salads at $6 each, how many would she need to sell at $5.50 to make at least the same amount of total revenue?
Prices Motivate Producers and Consumers

**KEY CONCEPTS**

The laws of demand and supply show that consumers and producers have different attitudes toward price. Consumers want to buy at low prices; producers want to sell at high prices. Therefore, prices motivate consumers and producers in different ways. You learned in Chapter 1 that an *incentive* is a way to encourage people to take a certain action. Here, you’ll learn that in the price system, incentives encourage producers and consumers to act in certain ways consistent with their best interests.

**EXAMPLE Prices and Producers**

For producers, the price system has two great advantages: it provides both information and motivation. Prices provide information by acting as signals to producers about whether it is a good time to enter or leave a particular market. Rising prices and the expectation of profits motivate producers to enter a market. Falling prices and the possibility of losses motivate them to leave a market.

A shortage in a market is a signal that consumer demand is not being met by existing suppliers. Recall that a shortage often occurs because prices are too low relative to the quantities demanded by consumers. Producers will view the shortage as a signal that there is an opportunity to raise prices. Higher prices act as an incentive for producers to enter a market. In other words, the prospect of selling goods at higher prices encourages producers to offer products for that market.

As more producers are motivated by high prices to enter a market, quantity supplied increases. When prices are too high relative to consumer demand, a surplus occurs. Producers can respond to a surplus either by reducing prices, or by reducing production to bring it in line with the quantity demanded at a particular price. Either way, falling prices signal that it is a good time for producers to leave the market. Sometimes, less efficient producers leave a market completely, as increased competition and lower prices drive them out of business. More often, producers shift their business to focus on opportunities in markets with higher potential profits.

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**QUICK REFERENCE**

An *incentive* encourages people to act in certain ways.

**FIGURE 6.11 CD PRICES AND PRODUCERS**

1. Competition from DVDs and video games causes a slump in CD sales—a surplus in CDs.

2. Some CD makers switch production to DVDs, video games; fewer CDs are produced—a shortage of CDs.

3. Discount chains begin to sell CDs, often below cost, to attract customers; competitive pricing of CDs.

4. Many small record stores go out of business or devote less shelf space to CDs, more to DVDs and video games.
Competitive pricing in the market often informs the choices made by producers. When a market is growing, and when there is unmet demand, a producer may decide to enter the market with a price that is lower than its competitor’s. The new producer can still, however, earn a profit by selling more units at the lower price. So, while prices are the signals that are visible in the market, it is the expectation of profits or the possibility of losses that motivates producers to enter or leave a market.

**EXAMPLE Prices and Consumers**

Prices also act as signals and incentives for consumers. Surpluses that lead to lower prices tell consumers that it is a good time to buy a particular good or service. Producers often send this signal to consumers through advertising and store displays that draw consumers to certain products. Producers may also suggest that the low prices won’t last, encouraging consumers to buy sooner rather than later.

High prices generally discourage consumers from buying a particular product and may signal that it is time for them to switch to a substitute that is available at a lower price. A high price may signal that a particular product is in short supply or has a higher status. Brand marketers rely on the consumer perception that a certain logo is worth a higher price.

Recall what you learned about normal and inferior goods in Chapter 4. Most consumers prefer to buy normal goods at the best possible price. They will buy inferior goods only when they cannot afford something better. While price is a powerful incentive to consumers, the other factors that affect demand also influence consumers’ buying habits.

**APPLICATION Making Inferences**

B. A cup of gourmet coffee commands a higher price than a regular coffee. How will this fact influence the take-out coffee market?
Michael Dell: Using Price to Beat the Competition

High-tech entrepreneur Michael Dell saw an opportunity to use competitive pricing to take business away from much larger companies. By 2005, IBM Corporation, Compaq Computer Corporation, and others had either left the PC market or were facing major problems. How did Dell thrive as its competitors struggled?

Lowering Costs to Reduce Prices

Michael Dell began assembling and selling computers as a freshman in college. He became so successful that he quit college in 1984 to focus on his business. He had sales worth $6 million in his first year.

Dell’s success was largely due to his approach to marketing and production. He bypassed computer retailers and sold over the telephone directly to knowledgeable computer users in business and government. Each computer was built to customer requirements and assembled after it was ordered. In this way, Dell lowered his costs significantly and became the low-price leader in the market. The company’s sales grew from $69.5 million in 1986 to almost $258 million in 1989.

Dell was also a pioneer in recognizing the potential for sales via the Internet. This strategy allowed the company to maintain close contact with its customers and to adjust its prices frequently, up and down, as market conditions dictated. Competitors who sold only in retail stores found it hard to compete on price because their costs were much higher. By 2005, Dell was the world’s leading supplier of PCs, with annual sales of almost $50 billion.

Now Dell is using his experience to make waves in the consumer electronics (flat-panel TVs, MP3 players, and the like) market. He sees the line between these two markets eventually fading. “The whole new ballgame is these worlds [computing and consumer electronics] converging,” Dell believes, “and that’s a world we’re comfortable in.”

APPLICATION Drawing Conclusions

C. What incentive did Michael Dell have to sell computers at lower prices than his competitors?
1. Use each of the two terms below in a sentence that illustrates the meaning of the term:
   a. competitive pricing  
   b. incentive

2. Explain the four characteristics of the price system.

3. Why is the price system an efficient way to allocate resources?

4. How do prices serve as signals and incentives to producers to enter a particular market? to leave a certain market?

5. How does the story of Dell Inc. demonstrate the effects of competitive pricing?

6. Using Your Notes  How does competitive pricing affect consumers? Refer to your completed chart. Use the Graphic Organizer at Interactive Review @ ClassZone.com

7. Making Inferences  A local supermarket decides to sell a premium brand of meats and cheeses in its deli department. This brand is priced about $2 more per pound than the store brand. About 80 percent of the space in the deli display cases is devoted to the premium brand and 20 percent to the store brand.
   a. How did price serve as an incentive to the supermarket?
   b. What kind of signals is the supermarket sending to its customers with this pricing strategy?

8. Applying Economic Concepts  A candy company whose products sold in supermarkets for about $3 a bag decided to enter the growing gourmet chocolate market. It purchased two small companies that made premium chocolates that sold for much higher prices. How does this story reveal the way the price system works as an incentive for producers while allocating resources efficiently?

9. Challenge  A large discount store has built its reputation on offering consumers low prices. However, its customers come from many different income levels. Recently, the store began offering higher priced jewelry and consumer electronics products. What signal might this send to producers of other premium products who have never sold in discount stores before?

Using Prices as Incentives  As you've learned in Section 2, prices motivate producers to act in certain ways. What actions do producers take in response to rising prices? How about falling prices?

Identify Price Incentives  Consider each situation that follows. Decide whether the scenario described is associated with rising prices or with falling prices.

- A farmer switches to organic methods when a report says organic foods are healthier.
- To maintain market share, a car wash adjusts its prices to meet a competitor’s.
- After a hot, dry spring, a landscaper decides to get out of the business.
- A retailer decides to begin selling this holiday season’s must-have toy.

Challenge  Which of the above situations describes a case of competitive pricing? What might happen to the producer if it did not take the action described?