Value-Added Incentives (and Why You Should Care)

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For the last eight years or so, the music industry has been forced to deal with the problem of "competing with free" - in other words, winning over people who are pirating music. One attempted solution has been to simply initiate litigation against people that share music illegally. This strategy has been both unpopular and largely unsuccessful thus far, though there is something to be said for targeting organizations that seem to pride themselves on facilitating copyright infringement.

Another solution has been to cut prices and make purchasing music easier than ever. Though initial efforts, like PressPlay, were not successful at all, stores like iTunes and Amazon MP3 have had moderate success. However, record labels are still hemorrhaging money, and even large increases in digital sales have not made up for losses in CD sales, despite the decreased costs associated with distributing music digitally. This is to be expected. Though the value of being able to easily browse and purchase digital music, even without DRM, is significant, free digital music is just as easy… and it's free.

Perhaps the most notable solution, value-added incentives, has become a trend within the last year or so. The idea is fundamentally simple; set up some sort of tiered pricing system that encourages customers to spend more money in order to obtain some kind of bonus or reward beyond the music itself. Just about a year ago, Nine Inch Nails did this by offering their album Ghosts I-IV for $0 to $300.

This system actually draws upon a fundamental principal of economics, which is that at the equilibrium price point for any given product or service, there are always people willing to pay more for that product or service. Fundamental economic theory suggests that the equilibrium price point is the most profitable for any given business.

A simple example would be a bottle of water being sold for $1. At this price, 100 people might purchase the water each day. At $1.50, the seller will earn more money *per bottle*, but if only 50 people buy the water, then the net revenue is lower. Likewise, at just 50 cents, the seller might attract a total of 140 buyers, but this too would be fewer than the revenue resulting from a $1 bottle.

A tiered pricing system can maximize revenue beyond that which would be gained from a single price point, even if that price is perfectly set to the equilibrium. Example incentives include merchandise, such as t-shirts, stickers, and posters, limited-edition products such as CDs with special artwork or vinyl records, concert tickets, phone calls with the artist, or anything in between.

Paying $10 could net the customer the regular version of an artist's CD, while paying $20 will give them a t-shirt, $50 a t-shirt and two concert tickets, and $250 a personal handwritten letter from the artist and the customer's name written in the "special thanks" of the artist's next CD. Incentives can also be used to encourage presales of an album; the band Umphrey's McGee created a hierarchy of presale bonuses based on the total number of orders placed.

Other artists who have applied this concept include John Freese, the former drummer of Nine Inch Nails, and Depeche Mode. The record labels Protagonist Records (which I have a release on) and Magnatune incorporate a sort of 'tipping' system, enabling customers to voluntarily pay more money than the minimum price of an album. This isn't exactly the same as value-added incentives, but it can have a similar bottom-line effect.

Mike Masnick, founder of Techdirt, wrote an interesting article last year about"The Economics of Free" which explained further why value-added incentives make economic sense. Essentially, he writes that there is no longer any scarcity attached to music due to digital distribution, and so the price of music as determined by the market will eventually approach zero.

In order to compete, companies must rely on non-scarce goods (like, say, t-shirts) to generate revenue. This isn't merely a concession to piracy - Masnick points out that the entire business model must be planned carefully around the dispersion of free content as a tool to increase market share.

There isn't anything inherently wrong with the traditional method of selling music, either in physical format or digital. However, even though many artists continue to be successful from pure music sales alone, they would be wise to consider the concepts of tiered pricing, non-scarcity, and value-added incentives in growing their market and revenue streams.