In recent years, behavioral research has generated fundamental insights to better explain observed consumer behavior. Despite bearing great profit potential these insights are rarely applied by marketing and pricing professionals. Managers are either not aware of this opportunity or do not have the right approach to achieve successful implementation and monetization. This article presents seven prominent psychological effects and best practice examples of how to successfully capitalize on them.

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Markets and pricing activities aim to directly or indirectly influence buying decisions. Most of these activities and their underlying rationale are still based on the image of a rational, well-informed and utility-maximizing consumer. This image, however, has been challenged by practitioners and researchers as it fails to explain commonly observed but seemingly irrational behavior. A striking example is the true story about “tipping a loser”1: At the start of his career, an inexperienced locksmith took hours to open a lock and often broke it. Despite bad quality work and high bills, he received generous tips from his customers. Once he learned to open a lock within seconds without causing any damage his clients started to complain about high bills and stopped tipping him. Clearly, this behavior is irrational but can be explained by consumers’ higher willingness to pay for effort (i.e., time to open a lock) than for results (i.e., an unlocked door). Behavioral approaches are able to explain such phenomena by analyzing consumers’ mental processes and the effects that shape their decisions.3

Numerous behavioral studies in recent years have revealed consumers’ limited rationality and show that even seemingly irrational behavior follows certain patterns and rules. As a result, applying psychological findings to marketing and pricing measures offers profitable opportunities to predict purchase behavior more precisely and target consumers more effectively. At the same time, managers need a sound understanding of the applicable mental mechanisms to monetize these insights in their specific business setting.

Behavioral research has generated a multitude of findings pertaining to various phenomena. Eventually, managers are left asking themselves: Which psychological effects are important? How can they be utilized in marketing and pricing practice? For which instruments, products, and business models are they particularly suitable? We address these questions by describing seven psychological effects that are especially relevant for marketing and pricing.

In addition, we discuss managerial implications and provide best practice examples of how these effects can be successfully implemented.

1. The deal effect – why $5 deals aren’t always the same

In a well-known study, participants were confronted with the following situation: First, they were told to either buy a radio for $25 or a television for $500 at a nearby store. Participants were then informed that another store, which was located 10 minutes further away, sold the same radio for $20 and the television for $495. Participants were only willing to make the longer journey to get the lower price for the radio. Why? In both cases, participants could save the same amount of money, namely $5. The reason is that savings for the radio amounted to 20% ($20 vs. $25) while the price discount for the TV was only 1% ($495 vs. $500). This so-called deal effect can be explained by the Weber-Fechner law: The barely noticeable difference between two stimuli is proportional to the magnitude of the stimuli. Simply put, the same price reduction is perceived to be less attractive at a high price level than at a low price level. In the study, the savings for the television would have to be around $100 (20% of $500) to generate a similar reaction than the $5 for the radio.

Implications: Consumers do not process price information in an isolated way, but relative to alternatives and reference values available in the buying situation. This finding can be applied to various aspects of price structuring and communication. First, price advantages and promotions should be communicated in combination with a reference price. In addition, pricing managers should seek ways to communicate savings in relation to preferably low base values. A revenue-based credit card bonus, for example, should not refer to the revenue itself (as is typically the case) but should be granted as a partial repayment of the credit card fees or the account fees. Why? A bonus in the form of a percentage of card revenue is a small number and therefore perceived as a small saving. Reversely, communicated as a portion of the card or account fees, even small absolute bonuses appear to be substantial and trigger a deal effect in customers’ minds. This principle can be transferred to many other product categories.

Another promising way to monetize the deal effect is cross-selling. If consumers purchase expensive products, they tend to be less price-sensitive when buying complementary products with...
comparably low prices. For example, consumers who purchase a car are willing to pay ridiculous amounts for extras as their price appears to be relatively low compared to the enormous cost of the entire car. In a different context (e.g., once they own the car for one year), most consumers would not be willing to pay several thousands of dollars for leather seats or a special exterior paint. An effective tool to implement this type of cross-selling are sales checklists: When advising customers on a product, sales representatives should use checklists to discuss possible add-on products or accessories which are priced lower than the base product.

2. The anchoring and adjustment effect – why 3+1 isn’t always 4

In many purchase decisions, a detailed cost-benefit assessment of all options would require a disproportionately high level of cognitive effort for consumers. Therefore, they rely on simplified mental strategies for decision making. These heuristics provide satisfactory results at a low level of effort. A prominent example is the anchoring and adjustment heuristic: Consumers start to assess an offer based on an initial value (anchor) which is often the most important product attribute. Then, they incorporate further information and adjust the initial evaluation to reach a final purchase decision. Studies show that a price which consists of multiple price elements leads to higher demand than an equivalent all-inclusive price. This result can be explained by the anchoring and adjustment effect: Consumers tend to focus on an offer’s base price (e.g., price of the physical product) and do not sufficiently include other price components (e.g., fees, services or taxes) in their overall price evaluation. As a result, the total cost of an offer is underestimated and the deal appears to be more attractive.

Implications: The anchoring and adjustment effect allows managers to increase the likelihood of buying by breaking down the total price of a product into a base price plus one or more compulsory surcharges. This price partitioning technique involves, for instance, adding handling fees, shipping costs or taxes to the base price. Consumers are likely to neglect (or only partially consider) these surcharges and perceive the offer as highly attractive. When priced separately, surcharges can also make product prices appear more competitive as the relative price position seems favorable compared to all-inclusive alternatives.

Furthermore, partitioned prices are an effective communication instrument to signal price fairness: A message is sent to consumers that specific elements of the total price do not contribute to the selling firm’s profits but are necessary surcharges imposed by third parties. Typical examples are taxes that are collected by the seller but passed to the government or shipping charges which are forwarded to a logistics service provider. In addition, price transparency is enhanced as partitioned prices provide a detailed understanding of the cost-benefit breakdown of an offer. Still, managers should act carefully when deciding on which components should be partitioned to which extent. Studies show that consumers can get annoyed if they get the impression that surcharges are inappropriately high or that sellers apply partitioned pricing to obscure the total cost of their offering. In this case, the positive effects of partitioned pricing diminish or even reverse.

3. The decoy effect – why irrelevant alternatives influence decisions

Consumers base their purchase decisions on the relative advantages an offer provides over other alternatives available. The decoy effect describes how adding seemingly irrelevant alternatives can affect consumers’ choice between two product options. By adding less attractive offers (decoy products) to the choice set, consumers’ preference for existing (more attractive) options is strengthened. Studies have shown that adding decoys to a product range can dramatically increase the share of high priced existing products. A prominent study on this topic was conducted in the context of newspaper subscriptions. One group of participants could choose between an online subscription for $59 per year and a combined online-print subscription for $125. The majority of participants in this group (68%) opted for the cheaper online-only subscription. The offer provided to a second group included a print-only annual subscription for $125 as a third alternative. This decoy option was obviously inferior to the combined subscription as it offered less value for the same money. However, in the presence of this clearly unfavorable alternative, the online-print bundle appeared to be much more attractive. As a result, the vast majority of participants in this group (84%) went for the higher priced online-print subscription.

Implications: The decoy effect is particularly effective when applied to offer structures with clearly defined value propositions, such as subscription models or portfolios with differing product ranks (e.g., good-better-best). Typically, three alternatives are required to capture the decoy effect. However, in some cases, adding a decoy to a single product offer can also influence purchase decisions. For example, a relatively small price gap between a low-value basic version and a high-value premium offer can reinforce the attractiveness of the latter. On the other hand, a premium offer which is significantly more expensive but only offers slightly more value can enhance the status of the basic option. Still, in order to promote the target product, the decoy option needs to be similar in its fundamental attributes, but, at the same time, clearly inferior in consumers’ perception.

4. The endowment effect – why consumers overvalue what they own

The endowment effect states that consumers value a product higher if they own it. The effect is a consequence of consumers’ loss aversion: Losing a product weighs heavier than gaining it. The following study illustrates consequences for purchase decisions: One group of participants received a coffee mug and was asked at which price they would be willing to sell it. A second group had to indicate their willingness to pay for the same mug.

Studies have shown that adding decoys to a product range can dramatically increase the share of high priced existing products.
The first group demanded an average price of $5.25, while the second group was willing to pay only $2.50 on average. Hence, the astonishing price difference between sellers and buyers amounted to 110%.

Implications: Once consumers (mentally) call a product their own, the perceived value of this product is higher than their original willingness to pay. From a marketing perspective, this effect can be utilized to design profit-enhancing offer structures. For example, optional components should always be included in the pre-configuration (opt-out or default option). Due to their loss aversion, consumers will find it more difficult to give up a pre-selected product or service than to actively select it; they feel like they already own it. The classic example of this phenomenon is price negotiations for a car: "You could also choose the standard seats instead of the leather ones, if this configuration is too expensive for you." "No, thank you; I definitely don't want to give up the leather seats." Another effective implementation of the endowment effect is offering discounted or free test products, trial subscriptions or test accesses. Consumers only need to (fully) pay after a certain period but, as the examples show, consumers are reluctant to give up what they already own and are likely to stay with their choice.

5. The compromise effect – why consumers avoid extreme decisions
If consumers can choose between a standard, premium and deluxe version of a product, they typically choose the middle premium option. Consumers usually do not know which of the various product attributes are most important to them. Middle options represent a compromise that combines different product features and the price of the product. The effect can also be described as extremeness aversion; i.e., the reluctance of consumers to choose extreme offerings of a product range.

Implications: Similar to the decoy effect, the compromise effect can be used to stimulate sales of higher priced products. Studies have shown that placing high-end products on the top end of a firm’s assortment leads to a higher share of middle to high priced alternatives. By adding high-end options, middle to high priced products move “closer to the center” of the product range and are more likely to be chosen. Consequently, this change in choice pattern leads to an increased average customer revenue. At the same time, managers should be aware of the increasing complexity of the offer structure which otherwise might lead to the paradox of choice (described in the next section).

6. The paradox of choice effect – why less choice is (often) more
Managers often consider a larger, more differentiated product range more attractive, as it better addresses individual consumer needs. At the same time, a broader product choice can also be detrimental for sales because it complicates consumers’ decision-making process and deters their likelihood to purchase. This paradox of choice is illustrated by the following study: Two groups of participants were either offered a small or a large selection of jams. In contrast to the propositions of classical decision theory (maintaining that the probability of finding the optimal product increases with an increasing selection), the group that was offered more jams bought significantly less. Why? Because the larger the selection, the more complicated it becomes to detect the ideal alternative. Consumers are either afraid of making the wrong choice and don’t buy a product or they buy something, but end up being dissatisfied, because by choosing one alternative they had to forego all others.

Implications: Letting consumers participate in product manufacturing can help decrease costs. The Swedish furniture retailer IKEA has built a company on this principle. For decades now, IKEA has been asking customers to self-assemble many of their furniture products – mainly for cost reasons. But this effect can also be utilized for marketing as the following three examples show: First, product configurations, such as those offered by sports goods manufacturers Nike and Adidas, let consumers (from their perspective) actively participate in the configuration of their product. At the same time, they satisfy consumer needs for
individuality and establish an emotional bond between customers and the brand. Second, online communities allow consumers to actively participate in the design of products. The German retailer Tchibo produces and distributes products that have been co-developed and co-designed by their community. Third, the restaurant chain McDonald’s has recently tested the possibility of asking customers in the U.S. to build their own meal combinations instead of offering non-customizable menus. The results were very positive and McDonald’s plans to roll out this concept in other countries. A crucial success factor is that the work steps assigned to consumers are easy, playful and lead to success in a convenient way. If consumers feel that they fail in assembling the product, the IKEA effect disappears or can even turn negative.

Summary
The findings of behavioral science research are a powerful supplement to conventional marketing and pricing approaches. Of course, not all psychological effects can be transferred to every firm in equal measure. Rather, each company’s customer- and product-specific characteristics need to be considered when deciding on which effect to utilize and to what extent. When used correctly, the effects described in this article offer managers numerous opportunities to better understand consumer decision-making processes. Furthermore, they also help them to address consumers with more targeted offers, to increase their willingness to pay and, as a result, to seize revenue and profit opportunities more effectively.

References