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PART V (Chapter 23)

Pricing and Consumers in a Changing World

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Pricing and Consumers in a Changing World

Introduction

Since the first edition of this book there have been many changes in the pricing environment. Comparison websites have increased competitive transparency and new technologies like Uber have facilitated rapid adjustment of prices to demand changes – something originally prevalent in electricity pricing and airline yield management has now become widespread in a range of services including transportation, sporting events and music concerts. Generally the ubiquity of information technologies has helped consumers with better information but it has also helped sellers with the tools to extract the maximum value from demand surges. But in spite of better information, rules of thumb and seemingly irrational decision-making are still prevalent.

In a rational world where everyone has good information one might expect that consumers will buy when total perceived value is greater than price charged. The greater the difference, the greater is their “willingness to pay” (WTP). In determining WTP, many other behavioral factors can disturb the rational analytic perspective of buyers. For instance, the notion of fairness might be important. This is illustrated by the launch of Radiohead’s album, *In Rainbows*. Fans were asked to name their own price for the album. Interestingly many consumers paid for the album and the average price paid was around £4. Similar examples have been seen for restaurant meals, concerts and other services (BBC 2015).

Marketers try an increasingly broad range of approaches to “hide” prices. They partition prices, they trade-off price for quality or volume, they set prices that price discriminate across segments, psychological needs, geography and urgency of need. According to one report from the UK’s Office of Fair Trading, over 20 percent of advertisements including prices were deemed to be deceptive in some way or another (Ahmetoglu *et al.* 2010). Price is also

an important signal; when Phillips, the electronics manufacturer released the Philips Intimate Massager and set the price at £89.99 – it was set at that level “to be seen as respectable” (Mortishead 2008), reflecting the role of price to signal product legitimacy.

Hyper-competitive markets, globalization, online auctions, new purchasing and retail formats, provide an increasingly complex array of contexts in which price has to be managed. The sellers need to understand the “value” the customer is searching for, when price might itself be one of the most important attributes for consumers (e.g. Severin *et al.* 2001). Recent research suggests mood and environment can deliver major benefits in encouraging consumers to increase their WTP. Thus, price is multifaceted. While it is about “what price do I charge,” it is also “how,” “where,” and “when.”

This chapter will explore key behavioral aspects of pricing, drawing on links to the rapidly changing world of technology. Specifically, the chapter will begin by contrasting traditional perspectives on price with more contemporary perspectives on price; it will then examine the notion of perceived value and its multifaceted nature. The chapter will then outline the key behavioral aspects of price including internal and external reference prices, pricing and consumer perceptions of fairness, price endings, decreasing and increasing price, price–quality perceptions, and consumer price knowledge.

Perspectives on consumer response to price

The essence of effective marketing is to create value for customers and capture that value for the firm through current profits and longer-term reputation and image. Value is created through a product that meets customer requirements, is available for them to access, and is communicated effectively. These three Ps of marketing are complemented by the fourth P that involves the effective use of price as it is set to capture the value the rest of the mix has created. A pricing strategy involves setting a price that creates an incentive for consumers to

buy a product or service and generate sufficient revenues to encourage the firm to sell that product. In short, consumers buy when perceived value from a product exceeds price. Perceived value represents their WTP; any price less than that, subject to a budget constraint, should lead to a purchase. Sellers need to understand WTP and competitor offerings when setting prices.

Some economic models assume that customers are perfectly aware of product features and competitive offerings and that all that is needed is to understand the demand–price relationship. Monroe and Lee (1999) list other restrictive assumptions of an economic model. This (rather narrow) economic perspective is sometimes contrasted with a marketing perspective, which explicitly sees price as an integral part of the marketing mix that signals as well as captures value. The manipulation of all four Ps together may create a difference between marketing and economic approaches to pricing, although such a perceived difference might involve a misinterpretation of textbook models of business behavior that merely seek to explain, in parsimonious fashion, the relationship between price, revenue, output, and profit. Some empirical research on price–quality relationships confirms that more often than not, long-term prices reflect differences in products and attributes (Murray and Sarantis 1999), and maybe there is less difference in economic and marketing approaches than is sometimes thought.

Fundamentally, consumers are expected to purchase an item whenever the perceived value of that item exceeds its actual price. The greater this gap, the greater the incentive to buy. Much marketing strategy is aimed at influencing behavioral factors that increase perceived value and thus the size of the gap. Gourville (1999) suggests the behavioral factors that disturb the simple relationship between price paid, WTP, and cost of goods and services, including the perceived fairness of price, the relative incentive to buy (e.g. value of consumer surplus relative to the price of the product), the difference between actual price and a

consumer's reference price, and price compared to perceptions of costs.

The economic notion of incentive to buy is when perceived economic value $>$ price. This gap is sometimes referred to as acquisition value or consumer surplus. The behavioral notion is that economic value + psychological value needs to be $>$ price. The marketing notion combines these approaches but recognizes that consumers often have less than perfect information and that price itself is a signal of quality and that savvy consumers might also consider the ease of purchase and use of a product as important creators of customer value and therefore WTP.

Economic, marketing, and behavioral factors influence WTP and therefore value to buyers. In addition, buyer knowledge of prices is affected by their past experience, search behavior and their ability to disentangle complex deals. Increasingly the view is that complex offers that surround products are sometimes interpreted poorly by buyers who deliberately bound or restrict their search for information or who are unable to disentangle competitive claims. Unit pricing, ethics, regulation, and competition affect the consumer's response to the different factors affecting WTP and the pricing strategies of sellers. Most importantly, the nature of perceived value to buyers is complex and influenced by a myriad of subjective factors.

Perceived value

The preceding section identified the delivery of value to customers as a fundamental element of the marketing concept that builds and sustains competitive advantage. By delivering value, companies try to satisfy customers, resulting in improved customer loyalty, sales, and profits. To this end, managers need to understand the nature of customer value and where they should focus their efforts to enhance the value they create for customers.

The concept of perceived value is defined above as the psychological and economic value

gained from consuming a product or service. The difference between perceived utility/benefits and costs is the incentive to buy and is referred to as consumer surplus or acquisition value in the economics and marketing literatures respectively. Perceived value may be confused with other similar marketing and economic terms, such as utility, price, and quality (Sánchez-Fernández and Iniesta-Bonillo 2007). The economic view of value as instrumental, task-related, rational, functional, and cognitive (Sweeney *et al.* 1999), is criticized by some authors with the view that perceived value is a multidimensional construct that consists of several inter-related attributes (e.g. perceived price, monetary and non-monetary costs, quality, utilitarian and hedonic benefits). The notion of value creation in the marketing literature has traditionally focused on transaction, maintenance and learning costs (e.g., Anderson and Sullivan 1993, Monroe 1971; Wilson 1995; Zeithaml 1988). Recent developments in the field have extended the definition of value to incorporate non-price elements such as life-cycle and privacy costs (Kumar and Reinartz 2016; Vargo and Lusch 2004). Karmarkar, Shiv and Knutson (2015), using tools of neuroscience find that for many regularly purchased or utilitarian products, leading a promotion with the price first significantly influences perceptions of value because considering the price first changed how people thought about the choice process, and changed the way the brain coded the value of a product. The value proposition to customers is whether product functionality is worth the price. Price primacy (viewing the price first) induces bargain-focused perceptions of value.

The perceived value construct has been identified as a major source of competitive advantage (Parasuraman 1997) and has been identified as the key determinant of repurchase intentions. Parasuraman and Grewal (2000) conceptualized this relationship through the development of the quality-value-loyalty chain. This framework posits that perceived value has three primary antecedents: service quality, product quality and price. The authors make the distinction that service quality offers the potential for the greatest competitive leverage as

it is generally more difficult for other producers to imitate.

The notion of perceived value suggests that subjective judgments of value, whether they be cognitive or affective, are what influences consumer decision-making. These evaluations are based on more than experience or knowledge relating to the benefits of the physical product but also a customer's individual perception relating to the purchase. Previous research has highlighted how such judgments of value are influenced by the context in which consumer decision-making takes place. Perceptions of value have been found to differ between product types, individuals, and circumstance (over time and in different environments). Consumers can also differ in the value they associate between both different and the same products. Even a consumer's value of the same product may vary over time and the types of values that are most salient are likely to vary with circumstance. In some research, four different types of value have been identified (e.g. Grewal *et al.* 1998; Woodruff 1997):

1. acquisition value: perceived benefits relative to perceived costs
2. transaction value: the pleasure associated with a perceived fair price
3. in-use value: benefits derived from using the product
4. redemption value: the residual benefit after a product has been consumed.

The dynamic nature of perceived value means that the importance placed on each different value is likely to change over time and in different contexts. For durable products, acquisition and transaction value are likely to have a stronger influence on purchase decisions, with in-use and redemption value becoming more important during latter stages of usage. In such cases, the decision to trial a product is more likely to be influenced by perceived acquisition and transaction value, whereas re-purchase behavior and customer

loyalty may be more strongly related to in-use and redemption value (Parasuraman 1997; Slater and Narver 1994).

Whether a simple or complex view of perceived value is used, recent developments in the field have shifted the emphasis away from a utilitarian and economic conception to a behavioral conception based on psychological theories that attribute consumer choices, in part, to simpler heuristics. An important heuristic identified in research studies into how buyers perceive the fairness or appropriateness of a price is that of the reference price which can be defined as the price against which buyers compare the offered price of a product or service. This concept is considered in the next section.

Internal and external reference prices

The notion of transaction value can be closely linked to a product's reference price (Urbany *et al.* 1997). The Nobel Prize winning work of prospect theory, whereby individuals evaluate their decisions based on losses and gains, rather than absolute magnitudes (Kahneman and Tversky 1979), has had important implications for our understanding of consumer response to price, and specifically perceptions of their transaction value. In applied consumer behavior studies empirical research for fast moving consumer goods (FMCGs) generally suggests that consumers make decisions about price by referring to some of kind of reference price, whereby the gap between what one thinks a product's price *should* be (e.g. a normal price, a fair price – its reference price) and the actual price of the product is a better predictor of behavior than the price alone (Mazumdar *et al.* 2005). In other words, if a consumer's reference price is higher than the actual price, then the consumer is more likely to frame the purchase as a “gain” and view the product as a good deal. However, if the reference price is lower than the actual price, then the consumer is more likely to frame the product as a “loss” and think the product is not such a good deal. Therefore, an important part of the behavioral

perspective on pricing focuses on this gap between the actual price and the reference price. This has been coined transaction value (Thaler 1985) or “sticker shock” (Winer 1986). Thus, in studies concerning consumer response to price, researchers typically study acquisition value, and also transaction value (Grewal *et al.* 1998; Lowe and Alpert 2010; Thaler 1985; Urbany *et al.* 1997). The implication is that longer-term price management and its impact upon these value perceptions is a more important objective than short-term price management because past prices signal a product’s worth to consumers – it is the price history as well as the current price which consumers use to make purchase decisions (Winer 1986). These past prices provide consumers with a reference price and the reference price is used to judge the expensiveness of a product.

For new products, the implication is that setting the right price for a product early on in its lifecycle is especially important, because it will set the standard against which the expensiveness of that product is judged in later periods. Therefore, reference price management is important to products in existing categories, but especially important to products in new product categories where consumer price perceptions have yet to be framed (Lowe and Alpert 2010; Marn *et al.* 2003). Thus, not only is price management important but, relatedly, so is *reference price management* (Nagle and Hogan 2006).

Marketers try to influence our reference price, and therefore transaction value, through external reference price claims (e.g. “Was \$109.99, now \$59.99”). Such promotions are often accompanied by time limited cues (e.g. “Hurry, before sale ends”). The most recent research in the area provides evidence, based on a series of field experiments, that reference price advertisements are generally more effective when consumers are shopping for a product, and that such advertisements are more effective when accompanied by a time limited promotion (Howard and Kerin 2006). This contrasts to some degree with prior work on reference price advertising which seems to suggest that reference pricing alone is effective in influencing

shopping intentions (e.g. Biswas and Blair 1991).

Pricing and fairness

The concept of a reference price has been shown to be multifaceted and context specific. For example, Lowe and Alpert (2007) show that different reference prices are used for new products as opposed to existing products. However, one commonly used reference price is a fair price (Mazumdar *et al.* 2005). Gourville (1999) identifies a variety of factors that influence the buyer's perception of the fairness of a price. Earlier Scitovszky (1944–5), observed “the normal or fair price is contrasted to the actual price whenever they are different, and it is only when they are different that judgments of cheap or expensive occur.” This relates again to the notion of transaction value. A large perceived margin is unfair and dissuades buyers from purchasing. Thus, a price hike in the context of current shortages might similarly be seen as unfair, as would a small sale reduction on a high price compared to that same (absolute) reduction on a low price.

In these cases, it might be argued that individuals are effectively deciding their response to a price change judged on its fairness. Perceptions of fairness impact WTP by consumers being less willing to pay a price they feel is “unfair.” This might be extended to a long-term depreciation of a seller's reputation and marketability of its products because of its perceived lack of “fairness.” Fairness is also an ethical issue that society in general might have a view on and this might influence the control or pressure to control its prices by regulators. The pricing of medicines in developing countries is a case in point (Dolan and Gourville 2009).

The main managerial issue is how to deal with customer perceptions of unfairness. That is, how does the seller encourage them to disregard “unfairness” in their decision-making? Gourville (1999) recommends actively managing price expectations and actively managing

perceptions of cost of goods sold. The counterpoint to ensuring customer perceptions of fairness is that many firms pursue pricing policies that are considered “fair” as in equitable between product lines, but that such pricing mismanages potential profits. Cost plus pricing is an example, as is averaging prices across groups of very different consumers. Cespedes *et al.* (2011) note that,

Many executives celebrate a sort of pseudo-democracy in their pricing policies. For years, UPS charged one price to all customers . . . When it entered the market, FedEx became the fastest U.S. company to reach \$1 billion in sales in part because its pricing recognized inherent value differences between customers.

One aspect of fairness is the appeal of price transparency of sellers. Lowe (2015) and Mohan, Buell, Ryan and John (2016) argue that transparency over costs generates customer trust and increases purchase probabilities. This holds in a range of situations, particularly when higher prices are justified through higher costs caused by social or ethical choices

The notions of fairness come from customers, not pricing formulas. Fairness is important and can be managed, but it is not about equity *per se*. A key issue in fairness is the extent to which prices move away from some reference point. The behavioral effect of increasing and decreasing price is now considered.

Increasing and decreasing prices

If managing consumer price perceptions is important, then understanding how price increases and price reductions affect consumer perceptions of value can be critical. It is quite common for marketers to reduce prices, usually through some kind of sales promotion, to stimulate demand for a product. To this end, marketers have a range of tools at their disposal, including

price discounts, coupons, bonus packs, contests, free gifts, introductory prices, etc. One issue that is important when assessing consumer reaction to sales promotions involves the depth and frequency of sales promotions. For instance, for FMCG products discounts of greater than 5–10 percent are generally necessary before consumers notice that there is even a discount (Gupta and Cooper 1992). This is known as the just noticeable difference (JND) (Monroe and Lee 1999) and suggests that marketers should reduce prices by an amount that is noticeable to consumers. It is likely that the JND level changes as a function of the product category under consideration, consumer involvement with the purchase decision, knowledge about the product category, and the magnitude of the product's cost to the consumer. Conversely, consumer response to discounts of different levels is not necessarily linear, such that larger and larger discounts have smaller and smaller marginal effects. For example, some research shows that discounts higher than 30 percent do not evoke a large marginal change in preference, as consumers tend to “discount the discounts” (Gupta and Cooper 1992). Therefore, those managers responsible for setting discounts should carefully consider the level of the discount that is being set so it achieves its objectives in an optimal way. Managers need to also consider the frequency of discounting too. Discounts which are too frequent may lead consumers to perceive that a sale is not a real sale. For example, Alba *et al.* (1999) show that a small but frequent discounting strategy may be most suitable for stores wishing to present a low-price image, rather than infrequent but heavier discounting.

Another issue that is important to consider when selecting a sales promotion is the kind of sales promotion to use (e.g. monetary versus non-monetary) and its differing effect upon consumer value perceptions. Consumers react differently to different types of sales promotions. For example, Chandon *et al.* (2000) broadly distinguish between monetary promotions (e.g. a discount) and non-monetary promotions (e.g. a free gift), and show that sales promotions techniques have benefits other than a monetary saving. These benefits

include utilitarian benefits such as monetary savings, enhanced value for money through increased quality, and increased convenience, and other hedonic benefits such as increased entertainment and enhanced exploration ability.

Taking a somewhat different approach other research contrasts the differences between monetary and non-monetary sales promotions based on their impact upon consumer reference prices. For example, Diamond and Campbell (1989) show that monetary promotions such as discounts lead to lower reference prices than non-monetary promotions, and this has consequences for transaction value. However, Sinha and Smith (2000) show *one-off* price promotions may not affect reference price. Intuitively, and based on prior research, it might be expected that introductory low prices or monetary discounts may downwardly bias a consumer's reference price (e.g. Diamond and Campbell 1989), whereas for extra free product offers, the reference price is more likely to remain unchanged (Sinha and Smith 2000). This is important because if an introductory low-price promotion leads to a lower reference price than an extra free product promotion, then one might expect the gap between the product's reference price and its actual price to increase. As the gap increases, this reduces transaction value, which in turn reduces purchase likelihood. Based on a similar premise, Lowe and Barnes (2011), using a national sample of UK consumers, show that introductory low price promotions are more (less) effective than extra free product promotions when the product is perceived as newer (less new). This seems to be because newer products are seen to be more risky and monetary promotions can reduce perceived risk relative to non-monetary promotions.

On the other hand marketers sometimes wish to increase prices. Again, drawing on prospect theory (Kahneman and Tversky 1979) this is most likely to be viewed as a loss by consumers, and in some cases consumers will perceive this to be unfair. Price increases are sometimes unavoidable due to increased input costs. Nonetheless these increases must be

framed in a way that consumers feel is fair. For example, Campbell (1999) shows there are two key causal influences on our judgments of price fairness. These are the inferred motive of the firm (e.g. whether the motive is judged to be negative or positive – as in whether or not the profits will be allocated to the firm or a good cause) and the inferred relative profit of the firm (e.g. a normal profit or a *more than* normal profit). This relationship is moderated by a firm's reputation (e.g. socially responsible or not socially responsible with other stakeholders – staff, the community, etc.). Bolton *et al.* (2003) extend this research and show that consumers' knowledge (measured subjectively – e.g. their perceptions) of prices, profits, and costs lead to changes in their perceptions of price unfairness. Therefore, based on this data it appears that consumers are skeptical toward a firm's motives and tend to assume price changes and price differences are unfair based on some kind of perceived motive for firms to take profit, even when they are actually beyond the firm's control. They conclude that price increases deemed to be most fair are deemed to be fair as a result of quality differences – so perceived differences in quality are an important cause of price fairness perceptions and should be an integral part of marketing communications. Thus, when increasing prices marketers should “nibble” not “bite” (Kalyanaram and Little 1994: 416), the opposite of when decreasing prices.

Price endings

Consumer response to prices also exhibits some peculiarities in relation to an offering's price ending. The study of price endings and odd-even pricing tactics (e.g. \$19.99 or \$20.00) is not new to the field of marketing. However, relatively little empirical research has provided conclusive evidence of the nature of the effect, and its moderating conditions. This is despite the fact that the practice remains widespread. For example, Schindler and Kirby (1997) show that the digits 0, 5 and 9 are over-represented in a large sample of newspaper advertisements,

consistent with many similar studies. The practice has also been shown to transcend different cultures (Simmons and Schindler 2003; Suri *et al.* 2004). Because of its prevalence, and ability to influence consumer choice, the topic is important for marketers and consumers alike.

The main proposition that has been tested in price ending research is that small one-penny price changes can have large effects upon sales, if prices are changed from an even number such as \$20.00 to an odd number (and in particular a number ending in 9) such as \$19.99. Thus, in some cases consumers could be highly price sensitive to price changes which are extremely small, and otherwise unnoticeable, leading to spiked demand curves at prices ending in 9 (Anderson and Simester 2003). There are three main theoretical arguments for such effects. One argument is that price ending effects are most likely to be seen when associated with cheaper products. However, Schindler and Kibarian (2001), based on a survey of market prices, show that 9-endings were not commonly associated with the cheapest products. Relatedly, there is evidence to suggest that 9-endings are typically associated with the presence of low-price appeals (e.g. a reference price or some kind of claimed saving, rather than cheaper products *per se*). Thus, a second explanation is based around retailing folklore, whereby managers who want sale prices to appear cheaper use 9-ending prices because they believe consumers will see these as being cheaper (Schindler 2006). A third argument advanced in the literature is based on the premise that consumers read prices from left to right and that right-hand digits are less important than left-hand digits. Either left-hand digits are recalled better by consumers (e.g. see Guéguen and Legoherel 2004), or, if the left-hand digit changes, then this change is most salient to consumers, leading to a left-digit effect (Thomas and Morwitz 2005).

In general, there is no widespread consensus about how price endings influence consumer choice, and because of limited systematic empirical research in the area, generalizations

about price ending effects are not empirically verifiable. For example, some studies find that odd prices ending in 9 increase consumption relative to even prices (e.g. Anderson and Simester 2003). Other studies find inconsistent effects or that odd prices *reduce* consumption relative to even prices (e.g. Bray and Harris 2006). These findings point to a variety of conditions that moderate the effect of 9-ending prices.

Some research shows that the price magnitude of the product (e.g. low-priced versus high-priced products) is important in research on price ending effects. Anderson and Simester (2003) show that \$9 price endings (as opposed to 9 cent) can increase sales by as much as 40 percent relative to other price endings. This effect was stronger for newer products than for existing products, providing some rationale for the inconsistent effects found by Bray and Harris (2006). More recent research points to the importance of the left-digit effect (Thomas and Morwitz 2005) as an important moderating condition. The left-digit effect suggests that 9-ending prices are only effective if the left digit changes as well (for example, from \$20.00 to \$19.99, rather than \$21.00 to \$20.00). This effect is shown by Thomas and Morwitz (2005) to be greater (smaller) when the difference between the two prices is smaller (larger). Therefore, the left-digit effect will be greater for a promotion such as “Was \$20.00, now \$18.99” (versus \$19.00) rather than a promotion such as “Was \$20.00, now \$11.99” (versus \$12.00). One aspect of price endings is the perceived exactness and precision of a price. Jerez-Fernandez, Angulo, & Oppenheimer, (2014) find that perceived exact prices yield better market outcomes than round-numbered bids. Their research emphasizes that price and its primacy in an offer, provides consumers with important signals of value. Other recent research finds evidence for consumer use of round prices when consumers are purchasing for convenience – these round prices are seen to be easier to process cognitively leading to convenience benefits (Wieseke, Kolberg and Schons 2016)..

Therefore, in summary, the evidence suggests that price endings are important and that

small price changes can have a dramatic influence on sales. However, this is not a universal truth, and based on the majority of research the effectiveness of price endings seems to depend upon a variety of different factors including association with other low price cues, price magnitude, product newness to customers, changes to the left digit, and managerial interpretation of consumer response to price endings. While price movements and price endings need to be managed effectively, often the greatest challenge to sellers is how to price the quality or attributes of a product that influence whether something is considered a good or poor buy. These price–quality perceptions are considered in the next section.

Price–quality perceptions

Price is usually assumed to be inversely related to demand. This is illustrated in Dolan and Gourville’s (2009) “Value-pricing thermometer” in **Figure 24.1**. Conventionally, a seller tries to increase the difference between price and cost of goods sold (profit) while consumers are more incentivized to buy, and the greater is the gap between perceived value to them and product price. The expected price– quality relationship is for higher prices to be linked to more attributes and better quality, because these lead to higher *perceived* and *objective* value. Research referred to earlier suggests that over time there is often a correlation between prices charged and the quality or attributes of a product or service. However, some research as well as extensive anecdotal evidence, suggests that there might be a positive relationship between price and perceived value in some circumstances – even though objective value and product attributes remains unchanged. Some pricing research shows consumers may infer quality from price when they lack the ability or motivation to process product-related information (Suri and Monroe 2003). Thus price *can* serve as a heuristic which provides information to consumers.

[Insert Figure 24.1 here]

[caption]**FIGURE 24.1** The value pricing thermometer (adapted from Dolan and Gourville 2009)

There are a number of circumstances when this price–quality relationship is likely. Higher prices may signal better quality to the consumer without adequate information; when product attributes are difficult to measure except through experience; or where there is high uncertainty on the part of the consumer about what to buy. Price might also be used as a quality signal where information search is difficult or there are few sources of available data (e.g. cars and electronic equipment versus perfume, clothes, or wine). The assumption underlying these perceived positive price–quality relationships is that as well as uncertainty and lack of information, price is also determined with reference to another or expected price point. The buyer’s receptiveness to price is about what s(he) expects. Buyers also have some notion of perceived quality that can be different to objective quality. According to Zeithaml (1988), perceived quality involves a higher level of abstraction than specific attributes, and resembles attitude. Judgments about quality are made within a buyer’s evoked set; comparisons with reference prices are critical. Such judgments about the superiority or excellence of a product or service is essentially user-based, rather than product- or manufacturing-based (Garvin 1983). This abstract view of quality is coupled with a view that buyers do not always know or remember prices paid, but encode prices in ways meaningful to them. This is parallel to the emotional and intuitive decision-making processes that Kahneman (2011) contrasts with more deliberate and cognitive approaches.

Recent research by Bornemann and Homburg (2011) suggests that with increasing psychological and temporal distance, price–quality relationships are more likely. People are more likely to construe price as indicating quality and less likely to focus on price as a cost,

the more distant they are from the purchase. Thus when a product is less part of a consumer's regular experience or when its purchase and consumption is for some time in the future, price-quality relationships are likely to be more pronounced. There is evidence that price-quality effects have decreased over the last three decades but still remain potent. Völckner and Hofmann (2007: 194) in a meta-analysis of price-quality relationship research conclude that over the period 1989–2006 the incidence of inverse price-quality relationships identified in the research literature declined. However they comment that:

consumers still use price as an important indicator of quality Managers must be aware that price-quality inferences remain important aspects of consumers' behavior and (should) consider them when setting prices . . . setting a low selling price or lowering a price with a discount not only lowers consumer costs but also threatens to lower their perceptions of product quality through negative signaling effects.

Thus, price-quality relationships are pervasive in many markets. However, there are limits to the extent that perceived value can be positively influenced by price. With the growth of social media, the buyer's ability to call-up data on price and quality comparisons has increased. Quality signaling using price may in the future require other strategies such as bundling and product augmentation to achieve increases in demand.

Consumer price knowledge

The extent to which consumers use different heuristics might depend upon the accuracy of their price knowledge. Consumer price knowledge has long been a subject of interest for practitioners and academics alike. Conventional neoclassical microeconomic models assume that consumers *know* the prices of the products they are purchasing. However, a wealth of

research suggests that this might not be the case (Dickson and Sawyer 1990; Gabor and Granger 1961). If so, this has important implications for what is known about price, and about how consumers use price in their purchasing decisions. For example, reference pricing studies that use scanner data to model consumer reference prices based on past prices consumers have been exposed to may not be accurate, if this is the case. Likewise, how reference prices are formed must be subject to some kind of systematic bias that is not yet well understood. More recently, Monroe and Lee (1999), in reviewing contemporary and emerging perspectives on pricing, argue that initial research in this regard is limited because it relies on the ability of consumers to *recall* prices. Instead, they argue, consumers may have knowledge about prices in a relative sense (e.g. being able to rank from cheapest to most expensive), even if they cannot recall exact prices. Using a sample of French supermarket shoppers, Vanhuele and Drèze (2002) provide an explicit test of this and tap into recallable price knowledge (e.g. whether or not the consumer can recall the price), price recognition (e.g. whether or not they can recognize if they paid a particular price), and the ability to spot deals (e.g. whether or not they can tell if something is a good deal). Like Monroe and Lee (1999) they conclude that consumer price knowledge is more pervasive than the ability to recall a particular price. This may account for the findings of reference price research using scanner data. Therefore, while shoppers cannot recall past prices accurately, they have the ability to spot good deals and bad deals. Estelami and De Maeyer (2004) expand existing research by examining consumer price knowledge for durable goods. They find that price knowledge varies considerably across a range of durable goods (e.g. higher for essential goods and lower for recreational goods). They also find that purchase frequency and amount spent on advertising are important variables that can explain consumer price knowledge, whereby more frequently purchased products and heavily advertised goods are associated with higher price knowledge. More recent research shows how the number of low-priced

items in a store can affect the degree to which the store has a low price image, and how different customers rely on different heuristics to make judgments in arriving at their perceptions. Specifically, they show that stores with greater numbers of low priced products are more likely to have a low-price image. However, this seems only to be the case for high-knowledge consumers; low-knowledge consumers associate a low-price image with the ease to which low prices can be recalled (e.g. the salience of promotions and other low price cues). Therefore, consumer price knowledge is an important variable for marketers to understand. Its link with other psychological concepts within the domain of pricing is important for theoretical and practical reasons, not least because marketers' actions can influence this rather malleable and subjective variable.

Behavioral pricing concepts in non-market settings

So far the discussion has centered around market goods, but how are goods and services valued (and implicitly priced) when there is no market? In a free market economy, goods and services are sold for prices that reflect equilibrium between supply and demand, that is the costs of production and what people are willing to pay. Non-market goods or services (non-market goods) are not bought or sold directly and do not have a directly observable monetary value. Examples of this include nature-based recreation activities such as visiting public parks and gardens, wildlife viewing, or rock climbing. A basic purpose of government is to provide citizens with non-market goods and to place values on such goods so that investment can be prioritized. Such decisions require governments to have an accurate understanding of the values attributed to such goods by society. To estimate the value of non-market goods, several economic tools have been developed, including: contingent valuation surveys; attribute-based methods, and travel cost methods (Brown 2003). However, recently an alternative tool for valuing non-market goods – happiness economics – has been proposed.

In neoclassical economics, utility is not a psychological experience that occurs during or after consumption. Instead, utility is defined by revealed preference: preferences (i.e. utility) are revealed from behavior (i.e. choices) (Stigler 1950). Proponents of revealed preference argue that information about utility is captured by choice, assuming that consumers act as rational agents (Kahneman and Thaler 2006). The reliance on measuring value through economic measures of utility (e.g. revealed preference and stated preference methods) has recently been criticized (e.g. Kahneman and Thaler 2006). The field of behavioral economics refers to the attempt to develop economic theory by providing it with more psychologically plausible foundations (Johnson 2006). Much emphasis in behavioral economics concerning valuation of both market and non-market goods focuses on subjective well-being (happiness) as an experience-based measure of utility (Diener 2009; Kahneman and Krueger 2006).

The term subjective well-being refers to “a broad category of phenomena that includes people’s emotional responses, domain satisfactions, and global judgments of life satisfaction” (Diener *et al.* 1999: 277). There are two distinctive components of subjective well-being: an affective part and a cognitive part (Diener *et al.* 1999; Kahneman 1999). The affective component refers to the presence of positive affect (i.e. emotions) and the absence of negative affect. The cognitive component of subjective well-being relates to an information-based appraisal of a person’s life as a whole (Schwarz and Strack 1999).

Behavioral economists argue that experienced utility can be measured and is distinct from decision utility (Kahneman and Thaler 2006). In response to criticisms concerning the measurability of experience utility, Kahneman *et al.* (1997) nominate how the concept can be operationalized through instant (hedonic and affective experience during consumption), predicted (beliefs about the experienced utility of future outcomes), and remembered (past hedonic and affective experience) utility. Following these major advances in the field of subjective well-being, much work is underway that evaluates the contribution it can make to

informing policy decisions (Loomes 2007). In particular, experienced-based utility, by providing measures of subjective well-being, can provide an alternative to estimating prices.

Recent studies in this field have used measures of subjective well-being as a proxy for individual welfare. This approach attempts to measure the marginal (dis)utility directly attributable to non-market goods. Although such an approach is still in its infancy, it has generally been applied in contexts that produce disutility and negative externalities, e.g. noise pollution (van Praag and Baarsma 2005), terrorism (Frey *et al.* 2009), droughts (Carroll *et al.* 2009), air pollution (Luechinger 2009) and flooding (Luechinger and Raschky 2009). Further empirical research using the experienced-utility approach offers potential to better understand and measure societal preferences concerning welfare maximization and public good investment decisions.

Implications for innovation in pricing

Probably one of the most important pricing innovations of the last decade is a move to more ‘dynamic pricing’. Dynamic pricing, a strategy that changes prices rapidly to reflect changes in demand is something practiced crudely in the retail electricity sector for some time and with some success although Joskow and Wolfram. (2012) propose greater and more refined use of dynamic pricing to enable better future resource use in the electricity industry. Kramer and Krueger (2016) identify dynamic pricing by Uber as one of the major contributors to its commercial success even though the ride-sharing platform also gained some notoriety among its consumers for this policy. However whilst the technique is becoming widespread, for instance in major sporting events, it is not necessarily consistent with improved profitability (Xu, Fader and Veeraraghavan, 2016).

The first and most important thing managers need to recognize is that getting the “right” price is critical for both revenue and profitability. Clearly, what is “right” depends as much

on customers' differential response to different prices as it does on organizational objectives. But how can a manager gauge the "right price"? One way is through field experiments testing different price/promotion levels (Almquist and Wyner 2001), an area in which the direct mail industry has previously led the way and in which digital marketers are progressing rapidly (with caution) given increased behavioral data and the chance to manipulate customer exposure to information. Other alternatives exist and simple direct approaches may yield reasonable solutions in some cases (Miller, Hofstetter, Krohmer and Zhang 2011) Yet another part of the solution is the acknowledgment that the value of a product or service sets the upper limit for how high a price can be raised, and that value is made up of psychological and objective or utilitarian value. Managers must understand what this psychological value is and the attributes of their products and services which relate to it. The psychological value of a product is not only determined by its brand, rarity, and social norms, but is also affected by perceived fairness or "rightness" of a price. These issues of fairness may be influenced by how, when, and where prices are charged, and involve both affective as well as cognitive decision processes.

Gourville and Soman (2002) assert that consumers typically tend to look at price differences in terms of the saving as a proportion of actual price and as an indicator of the size of the incentive to enter the transaction. Similarly, they may resent prices that are not a reflection of the costs of a good and sellers may need to add features that justify the perception of higher costs. For some goods, a reference price might be used to identify what is "fair," while what is a fair price might be the subject of more intensive introspection for utilitarian goods compared to luxuries. These insights suggest buyers make various judgments about perceived value and a fair price that, in common with decision-making generally, suffer from extensive biases.

The manager needs to understand these processes and the reference points most salient to

their customers in order to be able to tweak price most effectively. Once these reference points are understood, managers must manage price expectations through establishing clear reference prices, avoiding major and discontinuous price hikes, invest in establishing some product uniqueness to avoid price comparisons, and establish benchmarks for good value by outlining favorable price comparisons with *different* products known for being good value. Finally, managers can avoid cost of goods sold comparisons by bundling, adding abstract features and focus cost comparisons using absorption costing.

In the end, WTP is driven not only by the “economic utility” of the transaction, but also by the “psychological utility” of the transaction. There are many levers that managers can use to increase psychological utility or reduce dissonance. For example, adjusting price endings is one way where small price changes have been shown to lead to large changes in demand in some circumstances. However, these findings are based upon a variety of different factors including the product’s price magnitude, its relative newness, changes in the left digit, and accompanying promotional material with other low price cues. Managers must consider these moderating influences when setting price endings. When managing price, adjustments and sales promotions should ultimately be based on a longer-term pricing strategy, not just a knee-jerk reaction to competitors’ promotional offerings. Maintaining pricing discipline through active management of reference prices and other salient consumer reference points will lead to more favorable price comparisons. However, reference price is multifaceted and managers must understand their individual customers and the reference prices those customers use in different circumstances, and their attributions of fairness. For example, non-monetary sales promotions have been shown to take the focus off price and assist in maintaining reference price perceptions.

Ultimately consumers make apparently irrational decisions and bound their search behavior; sellers should be able to improve profitability by understanding these decision

processes. In summary, sellers must understand how WTP is influenced by objective value and psychological factors. They need to be able to estimate price sensitivity by customer, outlet, context, and use, and through establishing clear reference prices they need to integrate price decisions with the rest of the marketing mix.

Conclusions

This chapter has described how research into pricing, using behavioral concepts, represents a significant source of marketing innovation for alert sellers. Buyers without adequate information might make a number of seemingly conflicting purchasing decisions. Sometimes these are the result of time-saving heuristics or sometimes they are the result of apparently irrational behavior. Consumers often behave in somewhat counter-intuitive ways (e.g. using price as an indicator of quality, purchasing more with trivial price changes) and do not always have accurate information (e.g. low price knowledge) on which to base their decisions. These decisions might be thought of as irrational but stem from the key driver of behavior – perceived value. Price, a seemingly objective variable, may be interpreted by consumers in a *seemingly* subjective way. In order to understand how consumers might respond to price, managers must understand the reference points and heuristics that consumers use.

However, the information customers and companies are now being provided is changing the nature of transactions that take place and allowing buyers to be better matched with sellers. Further research can make a contribution by integrating the concepts discussed within this chapter into a new information rich environment.

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