



Pricing by intuition: Managerial choices with limited information[☆]



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ABSTRACT

In making pricing decisions, managers can choose from several pricing strategies. To ensure long-term business success, pricing choices need to balance numerous requirements, from revenue streams to keeping customers happy. The complexity of pricing decisions and time pressures that often accompany them prompt the need for fast, simplified decision algorithms. The present exploratory study examines the ways in which considerations of price fairness and competitive strategy combine in managers' decisions regarding the price level. Results of a survey of 116 brand managers provide no evidence of complex, compensatory decision algorithms. Cluster analysis of managers' responses to hypothesized pricing scenarios shows that with limited information available, decision-makers tend to simply charge consistently higher, lower, or equal prices compared to their competitors irrespective of the quality of their products. Descriptive profiles of the clusters suggest that brand strength has the strongest impact on managers' pricing choices, suggesting a brand heuristic as the main decision tool. Competitive intensity, organizational culture, and strategic orientation are also related to particular patterns of pricing decisions.

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Introduction

In running their businesses, managers can rely on intuitive or technocratic decision-making styles (Covin, Slevin, & Heeley, 2001; Khandwalla, 1977). A *technocratic* management style implies a heavy reliance on quantitative decision making tools and an overall propensity to be systematic, analytical, and scientific when making top-level business decisions. A variation of optimization decision mode would be expected in technocratic management style: decision-makers evaluate all attributes of alternatives, usually in a compensatory way. In very simple terms, compensatory way of evaluating cues or attributes implies that superior performance on one attribute can compensate the lack in another attribute. For example, in the eyes of a customer, a lower price of a product may compensate its lower quality. The choice is then being made based on a more attractive, optimal combination of cues (Katsikopoulos, 2011).

Executives' "gut feelings" about the appropriateness or inappropriateness of decisions heavily influence their choices in the *intuitive* decision mode (Covin et al., 2001, p.52). Intuitive style features attending to fewer data and spending less time and effort processing these data and often is dominant in fast-changing, competitive environments. The intuitive decision-making style implies reliance on heuristics for choosing between alternatives. Heuristics, described as cognitive processes that allow making fast and frugal decisions by limiting the amount of

information analyzed (Gigerenzer & Brighton, 2009, p. 107), have been studied in psychology for quite some time (Gigerenzer & Brighton, 2009; Gigerenzer & Goldstein, 1996, 2011; Tversky & Kahneman, 1974). Heuristics utilize fewer decision inputs and evaluate them in a noncompensatory way. In other words, a decision maker gives priority to a cue that has a stronger potential to indicate a better decision and leaves the rest of the cues out of analysis even if they still might have an ability to differentiate alternatives. (Gigerenzer & Goldstein, 1996; Katsikopoulos, 2011).

The rationality of decisions based on heuristics is a subject of hot debates. On the one hand is the argument that as not all available information is being utilized in the analysis of alternatives, decisions inherently carry a risk of systematic biases (Kahneman & Tversky, 1973, 1996). On the other hand are compelling arguments that intuitive decisions can be no less, and possibly more effective than those based on full-fledged analysis, as heuristics rely on past experiences and reflect the best practices for a particular decision-making environment (Gigerenzer & Brighton, 2009; Gigerenzer & Hoffrage, 1999) and therefore are ecologically rational (Goldstein & Gigerenzer, 2002; Smith, 2003).

While cognitive mechanisms behind heuristics receive a lot of attention in research in psychology, particulars of these processes are not clear when applied to business environment. For example, a take-the-best heuristic requires a search for cues, ordering them according to their validity and then picking an alternative as soon as a cue differentiates the alternatives. To understand and predict managerial decisions it is important to understand what cues managers attend to, and which ones they rank higher in terms of predictive validity (Brandstätter, Gigerenzer, & Hertwig, 2006; Gigerenzer & Goldstein, 1996). Of course, the answers to these questions will be specific to different business

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tasks and the environment where a task is being performed. This study focuses on the important task of pricing.

One of the four pillars of marketing, price plays multiple roles in marketing strategy. Price positions a product to appeal to a certain segment. It provides a signal of a product's quality to a customer. Price plays an important role in determining the revenue and is one of the most flexible marketing tools for responding to competitive threats. Pricing decisions are typically under the control of brand or product managers who can change prices without much investment. Results of price changes reflect almost immediately on a firm's bottom line (Marn & Rosiello, 1992; Rao, 1984). The need to maintain a high level of revenue and profit and at the same time keep consumers happy makes pricing decisions inherently ambiguous, especially when it comes to pricing new products (Monroe, 1990; Monroe & Della Bitta, 1978), and therefore, susceptible to intuitive decision making.

The goal of this exploratory study is to examine patterns of pricing decisions made with limited information to find out whether managers' pricing choices show meaningful patterns and whether they reflect any identifiable decision-making algorithms. Additionally the study investigates how these patterns are related to the environment in which managers operate. The third objective is to establish the extent to which identified algorithms are rational. The paper is organized as follows: first, it reviews the decision inputs that can be expected to affect pricing decisions. Second, the paper discusses environmental factors that can affect pricing choices. Next, it presents the analysis of the data obtained from the survey of brand managers and an illustration of the viability of observed decisions based on the data from the US automotive market. Finally, the paper discusses the implications of the findings and the future research opportunities.

Decision inputs: Keeping price fair

Erroneous pricing decisions can have both long- and short-term negative consequences for a brand. Setting a price too low reduces a firm's profits, drives down consumers' reference price points, and negatively affects perceived quality of a product and its overall market positioning. At the same time, overpricing may have a negative impact on consumers' perception of a brand repelling even loyal customers (Fournier, 1998). There are numerous examples of pricing strategies that consumers perceived as unfair and which had negative consequences for the companies in question. For instance, just two months after a successful launch of its iPhone in 2007, Apple drastically reduced the price of the product. This decrease offended thousands of loyal customers who waited in lines earlier to pay the original price that turned out to be inflated more than 30%! To moderate the situation, Apple had to issue a public apology and compensate its disgruntled customers. (*Wall Street Journal*, September 7 2007). Another case of public reaction to unfair pricing is the CDN\$2 billion class action lawsuit that has been filed in Ontario Superior Court in September 2007 alleging that major car manufacturers and dealers in Canada artificially inflated prices compared to the US at the same time conspiring to prevent Canadians from buying cars in the US.

Both cases above represent examples of viable pricing strategies – price skimming and geographic pricing (Tellis, 1986) – taken too far and therefore backfiring on decision-makers. Understanding the factors that lead to pricing actions that underestimate or ignore the possibility of consumers' revolt is critical both for academics and practitioners. While there exists a solid body of prescriptive research in pricing (Rao, 1984), not much is known about the extent to which these prescriptions are being utilized by practitioners (see Tellis, 1986 and Cavusgil, Kwong, & Chun, 2003 for classifications of pricing strategies in the field). Relatively few studies have explored subjective factors involved in pricing decisions (see Armstrong & Collopy, 1996 and Keil, Reibstein, & Wittink, 2001 for notable exceptions). So, while there exists a considerable understanding of consumer behaviors related to various

aspects of price, the knowledge of decision-making algorithms and inputs that managers utilize when setting prices is limited.

Managers face the need to balance competing demands in their pricing decisions: a price can be expected to reflect a firm's competitive strategy but at the same time should accommodate customers' value demands. Extant research points at three major approaches to pricing (Dean, 1976; Rao, 1984): premium pricing strategies (price skimming, price signaling, etc.), going-rate pricing (similar to the competition), and discount pricing strategies (penetration pricing, experience curve pricing, etc.). With premium pricing, firms offer a product at prices higher than comparable competing products while discount pricing implies lower prices (Dean, 1976; Monroe & Della Bitta, 1978; Tellis, 1986). Each of the above categories of pricing strategies aims at improving a firm's financial performance through higher sales volume or higher per-unit profit.

Together with financial performance, managers should also consider consumers' perceptions of price fairness (Shapiro & Jackson, 1978). The idea of fairness is pivotal for lasting relationships between consumers and brands (Campbell, 1999; Fournier, 1998). Breach of trust created by unfair prices may result not only in alienating customers (Aaker, Fournier, & Brasel, 2004) but in retaliatory actions (Xia, Monroe, & Cox, 2004). Consumers arrive at an unfairness judgment by comparing price levels to either their reference price or to the price of a substitute product with comparable levels of benefits (Campbell, 1999; Xia et al., 2004). Thus, it is reasonable to expect that if a product is priced above the competition, customers will perceive a price as more unfair if the level of benefits offered is the same or lower compared to a competing product than if the level of benefits is above the competition. While it is possible to argue that a premium price can be justified by a stronger, better recognized brand, this does not apply to inferior products. Indeed, when physical characteristics of compared products are similar, a stronger brand provides customers with an additional assurance of quality and in many cases – of the status associated with the brand. But this does not mean that managers can abuse a brand name by systematically offering consumers inferior products at a premium price. Models of brand equity from classic Aaker's (1996) model to the more recent Keller's (2003) model of brand resonance explicitly include product quality or performance as a foundation of consumers' loyalty and trust. Poor product quality can undermine even strongest brands, especially when it is accompanied by unjustifiable premium price.

Managers who care about consumers' perceptions of price fairness and at the same time about their company's revenues likely systematically follow one of the basic pricing strategies by favoring specific scenarios relating price levels to product benefits:

- 1) Undercutting (penetration pricing, experience curve pricing): that is, pricing products with benefits inferior or equal to competitors' at the level lower than competition and superior products at the level equal to the competition. Managers are expected to avoid scenarios with superior products being priced below the competition as such choices would unnecessarily hurt profitability of the business unit.
- 2) Premium pricing (price skimming, image pricing, price signaling): pricing inferior products on par with competition and products with equal or superior benefits at a premium. Again, managers are likely to avoid pricing inferior product at a premium as such strategy can alienate consumers.
- 3) Going rate pricing: setting the price equal to the competitors' irrespective of the level of a product's benefits. Such scenarios are characteristic to markets where products are commoditized and differentiating an offering is difficult.
- 4) Fair pricing: pricing products according to their relative benefits (pricing products with equal benefits on par with the competition; pricing products with lower benefits at a point less than competition; pricing products with greater benefits at a point above competition).

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