Journal of Retailing and Consumer Services 21 (2014) 696–707

Contents lists available at ScienceDirect

Journal of Retailing and Consumer Services

journal homepage: www.elsevier.com/locate/jretconser

Pricing practices: A critical review of their effects on consumer perceptions and behaviour

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ARTICLE INFO

Article history:
Received 11 May 2013
Received in revised form
20 April 2014
Accepted 29 April 2014
Available online 11 June 2014

Keywords:
Pricing practices
Critical review
Behavioural economics
Consumer psychology

ABSTRACT

With the present challenge to compete on price or product assortment, retailers and manufacturers are increasingly focusing on state-of-the-art pricing strategies which have their roots in behavioural economics and psychology. The current review is an empirical investigation on the relative effectiveness of various pricing practices on consumer perceptions and behaviour. Six pricing strategies were reviewed; drip pricing, reference pricing, the use of the word 'free', bait pricing, bundling and time-limited offers. The review shows that the former three have received a significant amount of attention and have a robust impact on consumer perceptions and behaviour. There is less research on the latter three; however, the available evidence does suggest that they, too, may be capable of influencing consumers' choices. Finally, it is also clear that the effects of pricing practices can be moderated by a variety of factors. Overall, the current review indicates that sellers are able to influence perceptions and purchase decisions of consumers based on the manner in which prices are displayed. The implications of these findings for retailers, policy makers and researchers are discussed.

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1. Introduction

Pricing practices used to advertise products and services to consumers – such as '3 for $5', '60% off' or 'sale – one week only' – are highly prevalent in today's society (Trinh et al., 2012). Furthermore, the design of price tags, rebates, sale adverts, cell phone plans, bundle offers, etc., are increasingly based on *psychological* variables rather than economic ones (Poundstone, 2009). This is perhaps not surprising as offering products which are not also available from competing retailers is becoming increasingly difficult (Sigurdsson et al., 2010). Certainly, products that prove popular are rapidly adopted by other retailers. Similarly, competitors can easily respond to price changes, in fact, more so than to most other tactics (Sigurdsson et al., 2010).

Achieving significant differentiation through breadth or depth of offered product lines or through price is likely to become even more challenging. For example, finding significant differences between retailers in their offers on, say, chocolate bars, or washing powder, is becoming increasingly unlikely (Simonson, 1999). Likewise, differences and similarities in price are not only becoming trivial, they are also now made salient to consumers, even when these are identical (or near identical) across retailers. Thus, as price (and assortment) becomes a less important differentiating factor, the 'design' of the price and the manner in which products are displayed and evaluated ought to increasingly become instrumental. In addition, marketers can tactically manipulate these designs to influence buyers' perceptions and purchase decisions (i.e. what and how much to buy), and this often does not have to involve any changes to the price. As such, pricing tactics have several very clear advantages.

On the other hand as the use of these practices is increasing, so is the attention from governments and regulators. Indeed, in recent years, government bodies have taken several steps to examine, understand, and monitor the use of these practices, and whether they are harmful to consumers (e.g. OFT, 2010). Taken together, this cross-disciplinary, cross-sector field of behavioural economics, marketing, and law also seems a fascinating area for prospective academic research.

Nevertheless, while pricing strategies are becoming an indispensable tool for retailers and manufacturers, and a focal point of recent government investigations, empirical research scrutinising their absolute (or relative) effects on consumers seems to be disjointed and, in many instances, scarce – even with the more common of the pricing practices used. Indeed, while pricing is a

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http://dx.doi.org/10.1016/j.jretconser.2014.04.013
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popular area of study, with almost 2000 articles on the topic (Leone et al., 2012), there has, to the authors' knowledge, not yet been an overarching review of the price psychology work. Accordingly, it is timely that a review of the literature on the impact of some of the more widespread price advertising practices on consumer perceptions and behaviour is carried out. Specifically, it is important to provide a state of the art evaluation of the evidence, outlining which practices work, the extent to which they affect consumers' decisions, and the mechanisms involved. No such review currently exists in the academic literature, so the authors have set out to address this gap, given the utility and timeliness of the information.

The review is laid out in the following way: first, we present a quick background as to *why* these practices may actually work (because from a rational economic point of view they *should not*) by reviewing the psychology of decision making. Next, we deal with each of the practices separately by explaining the psychological principle underlying the practice (i.e. why it works), and reviewing the literature on the effects of this practice on consumer behaviour (and judgements). Finally a general conclusion and a discussion on the implications for researchers and practitioners are both provided.

1.1. Psychology of consumer decision-making

Many economists maintain that the law of demand (consumers demanding more of a good the lower its price) is the most important empirical discovery in economics (e.g. Perloff, 2001). Consistent with classical economic theory, it has been assumed that consumers can assess the utilities or values of products based on their characteristics (e.g. price and product features) and that these values guide purchase decisions. For example, when faced with more than one product on offer (say, a digital camera), the consumer can simply determine the value of each alternative through its price, and information about other features (e.g. picture quality, memory size, of the camera) and then select the one with the highest overall value. Accordingly, people will have clear and stable preferences when they have complete information about the characteristics of the alternatives. However, this 'rational' view of the consumer is not supported by empirical findings.

A significant amount of recent research on consumer decision making has established that consumers are notoriously susceptible to the influence of environmental cues that are often irrelevant to the utility of the offer. For example, consumers have been shown to comply with signs that prompt them to buy higher quantities of a product even when there is no rational incentive to do so (Wansink et al., 1998). Studies have found that placing a sales sign on an item can lead to increased demand for that item even when the price remains the same (Inman et al., 1990). Recent research even shows that consumers' willingness to pay for a product can be influenced by manipulating the price of an adjacent and functionally unrelated product (Nunes and Boatwright, 2004).

These findings are consistent with the behavioural economics literature, dealing with the psychology of decision making. Behavioural economics is based on the science of judgemental heuristics (or mental shortcuts; rules of thumb) that most people rely on reflexively (Belsky and Golivich, 1999). Heuristics are characterised as an 'intuitive, rapid, and automatic system' (Shiloh et al., 2002, p. 417), which 'reduce the complex tasks of assessing probabilities and predicting values to simpler judgmental operations' (Tversky and Kahneman, 1974, p. 1124). These heuristics are often based on cues or key features in the surroundings (colours, numbers, sounds, smells, etc.). When one or another of these cues is present, automatic and reflexive responses can occur (Cialdini, 2001). Although the use of rules of thumb reduces cognitive and time constraints, they sometimes lead to severe and systematic errors such as biases and fallacies in decision making (Tversky and Kahneman, 1974). As such, consumers are inevitably susceptible to environmental influences.

The idea that, in many situations, consumers use mental heuristics when faced with a specific purchase decision, rather than retrieve preformed evaluations of product price or features and alternatives, has highly significant marketing implications. Specifically, they suggest that external cues, or features in the environment, context, and the manner in which prices are presented, are all likely to have a significant impact on consumer judgements. This is a key feature of pricing strategies. It is therefore important to reiterate the value that an empirical investigation of the relative effectiveness of various pricing practices on consumer perceptions and behaviour will provide. In particular, it is important to determine a) which practices of interest – if any – have a significant impact on behaviour, b) what particular aspect of behaviour they affect (e.g. buy more, search less, etc.), c) the extent of this effect, and d) under what conditions the specific effect is present vs. absent.

It is, of course, beyond the scope of this article to review the literature on the entire spectrum of pricing practices used. Therefore, the available academic evidence will be reviewed as regards six pricing practices, which have been identified as highly prevalent in today's marketplace (cf. OFT, 2010), namely: drip pricing, reference pricing, the use of the word 'free', bait pricing, bundling, and time limited offers. Table 1 provides a simple explanation of, and the potential mechanisms behind each practice.

2. Effect of pricing practices on consumer decision making: evidence from literature

2.1. Drip pricing (partitioned pricing)

Drip pricing mainly refers to purchases where consumers see an element of only the price upfront, and where either optional or compulsory price increments are revealed as they 'drip' though the buying process (e.g. airline taxes or charges to pay using credit cards). That is, the total price is revealed (or can only be calculated) only later on in the purchasing process. When price is separated in this way, it is also called 'partitioned pricing'.

Sellers can separate either a surcharge, in which the charge represents an additional amount inherent to the purchase situation (e.g., shipping and handling for online or mail order purchases, airline taxes, processing fees, etc.), or a component of the product (e.g., refrigerator, ice-maker, and warranty) or a consolidated total price for the bundle. While the consumer can choose whether to purchase these options in the latter scenario, in the former consumers cannot opt out of them.

The most dominant theory for explaining the effects of drip and partitioned pricing on consumer purchasing is anchoring and adjustment theory (Tversky and Kahneman, 1974; see Table 1), which suggests that buyers anchor on the piece of information they consider most important (e.g., base price) and then adjust insufficiently for one or more items (e.g., the surcharge), thus underestimating the total price.

While there are very few studies specifically examining drip pricing (i.e. looking at temporal price separation), several studies have examined the effect of 'price partitioning' (price separation), on consumer decision making. In a now widely-quoted study, Morwitz et al. (1998) show that partitioning prices this way may lead to a bias in behaviour such that consumers end up paying more and searching less when price-parts are partitioned as opposed to presented as a total price. In their auction experiment the authors found that separating a buyer's premium, which is a surcharge of 15% of the buyer's bid price, significantly increased demand for the good as compared to the situation where the

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