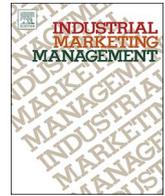




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Value-based pricing and cognitive biases: An overview for business markets

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ABSTRACT

To investigate how cognitive biases inhibit value-based pricing practices among managers in business markets, this article considers five different cognitive biases—perceived lack of control, herding, fixed-pie bias, ambiguity aversion, and egocentric fairness bias—and their effects on value-based pricing. Despite recent calls for more research on the psychological aspects of pricing, few studies have focused on business markets. Drawing on research in psychology and marketing for its theoretical foundation, this overview extends the limited body of existing research. The article's key contribution is to explain how psychological challenges affect value-based pricing practices, with implications and suggestions for further research.

1. Introduction

Value-based pricing is defined as the extent to which managers' pricing decisions take account of how customers perceive a product's benefits in relation to its price (Ingenbleek, 2014). In business markets, those benefits may involve cost decreases or revenue increases (see, for example, Anderson & Narus, 1998; Forbis & Mehta, 1981). Marketing scholars generally regard value-based pricing as an excellent means of achieving profitable pricing (e.g., Hinterhuber, 2004; Monroe, 2003; Nagle & Holden, 2002), and this view is strengthened by recent empirical evidence that links value-based pricing to better new product performance (Ingenbleek, Frambach, & Verhallen, 2013) and firm performance (Liozu & Hinterhuber, 2013). However, most firms continue to focus primarily on cost-based or competition-based pricing (Hinterhuber, 2008; Indounas, 2009; Kurz & Többens, 2012; Liozu, 2017).

Existing studies have frequently sought to explain this paradox (Liozu, Hinterhuber, Perelli, & Boland, 2012) by highlighting the organizational challenges of using value-based pricing. Among other issues, the literature notes organizational challenges such as the need for top management support (e.g., Liozu et al., 2012); implementation of appropriate pricing processes (e.g., Nagle & Holden, 2002); availability of data on customer value (e.g., Töytäri, Rajala, & Brashear Alejandro, 2015); and alignment of the sales force with value-based pricing (e.g., Forbis & Mehta, 1981; Nagle & Holden, 2002). While these and other organizational challenges go some way to explaining the paradox, pricing practice research has often overlooked psychological challenges on the assumption that managers act rationally (Iyer, Hong Xiao,

Sharma, & Nicholson, 2015).

In practice, however, Herbert Simon (1957) showed 60 years ago, that managers' rationality—where it operates at all—is bounded by environmental complexity and the limitations of human information processing. To cope, managers often try to simplify decisions through the use of heuristics (Tversky & Kahneman, 1974) such as satisficing (Cyert & March, 1963). Indeed, heuristics can be useful “rules of thumb” for making frugal decisions when faced with such challenges (for a review, see Gigerenzer & Gaissmaier, 2011). For example, Wübben and von Wangenheim (2008) show how, in the context of customer base analysis, simple managerial rules of thumb produce results similar to those from advanced stochastic models. However, heuristics can also lead to cognitive biases—that is, systematic misrepresentation of information—and so to flawed decisions. As Ariely put it, “cognitive biases often prevent people from making rational decisions, despite their best efforts” (Ariely, 2009, p. 80).

Although recent conceptual frameworks have taken account of the role of cognitive biases in managerial pricing practices (e.g., Hinterhuber, 2015; Iyer et al., 2015), these have not focused specifically on value-based pricing in business markets. An exception (to some extent) is Hallberg's (2017) investigation of value appropriation in buyer-supplier relationships, which considers cognitive biases but not as the central issue. Consequently, it remains unclear how cognitive biases may inhibit managers from focusing on value-based pricing practices. This is a significant gap in the literature, given ongoing calls for a focus on customer value in business markets (e.g., Anderson & Narus, 1998; Forbis & Mehta, 1981; Hinterhuber, 2004). Value-based pricing involves searching, interpreting, and

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¹ *Manager* is used here as broad term to refer to a range of personnel (e.g., marketing managers, pricing managers, sales managers) who are typically involved in the pricing process and who have partial or full pricing authority. Function-specific qualifiers (e.g., marketing, pricing, sales) are omitted for clarity and on the grounds that cognitive biases transcend titles—that is, they are challenging for any manager involved in pricing.

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communicating information about customer value (Ingenbleek, 2014; Nagle & Holden, 2002). Given the neglect of the distinct cognitive challenges related to these activities, the present article seeks to explain how a number of cognitive biases challenge managers' use of value-based pricing in business markets, and to propose directions for further research.

Specifically, the article contributes by taking a fresh look at the value-based pricing paradox, asking why so few firms adopt value-based pricing practices (Hinterhuber, 2008; Indounas, 2009; Kurz & Többens, 2012; Liozu, 2017) despite their theoretical advantages. Additionally, the article fills a critical void in the pricing literature (see Iyer et al., 2015; Kienzler & Kowalkowski, 2017) by exploring managerial pricing decisions through a theoretical lens other than economics.

The remainder of the article is structured as follows. The next section outlines the theoretical foundation of value-based pricing. There follows an overview of five cognitive biases that challenge managers' use of value-based pricing, building on research in psychology and marketing. The paper concludes with a discussion of theoretical and practical implications, along with directions for further research.

2. Theoretical foundation: value-based pricing

While firms' pricing practices are for the most part idiosyncratic (Hinterhuber & Liozu, 2012; Smith, 1995), these practices can be distinguished by type and by the extent to which managers use information regarding costs, competition and customers' perceived value to make pricing decisions (Ingenbleek, Debruyne, Frambach, & Verhallen, 2003). The pricing literature typically distinguishes three types of pricing practice: cost-based, competition-based, and value-based pricing (e.g., Hinterhuber & Liozu, 2012; Nagle & Holden, 2002; Shapiro & Jackson, 1978). However, these pricing practices are not mutually exclusive, as managers typically combine different kinds of information when setting prices, blending cost-, competition-, and value-based pricing (Ingenbleek et al., 2003). For example, managers setting the price for a new product may combine information from accounting data (e.g., R&D and production costs); from focus group interviews with customers (e.g., potential revenue increase from enhanced productivity); and from market analysis of competitors (e.g., product portfolios, prices).

Marketing scholars generally favor and advocate pricing practices that emphasize value-based pricing (e.g., Hinterhuber, 2004; Monroe, 2003; Nagle & Holden, 2002) on the basis that the maximum achievable price is determined by customers' perceived value rather than by competition and cost considerations (see Ingenbleek et al., 2003; Monroe, 2003). Value-based pricing is customer-focused (Nagle & Holden, 2002), and there is empirical evidence of its advantage over other pricing practices (e.g., Ingenbleek et al., 2013; Liozu & Hinterhuber, 2013). While value-based pricing poses certain challenges, it is more feasible than managers may believe. For example, published information about conducting a value analysis (e.g., Hinterhuber, 2004; Nagle & Holden, 2002) should enable managers to adapt market research methods to their particular context and requirements.

Pricing practices that emphasize customer perceived value require managers to deal with issues of subjectivity (Morris, 1987), uncertainty (Hogan, 2001), and difficulty (Hinterhuber & Liozu, 2012). *Subjectivity* refers to how customers value the same product differently—that is, customer value is unique to the individual customer (Morris, 1987). However, economic considerations often require managers to group customers together—for example, according to their similar perceptions of value (Nagle & Holden, 2002)—to derive “different customer segments [that] perceive different values within the same product” (Ulaga & Chacour, 2001, p. 529). In this way, subjectivity both necessitates and aggravates segmentation. Customers' perceptions of value remain *uncertain*—that is, hypothetical—until they obtain benefits and

make sacrifices in their use contexts (Hogan, 2001). Accordingly, “value is not created and delivered by the supplier but emerges during usage in the customer's process of value creation” (Grönroos & Ravald, 2011, p. 8). This means that information about customers' perceived value is more *difficult* to collect, interpret, and understand than other information commonly used in pricing practices (Hinterhuber & Liozu, 2012).²

As a consequence, managers responsible for pricing decisions have to cope with psychological challenges of cognition and judgment regarding customer perceived value. Ingenbleek et al. (2013, p. 562) argue, “pricing is much more complex than normative pricing models suggest and [...] to deal with this complexity managers cannot analyze all available information, but [must] instead engage in simplifying practices”. While the pricing practices literature acknowledges the relevance of environmental complexity and humans' limited information-processing abilities (see Simon, 1957), the question of how this affects managerial pricing practices remains relatively unexplored.

3. Cognitive biases and their effect on managerial pricing practices

The present article draws on Tversky and Kahneman's (1974) heuristics and biases program and the cumulative body of associated research. Given the diverse range of cognitive biases identified in that body of research, inclusion in this overview was determined by two criteria. First, the bias had to be theoretically relevant to managerial pricing practices in business markets. Second, the pricing practice literature had to provide sufficient direct or indirect empirical evidence of its nature and effects. On that basis, the following overview focuses on five cognitive biases—perceived lack of control, herding, fixed-pie bias, ambiguity aversion, and egocentric fairness bias—and their effects on value-based pricing. In particular, it describes how these different cognitive biases can inhibit value-based pricing practices among managers in business markets.

3.1. Perceived lack of control

Control is an important concept in psychology and sociology, frequently operationalized as a subjective, domain-specific, and outcome-oriented construct related to locus of control (LOC) (Skinner, 1996). LOC is defined as an individual's belief about who can control and influence outcomes (Rotter, 1966). According to Rotter, individuals with an internal LOC are confident that they can actively influence external events through their own actions and behavior. Conversely, he argues, individuals with an external LOC perceive luck, coincidence, or influential others as shaping external events that they must passively bear. It should be noted that LOC can vary on a continuum anchored at one end by a purely internal focus and at the other end by a purely external focus (Rotter, 1966).

Research in psychology has frequently investigated the illusion of control—that is, overestimation of one's perceived control in chance situations (for seminal research, see Langer, 1975). In contrast, perceived lack of control is defined as the tendency to underestimate one's control over events. The evidence suggests that people tend to underestimate their control in situations where they actually have control (e.g., Gino, Sharek, & Moore, 2011).

In the context of pricing, perceived lack of control manifests as a subjective perception of managerial control over pricing that leads to a concrete price outcome. As such, a range of evidence suggests that LOC

² It should be noted that, under certain circumstances, cost and competition information can also be difficult to obtain. For example, it is more difficult to calculate the costs of services than of goods (Hoffman, Turley, & Kelley, 2002), and costs for highly customized solutions are often hard to estimate (Sharma & Iyer, 2011). Additionally, information about competitors' prices may prove impractical as a direct point of reference for highly differentiated products in business markets.

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