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The Psychology of Pricing: It's All in Your Head

Pennies seem like the Rodney Dangerfield of U.S. currency – they get no respect. But price-savvy businesses know the true value of a penny and understand that a price change as small as one cent (or even a fraction of a cent) can deliver millions of dollars in additional profit. The key is knowing when the customer is willing to pay that extra penny.

The answer lies in the psychology of pricing, which is a tricky terrain to maneuver. Every customer wants to think he or she is getting a good deal, whether they are ordering a value meal or driving a new car off the lot, and a price change as a little as a penny can have a huge impact on the willingness to pay (WTP). Fully understanding what affects a person's WTP can help companies better price their products and services.

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One of the main considerations when evaluating a customer's WTP is the "reference price" of the brand with which a company aligns its offerings. This reference price can be influenced by a number of factors, including competitive comparisons (either between brands or everyday and feature prices of the same product), taste tests, symbolism or high-end store locations and amenities. WTP will increase if a higher-priced brand is used as a reference point; likewise, it will decrease if a lower-priced brand is used.

Companies also need to understand that as a whole, consumers are driven by proportional price evaluations, rather than absolute terms, and are more motivated to change stores or brands when the savings is a larger percentage of the overall price. In an example from a Northwestern University study, people were more than twice as likely to visit another store for a $5 savings on a $15 product than a $120 item. The payoff for switching stores or brands is a much higher proportionate, though perhaps not absolute, savings for the less expensive product.

Another psychological concept to consider in effective pricing is extremeness aversion. Buyers' psychology tends to keep them in the middle of the pack – they don't want to pay too much, yet they don't want the least expensive product either. Using this behavioral pattern, brands that offer a mid-range product can

capture a larger portion of the market, as many consumers trade up to a higher-priced product that is perceived as a better value.

Perhaps the most extreme example of the perceived value of consumer goods is the influence of location, particularly with B2C goods. Many buyers are willing to pay higher prices in more upscale locations, even for the exact same products. In the aforementioned Northwestern University study, students were asked how much they would be willing to pay for a pair of good quality diamond earrings. When no location was associated with the product, the price was $550. When told the earrings were from Tiffany & Co., with no change in quality, the price students were willing to pay jumped to $873, a 59 percent increase. That price plummeted to $81, again with no change to size or quality of the product, when the location was Wal-Mart. As in real estate, pricing consumer goods can rely heavily on location, especially when branding comes into play.

Companies should also consider gain-loss framing when pricing their products. Even when the economic cost of goods at two separate locations is the same, consumers favor pricing that comes with no negative psychological outcome. For example, gas stations that have a surcharge for credit card purchases are more likely to get both credit card and cash consumers when that charge is factored into the price. Credit card customers don't perceive the surcharge as a loss, and those paying cash experience the psychological benefit of earning a discount.

As companies become more pricing savvy, they are taking care to better understand what motivates customers to make favorable buying decisions. However, very few organizations have adequately equipped their decision makers to quickly respond to market feedback with new promotions, price changes and discount programs, and then execute these programs across the organization. Optimizing pricing will require investing in:

Sustainable processes and systems that:

- Are able to analyze effectiveness
- Can be decisive in determining the next steps
- Are able to continuously adapt pricing

The right resources:

- People that have pricing expertise
- Technology in the form of an integrated pricing system
- Automated processes that capture and analyze data

Understanding the various factors that influence customers' willingness to pay is a good start when it comes to developing pricing strategies. However, maintaining price leadership over time requires an in-depth and ongoing understanding of the market – and investments in the right people, systems and sustainable processes that can readily adapt to changes as they happen.

This article inspired by the Vistaar webinar '[The Psychology of Pricing](#)' by Tom Brzezinski.