To Get People to Pay, Understand How They Think

By PRIYA RAGHUBIR

"Can I Venmo you?" While older consumers may not get the question, a growing number of millennials do. In 2016, the peer-to-peer (P2P) online payment system processed more than $1 billion in a single month. Venmo allows users to make and share payments with family and friends directly via their bank account. The platform is especially popular among younger consumers, who prefer mobile apps over cash or cards.

When going out to eat, for instance, customers conveniently “Venmo” each other, with each person transferring money, even
The way people pay for goods and services is changing. This is having an impact on how consumers perceive the value of their purchases. Companies need to grasp this in order to craft sustainable business strategies.

very small amounts, directly to another user’s account. In 2017, the U.S. banking industry rolled out its own P2P payment network called Zelle, which links banks together and can process payments even faster than Venmo, in a matter of minutes versus one banking day. With dozens of new entities set to join the network this year, the way people pay for goods and services is changing fast, in what is being hailed as a revolution in personal payment.

Moves like these are having an impact on how consumers perceive the value of their purchases. These perceptions are being confounded by complex pricing promotions, rewards programs and loyalty schemes, enticing consumers to earn points, win perks and receive discounts on products.

Lying at the intersection of these trends are companies, which need firm foundations, based on sound behavioral economics principles, to craft sustainable business strategies.

In this article, I will describe several core concepts for understanding promotions and how people make spending decisions, based on research I have done related to consumer psychology around money. In doing so, I will highlight some caveats for companies engaging in promotional activities. In the end, the biggest payoffs come when companies are transparent about their offers and seek to build trust with their customers.

**Perception Is Everything**

Before we delve into the plethora of schemes that populate an ever more crowded payment environment, we first need to grasp two fundamental principles from behavioral economics: reference points and prospect theory/loss aversion. Both of these concepts are helpful starting points for devising marketing strategies, as well as for framing your offer, bearing in mind how consumers’ perceptions of value may be affected.

**REFERENCE POINTS.** Pretend you are on a plane, browsing the duty-free catalog. You see a bottle of cognac on offer, which comes with a promotional gift of a high-quality fountain pen. Up until that moment, you had estimated such a pen to be worth around $100. Now, however, because the pen is offered as a freebie, your expectation of the production cost of the pen is suddenly affected, as well as your perception of the profit margins around it. Your “reference point” for the pen will be diminished, as will the maximum amount you would be willing to pay for such a pen in the future. This recalibration will occur even though price information around the pen was not explicitly provided.

This illustrates the variability of a price reference point – the internal price that a consumer expects a product to have. This reference point may be based on past purchasing behavior or on a contextual view, such as when a merchant provides information at the point of sale, offering an attractive price that gives consumers the impression they are paying less than what they could be paying. A reference point may also be determined by what you believe is a fair price.

Many of the ways in which consumers’ reference points are set are obvious, but some are more subtle. Think about cosmetic companies in department stores. Often, these companies will offer a bundle of free goods with a given purchase of a certain amount. These promotions are usually held a few times a year to boost sales. Yet sometimes they can seem unrealistic, such as “buy $35
A customer’s pain of paying more than expected will have a stronger impact on future spending decisions than the satisfaction felt after having paid less than expected.

PROSPECT THEORY/LOSS AVERSION. Next, imagine you are shopping for a plane ticket and your reference point is $2,000. If you find a ticket for $1,500, you’ll be very happy. But what if the opposite occurs? What if the only ticket you can find costs $2,500? The pain of spending $500 more than your reference point will be felt more acutely than the pleasure you experienced at having found the ticket for $500 less.

This is an example of prospect theory, also known as loss aversion. The basic idea is that margins of utility diminish in the domain of gains with respect to a reference point, while in the loss domain, disutility is steeper. In other words, a customer’s pain of paying more than expected will have a stronger impact on future spending decisions than the satisfaction felt after having paid less than expected.

Now suppose that you bought the ticket for $1,500 and were satisfied with this price. At that moment, your reference point has changed. The next time you go shopping for a similar ticket, this will be the price you will expect to pay. If you subsequently find the ticket at your original expectation price of $2,000, you will find yourself in the domain of disutility. This time, the additional pain you feel for having to shell out an extra $500 will feel even greater than the pleasure of finding the ticket at your original reference price. This, in turn, will lower the likelihood of purchasing in the future to a much greater extent than a discount would increase the likelihood of purchase.

THE TAKEAWAY: Because freebies and price promotions don’t always work the way you want them to, they should only be used as a short-term tactic. Companies that rely on these tactics to boost sales can find themselves locked in a downward spiral. What’s more, by using discounts as incentives, you may be unwittingly training your customers to shop based solely on price. Since price is your main lever to make money, use this approach sparingly.

In scenarios where discounts are uncommon, cut-price offers can lead to an altered perception of quality. Rightly or wrongly, higher prices signal higher quality. Offering a discount for products that are rarely discounted can also suggest to customers that there is inadequate demand for the product at its original price and could likewise lead to a negative quality perception.

ABOUT THE AUTHOR

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THE TAKEAWAY: Technology now allows companies to continually optimize prices, taking into account a wide range of factors. However, beware of changing prices too frequently, as constantly oscillating prices could elicit sticker shock that drives customers away.

The Effects of Promotions

It is important to understand these psychological behavior patterns before talking about promotions and their effects on
MANAGERIALLY CONTROLLABLE CONTEXTUAL FACTORS (Promotional Features and Communication)

Hedonic benefits and entertainment of buying on deal
Exploration and thrill of trying new things
Feeling of being smart to buy on deal
Feeling of being lucky to avail of the deal
Annoyance of dealing with coupons or restrictions
Offering targeted promotions leads to perceptions of unfairness by those who receive shallower discounts

Promotional Effects
MANAGERS NEED TO GRASP THE 3 FUNCTIONS OF PROMOTIONS, AND THEIR DIRECT & INDIRECT EFFECTS ON SALES.

THE ECONOMIC VALUE OF PROMOTIONS. The economic effects of promotions can be monetary or non-monetary. Obviously, consumers benefit economically from most promotions, as indicated by the amount of the rebate or the face value of the coupon. They may also gain non-monetarily through increased shopping efficiency, since the consumer quickly identifies a needed product at a lower cost.

THE INFORMATIONAL CONTENT OF PROMOTIONS. Promotions also serve to inform consumers about a product, thus having a positive effect on purchasing behavior. For instance, the mere presence of an end-of-aisle display can not only remind consumers about the product, but also lead consumers to believe the product is offered at a discount. However, as mentioned earlier, the tactic of offering the product on promotion may end up backfiring, and consumers may be less willing to purchase it later.

THE AFFECTIVE APPEAL OF PROMOTIONS. Consumers’ feelings and emotions are
Coupons can be effective promotional tools. That said, higher coupon values don’t necessarily boost sales, and can start to erode profitability without increasing sales.

influenced when they see, purchase or miss a promotion. These affective influences can be either general or specific, positive or negative (see Exhibit 2).

For instance, consumers may feel annoyed when purchasing with a discount, if discount levels are low or if they are inconvenienced. Furthermore, research indicates that consumers often try to figure out why manufacturers or retailers offer a deal, so they can decide if the price is actually fair or not.

THE TAKEAWAY: Be aware of the different trade-offs involved with price promotions and their long-term effects. These can lead to lower price reference points for a brand as compared to one that is not promoted. Additionally, they can have long-term implications if the promotional price becomes the consumer’s new reference point.

Using the Tools Effectively
Keeping these ideas in mind, I will now highlight how consumer spending behavior plays out in relation to three specific sales and marketing tools commonly employed by companies today: coupons; gift cards/gift certificates; and points- or miles-based loyalty programs.

COUPONS. Whether it’s “buy one, get one free” or getting a percentage off a regular price, coupons can be effective promotional tools, on the simple premise that sales are promoted by lowering the economic cost to the consumer. That said, higher coupon values don’t necessarily boost sales, and can start to erode profitability without increasing sales.

Say you have a coupon for a lower entry fee to a museum. If you don’t know the actual price of entry and only get the coupon, you will use the value of the coupon to infer the price. Generally, people expect a discount in the region of 20 to 40 percent – with 20 percent being a normal discount and 40 percent being a steep discount. This means that if you see a $2 discount, you are likely to infer that the full price is $10. As such, if the coupon gives you a $5 discount, you may figure that the regular entry fee to the museum must be significantly higher – more like $25. If that were the actual price, you may think twice about going to the museum with your family, and opt to do something else instead.

The outcome is counterintuitive: a coupon for $5 off a $10 admission may actually lower purchase intentions, since people infer that the real price must be a lot higher, resulting in lower sales.

My paper, “Coupon Value: A Signal for Price,” looked at this issue – specifically, the conditions that cause consumers to draw unfavorable inferences about a brand’s price or quality from coupon discounts, and if these inferences lowered the overall benefits of a coupon promotion. I found that consumers did indeed use the value of the coupon to infer the actual price when they didn’t have that information.

THE TAKEAWAY: When offering coupon discounts, make sure you translate what the percentage of the discount is relative to the real price, so consumers can make well-informed decisions. Alternatively, do not offer discounts of more than 20 percent. The higher the discount, the higher consumers will imagine the price to be, unless additional information is provided.

GIFT CARDS/GIFT CERTIFICATES. The use of gift cards or gift certificates as a means of payment has grown popular in retail settings. These are typically prepaid cards that can be used in a store or related entity for purchases. Although consumers may spend more freely when using these, they may value a product purchased with this form of payment less than you would like.

In earlier research on credit cards that I carried out with Joydeep Srivastava, we found that people were willing to spend more for the same item using a card rather than cash; they
The downside of many loyalty programs based on points or miles is the subjective value perceptions of the products being offered as rewards. Rewards often sit in consumers’ accounts unused. were also less likely to remember purchases made with cards versus cash. Building on this finding, we conducted further research to see if these behaviors extended to gift cards.

Our paper – titled “Monopoly Money” – expresses the way people regard gift cards as somehow being less real than cash, and the form of payment (card vs. cash) is coupled with distinct spending behavior. According to our research, people who received a $50 gift card for purchases were likely to spend more than if they had $50 cash, as if the gift card represented “free money.”

Taking this a step farther, we are now looking at what happens when the gift card itself is purchased via a payment form other than cash, such as airline miles or credit card points. We want to find out if this effect is exacerbated when payment is even further removed from real money. Our research in this area is evolving.

THE TAKEAWAY: As the world moves toward more virtual currencies, consumers may tend to spend more freely and value the products they buy less. Cash is the most painful form of currency for consumers to use, with miles and rewards programs being the least painful. Thus, in descending order of pain, the payment continuum is as follows: 1) cash; 2) credit cards; 3) virtual systems such as Apple Pay or Google Wallet; 4) gift cards; and 5) miles, points and other rewards schemes, which I will talk about next.

LOYALTY PROGRAMS. A recent study carried out by WalletHub compared 11 of the largest U.S. airlines’ loyalty programs in terms of expected value for customers, showing how both companies and consumers benefit from these types of programs.

Besides boosting sales, these programs allow consumers to exchange miles or points for advantages such as tickets, accommodation and products. They also offer “status” benefits, such as free checked baggage or the use of VIP lounges. When successfully implemented, a rewards program can effectively increase customer loyalty and reduce price sensitivity.

However, when companies hand out rewards like free candy, customers may start to devalue them. Moreover, overly complex programs can negatively impact the value perception of the rewards being offered, as can unclear or unrealistic point systems – such as not knowing if a certain product is attainable for 25,000 points or 50,000 points or even if the desired product is worth it. In such case, the entire “currency” of points becomes less valuable to the point of being meaningless.

The downside of many loyalty programs based on points- or miles-based currencies is the extremely subjective value perceptions of the products being offered as rewards. In addition, rewards often sit in consumers’ accounts unused, because the items that can be purchased with earned miles or points is so limited.

It is worth noting that a 2015 Capgemini study found that almost 90 percent of social media sentiment on loyalty programs was negative. Of these negative sentiments, 44 percent cited the lack of reward relevance, flexibility and value, while the rest complained about a lack of a seamless multichannel experience and customer service issues.

THE TAKEAWAY: Companies could stand to improve the value of their rewards programs by minimizing any uncertainty and incoherence associated with exchange rates between the reward and more fungible forms of payment such as gift cards or cash back.

Cash Still in the Picture
Despite the steady decline of cash, this form of payment is unlikely to become obsolete. There will be occasions when consumers will want to have cash out of a sense of comfort, even if it is just a $20 bill. And there will always be some merchants who will prefer cash dealings, despite the various implications of working in
As virtual payment systems go mainstream, greater attention should be paid to consumers’ changing perceptions of money, of product value and of the trust they place in businesses.

a cash economy. So, while the number of cash-based purchases will drop, consumers will still keep some bills in their pockets. Researchers have found that people are less likely to spend money when they carry large bills in their pockets. This phenomenon is known as “the denomination effect.” In a recent study I carried out with IESE’s Mario Capizzani and Joydeep Srivastava, we set out to explore why this occurs.

We conducted four experiments in which people had to recall the amount of money they had in their pocket and the denominations, and estimate the value of coins in a bag, among other tasks.

We discovered that people had a harder time recalling a specific amount of money when it was carried in smaller, versus larger, denominations. Moreover, when people overvalued the amount of money they had, they were more likely to spend it.

Our study supported the idea that people may strategically choose to receive money in larger denominations so they can save more easily and exercise self-discipline in spending.

The Goal: Building Trust
As virtual payment systems go mainstream, greater attention should be paid to consumers’ changing perceptions of money, of product value and of the trust they place in businesses.

As already mentioned, constantly fluctuating prices, often driven by pricing optimization software, can have a significant effect on price reference points. The same is true with rewards programs. Today, there is an astonishing range of prices at which consumers can buy different types of gift cards of the same denomination. This has an important impact on the customer’s perception of the card’s real value.

From the consumer’s perspective, a $100 gift card should be worth the same number of miles or points, irrespective of the merchant offering the gift card.

When coming up with rewards programs, uniformity and coherence in price points are necessary for ensuring that customers have greater faith in companies. There is no simple formula for achieving this, especially in today’s changing payment world. Yet, by keeping a razor-sharp focus on fostering trust among customers, companies will be better equipped for long-term success. Trust remains a priceless asset.

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