

# ECO663

Week 7  
Consumer Behavior ver.1

Relativity and Decoy Effect

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Consumers' mind:

1. Think I want just on-line subscription for \$59.
2. No printed version (\$125) wanted.
3. Hmm, package deal (on-line + printed) = \$125 = free on-line version!
4. Although I don't really need printed version, I will go for package deal => spend \$125, instead of \$59.

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## Relativity

- Most people don't know what they want unless they see it in context.

e.g. bicycle

e.g. cell phone

e.g. car

## What kind of TV do you want?

- 36 inch Panasonic for \$ 690
- 42 inch Toshiba for \$850
- 50 inch Philips for \$1480

- People usually don't know what they want.

⇒ Majority picks "middle" one.

So, seller places "the one he wants to sell the most" as the middle option.

Which dish do you want to order?

- Menu Pricing

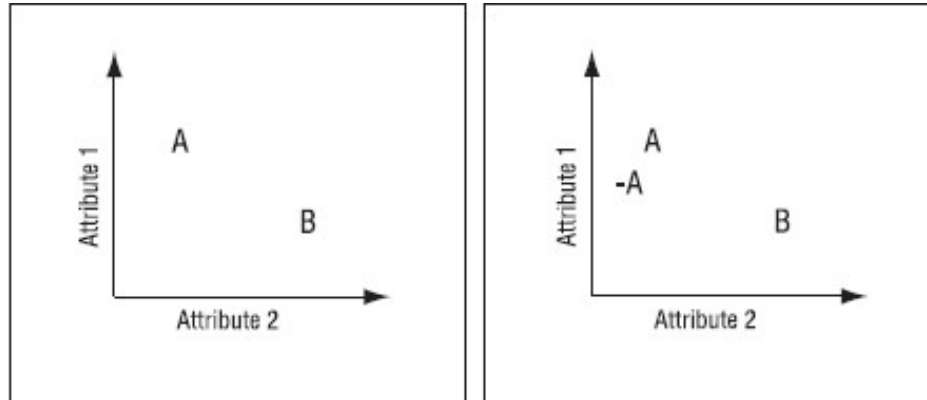
How should dishes be priced to maximize profit?

\*\*\*\* Inclusion of expensive entrée \*\*\*\*

⇒ Sales of second most expensive dish increases.

We (Consumers) are manipulated without realizing!

## Decoy Effect



## Rome or Paris

A: 1 week in Rome

B. 1 week in Paris

A- : 1 week in Rome, but without free breakfast

Tip:

If you are trying to sell something, add “decoy” which is slightly inferior to the one you want to sell.

## More examples on relativity

	Store A	Store B
Radio	\$25	\$15
Travel Time	0	5 mins

Option 1: travel 5 min and save \$10

Option 2: buy it for \$25



	Store A	Store B
TV	\$500	\$490
Travel Time	0	5 mins

Option 1: travel 5 min and save \$10

Option 2: buy it for \$500

⇒ 5 min is valued less than \$10 in the first case

⇒ 5 min is valued more than \$10 in the second case

Why?

Relativity

- Easy to upgrade to leather seat for \$3000 for the car costs \$25,000.
- Difficult to spend \$3000 for the sofa with leather although you sit on sofa for longer time.

## Traditionally... (Stigler (1970))

Search continues when

Expected saving > Cost of visiting one more shop

But this does not explain travel to store B for radio and not travelling to store B for TV while \$10 is saved by spending 5 mins for both case.

## Alternative theory...

Search continues when

Proportion of the saving to the total price  
 $>$  critical value ( $k$ )

Case 1 (radio)  $\$10$  saving/  $\$25 = 40\%$  saving  $\Rightarrow$  go to store B

Case 2 (tv)  $\$10$  saving/  $500 = 2\%$  saving  $\Rightarrow$  buy at store A.

$\Rightarrow 2\% <$  critical value ( $k$ )  $< 40\%$

What if...

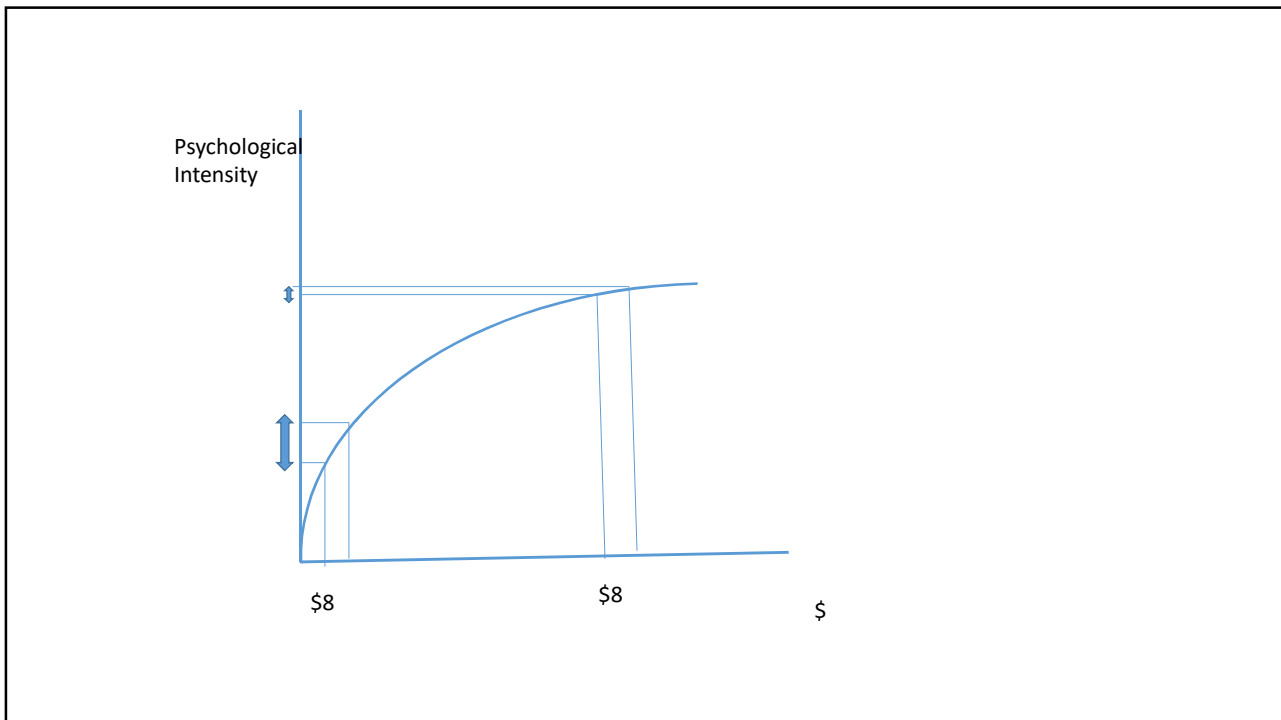
At store B, TV is now  $\$400$ . Travel to store B?  
 $(\$100 \text{ saving}/\$500 = 20\%)$

At store B, TV is now  $\$350$ . Travel to store B?  
 $(\$150 \text{ saving}/\$500 = 30\%)$

If no to 1<sup>st</sup> question and yes to 2<sup>nd</sup> question, then your  $k$ :  
 critical value is

$20\% < k < 30\%$

Meaning, if the expected saving is greater than  $k\%$  (which is  
 between 20 and 30%), you will travel.



Key Fact:

People act according to the relative (proportional) gain,  
not an absolute amount.

Question:

Is your acting based on this psychological tendency a  
rational behavior?

## e.g. Sales tricks using this fact

- Advertisement of a car

On newspaper: the base model for \$50,000,  
just one available

You will be asked to “upgrade” to more luxury model by  
adding “just” \$5000. Would you do so? ( $5000/50000 =$   
10% increase) => YES

A bit better tire for + \$2500 ? (just 5% increase)

Sound/media system for + \$2000? (just 4% increase)



- Sales person attempts to make you think additional costs (just an increment of the total cost, but do not exceed the personal “critical value”), not by the total cost (total \$59,500 car)

To avoid irrational decision due to relativity..

- Keep the options in the choice set small
- Realize the relativity affecting your decision

## Pain of Paying

- Pain of money “going away” from you
- Many payment options
  1. Prepaid
  2. Pay as you go (use)
  3. Fixed payment + per unit charge
  4. Multiple installment
  5. Multiple installment, starting 3 months later
- ...
- Depending on the presented payment option, the consumption levels could dramatically change.

- Cash vs. Credit card

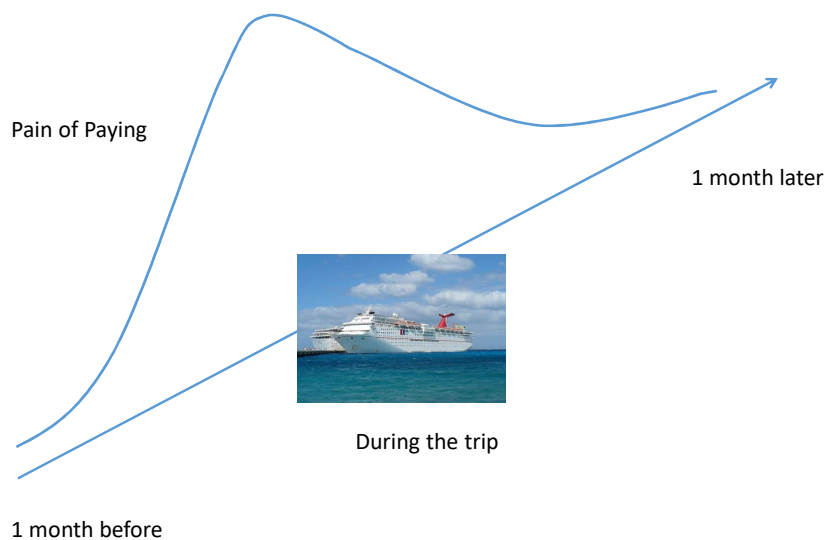
Pain of paying is greater for cash.

- Pre-paid vs. right after the consumption

e.g. Mediterranean cruise trip (costs \$5000)

Option 1: pay 1 month before

Option 2: pay the last day  
of the trip



## e.g. micro-pricing

### Movie channel

1. On demand (pay as you watch)
2. Each month (pay as much as you watched that month)
3. Pre-paid (deposit money beforehand)
4. Subscription (pay certain \$ each month for unlimited movies)

Q: What are the levels of “pain of paying” for each option?

Q: How much people actually pay for each option? (the largest – the smallest)

## Use of “Pain of Paying” to control our behavior

Case 1: When we want to decrease spending on certain goods => increase “pain of paying” (from consumer’s perspective)

- Buy paying by cash
- Seeing an increase in payment as you consume (gasoline meter, a meter for electricity usage in the living room, pay as you go (movie, apps, cell phones, internet))



Case 2: When we want to increase spending on certain goods => decrease “pain of paying”  
(from supplier’s perspective)

- Keep payment hidden (automatic deduction from your salary, automatic payment from your bank account)
- Pre-pay before consumption (your consumption level won’t be affected)

=> By minimizing pain of paying, you can enjoy the consumption more. (vacation, nice dinner..)



- All inclusive hotels are often more expensive than the hotels with “pay as you eat” system.
- But pain of payment is minimized.

- Need to carefully consider what you are trying to minimize.

Pain of Paying

Or

Total Cost