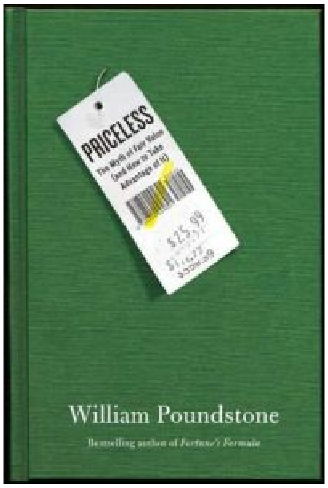

Book Priceless

The Myth of Fair Value (and How to Take Advantage of It)

William Poundstone
Hill and Wang, 2010

Recommendation

You might think you're a tuned-in consumer and immune to the tricks and gimmicks marketers deploy to get you to buy their products for top prices. But beware, says prolific business author William Poundstone: Your brain is keeping you from making rational cost decisions. This tour of the latest information on pricing techniques is well worth its price tag. Heed his information on the behavioral science that explains the flaws in the heuristics (rules of thumb) that keep shoppers and negotiators from being completely rational, and therefore, completely sharp. *BooksInShort* recommends Poundstone's smart facts, research and insights to every consumer or business manager who wants the best deal at the right price and thus needs to know what the right price is.

Take-Aways

- A person's perception of the fairness of a price depends on environmental and experiential cues.
- Buyers really don't know what something should cost, so they take their cues from "relative differences, not absolute prices."
- Companies raise prices by shrinking their products, and most shoppers don't notice.
- People subconsciously use unrelated "anchors" on which they base most of their financial decisions.
- There is no such thing as a fair price; anchoring, "priming" and the "power of suggestion" influence what you're willing to pay.
- Economic theories posit – incorrectly – that people are financially rational.
- "Mental shortcuts," like rounding, discounting or guessing, can undermine logic.
- Humans fear losses more than they value gains.
- The "cardinal rule of fairness" is "don't increase your profit at my expense."
- Market-driven societies demand that each person acts for his or her own sake, and "that money is the way you keep score."

Summary

Higher Prices Come in Smaller Packages

If you're like most people, you're pretty confident that you know what something ought to cost, whether it's a car or a jar of peanut butter. But consider this: Did you know that Skippy's peanut butter jar now holds only 16.3 ounces, down from its previous 18 ounces? Or that Kellogg's breakfast cereals now come in thinner – not shorter or more narrow – boxes than ever before? Or that Dial and Zest soap bars have slimmed down and that Puffs facial tissues are smaller, even though their container never changed size?

> "Prices are the most pervasive of hidden persuaders."

You may not have noticed these incremental changes, but you're paying the same prices for these products that you paid before they got smaller. Manufacturers routinely raise prices by shrinking products, and most consumers never notice. Buyers really don't know what something should cost, so – demonstrating what psychologists call "coherent arbitrariness" – they take their cues from "relative differences, not absolute prices." You can't tell how much something weighs, but you can discern whether one item is heavier than another. Similarly, your perceptions about cost, price and value depend on environmental and experiential cues.

"The More You Ask For, the More You Get"

Behavioral scientists have proven that people are subject to "anchoring and adjustment" in their decision making: Confronted with solving a problem that involves guesswork, people will subconsciously consider random, unrelated factors. If someone asked you, for example, if San Francisco's temperature averaged less 558°F (292°C), you would say yes. But if the questioner then asked to guess what the real average temperature might be, just hearing the 558 beforehand will lead you to respond with a higher number. Thus, 558 is a misleading "anchor." Your judgments depend on the information that "primed" you for the question. For example, a plaintiff presented the same exact case to two juries. When the lawsuit asked for $100,000 in damages, the first jury agreed to a $90,333 award, but with the same case, when the plaintiff asked for $700,000, the second jury awarded $421,538.

> "A price is...an expression of desire or a guess about what other human beings will do."

The field of "psychophysics" – that is, "the study of sensory perceptions" – attempts to measure subjective human experiences and, in so doing, comes up with the notion that "there are no absolutes, only contrasts." When determining fair prices, don't expect to find fundamental truths. Anchoring, priming and the "power of suggestion" influence what you're willing to pay.

Rational Economic Decisions?

Economists study how people make decisions about prices. But free-market, rational-investor economists (such as the followers of Nobel economics laureate Milton Friedman of the University of Chicago) routinely ascribe logic to investors, who supposedly have access to complete information about totally transparent markets. That's the theory; the reality is quite different. French economist Maurice Allais proved in the 1950s that people make choices based not on deriving a sensibly correct result but on how they perceive the framing of their options.

> "It is not 'fairness' so much as the appearance of fairness that drives the psychology of prices."

People play lotteries despite the infinitesimal chances of winning, and more people play when the prize grows, even though their chances of winning don't change. No rational person would spend money on a lottery ticket, but people focus on the potential prize, not the lousy odds. You buy insurance because you fear a disaster, no matter how unlikely, more than the pain of paying premiums.

> "A billionaire who's lost half his fortune can feel destitute, and a $5,000 lottery winner can feel on top of the world."

Human beings, when faced with making complex decisions, take "mental shortcuts" – rounding, discounting or guessing – that undermine logic. Short-term memory also plays a role in how people assign values. The human mind can only process about seven different factors at one time. For example, when buying a house, selling a car or agreeing to a business merger, you must consider numerous variables. No wonder people resort to "intuitive judgments" that may have little or no basis in the facts of their current problem: "We oversimplify because, simply, there's no other way of getting by in the world."

Human Heuristics

Psychologists Amos Tversky and Daniel Kahneman use the term "heuristics" to describe the mental shortcuts the mind takes when navigating through life, including how it considers price. Priming, anchoring and other unconscious mental exercises formed the basis for their groundbreaking work in the 1970s and 1980s. Tversky and Kahneman's "prospect theory" identified three facets of how individuals think about and react to "gains, losses and risk":

1. **"The relativistic nature of money"** – As psychophysics shows, people notice changes in wealth more than they appreciate absolute riches. For example, if you expect a $1,000 gift from a wealthy relative but get only $25, you perceive it as the loss of an imaginary $975 rather than as a $25 benefit.
2. **"Loss aversion"** – You fear losing something more than you value winning it. Stealing is a crime because people hate loss and see it as unjust. To get test subjects to agree to a coin toss where they could lose $100 but could win "X", the prize for winning has to be at least $200 to "balance the prospects of an equally probably $100 loss."
3. **"The certainty effect"** – You perceive the same risk differently, depending on your assessment of probability and circumstances. When gains are likely or losses unlikely, you exhibit "risk-averse behavior" – such as buying insurance or accepting the first offer on your house rather than waiting for a higher one. When gains are improbable or losses almost certain, you'll choose "risk-seeking behavior" – like the lottery player or the gambler on a losing streak.

> "What consumers say and what they do are not the same thing. Memories of prices are short, and memories of boxes and packages shorter."

Why do people feel more pain in losing than joy in winning? Perhaps it stems from humankind's evolution: A creature risks everything to find food to survive in harsh winter conditions, but when summer brings an abundant food supply, the same risky behavior would be counterproductive.

What's Fair Isn't Always Fair

The idea of a fair price is just that: an idea. Despite capitalism's laws of supply and demand, people diverge widely in what they view as equitable prices or wages. For example, research subjects regard the retailer who raises the price of snow shovels after a blizzard as unfair. Most folks see the "cardinal rule of fairness" as "don't increase your profit at my expense."

> "The mind generates an ongoing fiction in which it knows more and acts more logically and nobly than it does in reality. We believe this fiction. Anchoring is one small part of it."

Emotion trumps logic in the "ultimatum game," an exercise social scientists use to see how equitably people behave about money. A test subject must decide what percentage of a cash gift, say $10, he or she would share with a stranger. The stranger can veto the deal if it seems unfair. Reason dictates that the donor wants to maximize his or her share, but not to the point where the partner turns down the split. Similarly, the recipient should take even $1 of "free money." Yet recipients consistently deny deals of $2, while accepting $3 and above, and donors tend to divide the proceeds evenly. Emotions in the form of anger at being cheated or fear of being considered unfair drive what should be a cold, rational decision.

> "Despite their numerical nature, price decisions usually have a strong intuitive component."

Winning $100 makes you happy, but that same $100 will infuriate you if you know it's your share of your partner's $1,000 windfall, because "the value of money depends on context and contrast." Feelings of inadequacy, superiority, audacity and fear play a critical part in everyone's economic dealings. The human propensity to rely on heuristics comes into full conflict when complex negotiations around important issues, like wage or price negotiations demand consistent and smart choices. Or, as Tversky and Kahneman put it, "Incoherence is more than skin deep."

Tricks of the Pricing Trade

Marketing specialists and pricing consultants employ common strategies to get you to part with your money, strategies that you're usually not aware of before or during your purchase. For example, why would anyone pay $72 for a dinner in Amarillo, Texas? Plenty of people do just that at the Big Texan Steak Ranch restaurant which advertises a free 72 oz (2 kg) steak. But diners – who pay upfront for the steak and all the fixings – must consume their entire dinner within one hour. If they do, they get their money back; if not, they've just spent $72 for a meal.

> "A diner who orders based on price is not a profitable diner."

Supermarkets know which items consumers buy weekly, so retailers confine their price increases to esoteric or unusual items. You remember how much you pay for a soft drink, but not for chervil. Big grocery chains know that shoppers who push their carts in a counterclockwise path around the store buy more, so they locate store entrances on the right. At the other end of the consumption spectrum, luxury stores such as Prada and Coach display one outrageously priced item – like a $7,000 handbag – near the door so that wannabe big-spenders will treat themselves to a $2,000 bag. After seeing the former, the latter seems a comparative bargain.

> "Listen in to an estate negotiation, union contract talk or executive compensation meeting. Sooner or later, the speakers...say the magic word – 'I only want what's fair'."

One of the oldest pricing gimmicks is the "charm price" of 99 cents, or any price ending in a nine. Stores like Macy's priced goods this way in the 19th century. The charm price's genesis remains unclear, but its attraction to consumers continues unabated. Studies as late as 2004 show that charm prices are responsible for 24% greater sales than prices that aren't charms. Without any evidence, buyers believe that a charm-priced item is selling at a discount and, thus, is a bargain.

> "The way to sell a lot of $800 shoes is to display...$1,200 shoes next to them."

Restaurants have taken creative pricing to new heights. In one of his New York City restaurants, Chef Daniel Boulud offers a $100 hamburger; it's on the menu only to make the $50 steak seem affordable. Pricey restaurants aren't alone in indulging in "psychological menu design." Chain restaurants like Applebee's and T.G.I. Friday's use "bracketing" to get you to spend more while feeling better about it. For instance, they offer two sizes of steaks. You think you're being thrifty by opting for the smaller steak, but it's only the basic steak at the regular price. It just seems cheaper relative to the larger one. "Bundling" different menu items together spurs you to spend a bit more. Eateries regularly change what's in the bundled offering, so you never know what any single item costs. Menus no longer list prices on the right side because that encourages diners to focus on costs and order cheaper items. Restaurants have found that it is better to have a single round number – with no dollar signs – in the center after a florid description of an item's delights. Pictures, drawings and graphic elements draw attention away from prices and onto the food.

Money, Money, Money

In 2006, researchers wanted to see how "money priming" affected people's behaviors, so they subjected one group of test participants to images, games and discussions about money and kept another control group free of any exposure to finance. Findings showed that people exposed to money topics tend to evidence certain behaviors:

- **"Wanted more 'personal space'"** – Money-primed participants consistently chose to remain at a distance from others after their money interactions.
- **"Wanted to work alone"** – When researchers gave money-primed subjects a task to complete with the option to do it alone or with a team, they opted to work solo.
- **"Wanted to play alone"** – When the scientists asked participants to pick between two sets of activities – one solitary, one group-oriented – money-primed subjects were more likely to choose independent activities.
- **"Were less helpful to a stranger"** – In contrived situations in which someone dropped a bunch of pencils, the money-primed subjects tended not to help, and when they did lend a hand, "they picked up fewer pencils on average."
- **"Didn't ask for help themselves"** – Money-primed subjects waited 48% longer than participants in the control group to get assistance with what turned out to be an impossible assignment.
- **"Gave less to charity"** – When researchers asked participants to donate money to a college fund that was unrelated to the study, the money-exposed participants gave only half as much as subjects who were not primed with money.

> "Taco Bell president Greg Creed wrote...to rapper 50 Cent, asking him to change his name to '79 Cent,' '89 Cent' or '99 Cent' to promote the chain's low prices."

The study's leaders interpreted the results to suggest that people in a market-driven society behave as individuals who display "self-sufficiency." The rules of the market demand that each person acts for his or her own sake, and "that money is the way you keep score."

About the Author

William Poundstone is the author of several business books including *Fortune's Formula* and *How Would You Move Mount Fuji?*