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How Do Corporations Use The 'Decoy Effect' To Influence Consumer Spending Behaviour Through Pricing And Marketing Strategies? Case Study Of Two Corporations

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Abstract:
The analysis has indicated an extremely relevant and useful use of a decoy to increase the sales and revenue of products. These products tend to be on the expensive side and therefore may only be catering to people in the middle to high-income groups. Consumer preferences are heterogeneous and thus do not indicate that this theory will be a successful one for all products at all times. There have been failures – but the success rate of using a decoy is quite effective for as in the case of many brands illustrated in this paper.
Research Question: *The research paper will attempt to analyse the impact of the 'Decoy Effect' on the changing preferences of consumers in an environment which is essentially denominated by asymmetrical information. This theory is used as a pricing strategy for various business models. Questions such as - how this increases sales, and whether it impacts the profit of a corporation are some of the answers which will be attempted in the course of the paper.*
Keywords: *Decoy, Cost Benefit Analysis, Pricing, Sales, Revenue, Profits, Asymmetric Dominated, Dominant Determinant, Similarity, Heuristic, Regularity, Paradox of choice, Nudge Theory*

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I. Introduction

The Decoy Effect is a pricing strategy that businesses use such that they can influence consumers to switch from one option to another. The other option tends to be a more expensive and profitable one for the company. This effect requires the company in question to add another product of a similar type which gives the third option to the consumer. This third option is known as the decoy, and the characteristic of the decoy is that it is asymmetrically dominated.

This effect was first described by academics Joel Huber, John Payne, and Christopher Puto in a paper they presented in 1981. They used products like beer, cars, restaurants, lottery tickets, movies, and television sets. They challenged traditional marketing principles such as similarity, heuristics, and regularity conditions.

Native American people have been crafting and using duck decoys for hundreds of years. The most ingenious use was to use floating decoys to lure the water found to roosting areas which would result in them being bow hunted, netted, or snared. These decoys were an essential part of a hunting tool, so they could lure the birds within the reach of the bow and arrow, spear, or net.

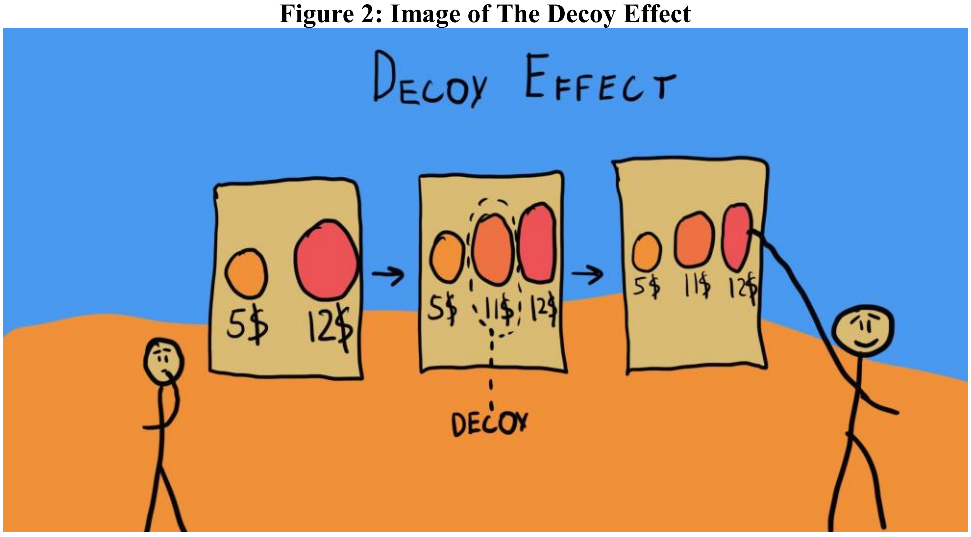
Figure 1: Image of a decoy duck used by Native Americans.

Source: Google Image

II. Definition

The decoy effect is described by how while choosing between two alternatives the addition of a third less attractive option (the decoy) influences a consumer's perception between the original two choices. These decoys are 'asymmetrically dominated'. They are completely inferior to one option (the target) but only partially inferior to the other (the competitor).

Figure 2: Image of The Decoy Effect



Source: Google Image

Asymmetrically Dominated

Asymmetric information is when one of the parties whether consumer or producer does not have complete information about the product. As opposed to symmetric information where both parties have complete knowledge and information of the product.

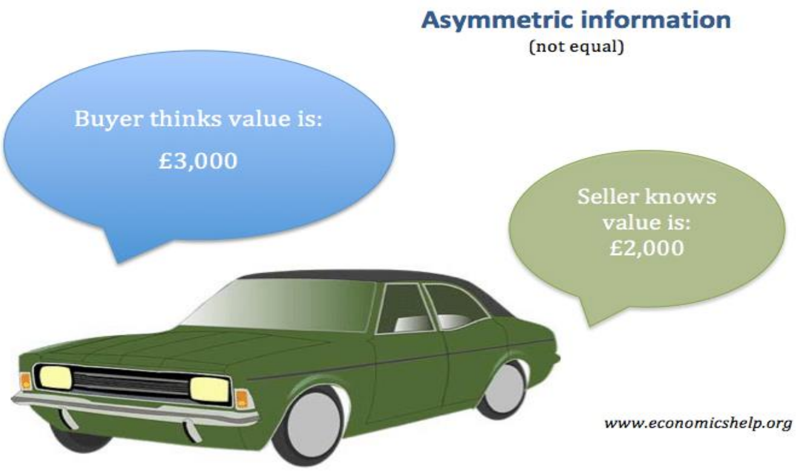
In the case of asymmetrically dominated indicates a 'dominance' along with asymmetric knowledge. This is an important marketing strategy and is reflected in choice probabilities or market shares. A normal standard model assumes that a new offering of a similar kind will take from others, in proportion to their original shares. This assumption of proportionality was incorporated in Luce's (1959) model of choice and is central to several models of consumer behaviour. There is an agreement that a new product takes a disproportionately larger share of similar products rather than dissimilar products. This is part of the similarity hypothesis and it led to the belief that when one is designing a new product it should be as dissimilar from the firm's current offering.

But in recent years it has been seen that the 'Similarity Hypothesis' is being consistently violated by the addition of an asymmetrically dominated product. The new alternative is typically closest to the item that dominates and what is surprising is, that the new alternative set helps the item closest to it which is a reversal of the similarity hypothesis.

Asymmetric Information

This is a term that refers to when one party in a transaction has more information than the other. In certain transactions, sellers can take advantage of buyers when the seller has more knowledge about the goods being sold than the buyer.

This information asymmetry creates an imbalance of power in transactions which could at times cause the transaction to be inefficient causing market failure in the worst case. Prime examples of this are asymmetric information leading to adverse selection, moral hazards, and monopolies of knowledge.



When looking at a car, a buyer can only see the externals and cannot know how reliable the engine is.
Figure 3: Depiction of Asymmetric Information, Adverse Selection
Source: www.Economicshelp.org

Thus it is important to gain as much information as possible concerning the product concerned. A lack of information can lead to adverse selection and eventually moral hazards and finally inefficiencies in resource allocation. This at times leads to scarce resources being cheaply priced while abundant resources being priced at a higher amount. The incorrect representation as far as price is concerned leads to a larger amount of scarce resources being used – further aggravating their shortage. It is important then to price the resources according to their supply, such that a judicious use could be done according to their availability. The price must indicate the availability of the resource.

III. The economic theory of pricing according to the 'Decoy Effect'

Consumers given a choice between three different products are not likely to opt for the cheapest one as they assume that it is inferior in quality, to the other two. They will not choose the most expensive product either as they assume that this product has unnecessary non-essential features.

Pricing is the major element of a marketing mix. It is how price is used as a weapon to increase sales and revenue which is the basis of the decoy effect. The other concept is the 'asymmetric dominance effect' also known as the 'attraction effect'. Psychologist Barry Schwartz has termed this as 'tyranny' or 'paradox of choice'. Behavioural experiments have indicated consistently, that greater choice complexity increases anxiety and hinders decision-making.

To reduce this anxiety, consumers tend to select only a couple of criteria, for example, price and quantity to determine the best value for money. The marketing division of the firm understands this basic nuance and tries to manipulate these key choice attributes. This they manage by planting a decoy which then steers a rational consumer who is only concerned with price and quantity, in a particular direction. This direction makes the consumer feel that he or she is making a rational, informed decision but in fact, they are being 'nudged' ('nudge theory' pioneered by Richard Thaler and Cass Sunstein). They have stated that " Any aspect of the choice architecture that predictably alters people's behaviour without forbidding any options". Not all nudging is manipulative, researchers argue that even manipulative nudging can be justified if the ends are noble. Decoy Theory could also be effectively used in social marketing to encourage people to make good decisions such as using less energy, eating healthier, or becoming organ donors.

The 'Nudging Theory' is an intersection of Psychology, Behavioural Economics, and Policy. It is an attempt to make judgements and choices easier but not cohesively.

IV. Impact of the Decoy Effect

Impact of the Decoy Effect on Sales

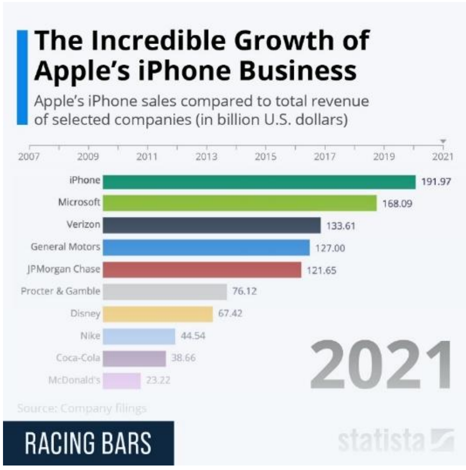
The decoy effect is essentially a sales tactic. Businesses adopt this practice to increase sales and profitability. The consumers, who are the main participants in this process, believe that they have got a 'steal deal'. In this manner, both the producer and the consumer are extremely happy with this pricing strategy. This effect tends to bend others to your will due to the 'asymmetric dominance effect'. It is the use of pricing that firms use to switch consumers from one option to a more expensive or profitable one. The moment a decoy is added to the options given to a consumer, the more expensive deal suddenly seems like the right one and they are willing to pay that extra amount because they feel that they are making a logical choice.

Consumers are normally more averse to lower quality than to higher price, and this is where the decoy comes in and exploits human proclivity which pushes the customer to an option that is both of a higher quality as well as a higher price but at the same time giving the impression that the consumer is making a rational informed decision.

The important aspect of this theory is that it is largely invisible, and yet so powerful. The fact that it is a nudge essentially means that the firm is not spending a large amount such that customers behave in a particular way, and neither does it work in a manner that doles out a form of punishment if the customer does not decide in any particular way. The main psychology behind this impact is that the firm portrays to the customer that whatever decision he or she makes is justified as a rational choice. In this process, the customer is happy as there is complete justification for their decisions.

Initially, this new option (when the decoy effect was being adopted) was seen to be cannibalising the market share of existing options. But, in fact, Joy Huber, John Payne, and Christopher Puto while running their experiments indicated that the decoy acted as a best friend in a room. The interesting aspect of this is that because you know it existed it doesn't mean you can spot it.

Figure 5: Increasing sales of Apple due to the Decoy Effect.



Source: Statista

Impact of the Decoy Effect on Revenue

The Decoy Effect normally increases both sales and revenue. Decoy Pricing is a marketing strategy that helps establish trust between buyers and sellers. Along with this, it helps firms to test new products or surfaces without risking too much investment upfront. The companies can gauge interest levels for certain features before investing.

It is a type of test market for future and innovative investment opportunities. At times it can backfire when consumers think that the firm is being manipulative and deceptive resulting in erosion of trust and eventually damaging relationships over time. The other issue could be the high pricing of the product which could turn off potential buyers rather than attract them to the product.

There are certain industries and certain products where such pricing does not work. Careful planning and execution as well as sufficient research into consumer preferences and behaviour patterns are extremely important conditions before such an attempt is made.

But by and large, whenever this effect is used, it is done so after a great deal of research and the impact is beneficial for both revenue and sales. This can be seen in Figure 5 when Apple Industries used the decoy effect to benefit the firm in the case of an increase in sales being translated into higher revenues. In this case, the cost of the decoy did not eat into the profits of the firm.

V. Case Studies

Starbucks

Origins of Starbucks

Starbucks was founded by Jerry Baldwin, Gordon Bowker, and Zev Sigel when they opened their first store in 1971 near the historic Pike Place Market in Seattle. The common factor amongst all of them, was that they all came from academia and loved coffee and tea. They sold high-quality coffee beans, dark roasted in small batches the European way. The name Starbucks was chosen from the first mate of 'Moby Dick' who loved coffee and high seas. The rise of the coffee culture is attributed to Starbucks, which introduced a wide variety of coffee experiences served as hot and cold drinks, cold bean coffee, micro ground instant coffee, espresso, café latte etc. Some offerings are seasonal or specific to the locality of the store and the country. By 1986, the company was operating 6 stores in Seattle. In 1987, the original owner sold the chain to Howard Schultz, who expanded the company to Vancouver, British Columbia, and Chicago. By 1989, there were 46 Starbucks stores. In June 1982, they came up with their first IPO (Initial Public Offering). The company's market value was $271 Million. The IPO was 12% of the total. By September 1992, Starbucks's share price had risen by 72%. During the last decade of the 20th century, Starbucks continued to acquire brands that would add to its basket. In the 21st century, they continued to acquire brands and companies, and in 2008, started a community website which was designed to collect suggestions and feedback from customers. In 2008, during the recession period in the US, they cut 1000 non-retail jobs to re-energise the brand and boost its profits. In 2013, they used the concept of 'tweet a coffee' to re-energise their brand. They also used the Decoy Effect to increase their sales and revenue.

The marketing strategy, used by Starbucks makes the small and medium options as overpriced as in the case of cups, so you are forced to think rationally and buy the larger cup as they appear to be 'value for money'.

The three classic tiered options are a dead giveaway of the decoy effect at work. The company uses this strategic pricing technique so that customers choose the size that is most profitable for the company.

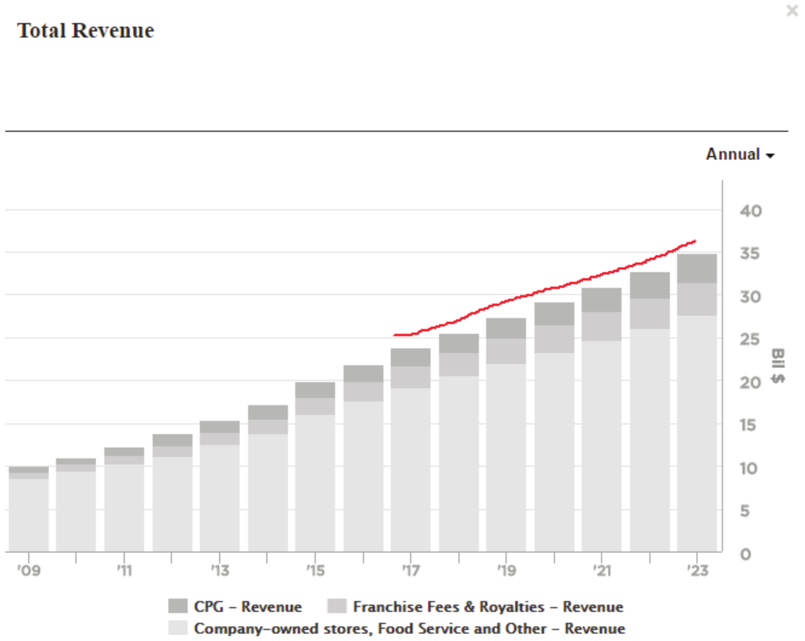


Figure 7: Increase in sales of Starbucks due to the Decoy Effect
Source: ResearchGate

The above is a clear indication of Starbucks continuing its upward trend as far as revenue and sales are concerned because it keeps on changing its marketing strategy along with the addition of the decoy effect in most of its products.

Apple

Origins of Apple

The Apple computer was founded on April 1st 1976 by Steve Jobs and Steve Wozniak who wanted to make computers small enough for people to have them in their homes and offices. It creates and markets consumer electronics, attendant computer software, and is also a digital distributor of media content. For three decades, since its inception, Apple Computer was predominantly a manufacturer of personal computers including the Apple II, Macintosh, and Power Mac lines. But it faced rocky sales, and a low market share during the 1990s. Jobs who was ousted from the company in 1995, returned to Apple in 1997 and thereafter he became a permanent CEO. He instilled a new corporate philosophy of recognisable products and simple designs. The iPod music player came out in 2001, iTunes in 2003, and the iPhone soon thereafter. When he returned to power, Steve Jobs developed the iMac.

Apple is known for its strategy of offering a range of options with various features and prices and it often introduces a Decoy option with more features than the basic model, but fewer features than the premium option – resulting in the premium option becoming more attractive. For example, they added a model of the iPhone that is a little less pricey than the most expensive one making it a bargain for the consumers, which in turn has managed to increase the average price paid by customers. It uses these biases, to bend your mind into thinking about whether you have got a really good deal.

Apple iPhones are ridiculously expensive but they still sell like hotcakes. The reason is the Decoy Effect being used in the pricing strategy that it uses to upsell its pricey products. Apple has a habit of launching three variants in its iPhone series It keeps the price of the most expensive variant quite close to the next step down. For example, the iPhone 14 costs ₹79,900. The 14 Pro costs ₹1,29,900, and the 14 Pro Max costs ₹1,39,900. The difference between Pro and Pro Max is only ₹10,000 indicating that if somebody has decided to buy a Pro, he or she will automatically move to a Pro Max Indicating very clearly, the Decoy Effect that worked.

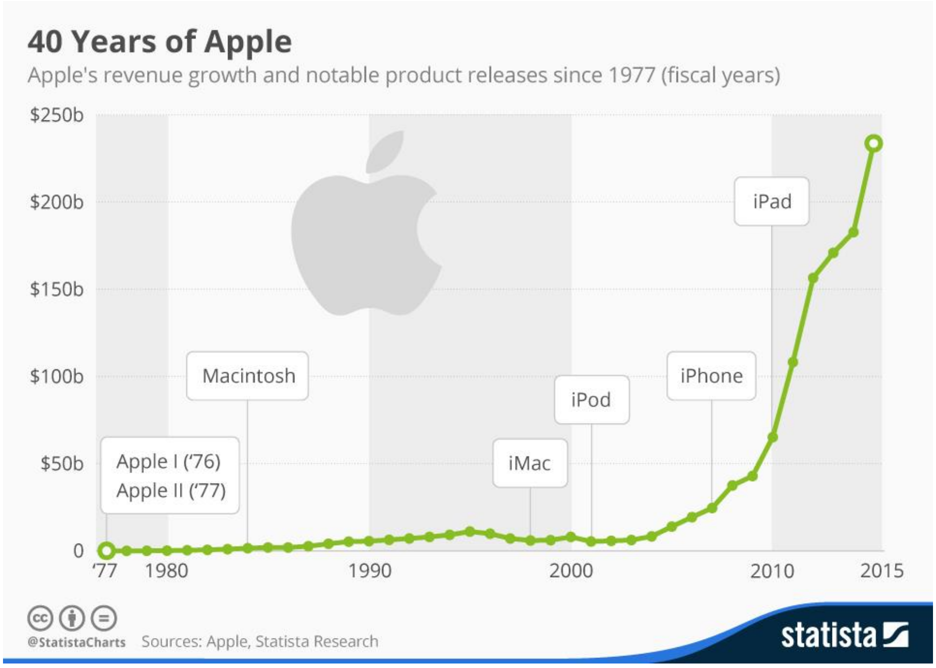


Figure 8: Increase in Apple's Revenue after the Introduction of iPhones
Source: Statista

VI. Cost Benefit Analysis concerning the Product

There is a cost that is involved in using a decoy product. Decoy pricing is based on human psychology and it adequately works on the mindset of the consumer. There would be a cost involved in making that particular product, but the benefit that it achieves in the form of higher revenue outweighs the cost of making the product. It is apparent that the retailer and the manufacturer benefit from this price effect but it is also possible that the extent of profit is reduced due to the introduction of the additional product or size.

The use of this theory is a win-win situation for a firm that correctly uses the pricing of a product or service and finally comes to the most effective one in every way, which for the firm means that it is a price which earns maximum profit. This theory is always used to increase sales. The results indicate that it does not always work in every setting and normally it is used in very stylized settings which have two products with two numerically depicted attributes. It also requires managerial significance through quantifying the substantial profit impact. There are horizontal attributes that should be considered such as – brand, taste, size, and packaging. As consumers have heterogenous practices, decoys to some consumers may not be decoys to others. If the decoy price is a higher one for the same or inferior quality product then it may not generate positive profit impacts for the firm. It is extremely important to limit this pricing practice where it could be effectively tapped to generate large sums of revenue for the firm.

VII. Conclusion

The Decoy effect is an interesting theory that has been used effectively in increasing sales and revenues of extremely well-known products. The ones that are in the limelight are those that have effectively and psychologically changed the mindset of the consumer in buying the product that was earlier not moving. This particular strategy has paid dividends for the firms in question. There are cases where it might not work which is when the product that is being showcased is either inferior in terms of quality or is too expensive. This particular theory is not something that can be used across the board as consumers are heterogenous in their selection of products. The use of this concept requires immense research, and if the firm hits the right price and model or quantity then the firm could achieve a sizable number of consumers shifting to the more expensive option. The company in this case would have achieved their target, and the whole process right from research to production would be remunerative.

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