Concept Using ‘Reference Prices’ Offers Another Way of Looking at How Consumers Make Their Choices, Johns Hopkins Researcher Says

_A new study from a Johns Hopkins Carey Business School researcher presents a broader model using reference prices, which he says may better account for how consumers make their choices._

Baltimore (PRWEB) July 26, 2018 -- How do you choose?

How do you decide, as a consumer, which automobile or pair of shoes or diet cola to buy when faced with a choice?

A prominent economic theory of the past several decades (multinomial logit, or MNL, model) holds that people choose one alternative over another because it appears to offer the greatest potential for satisfaction and usefulness. Another established idea of recent vintage (prospect theory) says people pick one thing because it promises gains while its alternative indicates likely losses.

In a new study, a Johns Hopkins University researcher presents a broader model using “reference prices,” which he says may better account for how consumers make their choices.

“Basically, reference prices are the data that people consider when they are trying to determine their willingness to buy something,” says author Ruxian Wang, an assistant professor at the Johns Hopkins Carey Business School with expertise in operations management and business analytics.

“The data may include your recollection of what you paid for a product in the past,” he adds. “But, in a more practical and reliable vein, the data mainly consist of the range of prices and quality levels for a number of products in a certain category at the time of purchase — for example, while you’re standing in a supermarket aisle trying to figure out which of various brands of canned soup to buy.”

Wang says this “reference price effect” is related to the MNL model and prospect theory in that the consumer’s hoped-for outcome, according to each of the three concepts, is the result he deems most beneficial to himself. However, he says, reference prices supply the consumer with greater context and flexibility through comparisons of multiple products, particularly about their price points and their quality. The choice is not framed as being between merely two alternatives.

The reference price effect can benefit sellers as well as consumers, says Wang.

“For a group of similar products,” he says, “a retailer could offer one item at a low price, which might help generate a reference price for the whole grouping. Then, some customers might decide they’re willing to spend a little more for the high-priced item in the group if they feel its quality is worth paying more for. This could be
a way for sellers to increase their profits.”

Indeed, adds Wang, retailers not attuned to the reference prices being established for their products by consumers put themselves at risk of “substantial losses.”

“If sellers don’t consider reference prices in how they set the supply and the pricing of their products, they could misjudge demand and, as a result, lose revenue and market share,” he says.

Wang suggests retailers might even be able to manipulate a reference price by heavily advertising a particular item or putting a product on prime shelf space.

The study was supported by an empirical analysis of data in which nearly 5,000 individuals in the United States were asked to choose from among four brands of ketchup.

“The clear conclusion from the analysis is that incorporating reference prices can significantly improve the accuracy of predictions of how consumers will make choices,” says Wang.

Titled “When Prospect Theory Meets Consumer Choice Models: Assortment and Pricing Management with Reference Prices,” the study was recently published in Manufacturing & Service Operations Management.

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