Information Asymmetry

Another important fact related to customer choice is that normally much of a customer's information is private, information that only the customer "knows" and information that cannot be directly observed by a firm. Normally, both a customer's preferences and wealth are private information. One can perhaps gain clues to a customer's preference by observing their purchase behavior over time (their so-called *revealed preferences*), and partial information on their wealth may be garnered from surveys and transactional data. But in general, much of the data affecting customers' choice behavior remains hidden.

This "information asymmetry" between customers and firms has implications for pricing and RM as discussed in detail in Chapters 6 and 8. To give a quick sense of the effect, consider how customers react to a posted price. Due to information asymmetry, the selling firm rarely knows a customer's true reservation price for their product. If they did, they could potentially offer the customer a price only marginally less than their reservation price and maximize the revenue obtained from each customer. Instead, most firms have to guess at each customer's reservation price. As a result, sometimes they price too high, and the customer does not purchase at all; other times they price too low, and although the customer may decide to purchase, they lose an opportunity for a revenue gain as the customer would have been willing to pay more. In this way, the private information of customers often allows them to retain some surplus, even from a monopoly seller.

Deviations from Rational Behavior

While rational behavior is the standard assumption underlying most of the theory and practice of RM, it is far from being completely accepted as a model of how an actual customer behaves. Indeed, much of the recent work in economics and customer behavior has centered on explaining observed, systematic deviations from rationality on the part of customers.

The seminal work in this area is that of Kahneman and Tversky [278, 277], who showed that customers often exhibit consistent biases when faced with simple choices in an experimental setting. Their key insight is that most individuals tend to evaluate choice in terms of losses and gains from their status quo wealth, rather than evaluating choices in terms of their terminal wealth as in classical utility theory. People also show a tendency toward "loss aversion" rather than risk aversion, and they have a strong preference for certainty of outcomes when evaluating choices. Finally, how gains and losses are expressed matter as well.

They showed that how questions of choice are "framed" have a large impact on customer choice. When choices are framed in terms of gains versus losses, customers typically care more about avoiding losses than about making gains. This is true even if the "gains" and "losses" amount to exactly the same choice. For example, if a public health policy choice is framed as a gain (200 of 800 diseased people will be saved) or as a loss (600 of 800 diseased people will die), most people respond differently, even though the outcomes are identical.

Other experiments revealed that people put a much higher value on a product they already own than one that they don't own because giving up a product they have feels like a loss. This behavior is part of the rationale behind the common marketing strategy of offering products on a "free 30-day trial"–that customers are much more willing to pay to "avoid losing" the trial product than they are willing to