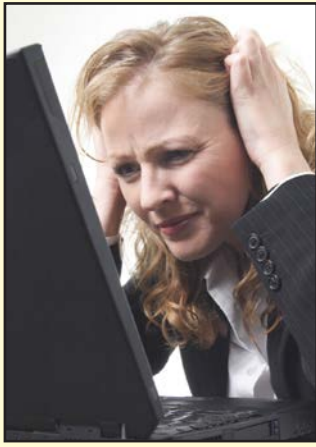


# Irrational Pricing Behaviors in Organizations



**Irrational behaviors in pricing can have devastating impacts on firm performance and reputation. Recent pricing disasters with Netflix's or JC Penney's pricing strategies have shown that the process of making pricing decisions is influenced by irrational organization and individual perspectives. The management literature is rich in papers that explore the subject of decision-making rationality and what drives managers in organizations to certain decisions versus others. However, the connection between the pricing decision-making process and decision-making irrationality has never been conceptually explored. We propose eight organizational perspectives influencing pricing rational behaviors. Stephan Liozu, CPP ([www.stephanlioze.com](http://www.stephanlioze.com)) is a member of the PPS Board of Advisors, the Founder of Value Inruption Advisors and specializes in disruptive approaches in innovation, pricing and value management. He earned his PhD in Management from Case Western Reserve University and can be reached at [slioze@case.edu](mailto:slioze@case.edu).**

**F**or decades, organizations were managed with the primary objective of maximizing economic value or maximizing profit (Grant 1996). Neo-classical economics was not concerned with the technology that drove production functions, the motivations that governed managerial decisions, or the processes that led to decisions being made in the context of the firm environment (Simon 1961).

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The aim of this paper is to identify circumstances, events, interactions, and other organizational factors that could potentially lead to managerial irrational pricing behaviors, in other words, to irrational decision-making. While most of the literature is concerned with rationality, we contend that irrational behaviors are motivated by these organizational perspectives. Following a short literature review, we explore eight such factors: uncertainty and complexity; internal conflicts and power struggles; institutional isomorphism; myths, routines, and recipes; competitive irrationality; irrational top-management behaviors; gut and intuition in decision making; and breakdowns in communication systems.

## Theoretical Foundation

The theory of decision-making addresses the critical question of how decisions are made in organizations and what organizational factors strongly influence managerial judgment when making these decisions. To support our argument, we focus on the relevant organizational factors, including bounded rationality (Simon 1961, Cyert and March 1992), uncertainty and ambiguity in decision making (Spender 1989, Brownlie and Spender 1995), and routines, rules, and standard operating procedures (Simon 1961, Feldman 2000).

Cyert and March (1992) developed a behavioral theory of the firm to address the process of decision making in modern firms from the perspective of organizational expectations, organizational goals, and organizational choice. Rationality is concerned with "the selection of preferred behavior alternatives in terms of some system of values whereby the consequences of behavior can be evaluated" (Simon Herbert 1961: 84). Therefore, a decision is organizationally rational if it is oriented toward the organization's goals; it is personally rational if it is oriented toward the individual's goals.

Irrationality can be explained in traditional ways by evaluating decision failures in practice. Irrational decisions may be the results of cognitive disturbances (Brunsson 1982) related to deficiencies in information, to deficiencies in decision makers' mental abilities, or simply to inherent rational limitations of human beings. Empirical research has found evidence of decision-making processes and behavioral frameworks that are highly irrational by the normative standard (Tversky and Kahneman 1974, Cyert and March 1992). Scholars have shown that apparent irrationalities have impacted insignificant decisions as well as very strategic ones, including national policy decisions that are potentially harmful to national security (Janis 1972).

## Managerial Irrational Pricing Behaviors

Our exploration of behavioral irrationality focuses on eight organizational perspectives that may influence pricing decisions and pricing process. There may be many more factors influencing, shaping, and disrupting decision-making processes in firms. We believe that the selected factors shown in the figure on the next page are the most commonly covered in scholarly work and are grounded in practice.

### Facing Uncertainty, Ambiguity, and Complexity

Leaders avoid uncertainty, despise ambiguity, and cannot handle complexity. Simon (1961:93) posits that actual behavior of lead-

ers in firms when making decisions or making choices falls short of objective rationality in three ways: 1) the incompleteness of knowledge, 2) the difficulties in anticipating consequences that will follow choice, and 3) the choice among all possible alternative behaviors. Managers may also suffer from a “bottleneck of attention” that impacts their ability to deal with more than a few things at a time (Simon 1961:90).

Bounded rationality refers to the notion that rational actors are significantly constrained by limitations of information and calculations (Cyert and March 1992:214). These constraints create an environment of uncertainty and ambiguity that pricing and marketing managers in firms must deal with on a daily basis and that may lead to irrational behaviors. For example, the degree of market information complexity, analyzability (Daft and Weick 1984), and the dynamics of the environment affect the level of pricing uncertainty and ambiguity in the decision-making process (Duncan 1972). As the environment becomes more and more complex, pricing and marketing managers shift their assessments from objective parameters to intuitive and subjective ones (Daft and Weick 1984). Others will inject myths (Lyytinen and Robey 1999) into their thinking, thus creating strong irrational influences on their overall operating principles.

According to behavioral theorists, managers in organizations simplify the decision-making process through a variety of behaviors (Cyert and March 1992:264): “satisficing” (“we make enough margin”) (March 1978); following rules of thumb (“that sounds like a good price”) (Schwenk 1988); defining standard operating procedures and organizational routines (“we have always priced that way”) (Pentland and Reuter 1994); and distributed cognitions (Boland Jr, Tenkasi et al. 1994).

Experienced pricing managers draw from their memory, training, and experience (Simon 1961:134). They construct and use “cognitive heuristics” (Brownlie and Spender 1995) or mental models (Porac, Thomas et al. 1989) to simplify complex pricing issues and engage in intuitive and responses to decision-demanding situations (Barnard and Andrews 1968). Brunsson (1985) proposes three types of uncertainty that can influence rationality and action.

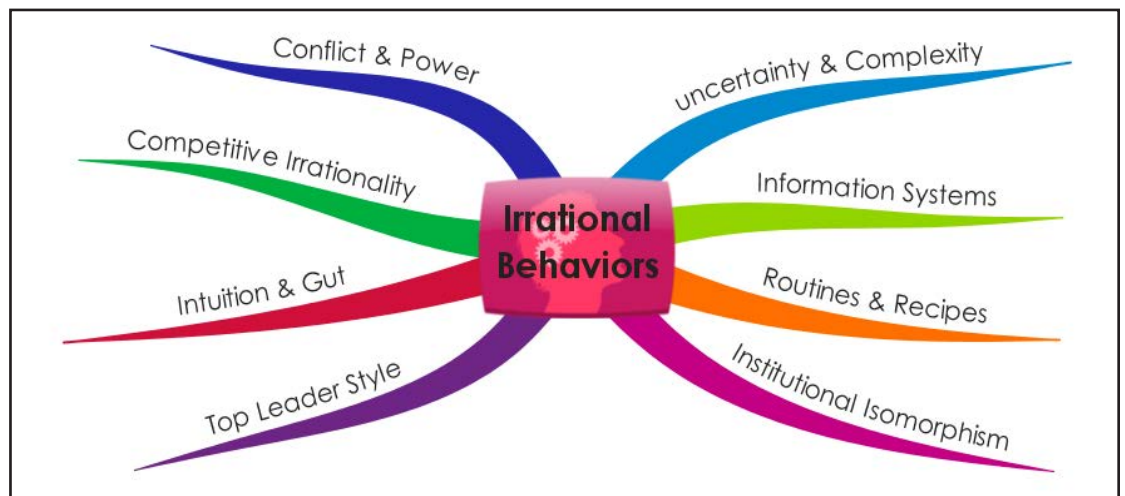
Besides judgment and estimation uncertainty, the most comprehensive type of uncertainty is associated with limitations in or absence of cognitive structure. In this situation, the newness and unfamiliarity of the pricing situation would be such that managers would be unable to make vague guesses about its relevance and resolution. Generally speaking, the resolution of uncertainty is to create a rationality, a recipe or an interpretative scheme (Brownlie and Spender 1995) leading to some type of pricing decision or action.

### Information and Communication System Breakdowns

How information is transmitted throughout the organization (Cyert and March 1992), how it is interpreted (Daft and Weick 1984), and how it is used (Ingenbleek 2007) are also important considerations. Interpretation gives meaning to data (Daft and Weick 1984). It is a process used by managers hoping to translate data into knowledge.

Two factors will affect the levels of interpretation in firms and the level of rationality injected into the pricing decision-making process. First, information equivocality, defined as the multiplicity of meanings conveyed by information about organizational activities (Daft and Macintosh 1981), may lead to different and conflicting interpretations particularly when dealing with subjective customer-value information. Second, when pricing responsibility is shared, information-assembly rules will guide the organization to process data using collective interpretation (Daft and Weick 1984). The analyzability of the external environment is also a factor influencing the level of interpretation in firms. The degree of complexity and analyzability and the dynamics of the environment will affect the levels of uncertainty and ambi-

Figure 1: Organizational Perspectives



guity in the pricing decision-making process (Duncan 1972). As managers face an unanalyzable environment, they will include judgments, intuition, invention, and irrational manipulation in the interpretation process (Daft and Weick 1984).

Organizations not only seek information through search behaviors, they also process information (Cyert and March 1992). We cannot ignore the process through which information is communicated in the organization. Information and knowledge arise at various points in the organization and must be transmitted via the organization’s formal and informal communication networks (Simon 1961).

Because pricing information is fragmented and comes in bits and pieces, we expect some bias in information-handling rules (Cyert and March 1992) due to perceptual differences among the subunits of the firm (Cyert and March 1992). These information-handling rules include both routing rules (who will communicate pricing information to whom, and about what) and filtering rules (what is being communicated, and in what form) (Cyert and March 1992). Communication of customer and competitive

information inside the firm can be affected by these routing and handling rules. Rigidity and the manager's experience also affect how valuable pricing information is deployed in the organization (Porac, Thomas et al. 1989, Ingenbleek 2007).

### **Organizational Routines, Rules, and Recipes**

Organizations avoid uncertainty (March, Simon et al. 1958). To make sense of conflicting signals and irrational behavioral temptations, they impose routines, standard operating procedures, industry traditions and practices, information-handling rules, and risk-avoiding agreements in order to reduce uncertainty in the choices they make and the goals they set (Cyert and March 1992). Traditional views about routines justify their existence based on a need for "cognitive efficiency" and less complexity (Simon 1991). This view suggests that routines arise because they are functional, minimize costs, increase managerial control, and create behavioral stability in the organization. However, rules and routines can be seen as repetitive and inflexible (Gersick and Hackman 1990), as fixed and mindless (Ashforth and Fried 1988), and as sources of organizational inertia.

Routines put the organization in "automatic mode" (Langer 1989). Finally, "recipes" can also influence the level of rational pricing behavior in leaders by limiting the frame of reference available to them when they are faced with uncertainty and ambiguity. Value recipes (Matthyssens, Vandenbempt et al. 2006) may limit a firm's ability to experiment with innovative pricing methods, while industry recipes (Spender 1989, Cyert and March 1992) will promote mimicking behaviors as managers search for pricing problem-solving recipes within their industry. For example, a powerful industry recipe might be the relationship between pricing and a specific, strongly anchored unit of measure. Finally, "recipe knowledge" reinforces the use of knowledge about recommendations, improvements and repair strategies (Sackmann 1991).

Routines, rules, and recipes create a stable repertoire of answers to problems, protecting leaders from irrational pricing actions and behaviors during the pricing decision-making process. However, because of their static and inflexible nature, they may also create a perception of irrationality for those on the receiving and execution end of the decision. Drawing standard and pre-existing answers from this repertoire of the organizational memory (Walsh and Ungson 1991) might lead to pricing decisions that are not aligned with the organization's goals, thus suggesting irrational behaviors.

### **Institutional Isomorphism**

Closely related to the concept of industry recipes, according to which firms copy widely accepted marketing and pricing strategies (Spender 1989), the concept that best captures the process of homogenization is isomorphism. Dimaggio and Powell (1983) define isomorphism by borrowing Hawley's 1968 definition: isomorphism is a constraining process that forces one unit in a

population to resemble other units that face the same set of environmental conditions.

The authors offer three mechanisms through which institutional isomorphic changes occur: 1) Coercive isomorphism results from both formal and informal pressures exerted on organizations by other organizations on which they depend (from corporate pricing teams for example); 2) Mimicry processes can also explain institutional isomorphism: uncertainty is a powerful force for imitation. Managers tend to search for existing and proven pricing-problem resolutions via benchmarking by attending pricing or industry conferences and identifying information that might resonate with their specific pricing problems. Mimicry means finding viable solutions at minimal expense (Cyert and March 1992) but can be a source of irrelevant and sometimes irrational

decisions (Pfeffer and Sutton 2006); 3) Normative pressures: professionalization is a key component of the explanation for institutional isomorphism. As the pricing function continues to organize and professionalize through relevant institutions, organizational similarities appear

among pricing organizations as they mimic organizational structure and develop similar pricing capabilities (systems, tools, approaches).

Finally, institutional isomorphism can also lead to irrational pricing decisions by promoting flock behaviors or a tendency to jump on bandwagons (Fiol and O'Connor 2003).

### **Conflict and Power Struggles**

Conflicts or disputes among departments can result from a lack of alignment between subunit goals or a the failure of a bargaining process among potential coalition members to reach a negotiated goal (Cyert and March 1992). For example, marketing, finance, and sales departments often conflict on whether profit should be maximized at the risk of impacting long-term relationships with customers (Anderson, Wouters et al. 2010). Opposing views and priorities can lead to resistance by some departments to adopting progressive and aligned pricing strategies (Lancioni, Schau et al. 2005). The power struggles and clan behaviors (Pfeffer 1978) are based on a desire to control the strategic planning process (Lancioni, Schau et al. 2005).

Finance departments traditionally see themselves as the protectors of the firm's profitability, thus promoting their ideology (Brunsson 1982) onto the rest of the organization. Accounting departments control the systems that provide accurate and relevant cost information (Lancioni, Schau et al. 2005). When multiple parties are involved in the pricing decision-making process, frictional conflicts (Pondy 1969), disputes, disagreements, and passionate discussions occur (Dutta, Zbaracki et al. 2003). In response to these frictions, the firm defines routines and mechanisms to avoid and resolve them, and requires a broader coordination mechanism across the groups involved in the decision-

Conflicts or disputes among departments can result from a lack of alignment between subunit goals or a the failure of a bargaining process among potential coalition members to reach a negotiated goal (Cyert and March 1992).



making process (Brandenburger and Stuart 1996). These learned and adaptive resolution routines become a critical resource for the firm (Dutta, Zbaracki et al. 2003).

The greater the task specialization in the organization, the more likely disagreements will occur (Pfeffer 1994). The division of pricing responsibility and tasks can increase uncertainty as information becomes highly fragmented. Irrational managers can voluntarily or involuntarily manipulate information to gain power in the organization (March, Simon et al. 1958) and promote organizational ideologies (Brunsson 1985). Restrictions on information sharing are a manifestation of inter-unit conflicts (Walton and Dutton 1969) and a clear materialization of irrational behaviors.

Finally, misalignment of organizational incentives can also generate conflicts and lead to breakdowns in organizational goal achievement (Kerr 1975, Hinterhuber 2008). “Rewarding A while hoping for B” (Kerr 1975) generates inadequate incentive structures and a potential failure of collaboration in the firm (Barnard and Andrews 1968) and clearly reflects poor judgment in leadership. Reward systems designed by management can serve either to sharpen or to blunt their decisive effectiveness (Walton and Dutton 1969).

### Competitive Irrationality

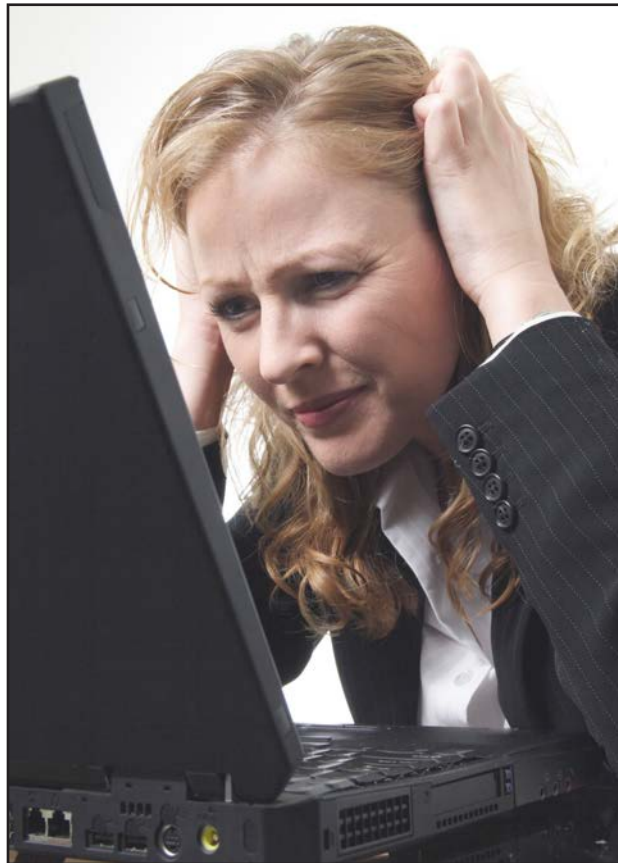
Faced with increased competitive intensity, pricing, commercial, and marketing managers might become overwhelmed by the amount of competitive information and the number of pricing decisions they must make (Dutta, Zbaracki et al. 2003). The level of competitive intensity in a market requires great reaction time and a strong capability to respond adequately. Increases in competitive activities can generate more irrationality, uncertainty, and “unanalyzability” of market information (Daft and Weick 1984), leading to an increase in stress levels. Besides the potentially disruptive and stressful relationship between competitive intensity and decision-making behaviors, continued intense rivalry might create long-term behaviors leading to competitive irrationality (Armstrong and Collopy 1996). In that context, decisions that are irrational are made to focus on damaging the profits of competitors (Graf, König et al. 2012) regardless of cost. Competitive irrationality might manifest, for example, as irrational market reactions with respect to price or market-share acquisition actions (price wars) or a rapid acquisition to capture the field and prevent competition from first-mover advantage.

### Intuition and Gut Feeling in Decision-Making

While some intuitive influences are generally expected in business

and pricing decision-making behaviors, many pricing decisions in firms are made because “it felt good,” “it felt all right,” or because decision-makers had gone around the room and gathered “collective intuition” from participants (Liozu and Hinterhuber 2012). In recent years, interest in intuition and gut feeling in decision-making theory has resurged, in part due to general dissatisfaction with the concept of rationality and its limitations (Sadler-Smith and Shefy 2004).

Making decisions based on intuition is increasingly viewed as a viable and acceptable approach in today’s business context (Burke and Miller 1999). Intuition may be an appropriate decision-making approach in certain situations and business scenarios, especially in situations of uncertainty or turbulence (Khatri and Ng 2000), novelty, or in situations related to human resources. Scholars relate the intuitive skills of managers to the intuitive skills of chess masters or physicians (Simon 1987). Managers retain in memory experience, schemas, and patterns gained through experience and organized in terms of recognizable chunks and associated information (Simon 1987). While some leaders are able to combine both approaches to reach a greater level of pricing-decision effectiveness (Simon 1987, Dane and Pratt 2007), many are unable to reach that balancing state and instead base significant firm decisions on pure gut feeling or impulse. In the words of one research informant, making a pricing decision is like playing Russian roulette (Liozu, Boland et al. June 2011).



### Irrational Top Management

Top management plays a key role not only in defining and promoting corporate-wide priorities and new strategic programs but also in identifying, allocating, and deploying strategic resources to support these programs (Chandler 1973). Executive experience, overall personality, and risk-aversion behaviors help determine the course and rate of structural adaptation and innovation (Chandler 1973, Jaworski and Kohli 1993). The influence, skills, and drive of upper management are a resource leading to better strategy and greater economic rents by firms (Barney and Clark 2007). Leadership styles (authoritative versus participative) and backgrounds (legal, finance, or marketing) also impact the organization (Simon 1961, Chandler 1973). Over the past twenty years, and most recently, we have witnessed corporate executives making bad strategic pricing decisions (JC Penney and Netflix, for example), leading to severe reductions in profit and in stock performance.

### From Irrational to Mindful Behaviors

Irrational behaviors might also be characterized as less-than-mindful behaviors (Levinthal and Rerup 2006). Recent developments in organization and management theories have led to the

emergence of a rich body of literature related to individual and collective mindfulness. Mindfulness does not represent a silver bullet for irrational leader behavior. Mindful behaviors can be defined by three distinct elements: creating new categories and not just relying on categories present in memory, welcoming new information by being open and attending to changed signals, and welcoming more than one view and being aware of multiple interpretations (Langer 1989).

Mindfulness is a state of alertness and lively awareness that is manifested in active information processing (Langer 1989). Fiol and O'Connor (2003) posit that the greater the level of mindfulness of decision makers, the more likely it is they will use decision making mechanisms to expand their search for information. Mindfulness contributes to expanded scanning, to context-relevant interpretation of internal and external conditions, and to increasing the high sensitivity of perception and high sensitivity of behavior to respond to diverse, changing stimuli (Levinthal and Rerup 2006). Weick et al. (2007) define mindfulness as a rich awareness of discriminatory detail. Mindful people have the big picture. Mindfulness is about the quality of attention.

In extending the concept of individual mindfulness (Langer 1989, Langer 1997), Weick et al. (1999) introduced the concept of collective mindfulness as the widespread adoption and diffusion of mindfulness among the organization's members, including pricing teams. Mindfulness helps organizations and their leaders notice more pricing issues, process these issues with care, detect and respond to weak signs of trouble sooner (Weick and Sutcliffe 2007), and avoid irrational pricing decisions.

Critical to the reduction of irrational pricing behaviors are the concepts of mindful scanning (Fiol and O'Connor 2003), anticipation of problems and moments of discontinuity before they happen (Gersick 1991, Weick and Sutcliffe 2007), preoccupation with failure and reluctance to simplify interpretations (Weick, Sutcliffe et al. 1999), awareness and response to changing stimuli (Levinthal and Rerup 2006), mindful problem solving (Langer 1997), and openness to new information, interpretations, and categories (Langer 1989). Therefore, mindfulness is needed in the pricing decision-making process, especially as companies adopt more advanced and sophisticated pricing practices (Liozu, Hinterhuber et al. 2012).

The fundamental question is the constant challenge of the equilibrium between rational and irrational pricing behaviors based on how predictable the business world is. In Simon's world, the human decision maker is not able to make decisions and to predict consequences, as a result of all the factors we described in this paper. Thus, decision makers live in a knowable world that is impossible to grasp and predict (Augier and Kreiner 2000). So the question becomes, can they better predict the future? Can pricing experts use their imagination to further advance their ability to make the best rational choice? We adhere to Shackle's use of imagined experiences in the context of choice:

Decision is choice, but choice amongst what? Not amongst actual experiences depending upon stimuli from without or our own motor responses, for when you are actually experiencing or physically doing something, it is too large to reject it in favor of something else. Choice is amongst imagined experience.

(Shackle 1964: 12)

In light of Shackle's argument, there is therefore a rationale for pricing leaders in organizations who think and act in ways others might identify as irrational. Mindful and creative leaders often fall into this category. The pricing profession as a whole and the pricing function in firms must embrace creativity and pursue a balance of technical and creative skills. But as organizations pursue pricing intelligence (March 1999), these somewhat irrational leaders are needed to create imagined experiences of what choices the future might require and to break down the strongest barrier to the pursuit of intelligence: reason – "actors' presumptions that they know their goals, themselves and the world they live in" (Augier and Kreiner 2000: 678).

### **Implications for Practice**

While grossly incomplete, our paper raises some interesting questions and potential applications for the world of pricing practitioners. First, top leaders in firms should play close attention to the organizational perspectives leading to potentially dangerous and destructive irrational pricing behaviors on their front lines. Second, and at the same time, these leaders should embrace creative thinking, embrace mindfulness concepts, and diffuse them throughout their organizations. In particular, they should awaken the imaginative power of their pricing teams.

It is difficult to predict the future. Predicting what choices might be needed in the future might be easier to explore. Third, every organization includes people who do not adhere to standard operating rules, conventions, and regulations. These people are often characterized as skeptics, organizational weirdos, or geniuses. Top leaders should stay connected with them and engage them in a different type of interaction or relationship. Finally, leaders themselves should walk the talk and embark in boundary spanning and mindful scanning activities to help feed the organization with more rational but challenging future-oriented information. It is their role to drive the vision and the future of the organization. They must be irrational in their own way while creating the stability needed to steer the boat.

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