

reciprocity enhances efficiency and produces wage rigidity. Agents choose higher-than-minimal performance levels, and employers offer payments that leave rents to agents.

Other sources of price rigidities are related to reference-dependent preferences, the fact that people seem to value gains and losses from initial reference points. The endowment effect or *status quo* bias is responsible for downward rigidities in the prices of real estate. Although original purchase prices are a sunk cost and should be ignored by sellers, people are averse to nominal losses, and this behavior makes the adjustment to market-clearing prices slower. The same effect has also been observed in the sale of shares on the stock market.

*Maria Paz Espinosa*

*See also:* Efficiency Wage Hypothesis; Endowment Effect; Fairness; Loss Aversion; Money Illusion; Reciprocity; Wage Stickiness, Loss Aversion, and the Phillips Curve

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## PRICE-QUALITY ILLUSION

Price-quality illusion denotes the rule-of-thumb association of the price of a product and its quality that leads consumers to infer the quality of a product from its price. A high-priced product is also perceived as high in quality and therefore purchased, and a low-priced product is perceived as low in quality and not purchased. Hence, the price signals the quality of a product. This inference results in purchasing behavior that violates the law of supply and demand and manifests itself in upward-sloping demand curves (Rao 2005). This is similar to Thorstein Veblen's Snob Effect. Wainstein and Sichel (1976) showed that a heuristic approach adequately describes such demand curves.

Extensive research on price-quality relations has shown the overall correlation of price and objective product quality to exist, but the relation varies across product categories and is negative for some categories such as services and nondurables (i.e., food and cosmetics). Even though price represents a poor cue for objective

product quality, it strongly influences consumers' product quality expectations and perceptions as well as their purchasing behavior.

Consumers rely on price as a cue and apply the price-quality heuristic when information on the quality of a product is not available, the product is complex (Kirchler et al. 2010), the product is unfamiliar (Völckner and Hofmann 2007), the product is socially desirable (Kirchler 2011), or advertising supports such an inference (Rao 2005).

From an economic perspective, such behavior represents an anomaly and cannot be explained theoretically (Rao 2005). Possible theoretical explanations come from the field of social psychology (Kirchler 2011). Bruner and Postman's (1949) theory of social perception states that key cues exist and that quality judgments are compromises between actual quality and quality expectations based on the key cue. If the price is a key and the actual quality is difficult to ascertain, a high price will induce high-quality expectations, and these expectations will dominantly influence quality judgments (Kirchler 2011).

On the other hand Festinger's (1957) theory of cognitive dissonance offers another possible explanation for the price-quality heuristic. According to Festinger, a perceived discrepancy between actual quality and price level could lead to cognitive dissonance and consequently to the revaluation of one of the elements to create consonant judgments. If the quality is low and the price is high, dissonance will result. This dissonance can be dissolved by reevaluating the quality of the product or the price level of the product (Kirchler 2011).

Applying the price-quality heuristic in some cases represents an adequate and necessary behavior that can result in satisfactory and good decisions. Nevertheless, consumers should abstain from frequent use due to the poor correlation between price and objective quality.

*Erich Kirchler and Jennifer Stark*

*See also:* Cognitive Dissonance; Fast and Frugal Heuristics; Herding; Heuristics; Snob Effect

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### PRIMING AND FINANCIAL DECISIONS

Priming is an implicit memory process, where exposure to stimuli or events affects the availability of specific information categories and response to subsequent events. As a result, it also influences decision making (Baron and Byrne 1997, Chapter 3). Priming may also be viewed as changes in preliminary conditions that impel the probability that a particular response will be pursued following the stimulus (Cramer 1968). Tulving (1983) refers to priming as facilitation of performance of one task on that of following identical or similar tasks. Noteworthy is that the availability of a specific knowledge category stored in memory is positively related to the probability of using it to interpret perceived information (Bruner 1957).

Priming processes are routinely activated in a variety of situations. For example, watching a horror movie may intensify attention, and modify interpretations and reactions to subsequent stimuli such as a squeaking gate, thereby causing the exposed person to act as in alarming situations. The same stimulus, when not followed up, may be left consciously unnoticed, or interpreted in a different, unexciting manner.

Priming procedures in the lab are usually composed of two consecutive stages, *exposure and testing*. In the first stage, subjects are exposed to a stimulus, and in the second, they are requested to execute a particular action, make a decision, or interpret a situation or the meaning of some substance. The exposure stage may be subconscious, aka automatic priming (flashing words or pictures for brief time spans such that the participants are not aware of seeing them), or conscious, gaining subjects' full awareness.

Several papers have dealt with priming and financial decisions. Erb, Bioy, and Hilton, employing a procedure for subconscious priming of risk attitudes, induced risk-seeking or risk-averse preferences across a range of decision scenarios. Subsequently, they showed that the induced priming effects may be reversed by drawing participants' attention to the priming event. Their results support the view that the formation of risk preferences may be based on preconscious processing, as, for example, postulated by the affective primacy hypothesis, rather than relying on deliberative mental operations, as posited by several models of judgment and decision making.

Meier-Pesti and Penz, building on the observations that, in investment decisions, women are more risk-averse than men and, in western cultures, risk taking is perceived as a masculine characteristic, hypothesized that the more people associate themselves with masculine attributes, the more financial risks they would tend to take. Their first study showed that differences between men and women in financial risk taking decreased when identification with masculine attributes

remained constant, while femininity was not related to financial risk taking. In their second study, gender priming on masculinity and femininity affected risk taking of the male sample.

Gilad and Kliger explore the influence of priming on financial decisions by reinforcing subjects' risk-seeking behavior under uncertainty and comparing it to behavior in control groups. They focused on professionals: commercial banks' investment advisors and accountants in CPA firms. The results indicate that priming affects subjects' risk attitudes and investment decisions. Professionals' decisions were affected more than undergraduates', suggesting they employ a more intuitive and less analytic approach in making their decisions.

Kliger and Gilad explore the role of colors as priming substance. Colors are widely present in the financial decision-making arena, with red and green prominently employed. Their between-subject experimental analysis exposed subjects to financial information on colored backgrounds and explored the effect on their investment decisions. The results indicate that red color priming emphasizes value losses of the underlying asset. To wit, subjects who were exposed to red assigned higher valuations and probabilities to events involving the loss domain than to events involving the gain domain relative to the valuations assigned by subjects who were exposed to green.

Doron Kliger

See also: Complexity and Heuristics; Emotions and Decision Making; Fast and Frugal Heuristics; Heuristics; Risk and Knightian Uncertainty

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### PRINCIPAL-AGENT THEORY AND BEHAVIORAL ECONOMICS

The theory of principal and agent in economics studies optimal contract design between two parties, of which one (the agent) is performing a certain task for the other (the principal). The principal's problem consists of specifying a contract that

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