ILI.DIGITAL

Behavioral Economics Meets Digital Business Models

How User Behavior Can Be a Strategic Driver of Value Creation

Science to business

Scientific advancement is driven by being inquisitive, and business is no different. ILI. DIGITAL has emerged from research: we bring together science, business, and technology to foster new thinking and business model disruptions.

We believe that data driven disruptions bring fascinating changes to the industrial landscape: better customer experience, new value business models, increased operational efficiency, and more.

With our origin, digital mindset, and solution competence, we provide the right setup to do so. Our multidisciplinary team combines data analysts, software developers, engineers, sociologists, etc., with a deep expertise in design research, behavioral economy, artificial intelligence, and beyond.

We see it as our responsibility to accelerate the transition from scientific concepts to executable business. With the intention in mind, ILI.DIGITAL Team presents a series of white papers on the trending topics — sustainability, circularity, digital health, metaverse, behavioral economics, — that show scientific advances in each area and their application in practice.

How ILI.DIGITAL Can Help You Build Better Customer Relationships

Businesses embark on a digital transformation journey to prepare for the challenges in the modern world. If considered in a company's business model, the shift from physical to digital can unlock new opportunities to generate new economic value. Products, services, and solutions, enabled by digital technologies, reflect the potential for digital business model transformation.

Companies are urged to think strategically about potential tools to generate competitive advantage through customer value while providing superior experiences to their customers. In this sense, behavioral economics offers the much-needed understanding and valuable tools to help companies identify, model, analyze and predict customer behaviors. This new layer of strategic information can deliver personalized experiences while supporting users to achieve their goals, creating value on both sides of the scale.

The utmost important factor in this connection of fields is to make sure behavioral economics-based strategies, product design, and interventions align with both the company's strategy and the users' needs. This connection enables sustainable value creation throughout the business-consumer relationship and builds a bridge between user experience, strategy, and customer value.

When developing digital products and services, companies need to collect data, analyze, experiment, and diagnose context-driven situations to craft optimal behaviorally-informed strategies. ILI.DIGITAL, a company focused on digital business model transformation, counts on expert teams and a range of tools and methods to strengthen this connection between consumers and companies.

When deployed by digital technologies, the core strategies at the upper management level morph into a business model, reflecting how the value is captured and delivered. ILI.DIGITAL's track record of successful use cases demonstrates the capacity to derive business value while combining strategic approaches with technology — from cloud services, big data, and analytics to mobility, artificial intelligence, and extended reality. Organizations with a need for business model transformation must consider ILI.DIGITAL's project-based approach, so that their product or service, designed with the user experience, behavioral elements, and a marketing strategy in mind, becomes an engaging, impactful, and high-value offer. Contact ILI.DIGITAL to learn more about how you can disrupt your business model at https://ili.digital.

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Management summary

The field of strategy transformed significantly within its introduction. Digital transformation pushed competition to a highly dynamic and demanding stage.

For sustainable competitive advantage, digital products and services must propose superior and long-lasting value to their users. Now more than ever, experience becomes a central topic in digital competition.

The field of behavioral economics combines psychological elements with economic theory, proposing new models to analyze decisions and behavior. Behavioral economics offers a variety of tools to analyze, predict and change behavior in digital environments.

Companies can purposedly design digital interfaces that influence behavior to support customer value creation, reflecting on the success of products and services.

Behaviorally-informed strategies need to be formulated in accordance with the overall strategy and the underlying business models to reach maximum efficacy in value creation for both companies and users. The results of interventions will be most effective when connected to the strategy and supporting the core business.

Introduction

Technological advancements brought digitization to our everyday lives, permanently changing how we interact with the world. This shift from physical to digital undoubtedly affects how business is done, especially by influencing the legacy cost structures, as distribution and scaling of digital assets are much cheaper and faster than physical. From the corporate environment's perspective, such changes uncover new opportunities for organizations, which can harness the economic value of new technologies by strategically crafting the underlying business model. In this context, products and services enabled by digital technologies play a significant role in redefining several industries, showcasing the undeniable potential for digital business model innovation initiatives.

The current technological status allows for more than basic functionality. Therefore, a critical success factor for digital initiatives is the creation of practical, usable, and aesthetically pleasing experiences. Experience and customer value have become essential, mainly because switching costs in the digital world are lower than in the physical, making people more likely to change from one product to another. This increasing digitalization of business activities makes it imperative for companies to develop a strategic understanding of how to stand out from the competition and design desirable solutions with sustainable revenue streams.

Considering that the number of decisions made in digital environments is ever-increasing, taking user behavior into account is a determining factor in building optimal digital interaction models. For this reason, the field of Behavioral Economics, whose "official" origins date back to 1960, has gained much attention in the business context in recent years. Behavioral researchers suggest that human behavior can be inconsistent with previous assumptions of rationality, mainly due to heuristics and biases that affect our decision-making process, weakening the predictive power of standard economic decision models.

In theory, the combination of technology, a suitable business model, and effective behavioral mechanisms presents a potential for creating strategic advantages and maximizing the desired results for both firms and clients. Moreover, by introducing psychological elements to the economics discipline, the field of behavioral economics aims to capture and model a real-world picture of how humans make decisions. In contrast with the classical assumptions, results can be dramatically different than expected by changing the way choices are presented. This connection between Behavioral Economics and Business is the central topic explored in this whitepaper.

The foundations: how we define customer value

Quickly recapping the foundations of business strategy, in the words of Peter Drucker, one of the most influential early business strategy scholars: the reason for a company to exist is to create a customer. As an essential characteristic of free markets, firms must compete to attract and win customers. Hence, the term "strategy" in a business context fundamentally relates to how firms cope with competition while establishing and sustaining value creation, as in the vision of Michael Porter, another legendary scholar in the field. In another influential definition by Chandler, strategy also encompasses how enterprises define goals, actions, and resources necessary to reach the desired objectives. In the bottom line, the connecting points between many theoretical definitions converge to the following point: to be successful, firms must provide better value to their customers than competitors on a sustainable basis. So how can we define "value" in the first place?

Strategy becomes crucial for assessing the added value when turning resources into final products. The same product — goods or services, physical or digital — can be created by organizing activities in different ways. Therefore, we can measure value in terms of price (mainly) or emotional commitment that customers are willing to pay for this product. There are six categories of value — real or perceived — that are created for the end consumer and used as a tool for differentiation-based strategies :

Economic: connected to wealth, resources, or the financial conversion process

Physical: connected to well-being, health, comfort, or rest

Emotional: connected to individual emotions (joy, fear, excitement, or similar)

Social: connected to interpersonal relationships

Cognitive: related to the quest for knowledge

Political: associated with influence, control, and power

A business that seeks differentiation will organize its activities in a way that allows the creation of differentiated products and a higher value perception among customers (considering the dimensions above). That is, crafting better products in terms of design, technology, innovation, or performance and ensuring better services, distribution channels, and a strong identity.

Digital product innovation combines many resources and industries, enabling new sociotechnical ecosystems and making it possible to dramatically reconfigure legacy processes while ultimately allowing new products and services to existing. This scenario makes the competition fiercer and turns a deep understanding of the user into a powerful weapon for successful digital initiatives.

From defining strategy to defining business models

Fast forwarding to the strategy field, The popular Business Model theory proposes a modern business strategy and value concepts. This chain of thought states that despite the status of technological advancements, technology has no economic value until it reaches the market via a business model. The term business model is mainly known as a strategic framework, used to describe how a company does its business, consisting of three main pillars:

The value proposition, or the offering that the company delivers to its target customers, creating competitive advantages;

The value creation system, which outlines the structure necessary to deliver the value proposition, including resources, organization, activities, and partners; and lastly,

The value capture, or the economics of the business, that includes cost and revenue structures.

The business model architecture offers a simplified representation of a complex and interconnected network of concepts, flexible enough to be idealized, adapted, and transformed, if necessary, in today's dynamic business environment. Recently, the idea evolved to be a widely applied analytical tool for assessing how firms operate, compete, and perform in the digital economy.

Strategy, business model, and tactics: what is the difference after all?

While business models define how a company creates and captures value, strategy relates more to a better understanding of business objectives and dealing with competition, a concept often excluded from the business model's theoretical boundaries. Another essential concept within the strategy universe is market tactics. While strategy informs the choice of business model through which the company will compete in the marketplace, the business model refers to the logic of a company, the way it operates, and how it creates value. Therefore, tactics refer to the remaining choices open to a company following its business model.

Now with the foundations of the (modern) strategy laid out, let us explore how behavioral economics comes into the field as a strategic concept for value creation as a differentiation strategy.

What has been going on in the field of behavioral economics

The increasing interaction with digital tools turns human beings into constant information generators. Digital unveils the possibility of using this data to analyze behavior at a scale and in many different scenarios, emphasizing the role of behavioral sciences in crafting better experiences, improving performance, and creating value.

By combining elements of psychology with economic theory, behavioral economics aims to provide a more realistic picture of how human beings behave in the real world, that is, not entirely based on the traditional assumptions of purely rational and self-maximizing individuals.

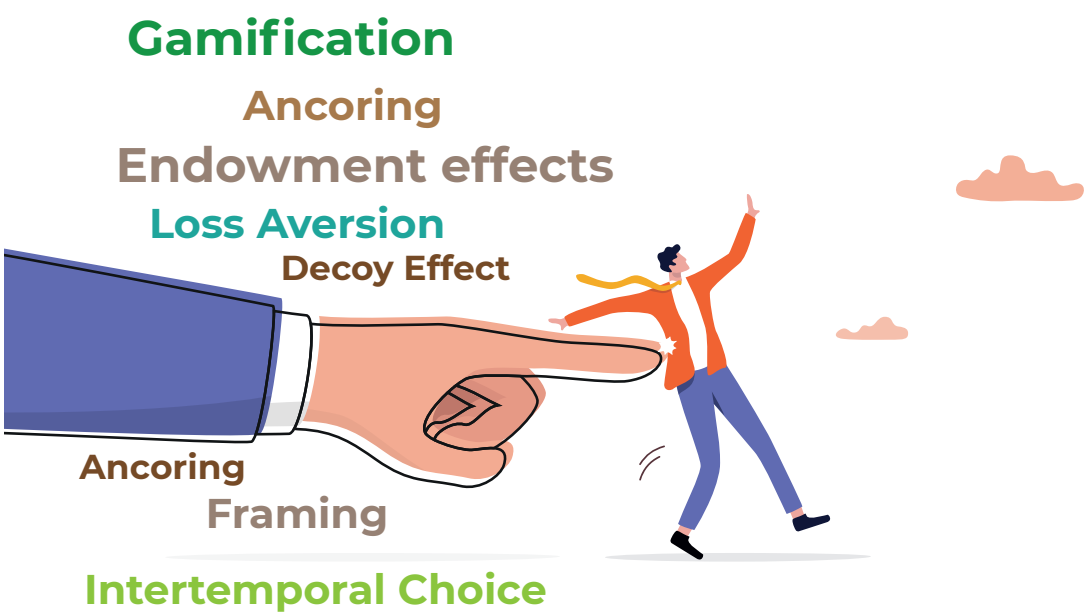
In other words, behavioral economics offers tools that can describe and realistically predict the human decision-making process, incorporating psychological, cognitive, emotional, cultural, and social factors in analyzing how individuals or groups make decisions.

The empirical emphasis pushes experimentation as a vital tool for behavioral economists.

In the last decades, scientists have conducted several seminal experiments supporting evidence that humans have finite thinking capacities. That is, heuristics and biases govern the real-world decision-making process, and the choice environment, incentive structures, or the way information is presented can heavily influence decisions, leading to systematic and predictable deviations from the standard norms.

A prominent example to support this claim is provided by the Nobel Prize winners Kahneman and Tversky's very famous series of experiments that led to the formulation of the Prospect Theory. Their investigations uncovered empirical evidence that individuals have an asymmetric assessment of gains and losses (or that people suffer from Loss Aversion), consequently proposing new explanatory models that account for individual differences in behavior. The international bestseller "Thinking Fast and Slow" documented this and many other experiments, stating that our brains work in two systems: "Fast," where we are supposed to make quick decisions with reduced effort and cognitive power, like which shirt to put on today. The other is "Slow," where in more "important decisions," our rational and analytical self takes control, for example, choosing which house to buy. As our evolutionary process relied heavily on instincts and fast decisions for survival, our "Fast" system is used much more frequently and unconsciously in our decision-making process. For this reason, our decisions are subject to heuristics and biases that might lead us away from optimal and rational choices.

After a chain of similar discoveries, behavioral economists started to create frameworks and tools for behavior change to incentivize expected behavior to maximize the decision-makers value or, in the case of a product, the end user's value. These methods gained popularity with the publication of the book "Nudge" by Richard Thaler and Cass Sunstein. The "Nudge" popularized one of the essential concepts for behavior change, called the Choice Architecture, which suggests that consumer behavior patterns are significantly influenced by how choices are designed and presented to individuals. For example, choice architects can use the power of inertia by setting up desired options as default or leverage the often-myopic interpretation of benefits, preferring the short over the long term, providing short-term incentives. In this way, one can nudge the behavior in specific directions while maintaining the individual's sovereignty (freedom of choice).

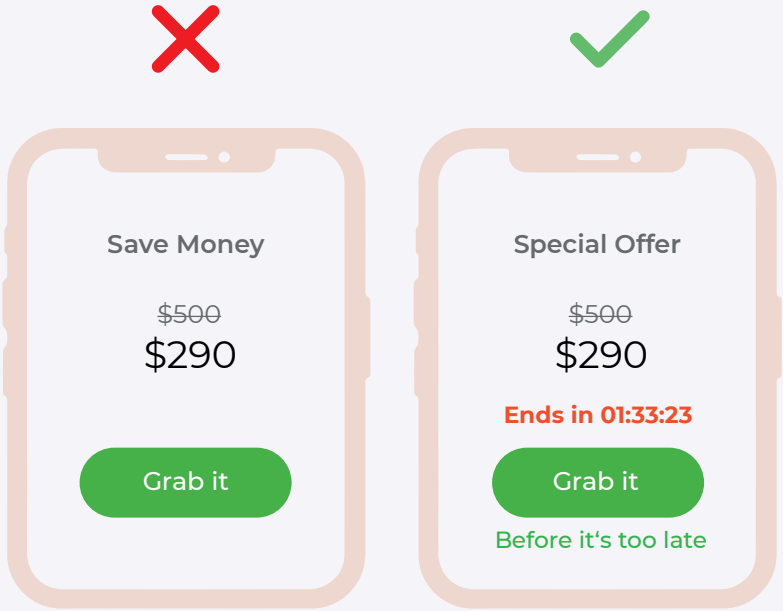


"Nudge" definition: a nudge compromises elements of the choice architecture that can predictably change people's behavior without restricting options or significantly changing the incentives' structure

One prominent example demonstrating the application of behavioral economics tools in practice is given by the famous program Save more tomorrow. Applying the inertia factor from the choice architecture by setting up smart default options produced significant improvement in the desired results of people's saving behavior. Multiple other case studies in many different scenarios produced similar results.

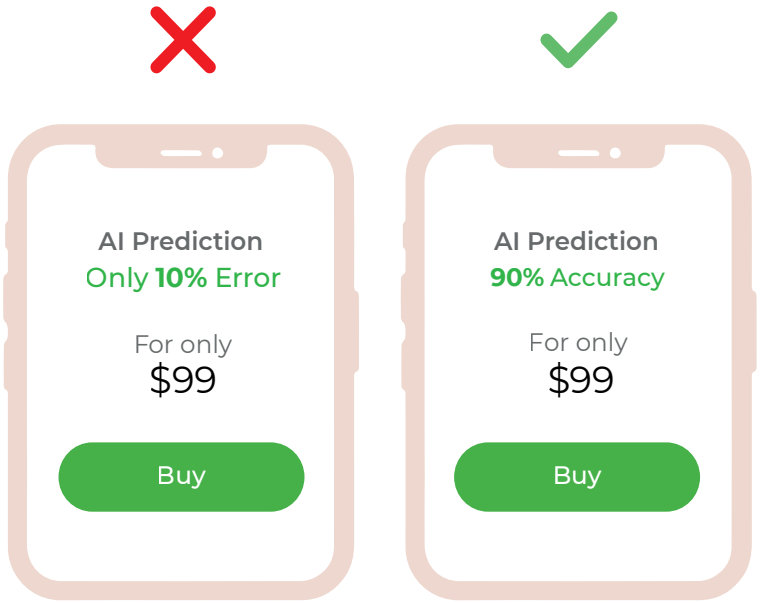
Some of the fundamental Concepts

Behavioral economics offers tools to influence users' decisions in digital territories by implementing purposely designed interfaces, mechanics, and interactive elements. As experts in the field, we have come across many examples in the scientific and business literature, and we mapped some of the most recurring concepts when it comes to practical business applications, described below:



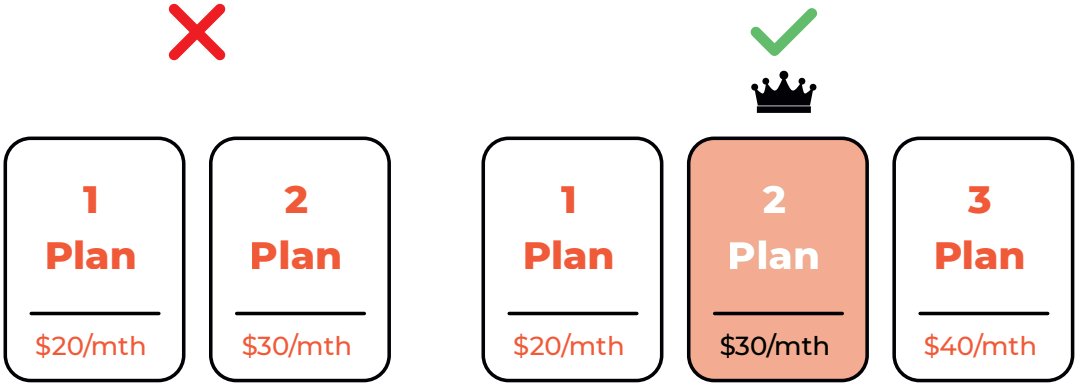
Loss Aversion

Loss aversion: concept associated with the prospect theory framework, in which the core idea is that individuals find the pains associated with losses to be higher (twice as much, on average) and more powerful than the pleasure associated with gains in the same amount. Therefore, people are more willing to take risks to avoid losses than to make equivalent gains.



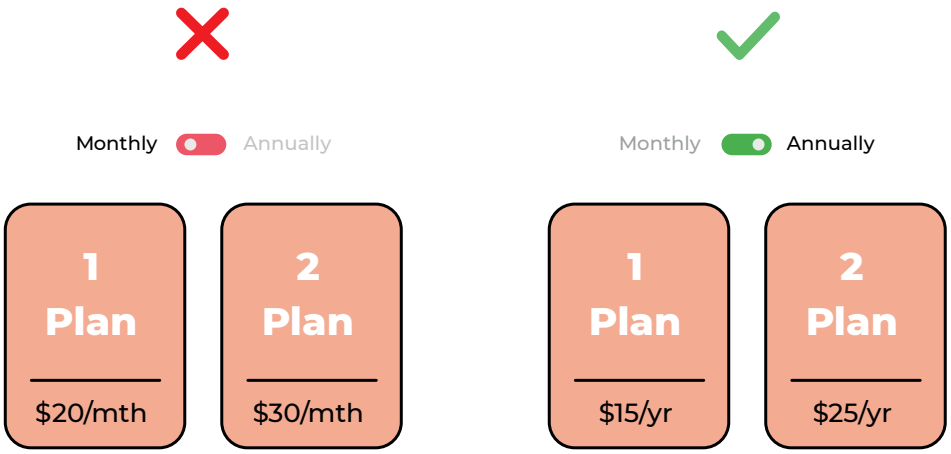
Framing

Framing: a frame is the way choices are formulated and presented. In short, choices can be introduced in ways that highlight different aspects of the same decision. As a prominent example in this paper, the same choice, presented negatively (as a loss) or positively (as a gain), generates considerably different answers from experimental subject groups, even though the expected results from the decisions in question are the same, with only the choice design being different.



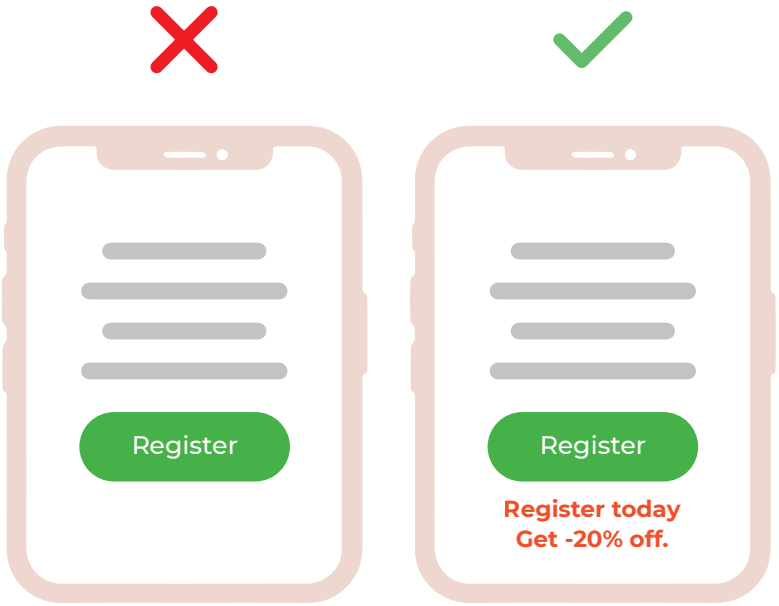
Decoy Effect

Decoy effect: Adding a third less-attractive option in a choice between two possibilities will influence our perception of the original two choices. The decoy effect is defined as an "asymmetrically dominated" choice. They are utterly inferior to the target choice but not entirely inferior to the other competing option.



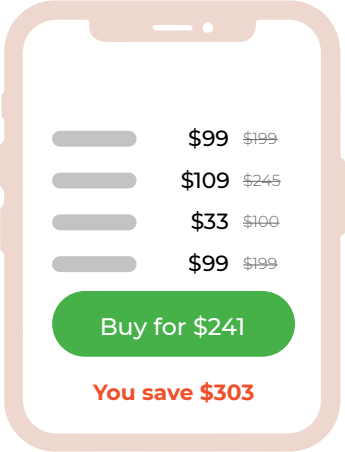
Status Quo Bias

Status quo bias: the tendency for individuals to remain in the status quo. That is, individuals will prefer to stay the same by taking no actions (inertia) or by sticking to a decision, as the disadvantages of leaving the current state seem more significant than the advantages associated with potential changes.



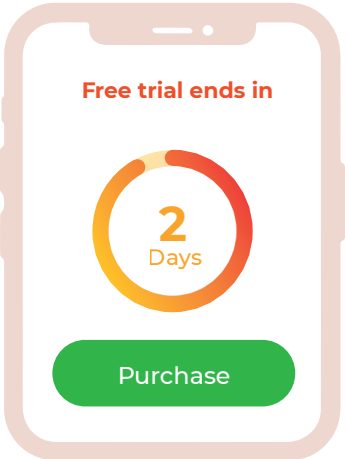
Intertemporal Choice

Intertemporal choice: area of research that includes time as a factor in decision-making situations. In this context, individual valuation of payoffs (rewards) might have different effects at different points in time, presenting an inconsistent behavior when it comes to time and demonstrating stronger preferences for the present or near-present values than in the future. For dealing with such situations, this area introduces time discounting models as alternatives to help capture economic behavior across time.



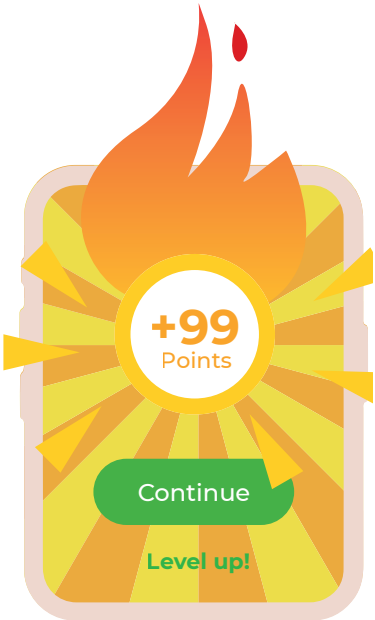
Ancoring

Anchoring and adjustment: the unconscious phenomenon whereby initial exposure to a number serves as a reference point and influences subsequent numerical judgment. Individuals make estimates related to a starting point (anchor) and adjust them according to their conclusion to make it higher or lower than the defined starting point. Exposure to different anchors may produce significantly different responses to the same question.



Endowment effect

Endowment effect: this bias occurs when individuals overvalue something that they own, regardless of its objective market value, which means that they become reluctant to part with an owned good for its cash equivalent or if the amount offered is lower than the value accepted.



Gamification

Gamification: concept characterized as the application of game-design elements and principles in non-game contexts, as a process of enhancing a service with concordances for gameful experiences and supporting the overall user value creation. This concept is often related to motivation, engagement, and habit-forming products and services, especially considering (but not exclusively) the digital domain.

Behavioral economics meets digital business

Now is the time to uncover the connections between behavior and value creation. In a digital environment, the choices and interactions happen through a digital interface, from which businesses can apply various design elements for behavior guidance purposes.

Like in physical spaces, several "nudge" principles can be applied in digital environments. We can think of incentives, understanding mapping, defaults, feedback, error expectancy and forgiveness, and structuring complex choices. With frequent digital decisions, such concepts become ever more present.

Digital nudging uses user interface elements to guide or influence people's choices in digital decision environments. In business activities, consumers typically go through a process of having a series of touchpoints with a company before making a purchase decision. We mostly know this process as the customer journey, which maps the experience of pre-purchases, purchases, and post-purchases. The use of choice architecture elements can be purposely designed to guide people's decisions in the direction of favorable outcomes, not only in each of the steps of the consumer journey but also across the steps in physical and digital environments alike.

The relevance and applicability of behavioral economics mechanisms in natural, public, and private environments is growing in economic research. The commoditization of data combined with the maturing of behavioral economics-related disciplines and powerful computing continuously enhances the ability to measure and shape behavior as never before. The consulting firm EY (2020) mentioned that investment in behavioral economics-based activities grew 146% over the past five years, enabling growth opportunities for business models developed in this segment.

Behavioral economics as a strategy

With the increasing number of digital platforms competing for people's attention, firms seek to differentiate themselves by adding a strategic layer that mixes psychological, behavioral, and design-driven methods on top of their core value propositions. We can think of strategy in this context as an intelligent unification of mainstream economic-grounded strategic frameworks and behavioral economic approaches to biases in human decision-making. In complement to the classic field of strategy discussed until this point, there is also a chain of thought advocating the term behavioral strategy, which considers individual decision biases to design behaviorally informed decision processes from a strategic management perspective.

When creating new business models, let us consider the approach introduced by ILI.DIGITAL — the Pattern of Success. ILI.DIGITAL focuses heavily on the strategic perspective of business model innovation as a value enabler. During the creation of the strategic foundations of digital business models, in addition to the innovation perspective and the core strategic and value elements, the company applies this authorial method for a superior digital business model design. It includes three key elements:

Lock-in experiences: keeping users attracted to the business model, expressed as switching costs or network externalities that keep users from changing to a competitor's offer.

Up-selling / cross-selling: techniques for creating additional revenue streams by in-creasing sales from existing customers or obtaining additional sales from new customers. Up-selling is an improvement or upgrade of the purchase intention for additional costs. Cross-selling means offering additional items to existing customers, increasing the connection between customer and firm, leading to a stronger relationship and higher switching costs.

Add-on services: additional services added to a core offering, which cannot exist standalone.

The collection of behavioral data enhances the pattern of success, so additional offers can be made at appropriate times to accurate customer profiles, increasing the efficiency and profitability of the offers. The combination of the value creation, capture, and delivery foundations, the pattern of success, behavior change, and the measurement mechanisms yield a robust strategic and interconnected framework for designing better digital business models.

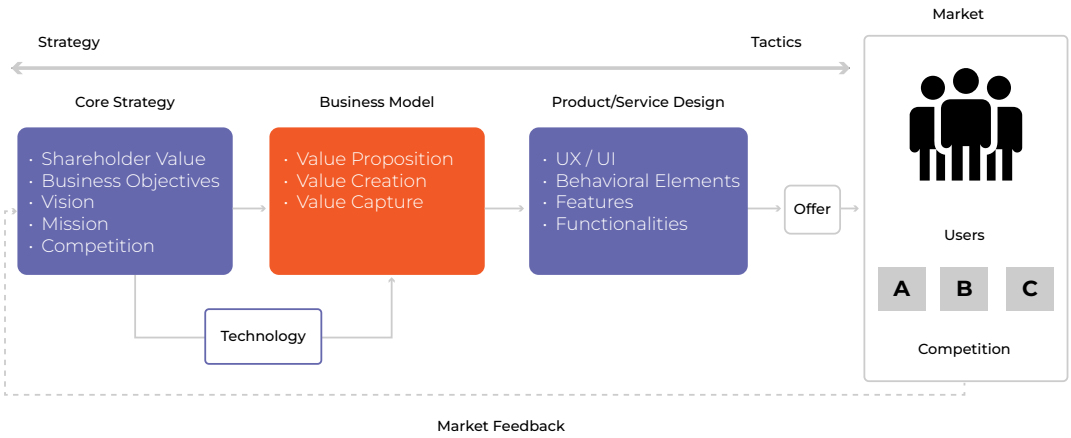
When we think about offering digital products and services, product innovation often comes with the need for behavioral change, creating the necessity for formulating an appropriate behavioral strategy to create sustainable value. Helping users change their behavior positively can directly support the core business. There are two main targets for behavior change: behaviors that users want to change within their daily lives and behaviors that occur within the product. For the second group, the business impact is clear. If a product offers superior performance and is henceforth adopted and recommended by the users, it will create a revenue stream for the company. For behavior change in people's daily lives, when the product objectives align with its business model, there can be the possibility for the following revenue streams. We can measure these effects based on the following dimensions:

Engagement: time spent using the product, subscriptions, recurring fees, and advertisement (also connected with lock-in experiences).

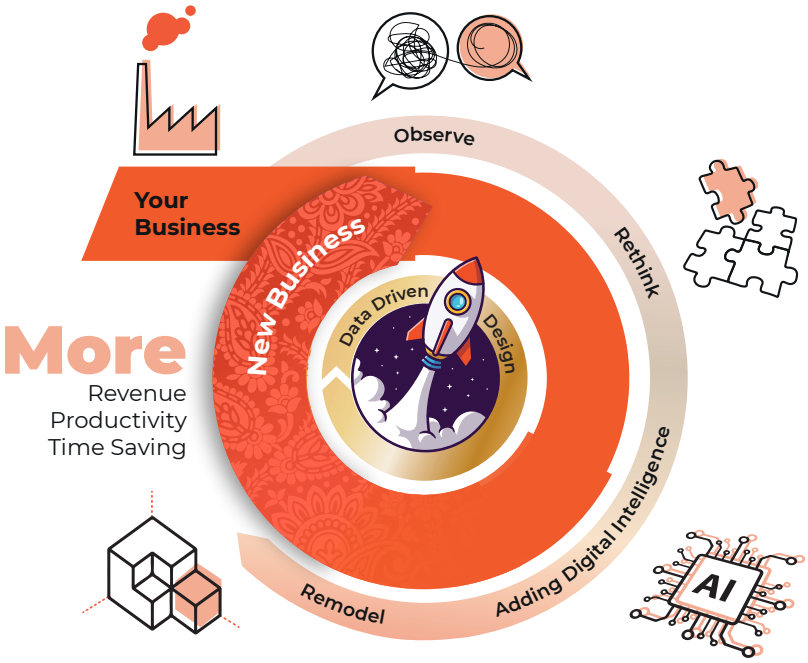
New sales: market penetration, cross-selling / up-selling, and add-on services.

Success in changing behavior: incentive-aligned third-party support (when a third party, an employer, for example, benefits from behavior change and has the power to support such initiatives financially).

Based on the analysis of how strategies are formulated, how business models are designed, and how products and services are idealized, there is a clear connection between behavioral economics and strategic goals. This relationship is illustrated in the following framework:



This value creation chain framework draws insights from how the core strategies are formulated, starting from a higher-level strategic perspective, transitioning to the selection of technologies and design of business models, which reflects the objectives defined during the strategic definitions. When a company has decided how to propose, capture, and deliver value to its clients, it is time to focus on market tactics and to design a compelling offer (differentiation strategy) in the shape of goods or services to generate optimal value by engaging and delivering higher value to its customers than the competition.



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About ILI.DIGITAL

Founded in 2010, ILI.DIGITAL is a company focused on digital business model transformation with expertise in multiple different fields. With 82 employees, ILI.DIGITAL has two offices across two countries (Germany and Pakistan). ILI.DIGITAL's mission is to "make corporates entrepreneurs again", empowering people from the upper management level to rediscover their inner entrepreneur and take the next steps for their company's future.

ILI.DIGITAL focuses on collaborating with customers from the automotive, pharma-, chemistry, and construction sectors as well as the industrial sector. The portfolio of the company's project-based services includes:

- Digital Business Building
- Strategy Consulting
- Project Management
- Marketing
- User/Design Research
- Development
- 3D Development
- Machine Learning
- Data Engineering
- Artificial Intelligence
- E-Learning
- Gamification
- Psychology
- Behavioral Economy
- Customer Experience

The company's multidisciplinary team combines entrepreneurs, business consultants, strategists, project managers, marketers, user researchers, designers, engineers, developers, 3D developers, gamification experts, and psychologists across a diverse spectrum of specializations.

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Team

Serhan Ili (CEO & Founder)
Serhan has a keen sense of opportunities, strong execution skills, and a passion for business. He has the right mindset, which empowers and dynamically pushes the team and projects. He makes success independent of coincidence. By turning physical assets into virtual miracles in the Metaverse, he enables the next generation of business models.

Vinicius Ferraz (COO & Data Scientist)
Vinicius is where technology and behavior meet. He combines both topics and thus has a unique understanding of the two drivers in the Metaverse. As a data enthusiast, his ever-growing data knowledge enables him to rule core Metaverse technologies and predict potential outcomes.

Vera Schott (CMO)
Vera creates strategic concepts for projects and designs virtual business models for a sustainable future. To further exploit the opportunities for the customer's journey in the Metaverse she brings in powerful marketing perspectives. "By combining these two skills, we elevate customer experiences by unleashing the magic power of extended reality."

Omar Abdelkafi (Project manager & Data Scientist)
Omar has a doctorate in artificial intelligence since 2016. With a solid technical background and a very fine knowledge of innovation, he is able to have a deep understanding of digitalization projects. Researcher in the soul and entrepreneur in the spirit, he will take your project to the next level.

Daniel Fuger (Head of Digital Business & UX Design)
Daniel is responsible for concept transfer. He maintains everything in the IT systems and is on the technical side of things. Starting with a lot of UX design experience, he is now part of project management. He can transform ideas and concepts into virtual success stories.

Tim Krodel (Strategy & Extended Technologies)
Tim is with the customer throughout the entire journey of digital business building. He builds strategic concepts for projects and helps turn physical assets into virtual miracles. With his deep understanding of future business models and extended technologies, he is key to bringing a business into the Metaverse.

Federika Ajdini (Project Manager)
Federika uses her background in biological engineering to design innovative concepts in the digital health world. Her past experience in the pharmaceutical industry provides us a deeper understanding of the pain points and helps us identify new opportunities.

CONTACTS

ili.digital

info@ili.digital

+49 721 6190970

Ludwig-Erhard-Allee 20

76131 Karlsruhe

ILI.DIGITAL