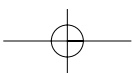
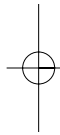
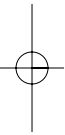


Part I

Proper Subjects that
Preceded Marketing



The Economists

In 1776, the year of the start of the American War of Independence, a Scotsman called Adam Smith published a remarkable book. It was called *An Inquiry into the Nature and Causes of the Wealth of Nations*, and it set out to explain how countries become wealthy. The lengthy title is usually condensed to simply *Wealth of Nations* nowadays, but the ideas within the book are still well-regarded to this day (Smith, 1998 [1776]). Smith's liking for lengthy titles extended into the book itself. It is subdivided into five books, totalling 32 chapters in all, and although each chapter is fairly short, the book is a substantial one which seeks to encompass all aspects of wealth creation.

Smith's work is important because it was the first book to be written about economics: it is interesting because it says a lot about life in the eighteenth century. For instance, Smith uses the example of pin manufacture, explaining the eighteenth-century process in considerable detail in order to show how division of labour increases efficiency. In Chapter Two of Book One, Smith outlines the basis of the marketing concept, as follows:

But man has almost constant occasion for the help of his brethren, and it is in vain for him to expect it from their benevolence only. He will be more likely to prevail if he can interest their self-love in his favour, and show them that it is for their own advantage to do for him what he requires of them. Whoever offers to another a bargain of any kind, proposes to do this. Give me that which I want, and you shall have this which you want, is the meaning of every such offer, and it is in this manner that we obtain from one another the far greater part of those good offices which we stand in need of. It is not from the benevolence of the butcher, the brewer or the baker that we expect our dinner, but from their regard to their own interest.


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The marketing concept essentially says that the route to success is to consider the customer's needs – which is exactly what Adam Smith was telling us 230 years ago. Smith saw self-interested exchange as one of the cornerstones of developing wealth in nations, and for developing the wealth of individuals. This is a concept which certainly has resonances for modern marketers – the idea that marketing delivers a standard of living was widespread in the 1960s and 1970s. Indeed, for many marketers the whole basis of marketing is the management of exchange.

Smith's ideas became the basis for the Classical school of economics (replacing the early Mercantilist and Physiocratic schools). Classical economics took the view that the 'invisible hand' of the marketplace would ultimately result in the greatest good for the greatest number, because each person would ensure his or her own welfare by exchanging with others: provided the exchanges were fair, the end result would be an increase in everyone's wealth. Smith suggested that three basic factors of production (land, labour and capital) could be combined in different ways to create wealth, and that (in the long run, at least) these factors would be combined in the most efficient way possible, since that would be in everybody's best interests. Later economists included the idea that entrepreneurship is also a factor of production: the willingness to risk one's own capital and creative effort in the hope of future rewards is essential if businesses are to start up and to prosper.

Smith also believed that a free marketplace would lead to full employment, and that government intervention in the marketplace (which had been advocated by the Mercantilists) would lead to distortions, thus reducing the efficiency of the market in creating wealth for everyone.

Not surprisingly, these ideas were warmly greeted by merchants and landowners. There has probably never been a time when business people didn't want to get the government off their backs, and following on from the radical intervention of government during the Mercantilist period (when governments applied huge tariffs to anything imported, and offered huge subsidies to anything which could be exported) Smith must have been a hero to the businessmen of his day.

 greed is good

Gordon Gecko, in the film *Wall Street*, famously said ‘The point is, ladies and gentlemen, greed is good. Greed works, greed is right ... and greed, mark my words, will save not only Teldar Paper but the other malfunctioning corporation called the USA.’ Smith could have written those words himself. But how true is this idea?

As is almost always the case with a one-solution argument, the frame of the picture has been drawn too small. Not everybody knows what’s good for them, for example. Some people are poor negotiators. Some exchanges are fraudulent. Some people have more power in the relationship than others – an idea put forward by a later economist, David Ricardo, who pointed out that we don’t have unlimited land, and therefore landowners will experience a steady increase in the value of their land as demand increases (Ricardo, 1992 [1817]). Two hundred years later marketers are still struggling with the concept that exchange is not always fair or good for the consumer – we know that it’s easy to sell people products which are unhealthy, environmentally damaging, or socially unacceptable but are we morally justified in doing so? According to Gordon Gecko (and Adam Smith), there is no problem, because greed is good. In which case we might as well all become drug dealers and pornographers, because that’s where the money is.

Before you rush off to start a new career, it may be worth considering the contributions of later economists. Ricardo has already had a mention for explaining that landowners have more power in the relationship than either capital or labour. Following on from this idea, Thomas Malthus (1992 [1798]) put forward the proposition that rising population would mean that limited resources would quickly be exhausted – population increases geometrically, whereas other resources only increase arithmetically. According to Malthus, we should all have starved to death long ago, which of course has not happened (at least in wealthy countries) because our population has stabilized and in any case our production of food has become much greater than anticipated. The basic principle remains, though, that the planet has only finite

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resources and (whether there are more of us or not) we are consuming those resources at an increasing rate. Malthus may have been replaced by Friends of the Earth, but the Cassandra-like warnings are growing ever louder.

Ricardo and Malthus filled in some of the gaps in Smith's thinking, and (of course) complicated the model quite a lot by adding a moral and ethical dimension. Some marketers (notably Kotler) have put forward the idea that marketers need to be socially responsible, and consider the long-term welfare of the customers. This concept has been expressed as 'societal marketing' – a lovely idea, but one which might be difficult to push through at a board meeting.

The drawbacks of classical economics became painfully clear as the nineteenth century rolled on. Wealth became concentrated in the hands of capitalists and landowners, and wages were screwed down as low as the employers could manage – there was plenty of labour around, but land was no more plentiful than it had been since the Ice Age, and capitalists held the purse-strings and controlled the means of production. This led to the economists having a bit of a re-think. The leading thinker on this issue was, of course, Karl Marx. Marx was a German living in London, and he saw all about him the effects of the *laissez-faire*, Smith-type classical economics. Non-intervention by government had not led, as Smith had thought, to the greatest wealth of the greatest number, but had instead created poverty and misery for the bulk of the population, and fabulous wealth for a few. Marx believed that capitalism would eventually destroy itself, because wealth was created by labour and eventually the starving masses would rise up and overthrow their masters, making private property obsolete in a world where the workers ran things (Marx, 1993 [1867]).

Marxist thinking created the great Communist countries of the twentieth century, and encouraged revolutionaries everywhere to rise up against the capitalists. It would be interesting to find out if Marxism could ever work: it was only ever tried in agricultural economies, never in a modern industrialized state,

so we may never know the answer. I always thought Marx was a brave soul, but with fatally-flawed thinking: he thought he had discovered the laws of history, but in fact there are no laws because people are just making things up as they go along. His belief that labour added value to raw materials did not take account of the idea of a bad workman, for instance – those of us who have been employers know that there are some people whom we should pay to stay at home, because they cause more damage than they are worth if they show up for work. He also ignored a factor which became the fourth element of classical economics: enterprise.

Enterprise is the willingness to take a risk, and it is an essential part of any business activity, especially in start-ups. Being prepared to back a new idea or a new product with hard cash and personal effort is what makes things happen, but this did not figure in Marx's thinking. Sitting in the British Museum Library (which is where he wrote *Das Kapital*, his monumental work on capitalism) he was probably not exactly in the entrepreneurial hotbed of London.

So far most economists had been thinking about wealth and welfare from a somewhat lofty plane – their thinking was about ways to increase the wealth of the country as a whole, and how economic policies could be applied to everything in order to create the right conditions for prosperity. Few of them had considered what happens at the level of the individual person or company. In other words, they had invented macroeconomics before inventing microeconomics. This may seem a little odd in view of the fact that the word 'economics' is derived from a Greek word meaning 'housekeeping'.

Classical economists had theorized that prices are determined by the costs of production. This may have been the case in the eighteenth century, but it is certainly not the case nowadays. The thinking was that suppliers would produce goods as cheaply as they could, then add on a profit margin and offer the products for sale. Most of us tend to think this is still largely the case, and most accountants and engineers use this approach when they calculate

prices, using cost-plus pricing. This self-centred view of the exchange process leaves out half the equation, namely the customers, despite Smith's declaration that 'the customer is king'. What Marginalist economists (represented by Alfred Marshall and Leon Walras) contributed was that prices are also determined by demand.

This may seem obvious now, but was not quite so obvious in the nineteenth century. Alfred Marshall (1997 [1890]) developed a complex mathematical proof for the laws of supply and demand – in order to tell us that if something is too expensive, people won't buy it, but if it is cheap they will buy more of it. Not exactly rocket science, but it is one of the key concepts of microeconomics. The 'pile it high and sell it cheap' school of marketing certainly has its adherents, but (as is always the case with economic, or any other, models) the frame is too small to show the whole picture. Walras, who was an economics professor at the University of Lausanne, felt himself to be on the periphery of economic thought. At the time, most economists were based in the UK, so Walras had to say something pretty profound to get himself noticed. What he actually came out with was a general equilibrium theory, which demonstrated mathematically that economies would naturally find an equilibrium in which the prices of commodities were stable (Walras, 1984 [1874]). In fact, the theory had more holes in it than a string vest, but later economists plugged many of the holes and Walras is now regarded as a major contributor to the field.

Where Marshall and Walras went slightly adrift is by postulating that competing products are identical, and that everyone has perfect knowledge of the marketplace. To put it as kindly as possible, these two assumptions do not easily transfer into the real world. It may be true that mackerel caught by two competing fishermen have little to choose between them, and therefore the fishermen would have to charge more or less the same price, but the same is not true of sausages, cheeses, Bird's Eye ready meals, cars, books, or indeed anything with some kind of manufacturing to add value to it. Marx would have loved the idea of product differentiation – it is proof positive that adding more labour to something increases its value.

The other assumption, perfect knowledge, also does not stand up to close scrutiny. Even if one has perfect knowledge (for example, by using the Internet to make comparisons), this does not translate readily into an ability to do something about it. Knowing that a second-hand Ford Mondeo can be bought for £300 less from a dealer in Sheffield does not help much if one happens to live in Penzance. Equally, knowing that one plumber can fix a burst pipe for £20 less than the plumber who is currently working on the pipe is no help if it is three in the morning and the kitchen is flooded. In practice, of course, perfect knowledge (like the perfect England football team) does not actually exist, however pleasant and intellectually satisfying it might be to discuss the possibility among friends.

Another interesting idea from the Marginalists was that capital, labour and land would each receive their proper reward according to their contribution to the finished product. This is a peculiar proposition, because it seems to imply that there is some kind of automatic process involved – perhaps the invisible hand of the market – and that people are powerless to change it. In practice, of course, people negotiate (or even cheat a bit) in order to increase their personal welfare at the expense of others. The main effect of the Marginalist view of reward is that those who were most successful at grabbing the loot for themselves were able to justify their rapacity with a solid academic argument – hurrah for marginalism. Like Smith before them, the Marginalists were (understandably) the darlings of the ‘haves’ while Marxist economists were beloved by the ‘have nots’.

Being able to put an acceptable face on the concept of greed is understandable, of course. When one’s friends ask what you do for a living, ‘Grind the faces of the poor’ is not the right answer. ‘Generate wealth and jobs for the poor’ sounds a lot better.

— ‘it’s the economy, stupid!’

During the 1992 American Presidential election, Bill Clinton needed reminding that the US economy was going to be a key issue in the campaign. His strategist, James Carville, put up a sign in Clinton’s

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campaign headquarters which said simply, ‘The economy, stupid!’ to remind Clinton to stay focused on economic issues.

Governments love to intervene (or interfere, depending on your viewpoint) in the economy because of the remarkable effect it has on voters. Everybody wants the economy to grow, because growth means more wealth to be divided up: once we have created a bit of wealth, everybody has an interest in how it is divided. Governments throughout the world feel an irrepressible urge to tinker with things, and of course because governments set the taxes and spend such a large proportion of the national wealth on welfare, wars and paperwork, they have a huge impact on the economy of the country anyway.

What the government gets up to may seem to be far removed from what marketers do in their day-to-day lives, except of course where legislation prevents us from advertising in a particular way, or selling a particular category of product. In fact, government policy has far-reaching effects on the business environment in which marketers operate. Policy has often shifted according to the current fashionable ideas among economists: whether the ideas are acceptable or not probably depends largely on the prevailing mood of the country. For example, in the Mercantilist era of economic thought, it was assumed that the wealth of a country could be measured by its ownership of precious metals – gold and silver, predominantly. These metals could either be mined or (for countries without mines) be bought using exported products. Thus countries such as England, having no gold mines, were forced to subsidize exports and apply huge tariffs to imports. (Wales does have gold mines, but these are small and have not added appreciably to the country’s wealth). The main effect of raising tariffs on imports was to add considerably to the level of smuggling: the seventeenth-century equivalent of the booze cruise was a short trip to Brittany to bring back French brandy and wines, landing back at an isolated Cornish cove to hide the booty.

A group of French economists, the Physiocrats, did not accept the Mercantilist view of the economy: they believed that agriculture was the true source of all wealth. This view seems to have

lasted until the present day in France, but in the eighteenth century it was a new idea. The Physiocrats also believed that income and output formed a circular flow, which could only be disrupted by government interference, so they advocated a *laissez-faire* attitude. This model turned out to be somewhat simplistic (surprises all round) and of course was not popular with governments, who naturally believe that it is their job to run things.

Smith rejected the idea that agriculture was the only source of wealth, but he did accept the view that governments should stay clear of trying to run the economy. However, a later Classicist, John Stuart Mill (1998 [1848]), pointed out that a *laissez-faire* attitude might be good for creating wealth, but to ensure its fair distribution governments would need to intervene. Mill's private life was itself a bit *laissez-faire*: he had a strictly intellectual upbringing, with little room for the emotional side of life, but he certainly made up the lost ground later by having a lengthy affair with his co-author (one Mrs Taylor) while she was married to the unfortunate Mr Taylor. When Mr Taylor died in 1851, Mill married Mrs Taylor and they lived as happily ever after as two economists can. Having discovered girls, so to speak, he became an MP and campaigned for votes for women, as well as writing a book on the subjection of women. The result of this was a large number of baby girls called Emily, Emmeline, Millicent and so forth, presumably so that their grateful mothers could shorten their names to Milly (Mrs Pankhurst, the famous suffragette, was christened Emmeline).

For the purposes of studying marketing, though, it is Mill's contribution to economics that is the most relevant. His view was that wealth could be created very well if government kept well clear, but that the wealth would concentrate in the hands of the few if there were no intervention. So government intervention became acceptable again.

Marxists, of course, called for radical intervention: this culminated in the planned economies of Eastern Europe during the twentieth century, and a fairly even distribution of wealth (nobody had anything). So far we have one vote for *laissez-faire* and two for intervention.

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Next up to bat were the Institutionalists. Institutionalist economists regarded individual economic behaviour as part of a wider social pattern, influenced by current ways of living and modes of thought. They advocated government intervention as a way of ensuring fair distribution of income, adding their voice to Mill's argument that limited intervention to distribute wealth is reasonable, provided it does not interfere with the basic mechanism of creating wealth. On paper this looks fine. In practice it is hard to see how, for example, taxing someone who is currently getting a larger than average share of the wealth will not tend to demotivate that individual from producing even more wealth. Not to mention that taxing so-called 'luxury' goods, such as sports cars and helicopters, has a profound effect on Joe Schmuck, who works on the Lamborghini or Robinson production lines.

Eventually the debate was resolved (temporarily, as it turned out) by an accidental experiment. In the 1930s, the Great Depression proved to be a major problem for governments. Smith had theorized that a rise in unemployment would lead to lower wages and prices, which would in turn stimulate the economy and thus lead to a return to full employment. In fact, the reverse happened. Falling wages meant people could not afford to buy anything, so factories closed and unemployment rose still further. Into the resulting confusion stepped John Maynard Keynes, whose seminal text *The General Theory of Employment, Interest and Money* (Keynes, 1960 [1936]) showed that the government needed to inject money into the economy, and increase spending power to get unemployment down. Keynes was literally a larger-than-life figure: he was 6' 6" tall (two metres, for those who have gone metric) and he ran one of the most successful investment funds of the 1930s on behalf of his college, King's College Cambridge. He was certainly not an ivory-tower academic: he advised the British Government at the Versailles Treaty talks, advised on how to pay for the Second World War, and was instrumental in setting up the Bretton-Woods Agreement on international currency exchanges after the war. He died of a heart attack in 1946, aged 62.

Keynes based his thinking on an adapted version of the Physiocrats' model, in which expenditure, consumption, and production formed a circular flow. In Keynes' model, exports represented an input of wealth into the economy and imports represented an outflow. Likewise, government expenditure represented an input, and taxation represented an outflow. At the time, governments worldwide believed that they needed to balance the budget (that is, take in as much tax as they paid out) in order to maintain the value of the currency against the value of gold, which was an international medium of exchange. Keynes theorized that, as governments took more taxation, unemployment would rise and even more tax would have to be raised from the remaining workers and companies in order to fund government. The theory worked out beautifully, with over 15 per cent of the UK workforce unemployed and even more on short-time working, and (at one point) German industry operating at only 25 per cent of capacity.

Sadly, Keynes was a voice in the wilderness until the Second World War forced the government to spend a lot of money and provide jobs. No one (apart from a few crackpots) would want to have a war just to provide jobs, but the Second World War did kick-start the world economy.


One of the drawbacks of Keynes' theories (as he admitted himself) is that injecting a lot of money into the economy does tend to cause inflation in the long run. 'But in the long run, we're all dead', he is famously quoted as saying. In the 1930s and 1940s, the general feeling was that the problems of (a) unemployment and (b) winning the Second World War were rather more urgent: a theoretical argument about inflation hardly registers on someone who is being bombed nightly by the Luftwaffe, no matter how cogent the argument. After the war, though, successive governments became tempted by the easy vote-winner of injecting non-existent money into the economy in order to create consumer booms, and in the mid-1970s inflation really kicked off. Economists were at a loss to explain what was happening. Most industrial countries had

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inflation and high unemployment both at the same time – which is supposed by Keynesians to be impossible.

Again a hero appeared, in the unlikely shape of Milton Friedman. An American, Friedman was the founder of the Chicago School of economics, a group of economists who believe in *laissez-faire*. Friedman (1962 [2002]) advocated (you guessed it) less government interference in the economy, and instead advised governments to control the money supply, allowing it to grow only at the same rate as the economy. Margaret Thatcher in the UK and Ronald Reagan in the USA leaped on this theory, and applied it to their economies, with the result that unemployment tripled – but inflation came down to reasonable levels, and (eventually) employment came back up. Incidentally, in 2005 Friedman also advocated legalizing marijuana – interesting for a guy born in 1912.

What does all this have to do with marketing, you ask? Well, marketers do not operate in a vacuum. They work within an overall business context, and more especially in a national economic context. Whether government is interventionist or not has a profound effect on marketers' ability to sell products and services. The state of the national economy, and the state of the economies of other countries (if one is lucky enough to work for a global organization) affects what consumers do, and consumers (as we know) are the rabbits we are hunting.

 small is beautiful – microeconomics

When I was an undergraduate I had two economics lecturers. One was around six feet tall and taught macroeconomics, the other was five feet four and taught microeconomics. Whether physical attributes influence choice of career is debatable, but I have never forgotten that microeconomics is about small economic behaviour.

Microeconomics contributes a lot to marketing thinking because it is concerned with the behaviour of individuals. It does make some key assumptions, which are debatable at the very least, but it is also a real science with numbers and everything, so we should take it seriously.

One of the first assumptions microeconomists make is that consumers are rational and seek to maximize the utility (or usefulness) they can get from their meagre store of money. There are two schools of thought on the utility issue: Cardinalists believe that utility can be measured, and Ordinalists believe that it can't be measured but that people are able to rank different 'baskets' of product and state which would be preferable.

A second assumption is that money has a constant value. If the marginal utility of money changes, for example because someone becomes richer or poorer, this throws the calculations for utility out of synch and we have no idea where we are. In other words, people who have more money than they can spend usefully tend to be a bit more wasteful, whereas those who have recently become poor might be exceptionally careful about what they buy.

Thirdly, microeconomists assume that the utility of each commodity can be measured. The yardstick for measuring utility is money: how much utility can the consumer obtain for a given amount of money? Utility, though, depends on the individual. What is useful to some people is of no value to others, and (more importantly) the utility of a commodity varies at different times even for the same individual.

The fourth assumption is the diminishing value of utility. As the consumer buys more of the product, the usefulness gained by each new addition is reduced. In other words, if you have no shoes at all, a pair of shoes is really useful, but as you buy more pairs their usefulness decreases until, if you have 200 pairs, the shoes are actually becoming a bit of a liability. This is called the axiom of diminishing marginal utility.

Fifthly, we have to assume that the total utility of a basket of goods depends on the quantities of the individual commodities. That is to say, if you have a bag full of groceries, the total value of the groceries is dependent on how much of each one you have (because, after all, the utility decreases as you have more of something).

A consumer is in equilibrium if the marginal utility of a product is equal to its price, because the consumer will be equally

happy to save the money or buy the product. If the product's marginal utility is greater than the price, the consumer will buy it, and if the product's marginal utility is less than the price the consumer will not buy it. This has a great deal of logical appeal, and is probably what happens most of the time. Put in simple terms, people like a bargain but do not like to be ripped off. If the product is very cheap, in other words if the marginal utility is much greater than the price, the consumer will keep buying more of the product until the marginal utility is reduced to the point where it is equal to the price (say, 50 pairs of shoes).

As a way of thinking about pricing, this has a certain appeal. As we drop the prices, sales will rise, but only up to a point. After a while cutting prices does not work any more because people have more than enough of the product. Also, the model demonstrates that people are not aware of, or influenced by, the costs of manufacture of a product. They are only influenced by how useful it is to them. Demand would therefore show as a curve on a graph – as price reduces, demand rises but not in a straight line. It will rise at first, but then start declining.

Economists also assume that firms have a role in setting prices – which appears to be common sense, but in the long run it is consumers who decide whether or not they are prepared to pay a particular price, and if they are not so prepared, the price must be cut. Economists make some fairly sweeping assumptions about how firms behave towards pricing, just the same. First, they assume that firms act rationally, as if they were composed of a single individual. This ignores the real decision-making in firms, which is based on office politics, career progression, personal gain, and occasionally some rational concern for the welfare of the firm. Secondly, economists assume that the firm seeks to maximize its profits and that this is the only goal. In many cases, companies are founded for all sorts of reasons – the founder had a whizzo idea that he or she thought ought to be done, or the directors like to make decisions and have fun, or whatever. Also, in recent years boards of directors have been much more concerned with maintaining share value rather than with making profits, since this is

actually of more use to shareholders. Thirdly, economists assume that firms are the primary users of factors of production (labour, land, capital and enterprise). They buy these from households, who are assumed to own everything (including the firms themselves).

These assumptions are all somewhat suspect. As a real science, microeconomics has to assume that people are rational, or chaos would be the result, but as anyone who ventures into a city centre on a Saturday night can testify, people sometimes behave irrationally. Economists, of course, are rational, so they tend to have a lot of formulae and deep thinking to do. Secondly, the assumption that utility can be measured objectively is highly unlikely – whether a product is useful or not depends on the individual, the time, the place, and the circumstances. A useless old piece of rope might be thrown out of a garage during a clear-out, but the same piece of rope might be extremely useful as a tow-rope for a broken-down car on a wet night.

Regarding the assumptions economists make about firms, these are also highly suspect. Firms do not act any more rationally than the individuals who work for them. This may be extremely rational, it may be entirely capricious, or it may be somewhere in between. Secondly, many firms do not seek to maximize profits, and there are many organizations which are non-profit-making but which still sell and buy. Thirdly, we have to perform some fairly clever mental gymnastics to account for factor purchases by other organizations (such as the government) which do not produce anything which is sold. We have to start assuming that the government charges taxes for its outputs, and that consumers have choice about paying taxes, for example. There is some truth in this, incidentally: a government which raises taxes beyond the point at which people are prepared to pay finds either that it is voted out of office, or (as the Labour Government of the 1970s found) people simply switch to a cash economy in which they do not declare their true incomes. Even in the early 2000s, many people avoid the high taxes on wines, spirits and tobacco simply by buying these products abroad.

Interestingly, economists do not assume that governments act rationally and consistently. Inter-departmental conflict is often

used to explain theories about government intervention in the economy. Whether this is a reflection on governments or on economists will be left as an exercise for the student.

A great deal of microeconomics is based around the concept of a basket of goods. The theory is that if you confront an individual with two shopping baskets with a different mix of goods in each, but to the same monetary value, the individual would be able to say which basket he or she prefers. Economists assume (for the sake of argument) that the individual in question would always choose the same basket. Also, the assumption is that adding more baskets will still lead to consistency – that if someone prefers Basket A over Basket B, and Basket C over Basket A, then Basket C will be the overall preference (you might want to read that again – I just had to).

This idea of comparing baskets leads us neatly on to the concept of the indifference curve. An indifference curve is the locus of points which yield the same utility. This means that the curve is drawn along a line of points where the individual sees the baskets of goods as being of equal value – he or she is indifferent as to which one to buy, because they are worth the same. In the simplest case, with only two products in the basket, the consumer will be happy to substitute one for another up to a point.

Here's an example. Imagine you are in the pub with some friends, and you send the idiot friend to the bar to buy some beer and sandwiches. Because the bar is busy, you decide to stock up a bit and order some extra beers. You ask your friend to bring three pints of beer and two packs of sandwiches, and your other friend (the greedy one) asks for one pint of beer and four packs of sandwiches. The idiot comes back with two pints for you and three packs of sandwiches, and four pints for your greedy friend and only one pack of sandwiches.

In those circumstances, you might feel indifferent about the mistake: you can take a pack of sandwiches home, and being one pint short isn't exactly going to spoil your day. Equally, your fat friend might accept the situation. Of course, you could always do a swap – if you swap your sandwiches for his beer, you would both be better off because you would now have exactly what you wanted in the first place.

This principle can be extended further, of course. For your greedy friend to be happy with no sandwiches at all, he would have to have a lot more than just one more pint of beer; and for you to be happy with no beer at all, you would have had to have a lot of sandwiches. In those circumstances, an exchange would leave both of you better off in terms of both beer and sandwiches.

This principle was first explained by a gentleman who rejoiced in the name Francis Ysidro Edgeworth. Edgeworth's name came about because his father, while a student, decided to elope with a penniless Catalonian refugee whom he met on the steps of the British Museum while he was supposed to be on his way to Germany. Francis Ysidro was actually born in Ireland, in (wait for it) Edgeworthstown, a place which he eventually inherited. He was a life-long bachelor, despite courting Beatrix Potter, so had no one to leave the town to. What he did leave, however, was a clear model to explain trade (Edgeworth, 1881). It was refined into a box-shaped diagram by Vilfredo Federico Damaso Pareto in 1906 (a busy year for Pareto – he also gave us the 80/20 rule in that year). The Edgeworth Box explains how trade always makes us better off.

This is another of those concepts which is obvious when someone explains it. Trade makes us better off because otherwise people wouldn't do it. The pub landlord wants your money more than he wants the beer – he has plenty of beer, more than he could ever drink by himself, but he needs the money to pay his overheads. You, on the other hand, clearly want the beer more than you want the money, or you wouldn't do the exchange.

Since marketing is largely concerned with managing exchange, Edgeworth and Pareto have made an important contribution to marketing thought. Now we know that we can offer people bundles of benefits (products) and we can vary the bundles to make them more or less attractive to specific people. If the bundle is more attractive than the money, people will buy the product: we can safely assume that, as people get richer, their supply of money approaches the point at which keeping it becomes less attractive than spending it and we can sell them stuff. The more money someone has, the less valuable it seems

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in comparison with bundles of benefits (helicopters, Porsches, and so forth).

Because people make comparisons between different bundles of benefits, and are prepared to accept substitutions, it may be difficult to predict demand. In effect, marketers are competing with every other 'bundle of benefits' for the consumer's hard-earned money. However, we can say with some confidence that the demand curve for most goods rises as prices fall – people are inclined to buy more of something if they can get it cheaper.

In some cases people would have been prepared to pay a lot more for the goods than is actually being asked. In other words, the consumer picked up a bargain. Alfred Marshall (see above) first pointed this out, so it has become known as the Marshallian surplus (Marshall, 1997 [1890]). For marketers, the key to success lies in understanding where the cut-off point lies. In an ideal world, we want consumers to go away feeling they had a bargain, but we want to push the price as high as we can in order to maximize our own profits. To do this, it would help if we knew how price-sensitive consumers were. In other words, what is the slope of the demand curve. If the curve slopes sharply, a large change in price would be needed to make a small change in demand. If the curve slopes gradually, a small change in price would lead to a large change in demand. This is called price elasticity of demand.

The elasticity concept says that some products are hardly price-sensitive at all – salt is the usual example, because it's a very cheap commodity which is not bought very often, so most people wouldn't even know what it costs, let alone spend time shopping around for a bargain. On the other hand, cars seem to be much more price-sensitive: even a relatively small change in price affects demand fairly strongly, at least in the kind of cars I buy. Elasticity depends in part on the existence of close substitutes, so perhaps a price rise for Nissan means that more customers switch to Ford, or vice versa.

Elasticity of demand also applies to income – as income rises, so does demand. An interesting side issue here is the concept of necessity and luxury. A good which is an absolute necessity would, one assumes, have a completely inelastic demand curve.

If you can't survive without it, you'd pay any price for it, would you not? In practice, no such item exists, and in fact some items which are necessary for life (water, for instance) are so cheap we can flush toilets with it. This means that the distinction between luxuries and necessities is an artificial one at best.

Finally, demand may be affected by related products. This is a useful thing to know because sales of one product may be a useful predictor for sales of another product. There was a time when sales of wedding rings was a good predictor for sales of baby clothes, with about a one-year time delay: those days are gone. Sales of cars precede sales of spare parts such as tyres and headlight bulbs, though, and we know that at Christmas sales of turkey and plum pudding precede sales of diet books. Such products are called complements, because their demand curves are complemented by the demand curves for other products. Likewise there are products which are regarded as substitutes: if there is a sharp rise in the cost of potatoes, for example, sales of rice or pasta are likely to rise as people switch to the nearest alternatives. Economists also consider the effect of wealth reduction: if the cost of mortgages rises (due to a rise in interest rates) the remaining cash within the household will be correspondingly less, so the family will have to spend less on other things. This is a familiar situation for most homeowners, which is why most people dream of paying off their mortgages.

Economists also talk about markets, and have a particular view of what constitutes a market. The economists' definition of a market is 'an area over which buyers and sellers negotiate the exchange of a well-defined commodity'. Markets are separated from each other by the type of commodity sold, by natural economic barriers such as transport costs, and by barriers created by governments (for example, high customs duties on some goods). Economists accept that markets are interlinked: all commodities compete for consumers' income (this is the concept of the economic choice), and also that costs of transportation or high customs duties might not separate the markets if the basic cost of the commodity is sufficiently cheaper in one market than

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in another. This kind of thinking is very much in line with marketing thinking – we assume that consumers only have a limited amount of money to spend, and that therefore we are competing with other firms whose products provide similar benefits.

Economists also assert that different markets differ from each other according to the degree of competitiveness shown by the various buyers and sellers involved in the market. Thus they account for a degree of human variation – although most economic theories centre around markets which are large enough that no single buyer or seller has sufficient power to influence price, which is a ridiculous concept since there is almost always one major firm in the market which is able to control what goes on.

Markets can themselves have an overall demand curve, which is affected mainly by macroeconomic factors (see above), such as interest rate rises, unemployment levels, international competition, and so forth. Demand curves can shift sideways – the same shape of curve can be moved by an overall shift in demand due to environmental factors, by sudden increases or decreases in supply, or sudden increases and decreases in demand. Note that economists also have a lot of theories about the supply side of the equation – these are of interest to marketers in terms of our responses to competition, and the possibility of an over-supply which would drive prices down. On the other hand, marketers always seek to differentiate their products from those of the competition, so they tend to regard other products as being an indirect threat.

A final word on markets from economists. They distinguish between a free market (one in which production is in the market sector and is not controlled by government) and a command economy, or centrally-controlled economy, in which all production and consumption is controlled by the central authorities, that is the government. In fact, there has never been a pure example of either type, although the Bolsheviks in Russia during the 1920s came close to having a controlled economy (issuing decrees about prices and forcing people to work in various occupations, and even instituting a slave economy under the doubtful logic of saying

that slavery run by capitalists was exploitation, but slavery under socialism was self-organization by the proletariat. One imagines that the average Russian serf would find it difficult to see the difference – but that's the drawback of being uneducated). For economists, a suitable aggregation of markets is called an economy (for example, the UK economy, the European economy). Whether an economy is a command economy or a free-market economy is only a question of degree – the former Communist countries, which were theoretically command economies, had considerable scope for free enterprise, and the so-called free-market economies of Western Europe actually have a substantial proportion of government-owned enterprises within their borders.

So where are we with the microeconomists? Have they helped us understand people any better? In some ways they have. Provided consumers are rational, thoughtful beings who go about their consumption activities in a logical and ordered fashion, the economists can explain what they do and why they do it. Provided the models consider simple cases (one or two consumers, a few product categories, some shopping baskets and a stopwatch and most microeconomists are as happy as sandboys), they hold up fairly well to scrutiny. But what happens when people are influenced by the wicked marketers, or by their friends, or by the influence of alcohol? How do they cope then?

For these explanations we need to look at the contribution made by behavioural scientists. This is the basis of the next chapter. Meanwhile, perhaps we should consider whether economics is a real science or not. Does it have boundaries? Does it have a clear core subject which it is intended to investigate? Does it carry out investigations which other researchers can duplicate? Does it seek to discover rules which can be universally applied? Does it deal with the abstract rather than with the concrete? I think the answers to these questions are mainly Yes, which (at least by my definition) makes economics a real science. As an underpinning for marketing thought, economics makes a very good beginning – it does not come anywhere near to explaining the whole picture, however.

