

# PRICING ON PURPOSE

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CREATING AND CAPTURING VALUE

RONALD J. BAKER



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## PRAISE FOR *PRICING ON PURPOSE*

“Once again Ron Baker has delivered logical and well supported arguments to build a compelling case for the benefits of a strategic and value-focused approach to pricing products and services. At NewLevel Group, we practice what Ron Baker preaches, and our firm as well as our clients are better off because of it.”

—John Heymann, CEO, NewLevel Group, Napa, California,  
[www.newlevelgroup.com](http://www.newlevelgroup.com)

“*Pricing on Purpose* is an essential—not to mention great—read for anyone who wants to take their business to the next level. To enjoy what you do, be valued by your customers, and be rewarded for it. What a concept!”

—Jayme Schneider, Chief Value Officer, Easdown & Partners,  
Wagga Wagga, Australia

“In this extremely well researched and entertaining book, Ron Baker provides a compelling argument to abandon the traditional cost-plus pricing method for a formula that better fits the 21st Century business.

He combines his 20+ years of pricing research with proven economic theories, and sprinkles it with historical references and fun anecdotes. *Pricing on Purpose* teaches how to create value for the customer and how to price to capture that value. I recommend this guide to all business leaders who dare to think outside the box.”

—Niquette Kelcher, Editor, SmartPros Ltd., [www.smartpros.com](http://www.smartpros.com)

“Despite finding it hard to agree with Ron Baker on some points I have to say I am a huge fan of his work. In *Pricing on Purpose* he has, once again, given us a fascinating book that is extraordinarily well researched and cogently argued. It’s too bad that more people aren’t following Ron Baker’s lead in seriously challenging some of the cherished and entrenched beliefs that define contemporary business models and drive decision-making—especially in service firms. No matter what business you’re in, pricing decisions are unquestionably amongst the most important you’ll make in driving its success. With that in mind, this entertaining and provocative book is essential reading.”

—Ric Payne, Chairman, Principa, [www.principa.net](http://www.principa.net)

*“Pricing on Purpose* is a practical ‘hands-on’ discussion about pricing in the marketplace and what the ‘value proposition’ means to the customer. Ron Baker has very skillfully woven theory and practical examples throughout this “must read” book and examines the art of pricing as one of the core competencies required for business as they grapple with an ever changing marketplace. Ron focuses on business looking out rather than looking in, of asking the right questions of the customer by putting price where it belongs—at the forefront of business development and success. It is a fascinating book full of challenging examples of modern price theory and practice.”

—*Peter Byers, Chartered Accountant, Byers & Co Ltd, New Zealand*

“What a great read for business owners everywhere. Ron Baker is truly a pricing expert. He first breaks the traditional mold of pricing and flows right into how to do it better. Business executives with an open mind will absorb every word and will find new ways to create more value for their businesses. The concept of putting someone in charge of the value of your business is revolutionary.”

—*Mark J. Koziel, Director of Media Planning,  
Joe Slade White & Company, Inc., East Aurora, New York*

“This is a must-read book. It is extremely well reasoned and has a solid business approach to leading organizations and changing their culture from cost-plus pricing, which is totally inefficient compared to the new business model of value pricing offered. If the reader just read the quotes and examples they would remind the reader of the basic and successful business models. But much more, the book is a true insight into what will make businesses great and profitable. The key point? Value is in the eye of the beholder and not in the eye of the seller. Efforts and costs do not equal value. Ron Baker has nailed it. If leaders pay attention and change their business model and culture, they will survive and prosper. If they do not, they will die.”

—*William Cobb, Cobb Consulting, Houston, Texas*

“Ron Baker has written one of the best primers on pricing I have ever read. By exploring and clearly explaining the economic theory behind pricing, combined with leading-edge pricing strategies from businesses in a wide-range of industries, *Pricing on Purpose* is an entertaining, informative, and refreshing look at one of the most important functions in any business: creating and capturing value. It is rich with real life examples of where strategic pricing led to a quantum leap in perceived value and profitability.”

—*Sheila Kessler, Ph.D., President, Competitive Edge and author,  
Measuring and Managing Customer Satisfaction, [www.CompetitiveEdge.com](http://www.CompetitiveEdge.com)*

“Like a master cartographer, Ron Baker charts a new course for today’s businesses to explore their pricing strategies and uncover the true value of their products and services.

*Pricing on Purpose* provides a compelling call to action to all of us in customer service businesses to re-examine our pricing practices and demand that the focus be on output and results, not internal costs and the mere doing of things. As a representative of the advertising agency business, I am appreciative of the brilliant insights this book provides and look forward to sharing it all with colleagues and clients as we attempt to break out of the antiquated cost-plus pricing model that has so dominated our industry for much too long.”

—Steven Koskela, CPA, Chief Financial Officer,  
Ground Zero Advertising, Inc., Los Angeles, CA

“You don’t need to be a cost accountant to appreciate Ron Baker’s newest book, *Pricing on Purpose*. All leaders who feel shackled to commodity and cost-plus pricing will profit both personally and professionally from Baker’s sage advice.”

—Matthew W. Homann, President and Chief Thinking Officer,  
LexThink, Inc., [www.nonbillablehour.com](http://www.nonbillablehour.com)

“Ron Baker’s pricing theories have resonated with me since I first read and heard him in 2000. His messages—true wisdom—expand and improve, literally, by the day. Resistance to value pricing usually begins with “well, how do I...?” and, in *Pricing on Purpose*, Ron gives excellent direction through the implementation process as well as the rationale behind it. I heartily applaud Ron’s artful dissemination of value pricing messages—he’s a worthy teacher.”

—Michelle Golden, President & CEO, Golden Marketing Inc.,  
St. Louis, Missouri, [www.goldenmarketinginc.com](http://www.goldenmarketinginc.com)

“Pricing is such a core function of any business yet it is overlooked at our peril. We set up structures that allow us to operate inside of our competencies and we seek to control our business so fully that we restrict its capacity to thrive. Pricing is a key competency not understood by so many of us in business. It requires the focus of the mind of the pricer to be outside of the organization and actively seeking to understand the behavior of the customer. The power of this action should not be ignored simply because it cannot be controlled. In *Pricing on Purpose*, Ron Baker has given us an almanac for better understanding and capturing the value we create. It is an invaluable and entertaining read, and a significant contribution for organizations interested in better understanding the economics of creating and capturing value.”

—Brendon Harrex, Chief Value Officer,  
Ward Wilson Business Advisors, Gore, New Zealand



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To my Mother, Florence Baker,  
for her enduring love and inspiration.

*The composition of this book has been for the author a long struggle of escape, and so must the reading of it be for most readers if the author's assault upon them is to be successful—a struggle of escape from habitual modes of thought and expression. The ideas which are here expressed so laboriously are extremely simple and should be obvious. The difficulty lies, not in the new ideas, but in escaping from the old ones, which ramify, for those brought up as most of us have been, into every corner of our minds.*

—John Maynard Keynes, *General Theory of Employment, Interest, and Money*, 1937

*Perhaps the sentiments contained in the following pages are not yet sufficiently fashionable to procure them general favour; a long habit of not thinking a thing wrong, gives it a superficial appearance of being right, and raises at first a formidable outcry in defence of custom. But tumult soon subsides. Time makes more converts than reason.*

—Thomas Paine, *Common Sense*,  
February 14, 1776

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# FOREWORD

When Ron Baker attended our *Strategy and Tactics of Pricing* class at the University of Chicago five years ago, it was an opportunity to finally put a face to an author, consultant, and practitioner in the art and science of pricing for professional services. With his new book, *Pricing on Purpose*, Ron has expanded his focus to include pricing of both business and consumer products and services. This is clearly his best book.

His quotes and stories show both the depth and breadth of his research for this effort. He seamlessly blends the works of others to create a well-written piece on the history of price, including some of the initial theories on how they evolved and how today's pricing manager should apply those works. He has approached pricing as an accountant, an economist, but most of all as a practitioner. It is about time that the field of pricing has moved beyond the mechanical field of finance to the realm of the marketer in a customer-focused world.

Too many times, authors present models that are allegedly all encompassing in their ability to solve a wide range of business problems. Ron hasn't done that. He admits that he doesn't have all the answers to today's business problems. As such, the book presents the many conflicts in the wide range of theories in pricing. Fortunately, that struggle is in itself a useful exercise since it is only through our study of history that we develop an understanding of the true complexity in any area of thought.

Ron has woven a delicate fabric of old and new perspective that adds much depth to the current writings in pricing. And, he has done that with a well-turned and informational phrase, drawing on many personal anecdotes to illustrate his points. His extensive research on current businesses lends further depth and credibility to his work.

His discussion of price-led costing turns the traditional focus on cost-led pricing completely around by showing that the latter is internally focused and lacks any real-world, customer-driven orientation. This is a perspective that leading product strategy specialists have been trying to get in place for several years. In pricing, it is quite revolutionary, yet critically important if the traditional approaches of costing are going to be relegated to their proper places in the history of management theory

*Pricing on Purpose* is one of the first books to move beyond the rhetoric of value, providing concrete examples of value in both a consumer and business context. Further, it provides the logic for the needed shift from cost-based pricing to value-based pricing. In doing so, Ron focuses in great depth on the customer experience in defining the nature and the value of the relationship.

The book contains a number of discussions around classic theories in pricing such as yield management, cost-based pricing, customer segmentation, and anti-trust legislation just to mention a few. Further, Ron has tested a number of “classic assumptions” and, drawing from his wide experience in a number of fields, has presented problems with many of those models and a far richer and more productive way to approach them. His premise that “bad customers often drive out good ones (Baker’s Law)” is a classic that totally changes the way managers think about customer churn. This is a constant theme throughout the book, to offer alternative perspective to current “rules of thumb” and provide a richer understanding of the true issues in pricing.

The chapter on antitrust law presents a complicated range of works and opinions in a simple yet complete manner. It is quite useful to practitioners who are often limited in their ability to adopt more current approaches to price discrimination (a good thing!) by in-house law practices that fail to reflect current antitrust thinking. This chapter provides us with a rich discussion of the evolution and history of antitrust laws as well as many stories and applications in today’s world.

The final discussion around the Chief Value Officer (CVO) provides a look at how leading-edge professional services organizations are “throwing cost-plus pricing on the trash heap” and moving toward a better understanding of what their customers really value and putting someone in charge of that so it is integrated effectively into the pricing, marketing, and sales practices of the firm. He provides a manifesto for the evolution of the pricing

committee to the “pricing cartel” in the firm, with extensive lists of objectives and primary activities for success. Finally, Ron has recognized the criticality of the right personal attitude for managers to be successful in the topsy-turvy world of pricing.

As a fellow pigmy who has “stood on the shoulders of giants,” I recommend this book as a fine example of how an author can extend the field of both strategic and tactical pricing. Enjoy!

Reed Holden

Holden Advisors, [www.holdenadvisors.com](http://www.holdenadvisors.com)

Concord, MA

He is the author of *The Strategy and Tactics of Pricing*,  
Third Edition.





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## PREFACE

*Two roads diverged in a yellow wood,  
And sorry I could not travel both  
And be one traveler, long I stood  
And looked down one as far as I could  
To where it bent in the undergrowth;*

*Then took the other, as just as fair,  
And having perhaps the better claim,  
Because it was grassy and wanted wear;  
Though as for that the passing there  
Had worn them really about the same,*

*And both that morning equally lay  
In leaves no step had trodden back.  
Oh, I kept the first for another day!  
Yet knowing how way leads on to way,  
I doubted if I should ever come back.*

*I shall be telling this with a sigh  
Somewhere ages and ages hence:  
Two roads diverged in a wood, and I—  
I took the one less traveled by,  
And that has made all the difference.*

—Robert Frost, “The Road Not Taken,” 1916

With the passage of time comes reflection and hindsight. As a young college freshman, I was faced with two very divergent roads, one leading to the study of economics and the other accounting, with the goal of eventually becoming a Certified Public Accountant. The road not traveled represents the

opportunity cost of the choices we make. I chose the CPA road, which led me down a very popular and secure path to a decent career rich with opportunities and a respectable standard of living.

Not only would these two roads lead to entirely different career paths, but they impose radically dissimilar visions of the way the world works on the traveler. Historian Will Durant once wrote, “Education is a progressive discovery of our own ignorance,” a statement I have learned to be profound upon reflecting on these two different paths. The well-traveled road offers only sights already seen; rarely does it lead us to new discoveries.

You may be wondering how this metaphor applies to a book about pricing, yet that is the point. The accounting road took me down the *cost accountant’s* view of the world, while the road not taken—that of the economist—is one of *value*, the ultimate determinate of price in any transaction. I used to believe that the two roads were not mutually exclusive—perhaps you could keep one foot on each path as you made your way into the business world to make executive level decisions. I was naïve. The cost accountant’s view of the world is pervasive, calcifying into the arteries of executives at all levels, affecting how they view the world and price their products.

We are ruled by our theories, whether we admit it or not, and a good theory produces what one economist has called an OIC moment (Oh, I see!). The moment of insight arrived for me when I learned the significance of the Marginalist Revolution of 1871 and the Subjective Theory of Value. Finally, I had a better understanding of how prices coordinate economic activity, and how value—subjectively determined by the customer—ultimately affects the prices we are willing to pay for the myriad goods and services offered in the world economy. Indeed, there is nothing more practical than a good theory, and the book you are about to read contains the theories proven to have explanatory and predictive power to explain much—although certainly not all—human behavior.

One of my mentors is Peter Drucker,\* who insists on asking before he publishes any book, “Why this book, now?” It is a good question to ask one-

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\*Sadly, Peter Drucker passed away on November 11, 2005, at age 95, just as this book was going to print. Unfortunately, there was not enough time to change the many citations to Mr. Drucker throughout the book to reflect this news. His passing, however, is not the beginning of the end, but the end of the beginning, since he has left a rich legacy—through his many books, articles, and teaching—that will be relevant for posterity. It is too bad the Nobel Prize is not given posthumously, since he certainly deserved one. R.I.P.

self before setting out to write a book on pricing and value, where much has already been written. I feel the same way about the topic as T.S. Eliot felt about Shakespeare, namely, that it is hopeless to try to say anything original about it; the best you can hope for is to be wrong about it in a new way.

That said, the objective of this book is to share what one very enthusiastic student of price theory has learned after taking the arduous journey of crossing over to the beginning of the road not originally taken in his youth, and finding the way to a new understanding of the way the world works. The hardest part of learning something new is unlearning so much of what one already thinks one knows. In a very important sense, this book is my *mea culpa* for my prior ignorance related to my worldview.

Unfortunately, price theory is ignored by too many in business today, as if there was nothing to learn from an academic discipline that has been positing and testing theories on this topic for centuries. Yet the economics profession has the intellectual high ground when it comes to value and price, with much wisdom to offer the willing student. It is truly tragic that these economic ideas are not better explored in business schools and MBA curriculums, since a lot of confused and muddled thinking could be avoided. For the most part, the cost accountant's view of the business world is mainstream, while the economist's remains heretical. This needs to change, and perhaps this book can begin to start a shift—however slight—in this direction, making what is unorthodox today conventional wisdom tomorrow.

It is my fervent hope that you enjoy the road of price theory we are about to travel together, providing insights into human behavior, some of which may be new and exciting for you. Sometimes you have to go a long way out of the way to come a short way correctly. If I can shorten your path by sharing my learning, this book will have accomplished its purpose.

Ronald J. Baker  
Petaluma, California  
July 29, 2005



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## ACKNOWLEDGMENTS

*What has been is what will be,  
and what has been done is what will be done;  
and there is nothing new under the sun.  
Is there a thing of which it is said,  
“See, this is new”?  
It has been already,  
In the ages before us.*

—Preacher in Ecclesiastes 1:9–10

A book is purely the product of intellectual capital, and is represented in the tangible form known as structural capital. What the reader does not see is the human and social capital without which this book would not exist. Richard Burton described in *The Anatomy of Melancholy* (second edition, 1624), “Pigmies placed on the shoulders of giants see more than the giants themselves.” I have stood on the shoulders of some true giants, and although it would be impossible to thank them all, the prominent ones deserve special mention.

So many of my views of the way the world works have been influenced by economists to whom I feel I owe a special debt of gratitude. Milton and Rose Friedman gave me my first introduction to serious economic ideas and I would like to thank them for making complex issues understandable to the masses. It is a very good thing the actuarial examinations are so difficult and that Milton Friedman chose his next best alternative and became an economist instead. Their son, David Friedman, an outstanding economist in his own right, taught me much through his textbooks and general economics books, not to mention through the lectures I have been privileged to attend. Like his mother and father, he provides incredible insight into human behavior.

Another economist who has taught me more than I could ever repay is Steven Landsburg, through his text and general books and his *Everyday Economics* articles in *Slate* ([www.slate.com](http://www.slate.com)). Landsburg is an incredibly brilliant and innovative thinker; and in unison with a gifted and engaging writing style, he makes one *want* to study the dismal science in greater depth. I had the great good fortune of meeting him in October 2000 at Cato University in Montreal, Canada, where he added even more to my intellectual capital.

A truly special debt is owed to George Gilder, who was my first serious introduction to supply-side economics and the primary importance of the role of the entrepreneur in creating growth, dynamism, and wealth in an economy. It is nearly impossible to classify George Gilder since he writes and speaks on a wide range of topics, from sociology and poverty, to feminism and the telecosm. He is truly an eclectic thinker, and is one of the best writers of his time. He taught me the moral case for capitalism, and I believe he will go down as the Adam Smith of the twentieth and twenty-first centuries.

Michael Novak, who presently holds the George Frederick Jewett Chair in Religion, Philosophy, and Public Policy at the American Enterprise Institute, along with Gilder, makes the moral case for business and capitalism from a religious perspective; he introduced me to the encyclicals of the late Pope, which also affirms the morality of capitalism while at the same time recognizing that any system devised by humans is destined to fall short of the Kingdom of God.

Many other economists have shaped my thinking on human behavior and, especially, the theories of value and price: Martin Anderson, Dominick T. Armentano, Robert J. Barro, Bruce Bartlett, Robert Bartley, Gary S. Becker, Mark Blaug, Warren Brookes, James M. Buchanan, Ronald H. Coase, Hernando DeSoto, Nicholas Eberstadt, Robert H. Frank, James Gwartney, Friedrich A. Hayek, Henry Hazlitt, David R. Henderson, Paul Heyne, Richard S. Howey, John Kay, Arthur Laffer, Dwight R. Lee, Steven Levitt, Deirdre N. McCloskey, Ludwig von Mises, Robert Mundell, Charles Murray, James Payne, Virginia Postrel, Leonard Read, Paul Craig Roberts, Murray N. Rothbard, Paul Seabright, Julian Simon, Mark Skousen, Thomas Sowell, George J. Stigler, Richard L. Stroup, Jude Wanniski, Jonathan B. Wight, and Walter Williams, among innumerable others, all of whom have served as absent educators through their works.

Peter Drucker is one of the only true management consultants who has consistently contributed real insight and wisdom to a profession constantly

enamored with the latest fad of the month. In one way or another, everyone who writes on business issues stands on his shoulders. Not only has he originated most of the management theories other so-called gurus now take credit for—and coined terms such as *knowledge worker*, *privatization*, and others—but he did it long before many of them were born. His legacy is large, and will endure for the ages. I believe he deserves a Nobel Prize.

Thomas T. Nagle and Reed Holden are two heroic individuals. As the authors of *The Strategy and Tactics of Pricing: A Guide to Profitable Decision Making* (now in its third edition), they have put pricing on the map—and the organizational charts—in companies around the world. It is impossible to improve on perfection, which is why I hope they forgive me for borrowing generously from their work. I owe them full credit for the graphical depiction in Chapter 9 that proves price determines costs, and not the other way around. Also, I owe them for the five Cs of value, the ten factors of price sensitivity, the seven segmentation strategies, and many other lessons I have learned from their books, public speeches, and their course at the University of Chicago Graduate School of Business, *Pricing: Strategy and Tactics*, which I attended in April 2001. They both are mentors and pioneers in the pricing movement, and I only hope to have a fraction of the impact they have had on companies and industries around the world. Under no circumstances should the reader condemn the prophets for the ineptitude and errors of the disciple.

Thank you, Eric Mitchell, president of the Professional Pricing Society, for giving me the opportunities to speak at your excellent conferences and to meet other pricing leaders, and for creating a forum where people responsible for pricing can exchange intellectual capital and further pricing skills in order for it to become a core competency in more organizations.

The Talmud says, “I have learned much from my teachers, more from my colleagues, and most of all from my students.” It is my good fortune that my students are also my colleagues, and indeed they have taught me more than I could ever requite. The word *colleague* comes from the Latin *colligare*, “to bind together,” and that certainly describes the relationships I have developed throughout the years with many professionals. Thank you to the tens of thousands of professionals around the world who have listened to me rant and rave about the deleterious effects of cost-plus pricing, but more importantly, for implementing the ideas I have proffered. I have learned from your failures and even more from your successes, and there is no greater pleasure than watching your colleagues do better for their customers—and in turn, themselves—than even they thought was possible.

An enormous debt is owed to John Dunleavy, Kurtis Docken, Laura Ritter, and the rest of the team at the California CPA Education Foundation. They continuously take risks by letting us teach new and unproven courses in my home state, and have gone above and beyond expectations in support of my work.

Sheila Kessler continues to provide me with wisdom, insight, inspiration, and knowledge I could not live long enough to learn on my own. I have said it many times, and in many places: Sheila is a remarkable woman whom I deeply respect and admire for her accomplishments. I am proud to call her a colleague.

To Ron Crone, Paul Dunn, Ed Kless, Michael McCulloch, Bill Mees, Ed Miller, Shirley Nakawatase, Paul Dunn, and Ric Payne, colleagues who engage me professionally and—since your friends are an extension of yourself—whose friendships I am blessed with every day.

To my fellow VeraSage Institute founders, fellows, and associates I owe enormous gratitude for furthering the quest of burying the billable hour and timesheets in professional service firms around the world. Your vision, leadership, and commitment to bettering the professions provides me with sustenance and inspiration on a daily basis, and words cannot express what each of you means to me: Scott Abbott, Justin Barnett, Michelle Golden, Daryl Golemb, Brendon Harrex (the world's first CVO!), Paul Kennedy, Mark Koziel, and Yan Zhu—thank you all.

Peter Byers, founder of VeraSage Institute New Zealand, is a wise man, kind soul, and dear friend. I only hope I am as open-minded and willing to constantly learn, and challenge my views of the world as you continue to do—it is truly heartening.

P.G. Wodehouse once spoke of an author who told all about how and why he wrote his book when a simple apology would have been sufficient, a sentiment I am fairly confident my British Trusted Advisor, Chartered Accountant, VeraSage Institute UK founder, quasi-Marxist—and perhaps most merciless—Creator and Web master of [www.ronbakersucks.com](http://www.ronbakersucks.com), Paul O'Byrne, would agree with. Your Monty Python sense of humor and wit is outrageous—always going for the jugular, never the jocular—your guidance and advice invaluable, and your friendship priceless—even *subjectively*. Thanks for who you are, all you have done, and continue to do.

Dan Morris, founder of VeraSage Institute USA, and fellow Cognitor and educator, has been a constant source of inspiration. Conversing with Dan is like stepping into a batting cage of ideas, and the result is frequently an even



better idea—usually from *him*. He constantly thinks outside the box—sometimes Pandora’s. I admire his passion, skill, talent, and commitment to bettering the businesses he serves. Most of all, I am grateful for our friendship.

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Another forensics coach, indefatigable supporter, and companion—who also happens to be my brother—Ken Baker deserves special thanks. He always says he cannot possibly live through another one of my books, but he came through again. I am sure he is tempted to say what Groucho Marx did upon publication: “From the moment I picked this book up until the moment I put it down, I could not stop laughing. Some day I hope to read it.”

To my mother, Florence Baker, who taught me patience, understanding, and tolerance, and to whom this book is dedicated as a small token of appreciation for everything she has done for me. To my late grandmother, Angelina Maria Zimmerman, thank you, Granny, for always believing in me, being the center of the family, and always showing your pride in your grandson. I only hope I continue to earn it.

My father, Sam Baker, who taught me the spirit of service and enterprise from the inside of a barber’s chair, and was my first introduction to an entrepreneur, although I did not know it at the time. He has spent many absorbing hours with me recounting the days of the “British Invasion” of the late 1960s and the impact it had on his chosen profession, barbering. His embrace of hairstyling, chemical services, retail, continuing education, and the unisex salon, long before they became commonplace in his profession, truly inspire me to continuously challenge the conventional wisdom of the majority. His experience is a history I treasure, both for the lessons it teaches and the pride it gives me. Goethe wrote, “*Was du ererbt von deinen Vätern hast, / Erwirb es, um es zu besitzen,*” which translated reads, “What you have inherited from your father, you must earn in order to possess.” I hope I have earned his legacy.



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## ABOUT THE AUTHOR

Ronald J. Baker started his career in 1984 with KPMG's Private Business Advisory Services in San Francisco. Today, he is the founder of VeraSage Institute, a think tank dedicated to educating businesspeople around the world.

As a frequent speaker, writer, and educator, his work takes him around the world. He has been an instructor with the California CPA Education Foundation since 1995 and has authored ten courses for them: *How to Build a Successful Practice with Total Quality Service*; *The Shift From Hourly Billing to Value Pricing*; *Value Pricing Graduate Seminar*; *You Are What You Charge For: Success in Today's Emerging Experience Economy* (with Daniel Morris); *Alternatives to the Federal Income Tax*; *Trashing the Timesheet: A Declaration of Independence*; *Everyday Economics*; *The Firm of the Future*; *Everyday Ethics: Doing Well by Doing Good*; and *The New Business Equation for Industry Executives*.

He is the author of the best-selling marketing book ever written specifically for professional service firms, *Professional's Guide to Value Pricing* (seventh edition), published by CCH, Incorporated. He also wrote *Burying the Billable Hour*, *Trashing the Timesheet*, and *You Are Your Customer List*, published by the Association of Chartered Certified Accountants in the United Kingdom. His prior book, *The Firm of the Future: A Guide for Accountants, Lawyers, and Other Professional Services*, co-authored with Paul Dunn, was published in April 2003 by John Wiley & Sons, Inc.

Ron has toured the world, spreading his value-pricing message to over 70,000 businesspeople. He has been appointed to the American Institute of Certified Public Accountant's Group of One Hundred, a think tank of leaders to address the future of the profession, named on *Accounting Today's* 2001, 2002, 2003, 2004, and 2005 Top 100 Most Influential People in the

profession, and received the 2003 Award for Instructor Excellence from the California CPA Education Foundation.

He graduated in 1984 from San Francisco State University with a Bachelor of Science in accounting and a minor in economics. He is a graduate of Disney University and Cato University. He is a member of the Professional Pricing Society and presently resides in Petaluma, California.

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# 1

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## WHY IS MOVIE THEATER POPCORN SO EXPENSIVE?

*...[M]en are fond of paradoxes, and of appearing to understand what surpasses the comprehension of ordinary people...*

—Adam Smith [1723–1790]

Why don't we observe movie popcorn price wars, similar to what other industries engage in from time to time? When asked this question, the overwhelming majority of businesspeople will answer, because there is no competition—the movie theater has a captive audience. Other common explanations include:

- Limited selling time
- High fixed cost of operating concession stand
- It is how the theater owner makes a profit
- Higher clean-up costs imposed by snack eaters
- Tastes and smells better than you can make at home
- Part of the experience of seeing a movie
- Because people will pay for it

At first glance, all of these answers appear reasonable, except to an economist. The most popular response—captive audience—leads to the question of why there are no pay toilets in the theater? You are certainly a captive audience in that regard, but perhaps theater owners understand that if they installed pay toilets they would lose at the box office what they made from the bathrooms. The high fixed costs, in terms of scarce square footage, equipment, fixtures, clean-up costs, and required employees, is certainly a

plausible reason, but does not really account for the large premium price of popcorn. To say it is where the theater owners make their profits is definitely true, but begs the question of why they do not make the profits from ticket sales and sell more popcorn at closer to cost? Eating popcorn is certainly part of the experience of going to the movies, and people will pay for it, yet this explanation is still incomplete.

Assuming theater owners want to maximize their profits, what do the theater owners know the rest of us, perhaps, do not? The consummate economist Steven Landsburg provides the answer:

I believe he knows this: *some moviegoers like popcorn more than others*. Cheap popcorn attracts popcorn lovers and makes them willing to pay a high price at the door. But to take advantage of that willingness, the owner must raise ticket prices so high that he drives away those who come only to see the movie. If there are enough nonsnackers, the strategy of cheap popcorn can backfire.

The purpose of expensive popcorn is not to extract a lot of money from customers. *That* purpose would be better served by cheap popcorn and expensive movie tickets. Instead, the purpose of expensive popcorn is to extract *different* sums from *different* customers. Popcorn lovers, who have more fun at the movies, pay more for their additional pleasure (Landsburg, 1993: 159).

This answer is more precise, since the important point is that “some moviegoers like popcorn more than others,” and the theater owner cannot separate these customers when they are outside queuing up for the movie. A method was needed to separate the snack eaters from those who just want to watch the movie, which the concession stand provides since it allows customers to divide and self-identify themselves. This may seem a subtle point, but it is highly profitable, since segmenting different types of customers allows the theater owners to charge them varying prices depending on the value received.

Students, children, and people with large families are usually more price sensitive, and not likely candidates to spend money on snacks. The theater owner does not want to turn these customers away, and hence keeps the box office price lower by charging higher prices to snack eaters. What you are really buying when you purchase a movie ticket is an opportunity set—a chance to enjoy the movie, or to enjoy it with popcorn. Economists call this a *two-part tariff*, defined as a pricing strategy in which the customer must

pay a fee in exchange for the right to purchase the product. Examples abound of this strategy: country clubs charging membership fees and monthly dues; Gillette charging for the razor then the blades; amusement parks charging an entrance price followed by a price for each ride.

Some people recoil at the thought of *price discrimination*—charging different prices to different customers—claiming the practice is blatantly unfair and should be illegal. But what would happen if the practice were outlawed? Theater owners, airlines, restaurants, and myriad other businesses would have to increase prices for the very customers who are least able to afford a higher price—children, students, large families, senior citizens, and so on. By engaging in price discrimination, businesses are actually increasing social welfare and making more products and services available to the poorest members of society. This is not to imply that price discrimination is based on race, gender, religion, or ethnicity, but rather is based on ability and willingness to pay. As this book will prove throughout, this practice is ubiquitous in any economy, and most price theorists agree it has a salutary effect on societal welfare.

If you found this answer for why movie theater popcorn is so expensive thought provoking, welcome to price theory. The German poet Goethe thought double-entry bookkeeping “among the loveliest inventions of the human mind.” One should say the same about price theory, as it truly is “one of the great products of the human mind,” as economist Donald (now Deirdre) McCloskey explains in his textbook, *The Applied Theory of Price*:

The theory of price is one among the larger intellectual achievements of the nineteenth century, such as the theory of heat engines, the decipherment of hieroglyphics, the professionalization of history, the invention of abstract algebras, and the theory of evolution. Price theory explains much human behavior (McCloskey, 1985: 1, 4).

Since price theory offers tremendous insight into human behavior, it is worth the time and effort to study it in greater depth. It is sometimes said that economics is nothing but refined common sense, which is certainly true. Yet many myths about this crown jewel of the social sciences persist, even among businesspeople.

This is one of the most glaring weaknesses in most business books and management ideas: They are all practice with no theory. Most do little else than propound platitudes and compose common sense into endless checklists and seven-step programs. Yet, all learning begins with theory. There is noth-

ing as sterile as a fact not illuminated by a theory; we may as well read the telephone book. This may explain why four out of five business books are never read to completion.

The schism between management theory and economics is profound, and one of the reasons is that the study of management theory is relatively young compared to its older sibling economics, which dates back hundreds of years. In their piercing book *The Witch Doctors: What Management Gurus Are Saying and Why It Matters*, John Micklethwait and Adrian Wooldridge, two staff editors for *The Economist*, level this charge against the immature discipline of management theory:

Management theory, according to the case against it, has four defects: it is constitutionally incapable of self-criticism; its terminology usually confuses rather than educates; it rarely rises above basic common sense; and it is faddish and bedeviled by contradictions that would not be allowed in more rigorous disciplines. The implication of all four charges is that management gurus are con artists, the witch doctors of our age, playing on business people's anxieties in order to sell snake oil. The gurus, many of whom have sprung suspiciously from the "great university of life" rather than any orthodox academic discipline, exist largely because people let them get away with it. Modern management theory is no more reliable than tribal medicine. Witch doctors, after all, often got it right—by luck, by instinct, or by trial and error (Micklethwait and Wooldridge, 1996: 12).

I have tried to avoid these four defects by having the theories presented herein drive the ideas, not the other way around.

Therefore, the book you are about to read is more theoretical than you may be used to if you are a regular reader of business books, or attend business seminars. I make no apologies for this, for as the great mathematician David Hilbert wrote, "There is nothing more useful than a good mathematical theory," and the same is true with respect to economics and the study of human behavior. Price theory will be utilized throughout as the overarching model to gain better insight into value and price.

All theories are subject to falsification, precisely how all science progresses. This is an interesting phenomenon, because it implies that most new theories—and especially management fads of the month—have to be wrong or irrelevant, or else knowledge would proceed at lightning speed and advance by Newtonian or Einsteinian leaps every day. It does not. This makes it difficult for editors and publishers to admit most of what they pub-



lish is trivial, or just plain incorrect. In reality, knowledge progresses slowly, in a never-ending iterative process best characterized as *knowledge creep*.

## MY COVENANT WITH YOU

In an attempt to contribute to your own knowledge creep, my goal is to have you think *with* me, not *like* me. You should be skeptical about the ideas presented and subject them to your own rigorous analysis and experience. Do not accept anything at face value, even from a so-called expert, for as Harry Truman said, “An expert is someone who doesn’t want to learn anything new, because then he wouldn’t be an expert.” I have been studying price theory for nearly two decades and I still consider myself a student and my knowledge incomplete with regard to this fascinating body of knowledge.

In that spirit, I have tried to follow the wisdom of an inspiring little book by John Milton Gregory, *The Seven Laws of Teaching*, first published in 1884, which sets forth the seven pillars necessary in order to educate effectively, and this shall act as my covenant with the reader:

1. A *teacher* must be one who *knows* the lesson or truth or art to be taught.
2. A *learner* is one who *attends* with interest to the lesson.
3. The *language* used as a *medium* between the teacher and learner must be *common* to both.
4. The *lesson* to be mastered must be explicable in the terms of truth already known by the learner—the *unknown* must be explained by means of the *known*.
5. *Teaching* is *arousing* and *using* the *pupil’s mind* to grasp the desired thought or to master the desired art.
6. *Learning* is *thinking* into one’s own *understanding* a new idea or truth or working into *habit* a new art or skill.
7. The *test* and *proof* of teaching done, the finishing and fastening process, must be a *reviewing*, *rethinking*, *reknowing*, *reproducing*, and *applying* of the material that has been taught, the knowledge and ideas and arts that have been communicated (Gregory, 1995: 18–19).

That said, the objective is to have the theories, concepts, and ideas presented become part of your—and your business’s—intellectual capital.

Gregory tells the story of a boy, “having expressed surprise at the shape of the earth when he was shown a globe.” The boy was asked, “Did you not learn that in school?” To which the boy replied, “Yes, I learned it, but I never knew it” (ibid.: 88).

Utilizing price theory, we can gain a better understanding of why human beings behave the way they do, especially—but by no means only—in a business context. The great economist Alfred Marshall, responsible for much of modern economics, defined the discipline as “a study of man’s actions in the ordinary business of life; it inquires how he gets his income and how he uses it.” Let us continue this study by asking what is conceivably the most fundamental question any businessperson has to answer.

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# 2

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## WHY ARE WE IN BUSINESS?

*Business must be run at a profit, else it will die. But when anyone tries to run a business solely for profit . . . then also the business must die, for it no longer has a reason for existence.*

—Henry Ford [1863–1947]

*Why are we here? I think many people assume, wrongly, that a company exists solely to make money. We have to go deeper and find the real reasons for our being. As we investigate this, we inevitably come to the conclusion that a group of people get together and exist as an institution that we call a company so that they are able to accomplish something collectively that they could not accomplish separately—they make a contribution to society, a phrase which sounds trite but is fundamental.*

—David Packard [1912–1996]

*There is only one boss: the customer. And he can fire everybody in the company, from the chairman on down, simply by spending his money somewhere else.*

—Sam Walton [1918–1992]

*There is never a good sale for Neiman-Marcus unless it's a good buy for the customer.*

—Herbert Marcus, advice to his son Stanley Marcus, circa 1926

All of these entrepreneurs built businesses that still exist by focusing on the customer, not profits. Put simply, profit is merely the oxygen for the body; it is not the point of life. Profit is nothing more than a *lagging indicator* of what is in the hearts or minds of your customers.

Peter Drucker, the most profound management thinker in history, has indefatigably pointed out that “there is only one valid definition of business purpose: to create a customer” (Flaherty, 1999: 131). This is known as the *marketing concept*. The purpose of any organization—from a governmental agency or nonprofit foundation, to a corporation or a church—exists to create results *outside* of itself. The result of a school is an educated student, as is a cured patient for a hospital, or a saved soul for a church. A business exists to create wealth for its customers.

The only things that exist inside of a business are costs, activities, efforts, problems, mediocrity, friction, politics, and crises. In fact, Peter Drucker wrote, “One of the biggest mistakes I have made during my career was coining the term *profit center*, around 1945. I am thoroughly ashamed of it now, because inside a business there are no profit centers, just cost centers” (Drucker, 2002: 49, 84). The only profit center is a customer’s check that does not bounce. Customers are indifferent to the internal workings of your company in terms of costs, desired profit levels, and efforts. Value is only created when you have produced something the customer voluntarily, and willingly, pays for. What makes the marketing concept so breathtakingly brilliant is that the focus is always on the *outside* of the organization. It does not look inside and ask, “What do we want and need?” but rather it looks outside to the customer and asks, “What do you desire and value?”

In fact, what is routinely called “capitalism” is more accurately described as “consumerism,” wherein the customer is sovereign—those with the gold rule. While the marketing concept has existed for decades, it is regularly ignored because businesses routinely lose sight of the fact that the sole reason they exist is to serve customers outside of their four walls.

A company exists to serve real flesh-and-blood people, not some mass of demographics known as “the market.” As Stanley Marcus (the son of one of the founders of Neiman-Marcus) used to love to point out, no market ever purchased anything in one of his stores, but a lot of customers came in and bought things and made him a rich man. In the final analysis, a business does not exist to be efficient, control costs, perform cost accounting, or give people fancy titles and power over the lives of others. It exists to create results and wealth *outside* of itself. This profound lesson must not be forgotten.

Unfortunately, in many instances, this lesson has never been learned. The conventional wisdom in business is to buy low and sell high and measure the bottom line by the historical profit-and-loss statement, which any first-year accounting student can manipulate. Our 500-year-old accounting model is

utterly inadequate at relating internal costs to external wealth created, and simply ignores the wealth-producing capacity of an organization. This is why we see market valuations many multiples of book value. Fra Luca Pacioli, who introduced the world to double-entry bookkeeping in 1494, may have been wrong—debits don't equal credits, and the gap represents the wealth-creating potential of an enterprise. Our accounting model completely ignores human capital, by treating it as an expense, even though the Nobel Prize-winning economist Gary Becker estimates human capital is responsible for approximately three-fourths of the wealth in any country.

Rather than maximizing shareholder value, leaders should focus on the wealth-creating capacity of their organizations, which is, ultimately, the leading indicator for optimizing shareholder value. As Jack Welch pointed out, “One thing we’ve discovered with certainty is that anything we do that makes the customer more successful inevitably results in a financial return for us” (quoted in Khalsa, 1999: 25).

Another reason we lose sight of the truth that businesses exist to create wealth is that the language of business is drawn largely from war and sports analogies. In sports, a competition is usually zero-sum; meaning one competitor wins, and the other loses. This is not at all relevant in a business setting. Just because your competitors flourish does not mean you lose. There is room for both FedEx and UPS, Airbus and Boeing, Pepsi and Coke, Ford and General Motors, and while their sparring might be mistaken as some war, as John Kay points out “not in Pepsi’s wildest fantasies does it imagine that the conflict will end in the second burning of Atlanta [Coca-Cola’s head office]” (quoted in Koch, 2001: 73). When Coca-Cola changed their recipe to New Coke, company spokesman Carlton Curtis stated, “You’re talking about having some guts—and doing something that few managements would have the guts to do.” If you find it amusing that grown men talk about *guts* and *recipes* in the same sentence, then it should be obvious that business has nothing to do with war.

Business is not about annihilating your competition; it is about adding more value to your customers. War destroys, commerce builds. Both sides to a transaction must profit or it would not take place, a point made as far back as the 1700s by Adam Smith. Marketplaces are conversations, derived from the Greek marketplace, the *agora*. It is where buyers and sellers meet to discuss their wares, share visions of the future, where supply and demand intersect at the equilibrium point with a handshake. It is as far removed from war as capitalism is from communism, and perhaps this war analogy, too, needs to be tossed onto the ash heap of history.

## YOU REAP WHAT YOU SOW— THE FOUR Ps OF MARKETING

*...[S]elling concerns itself with the tricks and techniques of getting people to exchange their cash for your product. It is not concerned with the values that the exchange is all about. And it does not, as marketing invariably does, view the entire business process as consisting of a tightly integrated effort to discover, create, arouse, and satisfy customer needs.*

—Theodore Levitt, *Marketing Myopia*, 1975

Shawn Fleming was a 19-year-old college dropout who in 1999 created Napster. In the first three months of 2001, 2.5 billion files a month were being downloaded, validating the economist's theory of demand, which states that the lower the price, the larger the quantity demanded, especially a zero price. Nevertheless, from the music industry's perspective, when you have millions of potential customers breaking the law, you do not have a crime wave, you have a *marketing* problem.

The point is not to argue the highly contentious legal issues of copyright and private property law, particularly as it relates to digitally downloaded music files. The more precise point is the lack of understanding of value by the music company executives. By keeping their focus on the inside of their companies, they completely ignored the external value potential of easily obtaining music files. It took Steve Jobs of Apple Computer to capitalize on this opportunity with iTunes—which at the time of this writing has a 70 percent market share on the legal downloadable music market—in an eerily analogous manner in which he capitalized on the personal computer opportunity invented at Xerox's Palo Alto Research Center, validating Mark Twain's line, "History doesn't repeat itself—but it does rhyme." Had the music company executives been focused on the outside of their companies—studying, analyzing, and innovating what their customers found valuable—they could have invested many millions into productive research and development rather than throwing away that sum down the judicial sinkhole. Yet the Napster saga is just one in a long history of revolutions taking place outside the confines of an existing industry, in what the Austrian economist Joseph Schumpeter labeled "creative destruction." The reason entire indus-

tries can be brought down is because competitors offer more value to the customer than the status quo.

In their course *Pricing: Strategy and Tactics* at the University of Chicago Graduate School of Business, Thomas Nagle and Reed Holden taught the four Ps of marketing using the farming analogy. This is a powerful analogy because it treats the four Ps as an interdependent system whose components have to work together in order to achieve the maximum result. Take *product*—your offering to the customer. Not only does this encompass the tangible product but also the service, experience, and transformational aspects of what the customer receives as well. In the farming analogy, product is the seed, crop, and planting process.

*Promotion* is an integral part of marketing. Whereas selling focuses on the needs of the seller, promotion concentrates on the needs—and desires—of the customer. Procter & Gamble spends around \$5 billion annually on advertising, approximately the same amount as Amazon.com's gross revenue. Promotion expenditures are becoming more sophisticated in their informational content, and how they target various segments of customers with the aid of technology. In the farming system, promotion is the equivalent of fertilizing the soil and watering the crop.

*Place* is not where the company headquarters is located, but rather which type of customer the company is targeting—your market niche. No company can be everything to everyone, and specialization has become more important in order to segment various customers in order to custom tailor a value proposition to suit their needs. Place in the farm analogy is the land where you plant and grow your crop.

Last, but by no means least, is *price*, perhaps the most complex of the four Ps. Because value is subjective—and solely determined by the customer—pricing is an *art*, never a science. In the past, pricing has been largely determined on a cost-plus basis, once again focusing on the *internal* costs and activities rather than the *external* value and results created. Such pricing policies are relying on a silent fifth P of marketing—*prayer*—by hoping internal costs plus desired profit has a direct correlation to value for the customer, an improbable reality, as we shall see.

In the farming analogy, your price is the harvest, when you reap what you sow. While there are many ways for money to flow out of a company, price is the only way you have to generate revenue by *capturing* the value from what you create. In the past 20 years, companies have begun to gain a deeper

understanding of this discipline, recognizing it as a separate body of knowledge and skill set. The Pricing Institute was founded in 1987, later Eric Mitchell formed the Professional Pricing Society in Atlanta, and Fordham University has created the Pricing Center, all done in an effort to disseminate intellectual capital with respect to the pricing function.

Industries—from airline, hotel, rental car, and retail businesses, to manufacturing, sports teams, and software—have invested enormous resources and intellectual capital in developing revenue management models and dynamic pricing software. For instance, a new automated pricing system at National Car Rental Systems in Bloomington, Minnesota, can make up to 40,000 price changes *per day*, and is credited with adding \$56 million in profitability the first year it was put into service. Sabre, developed by American Airlines, has the capacity to reprice every six minutes and is credited with adding 15 percent to revenues. Alcoa Aluminum achieved a 5 percent revenue increase due to its pricing program.

Compared to the other three Ps, price transmits the most important signal to the customer—what the company believes the product is actually worth. This message, in effect, is louder than any advertising and promotion, because it creates the ultimate acoustics in the marketplace. Pricing is a strategic function, which needs to be aligned with the other three Ps in order to create a viable value proposition for the customer. Yet most company executives will spend more time and resources on the other components of marketing, neglecting the importance of the pricing function.

They do so at their peril. Two studies, one performed by McKinsey & Company and the other by A.T. Kearny, both consulting firms, demonstrated that a 1 percent improvement in the following areas resulted in net income increasing as shown in Exhibit 2.1.

**EXHIBIT 2.1 Pricing Function and the Net Income Effect**

	McKinsey	AT Kearny
Reducing fixed costs	2.7%	1.5%
Increasing volume	3.7%	2.5%
Reducing variable costs	7.3%	4.6%
Increase price	11%	7.1%

Source: Marn et al, 2004: 82; Docters, et al., 2004: 6–7.



Depending on the industry, the net income effect can be even greater. Of course, this is a double-edged sword, because a 1 percent deterioration in any of these categories will cause net income to decrease by the same amount.

It is time for the pricing function to get a promotion, and for companies to begin to Price on Purpose—that is, pricing in order to capture the value created for the customer.

## YOU ARE WHAT YOU CHARGE

*Ultimately, a business is defined by that for which it collects revenue, and it collects revenue only for that which it decides to charge.*

—Joseph Pine II and James H. Gilmore, *The Experience Economy: Work Is Theatre and Every Business a Stage*, 1999

Let us revisit the Xerox saga again with an important question: Why did Xerox fail to capitalize on the innovations its Palo Alto Research Center developed? This included the computer technology that eventually led to the Apple computer, and launched the personal computer revolution. But Xerox did not see the opportunity right in front of it. In *Dealers of Lightning*, Michael Hiltzik offers this hypothesis for the failure:

In the copier business Xerox got paid by the page; each page got counted by a clicker. In the electronic office of the future, there was no clicker—there was no annuity. How would one get paid? The hegemony of the pennies-per-page business model was so absolute that it blinded Xerox to an Aladdin's cave of other possibilities (quoted in Hamel, 2000: 112).

A business is what it charges for. More precisely, a business is the value it creates. Ultimately, it must offer a value proposition a customer is willing to pay for. Xerox's pricing paradigm prevented it from seeking new and emerging opportunities in the marketplace, the same myopia that blinded the music industry to Napster. This shortsightedness is certainly not an uncommon phenomenon, because an organization's existing pricing paradigm can blind it to seeing more effective ways of creating and capturing value.

During 1815–1835, England's postal revenue was flat, even though the economy grew considerably during this period. The average price of mail-

ing a letter was 12 cents, and it was priced according to weight, enclosures, origin, and destination, with each letter requiring individual inspection. Paradoxically, payment was due at time of receipt from the addressee, not origin from the addresser, and if the letter was rejected no payment was earned.

In 1840, Rowland Hill, an unknown British schoolmaster in England, proposed a radical idea to change the way letters were priced. He suggested a price of one penny for a half-ounce letter, along with a prepayment system utilizing an adhesive postage stamp, to be paid by the addresser. This suggestion was met with virulent opposition from the postal authorities, who claimed it was “preposterous,” and a “wild and visionary scheme.” It took several years for the idea to be tested before its merits were convincing. From 1838 to 1863 the annual mail volume in England increased from 76 million to 642 million letters, and the revolutionary pricing method spread to other countries.

One could argue that a similar revolution has been occurring in the business world for the past 30 or 40 years. Some enlightened companies are finally beginning to realize how antiquated the cost-plus pricing method is, especially as the developed economies transition from an industrial to an intellectual capital economy. This transition is causing a tectonic shift in how wealth is created, how people work, who owns the means of production, and how organizations will need to be structured and led in the future in order to capture the opportunities in a knowledge economy. Let us now survey some of these profound changes as we march into economies dominated by mind, not matter.

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# 3

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## MIND OVER MATTER

*Because economies are governed by thoughts, they reflect not the laws of matter but the laws of mind. One crucial law of mind is that belief precedes knowledge. New knowledge does not come without a leap of hypothesis, a projection by the intuitive sense. The logic of creativity is “leap before you look.” You cannot fully see anything new from an old place.... It is the leap, not the look, that generates the crucial information; the leap through time and space, beyond the swarm of observable fact, that opens up the vista of discovery.*

—George Gilder, *Wealth and Poverty*, 1993

In 1974, then 19-year-old Bill Gates and 21-year-old Paul Allen founded a company called Traf-O-Data to read computer cards from machines monitoring traffic flow for local municipalities. In its first year, the company that was ultimately to become Microsoft generated \$20,000 in revenues and had three employees. Presently, depending on the day, Microsoft’s market capitalization ranks higher than all but nine nations’ gross national products (Spain ranks just above it), with 57,000 employees in 100 countries and annual revenues of \$36.8 billion as of June 30, 2004.

How did Microsoft, in a little more than one generation, exceed the value—in terms of market capitalization—of behemoths such as General Motors, Ford, Boeing, Sears, Lockheed, Kellogg’s, Safeway, Marriott (including Ritz-Carlton), Kodak, Caterpillar, Deere, USX, Weyerhaeuser, Union Pacific, and others—again, depending on the day of analysis—*combined*? It leveraged intellectual capital (IC), the chief source of all wealth.

Yet our understanding of the role IC plays in generating wealth is not well understood, or accurately measured for that matter. Generally accepted accounting principles (GAAP) do a horrendous job of valuing IC, because most of the cost of creating IC is treated as a period expense for GAAP. This

explains how Microsoft's GAAP assets, as reported on its balance sheet, account for less than 10 percent of its market capitalization. I am not making an argument here for better measurements, a subject we will return to in the next book in the *Intellectual Capitalism Series*. The fact of the matter is—and this causes major cognitive dissonance among businesspeople—the most important things in life cannot be measured. We do not necessarily need better *measurements*, we need better *understanding*.

Today, *intellectual capital* is sometimes thought of as nothing more than another “buzzword.” However, IC is not about the “new economy.” IC has always been the chief driver of wealth, as economists have argued since the term *human capital* was first mentioned in 1961. Wealth does not reside in tangible assets, or money; it resides in the IC that exists in the human spirit, and since this is so hard to measure (how does one measure the ambition of Steve Jobs to “change the world”), we tend to ignore it until it becomes so obvious—as in the case of Microsoft—that we have to recognize our old theories of wealth creation are no longer relevant.

Ideas have consequences, but ideas are everywhere. It is knowledge that is rare, and it is those with the right knowledge that are able to generate enormous wealth by taking the risks necessary to capitalize on it, from Bill Gates and Paul Allen, to Andrew Carnegie, Thomas Edison, and Walt Disney. Even Adam Smith's famous pin factory contained the idea of *division of labor*, an enormous wealth-generating idea, followed by ideas such as scientific management and the assembly line, the latter certainly capitalized on by Henry Ford.

## THE PHYSICAL FALLACY

For centuries, economists have been explaining the “physical fallacy”—that is, the belief that wealth resides in tangible things, such as gold, land, raw materials, and so forth—and it seems as if we still do not understand this basic economic concept. We seem to think that *matter* is more important than *minds*, while in fact it is the exact opposite. Taiwan, Hong Kong, and Singapore have no “natural resources” and yet they all have a higher standard of living than Russia and Indonesia, both rich in natural resources.

From a corporate perspective, a revealing episode in the early career of Walt Disney illustrates the physical fallacy on a human scale:

Back in the 1920s, when Disney first emerged as a cartoonist, his early successes led him to found a studio and to employ other artists to draw the thousands of pictures required for animated cartoon movies. Disney Studios was particularly successful with an early cartoon character called Oswald Rabbit, whose copyright was held by a movie distributor rather than by Disney. This distributor decided to eliminate the need to pay Disney by hiring away his cartoonists and both producing and marketing the product. From the standpoint of the physical fallacy, Disney was superfluous. He neither drew the cartoons nor transported the films to theaters nor showed them to the public. The distributor, with the Disney staff and the copyright on Disney's character, expected to profit from his coup—but without Disney's ideas the previously valuable character suddenly became worthless as a moneymaker at the box office. What had really been sold all along were Disney's ideas and fantasies. The physical things—the drawings, the film, and the theaters—were merely vehicles. It was only a matter of time before another set of vehicles could be arranged and the ideas incorporated in a new character—Mickey Mouse—which Disney copyrighted in his own name.

Many of the products which create a modern standard of living are only the physical incorporations of ideas—not only the ideas of Edison or Ford but the ideas of innumerable anonymous people who figure out the design of supermarkets, the location of gasoline stations, and the million mundane things on which our material well-being depends. It is those ideas that are crucial, not the physical act of carrying them out. Societies, which have more people carrying out physical acts and fewer people supplying ideas, do not have higher standards of living. Quite the contrary. Yet the physical fallacy continues on, undaunted by this or any other evidence (Sowell, 1980: 71–72).

The physical fallacy explains why Andrew Carnegie once stated in total confidence, “You can take away our factories, take away our trade, our avenues of transportation and our money—leave us nothing but our organization—and in four years we would reestablish ourselves” (quoted in Branden, 1998: 35). It is no different in a modern-day company. Its wealth-creating capacity resides in its IC, not its tangible assets. The company that created the yellow first-down line for NFL television broadcasts earns \$2 million per year for the idea. This concept may just have come to someone while showering, demonstrating how the wealth-creating results produced by IC have little relationship with inputs, or costs. This is a totally different environment from the Industrial Age, where there was more of a relationship between physical goods and wealth. In fact, 1997 marked the first year that

corporate investment in intangibles such as branding, training, and research and development (R&D) surpassed investment in the tangible assets of property, plant, and equipment.

Today, Microsoft has more wealth-generating capacity than many of the blue chip industrial organizations once thought so inevitable in their domination. By studying the success of IC companies, we can glean many lessons. I have learned many things from Peter Drucker, but perhaps nothing as profound and enduring as what he wrote in his autobiography *Adventures of a Bystander*:

I never heard well enough to be a musician. But I suddenly perceived that I myself would always learn by looking for performance. I suddenly realized that the right method, at least for me, was to look for the thing that worked and for the people who perform. I realized that I, at least, do not learn from mistakes. I have to learn from successes. It took me many years to realize that I had stumbled upon a method. Perhaps I did not fully understand this until, years later, I read—I believe in one of Martin Buber's early books—the saying of the wise rabbi of the first century: "The good Lord has so created Man that everyone can make every conceivable mistake on his own. Don't ever try to learn from other people's mistakes. Learn what other people do right" (Drucker, 1994: 75).

If I wanted to learn the successful traits of a marriage I would not bother talking with Elizabeth Taylor, and if I wanted to become a professional golfer, I would hang around the PGA tour, not the municipal golf course hackers on the weekend.

Adam Smith brought this profound insight into his seminal book *An Inquiry into the Nature and Causes of the Wealth of Nations* (1776). He wanted to explain why some countries were wealthy, not why most countries were poor (notice the title wasn't *An Inquiry into the Nature and Causes of the Poverty of Nations*). Poverty needs no explanation, nor do we learn much from studying it, since it is the natural condition of man since he emerged from the cave. What would we do once we discovered the *root causes* of poverty? Create more of it? What needs to be explained is *wealth*, not poverty. What separates a good social scientist from a mediocre one is this understanding. Charles Murray in his 1984 book *Losing Ground* (explaining how the welfare state has failed) pointed this out with respect to why teenagers have babies (a condition, like it or not, most certain to end in both mother and child living in poverty). He pointed out that studying teenagers who have

babies would not provide the insights needed to understand the phenomenon since you will hear reasons such as “babies are cute,” “sex is fun,” and “I wanted someone who would love me unconditionally.” Rather, you would be better off to study why the majority of teenagers *do not* have babies (parental opprobrium, social castigation, interferes with college education, etc.). These reasons provide the missing elements into ameliorating the problem. P.J. O’Rourke, the former foreign correspondent for *Rolling Stone* magazine and currently the Mencken Research Fellow at the Cato Institute, sums it up more humorously in the beginning of his book, *Eat the Rich*:

I had one fundamental question about economics: Why do some places prosper and thrive while others just suck? It’s not a matter of brains. No part of the earth (with the possible exception of Brentwood) is dumber than Beverly Hills, and the residents are wading in gravy. In Russia, meanwhile, where chess is a spectator sport, they’re boiling stones for soup (O’Rourke, 1998: 1).

I will follow this approach, studying successful practices from organizations that are effective at what they do, and the scope will be as far as it is wide. Wisdom is timeless, and many of the lessons shared herein are from what I have termed “Entrepreneur Heaven,” those creative and imaginative risk-takers who launched enterprises many of us still patronize to this day, who had the vision and fortitude to test their ideas in the free market, and solely be judged—and either rewarded or rebuked—by their customers. While this characteristic cannot be captured in a mathematical equation, it is certainly the cause of the majority of economic growth and dynamism.

## THE THREE TYPES OF INTELLECTUAL CAPITAL

The wealth-creating ability of intangible assets over physical assets is indisputable as we move from capital-based enterprises to knowledge-based enterprises. An excellent example of this is American Airlines’ Sabre reservation and information system.

On October 11, 1996, AMR Corporation, the parent company of American Airlines, sold (an equity carve out) 18 percent of its Sabre subsidiary in an initial public offering that valued Sabre at \$3.3 billion. On the previous day, AMR had a total market value (including Sabre) of about \$6.5 billion. Thus, a reservation system generating income from travel agents and other users of its services constituted half of the market value of AMR, equaling the value

of the world's second largest airline, owning 650 airplanes (in 1996) and other physical and financial assets, including valuable landing rights. A \$40 million R&D investment in Sabre during the 1960s and 1970s mushroomed into a market value of \$3.3 billion in the mid-1990s. By October 30, 1999, Sabre's share in the total market value of AMR increased to 60 percent, demonstrating the value creation potential (scalability) of intangibles relative to that of intangibles (Lev, 2001: 24).

While the airplanes American Airlines' owns show up on its balance sheet, Sabre was nowhere to be found. A teacher once asked Yogi Berra, "Don't you know anything?" and he said, "I don't even suspect anything." GAAP's deficiencies in measuring intellectual capital notwithstanding, for our purposes we are going to separate a company's IC into three categories, as originally proposed by Karl-Erik Sveiby—a leading thinker in knowledge theory—in 1989:

1. Human capital
2. Structural capital
3. Social capital (customers, suppliers, networks, referral sources, alumni, joint venture, alliances, etc.)

We will explore each of these in greater detail in the third book of the *Intellectual Capitalism Series*. Meanwhile, the crucial point to understand at this juncture is that it is the *interplay* among the three types of IC above that generates wealth-creating opportunities for your company. Human capital, for example, can grow in two ways: when the business utilizes more of what each person knows, and when people know more things that are useful to the firm and/or its customers. And since knowledge is a "nonrival" good—meaning we can both possess it at the same time—knowledge shared is knowledge that is effectively *doubled* throughout the organization. That is why former Hewlett-Packard CEO Lew Platt said, "If HP knew what HP knows, we would be three times as profitable."

Since knowledge can be found almost anywhere, and it does not have to be newly created, it is critical that we incorporate social capital into our company's IC, because defining our knowledge solely by our human and structural capital is too inward looking. The boundaries of a business do not just keep knowledge in; they keep it out as well. Expanding our definition of IC to the social environment within which a company operates gives us many more opportunities to leverage our knowledge. This is why British



Petroleum gives a “Thief of the Year” award to the person who has “stolen” the best ideas and Texas Instruments has a “Not Invented Here, but I Did It Anyway” award for ideas taken inside or outside the company. Knowledge companies constantly celebrate learning, not just the application of knowledge to the services it offers its customers. Knowledge companies have to do much more than merely extracting eight hours of work from their human capital; they have to leverage their minds as well. This requires a different level of thinking, and a totally different set of metrics to measure the effectiveness of organizational learning.

Most knowledge is created and owned by people, and thus resides in the human capital of any organization. Converting human capital into structural capital is one of the major roles of a chief knowledge officer (CKO). John Peetz, former CKO for Ernst & Young, summed up his knowledge mission this way: “For us knowledge management is critical. It’s one of our four core processes—sell work, do work, manage people, and manage knowledge.” As Thomas Stewart further explained, “In his self-written job description, Peetz outlined three responsibilities for a CKO: evangelizing about the value of sharing knowledge; running and backing projects that find, publish, and distribute knowledge around the firm; and managing a staff of about 200 people, mostly in the firm’s Center for Business Knowledge in Cleveland, and a firmwide infrastructure of Web sites” (Stewart, 2001: 82).

I have serious reservations about “managing people,” especially since we are talking about knowledge workers, whom I firmly believe cannot be “managed” in the traditional sense. Nonetheless, the essential role of a CKO is to capture the knowledge that exists within the minds of the people who work in the firm. As Ikujiro Nonaka and Hirotaka Takeuchi point out in their book *The Knowledge-Creating Company: How Japanese Companies Create the Dynamics of Innovation*, “The individual is the ‘creator’ of knowledge and the organization is the ‘amplifier’ of knowledge” (Nonaka and Takeuchi, 1995: 240).

This is no easy task since we must draw a distinction between *explicit* and *tacit* knowledge. Explicit knowledge can be documented and kept somewhere, in a manual, filing cabinet, web site, intranet, and so on. This type of knowledge usually comprises a company’s structural capital. Tacit knowledge is a different animal. *Tacit* in Latin means “to be silent or secret.” This is why it is so hard to explain how to ride a bike, swim, describe Marilyn Monroe’s face, or play golf like Tiger Woods. You could read all of the explicit knowledge—in books by Tiger, for instance—on how to play better

golf, but until you actually did it, your understanding would be severely limited. Explicit and tacit knowledge complement each other, because in Latin *explicit* means “to unfold”—to be open, to arrange, to explain. Germans say *Fingerspitzengefühl*, “a feeling in the fingertips,” which is similar to tacit knowledge (Stewart, 2001: 123). Another useful way to think about the difference is that information can be digitized while knowledge is intrinsic to humans. It is usually a totally different experience to read an author’s book than it is to have a chance to talk to him about it. The latter will give you a much richer, contextual feel for the explicit knowledge documented in the book, and in some cases may even be more valuable. Or consider the difference between reading a customer report and talking with the customer in person.

How often do companies take the time to mentor their colleagues on the importance of learning and sharing knowledge? “He’s learning me all his experience,” as Yogi Berra said about Bill Dickey. No doubt this gets done in most organizations, but it is on an ad hoc and as-needed basis, rather than a systemized, measured part of the performance criteria of team members. There is simply no mechanism in most companies to reward continuous learning, the sharing of tacit knowledge with peers, or externalizing tacit knowledge to explicit knowledge by writing an after action review—a report borrowed from the U.S. Army, which will be discussed in the next book in the *Intellectual Capitalism Series* and in Chapter 21—on various corporate functions. Because most companies are so caught up in efficiency and productivity quotas and working on their income statements, they are not building their invisible balance sheet—of which the primary asset is the knowledge that exists in the firm. Yet capturing this type of knowledge would be incredibly valuable to the company in terms of leveraging and ability to delegate, and as a way to increase the structural capital just in case certain human capital investors decide not to return to work.

## NEGATIVE INTELLECTUAL CAPITAL

Before we leave this important topic of IC, it is necessary to explain something that may, at first impression, not seem obvious. When IC is discussed, it is normally done in a very positive context, because most of the examples used are from successes in leveraging IC, such as Microsoft or the Sabre reservation system. Naturally, not all R&D projects or new products are suc-

cessful, and in fact, the failure rate is astonishingly high. Most new drugs fail, as do most consumer products and books published. Investments in intangibles contain much higher levels of risk and more uncertainty than in tangible assets. If my software product fails, those costs are usually gone for good, unless I can somehow leverage the knowledge I gained into another attempt (this is the second form of potential gain from a venture in addition to profits, the *epistemological* profit—meaning an advancement of knowledge). On the other hand, if I purchase an office building or a mall, and it fails, I can at least recover a portion of my investment.

But that is not the main point to make here and now. What is important here is there is such a thing as *negative* human capital, *negative* structural capital, and *negative* social capital. Certainly this sounds counterintuitive, but it is nonetheless true. Not everything we know is beneficial. Think of the IC a thief possesses; it is knowledge in the sense he knows how to perform his craft just as much as United Airlines knows how to fly planes and transport people around the world. But that does not make the knowledge valuable, and with respect to thieves, the social loss they impose is a societal negative.

Think of countries that dogmatically adhere to the principles of socialism or Marxism, even though both of these theories of social organization have been repudiated by empirical evidence. There has been enormous negative social capital built up over the past five decades in Castro's Cuba, just as there was in the former Soviet Union. As the latter struggles to make its transition to a free market economy, these negative legacies are being felt (lack of secure private property rights, no effective system of jurisprudence to adjudicate disputes, no efficient banking and credit system, and other institutions necessary for economic growth). When President Ronald Reagan was asked what he thought of the Berlin Wall during a visit to Germany, he gestured at the Wall and said succinctly, "It's as ugly as the idea behind it" (Morris, 1999: 461).

Examples of negative intellectual capital in an organization would include a rigid adherence to old methods that are hindering your people from achieving their potential. High on this list would include cost-plus pricing, Industrial Age efficiency metrics, focusing on activities and costs rather than results and value, and other forms of negative IC that have embedded themselves into the culture. These negative ideas have been leveraged throughout each type of knowledge discussed herein—human, structural, and certainly social—and have become part of our tacit and explicit knowledge systems.

One of the duties of this book is to point out how these legacy systems are indeed *negative* forms of IC and need to be replaced in the knowledge company of the future.

Throughout history, the “physical fallacy” was an idea that reigned supreme, that is, the notion that wealth is embedded in physical tangible assets. Economists now have a far better understanding of how wealth is created from free minds operating in free markets. This can be seen by observing various developing economies escaping the shackles of poverty, creating wealth and a better standard of living for their populations. It is now clear that wealth resides in minds, and economists have proven this at the macro level of economic organization. What is needed now is to apply these same ideas at the micro level of the business entity by positing a new theory for the intellectual capital company of the future.

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# 4

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## THE OLD BUSINESS EQUATION

*A theory that cannot be refuted is not scientific.*

—Karl Popper [1902–1994]

Theories are powerful because they seek to do one of three things: explain, predict, or prescribe. Yet, when one reads a typical business book today, the author will usually begin by saying something to the effect that “this book is not based on some ‘ivory tower,’ theoretical model, but based on practical, real-world experience and examples.” Beware when you read such a qualifier, because as Dr. W. Edwards Demming used to say, “No theory, no learning.” In a business environment, whether we know it or not, we are guided to a large degree by theoretical constructs that have been developed in order to simplify—and thus explain, predict, or control—our various behaviors. As Immanuel Kant said, “Concepts without perceptions are empty; perceptions without concepts are blind.” Theories build buildings and bridges, fly airplanes, and put men on the moon. As John E. Flaherty points out in his biography of Peter Drucker, *Shaping the Managerial Mind: How the World’s Foremost Management Thinker Crafted the Essentials of Business Success*:

Drucker’s explanation for the astonishing output of innovation during this period [the Industrial Revolution] was based on his insight that historically the introduction of a tool preceded its theoretical verification. For example, the lever was used for centuries before Archimedes developed a scientific formula to explain its operation. Eyeglasses were in existence in medieval times, but it was not until the eighteenth century that Sir Isaac Newton and Gottfried Wilhelm Leibniz gave us the theory of optics. It took about seventy-five years before William Thomson, 1st Baron Kelvin, provided a theoretical explanation of thermodynamics for James Watt’s steam engine. And it took several decades before a theory of aerodynamics could satisfactorily explain why the Wright brothers’ flying machine actually flew (Flaherty, 1999: 230).

The purpose here is not to debate the chicken and egg question of which comes first, theory or practice. It is self-evident that both are important. Certainly there is enough experience to evaluate the predominant theory of an Industrial Age enterprise. Indeed, the purpose of this chapter is to examine the flaws in the old theory in order to construct a better theory. After all, the theory that originally explained the Wright brothers' flying machine has been significantly enhanced by Boeing in order to keep its 777 in the air. This is how theories and knowledge progress—and they can have an enormous impact on our behavior. So even though discussing theory may be much maligned in today's business environment, I believe all learning starts with theory, and thus we will now critically examine the predominant theory of the Industrial Age organization.

### **“ANALYZING” THE PREDOMINANT BUSINESS EQUATION**

In Greek language, *analyze* means “cut to pieces,” which we will proceed to do with this theory before positing a better theory. When you think about the traditional theory of an enterprise, you would no doubt construct a model similar to this:

$$\text{Revenue} = \text{Capacity} \times \text{Efficiency} \times \text{Cost-Plus Price}$$

Since this model dominates the thinking of business leaders to this day, it is worth explaining the model in greater detail in order to understand both its strength and—as will be increasingly detailed—its fundamental weaknesses.

Consider a professional service firm, such as accounting, legal, architecture, engineering, consulting, or advertising; the archetypal pyramid firm model rested on the foundation of leveraging people power, in effect their “capacity.” The theory is this: Since the two main drivers of profitability are leverage (number of team members per owner and the hourly rate realization, a form of cost-plus pricing), if each partner could oversee a group of professionals, this would provide the firm with additional capacity to generate top-line revenue, and thus add to the profitability and size of the firm. If a firm wanted to add to its revenue base, it had two primary choices: It could work its people more hours, or it could hire more people. It is no secret which choice the average firm tends to choose, much to the chagrin of its already overworked team members. In most firms, the partners wait until demand is bursting at the seams before they add more professionals.

Now compare this practice with respect to capacity in other industries—this process of adding capacity *after* revenue is backward. If you think of any other industry or company—from Intel to General Electric, from FedEx to Microsoft—capacity is almost always added *before* revenue. Consider specifically FedEx: Before Fred Smith could deliver his first overnight package, he had to have trucks, drivers, airplanes, and facilities throughout the country, all at enormous fixed costs (indeed, those large fixed costs almost bankrupted FedEx in the early days). Most organizations operate with capacity to spare, which is vital in order to maintain flexibility in changing market conditions. I will discuss capacity issues in a later chapter, and offer an Adaptive Capacity Model in order to allocate an organization's fixed capacity to maximize value.

For now, let us look at the second element in the old theory—efficiency. Efficiency is a word that can be said with perfect impunity, since no one in their right mind would dispute the goal of operating efficiently. In fact, it is well known that in free market economies, efficiency is critical since it ensures that a society's resources are not going to waste. It is also well established that different levels of productivity largely explain differences in wages across countries. An American farmer will earn more plowing with a tractor than a Cuban farmer with an ox and hand plow; the American farmer is more productive, hence higher wages and more profits.

There is no doubt that increasing efficiency—or at least not sliding into inefficiency—is important. But the pendulum has swung too far in the direction of efficiency over everything else. It seems that innovation, dynamism, customer service, investments in human capital, and effectiveness have all been sacrificed on the altar of efficiency. It is critical to bear in mind that a business does not exist to be efficient; rather, it exists in order to create wealth for its customers.

Peter Drucker is fond of pointing out that the last buggy whip manufacturers were models of efficiency. So what? What happens if you are efficient at doing the wrong things? That cannot be labeled progress. In fact, one indicator that an industry is in the mature or decline stage of the product/service life cycle is when it is also most likely at the apogee of its theoretical level of efficiency.

The point is this: In industry after industry, the history of economic progress has not been to wring out the last 5 to 10 percent of efficiency, but rather to change the model in order to more effectively create wealth. From Walt Disney and Fred Smith, to Bill Gates and Larry Ellison—these

entrepreneurs did not get where they are by focusing on efficiency. All of these entrepreneurs created enormous wealth by delivering more effectively what customers were willing to pay for, not by focusing on efficiency.

Next is cost-plus pricing, a direct cousin of the DuPont return on investment formula. But the real ancestor of cost-plus pricing is the Labor Theory of Value, posited by economists of the eighteenth century and Karl Marx in the late nineteenth century. This theory was almost immediately shown to be false—in terms of its ability to explain, predict, or prescribe—as a method of determining value in a marketplace. Fortunately, a better theory was posited, known as the Subjective Theory of Value—that is, ultimately, the person paying for an item, not the seller's internal overhead, desired profit, or labor hours, determines the value of anything. Value, like beauty, is in the eye of the beholder.

The offense of believing internal costs have anything to do with value is serious. A business should be judged—and price based—on the results and wealth it creates for its customers. The cost-plus pricing paradigm is not worthy of businesses operating in an intellectual capital economy, and it is time we throw it on the ash heap of history. It is an idea from the day before yesterday.

Last, consider revenue. It is one thing to get *more* business, it is quite another to get *better* business. The “bigger is better” mentality is an empty promise for most companies. Acquiring more customers is not necessarily better. Growth simply for the sake of growth is the ideology of the cancer cell, not a strategy for a viable, profitable company. It is worth looking at the historical origins of this market-share myth. In the late 1800s and early 1900s, market share theory was an excellent rationale for antitrust enforcements. For business leaders, you can certainly see it in the algebraic effect of greater revenue in the equation. Once fixed costs are covered, any marginal revenue will contribute to the bottom line. Of course, this implicitly implies that any customer is a good customer, which is certainly a debatable proposition.

One widely quoted study is that by Harvard Business School professor Robert D. Buzzell, who in 1975 published an article in *Harvard Business Review*: “Market Share—A Key to Profitability.” This article provided empirical evidence that companies that had dominant market share had higher profitability levels. Of course, if one is not grounded in theory, then it is easier to confuse cause and effect by merely observing the manifestations of a competitive advantage. Height and weight are closely associated but you



will not grow taller by eating more. Market share is the *result* of a sustainable competitive advantage, not the *cause*.

BMW has approximately 1 percent market share, selling 213,127 vehicles in the United States in 2001, while recording a profit \$1.87 billion, greater than any other car company in the world. In 1999, Ford Motor earned a record \$7.2 billion, and yet its market share decreased from 25.7 to 23.8 percent. By encouraging customers to trade up to higher-margin vehicles, it sold 420,000 fewer low-margin cars, while selling 600,000 more high-margin vehicles. Other traditional marketing and sales leaders, such as Procter & Gamble, Southwest Airlines, and General Electric, began to switch their focus from top-line revenue growth and market share to increasing profitability.

Southwest Airlines is a leader in the low-fare travel niche, and it has remained focused on that niche like a laser beam. As former CEO Herb Kelleher pointed out, “Market share has nothing to do with profitability. Market share says we just want to be big; we don’t care if we make money doing it. That’s what misled much of the airline industry for fifteen years, after deregulation. In order to get an additional 5 percent of the market, some companies increased their costs by 25 percent. That’s really incongruous if profitability is your purpose” (Freiberg and Freiberg, 1996: 49).

If market share explained profitability, General Motors, United Airlines, Sears, and Philips should be the most profitable companies in their respective industries. Yet they have all turned in mediocre profitability records. Growth in profitability usually precedes market share, not vice versa. Wal-Mart, for example, was far more profitable than Sears, long before it had a sizeable market share. It seems profitability and market share grow in tandem with a viable value proposition that customers are willing to pay for. The road to hell is paved with the pursuit of volume. Do not make this mistake. More often than not, less is more.

I have exposed some of the flaws of the traditional Industrial Era business equation. Although this discussion is not meant to be comprehensive, it nevertheless sets forth a compelling case against the old theory. Is there a better theory, one that takes into account the real wealth-producing capacity and other critical success factors of the business of the future? It is a valuable accomplishment to point out defects in a theory—or falsify it entirely—but the real work begins by constructing a new theory, as this is how all knowledge advances.



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# 5

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## THE NEW BUSINESS EQUATION

*Models and theories exist to guide managerial judgment, not replace it.*

—John Kay, *Foundations of Corporate Success*, 1995

The old equation is no longer relevant to the driver's of success in the business of the future. Buckminster Fuller (designer, cosmologist, philosopher, mathematician, and architect—he designed the geodesic dome) once said, “You can't change anything by fighting or resisting it. You change something by making it obsolete through superior methods.” It is time to replace the old equation described in the previous chapter with this new model:

$$\text{Profitability} = \text{Intellectual Capital} \times \text{Price} \times \text{Effectiveness}$$

Let us explore each component of the above equation; then we will discuss why it is a better theory for explaining the success of companies operating in today's marketplace.

We start with *profitability*, rather than *revenue*, because we are not interested in growth merely for the sake of growth. As many companies around the world have learned—some the hard way, such as the airlines, retailers, and automobile manufacturers—market share is not the open sesame to more profitability. We are interested in finding the right customer, at the right price, consistent with our vision and mission, even if that means frequently turning away customers. I have coined a corollary to Gresham's law (bad money drives out good) from monetary economics, affectionately known as Baker's Law: *Bad customers drive out good customers.*

Adopting this belief means you need to become much more selective about who you do business with, even though that marginal business may be “profitable” by conventional accounting standards. Very often the most important costs—and benefits, for that matter—do not ever show up on a profit and loss statement. Accepting customers who are not a good fit for

your firm—either because of their personality or the nature of the work involved—has many deleterious effects, such as negatively affecting team member morale, and committing fixed capacity to customers who do not value your offerings. This is why the new equation focuses on *profitability*, not simply gross revenue. When it comes to customers, less is usually more.

As pointed out in Chapter 3, for our purposes in this book, intellectual capital is composed of three primary components:

1. *Human capital (HC)*. This comprises your team members and associates who work either for you or with you. As one industry leader said, this is the capital that leaves in the elevator at night. The important thing to remember about HC is it cannot be owned, only contracted, since it is completely volitional. In fact, more and more, knowledge workers own the means of your company's production, and knowledge workers will invest their HC in those organizations that pay a decent return on investment, both economic and psychological. In the final analysis, your people are not assets (they deserve more respect than a copier machine and a computer)—they are not resources to be harvested from the land like timber when you run out. Ultimately, they are *volunteers*, and it is totally up to them whether or not they get back into the elevator the following morning.
2. *Structural capital*. This is everything that remains in your company once the HC has stepped into the elevator, such as databases, customer lists, systems, procedures, intranets, manuals, files, technology, and all of the explicit knowledge tools you utilize in order to produce results for your customers.
3. *Social capital*. This includes your *customers*, the main reason a business exists; but it also includes your suppliers, vendors, networks, referral sources, alumni, joint venture and alliance partners, and reputation. Of the three types of intellectual capital, this is perhaps the most overlooked and least leveraged, and yet it is highly valued by customers.

Wealth does not exist in tangible resources—such as timber, land, real estate, oil, and so forth—but in ideas and their creative expression. Oil was completely useless—in fact, if you were a farmer it was an absolute nuisance—until the combustion engine was invented. If it were not for the piston engine and the electricity needs of the industrialized world, the

Middle East, which has been sitting on oil for thousands of years, would be nothing more than sand dunes, rocks, and caves.

To reiterate, there are four Ps of marketing: price, product, place, and promotion. Of these, *price* is the most complex component of the four Ps of marketing. Price is your company's only opportunity to *capture* the value you create through your value proposition. Yet pricing has been a sorely neglected topic until recently. In fact, pricing in most industries has been neglected and usually relegated to some rule of thumb, or cost-plus pricing formula. Thankfully, this is beginning to change.

For too long companies have let their price be solely or largely predicated on some arbitrary rule of thumb, competitor's prices, or on an overhead plus desired net income calculation. These pricing mechanisms are relics of Karl Marx's Labor Theory of Value, and are completely obsolete in an intellectual capital, innovative, and dynamic economy.

In the business of the future, *effectiveness* takes precedence over efficiency. A business does not exist to be efficient; it exists to create wealth for its customers. An obsessive compulsion to increase efficiency (doing things right) reduces the firm's effectiveness at doing the right things. The pursuit of efficiency has hindered most firms' ability to pursue opportunities, and hence the organization spends most of its time solving problems. One cannot grow a company and continuously cut costs and increase efficiency.

It is not that efficiency is bad, per se; it is that it has been pursued at the expense of nearly everything else. To add insult to injury, the efficiency measures that do exist in the modern organization tend to be *lagging* indicators that measure efforts and activities, not *leading* indicators that measure results and define success the same way the customer does. It is time for companies to develop testable hypotheses in the form of critical success factors and key performance indicators that measure the actual results of their output the same way customers do.

Effectiveness implicitly understands there is no such thing as a free statistic. Just because we can measure something accurately does not mean we should. Effectiveness understands that imprecise measurements of the *right* things are infinitely more valuable than precise measurements of the *wrong* things. This will no doubt shock some readers, especially those who were trained in cost accounting or possess MBAs. But controlling costs, and accounting for them, does not ensure success. Companies are not machines subject to the laws of electromechanical engineering. They are composed of human beings who do not check their emotions at the door, and they are sub-

ject to fears, doubts, variable levels of self-esteem, uncertainty, anger, rage, and a whole range of other emotions that cannot be captured by traditional efficiency measurements. In other words, *humans are messy*. Focusing on effectiveness does not eliminate these issues, but it does take them into account far better than efficiency metrics, which can be desensitizing and inhumane at times.

This new equation comports with the realities of an intellectual capital economy, taking into account knowledge workers who use their hearts and minds, not their brawn and hands. This equation recognizes the importance of mind over matter, the price thereof, and the effectiveness of the workers who produce it, as well as the customers who purchase it. It may not yet be a perfect theory, but it is far superior to the alternative discussed in the prior chapter.

## COGNITIVE DISSONANCE

I am going to rely on the reader's ability to hold two opposite thoughts in their head at the same time, while still functioning. I have a love/hate relationship with the above equation. On the one hand, it is a superior model for the business of the future because it recognizes the realities of the marketplace in which companies operate, and it focuses on leveraging the right things. It takes into account the importance of dynamism, innovation, and a whole host of other human activities that are simply not captured in the old equation.

On the other hand, because it is nothing more than an algebraic equation, it is an incredible simplification of the components that comprise the typical organization. When we look at equations we tend to think of each component comprising a separate part that can be individually manipulated and controlled, a very one-dimensional view of a business made up of human beings. What the equation does not explain is *how* to raise prices, or *how* to increase effectiveness; nor does it explain the interconnections and interdependencies of the various components. Certainly the equation can describe an abstract feature such as effectiveness, but it does not really enhance one's understanding of how change occurs in the firm as a whole. In other words, it can explain the *ends* (profitability), but not the *means* (how does one measure effectiveness?). Any equation assumes a certain cause-and-effect relationship, and tends to lead us to believe that these patterns are sequential and lin-

ear, and not subject to the perpetual feedback of prior causes. In the old equation, increase capacity and revenue grows; in the day-to-day realities of a company, trying to work your team members more hours is going to have a whole host of unintended consequences that will ultimately affect the goal of increasing revenue. No equation can capture the richness of these inter-related means.

Another problem with the equation is that it presents the characteristics of a firm as nothing but the sum of the parts; if you change one aspect, you invariably change another by an equal amount. But in a living, breathing, organic system such as a firm, parts and wholes are not linked so linearly. Thus, a small change in one of the parts can have a profound and dramatic influence on everything else. Think of the effects of a toxic manager who belittles and intimidates his team members. He may achieve higher efficiency in one aspect of the equation, and so totally destroy morale and motivation that the ultimate outcome will be a reduction in firm effectiveness, customer service, and profitability.

Peter Drucker has written extensively on why traditional management science fails to perform. Executives believe they can change one aspect of a company without affecting others, ignoring the reality of a firm being an *interdependent* system. Drucker explains the phenomenon this way:

There is one fundamental insight underlying all management science. It is that the business enterprise is a *system* of the highest order: a system whose parts are human beings contributing voluntarily of their knowledge, skill and dedication to a joint venture. And one thing characterizes all genuine systems, whether they be mechanical like the control of a missile, biological like a tree, or social like the business enterprise: it is interdependence. The whole of a system is not necessarily improved if one particular function or part is improved or made more efficient. In fact, the system may well be damaged thereby, or even destroyed. In some cases the best way to strengthen the system may be to weaken a part—to make it less precise or less efficient. For what matters in any system is the performance of the whole; this is the result of growth and of dynamic balance, adjustment, and integration, rather than of mere technical efficiency.

Primary emphasis on the efficiency of parts in management science is therefore bound to do damage. It is bound to optimize precision of the tool at the expense of the health and performance of the whole (Drucker, 2004: 97).

Any equation is similar to the difference between a map and a territory: one is a two-dimensional explanation and the other is full of complex and

rich interconnections that could never be captured on paper. Somebody once said that studying a living entity on paper is like performing an autopsy on dolphins versus swimming with them. Certainly both activities will give you a better understanding of dolphins, but which one will let you observe the rich and contextual feel of a living creature? Clinical pathologists implicitly understand this difference, because they instruct physicians to never treat a test result but rather to treat the patient.

The careful reader—perhaps the reader with scientific or marketing training—will note that the equation does not answer the important question of why we are in business, because it appears to put profitability above all else. This is a serious omission. The fact that a business needs to make a profit is a tautology, and is in fact quite irrelevant. Most importantly, a business must create and retain customers, and add wealth to their lives by providing them more in value than the price they are paying. The equation also does not answer the all-important question of where profits are derived, to be discussed in the next section.

One more criticism of this equation should be mentioned before we leave this analysis. The word *efficiency* has been deliberately replaced with *effectiveness*, bowing to the observation that a business does not exist to be efficient, but rather effective. What happens if you are 100 percent efficient at doing the *wrong* thing? *Effectiveness*, on the other hand, stresses the power to produce a particular effect, in this case, something of value for customers. Yet, this word, too, is not quite precise at describing the effect a modern firm is trying to create. I much prefer the word *efficacious*, meaning having the power to produce a desired effect. This term is used to describe the miraculous power of many drugs since it suggests possession of a special quality or virtue that makes it possible to achieve a result. In an intellectual capital economy, where wealth is created using the power of the mind—as opposed to the body—these characteristics better explain the value created by knowledge workers.

In any event, while one could point out other weaknesses in the new equation, in a book we must break things down into separate components in order to deal with them more effectively. We cannot do everything at once. This is the advantage of a theory, because while it will never capture the true essence of a living organization, it can be studied in its quantitative and qualitative parts, and our understanding of how those parts are interdependent can be better understood as a result. A theory need not be elegant nor capture the entire essence of the phenomena it is trying to explain; all it has to do in



order to be effective is allow us to predict, explain, or prescribe the behavior we observe. It is similar to a camera, not a photograph, in that it is a tool that can be used well or badly, to capture reality, not depict it.

Another important element of theory building is to have a preference to shave with Occam's Razor—that is, any hypotheses must not be developed beyond necessity. Unfortunately, most business books contain a paucity of theory—and when they do, the razor could not cut butter. To this end, the new equation is presented only as a model—a map—to help us capture a deeper understanding of how organizations can operate more effectively in an intellectual capital economy. No one would argue that you can get anywhere by looking at maps without venturing out to sea. But no one would suggest you would be very safe at sea without a map.

## WHERE DO PROFITS COME FROM?

*A ship in harbor is safe—but that is not what ships are for.*

—John A. Shedd [1859 to circa 1928]

In seminars around the world, we have presented to participants the following factors of production in any economy, and the type of income derived therefrom:

Land = Rents

Labor = Salaries and Wages

Capital = Interest, Dividends, and Capital Gains

We then ask a deceptively simple question: Where do profits come from? The answers range from entrepreneurs and value, to revenue minus expenses and customers. Nevertheless, the real answer is that profits come from *risk*. The word *entrepreneur* comes from the French word *entreprendre*, meaning “to undertake” (Richard Cantillon, writing in the 1730s, was the first economist to use the term). It is the basis for the English word *enterprise*. But not just entrepreneurs (or female, entrepreneurs) make profits; so do established enterprises.

When a business engages in innovation, it is taking a risk. In Italian, the word *risk* derives from *risicare*, which means “to dare,” which implies a

choice, not a fate, as Peter L. Bernstein points out in his outstanding study of risk, *Against the Odds*. In Arabic, *risk* means “earning one’s daily bread.” In other words, risk is an economic positive. There are four responses when confronted with risk: avoid it; reduce it; transfer it; or accept it. In the final analysis, a business cannot eliminate risk, as that would eliminate profits. The goal is to take calculated risks and choose them wisely. The problem in many firms is that they are operating in order not to lose, rather than to win. By setting a nice comfortable floor on their earnings (via the cost-plus pricing mechanism), they have placed an artificial ceiling over their heads as well. This is self-imposed, and it comes from the attempt to avoid risk and uncertainty (which is very costly in terms of lost opportunities).

Consider labor unions, the epitome of an institution attempting to avoid risk. Talk with union members, and you quickly discover that they credit the union for their standard of living. Certainly, they are paid an above-market wage (Milton Friedman has proved this point), and receive good benefits, a healthy pension, and generous time off. But have you ever met a wealthy rank-and-file union member? The trade-off they made for their union compensation package is an artificial ceiling they can never rise above, at least not while employed in a union job, since seniority and other stultifying restrictions limit their potential. Risk avoidance is the antithesis to a successful enterprise, condemning it to mediocrity, perhaps even extinction. The goal should be to maximize wealth-creating opportunities rather than to minimize risk, as Peter Drucker pointed out:

A business always saws off the limb on which it sits; it makes existing risks riskier or creates new ones....Risk is of the essence, and risk making and risk taking constitute the basic function of enterprise....This risk is something quite different from risk in the statistician’s probability; it is risk of the unique event, the irreversible qualitative breaking of the pattern (quoted in Kehrer, 1989: 53).

Drucker is explaining a basic economic theory known as Böhm-Bawerk’s Law—named after Eugen Böhm-Bawerk [1851–1926], the only economist to be pictured on an official currency, the Austrian 100 schilling note—which states, “Existing means of production can yield greater economic performance only through greater uncertainty; through taking greater risk” (ibid.: 298). Businesses have very sophisticated means of measuring the costs and benefits of risks, *once they have been taken*. But the risk occurs only *before* the event, and cannot be accurately measured until *after* it has

occurred. There is no theory—in economics or finance—that measures the cost of *not* taking a risk. Yet, it is precisely these losses that cost the business the most.

Risk and uncertainty are the twin banes of human existence. Consider what people will sacrifice to avoid them. Risk avoidance has created a \$1.5 trillion worldwide insurance industry. It is why rental car companies make more from the “collision damage waiver” insurance they sell than they do renting cars. It is why buyers of appliances (e.g., microwaves, stereos, and other electronic goods) will spend large sums on extended warranties for products that could be replaced more cheaply. It’s why criminals and prosecutors plea bargain, each being uncertain as to what a jury is going to do (completely rational behavior).

Peter Drucker classified risk into three categories: the affordable, the non-affordable, and the compulsory:

First, there was the risk a business could afford to take. If it succeeded at the innovation, it would not achieve major results, and if it failed, it would not do great corporate damage. Second, there was the risk a business could not afford to take. This risk usually involved an innovation that the company lacked the knowledge to implement, and usually would end up building the competition’s business. Third, there was the risk a business could not afford not to take. Failure to undertake this innovation meant there might not be a business several years hence (quoted in Flaherty, 1999: 172).

Naturally, in this book the third type of risk taking will be advocated. That is, taking those risks that will spur the firm to higher levels of effectiveness and profitability. Too often in organizations, risk taking is seen as a negative, a reckless use of resources better spent on other functions. Nothing could be further from the truth. Committing a portion of today’s resources to future expectations certainly entails risk, but since that is the source of profits—not to mention innovation, dynamism, and economic growth—it is a process inherent in the function of business entities. Economy-wide, profits may only constitute 10 percent of what the American economy produces, but in terms of creating an incentive to effectively produce the other 90 percent, they are essential. And profits are derived from *risk*; complacency is not an option.

This, by the way, is another defect you may care to note about the new equation, because it makes it look as if profitability appears by effectively leveraging intellectual capital at the right price, but misses the importance of

risk. We must always remember that profits, ultimately, are derived from risk taking, and no equation, no matter how complex and intricate, will ever be able to capture the essence of an entrepreneur, an effective executive, or profit-making enterprise.

This chapter has laid the groundwork for the remaining chapters, and the remaining books in the *Intellectual Capitalism Series*. We have covered a lot of material here, and have presented some radical—Latin for “getting back to the root”—ideas. I have argued that the old equation is not worthy of enterprises more and more composed of knowledge workers, because it leverages the wrong things and does not explain the elements of success in an intellectual capital economy. The new equation does all of these things and is a worthy model for the noble calling of enterprise. And while there are still shortcomings in the equation, it is a starting point for understanding the drivers of success for the business of the future.

Modern firms are knowledge organizations, and it is time for them to begin acting as if they understood this fact, rather than trying to constantly enhance efficiency by treating their human capital as if they had no mind of their own, redolent of the days of Frederik Taylor’s time-and-motion studies. Humans are not simply machines that exist to operate at peak efficiency, and the old equation keeps us mired in this mentality. I believe we can—indeed, must—do better than the opportunities presented by an antiquated model.

When I first publicly presented and contrasted the new equation with the old one at a seminar for a professional service firm, an attendee explained to me at the break why she thought the new equation was so superior to the old. She said, and I’m paraphrasing here, “Your equation presents so many more factors that enable a firm to achieve its objectives than the old one did. It is like being freed from a cage that has restricted our firm for decades.”

It is my fervent hope this new paradigm has a similar effect on all who study it and change their behavior as a result. The old paradigm is indeed far too restricting, and it does not represent the realities of the current marketplace in which companies find themselves. The enterprises of the future must lead the way by following a model worthy of a proud heritage of free minds operating in free markets being the catalyst for dynamism and growth.

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# 6

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## NINETY-NINE-CENT PRICING, ENGAGEMENT RINGS, AND THE ASSUMPTION OF RATIONALITY

*...[E]conomics is not a particular set of questions to be answered  
but a particular way of answering questions.*

—David Friedman, *Price Theory* (second edition), 1990

*The economist's greatest passion is not to change the world  
but to understand it.*

—Steven E. Landsburg, *The Armchair Economist*, 1993

Why do businesses engage in 99-cent pricing, forcing us to give and take those useless pennies? The common answer is, “It’s a sales gimmick. The customer perceives \$9.99 being cheaper than \$10.00.” From an economic point of view, this contradicts the theory of rationality, since it implies customers, over the long run, are too ignorant to tell the difference between \$9.99 and \$10.00. Might there be a better explanation? In other words, how does 99-cent pricing serve someone’s interests? Here is how economist Steven Landsburg explained the phenomenon of 99-cent pricing, in his book *The Armchair Economist: Economics and Everyday Life*:

The phenomenon of “99-cent pricing” seems to have first become common in the nineteenth century, shortly after the invention of the cash register. The cash register was a remarkable innovation; not only did it do simple arithmetic, it also kept a record of every sale. That’s important if you think your employees might be stealing from you. You can examine the tape at the end of the day and know how much money should be in the drawer.

There is one small problem with cash registers: They don't actually record every sale; they record only those sales that are rung up. If a customer buys an item for \$1 and hands the clerk a dollar bill, the clerk can neglect to record the sale, slip the bill in his pocket, and leave no one the wiser.

On the other hand, when a customer buys an item for 99 cents and hands the clerk a dollar bill, the clerk has to make change. This requires him to open the cash drawer, which he cannot do without ringing up the sale. Ninety-nine-cent pricing forces clerks to ring up sales and keeps them honest (Landsburg, 1993: 15–16).

Upon reflection, this appears to be a more adequate explanation than “sales gimmick,” does it not? And it comports with the history of both the cash register and 99-cent pricing. The brothers John and James Rittney patented the cash register in 1879, even labeling it the “incorruptible cashier.” In 1887, 5,400 cash registers were in operation, growing to 16,395 by 1890. The loud bells were installed so shopkeepers—who spent a lot of time in the backroom doing inventory and bookkeeping—could keep mental track of the number of times the drawer was opened.

One can witness this today in many retail and fast food chains, where signs are posted by the cash register reading, “If you don't receive a receipt, your meal is free.” Do the owners do this because they are concerned with the fastidiousness of your personal record keeping? Or, more rationally, are they providing you with an incentive to monitor their employees, a very low-cost way for them to keep their people honest?

This is why being grounded in a theory can be incalculably useful for understanding human behavior, which is why economists have stubbornly clung to this theory of rationality—they find it immensely valuable in explaining so much behavior. Yet this theory has been challenged by many social scientists, including economists.

These critics claim that the assumption turns the average person into a cold, calculating individual whose only interest is to maximize their wealth (or utility, or power, or whatever else they may be seeking). Why did the chicken cross the road? To maximize his utility, say the rationalists. However, what if we witness a person drinking a quart of oil, and then dying. Can we really explain his behavior as rational, or that he really enjoys motor oil? Opponents of rationality point out a theory that purports to explain everything ends up explaining nothing. They cite many examples where individuals do not appear to be behaving very rationally:

- We pay higher prices for goods and services endorsed by celebrities.
- We routinely vote in elections—even risking life and limb in inclement weather to get to the polls—even when we know our one vote will not decide the outcome.
- We leave tips in restaurants to strangers, in locations we will never visit again.
- People walk away from profitable transactions because they believe the terms are unfair.
- The British spent vast sums to defend the desolate Falklands, even though they no longer have an empire to defend (Argentine writer Jorge Luis Borges equated this war with two bald men fighting over a comb).
- Super Bowl crowds buy tickets for, say, \$350, which could then be sold later for, say, \$6,000. Yet very few people sell their tickets, even though only a small minority would have paid \$6,000 to attend the game.
- People die wealthy, have children, donate blood, return pesticides, recycle, and help strangers in distress, none of which appears to be “rational.”
- Economist Walter Williams, a smoker, thinks it is totally irrational to bury perfectly healthy pink lungs in the ground.
- We give gifts, rather than money, to our friends, family, and loved ones, even though we do not know what they truly desire.
- I spoke at a conference in California once when the lottery was up to \$30 million. I offered to buy a ticket—for up to 50 times the purchase price—from anyone. No one would sell to me.

Given the above, it seems as if the assumption of rationality is false, or at the least can be shown to be false in many circumstances. But rather than discard this theory, here is how Landsburg explains its usefulness:

But the fact of the matter is that all assumptions made in all sciences are clearly false. Physicists, the most successful of scientists, routinely assume that the table is frictionless when called upon to model the motions of billiard balls. They assume that the billiard balls themselves are solid objects. They assume that objects fall in vacuums.

All scientists make simplifying assumptions about the world, because the world itself is too complicated to study. All such assumptions are equally false,

but not all such assumptions are equally valuable. Certain kinds of assumptions lead consistently to results that are interesting, nonobvious, and at some level testable and verifiable.

The first physicist to have observed a helium-filled balloon would have admitted that there was no gravity, and the true physics of the situation would not have been discovered. By attempting to fit unfamiliar phenomena into familiar patterns, we arrive at deeper understandings of both the patterns and the phenomena.

To a large extent, the assumption of rationality is nothing more than a commitment to inquire sympathetically into people's motives. [When we observe what at first appears to be irrational behavior] we have a choice. Either we can remark—wistfully or cynically, according to our temperament—on the inadequacy of human nature, or we can ask, “How might such behavior be serving someone's purposes?” The first option offers the satisfaction of exempting oneself from the great mass of human folly. The second offers an opportunity to learn something.

Adopting the rationality assumption means pledging to treat all human behavior as worthy of respectful consideration. In the process, we discover possibilities and develop insights that would never arise if we allowed ourselves to simply dismiss as “irrational” anything we failed to understand immediately. By disallowing the easy way out, we commit ourselves to careful and creative analysis of why people behave as they do, which is an excellent habit for any social scientist to cultivate (Landsburg, 2002: 662).

David Friedman, the son of Milton and Rose Friedman, in his book *Hidden Order*, explains the assumption of rationality this way:

...[T]he assumption describes our actions, not our thoughts. If you had to understand something intellectually in order to do it, none of us would be able to walk.

Economics is based on the assumption that people have reasonably simple objectives and choose the correct means to achieve them. Both assumptions are false—but useful.

Suppose someone is rational only half the time. Since there is generally one right way of doing things and many wrong ways, the rational behavior can be predicted but the irrational cannot. If we assume he is rational, we predict his behavior correctly about half the time—far from perfect, but a lot better than nothing. If I could do that well at the racetrack I would be a very rich man.

...[R]ationality is an assumption I make about other people. I know myself well enough to allow for the consequences of my own irrationality. But for the vast mass of my fellow humans, about whom I know very little, rationality is the best predictive assumption available (Friedman, 1996: 3–5).



The great economist Ludwig Von Mises [1881–1973] refused to call bad decisions “irrational.” He stated, “Error, inefficiency, and failure must not be confused with irrationality. He who shoots wants, as a rule, to hit the mark. If he misses it, he is not ‘irrational’ he is a poor marksman” (Skousen, 2002: 205). Human action, according to Mises, is *purposeful behavior*. It is free will put into operation. In contrast, a billiard ball moves because it is hit by another; it can’t decide for itself. A physicist cannot explain why a car goes to Wal-Mart rather than K-Mart.

It is true that we can put a man on the moon, but still have people sleeping in the streets. Yet NASA has it easy, since rockets are governed by the unchanging laws of physics. Human beings are more complex; an alcoholic does not behave in a manner as predictable as a rocket in orbit. The assumption of rationality allows us to better explain and understand human behavior. As Albert Einstein told Heisenberg in 1926, “It is theory which decides what we can observe.”

According to economist Donald Boudreaux, to assume that people are rational is to assume the following three things:

1. Each of us acts purposefully, with a goal in mind. It can be fixed, or changed frequently.
2. Each of us learns.
3. Each of us has transitive preferences: If I prefer apples to bananas, and bananas to cantaloupe, then I prefer apples to cantaloupe.

Of course, there are times when it does not pay to be completely rational. There is a certain marginal utility from not bothering with marginal utility. Consider being confronted with two different decisions: what car to buy and what presidential candidate to vote for. Both decisions can be improved by investing more time and effort in studying the various alternatives. With respect to the car, your decision will be certain; but in the case of the presidential nominee, your one vote will not much matter. If the candidate you prefer would be elected without your vote, you are wasting your time; if the candidate would lose even with your vote, you are still wasting your time. Accordingly, you will invest more time and effort in purchasing the car, since the utility is much higher. Economists label this *rational ignorance*—it is rational to be ignorant when information costs more than it is worth.

We used the assumption of rationality in Chapter 1 when we answered the question, Why is movie theater popcorn so expensive. The knee-jerk

response is to respond that the theater owners would sell more popcorn at a lower price, yet the more precise explanation was that it is being used as a device to separate different segments of customers. This theory can explain much else, for instance, why don't rock concert promoters simply raise prices to eliminate long queues of eager fans waiting to buy tickets?

Similar to the theater owners, the rock concert promoters are rational businesspeople, attempting to maximize profits. By keeping the tickets at a cheaper price than would be necessary to eliminate the long queues, they are allowing more price-sensitive customers into the rock concert. These happen to be youngsters, who are precisely the most likely segment to purchase—once at the concert—programs, T-shirts, CDs, and other items from which the promoters make the majority of their profits.

The assumption of rationality also allows economists to explain why diamond engagement rings became common only in the 1930s, peaked in the 1950s, and have declined since. Prior to the 1930s, courts in the United States allowed suit for “breach of promise” (the so-called “jilted bride”), where damages were deemed to be reduction in future marital prospects, loss of virginity, and so forth.

Economist Margaret Brinig discovered that beginning in the 1930s, U.S. courts became reluctant to award for breach of promise, and between 1935 and 1945 it was abolished in states with about one-half the population of the United States. Hence, diamond engagement rings became a performance bond. If the bride was jilted, at least she got to keep the ring. Brinig further posits that the decline in the tradition since the 1960s is due to social changes: premarital sex is more common, contraception is more reliable, and virginity less important in the marriage market, among other factors.

In sum, the economist's theory of rationality is incredibly powerful and explains much human behavior. After all, for all of its faults, if one is going to make a case that people consistently behave in ways that are detrimental to their own interests, the alternative better be a very convincing explanation.

Contrary to the vision of capitalism being nothing but selfish individuals who only look out to maximize their own self-interest, free markets actually coordinate the behavior of billions of individuals, all trying to serve the needs of others, mostly complete strangers whom they will never meet, are of a different religion, and whom they may not even like. This purposeful behavior is coordinated through human action, not human design. Deirdre McCloskey makes this pertinent observation with respect to the assumption

of rationality: "...[I]t is some comfort to note that although economic man is incapable of sympathy, benevolence or love...he is also incapable of envy, malevolence or hatred. In short, he is splendidly neutral to others" (McCloskey, 1985: 230).

When you sit down to dinner tonight, consider this: It truly does take an entire village to make your dinner, yet none of the individuals involved either know you, or care about you. Yet you will still enjoy a first-rate meal. After you do, consider that all of those individuals—from farmers, truckers, grocery store owners, stock clerks, and myriad others—whose actions brought you that epicurean delight were coordinated through an incredible invisible hand known as the price system.



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# 7

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## THE INVISIBLE HAND: NO ONE PERSON KNOWS HOW TO MAKE A PENCIL

*He [the businessman] generally, indeed, neither intends to promote the public interest, nor knows how much he is promoting it.... He intends only his own security; and by directing that industry in such a manner as its produce may be of the greatest value, he intends only his own gain. He is in this, as in many other cases, led by an invisible hand to promote an end which was no part of his intention.... By pursuing his own interest he frequently promotes that of the society more effectually than when he really intends to promote it. I have never known much good done by those who affected to trade for the public good.... 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.*

—Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations*, 1776

Wyoming cattle ranchers most likely do not spend their waking hours thinking of the convenience and comfort of New Yorkers, they may even dislike them. Yet they wake up at the crack of dawn and toil on the ranch in order to secure a steady stream of meat products in New York's stores. Why do they do this?

While many cite the writing of Adam Smith as proof of capitalism's selfishness and greed, his views were much more insightful than mere self-interest. He dealt with human nature and psychology in his first, largely forgotten, book *The Theory of Moral Sentiments*, which also studied human feelings and acts of benevolence. In it, he wrote:

How selfish soever man may be supposed, there are evidently some principles in his nature, which interest him in the fortune of others, and render their happiness necessary to him though he derives nothing from it, except the pleasure of seeing it.... The greatest ruffian, the most hardened violator of the laws of society, is not altogether without it (quoted in Wight, 2002: 136).

Smith argued it was your *conscience* that made you do the right thing, and man's behavior could not be solely explained by mere greed. It is not love of New Yorkers that makes Wyoming cattle ranchers toil at dawn, but love for the dignity and superiority of their character. We desire not only to gain the external praise of others; we desire to gain the internal respect and praise of *ourselves*. We, ultimately, want to be *worthy* of our praise. We desire to be *praiseworthy*.

In an effort to feed a family, do productive work, and make a contribution to society, individuals engage in enterprise in order to serve the needs of others. In reality, *homo sapiens* is the only animal that coordinates elaborate task-sharing activities between unrelated members of the same species. Our ancestors 12,000 years ago, who wandered the plains in small bands in search of food worrying about opportunistic strangers inflicting warfare, murder, and thievery, would be in awe of our ability to step out our front door into a city of 10 million and drive to a supermarket stocked with just the right amount of meat, produce, and other essentials for daily sustenance—all done with no central coordinating intelligence. The amount of knowledge required to get products and services delivered to a place convenient for customers is an enormous challenge in terms of the knowledge among millions of people that has to be shared. It is beyond the capacity of the world's supercomputers combined.

How does this knowledge become coordinated at just the right place, at the right time, in the right quantity, and at the right price in order for you to walk into an office supply store and purchase the pencil of your choice? The answer is *prices*. In 1948, Leonard E. Read, founder of the Foundation for Economic Education, wrote a whimsical essay—in the voice of a pencil—wonderfully illustrating how something as simple as a pencil requires the coordination of thousands of different people, located in different countries, of various races and religions, whose actions are all coordinated from the signal of prices. It has become a classic essay, one that should be required reading for anyone who wants to gain a deeper appreciation of the miracle of free market prices. It is reproduced here in its entirety.

**No One Individual Knows How to Make a Pencil**

*I, Pencil* by Leonard E. Read



I am a lead pencil—the ordinary wooden pencil familiar to all boys and girls and adults who can read and write.

Writing is both my vocation and my avocation; that's all I do.

You may wonder why I should write a genealogy. Well, to begin with, my story is interesting. And, next, I am a mystery—more so than a tree or a sunset or even a flash of lightning. But, sadly, I am taken for granted by those who use me, as if I were a mere incident and without background. This supercilious attitude relegates me to the level of the commonplace. This is a species of the grievous error in which mankind cannot too long persist without peril. For, the wise G.K. Chesterton observed, "We are perishing for want of wonder, not for want of wonders."

I, Pencil, simple though I appear to be, merit your wonder and awe, a claim I shall attempt to prove. In fact, if you can understand me—no, that's too much to ask of anyone—if you can become aware of the miraculousness which I symbolize, you can help save the freedom mankind is so unhappily losing. I have a profound lesson to teach. And I can teach this lesson better than can an automobile or an airplane or a mechanical dishwasher because—well, because I am seemingly so simple.

Simple? Yet, not a single person on the face of this earth knows how to make me. This sounds fantastic, doesn't it? Especially when it is realized that there are about one and one-half billion of my kind produced in the U.S.A. each year.

Pick me up and look me over. What do you see? Not much meets the eye—there's some wood, lacquer, the printed labeling, graphite lead, a bit of metal, and an eraser.

**Innumerable Antecedents**

Just as you cannot trace your family tree back very far, so is it impossible for me to name and explain all my antecedents. But I would like to suggest enough of them to impress upon you the richness and complexity of my background.

My family tree begins with what in fact is a tree, a cedar of straight grain that grows in Northern California and Oregon. Now contemplate all the saws and trucks and rope and the countless other gear used in harvesting and carting the cedar logs to the railroad siding. Think of all the persons and the numberless skills that went into their fabrication: the mining of ore, the making of steel and its refinement into saws, axes, motors; the growing of hemp and bringing it through all the stages to heavy and strong rope; the logging camps with their beds and mess halls, the cookery and the raising of all the foods. Why, untold thousands of persons had a hand in every cup of coffee the loggers drink!

The logs are shipped to a mill in San Leandro, California. Can you imagine the individuals who make flat cars and rails and railroad engines and who construct and install the communication systems incidental thereto? These legions are among my antecedents.

Consider the millwork in San Leandro. The cedar logs are cut into small, pencil-length slats less than one-fourth of an inch in thickness. These are kiln dried and then tinted for the same reason women put rouge on their faces. People prefer that I look pretty, not a pallid white. The slats are waxed and kiln dried again. How many skills went into the making of the tint and the kilns, into supplying the heat, the light and power, the belts, motors, and all the other things a mill requires? Sweepers in the mill among my ancestors? Yes, and included are the men who poured the concrete for the dam of a Pacific Gas & Electric Company hydroplant which supplies the mill's power!

Don't overlook the ancestors present and distant who have a hand in transporting sixty carloads of slats across the nation.

Once in the pencil factory—\$4,000,000 in machinery and building, all capital accumulated by thrifty and saving parents of mine—each slat is given eight grooves by a complex machine, after which another machine lays leads in every other slat, applies glue, and places another slat atop—a lead sandwich, so to speak. Seven brothers and I are mechanically carved from this “wood-clinched” sandwich.

My “lead” itself—it contains no lead at all—is complex. The graphite is mined in Ceylon. Consider these miners and those who make their many tools and the makers of the paper sacks in which the graphite is shipped and those who make the string that ties the sacks and those who put them aboard ships and those who make the ships. Even the lighthouse keepers along the way assisted in my birth—and the harbor pilots.

The graphite is mixed with clay from Mississippi in which ammonium hydroxide is used in the refining process. Then wetting agents are added such as sulfonated tallow—animal fats chemically reacted with sulfuric acid. After passing through numerous machines, the mixture finally appears as endless extrusions—as from a sausage grinder—cut to size, dried, and baked for several hours at 1,850 degrees Fahrenheit. To increase their strength and smoothness the leads are then treated with a hot mixture which includes candelilla wax from Mexico, paraffin wax, and hydrogenated natural fats.

My cedar receives six coats of lacquer. Do you know all the ingredients of lacquer? Who would think that the growers of castor beans and the refiners of castor oil are a part of it? They are. Why, even the processes by which the lacquer is made a beautiful yellow involves the skills of more persons than one can enumerate!

Observe the labeling. That's a film formed by applying heat to carbon black mixed with resins. How do you make resins and what, pray, is carbon black?



My bit of metal—the ferrule—is brass. Think of all the persons who mine zinc and copper and those who have the skills to make shiny sheet brass from these products of nature. Those black rings on my ferrule are black nickel. What is black nickel and how is it applied? The complete story of why the center of my ferrule has no black nickel on it would take pages to explain.

Then there's my crowning glory, inelegantly referred to in the trade as "the plug," the part man uses to erase the errors he makes with me. An ingredient called "factice" is what does the erasing. It is a rubber-like product made by reacting rape-seed oil from the Dutch East Indies with sulfur chloride. Rubber, contrary to the common notion, is only for binding purposes. Then, too, there are numerous vulcanizing and accelerating agents. The pumice comes from Italy; and the pigment which gives "the plug" its color is cadmium sulfide.

### **No One Knows**

Does anyone wish to challenge my earlier assertion that no single person on the face of this earth knows how to make me?

Actually, millions of human beings have had a hand in my creation, no one of whom even knows more than a very few of the others. Now, you may say that I go too far in relating the picker of a coffee berry in far off Brazil and food growers elsewhere to my creation; that this is an extreme position. I shall stand by my claim. There isn't a single person in all these millions, including the president of the pencil company, who contributes more than a tiny, infinitesimal bit of know-how. From the standpoint of know-how the only difference between the miner of graphite in Ceylon and the logger in Oregon is in the type of know-how. Neither the miner nor the logger can be dispensed with, any more than can the chemist at the factory or the worker in the oil field—paraffin being a by-product of petroleum.

Here is an astounding fact: Neither the worker in the oil field nor the chemist nor the digger of graphite or clay nor any who mans or makes the ships or trains or trucks nor the one who runs the machine that does the knurling on my bit of metal nor the president of the company performs his singular task because he wants me. Each one wants me less, perhaps, than does a child in the first grade. Indeed, there are some among this vast multitude who never saw a pencil nor would they know how to use one. Their motivation is other than me. Perhaps it is something like this: Each of these millions sees that he can thus exchange his tiny know-how for the goods and services he needs or wants. I may or may not be among these items.

### **No Master Mind**

There is a fact still more astounding: The absence of a master mind, of anyone dictating or forcibly directing these countless actions which bring me into

being. No trace of such a person can be found. Instead, we find the Invisible Hand at work. This is the mystery to which I earlier referred.

It has been said that “only God can make a tree.” Why do we agree with this? Isn’t it because we realize that we ourselves could not make one? Indeed, can we even describe a tree? We cannot, except in superficial terms. We can say, for instance, that a certain molecular configuration manifests itself as a tree. But what mind is there among men that could even record, let alone direct, the constant changes in molecules that transpire in the life span of a tree? Such a feat is utterly unthinkable!

I, Pencil, am a complex combination of miracles: a tree, zinc, copper, graphite, and so on. But to these miracles which manifest themselves in Nature an even more extraordinary miracle has been added: the configuration of creative human energies—millions of tiny know-hows configuring naturally and spontaneously in response to human necessity and desire and in the absence of any human master-minding! Since only God can make a tree, I insist that only God could make me. Man can no more direct these millions of know-hows to bring me into being than he can put molecules together to create a tree.

The above is what I meant when writing, “If you can become aware of the miraculousness which I symbolize, you can help save the freedom mankind is so unhappily losing.” For, if one is aware that these know-hows will naturally, yes, automatically, arrange themselves into creative and productive patterns in response to human necessity and demand—that is, in the absence of governmental or any other coercive master-minding—then one will possess an absolutely essential ingredient for freedom: a faith in free people. Freedom is impossible without this faith.

Once government has had a monopoly of a creative activity such, for instance, as the delivery of the mails, most individuals will believe that the mails could not be efficiently delivered by men acting freely. And here is the reason: Each one acknowledges that he himself doesn’t know how to do all the things incident to mail delivery. He also recognizes that no other individual could do it. These assumptions are correct. No individual possesses enough know-how to perform a nation’s mail delivery any more than any individual possesses enough know-how to make a pencil. Now, in the absence of faith in free people—in the unawareness that millions of tiny know-hows would naturally and miraculously form and cooperate to satisfy this necessity—the individual cannot help but reach the erroneous conclusion that mail can be delivered only by governmental “master-minding.”

### **Testimony Galore**

If I, Pencil, were the only item that could offer testimony on what men and women can accomplish when free to try, then those with little faith would have a fair case. However, there is testimony galore; it’s all about us and on every

hand. Mail delivery is exceedingly simple when compared, for instance, to the making of an automobile or a calculating machine or a grain combine or a milling machine or to tens of thousands of other things. Delivery? Why, in this area where men have been left free to try, they deliver the human voice around the world in less than one second; they deliver an event visually and in motion to any person's home when it is happening; they deliver 150 passengers from Seattle to Baltimore in less than four hours; they deliver gas from Texas to one's range or furnace in New York at unbelievably low rates and without subsidy; they deliver each four pounds of oil from the Persian Gulf to our Eastern Seaboard—halfway around the world—for less money than the government charges for delivering a one-ounce letter across the street!

The lesson I have to teach is this: Leave all creative energies uninhibited. Merely organize society to act in harmony with this lesson. Let society's legal apparatus remove all obstacles the best it can. Permit these creative know-hows freely to flow. Have faith that free men and women will respond to the Invisible Hand. This faith will be confirmed. I, Pencil, seemingly simple though I am, offer the miracle of my creation as testimony that this is a practical faith, as practical as the sun, the rain, a cedar tree, the good earth (available at 209.217.49.168/vnews.php?nid=316 or Foundation for Economic Foundation at [www.fee.org](http://www.fee.org)).



## THE ROLE OF PRICES IN SOCIETY

*[Cannan spoke of the] wonderful way in which the people of the whole civilised world now co-operate in the production of wealth....*

*[C]onsider the daily feeding of London. There are.... six millions of people in and about London, so closely packed together that they cannot grow anything for their own consumption, and yet every morning their food arrives with unfailing regularity... they use coal which has been dug from great depths hundreds of miles away... in consuming... they eat and drink products which have come from Wiltshire, Jamaica, Dakota, or China, with no more thought than an infant consuming its mother's milk. It is clear that there is in existence some machinery, some organisation for production, which, in spite of occasional failures here and there, does its work on the whole with extraordinary success.*

—Edwin Cannan, Presidential Address to Section F of the British Association, 1902 (quoted in Ebenstein, 2003: 103)

The world is not zero-sum. One of the key insights from Adam Smith's 1776 treatise *Wealth of Nations* is misleadingly simple: if an exchange takes place between two parties voluntarily, both will benefit from it. In other words, both have to earn a profit from the exchange. Smith was the first person who articulated the concept of win-win. Many economic problems and fallacies are caused when we forget this simple fact of life.

In *Free to Choose*, Milton and Rose Friedman explain the role of prices in society:

Adam Smith's flash of genius was his recognition that the prices that emerged from voluntary transactions between buyers and sellers—for short, in a free market—could coordinate the activity of millions of people, each seeking his own interest, in such a way as to make everyone better off. It was a startling idea then, and it remains one today, that economic order can emerge as the unintended consequence of the actions of many people, each seeking his own interest.

The price system works so well, so efficiently, that we are not aware of it most of the time. We never realize how well it functions until it is prevented from functioning, and even then we seldom recognize the source of the trouble.

Prices perform three functions in organizing economic activity: first, they transmit information; second, they provide an incentive to adopt those methods of production that are least costly and thereby use available resources for the most highly valued purposes; third, they determine who gets how much of the product—the distribution of income. These three functions are closely interrelated (Friedman and Friedman, 1980: 13–14).

Only individuals earn income, not businesses or corporations, as these are merely intermediaries. As economist Herbert Stein—Ben Stein's father—was fond of saying, "There's no one around here except us people." In a sense, prices are a form of economic speech, and as such, should be protected with the same force and vigor with which the First Amendment protects free political and religious speech. In fact, the Friedmans proposed such a constitutional amendment in their book *Free to Choose*: "Congress shall make no laws abridging the freedom of sellers of goods or labor to price their products or services." Why is this necessary?

Because whenever a government steps in and tries to suppress the freedom of prices to perform their functions, disaster usually develops. Whether it is the inability of the former communist countries to feed themselves—through the forced collectivization of agriculture—or wage and price controls—leading to

chronic shortages of goods and services—trying to control prices by any other mechanism than the voluntary transactions is an abject failure. Corruption, black markets, violence and endemic crime are usually the results of suppressing economic freedom and capitalist acts between consenting adults.

Mikhail Gorbachev, when he was leader of the former Soviet Union, reportedly asked British Prime Minister Margaret Thatcher, “How do you see to it that people get food?” She answered that she did not. Prices did that. Oscar Wilde once said, “A cynic is one who knows the price of everything and the value of nothing.” Former USSR economists used to joke that it was the opposite for them. Apparently, Gorbachev never read Leonard Read’s essay, but one would think he would have read Friedrich Engels’ preface to the first German edition of *The Poverty of Philosophy* by Karl Marx, where he wrote:

[Engels pointed out that price fluctuations have] “forcibly brought home to the commodity producers what things and what quantity of them society requires or does not require.” [Without such a mechanism, he demanded to know] “what guarantee we have that necessary quantity and not more of each product will be produced, that we shall not go hungry in regard to corn and meat while we are choked in beet sugar and drowned in potato spirit, that we shall not lack trousers to cover our nakedness while trouser buttons flood us in millions” (quoted in Sowell, 2004b: 15).

Perhaps Engels understood the price mechanism better than Marxists of today. Certainly Gorbachev does, since in 2004 he reportedly sold the copyright to his prominent forehead birthmark to Wine Stain Vodka.

Nevertheless, it is amazing how little understanding there is—even among businesspeople—of the role prices play in any economy, be it communist or capitalist. Perhaps this is the result of neglecting economic education in our nation’s high schools and colleges. The major theme running through this book is that, ultimately, it is the customer who determines the value of anything in this world—a theory we will prove in the next chapter. In that spirit, let me quote, somewhat at length, from *Planned Chaos*, by the great Austrian economist Ludwig Von Mises:

In the market economy the consumers are supreme. Their buying and their abstention from buying ultimately determines what the entrepreneurs produce and in what quantity and quality. It determines directly the prices of the consumer’s goods and indirectly the prices of all producers’ goods, viz., labor and material factors of production. It determines the emergence of profits and losses and the formation of the rate of interest. It determines every individual’s

income. The focal point of the market economy is the market, i.e., the process of the formation of commodity prices, wage rates and interest rates and their derivatives, profits and losses. It makes all men in their capacity as producers responsible to the consumers. This dependence is direct with entrepreneurs, capitalists, farmers and professional men, and indirect with people working for salaries and wages. The market adjusts the efforts of all those engaged in supplying the needs of the consumers to the wishes of those for whom they produce, the consumers. It subjects production to consumption.

It is the consumers who make poor people rich and rich people poor. It is the consumers who fix the wages of a movie star and an opera singer at a higher level than those of a welder or an accountant (Mises, 1947: 25–26).

To the often-made charge of free market critics that decisions left solely to the market inevitably end in complete chaos, with no central direction, or unifying goals, Mises directs this stinging missive:

No “automatic” and “anonymous” forces actuate the “mechanism” of the market. The only factors directing the market and determining prices are purposive acts of men. There is no automatism; there are men consciously aiming at ends chosen and deliberately resorting to definite means for the attainment of these ends. There are no mysterious mechanical forces; there is only the will of every individual to satisfy his demand for various goods. There is no anonymity; there are you and I and Bill and Joe and all the rest. And each of us is engaged both in production and consumption. Each contributes his share to the determination of prices.

The dilemma is not between automatic forces and planned action. It is between the democratic process of the market in which every individual has his share and the exclusive rule of a dictatorial body. Whatever people do in the market economy is the execution of their own plans. In this sense every human action means planning. What those calling themselves planners advocate is not the substitution of planned action for letting things go. It is the substitution of the planner’s own plan for the plan of his fellowmen. The planner is a potential dictator who wants to deprive all other people of the power to plan and act according to their own plans. He aims at one thing only: the exclusive absolute preeminence of his own plan.

There is no such thing as an “excessive” advocacy of economic freedom. Men must choose between the market economy and socialism. The state can preserve the market economy in protecting life, health and private property against violent or fraudulent aggression; or it can itself control the conduct of all production activities. Some agency must determine what should be produced. If it is not the consumers by means of demand and supply on the market, it must be the government by compulsion (*ibid.*: 29, 34).

It is hard to argue with Mises' logic, especially given the abject failure of planned economies throughout the world. The price system allocates an economy's resources, directing them to their most valued uses. There are only two other ways to achieve this allocation: force or rationing. If you were to randomly drop tickets to the Rolling Stones from a helicopter, this would be a form of allocation. Economists probably would not mind, as long as people would be allowed to sell their tickets, and then you would end up with an allocation virtually indistinguishable from a price system.

In Great Britain, where they have the Nationalized Health Service, more than 10,000 people waited longer than 15 months for surgery in 2001, a situation those in the United States would not tolerate with their pets, let alone their loved ones. This is a form of allocation by rationing, decided by agents for the state who have different incentives and motivations than do the patients in need of care. The fact that medical care is scarce does not disappear under socialized medicine, it is merely allocated in a less efficient manner. In *How to Be Human—Though an Economist*, Deirdre McCloskey sums up the role of prices this way:

When I was 25, having studied economics for 6 years, I grasped suddenly that prices are for allocation, not fairness. When I was 28, an assistant professor... I grasped that prices are only one possible system of allocation (violence and queuing are others) but socially the cheapest. When I was in my thirties I could spot this stuff for myself in actual markets (McCloskey, 2000: 181).

When prices are not allowed to fluctuate by the dictates of free markets, by having ceilings or floors placed upon them by laws and regulations promulgated by government, chronic shortages, or surpluses, always result. These shortages and surpluses are not the result of physical scarcity, they are matters of price.

During the oil crisis in 1979 when drivers were queuing up at gas stations and buying gas according to the odd-even number at the end of their license plates, the amount of gas sold was only 3.5% less than the record-breaking year of 1978. The reason for the shortage was because it did not pay to discover and extract more oil at the existing price. Similarly, rent control causes shortages due to price, not physical scarcity, because it reduces the incentives to build more housing at existing prices.

Thomas Sowell, one of the nation's most prolific writers and thinkers in the area of the history of economic ideas, explains the role of prices in *Basic Economics*:

Many people see prices as simply obstacles to their getting the things they want. But high prices are not the reason we cannot all live on the beach front. On the contrary, the inherent reality is that there are not nearly enough beach-front homes to go around and prices are just a way of conveying that underlying reality. . . . [I]t is not the prices that cause the scarcity, which would exist under whatever other social arrangements might be used instead of prices.

From the standpoint of society as a whole, the “cost” of anything is the value that it has in alternative uses.

In a society of millions of consumers, no given individual or set of government decision-makers sitting around a table can possibly know just how much these millions of consumers prefer one product to another, much less thousands of products to thousands of other products. In an economy coordinated by prices, no one has to know.

Knowledge is one of the most scarce of all resources and a pricing system economizes on its use by forcing those with the most knowledge of their own particular situation to make bids for goods and resources based on that knowledge, rather than on their ability to influence other people (Sowell, 2000: 7, 10, 14).

On the debilitating effects of price controls, Sowell points out:

Prices rise because the amount demanded exceeds the amount supplied at existing prices. Prices fall because the amount supplied exceeds the amount demanded at existing prices. The first case is called a “shortage” and the second is called a “surplus”—but both depend on existing prices (ibid.: 22).

... “[S]hortages” and “surpluses” are matters of price, not matters of physical scarcity, either absolutely or relative to the population (ibid.: 24).

To say that prices are due to greed is to imply that sellers can set prices by an act of will. If so, no company would ever go bankrupt, since it could simply raise its prices to cover whatever its costs happened to be (ibid.: 40).

Free-market prices are not merely arbitrary obstacles to getting what people want. Prices are symptoms of an underlying reality that is not nearly as susceptible to political manipulation as the prices are. Prices are like thermometer readings—and a patient with a fever is not going to be helped by plunging the thermometer into ice water to lower the reading. On the contrary, if we were to take the new readings seriously and imagine that the patient’s fever was over, the dangers would be even greater, now that the underlying reality was being ignored (ibid.: 54).

One reason the Soviet Union collapsed was that allocating resources without a price system is difficult, and not very effective. Price controls do not, in actuality, control prices, they control people. Although a price-coordinated



economy may have no more total knowledge than one that is centrally planned, that knowledge is distributed in a much more effective manner, as are the decision-making processes of economic agents. The workings of market prices allow each individual to actually possess less knowledge than your ancestors. You can purchase and enjoy food without ever having to learn the trials and tribulations of farming, and you can fly across the continent without even being able to pass a physics examination. As another great Austrian economist, Friedrich Hayek, pointed out, “Civilization rests on the fact that we all benefit from knowledge which we do not possess.”

A lot of the knowledge we do not possess is that of prices themselves. Of the literally billions of prices that exist in the marketplace, most people are conscious of a relatively small number that directly effect their lives, usually as producers. Most of us are blissfully ignorant of, perhaps, over 90 percent of the prices that exist in a market economy. Do you know the price of a billiard table, or real estate in the Cayman Islands?

Of course, most businesspeople live the ultimate contradiction. They spend their nights praying for monopoly prices on the goods and services they sell, but then engage daily in the very activities that tend to drive those prices downward—by supplying more goods to the market. Now that we have examined the macroeconomic importance of prices and how they coordinate human activity, let us now turn our attention to the microeconomics of pricing. Prices, ultimately, are derived from value. And what determines value? In order to answer that question, we need a theory of value. Fortunately for those of us living today, the contentious process of positing and falsifying various theories of value occurred among some of the greatest thinkers in history, carried out in the arena of ideas.



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## A TALE OF TWO THEORIES

*In the final analysis, I find nothing as intellectually satisfying as the history of ideas. I have never been able to grasp how one can understand any idea without knowing where it came from, how it evolved out of previous ideas. Great theories, in economics as in other subjects, are path-dependent...; that is, it is not possible to explain their occurrence without considering the corpus of received ideas which led to the development of that particular new theory...without the history of economics, economic theories just drop from the sky; you have to take them on faith. The moment you wish to judge a theory, you have to ask how they came to be produced in the first place and that is a question that can only be answered by the history of ideas.*

—Mark Blaug, *Not Only an Economist*, 1997

Adam Smith [1723–1790] was confounded. One of the greatest economic and social thinkers in the history of ideas struggled with the so-called “diamond-water paradox,” which Smith explained in Chapter 4 of Book I of *Wealth of Nations*: “Nothing is more useful than water: but it will purchase scarce anything... A diamond, on the contrary, has scarce any value in use; but a very great quantity of other goods may frequently be had in exchange for it” (quoted in Skousen and Taylor, 1997: 27). None of us would be able to live beyond a couple of weeks without water, yet its price is relatively cheap compared to the frivolous diamond, which certainly no one needs in order to stay alive. Similar to 99-cent pricing, this conundrum led to some incredible discoveries, advancing our understanding of value. As the Danish physicist Niels Bohr once observed: “How wonderful that we’ve met with a paradox. Now we have hope of making some progress.”

Most people confronted with this paradox—including Smith—would resolve it by replying the supply of diamonds is sparse compared to water,

and hence they command a higher price. This is an intuitive, and very reasonable, solution. After all, water is approximately 71 percent of the earth's surface, while diamonds are found in only a limited number of places in the world, and the supply is even further restricted by diamond cartels, such as De Beers, which of course did not exist in Smith's day.

Yet the scarcity theory lacks explanatory power. If it was true, I, as the author of the book you are now holding, could sign your copy in pink crayon, attesting to the fact that only one copy exists of this book with my autograph in pink crayon. It is like a Picasso, one of a kind—in other words, scarce. How much is it worth? My autograph does not enhance the value of the book by one cent. Just because something is scarce does not make it valuable. Think about it: if scarcity determined value, then those drawings on your refrigerator from your children and grandchildren should be incredibly valuable, because they are, indeed, rare. There must be a better theory that solves this puzzle, so let us explore the antecedents of the theory of value.

## THE LABOR THEORY OF VALUE

Throughout history, humans have always correlated labor with value, inputs with outputs. In medieval English, the word *acre* meant the amount of land a team of eight oxen could plow in a morning. Some scholars have suggested that the labor theory of value originated in the thirteenth century with St. Thomas Aquinas, while Aristotle explained a good could obtain a price because there was a need for it. Yet each of these explanations leaves us devoid of a more precise theory of value. A representative from the school of Salamanca, Luis Saravia de la Calle (1544) attempted to provide one:

Those who measure the just price by the labor, costs and risk incurred by the person who deals in the merchandise or produces it, or by the cost of transport or the expense of traveling to and from the fair, or by what he has to pay the factors for the industry, risk and labor, are greatly in error, and still more so are those who allow a certain profit of a fifth or a tenth. For the just price arises from the abundance or scarcity of goods, merchants and money, as has been said, and not from costs, labor and risk. If we had to consider labor and risk in order to assess the just price, no merchant would ever suffer loss (quoted in Fog, 1994: 79).

This is a somewhat better insight into value, and it certainly contains a profound concept—that is, if cost plus risk were the only things that deter-

mined price, then what merchant would ever incur a loss? It does not take an economic genius for a merchant to sum up their costs, along with a desired profit in order to calculate a price. But does this equate to value? The argument that a just price arises from scarcity has been shown to be specious, so there must be another explanation.

Smith equated value with labor, writing in *Wealth of Nations*:

Labour alone, therefore, never varying in its own value, is alone the ultimate and real standard by which the value of all commodities can at all times and places be estimated and compared. It is their real price, money is their nominal price only (quoted in Cohen, 2001: 40).

If it usually costs twice the labour to kill a beaver as it does to kill a deer, says Smith, “one beaver should naturally exchange for or be worth two deer” (ibid.: 40).

“[The] real price of everything, what every thing really costs... is the toil and trouble of acquiring it.” Or in Smith’s terms, “Labour, therefore, is the real measure of the exchangeable value of commodities” (ibid.: 68).

The value of any commodity, therefore, to the person who possesses it, and who means not to use or consume it himself, but to exchange it for other commodities, is equal to the quantity of labour which it enables him to purchase or command. Labour, therefore, is the real measure of the exchangeable value of all commodities (ibid.: 72).

Smith here is identifying two separate forms of value—“value in use” and a “value in exchange,” which gave rise to the famous diamond-water paradox, since certain items for one’s own use were highly valuable (e.g., water) but commanded little in exchange for other goods, like diamonds. In essence, Smith decided to ignore a commodity’s value in use and just focus on value in exchange. Indeed, to this day, one sees various business books distinguishing value in use from value in exchange.

Yet, Smith understood there were factors other than labor that went into the cost of producing commodities—although labor was certainly the largest expense in his time—such as the cost of capital, equipment, rent, and the risk the entrepreneur was assuming. All these factors also had to be compensated in the price of the final commodity, so Smith posited a “cost of production” theory of value, in effect “adding up” labor, profit, rent, and cost of capital to determine price. Of course, this still begs the question of how a company could ever lose money by following this theory, since even the most inept businessperson would be able to add up all of these factors to derive a price that generates a profit.

One of the wealthiest economists to have ever lived, the British economist David Ricardo [1772–1823], who developed the law of diminishing returns, along with probably one of the most famous economic laws ever—the law of comparative advantage—in his 1817 treatise *Principles of Political Economy and Taxation* explains his theory of value:

The value of a commodity, or the quantity of any other commodity for which it will exchange, depends on the relative quantity of labour which is necessary for its production (quoted in Keen, 2002: 276).

Ricardo also adopted a cost of production theory of value, claiming price was determined by costs, although he did note some exceptions such as rare works of art, books, coins, and wines:

There are some commodities, the value of which is determined by their scarcity alone. No labour can increase the quantity of such goods, and therefore their value cannot be lowered by an increased supply. Some rare statues and pictures, scarce books and coins, wines of a peculiar quality, which can be made only from grapes grown on a particular soil, of which there is a very limited quantity, are all of this description. Their value is wholly independent of the quantity of labour originally necessary to produce them, and varies with the varying wealth and inclinations of those who are desirous to possess them (ibid.: 272).

...[M]y proposition that with few exceptions the quantity of labour employed on commodities determines the rate of which they will exchange for each other... is not rigidly true, but I say it is the nearest approximation to truth, as a rule for measuring relative value, of any I have ever heard (quoted in Skousen, 2001: 107).

In fact, Ricardo struggled with the labor theory of value until the last days of his life. As Mark Skousen writes in his luminous book *The Making of Modern Economics*:

About a month before his death he wrote a fellow economist, “I cannot get over the difficulty of the wine which is kept in a cellar for 3 or 4 years, or that of the oak tree, which perhaps had not 2/- [pence] expended on it in the way of labour, and yet comes to be worth £100” (ibid.: 108).

Here we have two eminent economists—although they were called moral philosophers in their day—who struggled to develop a unifying and credible theory of value. It would take another influential thinker to popularize a theory of value that appeared to accomplish his utopian objectives.

## KARL MARX, FALSE PROPHET

*The philosophers have only interpreted the world in various ways.*

*The point however is to change it.*

—Inscription, Karl Marx's tomb, Highgate Cemetery, London

*How do you tell a communist? Well, it's someone who reads*

*Marx and Lenin. And how do you tell an anti-communist?*

*It's someone who understands Marx and Lenin.*

—President Ronald Reagan, September 25, 1987

*Workers of the world...forgive me.*

—Karl Marx, graffiti on a statue, Moscow, 1991

John Maynard Keynes wrote in the famous final passage of his 1937 book *General Theory of Employment, Interest, and Money*:

[T]he ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly understood. Indeed, the world is ruled by little else. Practical men, who believe themselves to be quite exempt from any intellectual influences, are usually the slaves of some defunct economist. Madmen in authority, who hear voices in the air, are distilling their frenzy from some academic scribbler of a few years back... But, soon or late, it is ideas, not vested interests which are dangerous for good or evil (quoted in Buchholz, 1990: 219).

Perhaps Keynes was thinking of Karl Marx [1818–1883] when he wrote the passage above, for we know he could not stand Marx or the communist experiment, which he regarded as “an insult to our intelligence.” At a dinner with friends in 1934, Keynes reportedly said that of all the “isms,” Marxism was “the worst of all and founded on a silly mistake of old Mr. Ricardo’s [labor theory of value]” (quoted in Skousen, 2001: 154).

Marx is far from dead. His flock might have perished, but his church lives on. In a poll of 3 million Germans, he ranked as the third “best German” of all time behind Konrad Adenauer and Martin Luther. His labor theory of value still wields enormous influence over our present-day concept of value and price. Here is how Marx explained his theory in *Value, Price and Profit*, published in 1865:

A commodity has a *value*, because it is a *crystallisation of social labour*. The *greatness* of its value, or its *relative* value, depends upon the greater or less amount of that social substance contained in it; that is to say, on the relative mass of labour necessary for its production. The *relative values of commodities* are, therefore, determined by the *respective quantities or amounts of labor, worked up, realized, fixed in them*. The *correlative* quantities of commodities which can be produced in the *same time of labor* are *equal* (Marx, 1995: 31).

This sounds quite reasonable, until you put this theory to the test of explaining how people spend their money in the marketplace.

Marx's theory cannot explain how land and natural resources have value, since there is no labor contained in them. Taken to its extreme, the labor theory of value would predict those countries with the most labor hours—such as China or India—would have the highest standards of living. But this is demonstrably false, and what we witness instead in countries with *less* labor inputs and more entrepreneurship—and secure private property and other institutions conducive to economic growth—are vastly higher standards of living, including shorter hours for workers.

If Marx's theory was correct, a rock found next to a diamond in a mine would be of equal value, since each took the same amount of labor hours to locate and extract. Yet how many rocks do you see in the local mall's jewelry store? If you were to have pizza for lunch today, under Marx's theory, your tenth slice would be just as valuable as your first, since each took the same amount of labor hours to produce. One glaring flaw in Marx's theory was that it did not take into account the law of diminishing marginal utility, which states that the value to the customer declines with additional consumption of the good in question. Two friends, both adherents to this theory, emerging from a movie would have to have enjoyed it equally, since it took the same amount of labor hours to produce, and therefore each would value it the same. The pictures in your office and home of loved ones could be replaced with strangers, and these would be of equal value to you since they took the same amount of "labor" to produce. A comfortable chair produced in two hours would be less valuable than an uncomfortable one produced in eight hours by a klutz.

Frederic Bastiat [1801–1850], who Joseph Schumpeter wrote was "the most brilliant economic journalist who ever lived," would challenge the labor theory of value in the same manner he challenged protectionists—with devastating wit and illustrating the absurd by being absurd. His most famous illustration of the fallacies of protectionism was "The Petition of the Candlemakers," arguing that candle manufacturers were suffering ruinous



competition from a foreign rival that gave away its product for free—the sun—and the government should pass a law requiring the closing of all windows, dormers, skylights, inside and outside shutters, curtains, and so forth. In a similar essay, “The Left Hand and the Right,” Bastiat claimed that if more and harder labor equated to value, then the government should amputate everyone’s right hand, since the labor required for even the most menial of tasks would likely double, thereby increasing wealth. Ludicrous? Absolutely. Yet an effective way to falsify a theory—showing where and how it will not work.

Marx attempted to avert these dilemmas, and even recognized that art and land could appreciate in value without further labor, but he dismissed these anomalies as being of minor importance to the fundamental issue of labor power. He also constructed a novel concept he coined “socially necessary labor,” which is the only type that creates value:

It might seem that if the value of a commodity is determined by the *quantity of labour bestowed upon its production*, the lazier a man, or the clumsier a man, the more valuable his commodity, because the greater the time of labour required for finishing the commodity. This, however, would be a sad mistake. You will recollect that I used the word “social labour,” and many points are involved in this qualification of “social.” In saying that the value of a commodity is determined by *the quantity of labour* worked up or crystallized in it, we mean *the quantity of labour necessary* for its production in a given state of society, under certain social average conditions of production, with a given social average intensity, and average skill of the labour employed.

If then the quantity of socially necessary labour realized in commodities regulates their exchangeable values, every increase in the quantity of labour wanted for the production of a commodity must augment its value, as every diminution must lower it (ibid.: 33–34).

But how does one determine what is “socially necessary labor”? Marx’s theory ignored the consumer, who ultimately determines value, bringing Marx from a circuitous route right back to the values of the free market he so vehemently abhorred. The very nature of a transaction between a willing buyer and seller is not based on an equality of labor but rather the *inequality* in the subjective value of the good bought and sold. This takes us back to one of Smith’s central insights, that both the buyer and seller must gain from an exchange, or it will not take place. Were this not so, we could simply exchange five-dollar bills with each other and achieve a Marxian utopia.

For the historical record, although Karl Marx spent his entire life writing about finance and industry, he never set foot in a mill, factory, mine, or any other workplace, and he knew only two people connected with financial and industrial matters. His uncle in Holland, Lion Philips, was one of these individuals, who created what eventually became Philips Electric Company. Marx was also a profligate spender and an irresponsible debtor, rarely paying back what he borrowed and getting angry when the creditor asked for payment. He never seriously attempted to get a job, thinking his family should support his important work. This attitude caused his mother to cut him off completely, wishing that “Karl would accumulate capital instead of just writing about it” (Johnson, 1990: 60, 74).

After surveying these three seminal thinkers—Smith, Ricardo, and Marx—we have left the diamond-water paradox unanswered, and we lack a convincing theory of value. This was not because the theory did not exist, for it did. Unfortunately, it was mostly ignored. Adam Smith’s cost of production theory was held to be true, or Alfred Marshall’s famous scissors of supply and demand were believed to be the final authority on prices and value. Some truths need resurrection, not discovery, and nowhere is this more true than with respect to the Austrian school of economics and its subjective theory of value.

## THE MARGINALIST REVOLUTION

*[Carl] Menger is the vanquisher of the Ricardian theory.... Menger's theory of value, price, and distribution is the best we have up to now.*

—Joseph Schumpeter, *Ten Great Economists from Marx to Keynes*, 1951

In the middle of the nineteenth century, economic theory was at a dead end. Although the Industrial Revolution was progressing, the theories of classical economists such as Smith, Ricardo, and John Stuart Mill, among others, still lacked a comprehensive theory of value and price. There are particular epochs that occur throughout history, when an assembly of people construct the events that cause a substantial advancement for human society. One such era was 1776, with the publication simultaneously of Smith’s *Wealth of Nations* and the Declaration of Independence. Another was 1871–1874, when three economists ushered in the “neoclassical” marginalist revolution

and solved the diamond-water paradox that so beleaguered the classical economists and was the undoing of Marxian economics.

Three economists, from three different countries, developed the theory of marginalism and created a revolution similar to the Keynesian tsunami of the 1930s, although it took longer to diffuse into the economics profession, taking approximately 20 years to become generally accepted theory: William Stanley Jevons [1835–1882], from Great Britain, Leon Walras [1834–1910] from France, and Carl Menger [1840–1921] from Austria. There were fore-runners to the marginal theory, such as Hermann Gossen from Germany, Samuel Longfield, Antoine Cournot, and Jules Dupuit, and the early Spanish philosophers. But it was not until these three came together that the theory was accepted as valid in the economics profession. “Swedish economist Knut Wicksell, who lived through the marginalist revolution, described it as a ‘bolt from the blue’” (Skousen, 2001: 169).

What made this new theory so revolutionary? As Menger explains in his book *Principles of Economics*, written in 1873 when he was 33 years old:

Value is...nothing inherent in goods, no property of them. Value is a judgment economizing men make about the importance of the goods at their disposal for the maintenance of their lives and well-being. Hence value does not exist outside the consciousness of men....[T]he value of goods...is subjective in nature” (quoted in Ebenstein, 2003: 23).

The value of goods arises from their relationship to our needs, and is not inherent in the goods themselves....Objectification of the value of goods, which is entirely subjective in nature, has nevertheless contributed very greatly to confusion about the basic principles of our science....The importance that goods have for us and which we call value is merely imputed (Menger, 1873: 120–21, 139).

Value is like beauty—it is in the eye of the beholder. Menger further developed this theory with his *law of imputation*, wherein he labeled final consumer goods “lower order” and the necessary producer goods “higher order” (sometimes called producer goods, or capital goods). He then demonstrated that the demand for the higher-order goods—land, equipment, and other necessary inputs—“is derived from that of the corresponding goods of lower order.”

Menger illustrated this concept with the example of tobacco. Suppose, for some reason, that tobacco is no longer desired by people and the demand for it disappears. Existing tobacco products’ price would fall to zero, even though it was produced at a considerable cost. But what would happen to all

of the necessary factors of production—land, tobacco plants, tools, machinery, and so forth—the higher-order goods? They, too, would drop in price significantly, since the demand for these products is derived from the consumer’s demand for tobacco. Some of these goods might have a value, but only in *alternative* uses, not in the production of tobacco.

This was a refutation of the Ricardo-Marx labor theory of value. Menger wrote:

The determining factor in the value of a good, then, is neither the quantity of labor or other goods necessary for its production nor the quantity necessary for its reproduction, but rather the magnitude of importance of those satisfactions with respect to which we are conscious of being dependent on command of the good. This principle of value determination is universally valid, and no exception to it can be found in human economy (quoted in Skousen, 2001: 182).

Menger here articulates the concept of marginal utility and opportunity cost, although he did not use these terms. This theory has enormous explanatory and predictive capabilities, because it explains why people dive for pearls. Marx would say pearls have value because people dive for them (thus supplying labor). Menger would retort that people dive for pearls because people value them.

Each of the three marginalists refuted the labor theory of value, some more critical and castigating than others. Leon Walras repudiated the labor theory of value thus: “The theory which traces the origin of value to labour is a theory that is devoid of meaning rather than too narrow, an assertion that is gratuitous rather than unacceptable” (quoted in Howey, 1989: 58). Menger wrote, “Among the most egregious of the fundamental errors that have had the most far-reaching consequences in the previous development of our science, is the argument that goods attain value for us because goods were employed in their production that had value to us” (ibid.: 58). William Stanley Jevons said:

The fact is, that labour once spent has no influence on the future value of any article: it is gone and lost for ever. In commerce, by-gones are for ever by-gones; and we are always starting clear at each moment, judging the values of things with a view to future utility. Industry is essentially prospective, not retrospective; and seldom does the result of any undertaking exactly coincide with the first intention of its founders (ibid.: 59).

Interestingly, Jevons’ education in economics, according to his wife Harriet Jevons’ account, began when his mother read to him Archbishop [of

Dublin] Richard Whately's *Easy Lessons on Money Matters for the Use of Young People*, published in 1833. Jevons himself wrote near the end of his life that in "early boyhood I learned my ideas of political economy from a copy of these lessons...." Little wonder Jevons was predisposed to marginal utility and a refutation of the labor theory of value, since Whately wrote in that work:

When anything that is desirable is to be had by labour, and is not to be had *without* labour, of course we find men labouring to obtain it; and things that are of very great value, will usually be found to have cost very great labour. This has led some persons to suppose that it is the labour which has been bestowed on any thing that *gives* it value. But this is quite a mistake. It is not the labour which any thing has cost that *causes* it to sell for a high price; but on the contrary, it is its selling for a high price that causes men to labour in procuring it. For instance, fishermen go out to sea, and toil hard in the wet and cold to fish, because they can get a good price for them; but if a fisherman should work hard all night, and catch but one small fish, while another had, perhaps, caught a thousand, by falling in with a shoal, the first would not be able to sell his one fish for the same price as the other man's thousand. It has now and then happened that a salmon or a sturgeon has leaped into a boat by chance; but though this has cost no labour, it is not for that reason the less valuable. And if a man, in eating an oyster, should chance to meet with a fine pearl, it would sell for no less than if he had been diving for it all day.

It is not, therefore, labour that makes things valuable, but their being valuable that makes them worth labouring for (quoted in Howey, 1989: 3–4).

Jevons was read the above passage at the impressionable age of nine; how fateful that he would be able to recall it years later in the development of his seminal theory.

Philip Wicksteed, a British clergyman, wrote the first scientific critique of the Marxian labor theory of value in 1884, where he explained:

A coat is not worth eight times as much as a hat to the community because it takes eight times as long to make it....The community is willing to devote eight times as long to the making of a coat because it will be worth eight times as much to it (ibid.: 157).

The value of anything depends on the *margin*—the edge, the addition (or subtraction) to value. The margin is what happens next. The most difficult decisions we confront are marginal decisions. For instance, few of us waste any time deciding whether or not we have to work; the question is should we work more or fewer hours? A country does not debate whether or not to have

a military defense, but rather how big or small it should be. If you were to pile straws onto the back of a camel, eventually the camel's back would break. It might seem reasonable to blame all the straws, but if straws could talk (and think) they would blame the *marginal* straw—that is, the last one. After all, everything was fine before it got there.

Marginalism and the subjective theory of value, when combined, allow economists to explain much human behavior, far more accurately than the labor theory of value or Smith's cost of production theory of value. For example, equipped with these new theories, one is able to explain the following phenomena:

- Long after van Gogh's death, his "Portrait of Dr. Gachet" was sold by his sister-in-law in 1990 for \$82.5 million.
- Princess Diana's gowns sold at a Christie's auction in the last week of June 1997 (three months before her fatal car accident) for \$5.76 million.
- The success of eBay—all those articles in your attic you thought were worthless can now be sold to someone who values them.
- An Illinois company named LifeGem is now offering to take the carbon ash left over from a loved one's cremation and turn it into precious stones, tinted according to your taste. Its most expensive offering is a \$10,000 three-quarter-carat diamond.
- A piece of gum chewed by pop singer Britney Spears—"still has her teeth marks in it"—sold on eBay for \$100.
- Roses sell for more than tulips.
- In the oil business, there is a saying: What you spend does not matter; what you find does.
- After her interview with Barbara Walters, the lipstick shade Monica Lewinsky was wearing—Monaco's Glaze—sold out all over the country.
- With the publication of her 1963 book, *The Feminine Mystique*, Betty Friedan was in, and Betty Crocker was out. Friedan compared women's lives of "nothingness [and] emptiness" to those of concentration camp inmates. Then Martha Stewart came along 30 years later and took the same type of domestic chores—napkin folding, pumpkin carving, baking, and so forth—and turned it into a multi-billion dollar industry.
- The barstools on the late Aristotle Onassis's yacht, *The Christina*, were covered with the foreskin of the sperm whale penis, one of the most expensive fabrics you can purchase.

- The value of a diamond is not affected by whether it was discovered accidentally or it took a thousand days of labor.

Notice it is not labor driving the value in the above examples, but rather value to the customer, and they are fickle and heartless when it comes to caring about the labor (and profit desires) the owners of businesses put into something, as Ludwig von Mises pointed out in *Human Action*:

Neither the entrepreneurs nor the farmers nor the capitalists determine what has to be produced. The consumers do that. If a businessman does not strictly obey the orders of the public as they are conveyed to him by the structure of market prices, he suffers losses, he goes bankrupt.... Other men who did better in satisfying the demand of the consumers replace him.... The consumers... make poor people rich and rich people poor. They determine precisely what should be produced, in what quality, and in what quantities. They are merciless egoistic bosses, full of whims and fancies, changeable and unpredictable.... They do not care a whit for past merit and vested interests.... In their capacities as buyers and consumers they are hard hearted and callous, without consideration for other people (Mises, 1996: 270).

Mises also noted the weakness of classical economists focusing on the cost of production rather than utility to the customer:

Because the classical economists were able to explain only the action of businessmen and were helpless in the face of everything that went beyond it, their thinking was oriented toward bookkeeping, the supreme expression of the rationality of the businessman (but not that of the consumer) (quoted in Holcombe, 1999: 72).

If the customers change their preferences, needs, wants or desires, the value of some goods will increase while others decrease.

When we changed from a horse and carriage economy to the automobile, all sorts of goods of a higher order lost their value—hay production dropped, blacksmiths lost jobs, among others who supplied the old industry. If, for some reason, Americans were to change their minds about the justice and morality of the Union cause in the Civil War, the value placed upon the Lincoln Memorial in Washington, DC, would fall considerably, despite what it cost to build. Prices reflect what we value today, not of the “frozen labor”—Marx’s term—required to create what we valued yesterday.

Value depends entirely upon the *utility*—a measure of pleasure or satisfaction—the customer will receive. Where psychiatrists speak of *subjective well-being*, economists use the term *utility*. Each are conveying the same

idea: you engage in activities you receive pleasure or satisfaction from, not because others have toiled. People do not smoke to make the tobacco companies rich and happy, but rather from the utility they derive from doing so.

The popularity of the Atkin's diet will cause many workers in the companies that make pasta, doughnuts, chocolate, beer, and other high-carbohydrate products to lose their jobs. The reason labor unions cannot "save jobs" is because they cannot control what customers value, and it is what customers value that gives them the jobs in the first place. The Channel Tunnel between London and Paris cost billions to build, but the return on investment calculations and sunk costs do not matter to today's customers. They are only concerned with the relative price of taking the "Chunnel," flying, or taking the ferry.

Marginalism can also explain other aspects of human behavior not normally associated with the field of economics; like why don't newspaper company racks have elaborate antitheft protections that ensure customers only extract one newspaper at a time, similar to vending machines for soda or candy? Can one conclude from this observation that buyers of the *New York Times* are more honest than buyers of Coke, as a sociologist or criminologist might reason? Economists would answer no, it is because the marginal value of a second, third, or fourth newspaper is not as valuable as the next Coke, which can be saved and enjoyed later, unless you suffer the fate of this 1998 Darwin Award recipient—"bestowed upon individuals who improve our gene pool by removing themselves from it in a spectacularly stupid manner":

December 12, 1998: A man crushed beneath a vending machine while trying to shake loose a free soda? If you think it's an Urban Legend, you're wrong! Kevin, a nineteen-year-old Quebec student, killed himself at Bishop's University while shaking a 420-kilogram Coke machine. He had been celebrating the end of final exams with friends. He died beneath the soda machine, asphyxiated, with a blood alcohol level slightly over the legal driving limit.

Kevin's last act was committed in vain. "Even as it fell over, the vending machine did not let out a single can," the coroner reported.

Soda drinkers take note! The report also states that toppled vending machines have caused at least 35 deaths and 140 injuries in the last twenty years.

A spokesperson for Coke said that Canadian machines are now labeled with the warning, Tipping or Rocking May Cause Injury or Death. They have also installed antitheft devices in newer models to keep people from obtaining free drinks. Reference: *The Canadian Press*, cokemachineaccidents.com, *National Post* (Northcutt, 2003: 165).



New evidence alters beliefs, yet most scholars are born and die within the same paradigm. A few, like Einstein, Darwin, and the marginalist economists, create new ones. The Austrians, finally, had a testable theory to explain the diamond-water paradox.

## WHY ARE DIAMONDS MORE EXPENSIVE THAN WATER?

Besides being abundant, water tends to be priced based on the marginal satisfaction of the last gallon consumed. The German economist Hermann Heinrich Gossen [1810–1858] developed what is known as Gossen's Law: The market price is always determined by what the last unit of a product is worth to people.

While the first several gallons of water may be vital for your survival, the water used to shower, flush the toilet, and wash the dishes is less valuable. Less valuable still is the water used to wash your dog, your car, and clean your driveway. The market price of water reflects the last uses of the good for the aggregate of all consumers of water. On the other hand, the marginal satisfaction of one more diamond tends to be very high (even for Elizabeth Taylor).

If water companies knew you were dehydrated in the desert they would be able to charge a higher price for those first vital gallons consumed, and then gradually adjust the price downward to reflect the less valuable marginal gallons. Since they do not possess this information—the cost of doing so would be prohibitive—the aggregate market price for water tends to be based on its *marginal* value.

In fact, technology may be enabling electric utilities to devise a system of price allocation. At present, there is no mechanism for interrupting demand in a selective way, based on the priority of different appliances; regulators insist that everyone get a steady stream of power at a single price. A porch light and an elevator get the same priority; there is no way to prioritize different appliances when demand, and prices, surge. In 1995, the Progress and Freedom Foundation, along with Nobel laureate economist Vernon Smith, sponsored a series of workshops at the University of Arizona with 25 executives from utility companies throughout the United States—Florida Power, Duke, Ohio Edison, Mohawk, Pacific Gas & Electric, Southern California Edison, among others. By having customers voluntarily undergo power interruptions for certain appliances, there exist devices that allow them to shut off power to various devices when prices hit a certain level. This is sim-

ply another form of allocating a scarce resource, especially when supply is tight. Rather than blackouts and brownouts affecting everyone and every appliance equally, customers can make trade-offs between the value of various electrical appliances by using prices.

In any event, the Austrians rescued Adam Smith from his cost of production theory of value—and his artificial dichotomy between “goods in use” and “goods in exchange”—which had given the critics of free markets ammunition since they could claim that capitalists were more concerned with making profits than providing a useful service, as if profitable exchange is unrelated to consumer utility. Interestingly, there is evidence from Adam Smith’s lecture notes that he understood the concept of utility, and had the correct answer to the paradox ten years before writing *Wealth of Nations*, yet he clung to his adding-up theory of value. As Mark Skousen explains:

The Austrian school rescued Adam Smith and his model of natural liberty in three ways (in this sense, it was really a multiple revolution):

1. *The consumer origin of value*: Menger and the Austrians established the supreme role of the consumer in determining productive activity—that final demand, not labor time or the costs of production, determines the structure and pricing of the production process. The Austrians called this their “theory of imputation.” Utility imputed (determined) the value of inputs. By demonstrating this relationship, the Austrians established a new model no longer held hostage by the Marxian-socialist heterodoxy.
2. *Marginal utility/cost*: The Austrians demonstrated that prices and costs are determined at the margin—by the marginal benefit-cost to buyers and sellers. Marginal analysis forms the basis of modern-day microeconomics.
3. *Subjective value*: The Austrians demonstrated that Ricardo’s search for an “invariable measure of value” was, like Ponce de Leon’s search for the fountain of youth, all in vain. Menger and his followers revealed the value is entirely dependent on the desires of consumers and producers; that wages, rents, interest, and profits are determined by the subjective valuations of the customers and users. Thus, costs are never really fixed in the long run (Skousen, 2001: 172–73).

Whereas revolutionaries in the nineteenth century spent their time trying to overthrow capitalism, twentieth century revolutionaries spent theirs attempting to defend the labor theory of value. I have had the misfortune of arguing the labor versus the subjective theory of value with Marxist professors, and have concluded that their beliefs are not based on the scientific method of positing, observation, and falsifiability of theories, but rather a

sort of blind faith, what Marx himself might have labeled the opiate of the communist economists. As Thomas Sowell writes:

By the late nineteenth century, however, economists had given up on the notion that it is primarily labor which determines the value of goods.... This new understanding marked a revolution in the development of economics. It is also a sobering reminder of how long it can take for even highly intelligent people to get rid of a misconception whose fallacy then seems obvious in retrospect. It is not costs which create value; it is value which causes purchasers to be willing to repay the costs incurred in the production of what they want (Sowell, 2004b: 177).

Some critics of the subjective theory of value maintain that it is too simplistic to explain value. However, there is an enormous difference between simple and simplistic. Being simple often is the outward sign of depth of thought. Ronald Reagan had a simple idea about the Cold War: America wins, the Russians lose. A simple proposition, but certainly not easy to carry out. Most economic theories are relatively simple; it is the fallacies that get complicated. It is an unnecessary complication to believe that complex effects must have complex causes. The fact that the earth tilts on its axis is fairly straightforward, but this certainly causes complex reactions in plants, animals, people, ocean currents, and so forth. To say value is subjective is also fairly straightforward, yet this can cause a very intricate and interdependent set of economic activities, all coordinated through the pricing mechanism, such as allocating resources, goods, and services to satisfy that value.

One economist did alter the subjective theory of value, defecting from the Austrians, while simultaneously making his own advances in our understanding of price theory, as we shall see.

## THE MARSHALLIAN SCISSORS

*Natura non facit saltum; nature makes no sudden leaps.*

—Alfred Marshall, *Principles of Economics*, 1890

Alfred Marshall [1842–1924] did make a sudden leap, at least in his lifetime, by drawing the supply and demand curves you studied in your introductory economics course. The famous Cambridge professor, and founder of the so-called British or Cambridge school of economics, counted John Maynard

Keynes and A.C. Pigou (founder of price discrimination) among his students. Marshall not only drew the famous supply and demand curves, but also developed the mathematics of elasticity and the concept of consumer surplus, which we will explore in Chapter 14.

With the supply curve reflecting a cost of production concept of value, and the demand curve the utilities of buyers, Marshall merged the classical and marginalist schools together in one diagram (Exhibit 8.1).

Marshall believed that prices, over the long run, were based on the costs—including profit—of production, thereby resuscitating Smith’s theory. The value (price) of a good was determined by “the scissors of supply and demand.” Did one play a more important role than another? Marshall believed they were equally powerfully at influencing price, stating, “We might as reasonably dispute whether it is the upper or the under blade of a pair of scissors that cuts a piece of paper, as whether value is governed by utility or cost” (quoted in Buchholz, 1990: 157). Marshall thought there was a “natural” price, or what he called the long-period price, around which a commodity gravitated, represented by the *e* (equilibrium) point in the diagram.

Since Marshall had a major role in advancing microeconomics (from *micros* meaning “small”) and price theory, he influenced generations of business leaders. As Paul Samuelson famously stated, “I don’t care who writes a nation’s laws—or crafts its advanced treaties—if I can write its economic textbooks.”

The Austrian school, however, has some difficulties with Marshall’s concept of a long-period price, determined by the interaction of supply and

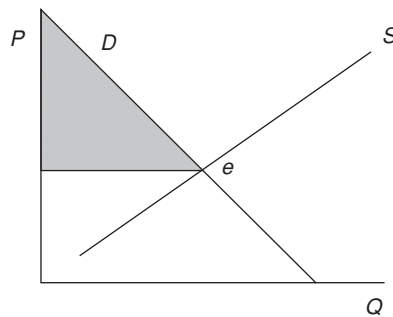


EXHIBIT 8.1 The Marshallian Scissors

demand. First, they point out that Marshall misunderstood the Marginalists, because the issue is not which blade of the scissors creates value. A price is paid because someone values it, and the price cannot exceed that value no matter what the cost of producing it is. Hence, the supply curve—tallying up costs—does not *cause* prices to be paid. You can spend a lot of money producing something customers reject.

Second, Marshall's demand curve does not represent how much you *want* a good, but rather how *much* of a good you want, at various prices. The former is determined by marginal utility—since it is based on how much you already have, and the subjective value you place on the good—while the latter is depicted by the demand curve showing various quantities demanded over a range of prices. The demand curve is the sum of individual demands across an entire market; it is an identity statement, it is simply true due to its definition. The demand curve does not tell us how much we actually value a good. Additionally, the supply curve sums the costs incurred by businesses for factors of production, which are *prices* themselves, influenced by the subjective value of the good. As Gene Callahan points out in his book *Economics for Real People: An Introduction to the Austrian School*:

The notion that prices equal costs is an expression of a tendency in the market, not a description of a state the market ever achieves. “Objective costs” don't necessarily determine price in the long run, because costs are prices themselves. Costs are not objective, both blades of Marshall's scissors are honed by subjective valuation (Callahan, 2002: 93–94).

Finally, Austrian economists are not obsessed with equilibrium, which they believe is an intellectual abstraction, but not of much value in the real world. They contend that free markets work best because of how they deal with disequilibrium, as a dynamic adaptive social system, beautifully illustrated by Schumpeter's phrases “creative destruction” and “dynamic disequilibrium.” Equilibrium is for tires, not an economy. Once again, Callahan explains this crucial difference:

Prices and quantities only change as the result of human action. Where in the world can a new price come from if not a human bidding or asking above or below the market price? Supply and demand curves give us a rough picture of market behavior as an effect of human action, and certainly not the cause of it. No one acts with the goal of bringing supply and demand into balance (ibid.: 319).

In summary, the Austrians contend that what a good costs to produce cannot directly determine its value, but *it will determine the quantity that will continue to be made*. Thus there is a constant tendency for marginal cost of production and market price to equal each other, although not because the first directly determines the second. And since there are rarely “single price” markets, businesses have the capability of segmenting customers and charging different prices to different groups based on subjective value.

None of this discussion is meant to imply that businesses cannot create the demand for a product. No one “demanded”—or subjectively valued—a Sony Walkman or the Apple iPod before they were produced and offered in the market. Quite often, supply does indeed create demand, especially as it relates to innovations and new technologies. But there is no guarantee of value just because costs were incurred; the high rate of product failures is a testament to this fact. Nonetheless, in the long run, a good will only *continue* to be produced if people value it, and its price can cover its full costs of production.

## TIME IS MONEY?

Benjamin Franklin is often cited by businesspeople for his much-repeated saying, “Time is money.” This little saying has certainly infected the way in which businesspeople view the value of the goods and services they deliver; unfortunately, it is taken out of context. The saying was written in 1748—over 100 years prior to Marx’s labor theory of value—in a letter Franklin sent to a young businessperson just starting out, and who sought Franklin’s advice. Here is what Franklin wrote in its entirety on the subject of time in a letter entitled “Advice to a Young Tradesman”:

To my friend, A.B.:

As you have desired it of me, I write the following hints, which have been of service to me, and may, if observed, be so to you. Remember that *time* is money. He that can earn ten shillings a day by his labor, and goes abroad, or sits idle, one half of that day, though he spends but sixpence during his diversion or idleness, ought not to reckon *that* the only expense; he has really spent, or rather thrown away, five shillings besides (quoted in Krass, 1999: 283).

Note that Franklin was not speaking of value, nor price; he was articulating the concept of *opportunity cost*. Cost means a foregone opportunity, the road not traveled, so to speak. In reality, *every cost is an opportunity cost*.

This is the idea that every activity or product in the economy has an alternative use, and was coined by the Austrian economist Friedrich von Wieser [1851–1926]. It is an important economic principle, but a seller's opportunity cost has little to do with the value provided to the customer. In fact, Franklin's statement has been misinterpreted as validating the labor theory of value, yet it does no such thing. Opportunity cost, like the supply curve discussed above, may influence the *quantity* of a good offered, not its *value*. Time is certainly precious, because it is a nonrenewable resource. But even resources are useless until a purpose is found for them that people will value. Recall that oil was worthless to the farmer until the invention of the combustion engine.

### WE LIVE IN A BARTER ECONOMY

Before we move on to see how these two theories of value—the labor and subjective—play out in the business world, it is helpful to suspend talking about absolute price in terms of dollars and cents. *Absolute price* is defined as “the number of dollars that can be exchanged for a specified quantity of a given good.” Instead, unless specifically mentioned, this book deals with *relative price*, defined as “the quantity of some other good that can be exchanged for a specified quantity of a given good” (Landsburg, 1996: 34). This is an important distinction because in the final analysis we live in a barter economy.

By purchasing this book you have traded some of your services for some of my services as an author; money is simply a way to eliminate the necessity of a coincidence of wants. In order to get a haircut, my barber does not have to need my book, especially at the same time I need a haircut. I can use money from the sale of this book to pay him, then he can buy what he needs, when he needs it, whether or not the people he purchases from need haircuts.

Money has no value, *per se*; value is based on what people are willing to give up. Money simply facilitates the myriad transactions that take place in the economy—its use is more efficient than bartering. Money is not a “store of value” or a “measure of value.” If you purchase a haircut for \$25 it does not mean that haircuts have a value of \$25. It simply means each party valued the exchange greater than what they gave up. Prices are not measurements of value but historical facts, indicating that at a given place and time, two parties exchanged a haircut for \$25.

The reason economists discuss *relative*, as opposed to *nominal*, prices can be illustrated by Florida oranges. Even though New Yorkers do not grow oranges, they tend, on average, to eat better oranges than the residents of Florida. To understand why, consider relative price. Suppose “good oranges” cost \$1 in Florida and “bad oranges” cost 50 cents (not bad per se, but “bad” relative to the “good” oranges). Therefore, the relative price of a good orange in Florida is two bad oranges. But for the New Yorker, because of 50 cents in transportation costs, a good orange costs \$1.50 and a bad orange costs \$1. Therefore, the relative price of a good orange is only 1.5 bad oranges. Since New Yorkers face a lower relative price, they eat, on average, more good oranges.

This explains why high-quality goods tend to get exported and why luxuries are disproportionately represented in international trade. Examples are British Rolls Royces, grapes from California, leather goods from Italy, French wines, Texas steaks, Colombian coffee, Idaho potatoes, Hawaiian pineapples, and Washington apples. Whenever a tax, transportation expense, or other fixed cost is added to a variable price of a product, what is known as the *Alchian-Allen effect* takes place: *Customers tend to shift their taste in favor of higher-quality products.*

For example, when the U.S. government began taxing packages of cigarettes, king-size and super-king-size were introduced to provide more smoking minutes per pack. The same logic applies to phone calls. In years past, many phones on airplanes charged a flat rate of \$10 per domestic call, no matter how long you talked. Charge a flat price for a phone call, and people will talk longer. Put a fixed charge on any product, and it will migrate to where its relative cost is lower.

## WRONG THEORY, SUBOPTIMAL RESULTS

As John Maynard Keynes said, “The difficulty lies, not in the new ideas, but in escaping from the old ones, which ramify, for those brought up as most of us have been, into every corner of our minds,” to which philosopher Bertrand Russell added, “The resistance to a new idea increases as the square of its importance.” The labor theory of value is similar to the Brezhnev Doctrine: *Once a Communist nation, always a Communist nation.* Luckily, science and modern civilization do not progress like this.



Just as geologists fought for decades against plate tectonics theory to explain earthquakes, and germ theory remained on the fringes of medical science until the late nineteenth century, the subjective theory of value is not widely taught, or practiced, in businesses. Yet when people see this theory explained, they intuitively understand it, because it comports to human behavior. And isn't this what learning is all about—understanding something you have known all along, but in a new way?

Despite this lesson, we return to our offices and fall back to pricing our products and services using a cost-base formula. As John Kenneth Galbraith said, “There are many misfortunes that can befall an economist. The worst, by far, is to have a theory in which he devoutly believes, and which is wrong, put into practice.” Let us next see how these two theories play out in the real world, and how suboptimal—in terms of profitability—the wrong theory can be.



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# 9

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## COST-PLUS PRICING'S EPITAPH

*We shall not grow wiser before we learn that much  
that we have done was very foolish.*

—F.A. Hayek [1899–1992]

Now that we have examined the difference between the labor and subjective theories of value, we are ready to see how these two valuation techniques affect companies' pricing policies. Andrew Carnegie was fond of saying, "Cut the prices; scoop the market; run the mills full... Watch the costs and the profits will take care of themselves." Of course, Carnegie made steel in mass quantities. In today's intellectual capital economy, there does not exist as strong a correlation between inputs and outputs, costs and value. The value of the book you are now holding is not the sum of the paper, ink, glue, and binding costs, but rather the value of the knowledge it contains.

In the past, cost-plus pricing was widely used and accepted, perhaps because it was widely taught in business schools and economic courses. Other justifications for cost-plus pricing include:

- It is fair, allowing a profit margin that can be justified by costs.
- The method has served us well, why should we change?
- Prices above a "fair" markup would attract competitors.
- Prices above a "fair" markup not followed by other firms would put us at a competitive disadvantage.
- With all of the talk of "transparency" today, our customers know our costs and would be aware of prices beyond a reasonable profit.

- The Market Share Myth—Top line revenue growth is the pathway to profits, and higher prices would decrease volume.
- Some executives think supernormal or windfall profits are immoral and unethical.
- Prices below full cost could start an unstoppable and devastating price war.
- Customers dislike price changes, and infrequent changes lead to market stability.
- Although it may be a suboptimal way to maximize profitability, it is relatively easy to compute.
- It helps stave off government regulations and antitrust litigation.
- It puts a justified floor on our profits.

This is by no means an exhaustive list of rationales for this antiquated pricing method; I have heard many others from scores of business leaders. Doing something stupid once is just stupid. Doing it twice is a philosophy. For all of the economic evidence assembled on why costs do not “add up” to equate to value, it is amazing how many businesses still cling to the cost-plus pricing method, a direct cousin to the Labor Theory of Value. The mirror image of a bad idea is rarely a good one. Fortunately, the Austrians gave businesspeople an important legacy, if only they would learn it.

In their outstanding book, *The Strategy and Tactics of Pricing* (third edition), Thomas T. Nagle and Reed K. Holden offer the following indictment of cost-plus pricing:

The problem with cost-driven pricing is fundamental: In most industries it is impossible to determine a product’s unit cost before determining its price. Why? Because unit costs change with volume. This cost change occurs because a significant portion of costs are “fixed” and must somehow be “allocated” to determine the full unit cost. Unfortunately, since these allocations depend on volume, which changes with changes in price, unit cost is a moving target (Nagle and Holden, 2002: 2).

...[P]ricing affects sales volume, and that volume affects costs. Cost-plus pricing leads to overpricing in weak markets and underpricing in strong ones—exactly the opposite direction of a prudent strategy. The financial questions that should drive proactive pricing are “How much more sales volume must we achieve to earn additional profit from a lower price?” and “How much sales volume can we lose and still earn additional profit from a higher price?” (ibid.: 3).

If one were to lay the two theories of value—labor and subjective—side by side, it would look like this:

**Cost-Plus Pricing**—Labor Theory of Value

Product » Cost » Price » Value » Customers

**Pricing on Purpose**—Subjective Theory of Value

Customers » Value » Price » Cost » Product

(adapted from Nagle and Holden, 2002: 4)

Notice how value pricing turns the order of cost-plus pricing inside-out, by starting with the ultimate arbiter of value—the customer. Goods and services do not magically become more valuable as they move through the factory and have costs allocated to them by cost accountants. The *costs do not determine the price*, let alone the value. It is precisely the opposite, as the Austrian economists pointed out; that is, the *price determines the costs* that can be profitably invested in to make a product desirable for the customer, at an acceptable profit for the seller. This subtle reordering of the value/manufacturing chain has a dramatic impact on value, price, and profit, as the following story illustrates.

## A TALE OF TWO AUTOMOBILES

U.S. soldiers stationed in Europe during World War II were attracted to the sporty British MG car. After the war, General Motors took a calculated risk designing and then manufacturing the Chevrolet Corvette, introduced in 1953, available in white with red interior only. After it projected how many units it would sell, and computed the cost per unit of manufacture, it utilized the DuPont return on investment (ROI) formula and tacked on a desired profit per automobile, deriving a suggested manufacturer price of \$3,490. GM only produced 315 Corvettes in 1953, and fewer than 4,000 in 1954 (Langworth and Norbye, 1986: 198, 203). This lackluster sales performance almost got the Corvette canceled, until Zora Arkus-Duntov took over as chief engineer and transformed the Vette into a genuine sports car in 1956 and 1957.

There is no doubt that, eventually, the Corvette turned a profit for GM, demonstrating that cost-plus pricing can be profitable, if you are making something of value for customers. However, cost-plus pricing is not a *profit-optimizing* pricing strategy, and herein is its fundamental problem. The best

cost system in the world does not guarantee that the product will be sold at the price derived. Furthermore, it is estimated that approximately 85 to 95 percent of costs cannot be contained once the product has been developed, designed, and manufactured.

As the Corvette was experiencing success, a competing automobile company took note, and by coincidence another executive was looking for his next big hit. As he explains in his autobiography:

When we analyzed all this information, the conclusion was inescapable. Whereas the Edsel was a car in search of a market it never found, *here was a market in search of a car*. The normal procedure in Detroit was to build a car and then try to identify its buyers. But we were in a position to move in the opposite direction—and tailor a new product for a hungry new market. Our goal was to have it sell for no more than \$2,500 with equipment (Iacocca, 1984: 64–65).

When Lee Iacocca developed the Ford Mustang, he reversed the order of the usual car-making pricing up to that point. Rather than giving his engineers carte blanche to develop a sports car and then marking up the resulting costs to arrive at a price—as GM did—he solicited the opinions of potential customers as to what features they would want in a sports car and what price they thought they would be willing to pay. Knowing people liked the Corvette, but thought it was too expensive at \$3,490, Iacocca wanted the price to be low enough to entice the potential sports car enthusiast. He then went to his engineers and asked if they could manufacture a sports car, with the desired features, and sell it at this price—no more than \$2,500—and still turn an acceptable profit for Ford.

This constrained the engineers with the final price and forced them to manufacture the car at a total acceptable cost, following Nagle and Holden's flowchart above for Pricing on Purpose. Iacocca explains how they accomplished this:

But the question was: could we afford the car? An all-new car from the ground up would cost \$300 to \$400 million. The answer lay in using components that were already in the system. That way we could save a fortune in production costs. The engines, transmissions, and axles for the Falcon already existed, so if we could adapt them, we wouldn't have to start from scratch. We could piggy-back the new car onto the Falcon and save a fortune. In the end, we would be able to develop the new car for a mere \$75 million. All this sounded great, but not everyone thought it could be done. By late 1961, we had a target date. The New York World's Fair was scheduled to open in April 1964 (ibid.: 66).

We ended up with a car that was an inch and a half longer than we had originally planned and 108 pounds heavier. But we held the line on price, and Mustang sold for \$2,368. On March 9, 1964, . . . the first Mustang rolled off the assembly line (*ibid.*: 71).

The Falcon, which premiered in 1960, was Robert S. McNamara's car, completely utilitarian, no bells or whistles and available only in solid colors. As one automobile reporter wrote, "He wears granny glasses and puts out a granny car." Nevertheless, by building the Mustang on the Falcon's chassis, in the first two years, it generated net profits of \$1.1 billion (in 1964 dollars), far in excess of what GM had made on the Corvette. The average customer was spending another \$1,000 on options, and while Ford projected that 75,000 units would be sold in the first year, the 418,812th Mustang was sold on April 16, 1965, only 13 months after the first rolled off the assembly line. By comparison, the Corvette reached 1 million in sales in July 1992, with the release of a white convertible with red interior, mimicking the first one.

From an engineering perspective, the car was mediocre; from a marketing and profitability perspective, it was one of the most successful cars in automotive history. This led Iacocca to quip:

I'm generally seen as the father of the Mustang, although, as with any success, there were plenty of people willing to take the credit. A stranger asking around Dearborn for people who were connected with the Edsel would be like old Diogenes with his lantern searching for an honest man. On the other hand, so many people have claimed to be the father of the Mustang that I wouldn't want to be seen in public with the mother! (*ibid.*: 76).

There is a long history of companies that became obsessively focused on cost, at the expense of providing a product or service of value to the customer. The fact of the matter is you can make a pizza so cheap no one is willing to eat it. The obsession with cost cutting can be counterproductive to fulfilling the real mission of any business: to create wealth for the customer. An obsession with cost accounting and cost control causes the business to be inward looking, rather outward focused, and as a result all costs are viewed as democratic and are subject to across-the-board cuts, without taking into account those costs that are essential for creating a superior value proposition versus those costs that add no value to the customer.

This is not to imply that a firm's internal costs are unimportant, or irrelevant, to the pricing decision, for they are certainly not. It is the order of those

costs that is important and needs to be reiterated: The profit-optimizing firm will only invest in those costs that can be recouped through the value delivered to the customer, not the other way around. In other words, the company explicitly understands that its price determines its costs, and does not let its costs dictate its price.

Pricing on Purpose organizations do not stop there. They are constantly asking, “How can we increase the value of what we provide.” The \$2,368 sticker price was not taken as a ceiling that could never be raised by Iacocca and his marketing team. By continuously innovating the Mustang—more features, bigger engines, the Shelby—they viewed the price as a number that could be managed by adding more value for different segments of customers. When you reflect upon the Subjective Theory of Value chain illustrated above, it is clear that cost and price are the easiest numbers to calculate. It is the value—because it is subjective—that poses the conundrum, but is essential to understand if a company is going to constantly increase the value proposition to its customers.

By establishing the price first, Iacocca was bucking the conventional wisdom in post-World War II business organizations of “build it and they will come.” It was a radical way to establish a price. But as we have learned, *radical* is Latin for “getting back to the root,” and the fact is that *price-led costing* was historically more ubiquitous than we might, at first glance, have thought.

## WISDOM IS TIMELESS

Any executive who has read this far would agree with the statement that the Mustang’s profits are more desirable than the Corvette’s. If you agree, what would your company have to do differently in terms of creating value, setting prices, and planning costs than it does now? Iacocca intuitively understood the Pricing on Purpose chain above, probably because he had a marketing background and understood the difference between looking outside versus inside an organization. Certainly the Austrian economists understood that price dictates costs, but it was a lesson largely forgotten by companies as they embraced cost-plus pricing.

An alternative explanation is that Iacocca understood the Pricing on Purpose chain because it was embedded in the DNA of the Ford Motor Company. Henry Ford understood price-led costing, recognizing that no cost is truly fixed and that value drives price. While price may be taught in busi-



ness schools as the last of the four Ps of marketing, Ford knew value had to be understood first. Oscar Wilde's famous quip, "A man who knows the price of everything and the value of nothing," was his definition of a cynic, not a businessman—and certainly not Henry Ford. With respect to the pricing revolution taking place in businesses around the world, Ford's understanding of this topic is truly prescient, as demonstrated in his autobiography, *My Life and Work*, published in 1922. It is worth quoting at length for the historical lessons it teaches. The notion that price determines cost was not foreign to Ford:

If the prices of goods are above the incomes of the people, then get the prices down to the incomes. Ordinarily, business is conceived as starting with a manufacturing process and ending with a consumer. If that consumer does not want to buy what the manufacturer has to sell him and has not the money to buy it, then the manufacturer blames the consumer and says that business is bad, and thus, hitching the cart before the horse, he goes on his way lamenting. Isn't that nonsense? But what business ever started with the manufacturer and ended with the consumer? Where does the money to make the wheels go round come from? From the consumer, of course. And success in manufacturing is based solely upon an ability to serve that consumer to his liking (Ford, 1922: 135–36).

Keep in mind that Ford's primary objective was the mass consumption of the automobile, so he focused more on driving the price down in order to increase volume. In a growing industry this is a viable strategy. In mature markets, it is probably better to increase value, thus allowing higher prices. Nevertheless, with Ford's objective in mind, consider his views on the importance of cost accounting and prices, which are profound (perhaps Ford was influenced by the Austrian economists?):

Our policy is to reduce the price, extend the operations, and improve the article. You will notice that the reduction of price comes first. We have never considered any costs as fixed. Therefore we first reduce the price to the point where we believe more sales will result. Then we go ahead and try to make the prices. We do not bother about the costs. The new price forces the costs down. The more usual way is to take the costs and then determine the price; and although that method may be scientific in the narrow sense, it is not scientific in the broad sense, because what earthly use is it to know the cost if it tells you that you cannot manufacture at a price at which the article can be sold? (ibid.: 146–47).

Notice Ford “never considered any costs as fixed.” He understood, in the long run, that all costs are avoidable, and by subjecting every cost to the test—does it add value to the customer?—he was able to increase the efficiencies in the factory:

But more to the point is the fact that, although one may calculate what a cost is, and of course all of our costs are carefully calculated, no one knows what a cost ought to be. One of the ways of discovering what a cost ought to be is to name a price so low as to force everybody in the place to the highest point of efficiency. The low price makes everybody dig for profits. We make more discoveries concerning manufacturing and selling under this forced method than by any method of leisurely investigation (*ibid.*: 146–47).

If you were to draw a diagram of the following statement, it would mirror the Pricing on Purpose chain above:

Standardization, then, is the final stage of the process. We start with [the] consumer, work back through the design, and finally arrive at manufacturing. The manufacturing becomes a means to the end of service. It is important to bear this order in mind. As yet, the order is not understood. The notion persists that prices ought to be kept up. On the contrary, good business—large consumption—depends on their going down (*ibid.*: 148).

Again, notice Ford’s emphasis on driving prices down in order to achieve large consumption. As is argued throughout this book, however, focusing on value can drive prices up.

None of the above is meant to be a hagiography to either Iacocca or Ford. I find both lacking in wisdom and good judgment in other areas. Iacocca, specifically, should have never been able to run to the government, hat in hand, to get a bailout for Chrysler back in the late 1970s. The magic of the free enterprise system is profit and *loss*, and the loss imposes lessons and prevents society’s resources from being wasted producing things people do not want—like the K car. The process of creative destruction must be able to run its course if an economy is to have growth and dynamism.

Henry Ford certainly had his own list of faults. He was a rabid anti-Semite, and had a pathological aversion to tobacco and alcohol, which led him to the belief that the economy could not run without alcohol Prohibition. He disapproved of eyeglasses and would plaster his hair with kerosene since he thought it was the cause of the healthy appearance of oil-field workers. The Puritan streak in him caused him to strongly disapprove of consumer

debt, which—contrary to conventional wisdom—lost him his market share to Alfred Sloan at General Motors.

Every businessperson understands the importance of payment terms. Indeed, terms are price. There is an axiom in business valuation negotiations: You can set the price if I can set the terms. Organizations such as General Motors Acceptance Corporation and GE Credit make more money *financing* what they manufacture than they do *selling* it. Despite the view that consumer credit is a recent phenomenon, it has actually been around for the past 200 years. As pointed out by Lendol Calder in *Financing the American Dream: A Cultural History of Consumer Credit*, in the United States, Cowperthwaite and Sons was reputedly the first furniture retailer in New York who sold furniture on installment terms in 1812; in the 1850s, buying “on time” (as it was known then), was introduced by sewing machine salesmen. Because of their success, other big-ticket items, such as pianos, organs, and the *Encyclopedia Britannica*, began to be sold on credit.

It was the automobile, however, that truly expanded installment credit. By 1924, almost three out of four new automobiles were bought “on time, generating approximately \$670 million of installment paper. Conventional wisdom suggests that the mass market for cars started when Henry Ford brought out the first Model T. However, it was really when dealers began offering installment options to customers that allowed them to buy cars they could not afford to pay cash for. In reality, Henry Ford did not lose out to General Motors simply because he offered only the Model T in black. Ford’s Puritan streak prevented him from embracing installment buying. Because he insisted on selling his cars in the 1920s for cash, he lost market share to General Motors, which established General Motors Acceptance Corporation (GMAC) in March 1919. Most installments required one-third down, and the balance to be paid in six to twelve months. The short term was due to the large repair bills that would normally occur after the first year of owning a car. By 1926, almost \$4 billion was loaned out by 1,600 to 1,700 financing companies for the purchase of automobiles. Consider the damage this delay in offering financing caused: at the end of 1921, Ford had a 62 percent market share of the 1.6 million vehicles sold annually, while Chevy had 4 percent and lost \$8.7 million. By 1926 Ford’s share was down to 28 percent.

Ford finally capitulated and established the Universal Credit Corporation in 1928, shortly after introducing his Model A. Unfortunately, it was a strategy done too late, as General Motors had by then captured a dominant share of the industry Ford was never able to retrieve. Ford’s aversion to consumer

debt prevented him from adding value to his customers—and achieving his goal of mass consumption—by offering installment sales, proving that customers’ constantly changing preferences are difficult to predict.

## MORE LESSONS IN THE SUBJECTIVE THEORY OF VALUE

If the labor and subjective theories of value confounded brilliant minds such as Adam Smith, David Ricardo, and others, imagine how difficult it would be for businesspeople to comprehend, who do not spend a fraction of the time formulating these types of theories, and have to deal with the day-to-day difficulty of pricing in the real world. The Subjective Theory of Value was a revolution in economics that is just beginning to be understood by businesses. But the history of business is the history of epiphanies, and sometimes the fog clears up and the right path is seen. This certainly happened—with respect to pricing—for Ben Cohen and Jerry Greenfield, founders of Ben & Jerry’s Ice Cream. In an essay written in 1997—before they sold the business on August 3, 2000 to Unilever, the British-Dutch food company—“Bagels, Ice Cream, or...Pizza?,” they explain what they term was their “famous pricing epiphany”:

We were working our hearts out for the first two or three years, and every year we just barely broke even. The first year we were thrilled to break even. We’d made our overhead; we could see the light at the end of the tunnel.

Then the next year came and we’d just broken even again, even though our sales had grown by \$50,000. This went on for three years. Each year we would break even and say we needed only to do a little more business to make a profit. Then the next year we’d do a lot more business and still only break even. One day we were talking to Ben’s dad, who was an accountant. He said, “Since you’re gonna make such a high-quality product instead of pumping it full of air, why don’t you raise your prices?”

At the time we were charging fifty-two cents a cone. Coming out of the sixties, our reason for going into business was that ours was going to be “ice cream for the people.” It was going to be great quality products for everybody—not some elitist treat. We aren’t just *selling* to people. We *are* the people! Ice cream for the people!

Ben said, “But, Dad, the reason we’re not making money is because we’re not doing the job right. We’re overscooping. We’re wasting ice cream. Our labor costs are too high—we’re not doing a good job of scheduling our employees.

We're not running our business efficiently. Why should the customer have to pay for our mistakes? That's why everything costs twice as much as it should."

And Mr. Cohen said, "You guys have to understand—that's human. That's as good as people do. You can't price for doing everything exactly right. Raise your prices."

Eventually we said, either we're going to raise our prices or we're going to go out of business. And then where will the people's ice cream be? They'll have to get their ice cream from somebody else. So we raised the prices. And we stayed in business (quoted in Krass, 1999: 462–63).

Excellent advice from an accountant, a profession not exactly known for looking at externally created value. Physician, heal thyself, as they say. Nevertheless, let us not confuse cause and effect. You will not be profitable simply because you raise your prices. You can only raise your prices if you offer a value proposition worth more to the customer than the cash they are parting with, which Ben & Jerry's Ice Cream obviously did. Ben's father also made a brilliant point by stating that you cannot price for 100 percent efficiency. This, once again, makes Peter Drucker's point that a business exists, first and foremost, to create wealth for its customers, not to operate efficiently. Many an efficient business has gone bankrupt because it did not create wealth for its customers, like the buggy whip manufacturers that were at the apogee of their efficiency curve when they were made irrelevant by the automobile. This illustrates, precisely, the difference between efficiency (doing things right), and effectiveness (doing the right things).

Another lesson in the Subjective Theory of Value was learned by Akio Morita, founder of Sony (named from the Latin word *sonus*, meaning "sound," and combined with the English word *sonny*, for "sonny boy"). He relates this lesson to the tape recorder Sony had brought to millions of people around the world in this essay written in 1974, "Moving Up in Marketing by Getting Down to Basics":

One weekend I took a stroll in my neighborhood and stopped in front of an antique shop. I am not interested in antiques, but I gazed at the various articles displayed in the show window. Out of curiosity I walked into the shop where a customer was asking the salesman various questions. And then the customer paid an amazingly high price for an antique that would not have attracted me in the least, and he walked out happily with it. I thought that our tape recorder was much more valuable, but he had gladly paid an even higher price for an antique.

I was surprised and intrigued by this behavior [so were the 18th and 19th century economists]. It taught me a basic principle of sales. This principle is that no sale can be achieved unless the buyer appreciates the value of the merchandise. I would not have paid such a price to buy the antique piece, because I am not interested in such things. But the other person, who understood the value of antiques, was willing to pay the price.

The tape recorder was a tremendous technical achievement in the eyes of those of us who had struggled to create it. For us it had a very high value, and we thought that the price we had put on it was even less than its true value. But the general public looked on it only as an interesting toy. This meant that unless the customer understood that the tape recorder was a valuable device with a wide variety of uses, he would not pay the price. The principle was this simple, but we realized that we were ignorant of even this basic principle. We therefore embarked on the task of teaching people how useful the tape recorder was in practical life.

This experience taught us a basic lesson in the marketing of our product, which has guided our policy ever since. A company such as ours, which is constantly developing new products, must always have the capability of educating prospective customers. Otherwise new markets for new products will never be created. . . . We realize that marketing means increasing the number of persons who can communicate to customers the usefulness and value of our new products in the same way as we would ourselves (ibid.: 316–19).

Certainly the Japanese have incorporated the lesson learned by Akito Morita by allowing price strategy to drive costs, not the other way around.

## LESSONS FROM JAPAN

In the January-February 1995 issue of *Harvard Business Review*, Peter Drucker explained the influential trend of price-led costing:

Although economists have known the importance of costing the entire economic chain since Alfred Marshall wrote about it in the late 1890s, most businesspeople still consider it theoretical abstraction. . . . A powerful force driving companies toward economic-chain costing will be the shift from cost-led pricing to price-led costing. Traditionally, Western companies have started with costs, put a desired profit margin on top, and arrived at a price. They practiced cost-led pricing. . . . Now price-led costing is becoming the rule. The Japanese first adopted it for their exports. Now Wal-Mart and all the discounters in the

United States, Japan, and Europe are practicing price-led costing (quoted in Drucker, 2003: 89).

Canon used this strategy in the research, development, manufacturing, and sale of the home copier, a technological breakthrough at the time, but one that was severely limited by the price people were willing to pay for the luxury of making photocopies at home. Keizo Yamaji of Canon, who is credited with turning Canon into the printing, imaging, and computer company it is today, assembled his engineers and gave them this challenge:

[I told them,] “I want you to make me a copier. It can be no bigger than a large breadbox. It can’t retail for more than \$1,200 in the USA. It mustn’t ever need servicing. And I want it in eighteen months.”

As he put it, “At first the engineers did what engineers always do—they whined! But then, guess what happened—they went out and they did it. It was a little bigger, it cost a bit more. While it did need servicing, it needed servicing very seldom, and it took just under two years to build instead of eighteen months. But I got my copier and the multibillion dollar business that it represented” (McGrath and MacMillan, 2000: 323–24).

Legend has it that the Canon engineers bought some beers and while looking at the aluminum can came up with the idea for the photosensitive drum cheap and light enough for a home copier. Being restricted by the final price focuses the company like a laser beam on only incurring costs that will add value to the customer. What separates this method from cost-led pricing is *when* costs are considered. As Henry Ford said, “No one knows what a cost ought to be.” It is *planned* costs, not *past* costs, that are critical since all pricing decisions deal with the future. Cost accounting and activity-based costing only deal with past costs, yet those are often quite irrelevant to pricing decisions made in a world of risk and uncertainty. By starting with the value and pricing decision *before* product development, Canon was able to create a new innovation and a multi-billion dollar market. As Nagle and Holden point out, “The job of financial management is not to insist that prices recover costs. It is to insist that costs are incurred only to make products that can be priced profitably given their value to customers” (Nagle and Holden, 2002: 4).

Home Bakery, a division of Matsushita, followed this same process in the design and development of the bread machine. This is a complicated appliance, since the company wanted to emulate the motions of a baker actually

twisting and kneading the dough as they do when baking fresh bread. The company gave its engineers these specifications for the machine:

1. It must knead, ferment, and bake bread automatically once the ingredients are put into the machine.
2. It should not need a special mix of ingredients.
3. A built-in timer must allow the user to prepare the ingredients at night and have bread ready to serve in the morning.
4. Bread making must not be affected by room temperature.
5. The bread should have a good shape.
6. It should taste better than a mass-produced and mass-marketed one.
7. The retail price should be between 30,000 yen and 40,000 yen (Nonaka and Takeuchi, 1995: 101–2).

The engineers hit the price and cost targets and in February 1987 the bread machine was launched at 36,000 yen, selling a record-setting 536,000 units in the first year (*ibid.*: 108). What if a company cannot stay within the price parameter established? Ikujiro and Hirotaka answer:

In Japan, keeping costs within a predetermined target was considered a key concern from the inception of the design stage. In the US, Itakura would be met with puzzled looks when he said anything like: “Well, if it’s going to cost that much, we can’t do it.” To US designers, “can” was purely a technical question completely unrelated from cost (*ibid.*: 219).

These examples are not meant to imply that other companies do not follow a price-led costing paradigm, for there are many other examples one could cite. Apple Computer, for instance, instructed Lucent that if it could make an adapter for under \$100 for Wi-Fi, it would incorporate a slot in all of its laptops. Lucent did just that, and in July 1999 Apple launched the option on its new iBook computers, naming it AirPort.

### **COST-PLUS PRICING, RIP**

With all of the evidence assembled, from the economists to the businesses cited, why does cost-plus pricing remain so endemic in the business world today, similar to a bull retreating to its *querencia*, a tiny area in the bullring maybe fifty square feet, within which the fighting bull fancies himself



entirely safe? *Si non e vero, e ben trovato*—if it isn't true, it ought to be. Many industries have developed “rules of thumb” for pricing, such as leading brands minus 10 percent; three to five times markup on wine in restaurants; three to six times markup on accountants', lawyers', or consultants' salaries to determine hourly rates to be charged, among many others. This turns pricing into a sort of wishful thinking, with no attention being paid to the external value created.

Cost-plus pricing is, to borrow a medical analogy, an *iatrogenic illness*—a disease induced inadvertently by a physician while providing treatment. An estimated 10 percent of all hospital patients are said to suffer from this illness, [paradoxically] about the same proportion of businesses that are sophisticated enough to have rejected cost-plus pricing.

As an economist grounded in the assumption that people, generally, are rational, and businesspeople, specifically, are profit optimizers—or at the least, *satisfiers*—one is drawn to the conclusion that executives perpetuate this pricing method because it is *safe* and *simplistic*. Sometimes a theory is accepted because it serves a purpose for the individuals using them, not because it is right or wrong. The idea that a practice is good because it has been around a long time is often a good justification for doing something, unless the conditions for which the tradition developed no longer apply. Science does not progress in this fashion; seniority does not define truth. As Blaise Pascal wrote in *Pensées*, “Custom is the whole of equity for the sole reason that it is accepted. That is the mythical basis of its authority. Whoever tried to trace this authority back to its origin, destroys it.”

Another reason for the popularity and widespread use of cost-plus pricing is the rule of the bean counters. Cost accountants have had a significant impact on pricing decisions in companies, and it is time to bring their tyrannical rule to an end. Cost accountants focus on the *inside* of an organization, yet all value takes place in the *external* world, beyond the four walls of the firm. By and large, accountants are not well equipped to judge and measure value, despite all the recent blather about activity-based costing. Our next task must be to put the cost accountants back where they belong, in allocating *internal* costs, not making *external* pricing decisions to capture value.

It is time we lay to rest cost-plus pricing, and for businesses to embrace the Pricing On Purpose chain explained in this chapter. Tradition is nothing but the democracy of the dead, but pricing is far too important to be left to the worldview of the bean counters, since they are prone to making too many wrong mistakes.



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# 10

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## THE WRONG MISTAKES

*It's all so simple, Anjin-san. Just change your concept of the world.*

—James Clavell, *Shogun*, 1975

There was once an immigrant tailor who came to this country and opened up a shop. He sewed buttons, stitched hems, made suits, and did all those other things tailors do. One day his son, who was an accountant, dropped by for a visit. While he was there, he noticed two cigar boxes sitting next to the cash register. One was labeled “paid bills,” and the other was labeled “unpaid bills.” The son chastised his father for keeping his records in such an unprofessional manner because the old man didn’t know what his profit was.

The father lovingly put his arm around the shoulders of his son and told him that when he came to this country many years ago, the only possessions he had were his clothes. Now he had a home, a car, a good business, good health, a daughter who was a college professor, a daughter who was an engineer, and a son who was not too sharp as an accountant. The old tailor then said, “When I add up all of my blessings and subtract the clothes on my back, what remains is my profit” (quoted in Stieber, 1998: 5–6).

I write this chapter, indeed this entire book, as a reformed sinner. I could have been the accountant in the above story, although my father—like Charlie Brown’s in the Peanuts comic strip—was a barber, not a tailor. To be sure, when I started my career as a CPA with one of the then Big Eight accounting firms, I might just as well have believed a business existed to keep fastidious books rather than creating wealth for its customers. An accounting education will foster the worldview that a business exists to close books, provide quarterly and annual financial statements, and allocate costs to every single product to ensure it is making a profit—like the mythological Greek King Midas—on everything it touches.

Part of the blame lies with management accounting, a thoroughly *inward-looking* discipline, from cost accounting to the DuPont return on investment (ROI) formula. This derivative of the labor theory of value can be found among the thinking of cost accountants after World War I. One of the century's most influential accounting academics was William Paton, who in a 1922 treatise described what he believed to be the cost accountant's chief activity:

The essential basis for the work of the cost accountant—without it, there could be no costing—is the postulate that the value of any commodity, service, or condition, utilized in production, *passes over into* the object or product for which the original item was expended and *attaches to* the result, giving it its value (quoted in Johnson and Kaplan, 1991: 135–36).

When one is in one's twenties, statements such as these are accepted as Gospel. Fortunately, Paton later repudiated this notion that costs are attached to a product as it moves through the factory in a speech he gave at a conference in 1970:

The basic difficulty with the idea that cost dollars, as incurred, attach like barnacles to the physical flow of materials and stream of operating activity is that it is at odds with the actual process of valuation in a free competitive market. The customer does not buy a handful of classified and traced cost dollars; he buys a product, at prevailing market price. And the market price may be either above or below any calculated cost figure (*ibid.*: 139).

Perhaps Paton read some of the Austrian economists' work in between making these two statements, for this is another way of articulating the subjective theory of value. Nonetheless, prior to World War I, the Industrial Revolution's entrepreneurs—such as Andrew Carnegie, Pierre du Pont, Alfred Sloan and other engineers of the scientific management movement—were the leaders in pioneering cost accounting for their operations. The most significant contribution made to management accounting theory was the invention of the ROI metric. H. Thomas Johnson and Robert S. Kaplan provide the history of the ROI measure in their award-winning book *Relevance Lost*:

The idea for the Du Pont return on investment formula originated, as far as we know, with F. Donaldson Brown, a college-trained electrical engineer and one-time electrical equipment salesman who joined the Powder Company's sales department in 1909 and became assistant treasurer of the company in 1914.

None of Brown's surviving records indicates how he hit upon the idea for his return on investment formula. Interestingly, Brown had no formal training or experience in accounting.

His experience in selling no doubt gave him an appreciation for the effect of turnover and distribution costs on a company's profits. Evidently, his mathematical, engineering, and marketing skills gave Brown a unique perspective on the determinants of company performance that was not understood by most contemporary accountants. Brown's idea about financial planning and control had a profound impact on the Du Pont organization and later on General Motors. Yet his ideas did not become widely known among professional accountants until the 1950s, when a new generation of management accounting textbooks introduced them into the standard MBA curriculum (ibid.: 86–87).

The importance of the DuPont ROI cannot be overemphasized, since it was the dominant theory taught to at least two generations of accountants and MBAs, yet it still lacked the explanatory power needed to solve the diamond-water paradox solved in Chapter 8. Indeed, the business schools unleash swarms of cost accountants and MBAs into the marketplace, armed with management accounting and other financial formulas all designed to allocate costs and scientifically determine ROIs, yet very few of them have an understanding of *value*, grounded in a proven theory. Today's business school graduates are greyhounds in accounting but ignoramuses in value and price.

It was not until I began seriously studying economics, with an emphasis on price theory, when I started to show contrition for my past cost accounting ways, and finally understood a comprehensive theory of value. It was a difficult road to travel, because as the Roman statesman and philosopher Seneca once said, "The mind is slow in unlearning what it has been long in learning." Working with customers in my accounting firm illustrated just how irrelevant the financial statements were in running a business in a world of risk and uncertainty. One customer said something I will always remember: "To use the financial statements you provide me once a year to run my business is the equivalent of timing my cookies with a smoke alarm."

I was a historian with a bad memory, coming in after the battles my entrepreneur customers were engaged in daily and bayoneting the wounded with my casualty reports (i.e., financial statements). And the biggest offense of all, I charged an hourly rate to do the work, falling prey to Marx's labor theory of value. I would even justify my billings to my customers by saying, "I only sell my time." What nonsense, since *no customer buys time*. In fact, a

quick detour into the world of professional services will illustrate just how wrongheaded the mindset of the accountant's view of the world really is.

## THE ALMIGHTY HOURLY RATE

Let us analyze how the *standard hourly rate* in a professional service firm is calculated, since it is no different from cost-plus pricing in any other industry:

$$\text{Hourly Rate} = \frac{\text{Overhead} + \text{Desired Net Income}}{\text{Expected Billable Hours}}$$

The first fact to note is that the above equation is not cost accounting; it is *profit forecasting*. There is no cost accounting theory that allocates desired profit—or a return on investment—among its costs. The desired net income in the equation is an *opportunity cost* concept, and while economists may use that theory, cost accountants do not. Hence, the more relevant question firms need to be asking is not “Did we make money on this customer,” but rather, “Did we *optimize* the profit from this customer?” The equation—or cost accounting in particular—cannot answer this more relevant question.

There are two essential problems with this cost-accounting formula. First, one way to increase revenue is to expand your overhead, a prescription for failure unless the company increases value to the customer concomitantly. The second problem is far more insidious, but quite prevalent, especially among professional service firms: the desired net income. There is no customer of a firm who lays awake at night wondering if his or her accountant, lawyer, architect, or advertising agency is making enough money. It is not the customer's job to provide a business with a profit. It is the company's job to provide a service so good the customer willingly pays a profit in recognition of what is being done for him. Cost accounting and cost-plus pricing confuses cause and effect, putting the inputs and activities before the result and value. The customer simply does not care about any of the numbers in the formula. Furthermore, if this formula actually modeled the real world, no business would ever lose money, since all businesses have overhead and desired net income. So what? What counts is value to the customer, which is conspicuously absent from the equation.

When you reward people for billable hours, you get billable hours, even if those hours logged on the timesheet are outright lies, or are worthless in

terms of creating results for the customer. You also create an incentive measurement that will verify C. Northcote Parkinson's Law: "Work expands to fill the time available." The customer simply does not care how long it took General Motors to build his or her car.

Professionals defend this practice by arguing that since they cannot fully anticipate every contingency in serving the customer, charging by the hour is fair since the customer is then paying only for what he or she uses. What they do not seem to understand is that the customer is hiring them precisely for their expertise and intellectual capital, and the fact they have done the work before and can point out all of the possible scenarios and contingencies. The last thing one wants to hear upon being wheeled into the operating room is the anesthesiologist saying, "Wow, I've never seen that before."

Pricing takes place in a world of risk and uncertainty, and sometimes the costs cannot be known in advance. Actuaries have to price the risk for natural disasters long before they know how much the damages inflicted are going to cost, let alone any profit left over. No one would purchase insurance under a cost-plus formula, priced in arrears. Imagine if the airlines priced in accordance with the cost-plus formula above:



### **Airlines Going to Billable Hours?**

The Denver lawyer stepped up to the airline ticket counter and asked to buy a ticket for a flight to Chicago.

"No problem," said the clerk, "but before I issue the ticket, I should remind you of the new way we charge for tickets. This year we have adopted a 'basic rate' of three dollars a minute for our flights. The clock starts when you check in at the gate and stops when you pick up your luggage. We mail you a bill about two months after the flight."

"Well, I guess that's okay," commented the lawyer.

The clerk continued, "Remember, we call it a 'basic rate' because we sometimes adjust that rate up or down if the flight is very empty or very full. Too, we may multiply that rate if our expert pilot finds a tailwind. We also adjust the rate according to what you will be doing in Chicago. You look like a lawyer, so I'll assume it's very important that you get there by plane, so we quadruple the basic rate. Another thing, how much is your annual income? You see, if you earn a great deal and it turns out the plane crashes, we will have to pay more on your spouse's damage claim, and we have, of course, to consider that increased risk of the airline."

The astounded lawyer choked, "But how much will this trip cost me? How do I know you don't slow down on purpose? How do I know your bill will be correct?"

The clerk stared down over the end of his nose. "I can see you're not familiar with the complexities of airline work. There are so many things we just can't know in advance—the winds, traffic delays, the weather, the routing. Airlines are a business, and we have to make a profit to stay in business. Now don't worry, we're very honest and sensitive about all this billing business and I am sure you'll be pleased with our fully itemized bill when you get it. If there's any question just call." Then the clerk whispered, "But just so we understand each other, if you don't pay the bill in full and promptly, you'll never fly on this airline again."

"Oh," grunted the Denver lawyer, "is there anything else I should know?"

The clerk smiled thoughtfully and murmured, "On your flight there is a new copilot in training, and we charge an additional 50 cents a mile. Copilots are really very important, you know, to carry the pilot's charts, to fly on clear calm days, even to land the plane if the pilot is busy with other matters. Too, if you fly with us again, your copilot may have become your pilot. Wouldn't that be great? One other thing, if the copilot uses computerized flight routing there will be an additional \$75 charge. But of course computerized flight routing is almost standard charge with technologically advanced airlines."

"But I just wanted to get to my meeting in Chicago and come home. Now I don't even know if I should fly at all," groaned the lawyer.

The clerk smiled again. "Mature passengers come to understand that flying is just a cost of doing business. They never know how much it costs 'til we bill them. But then, there's really no choice, is there?"

"No," conceded the lawyer, "I guess not."

And then the lawyer tried again. "Why can't you just give me a fixed price and I'll decide if I'll go or not?"

The clerk frowned. "But we can't do that. That wouldn't be fair to you. We might overcharge you and then you'd be unhappy. Or we might underestimate and then the airline would lose money and couldn't maintain the planes, and we certainly don't want that."

And so the Denver lawyer came to hate airlines and took his revenge by regaling acquaintances at cocktail parties about the new pitfalls of airline travel.

Fortunately, none of you readers run an airline, so you won't feel defensive (Reed, 1996: 3–4).



If you work in a company utilizing any form of hourly billing, understand it is nothing but a derivative of Marx's labor theory of value with a desired profit added on (or Adam Smith's adding up theory of value), a the-



ory totally repudiated in the economic marketplace because it has no relationship to value.

## IS ACTIVITY-BASED COSTING ANY BETTER?

One of the more devastating critiques of traditional cost accounting is how it tends to allocate average costs over a range of average products. Yet, average cost is useless, since it is so antithetical to the marginal theory of value. The move in recent decades toward activity-based costing (ABC), started by Kaplan and Johnson's book *Relevance Lost*, offers a partial solution to this dilemma.

While cost accounting measures the cost to do something, ABC captures the cost of not doing something, such as down time, inventory shortages, and rework. Traditional cost accounting is myopic, it only sees the costs in the bucket in front of it, while ABC takes into account costs not seen. This is at least progress, since usually the cost of not doing something far exceeds the cost of doing something, and cost accounting does not capture the former.

ABC always asks, "Does this process have to be done?" If so, what is the most effective way of doing it? This costing method has provided manufacturers with the information they need to cut costs substantially, but the real promise of ABC may rest with service industries. Peter Drucker makes this observation in his book *Managing in a Time of Great Change*:

Activity-based costing shows us why traditional cost accounting has not worked for service companies. It is not because the techniques are wrong.

It is because traditional cost accounting makes the wrong assumptions. Service companies cannot start with the cost of individual operations, as manufacturing companies have done with traditional cost accounting. They must start with the assumption that there is only *one* cost: that of the total system. And it is a fixed cost over any given time period. The famous distinction between fixed and variable costs, on which traditional cost accounting is based, does not make much sense in services.

But that all costs are fixed over a given time period and that resources cannot be substituted for one another, so that the *total* operation has to be costed—those are precisely the assumptions with which activity-based costing starts. By applying them to services, we are beginning for the first time to get cost information and yield control.

Banks, for instance, have been trying for several decades to apply conventional cost-accounting techniques to their business—that is, to figure the costs of individual operations and services—with almost negligible results. Now they are

beginning to ask, Which one *activity* is at the center of costs and of results? The answer: Serving the customer. The cost per customer in any major area of banking is a fixed cost. Thus it is the *yield* per customer—both the volume of services a customer uses and the mix of those services—that determines costs and profitability. Retail discounters, especially those in Western Europe, have known that for some time. They assume that once a unit of shelf space is installed, the cost is fixed and management consists of maximizing the yield thereon over a given time span. Their focus on yield control has enabled them to increase profitability despite their low prices and low margins (Drucker, 1995: 124–25).

This yield method is precisely what the airlines began to use after deregulation in 1978, focusing on yield (the amount of money the airline gets per passenger mile) and load (the percentage of seats filled by paying passengers) in order to price its tickets, balance supply and demand, and maximize the revenue on each flight. Prior to yield management, airlines used break-even analysis to analyze yield. This is totally unreliable, however, since it cannot predict yield, and some airlines learned that they needed a 90% load factor to break even!

Despite the advances ABC has made, it suffers from the same fundamental flaw as traditional cost accounting: it is an *inward*-looking cost allocation process, and does not take into account the customer or the value created. No matter how sophisticated a company's costing method may be, it is the least important piece of the puzzle. It is the value, then the price, that ultimately drive the costs, and ABC simply provides no insight on those two vital numbers. While the cost accountants are analyzing the *internal* costs and developing ever more elaborate allocation methods, the real value is taking place *outside* of the organization's walls. While the argument is not being made to eliminate cost accounting, it is strongly suggested that cost accountants not have a dominant influence in strategic pricing decisions. The fact of the matter is, no cost accounting method can capture pricing mistakes or lost pricing opportunities; they simply do not show up in the analysis or on a company's financial statements. An example may illustrate this point, again from the world of professional services, but is easily applicable to any type of lost pricing opportunity.

## MAKING THE WRONG MISTAKES

In 1997, Tim was the managing partner of a top accounting firm, and his best, long-term customer (of 20 years) had come to him wanting to sell

his \$250 million closely held business. He told Tim (and I am paraphrasing here), “You’ve been my CPA for 20 years and I trust you with my life. It is time for me to sell my business and enjoy my golden years. Here is what I want you to do:

- Update our business valuation in order to maximize the sales price.
- Fly with me anywhere we have to go to meet with potential buyers.
- Be actively involved at every stage of the sales negotiation.
- Perform the due diligence, along with the attorneys, of the qualified buyers.
- Work with the attorneys on the sales contract to make sure my interests are protected.
- Perform tax planning and structure the deal in such a manner as to maximize my wealth retention.

Obviously, this was a very sophisticated customer and it is true Tim had no idea, at the outset of this engagement, how long it would take to close the deal, and how much firm capacity (his and his team members) it would require. But he did know more than an average salesman would know. He knew the customer’s business was well niched, profitable, and growing. This would indicate a very high probability of success. He also knew this customer was an audit customer of the firm’s and therefore he would not be able to charge a contingency price based on a financial outcome (such as a percentage of the sales price or of any tax savings), since that would impair independence, which is illegal for an auditor.

When I asked Tim how he priced this engagement, he proudly proclaimed that every hour charged to this project was at his highest consulting rate of \$400 per hour, indicating, right from the start, that Tim knew there was more value on this project than he would ever be able to lie on a timesheet to capture. He further explained how he had updated the business valuation, negotiated with two buyers, and did all of the other tasks requested by the customer. As a result of Tim’s work, the customer received (and saved in taxes) an additional \$15,000,000, and acknowledged Tim was directly responsible for this outcome. In Tim’s own words, the customer was “elated.”

Tim then told how he priced the engagement. He reviewed all of the hours from the work-in-progress time and billing system, believed it did not adequately reflect the value he provided, and marked it up an additional 25 percent over the \$400 hourly rate. He then sent out an invoice for \$38,000, which the customer promptly—and happily—paid. He believed he was value

pricing. He was not—he was *value guessing*, since the customer had absolutely no input into the price, and only a customer can determine value.

When I asked Tim what he thought the customer would have paid if he had utilized a TIP clause (also referred to as the *retrospective price*, or *success price*), such as the following:

In the event that we are able to satisfy your needs in a timely and professional manner, you have agreed to review the situation and decide whether, in the sole discretion of XYZ [company], some additional payment to ABC [CPAs] is appropriate in view of your overall satisfaction with the services rendered by ABC.

The TIP is being based on the “overall satisfaction with the services rendered,” and not any financial contingency, which is the origin of the acronym TIP—to insure performance. This TIP clause would be discussed with the customer *before* any work began. If needed, you could put a minimum price on the engagement (such as \$10,000 to \$30,000) to cover immediate firm capacity. But in this case, given the 20-year relationship with the customer, even a price *solely* determined by a TIP would have been acceptable, since the customer was not likely to take advantage of Tim after the services he rendered.

In answer to my question, Tim said his customer would most likely have paid him \$500,000, a sum I believe to this day is below the real number—but at least better than the \$38,000 he finally charged. Nevertheless, since Tim knows the customer better than I, let us take his number as correct.

I informed Tim he had made the ultimate accounting entry:

	Debit	Credit
Experience	\$462,000	
Cash		\$462,000

Tim was providing extraordinary value to this customer, yet his cost-plus pricing theory prevented him from capturing it. Are we not ruled by our theories? This is why it is imperative to extinguish the cost-plus mentality from your company. No one in any seminar I have shared this story with believed Tim would have received less than \$38,000 for his services on this engagement. In effect, Tim paid a *reverse risk premium*—he was assured he would not go below his hourly rate, but in return he gave up the added value the customer already believed he had provided. This is not a risk worth taking if you want to maximize your firm’s profitability.

The deleterious effects of this are deeper than just being deprived the value from the work you provided on any one engagement. The problem lies at the very core of a company's measurement system and points out how it does not offer the opportunity to learn from lost pricing opportunities, or pricing mistakes.

In his inimitable way, Yogi Berra explains this problem eloquently in his book *When You Come to a Fork in the Road, Take It!*:

When we played the Pittsburgh Pirates in the 1960 World Series, it was hard to believe we lost. It was real strange. We crushed their pitching. We won three of the games, 16–3, 10–0, and 12–0. We were the more experienced and stronger team. But we lost in a wild and weird Game 7 when Bill Mazeroski hit that homer in the ninth inning over my head in left field. To this day, I thought the ball was going to hit the fence. Anyway, when a reporter asked me later how we could lose to the Pirates, I said, “We made too many wrong mistakes” (Berra, 2001: 75).

In baseball, like everything, mistakes are physical or mental. In tennis, they say “forced and unforced errors.” I like to say there's mistakes—and there's wrong mistakes. What I mean is that wrong mistakes are more serious, more avoidable, more costly. They're usually more mental than physical. There's nothing to be learned from a second kick of a mule (ibid.: 74).

When it comes to pricing, the wisdom from Yogi is profound. Tim made the *wrong mistake*, and here is why: He will not learn anything from it because the firm's primary assessment is billable hours. When the partners review the realization report on this engagement, they will see 125 percent, which is excellent when you consider most firms realize between 65 and 95 percent overall on each hour. Most likely, Tim will get nothing but accolades and praise from his fellow partners. No one will ask where the \$462,000 is because the billable hour metrics do not have a way to capture that type of information, which is precisely why pricing is more of an *art* than a science.

This is an excellent example of a wrong mistake for another reason: Tim (or the firm) will not learn anything from this lost pricing opportunity. The \$462,000 simply vanishes into thin air (or, more precisely, it remains on the customer's income statement). No knowledge was gained by the firm on how to price the next similar engagement in accordance with value—it will simply perpetuate the same mistake, over and over. Being a more accurate activity-based cost-accountant would also not have helped Tim to capture the value.

This is not meant to imply that with Pricing on Purpose you will never make mistakes. You certainly will. The difference is they will be the *right mistakes*, because with value pricing, as opposed to cost-plus pricing, you are forced to receive input from the customer as to your value, and have in place pricing strategies that will capture more of that value (like the TIP clause). If you engage in after action reviews (AARs), which perform value assessments on each engagement, and elicit feedback from your customers, you will learn from your mistakes and become better at pricing in the future (AARs will be illustrated in Chapter 21). Pricing is a skill similar to baseball, tennis, or golf: The more you do it, the better you get.

Most feedback that companies receive on pricing is negative: “Your price was too high.” Or it is ambivalent: “Your price was just right.” No customer ever discloses how much money your company left on the table. Since humans emerged from the cave and began to barter, it has been the customer’s job to do everything in his or her power to push down prices. There is nothing new about this, and it should not surprise any executive. Your firm’s job, however, is to push back. As Nagle and Holden explain:

Price negotiation is usually a David-versus-Goliath confrontation. David, the salesperson, has much less influence over what his company sells than the purchasing agent has over what his company buys. Purchasing agents are better informed since it is legal for them to compare prices and terms with other buyers, while it is illegal for sellers to do so. Finally, salespeople are usually paid for making sales, while purchasing agents are paid for saving money (Nagle and Holden, 2002: 200).

The cost-plus metrics, generally accepted accounting principles (GAAP) financial statement reporting, and even ABC analysis prevent companies from pricing commensurate with value since pricing mistakes (or missed opportunities) do not show up in any of these reports. As such, the company is denied the chance to acquire the proper value metrics and develop intellectual capital on pricing in order for it to become a core competency among the executives. All of the traditional metrics of a company focus on *internal* measurements, yet value is always an *external* issue—in the hearts and minds of the customers. Innovative pricing strategies, such as the TIP clause, that are outward focused and attempt to measure value have allowed more and more firms around the world to capture more of the value they provide, as the following story illustrates.



This story comes from Gus Stearns, a partner in an accounting firm, whom I met on September 25, 2000, at a conference in Las Vegas. Gus tracked me down at the dinner party, walked me over to the bar, and over a glass of wine told me his amazing TIP story. Here are the two e-mails I received from Gus explaining his success, the first one prior to our meeting in Las Vegas and the second one after:

April 20, 2000

Hello Ron,

I hope the tax season finds you well. I was fortunate enough to be at the Atlanta conference [January 2000] when you spoke and picked up an autographed copy of your book [*Professional's Guide to Value Pricing*], which I devoured on the plane trip back.

The engagement which I refer to (\$180,000 price) had already started a month or two before and I had used the old standard rate-time-hours routine and billed about \$2,000 at a standard rate of \$180/hour. After listening to you and reading the book, I was determined to reevaluate the price structure and simply went back to my customer and said, "Guys, this is what I am bringing to the table. It brings a lot of value which is etc., etc. I don't believe hourly rates based upon time is appropriate. I am unable to place a value on this. I need your help. You tell me what the value of all this is to you. You are the customer and only you can truly establish the value. I know I'll be happy with what ever you come up with." This is almost an exact quote.

I left it at that two months ago. I was handed a check for the first installment of \$50,000 on the way out at the end of the engagement. I guess this is what you call "outside-in pricing." I like it.

Gus Stearns, CPA

It gets better, since this engagement was in two phases. Here is the follow-up e-mail from Gus explaining the final result after the job was done:

Hello Ron,

Basically the large engagement was for a previous client that I had hired a controller for. He took over the tax work, at my suggestion, as

he was a CPA. The engagement was an exit and management succession strategy, which involved some fairly hefty income tax savings as well. The total time expended was about 100 hours, although a lot of the time was on unrelated things that I did not want to charge for due to the magnitude of the price (we quit using timesheets some time ago and have substituted “daily activity sheets” to make sure our clients get invoiced based upon perceived value of each engagement).

I used a flip chart in the presentation, pointing out the value of what they were getting. At the end of the presentation, I asked how much they thought it was worth, and suggested \$300,000, \$500,000, a million? I wanted them to think in big numbers. The CEO was rather excited and said a million. Knowing that this would be difficult to obtain in one fell swoop I suggested \$400,000 down and a retainer of \$4,000 per month. They agreed but asked that I serve on the board of directors and attend quarterly meetings through 2008, when the note to the previous owners would be paid off. They were also kind enough to put me on salary so I could participate in their pension plan, which is a 25 percent direct contribution from the company. This all adds up to a little bit over \$1 million.

Never once was the word “time” used or referred to by myself, or my client. They could have cared less about time. In all of our engagements, I never use the word. By concentrating on value and encouraging the client to participate in the valuation of the engagement our prices have skyrocketed. You were absolutely on-target when you said that accountants are terrible at valuing our services (myself included).

Keep up the wonderful work,

Gus



These types of engagements are not the *rule* in any firm, they are the *exception*. Nonetheless, they do arise, and when they do it is critical to recognize the value you are creating, and to utilize innovative pricing strategies to capture it. This also demonstrates why pricing is the most potent lever you have in terms of increasing your company’s profitability, much more than cutting costs or increasing efficiency.

I include these stories not because I believe you will earn a \$1 million TIP, but rather to illustrate how the cost-plus pricing mentality has placed a self-



imposed artificial ceiling over the heads of companies. Never in his wildest dreams would Gus have placed a \$1 million value on his work; but the customer did. Does he not deserve it?

In a world governed by the subjective theory of value, pricing mistakes do not leave a trail on financial statements or cost accounting reports, they simply vanish into thin air, lost forever, like a seat on a flight not sold. It is estimated that a 1 percent reduction in price translates into a \$20 million loss in operating profits for Coca-Cola (Monroe, 2003: 92). Does this make pricing an art or a science?

### SCIENCE OR AN ART?

Cost is a fact, pricing is a policy, and value is subjective. In order to optimize profit, an organization should devote more of its resources and intellectual capital to creating value, and then in turn set prices to capture that value. This forces the organization to constantly look outward, where all the results of any business take place. Cost and price are rather passive factors; the value is the essential ingredient. And since all value is subjective, it is an iterative process. After all, a price is nothing but an objective amount being placed upon a subjective value, which is going to leave plenty of room for trial and error.

This leads to an interesting debate, and there does not seem to be a consensus among pricing experts: Is pricing a science or an art? Thomas Nagle and Reed Holden, two of the most prominent authorities in the field of pricing, say in their book *The Strategy and Tactics of Pricing*:

As with most marketing decisions, the answers to strategic questions about pricing are more open-ended. Pricing is an art. It depends as much on good judgment as on precise calculation. But the fact that pricing depends on judgment is no justification for pricing decisions based on hunches or intuition. Good judgment requires that one ask the right questions and comprehend the factors that make some pricing strategies succeed and others fail (Nagle and Holden, 2002: 9).

Kent Monroe, another renowned pricing expert, in his *Pricing: Making Profitable Decisions* (third edition), describes pricing as an adaptive process:

There is no one right way to determine price. Pricing simply cannot be reduced to a formula—there are too many interacting factors. Successful pricing requires considering all internal and external factors and adapting to changes as they occur. Successful pricing is adaptive pricing (Monroe, 2003: 653).

Robert Docters et al., in their book *Winning the Profit Game*, are so sure of their book, they boast:

Once you've read this book, we believe you'll be convinced of the rewards of spending time on revenue and pricing. You will have the tools to be as confident of price optimization as you are today of cost reduction efforts... (Docters et al., 2004: xv).

This is an extraordinary assertion. Since value is subjective, it is unclear how any business can be *convinced* they are optimizing their pricing. In *Pricing for Higher Profit*, published in 1966, Spencer Tucker argued, "Pricing is at once a science and an art" (Tucker, 1966: 5). Coming down on the science side is John Daly in his book *Pricing for Profitability: Activity-Based Pricing for Competitive Advantage*:

Pricing is not an art. However, a well-designed pricing model may be beautiful in the same way as a well-designed piece of machinery. Pricing is a science as much as the design of that machinery is a science. If the person responsible for establishing price says, "Pricing is an art," it is a good indication that he or she is missing much of the basic data necessary to make informed pricing decisions (Daly, 2002: 2).

Once again, this is a dubious view in a world where price is determined by value, and value is always subjective, constantly changing with the whims and desires of fickle customers. The Dyson Dual Cyclone vacuum cleaner—certainly a well designed piece of machinery—was introduced in 1993 at a price of £200, an extraordinary price at the time for a vacuum cleaner. Part of the price premium was no doubt for the aesthetic quality of the machine, much like the Apple iMac and the iPod. Yet two pricing experts would probably never come to the same conclusion, regardless of how much data they were able to obtain. The science cannot be ignored, but neither can the art. No industry has transmogrified pricing into a science more than the airlines, with their yield management software capable of making millions of price changes based on myriad factors. However, a lot of those factors must be *judged*—and entered into the computer software—by a flesh-and-blood human being, such as which city is hosting the Super Bowl or the Olympics, and betting odds on sports games, which certainly affect air fares.

Daly further asserts, "Activity-Based Pricing can improve a company's profitability relatively inexpensively and painlessly through the elimination of pricing mistakes" (ibid.: 138). How does one measure a pricing mistake?

This is the cost accountant's view of the world, certain about the costs it measures and allocates. Pricers, though, must live in a world of uncertainty, and this simply cannot be eliminated by measurement alone. Costs certainly play a role in determining which products to offer, which to discontinue, which are more profitable, but not for setting strategic prices. Cost accounting deals, of necessity, with historical costs, and it is the present that judges the past, not the other way around.

In any event, I come down on the art side, not science. But on two points everyone seems to agree. First, pricing deserves a promotion, because it is the number one driver of profitability, and therefore should be an executive function. Second, pricing may be an art, but no doubt it is also a *skill*. And as with any skill, the more one engages in it, the better one gets. The objective is to have pricing become a core competency in your organization. This is what is meant by Pricing on Purpose.

This change in thinking was an emotional catharsis for me, given my extensive education in cost accounting and cost-plus pricing thinking. Nonetheless, it is the Austrians' theory of subjective value that has far more explanatory power on the subjects of value and price. This chapter was written in the spirit of Antony's address to the crowd in Shakespeare's *Julius Caesar*. In the play, you'll recall, Julius Caesar has just been assassinated, and the citizens of Rome gathered in the forum, grieving for their loss and angrily demanding an accounting. Brutus, who took part in the assassination, rises and attempts to defend the action by stating that he did not love Caesar any less than they did, but that he loved Rome more. Satisfied he has persuaded them that the assassination was justified, Brutus yields to Marc Antony, who addresses the crowd:

Friends, Romans, countrymen, lend me your ears;  
I come to bury Caesar, not to praise him.  
The evil that men do lives after them;  
The good is oft interred with their bones;  
So let it be with Caesar.

One company has buried standard cost accounting and relegated it to where it belongs, and the implications are just now beginning to be comprehended by business leaders around the world.



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# 11

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## PRICE-LED COSTING REPLACES COST ACCOUNTING

*Innovation requires builders, not bean-counters, and the last person who should be running something is the man who controls the costs.*

*Sure, you need that man in there somewhere to keep a rein on things, but he shouldn't be at the top.*

—James Dyson, *Against the Odds: An Autobiography*, 2003

A business does not exist to be efficient—it exists to create wealth for its customers. The traditional focus on efficiency in an intellectual capital-based economy is misplaced. This is not to say productivity is not important, but rather that it should not be the talisman for guiding the company to its core purpose: the creation of wealth.

Efficiency can be taken to ludicrous extremes. For instance, I doubt any efficiency expert would have suggested to the Nordstrom brothers to place pianos and hire piano players in their department stores. What could this possibly add to efficiency? Yet, how *effective* is it in providing a competitive differentiation Nordstrom can leverage to create a more valuable experience for its team members and customers?

If efficiency was the ultimate purpose of an organization, than perhaps Walt Disney should have made *Snow White and the Three Dwarfs*; think of the cost savings—in animator time and speed to market—from removing nearly 60 percent of the dwarfs!

Knowledge companies understand this dynamic. Disney and Microsoft know there is a vast difference between being efficient and being *persuasive*. Even Ben & Jerry's eventually learned that a business simply could not operate at—nor price for—100 percent efficiency. The new companies that have

created so much wealth in the past decades, from Google and Intel to Starbucks and Microsoft, did not get where they are by focusing on efficiency. They focused on creating wealth for their customers. Why, then, do most companies worship at the altar of efficiency?

It is time to replace efficiency with *effectiveness* (or better yet, *efficaciousness*), and begin to measure what counts, rather than counting for the sake of counting. Cost accounting simply cannot be allowed to continue its dominance in controlling a company because it has little correlation to, and is not an accurate measurement of, the external *results* and *wealth* that knowledge workers create for their customers.

Andrew Carnegie's favorite saying might have been, "Watch the costs and the profits will take care of themselves," but in an intellectual capital company, it should be, "Watch your value and price, and the profits will take care of themselves." Price is how the firm *captures* the results of its value proposition, and since a company is what it charges for, focusing on maximizing value is a better metric than maximizing profit, which is nothing but a *lagging* indicator, derived from value creation.

This debate between cost accounting and profitability is not over. Much work is being done in this area. In 1987, as mentioned before, H. Thomas Johnson and Robert S. Kaplan published *Relevance Lost: The Rise and Fall of Management Accounting*, which was named in 1997 one of the 14 most influential management books to appear in the first 75 years of *Harvard Business Review's* history. The book is credited with launching the activity-based costing revolution. Yet, these two thinkers have gone down very different paths since then: Kaplan going on to pioneering work in the field of performance measurement, creating the Balanced Scorecard, and Johnson moving on to what he calls "management by means." In fact, they are now feuding with each other, and have not spoken in years.

I have drawn inspiration from both Kaplan and Johnson. Many of the performance measurements to be discussed in the second book in the *Intellectual Capitalism Series* were inspired by Kaplan's Balanced Scorecard approach of determining nonfinancial indicators that drive profitability. As the Balanced Scorecard is implemented throughout companies of all sizes, more empirical research will have to be conducted to test its true effects. That being said, there is no doubt that any business should be able to come up with key performance indicators—or critical success factors—that have the qualities of being a *leading* indicator and can help implement the company's strategy and vision.

## TOYOTA—NO COST ACCOUNTING?

Johnson's book *Profit Beyond Measure* is a seminal work, although not yet fully developed. And while I have severe misgivings about some of his environmental rants in the book, when he profiles Toyota and Scania—the latter now owned by Volvo—as two manufacturers that *do not* have a standard cost accounting system, he is on firm ground. It is hard to argue with results, and Toyota is one of the most respected companies in the world, and has produced one of the highest-quality products at the lowest cost in the industry for years, dating back to 1926 when it started as a weaving machinery manufacturer. It has an unbroken record of profits, with zero layoffs, since 1960—a record unparalleled in the industry—and is a fierce innovator, and ranks top in any measure of productivity you care to analyze. Its annual vehicle sales are second only to General Motors (8.59 million to 6.78 million, in 2003). Its market value is close to the combined value of the Big Three automakers in almost every year except 1998. In 1997, it exceeded the market value of the Big Three and in 2003 it exceeded General Motors, Ford, Volkswagen, DaimlerChrysler, Nissan, and Renault.

In 2003, even after increasing efficiency by 16 percent, Chrysler was losing \$496 on each vehicle sold, while Ford was losing \$48. GM was making \$178 per vehicle while Honda made \$1,488, Toyota \$1,742 and Nissan \$2,402 (according to “A Survey of the Car Industry,” *The Economist*, September 4, 2004).

As Glenn Uminger, a financial controller at Toyota Motor Manufacturing-Kentucky (TMM-K)—which Johnson studies in depth in his book—since 1988, says, “TMM-K has never had a standard cost system to track operating costs, and we probably never will.” So how do they do it? How can a manufacturing company run without a standard cost accounting system? The answer lies in the subjective theory of value explained in Chapter 9, and how Lee Iacocca priced the Ford Mustang. Toyota understands price drives costs, not the other way around. Here is how Johnson explains it in his book, *Profit Beyond Measure*:

None of these comments is meant to imply that Toyota does not have accounting and production planning information systems. Of course it does. Toyota has a comprehensive array of information systems, accounting and otherwise, with which to *plan*, in advance of operations, and to *report* results of operations after the fact. But information from such systems is *not allowed to influence operational decisions* (Johnson and Broms, 2000: 106).

Toyota management discharges its responsibility for costs not by taking arbitrary steps to manipulate operations, but largely in the vehicle planning stage. During the design stage, long before the first penny has been committed to making a vehicle, Toyota has always placed enormous importance on setting and achieving cost targets. To do so, over the years Toyota has developed a famous technique for target costing. Simply stated, target cost is the maximum cost the company can afford to incur to produce and sell a vehicle and still earn a required profit at the price customers are expected to pay (ibid.: 109).

Johnson goes on to explain his theory that Toyota operates under “management by means” rather than “management by results.” It is an interesting viewpoint because it views the organization as a living system, based on interdependent relationships, and those are nearly impossible to quantify. He notes Dr. Edward Deming’s observation that over 97 percent of the events that affect a company’s results are not measurable, while less than 3 percent of what influences final results can be measured:

Managers who adopt the new thinking offered here will accept as second nature the idea that what decides an organization’s long-term profitability is the way it organizes its work, not how well its members achieve financial targets. This chapter compares the long-term records of Toyota and the American “Big Three” automakers to demonstrate the truth of this proposition. It posits Toyota’s principles as an example of new management thinking called “management by means.” Management by means is the antithesis of “managing by results,” practices identified...with Toyota’s American competitors. Those who manage by results focus on bottom-line target and consider that achieving financial goals justifies inherently destructive practices. Those who manage by means consider that a desirable end will emerge naturally as a consequence of nurturing the activities of all employees and suppliers in a humane manner. Managing by means requires a profound change in thinking that is a bold alternative to conventional management thinking and practice (ibid.: 12).

Management accounting simply takes accounting revenue, cost, and profitability information, which is appropriate for measuring the overall financial results of a business, and inappropriately attempts to trace it to the particular activities and products of the business that gave rise to those results. Assigning such quantitative measures to parts of a mechanistic system makes sense. However, the parts of a natural living system cannot be so treated. Accounting measures are unable to penetrate the organic, multifaceted union between customer and company that ultimately is the source of a company’s financial results. This union is the reason any company exists (ibid.: 145).



Because cost and profit are not objects, but are properties that emerge from relationships, quantitative measures can only describe them, they cannot explain them. Quantitative measures, unlike art, music, or the stories and myths that humans fashion with words, cannot convey understanding of the multidimensional patterns that shape the relationships from which results, such as cost and profit, emerge in a living system (ibid.: 188).

If Carnegie said, “Watch the costs and the profits will take care of themselves,” Johnson is saying, “Nurture the means. The results will take care of themselves.” Kaplan would say, “Measure the result and the means will take care of themselves,” and I say, “Watch your value, and the profits will take care of themselves.” The truth, most likely, lies somewhere in between, which is why I have borrowed ideas from both of these thinkers. However, I suspect that Johnson is closer to the truth than Kaplan, as even Peter Drucker might agree:

I do not believe that one can manage a business by reports. I am a figures man, and a quantifier, and one of those people to whom figures talk. I also know that reports are abstractions, and that they can only tell us what we have determined to ask. They are high-level abstractions. That is all right if we have the understanding, the meaning, and the perception. One must spend a great deal of time outside, where the results are. Inside a business one only has costs. One looks at markets, at customers, at society, and at knowledge, all of which are outside the business, to see what is really happening. That reports will never tell you (Flaherty, 1999: 86).

The world needs a new Frederick Taylor, and—excepting Peter Drucker, who is in a class all his own—Kaplan and Johnson are certainly serious contenders. Let the feud continue.

## THE PRICE-LED COSTING REVOLUTION

The lesson being taught by Henry Ford, Toyota, and Lee Iacocca with the Mustang, among the other examples cited, is that a company needs to start with value, then determine price, which finally dictates the costs that can be profitably incurred to produce a good or service desired by customers. This value chain would be obvious to a nineteenth-century marginalist economist, as it certainly was to Henry Ford and Toyota early in the twentieth century, and some enlightened companies today, such as Disney. Consider this tribute

to price-led costing from Jeff McCain, Principal Project Estimator, Project Estimating, at Disney:

In my role as a project estimator, it is common to see people viewing cost constraints as a primary part of the challenge Imagineers must solve. What I think some miss is how cost limits can themselves be instrumental in producing creative solutions.

This can be as simple as making the blank sheet of paper a known size so the blue sky ideas can flow. It can be the knowledge that a previous design can't be reused, so new and fresh ideas must be produced.

I've seen cost constraints motivate the team to produce a solution that looks better and lasts longer than the "real thing"—the status quo choice if costs weren't being considered.

Not earthshaking, but who else might say this if not an estimator? (The Imagineers, 2003: 128)

It seems so obvious to constrain your company with a final price before you begin to incur any costs, yet this practice is not widely followed, despite its proven successes. Costs are, no doubt, important to consider, but the crucial distinction is *when* they are considered. By its very nature, cost accounting is a historical function, but what is important for pricing are *planned* costs, not *past* costs. Furthermore, cost accountants usually pay far too much attention to sunk costs, which should have no influence over pricing or value considerations.

As Henry Ford pointed out, no one knows what a cost should be. Yet, cost accounting has held hegemony for far too long over the pricing strategies of businesses everywhere, embedding the conventional wisdom that costs determine price. Merely because a practice is widely adopted and utilized does not make it optimal, not to mention true. At one point, a majority thought the world was flat. As John Kenneth Galbraith points out, "I have learned that to be right and useful, one must accept a continuing divergence between approved belief—what I have elsewhere called conventional wisdom—and the reality."

One of Peter's Principles is that bureaucracy defends the status quo long past the time when the quo has lost its status. Cost accounting, and its more modern cousin activity-based costing, does not deserve to be the apotheosis of pricing, let alone running a business. No doubt, it has its role in any organization, but that role is very specific and historical, not one that should have

a major influence in pricing decisions. This may sound like the ultimate apostasy coming from a former CPA and cost accountant, but like the ancient mythological Greek Cassandra, I must speak the truth even if no one is prepared to believe.

One of the reasons cost accounting has gained such a strong foothold in the pricing decisions of companies is that there is someone in charge of this function, usually a cost accountant, estimating department, or the like. Today it is common to find a chief pricing officer (CPO), director of pricing, yield management group, or other such title, which is an enormous leap forward for developing and diffusing strategic pricing skills. Finally, pricing is getting the promotion it has long deserved to an executive function, as companies around the world start to realize price is the major driver of profitability. This is a very salutary trend, one bound to spread far and wide, helping to make pricing a core competency in the intellectual capital company of tomorrow.

For as good as it is to have a CPO, is it enough? Thinking back to Peter Drucker's marketing concept, the wealth a company creates for its customers exists outside of its four walls. Professional pricers may suffer some of the same fate as cost accountants—becoming too inward focused on efforts and activities, not results and wealth creation.

But who is in charge of value? Who in the company is keeping their focus on the outside in an attempt to understand and continuously enhance value for customers? Perhaps it is time to create a chief value officer, a role to be discussed in Chapter 21. Until then, since it has already been explained how value—not cost—is the ultimate arbiter of price, it is worth exploring how customers determine value, the subject we turn to next, as we explore what and how people really buy.



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# 12

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## WHAT AND HOW PEOPLE BUY

*There is never a good sale for Neiman-Marcus  
unless it's a good buy for the customer.*

—Herbert Marcus, advice to his son Stanley, 1926

Economists have a different definition of profit than accountants, because they consider both parties to a transaction. Adam Smith made the observation that a transaction between two parties will only take place to the extent that *both* parties benefit, by receiving more in value than they are giving up. U.S. Congressman Samuel Barrett Pettengill [1866–1974] gave the following excellent definition of profit from an economist's perspective:

The successful producer of an article sells it for more than it costs him to make, and that's his profit. But the customer buys it only because it's worth more to her than she pays for it, and that's her profit. No one can long make a profit producing anything unless the customer makes a profit using it.

Stanley Marcus [1905–2002], one of the sons of the founders of Neiman-Marcus, put it even more explicitly:

You're really not in business to make a profit, but you're in business to render a service that is so good people are willing to pay a profit in recognition of what you're doing for them.

This is the ultimate principle for any business because it places the focus where it belongs, on the customer.

It is a deceptively simple question: What are we getting paid for? Yet many businesses arrogantly assume they know what their customers want and believe they have been giving them exactly that for years. This is a myopic vision, and potentially harmful, because there now exists a plethora of

information available on why people buy, how they buy, and the decision process they go through, which businesses ignore at their peril. Economist Shlomo Maital, who has been teaching economics to business executives for decades, has put forth 13 forces that shape what people buy, in his book *Executive Economics*:

- A aptness
- B bandwagons and bubbles
- C cost, or price
- D demographics
- E elasticity, or sensitivity to price
- F fashion and fads
- G greed
- H habit
- I income
- J jazz
- K knowledge
- L loyalty
- M minds and money (From Maital, 1994: 171)

Some of the above factors explain why jewelers have long understood that people do not buy diamonds for the four C's inherent in them: color, cut, clarity, and carat weight. They implicitly understand what people are really buying is the reaction of others—the man pictures the reaction of the woman he loves while she imagines the reaction of her family, friends, co-workers, and so on. They also explain why movie attendance and book sales are dramatically affected by word of mouth—the so-called bandwagon effect.

Many theories attempt to explain why people buy what they do. Economist Thorstein Bunde Veblen [1857–1929] posited many theories in his book *The Theory of the Leisure Class* (first published in 1899), which Maital has drawn upon for some of the above motivations of why people buy. Veblen referred to a “barbarian culture,” citing that trophies such as property or slaves were signs of successful aggression. In today's culture, luxuries are the major signal of status and class, which Veblen reasoned were purchased for two reasons: to show others you are a member of the class above and to distinguish yourself from those below. Economists of the day did not take Veblen's book seriously, finding it obtuse and unsupported by

any evidence. One Chicago economist said, “I congratulated him and asked if he had thought of having it translated into English.”

A better theory is posited by Michael LeBoeuf, Ph.D., in his book *How to Win Customers and Keep Them for Life: Revised and Updated for the Digital Age*. He suggests that customers have the following motivations for these various purchases:

- Don't sell me clothes. Sell me a sharp appearance style, and attractiveness.
- Don't sell me insurance. Sell me peace of mind and a great future for my family and me.
- Don't sell me a house. Sell me comfort, contentment, a good investment, and pride of ownership [and a piece of the American Dream].
- Don't sell me books. Sell me pleasant hours and the profits of knowledge.
- Don't sell me toys. Sell my children happy moments.
- Don't sell me a computer. Sell me the pleasure and profits of the miracles of modern technology.
- Don't sell me tires. Sell me freedom from worry and low cost per mile.
- Don't sell me airline tickets. Sell me a fast, safe, on-time arrival at my destination feeling like a million dollars.
- Don't sell me *things*. Sell me ideals, feelings, self-respect, home life, and happiness (LeBoeuf, 2000: 22–23).

Successful salespeople do not necessarily ignore features in the products they are selling, but they almost always add “which means” to the end of every explanation of their product or service offering. For example, “This car has a V-8 engine, which means it will last longer because it doesn't have to work as hard as a smaller engine” (Williams, 1998: 98). Advertising giant Leo Burnett used to say, “Don't tell me how good you make it; tell me how good it makes me when I use it.”

Peter Drucker has advanced the notion that the patient knows the *symptoms*, but the doctor knows the *meaning*. But both must be listened to for a value-added relationship to develop. Doctors must not complain that the patient did not attend medical school and similarly, it does no good for a company to complain that its customers “just don't understand the value of what we do.” It is their job to make them understand the value of what they do and they can only do that by understanding—at a very deep and meaningful level—the motivations of why customers select and stay with the companies they do.

Again, Michael LeBoeuf distilled his summation of customer statements and posited the following overall theory to explain what people really buy:

Despite all of the untold millions of products and services for sale in today's marketplace, customers will exchange their hard-earned money for only two things:

- Good feelings
- Solutions to problems (LeBoeuf, 2000: 23).

This is a good theory, because it has a certain utilitarian streak to it—that is, the idea that individuals spend their time (and money) pursuing pleasure and avoiding pain. It is the old marketing axiom that says you really do not buy drill bits, you buy the hole it makes. Understanding that simple fact could help a company (such as Black & Decker) get into the laser beam business, since they, too, put holes in things. It also explains why so many people purchase lottery tickets; they are really buying a low-cost dream. Upjohn ran an ad for Rogaine that read: “Gentlemen, start your follicles.” Rogaine does not sell hair (it cannot legally make that claim, since it does not work 100 percent of the time); but it does sell *hope*, and its advertising reflects this motivation.

Callaway Golf founder Ely Callaway, who introduced the Big Bertha in 1991, priced at \$240 to \$300, while its competitor Taylor Made was selling for \$150, said “We sell the physical and emotional experience of hitting a satisfying golf shot, not increasing your distance by eight yards or that your handicap will fall” (Silverstein and Fiske, 2005: 199).

Focusing on the total customer experience—solving the problem and creating the good feelings—demonstrates not just *competency*, but *distinction*. But the utilitarian view posited by LeBoeuf does not help a firm custom tailor its service offering to its various customers. It is easy to get caught up in hairy hypotheses that are long and complicated, but I prefer to shave with Occam's razor—a medieval philosophical concept that states it serves no purpose to achieve a result with many assumptions rather than with a few. Which is why I prefer Theodore Levitt's theory of what customers really buy: *expectations*. Levitt was a marketing professor at Harvard Business School, and once the editor of *Harvard Business Review*. His expectations theory is useful because it forces the company to focus on the utility the customer is trying to maximize.

By ascertaining customer expectations, the company has the ability to manage—to a certain degree—those expectations. Southwest Airlines is a



master at managing customer expectations. Customers understand very well that it is a *no-frills* airline, with no assigned seats (although this is expected to change), no food, no first class, and so on. However, since they have lowered customers expectations in these areas, when they crack irreverent jokes, achieve a stellar on-time arrival record, and do not lose your luggage, all at a price comparable to driving yourself or taking the bus, most customers walk away with their expectations exceeded—and, more importantly, they come back to fly Southwest again. Compare these expectations to buying a first-class ticket on, say, United Airlines. The customer's expectations of every aspect of the flight are totally different.

*Harvard Business Review* has been reporting for years that customer *satisfaction* is no longer enough—a business must strive to *delight* its customers. Studies conducted by *Harvard Business Review* reveal that 65 to 85 percent of customers who chose a new supplier said they were satisfied or very satisfied with their former supplier. It is hard enough to meet a customer's expectations, let alone exceed them, if a company does not know exactly what they are. Becoming a customer and experiencing what they do is a good way to learn. The next best alternative is to constantly question the customer as to their expectations.

Because expectations are *dynamic*, not *static*, it is also imperative to continuously ask customers what they expect. A company should never rest on its laurels and assume it knows exactly what the customer is up to, as this humorous story from Sheila Kessler—a management consultant and former California Baldrige Quality Award examiner—in her book *Measuring and Managing Customer Satisfaction* illustrates:

Motorola noticed a radical increase in its pager revenues in Korea. When investigating how people there were using them, Motorola found that young women sometimes carried as many as seven pagers tucked into their waistband. Each pager represented a different boyfriend who was paging the woman—an exclusive communication link. The numbers of pagers a young woman wore was a status symbol (Kessler, 1996: 179).

Knowing your customer's expectations also enables you to ask Peter Drucker's deceptively simple question mentioned at the beginning of this chapter: What are we getting paid for? When the Caterpillar Company asked this question, they discovered that the customer was not merely purchasing its equipment, but also the ability to keep them continuously in service, because down time is costly. This enabled Caterpillar to respond with inno-

vative service options to ensure minimal loss to broken-down equipment. When General Electric asked this question for its jet engines, it came to the same conclusion Caterpillar did, and it innovated the “Power by the Hour” program for its aircraft engines, whereby it would be responsible for maintaining the engines and price for the serviceable usage the airline received.

Charles Revson, who launched the Revlon cosmetics empire, introduced color-coordinated nail polish and lipstick during the Great Depression. Many commentators hailed the bright colors as “trashy,” but by providing a fashion statement—and good feelings to millions of women—he was able to convert a product with low margins into a very profitable product. His competitors acted as if the product was a commodity, but Revson knew better. He believed nail enamel was not just a concoction of chemicals, or a beauty aid, but a fashion accessory, and he believed women should use different shades to suit different outfits, moods, and occasions. This, of course, greatly expanded the market, as women now purchased multiple nail colors, and matching lipstick expanded the market again. Indeed, he understood better than his competitors what he was really selling. His famous saying, “When it leaves the factory, it’s *lipstick*. But when it crosses the counter in the department store, it’s *hope*,” reflects the wisdom of a company in touch with its customers’ expectations.

Indeed, Revlon launched the most famous shade promotion in history, Fire and Ice, in the fall of 1952. Revlon executive Kay Daly, along with the marketing department, believed there was a little bit of bad in every good woman, and Revlon was going to lend “a little immoral support.” Along with a picture of model Dorian Leigh, the ad copy ran the headline “ARE YOU MADE FOR FIRE AND ICE?” You were, the ad stated, if you answered eight of the following fifteen questions in the affirmative:

Have you ever danced with your shoes off?

Did you ever wish on a new moon?

Do you blush when you find yourself flirting?

When a recipe calls for one dash of bitters, do you think it’s better with two?

Do you secretly hope the next man you meet will be a psychiatrist?

Do you sometimes feel that other women resent you?

Have you ever wanted to wear an ankle bracelet?

Do sables excite you, even on other women?

Do you love to look up at a man?

Do you face crowded parties with panic—then wind up having a wonderful time?

Does gypsy music make you sad?

Do you think any man really understands you?

Would you streak your hair with platinum without consulting your husband?

If tourist flights were running, would you take a trip to Mars?

Do you close your eyes when you're kissed? (Tobias, 1976: 118).

Continuous learning from customers is an ongoing process and requires many different listening posts to accomplish. It is not enough to send out periodic Internet “how are we doing” customer satisfaction surveys. Most people do not fill these out, limiting their response and usefulness right from the start. Furthermore, most of the questions are biased and may not deal with the issues the customer is concerned about. Not many customers are very excited to fill these out, because they tend not to spend their waking hours cogitating on how the businesses they patronize can provide more value. After all, it is not the customer's job to be innovative. Marriott has learned to engage customers in dialogues at many different levels, often surveying their business customers on the concierge level during cocktail hour through informal chats. The data may not be as scientific and precise, but there is no doubt to Marriott that the information conveyed is much more relevant to customers' true concerns and experiences. When one Chicago Marriott had budgeted \$20,000 in order to upgrade the black and white TV sets to color in the bathrooms located on the concierge level, based on actual conversations with engineering and concierge-level team members, they learned that not many people requested the upgrade. What they did want, based on insistent requests from guests, was irons and ironing boards.

Disney is another company that has mastered surveying and listening to their customers. In the Disney tradition, they have their own term for the art and science of knowing and understanding customers: *guestology*. At the Disney University course on customer loyalty, they teach that the most significant factor that determines whether a family will return to a particular resort hotel comes down to one item (and this Disney executives were shocked to learn, according to the instructors): *the swimming pool*. Since then, they invest heavily in each new resort's pool, a customer expectation bound to change at some point in the future. This constant striving to exceed customer expectations started with Walt Disney, who once vehemently

opposed constructing an administration building at Disneyland by objecting: “I don’t want you guys sitting behind desks. I want you out in the park, watching what people are doing and finding out how you can make the place more enjoyable for them” (Disney Institute, 2001: 42).

Focusing on the customer’s individual expectations forces the firm to individualize its service delivery to that particular customer’s wants and needs. No two customers should be treated equally. Customers want to be treated *individually*, or better yet, *specially*. This is inherently easier to accomplish in service organizations than in manufacturing, although with the recent trend toward “mass customization” of everything from Levi Jeans and baby dolls, to bicycles and children’s books, this is changing.

One brainstorming idea used by Richard Branson, founder of Virgin, is to ask the following question: “What are 10 things you would never hear a customer say about our company or our industry?” Supposedly, before Branson invests in a new industry, he has his executives come up with such a list. Things like, “Airlines treat their customers with respect and dignity; hotel food is excellent; banking is fun,” and so forth, help Virgin differentiate its value proposition from the established competition. For example, Virgin Bride—a one-stop shop for holding a wedding—was launched after one Virgin team member found it was a complete hassle to plan her own wedding.

There is another major lesson with respect to customer expectations. Businesses compete against *any* organization that has the ability to raise customer expectations. FedEx brought a new standard to the passenger airline business with respect to handling and tracking luggage, just as anyone who visits Disneyland or Walt Disney World has their expectations raised when it comes to customer service. Once people experience premium service, they want more of it and are less and less tolerant of those organizations that do not deliver on the promise. This expectation dynamism, though, requires that leaders constantly look beyond their own four walls to learn from other industries.

### **THERE’S NO SUCH THING AS A “MARKET”**

Stanley Marcus led Neiman-Marcus through the difficult Great Depression. He’s famous for many innovative creations, such as holding fashion shows and the famous Christmas catalog with the obligatory “his and her” Christmas gifts, among many others. After he sold his interest in the business, he became an author and consultant and his teachings hold many

excellent lessons for the willing student. One point he was especially fond of making was there was no such thing as a market, only customers:

I am unaware of any store, or any business school, for that matter, that conducts a course or a series of lectures on “The Care and Treatment of Customers.” I am referring to “customers” and not “consumers,” for never in my retail experience have I ever seen a “consumer” enter a store. I’ve seen lots of “customers,” for that’s what they call themselves (Marcus, 1979: 211).

At first glance, this is a contestable statement. Business executives, and certainly economists, pore over macroeconomic data of markets, trends, and demographics, lumping individuals into amorphous segments. No doubt this type of analysis is useful, but Marcus’ point is compelling once given serious consideration. In 2003 General Motors sold 8.59 million vehicles, yet each was sold *one at a time*. The micro level, where the customer interacts with the seller, is inherently a flesh-and-blood transaction. As economist Herbert Stein always said, “There is nobody here but us people.” In the final analysis, *markets* and *consumers* are statistical abstractions, while *customers* are human beings who want to be treated specially and individually.

As such, by constantly striving for a deeper understanding of your customer’s expectations, wants and desires, you will be in a position to capture a larger percentage of your customer’s wallet. According to Roy H. Williams, “A recent national survey tells us that 67 percent of all shoppers intend to return home with the item for which they are shopping, yet only 24 percent actually manage to do so. The other 43 percent tell your salespeople that they’re ‘just looking,’ and your salespeople let them leave your store disappointed and empty-handed” (Williams, 1999: 153). This was a particular sore subject for Stanley Marcus, who had this to say with respect to lost sales opportunities due to not paying attention to customers:

Americans used to be known as the world’s best salesmen. Recently, it has become difficult in most stores to encounter that quality of salesmanship, if indeed you can even find a salesperson. A few years back, I made up my mind I would not buy anything I did not urgently need unless a salesperson was convincingly persuasive. As a result of this self-imposed discipline, I have saved \$46,734 (Marcus, 1995: 55).

No one has been able to establish a gauge to determine how much business walks out of any institution because of salesperson failure. The problem is not the sales staff; it is management that has failed to educate its staff, to

supervise its staff and to establish and maintain standards and adequate compensation. It's tough, but so is training for the Olympics. To win the gold on the track or in business demands the consistent performance of participants (ibid.: 11).

We've never liked the word "clerk" at Neiman-Marcus, since it suggests an "order-taker," for which we have no place in our business. In sales meetings I have frequently said that vending machines can take orders for an exact piece of merchandise much better than a salesperson; vending machines don't chew gum or have bad breath, but they can't sell a person a more becoming shade, a better fit, or something so new that it has to be presented with an explanation. That's the function of the professional salesperson, who, armed with authority based on knowledge of the stocks and the individual, can find solutions to the customer's needs (Marcus, 1997: 169).

The volume of lost business to retailers and industry as a whole is appalling. Some merchandise can be sold without benefit of a salesperson, but many products require an introduction and presentation. If stores are dedicated to self-service, then it is incumbent on them to organize displays and stock for easy shopping, but if they profess to supply service and charge for it, then they must provide adequate, well-versed sales assistants. Stores and sales staffs have been spoiled by years of easy selling. During the Depression, I learned that the best way to sell anything was to encourage the prospective customer to feel the article while I discussed the benefits he would receive from it. We treated every prospect as though we wouldn't see another all day. And some days, we didn't (Marcus, 1995: 56).

Jean Parker, the training director of Neiman-Marcus during Marcus' leadership, gave this advice to every new class of salespeople:

Every one of you has been a customer. You have different reasons for buying in different stores from different salespeople. Now you're going to be on the other side of the counter. Don't think for one minute that all the people with whom you will be dealing shop for the same reason. Every customer is an individual (Marcus, 1979: 153).

The store used to have a standing offer of \$20,000 for any salesperson who was able to read the mind of the customer. No one ever claimed the prize. Constantly striving to exceed your customer's expectations is an incredibly high standard for any enterprise, but one worth pursuing in order to sustain a competitive advantage.

Now that we have discussed *what* people buy, let us turn our attention to *how* people buy, because it certainly has ramifications for formulating your company's value proposition, the subject of the next chapter.

## HOW PEOPLE BUY

*I like best the wine drunk at the cost of others.*

—Ascribed to Diogenes the Cynic, circa 380 B.C.

The first concept is that people buy *emotionally* and justify *intellectually*. I live in California, and I understand the best time for earthquake insurance sales is right after one. This is curious, especially from an actuarial point of view. If people were willing to assume the risk prior to a quake, why would they not be willing to assume the risk after one strikes? The probability of another earthquake striking simply because one just did does not change, since fault lines do not have memories any better than dice at the craps tables in Las Vegas. The purchase is not made based on the *intellectual* calculation of the statistical odds, but on the *emotional* desire for peace of mind. Customers are attempting to maximize their serenity.

Sports fans who gamble are another intellectual versus emotional curiosity. It is perplexing how season ticket holders will always bet on their home team. Why? If they were using their intellect, they would bet *against* them. That way, if their team lost, they would be dejected as fans but at least they would pocket some money. If their team won, they would be jubilant as fans, but be out a little money. They would merely be *diversifying* their risk. Yet they put all their eggs in one basket, behavior we would admonish them for if they were investing in the stock market. Gambling is not an intellectual exercise but an emotional one.

People also do not like to admit being *sold*, but they brag about what they *buy*. Think of the last time you made a major purchase—a boat, car, or appliance—and talked to a friend, colleague, or spouse and said, “Guess what I was sold today.” People do not like to feel they are being sold because it makes them feel like they are out of control. The best salesmen in the world actually empower customers to buy and help them envision their future with their product or service. Forget *selling*, focus on what the customer *buys*.

Which leads us to *how* people buy. In any economy, according to Milton and Rose Friedman in *Free to Choose*, there are four ways people can spend money (Friedman and Friedman, 1980: 116–17):

Whose Money	On Whom Spent	
	You	Someone Else
Yours	I	II
Someone else's	III	IV

*Category I:* When you spend your money on yourself, you will do everything in your power to maximize your utility. For example, if you are in the market for a car, you will download information from the Internet, talk to friends, visit dealerships, take test drives, read consumer reports, and so forth. You will try to get the biggest bang for your buck.

*Category II:* Perhaps you are buying a gift for a spouse, friend, or colleague. You will still want to maximize your utility and theirs, and shop around and try to get the biggest bang for your buck. If you doubted your ability to maximize utility for the recipients, you might simply give them money and put them into Category I.

*Category III:* When you spend someone else's money on yourself, this is the greatest luxury of all. A corporate expense account is a perfect example. There is very little incentive to economize. You might fly first class, upgrade your rental car, not eat all of your dinner, eat the cashews in the mini bar, and so forth. This is why airlines, hotels, and rental car agencies discriminate in their pricing against business travelers, since they know these people are not paying their own bills. They are, by definition, less price sensitive. Businesses serving travelers would be missing an enormous opportunity if they did not charge these customers higher prices.

*Category IV:* When you spend someone else's money on strangers there is very little incentive to economize. Government programs are a perfect example, and is why government spending is out of control. Health-care spending has moved from Categories I and II to Categories III (private health insurance) and IV (government spending on health care, such as Medicaid and Medicare). If groceries were purchased in these categories, prices would most definitely skyrocket, and Fido would dine on top sirloin every night. There is no incentive for the spending party to make value/price trade-offs, nor is there an incentive for the party providing the money to ensure they are meeting the expectations and utility of the receiving party. At least with a corporate expense account my employer has the satisfaction of knowing I received a direct benefit from the more expensive rental car and upgraded hotel suite, but a government employee has little incentive to follow-up with a recipient of a government sinecure.



In comments made at a White House Ceremony in his honor on May 9, 2002, Milton Friedman summarized his philosophy on the four ways to spend money:

My views on government spending can be summarized by the following parable. If you spend your own money on yourself, you are very concerned about how much is spent and how it is spent. If you spend your own money on someone else, you are still very much concerned about how much is spent, but somewhat less concerned about how it is spent. If you spend someone else's money on yourself, you are not too concerned about how much is spent, but you are very concerned about how it is spent. However, if you spend someone else's money on someone else, you are not very concerned about how much is spent or how it is spent.

These four categories hold many lessons about how businesses price their goods and services, and we will continue to refer to them throughout the rest of the book.

Understanding exactly *what* customers buy—expectations—will enable your company to exceed those expectations and thus be able to charge premium prices for your products or services. Understanding *how* customers buy—that they buy *emotionally* and justify *intellectually*, and that they do not like to feel they are being *sold* but like to *buy*—helps to focus on the true expectations of the customer. Let us now put it all together by providing a value proposition to the customer.



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# 13

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## THE VALUE PROPOSITION

*The secret of staying afloat in business is to create something people will pay for.*

—Thomas Edison [1847–1931]

In the 1980s, British Airways (whose initials, BA, at the time stood for Bloody Awful amongst flyers) had always been subsidized for its poor service and resulting losses. Margaret Thatcher ended that when she privatized the flagship carrier in 1987. Suddenly BA had to compete, and it started by rethinking its fundamental value proposition. It innovated the concept of Club World business-class service, which provided the business traveler—the most profitable segment in the airline industry—with a truly unique flying experience. BA’s major insight was to focus on the totality of the traveler’s experience, that is, how he or she experienced the airline from point of origin to destination. By the late 1980s, by focusing on the value proposition it was offering its customers, BA became the world’s most profitable airline.

Fortunately, more companies now realize it is not enough to focus on simply the value of the product or service being offered; they have to take into consideration the total ownership experience from the customer’s vantage point. They have to provide a value proposition that, when compared with the customer’s viable alternatives, offers a better deal. The originator of the value proposition, Michael J. Lanning (a former Proctor & Gamble executive and consultant with McKinsey & Company), defines it this way in his book *Delivering Profitable Value: A Revolutionary Framework to Accelerate Growth, Generate Wealth, and Rediscover the Heart of Business*:

Essentially, a value proposition is the *entire set of resulting experiences*, including some price that an organization causes some customers to have. Customers may perceive this combination of experiences to be in net superior,

equal, or inferior to alternatives. A value proposition, even if superior, can be a “Tradeoff,” i.e. one or more experiences in it are inferior while others are superior (Lanning, 1998: 55).

When most organizations think about their value proposition, they usually include at least some of the following elements:

- A long-term history
- In business for the long term
- Good reputation and/or brand name
- Technical expertise and quality
- Knowledgeable and experienced personnel
- Utilizes latest technology
- Trust
- Committed to our customers

Note that none of the characteristics describe the *experience* the customer will have with the company. No doubt, many of the above elements are essential, but they are not related to customer experiences. It is very difficult to catalog all of the various experiences a customer will have with an organization. In fact, this is an exercise the company needs to conduct in order to enhance the value of the total experience for its customers. However, some generalizations can be made. The experiences a customer will have in interacting with a firm generally revolve around three areas:

- Quality
- Price
- Service

A company must look at the interaction of all three of these variables and decide which combinations of each it will deliver to its customers. Focusing on any one is not enough, since the three are interdependent, not mutually exclusive.

Mercedes-Benz (now Daimler-Chrysler) always touted its high quality to the marketplace, since they essentially started the automobile industry and had built up a reputation for excellence in engineering. But in the early 1990s, Lexus and Infiniti came along and offered customers a superior value proposition, not just in terms of price, but rather in the totality of the owner-

ship experience. Between 1985 and 1992, Mercedes market share dropped from 11.6 percent to 6.4 percent, with the total units sold in the United States going from approximately 100,000 in 1986 to 59,000 in 1991. Resting on your laurels in terms of technical quality alone is a prescription for losing customers. The Japanese even have a term for this: *atarimae hinshitsu*, which means “quality taken for granted.”

No company can compete on quality alone; it is merely a *table stake*, that is, the minimum you need to play the game. Who is going to continue to purchase from an incompetent service provider? Besides, customers cannot easily judge the technical expertise of the services they require any more than you can be confident in the technical competence of your doctor. What customers do know is how they are treated—the bedside manner of the doctor—and based on the empirical evidence, this treatment determines whether or not the customer remains loyal. The number one complaint in the restaurant industry is not bad food—another name for inferior quality—but rather lousy service.

Neither is price enough to attract customers; if it were, books.com should have been a raging success, since it sold books cheaper than Amazon.com. Think of Southwest Airlines: By its own definition, it is the low-fare leader in the airline industry, but would that be enough to retain customers if it did not provide on-time flights and excellent service? If everybody were price conscious, we would all be driving Hyundais. Customers are not *price sensitive*; they are *value conscious*.

Only 15 to 35 percent of customers consider price to be the chief determinant, depending on what they are buying, according to Copernicus, a marketing investment strategy group in Auburndale, Massachusetts. Greater than 60 percent do not consider price at all, and almost 80 percent cannot correctly recall (within 10 percent) the price they paid for a product in the past seven days, although they do remember the brand. “In every product category, high-involvement buyers outnumber price-fixated shoppers more than two to one” (Minitier, 2002: 87).

Even the Internet—the technology that supposedly was going to usher in the era of “perfect competition,” where all customers would be able to get the lowest price at the click of a mouse—has proven that other attributes are more important to customers than lowest price, such as customer support, on-time delivery, shipping and handling, product content, privacy policies, ease of ordering, product information, web site navigation, convenience, and product selection.

As for customers in the business-to-business environment, 65 percent prefer value to low prices, according to Holden Advisors research. The reason they continue to demand low prices reflects the incentives of purchasing agents versus salesman, the former paid to save money and the latter paid to make sales, not maintain price integrity. What is more, purchasing agents have been rewarded for demanding low prices by getting discounts, concessions and other price decreases, thereby creating little Pavlov's dogs. If you subsidize something, you get more of it, including low-price buying behavior.

In recent times, companies have tended to think about their value propositions in terms of a SWOT analysis—strengths, weaknesses, opportunities, and threats. A SWOT analysis is indeed a useful concept for companies to work through, but it does not address customer experiences explicitly. The same can be said for benchmarking best practices. Unless you can relate these tools to what the customer actually experiences when dealing with your company, they are half-measures at best.

Many banks departmentalize their service offerings, from checking and savings accounts, business loans, personal loans, mortgages, and so on. This is fine from an internal procedural perspective, since this is how firms are structured in terms of work flow, personnel, and technology. Yet most customers would rather have a single contact within the bank to handle all of their needs, because customers do not experience a *strategy*, they experience the *execution* of the strategy.

Commerce Bank, located in New Jersey, Delaware, New York, and metropolitan Philadelphia, pays the lowest interest rates in its markets, while offering just four types of checking accounts, opting for a simple value proposition. Yet, the company offers excellent customer service, staying open seven days per week, including evenings. It offers free coffee and newspapers, and most branches contain free coin-counting machines, into which customers have fed a total of \$28 million of loose change. Between 1999 and 2004, the bank grew from 120 to 319 branches, with deposits increasing from \$5.6 billion to \$27.7 billion, and loans tripling from \$3 billion to \$9.4 billion (*Harvard Business Review*, May 2005, 89). People will pay a premium for excellent customer service.

Focusing on the value proposition—and the resulting experience the customer will have—forces the firm to utilize those items that provide the most latitude in creating an overall positive set of experiences for the customer. There is not much competitive advantage in technical quality by itself, for even companies that have adopted Six-Sigma levels of qualities—that is 3.4 defects per one million units—are not immune from customer defections.

You can produce the most flawless product in the world, but if the customer's service experience interacting with your firm is mediocre, it will not provide a competitive advantage. In other words, it is not that technical quality is not important, but that it is merely a table stake. Which leaves *price* and *service*. The former provides an enormous opportunity to provide a competitive differentiation to your firm's customers by adopting innovative and creative pricing strategies for various segments of customers you serve, or the art of price discrimination, which we will explore in the next chapter. The latter characteristic—service—is only limited by your company's imagination. It is excellence in service that separates outstanding companies from mediocre ones. Companies with an excellent service record are, for the most part, *price makers*, not *price takers*, in their respective industry. Think of Disney, FedEx, Nordstrom, Lexus, Ritz-Carlton, Four Seasons, and American Express: all of these companies charge a premium, they do not let their competition dictate their price, and they consistently offer a superior service experience to their customers. Another reason service excellence is such a critical component of your firm's value proposition is that your competitors can match your technical quality and price fairly easily. If they do not have the expertise in house, they can go buy it (or rent it); and there is always some company, somewhere, willing to do what you do for a lesser price, which your customers can find with the click of a mouse if you do not give them a better option. Lou Gerstner, the retired head of IBM, who grew IBM revenues by \$20 billion during his reign, all from IBM Global Services, said, "You are headed for commodity hell if you don't have services" (Peters, 2003: 88).

Competitors may be able to match (or beat) your price, but what cannot be very easily matched—or even observed, for that matter—is your firm's service quality, the bedside manner your company has with its customers. Moreover, as will be explained later in this chapter, most companies lose customers not over price or quality issues, but rather over service-related issues. Overall, then, service excellence is an enormous fulcrum to develop your organization's value proposition and create superior experiences for your customers.

## MOMENTS OF TRUTH

Karl Albrecht, who is probably the modern founder of the Total Quality Service (TQS) movement in the United States, defines the Moment of Truth (MOT) as follows:

Any episode in which the customer comes into contact with the organization and gets an impression of its service (Albrecht, 1992: 116).

Utilizing the MOT method is one of the most effective ways to develop your firm's value proposition. The term has its roots in the *hour of truth* in bullfighting, to signal the third and final hour, the killing of the bull. In a business context, MOT certainly has a more prosaic meaning, but in terms of delivering excellent experiences to customers, and hence lengthening a company's life, it is potentially just as fatal as to the bull.

Jan Carlzon, former president of Scandinavian Airlines, led the failing airline into one the most profitable airlines in Europe. His book, *Moments of Truth: New Strategies for Today's Customer-Driven Economy*, explains how he accomplished this transformation using the MOT philosophy:

Each of our 10 million customers came into contact with approximately five SAS employees, and this contact lasted an average of 15 seconds each time. Thus, SAS is "created" 50 million times a year, 15 seconds at a time. These 50 million "moments of truth" are the moments that ultimately determine whether SAS will succeed or fail as a company. They are the moments when we must prove to our customers that SAS is their best alternative (Carlzon, 1987: 3).

Taken individually, each MOT is a minor event. Over time, however, each interaction is like a pebble placed on a scale, with one side being service excellence and the other being service mediocrity. Eventually, that scale will begin to tip in one direction or the other. Generally, there are three possible outcomes to each MOT:

- Neutral experience (rarest)
- Positive experience (moments of magic)
- Negative experience (moments of misery)

Few customers come into contact with an organization and walk away with a neutral perception. When developing your company's value proposition, it helps to map out each potential MOT with the customer and be as inclusive as possible. Even mundane things like how accessible your parking is affects a customer's overall experience of dealing with your company. According to former CEO of Disney, Michael Eisner, guests come into contact with cast members over 2.5 billion times per year at Disney theme parks, and each MOT is a chance to win over a customer or lose one (Disney Institute, 2001: 74). Disney used the MOT mapping strategy and discovered



many children visiting its EPCOT Park at Walt Disney World were disappointed there were no Disney characters wandering around as there are in the Magic Kingdom. Disney has since placed characters in all of its parks, creating literally millions of magic moments for its guests. Furthermore, many times a child waiting on line for an attraction is prohibited from boarding due to height restriction, a moment of misery to say the least. Thanks to the MOT strategy, cast members have a supply of special certificates entitling them to board the ride without waiting in line when they reach the required height, transforming a moment of misery into a moment of magic and almost guaranteeing a return visit (*ibid.*: 161). Walt Disney World Resort guests are now eligible for Disney's Magical Express, whereby checked bags are taken directly to their hotel rooms and transportation is provided from the airport.

Walt Disney World recently announced a new way to acquire the pictures the park's many photographers snap, as explained in *Disney Magazine*:

The first phase of the program began November 1 [2004]. After taking a photo, cast members give guests a tracking card with a web address ([www.disneyphotopass.com](http://www.disneyphotopass.com)) and an ID code. As guests pose for more shots, the photographers swipe the cards to associate the guest's ID with the new photos in a database. Guests can later go to the web site, view their photos, and order prints.

Phase two, tentatively set for the end of January [2005], may place photographers in more locations (mostly character greeting spots). On the web site, guests will be able to add a themed border and character overlay to their shots. The highlight, though, is a DVD that will combine photos with action sequences: You might, for example, see Goofy painting over a shot of your gang at Mickey's Toontown Fair.

Saturn utilized the MOT strategy, helping it to develop its policy of one-price, no-hassle car buying, turning what should be an exciting purchase from one of adversarial confrontation to a fun and memorable experience.

The key here is to understand absolutely that the MOT forces the company to focus on the *outcome*, not the *activity*, of each encounter. At his CPA firm, Morris + D'Angelo, my colleague Dan Morris, e-mails all draft tax returns using the Acrobat portable document file (pdf) format, insisting the customer review and sign off—and pay the invoice—before the return is finalized and filed. This may shock some as an onerous process, adding an extra layer of complexity to processing tax returns, and no doubt it does; however, it also adds a personal touch to the rather impersonal process of

tax work: it gets the customers involved in their tax return; catches errors earlier, thereby lowering rework costs; speeds up payment; and creates literally hundreds of MOTs the firm can leverage into additional cross-selling opportunities.

Each MOT in your company is an opportunity to deliver exceptional value to your customers and make them feel special, cared for, and appreciated. Every contact is an emotional connection and exchange with the customer; and if you thought intellectual capital was hard to measure, try empathy. Karl Albrecht and Ron Zemke articulate this core principle of service excellence: “When the moments of truth go unmanaged, the quality of service regresses to mediocrity” (Albrecht and Zemke, 2002: 55). No MOT should ever be taken for granted, for no matter how small it may be, in the long run, each one determines the destiny of your company.

### WHAT IS BEYOND TOTAL QUALITY SERVICE?

It may be premature to discuss what is beyond service excellence, considering that the modern-day founder of the TQS movement in the United States, Karl Albrecht, has pronounced the revolution dead. One of the problems with quality service is it is easier to discuss than deliver. Although we supposedly live in a *service* economy, the level of customer service, by some indicators, has actually dropped in recent years. Here is how Albrecht sums up the movement’s fate:

As management movements go, customer focus had an unusually long run—nearly ten years (Albrecht and Zemke, 2002: 2).

Two primary factors, we believe, led to the fade-out of the customer focus movement. One was the aggressive promotion of competing management methodologies, particularly TQM [Total Quality Management], as solutions for the problems of service quality. The other was the “too hard” factor; that is, the disappointment and disillusionment felt by many executives when they realized that “customer service” was not the panacea or the quick fix they’d been led to believe it was. When they discovered that it involved such distasteful realities as financial investment, long-term commitment, constant attention to detail, service-oriented leadership, culture-building, perpetually listening to customers, and even changing the business design, many of them signed off (ibid.: 3–4).

One company that has never lost sight of its customer service focus is Southwest Airlines, still one of the most profitable airlines in the United States today. It has always believed “We are not an airline with great customer service. We are a great customer service organization that happens to be in the airline business” (Freiberg and Freiberg, 1996: 282). Southwest never fell for most of the management fads from recent decades because it felt those techniques lacked spirit and heart. This stance has certainly not impaired the company’s success at attracting and retaining good people who deliver fantastic customer service, not to mention achieving productivity and effectiveness levels that are the envy of the industry. Jack Welch, former CEO of General Electric, used to say, “The problem at too many organizations was that the employees perceive the boss as their primary customer.” “If,” he’d continue, “you think of an organization as a pyramid, and everyone is looking inside and up to the boss, the customers see nothing but the employees’ rear ends” (quoted in Wetherbe, 1996: 95).

Be that as it may, it is important to discuss a trend an astute observer can witness taking place in the marketplace today, as it is a level beyond TQS. Granted, you have to look at specific companies to find this trend, but it is worth exploring in order to broaden the horizons of the intellectual capital company’s value proposition. Let us start by posing these two questions:

- What is next for organizations that already provide unsurpassed customer service?
- What do companies such as Disney, Ritz-Carlton, FedEx, and Nordstrom, among others, see as they peer into the future and strive to offer a value proposition to their customers that prevents them from falling into the so-called “commodity trap,” while still allowing them to maintain their leadership role as price makers, not takers?

One compelling hypothesis comes from Joseph B. Pine II and James H. Gilmore, in their book *The Experience Economy: Work Is Theatre and Every Business a Stage*, wherein they put forth a futuristic value curve for businesses, with the following echelon of customer value:

- If you charge for *stuff*, then you are in the *commodity* business.
- If you charge for *tangible things*, then you are in the *goods* business.
- If you charge for *the activities you execute*, then you are in the *service* business.

- If you charge for *the time customers spend with you*, then you are in the *experience* business.
- If you charge for the *demonstrated outcome the customer achieves*, then and only then are you in the *transformation* business (Pine and Gilmore, 1999: 194).

It is interesting to speculate how companies could be in the experience business. This does not mean to charge for the time—as in billable hours—the customer spends with you, but rather to charge for the experience you create for the customer. As crazy as it may seem, imagine what would happen if you charged an admission price to enter your firm. This is not as uncommon as you might think. Already we are witnessing top hotels around the world charging an entrance price just to come and look at their décor, and wineries in the Napa Valley charging for tasting. What would you have to do differently in order to provide a value proposition worth paying for? Think of the difference between entering a Disney theme park and one of its retail stores in a mall. Although the mall store provides good service, it is nowhere near the standard of an amusement park experience. One of the reasons for this, perhaps, is that Disney does not charge you to enter the store. What would they have to do differently to induce customers to pay an admission? Would it result in a better and more lasting experience? My conjecture is that it would. You are what you charge for.

Politicians and pundits are constantly asking if America can long sustain its present standard of living without a strong manufacturing base—the so-called “hamburger flipper” theory of low-paying service jobs. But this is precisely the wrong question. A better question would be to ask if a manufacturing base could long survive without a strong service sector. In fact, the distinction between goods and services is an anachronism, mostly used by governmental agencies. Even if your company only sells *goods*, it should still consider itself in the *experience* business, since a product is nothing but an experience waiting to happen. General Electric manufactures jet engines, but makes more money from servicing them, and General Motors Acceptance Corporation makes more profit financing cars than GM makes manufacturing them. Is an Apple iPod merely a product, or an experience—an escape from the mundane? Without an emotional connection, even the best TQS eventually equates to boredom.

William Clay Ford, Jr., president and CEO of Ford Motor Company, describes the trend in the automotive industry from one of not wanting customer contact to delivering a complete ownership experience:

If you go back to even a very short while ago, our whole idea of a customer was that we would wholesale a car to a dealer, the dealer would then sell the car to the customer, and we hoped we never heard from the customer—because if we did, it meant something was wrong. Today we want to establish a dialogue with the customer throughout the entire ownership experience. We want to talk to and touch our customers at every step of the way. We want to be a consumer products and services company that just happens to be in the automotive business. The Internet is key to all of this (Gustafsson and Johnson, 2003: 124–25).

This attitude started with Henry Ford, who certainly understood the importance of service during the entire ownership experience, rather than just making an immediate sale:

For the only foundation of real business is service. A manufacturer is not through with his customer when a sale is completed. He has then only started with his customer. In the case of an automobile the sale of the machine is only something in the nature of an introduction. If the machine does not give service, then it is better for the manufacturer if he never had the introduction, for he will have the worst of all advertisements—a dissatisfied customer. There was something more than a tendency in the early days of the automobile to regard the selling of a machine as the real accomplishment and that thereafter it did not matter what happened to the buyer. That is the short-sighted salesman-on-commission attitude (Ford and Crowther, 1923: 41).

Another aspect of the customer's experience is aesthetics, as Apple's iPod, Dyson's vacuum cleaner, and Michael Grave's \$11 designer toilet brush, sold at Target, attest. Conventional wisdom said that customers would not pay more for a pretty design if functionality was equal, aesthetics being considered a frivolous luxury only the rich would pay a premium for. This was, after all, documented in Maslow's hierarchy of needs, especially for the poor and developing economies. No one is going to worry about the color of their products when they are hungry. Yet this conventional wisdom is more conventional than actual wisdom, for when the Taliban was overthrown in Afghanistan, men lined up at barbershops to get their beards shaved off, burkas became available in multiple colors, and make-up, nail polish, and hairstyling services were just as much in demand as medical services among Afghan women.

Contrary to popular belief, poor people have always paid attention to aesthetics, being responsible for creating body decorations, building the cathedrals of Europe, developing the sand paintings of Tibet, turning baskets and

pottery into decorative art, and inventing paints, dyes, jewelry, and cosmetics. The marginalist economists have a better theory than Maslow to explain this phenomenon. Individuals value the next increment depending on what they already possess. Needs and wants are not a fixed pyramid, where one level has to be completely satisfied before moving on to the next. More and more, on the margin, aesthetic quality is going to determine more of the value of products.

This is also a characteristic that Stanley Marcus acutely understood at Neiman-Marcus, always ensuring the concept of “air” making an aesthetic experience, not cluttering floor space to drive revenue per square foot. Marcus writes about a husband-and-wife team in Greenwich Village, Bill and Elizabeth Phelps, a worldly traveled couple, who supplied Neiman-Marcus with handbags of a superior quality. Bill Phelps made this memorable observation to Stanley following his first visit to the Neiman-Marcus flagship store in Dallas, Texas:

You, whether you realize it or not, have followed a time-tested principle in the building of your store. In any old European town, you will find that the cathedral is in a central location. It inspires its visitors by the greatness of its architecture, its stained-glass windows, its carved or gilded interior. Next to it, usually not more than a hundred feet away, is a fine shop where people, stimulated by the beauty of what they have just seen, can make a purchase. One wants to buy after being aesthetically stimulated. Invariably, on the other side of the cathedral, is the best restaurant in town, for after looking and buying, you are apt to be hungry. That’s what you have done in this store. You give your customers numerous examples of designs which are not for sale—the Swedish marble escalator walls, the hanging gardens, the blooming orchids, the sculpture and paintings. Having exposed them to all this beauty, you have desirable merchandise easily available for purchase, and then in your Zodiac restaurant on the sixth floor you regale them with the best food in the city (Marcus, 1997: 315–16).

Up until the time of his death in January 2002, Marcus admonished the retail industry for not offering anything unique, let alone a memorable shopping experience.

The reason there are so many stores in shopping centers can be attributed in great part to the number of lost sales that each store engenders. They prosper on each other’s failures. Stores are risking boring their customers to death. A riskless business is a dull one for salespeople and customers alike (Marcus, 1979: 78, 212–13).

Rose Marie Bravo, chief executive of Burberry, would agree with Marcus, writing in *The Economist's The World in 2005*:

Brands will force change in store design and even product offering by location as we look to pre-empt customers' ennui from seeing the same thing in London, New York and Tokyo.

Customers will want to have different, fresh experiences when they shop. Companies must therefore work on shorter cycles: putting together more "capsule collections" of clothing and accessories and delivering them more often to create the suggestion to customers that if they don't buy it now, it may not be there later. Mixing different artistic pursuits with branding will become more common, as exemplified by the success of Louis Vuitton's collaboration with Takashi Murakami, a Japanese artist. Architecture, photography, art, sculpture and design in general will all have a growing influence on product and store design and on the customer's ultimate experience (*The World in 2005, The Economist, page 105*).

What about the top of the Pine and Gilmore value curve—transformations? Let them first define what, exactly, they mean by a *transformation*:

While commodities are fungible, goods tangible, services intangible, and experiences memorable, transformations are *effectual*. All other economic offerings have no lasting consequence beyond their consumption. Even the memories of an experience fade over time. But buyers of transformations seek to be guided toward some specific aim or purpose, and transformations must elicit that intended effect. That's why we call such buyers *aspirants*—they aspire to be some one or something different. With transformations, *the customer is the product!* The individual buyer of the transformation essentially says, "Change me." So transformations cannot be *extracted, made, delivered, or even staged*; they can only be *guided*. Being in the transformation business means charging for the demonstrated outcome the aspirant achieves—the transformation itself—not for the particular activities the company performs (Pine and Gilmore, 1999: 171–72, 177, 192).

Think of the difference between a fitness center—one that charges for membership—versus a personal trainer. The latter earns more because he takes personal responsibility for the *outcome* of his customer's fitness regimen. And because he takes responsibility for the demonstrated outcome the customer achieves, he is more selective about whom he accepts as a customer, as well as more diligent in performing an up-front analysis of each customer's expectations and willingness to change. This is a critical analy-

sis, because if the customer is not willing to follow your advice, your attempt at transforming him or her is bound to fail. Service providers are poised at the top of the value curve—all it requires is imagination and not thinking that what you provide is a commodity. Today's sophisticated customers are demanding more from their professionals than merely providing services and a good experience; they want transformations and they hold the professional accountable for guiding the transition. Professionals such as accountants, financial planners, and attorneys already provide many transformations to their customers. For example, they can help their customers become millionaires, retire at a specific age, finance a child's education, grow and enhance the value of a business, and carry out a customer's last wishes through estate and gift planning. These are inherently personal transformations, guiding the individual into his or her preferred vision of the future. There is no similarity between this offering and a commodity, or even a bundle of intangible services. You are literally touching your customer's soul, forging a unique relationship with him or her virtually impervious to outside competition and commanding prices commensurate with the value of the results you are creating.

A business is defined by that for which it collects revenue. *You are what you charge for.* A company's price is the only opportunity it has to capture the value it creates for the customers it serves. Of the four Ps of marketing, price speaks the loudest, and dwarfs the others since it is the *objective* value it places upon its value proposition, which in the final analysis will be *subjectively* valued by the customers it is privileged to serve. Taking responsibility for the transformation of your customers—guiding them from where they are to where they want to be—is the ultimate expression of your firm's value-creating potential and this is how a firm should be judged and perceived by those who pay its price.

## IS BEING TRUSTED ENOUGH?

In the aftermath of Enron and other assorted accounting debacles of 2001 and 2002, there has been a lot of discussion about the *trust* factor in business. There is no doubting the importance of trust in business relationships. Accounting itself owes its origins to this very issue, since, from the late fifteenth century on, businesses that were originally based on kinship and family ties grew to a size that made it imperative to hire outsiders. In addition,



as personal finances became further separated from business finances, double-entry bookkeeping became a necessity in order for the principals of an enterprise to monitor the agents they hire.

In any economy, a high level of trust acts as a lubricant to commerce, reducing the need for lengthy negotiations, protracted contracts and costly litigation, or what economists refer to as *transaction costs*. Nobel Prize-winning economist Kenneth Arrow explains the function of trust:

Now trust has a very important pragmatic value, if nothing else. It is extremely efficient; it saves a lot of trouble to have a fair degree of reliance on other people's word. Unfortunately this is not a commodity that can be bought very easily. If you have to buy it, you already have some doubts about what you've bought. Trust and similar values, loyalty or truth-telling, are examples of what the economist would call "externalities." They are goods, they are commodities; they have real, practical, economic value; they increase the efficiency of the system, enable you to produce more goods or more of whatever values you hold in high esteem. But they are not commodities for which trade on the open market is technically possible or even meaningful (quoted in Fukuyama, 1995: 151–52).

With high levels of trust, commerce is more fluid and transaction costs can practically be lowered to zero, as economist Thomas Sowell points out:

Commercial transactions that require trust and reliability are more readily concluded among people who share not only certain traits, but whose possession of these traits can be verified more easily. An extreme example of this are the Hasidic Jews of New York's jewelry industry, who give each other consignments of precious gems to sell, without the need for contracts or other costly safeguards that would be absolutely necessary if dealing with strangers. Lebanese traders in the interior of Sierra Leone likewise have had to depend on the honesty and reliability of other Lebanese traders in the port city, who sold their consignments of produce in the international market and shared the proceeds. The Chinese in Southeast Asia have also been noted for the large and complex transactions which they conduct among themselves without written contracts (Sowell, 1994: 50–51).

You can't purchase trust—it is a *table stake* in a free market economy, and not just for professionals, but for *all* businesses. All transactions require trust; it is a basic expectation when conducting business. It certainly *is not* a core competency, because it is not an attribute you can do better—or at lower cost—than your competitor. Trust is complex and, obviously, there are dif-

ferent levels of trust, as it is a contextual concept. It is one thing to purchase a pack of gum at a convenience store, order fast food from complete strangers, or get a shave from a barber, and quite another to trust a baby sitter with your child. But it is a mistake for any company to advertise or market its trustworthiness; it is frankly something that must be demonstrated and earned (one way to accomplish this is to offer a money-back guarantee on all of your products). Merely having trusting relationships with your customers does not ensure they will remain loyal.

I fly quite extensively on United Airlines; I trust them with my *life*, which certainly requires a higher degree of certainty and confidence in a complete group of strangers than in selecting my grocery store or a hotel. In the airlines, safety is simply a table stake—it is necessary, since it is hard to sell anything to a corpse—but it does not ensure customer loyalty, or even profitability. If United’s service ever begins to decline, I will defect. No airline would advertise: “Fly with us, we won’t kill you.” The majority of transactions that take place in the worldwide economy are done under an umbrella of trust. This is a subtle point, but an important one. No company—or industry association—does itself a favor by continuously trumpeting its level of trust. Like your technical quality, it is merely a table stake. Those who talk about it injure it and are perceived less believable.

Certainly you can lose customers if they lose faith or trust in you—and you will be the last to know—but that is not the reason the majority of customers defect from companies. As we shall learn, most defections occur over the service experience, not issues of integrity and trust.

## FROM ZERO DEFECTS TO ZERO DEFECTIONS

I recall obtaining a new customer—during my days practicing public accounting—who was the owner of a successful travel agency. Her husband had passed away the prior year and she had never had to deal with the tax and accounting aspects of her business. Her husband had been using the same CPA for over 20 years and when I asked (as I made a habit of doing) why she left her CPA, her answer was very laconic and poignant and one I will *always* remember: “He showed no compassion.”

From what I could determine, the CPA’s work was technically proficient. My customer had no complaints about his price or the quality of his work. She even trusted him. When I called him to ask for copies of certain docu-

ments, he was shocked he had been replaced. It wasn't the *technical quality*, but the *service quality*, that made all the difference to her, not *what* she got, but *how* she got it.

During the 1980s, Total Quality Management (TQM) swept the business literature, and many companies rushed to institute a TQM program. TQM is a body of knowledge that dates back to the late 1800s, as part of the agricultural revolution. Yet applying TQM to a service business is no easy task, since it is a standards-based approach. Karl Albrecht has always been a strong critic of TQM, especially as it applies to a service business, as he pointed out in *The Northbound Train: Finding the Purpose, Setting the Direction, Shaping the Destiny of Your Organization*:

Too many quality efforts begin as administrative, analytical, mechanistic, control-oriented, dehumanized, standards-based management attempts to “tighten-up” the organization rather than loosen it up and empower the people to make their own individual quality commitments. This is why the doctrine, mechanistic TQM systems are ultimately doomed to failure (Albrecht, 1994: 32–33).

Albrecht then offers an example of an insurance company that invested heavily in a performance standard it considered important: a five-day turnaround in issuing policies, 90 percent of the time (ibid.: 139). This is the perfect project for a TQM model because it can be counted, measured against a standard, analyzed, constantly improved, and so forth. The only problem was, when Albrecht's consulting firm talked with the insurance agents and their customers, nobody cared about receiving their policies within five days.

What is the point? There is really no right way to do the wrong thing. As Peter Drucker says, “Nothing is so useless as doing efficiently that which should not be done at all,” which is why we have replaced efficiency with effectiveness in the New Business Equation. From a customer value proposition perspective, the breakdown here is easy to diagnose: TQM is an inside-out approach. The organization can internally count, measure, and analyze against almost any standard. But weighing yourself ten times a day will not reduce your weight. TQM may provide a scale but not the guiding light for what should be weighed. Some companies have embraced TQM largely because it utilizes mathematical and statistical methods we easily understand. But we need to shift our thinking from “everything begins and ends with management” to “everything begins and ends with customer

value.” Counting and measuring things for the sake of counting and measuring things will not be the *open sesame* to attracting and retaining customers.

The alternative to TQM is TQS, which Albrecht defined as “A state of affairs in which an organization delivers superior value to its stakeholders: its customers, its owners, and its employees” (Albrecht, 1992: 72). Notice how this definition is a goal condition to be sought, not a particular method of operation. Methods are developed as a way to achieve the goal, not as ends in themselves. The reason TQS is a better beacon than TQM for intellectual capital companies is that it recognizes the subjective value of what is delivered, not the objective quality. Customers expect their products to work; TQS puts the focus and emphasis on the subjective value and the service experience, the ultimate arbiters of whether the customer remains a customer. As Stanley Marcus used to admonish: “Service, or the lack of it, doesn’t come through on the computer printouts; it has to be observed” (Marcus, 1979: 42).

There is a sign in the textile plant of the Baldrige National Quality Award-winning Milliken & Company that reads “Quality is not the absence of defects as defined by management, but the presence of value as defined by customers.” Motorola, Inc., another Baldrige winner, has gained a worldwide reputation striving for Six-Sigma quality. It is an impressive standard, and Motorola has been able to achieve this in many aspects of its operations. But what happens when they achieve that impressive goal? Does that automatically give them customer loyalty or guarantee profitability? Zero defects is not enough. In the long run, customers will begin to expect this result and competitors will be able to match this standard. What counts even more is how Motorola treats its customers, for as Donald E. Peterson, former chairman of Ford Motor Co., said upon bringing that company back from the precipice of poor financial performance, “If we aren’t customer-driven, our cars won’t be either.”

In the 1990s, along the line of reasoning that being customer-driven was the ultimate goal of a company, many organizations began to calculate the lifetime value of an average customer. Consultants began asking their customers, “How much are you willing to spend to acquire a new customer?” Once this amount was determined, they would respond, “Then you had better be willing to spend *at least* that much to retain one.” It was the dawn of the customer loyalty economics movement, given voice by Frederick F. Reichheld and his book *The Loyalty Effect*, among others.

An automobile dealer computed that a brand-loyal customer was worth at least \$332,000 over the course of a lifetime; banking found \$156 per year in

profit; appliance manufacturers figured \$2,800 profit per customer over a 20-year period. Even the local supermarket calculated \$4,400 per year and \$22,000 over a 5-year period of residence in a neighborhood. The theory was that businesses should look at the value of the relationship over the long term, rather than simply the math of the moment. You are more likely to handle a customer complaint differently, or resolve a dispute in favor of the customer, if you take into account his or her lifetime value.

This lifetime value paradigm also proved, empirically, that customer *retention* was more profitable than customer *acquisition*. Various studies showed that it cost between 4 and 20 times more (depending on the industry) to acquire a customer than it did to retain one. The American Institute of CPAs found that it cost the average CPA firm *11* times more to acquire than to retain a single customer. As a result, *cross-selling* became the mantra in most professional service firms, with the focus shifting from market share to *wallet share*. In other words, for a CPA firm, for example, the question was, “What percentage of the customer’s audit, tax and consulting budget went to the firm?” For many firms, the goal was to get the number as close to 100 percent as possible. Also, many firms began to invest resources in order to discover the needs and wants of their existing customers and sell more services to them, rather than combing the streets looking for new ones.

The loyalty movement created another positive effect, at least in terms of replacing the TQM paradigm: it focused the company away from zero *defects*, towards zero *defections*. This focus makes imminent sense, since a firm would never be able to achieve zero defects—to err is human, after all. And even if it did achieve this magical standard, customers would still defect over service quality. Like trust, technical quality is a table stake, the basic expectation of the customer. You do not return to a hotel because it changes the linens and vacuums every day.

While the lifetime value of a customer is important, there is a better measurement for the intellectual capital company to be cognizant of and attempt to compute: the lifetime value of the *company* to the customer.

This puts the emphasis not on selling more *core* services, but on increasing the amount of spending each customer does with the company overall. As discussed previously, market share is simply the wrong measurement of success. What matters is to maximize the customer’s spending by ensuring his or her *longevity* (over a lifetime), *depth* (capturing a greater share of the customer’s wallet), *breadth* (obtaining revenues from complementary

sources) and *diversity* of spending (striving for new service offerings in order to generate wealth for the customer).

This approach requires the firm to strive for customer loyalty, or what I am calling *zero defections*, of the type of customers it wants. There is an undercurrent of opinion that believes customers cannot be loyal to an organization, other than perhaps cottage-type businesses, such as hairdressers, stockbrokers, travel agents, or local restaurants. “How can a person be loyal to an airline or a hotel chain?” asks Karl Albrecht, who suggests customers merely have strong *preferences*, not loyalty. I disagree. If you study human behavior, people are loyal to their spouses, schools, neighborhoods, communities, not-for-profits where they donate money and services, and so on. It is not so much that loyalty is dead in the business world, it is that a *reason* to be loyal is rare. Companies have to earn the loyalty of their customers, which goes far beyond just being trusted and providing technically functioning products. It requires providing service experiences that exceed the customer’s expectations, as well as personal transformations to guide them in achieving their dreams. How does a firm increase the loyalty of its customers? Let us consider this question by analyzing why businesses lose customers.

## WHY COMPANIES LOSE CUSTOMERS

In the United States in the 1980s, a wave of “Buy American” campaigns swept the nation; and while these campaigns have always existed in some form, during this time period it was given extensive coverage because of the beating the U.S. automobile industry was taking from the Japanese. When surveyed, a majority of the people (between 60 and 70 percent) responded they would buy American not only because they felt a patriotic duty, but also because it would be better for the country than purchasing foreign-made products. But the next time they walked into a car dealership, they drove home in a new Honda. Economists have a name for this dichotomy: *revealed preference*. This principle states: Watch what people *do*, not what they *say*, because it is what they do that reveals their true preferences.

Measuring customer loyalty should follow the same axiom. Where does the customer spend his or her money, not what does he or she say on satisfaction surveys. Many companies learned the hard way they could score high on satisfaction surveys and yet still have customers defect. That is because satisfaction measures the *past*, while loyalty attempts to measure the *future*.

Many companies have attempted customer satisfaction surveys with mixed results. As has been pointed out, there is no doubt you can learn some valuable things from them, but they are also fraught with dangers—low response rates, not addressing relevant issues, biased questions, and so forth. When conducting exit interviews, firms face the same challenges. Most customers are reluctant to give the firm the real reason why they left, so they tend to respond by saying, “You were too expensive.” Yet, the revealed preference shows the majority of defections occurred because of service deficiencies, and the impression the company did not care about them, a sort of perceived indifference. The Rockefeller Corporation studied why customers defect and found the following:

- 1% The customer dies.
- 3% The customer moves away.
- 5% The customer has a friend [who provides the service].
- 9% The customer is lost to a competitor.
- 14% The customer is dissatisfied with [some aspect of] the service.
- 68% *The customer believes you do not care about him or her.*

Notice how *price* and *quality* are conspicuously absent from the above list. The fact of the matter is that most defections are the result of human failings and perceptions of indifference, rather than price or technical quality. In other words, it is *how* people are treated—or mistreated—that determines their willingness to remain loyal. This is especially true for professional service providers, such as lawyers, doctors, accountants, architects, and so forth. This has important implications for your firm’s value proposition, pricing policies, and developing key performance indicators (this latter topic to be discussed in the next book in the *Intellectual Capitalism Series*). For our purposes here, and as it relates to the value proposition, it should be apparent that you want to compete based on service, not price or quality, unless your strategy is to be a low-price leader like Wal-Mart, Costco, or Southwest Airlines.

Marketing professor Theodore Levitt offered this analogy in a 1983 *Harvard Business Review* article:

The sale...merely consummates the courtship, at which point the marriage begins. How good the marriage is depends on how well the seller manages the relationship. The quality of the marriage determines whether there will be continued or expanded business, or troubles and divorce. The era of the one-night

stand is gone. Marriage is both necessary and more convenient (quoted in Hart and Bogan, 1992: 182).

The analogy is not perfect, because the onus is really on the company to instill a sense of loyalty in the customer; it is not a 50-50 partnership. Companies need to invest at least one-half of their advertising and marketing budgets for *retention*, rather than acquisition, which demonstrates the value the firm places on its existing relationships. No company has a right to attract new customers if its existing customers are not delighted with its service.

Your company's best customers are your competitors' best potential customers and you should always act as if they are at risk. By providing a value proposition that differentiates you from the competition, you can begin to lock the customer in *golden handcuffs*—increasing their switching costs—making it difficult for any competitor to offer more value. Customers will continue to patronize those businesses that give them a reason to be loyal and your company will get the behavior it rewards. Customer loyalty is worth rewarding. A Nordstrom team member expresses the attitude needed to ensure customer loyalty: “We are trained to make the customer, not the sale. We are trained to make customers.”

To ensure zero defections, every company must deal with problems when they arise. One of the characteristics separating excellent service organizations from mediocre ones is how they handle, and even encourage, customer complaints, a topic we explore next.

## CUSTOMER COMPLAINTS

A customer complaint presents both a danger and an opportunity, depending on how it is handled. Since it is virtually impossible for a company to remove all defects from its work, and especially in its service delivery processes, handling complaints when they arise provides a competitive differentiation for your company and enhances customer loyalty and goodwill if they are handled properly. Furthermore, complaints handled quickly result in higher loyalty; and for that reason alone, one of the highest-value activities a firm can add to its repertoire of TQS policies is a proper complaint recovery system.

The empirical evidence proves the point. One organization that has done extensive research in this area is Technical Assistance Research Programs



Inc. (TARP), now known as e-Satisfy.com of Arlington, Virginia ([www.ecustomerserviceworld.com/index.asp](http://www.ecustomerserviceworld.com/index.asp)). In its report “Basic Facts on Customer Complaint Behavior and the Impact of Service on the Bottom Line,” by John Goodman, the following facts are reported:

- Only 1 to 5 percent of customers will escalate their complaint to a local manager or corporate headquarters.
- For large ticket items, the complaint rate is higher, rising to 50 percent to front line and 5 to 10 percent of complainers escalating to local management or corporate. The existence of an 800 number at corporate HQ will, on average, double the number of complaints getting to corporate.
- Complaint rates vary by type of problem. Problems which result in out of pocket monetary loss have high complaint rates (e.g., 50–75%) while mistreatment, quality, and incompetence problems evoke only 5 to 30 percent complaint rates to the front line.
- Twice as many people are told about a bad experience than they are about a good experience.
- For major problems (those over \$100) 91 percent of customers won’t complain at all, they will just walk away; if they complain and it is not resolved to their satisfaction, only 19 percent will repurchase; if the complaint is resolved to their satisfaction, the repurchase rate increases to 54 percent; and if the complaint is *resolved quickly*, it jumps to 82 percent.

What is astonishing to realize from these statistics is that customers who complain can become more loyal than if they had no problem at all—if the complaint is handled quickly and resolved to their satisfaction. Marriott found the following percentages of intent to return when customers had a problem during their stay:

- No problems during the stay = 89 percent return rate.
- Had a problem during the stay and it *was not* corrected to customer’s satisfaction = 69 percent return rate.
- Had a problem during the stay and it *was* corrected to customer’s satisfaction, *before he or she left the property* = 94 percent return rate.

This is why it is so important to resolve all customer complaints quickly, or at least take action to resolve them immediately. Complaints are not like fine wines; they do not age well. Customers complain because there is a gap between what they wanted to happen and what actually happened. Once they experience a problem, their expectation of having it resolved quickly is actu-

ally low (which is precisely why most customers do not complain—they think it will do no good), so a complaint is an excellent opportunity to improve their condition and turn the experience from a moment of misery into a moment of magic. You will redirect their focus on the *satisfying outcome*, rather than the original problem.

The golden rule when it comes to customer complaints: It is not *who* is right, it is *what is* right. Carl Sewell, author of *Customers For Life: How to Turn That One-Time Buyer into a Lifetime Customer*, has this advice: “Everything you need to know about handling mistakes you learned in nursing school: acknowledge your error, fix it immediately, and say you’re sorry. Odds are, your customer, like your mom and dad, will forgive you” (Sewell, 1990: 164).

Hal Rosenbluth, CEO of Rosenbluth Travel, returns all commissions earned on any arrangements his company makes incorrectly, a policy almost unheard of in the travel industry. He explains the benefits of this policy in his book, *The Customer Comes Second and Other Secrets of Exceptional Service*:

It’s better to spend money refunding clients when they are not satisfied than to forfeit money in lost accounts for the same reason.

Many of our service-guarantee refunds have been because of supplier error [airlines, hotels, rental car agencies, etc.], but we returned our commissions to our clients because we hold ourselves responsible for the entire process (Rosenbluth, 1992: 135, 204).

When analyzing customer complaints and defects, ask *how*, not *why*. *Why* questions tend to generate excuses and justifications, while *how* questions will lead to knowledge to correct the problem. “How can we prevent this from happening again?” is a much better question than “Why did this happen?” Also, follow this five-step recovery process to deal effectively with all customer complaints:

1. *Apologize*. Say *I* am sorry, not *we* are sorry.
2. *Urgent effort*. Fred Smith, founder of FedEx, follows the “Sunset Rule”: “The sun will not set on an unresolved customer or employee problem that is not dealt with in some way.”
3. *Empathy*. Show understanding and compassion; fix the customer before fixing the problem.

4. *Compensation.* Be generous, show remorse; better yet, ask the customer how he or she would like it to be fixed (usually, the request is less than you would have given up).
5. *Follow-up.* Learn how the customer feels about the situation; provide closure.

The Ritz-Carlton gives its team members great latitude in resolving customer complaints, with each one informally authorized to spend \$2,000 on solving customer problems. In the Ritz-Carlton Basics, a set of 20 guiding principles every team member is held accountable for, number 13 states: “Never lose a guest. Instant guest pacification is the responsibility of each employee. Whoever receives a complaint will own it, resolve it to the guest’s satisfaction and record it.” This “ownership” of customer complaints is quite effective, and every company should have this attitude with respect to any customer problem.

Customer complaints can be more valuable than customer compliments because they provide the company with information on aspects of its service delivery that need to be improved, a second chance to gain the customer’s business, and an opportunity to actually increase the customer’s goodwill and loyalty. Given these facts, companies should actually provide an incentive for customers to complain, and one of the most effective strategies to do so is the 100 percent money-back guarantee.

### **THE 100 PERCENT MONEY-BACK GUARANTEE**

Many companies think it counterintuitive to offer incentives for their customers to complain, worrying they would be inundated with angry customers; or if they did not respond effectively, they might lose the customer. These fears are unwarranted, however. Supplementing the research discussed previously, Theodore Levitt made this observation with respect to asking for customer complaints: “One of the surest signs of a bad or declining relationship with a customer is the absence of complaints. Nobody is ever that satisfied, especially not over an extended period of time. The customer is either not being candid or not being contacted (quoted in Albrecht and Zemke, 2002: 86).

Christopher W.L. Hart's enlightening book *Extraordinary Guarantees: Achieving Breakthrough Gains in Quality and Customer Satisfaction* asks a very valid question: Why force people to pay for things that, in the end, they don't value? He documents the case of the Bugs Burger Bug Killer Company (based in Miami, Florida and run by Al Burger), a pest control company specializing in the hospitality industry. Al knew most customers did not want to *control* pests, but to *wipe* them out, so he developed an *extraordinary* guarantee to ensure his customers he could do the job:

You don't owe one penny until all pests on your premises have been totally eradicated. If a guest spots a pest on your premises, BBBK will pay for the guest's meal or room, send a letter of apology, and pay for a future meal or stay.

If you are ever dissatisfied with BBBK's service, you will receive a full refund of the company's services *plus* fees for another exterminator of your choice for the next year.

If your facility is closed down due to the presence of roaches or rodents, BBBK will pay any fines, as well as any lost profits, plus \$5,000 (Hart, 1998).

Would you pay a premium for the services of BBBK, given the above guarantee?

According to the U.S. Office of Consumer Affairs, 37 to 45 percent of all service customers are dissatisfied with some aspect of the service they receive, but do not complain. This risk of customer defection can be ameliorated by offering a money-back service guarantee, similar to the Sheraton Service Promise (Starwood Hotels), which reads:

Something not perfect? Just say so. Sheraton Service Promise:

If you're not satisfied, we're not satisfied. Sheraton's Service Promise ensures you'll have a great stay, or we'll make it up to you with an instant discount, points for our rewards program—or even money back. All you have to do is tell us or dial “0.”

Applies to hotel services in the U.S. and Canada, excluding group transactions. Level of compensation is at the discretion of hotel management.

The advantages of this policy are many. It demonstrates to customers that your company is serious about TQS and providing a valuable experience for them. It puts your money where your mouth is. It is one thing for a company to *tell* customers how good they are, quite another to *show* them with a service guarantee. It gives your entire organization the impetus to

exceed the customer's expectations, since now your money is on the line. This focuses the company on the only true profit center it has: a customer's check that does not bounce. The service guarantee establishes a competitive differentiation and helps to sway the marginal customer to select your firm (especially important in Request for Proposal [RFP] work). Because having a guarantee requires a higher level of trust, the company will do a more diligent job of prequalifying all of its new customers and will document the expectations of each party much more thoroughly. A service with a guarantee is more valuable in the marketplace than a service without a guarantee—because it dramatically decreases the customer's risk—and this alone enables the firm to command a premium price over its competition (think of FedEx, Nordstrom, Sheraton, and BBBK). It also provides word-of-mouth advertising for the company, because customers appreciate this policy and will be more enthusiastic about referring new customers. It provides the customer an incentive to complain, which as we have learned, is more valuable than the alternative, because it gives the company an opportunity to fix the service defect, preventing the same mistake being made with another customer. It is a constant trial—with the customer as judge and jury—and forces the company to update and improve system delivery processes.

With all of that said, there is even a more substantial reason you should offer a service guarantee to all of your customers: *You already do*. If any of your customers were to complain loudly enough, you would make adjustments to their account, according to their wishes. Or, you would ask the customer to pay only what he or she thinks is fair. Unfortunately, this is done *after* the fact, when you will receive no benefit from it. In effect, you have a *covert* service guarantee; I suggest you make it *overt* in order to gain a marketing and competitive advantage over your competition. Again, the idea is to have an *overt* extraordinary guarantee policy—one that you trumpet in the marketplace. Fred Smith, when he started FedEx, painted it on the side of his airplanes and delivery trucks: “Absolutely. Positively. Overnight.” If they don't deliver you don't pay—an *excuseless* culture.

The best source for developing a service guarantee is the front-line team members who have the most interaction with the customer. They understand where the breakdowns, inconsistencies, reworks, mistakes, and variations occur in the service delivery chain. They also understand what is possible to deliver, and can formulate a service guarantee they will have ownership and pride in.

Baldrige Award–winning firm Graniterock instituted such a policy, calling it “short pay.” This provides, in essence, a line-item veto to customers and allows them to deduct any amount of the invoice in accordance with their subjective value of the service provided. It is not a refund or discount policy; it is a pure service guarantee, because the customer is not required to return the merchandise. Here is how owner Bruce Woolpert explained the advantages of this guarantee:

You can get a lot of information from customer surveys, but there are always ways of explaining away the data. With short pay, you absolutely have to pay attention to the data. You often don’t know that a customer is upset until you lose that customer entirely. Short pay acts as an early warning system that forces you to adjust quickly, long before we would lose that customer (quoted in Collins, 2001: 80).

Will some customers take advantage of Woolpert’s policy? Probably. But consider Nordstrom, legendary for taking back merchandise not even purchased from its stores. It estimates that 2 to 3 percent of its customers take advantage of this policy, yet 97 to 98 percent appreciate the policy and are more loyal—and pay a premium price—as a result. Do not let the tail wag the dog. If any one customer were to abuse your service guarantee, he would actually be doing you a favor by self-identifying himself as a problem customer. Gladly refund his money and fire that person from your company.

Please do not misconstrue anything I have said here as meaning “The customer is always right.” That is patent nonsense. Even e-Satisfy.com has shown through its research that up to 40 percent of expressed dissatisfaction is caused by the customer’s own mistakes or unreasonable expectations. While the customer is not always right, it is no use to argue with him, since I have rarely seen anyone win an argument with a customer. The fact is, customers are entitled to their feelings and will act upon them, even if intellectually they are wrong. Sometimes the only course of action is to fire them—or, as some say, “outsource” them.

There is nothing worse for your firm’s morale than to continue to serve customers who do not understand or appreciate the value you provide. Given a choice between continuing a relationship with a toxic customer and the effect it might have on the morale of your team members, observe who former CEO of Southwest Airlines, Herb Kelleher, sided with, as this story from *Nuts! Southwest Airlines Crazy Recipe for Business and Personal Success* humorously illustrates:

...[a] woman who frequently flew on Southwest, but was disappointed with every aspect of the company's operation. In fact, she became known as the "Pen Pal" because after every flight she wrote in with a complaint. It was quickly becoming a volume until they bumped it up to Herb [Kelleher's] desk, with a note: "This one's yours." In sixty seconds, Kelleher wrote back and said, "Dear Mrs. Crabapple, We will miss you. Love, Herb" (Freiberg and Freiberg, 1996: 269–70).

And this is a company who computes that, for the year 1994, only five customers per flight accounted for their entire profit (ibid.: 121). So why would Kelleher so nonchalantly fire a customer? *Because he stands up for his people and puts them first.* Once his response was published in the Southwest newsletter, what do you think happened to team member morale? If it comes down to a choice between your team members and an unreasonable customer, side with the team members, even at the expense of short-term profits. The team members will make up for the lost revenue, but you can hardly ever recapture the loss of dignity and respect team members suffer by forcing them to work with rude and unreasonable customers. Even better, let your team members decide which customers to fire—you will be surprised how diligently they perform this task and then how motivated they are to make up the lost revenue.

## CAN CUSTOMER SERVICE BE RESUSCITATED?

Comedian Steven Wright once quipped he stayed in a hotel that was so old, the wake-up call was a letter slid under the door. The customer service revolution seemed to sweep the business world during the 1980s, and then began a gradual retreat in the 1990s and beyond, a disconcerting trend, to say the least. If we live in a service economy, why is good service so rare? Sure, there are pockets of excellence, but there is far more mediocrity, which is why we love to regale others with stories of heroic service precisely because they happen so rarely.

They say you cannot turn back the clock and go back to the old days. Nonsense. This is exactly what was happening with TQS, customer loyalty, Customer Relationship Management, and other concepts designed to put the customer at the epicenter of the business. Millions of dollars are being spent on consultants to relearn what was once common sense, practiced by the great entrepreneurs from the turn of the century to the mid-1950s—individ-

uals such as Stanley Marcus, Walt Disney, J.W. Marriott, and Ray Krock. The movie *Miracle on 34th Street* is a testament to the importance of customer service and the value of loyalty. When the Macy's Santa Claus sends the customers to the competition because it has the toy the child desires—and it is on sale—management gets upset, but the customers love it and do the rest of their Christmas shopping at Macy's. Somewhere along the line, this common sense practice was lost. Wisdom is timeless, and sometimes turning back the clock is the wisest course of action, otherwise we become prisoners of the moment.

Richard Branson was asked his rationale for launching his multifarious range of businesses, and he answered it was due to his frustrations with poor service. The same reason inspired John Cleese, of Monty Python fame, to write so many of its most famous sketches, such as Dead Parrot and Cheese Shop.

I have focused extensively on the value proposition in this chapter out of concern for the inconsistent level of service being offered in today's business world. It is extremely rare to be "wowed" by a service experience today, a rather sad state of affairs. If our business sector is not capable of delivering outstanding service, how will it ever migrate up the value curve to experiences, let alone transformations? Yes, it is difficult for organizations to continuously raise the bar of service standards, and exceed their customer's expectations, but most do not even appear to be trying. There are, no doubt, many reasons for this service apathy, from too much focus on what happens inside of a company, quality initiatives more concerned with the product than the customer who purchases it, to compensation structures and cultures that no longer support superior service. Another reason is the idea of a "commodity," a most pernicious word in the business lexicon, and it is of such vital importance to rid ourselves of this notion it will be discussed in Chapter 17. For now, let me offer another reason for substandard service, one with a more anthropological focus.

What has happened to the word *customer*, and why do so many businesses attempt to describe the people they serve as something else? After all, *customer* is derived from the word *custom*, which is something done regularly. Therefore, a customer is a person who buys, especially one who buys regularly. Now that describes the relationship I want with the people I serve. Why businesses, and particularly the professions, have adopted other terms is an interesting question, and one worth thinking about.

Why is it when I go see the doctor I am a "patient"; when I board an airplane, a "passenger"; when I get into a taxi, a "fare"? To my utility company



I am a “ratepayer”; to my insurance company, a “policyholder”; to a newsletter, cable, and cell phone provider, a “subscriber.” To my attorney and CPA I am a “client,” a particularly offensive word, since the welfare state has clients, and to the IRS I am a “taxpayer.” (The IRS is a tough case, because that is not necessarily descriptive of a volitional relationship; however, wouldn’t it be nice if the IRS started treating taxpayers as if they *were* customers?).

What’s going on here? Why not call customers what they are? Why do businesses develop a special terminology to describe what is, in essence, a commercial transaction? *The customer is sovereign, period.* Businesses have replaced the word *customer* with other terms because, according to Karl Albrecht in *The Only Thing That Matters*:

These labels signal that the company sees the customer as a passive figure, an object to be acted upon, or something to be processed through a system. The choice of these words makes the customer into a thing rather than a person. The words make it easier to obscure the fact that customers are *people*, entitled to judge the quality of the delivered experience and who make the ultimate decision about doing business with the organization.

Apparently we don’t like giving the customer that much power. We don’t like the feeling of having to earn the customer’s approval. We want to change customers into things we can manipulate, statistics we can analyze, or wild animals we have to capture to gain “market share.”

The loss of this focus on the customer as a human being is probably the single most important fact about the state of service and service management in the Western world today (Albrecht, 1992: 10).

Words affect our actions and attitudes, they have meaning. We use them to label and help us comprehend the world around us. Yet many of them are distorting lenses that can make us misperceive and misjudge what we are observing. The great nineteenth-century English jurist Sir James Fitzjames Stephen, put it aptly: “Men have an all but incurable propensity to prejudge all the great questions which interest them by stamping their prejudices upon their language.” Historically, auto dealerships referred to customers as “Ups.” This pejorative word, and the condescending attitude that goes along with it, may explain why so many dealerships offer such a lousy buying experience. It was not until the more progressive automobile lines came onto the market—such as Lexus, Acura, and Saturn—that the dignity of the customer was restored to its rightful place. This “raising of the bar” has certainly affected

how auto dealerships treat their customers, and has made it harder on those who still abide by the age-old practice that an “Up” is an adversary to be battled with and worn down so as to take every possible dollar out of his or her wallet.

Compare the attitude instilled by using the word “Up” with Walt Disney’s insistence that his customers be called guests. His attitude, which permeates the entire culture of all of Disney’s theme parks, is that everyone is on stage—hence they refer to their employees as cast members—to entertain the guest and show him or her a good time. I am not suggesting that if you change your vernacular you will automatically instill a culture committed to the customer. Far from it. But the words you use to describe the people you serve speaks volumes about the attitude of your organization—and it is the attitude and actions of your people that ultimately determine your culture.

If you were to examine all of the great sources of wealth creation throughout the history of the world, from the titans of the Industrial Revolution in the nineteenth century to Bill Gates and Steve Jobs today, you would notice this profoundly important truth: In every era, the businesses that succeeded and achieved excellence took a clear stand for the customer. Indeed, the central purpose of a business is to serve.

By emphasizing service—and striving for experiences and, ultimately, transformations—your company will offer a superior value proposition to its customers, allowing it to charge a premium price, one commensurate with the value you are creating. In order to capture this value, a company must Price on Purpose, and have an array of strategic pricing strategies, the topic we turn to next.

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# 14

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## THE CONSUMER SURPLUS AND PRICE DISCRIMINATION

*In 1890 the English economist Alfred Marshall suggested that if a parrot were trained to answer “supply and demand” to every question it was asked, the parrot could be given a degree in economics.*

—Michael Watts, Editor, *The Literary Book of Economics*, 2003

*When a reflective man buys a crowbar to open a treasure chest, he may well remark to himself that if necessary he would have been willing to pay tenfold the price.... Marshall gave the odd name of “consumer’s surplus” to these fugitive sentiments.*

—George Stigler, Nobel Prize-winning economist [1911–1991]

Recall from Chapter 8 the difference between relative prices and absolute prices, and how people make decisions based on the former, not the latter. Consider married couples with young children, who cannot be left alone, deciding on a night on the town, versus the same decision made by couples without children. Suppose an expensive date including dinner and a concert is \$150, whereas a cheap date is dinner and a movie costing \$75. Each couple faces the same two options. The childless couple would have to sacrifice the enjoyment of two movies and two dinners for one expensive date ( $\$150 / \$75$ ). The married couple, because they must hire a babysitter for, say, \$50, no matter which date they decide on, will most likely choose the more expensive date. Why? Because the relative price is only 1.6 cheap dates ( $\$150 + \$50 / \$75 + \$50$ ), compared to 2 for the childless couple. Therefore, we would expect to see married couples on more expensive nights on the town. For as good as Alfred Marshall’s supply and demand scissors are, they are not much help in predicting this behavior. To illustrate, a *BusinessWeek*

reader said that Hollywood should price new movies at \$30 for home viewing, because he compares it to \$75 for a night out at the movies (babysitter, popcorn, tickets). Not a bad idea, and certainly consistent with the concept of relative, not absolute, price.

Or consider the decision to purchase an airline flight. In one situation, you may be booking a flight for the entire family, and will most likely select the cheapest fare possible, even if you must sacrifice flying out of your nearest airport, departing or returning on the exact date and times you want, or a multiple-stop versus a nonstop route. What is interesting about this situation from a pricing perspective is how the notion of demographics, or even psychographics, do not offer much help. During the 1960s, marketing managers paid a lot of attention to segregating their customers based on demographics— income, neighborhood, race, gender, and so on. Then in the 1970s, an article was published asking the provocative question, “Would you treat Tricia Nixon Cox the same as Grace Slick?” (The former is the daughter of the late president Richard Nixon, and the latter the past lead singer with Jefferson Starship.) Demographically, these two ladies at the time were indistinguishable—both were 25 to 34 years old, family size of three, urban residents, and college educated. Psychographics opened up a whole new way of thinking about customer behavior, and many companies started to pay attention to it.

And yet, in the decision to purchase a flight for business or leisure, this way of separating customers does not offer much help in capturing the true value of the flight. What really determines the value of the flight is what you are doing at your destination. Taking an enjoyable family vacation provides value, but flying on a necessary business trip usually is more valuable. It also cannot be planned very far in advance, and usually needs to be at exact times, airports, and during the week (no Saturday layover). Demographically and psychographically it is exactly the same customer making both purchases, but in one case the value proposition is totally different. The airlines know this, and they have developed very sophisticated yield management systems enabling them to segregate customers and offer different value propositions depending on the customer’s relative price.

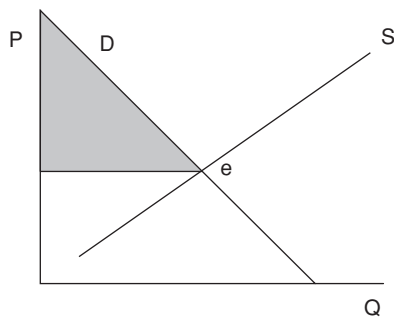
For another reason a business traveler is willing to pay more for a flight (thinking back to Chapter 12, how people buy), recall Category III, spending someone else’s money on yourself. Most of the people sitting in business class are not paying their own airfares, but rather flying on a corporate expense account, as opposed to you paying for your family to fly to its favorite vacation destination (Category I). The incentive to shop for the

cheapest flight, sacrifice a nonstop route, depart from a distant airport, or give up earning frequent flyer points is simply not as keen. The airlines, hotels, rental car companies, resorts, and restaurants certainly take this into account in their pricing strategies.

## PRICE ELASTICITY

Recall the Marshallian scissors shown in Chapter 8. With the supply curve reflecting a cost of production concept of value, and the demand curve the quantities demanded by buyers at various prices, Marshall merged the classical and marginalist schools together in one diagram (Exhibit 14.1).

Marshall believed prices, over the long run, were based on the costs—including profit—of production, thereby resuscitating Smith's theory. The value (price) of a good was determined by "the scissors of supply and demand." Did one play a more important role than another? Marshall believed that they were equally powerfully at influencing price, stating, "We might as reasonably dispute whether it is the upper or the under blade of a pair of scissors that cuts a piece of paper, as whether value is governed by utility or cost" (quoted in Buchholz, 1990: 157). Marshall thought there was



P = Price; D = Demand; S = Supply;  
e = Equilibrium price; and Q = Quantity

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**EXHIBIT 14.1** The Marshallian Scissors

a “natural” price, or what he called the long-period price, around which a commodity gravitated, represented by the *e* (equilibrium) point in the diagram. The Austrian economists refuted this idea of an equilibrium, noting that costs themselves are prices, and markets never really do reach a benign equilibrium, but rather are constantly adjusting to the subjective value of customers.

In any event, for our purposes here, to be included on a demand curve, customers must meet two specific requirements: (1) They have to be *willing* to buy the product; and (2) they have to be *able* to buy the product. For instance, a customer may not be on the demand curve for a Rolls-Royce because, although he is *willing* to buy the car, he is not *able* to buy it. Marshall also developed the concept of *elasticity*, another name for responsiveness. Elasticity is an attempt to measure how people respond to changes in prices; to measure the elasticity of demand, use this equation:

$$E = \frac{\text{Percentage change in quantity demanded}}{\text{Percentage change in price}}$$

Elastic demand exists when *E* is greater than 1. Conversely, an inelastic demand curve exists when *E* is less than 1. The traditional example of an elastic demand curve, one more horizontal than drawn in Exhibit 14.1, but downward sloping nevertheless, is a bale of hay. If the bale of hay is a true commodity, meaning farmer John’s bale is no different from farmer Joe’s, it would not make sense for a customer to pay a higher price for one than the other (unless, of course, there was some other way to differentiate the two farmers—location, certainty of delivery, service, personality, etc.). In other words, if farmer John increased the price of his hay relative to farmer Joe, the quantity demanded would drop, thereby lowering his gross revenues overall. Elastic demand exists in markets with many competitors and many substitutes, such as groceries.

Inelastic demand, on the other hand, exists when a company can raise its price, and the quantity demanded, while it will decrease, will not fall enough to lower revenues overall. The classic example is gasoline. When oil companies increase prices, demand falls, but not enough to offset the price increase, because there are not many substitutes for gas, and each customer needs a certain amount for necessities (commuting, grocery shopping, etc.). In fact, it is estimated that a 30 percent increase in the price of oil leads to a fall in quantity demanded of only 3 percent. Blood is an example of a per-

fectly inelastic demand curve—at least in an emergency situation—meaning the customer would demand a fixed quantity at any price, represented by a perfectly vertical demand curve.

If a company can compute the price elasticity of its products as this model prescribes, it seems as if the puzzle of pricing could be easily solved. Yet, in reality, it is not that simple. Elasticity calculations are computed quite extensively, at a minimum so a company can understand whether it has an elastic or inelastic demand curve (see Exhibit 14.2 for some price elasticities in the U.S. economy). Some of these calculations are quite precise, which is also a major drawback, as explained by Nagle and Holden:

Managerial judgments of price sensitivity are necessarily imprecise while empirical estimates are precise numbers that management can use for profit projections and planning. However, precision doesn't necessarily mean accuracy....Accuracy is a virtue in formulating pricing strategy; precision is only a convenience. No estimation technique can capture the full richness of the factors that enter a purchase decision. In fact, measurements of price sensitivity are precise specifically because they exclude all the factors that are not conveniently measurable. Yet both measurements and judgment are complements, not substitutes (Nagle and Holden, 2002: 360).

**EXHIBIT 14.2 Price Elasticities**

<b>Industry</b>	<b>Elasticity</b>
<i>Elastic Demands</i>	
Purchased meals	2.27
Metals	1.52
Furniture, timber	1.25
Motor vehicles	1.14
Transportation	1.03
<i>Inelastic Demands</i>	
Gas, electricity, water	.92
Oil	.91
Chemicals	.89
Beverages	.78
Tobacco	.61
Food	.58
Housing services	.55
Clothing	.49
Books, magazines, newspapers	.34
Meat	.2

Source: As quoted in Stiglitz and Walsh, 2002:91.

Vilfredo Pareto [1848–1923], the Italian economist who developed the Pareto Principle, would certainly have agreed with this statement. He once claimed that mathematics in economics is “make-believe logical.” Too much devotion to mathematics in determining price can miss the many subjective judgments customers make with respect to value. Robert Heilbroner, socialist economist and author of the popular book *The Worldly Philosophers*, coined the term *mathematical rigor-mortis*. Even Alfred Marshall himself hid his formulas and diagrams in the appendices to his textbooks, and in a letter written to a friend he warned that good mathematical theory might not be good economics, articulating these rules:

1. Use mathematics as a shorthand language, rather than as an engine of inquiry.
2. Keep to them till you have done.
3. Translate into English.
4. Then illustrate by examples that are important in real life.
5. Burn the mathematics.
6. If you can't succeed in 4, burn 3. This last I do often...I think you should do all you can to prevent people from using Mathematics in cases in which the English language is as short as the Mathematical (quoted in Skousen, 2001: 359).

This returns us to the debate of whether pricing is an art or a science. Certainly mathematics has its place in pricing, allowing us to test, predict, and determine elasticity. Yet, since pricing is an art more than a science, judgments are also vitally important and cannot be substituted with mathematical precision. Even if a company possesses a precise elasticity calculation it knows is accurate, it would only be part of the puzzle of pricing. Since elasticity normally lumps “consumers” together, it does not help us in segmenting customers into different value propositions, thereby offering individuals different bundles in order to maximize another concept Alfred Marshall developed—the consumer surplus.

## TEN FACTORS OF PRICE SENSITIVITY

In order to assist those who are in charge of Pricing on Purpose in ascertaining and judging price sensitivity, the following ten factors should be exam-



ined to see which apply to your particular customer circumstances. There are many factors that influence a customer's price sensitivity, and managers need to understand these factors long before setting a price to various market segments. Nagle and Holden identify ten factors affecting price sensitivity (Nagle and Holden, 1995: 95–99).

### 1. Perceived Substitutes Effect

This effect states that buyers are more price sensitive the higher the product's price relative to its perceived substitutes. New customers to a market may be unaware of substitutes, and thus pay higher prices than more experienced buyers. Restaurants in resort areas face less pressure to compete based on price (which locals may describe as "tourist traps"). Branding can also overcome, to a certain extent, the substitute effect. Woolite, for example, has maintained a relatively expensive price because it positions itself as an alternative to dry cleaning, not a substitute to regular laundry detergent. Sam Calagione, president of Dogfish Head Craft Brewery in Milton, Delaware, encourages customers to compare his beer—which retails for about four times the price of mass-market brands and at least twice that of other microbrews—to fine wines. This comparative message is reinforced with the company's packaging, such as its premium Pangaea beer, which comes in a 750-milliliter cork-finished wine bottle, and sells for \$14. Heinz's EZ Squirt Ketchup, launched in 2000, came in various hues—such as green, purple, orange, pink, and teal—while its marketing emphasized "creative applications" such as suggesting to kids to write their names in hot dogs and burgers. It was not merely food, it was an arts and crafts product, and parents started to buy different colors at once, causing a 10 percent leap in market share. Customers have a reference price when there are many substitutes, and as long as the offering is within that range—sometimes referred to as a zone of indifference—it will be considered acceptable, the point being your marketing can influence which products customers will compare yours with, possibly pushing up the price they are willing to pay.

### 2. Unique Value Effect

Buyers are less price sensitive the more they value the unique attributes of the offering from competing products. This is precisely why marketers expend so much energy and creativity trying to differentiate their offering from that of their competitors. Heinz ketchup, for example, developed a secret formula for making its product thicker and was able to increase its market share from 27 to 48 percent while maintaining a 15 percent wholesale price premium. The Volvo automobile has a reputation as the safest car, an attribute many find desirable and are willing to pay a premium to acquire (not just in price but lower fuel economy and performance).

Auction houses rely on the unique value effect in order to command the prices they do among their bidders. Rare artifacts from the John F. Kennedy estate are known as “positional” or “expressive” goods, since the people who purchase them are trying to position themselves in society, or express who or what they are (art collectors, for example).

### 3. Switching Cost Effect

Buyers will be less price sensitive the higher the costs (monetary and non-monetary) of switching vendors. Airlines that have a fleet of Boeing airplanes may be reluctant to switch to Airbus because of the enormous investment they have in their pilots, flight crews, parts inventory, and the mechanics of operating a certain plane. Many people are unwilling to give up certain software products due to the learning and familiarity they have with their existing product. Personal relationships are most susceptible to this type of perceived cost, due to the emotional investment the customer has made in the relationship. Childcare providers, doctors, lawyers, and accountants all can benefit from this effect, especially if they provide Total Quality Service.

### 4. Difficult Comparison Effect

Customers are less price sensitive with a known or reputable supplier when they have difficulty in comparing alternatives. People eat at McDonald’s, continue to use AT&T, lodge at Marriott and shop at JC Penney because they are familiar with these offerings and perceive them to be less risky than unknown alternatives. Stockbrokers price based on different criteria (shares of stock traded, or value of shares traded), making it difficult for the customer to compare one with the other. Cellular phone companies employ this strategy by offering different features among their myriad calling plans, making it very difficult to compare one company’s offering to another.

### 5. Price-Quality Effect

Buyers are less sensitive to a product’s price to the extent a higher price signals better quality. These products can include image products, exclusive products, and products without any other cues as to their relative quality. It is said that only 15% of Rolls Royce customers ask about price before purchasing (Docters et al., 2004: 220). A Rolex watch is another example. Certainly one does not buy it for accurate time keeping. These types of prestige products are an important form of marketing. Witness designer clothing and accessories, along with American Express’ Gold, Platinum, and Black credit cards, which command enormous premiums over alternative cards.

Some products might even be judged solely on price. A synthetic wax, targeted to luxury car owners, failed in the market at a relatively cheap price; it was not

until the price was raised that it began to sell, since customers did not want to apply a wax they perceived as being of inferior quality to their luxury car. Many customers still have a common visceral reaction that high price equates to high value (and quality). Marketers have discovered that utilizing a high price for new products is quite effective for signaling quality to the marketplace. Other marketing research has shown that while discounting familiar brands can increase sales, the same strategy for unknown brands can actually reduce sales.

#### 6. Expenditure Effect

Buyers are more price sensitive when the expenditure is larger, either in dollar terms or as a percentage of household income. A one-office accounting firm may not pay much attention to the price of paper clips, but an international firm that buys in large quantities will. Business purchasers look at the total amount of the purchase, while households will compare the expenditure to total income. Many people will not expend much energy shopping for the lowest price of soft drinks, but they will put more effort into searching for an automobile or a home. Higher-income customers often will pay higher prices because they do not have the time to shop as thoroughly as low-income individuals.

#### 7. End-Benefit Effect

This effect is especially important when selling to other businesses. What is the end benefit they are seeking? Is it cost minimization, maximum output, quality improvement? The fulfillment of the end benefit is often gauged by its share of the total cost. For instance, steel suppliers selling to auto manufacturers know that the price of the steel comprises a large component of the cost of the car; on the other hand, when steel is sold to a luggage manufacturer, the steel cost is relatively minimal compared to the other material used. High-end auto wax marketed to luxury car owners at \$50 and up is not a significant cost to operating an \$80,000+ automobile. AOG in the airline industry stands for airplane on ground, and usually an AOG is awaiting some small replacement part. How price sensitive is the airline with respect to a \$100 electrical switch that could get its plane back in the air and saves countless thousands of dollars, not to mention angry customers?

The end-benefit effect is also psychological. Think of going out for a romantic anniversary dinner and paying with a two-for-one coupon. Most people view price shopping as tacky when the purchase involves something emotional. Wedding florists, caterers, and bands certainly understand this principle. The larger the end benefit, the less price sensitive the buyer. Think of the Michelin tire ads showing a picture of a baby in diapers next to its radial tire proclaiming, "Michelin. Because so much is riding on your tires."

### 8. Shared-Cost Effect

Chapter 12 looked at the fact that when you spend someone else's money on yourself, you are not prone to be price conscious. This is one reason airlines, hotels, and rental car companies can all price discriminate against business travelers, because most of them are not paying their own way. This also explains some of the success of the frequent flyer and other reward programs. Many business travelers value these rewards and will not accept alternative offerings, especially since they are reimbursed anyway. Also, publications, educational seminars, and other business expenses are tax deductible, and this also reduces the buyer's price sensitivity relating to various business expenses.

### 9. Fairness Effect

Notions of fairness can certainly affect customers, even when they are not economically (or mathematically) rational. If a gas station sells gas for \$2.30 per gallon and gives a \$0.10 discount if the buyer pays with cash, and another gas station offers the same gallon at \$2.20 but charges a \$0.10 surcharge if the customer pays with a credit card, which station will sell more gas to credit card users? The economic cost is exactly the same, but most people will psychologically prefer to deal with the first station and not the second because there appears to be something inherently unfair about being assessed a surcharge.

In the past, rental car companies charged their customers if they brought back the car with less than a full tank of gas, and the price was usually two to three times the market rate. Many business travelers, who value their time more than vacationers, viewed this as being completely unfair, so they took the time to fill the tank before returning the car. Finally, the rental car companies figured out fairness was an issue, and now they price their "gas options" at less than the prevailing market price, inducing a large percentage of business travelers to opt to pay them for the gas. This has turned into a nice profitable service for the rental car companies, now that it is perceived as being fair and valuable to customers.

Perceptions of fairness are differentiated based on whether the product or service is a necessity or a luxury. This is why the pharmaceutical industry can receive such public condemnation when it prices new wonder drugs at a premium, even if these drugs prevent other, more costly, medical interventions. It is also why people will boycott stores that hike up the price of needed food, water, and building materials after a natural disaster, even though those price increases are necessary in order to provide the incentives for these products to be diverted from other locations to where they are valued more dearly. Companies that price based on capacity or season are careful to maintain relatively high regular prices so they can be seen as giving discounts to most customers, which is perceived as being "more fair" than charging a premium

above a lower “regular” price. Insurance companies emphasize peace of mind and security, rather than preventing a loss, which most customers resent having to pay for (fairness and pricing will be explored at greater length in Chapter 19).

#### 10. Inventory Effect

The ability of buyers to carry an inventory also affects their price sensitivity. Amateur cooks with large pantries will stock up on a good deal, but a single person living in a small apartment will not. The perishability of the item in question is another factor to consider.

Analyzing price sensitivity is certainly an important task for any business that wants to capture the value it creates from its offering. Taking into account these ten factors of price sensitivity is a good start to formulating your firm’s pricing strategy. Nagle and Holden offer a set of questions that should be asked about each of the above factors in preparing an analysis of price sensitivity:

##### 1. Perceived Substitutes Effect

- What alternatives are buyers (or segments of buyers) typically aware of when making a purchase?
- To what extent are buyers aware of the prices of those substitutes?
- To what extent can buyers’ price expectations be influenced by the positioning of one brand relative to particular alternatives, or by the alternatives offered them?

##### 2. Unique Value Effect

- Does the product have any unique (tangible or intangible) attributes that differentiate it from competing products?
- What attributes do customers believe are important when choosing a supplier?
- How much do buyers value unique, differentiating attributes?
- How can one increase the perceived importance of differentiating attributes and/or reduce the importance of those offered by the competition?

##### 3. Switching Cost Effect

- To what extent have buyers already made investments (both monetary and psychological) in dealing with one supplier that they would need to incur again if they switched suppliers?

- For how long are buyers locked in by those expenditures?
4. Difficult Comparison Effect
    - How difficult is it for buyers to compare the offers of different suppliers? (Be sure to account for the Internet in your answer.)
    - Can the attributes of a product be determined by observation, or must the product be purchased and consumed to learn what it offers (search, experience or credence as explained in Chapter 15)?
    - What portion of the market has positive past experience with your products? With the brands of the competition?
    - Is the product highly complex, requiring costly specialists to evaluate its differentiating attributes?
    - Are the prices of different suppliers easily comparable, or are they stated for different sizes and combinations that make comparisons difficult?
  5. Price-Quality Effect
    - Is a prestige image an important attribute of the product?
    - Is the product enhanced in value when its price excludes some consumers?
    - Is the product of unknown quality and are there few reliable cues for ascertaining quality before purchase?
  6. Expenditure Effect
    - How significant are buyers' expenditures for the product in absolute dollar terms (for business buyers) and as a portion of income (for end consumers)?
  7. End-Benefit Effect
    - What end benefits do buyers seek from the product?
    - How price sensitive are buyers to the cost of the end benefit?
    - What portion of the end benefit does the price of the product account for?
    - To what extent can the product be repositioned in customers' minds as related to an end benefit for which the buyer is less cost sensitive or which has a larger total cost?
  8. Shared-Cost Effect
    - Does the buyer pay the full cost of the product?
    - If not, what portion of the cost does the buyer pay?

## 9. Fairness Effect

- How does the product's current price compare with prices people have paid in the past for products in this category?
- What do buyers expect to pay for similar products in similar purchase contexts?
- Is the product seen as necessary to maintain a previously enjoyed standard of living, or is it purchased to gain something more out of life?

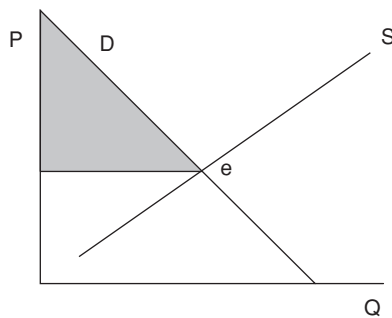
## 10. Inventory Effect

- Do buyers hold inventories of the product?
- Do they expect the current price to be temporary? (ibid.: 95–99)

## CONSUMER SURPLUS

Along with his supply and demand scissors and concept of elasticity, Alfred Marshall made another major contribution to price theory, as shown in his famous scissors diagram (Exhibit 14.3):

Notice the shaded area above the equilibrium price on the demand curve. Marshall pointed out that some customers are willing and able to pay more than the market price, represented by the shaded area, what he called *con-*



P = Price; D = Demand; S = Supply;  
e = Equilibrium price; and Q = Quantity

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**EXHIBIT 14.3** The Marshallian Scissors—Consumer Surplus

*sumer surplus*. Specifically, consumer surplus is defined as the amount by which customers value a product over and above what they pay for it.

For instance, I can remember finding a rare first edition of Stanley Marcus' book *Quest for the Best* in a used bookstore in San Diego. I had been searching for this book for a couple of years, since this was before the Internet, and was elated when I stumbled across it by chance. As soon as I skimmed through it and learned it was in good condition, and autographed by Stanley himself, I would have been willing to pay \$100 for it. Of course, the bookstore owner had no idea, nor does he even know me or of my desire to own this rare book. He priced it at \$10. I can assure you I did not offer to split the difference between my value price and his asking price. I left the store, as an economist would say, \$90 wealthier, keeping the entire consumer surplus to myself. This raises an interesting moral and ethical question: If it is unethical for businesses to charge high prices, is it also unethical for customers to seek out low prices? Is my keeping 100% of the consumer surplus any more or less unethical than the bookstore owner capturing any portion of it above \$10? We shall return to the ethics of pricing in Chapter 19. In the meantime, this is why Marshall thought the consumer surplus was a measure of customer well-being and satisfaction, because as prices become lower, the shaded area grows bigger, and more and more consumers can buy a greater quantity of products at the same price, the equivalent of having more income.

On the other hand, there is also a *producer surplus*, the difference between the price for which a producer would be willing to provide a good or service and the actual price at which the good or service is sold. The consumer's and producer's surplus provides a measure of the gain to both parties, and the sum being the social gain, or welfare gain, due to the existence of the market. While the consumer surplus is the gain the buyer receives from trade, the producer surplus is sometimes referred to as *economic rent*—the amount received by sellers of an item over and above what they would have accepted. Michael Jordan and Tiger Woods receive an enormous amount of economic rent above what would be needed to induce them to play their favorite sport. There is also a *consumer detriment*, representing the customers who are willing to pay more than cost but less than the market price. While consumer surplus makes customers happy, it is economic rent that makes companies—and individuals—rich.

In fact, because of this fact, some economists believe Marshall should have called his scissors “sales curves” and “bid curves” rather than supply and demand curves, since what they are really depicting is the highest price an individual would be willing to pay, or the lowest a seller would accept, for a given amount of product.



If a business can identify those customers willing and able to pay more, it can capture a portion of this consumer surplus. It is there for any company with a downward sloping demand curve, which is present even for the most elastic demand curves. What if the bookstore owner had known me, and my quest to find the rare Stanley Marcus book? Perhaps with the sophisticated customer relationship management (CRM) software of today he could track the desires of his customers and this would certainly assist him in pricing to capture a larger share of the consumer surplus. Yet, identifying these particular customers is only part of the puzzle, however, since then you have to charge different prices to different customers, and this presents some challenges, although not insurmountable.

Charging different prices to *different* customers is the definition of *price discrimination*, a term coined in 1920 by Arthur Cecil Pigou in *The Economics of Welfare*. Price discrimination occurs when a good or service is sold at different prices that do not reflect differences in production costs. Companies engage in this practice in order to extract the consumer surplus from various customers.

Pigou (along with John Maynard Keynes), was one of Marshall's student prodigies who took over the Cambridge economics department upon Marshall's departure. Because the word *discrimination* has become a pejorative in today's vernacular, marketers have developed euphemisms for price discrimination, such as *market segmentation* or *yield management*. Since this book rests on the broad shoulders of the history of economic ideas, I do not have the temerity to alter the language of an entire academic discipline. It is the approach to the topic, in any case, with which we are here interested. It is worth reiterating that price discrimination does not imply discriminating against people based on race, gender, religion, ethnicity, and so forth, but only on their willingness and ability to pay, which is based on the value they are receiving. Also, as we shall see later, price discrimination receives an unwarranted opprobrium among businesspeople, because it is so misunderstood. A strong case can be made that the poorest members of any society are among the main beneficiaries of this form of pricing.

## PRICE DISCRIMINATION PRINCIPLES

Price discrimination is demand motivated, not cost motivated, as Mark Skousen and Kenna C. Taylor explain in *Puzzles and Paradoxes in Economics*:

In a single-price market there is a great deal of consumer surplus because the price in the market for all units derives from the value attributed by consumers to the last unit consumed, thus making for consumer surplus on the earlier more valuable units consumed. This reflects the fact that the desire for any good or service is subject to the law of diminishing marginal satisfaction, so that the more valuable first units are consumed earlier and less valuable ones are consumed later as the price declines (Skousen and Taylor, 1997: 57–58).

Recall the discussion of why diamonds are more expensive than water, despite the fact one can live without the former but would die without the latter. Besides being abundant, water tends to be priced based on the marginal satisfaction of the last quantities consumed, so the water you use to wash your car is far less valuable than the first few gallons drunk to quench your thirst. Of course, if the water companies knew you were dehydrated in the desert, instead of washing your dog, they would be able to price those precious first gallons at a higher price; but learning this type of information about exactly what *all* of their customers are doing with the water they use is prohibitively expensive. However, bottled water companies have figured out how to extract some of the consumer surplus, since they are partially selling convenience, and able to charge a higher price for water than gasoline.

In a perfect market (from the seller's perspective anyway), customers would each pay their *reservation price* for each product or service, defined as the maximum amount they are willing and able to pay for a product. This would be the ultimate expression of pure price discrimination. Unfortunately for producers, the marketplace is not perfect and other methods must be devised to ascertain how much different buyers value their offerings, such as popcorn lovers valuing the movie experience more than non-eaters. Successful pricing strategies are designed to induce customers to better reveal their reservation price, thereby capturing a larger percentage of the consumer surplus. To achieve price discrimination, four requirements must be met:

1. **The firm must have market power**—Not monopoly power, but a downward-sloping demand curve, so a firm can raise prices *without* losing all of its customers—as would happen with a completely horizontal demand curve—imperfect, as opposed to perfect, competition.
2. **Buyers with different demand elasticities must be separable into submarkets**—Differences arise from income disparities, preferences, locations, etc.

3. **The transaction cost is less than the potential profit**—Costs associated with separating buyers with differential demands must be lower than the differential gain in profit expected from the multiple-price as compared with the one-price strategy.
4. **The seller must separate buyers to avoid arbitrage**—Otherwise, products sold more cheaply in one location can be purchased there and transported to a higher-price location (Skousen and Taylor, 1997: 57–58).

These four requirements present barriers to engaging in price discrimination, but they are surmountable, and as we shall see, many companies have developed very imaginative and creative ways to overcome these challenges. Let us explore each of the four requirements. First, companies must have market power, meaning a downward-sloping demand curve. Even the most elastic products meet this requirement, which means the company has some ability to control the price they charge rather than merely being a *price taker*.

Second, separating buyers with different demand elasticities requires that a company understand its customers' motivations, how they benefit from its product, and how it will be used in order to judge the marginal value. If you sell in business-to-business markets, understanding your customer's business model, how they make money, and how you can help them be more successful is essential in separating them into various value segments. This is obviously easier with long-term customers, with whom a deep relationship has been established.

The third requirement is that the potential profit must be greater than the costs of separating buyers for price discrimination purposes. A case in point where this requirement became a barrier to charging different customers different prices was Disneyland's A–E ticket system (E stood for *exciting*), used to price its attractions. On October 11, 1955 (the year Disneyland opened) A, B, and C tickets cost from 10 cents to 50 cents each, depending on the attraction. D tickets were added in 1956 and E tickets in 1959, priced at 50 cents each. From a pricing perspective, the A–E ticket system was a pure price discrimination strategy, whereby the park charged the highest prices to those guests who simply had to ride the most exciting rides, and some rode multiple times, similar to theater owners extracting the consumer surplus from the popcorn lovers. However, over time the problems with the A–E system began to outweigh the benefits. Disney had to print the tickets, its guests had to wait in long lines to purchase them (thus diminishing the fun and experience of the park visit), and the cast members at each ride had to handle and police the tickets, sometimes turning away guests carrying the wrong ticket.

The total costs of engaging in this type of customer segregation began to exceed the marginal profits derived from it, and in 1982 Disneyland changed to the Disneyland Passport, a fixed-price, unlimited use of attractions, all-day pass. The A–E ticket system is still in place in carnivals and fairs, which employs this two-part tariff since they charge an admission price in order to enter and then you can purchase the ride tickets.

The fourth, and final, requirement, avoiding arbitrage, is much easier for service providers to meet than product sellers. If a bakery were to sell pies in two nearby towns, and price them at \$10 in one town and \$5 in the other, eventually customers would buy in the lower-price location. Some customers would even buy pies in the lower-price location and transport them back to the higher-price location and sell them, thus keeping some of the consumer surplus for themselves, a process known as arbitrage. We witness this with drugs being purchased in Canada by American citizens due to lower prices. Some high-priced U.S. drugs, such as for AIDS or Norplant, sell for much lower prices in less developed countries, due to a more elastic demand curve. Sometimes drug companies will package products differently in different markets, varying the sizes and quantities in order to make arbitrage more difficult.

But one cannot arbitrage services. You cannot send your butler, who may be charged on a sliding scale based on his income, to get your kidney transplant. A customer cannot sell their tax return or legal services to someone else. Services consumed on location, such as movie theater popcorn or medical and dental care, are not susceptible to arbitrage, making it easier for companies in these industries to engage in price discrimination.

We have studied the four requirements necessary to price discriminate, let us now examine the three degrees of price discrimination:

1. **First-degree price discrimination**—Charging each customer the most that he would be willing to pay for each item that he buys, thereby transferring all of the consumer surplus to the seller.
2. **Second-degree price discrimination**—Charging the same customer different prices for identical items.
3. **Third-degree price discrimination**—Charging different prices in different markets (Landsburg, 1996: 363–65).

Due to the high transaction costs of determining what each and every buyer is willing to pay, auctions and negotiable price markets are the closest approximation to first-degree price discrimination. Whether it is the late

Princess Diana's dresses or articles from the Kennedy estate, buyers line up and identify the maximum amount they are willing to pay, and thus the item is sold to the individual who *values* it the most. Some of the more famous examples from the Kennedy estate were JFK's golf irons and woods, which sold for \$387,500 and \$772,500, respectively, to Arnold Schwarzenegger. A \$100 necklace of fake pearls went for \$211,500. Even the Lunokhod 2 vehicle, which sits on the moon's surface and can never be brought back to earth, secured a bid of \$68,000 (Lacey, 1998: 11, 301). Traditional cost-plus pricing cannot explain these prices; the subjective theory of value can. Perhaps a more vital lesson to be learned from these examples, which can be carried over to the three different degrees of price discrimination, is this: If the auction house had used a mathematical formula to determine the price, do you think it would have come up with the prices ultimately paid? To the extent pricers rely solely on formulas to establish price, they are most likely underpricing. It is an art, not an exact science.

Other than in auction houses, perfect first-degree price discrimination rarely exists, since more knowledge is required than most sellers can ever possess. However, this knowledge can sometimes be approximated, as pointed out by economist Steven Landsburg:

In the ancient days when people spoke with their computers through the medium of gigantic stacks of "computer cards," IBM required users of its computers to buy all of their cards from IBM. The cards were priced above marginal cost. This strategy was widely misinterpreted as an attempt to extend IBM's monopoly power from the market for computers to the market for cards. However, this explanation makes no sense. If buyers of computers are required to pay more for cards, their willingness to pay for computers is reduced and IBM loses on the computers what it makes on the cards. In actuality, *the card strategy enabled IBM to charge different prices to different customers*. In effect, those who used more cards were charged more for their computers.

IBM's ideal strategy was to require each buyer of a computer to pay the amount that a computer was worth to him. This was well-approximated by charging a higher price to the heavier users. The card strategy accomplished this (Landsburg, 1996: 365).

Second-degree price discrimination exists when businesses charge the same customer different prices for identical items, such as Proctor & Gamble giving Wal-Mart a discount on Pampers for large-quantity orders. Another

example is utility companies and cellular phone companies charging different rates for “peak” and “off-peak” use, the theory being that a phone call placed during peak hours is more valuable (say, for a salesman to make an appointment with a prospect) than a call during off-peak hours (say, to order a pizza on the way home from work).

An example of third-degree price discrimination—charging different prices in different markets—is coupons. If Proctor & Gamble can make a profit selling a box of Tide soap with a 50-cents-off coupon, what are they making when a customer buys a box without a coupon? Priceline.com is a variation of the coupon strategy on the Internet, allowing the more price-sensitive customer to book travel arrangements. Coupons are a way in which manufacturers attract those customers whose demand is more elastic. Not everyone redeems coupons, and that is the point, for if everybody did, they would be superfluous. The manufacturer would simply discount the price of the product by the coupon amount and be done with it, saving the costs of printing, distributing, and redeeming the coupons, not to mention the cost of fraud. This is not a small amount of money. In 2000, 330 billion coupons were distributed, yet fewer than 4.5 billion were redeemed, with a total redemption value of \$3.6 billion. Fraud was estimated to cost \$1 billion per year (Monroe, 2003: 478).

In order to price discriminate, sellers must be able to identify and separate different groups of customers. This requires not so much scientific knowledge as it does the special knowledge of time and place, a form of know-how of great significance to any society’s allocation of resources, as explained by one of the twentieth century’s greatest economists.

## THE USE OF KNOWLEDGE IN SOCIETY

Friedrich A. Hayek, the 1974 Nobel Prize winner in economics, addressed the American Economic Association in 1945 on the occasion of his retirement as its president. The title of his address was “The Use of Knowledge in Society,” wherein he called attention to the important social role of prices as carriers of information and contrasted this knowledge with so-called scientific knowledge. I quote Hayek here at length because in this address he articulated the theoretical justification for price discrimination, whereby firms can take advantage of “special knowledge of circumstances of the fleeting moment not known” to their competitors:

Today it is almost heresy to suggest that scientific knowledge is not the sum of all knowledge. But a little reflection will show that there is beyond question a body of very important but unorganized knowledge which cannot possibly be called scientific in the sense of knowledge of general rules: the knowledge of the particular circumstances of time and place. It is with respect to this that practically every individual has some advantage over all others in that he possesses unique information of which beneficial use might be made, but of which use can be made only if the decisions depending on it are left to him or are made with his active cooperation. We need to remember only how much we have to learn in any occupation after we have completed our theoretical training, how big a part of our working life we spend learning particular jobs, and how valuable an asset in all walks of life is knowledge of people, of local conditions, and special circumstances. To know of and put to use a machine not fully employed, or somebody's skill which could be better utilized, or to be aware of a surplus stock which can be drawn upon during an interruption of supplies, is socially quite as useful as the knowledge of better alternative techniques. And the shipper who earns his living from using otherwise empty or half-filled journeys of tramp-steamers, or the estate agent whose whole knowledge is almost exclusively one of temporary opportunities, or the *arbitrageur* who gains from local differences of commodity prices, are all performing eminently useful functions based on special knowledge of circumstances of the fleeting moment not known to others.

It is a curious fact that this sort of knowledge should today be generally regarded with a kind of contempt, and that anyone who by such knowledge gains an advantage over somebody better equipped with theoretical or technical knowledge is thought to have acted almost disreputably. To gain an advantage from better knowledge of facilities of communication or transport is sometimes regarded as almost dishonest, although it is quite as important that society make use of the best opportunities in this respect as in using the latest scientific discoveries (Hayek, 1945: 521–22).

This observation has far-reaching implications for the pricing policies of for-profit entities. What Hayek is basically saying is that it is perfectly normal—and beneficial—for firms to take into account special circumstances in order to provide the most value, and hence receive the highest price, in the delivery of its services. Robert G. Cross, author of *Revenue Management: Hard-core Tactics for Market Domination*, and pioneer of Delta Airlines discriminatory pricing policies, cited Hayek's article as laying the "theoretical groundwork for [his] modern Revenue Management" theory (Cross, 1997: 50).

The majority of the most important knowledge in any field of endeavor, be it sports, entertainment, or business, is *tacit* knowledge—that is, knowl-

edge specific to time, place, and circumstances. This form of knowledge is extremely difficult to articulate and relatively expensive to transfer, often traveling only through apprenticeship and trial and error. Your local coffeehouse knowing exactly how you like your morning ritual, a barber understanding exactly how his customer likes his haircut, the local hotel understanding how the college football schedule influences the demand for rooms, travelers in unfamiliar cities befriending a local in order to discover good restaurants and sightseeing locations, and the advantage a golfer has who has played on the course many times and is said to have local knowledge—all point to the fluctuating value of location, location, location.

A pricing system depends on this tacit knowledge in order to allocate resources to those who value them the most. Although this type of knowledge may be unscientific in the technical sense, it is certainly valuable to any business trying to formulate its pricing strategy. Understanding that not all customers are created equal and segmenting them into different groups in order to offer various value propositions based on their ability and willingness to pay is an essential component of Pricing on Purpose. Let us now turn our attention to various customer segmentation strategies.



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# 15

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## CUSTOMER SEGMENTATION STRATEGIES

*The truth is, it's actually more fair to treat different customers differently. A customer who invests more in your firm is certainly owed a greater level of service and attention, and by treating customers individually the enterprise can usually raise the general level of service for nearly all customers. Customers don't want to be treated equally. They want to be treated individually.... Any company that treats a customer the same as "everybody" is treating that customer like nobody.*

—Don Peppers and Martha Rogers, *Enterprise One to One: Tools for Competing in the Interactive Age*, 1997

The Italian economist and sociologist Vilfredo Pareto [1848–1923] developed the Pareto Principle, which states: *In any phenomenon, only a few of the contributors account for the bulk of the effect.* He was referring to the distribution of income and wealth in various countries, but the same applies to customers in any business. Consider these statistics:

- Lexus accounts for 3 percent of unit sales for Toyota, yet contributes 30 percent of Toyota's total profits.
- The top third of credit card holders account for 66 percent of credit card charges.
- Only 21 percent of moviegoers account for 80 percent of the attendance.
- The top third of personal long-distance callers account for 68 percent of long-distance billing.
- A study of the revenues of 300 movies released over an 18-month period found that four (1.3 percent) accounted for 80 percent of box

office receipts and the other 296 movies (98.7 percent) earned 20 percent of box office receipts.

- The top third of diners at family restaurants account for almost 90 percent of the visits.
- The top third of shoppers account for 80 percent of the grocery spending in any particular supermarket.
- 5 percent of households buy 85 percent of Levi's blue jeans.

A mistake made by a lot of businesses is to treat each customer like an "average customer." In reality, there is no such thing as an *average* customer. There are only *individual* customers, and therefore you should set an appropriate, customized price for each of them, or at the least, different segments of the same type of customer.

Marketers have long understood that the majority of profits in an enterprise do not come from the majority of customers, and therefore they invest an enormous amount of intellectual capital "building fences" around the high-value customers, segregating them from the masses to extract the consumer surplus in very creative ways. While economists call this price discrimination, marketers call it market segmentation. In the past 20 years or so, sophisticated yield management software has become more common in industries that have the following characteristics:

- Perishable inventory and/or seasonal demand
- High fixed costs and relatively low marginal costs
- Fixed capacity
- Advance purchase (Ingold et al., 2000: 164)

Industries meeting these characteristics are airlines, hotels, rental car companies, ski resorts, and software firms, among others. Yield management was developed by airlines in the late 1970s after deregulation, and began to be adopted in the hotel industry in the mid-1980s, although it has been conjectured that this form of pricing may be much older than we believe, as this story illustrates:

Yield Management is not new. Indeed, it may be entering its third millennium as a management technique. We are told that Joseph and Mary had to be accommodated in a stable two thousand years ago because there was no room at the inn. But perhaps the innkeeper had identified them as customers who could not afford a premium rate on a night of peak demand and had decided

to hold out for better business. After all, he might have known that there were three kings in town who had yet to find accommodation (ibid.: 339).

In hotels, yield management requires desk clerks to turn down some customers, saving capacity for last-minute, high-value customers, sometimes achieved by managers engaging in “phantom bookings” to reserve rooms. Quoting the “rack rate”—the industry term for full-rate—is another strategy employed to reserve rooms for last-minute travelers. The name predates computers, referring to a mechanical rack that held small slips of paper known as duckets, which stated the retail room rate. Yield management allows pricers at Walt Disney World to maximize revenue over its entire population of rooms, not just each hotel. Marriott and others utilize it to maximize prices for each city-region.

According to Tom Nagle and Reed Holden in their book *The Strategy and Tactics of Pricing*, there are seven effective segmentation strategies to specifically identify different types of customers in order to capture the consumer surplus:

1. *Buyer identification.* Senior discounts, children’s prices, college students, and coupons are all examples of ways to specifically identify different buyers.
2. *Purchase location.* Dentists, opticians, and other professionals sometimes maintain separate offices, in different parts of the same city, or in different cities, which charge different prices based upon the economic and demographic makeup of each. Coca-Cola and other soft drinks sell at radically different prices depending upon where they are purchased, from discount retailers being the cheapest price per ounce and bars and vending machines being the most expensive. With the increasing use of the Internet to make purchases, being able to segment by location is becoming more difficult, but still feasible.
3. *Time of purchase.* Theaters offering midday matinees, restaurants charging cheaper prices for lunch than dinner, and cellular and utility companies offering pricing based on peak and off-peak times are all examples of segmenting by time of purchase.
4. *Purchase quantity.* Quantity discounts are usually based on volume, order size, step discounts, or two-part prices. Customers who buy in large volumes tend to be more price sensitive but less costly to service, and they have more incentive to shop for a cheaper price. Thus,

they are offered volume discounts. When offering discounts to business buyers, one must be careful not to violate the antitrust laws against price discrimination, as discussed in Chapter 20. Two-part pricing involves two separate charges to consume a single product. Rental car companies use a flat price plus a price per mile, health and country clubs charge both membership fees and monthly dues. Night clubs charge a cover at the door as well as for drinks and food.

5. *Product design.* Offering different versions of a product or service is a very effective way to segment a market, either by adding more features, or taking some away. Premium gasoline, for instance, only costs the oil companies approximately 4 cents more per gallon to refine but sells at the pump for anywhere from 10 to 15 cents more. The Apple iPod comes in various sizes of megabytes, and it also has a low-end model, the iPod Shuffle, which plays songs randomly rather than those chosen by the customer, a pure value trade-off to obtain the lower price. Pricers call this type of low-end product a *flanking product*, a signal to competitors to not start a price war in the higher-value segment.
6. *Product bundling.* Restaurants bundle food on the dinner menu as opposed to à la carte, usually at cheaper prices. Symphonies, theaters, and sports teams bundle a package of events into season tickets. IBM and Hewlett-Packard bundle hardware, software, and consulting services in order to increase the value of their respective offerings.
7. *Tie-ins and metering.* Before the Clayton Antitrust Act of 1914, tie-in sales were common. American Can, for instance, leased its canning machines with the requirement they be used to close only American's cans. Since the passage of the Clayton Act, the courts have refused to accept tying agreements, except for service contracts where it is essential to maintain the performance and/or the reputation of a new product. While using the tying method with a contract may be illegal, opportunities still exist to use this strategy without a contract. For example, razor blade manufacturers design unique razors requiring customers to purchase its blades for refill, and a certain toner must be used on various leased copy machines.

Segmenting customers by one or more of the above methods is among the most effective pricing strategies any business can employ, and also among the most difficult. It takes an enormous amount of intellectual capital, cre-

ativity, and customer research in order to be effective. With the increasing propensity for customers to utilize the Internet to make their purchases, market segmentation is taking on a new dynamic: While it will become easier to segment potential customers based on their profiles, search, and buying habits, it will also require experimentation with different pricing policies. Prior to the Internet, firms encountered a *menu cost*, the cost of changing prices such as the printing of new price lists or menus. The Internet has dropped menu costs to practically zero, which makes it easier for sellers to test various prices among different segments of customers. While the Internet may make it easier for buyers to find lower prices, it also makes it easier for the seller to find buyers willing to pay higher prices, especially if they receive a customized offering.

### **SEARCH, EXPERIENCE, AND CREDENCE ATTRIBUTES**

From a marketing perspective, products and services can be separated into three classes: search products, experience products, and credence products. Search products or services have attributes customers can readily evaluate before they purchase. A hotel room price, an airline schedule, television reception, and the quality of a home entertainment system can all be evaluated before a purchase is made. Well informed buyers are aware of the substitutes that exist for these types of products and thus are likely to be more price sensitive than other buyers, unless there exists some brand reputation or customer loyalty. This sensitivity, in turn, induces sellers to copy the most popular features and benefits of these types of products. Price elasticity is high with respect to products with many substitutes, and since most buyers are aware of their alternatives, prices are held within a competitive band.

Experience products or services can be evaluated only after purchase, such as dinner in a new restaurant, a concert or theater performance, a new movie, or a hairstyle. The customer cannot pass judgment on value until after he or she has experienced the service. These types of products tend to be more differentiated than search products, and buyers tend to be less price elastic, especially if it is their first purchase of said product. However, since they will form an opinion after the experience, if it is not favorable, no amount of differentiation will bring them back. Product brand and reputation play an important role in experience products, due to consistency of quality

and loyalty. For instance, when customers travel, so does reputation, as with airlines, hotels, rental cars, and so forth.

Credence products or services have attributes buyers cannot confidently evaluate, even after one or more purchases. Thus, buyers tend to rely on the reputation of the brand name, testimonials from someone they know or respect, service quality, and price. Credence products and services would include health care; legal and accounting services; tax and consulting services; baldness cures; pension, financial, and funeral services; and even pet food (since you have to infer if your pet likes it or not). Credence services are more likely than other types to be customized, making them difficult to compare to other offerings. Because there are fewer substitutes to a customized service, and there is more risk in purchasing these types of services, price elasticity tends to be relatively low—that is, the majority of customers purchasing credence services are relatively price insensitive compared to search or credence goods.

At a time when office space in London was going for £27 per square foot, an advertisement appeared for space at £22. Yet, it did not have the intended effect. Rather than people thinking “this must be a great deal,” it made them think “there is something wrong with this property,” which will only be discovered after incurring substantial search costs, such as investigating the property. One of the most important functions price plays, especially with credence products, is to certify and signal quality, and dropping prices significantly distorts this signal. Since customers do not usually possess perfect information—as is assumed in the economists’ perfect competition model—markets tend to use other imperfect adjustments rather than discounting the listed price per square foot, such as free rent periods, leasehold improvement allowances, shorter or longer lease terms, and so forth.

One of the lessons of categorizing products and services in this fashion applies to menu pricing, or bundling various offerings. In order for price bundling to be effective, at least one of the bundled offerings should be a search product because buyers of that product will tend to be more price sensitive and then can be convinced to move up in price to the more valuable credence offerings.

## PRICE PSYCHOLOGY AND RISK

Although not segmentation strategies per se, all businesses need to have an understanding of the role price psychology and risk play in influencing cus-

tomers' buying decisions. Since people tend to buy emotionally and justify intellectually, the study of pricing psychology is a worthwhile endeavor. There are two characteristics of price psychology:

1. Price leverage
2. Pricing emotions

Price leverage is not an advantage possessed by one party over the other. It is a question of who has the most (or least) price sensitivity at a given point of time during a transaction. A product or service *needed* is almost always worth more than a product or service *delivered*, and therefore most businesses provide a price to customers *before* they buy, so they can make the all-important value versus price comparison. Many restaurants make a deliberate attempt to sell dessert (or at least display it) while the customers are still hungry, maintaining their price leverage. However, some businesses, especially professional service firms, defy this psychology by pricing *after* the work has been done, thereby sacrificing leverage to the customer and hence pricing when they possess the least amount of leverage. This usually leads to write-downs, write-offs, and unhappy customers, not to mention that after an engagement is over is precisely the wrong time to discover the customer did not agree with your price since there is not much you can do at this point in the transaction. This deleterious effect can be overcome by offering a fixed price for a given scope of services, and when the scope differs from expectations, utilizing a *change order*, such as in the contracting or auto repair industries.

The second type of price psychology is *pricing emotions*, of which there are three that customers will experience at various times through a purchasing cycle:

1. Price resistance
2. Payment resistance
3. Price anxiety

As long as you are dealing with people, you will encounter *price resistance*—also known as *sticker shock*—usually at the beginning of the buying process, making it easy to identify. The best way to overcome it is by educating customers about the value being provided. By discussing value, rather than price, you lower a customer's price resistance. All customers have a natural incentive to *lower* your price, but at the same time, to *maximize* their

value. It is far more strategic to have a discussion around what they are trying to maximize rather than what they are trying to minimize.

Price bundling is an effective way to overcome sticker shock as well, as it focuses the customer on the totality of the offering, rather than on specific components. Witness the success McDonald's has had with its Value Meals. Items most frequently purchased are combined, leading customers to consider the value of the total meal, not just its parts. This has been an unquestionable success for McDonald's, so much so that all of its competitors have emulated the strategy (which was started by Taco Bell).

Prices should not be lowered for customers suffering from sticker shock, because this cheats your firm's best customers—those who value what you provide—and subsidizes your worst customers—those drawn to you by price considerations alone. These will be the first customers to defect once they find a provider with a lower price. Rather than lowering price, consider removing value from the offering, thereby forcing the customer to make a price/value trade-off. For instance, sometimes technology firms will lower price, but only on older technology.

Many people automatically equate high price with high quality, a well-known psychological response. In his fascinating book, *Influence: The New Psychology of Modern Persuasion*, Robert B. Cialdini tells of a friend who had opened an Indian jewelry store in Arizona. She had an allotment of turquoise jewelry she had not been able to sell, even during the peak tourist season. Before leaving town, she wrote a note to her head saleswoman, "Everything in this display case, price  $\times$  1/2," hoping just to be rid of the offending pieces, even if at a loss. When she returned, she was surprised to learn all of the jewelry had been sold. But the employee had read the "1/2" in the scrawled message as a "2." The entire allotment had sold out at twice the original price (Cialdini, 1993: 1–2). As Harry Beckwith states in his book *The Invisible Touch: The Four Keys to Modern Marketing*, "Like money, price talks. It changes perceptions. Price changes the actual experience of using the service: A high price actually improves the experience. Watch what your price says. Push price higher. Higher prices don't just talk, they tempt" (Beckwith, 2000: 78–80).

Payment resistance is simply the customer's unwillingness to cut the check. Who likes to pay their bills? Payment resistance is overcome by getting the customer to agree to the terms *before* the product or service is rendered. Lawyers overcome this emotion by requiring retainers, as do firms that require customers to pay progress billings at an agreed-upon interval.



The old axiom of business valuations applies: “I’ll let you set the price if you let me set the terms.” Always make payment terms an integral part of your pricing strategies. General Motors Acceptance Corporation and General Electric Credit, among others, actually make more money financing what they manufacture than they do selling it, and have launched enterprises that make a profit from payment terms. Be sure to make paying your firm as easy as possible for the customer.

The last pricing emotion, *price anxiety*, is also known as *buyer’s remorse*. Anytime a customer spends a relatively large amount of money—for a house, automobile, expensive jewelry, and the like—it is quite natural to experience this emotion. Luxury automobile advertisements, for instance, are targeted at existing owners, rather than potential owners, in order to provide reassurance they made a good and prudent decision. Price anxiety is less likely to affect repeat customers. Offering excellent customer service, and a service guarantee, as discussed in Chapter 13, are also effective methods to ameliorate buyer’s remorse.

## UNDERSTANDING CUSTOMER RISK

Any purchase entails risk. Services are relatively more risky than products, especially credence services discussed above. This is one reason why there is greater loyalty to service providers than products manufacturers. The seven types of customer risk are:

**Performance risk** is the chance the service provided will not perform or provide the benefit for which it was purchased.

**Financial risk** is the amount of monetary loss incurred by the customer if the service fails. Purchasing services involves a higher degree of financial risk than the purchasing of goods because fewer service firms have money-back guarantees.

**Time loss risk** refers to the amount of time lost by the customer due to the failure of the service.

**Opportunity risk** refers to the risk involved when customers must choose one service over another.

**Psychological and social risk** is the chance that the purchase of a service will not fit the individual’s self-concept. Closely related to psychological risk is social risk, which refers to the probability a service will not meet with

approval from others who are significant to the customer making the purchase. Services with high visibility will tend to be high in social risk. Restaurants and hair stylists are examples of service industries that are perceived to have a high level of social risk. Even for business-to-business marketing, social risk is a factor. Corporate buyers are concerned that a service they purchase will meet with approval of their superiors. [Thus, IBM's famous slogan: "No one ever got fired for choosing IBM.]"

**Physical risk** is the chance a service will actually cause physical harm to the consumer (Kurtz and Clow, 1998: 41–42).

An amusing example of social risk comes, once again, from Robert Cialdini's book, *Influence*. It is also a fairly effective price-discrimination strategy. Cialdini was in a toy store in January purchasing a big, electric road-race set for his son. He ran into a neighbor making the same purchase for his son. They recalled they had run into each other the previous January, too, making rather expensive post-Christmas gift purchases for their sons, and chalked this up to coincidence. Cialdini later recounted this story to a friend who had worked in the toy business, and the following conversation ensued:

"No coincidence," he said knowingly.

"What do you mean, 'No coincidence'?"

"Look," he said, "let me ask you a couple of questions about the road-race set you bought this year. First, did you promise your son that he'd get one for Christmas?"

"Well, yes, I did. Christopher had seen a bunch of ads for them on the Saturday morning cartoon shows and said that was what he wanted for Christmas. I saw a couple of the ads myself and it looked like fun, so I said okay."

"Strike one," he announced. "Now for my second question. When you went to buy one, did you find all the stores sold out?"

"That's right, I did! The stores said they'd ordered some but didn't know when they'd get any more in. So I had to buy Christopher some other toys to make up for the road-race set. But how did you know?"

"Strike two," he said. "Just let me ask one more question. Didn't this same sort of thing happen the year before with the robot toy?"

"Wait a minute...you're right. That's just what happened. This is incredible. How did you know?"

"No psychic powers; I just happen to know how several of the big toy companies jack up their January and February sales. They start prior to Christmas

with attractive TV ads for certain special toys. The kids, naturally, want what they see and extract Christmas promises for these items from their parents. Now here's where the genius of the companies' plan comes in: They under-supply the stores with the toys they've gotten the parents to promise. Most parents find those things sold out and are forced to substitute other toys of equal value. The toy manufacturers, of course, make a point of supplying the stores with plenty of these substitutes. Then, after Christmas, the companies start running the ads again for the other, special toys. That juices up the kids to want those toys more than ever. They go running to their parents whining, 'You promised, you promised,' and the adults go trudging off to the store to live up dutifully to their words."

"Where," I said, beginning to see now, "they meet other parents they haven't seen for a year, falling for the same trick, right?"

"Right. Uh, where are you going?"

"I'm going to take that road-race set right back to the store." I was so angry I was nearly shouting.

"Wait. Think for a moment first. Why did you buy it this morning?"

"Because I didn't want to let Christopher down and because I wanted to teach him that promises are to be lived up to."

"Well, has any of that changed? Look, if you take his toy away now, he won't understand why. He'll just know that his father broke a promise to him. Is that what you want?"

"No," I said, sighing, "I guess not. So, you're telling me that they doubled their profit on me for the past two years, and I never even knew it; and now that I do, I'm still trapped—by my own words. So, what you're telling me is, 'Strike Three.'"

He nodded, "And you're out" (Cialdini, 1993: 65–66).

The toy business is said to be treacherous, according to a Mattel executive, because "Your customers are two feet tall, their tastes are hard to determine, and they don't have a lot of money." It seems from the above story they have found one way, at least, to overcome this treachery.

It must be emphasized that the above risks are *perceived*, not necessarily *actual*, risks, and the perception is in the mind of the customer. The actual probability of service failure is immaterial. Usually, all things being equal, the service provider that offers the lowest perceived risk will be chosen. FedEx's guarantee of "Absolutely. Positively. Overnight." was a strong factor that led to—and maintains—its dominant share of the overnight delivery

market at a premium price. This guarantee was especially important when FedEx began since no one knew whether or not it could actually deliver on its promise. Even though the FedEx guarantee has been somewhat diluted since its inception, it still has incredible appeal to customers everywhere since it lowers their perceived risk.

Popular tax preparation firm H&R Block has offered a guarantee of satisfaction, which lowers the perceived risk to the customer, by stating:

If we make any error in the preparation of your tax return that costs you any interest or penalty on additional taxes due, while we do not assume the liability for the additional taxes, we will pay that interest and penalty. Furthermore, if your return is audited, we will accompany you at no extra cost to the Internal Revenue Service and explain how your return was prepared, even though we will not act as your legal representative.

Of course, the response to this guarantee from members of the accounting profession was, basically, “So what?”—joking you might as well bring your dog along to the IRS for all the help H&R Block was going to be. But that misses the point. The success of Block’s guarantee is it made *overt* a policy many CPAs keep *covert*, thus lowering the *perceived* risk in the customer’s mind. This highlights the importance of making the service guarantee an instrumental part of your firm’s marketing offering, as discussed in Chapter 13. Consider this thought experiment: You want to build a pool for your home. You go online and do some comparison shopping, securing four bids: \$50,000, \$49,500, \$38,700, and \$34,600. Which would you choose? Would your decision be influenced if one of the companies provided a satisfaction guarantee? Would you, like most customers, automatically throw out the low bid, and naturally assume the highest bid was going to provide the best long-term satisfaction?

Be sure to perform a risk analysis using the above seven factors, and find ways to mitigate those risks, keeping in mind it is the *perceived* risk to the customer that is important. Most companies do an inadequate job of assessing and pricing risk; it may make sense to employ the services of an actuary for this type of intellectual capital, and learn the actuary’s famous axiom: There is no such thing as bad risks, just bad premiums.

## PRICING AND THE COMPETITION

An executive responsible for pricing has to be part economist, psychologist, sociologist, investment banker, actuary, finance officer, and accountant,

among other mindsets. Pricing does not take place in a vacuum. It is a multi-disciplinary skill, drawing insights from the academic disciplines of marketing, finance, operations, risk analysis, psychology, economic theory, portfolio theory, and many more. Rarely is a single pricing strategy relevant for an entire product line, or even one product within a line. Pricing is more akin to a game of chess, where one player will make a move, alter the dynamics of the game, and the opponent will try to counteract with their own strategy. For as mathematical as you make the pricing function, judgment and intuition are more important, as they are in chess, according to Garry Kasparov, world chess champion since 1984 (who won, and lost, to IBM's Deep Blue supercomputer):

People who see chess as a scientific pursuit played by some kind of human supercomputer may be surprised, but it takes more than logic to be a world-class chess player. Intuition is the defining quality of a great chess player. That's because chess is a mathematically infinite game. The total number of possible different moves in a single game of chess is more than the number of seconds that have elapsed since the big bang created the universe. Many people don't recognize that. They look at the chessboard and they see 64 squares and 32 pieces and they think that the game is limited. It's not, and even at the highest levels it is impossible to calculate very far out. I can think maybe 15 moves in advance, and that's about as far as any human has gone. Inevitably you reach a point when you've got to navigate by using your imagination and feelings rather than your intellect or logic. At that moment, you are playing with your gut.

Often, your gut will serve you better than your brains. I've been working now on a five-volume book called *My Great Predecessors*, which reviews the development of the game of chess by looking closely at the playing histories of the great players of the past 200 years. When analyzing their games together with a computer, I found something very interesting. It was often at the very toughest moments of their chess battles—when they had to rely on pure intuition—that these great players came up with their best, most innovative moves. Ironically, when the games were finished and the players had the luxury of replaying them for publication, they typically made many more mistakes than they did when actually competing. To me the implication is clear: What made these players great was not their analytic prowess but their intuition under pressure (“Strategic Intensity: A Conversation with World Chess Champion Garry Kasparov,” *Harvard Business Review*, April 2005, 50).

Having pricing skills similar to a chess master might seem far-fetched, but is there any doubt this skill is what is sorely missing from companies' core

competencies today? One very useful method executives can learn from chess masters is their analysis of a game after it has been played. A similar strategy, known as after-action reviews, will be proposed in Chapter 21, in order to develop pricing skills within the organization.

All too frequently, executives will complain about price problems and price pressures, but these are rarely mere pricing problems. They usually deal with communication, branding, image, product, distribution, service excellence, segmentation, and other ill-conceived, ignored, or poorly executed functions of a cohesive marketing strategy not focused on value.

Executives will also let capacity utilization play a devastating psychological game with their pricing, especially when it is underutilized. The logic seems to be “better some job (at a low cost) than no job at all.” Yet, this could have very serious long-run consequences, such as sending a message into the market that your firm will capitulate on price, thereby degrading the integrity of your pricing. It also rewards your customers for shopping on price, a practice they will continue unabated until forced to make a value trade-off.

Almost all companies claim to want to sell a differentiated product or service, but often the sales force is not given the proper training, or incentives to do so. Pricing on value takes time, energy, executive attention, and resources. There is no such thing as a free competitive advantage. Many salespeople will resort to their comfort zone and cut price in order to make sales quotas. Price is perhaps the quickest way to influence sales volume, and it is certainly easier than branding, image, distribution, packaging, marketing, product changes, design, and service excellence, not to mention cheaper. While it is the sales force that executes a pricing strategy, it is the executives who design and disseminate it, and ultimately it is their responsibility to ensure pricing becomes a core competency within the organization.

It must be constantly remembered that pricing can only capture value, it does not create it (although it can certainly enhance the perception of it). Value is created based on a company’s competitive advantages. If a company is not attaining its desired price from its customers, usually more is wrong than simple “cutthroat” competition.

None of this discussion should be taken to imply a business should not be cognizant of its competitors’ pricing strategies; customers certainly will be, especially through the Internet. But it is far too easy to fall into the oft-repeated error of thinking your competitors set the upper boundary of your price. Your customers’ perception of value sets the boundaries of your price, both the lower and the upper end. If you listen closely enough, your cus-

tomers will always communicate to you—both in words and, more importantly, in actions—what price they are willing and able to pay.

Pricing is an art, not a science. It cannot be reduced to precise mathematical formulas and checklists. To be successful, pricing must be adapted to both the internal and external environments of the business. Pricing is a strategic marketing decision, and deserves just as much attention as—if perhaps not more than—packaging, distribution, advertising, and promotion. Pricing decisions need to be made with a full understanding of the long-term ramifications of those decisions. Lowering price to make the next sale should never be permitted, unless it is part of a coherent marketing strategy.

The customer segmentation strategies discussed in this chapter are a vital component of implementing price discrimination strategies in order to capture value and maximize profits. Let us now examine how ubiquitous this practice is in the business world, illustrating how reliably and authoritatively the economic theory explains the reality.





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# 16

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## PRICE DISCRIMINATION IN PRACTICE

*...[N]ot only is price discrimination pervasive in society, it is an important way in which society covertly and unintendedly redistributes consumption, much of it from rich to poor... [I]ts effects on output and welfare relative to single-price firms with monopoly power are likely to be positive... [I]t tends to make consumption more equal across income classes.*

—Mark Skousen and Kenna C. Taylor,  
*Puzzles and Paradoxes in Economics*, 1997

One of the most scorned and disdained—and least understood—pricing strategies is employed by the airline industry, illustrated by this anonymously authored e-mail about purchasing house paint, circulated in Australia where Qantas has a large share of the market:



First a reprise of how ordinary hardware stores sell paint:

Customer Hi. How much is your paint?

Salesman We have normal quality paint for \$18 a litre and premium paint for \$25. How many litres would you like?

Customer Five litres of normal paint please.

Salesman Great. That will be \$90.

Now, imagine you are buying paint from Qantas: First you spend days trying to reach them by phone to ask if they have paint. Nobody answers. So you drive to a Qantas store.

- Customer Hi. How much is your paint?
- Salesman Well, sir, that all depends on quite a lot of things.
- Customer Can you give me a guess? Is there an average price?
- Salesman Our lowest price is \$12 a litre, and we have 60 different prices up to \$200 a litre.
- Customer What's the difference in the paint?
- Salesman Oh, there isn't any difference; it's all the same paint.
- Customer Well, then I'd like some of that \$12 paint.
- Salesman When do you intend to use the paint?
- Customer I want to paint tomorrow. It's my day off.
- Salesman Sir, the paint for tomorrow is the \$200 paint.
- Customer When would I have to paint to get the \$12 paint?
- Salesman You would have to start very late at night in about 3 weeks. But you will have to agree to start painting before Friday of that week and continue painting until at least Sunday.
- Customer You've got to be kidding!
- Salesman I'll check and see if we have any paint available.
- Customer You have shelves FULL of paint! I can see it!
- Salesman But it doesn't mean that we have paint available. We sell only a certain number of litres on any given weekend. Oh, and by the way, the price per litre just went to \$16. We don't have any more \$12 paint.
- Customer The price went up as we were talking?
- Salesman Yes, sir. We change the prices and rules hundreds of times day, and since you haven't actually walked out of the store with your paint yet, we just decided to change. I suggest you purchase your paint as soon as possible. How many litres do you want?
- Customer Well, maybe five litres. Make that six, so I'll have enough.

- Salesman Oh no, sir, you can't do that. If you buy paint and don't use it, there are penalties and possible confiscation of the paint you already have.
- Customer WHAT?
- Salesman We can sell enough paint to do your kitchen, bathroom, hall and north bedroom, but if you stop painting before you do the bedroom, you will lose your remaining litres of paint.
- Customer What does it matter whether I use all the paint? I already paid you for it!
- Salesman We make plans based upon the idea that all our paint is used, every drop. If you don't, it causes us all sorts of problems.
- Customer This is crazy!! I suppose something terrible happens if I don't keep painting until after Saturday night!
- Salesman Oh yes! Every litre you bought automatically becomes the \$200 paint.
- Customer But what are all these "Paint on sale from \$10 a litre" signs.
- Salesman Well, that's for our budget paint. It only comes in half-litres. One \$5 half-litre will do half a room. The second half-litre to complete the room is \$20. None of the cans have labels, some are empty and there are no refunds, even on the empty cans.
- Customer To hell with this! I'll buy what I need somewhere else!
- Salesman I don't think so, sir. You may be able to buy paint for your bathroom and bedrooms, and your kitchen and dining room from someone else, but you won't be able to paint your connecting hall and stairway from anyone but us. And I should point out sir, that if you paint in only one direction, it will be \$300 a litre.
- Customer I thought your most expensive paint was \$200!
- Salesman That's if you paint around the room to the point at which you started. A hallway is different.
- Customer And if I buy \$200 paint for the hall, but only paint in one direction, you'll confiscate the remaining paint?

Salesman No, we'll charge you an extra use fee plus the difference on your next litre of paint. But I believe you're getting it now, sir.

Customer You're insane!

Salesman But we're now THIS COUNTRY'S only paint supplier! And don't go looking for bargains! Thanks for painting with Qantas.



Once the airlines were placed into open competition by the Airline Deregulation Act of 1978, pricing decisions were no longer set by government fiat. Southwest perfected a two-tier pricing system—peak and off-peak—that basically applied the economics of price elasticity to passenger flight, and charged passengers based upon their price sensitivity to a given fare. Other airlines also developed sophisticated price discrimination strategies—referred to as yield management—and the pricing of tickets became very sophisticated, not to mention complicated, as the United States airline industry changes its prices 12 million times a day.

A fascinating book by Robert G. Cross, *Revenue Management*, candidly reveals the secrets of airline pricing. Cross, a lawyer, accepted a position in the legal department of Delta Air Lines at the time of deregulation. In the mid-1980s, he found himself in the marketing division in a “free-formed position designed to identify problems and new opportunities on the marketing side.” He explains that airline performance is measured by two basic metrics:

Yield—the amount of money the airline gets per passenger mile

Load—the percentage of seats filled by paying passengers

Cross estimated that if Delta were simply discounting one seat unnecessarily on every flight, it would cost the company \$52 million in annual revenue. At the time, Delta operated approximately 1,500 daily flights for a total of 86 million seats on an annual basis. Here is the dilemma Cross faced in looking into Delta's pricing policies:

Some flights that had been loaded with discount seats sold out well in advance of the departure. But on these flights, Delta would also turn away significant last-minute, full-fare traffic. This added up to a lot of lost revenue. Also, on

numerous occasions we had severely limited discount fares and ended up sending flights out with empty seats that could have been filled with discount passengers...I estimated that Delta was leaving as much as 200 million dollars a year on the table, just from misallocating discount seat availability on its flights. This number was so mind-boggling, I didn't dare tell anyone. No one would have believed it!

In one year's time, Delta realized an incremental revenue gain of \$300 million solely from the new seat inventory control process. This 300 million dollars accounted for half the 600 million dollar turnaround Delta reported in fiscal 1984 (Cross, 1997: 42, 45).

Why do airlines change prices so often? Why are the odds of paying the exact same fare as the person you're sitting next to so low? The answer is found in price discrimination, which some people have a visceral and emotional reaction against, claiming it is unfair and unethical. Yet, what is the alternative? Would it be more fair to charge one price for each seat no matter the type of customer, when they purchased their ticket, whether or not they can make changes to their itinerary, select the times and airports they want to fly to and from, or whether they were flying to see the Olympics or a Super Bowl or a remote location to visit family?

This form of pricing has come under severe criticism as of late, the charge being it does nothing to build customer loyalty, is capricious, and is difficult for personnel to explain to outraged customers who are offered various prices, even within the same day, or hour. Frederick Reichheld, who has done seminal work in the field of customer loyalty economics, explains why he believes this form of pricing does not build loyalty in his book *Loyalty Rules!*:

This price gaming does little to build customer trust or improve convenience. One of the few airlines that has avoided this approach is Southwest, which concluded that the yield management systems are unfair, complicated, and expensive to administer. So Southwest has one price for advance purchase and one fare for unrestricted purchase. Customers know that they are getting a fair deal. The accountants at the competition probably believe that Southwest is leaving a lot of money on the table with this unsophisticated pricing strategy that emphasizes fairness and simplicity over extracting maximum value from every customer, but they cannot deny that Southwest is the only consistently profitable major airline (Reichheld, 2001: 144).

I have tremendous admiration for Mr. Reichheld, but on this issue I must respectfully disagree. Southwest was one of the pioneers of the peak/off-peak

pricing structure. Furthermore, they do indeed engage in yield management and price discrimination. Looking up a flight from Oakland, California, to Burbank, California, on July 13, 2005, for one month away, I found four different fares on Southwest's web site, ranging from \$67 to \$103 one-way, all with various rules and restrictions. If the same trip were to be booked for tomorrow, it would be priced at \$103 one-way. That is quite a range of different prices, even though the overall fare is relatively low, and hardly the two fares Reichheld mentions. The airline industry is a marginal business, and Southwest knows only several passengers per flight make up its profits. Why shouldn't they engage in yield management? Those different tickets are not the same value proposition to every passenger. If you did not have the luxury of being able to plan your trip one month in advance, you would be delighted Southwest has reserved capacity to accommodate you at the last minute. That is not the same ticket as someone who purchased the same flight over one month ago.

Reichheld is confusing simplicity for sameness, yet no two airline seats are the same; it all depends on when you purchase your ticket, Saturday lay-over, what you are doing at your destination (business or leisure), and other rules that are in place in order to estimate the value each passenger puts on the flight. Holding up Southwest's pricing strategy as a model to emulate because it is simple is a *non sequitur*. Try flying Southwest overseas, or even across the United States, which is an arduous task—unless you do not mind stopping multiple times. Southwest has many lessons to teach, such as its excellent service and in managing customer expectations, but its pricing strategies are not that much different from other airlines, and confirm the value of yield management in driving profitability.

Airplane seats are only equal in *retrospect*, after you are sitting on the plane. But customers do not buy in retrospect, they make their purchases prospectively, and one of the things they are purchasing is the certainty of sitting on the flight they want, when they want it. Not only is a product *what* you buy, it is *when* you buy it as well. An apple today is a different product than one tomorrow. This is why the airlines will guarantee a seat to the most valued frequent flyers, on short notice, since these are usually business passengers who must get to their chosen destination. By reserving capacity for these types of last-minute bookers, the airlines are absorbing the risk of the plane taking off with empty seats that may have been sold at a cheaper fare to, say, leisure travelers. Why are the airlines

willing to take this risk? Because they capture a higher price from this segment of traveler. Also, they are, in effect, providing an interest-free loan to last-minute passengers, who are frequently buying first-class, business-class, or full-fare coach tickets. Only those who choose to ignore the economics of price allocation simplistically complain that this is an unfair pricing method.

By engaging in price discrimination, airlines are able to offer a range of prices encompassing more of the demand curve, which actually allows lower income individuals access to more seats than would be the case if they had a one-price policy, which is why so many more millions fly today than 30 or 40 years ago. A world without price discrimination is a world where children would pay the same as adults, no coupons would exist to induce lower-income customers to purchase, no sales would take place, and senior citizens would not receive discounts (why else does one join AARP?). It would be a world where those who value a product more would pay a lower price while those with lower incomes would be prevented from purchasing a product with a lower value to them.

If you pay close attention to pricing methods, you soon discover price discrimination is nothing new; it has a long history. In the days of the railroads, third-class carriages—which were among the cheapest priced tickets—were placed in front of the train where passengers had to tolerate cinders in their hair and eyes since there were no roofs or seats. This is an inherent value trade-off for a lower price. For nonhuman cargo, railroads soon discovered they could charge based on the nature of the cargo, not just its weight—which is what drives costs—a form of customer segmentation to identify less price-sensitive shippers. Even Amtrak and the Eurostar Channel engage in price discrimination, a governmental nod to the efficiency and fairness of this free market practice. Let us look at other innovative examples of this practice, all the while noticing how these various examples segment customers, overcome the four hurdles to price discrimination, and identify which degree of price discrimination is being used, as discussed in Chapter 14.\*

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\*In some instances, price discrimination is illegal if the firm is selling to an intermediary and not to the end-use customer. We will explore the antitrust laws in Chapter 20.

## United States Postal Services

The United States Postal Services (USPS), as well as other services around the world, recognize not all customers are equal by offering first-class rates, bulk rates, postcard, and book rates. Even though mass mailers have lobbied to get their bulk-rate stamps to look like first-class stamps—in order to get customers to open them—the USPS refuses, recognizing the different value offered.

## Tape

3M Scotch and Highland are kept separate, distinguished by the former being able to be removed without tearing, whereas the lower-priced Highland brand tears. Notice how value was *removed* in order to provide a lower-priced brand, a classic value-price trade-off.

## Hardcover versus Paperback Books

John Grishman, Steven King, J.K. Rowling, and other best-selling authors' novels are priced at nearly \$30 in hardback, and around \$10 in paperback. Would you be shocked to discover the production cost to the publisher is approximately the same for both books? What the publisher is doing is having those fans of *Harry Potter* who simply cannot wait for the paperback version, due out in twelve months, self-identify themselves and buy the hardcover, thus extracting an additional \$20 in consumer surplus. The fact that serious book lovers prefer hardcover books to paperbacks (they last longer and look more impressive in one's library) is simply icing on the cake, and merely adds to the perceived value of the hardcover. The real goal is *charging different prices to different customers* based on their individual demand elasticities, not on cost.

## Senior Discounts

The one demographic group in the United States least in need of discounts is seniors. As a group, they are the wealthiest people in society. They have worked all their lives, have had longer to save, and thus have more to show for their accumulated years. So why do businesses offer these wealthy individuals discounts? Seniors have one thing on their hands a lot of other customers lack: time. They tend to seek out and patronize establishments that



offer them discounts, even if they must arrive at certain times or clip coupons, referred to as *hurdle pricing*. Part of this may be because many of their *reference* prices were formed during the Great Depression, or shortly thereafter. If a restaurant can make a profit serving a senior citizen a prime rib dinner at \$7.95, what are they earning from a customer who pays \$12.95? Restaurants engage in the same practice with “early bird” dinners and by charging much higher prices on the dinner menu—where meals are more likely to be enjoyed and valued more—than on the lunch menu for basically the same food.

### Children’s Prices

At the fair, Disneyland, and movies, and on planes, trains, and buses, kids take up the same amount of capacity, yet they are charged a lower price than an adult. This is done to prevent discouraging parents from bringing their families, and because children have a more elastic demand curve than their parents. But from a cost standpoint, is it any cheaper for the airline to fly a child than an adult?

### Nightclubs

Arrive early and admission is free and happy hour drink prices are less—tactics used by the owner to attract crowds early so that by nighttime it is a happening place, when the owner will be able to extract a cover price from the nightclub crowd. The concept of a cover charge is a two-part tariff—similar to the movie theater popcorn strategy discussed in Chapter 1.

### Newspapers

This one is obvious: Newsstand purchasers pay more for their newspapers than subscribers, who pay a cheaper, subsidized rate, covered by the advertisers. The cheaper subscription rate helps boost circulation, thereby increasing the advertising rates that can be charged. *Different customers, different prices.*

### Automobiles

Many cars from the divisions of GM—as of this writing, Chevrolet, Pontiac, Buick, Cadillac, and GMC—are produced in the same plant, with little vari-

ance in cost. Yet when those cars arrive at the showroom, the sticker price of a Cadillac is far higher than a Buick, and no doubt higher, as a percentage, than the variance in the cost of production. This is GM's way of having a car for each location on the demand curve, the theory being that you will be loyal to GM from your first car (a Chevy) to your last (a Cadillac). This is the embodiment of a car for "every purpose and purse," Alfred Sloan's famous price pyramid strategy.

A Geo Prism and a Toyota Corolla are built on the same assembly line, but the Toyota sells for over \$2,800 more. Mercedes-Benz has decided to serve the high-end market with its Maybach brand, selling for \$300,000.

### Lexus Lanes and Congestion Pricing

New toll systems are emerging throughout the world, and not just highways, bridges, or tunnels, but entire cities, such as Singapore and London, which charge various tolls depending on the day of the week and the time of day. Switzerland and Austria began charging trucks under the same method, and Germany and Great Britain are expected to follow by 2008. As drivers have begun switching to more fuel-efficient vehicles, traditional gas taxes have leveled off, and since building new roads is more difficult with increasing governmental budget constraints and environmental impact concerns, many governments are beginning to realize that managing demand through the pricing mechanism makes enormous sense. Fuel taxes may be good for encouraging fuel-efficient vehicles, but they do nothing to solve congestion. The problem with congestion is not lack of roads, since most roads are empty most of the time, but rather an efficient system for allocation—a pricing issue. Presently, capacity is allocated by queuing. Pricing based on time of day would be a more efficient allocation system, forcing users to make price/value trade-offs regarding when and where they drive. As *The Economist* predicts:

So expect the car you buy in, say, 2020 to come with a built-in OBU [On-Board Unit], capable of charging you depending on where and when you drive and how much traffic there is. No doubt it will be able to tell you that it will be rather pricey for you to take a certain road because it is already congested, and suggest an alternative. But it might also be able to inform you about the nearest (and cheapest) petrol station, book your car for servicing and phone the ambulance in case of an accident.

All this could have unpredictable effects. Roads could be more easily privatised, and rates varied accordingly. Car-insurance premiums could be charged by the mile, the kind of road and the reputation of the area the car is passing through. And local and online retailers' fortunes could improve, as shoppers start to think twice about making an expensive trip to a far-away shopping mall ("The Road Tolls for Thee," *The Economist Technology Quarterly*, June 12, 2004, 32).

Consider the Golden Gate Bridge, which charges \$5 per crossing from north to south. If it were to have one lane at \$3, two at \$5 and one at \$15 during peak periods, overall revenues would most likely increase. Landing slots at airports could be allocated by price rather than the existing practice of delaying flights, due to weather or other delays, based on queuing allocation. Larger planes filled with more passengers, and flights with tight connections will value takeoff rights more than their smaller counterparts. Expect to see this type of pricing strategy adopted by governments in the future.

### Free Extras and Trade-in Discounts

When you order a pizza with free delivery, you are being charged less than someone who picks up at the take-out counter. People ordering over the phone have more elastic demand because they can easily hang up and order somewhere else. Whenever a merchant is offering "free extras" that only *some* customers accept, they are usually designed to appeal to more price-sensitive customers.

Printer manufacturers sometimes offer trade-in allowances for your old printer if you purchase a new one. Jewelers do the same with watches. They will discard the item as soon as they get it. If you already own what they are trying to sell you, chances are good your demand curve is more elastic than someone who does not own the product; thus, people who already own printers are charged less than those who do not.

### Cosmetics

Cosmair manufactures both L'Oréal and Lancôme cosmetics, among others, which contain virtually identical ingredients; the former sells in drug stores while the latter sells at much higher prices in department stores. Estée

Lauder utilizes the same segmentation strategy with its Lauder, Clinique, Aramis, Prescriptives, Origins, Donna Karan, and jane (teenage) brands.

### Satellites

GE Americom offers a gold, silver, and bronze service, similar to American Express's Green, Gold, Platinum, and Black segmentation strategy. There is no difference in the actual transponder, only in the right of continual usage. If a Bronze user's communication is interrupted, he or she will be switched to another satellite, if available. If a Gold user's service is interrupted, he or she will be reassigned no matter what, even if it means displacing a bronze or silver user. This is another example of how value can be subtracted in order to offer lower price value propositions to more price-sensitive segments.

### Exports

It is not uncommon for products positioned in the country of origin as low-priced goods to be sold as a higher-priced niche product abroad. Lowenbrau beer is a low-priced beer in Germany, but positioned as a premium brand in the United States. Scandinavian Airlines (SAS) charges more for flights *from* Scandinavia—where its market is more captive—than *to* Scandinavia, where customers have alternative destinations.

### British Pubs

You would not normally associate British pubs with dynamic pricing policies, but as *The Economist* reports, they are experimenting with a process called “business intelligence,” which combines customer relationship data mining with pricing on the margin:

The traditional British pub seems like an unlikely place to find the latest in data mining. But some pub chains now change the prices of different drinks from day to day, using software that assesses the impact that “happy hour” offers have on sales. If discounting a particular beer boosts sales one day, it is likely to remain discounted the next—and if not, something else will be tried. As well as being much faster than traditional data mining, this kind of thing requires many other elements to be in place, such as the capacity to track inventory accurately and re-price products dynamically. So the term “data mining” is being displaced by “business intelligence” (BI), which comprises

the other necessary elements as well (“A Golden Vein,” *The Economist Technology Quarterly*, June 12, 2004, 22).

### **Local Resident Discounts**

Many golf courses, theme parks, and hotels in resort locations offer local residents discounts, knowing they are more price sensitive than tourists. Disneyland offered a “Resident Salute” discount of \$20 off the normal admission to locals; a few weeks later the first Gulf War started and its revenues maintained while that of its competitors nose-dived.

### **Weight Out**

Rather than raising or lowering prices, some manufacturers will reduce (or increase) the size of their products, since customers are usually less likely to notice weight than price. Also, ingredients can be added that change the nature of a product to prevent customers from purchasing a low-price alternative for a higher-valued product, such as salt added to cooking wines to prevent them from being used as drinking wines.

### **College Tuitions**

Colleges are masters at price discrimination, charging different students different tuitions based on a host of identification and segmentation strategies—state resident versus out-of-state residents, scholarships, financial aid, and so forth.

### **Hotels and Resorts Minimum Stay**

During special events, such as peak ski season or college graduations, local hotels and resorts may institute a three- or four-night minimum stay policy. This is much more palatable to most customers than a doubling or tripling of a normal single night price.

### **Theaters**

The most expensive seats will be sold first, thus discouraging patrons from buying the cheap seats and then moving to the more expensive ones during the performance. Furthermore, theater operators will allocate the total seats

at various prices, depending on the best view, a process known as “scaling the house.” Bruce Springsteen concerts now require specific identification—similar to airline tickets—to avoid arbitrage (i.e., scalpers).

### **Value—Not Cost—Drives Price**

Cost and value are sometimes inversely related. Laser printers are valued by the printing speed per page; the less expensive printers have higher-priced components to slow them down. FedEx’s two-day and three-day service is priced lower, but arrives at the depot the same day and must be held, raising the cost of handling (albeit minimally). It costs airlines more to fly minors, due to increased security and monitoring costs, yet they pay less.

### **Customer Loyalty Programs**

From airlines to casinos, customer loyalty programs have become a popular segmentation strategy. Not only do they provide a reason for customers to become, and remain, loyal, but they are also a strategic pricing mechanism. If you are a frequent flyer on a particular airline that does not fly where you need to go, you will be forced into flying with a competitor. Assume the airfare would be the same between your carrier and the competitor’s. Because you are not earning any miles, the competitor’s flight is actually valued less, and therefore the competitor is charging a noncustomer a *higher* price. Alternatively, if you were to purchase the same ticket on your preferred carrier, you would value it more at the same price, leaving room for the airline to charge a premium. Loyalty programs also use the carrot incentive approach, holding out various perks if you are willing to spend more of your budget exclusively with them.

### **Men’s Shirts versus Women’s**

Why do men’s shirts cost less to dry clean than women’s? Is it because women’s blouses contain more delicate fabric? Then why not just discriminate based on the fabric (as is usually done with silk)? If men’s shirts are machine pressed and women’s hand pressed—thus requiring more labor—then why not just different prices for different types of pressing? Are men more price sensitive, and more likely to tolerate dirty shirts? Do women demand higher-quality work, complain more, or cause more rework? Is it

due to greater customer loyalty? To a dry cleaner? If there were not substantial cost differences between serving men and women, why do we not see some dry cleaners specializing in just women, charging a price below what other cleaners charge women, but higher than what they charge men? All things being equal, the more competitive an industry, the less price discrimination exists. We do not see farmers or gasoline stations offering senior citizen discounts. Either women's shirts are more expensive to clean, or there is price discrimination. Economists who have researched this issue are not clear which is the answer. Many states have passed laws outlawing this type of discriminatory pricing, with the predictable result that men's prices have increased rather than women's decreasing.

### Planned Obsolescence?

In the late 1950s, Vance Packard published *The Waste Makers* and introduced the term *planned obsolescence*. Do companies really plan for obsolescence? Would companies really not want to sell one pair of panty hose for \$52, rather than making 26 separate sales at \$2? Think of the lower transaction costs resulting from one sale rather than 26. Perhaps the real reason is women do not want to spend \$52 for one pair of pantyhose; what if they are lost, or they do not have \$52 to spare? So, the company is actually providing a risk against loss, or providing a \$50 loan. Obsolescence occurs because customers reveal a preference for new products, not from sinister motives of companies.

### Nonmarket Price Discrimination

Economists study human behavior with the theories and models they have developed to study market transactions. Some of these theories provide enormous insight to behavioral choices outside the realm of goods and services, such as 99-cent pricing and diamond engagement rings discussed in Chapter 6. Consider mandatory motorcycle helmet laws. These laws make it harder for insurance companies to discriminate in favor of more safety-conscious riders; these types of nondiscriminatory laws carried to an extreme would imply that Evil Knievel should pay the same insurance as a weekend motorcyclist. When local governments learn continuous parking tickets do not have the deterrent effect they desire for some residents in congested areas, they apply a Denver Boot to the car, thus raising the price of illegal parking for the least price-sensitive parking violators.

If you were to see Anna Nicole Smith walking down the street holding the arm of an older gentleman, what type of assumption would you be safe in making regarding his wealth? Anna is engaging in a type of price discrimination since she knows the older man has limited desirable traits to offer a potential mate other than his enormous wealth.

One of the many controversies surrounding the death penalty is whether or not it is a deterrent to murder. Applying the economic principles of price theory to this situation—which economists such as Gary Becker and Isaac Ehrlich, among others, have done—you could derive a demand curve for murder. Whether it would be an elastic, or more inelastic, demand curve is subject to empirical testing, just like any other good or service purchased. One effective way to test the deterrent effect of the death penalty is to vary the price and observe the changes in the choices murderers make. For example, if you murdered on Monday, Wednesday, or Friday, you would receive a life sentence with no possibility of parole. If you murdered on Tuesday, Thursday, or the weekend, you would get the death penalty.

### **New Product and Service Offerings**

As was discussed in Chapter 13, the value proposition of any company is price, quality, and service. There is no doubt that price can be an effective way to compete for some companies. Think of Wal-Mart, Southwest Airlines, Costco, Dell Computers, or Timex watches. All of these companies have used price as an effective competitive differentiation and have relentlessly driven out needless costs from their operations. On the opposite side of the spectrum there is Nordstrom, Lexus, FedEx, Bose, and Disney, all of which command premium prices because they offer premium quality, total quality service, and exceptional experiences. In the middle are companies such as JC Penney, Buick, Casio watches, and Sony televisions, where price plays a more neutral role.

When launching a new product or service, any business has to decide between three generic pricing strategies: skim pricing, penetration pricing, and neutral pricing. Selecting one of these methods is a major strategic marketing decision, not to be taken lightly, and must be adopted by the leaders of the organization, because it will transmit a definitive message to the marketplace regarding the firm's offering. The price a company puts on its new product is a distinct message to potential customers of what the value of the product is, and this signal usually dwarfs any advertising, marketing, and



promotion undertaken in the product launch cycle. The different prices reflected in these three strategies are not defined by the company's price relative to that of competitor's similar offerings, but rather a strategy to drive sales. The price in each of these strategies is actually defined relative to the value of the product being offered.

Many companies make the serious mistake of underpricing a new product under the assumption it is necessary to induce customers to try the new offering. According to Michael Marn et al., price consultants at McKinsey & Company, in their book *The Price Advantage*, this error is more common than not:

In our experience, when a new product pricing error is made, 80 to 90 percent of the time the release price is too low. Release price, also launch or target price, is the price you want the market to associate with that product. More than any press release, sales pitch, or catalog description, the release price tells the market what a company really thinks a new product is worth (Marn et al., 2004: 93).

Let us examine the three pricing strategies in order to gain an understanding of which strategy is appropriate given the realities of the marketplace.

### Skim Pricing

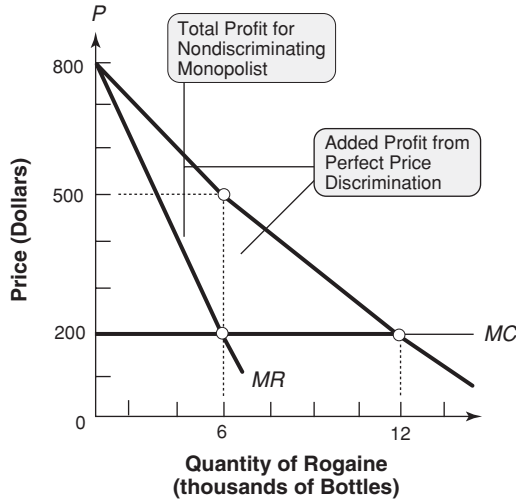
In any market, there is a certain segment of buyers who are relatively price insensitive because they value the offering so highly. Think of early adopters in the technology industry who rush to purchase the latest and greatest gadgets, newest high-speed computers, printers, and audio equipment, such as the 500 videophiles who purchased the first VCRs—made by Ampex—from Neiman-Marcus between 1963 and 1968 for \$30,000.

Skim pricing is a conscious decision to sell to this segment at premium prices more commensurate with value, thereby earning more profit than could be made selling at a lower price to an albeit wider market. The firm is not so much interested in market share as it is in extracting the perceived value from this smaller segment of the market. When Apple Computer launched its iPod—touted by Steve Jobs as the “Walkman of the twenty-first century”—in October 2001 they priced it at \$399, more than double the price of competing MP3 players. This launch coincided with the nadir of the dot.bomb economy, Intel admitting it could not successfully enter the consumer electronics market, lawsuits being filed over downloadable music, and

the country still reeling from the 9/11 attacks. Internet discussion boards wittily suggested that iPod meant “idiots price our devices,” and “I prefer old-fashioned discs.” Hardly. By summer 2005, Apple had shipped its 21 millionth iPod, and sold 4.5 million during the prior year’s holiday season alone, with market share growing from approximately one third to two thirds between 2003 and 2004 for the high-capacity, hard disc–based music players, providing a profit to Apple for each iPod almost equal to the profit from the flagship iMac computer, while costing a fraction of the iMac to manufacturer (proving, once again, that value drives price, not costs). The iPod’s complementary music store, iTunes, has achieved a 70 percent market share for legal, downloadable music. Bill Gates has stated publicly that Apple should enjoy this success while it lasts, because it will not last, the logic being cell phones or other personal digital assistants will enable people to access music easier than carrying around a separate iPod. Yet this is debatable from an experience point of view. An iPod gives users complete control over their environment, and allows them to escape the daily mundane. It has been noted that iPod users are far more selective in answering their cell phones, suggesting that combining these functions may not be perceived as valuable since it would be an intrusion of privacy. The iPod strategy also proves the market share myth, discussed in Chapter 4. The market share it generated was a manifestation of a successful value proposition, not a cause.

Similar to technology, new drugs are also good candidates for a skim pricing strategy. When Upjohn launched Rogaine, it ran an ad that read, “Gentlemen, start your follicles.” Like Revlon founder Charles Revson, Upjohn knew it was selling hope, not necessarily hair, since Rogaine does not work 100 percent of the time. Upjohn also used a skim-pricing strategy, by having the product only available, at first, by doctor prescription, giving it enormous creditability in the marketplace. And while this strategy may take longer to diffuse the product into the broad marketplace, it does capture a larger portion of the consumer surplus from the early adapters, precisely the customers who value the product the most. To illustrate how much more profitable this pricing method can be, consider the graph in Exhibit 16.1 for a “hair growth” product (all numbers are fictional):

Assume fixed costs are zero while marginal costs are constant at \$200 per bottle. If a single profit-maximizing price were set, the manufacturer would charge \$500 per bottle and sell 6,000 units; total profit would be \$1,800,000 [ $(\$500 - \$200) \times 6,000 = \$1,800,000$ ]. But can the manufacturer benefit from price discrimination?



**EXHIBIT 16.1** Price Discrimination—Sequential Skimming

For example, sell the first few bottles for between \$800 and \$799, the next few for between \$799 and \$798, and so on, until the last bottle is sold for only a fraction over \$200—sometimes referred to as *sequential skimming*. If done successfully, price discrimination allows the manufacturer to boost profit from the \$1,800,000 (the rectangular area) associated with normal monopoly pricing to \$3,600,000 (the area of the entire shaded triangle above marginal costs) (adapted from Byrns and Stone, 1991: 552–53).

The early adopters paid the \$800 per bottle. Today you can purchase Rogaine at Costco, and the price has dropped more toward the marginal cost. However, Upjohn was able to capture a larger portion of the consumer surplus by adopting the sequential skimming-price strategy. This strategy is appropriate when:

- The product performs better than existing alternatives.
- There are early adapters who will value the product highly (more inelastic demand curves).
- Demand will become more elastic over time, especially as competitors enter the market.

- A skim price sets a *reservation* (or walk-away) price during an experimental launch, giving the company the choice of when it decides to reduce price.
- A company does not have the capacity and/or financial wherewithal to meet expected demand.
- A high price will signal high quality, especially if the product is a credence product.
- It signals to actual and potential competitors that the company does not want a price war.

None of the above is meant to imply that there are not disadvantages with a skimming-price strategy. As with all pricing decisions, there are no absolute solutions, only trade-offs, and these must be considered strategically, depending on the objectives the company is trying to achieve in the long run. Some disadvantages of a skim price are:

- It will not induce customers to try the product as much as a neutral or penetration price.
- It will take longer for a product to diffuse and become generally accepted in the market.
- If a skim price generates supernormal or windfall profits, it will attract competitors.

## Penetration Pricing

Penetration pricing is when the company decides to set the price below the product's value to the customer, thereby ensuring a larger customer base. It is the trade-off of higher sales volume versus higher margins, and can be a very effective strategy especially for new entrants into particular markets.

Penetration prices are not necessarily cheap, but they are low relative to perceived value. For instance, Lexus used a penetration pricing strategy in order to bring Mercedes, Audi, BMW, and Porsche to its knees when it launched its LS (luxury sedan) 400 in early 1989 at \$35,000, 40 percent less than BMW and Mercedes, and the same as Cadillac. The Lexus was relatively inexpensive compared to its value, and it was also less expensive relative to its competitors, and thus was perceived to offer a higher value. MCI and Sprint used penetration pricing against AT&T after the telecommunications market was deregulated, to great success.

Apple's iTunes deployed a penetration price strategy, at \$1 per downloadable song. And although it has achieved a 70 percent market share, it actually breaks even but drives sales of the iPod, where the profits are generated. Apple Computer, which has a global market share in computers of about 3 percent, selected this strategy with its Mac mini. Using a "halo effect" from its successful iPod, Apple is trying to induce Windows users to give the Mac a try, convinced many would find it superior to Windows. The penetration price for the Mac mini is \$499, or \$599 for a more powerful version, approximately \$800 less than the flagship iMac. The value trade-off for the user is, in CEO Steve Job's words, BYODKM, or "bring your own display, keyboard and mouse." This is a new strategy for Apple, which has always maintained relatively high prices for its computers. Yet the penetration price shrewdly mitigates two risks: it is unlikely to cannibalize existing sales and profit margins; and it just might induce many Windows customers into making the switch, for as Jobs says, "people who are thinking of switching will have no excuse."

Penetration pricing is appropriate when:

- Demand for the product is relatively elastic and very sensitive to price changes.
- Search or experience products are involved that can be easily judged by customers before or after use.
- Economies of scale or scope can be achieved in producing massive quantities.
- The threat of competitor imitation is very strong.
- Not a large enough segment is willing and able to pay a higher price.
- The company has available capacity and financial wherewithal to produce in large volume.
- A low introductory price may prevent competitors from entering the market.

Penetration pricing can be used at any stage in the product or service life cycle, and is usually deployed after a steady customer base is established in order to drive sales. To reiterate, though, it is a price set relative to the product's value, not a competitor's pricing strategy. Do not let your competitors determine your price, because they have no interest in your firm's long-term viability.

## Neutral Pricing

The neutral pricing strategy is generally a default strategy. In effect, this strategy minimizes the role of pricing in the marketing mix, not utilizing price to gain or restrict market share. A company may select this strategy when it knows its product, promotion, or distribution offers other more powerful advantages to the customer. The neutral price does not mean a price in between that of competitors, but in relationship to value. Apple laptop computers and Sony televisions, for example, are consistently priced above competitor levels, but because they offer such excellent value, the market still perceives the price as neutral.

Another reason to adopt a neutral price is to maintain the coherence of a product line. General Motors, for instance, priced its Chevrolet Camaro at a level that made it affordable to a wider market, even though there was a certain segment of that market willing to pay more for its sporty appearance and performance. Because GM already had a skimmed price product in its lineup, the Corvette, it did not want to be redundant by offering another one. The Chrysler PT Cruiser and Mazda Miata were priced neutrally, and many believe far below value, while the manufacturers saw the strategy as a way to draw traffic into the showrooms by being associated with a “hot” car, a clear example of the pricer’s nightly dilemma: “How much money did I leave on the table today?”

All of the price discrimination and segmentation strategies discussed in this chapter explicitly recognize that not all customers are created equal. Charging different prices to different customers based on the subjective value they place on your offerings is one of the most effective ways to increase a firm’s profits, without adding proportionately to overhead. Developing the strategies necessary to take advantage of price discrimination takes innovativeness, creativity, and experimentation—the same characteristics needed in order to avoid the so-called “commodity trap,” which we turn to next.

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# 17

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## THERE IS NO SUCH THING AS A COMMODITY

*There is no such thing as a commodity.  
All goods and services are differentiable.*

—Theodore Levitt, *Harvard Business Review*,  
January–February 1980

During the days of Prohibition, 25 of Chicago’s top bootleggers were rounded up in a surprise raid. During their arraignment, the judge asked the usual questions, including the occupation of each suspect. The first 24 were all engaged in the same activity. Each claimed he was a real estate agent. “And who are you?” the judge asked the last prisoner. “Your honor, I’m a bootlegger,” he said. Surprised, the judge laughed and asked, “How’s business?” “It would be a lot better,” he answered, “if there were not so many realtors around.”

G.K. Chesterton once wrote, “Competition is a furious plagiarism.” Yet the fact of the matter is there is *no such thing as a commodity*. Anything can be differentiated, which is precisely the marketer’s job. Believing that your company—and the products and services it offers—is a commodity is a self-fulfilling prophecy. If *you* think you are a commodity, so will your customers. How could they believe otherwise? This notion of selling a commodity is one of the most pernicious beliefs, which leads to price wars, incessant copying of competitor’s offerings, and lack of innovation, creativity, and dynamism, not to mention suboptimal pricing strategies. Consider this story from *The Tom Peters Seminar*:

Transformation. Breaking the mold. Anything—ANYTHING—can be made special. Author Harvey Mackay tells about a cab ride from Manhattan out to La Guardia Airport: First, this driver gave me a paper that said, “Hi, my name

is Walter. I'm your driver. I'm going to get you there safely, on time, in a courteous fashion." A mission statement from a cab driver! Then he holds up a *New York Times* and a *USA Today* and asks would I like them? So I took them. We haven't even moved yet. He then offers a nice little fruit basket with snack foods. Next he asks, "Would you prefer hard rock or classical music?" He has four channels. [This cab driver makes an above-average amount per year in tips.] (Peters, 1994: 235–36)

If a taxi cab driver can establish a rapport with a complete stranger in a 15-minute ride to the airport, what is possible with a customer relationship over the course of a lifetime? Note how the cab driver differentiated himself with low-cost items (newspaper, candy, and so on). It is not the cost that counts, but the value *perceived* by the customer; and in this instance the little touches make all the difference. If a taxi cab driver can be this imaginative and creative, what is the excuse of today's business leaders? Peters expounded on this theme in his later book *The Circle of Innovation*:

But my sympathy and empathy run (TOTALLY) out when it comes to... professional services... of any sort. Oy vey! I've had Big Six accountants tell me that the audit is "becoming commoditized." I've had engineering-services professionals tell me that their business is being determined "entirely by price." I've had trainers lament that "leadership training" is now a commodity.

And... it makes me sick. Look... THE DELIVERY OF A PROFESSIONAL SERVICE IS ABSOLUTELY, POSITIVELY NOTHING MORE THAN THE DELIVERY OF YOU AND/OR ME!

Is the person you see when you look in the mirror at 6:00 A.M. a "commodity"? No! It's Tom Peters. It's Mary Jones. It's Jeff Smith. It's Jane Doe. It is a person. Singular. With character. Unique skills. The delivery of professional services is the delivery of... Jane Doe, Tom Peters, and so on.

If professional services become "commoditized," it means that you and I have become commoditized. I say again: The delivery of a professional service is the delivery of who you are, who I am. P-E-R-I-O-D (Peters, 1998: 324).

The potential for competitive differentiation is limited only by your company's imagination. Many business leaders lament that since their industries are mature, commoditization is inevitable, despite all the empirical evidence surrounding them that this is simply not so. Consider candles, an industry literally in decline for the past 300 years. Yet Blyth Industries custom tailors its candles for the specific location, companion, and occasion, growing from \$3



million in sales in 1982 to nearly \$500 million in 1996, with a market capitalization of \$1.2 *billion* dollars in 1997. Candles!

Even the declining lettuce business has been differentiated by prewashing it, cutting it up and packaging it—along with some salad dressing on the side—for the customer in order to save time. As a result, from the late 1980s to 1999, a \$1.4 billion industry was created. And Great Northern Wholeaves Lettuce has come up with the innovation of *ripped* lettuce (not cut), offering restaurants a way to handle waste and save time. Wholeaves Lettuce commands a premium price. Lettuce!

Dean Foods accomplished much the same thing with milk, another mature industry. Since 80% of milk is consumed at home, and people are spending less time eating at home (in 1997, spending on take-away meals and restaurants was larger than spending on groceries), Dean Foods created Milk Chug, making milk portable and convenient, causing a 269% rise in milk sales in Chicago, and the first per capita increase in milk consumption in the past 20 years.

Also in Chicago, the Three Dog Bakery has created a niche in selling cakes and pastries for your dog. The World Bank estimates that one-half of the world's population survives on less than \$2 per day, yet wealthy pet owners are spending approximately \$16 on birthday cakes—for their dogs.

It is not easy to compete with Band-Aid, a product that has become a noun. Yet Curad put cartoon characters on their bandages and kids preferred them over Band-Aid. How could you make a collectible version of your product?

Design can be another very effective competitive differentiation. Why is paint sold in cans? Cans are awkward, hard to open, pour, store, and so forth. Dutch Boy finally figured out that if it redesigned its packaging, placing the paint in light, easy-to-carry and easy-to-pour jugs, it could differentiate itself. Newspapers suffer from the same traditional thinking, continuing to print on oversized pages, which dates back to Walpole's time when the government could not curb the opposition press, so it decided to put a tax per page. Hence, the larger pages were originally a tax avoidance scheme, and certainly have not persisted because they are convenient for readers. Some industries are prisoners of their history.

Wineglass maker Riedel, an Austrian firm, has been in the glass business for over 300 years. Recently, they have introduced a series of ten glasses, each with a customized shape and sized for different types of wine, ranging in price from \$8 to \$85, selling over 5 million per year.

According to Harvard Business School professor emeritus Bob Hayes, “Fifteen years ago companies competed on price. Now it’s on quality. Tomorrow it’s design.” No one understands the importance of the latter better than Steve Jobs, whose designs create an emotional bond with the customer, as expressed in Apple’s products such as the iMac, iPod, Tiger Operating System, and other products. Owning an iMac is more than merely computing. Customers are buying freedom, adventure, an escape from the mundane, as well as other aspects of owning a computer that cannot be reduced to technical features and benefits, but rather have to be experienced. As Jobs explains:

We don’t have a way to talk about this kind of thing. In most people’s vocabularies, “design” means veneer. It is interior decorating. It’s the fabric of the curtains and the sofa. But to me, nothing could be further from the meaning of design. Design is the fundamental soul of a man-made creation that ends up expressing itself in successive outer layers of the product or service (Young and Simon, 2005: 230).

A.G. Lafley, CEO of Procter & Gamble, wants design, not simply price or technology, to become a key differentiator for the company. In a *Fast Company* interview he was asked, “How do you respond to the notion, popularized by Wal-Mart and others, that prices rule the world?” He replied:

I think it’s value that rules the world. There’s an awful lot of evidence across an awful lot of categories that consumers will pay more for better design, better performance, better quality, better value, and better experiences. Our biggest discussion item with a lot of retailers is getting them to understand that price is part of it, but in many cases not the deciding factor. Design is part of brand equity (*Fast Company*, June 2005, 57).

Hallelujah! Another way to separate your offering from the competition is to offer two offerings side by side, taking advantage of the so-called *isolation effect*, as Norma’s restaurant in Le Parker Meridien Hotel on West 57th Street in New York did when it began offering a \$1,000 omelet on May 5, 2004. Billed on the menu as the Zillion Dollar Frittata—containing six eggs, a lobster, and approximately 285 grams of sevruga caviar—it has this message next to the entry: “Norma dares you to expense this” (displaying an understanding of Category III spending). They also offer a “budget” version of the omelet, which sells for \$100, a bit more palpable when shown after the \$1,000 offering, and an effective marketing strategy. Stanley Marcus—son of one of the founders of Neiman-Marcus and creator of the store’s famous

Christmas Catalog with his and her gifts—always insisted on offering \$100 Christmas Gifts in the store, with the logic being that a bit of the magic of the Christmas Catalog gifts would rub off on the lesser-priced offerings.

Patek Philippe also understands this by offering only four of the most expensive watches they make: the Calibre '89 sold at auction for \$2.7 million, and the other three sold for even more. In comparison the company's \$17,500, or \$2,000 offerings, seem less spendthrift, not to mention the unique value message in its marketing: "Which is perhaps why some people feel that you never actually own a Patek Philippe. You merely look after it for the next generation."

Augmenting your offering to enhance the customer experience is another effective method of avoiding the commodity trap. Even Walt Disney World, certainly a company with a world-class experience offering, continuously innovates new ways to enhance the moments of magic for its guests. In the summer of 2003, it offered guests to the parks an opportunity to rent Pal Mickey for \$8 a day, or \$32 for a week. The doll fits into a backpack and is designed like your average plush toy, but with high-tech features: he knows where you are in the park and can point out attractions, show times, ride height restrictions, line waiting times, where the Disney characters are hanging out, and fun facts and trivia about the parks, all to simulate having your own personal tour guide. For the guests who grow attached to Pal Mickey, they can purchase him for \$50 (*Disney Magazine*, Summer 2003, 18).

Imagine investing \$1 million of your own money into a start-up company selling dolls to girls. Most people would be deterred from facing Mattel and its flagship Barbie doll, but not former elementary school teacher Pleasant T. Rowland, creator in 1985 of The American Girls Collection and founder of the Pleasant Company. Inspired by a trip to Colonial Williamsburg, she reflected on what a poor job schools do of teaching history, and how sad it was that more kids could not visit this fabulous classroom of living history. She explains why she created the company:

I began Pleasant Company more than a decade ago to provide girls with beautiful books, dolls, and pastimes that celebrate the experience of growing up as an American girl. As an educator, I wanted to give girls an understanding of America's past and a sense of pride in the traditions they share with girls of yesterday. Out of this desire, The American Girls Collection was born.

The American Girls Collection and its contemporary counterpart, American Girl Today, were created especially for girls ages 7 to 12—girls who are old

enough to read and still love to play with dolls. For younger girls we offer Bitty Baby, a line of soft, huggable baby dolls, board books, and accessories that encourage creative play and nurturing behavior.

At Pleasant Company, we are committed—as you are—to providing your American girl with rich, age-appropriate play experiences. By choosing the right books and toys for your daughter at the right age and stage of her growth, you protect her development, nourish her spirit, and give her imagination wings (from [www.americangirl.com/corp/html/customers.html](http://www.americangirl.com/corp/html/customers.html), accessed June 29, 2005).

The average American Girl doll sells for \$84, approximately \$60 more than a Barbie. The Chicago store on Michigan Avenue generates \$40 million in sales, attracting more than 1 million visitors annually, making it the highest performing store in the area. According to a company executive, “If you ask any of our twelve hundred employees what business we are in, no one will say ‘the toy business.’ Every one of them will say, ‘We’re in the girl business’” (quoted in Silverstein and Fiske, 2005: 213). The company certainly understands that it sells more than merely tangible dolls by making the “experience” part of its value proposition. In 1998 Rowland sold the company to Mattel for \$700 million.

Would you ever pay more for a share of stock—whose price is publicly listed and traded on the New York Stock Exchange—to one broker over another? After all, how can a share of stock be differentiated? It may be one the few examples of a pure commodity. Before you answer, visit [www.oneshare.com](http://www.oneshare.com), where you can only purchase *one* share of stock at a time, valued primarily as gifts for babies and teenagers. Included in the ten best-selling shares, which you can have framed for an additional price, are Disney, DreamWorks Animation, Boyd’s Collection, Denny’s, Harley Davidson, Microsoft, Lincoln Logs, Vermont Teddy Bear, Krispy Kreme, and Sirius Satellite. You pay the market price for the stock (minimum \$15), a \$39 one-share fee, and a frame ranging from \$44 to \$74 depending on your style choice ([www.oneshare.com](http://www.oneshare.com), accessed January 1, 2005). A share of stock!

How fast is Starbucks growing? “I don’t know for sure,” quipped one comedian, “but I do know they just opened one in my living room.” Opened in Seattle, Washington, in 1971, Starbucks—named after the coffee-loving first mate in Herman Melville’s *Moby Dick*—has grown to over \$5.3 billion a year in revenue. Howard Schultz, the founder, earned a business degree in 1975, and worked for Xerox until he joined Starbucks in 1982 as

an employee. In 1987 he bought the Starbucks chain for \$3.8 million and took it public in 1992. Here is how he explains the phenomenon that is now Starbucks:

We never set out to build a brand. Our goal was to build a great company, one that stood for something, one that valued the authenticity of its product and the passion of its people. In the early days, we were so busy selling coffee, one cup at a time, opening stores and educating people about dark-roasted coffee that we never thought much about “brand strategy.”

We built the Starbucks brand first with our people, not with consumers—the opposite approach from that of the crackers-and-cereal companies. Because we believed the best way to meet and exceed the expectations of customers was to hire and train great people, we invested in employees who were zealous about good coffee.

If you look for wisdom on brand marketing, most of what you’ll find is based on the Procter & Gamble model. That is, you go after mass markets with mass distribution and mass advertising, and then focus on grabbing market share from your competitors. That’s the basic way of life for mature products in established markets.

At Starbucks, we have a different approach. We’re creating something new. We’re expanding and defining the market. We didn’t set out to steal customers away from Folgers or Maxwell House or Hills Brothers. We didn’t go for the widest possible distribution. We set out, rather, to educate our customers about the romance of coffee drinking. We wanted to introduce them to fine coffees the way wine stewards bring forward fine wines. Just as they might discuss the characteristics of a wine grown in a specific region or district of France, we want our baristas to be able to intelligently explain the flavors of Kenya and Costa Rica and Sulawesi.

Today, there’s a lot of marketing rhetoric about adding value to products. At Starbucks, the value was there from the beginning, in the coffee itself. When your average sale is only \$3.50, you have to make sure customers come back. And ours do—on average eighteen times a month (Krass, 1999: 301–4).

The success of Starbucks has been so meteoric, *Harvard Business Review* has labeled it the Starbucks Effect:

Ten years ago, only 3 percent of all coffee sold in the United States was priced at a premium—at least 25 percent higher than value brands. Today, 40 percent of coffee is sold at premium prices. We’ve found plenty of evidence of the Starbucks Effect. When individual companies increase the perceived “premi-

umness” of a product through innovations in the product itself or the way it’s delivered, the entire category can reap higher prices and profits (Vishwanath and Harding, 2000: 17).

If coffee beans and water can be differentiated—not to mention command a premium price—what is the excuse from your marketing department? Not only has Starbucks moved coffee up the value curve, it has also differentiated itself based on payment terms, by offering prepaid credit cards for use in its stores. When the Starbucks credit card was launched in November 2001, 26 million cards were sold, generating more than \$60 million in pre-payments, or about 10% of sales, demonstrating the importance of paying attention to payment terms in your pricing strategy.

Basic economics teaches that it is very difficult to sell something someone else is giving away for free. Yet notice bottled water. Water covers nearly three-fourths of the earth’s surface. Could there be a larger commodity than water? You wouldn’t think so until you read these facts from [www.bottledwaterweb.com](http://www.bottledwaterweb.com), an industry portal:

Walk down a grocery aisle in any town in the U.S., Canada, Europe or Asia and there is a virtual tidal wave of bottled water brands. This \$35 billion worldwide industry continues to grow as water quality concerns and fitness and health awareness increases. Bottled water sales in the U.S. rose 7.5 percent in 2004 to \$9.2 billion, according to Beverage Marketing Corporation, a New York-based research and consulting firm.

PET [Polyethylene Terephthalate, the popular high quality plastic bottle usually produced in smaller sizes (2-liters and under)] bottled water sales in 2004 reached about 23.8 gallons per capita according to Beverage Marketing ([www.bottledwaterweb.com](http://www.bottledwaterweb.com), accessed June 29, 2005).

Perhaps this is why Evian is “naïve” spelled backwards. Charles Revson, founder of Revlon and a man who understood exactly what his customers were buying, illustrated in his famous saying, “When it leaves the factory, it’s *lipstick*. But when it crosses the counter in the department store, it’s *hope*.” Revson refused to believe that what he sold—a relatively straightforward concoction of chemicals—was a commodity, and he reportedly would spend 45 minutes in front of a seminar of his international marketing executives having a dialogue with a glass of water, attempting to illustrate the meaning of product differentiation. As explained by his unauthorized biographer Andrew Tobias in *Fire and Ice*:

...[T]he water glass caught his eye. He picked it up, held it out in front of him, and said, in his friendliest way, "Hello, glass. What makes you different? You're not crystal. You're a plain glass. You're not empty, you're not full..." and then he began telling the glass how it could be made special...by changing the design, changing the color of the water, giving it a stem, and so on (Tobias, 1976: 235–36).

## THE PERILS OF BENCHMARKING

*The best swordsman in the world doesn't need to fear the second-best swordsman in the world. No, the person for him to be afraid of is some ignorant antagonist who has never had a sword in his hand before; he doesn't do the thing he ought to do, and so the expert isn't prepared for him; he does the thing he ought not to do, and often it catches the expert out and ends him on the spot.*

—Mark Twain [1835–1910]

One cause of the commodity trap is ruthless imitation on the part of companies, cloaked in the names of benchmarking and best practices. Rather than investing in research and development and experimenting with innovation, a lot of companies are spending precious executive resources trying to figure out where they are relative to the competition by studying financial indicators and other forms of competitive intelligence.

While no doubt useful for some applications, benchmarking is not a way to build a strategic advantage. It is as if entire industries are gazing at each other's navels and bathing in the same bathwater, rather than looking for ways to change the rules of the game. Pouring over lagging indicators such as financial ratios—debt-to-equity, net income percentages, labor as a percentage of revenue, and so forth—rarely spurs innovation and dynamism within an industry. Comparative financial information has a place, but it must be tempered with a theory of what is being observed if we are to gain an understanding of the underlying causes.

The major problem with benchmarking studies and best practice reports is that one is studying the *results* of a process, but not the process itself. They tend to confuse cause and effect, as Harvard Professor Clayton M. Christensen makes clear in *The Innovator's Solution*:

Consider, for illustration, the history of man's attempts to fly. Early researchers observed strong correlations between being able to fly and having feathers

and wings. Possessing these attributes had a high *correlation* with the ability to fly, but when humans attempted to follow the “best practices” of the most successful flyers by strapping feathered wings onto their arms, jumping off cliffs, and flapping hard, they were not successful—because as strong as the correlations were, the would-be aviators had not understood the fundamental causal mechanism that enabled certain animals to fly. It was not until Bernoulli’s study of fluid mechanics helped him articulate the mechanism through which airfoils create lift that human flight began to be *possible*. But understanding the mechanism itself still wasn’t enough to make the ability to fly perfectly *predictable*. Further research, entailing careful experimentation and measurement under various conditions, was needed to identify the *circumstances* in which that mechanism did and did not yield the desired result (Christensen and Raynor, 2003: 14–15).

Financial averages can be devastatingly misleading without understanding the underlying causes of the results one is observing; I can prove statistically that everyone in the world has, on average, one testicle. Furthermore, there is a *selection bias* in the data being analyzed; rarely is it a truly random sample or a statistically significant sample size.

Avoid benchmarking your competitors—why benchmark mediocrity? Truly effective benchmarking usually takes place outside of one’s industry, such as when Henry Ford was inspired to create the assembly line from a visit to a slaughterhouse where he observed the overhead trolley system. What was standard in one industry became a revolution in another—old ideas in new places.

## COMPETITIVE RESPONSES

What should pricers do when they are confronted with naïve competitors attempting to engage in a price war? Begin by attempting to ascertain—through gathering of competitive intelligence—why they are dropping prices; it may not be to start a price war but rather to simply clear out inventory or utilize excess capacity. Successful companies tend not to spoil the market, the ones offering inferior value propositions do, and thus have the most to gain from initiating price wars. If you find yourself in the unfortunate position of having to offer a price discount, do not announce it publicly, as this will provide a signal to your competition and they may intensify the war. The risk in lowering prices is to signal to customers that



you have been overcharging them in the past, while giving legitimacy to your competitor's offerings.

Examine ways to offer more value at the same price—quicker deliveries or lead times—rather than match the price discount. Offer more favorable payment terms, or longer contracts. Rather than discounting planned price increases, delay them. If you are going to provide a discount to match a competitor, consider doing it only on incremental volume. Consider offering other value-added benefits—co-op advertising, loyalty programs, and so forth—that will maintain the integrity of your “list price” and shift the discounts off-invoice.

Pricers need to consider the total cost of engaging in a price war, not just one battle. You may gain marginal market share by undercutting your competition, but the risk is that you will lower prices throughout the entire industry, which are very difficult to return to prewar levels. Customers, like elephants, have excellent memories, especially at remembering the lowest price they ever paid, which is why grandpa constantly regaled you with stories of how candy used to cost five cents in his day. Price wars can desensitize customers to value, making them focus more on price.

If the competitor should return to more rational behavior with a price increase, immediately follow, so as to reward smart pricing. It is always better to let competitors maintain an advantage based on a higher price than a lower one, since this makes it more costly for them to cut prices in the future. Do not fall prey to what economists call *coordination failure*—a situation in which each firm is reluctant to be the first in its industry to announce a price change. This industry-wide hesitation produces price stickiness.

Imitating competitors' prices is known as *conscious parallelism*, which is lawful in the United States and the European Union as long as there is not explicit agreement among the companies. Of course, as with all antitrust laws, there is an enormous gray area between illegal collusion and lawful conscious parallelism, and it is always wise to engage legal counsel for guidance (see Chapter 20, Antitrust Law). Also weigh the benefits and costs of offering a price match guarantee to your customers, a way to engage in tacit price collusion among competitors. This strategy can result in less competition and higher prices, although this effect is not assured.

Executives need to constantly speak and write about the importance of value and the perils of price wars in industry and trade publications. Be sure not to engage in speculative pricing declarations, since you can announce

only what your company *actually* intends to do with prices in the future. In the final analysis, the best way to avoid price wars is to avoid the commodity trap by offering more value to your customers; but if you are caught in one, these strategies can help to ameliorate the effects and shorten the length of these self-destructive practices.

## PURGING THE COMMODITY WORD

Unless your company decides to compete based on price—such as Wal-Mart, Costco, H&R Block, and Southwest Airlines—you cannot create a loyal customer based solely on being the low-cost provider. If customers are attracted by your low price, they will easily leave for another firm that offers an even lower one. Cutting your price in order to attract a customer rewards customers to constantly ask for future price concessions, thereby subsidizing your worst customers at the expense of your best ones. The notion that customers get excited over a low price anyway is not grounded in reality, as Roy H. Williams humorously points out:

“I WAS CHARGED A FAIR PRICE” is not the statement of an excited customer, yet many business owners mistakenly believe they need only convince the public that they will be treated “fairly” to win their business. Phrases like “Honest Value for Your Dollar” and “Fair and Honest Prices” tempt me to say (with no small amount of sarcasm), “Yippee Skippy, call the press.”

If the most your customer can say when he walks out your door is “I was treated fairly,” your business is pitifully stale and you have virtually nothing to advertise. Why? Because the expectation of “fair treatment” is such a basic assumption in business dealings that most people take it for granted. What we really hope to find is the “delight factor” (Williams, 1998: 88).

This is true whether you sell to business or consumers. As Sean Finn, Senior Vice President of Public Affairs and Chief Logistics Officer of Canadian National Railway Company in Montreal, said about its law firm, “Any time a law firm realizes that we don’t view their services as a commodity, we get a better product. It’s not just a question of money...we look at the value provided.” Why do so many companies ignore this message?

So many companies are prisoners of their past, assuming that the way they have always done it is the only way. Yet it takes creativity and innovation to separate yourself from the competition. Offering only a cheap price is the last

refuge of a marketing department out of ideas for creating value for customers. Former Grateful Dead singer Jerry Garcia expressed it well when he said, “You do not merely want to be considered the best of the best. You want to be considered the only ones who do what you do.”

In any event, there is absolutely no excuse—none—for businesses to think of themselves as commodities. Any company can compete on price; it is truly a fool’s game. On the other hand, competing based on Total Quality Service, positive customer experiences, and transformations requires more thought, creativity, and investment. The commodity trap is a self-fulfilling prophecy, breeding cynicism and stifling creativity, dynamism, and innovation. The old canard—usually expounded by noncreative types—that good ideas are everywhere and it is really execution that matters, would be relatively easy to overcome if only it were true. But it is not true; for if it were, we would have better movies—not remakes of *Bewitched* and *I Dream of Jeannie*—books, products, more memorable experiences, and longer lasting transformations from the companies we patronize. Both ideas and execution are important. There is no effective way to implement a bad idea, and history provides many lessons, from Napoleon invading Russia to countries attempting to implement socialism. Were these bad ideas, or simply a case of poor execution?

As the examples in this chapter illustrate, a company’s marketing function is to differentiate itself from the competition and develop a value proposition that customers are willing to pay a premium price for because of the superior value it delivers. If your company finds itself continually competing on price, it is taking the easy way out—since price is always the easiest way to make marginal sales. It is also the apparent factor to place blame on for an organization’s lack of awesome service and providing a memorable experience. Constant price discounts signal that you are targeting the wrong customer segments, not developing a viable value proposition that separates you from the competition, not getting your share of negotiation success, or offering too much service in your basic package. Do not let your firm acquire a core competency in cutting prices by falling into the commodity trap. More sophisticated customer segmentation can assist you in tailoring various value propositions to different customer groups, while reserving capacity for your best customers, a topic we turn to next.



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# 18

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## BAKER'S LAW: BAD CUSTOMERS DRIVE OUT GOOD CUSTOMERS

*We hold these truths to be self-evident, that  
all men are created equal....*

—Thomas Jefferson, The Declaration of Independence,  
July 4, 1776

Whenever anyone quoted those immortal words from the Declaration of Independence—all men are created equal—Federalist Fisher Ames, an ardent opponent of Thomas Jefferson and a superb congressional orator, would retort, “And differ greatly in the sequel.” While Fisher’s admonishment might not be the best way to administer a country’s laws—where all should be treated equally—it is profound when it comes to understanding no two customers are equal. A German proverb teaches, “He who seeks equality should go to a cemetery.”

The concepts of price discrimination discussed in Chapter 14 are a recognition of this human reality, and while marketers use the term *segmentation*, the concepts are similar. An effective method of segmenting a market is to build “fences” around various segments, a term introduced by Richard Harmer in a speech at PRICEX93 in March 1993 (Nagle and Holden, 2002: 157).

All companies have a theoretical *maximum capacity* and a theoretical optimal capacity. From a strategy perspective, it is essential to see how that capacity is being allocated to each customer segment. Your maximum capacity is the total number of customers your company can adequately service, while the optimal capacity is the point at which customers can be served adequately while maintaining a competitive advantage. Ensuring a proper amount of capacity is allocated to various customer segments, while offering

a differentiating value proposition within each segment, is an essential element of implementing price discrimination strategies. It also prevents bad customers—those who are not willing to pay for the value you deliver—from crowding out good customers. The Adaptive Capacity Model is a metaphor for achieving these objectives.

## THE ADAPTIVE CAPACITY MODEL

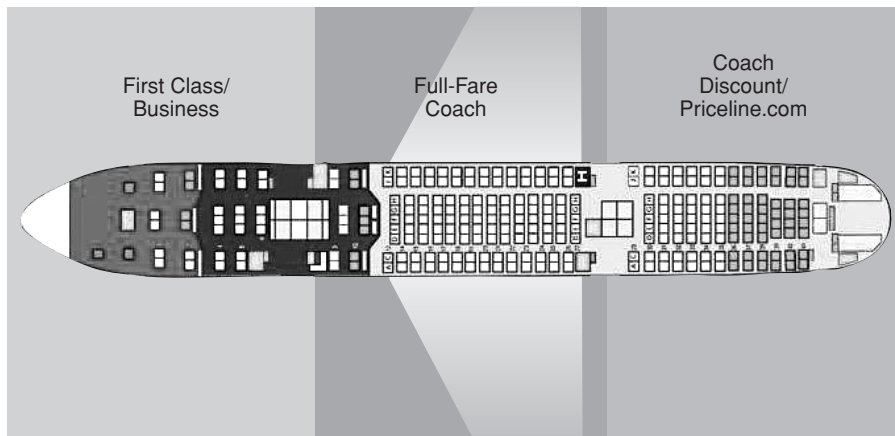
In his essay on the art of poetry, Aristotle made the following observation: “But the greatest thing by far is to be a master of metaphor. It is the one thing that cannot be learnt from others; and it is also a sign of genius, since a good metaphor implies an intuitive perception of the similarity between dissimilars” (quoted in Satinover, 2001: 66).

Taking a cue from the railroads that offered first-class and coach service, United Airlines developed Skylounge in 1936, aviation’s first extra-fare plane. Then in April 1940 United introduced the concept of coach service between Los Angeles and San Francisco, where customers had the option of paying a reduced fare and receiving minimal service on more crowded, older, and slower planes.

Think of your company as a Boeing 777 airplane, similar to Exhibit 18.1. When United Airlines places a Boeing 777 in service, it adds a certain capacity to its fleet. However, it goes one step further, by dividing up that marginal capacity into five segments:

- A. First class
- B. Business class
- C. Full-fare coach
- D. Coach
- F. Discount/Priceline.com

The airlines—and hotels, cruise lines, golf courses, car rental agencies, and other industries with fixed capacity—are adept at managing their adaptive capacity to maximize their revenue and profitability. There are many examples of this strategy in practice, and we have already examined the complexity of airline pricing in Chapter 16. Now we want to look at offering various value propositions to different customer segments. For instance, I looked up (June 30, 2005) a United Airlines flight from San Francisco to



**EXHIBIT 18.1 Adaptive Capacity Model**

Auckland, New Zealand, for tomorrow and they are able to accommodate me, either in first class, business class, or full-fare coach. The airlines understand it is the last-minute purchaser who values the seat the most, and hence they reserve a portion of each plane's capacity for their best customers. They do this even at the risk the plane will take off with some of those high-price seats empty—and that revenue can never be recaptured since they cannot inventory seats. Why do they take that risk? Because the rewards of reserving capacity for price-insensitive customers comprise the majority of their profits. I was given the following options:

Coach fare (H), cancellation fee, restrictions	\$1,929
Coach fare (B), unrestricted, changes allowed	\$2,725
Business class	\$6,987
First class, layover at LAX required	\$7,001

At each fare level, the customer is forced to acknowledge value and make a price/value trade-off. At the lowest price, there are restrictions on itinerary changes and various fees apply to any alterations, whereas as you move up in price there are fewer restrictions in changes to the ticket. Note the small difference between business class and first class, yet the value trade-off is a

layover in Los Angeles rather than a direct flight from San Francisco. Had I searched for alternative airports, or departure dates, I may have been offered even lower fares, since I would not be getting my first choice but rather the spare capacity the airline has available. If I book my flight three months rather than one day in advance, the cheapest fare I am offered is \$1,059, while first class is approximately the same, at \$6,980. By booking my ticket one day in advance, United has, in effect, provided me an interest-free loan, which is also taken into account in the price of the ticket. Each price point forces the customer to acknowledge a different value proposition; different customers, different prices.

Airlines reserve some capacity for coach, leisure, and Priceline.com (or bereavement)-type seats, which they offer well in advance of the flight. However, no airline *adds* capacity in order to accommodate these customers. And this point is critical, because too many companies will, in fact, add capacity—or reallocate capacity from higher-valued customers—in order to serve low-valued customers. This is the equivalent of the airlines putting the upper deck in the back of the plane rather than the front.

Furthermore, many companies will turn away high-value, last-minute work for its best customers because it is operating near maximum capacity and usually at the low-end of the value curve for price-sensitive customers. This is common during peak seasons, where high-value projects will arise from customers, but the firm is at maximum capacity and cannot handle the marginal work. The lost profit opportunities because of this are incalculable.

Many worry about running below optimal capacity and cut their prices in order to attract work, especially in the *off* season. This strategy is fine, but you must understand the trade-off you are making. Usually, that capacity could be better utilized selling more valued services to your first-class and business-class customers. This way, the firm does not cut its price and degrade its pricing integrity in order to attract price-sensitive customers, sending a signal into the marketplace that it is willing to engage in this strategy and affecting the perception of its value proposition. According to most pricing consultants, pricing mistakes are usually the result of misallocating capacity to low-value customers due to the fear of not running at optimal (or maximum) capacity.

Of course, in any high-fixed-cost environment, there are multiple strategies for managing capacity, both from the demand side (pricing) and the supply side (offerings). The company wants to make sure it can supply exactly what each customer segment demands, when they demand it. Organizations



have several strategies for managing their capacity at the supply-side level, including:

- Hiring part-time team members
- Working overtime
- Cross-training of team members
- Increasing customer participation in the service (think of ATM machines in banking)
- Sharing facilities and team members with other firms
- Outsourcing

All of the above strategies work well for supply-side management. However, it is on the demand side where the profit-optimizing strategies exist for the firm. The conventional wisdom is you have to be at maximum capacity—where demand exceeds supply—in order to raise prices. But since when do you have to wait to be fully booked to demand a premium price? Do not confuse working *harder* (supply-side capacity) with working *smarter* (demand-side pricing). Many industries today already have too much capacity, due to the productivity gains from management innovations—such as just-in-time inventory, Six Sigma, and Total Quality Management—and technological advances, the same trend we saw in the twentieth century with agriculture. For example, it is estimated the automobile industry has the capacity to produce 20 million cars each year in excess of the world market demand. Price is ultimately driven by value, not capacity levels.

Yet capacity does play a role in how many segments a company can handle. Have you ever wondered why certain stores cater to only one type of customer (e.g., Gucci), but few airlines or hotels do? Paradoxically, an airline or hotel that only catered to business travelers would have to increase its prices to an uncompetitive level, relative to one that served both classes of customer, due to the higher-capacity utilization of the former. Since any one organization has to build capacity to meet peak demand, but the timing of that demand is not known with certainty, segmenting the market into business and pleasure allows them to lower capacity costs and keep prices lower than they would be otherwise. Contrary to conventional wisdom, offering advance-purchase discounts to leisure travelers reduces prices for *all* customers. In reality, leisure travelers subsidize business travelers. This is why the Concorde now sits in various museums around the world, since it could

not maintain an appropriate balance between business and leisure travelers. In addition, this has implications for the fairness of price discrimination, a topic we will explore in Chapter 19.

One innovative way of dealing with capacity is from Printingforless.com, launched in March 1999. A typical Heidelberg press costs \$5 million or more, yet it tends to sit idle approximately half the time in most print shops. Printingforless.com aggregates this excess capacity and connects customers with printers who can remain anonymous, allowing them to maintain their existing pricing structures in their own communities, while Printingforless.com handles customer service, preparation work, and simply outsources the printing. Priceline.com has done much the same thing with airlines and hotels.

## GRADING YOUR CUSTOMERS

In terms of capacity, think of the above five classes of airline customers as your A, B, C, D, and F customers. How much fixed capacity will you allocate to each class? What will be the criteria you use to ascertain where in your airplane each customer sits? How much capacity will you reserve for each customer segment? Answering these questions forces you to understand the trade-off you are making between serving various groups of customers. By viewing your company as an airplane with a fixed number of seats, you will begin to adapt your capacity to those customers who appreciate—and are willing to pay for—your value proposition.

With sophisticated customer relationship management and/or yield management software, we are now able to break down customer information at a granular level, thereby assessing the value of each customer to the company, and even the value of the company to each customer (a more significant metric). For example, Continental Airlines' database enables it to track each customer's choice of seating, preferred method of booking tickets, number of flights departed on time or canceled, luggage lost, ticket price paid, and miles flown. This level of detail enables Continental to segment its most valued customers and offer them additional service levels. It also helps them analyze which routes to maintain or terminate. For instance, a particular flight considered unprofitable turned out to be an essential connecting flight between hubs utilized by high-value customers, so it was maintained. These types of decisions enable pricers to maximize the profitability across the entire network of flights, rather than looking at each route independently.

Customers can be segmented by value perception into four categories, as explained by Nagle and Holden in *The Strategy and Tactics of Pricing* (third edition):

Price Sensitivity	High	Price Buyers	Value Buyers
	Low	Convenience Buyers	Relationship Buyers
		Value of Brand	

Source: Adapted from Nagle and Holden, 2002:106.

*Price buyers* are simply looking for the lowest price, with little concern for marginal value and low brand loyalty. They are a distinct minority in almost every category, usually comprising not more than 15% to 20% of customers. These customers should be allotted only so much capacity and offered a stripped-down version of your offering. Airlines achieve this by making the most price-sensitive passengers fly out of airports, and at departure times, of the airlines' choosing. Curtailing services and/or features is another effective method of reducing value to these customers, thereby forcing them to make a price/value trade-off. Printer manufacturers will add chips to slow the print speed on their cheaper models, while Apple's iPod Shuffle will only play songs randomly, not the first choice of the user. Look for ways to *remove* value from your core offering. Also, it may be possible to eliminate characteristics that reduce the company's cost to serve these customers, such as self-service, pick-up rather than delivery, and other value-added offerings acknowledged and appreciated by other customer segments.

*Value buyers* are willing to pay more for marginal value and tend to be loyal to various brands they perceive as offering more value for the same dollar, but only after doing extensive homework on competing offerings. This type of buyer may show a preference, and be willing to pay more, for a particular brand, but remain ever vigilant that the marginal benefits must exceed the marginal cost. In planning a vacation, these buyers will study all of the alternatives and carefully weigh each trade-off. If they spot a special targeted offer, even if a nonpreferred brand, they are more likely to accept it. If your company offers a loyalty program, these buyers would usually be in the first or second tiers, because they will defect if more valuable offers are presented.

*Convenience buyers* are not very brand loyal but are more willing to pay a higher price for exactly what they want, when they want it. Time tends to be of the essence, since the offering is either urgently needed (your automatic

garage door breaks over the weekend, or you need a locksmith) or too small an expenditure to justify high search costs. 7-11 thrives on these types of buyers. Since they do not put much value in any one particular brand, they are not usually candidates for loyalty programs, but are a profitable segment.

*Relationship buyers* place a high value on brand loyalty and are willing to pay for perceived value, as well as incremental value offerings. These buyers are usually in the top tier of any loyalty program and show strong brand loyalty, valuing the intangible services as well as the tangible offerings. Top-tier frequent flyers appreciate greatly how the airlines provide special check-in and security lines, let them board first, tag their luggage so it comes up first, guarantee a seat on flights even with short notice, provide airport lounges with business centers, and offer myriad other benefits of being loyal to one carrier.

Copper Mountain ski resort in Colorado offers the Beeline Advantage program, priced at \$124 for a day, approximately twice the normal lift ticket, whereby customers get early access to the runs (when the powder is fresh) and special lines. Universal Studios Theme Parks standard admission price is \$49, but for \$99 you can get a “Front of the Line Pass” and for \$129 a “VIP Experience,” giving guests behind-the-scenes access. Dell Inc. has a Priority Call Routing offering for \$89 whereby a customer’s service calls are moved to the front of the line.

## THE CONCIERGE SERVICE MODEL

Another advantage of the Adaptive Capacity Model is how it forces the company to design its value propositions around its best customers. While it is a good strategy to remove value from price-sensitive customers—forcing them to sacrifice value for a lower price—what about your relationship customers who appreciate value, are willing to pay for it, and are most receptive to enhanced value?

The Federal Reserve Board reports more than 250,000 American households have a net worth exceeding \$10 million; 500,000 have a net worth in excess of \$5 million; and a million are worth \$3.7 million or more; and those with \$1 million in net worth has soared above 5 million. Furthermore, over 25 million households have incomes over \$75,000. These high-income earners are driving the so-called new luxury “mass prestige” (or “masstige”) market.

In their book *Trading Up: Why Consumers Want New Luxury Goods—and How Companies Create Them*, Michael Silverstein and Neil Fiske of the

Boston Consulting Group point out that this new luxury market reached \$400 billion in the United States in 2003 and is estimated to grow to \$1 trillion by the end of this decade (growing at 10–15 percent annually), and reach \$2 trillion globally, comprising 20 percent of a category's unit volume, 40 percent of its dollar volume, and 60 percent of its profits (Silverstein and Fiske, 2005: xiv–xv, 4). This new luxury market is being driven by increased personal income as well as discount retailers saving consumers \$100 billion in 2003. It appears people are willing to buy necessary staples from Wal-Mart, but they take those savings and splurge on a spa weekend. While moving up in product categories is not a new phenomenon, a larger percentage of the population is now engaging in this practice, while at the same time trading down in certain categories. Silverstein and Fiske observe differences of between five and ten times between the highest and lowest price points in these categories.

You can witness this across many different categories, such as premium wines, beers, Victoria's Secret, cosmetics, premium pet foods, luxury cars, and even cellular phones. Vertu, a subsidiary of Nokia, offers cellular phones ranging in price from \$4,900 to \$19,450. Why would anyone except the idle rich purchase a phone for this amount? *The Economist* explains:

A big selling point is a special button that connects the user to Vertu's dedicated concierge service, which can organize travel, restaurant and hotel bookings, or find a good doctor or florist in a foreign city. When Ms [Gwyneth] Paltrow mislaid her phone's charger she called the concierge and a new one arrived within minutes. The concierge service is available worldwide in five languages. Detailed records are kept of each customer's preferences ("The Origins of Vertu," *The Economist*, February 22, 2003, 62–63).

American Express now offers the Black Card, a premium credit card that also has a concierge service, at an annual membership of \$2,000. Financial services, legal, accounting, health care, elder care, pet care, travel, home maintenance, and myriad other services are excellent candidates for a trade-up offering. Doctors are beginning to provide a premium level service, giving patients who pay an annual retainer greater access to appointments, medical information, and more personalized attention. Approximately 300 primary care physicians nationwide now offer "concierge care" to patients willing to pay from \$1,500 to \$20,000 annually, in effect giving them their own private on-call doctor, who even do house calls.

Howard Maron, the former team doctor for the National Basketball Association's Seattle Supersonics, was the founder of the retainer-based

model of health care with the launch, in 1996, of Seattle-based MD<sup>2</sup>, although Maron prefers to call this service “highly attentive medicine.” In an interview in the July 2005 *Worth* magazine, Maron was asked to describe a typical patient experience at MD<sup>2</sup>:

We don’t have a waiting room. Our office is locked. It’s fully staffed. The door is closed, but it’s available all the time by appointment. When a patient comes to the door, the door is locked behind him and he has the entire office to himself. We’re not in a hurry. If a patient needs to do business in the meantime, needs to attend to a phone call, fine, we’ll wait. Again, how can a doctor do that unless he has very few patients (“Concierge Medicine: Weighing this Controversial Alternative to Traditional Health Care Providers,” *Worth*, July 2005, 71).

With practices in Bellevue, Washington, and Portland, Oregon, MD<sup>2</sup> prices this individualized care at \$13,200 per year for an individual, or \$20,000 for a couple, with an additional \$2,000 for each child. Each office only caters to 100 families in its two-person practice. Critics claim that this form of elitist medical care is more style over substance, putting forth the argument that no studies have proven doctors who spend more time with a patient, or who have smaller patient loads, result in longer life spans or earlier diagnosis of life-threatening maladies for their patients. They also claim this is a form of “cherry-picking” healthy and wealthy patients, which creates shortages of doctors for middle- and lower-income patients.

Yet medical care is a luxury good, an item people will purchase more of when their income rises. Patients are not concerned with medical studies that prove that this type of personalized attention has salutary effects across a range of patients; they are only concerned with how this type of care affects them. Value is subjective, and they are paying for peace of mind and instant access, since the opportunity cost of their time is so high. It may be too early to judge the success (or failure) of this type of care, but there is no doubt that a certain group of customers are willing and able to pay for it, and hence providers are willing to supply this type of concierge medicine.

My colleague, Dan Morris, has long believed that social capital is the least leveraged of all of the intellectual capital in most businesses. He has borrowed a very old concept from the hotel industry in order to change this situation in his accounting firm—what he calls the Concierge Service Model. In effect, Dan wants his best customers to call him for *anything* they need, *anytime, anywhere*. The logic is not to offer a “one-stop shop,” but rather a

“first-stop shop” experience for your customers. It has been suggested that the only true scarce resource in today’s information-rich and knowledge-intense economy is people’s *attention*. The Concierge Service Model was devised in order for your best customers to think of your firm first for any need or want they might have.

Dan’s firm has helped people get Super Bowl tickets, five-star restaurant dinner reservations, theater tickets, a plumber, a new roof, an automobile, a doctor or dentist for newcomers to town, and so forth. The theory is you already know someone in your network who can satisfy the customer’s need or want. Is it not better to recommend them to someone in your network in order to leverage your firm’s social capital? If you trust the people within your network, this will be a win-win situation all around—your firm will be offering higher value, your customers will appreciate the additional business you send their way, and the customers will be satisfied and, most likely, have their expectations exceeded. If no one in your network can satisfy the customers’ need, chances are they know someone who can. And even if it turns out that no one can satisfy the customer, isn’t it nice to know your customer is thinking of your firm first for anything that he or she may desire? You are putting “velvet ropes” around the customers, helping to ensure that they do not let a potential competitor penetrate the sphere of your influence, while increasing their switching costs.

This service mentality has the salutary effect of raising your firm’s collective consciousness with respect to its best customers, while offering a better experience to them. You move through the following levels in order to provide a full service concierge:

- Awareness
- Familiarity
- Knowledge
- Understanding

Once you move to a level of understanding of your customers’ wants, desires, hopes, aspirations, future goals, and so on, the Concierge Service Model becomes easier to facilitate. It does entail some risk; you have to refer businesses you know are excellent value providers, but your customers are an excellent source for this talent. You also have to reserve capacity for these front-of-the-plane customers, so the firm is not able to handle as many customers as a firm of equivalent size. Yet Dan does not let the risks overshadow

the opportunities of offering this dynamic service model. He knows that it increases customer loyalty, he can charge a premium price for offering this service, it deepens the relationships throughout the firm's social capital base, and instills the mindset among his team members that they are not just a technical professional firm, but a total-solutions firm, providing an enormous competitive differentiation in the marketplace.

Furthermore, taking advantage of the opportunities of customer segmentation, the firm has established Express Tax Services, a low-cost income tax preparation firm, which caters to the more price-sensitive customer. When this alternative firm was established, it also enabled the mother ship to transfer customers from the back of the plane to this new firm, freeing up capacity in the boutique firm to offer higher-level services to its more premium customers.



### Concierge Service Model

The Concierge Service Model (CSM) reflects my analysis of the ultimate value proposition for leading customers. This model is not designed for a company's rank-and-file customers. Rather, it is specifically designed to provide a complete service solution for any unfulfilled need or want to those customers who desire a higher level of service from our firm.

The CSM has been established to leverage a company's depth of intellectual capital and related social capital to enable its team members to deliver solutions within and outside of their core areas of expertise.

Leading customers, those customers who provide either current or future significant profits, are both extremely valuable and extremely valued. I determined our firm's best customers were the envy of all of my competitors, and my competitors were certainly willing to impact my customers' purchasing decisions.

In order to provide additional control over the relationship between our firm and our customers, I started to leverage knowledge, relationships, and information that was outside of our normal and daily routines.

It started out by solving simple issues like suggestions for anniversary gifts, preferred restaurant ideas, and travel destinations. Although we are not retailers, restaurateurs, or travel agents, our combined 35 years of business experiences along with our 80 years of life experiences allowed my founding CPA firm partner and I enough knowledge to share with our better customers those special items, locations, and events we had found that made dramatic impact and improved our lives.



As word spread among and between our leading customers, referral sources, and professional colleagues, we were more and more frequently approached by our customers for our advice and opinions on areas outside of our core competencies (accounting, tax, and general business advisory services) and we were enjoying this increased respect and confirmation of our abilities to match a customer want with a desired outcome.

We started to experiment with our service offerings and our pricing by segregating our customers into differing groups and requiring a price premium for these concierge services. Those customers that opted for our premium level of services recognized that, through our direct sources of several hundred current customers and nearly a thousand key contacts in our relationship database, we were their "hub" for nearly any information and opinion for which they were searching.

Our most challenging requests have included acquisition (without paying a scalper's premium) of Super Bowl tickets, sold out Broadway shows, dinner reservations at fully booked restaurants across the country, and itineraries, including recommended accommodations, for travel on nearly every continent.

We have also provided access to emergency medical treatment for customers and their out-of-town guests. These services were for our home town while we were traveling. As Harvey Makay explained, 2:00 A.M. is a terrible time to learn that you need a referral to a doctor. What we have learned is that our network of customers, team members, referral networks, and professional associations is an excellent source for effective and efficient solutions and advice for our customers.

The CSM has provided our firm with additional protections from encroachment by aggressive competitors, enhanced the personal and professional lives of our customers and their loved ones, and has provided both financial and emotional enrichment for all of our team members.

Nothing can compare to helping others achieve their dreams. Through our continuous process of developing our social and knowledge networks, we will continue to be our customers' leading source for happiness and problem solutions, and by so doing we will preserve our pricing advantage and insure our future.



## THE FORCED CHURN

What happens when your plane becomes filled with too many C, D, and F customers? These customers are usually the ones who complain most vociferously about your price and the debilitating effect is that we tend to listen to them the most and begin to disregard value created, which affects how we

price our A and B customers. Firing customers is not a one-time event, however, but a continual process. We have observed the most profitable service firms religiously cull through their customer base and “outplace” between 5 and 10 percent of their customers each year.

One caveat: Be sure you have done everything within your power to turn a low-value customer to a high-value customer. The fact of the matter is *your customers are not going to get better until you do*.

An essential first step in analyzing customer segments is a Pareto Analysis—a ranking of all customers from highest to lowest in revenue. Without fail, 20 percent of the customers generate between 67 and 85 percent of the revenue. This is the first step in ascertaining how the firm is allocating its fixed capacity to its different customer segments. Given the realities of the Pareto Analysis, gaining an understanding of how your company is already dependent on the top 20 percent of customers illustrates the risks being assumed by focusing too many resources on the bottom 50 to 80 percent, and putting the remaining high-valued customers at greater risk for defection by ignoring their needs and wants. Many companies have learned that *fewer* customers equates to higher profits, better service, improved team member morale, and less complexity in the organization.

In the mid-1990s, Lake Tahoe began a major renovation, where many older motels, stores, and other buildings were bulldozed down by the lake, just on the California side of the state line. A local newspaper article claimed that for every new room added, somewhere between two and three would be lost. Obviously, the developers were shifting up the value curve by constructing higher-end hotels, time-shares, condominiums, and so forth. Why shouldn't (some) companies remove somewhere between one and four customers for every new one added? This led to the concept of what we have since labeled the *forced churn*.

The cable and cellular phone industry track the *churn rate*—that is, the number of lost customers is divided by the number of new customers acquired (you can perform the calculation with both the number of customers and the revenue from the customer). As a way to upgrade your firm's customer base from C, D, and F customers, each time a new customer is obtained, you would fire somewhere between one and four old customers. Of course, the exact ratio would depend on how many C, D, and F customers your firm has and what factor the executives are comfortable with. Not only would this free up capacity to serve the new customers, it would shift the firm up the value curve, allowing your plane to add more full-fare coach,

business-class, and first-class seats. The French have a wonderful saying that epitomizes this strategy: *Recueillez pour mieux avancer*, which translated means “Fall back, the better to advance.” By implementing this strategy gradually, many service firms feel more comfortable upgrading their customer base, and their sense of security is not jeopardized by firing a large number of customers all at once.

Obviously, this strategy is going to be more applicable to service firms than mass-market manufacturers. Yet even mass-market suppliers engage in unprofitable strategies, such as lowering prices during the final days of a quarter in order to achieve revenue goals. An old joke has the CFO calling down to the shipping department on the last day of the quarter to inquire on sales levels. The foreman replies, “Too early to say; it’s only lunchtime, so we’re only halfway through the quarter.” According to Holden Advisors, “PeopleSoft was closing 80% of its license revenue on the *last day* of the quarter, offering discounts of up to 80%; while Oracle admits they are closing 40% of the business in the last month of a quarter.” Making price concessions in this manner creates little Pavlov’s dogs, and we should not be surprised when customers engage in these hardball negotiating tactics—after all, we reward them for doing so.

## THOUGHTS ON REQUESTS FOR PROPOSALS

*Never forget that your weapon is made by the lowest bidder.*

—Law Number 20 of Murphy’s Laws of Combat

In auction markets, economists refer to the dreaded *winner’s curse*—whereby the winning bidder is often a loser. In other words, the only requests for proposals (RFPs) that sellers will accept are ones you should not make. One of the ways to avoid the winner’s curse is to bid more conservatively when there are more bidders. Thomas Nagle and Reed Holden explain why:

To understand the curse, imagine first that you are one of two bidders and you win a bid with the lower price. You will probably be quite happy. Now imagine that you are one of ten bidders and you believe that your competitors are sophisticated businesspeople who know how to bid a job. Again you win. Are you still happy? What does it mean that you bid below nine other knowledgeable bidders? Perhaps it means that you were willing to take less profit on the

job. On the other hand, it could also mean that you underestimated the cost to complete the work.

The more bidders there are, the more likely you will lose money on every job you win, *even if on average you estimate costs correctly and both you and your competitors set bids that include a reasonable margin of profit*. The reason: The bids you win are not a random sample of the bids you make. You are much more likely to win jobs for which you have underestimated your costs and are unlikely to win those for which you have overestimated your cost.

The only solution to this is, in effect, to formalize the principle of “selective participation.” You do that by adding a “fudge factor” to each bid to reflect an estimate of how much you are likely to have underestimated your costs if you actually win a bid. Needless to say, adding this factor will reduce the number of bids you win, but it will ensure that you won’t ultimately regret having won them (Nagle and Holden, 2002: 225).

RFPs have become more commonplace as competitive bidding has replaced negotiation for price buyers. It is as if dysfunctional buying practices have arisen to counter dysfunctional selling practices. It is important to judge the seriousness of potential buyers going out to bid, as a lot of the RFPs are, in reality, nothing but hammers used against existing suppliers to obtain price concessions. Your company should not waste its resources drafting RFPs to anonymous buyers whose criteria for judging your company’s offering are not known to you. It is important to have some contact with the economic buyer, that is, the person who can actually make the decision to hire you, rather than just the procurement department. Establishing relationships and having internal advocates in the customer’s enterprise also helps to ensure that your value is being considered, not just your price.

In their book *Co-opetition*, Adam Brandenburger and Barry Nalebuff offer this sage advice with respect to RFPs:

There seems to be a natural impulse to offer competition for free. After all, that is what business people are supposed to do, is it not? You want a bid? I’ll give you a bid....

The right question to ask is: How important is it to the customer that you bid? If bidding is so important, then you should get compensated for playing the game. If it is not so important, then you are unlikely to get the business and even less likely to make money. You might want to reconsider bidding at all (Brandenburger and Nalebuff, 1996: 84).

Another strategy with RFPs is: *No surprises*. Your potential customer should know everything in your RFP before you submit it. Gaining an understanding of your customers' expectations, business model—how they make money—and how your company can add value is imperative to increase your odds of a successful RFP, one that will not suffer from the winner's curse. Search for the differences that will ultimately be weighed in selecting a new supplier. If customers are worth bidding on, they are worth spending some resources on in order to improve your chances. Brandenburg and Nalebuff discuss the following eight hidden costs of bidding, which are also worth considering:

1. **There are better uses of your time.** Keeping current customers happy may be a better strategic advantage as opposed to chasing after other companies' customers. Attracting a new customer can cost three to six times more than holding on to an existing one, and the existing one is most likely less price sensitive.
2. **When you win the business, you lose money.** A customer won on price alone is signaling they have no loyalty, and will leave you once they find a lower price. Do not fall into the trap of thinking you can start with a low price and raise it later; the evidence is overwhelming this will not work, as once you set a low price you are rewarding the customer for beating you up on price.
3. **The incumbent can retaliate.** If this is a good customer, then your win is someone else's loss. If it is a bad customer, then you have already made a mistake. The incumbent supplier is likely to respond, perhaps by targeting one of your good customers. He may not be successful, but he can force a price concession on your part. If he is successful, you both have achieved nothing but turning two high-margin customers into two low-margin customers—a real lose-lose scenario.
4. **Your existing customers will want a better deal.** Lowering your prices within RFPs sends a distinct message into the marketplace that will no doubt find its way to your existing customers. Some will believe you've been overcharging them and may leave; others will demand price concessions. Is winning one job worth the risk?
5. **New customers will use the low price as a benchmark.** Once again, sending the wrong signal to all potential future customers.
6. **Competitors will also use the low price as a benchmark.** Since your competitors can easily discover your RFP price, they will use this as a reference price in future RFPs, most likely resulting in lower priced RFPs in the future amongst all bidders.

7. **It does not help to give your customer's competitors a better cost position.** Your future and that of your customer are naturally linked. If your future is tied to Boeing, you do not want to help Airbus get a lower price. Unless you have very good reason to believe that you can get Airbus' business while keeping Boeing's, bidding for Airbus' business is costly. You help your competitor's customer and thereby hurt your own.
8. **Do not destroy your competitor's glass houses.** The notion you win if your competition loses is simplistic and potentially dangerous. If you lower your rival's profits, he now has more reason to become aggressive by going after your accounts with abandon, potentially launching a self-destructive price war. In contrast, the more money your competition is making, the more it has at risk from getting into a price war (ibid.: 86–88).

This is where the firm's value proposition becomes a critical differentiator from its competitive bidders. By offering an unconditional money-back service guarantee and competing on total quality service, your firm can maintain a premium over the competition. Do not let the RFP be the first time you test your price, as this can result in a waste of resources going after price buyers who have no intention of considering value. Another effective strategy is to offer various value propositions—in the form of differing options—within the RFP, thereby preventing it from becoming merely a one-shot, take-it-or-leave-it option. Maintaining your pricing integrity on the RFPs you decide to submit sends an important message within your company that pricing is a strategic decision—one based on value—and not just a number to be arbitrarily derived in order to make the next sale.

Be sure to maintain a mortality log for RFPs submitted but not accepted. Perform postmortems on lost bids and determine the reasons. This will help you focus on value for future RFPs rather than merely cost and price. The better you know the customer and the more thorough you are at ascertaining both their needs and wants, the higher probability you have of securing your share of profitable RFP work.

Keep the winner's curse in mind as you prepare RFPs and be sure the potential customer is serious about doing business with you and not just using your bid as a way to lower their existing price. Some firms have tested this commitment by charging for a proposal and then offering a full credit if the bid is accepted.

Tom Peters is fond of making this point: "It's axiomatic: You're as good—or as bad—as the character of your Customer List. In a very real sense, you

are your Customer List.” If you operate an enterprise fortunate enough to select your customers, this is excellent advice. The Adaptive Capacity Model enables you to segment various customers based not only on the value they bring to the company, but the value the company brings to them.

Devising various value propositions to these different segments also enables companies that serve the mass market to reward their best customers, and capture some of the consumer surplus that exists, while at the same time serving more price-sensitive customers. It is worth becoming diligent in forecasting your company's capacity into the future, and allocate it more strategically across different markets. The Adaptive Capacity Model prevents *dumbbell pricing*—an imbalance between high-end and low-end offerings—by offering various options all across the spectrum, based on value.

Recognizing that not all customers are created equal, or should be charged the same price, is essential to avoiding Baker's Law: *Bad customers drive out good customers*. Next we turn our attention to the ethics of pricing.





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# 19

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## ETHICS, FAIRNESS, AND PRICING

*Market Competition leads a self-interested person to wake up in the morning, look outside at the earth and produce from its raw materials, not what he wants, but what others want. Not in the quantities he prefers, but in the quantities his neighbors prefer. Not at the price he dreams of charging, but at a price reflecting how much his neighbors value what he has done.*

—Friedrich A. von Hayek [1889–1992]

*Capitalism offers nothing but frustrations and rebuffs to those who wish—because of claimed superiority of intelligence, birth, credentials, or ideals—to get without giving, to take without risking, to profit without sacrifice, to be exalted without humbling themselves to understand others and meet their needs.*

—George Gilder, 1981

Throughout history the morality of profits and a just price has been debated endlessly, as it should be. Father Richard John Neuhaus, in his book *Doing Well and Doing Good: The Challenge to the Christian Capitalist*, explains the ancient debate of a “just” price:

The idea that there is a right amount or a “just” amount always runs up against the question, Compared to what? The conventional answer is that one pays what the market demands, or what the market will bear. From Athens to Elizabethan England to the Great Terror of the French Revolution, societies have experimented with “sumptuary laws” setting limits on people’s income and expenditures. The experiments have never worked out very well, the obvious reason being that it is almost impossible to agree on standards. Few egalitarians, even among the well-to-do, propose a top income limit that is less than what they themselves receive (Neuhaus, 1992: 193).

This notion of a “fair” or “just” price has bedeviled philosophers, religious leaders, rulers of nations, and businessman for centuries. During the Dark Ages merchants could be put to death for exceeding the communal concept of a “just” price (*justum pretium*, the right price). In A.D. 301, Diocletian, the Roman Emperor, issued an edict fixing prices for nearly 800 items and punishing violators with death. Severe shortages transpired, as any economist would be able to predict when you put a ceiling on market prices.

In ancient China, India, Rome, and almost everywhere throughout the Middle Ages, all interest charges were called “usury” and were prohibited entirely, making economic progress through lending and risk-taking all but impossible. Today, so-called “price gougers” are subject to societal condemnation, regulatory harassment, and editorial vitriol. Oil companies are frequently a prime target of public outrage, especially when prices at the pump vary from one city to another. Pharmaceutical companies are held in special contempt when they charge \$5 to \$20 (or more) per pill, even if the dosage reduces more costly medical intervention by other means, such as surgery. In May 2000, the late Senator Paul Wellstone claimed, “We have an industry that makes exorbitant profits off sickness, misery, and illness of people, and that is obscene.” Yet this is similar to arguing that farmers make money off our hunger, when in reality they make money by keeping us from hunger. Drug companies do so by making us healthy.

The problem with a “just” price is who gets to decide what is just? The free market already provides an answer to this question—*whatever someone is willing to pay*. There is no objective standard for “fair,” which is why we have *free* speech rights, not *fair* speech rights. Although it sounds heretical, it is not. An old legal maxim teaches: *Emptor emit quam minimo potest, venditor vendit quam maximo potest* (The buyer buys for as little as possible; the seller sells for as much as possible). Ultimately, the customer is sovereign, spending his or her money only when it maximizes utility.

To believe the free market is imperfect with regard to the fairness of prices is to grossly underestimate your own sovereignty as a customer while putting your faith in some anonymous third party—usually a governmental regulatory agency or the courts—to determine what is “fair.” Yet prices contain a wealth of information that no central agency can possibly possess, which is why wage and price controls have failed *everywhere* they have been tried. If it is immoral for a company to charge premium prices to customers, does it follow it is also immoral for customers to pay low prices?

Why is an oil or pharmaceutical company condemned for earning windfall profits when market conditions change, while an individual homeowner who realizes a tidy profit off of a hot real estate market is applauded? Popular movie stars, directors, and entertainment companies can earn above-normal profits without so much as a whisper of public protest. Premium ice creams and chocolates are very expensive and yield profit margins that would have made the “robber barons” of yesterday blush. Very few of us would continue working at 50 percent of our present salaries. Are we not charging what the market will bear? Why are individuals and corporations held to different standards?

To believe prices are determined by greed is to believe sellers can establish prices at whatever level they desire, in effect never having to suffer losses or bankruptcy. Homes along the ocean front command high prices, but this does not prove that fresh air causes greed. Prices convey information, while allocating resources and distributing income; they are similar to thermometer readings, and no patient is made better off by artificially lowering the temperature reading.

Perhaps it is not so much *price* that bothers people as it is *profits*. Profits have a bad reputation because most people simply do not acknowledge where they come from. Profits come from *risk*. The entrepreneur gives long before she receives. She pays wages, vendors, landlords, and the other costs of running a business in advance of having anything left over (profits). Very few individuals work for 100 percent stock options, yet business owners, in effect, do exactly this, since profits are only left over after everyone else has been paid. If it were true that profits caused high prices, then we should witness lower prices in those countries with no profits, such as socialist or communist countries. Yet the empirical evidence is to the contrary. Even though profits comprise only 10 percent of national income, they are crucial in allocating the other 90 percent. Of course, since most enterprises do not make an economic profit, perhaps we should say the *pursuit* of profit is the necessary ingredient. In any event, whenever someone laments that a particular industry (or company) is making obscene profits, there is an effective retort: If you believe that, buy their stock.

It is easy for politicians to focus on windfall profits of particular industries at particular times, as if economic cycles were not cyclical. Yet one never hears about windfall losses, such as the airlines never turning a profit—in effect shareholders and creditors subsidizing passengers—or IBM losing

over \$15 billion during 1991–1993. But are supernormal profits moral? In his seminal book *Wealth and Poverty*, George Gilder had this reply to economist John Kenneth Galbraith's long-standing criticism of business firms seeking windfall profits:

Galbraith maintains that businesses, far from giving without predetermined returns, actually seek to control their markets, often with aid of government, to “administer” prices and quantities of production and exclude all rivals. This revelation is sometimes offered in the spirit of a child discovering that his parents indulge in sexual intercourse. But we must grant that the child is right. For all their ideological commitment to free enterprise, businesses are primarily devoted to successful enterprise, pursue it any way they can, and are delighted to benefit when government blocks the competition. In precisely the same way that many “liberal” economists can profess egalitarian socialism while waxing rich on the capitalist system, corporations can feed off of government while celebrating free markets (Gilder, 1993: 47–48).

Profits are an indicator that a useful social purpose is being filled and needs are being met. In a free market, no profit could exist without people voluntarily entering into a transaction where each receives more than they give up, what one commentator coined “capitalist acts between consenting adults.” For any exchange to take place, both parties must receive a gain, otherwise we could simply exchange \$5 bills with each other.

All businesspeople live the ultimate contradiction. They pray at night for supernormal profits and spend their days driving down those profits by competitively supplying customers with more of what they want. As the Austrian economist Joseph Schumpeter so poetically phrased it, entrepreneurial innovations make up the “perennial gale of creative destruction,” whereby entire industries have been eliminated due to this dynamism of free markets. Buggy whip manufacturers did not invent the automobile and slide rule manufacturers did not invent the calculator. Both of these innovations, and a plethora of others, rose up and decimated existing stocks of infrastructure and propelled our economy forward. Businesses are the ultimate change agents in society, ushering in new products, services, and ways of conducting our affairs. This role of business is often ignored in the debate over the social responsibility of business.

Perhaps we should look for guidance to a higher ethical and moral order for the answer to the questions: Are profits moral? What is the social responsibility of business? The late Pope John Paul II issued an encyclical on

May 1, 1991, entitled *Centesimus Annus* (“The Hundredth Year”). It was a celebration of Pope Leo XIII’s 1891 encyclical *Rerum Novarum* (“The New Things”). Encyclicals are not addressed solely to the Catholic faithful but “to all people of goodwill,” traditionally used to inform the people of the world about questions that affect all of us; they are the Church’s “social doctrine,” “social teaching,” or even “social magisterium.” This particular encyclical is remarkable, for the Pope is basically making the argument that capitalism is a moral system, and that prosperity is dependent on economic freedom. It is quite a document from a church with a history of being highly skeptical with respect to capitalism and free markets. This is not to say that the Pope believed capitalism is the moral superior of any other system; only that, based on the world history thus far, it tends to ameliorate many of the problems that humans have to deal with. No system, from the Pope’s point of view, is superior to the Kingdom of God. Even a free economy leaves people free to do bad things.

As Richard John Neuhaus wrote, “The Christian who is engaged in economic activity understands that he is responsible to the Ultimate Economist, who is none less than God” (Neuhaus, 1992: 20). Even Pope Leo XIII’s 1891 encyclical contained scathing denunciations of capitalism; but it also foretold the death of socialism, an absolutely prescient and heretical view in the days when socialism was the utopian vision of the new world. Nobody, it seems, dreams about capitalism, until they are faced with life under the misery and poverty of communism or socialism.

When the late Pope John Paul II introduced *Centesimus Annus* on May 1, 1991, he said “Economic freedom is an aspect of human freedom, which cannot be separated from its other aspects and which must contribute to the full realization of people in order to construct an authentic human community” (Neuhaus, 1992: 184). Here are some of the more interesting passages as they relate to economic freedom and the role of profits in society (references are to the paragraph number of the encyclical):

...[M]an, who was created for freedom, bears within himself the wound of original sin. Man tends toward good, but he is also capable of evil. He can transcend his immediate interest and still remain bound to it. The social order will be the more stable the more it takes this fact into account and does not place in opposition personal interest and the interests of society as a whole, but rather seeks to bring them into fruitful harmony. Where self-interest is suppressed, it is replaced by a burdensome system of bureaucratic control that dries up the wellsprings of initiative and creativity. [There is no] perfect social

organization that makes evil impossible. No political society can ever be confused with the Kingdom of God. God alone can separate the subjects of the Kingdom from the subjects of the Evil One, and this judgment will take place at the end of time (§ 25).

At one time, the *natural fruitfulness of the earth* was the primary factor of wealth. In our time, *the role of human work* is increasingly the productive factor both of nonmaterial and material wealth. Also, more than ever is *work with others* and *work for others*; it is a matter of doing something for someone else (§ 31).

In our time, another form of ownership is becoming no less important than land: *the possession of know-how, technology, and skill*. The wealth of the industrialized nations is based much more on this kind of ownership than on natural resources. A person produces something so that others may use it after they have paid a just price, mutually agreed upon through free bargaining. It is precisely the ability to foresee both the needs of others and the combination of productive factors most adapted to satisfying those needs that constitutes another important source of wealth in modern society. In this way, the role of disciplined and creative *human work* and *initiative and entrepreneurial ability* become increasingly decisive (§ 32).

Besides the earth, man's principal resource is *man himself*. Disciplined work in collaboration with others creates the ever more extensive *working communities* that transform man's natural and human environments. Important virtues are involved in this process, such as diligence, industriousness, prudence in undertaking reasonable risks, reliability and fidelity in interpersonal relationships, as well as courage in carrying out decisions that are difficult and painful but necessary, both for the overall working of a business and in meeting possible setbacks (§ 32).

It would appear that *the free market* is the most efficient instrument for utilizing resources and effectively responding to needs. But there are many human needs that find no place on the market. It is a strict duty of justice and truth not to allow fundamental human needs to remain unsatisfied. It is also necessary to help needy people acquire expertise, to enter the circle of exchange, and to develop their skills to make the best use of their capacities and resources. Prior to the logic of a fair exchange of goods, there exists *something that is due to man because he is man*, by reason of his lofty dignity (§ 34).

In [one] sense, it is right to speak of a struggle against an economic system, if that system upholds the absolute predominance of capital, the possession of the means of the production and of the land, in contrast to the free and personal nature of human work. The alternative is not the socialist system, which in fact turns out to be state capitalism, but rather *a society of free work, of enterprise, and of participation* (§ 35).

The Church acknowledges the legitimate role of profit as an indication that a business is functioning well. When a firm makes a profit, this means that productive factors have been properly employed and corresponding human needs have been satisfied. But profitability is not the only indicator of a firm's condition. It is possible for the financial accounts to be in order, and yet for the people—who are the firm's most valuable asset—to be humiliated and their dignity offended. This is morally inadmissible [and] will eventually have negative repercussions on the firm's economic efficiency. The purpose of a business firm is to be a community of persons endeavoring to satisfy basic needs at the service of the whole of society (§ 35).

Honesty and ethical standards do not always pay off. They often have costs. For moral reasons alone, these costs are worth paying. For business reasons, too, since reputation is a priceless asset, and loss of reputation is the single biggest risk a company faces.

Dr. Samuel Johnson wrote, "There are few ways in which man can be more innocently employed than in getting money," and John Maynard Keynes agreed, stating, "It is better that a man should tyrannize over his bank balance than over his fellow citizens."

No doubt businesses act in a social context, as do all individuals, and should be held accountable for doing the right thing for the right reasons. None of this is inconsistent with the pursuit of profit and meeting human needs and wants. Parents do not raise their children to become rugged individualists, and no company was built by the efforts of a single human being.

Ethical conduct, integrity, trust, and honesty are not just moral principles, they are also major economic factors, which all businesses and professionals should be judged against and held accountable for.

## THE MORALITY OF PRICE DISCRIMINATION

This book has documented countless cases of price discrimination while also providing several strategies to implement it, all the while understanding that this method of pricing is similar to playing with fire, since it can be perceived as being grossly unfair. A.C. Pigou, the first economist to use the term *price discrimination*, understood the perceptual problems intrinsic with this form of pricing, noting that businesses had to be careful in setting pricing policy: "Since a hostile public opinion might lead to legislative intervention, [the company's] choice must not be such as to outrage the popular sense of justice."

Certainly we witnessed this public outcry when in 2000, the online retailer Amazon.com was found to be offering different prices on DVDs to different customers. Customers thought it unfair that customers from wealthier locations were being charged a higher price. Coca-Cola created a similar public outcry in October 1999 when Douglas Investor, its chairman, announced that the company had vending machines that could automatically change the price for cans of soda based on the temperature outside. In Japan, using wireless technology to adjust prices based on the temperature is fairly commonplace. Is it moral?

Rather than analyzing the consequences of actions, the philosophical theory known as deontology holds that one should do what is right—*deontology* is Greek meaning “duty.” Deontologists believe in universal principles (thou shall not steal, etc.) and consequences should not be the only criteria used to judge moral behavior. The leading deontologist is the German Philosopher Immanuel Kant [1724–1804]. Kant proposed two questions, “What may we hope for?” and “What ought we to do?” Kant’s theory places motives for actions as higher importance than the consequences of those actions. In other words, one should do what is right, for the right reasons. If one is honest only because one believes that honesty pays, it is not as moral as those who are honest because it is the right thing to do. Here is what Kant had to say with respect to a merchant’s pricing policies in *Grounding for the Metaphysics of Morals*:

...[T]hat a dealer should not overcharge an inexperienced purchaser certainly accords with duty; and where there is much commerce the prudent merchant does not overcharge but keeps a fixed price for everyone in general, so that a child may buy from him just as well as everyone else may. Thus customers are honestly served, but this is not nearly enough for making us believe that the merchant has acted this way from duty and from principles of honesty; his own advantage required him to do it. He cannot, however, be assumed to have in addition an immediate inclination toward his buyers, causing him, as it were, out of love to give no one as far as price is concerned any advantage over another (quoted in Bowie, 1999: 121–22).

Kant most likely would not approve of price discrimination. Of course, that may be a premature judgment, since it was not as ubiquitous a practice in his day as it is presently, and economists’ understanding of welfare economics has improved to the point where it has been proven to have beneficial effects, especially for lower-income customers.



The analogy of progressive taxation may help to clarify this issue. James Coffield, in *A Popular History of Taxation*, asked, “What would you say of a baker or a grocer or any merchant who would demand for the same commodity a price varying with the wealth of the purchaser?” Coffield was actually leveling a charge against the progressive income tax, a valid charge, in my opinion. The question then is: Is it a valid criticism of the free market? There is a profound difference between taxes paid and prices paid in the market for goods and services. The former is guided by the Ability-to-Pay Principal, which basically means tax burdens should be assigned not on the basis of who benefits from government programs, but rather on the basis of who has the ability to pay—that is, taxes should rise with income. The latter is guided by the Benefit Principal, which says prices are seen as a quid pro quo for the services provided to the purchaser. With taxes, there is not a correlation between benefits received and the amount paid. Taxes are forced exactions; they are not voluntary; they are not debts because there is no principal of fair value received. Even the U.S. Treasury Department defines a tax as “a compulsory payment for which no specific benefit is received in return.” Prices in the free market, on the other hand, are established by people’s willingness to pay (subjective value), not just their ability, and therefore, income is not the sole determinant.

Progressive taxes are similar to the businessman who walks by the newsstand every day after work, drops two quarters in the can of the newsboy attending the stand, but never takes a paper. One day, after repeating this daily ritual, the young boy runs up to the businessman and says, “Mister, mister, wait.” The businessman turns around, looks at the young boy, and responds, “You probably want to know why I walk by everyday and give you two quarters but never take a paper, right?” The young boy replies, “Oh, no, I don’t care about that. I just wanted to let you know the price has increased to 75 cents.”

Why does the public outcry only apply to free market price discrimination and not progressive taxation? Very few businesses are *price takers*—that is, if they were to raise their price by \$1 they would lose *all* their customers. Since they face an entire demand curve, the vast majority are *price searchers*, able to segment various groups of customers and make different offerings to them. Voluntary exchange between buyers and sellers in most markets usually results in a price below the maximum amount buyers are willing to pay—the consumer surplus—and does not reveal the minimum amount sellers are willing to accept—creating a *producer surplus* for any price above

this amount. These surpluses provide a measure of the welfare gain to both parties as a result of the existence of the market.

As we saw in the previous chapter, leisure travelers actually subsidize the business traveler, due to the large capacity requirements of the airline and hotel industries. As a management executive at Marriott explains:

If it weren't for incremental leisure guests, business guests would have to pay a higher price for their rooms...either we accommodate both guests [i.e., leisure and business], one paying \$79 and one paying \$125, or we ask the business guests to pay \$145.

It is hard to see how even Immanuel Kant could argue with the welfare effects of price discrimination, complaining against the practice of charging children and seniors a lower price, or offering discount coupons to fixed income, or merely frugal, customers. Nobel Prize-winning economist Milton Friedman was fond of saying there is no such thing as a free lunch; yet the consumer surplus is, in effect, a free lunch, especially beneficial to the poor and lower-income members of society.

Even though economists can justify the practice of price discrimination with social welfare empirical evidence, businesses still must take into account the perceptions of fairness in establishing its pricing policies. Although customers are assumed to be rational economic agents, there is no doubt that emotions and perceptions of fair play influence their behavior. A strategic pricing policy takes these perceptions into account. Fortunately, there is now some guidance to assist in taking into account another dimension of human behavior beyond maximum utility calculations and the theory of rationality.

## PROSPECT THEORY

In 2002, Super Bowl tickets sold in the official channel for \$350, yet could be purchased on the market for as high as \$6,000. Very few people who purchased the tickets for \$350 sold for \$6,000, even though not many would have paid \$6,000 originally, seemingly in defiance of the assumption of rationality discussed in Chapter 6.

Consider these two scenarios:

You possess a ticket to a Broadway play, costing \$50. Upon arriving at the theater, you discover that you have lost the ticket. Would you buy another one?

You arrive at a Broadway play you want to see, costing \$50. Upon arriving, you discover that you have lost \$50 in cash. Do you buy a ticket to the play?

Most people answer that they would still buy a ticket if they lost \$50 cash, but less than half would buy another ticket for the one they lost. Yet, there is no economic difference between the two scenarios, except the way they are framed.

Israeli psychologists Daniel Kahneman and Amos Tversky created in 1979 what has become known as behavioral economics—they labeled it *prospect theory*. It sets out to describe how people evaluate losses and gains (in 2002, Kahneman shared the Nobel Prize in economics; unfortunately, Tversky had already passed away and the Nobel Prize is not given posthumously). Prospect theory maintains that people give more weight to losses than gains, and certainly the experiments discussed above lend credence to this theory. In fact, *loss aversion* posits that we feel the pain from a loss twice as keenly as we feel the pleasure from a similar-sized gain.

The Super Bowl ticket outcome is explained by the *endowment effect*. This says that people demand much more to give up something than they are willing to pay for it. Ownership creates inertia.

More people are willing to pay \$500 for a global positioning system when buying a new car rather than installing it in their existing car. When employees were asked what percentage of their forthcoming raise they wanted to invest in their 401(k) plans, a larger percentage was stated if they were asked months *before* the raise, than after they already received it in their paychecks. A future sacrifice is a sacrifice unfelt.

Suppose you want to buy a new \$20,000 car. Would you rather sell your Microsoft stock for \$20,000 (you paid \$10,000), or \$20,000 of your General Motors stock (you paid \$30,000). Most people answered they would sell the winner (Microsoft) and hang on to the loser, what Peter Lynch referred to as pulling up the flowers and watering the weeds. Of course, there is no absolute rational answer since future values are impossible to predict. But it is curious since the goal of investing in the market is to make money, not redeem past mistakes.

In a purely rational sense, a price difference of \$400 between two products is the same no matter what the total product price is. However, that same \$400 is perceived to be a much larger difference for a \$1,000 purchase than it is for a \$20,000 purchase. In one study, 68 percent of the respondents said they were willing to drive to another store to save \$5 on a calculator selling

for \$15; but if the same calculator cost \$125, only 29 percent of the respondents were willing to do so (Nagle and Holden, 1995: 300). The tendency of buyers to engage in this type of calculation is known as the Weber-Fechner Law, which states that *buyers perceive price differences in proportional terms, not absolute terms*. This refers to the percentage change in price, and not to the absolute level, and indicates that there is an upper and lower threshold of price in the mind of each customer. If the price falls outside of that band, customers ignore the offering.

It appears that many actions people take are done with the full knowledge they are *irrational*, as the above examples illustrate. People will reject transactions whose terms they perceive to be unfair, even though the exchange would make them better off in an absolute sense, and rationality would predict that they should accept the deal.

How a price is framed can make all the difference in dealing with perceptions of fairness. In the Coke vending machine example discussed earlier, it would have been perceived as fair if Coke started with the higher temperature price and lowered it as the weather became cooler. It is more acceptable to list peak season prices and then discount from those than to add premiums to a lower listed price. Gas stations learned that it is better to offer a discount when customers pay in cash rather than charge a premium for using a credit card. Even though these transactions have the exact same economic consequences, since they are perceived as being fair, they are more accepted.

Imagine the following scene:

You are lying on the beach on a hot day....For the past hour you have been thinking about how much you would enjoy a nice cold bottle of your favorite brand of beer. A companion gets up to make a phone call and offers to bring back a beer from the only nearby place where beer is sold (a fancy resort hotel) [a run-down grocery store]. He says that the beer might be expensive and so asks how much you would be willing to pay for the beer. He says he will buy the beer if it costs as much or less than the price you state, but if it costs more than the price you state he will not buy it. You trust your friend, and there is no chance of bargaining with the (bartender) [storeowner]. What price do you state? (quoted in Frank, 1998: 174).

The median price stated from the fancy hotel was \$2.65 and from the grocery store \$1.50. Note that the customer would be drinking the beer on the beach and not entering the hotel or store where the beer was purchased, and thus—under the theory of rationality—should be willing to pay the same

amount no matter where the beer is ultimately purchased. But most people who participated in this study expressed the feeling they would rather go thirsty than be “ripped off” by the grocery store.

Of course, one can make the argument that this experiment is not completely valid because the participants were asked to *imagine* sitting on a beach in the hot sun, rather than actually doing so. Therefore, they are stating how they *think* they would react under those circumstances, which may be different from what they actually would do under those circumstances—their *revealed preference*. That said, there is no doubt that pricers need to understand how prices affect their customers’ perceptions of fairness, and if there are superior ways to frame prices, payment terms, or other conditions of the transaction that will not violate people’s subjective and emotional determinations of fairness.

Ethics and pricing cannot be separated, nor should they be. The concept of a “just price” will most likely not be solved anytime soon. Companies should be prepared to defend and justify their pricing policies, and the most efficacious way to do this is based on value.

It has been noted that ethics is doing the right thing even when no one is watching. Ethical behavior is obedience to the unenforceable, whereas the law is obedience to the enforceable. We now turn our attention to the enforceable antitrust laws.



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## ANTITRUST LAW

*Monopoly had become as popular a subject in economics as sin has been in religion. There is a characteristic difference: Economists are paid better to attack monopoly than the clergy are to wrestle with sin. It is to be observed that the economists who defend monopoly in antitrust cases are better paid than the government's economists: Do sinners always earn more than the virtuous who combat them? Probably yes; one must be compensated for bearing the opprobrium of sinning.*

—George J. Stigler, *Memoirs of an Unregulated Economist*, 1985

After the Civil War, with the development of better transportation systems that integrated a host of local markets into a national market, business corporations grew to unprecedented size in order to take advantage of economies of scale. As this process unfolded, many small and undercapitalized businesses went bankrupt or were purchased by larger concerns, and the term *robber baron* gained currency. The public was suspicious of this concentration of economic power, and politicians responded in 1890 by passing the first antitrust law, the Sherman Antitrust Act. The act was thought the perfect remedy to stop any business from monopolizing its market and to restore efficient competition to the economy.

Over the years, antitrust policy has evolved through further legislative acts and amendments, regulatory guidelines and judicial interpretation, which obviously have implications for various pricing decisions. Although services are not subject to certain provisions of these laws—for instance, price discrimination—many businesses are affected, and the laws need to be taken into account when formulating pricing strategy.

This chapter is not intended to be a comprehensive examination of the legal and strategic ramifications of antitrust law, but rather to serve as an introduction to the cornerstones of federal antitrust legislation and landmark

cases, the justifications for them, and the criticisms leveled against them in recent years. Each state has its own antitrust provisions, and will not be addressed here due to space considerations. The major antitrust legislation and landmark cases are as follows:

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Sherman Antitrust Act, 1890	Made acts in restraint of trade illegal.
Standard Oil and American Tobacco Cases, 1911	Broke up both firms (each of which accounted for more than 90% of their industry) into smaller companies.
The Federal Trade Commission Act (FTC Act), 1914; establishment of the Federal Trade Commission	Established to investigate unfair practices and issue orders to “cease and desist.”
Clayton Act, 1914	Outlawed unfair trade practices. Restricted mergers that would substantially reduce competition.
Robinson-Patman Act, 1936	Strengthened provisions of the Clayton Act, outlawing price discrimination.
Alcoa Case, 1945	Alcoa, controlling 90% of the aluminum market, was found to be in violation of the Sherman Act.
Tobacco Case, 1946	The tobacco industry, a concentrated oligopoly, was found guilty of violation of the Sherman Act on the basis of tacit collusion.
Celler-Kefauver Antimerger Act, 1950	Placed further restrictions on mergers that would reduce competition.
DuPont Cellophane Case, 1956	Broadened the definition of market. Ruled that a 20% market share was insufficient to establish market power.

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Source: Stiglitz and Walsh, 2002: 279

## ANTITRUST ENFORCEMENT AND THE CONSUMER

The U.S. Department of Justice’s web site contains an explanation of the antitrust laws, entitled “Antitrust Enforcement and the Consumer,” signed by Joel I. Klein, Assistant Attorney General, Antitrust Division. Here is how the pamphlet explains the purpose of antitrust laws:

Many consumers have never heard of antitrust laws, but when these laws are effectively and responsibly enforced, they can save consumers millions and



even billions of dollars a year in illegal overcharges. Most states have antitrust laws, and so does the federal government. Essentially, these laws prohibit business practices that unreasonably deprive consumers of the benefits of competition, resulting in higher prices for inferior products and services ([www.usdoj.gov/atr/public/div\\_stats/1638.htm](http://www.usdoj.gov/atr/public/div_stats/1638.htm)).

The pamphlet answers “What are the federal antitrust laws, and what do they prohibit?”

There are three major federal antitrust laws: The Sherman Antitrust Act, the Clayton Act and the Federal Trade Commission Act.

The Sherman Antitrust Act has stood since 1890 as the principal law expressing our national commitment to a free market economy in which competition free from private and governmental restraints leads to the best results to the consumers. Congress felt so strongly about this commitment that there was only one dissenting vote to the Act.

The Sherman Act outlaws all contracts, combinations, and conspiracies that unreasonably restrain interstate trade. This includes agreements among competitors to fix prices, rig bids and allocate customers. The Sherman Act also makes it a crime to monopolize any part of interstate commerce. An unlawful monopoly exists when only one firm provides a product or service, and it has become the only supplier not because its product or service is superior to others, but by suppressing competition with anticompetitive conduct. The Act is not violated simply when one firm’s vigorous competition and lower prices take sales from its less efficient competitors; rather, that is competition working properly.

Sherman Act violations are punished as criminal felonies. The Department of Justice alone is empowered to bring criminal prosecutions under the Sherman Act. Individual violators can be fined up to \$350,000 and sentenced to up to 3 years in federal prison for each offense; corporations can be fined up to \$10 million for each offense. Under some circumstances, the fines can go even higher.

The Clayton Act is a civil statute (it carries no criminal penalties) that was passed in 1914 and significantly amended in 1950. The Clayton Act prohibits mergers or acquisitions that are likely to lessen competition. Under the Act, the government challenges those mergers that a careful economic analysis shows are likely to increase prices to consumers. All persons considering a merger or acquisition above a certain size must notify both the Antitrust Division and the Federal Trade Commission. The Act also prohibits certain other business practices that under certain circumstances may harm competition.

The Federal Trade Commission Act prohibits unfair methods of competition in interstate commerce, but carries no criminal penalties. It also created the Federal Trade Commission to police violations of the Act.

The Department of Justice also often uses other laws to fight illegal activities, including laws that prohibit false statements to federal agencies, perjury, obstruction of justice, conspiracies to defraud the United States and mail and wire fraud. Each of these crimes carries its own fines and imprisonment terms which may be added to the fines and imprisonment terms for antitrust law violations (*ibid.*).

It also answers “How are antitrust laws enforced?”

There are three main ways in which the federal antitrust laws are enforced: criminal and civil enforcement actions brought by the Antitrust Division of the Department of Justice, civil enforcement actions brought by the Federal Trade Commission and lawsuits brought by private parties asserting damage claims.

The Department of Justice uses a number of tools in investigating and prosecuting criminal antitrust violations. Department of Justice attorneys often work with agents of the Federal Bureau of Investigation (FBI) or other investigative agencies to obtain evidence. In some cases, the Department may use court authorized searches of business, consensual monitoring of phone calls and informants equipped with secret listening devices. The Department may grant immunity to individuals or corporations who provide timely information that is needed to prosecute antitrust violations, such as bid rigging or price fixing.

A provision in the Clayton Act also permits private parties injured by an antitrust violation to sue in federal court for three times their actual damages plus court costs and attorneys’ fees. State attorneys general may bring civil suits under the Clayton Act on behalf of injured consumers in their states, and groups of consumers often bring suits on their own. Such follow-on civil suits to criminal enforcement actions can be a very effective additional deterrent to criminal activity.

Most states also have antitrust laws closely paralleling the federal antitrust laws. The state laws generally apply to violations that occur wholly in one state. These state laws are enforced similarly to federal laws through the offices of state attorneys general (*ibid.*).

It also offers this advice to “How can you know if the antitrust laws are being violated?”

If any person knows or suspects that competitors, suppliers or even an employer are violating the antitrust laws, that person should alert the antitrust agencies so that they can determine whether to investigate. If you suspect your own company, remember that antitrust violations can be a federal felony; if you know about a violation and you say nothing, in certain circumstances you yourself could later be held criminally responsible and, in addition to losing

your job and your reputation in your community, you could be subject to substantial fines and even imprisonment.

Price-fixing and bid-rigging conspiracies are most likely to occur where there are relatively few sellers that have to get together to agree. The larger the group of sellers, the more difficult it is to come to an agreement and enforce it.

Keep an eye out for tell-tale signs. For example:

- generally, any evidence that two sellers of similar products have agreed to price their products a certain way, to sell only a certain amount of their product, or to sell only in certain areas or to certain customers;
- large price changes involving more than one seller of very similar products of different brands, particularly if the price changes are of equal amount and occur at the same time;
- a seller's statement that "We can't sell to you; according to our agreement, so-and-so (the seller's competitor) is the only firm that can sell to you;"
- fewer competitors than normal submit bids on a project;
- competitors submit identical bids;
- the same company repeatedly has been the low bidder who has been awarded contracts for a certain service or in a particular area;
- bidders seem to win bids on a fixed rotation;
- there is an unusual and unexplainable large dollar difference between the winning bid and all other bids;
- the same bidder bids substantially higher on some bids than on others, and there is no logical cost reason to explain the difference.

These signs are by no means conclusive evidence of antitrust violations. More investigation by trained lawyers and economists would be required to determine that. But they may be indications, and the people who enforce the antitrust laws want to hear about them (ibid.).

## THE SHERMAN ANTITRUST ACT, 1890

*A careful student of history of economics would have searched long and hard, on the unseasonably cool day of July 2 of 1890, the day the Sherman Act was signed by President Harrison, for any economist who had ever recommended the policy of actively combating collusion or monopolization in the economy at large.*

—George Stigler, Nobel Prize-winning economist,  
*The Economist as Preacher, and Other Essays*, 1982

Sections I and II of the Sherman Antitrust Act read, in part:

Section I

Every contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce among the several States, or with foreign nations, is hereby declared to be illegal . . .

Section II

Every person who shall monopolize, or attempt to monopolize, or combine or conspire with any other person or persons, to monopolize any part of the trade or commerce among the several States, or with foreign nations, shall be deemed guilty . . .

A 1974 amendment to the Sherman Act made violations felonies rather than a misdemeanor as in the original law.

The first legal action involving the Sherman Act to reach the Supreme Court was the E.C. Knight case, decided in 1895. For the Justice Department, the case turned out to be a mild disaster. While the court admitted that the acquisition of the E.C. Knight Company and three other independent sugar refineries by the American Sugar Refining Company did tend to create a monopoly in sugar manufacturing, it held that the “sugar trust” was not in violation of the Sherman Act.

In 1904, the federal government won its first case, in *United States v. Northern Securities*, preventing a merger allegedly designed to reduce price competition between two railroads. Energized by its victory in this case, the Justice Department initiated a number of legal actions against large corporate holdings, none of which were as important as the one filed in a St. Louis Federal Court on November 15, 1906, against the Standard Oil Company of New Jersey.

The modern petroleum industry began in 1846 when Dr. Abraham Gesner, a Canadian geologist, discovered that oil could be distilled from coal, and kerosene could be drawn off and used as an illuminant. By 1880, John D. Rockefeller was the king of the industry, with his Standard Oil Company holding the dominant market share, which grew between 1870 and 1879 from 4 to 90 percent. How did he achieve such a dominant market position? “Between 1870 and 1885, the price of refined kerosene dropped from 26 cents to 8 cents per gallon. In the same period, the Standard Oil Company reduced average costs per gallon from almost 3 cents in 1870 to 0.452 cents in 1885” (Armentano, 1990: 60).

Legend has it this was predatory pricing: the act of deliberately under-selling competitors in certain markets in order to drive them out of business. Once they are gone, the monopolist raises the price in the absence of competition. History books have immortalized this view of Standard Oil, and predatory pricing has been a major concern of government antitrust lawyers, politicians, and the general public then and now. However, like most conventional wisdom, this theory is more conventional than wisdom, as explained by Dominick T. Armentano in his indictment of antitrust laws, *Antitrust and Monopoly: Anatomy of a Policy Failure*:

Unfortunately for lovers of legends, this one has been laid theoretically and empirically prostrate. In a now classic article, John S. McGee theorized that Standard Oil did not employ predatory practices because it would have been economically foolish to have done so. In the first place, McGee argued, such practices are very costly for the large firm; it always stands relatively more to lose since it, by definition, does the most business. Second, the uncertainty of the length of the forthcoming battle, and thus its indeterminate expense, must surely make firms wary of initiating a price war. Third, competitors can simply close down and wait for the price to return to profitable levels; or new owners might purchase bankrupt facilities and ready them to compete with the predator. Fourth, such wars inevitably spread to surrounding markets, endangering the predator's profits in his "safe" areas. And last, predatory practices already assume a "war chest" of monopoly profits to see the firm through the costly battles; firms apparently cannot initiate predatory practices unless they already possess monopoly power. But if this is true, firms cannot gain initial monopoly positions through predatory practices.

Thus...Standard's position in oil refining grew rapidly because of the natural decline of small competitors; the increasing capital and innovation requirements of large-scale oil technology; the economic advantages achieved through intelligent entrepreneurship; the ownership of tank cars and pipelines; vertical integration into barrels, cans, glues, exporting; and the consequent lower transportation costs provided by the railroads. It did not grow from any general reliance on alleged predatory practices (ibid.: 63–64).

Economist John R. Lott, Jr. has also examined the incidence of predatory pricing and has found little evidence for it. In his book *Are Predatory Commitments Credible?* he writes:

George Stigler wrote that support for "the Sherman Act came from small business interests" who desired protection from more efficient competitors. These small firms may have justified the law as protection against predation, but,

from a wealth-maximizing point of view, Stigler's evidence indicates that the motivation for this law was no different than that for high tariffs barriers. Indeed in 1890 the strongest supporters of the Sherman Act, including [Senator John] Sherman himself, were supporters of high tariffs to protect their constituents from competition. The evidence in this book is consistent with Stigler's and Hazlett's hypothesis that antitrust enforcement was intended to punish more efficient firms rather than to increase efficiency (Lott, 1999: 121–22).

It is important to note that most antitrust cases are filed by one business against another (customers have no standing to sue). The treble damage provisions also provide an incentive for harmed competitors to call attention to the government of violations. There are two arguments for this private law enforcement. First, those who are harmed by anticompetitive behavior are in the best position to witness a violation of the law. Second, the government might be less aggressive in enforcing the laws due to the political influence of large companies. Supporting the notion that most antitrust cases are filed by inefficient competitors—since the number of private suits doubled between 1960 and 1970s—economist Steven Landsburg describes another case in his *Price Theory and Applications* textbook:

In 1991, three pharmacies in Arkansas sued Wal-Mart for predatory pricing of prescription drugs. The three pharmacies maintained that Wal-Mart had deliberately set low prices to drive them out of business and establish a monopoly; Wal-Mart responded that it offered lower prices because it was more efficient than the other pharmacies. In essence, the plaintiffs were arguing that Wal-Mart priced below marginal cost, whereas Wal-Mart argued that both its prices and its marginal costs were low. A trial court agreed with the plaintiffs, but the Arkansas Supreme Court (in a 4-3 decision) overturned the trial court and ruled in Wal-Mart's favor.

Wal-Mart was helped at trial when one of the plaintiffs admitted that competition from Wal-Mart had provoked him to greater efficiency, which suggests that before Wal-Mart's arrival, prices had in fact been higher than necessary (Landsburg, 2002: 388).

It is difficult to understand how the customer's interests are served by bringing a lawsuit against a business that offers lower prices for products they desire. Thus are the contradictions inherent in antitrust laws and their enforcement, as well as the lingering myth—against all empirical evidence—of predatory pricing. As David Friedman, Milton Friedman's son and an

exceptional economist at illustrating unintended consequences, writes in his textbook *Price Theory*:

One consequence of such myths may be to encourage monopoly. Selling at below cost is a poor way of driving your competitors out of business but may be a good way for a new firm to persuade customers to try its products [such as the penetration pricing strategy discussed in Chapter 16]. Under present antitrust law, a firm that does so risks being accused by its competitors of unfair competition and forced to raise its price. Laws that make life hard for new firms—or old firms entering new markets—reduce competition and encourage monopoly, even if they are called antitrust laws (Friedman, 1990: 279).

Even though the government won its case against Standard Oil and tobacco trusts, supporters of antitrust were still not satisfied with the narrow interpretations by the court and Congress began work on two additional legislative initiatives designed to prevent further anticompetitive business practices.

## THE FEDERAL TRADE COMMISSION ACT, 1914

The Federal Trade Commission was established in order to enforce the provisions of the Sherman Antitrust Act in a more rapid manner than could be achieved by judicial law. The first sentence of the FTC Act reads, “Unfair methods of competition in commerce are hereby declared unlawful.” Section 5 of the FTC Act reads, “The Commission is hereby empowered and directed to prevent persons, partnerships, or corporations . . . from using unfair methods of competition in commerce.” The FTC could ban a business practice merely because of the suspicion that it promoted unfair competition, without the permission of a court.

Restrictive practices usually deal with the relationship between a firm and its distributors and suppliers. Practices such as tying, exclusive dealing, and price discrimination fall under the definition of restrictive practices (the Robinson-Patman Act of 1936 strengthened the provisions outlawing price discrimination, discussed further below). What, exactly, constitutes restrictive practices has changed over time with varying court interpretations. Some practices are illegal per se, such as conspiring to fix prices, which General Electric and Westinghouse were found guilty of in 1961. Archer Daniels Midland (ADM) was also involved in several price-fixing cases

involving lysine, citric acid, and high fructose corn syrup, leading to more than \$100 million in fines and some of its officers serving in prison.

In the late 1970s, the FTC discovered unintended consequences with one of its regulations against alleged “bait-and-switch” tactics. Customers would travel to stores only to discover the sale item was out of stock. In the mid-1970s the FTC issued a series of regulations requiring companies to have a “reasonable quantity” of any advertised sales price item. Of course, items are put on sale usually because they are not selling well, and by requiring companies to have on hand a “reasonable quantity” of slow-moving items, many businesses simply stopped offering sales altogether. Since lower-income customers are more willing to spend time shopping for sales than high-income customers, this regulation actually hurt the very people it was designed to protect. Fortunately, the FTC rescinded these regulations.

Currently, the FTC uses a “rule of reason,” which balances higher prices with efficiency gains. For instance, the New York attorney general has argued that Budweiser restricts competition due to its exclusive distribution territories, whereby there exists only one distributor for each territory. Anheuser-Busch counters it needs to maintain exclusive territories in order to ensure efficiency and freshness in beer delivery, and so far the courts have upheld this under the rule of reason.

Also, the FTC has the authority to subject pricing practices to administrative review, not in order to punish past wrongdoing, but to make new law. The FTC is empowered to order a business to cease and desist from any practice it deems unfair, even if that practice would not necessarily be deemed unfair or anticompetitive in a court of law.

## THE CLAYTON ACT, 1914

The Clayton Act was passed to correct various defects and omissions of the Sherman Act. Specifically, it prohibits anticompetitive mergers, tying arrangements, exclusive dealing agreements, interlocking directorates, and the acquisition of stock in competitor companies. The antimerger provisions were further strengthened in 1950 when Congress passed the Celler-Kefauver Antimerger Act. Also, Section 2(a), as amended by the Robinson-Patman Act, prohibits predatory price discrimination, but only in tangible products (it does not cover real estate, services, technology licenses, lease of facilities, or contract rights and privileges):



That it shall be unlawful for any person engaged in commerce, in the course of such commerce, either directly or indirectly, to discriminate in price between different purchasers of commodities of like grade and quality, where either or any of the purchases involved in such discrimination are in commerce, where such commodities are sold for use, consumption, or resale within the United States or any Territory thereof or the District of Columbia or any insular possession or other place under the jurisdiction of the United States, and where the effect of such discrimination may be substantially to lessen competition or tend to create a monopoly in any line of commerce, or to injure, destroy, or prevent competition with any person who either grants or knowingly receives the benefit of such discrimination, or with customers of either of them: Provided, That nothing herein contained shall prevent differentials which make only due allowance for differences in the cost of manufacture, sale, or delivery resulting from the differing methods or quantities in which such commodities are to such purchasers sold or delivered: Provided, however, That the Federal Trade Commission may, after due investigation and hearing to all interested parties, fix and establish quantity limits, and revise the same as it finds necessary, as to particular commodities or classes of commodities, where it finds that available purchasers in greater quantities are so few as to render differentials on account thereof unjustly discriminatory or promotive of monopoly in any line of commerce; and the foregoing shall then not be construed to permit differentials based on differences in quantities greater than those so fixed and established: And provided further, That nothing herein contained shall prevent persons engaged in selling goods, wares, or merchandise in commerce from selecting their own customers in bona fide transactions and not in restraint of trade: And provided further, That nothing herein contained shall prevent price changes from time to time where in response to changing conditions affecting the market for or the marketability of the goods concerned, such as but not limited to actual or imminent deterioration of perishable goods, obsolescence of seasonal goods, distress sales under court process, or sales in good faith in discontinuance of business in the goods concerned (Armentano, 1990: 281–82).

### THE ROBINSON-PATMAN ACT OF 1936

After the passage of the Clayton Act in 1914, chain stores grew rapidly and increased their buying power, and this type of price discrimination was thought to threaten the survival of independent wholesalers and retailers. Therefore, in 1936, Congress passed the Robinson-Patman Act in order to strengthen the Clayton Act. This was in the middle of the New Deal, and protecting small businesses was viewed as a legitimate goal of antitrust policy.

During the Great Depression, government policymakers were averse to price competition, believing it to be a major cause of the economic stagnation of the 1930s. Small business interest groups, in fact, were the impetus behind the passage of the Act, which was actually drafted by the U.S. Wholesale Grocers' Association. The Act:

Deleted the exemption, which existed in the original Clayton Act, that allowed firms to price discriminate among buyers who purchased different quantities of a good.

Forbade price rebates to selected buyers in the form of fees for brokerage, handling, processing, or any other services when those same fees were not offered to all buyers equally.

Made it illegal for buyers (that is, the large chains) to solicit lower prices from manufacturers if those prices would be discriminatory under the amended Clayton Act (Nagle and Holden, 1995: 365).

Economist Steven Landsburg explains the Supreme Court's interpretation of the Robinson-Patman Act in the 1967 case *Utah Pie v. Continental Baking Company*:

Utah pie was a small local company with 18 employees marketing frozen pies in the Salt Lake City area. Continental Baking, Carnation, and Pet were large national producers of a wide variety of food products. Utah Pie alleged that these three giants price-discriminated in an injurious way by selling frozen pies at a lower price in Salt Lake City than they did elsewhere. The Supreme Court agreed.

All parties to the Utah Pie case were in agreement that the defendants charged lower prices in Utah Pie's marketing territory than they did outside it. However, this could have resulted from the fact that elasticity of demand for Continental pies was greater in areas where Utah Pie's products were sold. In other words, Continental's actions could have been a simple case of ordinary third-degree price discrimination [see Chapter 14].

...[T]he price discrimination could have been considered predatory only if the defendants had priced below marginal cost in the Salt Lake City area. No evidence was offered that they had done so. Thus, the Supreme Court's decision makes deviation from marginal cost an irrelevant criterion in deciding whether a pricing policy can be considered predatory. For this reason, economists generally regard Utah Pie as a bad decision. By forbidding Continental et al. to undercut Utah Pie's prices, the Court is as likely to have created a local monopoly (in the hands of Utah Pie) as to have prevented one.

In fact, the Supreme Court essentially took the position that the mere fact that the price of pies decreased in Salt Lake City constituted a violation of the Robinson-Patman Act! This reinforced the Court's interpretation of the Sherman and Clayton acts, by reaffirming that benefits to consumers are not considered a defense against the charge of injury to other firms (Landsburg, 2002: 389–90).

The foregoing acts are the major foundation of antitrust policy today. They have been amended many times by later legislative acts and special exemptions have been granted to various interest groups, such as labor unions, insurance companies, and farm cooperatives.

### **PRICE DISCRIMINATION AS PROHIBITED BY THE ACTS**

Since so much of this book has dealt with price discrimination, it is worth exploring the judicial interpretations of this ubiquitous practice to ensure that your pricing strategies do not run afoul of these laws.

The term *commodities of like grade and quality* as used in the Clayton Act has been interpreted narrowly by the courts to mean tangible goods; the Act does not apply to discrimination in services. Price discrimination among final consumers is prohibited under the Civil Rights Act if the basis for such discrimination is the race, religion, or sex of the purchaser. Furthermore, any tangible difference in the materials, workmanship, or design is recognized as a difference in grade or quality, and thus a manufacturer can sell a deluxe model (think of Chevy vs. Cadillac), or a customized model, at a premium price that more than reflects the cost of production, without violating the law.

One of the landmark legal cases in the price discrimination area is *The Borden Company v. Federal Trade Commission*, 339 F. 2d 133. In April of 1958 the FTC issued a complaint against the Borden Company, accusing it of selling goods of like grade and quality to different buyers at different prices with the effect of reducing competition. The goods in question were Borden's private label evaporated milk and "identical" milk that it made and sold under private label. The price difference between the two milks was substantial, and the FTC charged that this difference violated the Robinson-Patman Act. On November 28, 1962, the FTC ordered the Borden company to cease price discriminating on goods of like grade and quality sold to different buyers at different prices.

On December 4, 1964, a Circuit Court of Appeals dismissed the FTC's cease-and-desist order against Borden. As Armentano documents in *Antitrust and Monopoly*:

Circuit Judge Joseph C. Hutcheson, Jr., reviewing the undisputed facts in the case, argued that the first issue was "whether or not the Commission applied the correct legal test in deciding that the commodities sold at different prices were of like grade and quality."

Judge Hutcheson indicated that the record clearly showed that Borden's own brand of evaporated milk did command a premium price in the market, and that the Borden product was recognized as a premium product by both consumers and dealers who sold evaporated milk. To support these conclusions, the court quoted testimony of grocers that had stated that consumers asked for the Borden brand by name, and could not be convinced to accept some other brand. Significant price differentials had to exist, apparently, before dealers would even stock and sell other brands. That dealers continued to purchase both products and the different prices indicated, to the court, that one was a "premium line" and one was not.

But was the "demonstrated consumer preference" for the Borden brand to receive legal recognition? The Circuit Court thought it should. Contrary to what the FTC declared, there was no clear Congressional intent on the matter of "private brands" and price discrimination. In fact, if the intent of the Robinson-Patman and the rest of the antitrust statutes generally was to avoid price rigidity and price uniformity, then "commercial factors" had to be considered in pricing.

[Armentano then quotes from the Court's opinion:]

An established brand name may have a large following among purchasers. This fact can be of great economic significance in a competitive market. We do not believe it was the intention of Congress that such clearly demonstrable consumer preference should simply be ignored in determining when products may be priced differently. As a practical matter, such preferences may be far more significant in determining the market value of a product than are its physical characteristics (Armentano, 1990: 189).

The Court ruled in favor of Borden and set aside the FTC order. Subsequently, the Supreme Court reversed the Circuit Court of Appeals decision on the issue of "like grade and quality," and remanded the Borden case back to the Appeals Court. Also, the Supreme Court hypothesized that if a manufacturer sold its branded, higher-priced milk to a retailer, but refused to sell the private-label brand to him:

the retailer who was permitted to buy and sell only the more expensive brand would have no chance to see to those who always buy the cheaper product or to convince others, by experience or otherwise, of the fact which he and all other dealers already know—that the cheaper product is actually identical with that carrying the more expensive label (ibid.: 190).

Justice Stewart and Harland dissented from the majority, and Stewart wrote, rather disgustingly:

In the guise of protecting producers and purchasers from discriminatory price competition, the Court ignores legitimate market preferences and endows the Federal Trade Commission with authority to disrupt price relationships between products whose identity has been measured in the laboratory but rejected in the marketplace. I do not believe that such power was conferred upon the Commission by Congress... (ibid.: 191).

The Circuit Court again considered, and again dismissed, the FTC cease-and-desist order, ruling “the record does not contain substantial injury to competition at the seller’s level.” Recall the discussion, from Chapter 16, of the price difference between Lancôme and L’Oréal cosmetics. The brand is far more important to customers than the actual ingredients of the makeup, and thus a higher price is charged for Lancôme than for L’Oréal.

Another key phrase in the Clayton Act quoted above is in commerce, which has been interpreted to mean an injured party has to be a business whose ability to compete has been hampered by a discriminatory price. Consumers can always be charged different prices since they are not using the products in commerce. A wholesaler, however, may be found in violation for charging different retailers different prices because the retailers are engaged in commerce.

The term *substantially to lessen competition* has two interpretations.

Price discrimination will be found to violate the law if it harms competition at either of two levels. Primary-level competition is between the firm that price discriminates and its own competitors. Secondary-level competition is between two firms that are customers of the firm that price discriminates (or are customers of a middleman who is, in turn, a customer of the price discriminating firm). The courts do not want to discourage price-cutting at the primary level, even when it is discriminatory, unless competition is clearly harmed (Nagle and Holden, 1995: 376).

There are three specific affirmative legal defenses a company can invoke to protect itself from prosecution for illegal price discrimination: (1) meeting competition, (2) changing market conditions, or (3) cost justification.

## CRITICISMS OF ANTITRUST POLICY

Antitrust policy has come under intense scrutiny in recent decades, especially by the economics profession. One of the most thorough indictments is Dominick T. Armentano's *Antitrust and Monopoly*. His work is a major exploration of the economic theories underlying antitrust law, and how those theories are flawed, as well as the major court cases and regulatory actions in the antitrust area. He concludes that both "antitrust theory and history are an elaborate mythology with no solid foundation in either logic or fact." Here is a partial summary of his more scathing conclusions:

In many of the classic antitrust cases, both public and private, the indicted defendant firms had lowered their prices, expanded their outputs, engaged in rapid technological change, and generally behaved in ways consistent with an efficient and rivalrous market process. Indeed, it was precisely this rivalrous behavior that may have precipitated the antitrust legal action. There is now wider recognition among antitrust specialists that competition is a process—not an equilibrium condition—and that antitrust (especially in the private cases) has been employed often as a legal club to thwart competitive behavior and protect existing market structure (Armentano, 1990: 2).

Government, and not the market, is the source of monopoly power. Government licensing, certificates of public convenience, franchises, tariffs, and other legally restrictive devices can and do create monopoly, and monopoly power, for specific business organizations protected from open competition. Thus, ironically or intentionally, the bulk of the abusive monopoly in the business system has always been beyond the scope of antitrust law and antitrust policy (*ibid.*: 3).

...[V]arious scholars have demonstrated that these particular "antitrust" statutes were often supported and employed by established business interests in an attempt to restrain and restrict the competitive process. Unable to compete effectively with more efficient business organizations, certain special interests sought political and legislative restrictions in an attempt to secure or enhance existing market positions (*ibid.*: 6).

In many and important and embarrassing ways, the Borden controversy is a fitting climax—a climax of absurdity—with respect to price discrimination

under the antitrust laws. It is the theoretical dead-end to which a mechanistic, demand-ignoring, “costs (should) determine prices” theorem can be pushed. The products under discussion were clearly distinguished in the mind, and in the market behavior of the consumers; the products did not really compete directly with each other; the products had different brand names, sold in different ways and at different prices, to different buyers. Yet they were declared by an “expert” regulatory commission and by the highest court in the land to be “equal” and of like grade and quality. Declaring it, apparently, would make it so.

What was the Borden Company to do under the circumstances? Were they to adulterate the production of private-brand evaporated milk in order to make it chemically “unequal”? Or were they to raise the price of the private-label milk to the Borden brand “equivalent”? The latter proposal would surely end the alleged “discrimination,” although it could bring a huge loss in the sales to Borden on their private-label accounts. Of course they could lower the price of the Borden brand to the private label rates; but this action could bring the Justice Department down upon Borden for attempting to eliminate competition from the market. One would also have to assume, since Borden had not voluntarily adopted this policy, that such a reduction in price would lower, rather than increase, Borden’s profits. In summation, therefore, Borden was illegally discriminating in price, and no change in its prices could have, it appears, been wholly consistent with the antitrust laws. Any change Borden might have made, other than giving up its private-label business altogether (a refusal to deal?), might have tended to “injure” someone in violation of the law (ibid.: 191–92).

Nobel Prize-winning economist Gary S. Becker also critiques the antitrust laws in his book *The Economics of Life*:

During the 1980s both the government and private antitrust cases have declined dramatically, while malpractice, product liability, and other business litigation has boomed. Specialists in antitrust law have shifted to other business areas as the once-prosperous antitrust field has fallen on difficult times.

The immediate cause of the decline has been the growing influence of economic analysis of competition and business practices on the thinking of judges and government officials. That analysis shows that competition usually promotes efficiency and the well-being of consumers and that anticompetitive behavior arises mainly from unwise public policies and a natural tendency for rival producers to collude on prices and production.

Conspiracies in restraint of trade tend to break down eventually without an active antitrust policy. Companies that are part of a conspiracy cheat on their

output quotas, and high prices attract new companies into their industry. The experience of OPEC illustrates the spontaneous breakdown of an open conspiracy outside antitrust laws. However, antitrust policy can certainly discourage business conspiracies by imposing large fines and other punishments.

Competition will weed out inefficient behavior without government intervention. Antitrust action should only challenge behavior that obviously encourages collusion, such as agreements among rival producers to divide a market into exclusive territories.

Since domestic producers try to use their political clout to reduce foreign competition through tariffs or import quotas, an open trade policy is as valuable as antitrust laws in the fight against collusion and anticompetitive behavior (Becker and Becker, 1997: 162–63).

Another Nobel Prize–winning economist, George J. Stigler, began his career as a proponent of vigorous antitrust laws and enforcement. After studying the issue most of his professional life, however, he came to doubt the efficacy of antitrust policy. In his 1982 book *The Economist As Preacher, and Other Essays*, he notes three lessons he learned with respect to antitrust laws:

After many years of abstention, I have recently been a participant in several antitrust cases. From these cases I have learned three things:

1. It was not exactly news, but it was impressed upon me that justice does not always prevail, and it is fortunate that Justice does not always prevail.
2. The number of economists, ranging from Nobel prize winners to graduate students no better known than the Unknown Soldier, who are employed in antitrust actions is large, running into the many hundreds.
3. The rate of compensation for economists in this activity is not in violation of the federal minimum wage law.

I simply record that antitrust testimony is probably one of the three or four major sources of income of economists, well below teaching and research but possibly equal to that earned from writing, lecturing, and televising the mother science, or from making macroeconomic predictions.

If you are unsatisfied with the adequacy of these explanations for the rise in favor among economists of the antitrust policy, you share that feeling with me (Stigler, 1982: 46).

Here is how Stigler summed up his opposition to the Robinson-Patman Act in 1969, before the Subcommittee on Small Business and the Robinson-Patman Act of the House Select Committee on Small Business:



... The Robinson-Patman Act is opposed by virtually all economists. I hope the Subcommittee will reflect upon the fact that if all the prominent economists in favor of the Robinson-Patman Act were put in a Volkswagen, there would still be room for a portly chauffeur (Stigler, 1985: 127–28).

Even Adam Smith was suspicious of any law advocated by groups of businessmen. Despite conventional wisdom, Adam Smith was no apologist for business people. In fact, he did not have many nice things to say about them, always calling into question the motives of their behavior. Professor Thomas Sowell used to offer his students an automatic grade of “A” if they could locate a nice word for businessmen in either of Smith’s two books, *The Theory of Moral Sentiments* or *Wealth of Nations*. No student was ever able to take advantage of Sowell’s offer. Smith was apprehensive of any meeting among businessmen, writing in *Wealth of Nations*:

[T]he proposal of any new law or regulation of commerce which comes from this order ought always to be listened to with great precaution . . . it comes from an order of men, whose interest is never exactly the same with that of the public, who have generally an interest to deceive and even to oppress the public, and who accordingly have, upon many occasions, both deceived and oppressed it (quoted in Blaug, 1997: 53).

Federal Reserve Chairman Alan Greenspan has also weighed in on anti-trust laws, in 1962 writing:

The world of antitrust is reminiscent of Alice’s Wonderland: everything seemingly is, yet apparently isn’t, simultaneously. It is a world in which competition is lauded as the basic axiom and guiding principle, yet “too much” competition is condemned as “cutthroat.” It is a world in which actions designed to limit competition are branded as criminal when taken by businessmen, yet praised as “enlightened” when initiated by the government. It is a world in which the law is so vague that businessmen have no way of knowing whether specific actions will be declared illegal until they hear the judge’s verdict—after the fact (quoted in DiLorenzo, 2004: 134).

Economist Yale Brozen’s 1982 treatise *Concentration, Mergers, and Public Policy* concluded that antitrust laws were “restraining output and growth in productivity” and contributing to a deterioration of the competitive position of the United States in competitive markets” (ibid.: 146).

Economist Murray Rothbard [1926–1995] explained how the luxury of hindsight is not how decisions have to be made in the marketplace:

Production *precedes* the sale of final products, and production costs must be incurred *before* consumers can demonstrate their preference for one's products. Hence, it is nonsense, for instance, to define a monopoly price as a price above marginal cost (or of marginal revenue higher than marginal cost) because the cost curves on the one hand and the demand and revenue curves on the other do not exist simultaneously. The only curves that exist simultaneously with cost curves are entrepreneurship estimated *future* demand and revenue curves (quoted in Holcombe, 1999: 235).

The great Austrian economist Joseph Schumpeter wrote in *Capitalism, Socialism and Democracy*, published in 1942 (third edition):

The introduction of new methods of production and new commodities is hardly conceivable with perfect—and perfectly prompt—competition from the start. And this means that the bulk of what we call economic progress is incompatible with it.... In this respect, perfect competition is not only impossible but inferior, and has no title to being set up as a model of ideal efficiency (quoted in McCloskey, 1985: 389).

Seminal management thinker Peter Drucker also contributes to the anti-trust debate:

Antitrust is an obsession of American lawyers, but I have no use for it. Any monopoly holds an umbrella over the newcomers, to be sure, but I am not afraid of monopolies because they eventually collapse. Thucydides wrote years ago that hegemony kills itself. A power that has hegemony always becomes arrogant. Always becomes overweening.... It becomes defensive, arrogant, and a defender of yesterday. It destroys itself (Drucker, 2002: 72).

Indeed, studying the history of antitrust cases and policy, one is left with the conclusion that almost any type of pricing behavior by a company is in violation of the law. If a company raises its prices above its competitors, it must be a monopoly. If a company lowers its prices below that of its competitors, it is obviously engaging in predatory behavior. If a company maintains its prices for any period of time, it must be colluding with its competitors to fix prices.

## THE CASE AGAINST MICROSOFT

On June 7, 2000, federal judge Thomas Penfield Jackson found Microsoft Corporation to be in violation of the antitrust laws, and ordered the company be broken up into two separate companies as a remedy—one company con-

trolling the Windows operating system and the other selling software applications (such as Microsoft Office).

A decade earlier, in 1990, the FTC investigated the company's software licensing practices and decided to close the case in 1992 without filing any charges. In 1998, under pressure from Microsoft's competitors, Senator Howard Metzenbaum (Democrat, Ohio), and Senator Orrin Hatch (Republican, Utah), the Department of Justice, and 20 state attorneys filed an antitrust suit against the company. It is interesting to note that 90 percent of all antitrust litigation is brought by private parties, usually competitors of the alleged monopolist (Armentano, 1999: xi). This case is unprecedented in American history, in terms of attacking a successful and innovative private company without any evidence of harm to the consumer (or high prices, for that matter, since prices in the computer industry have been falling rapidly for the past two decades). In addition, in an industry that operates in dog years (i.e., one year is like seven), the ultimate decision will be obsolete by the time the ink dries. Obviously, nothing was learned from the decade-long IBM antitrust suit, which wasted millions with no measurable benefits to the company, competition, or the consumer.

The offense is serious. As we have seen, anytime the government interferes with the pricing mechanism of the free market, unintended consequences are sure to follow. It needs to be emphasized that "monopoly" is not illegal under the Sherman Act; "monopolization" is. In many economists' opinion, monopolization was never proved against Microsoft. The case against the company was premised on the assumption that Microsoft was expanding its monopoly in operating systems to the Internet browser market. This is an interesting claim, since Microsoft gave away its browser for free, and Netscape reportedly distributed over 100 million copies of its browser, Navigator, during 1998 (*Wall Street Journal*, November 6, 1998, A3). In fact, as in most antitrust cases, the Department of Justice actually sought a preliminary injunction to require that Microsoft offer Netscape's browser with Windows or, alternately, sell its browser separately (*Wall Street Journal*, May 19, 1998, A3). It is an interesting question how selling a product once given away for free benefits consumers; but this is precisely the result in the majority of antitrust cases brought by the government—that is, the end result is usually a price increase to the customer. Ironically, the Justice Department itself is a major purchaser of Windows, because they claim it was the best deal for the taxpayers. Most economists believe that an independent determination of a "competitive price" in a free market is impossible. Free markets contain only free-market prices, as the late economist Murray N. Rothbard argued.

It was further alleged that Microsoft's agreements with Internet service providers were restrictive of competitors. This is stating the obvious: *All* business contracts are restrictive, limiting options and excluding options to both parties to the agreement. Had Microsoft restricted the licensing of its operating system to a few select businesses, it could have been accused of monopolizing in restraint of trade.

Dominick T. Armentano, once again, provides the critique of the inherent contradictions of antitrust laws:

The enforcement of the antitrust laws is predicated on the mistaken assumption that regulators and the courts can have access to information concerning social benefits, social costs, and efficiency that is simply unavailable in the absence of a spontaneous market process. Antitrust regulation is often a subtle form of industrial planning and is fully subject to the "pretense-of-knowledge" criticism frequently advanced against government planning (Armentano, 1999: 19).

The problem with these "calculations" is that they cannot actually be made; because individual costs and benefits are ultimately subjective and personal, they cannot simply be added up or subtracted to determine net social efficiency or welfare.

A metaphor can illustrate the inherent difficulties of aggregating personal costs and benefits. Assume a temperature of 70 degrees in a room. It is apparent that different people in that room can feel either warm or cold; the 70-degree figure does not actually measure how cold or warm individuals feel but only the level of mercury on an objective scale. The subjective states of warm and cold are not themselves directly knowable or measurable by others, and they are not susceptible to addition, subtraction, comparison, aggregation, or any other mathematical manipulation. Temperature readings can be averaged, but feelings of comfort or discomfort on the part of different individuals cannot be manipulated mathematically. Neither can their individual costs and benefits (*ibid.*: 102–3).

Fortunately, Judge Jackson's ruling was thrown out in Federal Appeals Court in June 2001 and the Justice Department and Microsoft eventually reached a settlement.

### **THE PROBLEM WITH ANTITRUST LAWS— THE WRONG THEORY**

Any first-year microeconomics student is taught the perfect competition model, which rests on many assumptions as delineated in this microeconomics textbook, including:

1. Firms and individuals take market prices as given—each is small relative to the market so that their decisions do not affect the market price.
2. Individuals and firms have perfect information about the quality and availability of goods, and about the prices of all goods.
3. Actions by an individual or firm do not directly affect other individuals or firms except through prices.
4. Goods are things that only the buyer can enjoy—if I buy and eat a slice of pizza, it is no longer available for you to eat; if you buy a bike, we both cannot use it at the same time (Stiglitz and Walsh, 2002: 228).

There are several problems with this model. In a world of perfect competition there would be no need for advertising; yet Proctor & Gamble alone spends \$5 billion annually on advertising its products, and we surely cannot make the argument that Proctor & Gamble is irrational. Information is not free, and hence consumers will only search for information up to the point where marginal benefits exceed marginal costs. Furthermore, we witness price dispersion in markets—the same good being sold at different stores for different prices. Far from being a sign of monopoly power among sellers, price dispersion is simply price discrimination in action, selling at different prices to a range of customers depending on their elasticity of demand. None of these everyday realities can be explained by the perfect competition model; in fact, they are quite inconsistent with it.

The perfectly competitive model that posits all sellers are price takers would be, in reality, a world of no competition, no innovation, no market power, and no dynamism. It is emphatically a market no developed country's people would want to live in. Yet, it is the ideal model used by antitrust economists and lawyers to benchmark anticompetitive behavior, and it is contrary to how the real world works. Competition, by its very nature, is not a level playing field. All businesses are striving for monopoly profits, but even when attained they are not long sustained. No market reflects the assumptions of the competitive model, which is why the majority of economists agree that the extreme cases of monopoly (no competition) and perfect competition (where no firm has any effect on market prices) are rare. Most markets are characterized by imperfect competition.

Antitrust laws ultimately rest on the foundations of politics and social views, as George Stigler finally concluded after a life's work studying competitive markets:

Consider the enormous attention that is devoted to monopoly in modern economic theory, an attention so vast that it has virtually taken possession of the

literature on industrial organization. The evidence that monopoly is important is negligible, and the evidence that it is a quite minor influence on the workings of the economy is large. I have slowly been approaching the view of Schumpeter, that the eminent role of monopoly in economic literature is due to the influence of general social views (Stigler, 1982: 24).

Expanding on Joseph Schumpeter's concept of creative destruction being the force for dynamism, progress, innovation, and growth in the economy, George Gilder wrote the following eloquent indictment of the beloved perfect competition model in *Wealth and Poverty*:

Because there is no demand for new and unknown goods, no demand for the unforeseeable fruits of innovation and genius, preoccupation with demand fosters stagnation (Gilder, 1981: 30).

The notion of perfect competition—a prime image of classical theory—is extremely useful in depicting the behavior of particular markets for existing goods. But it has little to do with the central activity of capitalism, which is the turbulent process of launching new enterprise. As has been often observed in academic analyses, perfect competition actually comes to mean no competition at all: an equilibrium in which all participants have perfect information and in which companies can change neither prices nor products and can essentially affect neither supply nor demand.

Perfect competition thus excludes most supply-side behavior: all the acquisition and manipulation of knowledge that is the main activity of real entrepreneurs. Free men and creative enterprise—all the secrets and surprises of actual competition—are banished in favor of a mechanism by which savings are automatically invested, supplies and demands are simultaneously reconciled, and the entrepreneurial role could be best performed by modern computers (ibid.: 31).

Antitrust has a rich and fascinating history, rooted firmly in the development of economic theory as well as the emotional appeal among the public, politicians, and the media. The robber barons have an infamous reputation among American culture, even though many would argue it is a misapplied name for entrepreneurs who brought needed goods and services—at constantly lower prices—to the masses.

In any event, executives in charge of pricing need to be cognizant of the law and its implications for devising pricing strategies and tactics. And although the laws do not apply to services, if your company is engaged in manufacturing, or deals with distributors and suppliers, then appropriate legal advice needs to be obtained to ensure you are complying with all applicable federal and state antitrust laws.

## WHO IS IN CHARGE OF VALUE?

*The final question needed in order to come to grips with business purpose and business mission is: “What is value to the customer?” It may be the most important question. Yet it is the one least often asked. One reason is that managers are quite sure that they know the answer. Value is what they, in their business, define as quality. But this is almost always the wrong definition. The customer never buys a product. By definition the customer buys the satisfaction of a want. He buys value.*

—Peter Drucker, *Management: Tasks, Responsibilities, Practices*, 1993

My VeraSage Institute colleagues and I have had the privilege of posing this question—Who’s in charge of value in your company?—to thousands of businesspeople around the world. We are usually met with a momentary *staring ovation*, and then someone will inevitably shout out, “Everyone!”

Really? I live in California, where I’m told everyone “owns” the Golden Gate Bridge. I would like to sell my portion; unfortunately I encounter what economists call the *tragedy of the commons*. If everyone owns something, no one does. No one has an incentive to protect and maintain the value of the asset in question. Think *public toilet*. Species become extinct because no one owns them, such as the American Buffalo; species thrive—such as dogs, cats, cattle and even elephants—because they are privately owned. You can bet your retirement fund that Kentucky Fried Chicken (KFC Corporation) is not about to let chickens become extinct.

Despite present-day management gurus who claim to have discovered the concept of core competency, in reality it is a very old principle. Adam Smith’s famous example illustrated how a pin factory could produce up to 48,000 pins in a day if it *divided* and *specialized* the labor in such a way as to assign a particular task to each worker, whereas perhaps not one pin a day could be manufactured if each person made a whole one on his or her own.

Smith demonstrated that the *division and specialization of labor* were a central cause of the wealth of nations; they are also the central cause of the success of a business. Not everyone can be good at everything.

Nonetheless, it is rare to encounter a salesperson or executive who does not believe that he or she is quite competent at pricing, even though the evidence is overwhelming that this is not the case. Furthermore, everyone in the company already knows who the best and weakest pricers are, and in many businesses there exist no clear lines of authority for this function. This is not Pricing on Purpose, and it is a serious violation of the division and specialization of labor, not to mention a barrier to profitability. In golf, the less skilled players receive a handicap; with respect to poor-performing pricers, the handicap is less profit.

Pricing is far too important to the viability of the firm to be left to mediocre pricers. As we have seen, no other area—not cost cutting, productivity increases, or increases in volume—can have as large an impact on profitability as does pricing. It is time for companies to recognize that if they are serious about pricing commensurate with the value they create, they need to establish a core group of enthusiastic pricers in order to make pricing a core competency within the firm. Pricing needs to become a *function* within the firm, delegated to a chief value officer (CVO) and a pricing cartel, who will develop an intellectual capital base of skills in this vitally important area, while developing pricing policies in alignment with the company's overall strategy.

In a company, someone needs to own the value and pricing functions, someone who can be held accountable for creating and capturing value across the entire range of customers. When you consider how much executive attention the cost accounting and purchasing functions receive in most organizations—with the elevation of a new title, chief purchasing officer (CPO)—shouldn't the pricing function get the same level of executive commitment, attention, and resources as a function designed to control costs? A report by the London Business School and Ariba, a software company, claims that the new CPOs at 70 percent of European firms report directly to the board of directors, an increase of 20 percent over the prior year (*The Economist*, "A Rise in the C-Level," February 26, 2005, 60). The so-called CXO movement is the designation of new executive titles that begin with *chief* and end in *officer*. Many of the Fortune 500 companies have a chief revenue officer, or chief pricing officer, and while these appointments are a step in the right direction in order to have pricing become a core competency within a company, this chapter will posit that there still exists a lacuna in most companies—understanding and measuring value.



Since price, ultimately, is determined by value—and now that we have explored in detail the subjective theory of value and price theory, we have a better understanding of this concept—shouldn't someone within the company be in charge of comprehending, communicating, and capturing value? All businesses talk about value, and all agree it is essential to create, and constantly add to, but who is in charge of it? Until it is elevated to the executive suite, it is not going to receive the attention, resources, and alignment with overall corporate strategy that it merits. After all, a business exists to create wealth—value—outside of itself, and until someone is held responsible and accountable for understanding the impact on customers, companies will continue to operate below potential in the value-creating function. Let us appoint a CVO in order to take a stand for customer value within the organization. One throat to choke.

## THE MARKETING CONCEPT

Recall the *marketing concept* from Chapter 2—the sole purpose of a business is to create wealth outside of itself. Unlike a biological organism, the true test of a company's success lies outside of its four walls. As Peter Drucker says, “All results are external, there is no such thing as a profit center,” there are only cost, activity and effort centers. The only profit center in your company is a customer's check that doesn't bounce.

The four Ps of marketing—product, promotion, place and price—all must look outside of the organization and ask, “What do our customers value, and how can we increase that value?” Marketing executives must focus *outside* the four walls where the results are created, whereas cost accountants focus on the *inside* of a company. Becoming better cost accountants is not going to help us create value for our customers, nor will it be much assistance in capturing that value through strategic pricing.

For pricing to become a core competency in any business, it must understand the five Cs of value, as documented in *The Strategy and Tactics of Pricing: A Guide to Profitable Decision Making* (third edition) by Thomas Nagle and Reed Holden:

1. *Comprehend* value to customers
2. *Create* value for customers
3. *Communicate* the value you create
4. *Convince* customers they must pay for value
5. *Capture* value with strategic pricing based on value, not costs and efforts

Source: Nagle and Holden, 2002: 164.

These five components determine the wealth-producing capacity of any business, and will drive profits in the long run.

Yet in many companies, according to McKinsey & Company, marketing is poorly linked to corporate strategy. According to a McKinsey survey of 30 large U.S. companies, more than one-third reported their boards spent less than 10 percent of their time on marketing and customer-related issues. How can a company continually create value, let alone capture it with more effective pricing strategies, if it does not have someone overseeing this responsibility? It is worth recalling what Akito Morita, founder of Sony, learned from his trip to the antique store (told in Chapter 9):

This experience taught us a basic lesson in the marketing of our product, which has guided our policy ever since. A company such as ours, which is constantly developing new products, must always have the capability of educating prospective customers. Otherwise new markets for new products will never be created... We realize that marketing means increasing the number of persons who can communicate to customers the usefulness and value of our new products in the same way as we would ourselves (quoted in Krass, 1999: 316 F–19).

Any company that does not understand the value of its own offerings will, by default, perform a suboptimal job communicating it to its customers. Yet your customers purchase relatively infrequently, while your company sells many more times. Is it not worth gaining a deeper understanding of value so you can leverage that knowledge across your entire customer base, rather than just a few sales? This is precisely why the role of CVO was created.

### THE WORLD'S FIRST CVO

*Do not go where the path may lead;  
go instead where there is no path and leave a trail.*

—Ralph Waldo Emerson

Who is in charge of value in your company? If you worked at Ward Wilson, a four-office, ten-partner, 100-team member chartered accounting firm in Invercargill, New Zealand, your answer would be Brendon Harrex, who was recently appointed CVO in March 2005, responsible for creating and capturing value across the entire firm.

Brendon, at age 31, is the youngest partner in the firm, and is an amazing visionary, bringing leadership as well as the perspective of the customer to his firm. He understands the historical significance of his appointment, and realizes it will change the way service firms think of value and pricing for posterity.

### What Brendon Has Learned So Far as CVO



I am learning so much in the CVO role. It is like climbing a mountain—just when you think you are nearing the top, you find it is merely another ridge-line and the horizon still is a distant vision.

I am coming to realise what a wimpy pricer I really am. I think sometimes we price for the 80% of the job that everyone else can do and forget to capture the real value that being focussed and fanatical brings to a customer.

I am learning very quickly that as an individual and a business you can not be all things to all people and you have to say no quite a lot more than I am used to.

I am learning how scared many of us are of change, even if there is no logical or illogical argument supporting the status quo.

I am learning that business value is maximised when we realise that the customer owns the shop.

I am learning that fun is maximised when we realise the customer owns the shop and start acting like it.

I am learning that as in life, control in business is just an illusion. Yet we allocate valuable resources into sustaining the illusion.

I am learning that vision drives the structure and sometimes the structure needs changing to assist fulfillment of the vision.

I am learning the value of a decision and the high cost of indecision.

I am learning that the less we focus on our own importance, the more important we become.

I am learning that one wrong doesn't overcome another.

I am learning the importance of laying the foundation before beginning to build.

—Brendon Harrex, CVO,  
Ward Wilson, Invercargill, New Zealand

Why is this chartered accounting firm investing such an enormous amount of human capital into the value/price function? Because they realize they can only cut costs, re-engineer, implement Total Quality Management (TQM) and Six-Sigma programs to a certain point, and diminishing returns have already arrived. By focusing on creating value, and then capturing it through pricing more intelligently, they are realizing large returns for their investment.

The CVO role grew out of an experiment we conducted with professional service firms. We initially established a pricing committee—or what I prefer to call a *pricing cartel*, since it conjures up the image of deliberately fixing prices within your company—a group of people who would have ultimate responsibility for pricing all engagements above a certain dollar threshold, in several firms around the world. Although professional service firms are not exactly similar to other industries, they still offer many challenges when it comes to pricing.

As in any company, pricing exists at the crossroads of almost every other discipline, such as marketing, sales, finance, engineering, and even research and development (recall *price-led costing*, discussed in Chapter 9, whereby product developers are restricted with the sales price before incurring any production costs). Yet these various functions sometimes have conflicting objectives and priorities. Marketing tends to focus on brand awareness and market share, while finance may insist on maintaining certain margins, and sales is interested in making the next sale. Pricing tends to become an afterthought, taking a back seat to these other functions that normally can secure executive attention and clout.

What we learned with our pricing cartel experiment was enlightening. While every firm that implemented the idea became better pricers, and were more effective on focusing on the customer, some of the cartels degenerated into what one British partner described as “an auction house.” He said (I am paraphrasing here; this conversation took place just outside of London in April 2004):

We’d sit around and discuss a particular contract for a client and when we finished with scope and an obligatory nod to value, we started throwing out prices. One member would say £10,000, the next £12,500, on up to £20,000. It dawned on me after this scenario was repeated several times we were becoming as *inward* focused as cost accountants. Yes, we had moved up from costing the job to placing a more strategic price upon it, but we were still not giving proper attention to the *outward* value we were creating, or should have been creating, for the customer. This was an epiphany for us. Soon thereafter,

we created a *value council*, whereby the focus is, first and foremost on value, then price. This has been much more effective, and has resulted in happier customers and greater profits for the firm.

In this particular firm, the value council has become the eyes, ears, and throat for the customer. Rather than merely setting prices, they have begun to strategically think about value—we have become “obsessed with value” as the partner now says—which should be the basis for how prices are set.

### VALUE, NOT COST, DETERMINES PRICE



Meet Jayme Schneider, an accountant with Easdown & Partners in Wagga Wagga, New South Wales, Australia. This five-partner, 24-team member chartered accounting firm appointed Jayme CVO in March 2005, making her the first CVO in an accounting firm in Australia, and the first female, nonpartner CVO in the world. Jayme is 27 years old, and will now have the same responsibilities, and accountability, her counterpart Brendon has across the Tasman Sea.

Both Jayme and Brendon will now be responsible for implementing a value pricing culture in their respective firms. Hourly billing—a variant of cost-plus pricing—is dead, and no longer will either of these firms establish, quote, or use hourly pricing with their customers. Furthermore, Easdown & Partners will eliminate timesheets as of July 1, 2005, while Ward Wilson will eliminate them November 1, 2005, joining some 300 other pioneering service firms around the world that have trashed this antiquated measurement device, and blazing the trail for the rest to follow.

Hourly rates and timesheets are *internal*-looking metrics that have absolutely nothing to do with the *external* value created for the customer. They do not measure the qualities important to the customer (do you care how long it took for General Motors to build your car?), nor do they judge knowledge workers on the most important characteristics of being a true professional.

As we have seen, wealth is created from intellectual capital, which only human beings create. We must stop thinking in terms of management and operational efficiency metrics that are irrelevant in a knowledge environment. The most important traits in a knowledge worker cannot be measured,

they must be *judged* and *discerned*. Characteristics like interpersonal skills, passion, desire, motivation, innovation, creativity, risk taking, knowledge, and pride may not show up anywhere on a firm's financial statements or cost accounting reports, but they are the traits that will ultimately determine the fate of a firm. Knowledge work is nonlinear and not subject to the cadences and rhythms of an assembly line; rather it moves by iteration and reiteration, a process of the mind. The traditional metrics of productivity need to be replaced by *judgment*, and there is an enormous difference between a measurement and a judgment: a measurement requires only a stick; a judgment requires knowledge and discernment.

Another major responsibility of the CVO is to develop, test, and track key performance indicators (KPIs) in order to monitor and evaluate the results the firm is producing outside of itself. KPIs such as turnaround time, customer loyalty, number of customer contacts per week, and share of customer wallet, among others, have been selected to monitor firm-wide performance. For team members, *judgments* on interpersonal skills, customer feedback, continuous learning, and personal development have been selected by these firms to monitor progress on these necessary characteristics of a true professional. (We will explore KPIs and other metrics of measurement and judgment in the second book in the *Intellectual Capitalism Series*.)

No customer buys hours or costs, yet many businesses continue to price on a cost-plus basis. Both Brendon's and Jayme's mission is to change the culture in their firms from focusing on activity, efforts, and inputs—which is what cost accounting and activity-based costing measures—to one of results, output and value, the same things customers care about. In order to achieve this, the following diagram will now be embedded into the DNA of their firms. This diagram was originally discussed in Chapter 9, but is being summarized here to explain its impact on the responsibilities of the CVO. First, consider how most companies have traditionally been taught to think of the pricing function:

Cost-Plus Pricing:

Product → Cost → Price → Value → Customers

Notice you start with the product (or service), determine its cost, mark up that cost with a desired profit to set the price, and then pray the customer values the output at a level higher than the price they are being asked to pay. Notice where the customer is in this chain of events—at the end! Pricing On Purpose inverts this chain to correspond with the economic realities of the marketplace.

Pricing on Purpose:

Customers → Value → Price → Cost → Product

This value chain recognizes that value is like beauty, it is in the eye of the beholder. It is in total alignment with the *subjective* theory of value to the customer. Customers do not care about your internal costs, nor your profit desires. They demand value higher than the price they are paying, and they want to make that comparison *before* they buy, not after.

This inversion reveals a further fact of economic life: Your costs do not determine your price; rather, your price determines your costs. This is anathema to a cost accountant, but self-evident to a pricer. You should ask yourself before taking on any job if the price charged will allow you to invest in the costs required to develop the product or service at a profit the company can tolerate—again, *price-led costing*. If not, you should not undertake the project. The important point about this process is *when* you are making that determination—*before* you produce the product, not during, and certainly not after.

CVOs understand that the hardest part of this new value chain is determining value. After all, cost is relatively easy to determine, since most companies employ cost accountants capable of allocating fixed and variable costs to each widget. Setting price above cost is also not difficult—even the most inept businessperson should be able to accomplish this. In determining value, cost accounting provides little help, since customers purchase value, not a bundle of allocated costs.

## FRAMEWORK FOR THE CHIEF VALUE OFFICER

Since the CVO position is relatively new, and the two CVOs discussed above are just getting underway in their new functions, along with my VeraSage Institute colleagues, we have developed a framework for the responsibilities, functions, and characteristics of a successful CVO. It is an unusual position, one that has yet to prove its value, except to note both Brendon and Jayme have already made substantial progress in their respective firms creating and capturing more value.

Even though the CVO position is not yet common in businesses, we have observed the traits and characteristics of particular individuals that indicate they would be effective in this role. In order to document what we have learned so far regarding the CVO function, the acronym LACEY is a useful

way to break out the functions and traits of a successful CVO and provides a framework for companies who are willing to experiment with appointing an individual to this position:

- Leadership
- Attitude
- Commitment
- Experimentation
- Youth

Let us examine each of these attributes, and discuss the functions required for each one.

## LEADERSHIP

A company will never rise above its leadership. CVOs implicitly and explicitly understand that the company's prices are the language in which they strategically communicate value to customers. Even though companies are becoming more sophisticated with respect to the pricing function, value too often has been put aside. Now that we have a theory for value—the subjective theory of value—it should be promoted to the executive suite as the basis for all pricing decisions. Friedrich Nietzsche once said that a man has no ears for that which experience has given him no access. It is time to give value prominent access among leadership.

CVOs understand that there is nobility in getting paid what the company is worth. Nothing is more satisfying than customers who believe—and act on the premise—that they get what they pay for. Perhaps the first important characteristic of a successful CVO is high self-esteem; they believe that their company's products and services are worth every penny they charge. They are more concerned with developing a value proposition based on value, not price.

Frank Lloyd Wright, at the age of 89, testified in a trial that he was “the greatest architect in the world.” Afterward, his wife suggested that modesty would have been more effective. Wright replied, “You forget, Olgivanna, that I was under oath.”

When I first began teaching pricing, I never gave much thought to self-esteem, although I was always amazed when people would challenge me on their ability to raise prices. Or they said they would feel guilty about charg-



ing above a “fairly determined” cost-plus price. The epiphany for me was that this was not a strategic, or even a competency, issue, but rather a low self-esteem issue. Some of these executives truly did not believe that they were worth more than costs plus some arbitrary profit margin.

Yogi Berra has often said that 90 percent of the game is half mental, and the same applies to pricing, since it is a skill played between your ears. It requires multiple mindsets and the ability to synthesize ideas from many disciplines. Psychologist Nathaniel Branden has done extensive work on self-esteem. His treatise on the subject is *The Six Pillars of Self-Esteem*, wherein he defines it as:

1. Confidence in our ability to think, confidence in our ability to cope with the basic challenges of life; and
2. Confidence in our right to be successful and happy, the feeling of being worthy, deserving, entitled to assert our needs and wants, achieve our values, and enjoy the fruits of our efforts (Branden, 1994: 4).

In his book *Self-Esteem at Work: How Confident People Make Powerful Companies*, Branden discusses the critical role self-esteem has in the success of enterprise:

A simple example is the fact that analyses of business failure tell us that a common cause is executives' fear of making decisions. What is fear of making decisions but lack of confidence in one's mind and judgment? In other words, a problem of self-esteem.

Yet another example pertains to competence at negotiating. A study discloses that whereas people with healthy self-esteem tend to be realistic in their demands, negotiators with poor self-esteem tend to ask for too much or too little (depending on other personality variables)—but in either case being less effective than they could be (Branden, 1998: xii).

There is virtually no aspect of business activity—from leading to managing to participating in teams, and from dealing with customers to engaging in research and development to responding to new challenges and new ideas—that is not significantly affected by the level of one's self-esteem (ibid.: xiii).

In today's competitive business environment, low self-esteem is a competitive disadvantage while high self-esteem confers a competitive advantage. Yet how can people feel good about themselves, their work, and their service to the customer and the greater community if they believe they are commodities and are constantly being beat up over their price? Consider this

e-mail I received from Diane, an owner of a CPA firm, which illustrates the importance of self-esteem and the effect it can have in thinking about your business:

September 28, 2002

Dear Ron,

Finally (and I may have told you this before) the biggest change in all of this has been to my self-esteem. About 10 years ago, not long after beginning my solo practice, my mother-in-law, who is an attorney, said to me, "Diane, just remember, men are in business to make money and women are in business to take care of people. Get over it!" What she meant was that the female attitude of "I'll take care of you" will give you little satisfaction and make you no money. If you are going to be taken away from your family, you might as well make a hell of a lot of money and feel really good about it. But that is easier said than done. I fell into the trap of helping my clients and forgetting myself. Was I popular? Did my clients love me? Yes! But I didn't feel the same. Only when I took my practice seriously and began placing a value on my services by Pricing on Purpose did I begin to feel successful. If you feel successful, you are successful and then the money follows. When you reduce your value to an hourly rate it feels lousy, no matter how high the billing rate.

Good luck, and keep up the good work! Keep in touch.

Diane Green

*You will never get paid more than you think you are worth.* And if you do not think you are worth more than cost-plus pricing, why would your customers? I have had countless businesspeople tell me, in no uncertain terms, they could never increase their prices, and yet we know countless others who have and the customers not only do not leave, they appreciate the extra level of service, and all the other salutary effects of pricing based on value, not costs.

In addition to high self-esteem, a CVO must have demonstrable leadership skills, while commanding respect and creditability across multiple functions within the company. He or she will be responsible for communi-

cating the importance of pricing and value to the media, thereby negating price wars within the industry. Since competitors tend to judge a company's pricing behavior based on its most ruthless actions, think of the message that appointing a CVO would send to others in your industry about how committed you are to price for value and not engaging in self-destructive price wars.

The CVO is also responsible for establishing the value cartel, a group of motivated team members who look upon pricing as an enormous opportunity, not a limitation. Obviously, it is not being suggested that the company organize a real cartel with other firms in order to set prices, which would be illegal. Rather, to establish an *internal* cartel that will have final authority to set prices in order to maximize profits across the entire company, while also acting as an educational unit and resource in order to assist all employees in capturing prices commensurate with value.

The size of the cartel will vary by company size, industry, and customer segments, but it has been our experience that smaller is better (usually four, with no more than ten). It should not consist of all executives, but should have a cross-selection of disciplines, from finance, marketing, sales, and so forth. Some companies have made one-half of the positions rotate, perhaps on a two- or three-year basis, in order to bring in fresh perspectives, while spreading the value message throughout the organization.

The final determination of the cartel's membership should be made by the CVO, possibly in conjunction with the CEO, who should begin by asking for volunteers, thereby self-identifying those team members with an interest in the art of pricing (volunteers not selected may be eligible for future terms). But it is important to emphasize that the cartel is not a jury; it does not require unanimous consent to make decisions. The CVO always holds the tie-breaking vote, in order for there to be true leadership and accountability. Margaret Thatcher, former Prime Minister of Britain, was fond of pointing out, "Consensus is the negation of leadership."

Imagine when Jack Welch was CEO of General Electric and announced his Six Sigma initiative as a corporate-wide goal. If anyone on his executive team—or any other manager—thought it was a bad idea, what do you think his or her choices would have been? To ask the question is to answer it. Leadership demands tough decisions (the word *decision* comes from Latin *decidere*, meaning "to cut off"), and sometimes individual opinions have to be sacrificed for the good of the company.

## The Cartel's Mission and Functions

Examples of mission statements for the cartel are:

- To ensure [company name] Prices on Purpose, according to the value received by the customer, not the costs incurred.
- To make pricing for value a core competency within [company name].
- To change the marketing culture within [company name] to one that comprehends, creates, communicates, convinces, and captures the value of the products we provide to our customers.

Similar to a SWAT team—or the Green Berets—the cartel would meet as needed in order to establish value and prices. Since the team would see pricing from a company-wide perspective, they are in the best position to ensure that prices are not set below value. This may require someone from the cartel to assist in the sales process with salesman who may not be up to speed in pricing for value.

It will also slow the process of quoting prices, and although most salesman treat this as a disadvantage, it is in fact an enormous advantage. Here's why: The sooner the company establishes a price, the lower it will be. Why? Because most likely it has not given enough thought, creativity, and innovation to the value proposition being offered to the customer. It is much better to step back and have four or six minds come together to make sure the company is offering the maximum value to the customer, and pricing accordingly. The cartel will be obsessed with value, which is exactly where the focus needs to be when it comes to marketing.

Other functions of the cartel would include:

- Establishing all prices, including minimum prices and tiered bundling offers, consistent with the Adaptive Capacity Model discussed in Chapter 18 (see Exhibit 21.1 for Questions to Consider before Establishing Price).
- Performing the Pareto analysis and grading customers (Baker's Law: Bad customers drive out good customers). Twenty percent of your customers generate 80 percent of your revenues. Should the firm "out-place" some of its customers in order to focus on providing more value-added services to better customers who are less price sensitive and more valuable to the company?

**EXHIBIT 21.1 Questions to Consider before Establishing Price**

How do we help the customer grow their business and be more profitable?	
How do we help reduce the customer's risk?	
How do we help make their business more valuable?	
How do we help our customer get things done?	
How do we remove surprises for our customer?	
At what price would this product be so expensive a customer would not consider buying it?	
At what price would the product be expensive, but the customer would still buy it?	
At what price would the product become inexpensive?	
At what price does the product become so inexpensive the customer would question its value?	
What price would be the most acceptable price to pay?	
What costs can we afford to invest in at the target price and still earn an acceptable profit?	
How will we segment the market and offer different value propositions to each?	
How much more value would we need to achieve for a price cut to still be profitable?	
How much volume could we afford to lose due to a price increase, and still maintain profitability levels?	

- Establishing all company pricing policies, and who has the authority to grant exceptions.
- Establishing the company's 100 percent money-back guarantee. Why should your customers bet on you if you won't? Offer an unconditional service guarantee to all customers, thereby gaining a competitive differentiation, and an opportunity to command premium prices.
- Selecting KPIs for value and pricing competence. These KPIs go a long way to change the focus from internal processes and efforts to external results and value. (The next book in the *Intellectual Capitalism Series* will deal with KPIs.)
- Conducting after-action reviews (AAR; also referred to as *postmortem analysis*). Every major product launch or service delivered needs to be reviewed in order to assess what was learned, how adequate was the price, what was the value created, and how could the company have priced it better. This process will, over time, build an intellectual capital base of skills that will turn pricing into a core competency. A sample AAR is presented in Exhibit 21.2.
- Continuing learning and teaching. Like the Green Berets, the cartel is not just an effective group of pricing warriors; it is also a teaching organization, responsible for reading books, articles, and other information on the art of pricing. Furthermore, it continuously teaches every team member the importance of pricing for value. Tiger Wood's father, Earl Woods, was a Green Beret. Witness the effect on Tiger's self-esteem and commitment to excellence. Since pricing is a self-esteem issue—you have to believe you are worth it before your customer will—this is a trait the cartel can enhance by achieving pricing excellence and sharing success stories throughout the firm.
- Dealing with price objections from customers and salespeople. Everyone involved in sales has heard pricing objections from customers, which is to be expected. After all, it is the customer's job to push down prices. That said, it is the company's job to push back, and that is done most effectively by focusing on value, not capitulating on price. The number of pricing objections is finite, and the cartel should have answers for all of them.
- Developing sales compensation plans that reward making profitable sales and maintaining prices, not merely making sales to drive market share or achieve quota. The cartel needs to ensure that salespeople are as hard on maintaining prices as customers are on lowering them.

**EXHIBIT 21.2 Sample After-Action Review**

Did we add value for this customer?	
How could we have added more value?	
Did we capture value?	
Could we have captured more value through a higher price?	
If we were doing this contract again, how would we do it?	
What are the implications for product/service design?	
Should we communicate the lessons on this contract to our colleagues and how?	
How could we have enhanced our customer's perception of value?	
What did we teach this customer?	
What other needs does this customer have and are we addressing them?	
Did this contract enhance our relationship with this customer?	
What impact has this contract had on developing our customer's trust in us?	
How would you rate our customer's price sensitivity before and after this job?	
How has this contract advanced us?	
Did we have the right team on this contract?	
How high were the costs to serve?	
What could we do better next time?	
Do we need to update our customer complaint register?	
How could we thank this customer for their business?	

- Monitoring competitors' pricing and performing competitive reconnaissance, as well as devising the company's reactions to pricing pressures.
- Becoming members of professional pricing organizations, attending seminars, and networking with other pricing professionals in order to develop intellectual capital and adopt leading practices.

The cartel, under the leadership of the CVO, will be the group responsible for keeping the company obsessed with value and wealth creation for customers—the main purpose of any business. It is a group that will force the company to work smarter, not harder, since pricing is the single largest driver of profitability in any company. Like the division and specialization of labor, the cartel is an old idea whose time has come to be applied in a new place.

The U.S. Army has a policy of doing AARs, which take place after every training event. The Army has a saying that they never want to build the same bridge twice. After studying the Army's use of AARs, which originated in 1973, I am convinced it is a practice that would have many salutary effects for companies, especially as it relates to the role of CVO. Perhaps we have ignored innovations in the military, since its mission—to break things and kill people—seems to be so divergent from a civilian organization. However, this is far too parochial an attitude, and again we discover a useful practice from another sector. Since the AAR is such a useful method for turning tacit knowledge into explicit knowledge, not to mention for fostering learning and sharing of knowledge throughout the organization, I will quote at length from Gordon R. Sullivan and Michael V. Harper's book *Hope Is Not a Method: What Business Leaders Can Learn From America's Army*:

An AAR takes place after every training event. Its purposes are simple: learning, improving, doing better the next time. The participants sit down with a facilitator called an "observer-controller" who has been with them throughout the event, and they discuss what happened. To do this effectively requires several things. First, there must be a fairly good basis for understanding what actually happened.... Soldiers call this "ground truth." Combined with ground truth, there must be a fairly unambiguous understanding of what should have happened, and that comes from having standards derived from doctrine.

The most difficult challenge is developing a culture that values this kind of learning. A colleague in industry once described an attempt to initiate a similar program in his company. He told me of a dialogue with a loading dock foreman who, in great frustration, finally said to him, "Look, I can either ship product or talk about it. Which do you want me to do?" The answer can only



be “Both,” but it is hard to make that answer a reality. It took a decade for the AAR process to become respected in the Army, for us to learn that you can do both—ship product and talk—and that carefully structured talking leads to more effective shipping or whatever. It is an investment that no one can afford not to make.

For America’s Army, the AAR was the key to turning the corner and institutionalizing organizational learning. You probably never become a learning organization in any absolute sense; it can only be something you aspire to, always “becoming,” never truly “being.” But, in the Army, the AAR has ingrained a respect for organizational learning, fostering an expectation that decisions and consequent actions will be reviewed in a way that will benefit both the participants and the organization, no matter how painful it may be at the time. The only real failure is the failure to learn (Sullivan and Harper, 1996: 191–93).

Earlier we argued that, as we face our external environment, “We don’t know what we don’t know.” As we face our internal environment, it seems that the opposite is too often true: “We don’t know what we *do* know.” As an important organizational asset, knowledge is usable only if it can be identified and disseminated so as to contribute value. The challenge is to discover what is known in any part of the organization and, if it is valuable, make it known to all (*ibid.*: 206).

## ATTITUDE

I will always remember conducting a pricing seminar for a legal association where throughout the course of our discussion on some of the same pricing strategies contained in this book, one particular attorney (Mark, not his real name) would interrupt me approximately every ten minutes during my two-hour talk and say things like:

“I can’t do that.”

“That would never work in my firm.”

“My clients would never go for that.”

“That may work in some of these other firms, but never mine.”

Mark was a partner in a major law firm. After hearing his litany of objections—despite other firms in the room who had successfully implemented some of the strategies—I finally said: “Mark, you are right, you cannot do any of these pricing strategies because you view pricing as drudgery, a chore,

a limitation that prevents you from offering legal services. If you were my partner, you would be the last person to whom I would give responsibility for pricing. In fact, I would not let you price at all.”

The CVO and members of the cartel have to view pricing as an enormous opportunity for the company to create and capture value, rather than a limitation imposed on them in which they have no control, like the weather. Pricing is far too important to assign to narrow minds. Pricers have to be intellectually curious, constantly learning and studying why humans behave the way they do.

I am beginning to believe a background in accounting—either financial, management, or cost—is actually a limitation for an effective pricer, since these disciplines contain far too much baggage on the importance of internal cost allocations, and completely ignore a theory of value. Accounting, for starters, is not a theory, for perhaps the reason explained in a joke told by a graduate economics student:

One day in microeconomics, the professor was writing the typical “underlying assumptions” in preparation to explain a new model. I turned to my friend and asked, “What would economics be without assumptions?” He thought for a moment, then replied, “Accounting.”

The principles of accounting are not a theory since they are not posited as a falsifiable hypothesis; they are simply a set of guidelines, rules, and procedures for measuring financial items such as assets, liabilities, revenues, and expenses, grounded by postulates such as relevance, reliability, and materiality. It is little wonder the accounting profession has not taken the lead in movements such as the balanced scorecard, or social and environmental audits, which attempt to look at more indicators than merely historical financial performance—all *lagging* indicators.

Ironically, the first two CVOs have been appointed by chartered accounting firms. But Brendon and Jayme have the right attitude with respect to pricing, since both always believed the traditional way their respective firms priced—by the hour—made no sense. They also understood how the traditional profit and loss statement of their firms and their clients did not relay specific enough information on pricing effectiveness. They simply average all pricing activity together, confusing cause and effect. Yet pricing mistakes (over and under) do not cancel each other out any more than three deer hunters change reality by each taking a shot at a buck—the first missing by one foot to the left and the second one foot to the right, while a third hunter

(probably an accountant) yells, “We got him!” Pricing competence needs to be measured, and that requires developing testable theories on the factors that drive it.

Look for a CVO who is constantly learning, and who is moving through the five levels of learning: awareness, awkwardness, application, assimilation, and art. Pricing is an iterative process of the mind. Although it may require substantial investment—to purchase sophisticated pricing software, for example—it will always require human judgment; otherwise it will be the embodiment of garbage in, garbage out. Pricing strategy, ultimately, is a human endeavor. As Professor Ernest Rutherford, the man who split the atom, said, “It’s true we don’t have much money so what we have to do is think.”

## COMMITMENT

Fortunately, many of the larger companies have already given pricing a promotion. The Professional Pricing Society reports that nearly one in five price managers report to senior management, nearly twice as many as in 2002; 41 percent report to a marketing executive, 18 percent to a finance manager, and 10 percent to a sales executive.

A CVO and cartel that do not have the support of the CEO are destined to be feckless. Effective centralized pricing has to have total authority, which we believe needs to be vested in one individual so there is one throat to choke. Taking it a step further, if value creation is truly the purpose of a company, the CVO should report directly to the CEO. This will send a powerful message throughout the organization that the leaders are serious about value and pricing, as well as to competitors, thereby possibly reducing the threat of price wars.

The commitment to a CVO also provides a competitive advantage, since competitors can only monitor historical pricing, not value. Value creation and pricing competence create a sense of self-worth among team members, and although nearly impossible to measure quantitatively, can certainly be observed in morale. Why should your company not be paid what it is worth?

Perhaps the largest commitment required will be in the area of pricing talent. Since this is a relatively new skill in the marketplace, talent is presently hard to find, and companies will have to simply develop it internally. Many companies, from General Electric to Disney, have made substantial investments in corporate universities, and if you work for a company with one, you should lobby for pricing skills to be added to the curriculum.

If resources are limited, the best advice is: Read, read, read. There are many more books out there on pricing than there were even ten years ago, which is why there is a suggested reading list in the back of this one, offering some of my favorites and must-reads. Assign the cartel a reading list, and make every member present what they learned, and what they think the company should do differently as a result, to their colleagues. There are also graduate level courses on pricing taught at many universities' executive education divisions, which are worth the price of admission. Be sure to join one of the pricing associations, which provide seminars, workshops, and a chance to share intellectual capital with other pricers. Do not fall into the trap of worrying about educating people who might leave. There is no doubt that risk exists. But a better question is: What if you do not educate them and they stay?

For organizations serious about Pricing on Purpose, it is necessary to back their words with actions. Obtaining a competitive advantage is never free.

## EXPERIMENTATION

CVOs have to take a stand for the customer, constantly asking how the organization can provide more value. They have to be willing to experiment and cannot be prisoners of the past. "That is the way we have always done it," draws nothing but contempt from CVOs, since they have little respect for the status quo. They are not simply seeking change for change sake, but in order to fulfill the purpose of the organization.

After observing Brendon institute some changes in his firm—along with the normal amount of resistance—I recalled the late economist Julian Simon's struggle with airlines. If you have ever been bribed off an oversold airplane—with a free flight voucher, upgrade, or airline money equivalent—you have Mr. Simon to thank. Until 1978, travelers were bumped off overbooked planes rather capriciously—the airlines preferred to bump old people and military personnel on the theory they would be least likely to complain—and this caused enormous amounts of customer complaints and ill will. Sometimes an entire flight would be canceled and rebooked at proper capacity, causing even greater outrage. Worse yet, the problem fed upon itself, because passengers began to expect being bumped and so would book several flights under various names to ensure a seat on at least one; this caused the airlines to increase bookings even more in order to ensure decent

load factors. A flight attendant friend who worked for United Airlines told Simon of this problem:

The next day when shaving it occurred to me that there must be a better way; indeed, an auction market could solve the problem by finding those people who least mind waiting for the next flight. The practical details fell into place before the shave was complete.

In 1966 and 1967 I wrote to all the airlines suggesting the scheme. The responses ranged from polite brushoffs, to denials that they overbooked, to assertions that the scheme could not work, to derision.

...I was unable to persuade any airline (or the Civil Aeronautics Board) to conduct an experiment for even one day on a single airline at a single airport at a single boarding gate—an experiment that I believed would be sufficient, even with the inevitable breakdowns in any new activity (Simon, 2002: 289–94).

Had the airlines had a CVO, Simon's idea would have been tested much sooner, to the benefit of both the airlines and its customers.

Soren Kierkegaard wrote, "Purity of soul is to will one thing." What is more important than to champion the cause of value creation within today's companies? A CVO is never satisfied with the status quo because he or she will constantly be on the search for new ways of doing things, all the while eliminating procedures and processes that do not add value to the customer. This is the CVO mandate.

## YOUTH

*Age is, of course, a fever chill  
that every physicist must fear.  
He's better dead than living still  
when once he's past his thirtieth year.*

—Paul Dirac, 1933 Nobel Laureate in Physics [1902–1984]

Out of all of the characteristics in LACEY, I will admit a certain amount of uncertainty as to the implications of this last one. Facts are indeed stubborn things; we are all entitled to our *opinions*, but we are not entitled to our *facts*. One definition of a visionary is "someone with an inner vision not yet supported by external facts." Consider these truths:

- The average age of the signers of the Declaration of Independence was 45, Benjamin Franklin being the oldest at 70 and Thomas Lynch, Jr. (South Carolina) the youngest at 27.
- The average age of the delegates to the Constitutional Convention was 43, the oldest being Benjamin Franklin at 81 and the youngest Jonathan Dayton at 26.
- The average age of the Marginalist Revolution economists (discussed in Chapter 8) was 35.
- Adam Smith was 36 when he wrote his first book, *The Theory of Moral Sentiments*, containing the genesis of his later masterpiece *Wealth of Nations*.
- Blaise Pascal, who proved Euclid's 32nd theorem, was 28 by the time he completed most of the scientific work for which he is famous.
- Albert Einstein developed his theory of relativity at age 26.
- The average age of the Manhattan Project scientists was 25.
- Steve Jobs was 21 and Steve Wozniak 26 when Apple Computer was founded; they were 29 and 34, respectively, when the Macintosh was launched.
- Walt Disney was 27 when Mickey Mouse was introduced to the world.

Charles Murray, Bradley Fellow at the American Enterprise Institute, wrote an absolutely fascinating book, *Human Accomplishment*, wherein he identified 4,002 individuals who basically invented, developed, or proved the most consequential ideas in the history of the world, from 800 B.C. to 1950:

It is a fact that takes some getting used to, but the evidence for it is overwhelming: When you assemble the human résumé, only a few thousand people stand apart from the rest. Among them, the people who are indispensable to the story of human accomplishment number in the hundreds. Among those hundreds, a handful stand conspicuously above everyone else (Murray, 2003: 87).

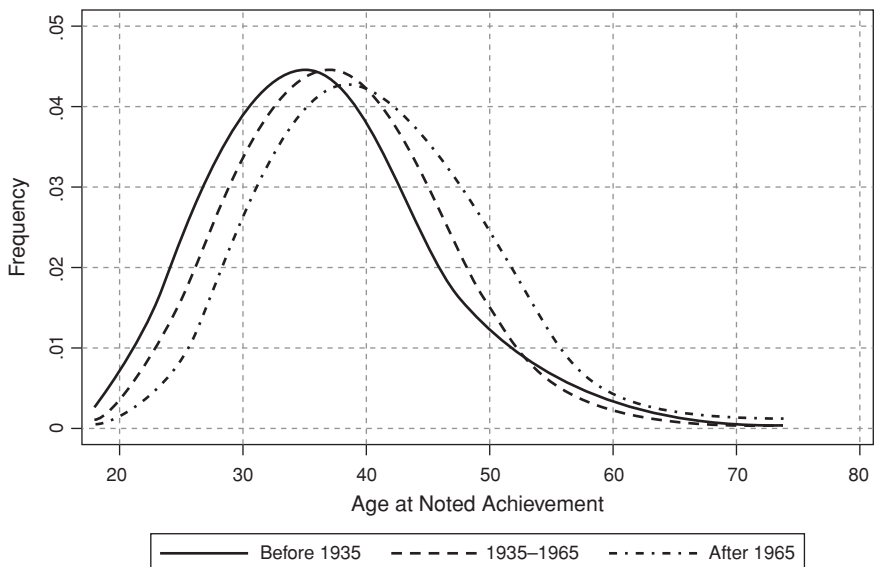
The mean age of these individuals was 40. We truly do stand on the shoulders of these giants.

Benjamin Jones, assistant professor of Management & Strategy at the Kellogg School of Management, Northwestern University, wrote in "Age and Great Invention" (April 2005) that

...the age at which noted innovations are produced has increased by approximately 6 years over the 20th century. This trend is consistent with a shift in the life-cycle productivity of great minds. It is also consistent with an aging workforce. I find that innovators are much less productive at younger ages, beginning to produce major ideas 8 years later at the end of the 20th century than they did at the beginning. Furthermore, the later start to the career is not compensated for by increasing productivity beyond early middle age (Jones, 2005: Abstract).

His paper includes a series of graphs depicting this reality, one of which is shown in Exhibit 21.3 (Jones, 2005: 36).

What does all of this mean? I will admit to not being entirely sure. One thing is certain: We are not suggesting you cannot teach an old dog new tricks. Instead, this research suggests you should not expect an old dog to develop a new trick to add to the repertoire. If organizations want innovation and dynamism, they will have to give more authority and responsibilities to their youthful team members. This is not to say that the CVO needs to be below the age of 45, but it is interesting that the first two CVOs are 31 and 27, respectively. At the least, some people in their twenties or thirties should



**EXHIBIT 21.3** Shifts in the Age Distribution of Great Innovation

be on the cartel. Organizations, like people, tend to calcify with age, and youth can keep the blood pumping at a more vigorous pace. No doubt they will make more mistakes and incur more failure, yet risk is where profits come from. What is the alternative? Ossification is not an option.

A 30-year-old junior economist working at the Treasury Department in the 1940s suggested taxes be withheld directly from employees' paychecks, a pay-as-you-go system, as opposed to the once a year payment, as was traditional. The biggest opponent of this new idea was the Internal Revenue Service, validating the first law of bureaucracy—the only feasible way of doing anything is the way it is being done. They believed it was simply not feasible, even though the young economist had brought them evidence of other countries that had successfully adopted this system. Today, when people suggest the elimination of tax withholding, the IRS is the biggest opponent of the change, claiming it is not feasible to have taxpayers voluntarily comply any other way. History, indeed, does rhyme. The young economist? Milton Friedman, who to this day regrets being part of implementing this new method in the brashness of his youth.

## NOT FINAL THOUGHTS

It is often said we get what we measure. If this is true, isn't it time we measure what we want to become? Who in your company is measuring value? An old proverb instructs "Trees die from the top," and unless someone in your organization owns the value function, it will not get the proper executive attention, respect, and resources it deserves.

Brendon and Jayme—as the world's first CVOs—provide light at the end of our tunnel vision. The CVO position is not just a fad, something people merely talk about—it is actually being done, and it will no doubt change the competitive landscape, at least in the accounting profession.

If you are competing against a company with a CVO—either for customers or talent—you may be at a severe competitive disadvantage. The Roman God Janus had two sets of eyes, one to see what lay behind and the other to see what lay ahead. A CVO is an outward-looking position, with duties carried out in a world of risk, uncertainty, innovation, and faith in the future, where value is solely determined by the customers your company is privileged to serve. If the only set of eyes you possess look behind you—at historical costs and efforts—you are destined for a perilous future.

So, who is in charge of value in your company?



## PRICING ON PURPOSE: GETTING PAID FOR THE VALUE YOUR COMPANY CREATES

*A new scientific truth does not triumph by convincing its opponents and making them see the light, but rather because its opponents eventually die, and a new generation grows up that is familiar with it.*

—Max Planck, physicist [1858–1947]

Winston Churchill once said America will do the right thing—once it has exhausted the alternatives. One could say the same about cost-plus pricing and Pricing on Purpose. Any industry has a genetic immune system providing a natural resistance to new ideas. Of course, sometimes we are resistant to change for good reason. If every crackpot idea were tested, the costs would be astronomical while the benefits minimal. Yet—and this is where we must strike a healthy balance between resistance and experimentation—if no new ideas were ever tried, we would still be in the Stone Age.

Fortunately, history is written by the winners and is replete with renegades who were ridiculed and eventually triumphed. Yesterday's cranks are frequently tomorrow's conventional wisdom.

### THE DIFFUSION OF AN IDEA

The diffusion of an idea is the process whereby an innovation is communicated through certain channels over time among the members of a social system. It is essentially a social process, and often takes a substantial amount of time before an idea becomes accepted by an overwhelming majority of a population.

Consider, as evidence, germ theory—the idea that diseases are transmitted by specific germs, or microorganisms, as has been proved for many infectious diseases. Scholars have traced this theory back to the sixteenth century. It was generally ignored until Jacob Henle revived it in 1840. Still, it remained on the fringes of medical science until 1865 when it reached a critical mass of acceptance, and became conventional wisdom by 1914. It is one the most significant ideas that bettered the human condition, while prior to its acceptance its absence was one of the reasons a trip to the doctor, on average, did not do much good—and sometimes a net harm—until the 1920s.

Contemplate the fax machine, invented in 1843 by Alexander Bain, a Scottish clockmaker who called it a recording telegraph. In 1948, RCA introduced a fax machine that transmitted messages via radio waves, yet the fax machine did not diffuse into the general population until 1987—150 years to become an overnight success! History, science, economics, and other books are filled with similar stories.

Usually, a critical mass is obtained when 17 percent or so of a population adopts an idea, then it becomes a question of time before the remaining percentage follows. Yet when one studies the history of idea diffusion you quickly realize reaching that 17 percent can be an extremely long process.

Max Planck's comment at the beginning of this chapter has often been interpreted as "science progresses funeral by funeral." This seems a rather pessimistic view of mankind's progress, as if we had to line up our elders and shoot them in order to advance. Yet, sometimes it seems so. Even though the labor theory of value has been discredited and discarded on the unmarked grave of history, it refuses to lie peacefully in its coffin, affecting the way businesspeople think of value and price to this day. Any time you see companies use cost-plus pricing you are witnessing a derivative of the labor theory of value in action, as if inputs equated to value. An idea from the day before yesterday is holding tomorrow hostage despite the empirical evidence that the subjective theory of value better explains human behavior and how prices are the objective manifestation directed at satisfying wants.

Combined with the marginalist revolution discussed in Chapter 8, the subjective theory of value developed price theory into the crown jewel of economic science, a profound contribution that Joseph Schumpeter emphasized in his eulogy of Carl Menger, one of the marginalist revolution economists:

What matters, therefore, is not the discovery that people buy, sell, or produce goods because and insofar as they value them from the point of view of satis-

faction of needs, but a discovery of quite a different kind: the discovery that this simple fact and its sources in the laws of human needs are wholly sufficient to explain the basic facts about all complex phenomena of the modern exchange economy, and that in spite of striking appearances to the contrary, human needs are the driving force of the economic mechanism beyond the Robinson Crusoe economy or the economy without exchange. The chain of thought which leads to this conclusion starts with the recognition that price formation is the specific economic characteristic of the economy—as distinct from all other social, historical, and technical characteristics—and that all specifically economic events can be comprehended within the framework of price formation. From a purely economic standpoint, the economic system is merely a system of dependent prices; all special problems, whatever they may be called, are nothing but special cases of one and the same constantly recurring process, and all specifically economic regularities are deduced from the laws of price formation. Already in the preface of Menger’s work [*Principles of Economics*], we find this recognition as a self-evident assumption. His essential aim is to discover the law of price formation. As soon as he succeeded in basing the solution of the pricing problem, in both its “demand” and “supply” aspects, on an analysis of human needs and on what [Friedrich von] Wieser [1851–1926] has called the principle of “marginal utility,” the whole complex mechanism of economic life suddenly appeared to be unexpectedly and transparently simple (quoted in Holcombe, 1999: 99).

## OBSTACLES TO DIFFUSION

What are the major obstacles inhibiting the diffusion of Pricing on Purpose?

### DNA

Cost-plus pricing has existed over many generations, becoming part of the molecular structure of businesses everywhere. This is similar to an evolutionary process, and it will, most likely, take another one to three generations to diffuse pricing competency throughout the business world.

### Metrics

Peruse any financial statement, study any benchmarking report, read any trade journal, listen to most any consultant, efficiency expert, or cost accountant, and you will find metrics related to costs and efforts being the basis for pricing. Value is usually ignored since it is difficult to measure, and

in its place we substitute historical costs and other lagging indicators because they are easier to calculate, even though they do not shed much light on customer value.

### **No Burning Platform**

Unless an industry is facing a crisis, it usually does not have an incentive to radically change its strategies and processes. Contrast this with the barbering profession in the 1960s when it was confronted with the “British Invasion.” Barbers always had a predictable and steadily rising income in good times and bad, but it all changed with the Beatles and men growing their hair longer. They were forced to change or become extinct.

### **Pricing Not Considered an Executive Function**

Pricing has always been relegated to the last of marketing’s four Ps, derived after a product or service was produced, based on allocating costs and tacking on an arbitrary profit margin. Rarely was it linked to overall corporate strategy, nor were any major investments made in the intellectual capital required for pricing to become a core competency. Fortunately, this is beginning to change, but Pricing on Purpose still needs to be diffused wider in order to reach a critical mass.

### **Lack of Leadership**

Most businesses are overmanaged and underled. A firm composed of knowledge workers requires leadership and vision. It requires knowing you are doing the right things, not just doing things right. It requires focusing the company on the external results and wealth it creates for the customer and simultaneously building the type of organization people are proud to be a part of and contribute to. It requires a sense of dignity and high self-esteem that you are worth every penny you charge. It requires an attitude of experimentation, not simply doing things because that is the way they have always been done. It requires less measurement and more trust.

### **Disdain of Theory**

Pick up any book, or attend any seminar, and one of the first things you will hear is “This course is not based on ivory tower theory, but practical steps

you can take back to the office Monday morning and implement.” Yet we are ruled by our theories because they help us make sense of a complex world, even if we do not consciously think about them. All learning starts with theory. The positing and falsification of theory is the cornerstone of all scientific and business progress, but you would never know it from most business books, where theory is avoided as if it were some type of plague.

### **Truth Is Not Determined by Popular Vote**

At one point in our history the majority of learned opinion thought the earth was flat, which of course did not make it so. One of the most puerile objections to Pricing on Purpose is, “If these ideas are so good, why aren’t more companies doing it?” Fortunately, thanks to pioneers such as Tom Nagle, Reed Holden, Kent Monroe, Eric Mitchell, and the Professional Pricing Society, among many others blazing the trail for pricing leadership, more companies are following these ideas, and pricing has been put on the organizational chart of many organizations around the world. Yet many more need to follow, and have not because, quite frankly, that is not how science progresses, nor does an idea become validated simply because a substantial portion of a population engages in it (think Nazism or communism). The scientific method, invented in Europe between 1589 and 1687, gave us concepts such as hypothesis, falsification, parsimony, and the experimental method. This is the tried and true way new ideas should be tested, not by a democratic vote or opinion poll. Cost-plus pricing philosophies have built up incredible inertia in most organizations, and they will not be refuted overnight. It is not possible for the Subjective Theory of Value to be completely right; it can only claim it is limited in being wrong. All theories are subject to falsification, but in the meantime, partial explanations are better than none. Someday the subjective theory of value may be replaced with a better theory. I only hope I live long enough to see it.

### **Consultants**

This obstacle is perhaps the most disconcerting because consultants are usually the “change agents” in the population spreading new ideas. Yet, some of the most mind-numbing opposition I have had to Pricing on Purpose is from this sect, reminiscent of the guilds of yesterday that degenerated into technologically conservative organizations. With respect to the particular ideas

contained in this book, the consultants are arguably modern day Luddites (there are, of course exceptions, such as McKinsey & Company, A.T. Kearny, Accenture, and others, that have made substantial investments in the area of pricing skills). Simply put, they are keeping industries mired in the mentality that measuring efforts and activities is correlated with results and wealth creation.

For an economy—or a business—to be truly innovative, it must not only do new things, it must stop doing old things. It is not possible to create tomorrow unless one first disposes of yesterday. Maintaining yesterday is always expensive. The human body has an automatic mechanism to discharge waste, but it appears the corporate body does not—that requires leadership, which is why we advocate the position of CVO to put every policy, procedure, service, and activity on trial for its life, by asking the following questions: “If we didn’t do this already, would we go into it the way we are now?” And if the answer is no, then the next question is, “What would we do?”

Peter Drucker—irrefutably the world’s best management consultant—was 13 years old when a teacher asked him what he wanted to be remembered for. Drucker, now in his nineties, is still attempting to answer that question, “because it pushes you to see yourself as a different person—the person you can *become*.” What can your business or industry *become*?

## WOULD YOU WANT YOUR SON OR DAUGHTER TO WORK THERE?

*Our future is too important to be left to the statisticians and logicians. They can predict based only on a straight-line continuation of the past and present, a pretty sorry prospect. Valuable as such planning is, we need to stop being so logical. The future should be left to the dreamers.*

—Stanley Marcus, *Stanley Marcus from A to Z, Viewpoints Volume II*, 2000

As I was writing this concluding chapter, I had a fortuitous phone conversation with Dr. Sheila Kessler. Sheila is a remarkable woman—a consultant for over 100 of the Fortune 500 companies, a former Baldridge Quality Award examiner for the California Council on Service and Quality, author of nine books—and has worked and consulted in 54 countries. Every time I have the good fortune to speak with her, my intellectual capital rises immeasurably.

During our conversation Sheila asked the question, “How many companies do you truly admire?” This goes far beyond merely doing business with them, but more relates to whether you would want your son or daughter to work for them. It is an excellent question, and for all of her experience—with literally thousands of companies around the world—she said there are perhaps twenty that would make her list. *Only 20?*

As I thought about it, I could not name more than 20 myself; and although Sheila’s and my list differ on the companies we truly respect and admire, is it not a sad commentary we cannot name more? This is a very reflective question, because it caused me to think deeply about the business education most of us have received at universities, continuing education courses, seminars, conferences, and especially the books we read.

We all rely on the free market for our standard of living, an interdependent system that requires us to serve the needs of others before we have any claim on resources for ourselves—to supply before we demand. Each of us would like to earn more; purchase goods and services that add value to our lives and those of our families; work for companies where we can utilize our intellectual capital to continuously serve the needs of others and take pride in making a contribution larger than ourselves; all the while diversifying our investment portfolios in other companies engaged in the same enlightened activities and earn a decent economic return to enjoy in our golden years.

The history of business is the history of dreamers, and entrepreneurs, those rare individuals who cast aside the security of a paycheck, mortgage everything they have, and chase a dream that ends up creating our futures. The great economist Joseph Schumpeter referred to this process as the “perennial gale of creative destruction.” The factories and technologies of tomorrow—nothing more than a glimmer in the eyes of a garage tinkerer today—will at some point rise up and supplant the old order, disrupting the status quo and making a mockery of static income and wealth distribution tables. It is the college sophomore dropout who starts a software company and creates the world’s standard operating system—Microsoft’s Bill Gates. It is the tenacious student who charges against the odds despite receiving a “C” on his term paper and launches a company that, most likely, every reader of this book has used, or uses, on a regular basis—Fred Smith’s FedEx.

The tempo of business is not one of stability, order, and a level playing field, but rather of disequilibrium and instability. Stability and equality only exist in the graveyards. Ralph Waldo Emerson once wrote, “An institution is the lengthened shadow of one man.” Mike Vance, former Dean of Disney

University, tells this story of Walt Disney's final hours in 1966 in his book *Think Out of the Box*:

At Disney studios in Burbank, California, Mike could gaze out of his office window, across Buena Vista Street, to St. Joseph's Hospital where Walt Disney died. The morning he died, Mike was talking on the telephone when he saw the flag being lowered over at the hospital around 8:20 A.M. His death was preceded by an amazing incident that reportedly took place the night before in Walt's hospital room.

A journalist, knowing Walt was seriously ill, persisted in getting an interview with Walt and was frustrated on numerous occasions by the hospital staff. When he finally managed to get into the room, Walt couldn't sit up in bed or talk above a whisper. Walt instructed the reporter to lie down on the bed, next to him, so he could whisper in the reporter's ear. For the next 30 minutes, Walt and the journalist lay side by side as Walt referred to an imaginary map of Walt Disney World on the ceiling above the bed.

Walt pointed out where he planned to place various attractions and buildings. He talked about transportation, hotels, restaurants and many other parts of his vision for a property that wouldn't open to the public for another six years.

We told this reporter's moving experience, relayed through a nurse, to each one of our organizational development (OD) groups... the story of how a man who lay dying in the hospital whispered in the reporter's ear for 30 minutes describing his vision for the future and the role he would play in it for generations to come.

This is the way to live—believing so much in your vision that even when you're dying, you whisper it into another person's ear (Vance and Deacon, 1995: 30).

Soon after the completion of Walt Disney World a VIP visitor remarked to Vance, "Isn't it too bad Walt Disney didn't live to see this." Vance replied, "He did see it—that's why it's here."

One of the things that separates humans from animals is that humans know they have a past and a future, and they are willing to invest to improve the future, even though they know as mortals they will not be around to enjoy the fruits of those investments. Animals are not wealthy or poor; they are either well fed or hungry. History remembers the *builders* and *creators* of wealth, never *consumers*.

None of us would want to live in a world of perfect competition, where companies are merely price takers with infinitesimal influence on the price



they must accept for their offerings; a world where there is nothing but commodities, no innovation, no dynamism, no attention being paid to external value, a ruthless quest for efficiency at the expense of effectiveness and results created externally. It is easy to pay too much attention to the destruction, and ignore the creativity, of capitalism, since the former can be immediately measured yet the latter exists only in the hearts and minds of dreamers.

The old paradigm of running a business is losing relevance to successful behavior in today's intellectual capital economy. Old strategies rarely produce new results. It is my fervent hope you accept the challenge to help establish new traditions for your industry, ones based on constantly creating and adding value, along with service, to others. Pricing on Purpose will enable you to be paid what you are worth and stop sacrificing profits on the altar of cost-plus pricing and the accountant's view of the world.

The founding framers of America began their new country with a clear vision of the future, *Novus Ordo Seclorum*—"A new order of the ages," as is printed on the back of each dollar bill. I offer this new vision of a business focused on value—one where your sons and daughters would gladly work with your blessing—a new way of thinking and operating, emphasizing customer value and a sense of service to others first. A world in which these virtues are practiced as much as they are preached. A reality whose time is here.



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## SUGGESTED READING

*A man without a favorite author is a lost soul.  
He remains an unimpregnated ovum, an unfertilized pistil.  
One's favorite author... is pollen for his soul.*

—Lin Yutang, *The Importance of Living*, 1937

I thought it would be useful, for the reader wanting to deepen their learning of the topics explored in this book, to provide a suggested reading list, listing some of the best books written by leading thinkers—in my opinion—sorted by the topics in this book. There is always a risk in recommending a book to others, similar to arranging a blind date, which is perhaps why readers do not finish reading four out of five business books. Nevertheless, I will take the risk and proffer to you books I know will add to your intellectual capital. Most of the following books are included in the Bibliography and hence publisher and date of copyright are omitted from the following list.

### ANTITRUST LAW

Dominick T. Armentano. *Antitrust and Monopoly: Anatomy of a Policy Failure* (second edition); and *Antitrust: The Case for Repeal* (revised second edition). Among the best books available repudiating antitrust policy and the unfounded economic assumptions that underlie it. They explode one myth after another, with historical accuracy and empirical evidence. After reading these volumes, you will understand why the majority of economists reject so many antitrust laws.

Robert H. Bork. *Antitrust Paradox: A Policy at War With Itself*. Judge Robert Bork provides a critique of the antitrust laws, and how they do not, for the most part, benefit consumers or increase economic welfare.

John R. Lott, Jr. *Are Predatory Commitments Credible?: Who Should the Courts Believe?* Lott conducts an empirical analysis of the accusation of predatory pricing over a 30-year period, concluding that predatory pricing is not an important phenomenon among profit-maximizing firms, thereby shattering one of the enduring myths of business folklore.

Richard Posner. *Antitrust Law* (second edition). Judge Richard Posner's first edition of this work was considered a jeremiad against antitrust practices. In this edition, Posner admits the laws are here to stay, makes the argument that they exist to promote economic welfare, and offers new perspectives on dealing with vexing questions of the new economy, such as software, communication companies, and Internet service providers.

George J. Stigler. *The Economist as Preacher and Other Essays*; and *Memoirs of an Unregulated Economist*. This 1982 Nobel Prize-winning economist appeared before Congress in 1950 advocating that U.S. Steel Corporation be broken up. At the beginning of his career, Stigler was a proponent of vigorous antitrust enforcement. After studying the topic for most of his career, he concluded that the laws were counterproductive. These books are not his more scholarly works on the topic, but provide insight into why he changed his mind on antitrust laws over the course of his distinguished career.

## ECONOMICS

Economics is far from being concerned with predicting the stock market, budget deficits, inflation, unemployment, and other macroeconomic indicators. The real fertile minds in economics study human behavior, and as we explored, have quite a lot to say about it, perhaps just as much as psychiatrists and psychologists. Reading the following authors can change your perspective on economics from the "dismal science" to an endlessly fascinating journey of understanding why people behave the way they do.

Gary S. Becker. *The Economics of Life*. Becker is the 1992 Nobel Laureate, and this book is a compendium of his popular monthly columns from *Business Week*. Becker is famous for applying economics to a wide variety



of public policy issues, from discrimination and marriage and family, to crime and punishment.

David D. Friedman. *Price Theory: An Intermediate Text* (second edition); and *Hidden Order: The Economics of Everyday Life*. David Friedman is Milton and Rose Friedman's son and an outstanding economist from Santa Clara University. Both of these books are an excellent read, the latter being especially entertaining.

Milton and Rose Friedman. *Free to Choose: A Personal Statement; Capitalism and Freedom*; and *Two Lucky People*. Milton and Rose Friedman are each eminent economists, and these books are classics, and must-reads for anyone who wants an understanding of how free markets work.

George Gilder. *Recapturing the Spirit of Enterprise*; and *Wealth and Poverty: A New Edition of the Classic*. In my opinion, Gilder is the best writer and thinker on economics, sociology, technology, and entrepreneurship that you will find. I discovered his work, *Wealth and Poverty*, in 1981, and it forever altered my vision of the way the world works. These two books are his classics, but he has written many others. If you read only two books from this entire list, read anything by Gilder—twice. Gilder is a senior fellow at Seattle's Discovery Institute ([www.discovery.org](http://www.discovery.org)).

Henry Hazlitt. *Economics in One Lesson*. This book is a classic, originally published in 1946, written by a self-taught economist who worked as a journalist. F.A. Hayek said of this work, "It is a brilliant performance. It says precisely the things which need most saying and says them with a rare courage and integrity. I know of no other modern book from which the intelligent layman can learn so much about the basic truths of economics in so short a time."

John Kay. *The Business of Economics; Foundations of Corporate Success: How Business Strategies Add Value*; and *Culture and Prosperity*. Kay is one of Great Britain's leading economists, currently a visiting professor at the London School of Economics. He is quite adept at explaining economic theory and how it applies to real-life business situations. His books are not easy reads, but worth the effort to understand how economic theory and business really are complements. You can learn more about Kay at [www.johnkay.com](http://www.johnkay.com).

Steven E. Landsburg. *The Armchair Economist: Economics and Everyday Life; Price Theory and Applications* (fifth edition); and *Fair Play: What Your Child Can Teach You About Economics, Values, and the Meaning of Life*. Like David Friedman, Landsburg is an incredibly brilliant economist,

besides being an excellent and entertaining writer. He will no doubt challenge, and in many cases persuade, you with his cogent analysis of contemporary issues. *Fair Play* is a book written for his young daughter, and relates complex economic issues down to the child's sandbox—a truly fascinating read. To read Landsburg's "Everyday Economics" columns, go to [www.slate.com](http://www.slate.com).

Steven D. Levitt. *Freakonomics*. Levitt is another dynamic economist applying price theory to the study of a multitude of current topics in this best-selling book, and reaching some unconventional—and sometimes controversial—conclusions. An astounding read. He is the director of the Initiative on Chicago Price Theory at the University of Chicago, and winner of the John Bates Clark Medal, awarded to the best American economist, every two years, under the age of 40.

Charles Murray. *Human Accomplishment*. Although not an economics book per se, it is such an important work that it is worthy of inclusion in the study of human behavior. Murray studied outstanding human accomplishment from 800 B.C. to 1950, and concludes we stand on the shoulders of 4,002 individuals who invented, created, or otherwise innovated all human progress in the sciences (including technology), philosophy, music, visual arts, and literature. What is astonishing about these 4,002 individuals is that the mean age at the time of their contribution was 40. This book proves that there is, indeed, such thing as a free lunch. A good companion read is Benjamin Jones, "Age and Great Invention." Available at [www.kellogg.northwestern.edu/faculty/jones-ben/htm/Research.htm](http://www.kellogg.northwestern.edu/faculty/jones-ben/htm/Research.htm).

Mark Skousen. *Puzzles and Paradoxes in Economics*; *The Making of Modern Economics: The Lives and Ideas of the Great Thinkers*; *The Power of Economic Thinking*; and *Vienna and Chicago: Friends or Foes?* Skousen is one of my favorite writers, and does an excellent job with the history of economic ideas, especially from an Austrian perspective. Each of these four books is an excellent read, the second one an engaging and engrossing survey of the leading economic thinkers, providing not only a summary of their work, but also their private and personal lives, while the last is an examination of the differences—and commonalities—between the Chicago and Austrian schools of economics.

Adam Smith. *The Theory of Moral Sentiments* (1759); and *An Inquiry into the Nature and Causes of the Wealth of Nations* (1776). These are Smith's major books, which are the basis for the classical economic view of markets. Smith is wrongly attributed with saying—or making the case that—greed is good; he never said or implied any such thing. He believed in a system

of natural liberty, operating under the guidance of an “invisible hand.” For an excellent summary of Smith’s thinking, in the genre of an academic novel, see *Saving Adam Smith*, by Jonathan B. Wight, a well-written, innovative work of economic history. The Liberty Fund has an excellent electronic library of each of Smith’s works, which you can search by topic, keyword, phrase, and so forth, at [www.econlib.org](http://www.econlib.org).

Thomas Sowell. *Applied Economics: Thinking Beyond Stage One*; and *Basic Economics: A Citizen’s Guide to the Economy* (revised and expanded edition). Thomas Sowell is one of the nation’s leading economics writers and scholastic thinkers, and is the Rose and Milton Friedman Senior Fellow on Public Policy at the Hoover Institution, Stanford University. What is extraordinary about these works is that Sowell explains economics without using any graphs, equations, or charts, and makes the complex quite understandable. He has written many books, all of which are worth reading. You can learn more about Thomas Sowell at [www.tsowell.com](http://www.tsowell.com).

Richard H. Thaler. *The Winner’s Curse: Paradoxes and Anomalies of Economic Life*. This book explains the famous winner’s curse, applied in this book to request for proposals and other bidding situations in Chapter 18. Thaler is one of the pioneers of a new area of research known as “behavioral finance” and offers many interesting examples and theories of human behavior, some of which challenge the economist’s assumption of rationality.

## MANAGEMENT CONSULTANTS AND CONSULTING

Although this field lacks the extensive history of economics and other academic disciplines, some consultants do offer intelligent guidance to business leaders today, while others do not, and have been appropriately criticized in recent years.

Peter Block. *The Answer to How Is Yes: Acting on What Matters*. This is a splendid book, detailing the importance of starting with “why” questions rather than “how” questions when confronted with any change. Anyone involved in changing people’s minds needs to read this illuminating and lucid book.

Peter F. Drucker. *Adventurers of a Bystander; Managing in a Time of Great Change; Management Challenges for the 21st Century; Managing in the Next Society*; and *Peter Drucker On the Profession of Management*. Drucker is the one truly serious thinker the management consultant industry

can point to with justifiable pride. Read anything, and everything, by Drucker. For excellent one-book summaries of his life's work, see *The World According to Peter Drucker*, by Jack Beaty, and *Peter Drucker: Shaping the Managerial Mind*, by John E. Flaherty.

John Micklethwait and Adrian Wooldridge. *The Witch Doctors: What Management Gurus Are Saying and Why It Matters*. This piercing work—by two editors from *The Economist*—gave voice to the backlash against the \$100+ billion profession known as “consulting.” Although the authors bestow far too much power to the consultants in altering the course of life, referring to them as “the unacknowledged legislators of mankind,” their four defects of the “witch doctors” of our age are mortally accurate. The profession has yet to refute successfully the charges against it, so eloquently laid out in this book. For all those who have suffered through many a poorly written business book, Micklethwait and Wooldridge offer a refreshing alternative.

Richard Minitzer. *The Myth of Market Share: Why Market Share Is the Fool's Gold of Business*. This little book makes a simple, but important, claim: Companies that pursue market share rather than profits hurt shareholders. A great read, which also provides the historical context for the term *market share*.

## MARKETING AND SELLING

Michael T. Bosworth. *Solution Selling: A System for Difficult to Sell Products*; and *Customer Centric Selling*. Both books look at the sales process from the perspective of the customer, how to focus on value-added services, and how a company's sales methodologies can actually provide, in and of themselves, a competitive advantage.

Seth Godin. *Purple Cow: Transform Your Business by Being Remarkable*. Godin has written many books on marketing, yet this is one of my favorites. The purple cow is the fifth P of marketing—how to make your product or service remarkable, consistent with the message of Chapter 17.

Christopher W. Hart. *Extraordinary Guarantees: Achieving Breakthrough Gains in Quality and Customer Satisfaction*. Examines the economics of offering your customers a 100 percent money back guarantee, especially for service firms. Required reading for any company wanting to utilize this strategy in order to gain a competitive advantage, add more value, and lower customer risk.

Theodore Levitt. “Marketing Myopia,” *Harvard Business Review*, September–October 1975; and “Marketing Success through Differentiation—of Anything,” *Harvard Business Review*, January–February 1980. Levitt is the marketer’s marketer, offering many thought-provoking insights, and forcing executives to think about their business from the perspective of the customer.

Neil Rackham. *SPIN Selling*; and *Rethinking the Sales Force: Redefining Selling to Create and Capture Customer Value*. The first book presents a sales method, backed by significant empirical evidence from effective sales forces around the world. The second book will help companies move from “transaction selling” to “consultative selling,” and finally to the most valuable relationship of all, “enterprise selling.”

Roy H. Williams. *The Wizard of Ads: Turning Words into Magic and Dreamers into Millionaires*; *Secret Formulas of the Wizard of Ads*; and *Magical Words of the Wizard of Ads*. Three splendidly written books with many insights into human behavior and effective advertising.

Mahan Khalsa. *Let’s Get Real or Let’s Not Play: The Demise of Dysfunctional Selling and the Advent of Helping Clients Succeed*. This book outlines a sales methodology focused on value, while recognizing that *both* the seller and the buyer have to benefit from the transaction. It is well written and the advice is practical.

## MORALITY, ETHICS, CAPITALISM, AND PROFITS

Norman E. Bowie. *Business Ethics: A Kantian Perspective*. An interesting look at how philosopher Immanuel Kant’s teachings can be applied to the ethical issues facing business leaders today. Although I do not agree with all of the conclusions of the author, it is a thought-provoking book.

Peter F. Drucker. “What is Business Ethics” *The Public Interest*, Spring 1981. In this article, Drucker challenges the whole notion of business ethics, arguing that if it continues to be discussed as separate from everyday right and wrong behavior, it will degenerate into casuistry. Claiming that it should not matter if a person acts as an employee of a manufacturer, hospital, or government agency, ethical behavior should be judged on standards of right and wrong, which is not specific, nor exclusive, to business enterprises.

Milton Friedman. “The Social Responsibility of Business Is to Increase Its Profits.” *The New York Times Magazine*, September 13, 1970. In this most

cited article on the issue of corporate social responsibility, Friedman argues that corporations should focus on what they do best—maximizing profits by offering valuable products and services to its customers, while staying well within the bounds of the law. Corporate managers—who are not owners—should not spend other people’s money on charitable programs. Not only are they not competent to judge the effectiveness of these programs, they are taking money out of the owner’s pockets. Far better to maximize profits, distribute them, and let individual shareholders make their own charitable decisions. As usual, Friedman offers a very compelling argument, even though I wish he would claim profits are the *result* of offering value to customers, not the main purpose of a business.

George Gilder. “The Soul of Silicon.” Speech delivered to the Vatican (May 1997), published September 9, 1997. This is Gilder at his best. This is one of the best defenses of capitalism, free markets, profits, and the morality of enterprise ever written. See the George Gilder Archives at the Discovery Institute web site at [www.discovery.org](http://www.discovery.org).

Richard John Neuhaus. *Doing Well and Doing Good: The Challenge to the Christian Capitalist*. An excellent book, exploring the moral foundations of work, enterprise, and profits, as well as the late Pope John Paul’s encyclical of May 1, 1991, *Centesimus Annus* (“The Hundredth Year”) as discussed in Chapter 19. Neuhaus is a theologian and editor of the religious magazine *First Things*.

Michael Novak. *The Catholic Ethic and the Spirit of Capitalism*; and *Business as a Calling: Work and the Examined Life*. Two exceptional books from one of the most thoughtful and cogent writers of our times, also a theologian. Novak makes a profound argument for why business is a serious moral enterprise. Required reading for anyone interested in morality, ethics, and enterprise. For more information on Novak, visit [www.michaelnovak.net](http://www.michaelnovak.net).

## PRICING

Ronald J. Baker. *Professional’s Guide to Value Pricing* (seventh edition; CCH, Incorporated). The author’s first book, written specifically for accountants, lawyers, and other professional service firms. It challenges the pricing-by-the-hour paradigm (a form of cost-plus pricing) and offers alternatives for professionals to get out from under the artificial ceiling imposed—on themselves—of the billable hour, while offering alternatives to maintaining timesheets.

Ronald J. Baker and Paul Dunn. *The Firm of the Future: A Guide for Accountants, Lawyers, and Other Professional Services*. This book explores the Old and New Practice Equations for leveraging intellectual capital in today's knowledge economy. Topics discussed include intellectual capital; customer selection; pricing; key performance indicators; leadership; and issues facing the professions.

Ronald J. Baker. *Burying the Billable Hour; Trashing the Timesheet; and You Are Your Customer List*. This series was published by the Association of Chartered Certified Accountants (ACCA), the world's largest, fastest-growing international professional accountancy organization, with nearly 300,000 members and students in 160 countries. You can download these books (in pdf) for free from the ACCA web site at [www.accaglobal.com/?view=Search+results&freesearch=Burying+the+Billable+Hour](http://www.accaglobal.com/?view=Search+results&freesearch=Burying+the+Billable+Hour).

Robert G. Cross. *Revenue Management: Hard-Core Tactics for Market Domination*. Cross was instrumental in developing dynamic pricing for Delta Airlines, and this book explains the concepts of what he calls revenue management, marketers call yield management, and I call price discrimination.

John L. Daly. *Pricing for Profitability: Activity-Based Pricing for Competitive Advantage*. This book is valuable for the activity-based costing advice it gives, yet I disagree with the author's conclusion that pricing is not an art. Unfortunately, it is far too focused on the *inside* of the company, completely ignoring a theory of value, which is the ultimate determinant of price, not more accurate activity-based cost accounting.

Robert G. Docters, Michael R. Reopel, Jeanne-Mey Sun, and Stephen M. Tanny. *Winning the Profit Game: Smarter Pricing, Smarter Branding*. An excellent book on pricing written by two consultants from A.T. Kearney—a professor, and a consultant—it offers many real-world examples of effective pricing strategies. While it does not present a theory of value, and makes the hyperbolic claim that you can eliminate pricing mistakes with the strategies presented, pricers will still find it useful for current thinking on pricing and branding smarter.

H. Thomas Johnson and Anders Bröms. *Profit Beyond Measure: Extraordinary Results through Attention to Work and People*. This is the book co-authored by one of the founders of activity-based costing, who has since gone on to develop *managing by means*. The book is a study of the legendary Toyota (and Scania) production process, all done without a standard cost accounting system, and is discussed in Chapter 11 of this book. It is an embryonic book, but I believe it offers many avenues for further research.

Michael V. Marn, Eric V. Roegner, and Craig C. Zawada. *The Price Advantage*. Written by three consultants from McKinsey & Company, this book also offers valuable advice for professional pricers in all companies. The authors claim that while less than one-third of major companies around the world had functional pricing departments ten years ago, today four out of five do. I especially like the Pocket Price Waterfall concept presented, as well as the practical advice for strategic pricing (although it lacks a theory of value).

Kent B. Monroe. *Pricing: Making Profitable Decisions* (third edition). Monroe is one of the leaders in making pricing a strategic function in corporations around the world. For the serious student of pricing, Monroe's work is essential, offering in-depth analysis on all facets of pricing.

Thomas T. Nagle and Reed K. Holden. *The Strategy and Tactics of Pricing: A Guide to Profitable Decision Making* (third edition). If you only read one pricing book from this list, make sure it is this one. This is the single best pricing book I have ever read, one to which I owe many of the insights in this work. Nagle and Holden are pricing pioneers, each with their own pricing consulting firms, Nagle at [www.strategicpricinggroup.com](http://www.strategicpricinggroup.com) (now owned by Monitor Group, [www.monitor.com](http://www.monitor.com)) and Holden at [www.holdenadvisors.com](http://www.holdenadvisors.com).

## PSYCHOLOGY

Nathaniel Branden. *The Six Pillars of Self-Esteem*; and *Self-Esteem at Work: How Confident People Make Powerful Companies*. Branden has written extensively on self-esteem, with the first book being his treatise on the topic, while the second discusses the importance of this topic in a business environment.

Robert B. Cialdini. *Influence: The New Psychology of Modern Persuasion*. A fascinating book, shedding much light on human behavior.

## TOTAL QUALITY SERVICE, AUTOBIOGRAPHIES AND BIOGRAPHIES

Karl Albrecht. *The Only Thing That Matters: Bringing the Power of the Customer into the Center of Your Business*; *The Northbound Train: Finding*



*the Purpose, Setting the Direction, Shaping the Destiny of Your Organization*; and *Service America in the New Economy*. Albrecht is the modern founder of the customer service revolution, with the publication of his 1985 book, *Service America!*. These later works expand on his theory, while the last book explains why he thinks the service revolution has, for the most part, died.

Jan Carlzon. *Moments of Truth: New Strategies for Today's Customer-Driven Economy*. Carlzon was head of SAS Airlines when this book was published, and was the inspiration for some of Albrecht's later work on Total Quality Service. This exploration of the Moment of Truth strategy—looking at each interaction the customer has with your company—still holds many relevant lessons for today's leaders.

Henry Ford and Samuel Crowther. *My Life and Work*. This book was originally published in 1922, and is remarkable for the insight it provides on pricing, essentially mirroring the Pricing on Purpose value chain presented in Chapter 9, and illustrating how Ford understood that, ultimately, price drives costs, not the other way around.

Disney Institute. *Be Our Guest: Perfecting the Art of Customer Service*. A behind-the-scenes look at the best practices and systems used by Disney's theme parks to provide moments of magic for its guests.

Stanley Marcus. *Quest for the Best; The Viewpoints of Stanley Marcus: A Ten-Year Perspective; Minding the Store: A Memoir; and Stanley Marcus from A to Z: Viewpoints Volume II*. Stanley Marcus was the son of one of the founders of Neiman-Marcus, and ran the store during the Great Depression until the late 1960s. I consider Marcus the leader in customer service, and the many stories and examples in these works support this view. An amazing man and a great life story.

Robert O'Brien. *Marriott: The J. Willard Marriott Story*. A well-written story on the man who began in a hole-in-the-wall root beer stand and \$6,000 in start-up capital and built the present Marriott Empire. It is inspiring to read how Marriott always put the customer first and understood the value of great service and loyalty long before either became a fad—wisdom is timeless.

Joseph B. Pine II and James H. Gilmore. *The Experience Economy: Work Is Theatre and Every Business a Stage*. The authors propose a new value chain for businesses, going from services to experiences to transformations. It is a thought-provoking thesis, and was explored in Chapter 13.

Frederick F. Reichheld and Thomas Teal. *The Loyalty Effect: The Hidden Force Behind Growth, Profits, and Lasting Value*; and *Loyalty Rules! How*

*Today's Leaders Build Lasting Relationships.* The first book is Reichheld's seminal work on customer loyalty economics, empirically proving that retaining existing customers is more profitable than acquiring new ones. The second book expands on these themes. Necessary reading for all leaders responsible for customer service.

Dr. Edward E. Rosenbaum. *A Taste of My Own Medicine: When the Doctor Is the Patient.* An absolutely engrossing book about a doctor who contracts throat cancer and becomes a patient in his own hospital, an experience that profoundly changes how he views his own patients and what it means to be a doctor. If you have ever had a loved one battling cancer, this book will resonate with you. It is a moving story, passionately told, and is the book the movie *The Doctor*, starring William Hurt, was based on (which I would also recommend you see). This book gives insight into the customer service revolution going on in the medical profession, especially in some hospitals.

Richard S. Tedlow. *Giants of Enterprise: Seven Business Innovators and the Empires They Built.* This is a fascinating historical account of the lives of Andrew Carnegie, George Eastman, Henry Ford, Thomas J. Watson, Sr., Charles Revson, Sam Walton, and Robert Noyce. A great read.

Andrew Tobias. *Fire and Ice: The Story of Charles Revson—the Man who Built the Revlon Empire.* An amazing and engrossing story.

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