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Commentaries on Ratchford, "The New Economic Theory of Consumer Behavior: An Interpretive Essay"

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In the introduction of his paper, Ratchford states that his purpose is to diffuse the "new theory" of consumer behavior in economics to noneconomists. This is a worthwhile undertaking, because, for several years, it has been clear to those of us in economics concerned with applied demand analysis that the "new theory" provides a natural bridge between the analysis of consumer behavior in economics and in marketing, sociology, and psychology. Until now, the situation has been that noneconomists have had little time for the economist's approach to the study of consumer behavior, and conversely. Probably more than anything else, however, this disdain of one discipline for the approach of the other is the result of a gap in communication, and Ratchford's essay is an important contribution to the elimination of this gap. Thus, on the whole, I feel that Ratchford has been successful in meeting his objective.

The "new theory" of consumer behavior in economics is popularly credited to Kelvin Lancaster (1966), although Richard Muth (1966) has equal claim as an originator. In essence, what the "new theory" does is to apply the linear activity analysis model of the firm, developed in the late 1940's by Dantzig, Dorfman, Koopmans, and others, to the theory of consumer choice. The impact of the new theory was immediate, and in the 10 years since its publication in the Lancaster and Muth papers, it has acquired a substantial literature.

Still, readers of Ratchford's essay should not come away with the idea that the "new theory" has completely replaced the "old" theory of consumer behavior in economics, for this is not the case. Neither in theoretical discourse nor in empirical application does the new theory form the principal framework of analysis. There are two reasons for this, the first being the fact, and I wish to emphasize this, that the old and the new theories are not contradictory. By making characteristics, rather than goods, the objects of choice in the utility function, the new theory constitutes an important theoretical advance; for, as noted by Ratchford (a) it can deal in a natural way with new goods (which the conventional theory could not), and (b) it provides an operational, and highly practical, way of defining substitution and complementarity among goods.

However, perhaps the most important contribution, at a theoretical level, that the new theory made is that it caused economists to recognize that the utility function, when defined with respect to goods, reflects not only the preferences of the consumer, but also the technology of consumption. The profession was quick to note the importance of this separation, for as observed by Tibor Scitovsky (1966, p. 47) in his discussion of a paper given by Lancaster at the American Economic Association meetings in New York City in December, 1965:

...I should just like to say how much I welcome Professor Lancaster's new approach to the theory of consumer's demand. There is nothing more frustrating than to watch, and watch silently, the stupid way in which some people squander their money and get little to show for it. I used to be told that I may not even criticize them, since all they were doing was to spend money their own way, and I as an economist must respect the other consumer's sovereignty. Now Professor Lancaster has relieved my frustration. At last I can look down my nose, without a pang of professional conscience, upon the sorry mess some people make of the noble art of spending money. Now I can respect the poor sucker's sovereignty and still criticize him for his inefficiency in catering to his own sovereign tastes. Another advantage of the new approach is that at long last we can embrace and accept as an equal a much maligned and looked-down upon colleague, the home economist. It is now clear that her work is no more humble, no more lowly, than that of the management scientist and the operations researcher.

With regard to applied demand analysis, the new theory of demand has very definitely had an impact, but the typical empirical demand study still begins from the old theory as a point of departure. In general, the reason for this is not antagonism toward or lack of appreciation for the new theory, but rather problems of measurement. Most of the empirical work based on the new theory to date has focused on durable goods, particularly automobiles and housing, where characteristic...
tics are well-defined and are there for everyone to see. With most goods, however, the characteristics that they yield are either nebulous to begin with or else present major problems of definition and measurement. The examples used by Ratchford, “whiteness” and “decay prevention” are cases in point. As a consequence, applied demand analysts frequently have little choice but to work directly with goods. However, regarding this, a point that Ratchford makes implicitly, but which I would like to emphasize, is that economists could very likely benefit from the techniques in measurement of nonobservable phenomena that have been pioneered by psychologists and sociologists.

I shall finish this commentary on Ratchford’s essay with the following brief observations:

1. I especially like Ratchford’s emphasis on the fact that economists and noneconomists studying consumer behavior are typically interested in different questions. Economists usually are interested in the effect of price and income changes, taking preferences and the consumption technology as given, on quantities consumed of goods, while those in marketing and social psychologists are interested in the formation of preferences. As Ratchford notes, each discipline’s interests can be accommodated within the framework of the new theory.

2. In his essay, Ratchford leans most heavily on Lancaster’s book (1971) and the papers of Baumol (1967) and Rosen (1974). The paper by Lipsey and Rosenbluth (1972), which, inter alia, analyzes inferiority in characteristics, should also be brought to the attention of readers.

3. Ratchford quite properly emphasizes the relationship of the new theory to the work on hedonic price indices. Ratchford mentions that Rosen (1974) was the first to provide a foundation for hedonic price indices on the new theory. In this connection, I would also like to mention the doctoral dissertation at Michigan of William Alexander (1972).

4. Finally, it seems to me that an area of possibly very fruitful collaboration between economists and noneconomists in the framework of the new theory of demand concerns the impact of advertising, the distinction between the objective characteristics of a good and the characteristics as perceived by the consumer, and how the latter changes in response to advertising.

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We are watching the end of economists as we have known them. Economists say this in repeated articles and news reports; therefore, no need to belabor the point, except to explain that the failures are those of not dealing with human behavior; ignoring consumers’ choice mechanisms, missing the multiple utilities that underlie consumption and the real nature of competition.

(Starr, 1975, pp. 4, 14) The theories of Lancaster, Baumol and Rosen, so ably presented by Professor Ratchford, are presumably part of this change.

There are three aspects of the new economic theories which Professor Ratchford’s article mentions that deserve to be emphasized. First is the notion of a goods group. It should be stressed that it is not necessary to accept the Lancaster theory in any other way to accept this concept. A simple extension of the traditional economic theory of consumer behavior provides fully for a “goods group.” This extension goes under the name of a utility tree, and the interested reader will find a full exposition of it in the papers by Strotz (1957, 1959) and Gorman (1959). There exists evidence that the concept is empirically reasonable at the individual
level in the recent information processing studies of consumer behavior summarized by Bettman (1974). Another interesting hypothesis is that the final branches of the utility trees of many (almost all) consumers are similar. This hypothesis underlies almost all econometric estimation of demand relations; indeed were this hypothesis to be true, a natural definition of an industry would exist.

Second is the issue that for some products a “consumer buys only one brand of the good per year.” One is immediately tempted to ask why. Here Professor Ratchford’s review has been too concise. The Ironmonger (1972) theory, because it explains in detail why such phenomena exist, is worthy of more than a brief footnote. Ironmonger argues that consumers can be regarded as having a system of priorities among their wants. He assumes these priorities to be so ordered that at a given income and prices the consumer will satiate as many wants as possible, going down the order of priority from most important toward the least. Thus, the priority patterns of consumers provide an answer to the question of why only so much of a particular brand may be desired per unit time. These priority patterns are readily discernible empirically (Pyatt 1964, Paroush 1965, McFall 1969). The remarkable thing is not that they exist, but that many general theories of consumer behavior have ignored them. Taking priority patterns directly into account is a major strength of Ironmonger’s work which distinguishes it from the theories Professor Ratchford reviews in greater detail.

The third aspect of the new economic theories which deserves emphasis are the implications for empirical research. Here, once again, the old tradition of economics is followed. Estimation is stressed; hypothesis testing is not. The estimation techniques presented will yield estimates whether the theory is correct or not. They are not designed to answer the vital question of whether the theory is appropriate to a particular situation. As is true in all formal analysis, grant the assumptions and the answers follow routinely by application of logical rules. Unfortunately, it is an open question as to whether the assumptions are correct. For example, there is some limited evidence that overall product preference is not a simple additive function of product characteristics (Simon, Haines, and Alexis 1974). This might mean that the transformation matrix as defined by Lancaster does not exist in some market situations. The essential point is that the development of the theory is not accompanied by the development of techniques to ascertain its bounds of relevance. Personally, I feel the Lancaster-Baumol model is most appropriate in industrial marketing environments, and have, indeed, applied it there for estimating the sensitivity of demand to changes in the relative price of a product (Miller and Haines 1970). However, determination of where a Lancaster type model is most useful must wait for development of adequate hypothesis testing procedures.

Thus, it can be argued that the Lancaster theory is interesting and valuable. But it has much in common with the age of economists “as we have known them.” Comparison of the theoretical analysis with that presented in such works as Kuehn and Weiss (1965), Nico- sia (1966), Engel, Kollat, and Blackwell (1968), Howard and Sheth (1969), and Bass (1974) makes the point quite obvious. The future will see these theories used, expanded, and corrected until a more appropriate and more useful set of consumer behavior theories are derived. Lancaster’s work, along with that of Rosen and Ironmonger’s, is surely a valuable part of the process.

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