Promotion Policies Costing Consumers Billions of Dollars

"Everyone loses" in an ironic marketing twist

Ask the man on the street what causes inflation, and chances are he'll point to the government. Why not? Even government admits its role, boastfully when the rate isn't too lofty. While there's no question about how price levels are affected by fiscal policy, and its impact on supply and demand, one expert suggests that consumer prices are being artificially inflated by marketing practices actually designed to lower prices. Adding to the irony, these same practices are not only costing consumers billions every year, they're also hurting the manufacturers who produce the products and the store owners who distribute them.

The culprit, according to Robert G. Brown, president of SPAR, one of the country's leading promotion analysis firms, is the age-old practice whereby manufacturers offer stores financial inducements—generally discounts or free merchandise—to buy their products. Known in the field as trade promotions or "deals," these programs represent the expenditure of billions of dollars per year, an expenditure which, Brown says, has actually resulted in higher everyday consumer prices, a situation which helps encourage the growth of generics.

"The theory," explains Brown, "seems sound enough. Stores, by purchasing large quantities of a promoted product at a discount, pass along the savings to their customers, who will buy the product more readily because of its lower price. Everyone benefits. Consumers save money. Stores sell more volume while increasing their profits. Manufacturers increase sales and pick up new customers."

The reality, unfortunately, is something else. Brown: "In recent years, the use of trade promotions has become loose and indiscriminate, which has created something of a vicious cycle. Here's what happens: The manufacturer announces the deal, the trade buys. But these buyers weren't born yesterday. When possible, they take on as much of the promoted product as they can, not just for the promotion but for inventory as well. While there's nothing wrong with this, heavy promotion buying reduces orders for the full-priced product after the promotion. Similarly, when manufacturer deals become predictable, buyers wait for them. This cuts into the demand for full-priced product between promotions. After a while you're not only selling too much at discount, you're also presenting production with the problem of being over-loaded at some point and idle at others. Profit margins are squeezed while manufacturing efficiencies crumble. In addition, today a new businessman called a diverter exists only to buy the product while at deal and then actually sells it to chains when the manufacturer's deal ends."

The next step is all too predictable. In the face of lost full-price sales and heightened production costs, manufacturers raise list prices. "The problem is compounded," Brown continues, "by the intense competition for retail space. Put simply, the more space the trade dedicates to a product, the more the product will sell. It doesn't take a genius to realize that given two competing brands the trade will be more apt to buy more of the one with the higher discount. This of course promotes discount competition. The manufacturer that tries to get out of the cycle by trimming discounts, or eliminating deals is apt to find itself off the shelves. The deep discounter eventually runs into reduced margins, and when equilibrium is reestablished, all list prices are higher."

Recently, in the face of this "everyone loses" scenario, several packaged goods companies have announced that they will no longer participate in this extreme cycle of higher trade promotions and higher lists and therefore stabilize and even lower their list prices. Though Brown praises the motives of these companies, he isn't very confident that they can unilaterally change the system. "There will always be some buyers out there who'll be looking to increase trade discounts, and some manufacturers who will offer greater discounts to increase share in the short run. Competitors will only allow their business to suffer so much. Unless they resort to certain other promotional forms, and utilize them effectively, they'll either go out of business or go back to increased dealing."

Brown does believe that there is a solution. "For every brand in every retail category there is an optimum trade promotion strategy, one that correctly balances the timing and frequency of promotions with every day shelf price as well as the size of the discount. It does take a hefty commitment of time and energy to identify that mix, but it's within the grasp of all major packaged goods manufacturers. If they'd make that commitment, they could break the cycle. Trade promotion is a powerful and effective tool when used intelligently, and several companies are working in that direction. But until the majority of companies in the industry (both manufacturers and retail trade) accept the fact that they alone can stop the cycle, it will be 'everyone loses' for a long time to come."