Marginal Analysis vs. Realism : Founding a Pricing Theory in Marketing, 1939-1956

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Recently, the field of pricing in marketing has experienced some important developments, and, at the same time, a growing need "to gain an understanding of its origins and its patterns of change" (Savitt 1980). The purpose of this article is then to provide a historical perspective of the works developed during the marginal controversy period (from Hall and Hitch's classic study in 1939 to Earley's empirical investigation in 1956) which contributed to emancipate marketing from economics guardianship.

Why, at the beginning of the 1930s, did some academicians undertake a completely new approach to a field so legitimated within economic theory? Was there a social demand, particularly among managers, for a different explanation from that proposed by conventional (economic) pricing theory? Was there by the end of the fifties, as suggested by Keith (1960, p. 35) a "marketing revolution", notably due to a change in marketing philosophy and the rising dominance of marketing within organizations? Is it possible to identify some causes and influences of this theoretic and environmental changes? (Hollander 2001, p.3)

The principal explanation in this regard is that, from the beginning of the 20th century, the German Historical School of Economics strongly inspired a questioning of the neoclassical paradigm: certain academicians started to criticize the marginal theory, as well as the substantive rationality of the *homo oeconomicus*, on the basis of historical and statistical methodologies, pragmatism and realism (Jones and Monieson 1990, p.102). Some years later, these doubts about the dominant theory of the firm led to an important confrontation between marginalism, managerialism and behaviorism, in what is known as the marginal controversy. This questioning was rapidly transformed into the emergence of seminal works which intended to describe the art of pricing as a reality of the firm.

A TRUE ANTI-MARGINALISM ATTACK

Though pricing has been integrated as a marketing function in some textbooks (Weld 1916, Duncan 1921), it rapidly disappeared until the emergence of a descriptive stream of research in marketing. These innovative intellectual proposals represent an important branching off from conventional economic theory. Conventional pricing theory, with marginalism as its underlying principle, actually received deep criticism between the beginning of the 20th century and the end of the fifties. The criticisms concerned the assumptions that helped to build this theory, and which are considered unrealistic by its detractors (product homogeneity, perfect information, substantive rationality). Indeed, "rather than knowledge of costs and demand, sellers possess an acute awareness of the uncertain character of market conditions." (Oxenfeldt 1951 , p. 79) And, when faced with this uncertainty, the marginal model seems to offer little support to reach a different objective, other than maximizing shortrun profits, which few businessmen seem to pursue. As Fellner states, businessmen opt for actions which will minimize risks despite a likely sacrifice on potential profits, because they are never absolutely sure to know the exact demand conditions (1948, p. 249). In other words, manufacturers prefer more reassuring and risk-free procedures, like routines, to more rational methods.

The first descriptive studies

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During this period, a vast amount of research and reflection has been conducted to identify who holds the truth. In one hand, managers, educated in the "young" business schools, who do not recognize traditional economic principles in their "real" world, and whose awareness has been heightened by a young discipline, marketing. And, in the other hand, pricing academicians - among them many economists who admit that modern price theory does not provide a satisfactory explanation for price behavior[1]- whose purpose is to validate, or invalidate the controversial hypotheses. This controversy further intensified within academia to a climax by the end of the 1940s, which Dorward described as "a true anti-marginalism attack" (1987, p. 98).

For the academicians who follow conventional pricing theory, every price is the result of objective and subjective complex forces, and the actors behavior can be described following the logical process of finding a maximum, as Nourse or Machlup did, for example. For the others, who participated to the development of business economics, like Dean, Mason or Oxenfeldt, the prices of selected products sold in the same objective conditions must behave in one same way, and it is possible to formalize this behavior in a more realistic theory. These authors want to rethink the price's part in the new American firm, by making the apology of American democracy and free enterprise[2]. These important researchers will contribute to change pricing into one of marketing's spearheads.

The first studies in this regard, conducted in the 1930s, aimed to observe the real pricing methods used by the firms. Among these studies, Churchill's (1932), Agnew's (1935), Hall and Hitch's (1939), and Vanderblue's (1939), reveal that managers do not follow the marginal analysis principle, which consists in equalizing marginal revenue and marginal cost to determine an optimal price (and optimal output) thereby maximizing profits. Rather than this classic model, managers would prefer an approach based on full cost, plus a "fair" profit. And it is within the identification of this "fair" profit that the heart of the controversy lies. Indeed, all related studies show that it is very difficult to identify why selected margins are better than others. Several answers were brought, notably that "(...) Margins allegedly added in the past apparently are considered 'fair' simply because they have been used for many years. But how does a particular margin become the custom? None of the businessmen surveyed even suggests that the margin either originally or now, would lead him to the most profitable price ; respondents stress the ethics rather than the lucrativeness of setting price on the basis of customary markups" (Oxenfeldt 1951, p. 158). Within the different surveys of pricing methods, several proposals were advanced to explain managers' attachment to full cost pricing. Among them, the proposal that often managers simply cannot get the requisite information to adequately establish prices within economics precepts (market being too much concentrated and the demand too unpredictable). Some, more radical proposals, suggested that businessmen did not receive an adequate education, and as a result, they ignore marginal analysis principles, or formulate them incorrectly.

Hall and Hitch study (1939), which is potentially the most important research conducted within this period, needs particular attention because of its methodology and the many repercussions it had. These two scholars interviewed British managers between 1937 and 1939. First, an oral questionnaire was submitted to managers, and then, a discussion was instigated to examine some aspects in detail. The target sample in this survey consisted of thirty-eight firms: thirty-three manufacturers of different products, three retailers and two building firms. These companies were chosen according to the personal relations of the authors, allowing an easier access, and (maybe) more sincere answers. Naturally, the small sample size does not permit a generalization of the results, but gives an idea of the importance granted by managers to the full cost method (which will be later developed by Andrews in 1949), and more especially of the reasons given by the respondents to their trust into this principle. It also appears that the cost calculation method very widely differs between industries, and even within the same industry, from one firm to another. In the same way, the mark-up added can be very different from one industry to another. For the majority of respondents, a particular margin can be considered as fair because it arises from a pricing routine (Katona 1951, p. 253), or because there is a status quo within competitors (the first to cut prices will automatically be followed), or because they fear that a price modification induces a change in the buyers habits, often reluctant to changes.

All the results in this period show clearly that managers do not behave according to the marginal principle. Indeed, long-run predominance in pricing, investment and product policies, and the defensive decisions taken go against marginalism, which advocates an opportunist attitude towards short-run profits. As these studies demonstrated, the full cost adoption in pricing rejects the main element of marginalism which is a price calculation based on marginal cost.

The stress on costs and a kind of consensus towards consumers and competitors has a simple explanation: during the Great Depression period, firm's permanence was a difficult objective to reach, supported by many measures

[1] See for example the comments of Jaffe, Bronfenbrenner, McCraken, and McCord Wright about papers discussing the "Economic Theory of Imperfect Competition, Oligopoly and Monopoly", presented in the *American Economic Review*, Papers and Proceedings, May, 1948, pp. 19-32.

[2] During the thirties, prices were involved in many legal battles which resulted in the Robinson-Patman Act (1936) and in the Miller-Tydings Act (1937),as well as in the creation of the Temporary National Economic Committee (TNEC) (Lynch 1946).

taken by the government[3]. So, even if managers do not take rational pricing decisions, by trying to reach a "fair" profit instead of a maximized one as recommended by conventional theory, they develop methods still used today. One must note that the break-even point analysis was finalized during this period, and, although simplistic, remains very useful. It is through developing such techniques that marketing's conception of rationality deviates from economics', and where we can see a growing disparity between economists and marketing academicians (and managers), dating from the beginning of the 20th century, and spread more widely in the 1930s: "Rather than considering the market described by economic theory as homogeneous and disembodied (theoretical), it was enough to grasp it as heterogeneous or liable to be so, tangible, carnal (empirical). Markets were there, but remained to be created or redefined, built, shaped, differentiated, segmented ... Such was the manager's discovery who, then, invented modern business techniques and knowledge: marketing. " (Cochoy 1999 , p. 75). The Great Depression is thereby the right occasion for marketing to get its legitimization, embodying a more realistic thought, and formalizing techniques that will allow firms and markets reconciliation.

A progressive stand back

This breaking off in the important results of the 1930s, when the controversy between *marginalists* and *reaslists* started, took another dimension after WWII. Indeed, these turbulent times are characterized in the United States by a period of growth, when production capacities were completely spent, and when profits exceeded predictions. Expectations were high and uncertainty was limited: a good opportunity for conventional economists to put a second breath back to the controversy, even if marketing was at this time a freshly institutionalized academic discipline.

Fritz Machlup's paper (1946), a fervant marginal analysis defender, is a good illustration of this time period. As Machlup states, most of the descriptive studies reject marginal analysis because its critics are unable to see how marginal analysis can be applied to their material: "the alleged inapplicability of marginal analysis is often due to a failure to understand it, to faulty research techniques, or to mistaken interpretation of findings"(p. 520). So, the main error committed by the realists would be that they admit as "true" the postulates upon which marginal theory is based, and then deviate from its real meaning. The purpose of marginal analysis according to Machlup, is "to explain the effects which certain changes in conditions may have upon the firm's actions. What kind of changes may cause the firm to raise prices? To increase output? (...) Economic theory, static as well as dynamic, is essentially a theory of adjustment to change. The concept of equilibrium is a tool of this theory of change; the marginal calculus is its dominating principle." (p. 521). But the gulf between realists and marginalists takes as well a semantic, terminological dimension. In other words, they do not speak the same language: "to ask a business man about the elasticity of the demand for his product is just as helpful as inquiring into the customs of an indigenous Fiji Islander by interviewing him in the King's English." (Ibid, p. 537).

Machlup's article shows the growing gulf among economics and marketing academicians: some study the forces which provoke changes on the market, whereas the others focus on the actions led by companies to adapt to changes on their markets. However, as managers' action becomes an evident stumbling block, the market itself turns into a theoretical obstacle. Indeed, realists start to qualify their economists "fathers" definitions. As Oxenfeldt states, the market, in its broad meaning, makes the best of the economics definition: "*Market*, used in its broadest meaning, designates the mechanism fot determining what is produced and what prices are charged." (1951 , p. 36). To Hamilton (1940): "At the hub of all activity stands the market. Each must take to it his mite of labor and property; from it each must fetch away the wherewithal of his living." (p. 9). Nevertheless, Oxenfeldt extends this thought by defining the market in a more narrow sense: "it is about the conditions and arrangements involved in the purchase and sale of products. Thus defined, markets include such things as the technological conditions of manufacture, the durability, costliness, and uniqueness of the product sold, and the number and location of buyers and sellers. Narrowly construed, market designates the place where all buyers and sellers meet for the express purpose of exchanging goods." (Ibid, p. 36). The market, thus, is a place where managers' action can get a foothold, and where the language used -to resume Machlup's criticism- is managers'. From the marginal controversy seems to appear proposals directly addressed to the managers, diverting the economic rules with the goal of a direct and useful applicability. From then on, marketing as an autonomous discipline will lead its own studies, attempting to prove the legitimacy of its field.

A TIMID EMANCIPATION FROM ECONOMICS GUARDIANSHIP

Doubting the nature of the research to be conducted

Since the 1940s, a wave of criticism arises among marketers, due to its descriptive content: "*official* marketing is only descriptive, based on an inductive reasoning and hardly capable of observing, relating and describing without referring to implicit hypotheses. It is only an utilitarian and professional application of economics" (Micaleff 1997, p. 3387). This is particularly true with regard to pricing, which

[3] The *National Industrial Recovery Act* (1933) was mainly established to allow firms to raise their prices and help consumtion to recover. (Converse, Huegy and Mitchell 1958, p.93.)

is widely based on the neoclassical paradigm. In spite of numerous works criticizing this crushing paradigm, it continues with dominating pricing theory, in a disguised form. Paraphrasing Reynaud[4] : "they dethroned the king, but kept the monarchy." (1954, p. 75).

Although marketing in this time becomes an important element in management, the promises of a strong theoretical and conceptual development, made by the pioneers, are far from being achieved. Instead of the conceptual framework announced for pricing, only few principles are proposed (Churchill 1932, Agnew 1935, Nourse 1938), in other words "studies which can not connect individual facts with strong generalizations" (McInnes 1964, p. 51). But the real debate turns around the realism of the proposed theories and the goal of a theory as a body of systematized knowledge. Indeed, it is normative theory that is concerned with prescribing what managers "ought to do" when faced with a pricing issue. The purpose of a normative theory is to educate the decision-maker on the best way to determine the optimal price according to given assumptions. Because it has been neglected, this debate between economic and marketing pricing approaches is revised. For the economists, theory is designed to abstract reality and yield valid and meaningful predictions about phenomena not yet observed (Friedman 1953). Till the end of the fifties, pricing theory in marketing is exclusively descriptive. The main advances lie then in this outwardly will to stand apart from a too distant theory towards managerial concerns. Descriptive pricing theory developed by marketing is based on management knowledge of the way prices are actually set. Since Hall and Hitch's paper (1939), most of the studies realized attempt to penetrate the pricing process based on an assumption that the models on which they are based can be transposed directly to the observed situations. Thus, this descriptive dynamics knows some limits. Marketers seem to have too quickly examined the important concepts proposed during more than half a century by the economic theory.[5] Economists at that time studied richer pricing policies than those proposed by marketing (Hauser 1984 , p. 63) : for example, multidimensional strategies (two-part pricing, etc.), non-linear pricing structures, which were analyzed under numerous market structure assumptions. Segmented pricing problems, involving price discrimination for example, were also widely examined by economists (Cassady 1946). From then on, it seems almost paradoxical that marketing literature, apparently centered on managerial action, is darkened by its economic equivalent regarding to the range of the pricing policies for consideration.

It is, however, necessary to recognize that it is mainly in the vision of pricing as signal of product differentiation and segmentation that economics domination takes place. While marketing and economics recognize markets as heterogeneous since Chamberlin's contribution (1933), they differ in the way they exploit this diversity. Marketing literature rather tends to modelize the diversity as a stochastic phenomenon, and considers pricing policies as an optimization of expected performance according to a specific market response. Economists on the other hand, study mechanisms which can exploit this heterogeneousness with discriminatory purposes. They particularly develop pricing policies which can lead to an indirect discrimination by consumers' auto-selection, by trying to maximize their respective utility. Thanks to this skillful concept, every consumer accepts a different price according to his preferences, as revealed in the purchasing process. As Hauser indicates, "the differences are in the degree, not in fundamental philosophy" (1984, p. 65); there is thus no gap between both disciplines, but maybe a single different vision.

Economics is a mature science in this period, with solid roots in the 18th century, when Adam Smith (1776) observed the English marketplace and formulated his famous "invisible hand" theory. Since then, a myriad of researchers has developed a series of elegant mathematical theories, as well as empirical evidence on how markets behave. In contrast, marketing is, even today, only an embryonic science, with roots in early 20th century, and the explosion of systematic scientific researches would only begun in the sixties. "To study pricing, marketing science can learn from and build on the body of economic theory much as Renaissance physicists learned from the Ancient Greeks"(*Ibid.* p. 66).

A mere *"aggiornamento"* ?

It is not necessary to consider pricing theory in marketing as a branching off from economics theoretical propositions, but rather as an alternative. The ambitions relating to the marketing of a realistic and useful pricing theory developed gradually. In relation to this, it is interesting to observe how late pricing integrated into the marketing concept elaborated in the fifties (which swept the institutional and functional approaches), as Bartels states in his study of the history of marketing though. "Although from 1919 J.G. Frederick put in relation sales management with the marketing activity, and that in 1926 L.S. Lyon used the terms of *marketing management* and *marketing strategy*, it is only in the fifties that a new meaning would be granted to these terms (...). Among those who investigated marketing management from this new vision: Wroe Alderson and John R. Howard"(1976, p. 178). While at this time, many authors contribute to the evolution of marketing by editing surveys, or like Converse by republishing their famous textbooks (Converses, Huegy and Mitchell 1958, reprint of 1930 edition), which are certainly

[4] Reynaud was one of the leading academicians in economic psychology in France.

[5] This problem has been now partially settled thanks to several conferences, in particular those held at the University of Bradford in 1967 (Taylor and Wills 1969) and at the University of Rochester in 1982 (Rao 1984).

important but offer relatively little innovative[6], Alderson ground-breaks by creating a new way of considering marketing management. He begins, in what is considered the first marketing management textbook (1957) to explain managerial action and marketing behavior with the assistance of concepts borrowed from other human sciences such as psychology, sociology, anthropology, political sciences, and other disciplines such as physics and biology. This immediately distinguishes the work from his predecessors who only thought in economic terms. Alderson names his theory "functionalism", because it describes managerial decisions as a function of the environment. For him, the most important problems faced by managers are marketing problems. Although less puzzling, the proposition made by Howard in the same year (1957) is remarkable. Howard noted that the term of "marketing manager" is a novelty, he gives it a more complete scope of action: it concerns the management domain referring to sales problems in a broad sense, including pricing. From then on, pricing is recognized as a domain of managerial action, and marketers can pretend to build an original theory on a field deserted by the economists.

In this new perspective, an important study is going to make a significant contribution. By the end of 1950s, the innovative marketing theory has developed important theoretical tools. The objective is not to establish marginal analysis useful, but to describe the pricing methods used by the firms, mobilizing concepts developed by the marketing theory. The research conducted by Kaplan, Dirlam and Lanzilotti (1958), one of the major empirical studies of its time, is based on interviews -led between 1948 and 1951 and updated between 1956 and 1957- with leaders of twenty big companies. For the authors, who choose to present pricing methods according to the market structure (although most of the interviewed considered their market as highly competitive) and products characteristics, it is very difficult, even impossible, to establish a homogeneous taxonomy. "Indeed few companies were able to tell us: 'our strategy is to set prices according to one specific objective and a uniform procedure.' It seemed difficult to consider the existence of one universal pricing rule, except maybe, in the case of new products" (p. 8). During the study, most of the managers did not seemed concerned by the practical details of price setting; cases even appeared where managers were not conscious of the way prices were fixed in their company. Even for executives in charge of pricing, it was sometimes impossible to list the pricing decisions made. The difficulty faced by the authors, to get solid material from the interviewees, stemmed from the fact that pricing for many is more intuitive or art than science, or, at least, a process guided by the use of models and calculus. Furthermore, many executives would hide costs supported, or profits losses for certain products. Despite these limitations, Kaplan, Dirlam and Lanzilotti's study is one of the major pricing contributions in this period, and for the first time, embraced the concepts developed in marketing. The objective of the study was to improve the state of knowledge of the price-making process, considered as inadequate in the 1950s, with particular reference to the motivational hypothesis of the firm, i.e. the specific objectives upon which business firms base pricing decisions, and the mechanics of price formulation. The main contribution lies in this detailed description of big business pricing behavior. These policies are function of the "product and market characteristics, and firm characteristics (investment policy, size, current or expected position in the industry)" (Kaplan, Dirlam and Lanzilotti 1958 , p. 127).

Lanzilotti resumes the results of this study in an article published in 1958. The main contributions are the following:

- a) the large company has a fairly well-defined pricing goal that is related to a long-range profit horizon;
- b) its management seeks -especially in multiproduct multimarket operations- a simultaneous decision with respect to price, costs and product characteristics;
- c) its pricing formulas are useful devices for checking the internal consistency of the separate decisions against the general company objective.

"Under this hypothesis no single theory of the firm - and certainly no single motivational hypothesis such as profit maximization- is likely to impose an unambiguous course of action for the firm for any given situation; nor will it provide a satisfactory basis for valid and useful predictions of price behavior" (Lanzilotti on 1958, p. 938-939). As he suggests, pricing policies are in almost every case equivalent to company policy that represents an order of priorities and choice from among competing objectives, rather than policies tested by any simple concept as profit maximization. Mason adds: "the managerial philosophy not only calls into question the assumption of profit maximization as workable description of entrepreneurial behavior but denies the institutional basis of the classic profit motivation" (1958 , p. 35).

Finally, another relevant aspect of this research lies in the conception of the market held by managements of large corporations by the end of the 1950s. Individual products, markets and pricing are not considered in isolation; the unit of decision-making is the firm, and pricing and marketing strategies are viewed in this global context.

This progressive reflection from the economic guardianship also materializes, within the descriptive works, by a mixture of studies of managerial techniques and original propositions. Among them, the break-even point analysis is one of the more interesting. Finalized in the thirties and revised by the end of the forties in particular by Eiteman (1949) or other business economists like Dean

[6] In this book, chapters on pricing follow the economic framework : pricing problems are tackled in terms of price level on the market place and the manufacturer is considered to have a narrow scope of action.

(1948), this technique can give an explanation why managers were seduced by the new ideas of marketing as a way to keep in touch with reality. Indeed, this very simple approach effectively demonstrates the interdependence between price, costs and profits. The break-even point represents the volume of sales necessary to cover fixed costs. It can be described as follows: 1) Price setting; 2) Calculation of the contribution margin at the current price level and of the breakeven sales change, which is the minimum increase in sales volume necessary for the price setting to produce an increase in contribution relative to the baseline. In this basic case, it was supposed that the cost function is linear, and corresponds to a variable unit cost constant and equal to marginal cost. 3) Estimate of the feasibility of the sales targets. If the real sales volume exceeds these objectives, marginal contribution is then positive.

This tool, often presented in its graphic version, provides managers with an easy decision-making (although limited because it does not take into account neither demand reactions nor competitors). Although its success can be partially explained by its ergonomy (and its educational qualities), the main reason is its reliance on reliable and available information within the firm: costs.

The use made by managers of accounting information is mobilized by some as an argument in favour of marginal theory. In an important study, Earley (1956) tests the influence of marginal principles among leading American manufacturing firms. According to him, these firms are presumably the vanguard in the use of newer management techniques, and are likely to set the dominant patterns of future business practice. "Marginal accounting and costing principles have a strong hold among these companies, and the bulk of them also follow pricing, marketing, new product, and product-investment policies that are in essential respects marginalist" (Earley 1956, p.66). Indeed, companies do not seem to conceive of short-run vs. long-run profitability as alternative and inconsistent goals, and seek to maximize their long-run welfare by trying to maintain or increase their current profits within a realistic horizon. But in doing this, two serious questions arise: is profit-maximization a realistic assumption, or a good performance criteria? Is it correct to determine prices on the basis of costs, as the proper function of cost in pricing is to determine the profit consequences of pricing alternative, as breakeven analysis demonstrates?

CONCLUSIONS

The question of the correct interpretation of marginal analysis underlies the issue of general scientific methodology, in other words, "the legitimacy and usefulness of abstract theorizing on the basis of unrealistic assumptions" (Machlup 1967, p.2). Indeed, the marginal controversy has arisen over a non-existent entity (Cyert and Hedrick 1972, p.398). Such concepts as profit maximization demand function and marginal cost may have a precise meaning in theoretical model but not always in a real situation. The marginal analysis is *a priori* in the sense that its behavior can be deduced from assumptions that abstract the environment. Realists' models cease to be *a priori* since the firm's behavior is no longer deduced from the assumptions simplifying the environment (Cyert and Hedrick 1970, p399). The question is: "can a theory be tested by the realism of its assumptions?" (Friedman 1953, p16.) It appears that for conventional economists, the goal was the development of substantive hypothesis designed to abstract features of complex reality. Marketers, on the contrary, attempted to describe and/or model pricing decision making to help managers faced with real world situations.

Up until the end of the 1950s, pricing policies remain "intuitive and routine", and few companies seem interested in changing methods which, according to them, proved themselves: "pricing policy is the last stronghold of medievalism in modern management. Frequently, pricing is still based on the theological notion of 'just' price. It is still largely intuitive and even mystical in the sense that the intuition is often the province of the big boss. It still has a large element of tradition" (Dean 1947, p.4). Then, theoretic propositions realized since there in marketing "are only simplistic reactions to complex forces"(Monroe 1979, p.3). Front of economic theory normativity, marketing only seemed able to propose techniques, which made price a variable of weak importance, even among marketers (Udell 1964, 1968). However, this robust focus on reality made marketing academicians conscious of the fields to be conquered; understanding mechanisms which connect the firm with its environment (notably customers and competitors) will thereby enable marketing to structure in a scientific way its proposals, and acquire legitimacy in this field.

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