



Contents lists available at ScienceDirect

## Journal of Business Research



# The micro-foundations of pricing strategy in industrial markets: A case study in the European packaging industry<sup>☆</sup>

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## ARTICLE INFO

### Article history:

Received 25 June 2015

Accepted 20 February 2016

Available online xxxx

### Keywords:

Human capital

Judgment

Micro-foundations

Pricing strategy

Value appropriation

## ABSTRACT

The choice and implementation of pricing strategy is often described as an optimization problem where the firm chooses the most profitable pricing strategy given certain external determinants. Contrary to this notion, recent research indicates that the pricing of products is a costly and complex activity, and that firms may differ in their capability to implement pricing strategies. This case study of industrial pricing strategy in the European packaging industry examines how different assets and routines are involved in the implementation of pricing strategy. The study particularly highlights the role of individual judgment, human capital and commercial experience for the implementation of pricing strategy in markets that because of customization are subject to high levels of uncertainty.

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## 1. Introduction

How is the choice and implementation of pricing strategy in industrial markets affected by firm-specific assets and routines? The choice of pricing strategy is in a large part of the pricing literature described as frictionless, profit maximizing and mainly affected by external determinants (e.g., Forman & Hunt, 2005; Nagle & Holden, 2002; Noble & Gruca, 1999; Tellis, 1986). Contrary to this notion of pricing strategy, other studies stress that firms incur substantial physical-, managerial-, and customer costs when setting and changing prices for their products, and that this may lead to significant price rigidity and path-dependence in pricing decisions (e.g., Bergen, Ritson, Dutta, Levy, & Zbaracki, 2003; Blinder, Elie, Canetti, & Rudd, 1998; Hallberg, 2008; Mankiw, 1985; Zbaracki, 2007; Zbaracki & Bergen, 2010; Zbaracki, Ritson, Levy, Dutta, & Bergen, 2004). This case study examines the challenges firms face when selecting and implementing industrial pricing strategies. Examples of challenges faced by the studied firms include keeping track of and pricing up to 5000 different references spread over a 1000 different customers, gaining access to and processing highly customer-specific information when putting together large industrial deals, and gaining control over key decision-makers in the pricing process that due to high levels of complexity and customization have significant individual discretion. The results of the study show that individual judgment, human capital and commercial experience are particularly important for the implementation of pricing strategy under these conditions.

The debate between those who view pricing strategy as an analytical exercise and those who view it as a complex organizational challenge points to a problematic research practice in pricing-, marketing-, and management research to import assumptions about human rationality and perfect information from economics despite the fact that these assumptions in many cases are unrealistic and highly problematic in the management context in which they are applied (Foss & Hallberg, 2015; Hallberg, 2015). A result of the practice of importing assumptions from economics is that organizational factors and micro-level mechanisms that affect the choice and implementation of strategy are downplayed (see Abell, Felin, & Foss, 2008; Felin & Foss, 2005; Levinthal, 2011; Powell, Lovallo, & Fox, 2011). For example, there remains important questions concerning why firms seem to resist value-based pricing strategies and techniques that from an analytical standpoint are most profitable (see Hallberg & Andersson, 2013; Hinterhuber, 2008a). Attempts at remedying this divide have been made by emphasizing price-setting practices (Ingenbleek & van der Lans, 2013), pricing orientation/approaches/practices (Hinterhuber, 2008b; Liozu & Hinterhuber, 2013), and value-based pricing (Hinterhuber, 2004; Liozu, Hinterhuber, Boland, & Perelli, 2012). Nonetheless, a review shows that there is a gap in the pricing- and management literature: We lack *sufficient* empirical analysis of the organizational and micro-level mechanisms associated with identifying and implementing industrial pricing strategies. While prior research on price adjustment costs (e.g., Zbaracki, 2007, etc.) and pricing capability (Andersson, 2013; Dutta, Zbaracki, & Bergen, 2003; Hallberg, 2008; Liozu & Hinterhuber, 2013) have contributed substantially to our understanding of the type of investments firms make in order to develop their capability to set and change prices and how this might affect competitive advantage, there still remain important questions

<sup>☆</sup> I am grateful to Andreas Hinterhuber, Stephan Liozu, and two reviewers of this journal for comments on previous versions of this article. The usual disclaimer applies.

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regarding *how* the implementation of differential pricing strategies are affected by individual judgment, assets, and routines.

This study examines how three firms in the European packaging industry have implemented their pricing strategies. The study specifically highlights the micro-foundations of industrial pricing strategy by focusing on the internal resources and processes of the seller.<sup>1</sup> The results show that differences in pricing strategy can be described along dimensions such as price discrimination, operating leverage, and price elasticity, where each dimension is associated with specific types of decisions and supporting assets and routines. Among other things, the results indicate that the implementation of pricing strategy may be severely restricted by firms' ability to hire the right individuals and develop the specific assets and routines that enable a particular pricing strategy. While these restrictions may be viewed as bad news for pricing strategists who want to rapidly change their firm's pricing strategy, it may also be seen as proof of the strategic nature of pricing and the fact that firms may gain competitive advantage from implementing a superior pricing strategy that due to rigidities and path-dependence in the underlying resource-base is not immediately available to competitors (Barney, 1991).

## 2. Theoretical background

A firm's pricing strategy is a policy or schedule that the firm develops in order to govern how its prices vary over products, customers, or time. In line with definitions provided by other authors (e.g., Forman & Hunt, 2005; Hinterhuber, 2004; Liozu & Hinterhuber, 2013; Noble & Gruca, 1999; Tellis, 1986), pricing strategy is viewed as the means by which a firm achieves specific market outcomes in response to a given scenario by the use of a certain price. Micro-foundations, in turn, refer to "how intentional human action and interaction causally produce strategic phenomena" (Abell et al., 2008: 492). The framework presented in this section relates micro-foundations grounded in psychology (e.g., Goldstein & Gigerenzer, 2002; Kahneman, 2003) with pricing strategy by outlining the specific types of individual judgments, assets, routines that firms rely on when implementing pricing strategies.

### 2.1. The micro-foundations of pricing strategy

Given the evidence speaking in favor of certain pricing strategies, such as value-based pricing strategy (Liozu & Hinterhuber, 2013), one would expect most firms to choose and implement these strategies using the latest tools and techniques available. However, the fact that this is not always the case suggests that there may be significant barriers present in the process of implementing new pricing strategies that prevent firms from choosing the most optimal strategy (Hinterhuber, 2008a). For example, studies indicate that sales force management, organizational control, and pricing delegation may be particularly problematic areas for firms seeking to implement value-based pricing (Hallberg & Andersson, 2013).

Pricing decisions are, as most forms of business-decisions, made by bounded rational decision-makers acting under some level of complexity (Simon, 1945). In cases where complexity and uncertainty is high, the application of programed and institutionalized solutions are ruled out in favor of more intuitive approaches, individual discretion and judgment (see Foss & Klein, 2012). Judgment has been subject to extensive research in psychology and behavioral economics (e.g., Gigerenzer, 1991; Gigerenzer & Hoffrage, 1995; Goldstein & Gigerenzer, 2002; Kahneman, 2003; Smith, 1991, 2003, 2008; Tversky & Kahneman, 1974, 1981). This research has developed into two approaches: one "cognitive bias approach" (e.g., Tversky & Kahneman, 1974) and one

"fast and frugal heuristics approach" (e.g., Brighton & Gigerenzer, 2015). These approaches share an emphasis on *ecological rationality* (decision-makers rely on emergent heuristics and institutions adapted to the specific structure of the environment) over *constructivist rationality* (decision-makers rely on deliberate and maximizing rational choice).

The "cognitive biases approach" suggests that boundedly rational decision-makers in uncertain exchange relationships are subject to specific decision-biases (see Kahneman, 2003), but that these biases may be corrected for depending on actors' access to institutions and decision-supporting systems (Kahneman & Lovalló, 1993; Smith, 2008; Stanovich & West, 2000). The "fast and frugal heuristics approach", on the other hand, points to the individual-level functional heuristics that aid decision-making under uncertainty. Hence, while not adhering to rational choice principles, individuals faced with uncertainty should not be assumed to make biased choices, but rather to rely on heuristics that develop over time to fit the specific structure of the environment where decisions have historically been made (Mousavi & Kheirandish, 2014).

The studies in psychology and behavioral economics outlined above have important implications for the choice and implementation of pricing strategy: First, they imply that there is significant room for heterogeneity in individual judgment about prices (e.g., better/worse pricing decisions) and that pricing strategy may be significantly improved by understanding how individual judgment deviate from rational choice principles. Second, decision-makers have the opportunity to develop institutional responses to uncertain conditions in terms of acquiring or developing particular assets, routines and social structures to aid decision-making (see Raghuram, 2006). Relative prior studies, this implies novel forms of heterogeneity in the assets and routines that are acquired and developed to enable the implementation of pricing strategy. Specifically, firm-specific assets and routines may be understood as decision-supporting systems (in the sense of Kahneman, 2003) that allow for more effective use of commercial information in pricing decisions, while heterogeneous human capital and commercial experience are related to the individual-level heuristics that decision-makers develop when making judgments under uncertainty (see Brighton & Gigerenzer, 2015).

### 2.2. Assets and routines as foundations of pricing strategy

One business research area where decision-supporting structures have been given attention is in the literature on organizational capabilities (e.g., Amit & Schoemaker, 1993, etc.). Basic firm-level capabilities exist in different functional areas, such as manufacturing, marketing, sales, etc. Dutta et al. (2003) argue that firms develop specific organizational capabilities to support the execution of pricing related activities and the implementation of pricing strategy. Specifically, pricing capabilities affect firm performance by enabling greater value appropriation through prices that better match the perceived benefit of the product sold and the demand characteristics in the focal market. According to Dutta et al. (2003), pricing capability can be described in terms of particular routines, coordination mechanisms, systems, skills, and resources that enable activities of two kind: *price-setting capability within the firm* and *price-setting capability vis-à-vis customers*. The price-setting capability within the firm includes activities such as identifying competitor prices, setting pricing strategy, and translation from pricing strategy to price. The price-setting capability vis-à-vis customers involves activities such as convincing customers on the price change logic, and negotiating price changes with major customers.

Dutta et al. (2003) show how particular pricing outcomes result from firms' routines, coordination mechanisms, systems, skills, and resources. Further, the development of an effective pricing process (i.e., setting, changing and negotiating prices) is shown to be time-consuming, costly and complex with significant organizational and informational barriers restricting the process. Hence, the development of

<sup>1</sup> While important for a comprehensive analysis of market exchange, this study is not designed to examine the role of external factors and factors directly related to the buyer, such as market structure, customers' purchase volumes, relative negotiation power, etc.

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