MORAL IMPLICATIONS OF BUSINESS PRICING[1]

This article reviews moral aspects of pricing from three vantage points. First, it looks into the psychological factors in pricing. That is, it questions the validity of the phrase "market exchange" as this notion appears in manuals of moral theology. Secondly, it investigates the relationship between profit and price. The question "how much profit is moral" and its rejoinder "what is a just price" can be asked from two different perspectives: the sellers and the buyers. The second part of the article develops these two viewpoints. The third section concentrates on the moral obligation of following a trade association code of ethical behavior. This question takes on special relevance when a code includes pricing policies, competitive restrictions and other practices that appear contrary to legal regulations.

These separate sections represent three areas that an open discussion with a panel of resource personnel on pricing covered in the 1966 Annual Convention of the Catholic Theological Society of America.[2] The moral evaluations stated in this article reflect some of those suggested during the discussion. However, the development of positions and the final evaluations are mine. They are not definitive and only represent initial investigation of these problems. In order to avoid any misunderstanding, I assume full responsibility for the

1 At the 1966 Convention in Providence, Rhode Island the topic, *A Moral Problem in Business-Pricing,* was considered at an informal symposium. The Reverend Thomas F. McMahon, C.S.V., who was co-chairman, has written this article as a result of the discussion.

2 The panel of resource personnel included Richard Athey, O.P., of the National Conference of Christian Employers and Managers, Chicago (Co-Chairman); Thomas F. McMahon, C.S.V., of the Viatorian Seminary, Washington, D.C. (Co-Chairman); Raymond C. Baumhart, S.J. and Theodore V. Purcell, S.J., of the Cambridge Center for Social Studies (Cambridge, Massachusetts); Richard Sunderland of General Meters and Controls (Chicago, Illinois); and Alfred A. Albert of Royal Albert Realty (Boston, Massachusetts). Raymond Baumhart, Alfred Albert and Edward Jamieson (former President, National Conference of Christian Employers and Managers) presented cases for discussion.

views presented and I hope that they will lead to further discussion among moral theologians and businessmen.

I. Psychological Factors in Pricing

Price reflects economic or market exchange of values. Pricing also assumes equivalence of values bought and sold. Placing a price tag on values, however, is at most ambivalent. On the one hand, values are elusive; they defy quantification, as marketing and advertising researchers attest. Why people prefer one brand name product to an almost identical item of another brand or why they prefer one color of packaging over another color cannot easily be determined. Furthermore, why one product succeeds and the majority of similar items fail is still conjecture. Like hot-stove baseball enthusiasts, marketing executives enjoy the sport of "second guessing." On the other hand, buyers and sellers employ *some* criterion for determining price. The seller, whether manufacturer, wholesaler or retailer, views price in light of competition, supply and demand, cost and profit. The buyer (especially if he is the ultimate consumer) aligns price with a product or a service that will fulfill some need or want. He expects satisfaction. Although the seller judges price primarily according to objective factors, the buyer perceives price through the essentially subjective characteristic of satisfaction.[3] Nonetheless, both buyer and seller exchange equivalently, according to perceived values.

This oversimplified analysis of a buyer's and of a seller's views of price leads to an important moral question in pricing: "Is it

[3] "The psychological factor in buying and selling," writes Otto A. Piper in *The Christian Meaning of Money*, Library of Christian Stewardship (Englewood Cliffs, N.J.: Prentice-Hall, 1965), p. 5, "presupposes a system of prices which is based upon the objective value of goods yet which is sufficiently flexible to adjust itself to the condition of the market. . . . The price of a good is based upon the effort needed to discover, handle, gather and transport the raw materials; the skill and sagacity of the workers; the experience and planning of the producer; the use and evolution of the productive apparatus; the cost of advertising and distribution; and the price of the public legal order expressed in terms of taxes, to mention only a few of the most important objective factors which go into the making of a good and its price. . . . The objective character of the price explains in turn why in antiquity people felt irresistibly attracted by gold and made it the basis of economic measurements. It was not the practical value of this metal, buit its numinous character."

immoral to 'sell' satisfaction?" However, this question about selling satisfaction really cannot be answered apart from two other questions. First, is selling product-related satisfaction immoral? Secondly, is selling satisfaction immoral if the seller capitalizes on the psychological needs of the buyer?

Peter F. Drucker, internationally known management consultant and professor of management at New York University's Graduate Business School, seems to relate satisfaction with product when he writes in *Managing for Results*:

> The customer rarely buys what the business thinks it sells him. One reason for this is, of course, that nobody pays for a "product." What is paid for is satisfactions. But nobody can make or supply satisfactions as such—at best, only the means to attaining them can be sold and delivered.[4]

The "means" for obtaining satisfaction is associated with the product sold. Meat, clothes and automobiles give consumer satisfaction.

Satisfaction thus appears to have a basis in the product. Some buyers receive satisfaction from standard products packaged for utility. Others obtain satisfaction from the same product sold in expensive packaging at a higher price. In either case, consumer satisfaction is rather closely related to the product. The product, not the package, gives substantial satisfaction. A more attractive package merely adds to the satisfaction already obtained from the product. The consumer perceives some good connected with the purchase of the product. Apparently, brand name products give greater satisfaction to some people than generic products do. However, a buyer might not be aware of the underlying psychological reasons for brand name purchasing. Psychologists and sociologists suggest that status, peer approval, ethnic background, education and other factors subtly influence a buyer's choice of product and price.[5] Selling product-related satisfactions is, therefore, the subjective element of market value.

[4] P. F. Drucker, *Managing for Results* (New York: Harper and Row, 1964), p. 94.

[5] In testing these theories, marketing researchers possess only a rudimentary knowledge of why the "normal" purchaser prefers one product over another. They cannot ascertain clear-cut motivation in consumer preference. Until professional researchers develop adequate theories on consumer behavior, they expect only limited assistance from moral theologians in developing realistic moral guidelines. However, R. Ferber, D. F. Blankertz and S. Hollander, Jr.,

Consumer-expected satisfaction, however, need not necessarily be fulfilled in market equivalence. A customer might feel that brand X soap will make her skin more youthful looking. Although satisfaction is personal, satisfaction in market equivalence refers either to a general class of customers (e.g., cleaning value of ordinary bath soap) or to particular segments of the market, (e.g., hand soap for mechanics; cold cream soap for cosmetological reasons). Whether an individual customer will receive satisfaction remains a matter of conjecture. If a sufficient number of customers become dissatisfied, they will not repeat purchases. Lessening of repeat sales may actually indicate that market equivalence is lacking.

As long as expected satisfaction is not puffed up through misleading or deceptive advertising and other promotional activity, it can be assumed that product-related satisfactions (if reenforced through repeat sales) are generally in accordance with legitimate desires of mankind. Rational decision-making presupposes, and requires, some emotional direction. Attraction to one or another product orientates a customer to a decision. Product-related satisfactions will then include emotional factors as supermarket open-display "impulse" buying suggests. From the viewpoint of market equivalence, product-related satisfaction is one side of the coin of market equivalence. The other side of the coin, objective equivalence, lies with the seller. When the factors of subjective and objective exchange are equitable, the contract is moral.

If the seller turns objective factors into subjective factors (e.g., to the psychic needs of the buyer), is there a question of immoral behavior? In other words, may the seller capitalize on the psychological needs of the buyer? A salesman soon realizes that certain buyers need reassurance. Others, like middle managers, want to feel important. Still others, like older purchasing agents, attempt to establish a "Dutch uncle" relationship with younger salesmen. If salesmen handle these situations with "worldly prudence," they will be able to sell higher priced products to buyers with psychic needs.

in their textbook *Marketing Research* (New York: The Ronald Press Co., 1964), pp. 591-616, ask a series of pertinent questions on the morality of testing in marketing research. Moral theologians who possess formal training in the social sciences would find this an interesting area for thorough study.

Or, if the sellers are agents with some discretionary pricing power, they will obtain higher prices for their products.

In these situations, personal needs are unrelated to products. Emphasis lies in the therapeutic value of the buyer-seller relationship. The buyer-seller relationship is what really counts. For all practical purposes, the product-price equivalence becomes secondary, although the buyer would probably deny this assertion. The salesman recognizes the need of the buyer and capitalizes it through flattery, personal gratification, special attention and other forms of fawning. The buyer "rewards" the seller with purchases of high profit-margin products. The "means" for satisfaction (to use Drucker's terminology) is not the product but the "special attention" of the seller.

This situation suggests the classical case in which the seller charges more because of the peculiar condition of the recipient. Traditionally moralists have judged this to be unjust pricing. This method takes price outside of objective market equivalence (e.g., supply and demand) and places it in the subjective condition of personal need. The seller then employs an unfair competitive advantage. Furthermore, under the guise of product satisfaction, the salesman takes advantage of the peculiar condition of the purchaser. This type of salesmanship seems to contain some form of deception. At least, it lacks respect for human dignity and the pitiable state of the buyer. In the last analysis, it becomes a type of commercial bribery. From another point of view, it is an abuse of the fiduciary relationship that frequently develops between buyer and seller in their personal contacts over the years.

If the buyer realizes that this "special attention" of the seller fulfills a personal need, may he continue to encourage the salesman's flattery? The answer depends in part upon the status of the purchaser; that is, whether he is an independent businessman or whether he is an agent who represents a company.

If he is an independent businessman (e.g., small retailer), he judges his action in light of his responsibility to himself and to others. If he absorbs the costs, then the moral issue about pricing is not involved. If he passes on the cost of his personal gratification to his customers in the form of higher prices, he then appears to be acting inefficiently as a businessman. If retail customers willingly pay the additional cost e.g., because of the home delivery service he includes, it would be difficult to pinpoint cost inefficiency. The moral issue of inefficiency, however, requires projection into the larger framework of the purpose of business in society, the norms for business survival and the rights of employers and employees. These questions are too encompassing for evaluation at this time.

If the buyer is not an independent businessman, the issue changes. In his capacity as a buyer (e.g., purchasing agent) for a company, an employee is bound both by contractual agreement (generally implicit) and by fiduciary relationship to employers to purchase an acceptable quality of goods and services at the most efficient price. As an agent he is bound to carry out orders. If he has discretionary power, he judges quality and price according to the objectives, policies and practices of the corporation, allowing, however, for a reasonable degree of initiative and experimentation. When a purchasing agent allows personal satisfaction to interfere with contractual and fiduciary relationships, he compartmentalizes values into personal and company. He thereby establishes at least a potential conflict of interests.[6] In conflict of interests, contractual obligations take precedence. He offered his services for a price. Unless a purchasing agent employs means to safeguard his contractual commitment with the firm and his fiduciary relationships with its members, he exposes the company, its management, its employees and its stockholders to possible loss of legitimate savings through cost efficiency. He also receives "satisfaction" that rightfully belongs to the company in the form of product quality and price. It becomes a form of commercial "kickback." Finally, he places himself (and his family) in jeopardy of losing his job and his reputation. In a practical business situation, however, executives often recognize "out of line" costs and production managers complain about inadequate supplies. In time economic factors can often effectively expose a situation that has moral implications.

If selling to the needs and "well-ordered" desires of the buyer

[6] See T. M. Garrett, S.J., *Business Ethics* (New York: Appleton-Century-Crofts, 1966), p. 76, for the distinction between potential and actual conflict of interests.

means product-related satisfaction, price represents market equivalence and is therefore moral. If selling to the needs of the buyer means personal psychic satisfaction that is unrelated to product, price then means an exchange based on the peculiar condition of the subject. It becomes a form of commercial bribery. When the buyer, as agent for a firm, knowingly permits this type of salesmanship, he might infringe upon contractual agreement with the firm (through loss of cost efficiency), fail in the trust his superiors place in him, and expose himself (and his family) to loss of steady income. Selling to the personal psychological needs of a purchasing agent appears to be exploitation and therefore becomes immoral, at least in its circumstances.

II. Price and Profit

Two factors affect the price-profit relationship: first, subjective viewpoints of persons involved; secondly, objective situation of the market, the industry and the company.

Customers, business managers and shareholders have different views about the relationship between price and profit.[7] Except for public indignation over high prices and their relation to profit in the overall rising cost of living and in specific industries (e.g., meat packing, supermarket, gasoline), customers judge price in light of expected product-related satisfaction. They are not ordinarily concerned with profit.

Businessmen look at the trilogy of cost, price and profit as a sandwich. Price is the "meat" between the two pieces of bread, cost and profit. Accepting increasing profits as an objective, businessmen regard price as an important means to this goal.

Shareholders, however, have another objective in mind. They seek return on investment. They expect higher returns (in dividends) from greater risks (e.g., in newly established companies breaking into an established industry, such as electronics a few years

[7] Employees, especially those who belong to labor unions, are more concerned with company profit than with the prices the company charges. However, labor cost—a direct cost—is probably the highest cost and cannot be ignored in determining prices. But our concern in this article is primarily with the price-profit relationship.

ago, or in newly established industries, such as the space industry today). Price becomes just one of the many elements that contribute to profits and consequently to dividends.[8]

Each of these positions will be reviewed with special emphasis on what is called "full line pricing" and its relation to profit.

The objective situation of the market, the industry and the company affect pricing primarily in their *marketing* practices. Company strategy to increase sales quota, to push faster stock turnover, to improve cost efficiency, to secure larger market share and to enter new market or market segments, tends to affect price more directly than do industry or market factors. Competition is perhaps the one notable exception. The lower dollar value of the "money market," interest rates on business loans, wage increases and rising costs of raw materials indirectly condition the market for higher prices. These objective elements will only be considered in this article when they have some bearing on the decisions of stockholders, business managers and consumers.

The principal concern of this section of the article will be the relation of the price of an individual product to overall or net profit. More specifically, I will investigate the feasibility of applying the moral theologian's concept of the price-profit relationship ("cost plus a reasonable profit") to actual business practices. In order to achieve a realistic evaluation, I will present a brief exposition on profit, a look into "cost-plus" pricing practices in business and, finally, a suggestion for the pastoral application of pricing.

1. *The Notion of Profit.* Profit is expressed as a percent of something. Two of the most common forms of expressing profit (usually as a ratio) are (1) percent of sales and (2) percent of investment.

Percent of Sales. In late 1966 and in early 1967, sales in a number of industries increased but overall profits from these sales were reduced. The ratio of profit to sales is one indication of a company's profitability. Where stock turnover is quick, as in supermarkets,

[8] Net profit is not entirely shared by stockholders. It is current business practice to "plow back" a large share of net profit for future expansion (e.g., into international markets), new processes (e.g., steel's conversion to oxygen furnaces) and reserve for future contingencies (e.g., tariff adjustments of the Kennedy Round and their effect on industry sales).

profit as a percent of sales remains low (from .9% to 2.7%), but where turnover is slow, as in drugs, profit as percent of sales is high (about 10.2%). More profit then does not necessarily imply more sales. Industry characteristics have to be taken into consideration.

The housewife supermarket boycott is an interesting illustration of employing percent of sales as an apology for higher prices. Supermarket managers insisted upon higher prices being necessary because their return on sales was so low. They claimed they made a profit of just a few cents on each dollar spent on food. What they did not tell the housewives, however, was that net profit as percent of investment was much higher (from 9.2% to 17.6%). When a low percent of sales is combined with high turnover as it is in supermarkets, net profit as percent of return on investment becomes high.[9]

Percent of Investment. Profit as percent of investment expresses the ratio of net profit to total assets of the company. This ratio is used in inter-industry and infra-industry companies. Stockholders show interest in a company's profit as a percent of investment. Especially in highly diversified corporations and in conglomerates, return on investment becomes a form of "common denominator" among its various divisions.

Short-Long Run Profit. Businessmen distinguish between short run (e.g., quarter, year) profit and long run (e.g., over one year, or enough to keep the company a "going concern") profit. Businessmen and investors rivet their attention on long run profits. They use short term profit ratios as thermometers that indicate the health of the company. Speculators—as distinct from investors—will also investigate short run profits.

This brief exposition on the notion of profit leads to a consideration of its moral aspects.

2. *Fair Profit.* How much profit is "fair," "reasonable," "honest," or "just?" This question is the *bête noir* of conscientious businessmen and questioning moral theologians because classical economists,

[9] Department store "revolving credit" employs this type of calculating—for a different reason. For example, the 1% or 2% per month charge adds up to 12% or to 24% interest per annum. Sometimes the interest rate does not include "hidden" costs (e.g., opening costs, service charges) so that an advertised 6% actually approximates 11%).

insisting on profit maximization, exclude the market environment as the proper place for human concern and social responsibilities. Although generalizations frequently tend to oversimplify complex situations, they do highlight important points. The following remarks of economists, businessmen and moral theologians will hopefully illustrate this latter advantage.

a) *Classical economists.* Adam Smith and his successors postulate profit maximization as the only rational way to operate a business. They assumed an entirely competitive market system that had built-in checks and balances to prevent predominance of one or another economic force. The market forces would remain freely competitive, according to their theory, if it enjoyed freedom from intrusion of government and other social bodies. Eventually free competition would provide for the needs of everyone. Unfortunately, history, especially in the growth of the American economy, belies this ideal.

The giant American diversified corporations hardly fit within this idealistic mold. Unless government exercises control, some of these corporations (and their labor union counterpart) could conceivably destroy competition, establish economic empires, raise prices excessively and obtain unreasonable profits. With this threat to the economic structure, the question of an "upper limit" to profit becomes crucial in the American economy. It deserves serious study. Apart from the abuses of a monopolistic economic structure, most business enterprises live within a comparatively active competitive framework. Their executives face an apparent dilemma between profit maximization and "fair" profits. They ask the question: "Is seeking 'all the market will bear' a safe moral norm as well as a legitimate economic law? Is a businessman morally justified in seeking profit maximization?" The classical economist sees no conflict between profit maximization and "fair" profit, provided profit is not obtained through unethical actions. Unethical actions may not be "profit-justified."[10] For all practical purposes, they see profit maximization

[10] Robert H. Salisbury of Washington (Mo.) University holds the opinion that profit is not the ultimate goal of business activity; rather a measure of efficiency and risk. Efficient production and services for consumer satisfaction is the goal. Consequently, unethical actions (e.g., stealing company secrets from

as socially and morally indifferent.

b) *Governmental Action.* Government perceives business profit in light of competitive structures of industries and its effect on consumer needs. The government curbs net profit by two general means. Its more obvious approach includes taxation, price controls, standardization of products and procedures, set markup on products (for government use, usually cost plus 10%) and regulation of industries. Government directly regulates profit of public utilities, transportation and communication. These industries immediately affect the public good. The most recent governmental action reduced the American Telephone and Telegraph Company's 8% return on investments in its interstate and foreign business to 7%-7½%. This action followed a twenty-month inquiry into the cost, capital and profit structure of the company. It illustrates the caution of the government in determining profits, as well as the complexity of setting an "upper limit" for profit.

The government also employs more subtle methods to check industry profits in building low rent housing, in providing low interest rate mortgages on houses and in enacting welfare legislation. Senate hearings on pricing policies of brand name drugs (ostensibly to investigate government purchases of pharmaceuticals for military hospitals, government institutions and Medicare-subscribed private hospitals) suggest tighter control of drug industry prices and profits.

What prevents the government from stipulating an "over-the-board" return of a determined percent on investments, say 7% to 12%, depending upon the industry, as it has in AT&T? Would not this be a "fair" return? Two reasons immediately come to mind. First of all, competition is limited in these highly regulated industries; they enjoy a "quasi-monopolistic" status. Secondly, economists, businessmen and government officials agree that a predetermined norm would stifle a dynamic economy, would induce inefficient operation and would be practically impossible to control effectively.[11]

a competitor) cannot be justified on the basis that they are necessary in a free enterprise economy. See R. H. Salisbury, "Ethical Standards and the Business Community," *Ethics and Standards in American Business,* Joseph W. Towle, ed., (New York: Houghton Mifflin Co., 1964), pp. 41-49.

[11] U.S.S.R. remains the primary exhibit of a controlled economy's inefficiency and waste. For an interesting overview of this problem, see M. I.

Nonetheless, a predetermined norm is precisely what some moral theologians have suggested in their statements on "fair" profits. They offer good reasons for their position, as we shall immediately see.

c) *Moral Theologians' Rule-of-the-Thumb.* Marcellino Zalba, S.J.[12] of the Gregorian University (Rome) suggests a norm that Henry Wirtenberger, S.J. of Loyola University (Chicago) approves:

> Using the normal rate of interest as a guide, some moralists hold that a merchant who undertakes the expense and risks of business may justly receive twice the interest rate of his reward—that is, 10 percent if the interest rate is 5, and so on.[13]

These authors acknowledge a higher rate for large investment of capital in durable goods or in the discovery of precious metals. They relate profit to cost of production, although Wirtenberger states that excessive costs (presumably a result of inefficiency) should not be passed on to consumers.

How realistic is this approach when economists, businessmen and government officials reject (with exceptions) any form of predetermined upper limit for profits?

First of all, the predetermined percentage approach refers to overall or net profit of the whole firm (or a division).[14] It does not apply to profits on individual products, as I will indicate later on in the article. Secondly, corporations and industries at times employ unique accounting procedures that give great variation in determining profit and loss. For example, the Federal Communications Commission in its appraisal of the Bell Telephone System claimed that

Goldman, "Product Differentiation and Advertising: Some Lessons from Soviet Experience," *Marketing and the Behavioral Sciences,* Perry Bliss, ed. (Boston: Allyn and Bacon, Inc., 1963), pp. 504-522.

[12] M. Zalba, S.J., *Theologiae Moralis Summa* (Madrid: B.A.C., 1957), Vol. II, n. 1079.

[13] H. J. Wirtenberger, S.J., *Morality and Business* (Chicago: Loyola University Press, 1962), p. 150.

[14] Federal agencies are currently investigating abuses of net profit for highly diversified corporations where one division seems to support another division that is purposely selling "low" to capture a large share of its market. To offset this questionable practice, the government is considering tax reporting by division.

their 1966 earnings were 8.5%. The company, however, calculated its rate of return in 1966 at 8.1%.

Furthermore, industries differ in their "average" profit, and this average varies from year to year, especially in "growth" industries like electronics, oceanography and space. For example, the highly technical meters and control industry, although it requires expensive research and engineering costs, had an average return on investments (10 year period) at 7.3%. The lowest return was about 2%; the highest showed 10.5%. The company with 9.2% had the most sophisticated product, while the company with 10.5% produced the most standardized products. The 500% industry variation (2% to 10.5%) illustrates the need for flexibility in determining a "just" return, even in terms of specific industries. The meter and control industry, which is considered to be small business, achieved a net return lower than the national average published in the *Small Business Index.*

Why would not the averages expressed in industry studies or overall averages (such as the *Small Business Index*) be as "just" for determining morality as Zalba's rule-of-the-thumb? Furthermore, would not industry averages be more realistic? Two reasons militate against the use of industry averages. First, industry averages in no way represent what "ought" to be; they rather reflect *what is.* Morality, however, is concerned with *what ought to be.* Secondly, industry averages might reflect only slight risks (e.g., public utilities, telephone network). Thirdly, industry averages say nothing about industry policy and procedure for attaining net profit. For example the Federal government has kept constant surveillance on the drug industry for its high profit and high prices. It is interested in seeing the *why* in the relationship between high prices and high profits.

Finally, "averages," statistically considered, are hardly valid "moral" norms. The "average" profit of an industry could be attained by a few firms with excessively high returns and the rest with below average profits.[15] Average, then, indicates only one element

[15] *Fortune* magazine in its annual survey of the largest corporations and industries in the United States stresses the median. A median shows where most of the firms cluster. Thus, when pharmaceuticals for 1966 have a median of 18.4% return on invested capital, it means that most firms surveyed are within this range.

in the price-profit composite. In an economy where industry structure encourages price leaders and price followers, vertical and horizontal mergers and limited competition, industry averages could at most become one factor in assessing the "just" or "reasonable" profit. Even comparison of one industry with another, or comparison of an industry with the overall average merely describes *what is*.

The *what is* of industry averages, however, may be the springboard to the *why it is*. An investigation of *why it is* leads to questions of *what it should be* from a moral viewpoint. Nonetheless, net profit as a percent of investment really contains more than a collectivity of contributing factors, both quantitative (e.g., business costs, however determined) and qualitative (e.g., brand name, good will). Zalba's norm, it seems, satisfies only one factor in determining profit; it is risk. Even the qualifications that Wirtenberger adds (*viz.*, large investments of capital for durable goods, discoveries of minerals) merely describe risk-taking circumstances. Risk refers to stockholders' investment. In this sense, Zalba's norm becomes significant. Banks give prime interest rates to the least risky borrowers (who are usually well-established corporations). A lower risk means a lower rate for borrowing money. Some businesses have greater risks than others. Market conditions are constantly changing (e.g., the impact of the lower tariffs of the Kennedy Round). Catastrophes occur in the socio-economic and political spheres (e.g., closing of the Suez Canal). Unforeseen personnel problems interrupt production or marketing (e.g., wildcat strikes of airlines). Governmental regulations and their application frequently prescribe tighter controls (e.g., auto safety). Miscalculated technical and production difficulties raise costs in attaining high volume production (e.g., in 1966 General Tire and Rubber Company, which owns 85% of Aerojet General space and missiles, wrote off eleven million dollars because they miscalculated the cost for high volume production of space equipment). If bank interest on loans reflects prudent risk, then business, which requires greater risk, should rightfully have a higher return on investment than the prime interest of banks. Granted the assumptions of greater risk in business, it is then "reasonable" to expect *proportionately* greater return. For Zalba, this proportion means "doubling the interest rate." The rule-of-the-thumb of double interest rates as a norm for business profits thus appears to be an operable norm for stockholders who look for high return on investment.

Stockholders, however, are only one of the claimants to the corporation. There are others—managers, employees, suppliers, competitors, customers, community (local, national, international). When businessmen ask for a moral norm on profits, they are interested in their responsibilities to these claimants. They perceive their responsibilities to all the claimants, not just to stockholders.

Businessmen are beginning to question profits as an end in themselves. Many of them rather look at profit as a *conditio sine qua non* of the corporation or as a means for continually providing goods and services. The corporation—not profit—provides goods and services. Higher profits, of course, encourage better investment. The impact of the corporation on society, however, has become so great that it can hardly be considered as a "private person" anymore. There is more to a corporation's relationship to society than profits and risks. Thus, risk only partially explains profit. A more inclusive norm than a double rate of interest, then, seems necessary, and this norm should include the social functions of profit. It also requires further investigation of the impact of large corporations of the contemporary economic structure of society, including the shift of *power* to corporate enterprise and the *locus* of responsibility in corporate decision-making.

Nonetheless, Zalba's norm has a counterpart in the above mentioned Federal Communications Commission decision on the Bell Telephone system profit. Investment in AT&T has a very limited risk, so proportionately, return on investment will be lower than in the situations that Zalba envisioned. The FCC calculated AT&T's profit limit at approximately 1½ times the current prime interest rate (5%). Interestingly enough, the last time the FCC reduced Bell's profit margin and cut prices on long distance telephone calls, customers made more calls so that the lower percent return on sales (e.g., service) had greater "turnover" (e.g., more telephone calls) and profits soared. Will this same supply and demand phenomenon occur again? If it does, how effective is the predetermined upper limit to profit?

3. *Profits and Basic Needs.* From another viewpoint, the FCC ac-

tion on AT&T and other government agencies regulating community welfare industries (e.g., transportation) seem to imply a relationship between profit margin and basic needs. Telephone service, for example, is no longer a luxury. In many situations it is more than a "convenience" service. Telephone service has become a relative need for many Americans. In emergencies, it is crucial to life, national survival, economic activity and even apostolic ministry. On the one hand there is a question of need. On the other hand there is the role of profit. But is there a relation of profit to need? Should profit thereby be lower for industries that cater to social needs? Should industries that produce products or services related to basic needs (e.g., drugs, food, clothing) receive less profit than those industries that produce convenience or luxury items? Or, on the contrary, do those industries that thrive on the human condition have a right to higher profits because they perform a more "worthy" social service? More directly in line with the profit-price relationship, should prices of basic needs be lower because they are "common necessity" and therefore have to be priced within the income of citizens *ut in pluribus* (or at least with subsidies, as in the case of welfare)? Or should the prices of necessities be higher because they assume a certain dignity relative to man?[16]

These questions suggest the dilemma of classical economics about water and diamonds. Should not water be more expensive than diamonds because water has the more "valuable" function of sustaining life? The economists, of course, project this question into the framework of scarcity of supply and inelasticity of demand for basic needs. Underlying this question is the assumption that value is determined by intrinsic worth. Market value, however, has been traditionally determined through the market conditions of supply and demand. Augustine, Albert, Thomas and later Scholastics recognized the effect of supply and demand on market price.[17] And so does contem-

[16] These questions are based on certain assumptions; namely, the firms are equally efficient; they have similar costs; they are profit making institutions.

[17] For a brief but interesting historical perspective of the just price concept, see T. F. Devine, S.J., "The Just Price," *Marquette Business Review,* Vol. 10, No. 3 (Fall, 1966), pp. 148-161. Vol. V of the *New Catholic Encyclopedia* contains an excellent overview of the development of economic theory. Especially useful for moral theologians are the articles "Economic Justice" by L. C. Brown, S.J. and "Economic Value" by T. F. Devine, S.J.

porary man. Water is relatively expensive in the Mideast where supply is short. Diamonds are "scarce," due to the South African monopoly. Gold is a "precious" metal because its supply is limited. A serious freeze in Florida restricts supply of oranges; consequently, frozen orange juice rises in price during the winter months. These situations illustrate the inter-connecting factors of supply, demand and price in a dynamic market. Intrinsic worth, however, presupposes a static concept of market value. The moral issue, on the contrary, assumes a dynamic concept of market value.

From another viewpoint, market value changes with rising and falling standards of living. "Yesterday's luxuries are today's needs" (and vice versa in times of tight money, economic recession and depression) reflects the changing scale of economic values. Therefore, the moral evaluation of the relationship between profit and basic need also includes a prudential investigation of the standards of living of specific times in distinct places.

Nonetheless, some needs remain basic (e.g., food, shelter, clothing) at all times, although they vary according to kind and degree. Should these basic needs (e.g., drugs for the sick), convenience goods (e.g., shampoo, electrical household appliances) and luxury items (e.g., jewelry, high quality automobiles) have different prices and different profit margins precisely because they are needs, conveniences and luxuries?

Industry structures prevent categoric answers to these questions. Once again, industries, even those that specialize in basic needs, have different structures, accounting procedures, pricing policies and profit margins. Two basic need industries—food supermarket and drug—offer excellent illustrations.

The drug industry and the food supermarket industry, although catering to basic needs, take different shares of the consumers' dollars: 18½¢ of tax income dollars for food; $\frac{7}{10}$¢ out of each dollar of all their expenditures for drugs. The increase in food prices can be traced to the "price spread" between what farmers receive and what consumers pay. Higher labor costs, higher taxes and higher transportation costs account for more than two-thirds of this increase in the food industry. Distribution costs of drugs have also increased. Drug manufacturers receive about 40%, retailers about

40% and distributors about 20% of every retail drug prescription price.[18]

All outlays, including higher distribution costs, affect price. Marketing costs—promotion, advertising, transportation—are in themselves legitimate costs. The manner of allocating these costs, however, has caused consternation in both industries.

Drug industry critics have consistently questioned costs in research and in production. They realize that preparing a laboratory-approved drug on the market for mass consumption requires research into production methods. On the one hand, these are marketing costs. On the other hand, they become production costs. Some of the critics feel that the drug industry artificially expands the notion of research to include marketing costs. Furthermore, the high cost of drug promotion, especially of the highly-trained, well-paid "detail men" who visit physicians' offices, has lately been questioned as a legitimate selling expense.[19] Ultimately, the customer pays for this personalized service. Although drug firms have contributed magnificently to the breakthrough of drug therapy and to the control or elimination of disease, they have been accused of spending almost four times as much for advertising as they do for research. And much of the research appears to be "molecule-manipulating" that is an attempt to obtain the same results as competitors' patented drugs.

If net profit, after taxes, averages about 13%, drug industry profit cannot be considered exorbitant, in light of the norm proposed by Zalba. The real questions then center about the legitimate costs that make prices so high to the consumer. How may anyone assert with certitude that the 13% return is either "just" or "unjust" when many of the costs are questionable, especially in the current discussion on generic drugs? In short, the question of drug industry

[18] The druggists' markup is usually 67% of the wholesale cost, but it shows a profit of 40% of the retail price. Thus, a $3.00 item will be sold for $5.00, although the druggists also maintain a "minimum prescription fee" of about 75¢, according to R. Burack, *The Handbook of Prescription Drugs* (New York: Pantheon Books, 1967), p. 75.

[19] For a brief exposition on the nature of drug promotion, see Burack, *op. cit.*, pp. 14-16. For a broader but more popular treatment, see M. Mintz, *The Therapeutic Nightmare* (Boston: Houghton-Mifflin, 1965).

profit is in reality a question of price. Do drug manufacturers engage in "price-determined cost?" Or do they sell drugs according to a "cost-determined price?" If the answer to the first question is "yes," then the drug industry seems to be capitalizing upon the needs of mankind in order to achieve high profit. If the investigation proves to be "no" to the first question and "yes" to the second question, then a study of the allocation and justification of costs in the drug industry is warranted.[20] Until an independent study of drug industry pricing appears, I believe it is mere conjecture to stigmatize the drug industry as capitalizing upon human needs. Furthermore, it is difficult to attain "common estimation" of market value for drugs when two large brand name pharmaceutical firms charge $2.00 and $6.62 respectively for substantially the same penicillin tablet.

The national food supermarket chains illustrate an entirely different relationship between profit and price. The 1966 percent return on sales of the national food supermarket chain (listed in *Fortune* magazine's survey) ranged from .9% to 2.3% and percent return on investment from 9.2%to 17.6%.[21] In general, the food processing industry had higher percent returns on sales but lower percent returns on investment than the national supermarket chains. Although supermarket chains slashed prices last year in the wake of the housewife boycott, their operating costs rose to 22% of sales. In order to offset shrinking profit margins due to rising costs and low markups on food products, supermarkets and retailers added high markup items (30% to 50%), namely, bakery goods, cosmetics, greeting cards, records and nylons. As a further step in reducing operating cost, some chains have eliminated trading stamps. Accord-

[20] Some of the questions that might be asked center around drug industry costs. For example, how valid is the claim that pharmaceutical manufacturers spend approximately $3,000 in advertising each year for each doctor in the United States? If the claim is true, does the customer have to bear this cost? How are research costs allocated? Are "molecule-manipulating" procedures legitimate costs? Why do prices for substantially the same drug vary so widely among different firms? How can the price differential between brand names and generic drugs be adequately explained? Those questions, and others like them, must be answered before a realistic moral appraisal of drug pricing can be made.

[21] See *Fortune*, Vol. LXXV, No. 7 (June 15, 1967), pp. 220-221; also p. 173.

ing to some grocers, stamps cost between 2.5% and 3% of sales. Notwithstanding pressures from housewife boycotts, supermarket chains have taken steps to keep prices down.[22] Their profit appears to be reasonable. Their method of obtaining profit, however, might also be questioned, primarily about the practice of carrying high profit items to cover low profit products. This practice is called "product line pricing" or "full line pricing."

4. *Profit and Product Line Pricing.* Full line or product line pricing refers to a complete range of similar items; e.g., cosmetics, frozen foods, automobiles. Sometimes a full line contains complementary items; e.g., razors and blades; tennis rackets and tennis balls. Sometimes businessmen add products to a line in order to offset competition. If Company A has a $1.00 shampoo, then Company B will add a $1.00 shampoo to its existing line of $.75 and $1.50 shampoos, in order to cover a specific market segment that prefers a moderately priced product. Full product lines, then, represent service to consumers.

a) *Business Viewpoint.* When businessmen add products to their existing lines, they frequently use "inversion" pricing. That is, they start with price, determine the characteristics of a product (if it has any), set up promotion and then select the materials from which the product will be made. This method is the reverse of "cost plus markup" pricing. If raw materials are expensive and if cheaper substitutes cannot be found, the product might become a "profit loser;" it might actually cost more to produce than it receives in return. This situation, however, does not necessarily disturb businessmen. They usually have other products with high profit margins (e.g., profit that remains after all business costs have been deducted). The highly profitable products carry the losers or "pacers" (those products that break even) so that an *overall* profit is attained and service is complete. Without complete service, the argument goes, customers will switch to competitors' brands. Consequently, businessmen view product lines as one product with one staggered price range that produces one

[22] In the 1966 *Fortune* survey, food and beverages in all categories have a median of 11.1% return on investments. This is lower than the all industry median of 12.7. The food industry thus seems to be within moral limits of just price and just profits as Zalba describes them.

overall or net profit. In general, high quality, high priced items produce more profit than do low quality, low priced goods. Specialty goods and "fads" (low cost, high price, and quick but short turnover) are, of course, the exception. Furniture, automobiles, refrigerators and other durable goods have a proportionately higher profit margin than canned food stuffs, mass produced clothes and nondurable items. The profit on durable goods must be spread out between purchases.

b) *Consumer Viewpoint.* Customers, however, need not look at their individual purchases with such an overall view. Customers relate products to satisfaction. Satisfaction is perceived differently by different persons. Some perceive price in relation to product: higher price means better quality, and higher quality means greater satisfaction. Other customers perceive lower price as a "better deal" and thus they receive satisfaction from this accomplishment. In general, however, the customer assumes that he is "getting more" from higher priced goods. In relation to consumer satisfaction "more" can take many forms; e.g., better quality, status, longer lasting products, better quantity, better service, etc. One of the promotional messages of national trade brand names is guaranteed quality. It assumes the inability of customers to distinguish good from bad merchandise. Perhaps the promoters of brand names have a point. In a mass produced economy where proliferation of almost identical products is commonplace, the buyer is faced with a decision of selecting one from twenty to thirty brands of soaps, detergents, cosmetics, frozen foods and other mass produced items. He cannot judge the relative merits of each. The buyer then trusts the seller, who sends his "message" through mass media. Even retail salesmen cannot easily distinguish the differences of quality. (Nor is it an uncommon experience for retailers to push the brand with the highest profit margin.) When sellers stress specific characteristics of their high-priced products, they raise the expectations of buyers (provided the normal allowance for some advertising "puffery"). From the customers' point of view, higher priced items reflect higher quality.

c) *Moral Issues in Product Line Pricing.* The different viewpoints of buyer and seller in product line pricing raises some questions. Is the buyer deceiving the customer when higher priced items reflect only higher profit margins that in effect carry lower priced products? Is there a form of subsidizing the purchasers of low price, high cost "profit losers"? Do customers really assess products on their intrinsic merits, so that high priced goods mean "more" in terms of value? Granted the assumption that customers who are not satisfied with products will not repeat purchases, are businessmen, in fact, perpetrating deception in product line pricing?

Sellers do not ordinarily intend to deceive buyers when they use full line pricing strategy. They consider full line pricing to be a legitimate business practice that has two effects. First, it provides a satisfaction for a full range of consumer tastes and pocketbooks. Secondly, full line pricing spreads out cost and revenue, and thereby levels out profit over the whole line. The first effect, wide range of satisfactions, is commendable. This helps fulfill one of the purposes of business; namely, to provide goods and services for society. (Proliferation of convenience and luxury items, however, becomes an issue in the broader question of social responsibility and the wastefulness of resources.) Less certain is the second effect of spreading out cost and revenue to acquire a reasonable net profit. The fact that businessmen accept full line pricing as a legitimate business practice does not for that reason make it moral, but it does seem to rule out serious reasons for indicating deception. Perhaps it is rather a question of customer ignorance of business practices, including "inversion pricing." As currently practiced, pricing policies and procedures are treated as trade secrets. Except for generalities, executives have no intention of informing the public of their price structure. Unless pricing becomes obviously outrageous, customers accept current pricing practices as a fact of the economic life.

The previous exposition on supermarket pricing after the housewife boycott illustrated the role of pricing in attaining profit. This same illustration may be used to investigate the problem of product line pricing. Do the high profit items (e.g., cosmetics) in fact subsidize the low profit product (e.g., canned goods)? In a word, is the customer who purchases the high priced, high profit margin item subsidizing the person who purchases the low priced, low profit margin product?

The answers to these questions, I believe, lies in the freedom of the consumer. If he has freedom of choice so that he may purchase the lower priced goods, then it seems that there is an equal exchange of market value. If the customer receives satisfaction, then the seller has fulfilled his part of the contract. (It is assumed once again that we are speaking of customers in general.) When the customer does *not* have freedom of choice (e.g., drug prescriptions), the question of product line pricing requires further investigation. Price and profit cannot be separated. But it seems that a customer who does not have freedom of choice is "forced" to provide for the needs or the desires of others who purchase lower priced goods. The so-called welfare aspect of this business practice becomes suspect when the whole purpose of product line pricing centers about overall profit for businessmen. Furthermore, when product line pricing contributes to the proliferation of convenience goods and luxury items merely to offset competition, it appears to add to social cost in the form of waste. If this is true, then the whole notion of product line pricing should be reevaluated in light of social justice. Finally, if product line pricing has true social value (e.g., supermarket food prices are kept low), and if consumer satisfaction is achieved through proportionate equality in market values, then it seems that product line pricing fulfills the mandates of both social and commutative justice.

These tentative statements about subsidization and product line pricing must be adjusted to industry practices and to the company's overall line of products. They also require a more thorough study from moral theologians.

5. *Pastoral Aspects of Pricing.* Thomas M. Garrett, S.J. states:

> Older theories of the ethics of pricing suffer from two defects: they are inapplicable to many segments of the American economy and they make no allowance for the cost of price instability. These defects arise from the fact that they are both economic and ethical theories which were developed to explain or regulate a much simpler economy.[23]

He sees traditional price theories, especially collective judgment and exchange of value, impossible to estimate in our complex society.

[23] T. M. Garrett, S.J. *Business Ethics* (New York: Appleton-Century-Crofts, 1966), p. 134. Garrett develops his pricing theory on pp. 133-148.

Furthermore, he claims that laws regulating price tend to discourage price competition. In place of the traditional theory of price, Garrett suggests that fairness of prices can be determined through the basic impediments to human acts: fraud, ignorance, power and passion. In general, when power, fraud, ignorance and passion, either singularly or collectively, affect the customer's judgment, the purchaser lacks that freedom which is suitable and desirable for a buyer-seller contract. For example, price fixing causes power to destroy equality between buyer and seller. Resale price maintenance uses power to force prices up or at least to make customers buy a service that they might not truly desire. The intention to create irrational passion through advertising so that customers may be exploited can be considered objectively unethical.

Garrett's theory eliminates the need for complex qualifications in applying moral principles to concrete situations. In a way, he approaches pricing through an indirect method. More importantly, he dispenses with the paraphernalia of industry practice and exposes basic moral issues that really underly the whole problem of pricing. His approach is most refreshing.

This theory may be most useful in solving particular pastoral problems in pricing. It does not, however, solve the *issue of pricing* in the American economy. It points out moral issues. Buyers will be able to recognize fraud, ignorance, power and passion. Sellers, however, will not be so easily convinced that they are employing these questionable or unethical means in their business practices. In order to convince sellers, one would have to delve into the complexities of the economic structure, the peculiarities of industry practice and the price-profit relationship in company policies.

III. A Comment on the Codes of Ethical Behavior

Businessmen show concern about the moral binding force of ethical codes. This section of the article will look into some of these problems. Before an investigation can begin, two assumptions must be made. First, codes that we are considering are not contrary to governmental regulations (e.g., anti-trust legislation and application; Federal Trade Commission policy). Secondly, the codes under consideration do not favor one group at the expense of others in an industry (e.g., wholesalers over manufacturers), nor do they merely state norms for business etiquette, nor do they only protect inefficient businessmen. Finally, these codes have industry-wide acceptance (e.g., the code of the Direct Mail Advertising Association).

However, the usual vehicle for codes remains the trade association, which ordinarily represents one segment of an industry. For example, brewers and retailers did not in fact accept The National Beer Wholesalers Association's "Code of Fair Practices for Wholesalers."

Like civil law, codes of ethical behavior in no way explicitly mention moral obligation. They refer to ethics and morality, but they do not consider the questions of conscience. Unlike civil law, codes do not directly relate to the common good. The codes immediately direct the actions of industry members. In upgrading the ethical posture of an industry, the codes indirectly contribute to the common good. The content of the codes, like that of civil law, frequently entails moral obligation. That is, they frequently explicate basic obligations contained in the norms of justice. Sometimes they contain a new application of the old notion of "prescribed because good" and "proscribed because bad." In other words, certain actions bind regardless of codes. In other cases (e.g., industry-wide practices that favor a certain percent markup, discount, etc.), the content is sometimes binding and sometimes not binding, depending upon the situation. The Wedge Principle might enter into these judgments. For example, in the code of fair practices for beer wholesalers, one of the articles states:

> I shall never refer to the activities, policies or characteristics of another wholesaler or his suppliers' brands in a derogatory manner when conversing with a retailer.

It is one thing if "derogatory" means a form of protection for the wholesalers. It is quite another thing if derogatory means unjust criticism or uncharitable remarks. When a whole industry is involved in "stabbing in the back," the fiduciary relationships between members of the industry will disintegrate.

A look into the binding force of codes, then, can be reduced to this question: Do codes *qua* codes bind *in se?* That is, does the promise to follow a code of ethical behavior bind in conscience?

The answer, it seems, depends upon different situations. When codes have been imposed on members of a trade association by the fact of membership, without any explicit sign of voluntariness on the part of the member, it is difficult to assess an obligation for that reason. Trade associations are only positive societies; no moral obligation is thereby accepted apart from an implicit or explicit agreement. Although request for admission into an association implies the obligation to follow its regulations, including a code of ethics, it does not entail a moral obligation. The only sanction for a fraction on the rules can be expulsion and this expulsion has no moral implication.

When a code of ethical behavior is proposed to the membership of a trade association for approval, different situations can arise. If a member approves a code, he probably intends to assume an obligation—but only to the extent of his promise. At most, codes fall within the obligation of personal promises. If a member voted against a code but the code nonetheless passed the majority vote, he is then obliged to observe the code as a member. But there does not seem to be any other obligation stemming from the code than that of external compliance. That is, there does not seem to be a moral obligation imposed by the fact of the code.

If a person intends to bind himself in conscience but sees that other members have not fulfilled their promises, he is then not obliged. He would place himself at a disadvantage. Nonetheless, the obligations stemming from justice and charity still bind.

In a word, no code of itself binds in conscience except perhaps from fidelity and then only when the whole industry follows its prescriptions. Because codes frequently include basic moral practices, they bind from justice, but not because they are prescribed or proscribed by the trade association. In these instances codes have an educational and motivational effect upon members, inasmuch as they pinpoint practices that should be avoided or encouraged. Social sanction for abusing the code has a therapeutic effect on the whole industry. Sanctions of this sort, however, do not imply an infraction of the moral order.

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