Theory of Full-Cost or Average Cost Pricing

Divya Kishore

29 July 2020

In 1939, Hall and Hitch of the University of Oxford mounted a 'root-and-branch' attack on the notion of profit maximisation on the basis of answers to questionnaires of 38 entrepreneurs, 33 of whom were manufacturers, 3 retailers and 2 builders. On the basis of the empirical study, Hall and Hitch concluded that the majority of entrepreneurs under oligopoly base their selling prices upon, what they call, 'full cost' and including an allowance of profit, and not in terms of the equality of marginal cost and marginal revenue at all.

Thus a price based on full average cost is the 'right price', the one which 'ought to be charged', based on the idea of 'fairness to competition' under oligopoly. But what is full cost? Full cost is full average cost which includes average direct costs (AVC) plus average overhead costs (AFC) plus a normal margin for profit: Thus price, P = AVC + AFC + profit margin (usually 10%).

According to Hall and Hitch, there are certain reasons which induce firms to follow the full-cost pricing policy:
(i) Tacit or open collusion among producers;

(ii) Failure to know consumers' preferences;

(iii) Reaction of competitors to a change in price;

(iv) Moral conviction of fairness; and

(v) Uncertainty of effects of price increases or decreases. All these reasons prevent oligopolistic producers from setting a price other than the full-cost price.

Thus firms set their price on the basis of the full-cost principle and sell at that price whatever the market takes. They observed that prices were sticky in the oligopoly market despite changes in demand and costs

But how is the level of output determined?
It is determined in any of the three ways:
(a) As a percentage of capacity output; or

(b) As the output sold in the preceding production period; or

(c) As the minimum or average output that the firm expects to sell in the future.

If the firm is a new one, or if it is an existing firm introducing a new product, then only the first and third of these interpretations will be relevant. In these circumstances, indeed, it is likely that the first will coincide roughly with the third, for the capacity of the plant will depend on expected future sales.

Criticism:
The full-cost pricing theory has been severely criticised on the following grounds:
(1) Not free from profit maximisation:
Critics like Robinson and Kahn have pointed out that the full-cost pricing theory is not free from the elements of profits maximisation which entered into the pricing decisions of many of the firms investigated by Hall and Hitch.

(2) Whose full cost?
One of the weaknesses of the theory is that it fails to point out the firm whose full cost will determine the price in the oligopoly market that will be followed by the other firms.

(3) Firms follow Independent price policy:
The full-cost pricing theory is criticised for its adherence to a rigid price. Firms often lower the price to clear their stocks during a recession. They also raise the price when costs rise during a boom. Therefore, firms often follow an independent price policy rather than a rigid price policy.

(7) Not for perishable goods:
This method cannot be used for price determination of perishable goods because it relates to the long period.