
The Theory of Monopolistic Competition, Marketing's Intellectual History, and the Product Differentiation Versus Market Segmentation Controversy

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Abstract

Edward Chamberlin's theory of monopolistic competition influenced greatly the development of marketing theory and thought in the 1930s to the 1960s. Indeed, marketers held the theory in such high regard that the American Marketing Association awarded Chamberlin the Paul D. Converse Award in 1953, which at the time was the AMA's highest honor. However, the contemporary marketing literature virtually ignores Chamberlin's theory. The author argues that the theory of monopolistic competition deserves reexamining on two grounds. First, marketing scholars should know their discipline's intellectual history, to which Chamberlin's theory played a significant role in developing. Second, understanding the theory of monopolistic competition can inform contemporary marketing thought. Although our analysis will point out several contributions of the theory, one in particular is argued in detail: the theory of monopolistic competition can contribute to a better understanding of the "product differentiation versus market segmentation" controversy in marketing strategy.

Keywords

Chamberlin, marketing strategy, product differentiation, market segmentation

As research specialization has increased, . . . knowledge outside of a person's specialty may first be viewed as noninstrumental, then as nonessential, then as nonimportant, and finally as nonexistent.

Wilkie and Moore (2003, 142).

In 1927, a young doctoral student completed his dissertation in economics at Harvard; in 1933, the dissertation was published as a book. The student was Edward Hastings Chamberlin; the book was *The Theory of Monopolistic Competition*. The theory was proposed as "a *general theory*, designed to replace that of generalized pure competition (of Marshall or Walras, for instance) as a point of departure and as a basis for analysis of the entire economy" (Chamberlin 1951, 343; italics in original). In light of its "replacement" thesis, economists vigorously debated the theory in the 1930s to the 1950s: "During a relatively short period of time (1926-41), monopolistic competition theory dominated international economic science, . . . [but] there were technical difficulties in the mathematical modeling of monopolistic competition . . . [that] made it unattractive in a science that was being formalized and extended into general equilibrium" (Keppler 1994, 3, 7). By the mid-1950s, the debate's verdict was in: advocates of perfect competition had won, and those promoting the theory of monopolistic competition as a starting point for analyzing competition had been "defeated" (Stigler 1957, 17).¹

Despite the theory's defeat in economics, the theory of monopolistic competition (hereafter, TMC) influenced greatly the development of marketing theory and thought in the 1930s to the 1960s (Dixon and Wilkinson 1989; Grether 1967). That is, TMC was influential at the end of marketing's "second era" and the beginning of its "third era" (Wilkie and Moore 2003).² For example, in his argument that progressive differentiation of products and services is the key to defining the values created by marketing, Alderson acknowledges that "this step-by-step differentiation of an economic good is the essence of the economic process as recognized by Chamberlin" (Alderson 1957, 70). In addition, in discussing his functionalist approach, Alderson (1957, 101) maintains that the "substance of the functionalist approach is very similar to what Chamberlin implied by monopolistic competition." As a third example, Alderson (1965, 184) notes that "this writer has drawn upon E. H. Chamberlin for the treatment of differential advantage although the term has never been used by Chamberlin."

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Theorists in marketing's second and third eras held TMC in such high regard that Chamberlin received the American Marketing Association's Paul D. Converse Award in 1953, which at the time was the AMA's highest honor. The citation stated:

You have been selected by our national jury of scholars to receive this award for your contribution to the advancement of theory in marketing, primarily through your development of *The Theory of Monopolistic Competition*. Although you probably consider the study a development of economic thought, it has had a major impact on marketing thinking. . . . Such effects widen through the years and the influence of an idea is seen in the direction it gives to research, to thought, to practice, and to the philosophy of men. (Grether 1967, 307)

Contrary to the citation's prediction, the influence of Chamberlin's TMC on marketing has not "widened through the years," nor is there evidence that it has given "direction" to research, thought, or practice. Indeed, a citation analysis (Web of Science, 1981 to present) for "E.H. Chamberlin" and "marketing" conducted by the author finds only twenty-five citations. Furthermore, of the marketing-related *articles* citing Chamberlin, less than a dozen are in marketing *journals*. In short, the contemporary marketing literature virtually ignores Chamberlin's TMC. Therefore, the conclusion of Dickson and Ginter (1987, 2) that Chamberlin's TMC has been "overlooked" still stands.

Chamberlin's TMC joins other works in being highly influential in marketing's intellectual development, yet virtually ignored in contemporary marketing theory and thought. Consider Wroe Alderson. At the beginning of the "era three" of Wilkie and Moore (2003), Alderson was judged to be "without doubt the most influential marketing theorist in recent times" (Grether 1967, 315) and at the era's end, a survey of marketing academics ranked Alderson as the number one contributor to the development of marketing thought (Chonko and Dunne 1982). Furthermore, scholars in the current era now laud Alderson as "unquestionably the pre-eminent marketing theorist of the mid-twentieth century" (Wooliscroft, Tamilia, and Shapiro 2006, xvii). However, Alderson's work is seldom used as a foundation for (or even cited in) contemporary marketing research, which leads Wooliscroft, Tamilia, and Shapiro 2006 (2006) to (1) develop a historical perspective on Alderson, the person, (2) provide commentaries on, and extensions of, Alderson's work, and (3) argue that Alderson's work "continues to provide . . . many important conceptual building blocks . . . which contemporary marketing scholars can use in their efforts to improve both the theory and practice of marketing" (xviii).

The author argues that Chamberlin's TMC, like the work of Alderson, deserves reexamining on two grounds. First, as Jones and Keep (2009) and E. H. Shaw (2009) point out, marketing scholars should know their discipline's intellectual history, to which Chamberlin's TMC played a significant role in developing. Second, understanding TMC can inform contemporary marketing thought. Specifically, though our analysis will point out several ways TMC can inform both macromarketing and

micromarketing thought, one contribution is argued in detail: TMC can contribute to a better understanding of the "product differentiation versus market segmentation" controversy in marketing strategy.

The author intersects with macromarketing in at least three ways. First, he contributes to marketing's intellectual history and the history of both marketing practice and marketing thought has long been considered an important component of macromarketing. Indeed, this journal institutionalized history as a part of macromarketing with the establishment of the marketing history section in 1998. Second, the author addresses the nature of competition, specifically *monopolistic* competition, and the subject of competition has long been associated with macromarketing. Again, this journal institutionalized "competition and markets" as an important part of macromarketing with the establishment of a separate section in 1998. Third, the author is macro in that it discusses product differentiation in association with marketing systems that are characterized by heterogeneous, intra-industry demand and heterogeneous, industry supply. That is, product differentiation has consequences for marketing systems, as stressed in macromarketing by Hunt (1981) and Layton (2009).

The author begins the analysis with an overview of the origins, assumptions, and formal structure of the Chamberlin's TMC. Then, he discusses the debate in economics concerning TMC and the impact of TMC on marketing.

The Development of the Theory of Monopolistic Competition

Chamberlin's development of TMC was prompted by several considerations. Appendix H, in Chamberlin (1962), highlights three: (1) his analysis of the problem of setting railway rates, which he studied when he was a graduate student at the University of Michigan, (2) his observation that many industries contain firms whose products are heterogeneous, and (3) his recognition that the economics literature of his time provided no clear explanation of how industry prices settled at the point of equilibrium between supply and demand. However, he laments, misconceptions concerning the origins, and nature of TMC contributed to the confused nature of the debate over the theory's merits.

Some writers maintained that TMC was developed as a response to the depression of the 1930s. However, Chamberlin's (1933) *Theory of Monopolistic Competition* was first written as a PhD thesis at Harvard in 1927, before being shortened to book form six years later. He revised it seven times, with the last edition bearing a 1962 copyright. Therefore, TMC was developed *prior* to the great depression and "is without reference to any particular period of business, either good or bad" (Chamberlin 1962, 293). Other commentators argued that TMC was an attack on Marshall, but Chamberlin (1962, 316) pointed out that TMC "was an attack, but not on Marshall, but on the theory of perfect competition . . . [and] those who simply regard 'competitive' and 'monopolistic' as separate categories, with different principles in each case and a clear line of distinction between them."

Still others viewed TMC as a *form* of imperfect competition. But, Chamberlin (1951, 343) saw it as “not a theory of ‘imperfections’ in any sense.”

Although the author focuses on TMC, it should be noted that Joan Robinson’s (1933) theory of imperfect competition was also much debated in the 1930s–1940s, often in conjunction with Chamberlin’s theory of monopolistic competition. As Chamberlin (1962, 207) points out, “imperfect [competition] and monopolistic competition have been commonly linked together as different names for the same thing.” However, his 1962 edition devoted an entire chapter (Chapter IX) to discussing the differences between the theories of monopolistic competition and imperfect competition. The chapter “reaffirm[s] the nature of monopolistic competition as a composite of monopoly and competition, calling attention here to a fundamental difference between Mrs. Robinson’s conception of the problem and my own” (191). Specifically, “this concept of a blending of competition and monopoly [in monopolistic competition] is quite lacking in Mrs. Robinson’s *Imperfect Competition*” (205; italics in original).

That is, for Chamberlin, but not for Robinson, the fact that an industry is characterized by product differentiation implies that there is a form of competition (monopolistic competition) that is a blend of competition and monopoly. Indeed, in the very first chapter of Robinson (1933, 17), she defines a commodity as a “consumable good, arbitrarily demarcated from other kinds of goods, but which may be regarded for *practical purposes* as homogeneous within itself.” She then goes on to define what a demand curve is and then to use “motor cars” as an example of a “commodity” that has a single, industry demand curve. For Chamberlin’s TMC, in contrast, assuming that the motor car industry can be viewed as producing a homogeneous commodity for the “practical purpose” of generating an industry demand curve is totally contrary to the theory’s emphasis on the consequences of product differentiation in real industries. In fact, Chamberlin (1954b) actually uses the motor car industry as a prototypical example of the kind of industry for which it is theoretically (and practically) impossible to draw an industry demand curve. To those who insist that the motor car industry *should* produce a homogeneous product, Chamberlin (1954a, 259) asks, “if we are to imagine a purely competitive automobile industry, will its homogeneous product be Packards, Plymouths, or Peugeots?”

There is also an interesting sidenote on the debate in economics concerning Robinson’s theory of imperfect competition. As early as the 1950s, Robinson (1951, vii–viii) was lamenting that, instead of the Marshallian, evolutionary process approach that she *could* have adopted, her static–equilibrium analyses represented a “wrong turning.” Because, she pointed out, the neoclassical approach lacked a “comprehensible treatment of historical time,” the “theoretical apparatus [was] useless for the analysis of contemporary problems in the micro and macro spheres” (Robinson 1979, 58). Accordingly, she later pleaded for “getting economic theory out of the desert of equilibrium and into fruitful fields” (Robinson 1980, xiv). Loasby (1991) provides an extensive and very sympathetic

analysis of Robinson’s “wrong turning.” As Mongiovi (1992, 964) recounts, “The despair that marked the final years of her [Robinson’s] life was due not only to the discipline’s indifference to her message [that equilibrium analysis is a desert], but also to her rising doubts about whether the method she endorsed could in fact help to explain processes in historical time.” Joan Robinson’s despair is understandable.³

For TMC, a common, if not the *most* common, form of competition is characterized by “product differentiation,” which implies a form of competition that contains elements of both competition and monopoly. As he put it, his dissertation and book sought to develop “a hybrid theory of monopoly and competition” (1962, 296). The first edition’s preface maintained that “economic theory is often remote and unreal, not because the method is wrong, but because the underlying assumptions are not as closely in accord with the facts as they might be” (Chamberlin 1933/1962, xi). What, then, are the assumptions of TMC?

Assumptions

The first assumption of TMC is that the theory applies to those industries in which there is product differentiation, which he defines very carefully:

A general class of product is differentiated if any significant basis exists for distinguishing the goods (or services) of one seller from those of another. Such a basis may be real or fancied, so long as it is of any importance whatever to buyers, and leads to a preference for one variety of the product over another. Where such differentiation exists, even though it be slight, buyers will be paired with sellers, not by chance and at random (as under pure competition), but according to their preferences. (Chamberlin 1962, 56)

TMC’s second assumption is that product differentiation is the state of affairs in an industry that results from both heterogeneous demand (i.e., differences in buyers’ preferences) and heterogeneous supply (i.e., differences in what firms choose to produce or are capable of producing). TMC recognizes that heterogeneous demand alone is not sufficient to result in product differentiation. Firms may be unaware of demand heterogeneity, collude to ignore demand heterogeneity, or be required by state fiat to produce a homogeneous product.

Recall that Chamberlin maintained that problems in economic theory result “not because the method is wrong.” Therefore, TMC’s third assumption is that the method appropriate for economic analysis is that of static equilibrium, with its reliance on mathematics and geometric reasoning. We should be mindful that, in the 1920s and 1930s, the neoclassical research tradition had not yet “hardened” (Lakatos 1978) around static equilibrium analysis and general equilibrium theory (Nelson and Winter 1982; Weintraub 1984), and many economists were still advocating a Marshallian, dynamic, biological metaphor, evolutionary approach to economic theory. Indeed, Chamberlin’s selection of equilibrium analysis and his

development of the equilibrium *firm* (as a complement to Marshall's *industry* equilibrium) furthered the static-equilibrium approach to economics. Historians note that Chamberlin's selection of equilibrium analysis contributes to explaining "why, how and when Marshall's use of the biological analogy was suppressed and eventually eliminated from economics" (Foss 1994).

TMC's fourth assumption is that monopolistic competition is to be judged using perfect competition (or "pure" competition in Chamberlin's terminology) as the reference.⁴ Because perfect competition leads to a Pareto-optimal allocation of scarce resources in the face of unlimited human wants, perfect competition is the "gold standard." That is, perfect competition is the standard to be used because perfect competition is, well, *perfect*.

Nelson and Winter (1982) note that economic theory can be divided into two types: (1) "appreciative theory," the informal theoretical discussion that one finds at the beginning and end of typical journal articles in economics and (2) "formal theory," the equations in the middle of the articles that are considered by the neoclassical economics' research tradition to be each article's major contribution. Accordingly, Chamberlin's TMC has both formal and informal theories. We begin with the formal theory.

TMC's Formal Theory

Chamberlin (1962, 74-81) begins developing his formal theory by analyzing the circumstances that must prevail for an individual monopolistic firm to be in equilibrium. He draws a downward sloping demand curve for the firm, a U-shaped total cost curve, a downward sloping marginal cost (MC) curve, and a U-shaped marginal revenue (MR) curve.⁵ He next assumes firms to be profit maximizers and points out that the profit maximizing quantity occurs where $MC = MR$. He then directs the reader to the demand curve and shows that the profit maximizing quantity occurs at a price that exceeds MR. Because under pure (perfect) competition $MC = MR = \text{Price}$, he concludes:

[T]he effect of monopoly elements on the individual's adjustment . . . is characteristically to render his price higher and his scale of production smaller than under pure competition. This is the result of the sloping demand curve, as compared with the perfectly horizontal one of pure competition. No matter in what position the demand curve is drawn, its negative slope will define maximum profits at a point further to the left than if it were horizontal, as under pure competition. This means, in general, higher production costs and higher prices. (Chamberlin 1962, 77-78)

Chamberlin (1962, 81-100) turns next to the issue of competition from substitutes and, again, focuses on the static-equilibrium situation. He posits that each monopolistic firm belongs to a group of competitors and he seeks to determine the nature of such *group* equilibria (which parallel the customary *industry* equilibria). However, determining a group's

equilibrium position poses a challenge because each firm's product "has distinctive features and is adapted to the tastes and needs of those who buy it, . . . [which] lead to wide divergences in the curves of cost of production, and buyers' preferences account for a corresponding variety of demand curves" (81). His "solution" is to assume that the demand and cost curves for all group members are identical, which he characterizes as a "heroic assumption" (1962, 82).

Given identical demand and cost curves for a group of monopolistically competitive firms, Chamberlin (1962) argues that the surplus profit of the group's members that stems from their higher prices (compared with perfect competition) attracts new entrants to the group. The total quantity sold by the group must then be divided among more producers, which shifts each firm's demand curve to the left. Consequently, each firm's profit maximizing price increases and quantity produced decreases. Therefore, at the group equilibrium point (where there is no further entry or exit of firms, no further price-quantity adjustments), each firm's demand curve is tangent to its total cost curve. At this group equilibrium price and quantity, all surplus profits have been competed away, but "the price is inevitably higher and the scale of production inevitably smaller under monopolistic competition than under pure competition" (1962, 88).

Chamberlin (1962) then extends his analysis to other welfare implications of monopolistic competition. As to product quality, he argues that it will be "inevitably somewhat inferior" (99). As to the factors of production, because excess productive capacity has no "automatic corrective," the "surplus capacity is never cast off and the result is high prices and waste" (109). As to whether labor is exploited in the sense of receiving less than the value of its marginal product, as argued by Robinson (1933), "all factors are necessarily 'exploited' . . . [for] it would be impossible for employers to avoid the charge of 'exploitation' without going into bankruptcy" (183).

TMC's formal theory paints a dismal picture of the welfare implications of the monopolistic competition spawned by heterogeneous demand and supply. Compared with perfect competition's homogeneous demand and supply, prices are higher, quantities produced are lower, excess capacity is permanent, products produced are inferior, and all factors of production are exploited.

TMC's Informal Theory

The vigorous debate over TMC in the 1930s and 1940s did not lead Chamberlin to change or modify his formal theory nor did it shake his conviction that a static equilibrium method of analysis was appropriate. However, the debate did prompt him to develop additional *informal* theory, which he presented in a new and final Chapter IX in the 1946 and succeeding editions of his book. He then supplemented the informal theory in his later articles (Chamberlin 1950, 1951, 1954a, 1954b).

Recall that Chamberlin had consistently used pure (perfect) competition as the standard against which monopolistic competition would be compared. His later analyses led him to

conclude: “[The concept of] ‘free enterprise’ has too long been loosely identified with ... ‘perfect’ or ‘pure’ competition ... The explicit recognition that product is differentiated brings into the open the problem of variety and makes it clear that *pure competition may no longer be regarded as in any sense an ‘ideal’ for purposes of welfare economics*” (1962, 214; italics in original). Indeed, he pleads *mea culpa*: “I must plead guilty myself to having done what is here held to be meaningless” (1951, 349). In Chapter IX of his book and his subsequent articles, he develops numerous arguments—informal theories—to justify not only his conclusion that perfect competition is in no sense ideal but also that the very concepts *industry* and *commodity* represent nothing less than a “snare and delusion” (Chamberlin 1950, 86).

Chamberlin’s arguments against using perfect competition as a competitive ideal can be placed into two general categories: (1) heterogeneous, intra-industry *supply* is natural, not artificial, and (2) heterogeneous, intra-industry *demand* is natural, not artificial. As to the first category, Chamberlin (1962, 214) points out that every supplier is necessarily unique in its physical location: “Retail shops, for example, could not all be located on the same spot.” He also argues that there are natural “[p]eculiarities of any individual establishment which cannot be duplicated ... [such as] reputation, skill, and special ability ... [that result in] returns which cannot be reduced by others moving in to share them” (1962, 112). Finally, heterogeneity of supply is natural because it is a direct response to heterogeneous demand: “Commodities are differentiated ... partly in response to differences in buyers’ tastes, preferences, locations, etc., which are as much a part of the order of things *within* any broad class of product as they are *between* one class of product and another” (Chamberlin 1962, 213; italics in original). That is, one reason for the differences between Cadillacs and Fords is that some consumers desire luxury automobiles and have the incomes to buy them, while others desire more economical transportation.

As to heterogeneous, intra-industry demand being natural: “Differences in tastes, desires, incomes, and locations of buyers, and differences in the uses which they wish to make of commodities all indicate the need for variety” (Chamberlin 1962, 214). Such differences are natural because, he stresses, “human beings are individuals” (1950, 86). Therefore, product differentiation is neither “the reprehensible creation by businessmen of purely fictitious differences between products which are by nature fundamentally uniform” (1950, 87), nor “an optical illusion based upon ignorance, ... imperfect knowledge, ... [or] irrational preferences” (1950, 88). Instead, the belief that consumers would prefer homogeneous, intra-industry goods were it not for consumers’ ignorance, irrationality, and susceptibility to the wiles of advertising is economic arrogance:

Diversity is the natural consequence of the system of demands, in the same sense as is any variety whatever in the output of the economic system ... A preference for the *New York Times* over the *Daily Record* is not to be dismissed as irrational or

of no consequence merely because they are both a part of the ‘newspaper industry.’ The general principle of free choice in the spending of one’s income includes not only freedom to vary the proportions between the larger categories of food, shelter, etc., but freedom also to express a market demand for Smith’s sausages if one believes them superior to Jones’s. (Chamberlin 1954a, 260)

Economics and TMC

As previously noted, Chamberlin failed to achieve his objective of developing a theory to replace perfect competition as a point of departure for economic analysis. However, four aspects of the debate that resulted in TMC’s defeat are of interest here. First, all participants in the debate agreed that static equilibrium methodology—as developed in Chamberlin’s “formal” theory—was the appropriate procedure. Although Marshall ([1890] 1949) gave equal prominence to both evolutionary and mechanistic (i.e., static–equilibrium) metaphors, by 1950 the evolutionary metaphor had been abandoned in economics (Foss 1991), and the neoclassical research tradition “hardened” (Lakatos 1978) around static equilibrium, profit-maximization, firms-are-cost-curves, perfect competition, and the language of mathematics. Marshall’s evolutionary, dynamic approach was dismissed in mainstream economics as his “prattle about the biological method” (Samuelson 1967, 112; italics added).

Consequently, in mainstream economics, the term “competition” lost its Adam Smith roots concerning the rivalry between and among firms. “Competition” became synonymous with “perfect competition,” which is why the adjective *perfect* is often dropped in academic discourse as redundant with, simply, *competition* (Hunt 2000). For example, readers should note that Chamberlin (1962, 296) himself calls monopolistic competition “a hybrid theory of monopoly and competition,” instead of a hybrid theory of monopoly and *perfect* competition.

Second, the debate’s participants ignored, dismissed, and rejected Chamberlin’s “informal” theory. Specifically, they ignored his appeal that economic theory needs a new standard for evaluating welfare effects because “*pure competition may no longer be regarded as in any sense an ‘ideal’ for purposes of welfare economics*” (Chamberlin 1962, 214; italics in original). Furthermore, participants provided no answer to his famous question: “if we are to imagine a purely competitive automobile industry, will its homogeneous product be Packards, Plymouths, or Peugeots?” (Chamberlin 1954a, 259). Keppler’s (1994) review of the debates over TMC contains no analysis of Chamberlin’s argument against the use of perfect competition as the ideal, no answer to Chamberlin’s Packards–Plymouths–Peugeots question. Even Bishop’s (1967) discussion of the welfare effects of monopolistic competition, which is in a volume “in honor” of Chamberlin and TMC (1) starts from the position that Pareto-optimality is ideal, (2) focuses on the problem of determining the “optimal product

variety,” and (3) concludes that, for monopolistic competition, there are “practical limitations standing in the way of any thoroughgoing application of . . . ideal welfare principles” (263).

Third, the debates over TMC became intertwined with the controversies concerning the philosophy of economic science (the “realism” of assumptions issue) and the extent to which government should intervene in the economy by means of regulation and legislation. In this debate, the two sides are often considered to be the “Chicago school” versus the “Harvard school.” Thus, Stigler ([1949] 1983), of the Chicago school, writes that monopolistic competition fails the crucial test for viable economic theories. For him, this test is that the theory must make interesting and accurate predictions:

The purpose of the study of economics is to permit us to make predictions about the behavior of economic phenomena under specified conditions. The sole test of the usefulness of an economic theory is the concordance between its predictions and the observable course of events. Often a theory is criticized or rejected because its assumptions are “unrealistic.” . . . This is a most unreasonable burden to place upon a theory: the role of description is to particularize, while the role of theory is to generalize. (Stigler [1949] 1983, 319)

Friedman’s (1953) famous essay expanded Stigler’s discussion and claimed that the “relevant question to ask about the ‘assumptions’ of a theory is not whether they are descriptively ‘realistic,’ but whether they are sufficiently good approximations for the purpose in hand” (15).⁶ That is, the key question is whether a theory’s assumptions are “close enough” to the real world that it can make accurate predictions. For the Chicago school, perfect competition is argued to be close enough to real-world competition and, therefore, is to be preferred over TMC. Furthermore, for the Chicago school, government intervention in the economy is to be avoided because those firms that do not act in accordance with perfect competition (e.g., do not profit maximize) will be selected out in the evolutionary *process* of competition.

In contrast, the “Harvard school” believes that TMC showed that existing competition in existing economies is *imperfect*, which provides grounds for significant government intervention to correct imperfections. For example, Samuelson (1967) argues that “Chicago writers are simply wrong in denying that . . . reality will falsify many of the important qualitative and quantitative predictions of the [perfectly] competitive model” (108).⁷ Indeed, “free enterprise can lead to greater inefficiency than either monopoly or ideal planning or a perfectly competitive configuration . . . [and it is not the case] that the wastes of imperfect competition under *laissez-faire* are small, or preferable to what would result from some government interferences” (125, 136). Therefore, for the Harvard school, TMC provides theoretical justification for government intervention.

Readers should note that neither the Chicago school nor the Harvard school acknowledges any legitimacy to the

“informal” theory of TMC. That is, neither side agrees with Chamberlin that perfect competition is “in no sense ideal.” Furthermore, neither side sees any benefit to allowing consumers, as Chamberlin puts it, to prefer—and purchase—Packards over Plymouths or Smith’s sausages over those of Jones. Therefore, it is no surprise that the standard treatment of TMC in economics’ textbooks is:

In the end, we can conclude only that monopolistically competitive markets do not have all the desirable welfare properties of perfectly competitive markets. That is, the invisible hand does not ensure that total surplus is maximized under monopolistic competition. Yet because the inefficiencies are subtle, hard to measure, and hard to fix, there is no easy way for public policy to improve the market outcome. (Mankiw 1998, 370)

In short, allowing consumers to prefer and purchase Packards over Plymouths or Smith’s sausages over those of Jones is a *problem* because allowing consumers the freedom to choose introduces “inefficiencies” in the economy.

Economics and TMC: An Evaluation

Although it might have been reasonable to assume in the 1930s and 1940s that the primary effect of heterogeneity of supply in most industries is that it introduces “inefficiencies,” it is not a reasonable position in the twenty-first century. Schumpeter (1950, 106, 110; italics added) was prescient:

What we have got to accept is that it [the imperfect competition of large corporations] has come to be the most powerful engine of . . . the long-run expansion of total output . . . In this respect, perfect competition is not only impossible but inferior, and has not title to being set up as a model of regulation of industry . . . It is therefore quite wrong . . . to say . . . that capitalist enterprise was one, and technological progress a second, distinct factor in the observed development of output; they were essentially one and the same thing, as . . . the former was the *propelling force* of the latter.

Since the time of Schumpeter (1950), studies of innovation routinely stress the role of profit-oriented firms in industries characterized by heterogeneous supply. Studies of innovations in industries such as machine tools (Rosenberg 1963), aircraft (Constant 1980), synthetic chemicals (Freeman 1982), metallurgy (Mowery and Rosenberg 1989), and semiconductors (Dosi 1984) all support the view that the pursuit of increased profits in “monopolistically” competitive industries prompts innovations. To those who cling to the view that innovations and technological progress are exogenous to competition, Grossman and Helpman (1994, 32) ask “What would the last century’s growth performance have been like without the invention and refinement of methods for generating electricity and using radio waves to transmit sound, . . . and without the design and development of products like the automobile, the airplane, the transistor, the integrated circuit, and the computer?” They believe the answer to their query is obvious.

In short, the existence of intra-industry heterogeneity of supply in industries characterized by product differentiation and monopolistic competition is not a *problem* to be *solved* because of “inefficiencies.” Rather, its existence is a *desirable situation* to be *recommended* because it prompts the innovations that promote increases in productivity and economic growth. For Romer (1994, 11, 14), a leading scholar of economic growth, “it is obvious in retrospect that endogenous growth theory would have to introduce imperfect [monopolistic] competition, . . . [which implies] the passing of perfect competition.” (See Hunt [1997] for how resource-advantage theory provides a theoretical foundation for endogenous growth models.)

Marketing and TMC

Because (1) marketing scholars should know their discipline’s intellectual history (Jones and Keep 2009; E. H. Shaw 2009) and (2) Chamberlin’s TMC played a significant role in developing marketing theory and thought, then (3) contemporary marketers should know the history and characteristics of TMC. Indeed, Chamberlin’s TMC, through its impact on Alderson and others, such as Fisk and Dixon (1967) and Narver and Savitt (1971), provides a foundation for the assumptions of heterogeneous, intra-industry demand and supply, both of which are staples of contemporary marketing theory and thought (e.g., Hunt and Morgan 1995).

In addition, TMC’s stress on the desirability of allowing consumers the freedom to choose from among the market offerings of marketplace rivals accords well with the marketing concept, as well as the market orientation of many firms (e.g., Kohli and Jaworski 1990; Slater and Narver 1994). Furthermore, recall that TMC’s recognition that heterogeneity of supply is natural in macromarketing systems (Layton 2009) because there are natural “[p]eculiarities of any individual establishment which cannot be duplicated . . . [such as] reputation, skill, and special ability . . . [that result in] returns which cannot be reduced by others moving in to share them” (Chamberlin 1962, 112). Therefore, TMC can be viewed as one of the forerunners—along with Penrose (1959)—of the resource-based and competence-based views of strategy (e.g., Aaker 1995; Barney 1991; Day and Nedungadi 1994; Heene and Sanchez 1996; Wernerfelt 1984). In addition, Hunt (2000) acknowledges the contribution of Chamberlin to the development of resource-advantage theory, which is argued to be toward a general theory of marketing. To macromarketing and micromarketing theory and thought, TMC offers all these contributions.

Here, we focus on the contributions of TMC to marketing strategy. Specifically, we argue that TMC has the ability to inform a key issue in marketing strategy, which we label “the product differentiation vs. market segmentation” controversy.

The Nature of the Product Differentiation Controversy

Although the concept “differentiation” in marketing traces at least back to Shaw’s (1912) observation that there is an

“increasing differentiation of commodities,” there is still much confusion as to what product differentiation is and how it relates to market segmentation. As Dickson and Ginter (1987) point out, some marketing articles and texts describe product differentiation and market segmentation as *alternative* strategies, while others see product differentiation as a *complement* or a means to implement a strategy of segmentation. Furthermore, when marketers distinguish between “differentiated” and “undifferentiated” strategies, “the potential for misunderstanding is exacerbated . . . [because] where product *differentiation* is discussed as an alternative to market segmentation, it is described as being an *undifferentiated* marketing strategy” (Dickson and Ginter 1987, 1; italics added). Since the documentation of the problem by Dickson and Ginter, the confusion concerning product differentiation and market segmentation continues, with some marketers attempting to resolve the controversy by maintaining that differentiation is *both* an alternative to and a means to implement a segmentation strategy (Schnaars 1998).

Therefore, the product differentiation controversy in marketing centers on what product differentiation is and whether it is an alternative or complement to market segmentation. Chamberlin’s TMC, we argue, can inform marketing thought by (1) showing how the confused status of product differentiation versus market segmentation came about and (2) suggesting insights for resolving the controversy.

Smith (1956) and the Product Differentiation Controversy

The concept of product differentiation entered the modern marketing literature in Smith’s (1956) classic article, for which he received the Paul D. Converse Award in 1981.⁸ Although (1) A. W. Shaw’s (1916) use of “market contours” was an early academic forerunner of what is now called “market segmentation” in marketing, and (2) Wheeler (1935) used the term “segment” in library studies to indicate groups of consumers in the 1930s, and (3) Hollander and Germain (1992) trace the actual *practice* of market segmentation to at least as early as the 1880s, it was Smith’s seminal article that prompted the stream of literature that has resulted in market segmentation being a key component of marketing strategy (Dibb 1995, 2001; Dibb and Simkin 2009; Hooley and Saunders 1998). Indeed, market segmentation strategy is “one of the most widely held theories in strategic marketing” (Piercy and Morgan 1993, 123), is “considered one of the fundamental concepts of modern marketing” (Wind 1978, 317), is “the key strategic concept in marketing today” (Myers 1996, 4), and is one of the basic “building blocks” of marketing (Layton 2002, 11). Essentially, the thesis of market segmentation strategy is that, to achieve competitive advantage and, thereby, superior financial performance, firms should identify segments of demand, target specific segments, and develop specific marketing “mixes” for each targeted market segment (Hunt and Arnett 2004).

Notice, however, that Smith (1956) considers market segmentation to be an *alternative* to product differentiation. What,

then, for Smith, is product differentiation? At the outset, we note that Smith mentions that the source of his article was “the work of Robinson and Chamberlin” (3).⁹ In addition, Smith’s (1978, 1982) two retrospects acknowledge the influence of Alderson, who, in turn, gave much credit to Chamberlin. Therefore, we might expect that Smith would adopt Chamberlin’s definition, which focuses on the state of affairs in an industry characterized by different consumer preferences for different suppliers’ products, which are based on “real or fancied” differences in those products.

Furthermore, recall that at the time of Smith’s writing, Chamberlin had already developed his informal theory argument that product markets are “fundamentally heterogeneous” (Chamberlin 1954b, 33). Summarized succinctly, this argument is that because in most industries (1) heterogeneous, intra-industry demand is natural (i.e., consumers in, say, the automobile market, have different tastes, preferences, incomes, and use requirements) and (2) heterogeneous, intra-industry supply is natural (i.e., individuals and firms in, say, the automobile industry have different skills and capabilities), then (3) products will be differentiated in most industries (including the automobile industry), and therefore (4) the concept of the *industry* demand curve in economics represents a “snare and delusion” (Chamberlin 1950, 86).

Although Smith (1956) could have followed Chamberlin’s lead, he did not. Instead, he defines, “In its simplest terms, *product differentiation* is concerned with the bending of the will of demand to the will of supply, . . . securing a measure of control over the demand for a product by advertising or promoting differences between a product and the products of competing sellers, . . . [which] result[s] in prices that are somewhat above the equilibrium levels associated with perfectly competitive market conditions” (Smith 1956, 5).

An interpretation of Smith (1956). One interpretation of Smith’s classic article is that it agreed with the winner’s side of the TMC debate in economics. That is, it accepted the standard, neoclassical argument: because in most industries (1) homogeneous, intra-industry demand is “close enough” to being natural (and any observed differences in tastes, preferences, and use requirements are artificial, contrived, and resulting from advertising), and (2) homogeneous, intra-industry supply is “close enough” to being natural (i.e., individuals and firms in the factor markets are relatively uniform as to their skills and capabilities), then (3) the natural state of affairs in most industries is that products will be homogenous, and therefore (4) efficiency will be maximized.¹⁰ Indeed, as economics’ historians have noted, “under monopolistic competition . . . prices are, as it were, two steps higher . . . because selling costs must be added, and . . . because the demand curve is tipped from the horizontal” (Kuhn 1970, 194).

Therefore, Smith’s “bending the will of demand to the will of supply” can be interpreted as a firm in an industry taking its naturally occurring, horizontal demand curve and artificially tipping, tilting, or sloping it downward. Such an interpretation would imply that Smith believed that homogeneous, intra-

industry demand and supply are natural. In addition, it would imply that product differentiation strategy is an *alternative* to market segmentation strategy. As evidence of this interpretation, note that Smith (1956, 5) maintains that the purpose of product differentiation strategy is “to establish firm market positions and/or to insulate their business against price competition.” Call this first interpretation the “resisting homogeneity” view, which accords well with the neoclassical economics’ view.

A second interpretation of Smith (1956). There is a second interpretation of Smith’s product differentiation strategy that can be inferred from his “bending the will of demand to the will of supply.” The second interpretation is that in most industries (1) heterogeneous, intra-industry demand is natural and (2) heterogeneous, intra-industry supply is natural, but (3) as a matter of corporate strategy, a firm may decide to *ignore* the heterogeneity of demand and (4) produce and market a single, standardized product, which it then (5) promotes vigorously. In such an interpretation, “bending the will of demand to the will of supply” is not to tilt or slant a firm’s naturally occurring, horizontal demand curve. Rather, it is to ignore all the naturally occurring, tilted, or slanted demand curves facing the firm and treat the marketplace as if it were a single, homogeneous market. Call this second interpretation the “ignoring heterogeneity” view.

There is much in Smith’s (1956) article that supports the “ignoring heterogeneity” interpretation. Note that Smith recognized that most industries have “a diversity in supply” that results from differences in producers’ “specialized or superior resources” (1956, 3). In addition, note that Smith maintains that “the strategy selected may consist of a program designed to bring about the *convergence* of individual market demands for a variety of products upon a single or limited offering to the market” (1956, 3; italics in original). Furthermore, he maintains that through “product differentiation . . . variations in the demands of individual consumers are minimized or brought into line by means of effective use of appealing product claims designed to make a satisfactory volume of demand *converge* upon the product or product line being promoted, . . . [which is] the marketing counterpart to standardization and mass production in manufacturing” (1956, 3). Indeed, product differentiation “seeks to secure a layer of the market cake, whereas one who employs market segmentation strives to secure one or more wedge-shaped pieces” (1956, 5).

Toward Resolving the Controversy

The preceding warrants, I argue, two conclusions. First, there are more passages in Smith (1956) that support the “ignoring heterogeneity” interpretation of Smith’s argument than there are that coincide with the “resisting homogeneity” view. Therefore, the “ignoring heterogeneity” view dominates the “resisting homogeneity view.” Second, there clearly is a *strategy* that is consistent with the ignoring heterogeneity view. This strategy would entail: (1) ignore the various market

segments, (2) treat the marketplace as a whole, (3) produce a single, standardized product, and (4) try to “bend the will of [heterogeneous] demand” by convincing a significant share of consumers to purchase the product that one chooses to produce. Note that some firms may, indeed, decide to ignore heterogeneity and promote heavily a single version of a product when, for example, tailoring different products for different market segments is viewed as too costly. Note also that the strategy would properly be considered an *alternative* to market segmentation.

The preceding implies that Smith’s (1956) article did describe two alternative strategies, but his labeling of the strategies was problematic. Indeed, the label “product differentiation” was a “relatively poor choice” (Hollander and Germain 1992, 109) for signifying the standardized product strategy implied by firms’ ignoring heterogeneity in demand. This is because producing a single product contradicts a portion of the clear English meaning of joining “product” with “differentiation.” That is, any phrase containing *product* and *differentiation* should involve products or product versions that are in some ways different. The academic usage of terms may differ from the usage of words in conversational English, but it is bad form for academic usage to *contradict* conversational English. Contradictions invite confusing communications—as it has in the product differentiation versus market segmentation controversy.

If “product differentiation” fits poorly the strategy embodied in the ignoring heterogeneity interpretation, what is a better label? Consider products as bundles of attributes, as argued by Lancaster (1979) and the multiattribute models in consumer behavior (e.g., Fishbein and Ajzen 1975). Essentially, the strategy embodied in the ignoring heterogeneity interpretation consists of producing one particular bundle of attributes that may fit no market segment *well* but may fit multiple market segments *adequately*. Given the emphasis placed on promotion by Smith, such a strategy might be described as a *promotion-enhanced, standardized product* strategy, and it might be best labeled a “mass market” strategy. In these terms, it is the *mass market* strategy that Smith (1956) viewed as prevalent in his time and that he was arguing *against*. Furthermore, Smith provides ample evidence as to how he would compare the relative merits of a market segmentation strategy versus a mass market (i.e., promotion-enhanced, standardized product) strategy. For him (1956, 6), “market segmentation . . . will not be denied.” Half a century later, his view still holds.

Conclusion

Chamberlin’s theory of monopolistic competition, like the work of Alderson, deserves revisiting. Marketing scholars should know their discipline’s intellectual history, to which Chamberlin’s TMC significantly contributed. Chamberlin’s TMC, through its impact on Alderson and others, provides a foundation for the assumptions of heterogeneous, intra-industry demand and heterogeneous, intra-industry supply, both of which are staples of contemporary macromarketing and micromarketing theory and thought. In addition, TMC’s view that allowing consumers the

freedom to choose from among the different market offerings of marketplace rivals accords well with the theory and strategy underlying both the marketing concept and the market orientation. It also accords well with what we now know from the economics of economic growth literature about how monopolistic competition promotes the increases in productivity required for economic growth. Furthermore, TMC’s recognition that heterogeneity of supply is natural may be viewed as a forerunner of the resource-based and competence-based views of strategy. All these contributions warrant the incorporation of TMC into marketing theory and thought.

The author shows how TMC can *also* inform a key issue in marketing strategy, the product differentiation controversy. Based on TMC and the preceding analysis, several recommendations are supported. First, “product differentiation” or “the product in an industry is differentiated” should be used to refer to the state of affairs in an industry characterized by heterogeneity of demand and supply, in which “buyers will be paired with sellers, not by chance and at random (as under pure competition), but according to their preferences” Chamberlin 1962, 56). This state of product differentiation should not be considered an “imperfection,” but a key component of a kind of competition that, because of its association with the innovations that result in increases in productivity and economic growth, has positive welfare implications.

Second, “product differentiation” is not an alternative to market segmentation. Indeed, one should avoid using “product differentiation” in conjunction with “strategy.” Rather, “product differentiation” may be used to describe a portion of the process by which a market segmentation strategy is implemented. That is, in a market segmentation strategy, firms tailor their market offerings for particular market segments, which then results in products being “differentiated” in the marketplace. However, using “product differentiation” as a means of describing the implementation of a market segmentation strategy should probably be avoided because it invites confusion. That is, many readers who have read Smith’s (1956) famous article or have been exposed to the standard, economics, “resisting homogeneous demand” interpretation of Smith’s position will be confused when “differentiation” is used to identify firms that tailor their market offerings for particular market segments.

Third, the label “mass market” strategy can be used to identify those firms whose strategy is to resist the natural heterogeneity of demand in the marketplace by vigorously promoting a standardized product. That is, they choose not to engage in a market segmentation strategy, despite the fact that “market segmentation may be regarded as a force in the market that will not be denied” (Smith 1956, 6). Again, the academic usage of terms should not directly contradict the common meaning of terms in standard, conversational English, and “differentiation,” if it implies anything, implies that a firm is not producing a standardized product for the marketplace.

Chamberlin’s TMC warrants a place in contemporary macromarketing and micromarketing theory and thought. Indeed, marketing theory and thought can be enriched by incorporating the

theory of monopolistic competition. Consistent with the admonitions of Wilkie and Moore (2003), significant benefits accrue to marketing in era four when scholars acknowledge the contributions of those in eras one, two, and three. Perhaps, more importantly, benefits accrue when marketing scholars *understand* how the contributions of those in previous eras shaped the contours of contemporary theory and thought.

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Notes

1. Keppler (1994) and Kuenne (1967), as well as the bibliography in Chamberlin (1962), provide good summaries and detailed sources of the debates.
2. Hollander et al. (2005) provide an analysis of the purposes, advantages, problems, and limitations of periodizing marketing history and the history of marketing thought. For them, “the most appropriate technique for periodizing marketing history is to use turning points in the material itself being studied” (2005, 39). Witkowski (2010) argues, in contrast to Wilkie and Moore (2003), that marketing’s “first era” came to an end in 1936–1937, with the launch of the *Journal of Marketing* and the establishment of the American Marketing Association.
3. As pointed out by a reviewer, other voices that extended/complemented the theses of Chamberlin and Robinson include Bain (1954, 1956, 1968), Clark (1954, 1961), and Holdren (1965). In marketing, see Hunt (2000) for the implications of these works for dynamic competition theory.
4. The difference between Chamberlin’s “pure competition” and “perfect competition” is that the latter, but not the former, includes perfect knowledge. Because this difference plays no role in the issues examined in this article, “pure” and “perfect,” are used interchangeably.
5. In marketing, Hunt (2000) provides a useful summary of TMC. Our discussion in this section draws on his summary.
6. In marketing, Shugan (2007) takes the Friedman (1953) position, and Tsang (2009) argues to the contrary.
7. Note that Samuelson saw it as redundant to put “perfectly” before “competitive model.”
8. Goodman’s (1986) historical paper notes that Smith’s 1956 *Journal of Marketing* article was an extended and revised version of an article entitled “Imperfect Competition and Marketing Strategy,” which was published in 1955 in Alderson’s *Cost and Profit Outlook*.
9. Consistent with many works published in the *Journal of Marketing* in the 1950s, Smith (1956) does not cite specific works of Chamberlin, only “Chamberlin.”
10. Readers should note the use of the word “most” in the standard neoclassical argument. As a reviewer points out, there are, indeed, *some* markets that are close enough to being homogeneous that industry demand and supply curves are meaningful. For more on this issue, see Hunt (2000, 197-9). For a discussion of the use of “close enough” in antitrust, see Hunt and Arnett (2001).

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