The Wheel of Retailing

- STANLEY C. HOLLANDER

New types of retailing frequently start off with crude facilities, little prestige, and a reputation for cutting prices and margins. As they mature, they often acquire more expensive buildings, provide more elaborate services, impose higher margins, and become vulnerable to new competition.

The author examines the history of numerous retail institutions to determine if this process really constitutes a "natural law of retailing."

"The wheel of retailing" is the name Professor Malcolm P. McNair has suggested for a major hypothesis concerning patterns of retail development. This hypothesis holds that new types of retailers usually enter the market as low-status, low-margin, low-price operators. Gradually they acquire more elaborate establishments and facilities, with both increased investments and higher operating costs. Finally they mature as high-cost, high-price merchants, vulnerable to newer types who, in turn, go through the same pattern. Department-store merchants, who originally appeared as vigorous competitors to the smaller retailers and who have now become vulnerable to discount house and supermarket competition, are often cited as prime examples of the wheel pattern.¹

Many examples of conformity to this pattern can be found. Nevertheless, we may ask: (1) Is this hypothesis valid for all retailing under all conditions? (2) How accurately does it describe total American retail development? (3) What factors cause wheel-pattern changes in retail institutions?

The following discussion assembles some of the slender empirical evidence available that might shed some light on these three questions. In attempting to answer the third question, a number of hypotheses should be considered that marketing students have advanced concerning the forces that have shaped retail development.

TENTATIVE EXPLANATIONS OF THE WHEEL

(A) Retail Personalities. New types of retail institutions are often established by highly aggressive, cost-conscious entrepreneurs who make every penny count and who have no interest in unprofitable frills. But, as P. D. Converse has suggested, these men may relax their vigilance and control over costs as they acquire age and wealth. Their successors may be less competent. Either the innovators or their successors may be unwilling, or unable, to adjust to changing conditions. Consequently, according to this view, deterioration in management causes movement along the wheel.²

(B) Misguidance. Hermann Levy has advanced the ingenious, if implausible, explanation that retail trade journals, seduced by profitable advertising from the store equipment and supply industry, coax merchants into superfluous "modernization" and into the installation of overly elaborate facilities.\(^7\)

(C) Imperfect Competition. Although retail trade is often cited as the one type of business that approaches the Adam Smith concept of perfect competition, some economists have argued that retailing actually is a good example of imperfect competition. These economists believe that most retailers avoid direct price competition because of several forces, including resale price maintenance, trade association rules in some countries, and, most important, the fear of immediate retaliation. Contrariwise, the same retailers feel that service improvements, including improvements in location, are not susceptible to direct retaliation by competitors. Hence, through a ratchet process, merchants in any established branch of trade tend to provide increasingly elaborate services at increasingly higher margins.\(^4\)

(D) Excess Capacity. McNair attributes much of the wheel effect to the development of excess capacity, as more and more dealers enter any branch of retail trade.\(^5\) This hypothesis rests upon an imperfect competition assumption, since, under perfect competition excess capacity would simply reduce margins until the excess vendors were eliminated.

(E) Secular Trend. J. B. Jefferys has pointed out that a general, but uneven, long-run increase in the British standard of living provided established merchants with profitable opportunities for trading up. Jefferys thus credits adjustments to changing and wealthier market segments as causing some movement along the wheel. At the same time, pockets of opportunity have remained for new, low-margin operations because of the uneven distribution of living-standard increases.\(^6\)

(F) Illusion. Professor B. Holdren has suggested in a recent letter that present tendencies toward scrambled merchandising may create totally illusory impressions of the wheel phenomenon. Store-wide average margins may increase as new, high-markup lines are added to the product mix, even though the margins charged on the original components of that mix remain unchanged.

DIFFICULTIES OF ANALYSIS

An examination of the actual development of retail institutions here and abroad does shed some light on both the wheel hypothesis and its various explanations. However, a number of significant difficulties hinder the process.

(1) Statements concerning changes in retail margins and expenses are the central core of the wheel hypothesis. Yet valid information on historical retail expense rates is very scarce. Long-run changes in percentage margins probably do furnish fairly reliable clues to expense changes, but this is not true over short or intermediate periods. For example, 1957 furniture-store expense rates were about 5 percentage points higher than their 1949-1951 average, yet gross margins actually declined slightly over the same period.\(^7\)

(2) Historical margin data are somewhat more plentiful, but these also have to be dredged up from fragmentary sources.\(^8\)

(3) Available series on both expenses and margins merely note changes in retailers' outlays and receipts. They do not indicate what caused those changes and they do not report changes in the costs


\(^{9}\) Same reference as footnote 1.
borne by suppliers, consumers, or the community at large.

(4) Margin data are usually published as averages that may, and frequently do, mask highly divergent tendencies.

(5) A conceptual difficulty presents an even more serious problem than the paucity of statistics. When we talk about "types" of retailers, we think of classifications based upon ways of doing business and upon differences in price policy. Yet census categories and other systems for reporting retail statistics are usually based upon major differences in commodity lines. For example, the "pineboard" druggists who appeared in the 1930s are a "type" of retailing for our purposes. Those dealers had cruder fixtures, charged lower prices, carried smaller assortments, gave more attention to turnover, and had less interest in prescriptions than did conventional druggists. Yet census reports for drugstores necessarily included all of the pineboards that maintained any sort of prescription department.

Discount houses provide another example of an important, but amorphous, category not reflected in census classifications. The label "discount house" covers a variety of retailers. Some carry stocks, others do not. Some have conventional store facilities, whereas others operate in office buildings, lofts, and warehouses. Some feature electrical appliances and hard goods, while others emphasize soft goods. Some pose as wholesalers, and others are practically indistinguishable from all other popular priced retailers in their fields. Consequently discount dealers' operating figures are likely to be merged into the statistics reported for other appliance, hardware, or apparel merchants.

EXAMPLES OF CONFORMITY

British

British retailing provides several examples of conformity to the wheel pattern. The grocery trade has gone through several wheel-like evolutions, according to a detailed analysis made by F. G. Pennance and B. S. Yamey. Established firms did initiate some changes and some margin reductions, so that the pattern is obscured by many cross currents. But the major changes seem to have been due to the appearance and then the maturation, first, of department-store food counters; then, of chain stores; and finally, of cut-price cash-and-carry stores. Now supermarkets seem to be carrying the pattern through another evolution.10

Jefferys also has noted a general long-run upgrading in both British department stores and chains.11 Vague complaints in the co-operative press and a decline in consumer dividend rates suggest that wheel-like changes may have occurred in the British co-operative movement.12

American

Very little is known about retail margins in this country before the Civil War. Our early retail history seems to have involved the appearance, first, of hawkers, walkers, and peddlers; then, of general stores; next, of specialty stores; and finally, of department stores. Each of these types apparently came in as a lower-margin, lower-price competitor to the established outlets, and thus was consistent with the wheel pattern. We do not know, however, whether there was simply a long-run decline in retail margins through successive improvements in retail efficiency from one type to another (contrary to the wheel pattern), or whether each of the early types was started on a low-margin basis, gradually "up-graded," and so provided room for the next entrant (in accordance with the pattern).

The trends toward increasing margins can be more easily discerned in many branches of retailing after the Civil War. Barger has described increases over the years 1869-1947 among important retail

11 Same reference as footnote 6.
segments, including department stores, mail-order firms, variety stores, and jewelry dealers. He attributes much of the pre-World War I rise in department-store margins to the absorption of wholesaling functions. Changes in merchandise mix, such as the addition of soda fountains and cafeterias to variety stores and the upgrading of mail-order merchandise, seem to have caused some of the other increases. Finally, he believes changes in customer services have been a major force in raising margins.

Fabian Linden has extended Barger's observations to note similar 1949-1957 margin increases for department stores, variety chains, and appliance dealers.

Some other examples of at least partial conformity to the wheel pattern may be cited. Many observers feel that both discount-house services and margins have increased substantially in recent years. One major discount-house operator has stated that he has been able to keep his average markup below 12%, in spite of considerable expansion in his facilities and commodity mix. However, the consensus seems to be that this probably is an exception to the general rule.

A study of gasoline pricing has pointed out how many of the so-called "off-brand" outlets have changed from the "trackside" stations of pre-war days. The trackside dealers typically maintained unattractive and poorly equipped installations, at out-of-the-way locations where unbranded gasoline was sold on a price basis. Today many of them sell well-promoted regional and local brands, maintain attractive, efficient stations, and provide prompt and courteous service. Some still offer cut prices, but may have raised their prices and margins up to or above national brand levels. Over time, many of the pineboard druggists also seem to have become converted to fairly conventional operations.

NON-CONFORMING EXAMPLES

Foreign

In underdeveloped countries, the relatively small middle- and upper-income groups have formed the major markets for "modern" types of retailing. Supermarkets and other modern stores have been introduced in those countries largely at the top of the social and price scales, contrary to the wheel pattern. Some non-conforming examples may also be found in somewhat more industrialized environments. The vigorous price competition that developed among Japanese department stores during the first three decades of this century seems directly contrary to the wheel hypothesis. B. S. Yamey's history of resale price maintenance also reports some price-cutting by traditional, well-established British merchants who departed from the wheel pattern in the 1880s and 1890s. Unfortunately, our ignorance of foreign retail history hinders any judgment of the representativeness of these examples.

American

Automatic merchandising, perhaps the most "modern" of all American retail institutions, departed from the wheel pattern by starting as a high-cost, high-margin, high-convenience type of retail-


ing. The department-store branch movement and the concomitant rise of planned shopping centers also has progressed directly contrary to the wheel pattern. The early department-store branches consisted of a few stores in exclusive suburbs and some equally high-fashion college and resort shops.

Only in relatively recent years have the branches been adjusted to the changing and more democratic characteristics of the contemporary dormitory suburbs. Suburban shopping centers, too, seem to have appeared first as “Manhasset Miracle Miles” and “Ardmores” before reaching out to the popular price customers. In fact, complaints are still heard that the regional shopping centers have displayed excessive resistance to the entry of really aggressive, low-margin outlets. E. R. A. Seligman and R. A. Love’s study of retail pricing in the 1930s suggests that pressures on prices and margins were generated by all types of retailers. The mass retailing institutions, such as the department and chain stores, that had existed as types for many decades were responsible for a goodly portion of the price cutting. As McNair has pointed out, the wheel operated very slowly in the case of department stores.

Finally, Harold Barger has described the remarkable stability of over-all distributive margins during the years 1919-1947. Some shifting of distributive work from wholesalers to retailers apparently affected their relative shares of the total margins during this period, but this is not the type of change contemplated by the wheel pattern. Of course, the stability Barger notes conceivably could have been the result of a perfectly smooth functioning of the pattern, with the entrance of low-margin innovators providing exactly the right balance for the upcreep of margins in the longer established types. But economic changes do not come in smooth and synchronized fashion, and Barger’s data probably should indicate considerably wider oscillations if the wheel really set the mold for all retailing in the post-war period.

CONCLUSIONS

The number of non-conforming examples suggests that the wheel hypothesis is not valid for all retailing. The hypothesis, however, does seem to describe a fairly common pattern in industrialized, expanding economies. Moreover, the wheel is not simply an illusion created by scrambled merchandising, as Holdren suggests. Undoubtedly some of the recent “upcreep” in supermarket average margins is due to the addition of nonfood and other high margin lines. But in recent years the wheel pattern has also been characteristic of department-store retailing, a field that has been relatively unreceptive to new commodity groups.

In some ways, Jefferys’ secular trend explanation appears most reasonable. The tendency of many established retailers to reduce prices and margins during depressions suggests also that increases may be a result of generally prospering environments. This explanation helps to resolve an apparent paradox inherent in the wheel concept. Why should reasonably skilled businessmen make decisions that consistently lead their firms along seemingly profitable routes to positions of vulnerability? Jefferys sees movement along the wheel as the result of sensible, business-like decisions to change with prospering market segments and to leave the poorer customers to low-margin innovators. His explanation is supported by the fact that


Same reference as footnote 8, pp. ix, x.
the vulnerability contemplated by the wheel hypothesis usually means only a loss of market share, not a loss of absolute volume. At least in the United States, though, this explanation is partially contradicted by studies showing that prosperous consumers are especially prone to patronize discount houses. Also they are equally as likely to shop in supermarkets as are poorer consumers.\(^7\)

The imperfect competition and excess capacity hypotheses also appear highly plausible. Considerably more investigation is needed before their validity can be appraised properly. The wheel pattern developed very slowly, and very recently in the department-store field. Yet market imperfections in that field probably were greater before the automobile gave the consumer shopping mobility. Major portions of the supermarket growth in food retailing and discount-house growth in appliance distribution occurred during periods of vastly expanding consumption, when excess capacity probably was at relatively low levels. At the moment there is little evidence to suggest any clear-cut correlation between the degree of market imperfection and the appearance of the wheel pattern. However, this lack may well be the result of the scarcity of empirical studies of retail competition.

Managerial deterioration certainly must explain some manifestations of the wheel, but not all. Empires rise and fall with changes in the quality of their leadership, and the same thing seems true in business. But the wheel hypothesis is a hypothesis concerning types of retailing and not merely individual firms. Consequently, the managerial-deterioration explanation holds true only if it is assumed that new people entering any established type of retailing as the heads of both old and new companies are consistently less competent than the first generation. Again, the fact that the wheel has operated very slowly in some fields suggests that several successive managerial generations can avoid wheel-like maturation and decay.

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