

Economic Drivers
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“Virtue is excellence, something uncommonly great and beautiful, which rises far above what is vulgar and ordinary.”

“Consumption is the sole end and purpose of all production; and the interest of the producer ought to be attended to, only so far as it may be necessary for promoting that of the consumer.”
---Adam Smith (1723–1790)

Purpose:

The primary purpose of this document is to augment the strategic formulation and implementation material typically found in a management or strategy textbook. The benefit and cost drivers are rooted in core economic principles, such as fixed costs, variable costs, average costs, marginal costs, opportunity costs, transactions costs, diversification, etc. There are key competition and technology drivers that influence market position and overall success as well.

Rather than presenting the mathematics of the underlying economic principles, aphorisms and pithy quotes are used as helpful learning mnemonics.

Benefit Drivers:

Benefit drivers typically have a key *consumer*-oriented attribute, such as increases in actual or perceived quality. Benefit drivers form the basis on which a firm can *differentiate itself*. Strategic use of benefit drivers leads to increases in profits through *increases in revenues*.

1. Physical Characteristics

(“You only get one chance to make a first impression.”)

“Within General Motors both the Cadillac and Chevrolet vehicles share similar engine, transmission, and underframe components; however, the Cadillac line will have the upgraded body styles and offer more interior amenities.”

2. Service or Complementary Goods

(“If we give away the *razors*, we can sell them the *blades*.”)

“If we get the ink-jet printers into the hands of more users (at a relatively low margin), we can sell them print cartridges (at a relatively high margin).” “If we get the gaming consoles into the hands of the players (at a *good* margin), we can then sell them the games (at an even *better* margin) and then sell them expansion packs and such (at the *best* margin).” “A water filtration system needs filters.”

3. Sale or Delivery Factors

(“Marketing is the whole company as seen by the customer.”)

“Home Depot can recommend affiliate installers for a newly-purchased water heater.” “Major airlines offer frequent flyer miles with each transaction.” “‘In-N-Out’ has a secret menu.” “Many people keep their boxes from Tiffany’s.”

4. Expectations Enhancing
(“The customer didn’t know they needed it until we produced it.”)

“Apple’s view is that it creates products to drive what the consumer will believe she or he needs.” “A BMW isn’t a car.” “Gucci sells handbags to individuals who are looking to signal or improve their social and economic position in life.”

5. Subjective Features or Image
(“You don’t know me!”)

“Using social media to sell Lip Kits, and in just under three years, Kylie Jenner has become the youngest self-made billionaire in history.” “The sales of *pinot noir* wine went up dramatically after the film ‘Sideways’ was released.”

Cost Drivers:

Cost drivers typically have a key *production*-oriented attribute, such as decreases in average or marginal costs. Cost drivers explain why *costs vary across firms*. Strategic use of cost drivers leads to increases in profits through *decreases in expenses or capital expenditures*.

1. Size
(The *economy of scale* matters.)

“By bargaining for hamburger meat as a single, large organization, McDonalds can obtain the best price for hamburger meat, and therefore have the lowest average cost of food materials.” “The CSU system has 23 campuses, but often buys Library databases and other major goods and services as a single system.”

2. Experience
(“We are further down the *learning curve* than all or nearly all other firms.”)

“Andy Gump pioneered the business of renting portable toilets. Their employees are generally more knowledgeable than other firms; therefore, they tend to make fewer errors and omissions.” “Nobody ever got fired for buying IBM.”

3. Location
(“Some regional economies are built with plans for specialized and localized exchange.”)

“Initially, the film industry settled in Los Angeles. They needed plenty of undeveloped land, and they could film and shoot on location (with expensive equipment and personnel) all year around.” “FedEx and UPS planes are at Ontario airport; that region has an entire transportation and logistics ecosystem.”

4. Government Factors
(“It’s the economy, stupid.”)

“The State of New York lured the “Tonight Show” to New York by passing a law that offers tax incentives to major TV shows that relocate there.” “In general, corn farming and dairy milk is subsidized by the U.S. Government.”

5. Focus
(“Which *segment* of which vertical industry sector can we best succeed in?”)

“For many decades Volvo’s target market was suburban, dual-income, middle-class families with at least one child; therefore it should have relatively low advertising costs per each vehicle sold.” “Southwest Airlines only flies Boeing 737s; therefore, it should have lower costs for service and maintenance.”

6. Vertical Integration

(“How can we control more of the supply- and value-chain?”)

“Starbucks buys coffee beans on the open market but also owns a few of its own farms in South America to exert more control of coffee bean production process. This helps stabilize bean costs over time and also enables the growing of special beans.” “Amazon makes some its own movies (backward vertical integration), and also, leases some freight airplanes (forward vertical integration).”

7. Efficiency

(“How can we best leverage the net marginal change in our favor?”)

“It is better for Exxon to build a slightly larger diameter pipe to transport oil because while the circumference of a cylinder grows *linearly* ($2\pi r$), the corresponding volume grows *quadratically* (πr^2).” “For the same class section, a university can pay a college instructor to teach *four* times as many students for *two* times the amount of pay.” “Chipotle doesn’t pay dividends.”

Competition Drivers:

There are several other, general factors that can materially impact the above core benefit and cost drivers. Strategic use of competitive drivers leads to increases in profits by *creating and maintaining a dynamic market position* within one or more industries.

1. Horizontal Integration

(“In how many markets do we wish our organization to be successful in?”)

(“Should we plan to *stick to our knitting*?”)

“3M manufactures approximately 60,000 products across hundreds of business lines.” “Apple changed computing, phones, music, and movie animation.” “The Boy Scouts accepts girls.” “General Electric, General Motors, Coca-Cola, and Gap have all reduced their product lines significantly in the past few years.”

2. First-mover Advantage (“*bleeding edge*”) (“the early bird catches the worm”)

Second-mover Advantage (“*cutting edge*”) (“the second mouse gets the cheese”)

“Toyota had the first, viable hybrid vehicle: Prius. Toyota is now the largest auto manufacturer in the world. (First-mover advantage)” “Facebook has been much more successful than MySpace. (Second-mover advantage)”

3. Make-or-Buy

(“Do we need to *own* it—that is, do we need to own the *means of production*?”)

(“*Data is the new oil*; every business is now in the data business.”)

“Nike owns neither shoe factories nor shoe stores; for the most part they just manage their brand.” “Emirates Airlines wants to do more than just flying

customers as a part of a trip. In the future, they want to capture as much *data* about a passenger and the passenger's trip, and then do extensive *analytics* themselves." "Of the 84 cities in L.A. County, about half manage their own Police Departments while the other half contract with the County Sheriff."

4. Capital-for-Labor Substitution

("Robots will take over the world. Help! I've been replaced by a computer!")

"Both the VW plant in Germany and the LEGO plant in Denmark are huge, and both are nearly entirely automated." "Turnitin helps instructors check for plagiarism which is a very time-consuming task." "As the required minimum wage increases, McDonald's is using fewer human order-takers and using more touchscreens/kiosks to take orders." "AI systems can make some decisions."

5. Commitment

("At what point do I demonstrate that I have *skin in the game*?")

("When does the *talk* become the *walk*? How will others know that *I am serious*?")

("How do I ensure—including legally—that a *relationship will be successful*?")

"Doing business in Myanmar (formerly Burma) is difficult; they have little infrastructure, including a legal system to enforce contracts." "R. R. Donnelly and Sons was the sole printer of the Sears catalog for more than 125 years." "The CSU System got serious about graduation rates when the state offered additional monies to improve student success and academic performance."

6. Game Theory

("If my firm implements a particular strategy, how will others *react*?")

"Burger King (or "Five Guys"), in general, waits for McDonalds (or "In-and-Out") to find a suitable restaurant location; Burger King then finds a location very near the McDonalds location." "Additionally, one car wash will likely accept a coupon from all other car washes in the area." "When one airline changes a price, other airlines also change prices, often within minutes."

Technology Drivers:

In an industrial and post-industrial economy, the strategic impact of technology can be both wide and deep. There are several other, technological factors that can materially impact the above core benefit and cost drivers. Strategic use of technology drivers leads to increases in profits by *early identification and leverage of state-of-the-art technologies*.

1. Innovation Productivity

("The best way to have a *good* idea is to have *many* ideas—i.e., have 'happy accidents'.")

"Post-it notes use a chemical adhesive that was originally designed to be 'very sticky'; however, it turned out that an accidental manufacturing prototype resulted in an adhesive that was 'just sticky enough'". "Viagra was originally intended to be a blood pressure medication; during field trials, however, a significant side-effect was noted in males." "WD-40 was the 40th variation."

2. Incremental Improvements

("The world is made up of visible things but is held together by invisible things.")

“Spanx are essentially ‘girdles’ but with a better fabric; also sell them to men.”
“The McDonalds on the corner of Nordhoff/Reseda has an automated, robotic soft drink machine for the drive-thru.” “When a hospital buys a new X-ray machine, it will just assume that the resolution of the X-ray image is higher than it was 10 years ago and also uses less radiation.” “Over the past decade, titanium has replaced steel in many hammers used by both professionals and hobbyists.”

3. Disruptive Technology

(“Can an industry be changed by a *startup David* slaying an *established Goliath*?”)

“Netflix started with just a small inventory of videos on DVD, a small number of customers, and delivery only via the U.S. Post Office; now it’s a Hollywood studio.” “Space-X has demonstrated that a rocket can be used more than once.” “IT Cloud providers eliminate much of the need for small, individual servers.”

4. Disintermediation

(“Whatever you do, eliminate the ‘middle-man’.”)

“Redbox allows customers to select their movies without a salesperson.”
“Bitcoin can be used without any reference to fiat (U.S. central control) currency.” “The use of open source software may not involve any company.”

5. Commoditization

(“PCs are ubiquitous; everyone now lives a digital life.”)

“IBM invented the modern, desktop PC for widespread use in business, but IBM eventually sold their entire PC business to Lenovo.” “Harrah’s pioneered the use of tracking in-house casino habits by gamblers electronically with individual electronic cards; now, all casinos do it.” “Index funds changed investing.”

6. Increasing Returns

(“In a knowledge economy, it is *increasing returns to scale* that matters most.”)

(“Building a *network* matters, especially when the network makes it hard to *switch*.”)

“The first copy of Windows 10 cost billions (very high average costs); however, each additional copy costs nearly zero (very low marginal costs).” Amazon lost money for many years but gained market share. Also, in addition to products, Amazon sells its own infrastructure: AWS.” “Starting Facebook (LinkedIn, Indeed, etc.) was difficult, but because the company knows about the network for each user, each additional user contributes more to the company. That is, the network itself has value, even if there is no direct sale to the individual user.”

Source:

The mnemonics and examples used above are original. However, the categories used above were generally excerpted and adapted from the following text:

Besanko, D., et al. (2016) *Economics of Strategy*, (7th ed.), Wiley.

Approximately 75% of the examples above were contributed by my students since 2007; the remaining 25% of the examples originated with the instructor.