Economic Benefit and Cost Drivers

wayne.smith@csun.edu

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Course: *MGT 360*
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"Virtue is excellence, something uncommonly great and beautiful, which rises far above what is vulgar and ordinary."
---*Adam Smith (1723–1790)*

"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 in the textbook. The qualitative ("management") side of strategy principally concerns the many facets of vision, mission, objectives, and goals. The quantitative ("economics") side of strategy principally concerns "benefit" drivers and "cost" drivers. Each benefit and cost driver is rooted in core economic principles, such as marginal costs, opportunity costs, transactions costs, diversification, etc. Finally, rather than presenting the mathematics of the underlying economic principles, aphorisms and 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*.

1. Physical characteristics
   ("You only get one chance to make a first impression.")

   > "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 cartridges (at a relatively high margin)."

3. Sale or Delivery Factors

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

> "Home Depot can recommend affiliate installers for a newly-purchased water heater. Time-Warner requires the use of prescribed, third-party cable installers. Uber drivers can also deliver packages."

4. Expectations Enhancing
("The customer didn't know she or he needed it until we produced it.")

> "I'm going to wait in line at the Apple Store for six hours to be the first to get the latest iPhone. If people see me with a Gucci handbag, then they know that I'm looking to improve my social & economic position in life."

5. Subjective Features or Image
("You don't know me!")

> "Our firm procures gasoline for our service delivery fleet from this gas vendor because this vendor supports inner-city, youth tennis programs."

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*.

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

> "For both franchisee- and corporate-owned stores, McDonalds can maintain high quality and lower the overall cost of food materials by bargaining as a single, large organization."

2. Experience
("People trust us; we are further down the *learning curve* than many 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."

3. Location
("As everyone knows, in real estate, it's *location, location, location.*")

> "In the 1950's, Cupid's hot dogs (at the corner of Nordhoff and Lindley) decided that they should be located within walking distance from a small but growing University. FedEx and UPS planes are at Ontario airport; in fact, there is an entire transportation & logistics ecosystem in that region."

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 is subsidized by the U.S. Government."

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

> "Volvo's target market is suburban, dual-income, middle-class families with at least one child. It follows, therefore, that significant expenses such as targeted advertising should be well-understood and have less waste."

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 should help stabilize bean cost over time."

7. Efficiency
("How can we best leverage the net marginal change in our favor?")

> "It is more productive for Exxon to build a slightly larger diameter pipe to transport oil because while the circumference of a cylinder grows *arithmetically* ($2\pi r$), the corresponding volume grows *geometrically* (πr^2). For the same class section, a university can pay college instructors to teach *four* times as many students for *two* times the amount of pay."

<u>Other Factors</u>**:**
There are several other factors that can materially impact the above core benefit and cost drivers. A few of these key factors are listed below.

1. Horizontal Integration
("In how many markets do we wish our organization to be successful in?")
("Should we plan to *stick to our knitting?*")

> "General Electric manufactures light bulbs, medical imaging devices, and aircraft jet engines. GAP, Inc. also owns Baby GAP, Banana Republic, and Old Navy."

2. First-mover Advantage ("*bleeding edge*")
("The early bird catches the worm.")
Second-mover Advantage ("c*utting edge*")
("The second mouse gets the cheese.")

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

3. Make-or-Buy
(“Do we need to *own* it—that is, own the *means of production*?”)

> “U.S.-based Apple contracts with China-based Foxconn and Taiwan-based Pegatron to supply iPhones, but Apple also makes a few models of its Macs in the U.S. Nike owns neither shoe factories nor shoe stores; they, for the most part, just manage the brand. Pepsi prefers to own most of their bottlers; Coca-cola prefers to contract with most of their bottlers.”

4. Commitment
(“How do I know—including legally—that any given *relationship will succeed*?”)

> “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. Vin Scully has broadcasted Dodgers games since 1950.”

5. Disruptive Technology
(“The *Internet* changes everything.”)

> “Mobile Internet”, “Automation of knowledge work”, “The Internet of Things”, “Cloud technology”, “Advanced robotics”, “Near-autonomous vehicles”, “Next-generation genomics”, “Energy storage”, “3D printing”, “Advanced materials”, “Advanced oil and gas recovery”, and “Renewable energy.”

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 strategically, other airlines often do similarly.

Source:
This material was excerpted and adapted from the following text:

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