

Three Lessons Learned from Tesla's Success | Mateusz Machaj

04/07/2016 Mateusz Machaj :

Last week, we saw some new threats emerge against the existing auto industry. In [Apple mania](#) style, people lined up in different cities to preorder an electric car almost no one has driven or seen. It's a car that is about to be delivered in two years (or perhaps later because of huge preorder numbers). Total preorders (including online) for Tesla Model 3 [surpassed many expectations](#) at more than a quarter of a million in less than three days. To put things in perspective, this preorder number is more than 70 percent of annual sales for Mercedes Benz C-Class, the leader in this market segment.

Such a big Schumpeterian disruption can actually teach us something about how markets work, and it provides us with an opportunity to revisit again long-living myths about the true meaning of market competition.

Lesson 1: If the consumers have freedom, competition will exist in any market.

Most economic textbooks and experts emphasize the role of competition in the market. For various reasons, however, they are often suspicious of the completely free market, believing that some industries are not truly competitive in nature. Why? Because in some sectors, huge costs associated with entry (and exit) may divert the competitive process from its optimal path. Or so it is believed.

The auto industry is often held up as a good example for this: huge investments are needed. Economies of scale, though efficiency-driven, may work as a barrier to entry. Apparently not all sectors are open to full competition.

And then along comes Elon Musk with the team of Tesla Motors thirteen years ago, creating something we were told couldn't happen: they built an auto start-up company.

Now, some will point out that Elon Musk and his companies have been the recipients of government subsidies and tax breaks. And it's true that our analysis must unfortunately be distorted by the presence of government intervention. But, we'll find [similar distortions](#) anywhere we go. After all, Tesla's competition (i.e., Ford, Chrysler, and GM) has been receiving special tax breaks and subsidies from government entities [for many years](#).

We should not let these issues, however, distract us from the fact that Tesla is competing against much larger companies in a similar market environment, and Tesla continues to exist even though many other companies have attempted to do what Tesla is doing — and [have failed](#).

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Even in a market environment with government interventions, what one really needs to succeed is a good product that appeals to the consumer. Therefore any market where the consumers have at least some

freedom to choose — even the markets dominated by big players with profits surpassing some small national economies — entrepreneurs can offer real competition. Once an entrepreneur convinces the investors and proves to the clients that a new product is innovative and makes sense, the established players in the sector face a real threat to their existence. No matter how big they are, there is always potential competition behind every corner.

Lesson 2: The market is an excellent testing mechanism for mass production.

The story of Tesla Motors is a perfect demonstration of how innovative ideas are tested in the market and how innovative process is constantly under the assessment of the business owners (contrary to bureaucratic political spending). Musk and his team started small with production of a sports car to demonstrate an electric's car feasibility. They used an existing model (Lotus), exchanged traditional parts (i.e., the motor) for an electric mechanism with a battery. It was a good way to take a relatively small step (in terms of budgeting). Instead of spending too much on a bigger, riskier project, the company decided to do the initial testing. Investors became interested, more money flowed in, and it was then possible to develop the unique Tesla Model S, fully produced by the company.

At this point, Tesla was still limited to pricey, luxurious cars [aimed at wealthier customers](#). The Model S was made to prove to the world that the company was capable of producing cars fully on their own. The model was not made primarily to make money in a niche market, but to get investors to finance mass production. Tesla S lost money, but the much-less-expensive Model 3 may be a success — if the consumers decide to make it one.

The story nicely demonstrates how the market allows entrepreneurs to cautiously present a new type of product and assess it along the way. Instead of starting the whole project immediately, Tesla has taken a rational, slower route toward mass production. Tesla is making headlines with its huge preorder numbers, but there are many other unseen cases of companies which made bad innovative products and were wiped away by the market during the testing phase. (Under government sponsorship they would simply continue indefinitely.) Markets have a way of ridding us of products few people want.

One can also note how luxury products finally get less and less luxurious as time goes by. Thanks to capital formation along with private investment, products that used to be expensive start to be produced in much bigger numbers. That was the case with phones, computers, soap, tractors, and an endless list of other products and services. More competition and mass production lead to price deflation (or real wage increases).

As Mises emphasized time and again: the biggest profits are in the mass-production. Henry Ford understood it well and the Tesla case may illustrate this too.

Lesson 3: Patents harm consumers and inhibit progress.

Another interesting aspect about Tesla Motors is that they are patent free and allow all other producers to use their technology. Although this may be seen as simply a charity-for-humanity move, there is another side of the coin: it is supposed to bring them more profits.

Tesla believes it can openly share its technology because the company is very confident and firmly believes in its products. They rest assured that no one comes even close to the quality of what they

produce. Under those circumstances it makes perfect economic sense to spread the innovations around the market. Tesla understands that adoption of new products and technologies that can be used to improve electric cars boosts the sector overall and leads to diversification. When one remains a leader in such a market, patents are simply unnecessary. The monopoly privileges offered by patents are most important for weak companies, or for companies that embrace the status quo and are disinterested in further evolution of the market. If one see oneself as the fastest runner in any case, one is focused on running as fast as possible, without any need to burden and hamper the competitors.

Ultimately, Tesla Motors, like any other company, may simply fail. Or, it may well be the biggest success in the auto industry since Ford. No matter how the future is shaped, one major lesson is yet again to be learned: If consumers and investors are free to choose, any entrepreneur focused on serving customers can compete against even huge established corporations. Moreover, the market provides a way to reward the most innovative and customer-centered entrepreneurs.

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