

**INSIDE BUSINESS 1-1****The Goals of Firms in Our Global Economy**

Recent trends in globalization have forced businesses around the world to more keenly focus on profitability. This trend is also present in Japan, where historical links between banks and businesses have traditionally blurred the goals of firms. For example, the Japanese business engineering firm, Mitsui & Co. Ltd., recently launched “Challenge 21,” a plan directed at helping the company emerge as Japan’s leading business engineering group. According to a spokesperson for the company, “[This plan permits us to] create new value and maximize profitability by taking steps such as renewing our management framework and prioritizing the allocation of our resources into strategic areas. We are committed to maximizing shareholder value

through business conduct that balances the pursuit of earnings with socially responsible behavior.”

Ultimately, the goal of any continuing company must be to maximize the value of the firm. This goal is often achieved by trying to hit intermediate targets, such as minimizing costs or increasing market share. If you—as a manager—do not maximize your firm’s value over time, you will be in danger of either going out of business, being taken over by other owners (as in a leveraged buyout), or having stockholders elect to replace you and other managers.

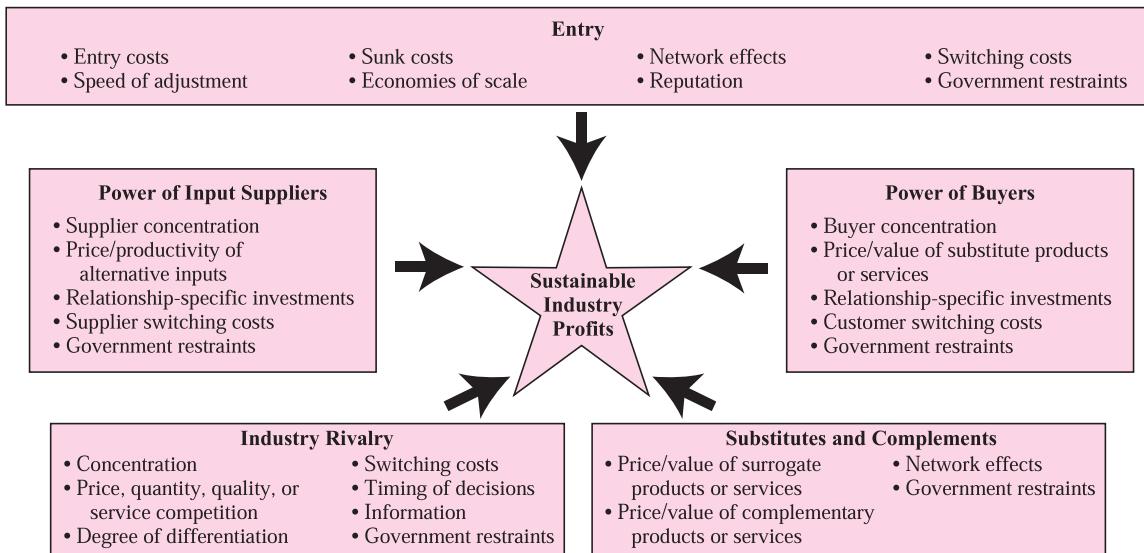
Source: “Mitsui & Co., Ltd. UK Regulatory Announcement: Final Results,” *Business Wire*, May 13, 2004.

Smith is saying that by pursuing its self-interest—the goal of maximizing profits—a firm ultimately meets the needs of society. If you cannot make a living as a rock singer, it is probably because society does not appreciate your singing; society would more highly value your talents in some other employment. If you break five dishes each time you clean up after dinner, your talents are perhaps better suited for balancing the checkbook or mowing the lawn. Similarly, the profits of businesses signal where society’s scarce resources are best allocated. When firms in a given industry earn economic profits, the opportunity cost to resource holders outside the industry increases. Owners of other resources soon recognize that, by continuing to operate their existing businesses, they are giving up profits. This induces new firms to enter the markets in which economic profits are available. As more firms enter the industry, the market price falls, and economic profits decline.

Thus, profits signal the owners of resources where the resources are most highly valued by society. By moving scarce resources toward the production of goods most valued by society, the total welfare of society is improved. As Adam Smith first noted, this phenomenon is due not to benevolence on the part of the firms’ managers but to the self-interested goal of maximizing the firms’ profits.

**Principle****Profits Are a Signal**

Profits signal to resource holders where resources are most highly valued by society.

**FIGURE 1–1** The Five Forces Framework

### The Five Forces Framework and Industry Profitability

A key theme of this textbook is that many interrelated forces and decisions influence the level, growth, and sustainability of profits. If you or other managers in the industry are clever enough to identify strategies that yield a windfall to shareholders this quarter, there is no guarantee that these profits will be sustained in the long run. You must recognize that profits are a signal—if your business earns superior profits, existing and potential competitors will do their best to get a piece of the action. In the remaining chapters we will examine a variety of business strategies designed to enhance your prospects of earning and sustaining profits. Before we do so, however, it is constructive to provide a conceptual framework for thinking about some of the factors that impact industry profitability.

Figure 1–1 illustrates the “*five forces*” framework pioneered by Michael Porter.<sup>3</sup> This framework organizes many complex managerial economics issues into five categories or “forces” that impact the sustainability of industry profits: (1) entry, (2) power of input suppliers, (3) power of buyers, (4) industry rivalry, and (5) substitutes and complements. The discussion below explains how these forces influence industry profitability and highlights the connections among these forces and material covered in the remaining chapters of the text.

**Entry.** As we will see in Chapters 2, 7, and 8, entry heightens competition and reduces the margins of existing firms in a wide variety of industry settings. For this reason, the ability of existing firms to sustain profits depends on how barriers to

<sup>3</sup>Michael Porter, *Competitive Strategy* (New York: Free Press, 1980).

entry affect the ease with which other firms can enter the industry. Entry can come from a number of directions, including the formation of new companies (Wendy's entered the fast-food industry in the 1970s after its founder, Dave Thomas, left KFC); globalization strategies by foreign companies (Toyota sold vehicles in Japan since the 1930s but waited until the middle of the last century to enter the U.S. automobile market); and the introduction of new product lines by existing firms (the cellular phone industry's recent entry into the market for personal digital assistants).

As shown in Figure 1–1, a number of economic factors affect the ability of entrants to erode existing industry profits. In subsequent chapters, you will learn why entrants are less likely to capture market share quickly enough to justify the costs of entry in environments where there are sizeable sunk costs (Chapters 5, 9), significant economies of scale (Chapters 5, 8), or significant network effects (Chapter 13), or where existing firms have invested in strong reputations for providing value to a sizeable base of loyal consumers (Chapter 11) or to aggressively fight entrants (Chapters 10, and 13). In addition, you will gain a better appreciation for the role that governments play in shaping entry through patents and licenses (Chapter 8), trade policies (Chapters 5 and 14), and environmental legislation (Chapter 14). We will also identify a variety of strategies to raise the costs to consumers of “switching” to would-be entrants, thereby lowering the threat that entrants erode your profits.

**Power of Input Suppliers.** Industry profits tend to be lower when suppliers have the power to negotiate favorable terms for their inputs. Supplier power tends to be low when inputs are relatively standardized and relationship-specific investments are minimal (Chapter 6), input markets are not highly concentrated (Chapter 7), or alternative inputs are available with similar marginal productivities per dollar spent (Chapter 5). In many countries, the government constrains the prices of inputs through price ceilings and other controls (Chapters 2 and 14), which limits to some extent the ability of suppliers to expropriate profits from firms in the industry.

**Power of Buyers.** Similar to the case of suppliers, industry profits tend to be lower when customers or buyers have the power to negotiate favorable terms for the products or services produced in the industry. In most consumer markets, buyers are fragmented and thus buyer concentration is low. Buyer concentration and hence customer power tend to be higher in industries that serve relatively few “high-volume” customers. Buyer power tends to be lower in industries where the cost to customers of switching to other products is high—as is often the case when there are relationship-specific investments and hold-up problems (Chapter 6), imperfect information that leads to costly consumer search (Chapter 12), or few close substitutes for the product (Chapters 2, 3, 4, and 11). Government regulations, such as price floors or price ceilings (Chapters 2 and 14), can also impact the ability of buyers to obtain more favorable terms.

**Industry Rivalry.** The sustainability of industry profits also depends on the nature and intensity of rivalry among firms competing in the industry. Rivalry tends to be less intense (and hence the likelihood of sustaining profits is higher) in concentrated

industries—that is, those with relatively few firms. In Chapter 7 we will take a closer look at various measures that can be used to gauge industry concentration.

The level of product differentiation and the nature of the game being played—whether firms’ strategies involve prices, quantities, capacity, or quality/service attributes, for example—also impact profitability. In later chapters you will learn why rivalry tends to be more intense in industry settings where there is little product differentiation and firms compete in price (Chapters 8, 9, 10, and 11) and where consumer switching costs are low (Chapters 11 and 12). You will also learn how imperfect information and the timing of decisions affect rivalry among firms (Chapters 10, 12, and 13).

**Substitutes and Complements.** The level and sustainability of industry profits also depend on the price and value of interrelated products and services. Porter’s original five forces framework emphasized that the presence of close substitutes erodes industry profitability. In Chapters 2, 3, 4, and 11 you will learn how to quantify the degree to which surrogate products are close substitutes by using elasticity analysis and models of consumer behavior. We will also see that government policies (such as restrictions limiting the importation of prescription drugs from Canada into the United States) can directly impact the availability of substitutes and thus industry profits.

More recent work by economists and business strategists emphasizes that complementarities also affect industry profitability.<sup>4</sup> For example, Microsoft’s profitability in the market for operating systems is enhanced by the presence of complementary products ranging from relatively inexpensive computer hardware to a plethora of Windows-compatible application software. In Chapters 3, 5, 10, and 13 you will learn how to quantify these complementarities or “synergies” and identify strategies to create and exploit complementarities and network effects.

In concluding, it is important to recognize that the many forces that impact the level and sustainability of industry profits are interrelated. For instance, the U.S. automobile industry suffered a sharp decline in industry profitability during the 1970s as a result of sharp increases in the price of gasoline (a complement to automobiles). This change in the price of a complementary product enabled Japanese automakers to enter the U.S. market through a differentiation strategy of marketing their fuel-efficient cars, which sold like hotcakes compared to the gas-guzzlers American automakers produced at that time. These events, in turn, have had a profound impact on industry rivalry in the automotive industry—not just in the United States, but worldwide.

It is also important to stress that the five forces framework is primarily a tool for helping managers see the “big picture”; it is a schematic you can use to organize various industry conditions that affect industry profitability and assess the efficacy of alternative business strategies. However, it would be a mistake to view it as a comprehensive list of all factors that affect industry profitability. The five forces

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<sup>4</sup>See, for example, Barry J. Nalebuff and Adam M. Brandenburger, *Co-Opetition* (New York: Doubleday, 1996) as well as R. Preston McAfee, *Competitive Solutions* (Princeton: Princeton University Press, 2002).