An Economic Analysis of Two Competitive Strategies: Cost Leadership and Product Differentiation

Abstract

The cost leadership and product differentiation are two kinds of competitive strategies that are widely used by the enterprises. Unfortunately, the economic implications of these two strategies have not been received sufficient attention for a long time, thus affecting the results of strategy implementation. This paper is organized into three sections. In the first section, the author analyzes two factors that affect consumer demand, namely, the value of the product perceived by the consumer and the price of the products. Then the utility function reflecting consumer preference is constructed and the inherent relationship between competitive strategies and consumer's utility is revealed. The author points out that improving consumer utility should be the basic starting point in selecting competitive strategies. In the second section, the relationship between the cost, the cross elasticity of product's demand and these two competitive strategies is examined. In the last section, the recommended process of selecting competitive strategies is presented. The aim of this paper is to provide new insights into the improvement of the enterprise's decisions on competition.

Key Words: Cost leadership; product differentiation; strategic management; economic analysis

1 Introduction

Cost leadership and product differentiation are two widely used competitive strategies. But the relationship between these two strategies and their applying conditions have not been received sufficient attention; in particular, there still lacks in-depth analysis of the economic implications of these strategies and the relevant factors affecting the selection of the strategies, such as the product's industrial characteristics and production conditions. As a result, the results of strategy implementation are adversely affected. In recognition of this, this paper is organized into three sections. In the first section, the author starts with the analysis of consumer demand and constructs the demand model that reflects consumer utility. Then the inherent relationship between these two strategies and consumer's utility is revealed. The author points out that improving consumer utility should be the basic starting point in selecting competitive strategies and also discusses the ways of improving consumer utility. In the second section, starting with the in-depth analysis of the relationship between the cross elasticity of product's demand, cost and the economies of scale, the author examines these factors' impact upon the selection of these two competitive strategies, and points our that there exists substitutability between these two strategies. In the last section, the recommended process of strategic decision is presented. The aim of this paper is to provide new insights into the further understanding of the law of market competition and the improvement of the enterprise's decisions on competition.

2 The analysis of the relationship between consumer utility and two competitive strategies

The analysis of consumer demand constitutes the basis for formulating competitive strategies by enterprises. In other words, in order to win consumers and gain strength in market competition, enterprises must select the proper competitive strategies that fit the characteristics of consumer demand. According to the general principle of economics, the consumer's demand for a product is determined by consumer's payment capacity and purchasing desire. For this reason, the focus of the competitive strategies is to stimulate consumer's purchase motivation. Under the given payment capacity of a consumer, the purchase motivation of the consumer is determined by two factors: the first factor is the value of the product, including the useful value, quality and the after-service of the product. In short, it is the psychological price of the product given by the consumer. The second factor is the selling price of the product, or the cost that should be paid by the consumer to acquire the product. The occurrence of consumer's purchase is preconditioned by the fact that the value of the product perceived by the consumer is higher, or at least not lower than the selling price of the products. In economics, the excess of the benefit a consumer gains from purchase of products over the amount paid for them is called consumer surplus. Generally speaking, the higher the consumer surplus of a product, the higher is the demand for this product. The level of consumer's preference toward consumer surplus can be expressed by utility function, as shown in formula (1).

$$U = f(v, c) \qquad (1)$$

Where U represents consumer utility, v represents the value of the product, and c represents the price or cost paid by the consumer to acquire the product. Without affecting the generality, the above utility function can be rewritten as:

$$f(v, c) = v / c \ , \quad c > 0 \qquad (2)$$