Market Structure and Marketing Strategies

By
DeeVon Bailey, Ph. D. (dbailey@econ.usu.edu)
Department of Economics and Cooperative Extension Service
Utah State University
Logan, Utah
October 31, 2005
Industry Structure, Conduct, and Performance

• Economists have long believed that if one knows the structure of an industry that one can predict how firms in that industry will behave (conduct). Structure is also thought to influence profitability and efficiency (performance) in an industry.

• The structure of an industry influences the options that are available to any firm in that industry in terms of pricing and marketing strategies.
What is the Structure of an Industry?

• Economists define structure by four different criteria:
  – The number of firms in a industry
  – The size of firms in an industry
  – The amount of product differentiation in an industry
  – The ease of entry and exit into and out of an industry
Number of Firms

• Simply put, economic theory suggests that markets with large numbers of firms (both buyers and sellers) are more competitive than markets with small numbers of firms.

• Farming is an industry with a relatively large number of firms that are selling products and is often used as an example of an industry with many firms.
  – Approximately 2.1 million farms in the United States (2002 Census of Agriculture)
  – Average of about $94,000 in sales per farm

• Compare to the U. S. car industry
  – Three domestic car manufacturers
  – GM sells approximately 5 million cars per year
  – Ford sells approximately 4 million cars per year
Size of Firms

• Economic theory suggests that many, small firms will tend to behave more competitively than a few large firms in a market.
• In agriculture, the size of firms varies but tends to be smaller than most other industries.
• The following slide shows that fewer than 2% of the farms in the United States produce 50% of total farm sales.
• Even with an uneven distribution of size for U. S. farms, farming still tends to have smaller firms than other industries.
Smallest Number of Farms That Make Up a Given Proportion of Total Farm Sales in the United States in 2002

Source: 2002 Census of Agriculture
2004 Sales for Selected Firms

- ConAgra: $14.52
- Tyson: $26.40
- WalMart: $259.00
- McDonald's: $19.07
Product Differentiation

- Product differentiation refers to the ability of a customer to discern between products from different producers.
- Differentiation is accomplished by:
  - Packaging
  - Product characteristics
    - Price
    - Convenience
    - Form and place of consumption
  - Advertising
  - Branding
  - Certification
Differentiation Makes Similar Products Different Other from Competitors in the Minds of Consumers
“Atomistically” Competitive Markets

• Economic theory attempts to explain how firms and people behave. Economic theory generally makes assumptions that simplify a problem so that it can be “modeled.” This just means that the theory will provide general insights about how firms and people behave but will not explain every possible situation or behavior.

• Economic theory suggests that atomistically competitive markets are markets characterized by many small firms (both buyers and sellers). Other characteristics of atomistic competition are described in the next slide.
Atomistic Competition

• Characteristics:
  – Long-run “U-Shaped” average cost curve. This means the firms are small and all about the same size
  – Price takers. This means that no single firm’s production decisions can influence the market price
  – Relatively easy entry and exit. This means that a relatively small amount of investment is required to enter the industry and firms wishing to leave can easily sell their assets.
  – Homogeneous (non-differentiated) products. This means that each producer produces the same product and buyers cannot perceive a difference in the products they buy from Firm A and Firm B.
Choices in Atomistic Competition

• Because the firm cannot control prices by its own output decisions and because it produces the same products as other firms in the same industry, then the choices available to the firm are to:
  – Decide to produce or not to produce
  – Use inputs efficiently (reduce costs). The firm can reduce costs by being as efficient as possible and this is in the control of the firm (at least to some extent).
  – Risk management – the firm can try to reduce price risk by diversifying, contracting, etc.
  – Take advantage of cycles – If prices are high or low, it is only a temporary phenomenon.
Examples of Atomistic Competition

• There is no industry that perfectly models atomistic competition, but farming (producing commodities) is often used as an example of an industry approaching atomistic competition (at least on the sellers side).
Monopolistic Competition

• The characteristics of monopolistic competition are:
  – There are many firms that are all about the same size (have “U-shaped” average cost curves).
  – The most distinguishing characteristic of monopolistic competition is the fact that the firms have highly differentiated products. This means that consumers believe there are significant differences between the products offered for sale by different firms.
  – Demand affected by the prices the firm charges and the amount of promotion the firm undertakes.
Monopolistic Competition Cont’

• Above “normal” profits are only obtainable if
  – Costs are lower than competitors or
  – The product has a higher acceptance rate than rivals

• Above normal profits encourage entry by competitors and expansion of outlets by existing firms
Choices in Monopolistic Competition

- Monopolistic competition emphasizes product differentiation and consumer loyalty
  - Increase demand by promotion
  - Decrease costs
  - Develop superior products and services
Examples of Monopolistic Competition

• Fast-food stores – even though fast food corporations are large, the individual outlets for fast food tend to be relatively small and are in intense competition with each other.

• Many food retailers and manufacturers spend tremendous amounts of money attempting to differentiate their products. While the firms may be large, their differentiated products appear in relatively large numbers and compete against each other.
Advertising Expenditures for Selected Companies Reported as of June 2003

<table>
<thead>
<tr>
<th>Company</th>
<th>Annual Advertising Expenditures in Billions of $s</th>
</tr>
</thead>
<tbody>
<tr>
<td>Procter and Gamble</td>
<td>$2.67</td>
</tr>
<tr>
<td>Unilever</td>
<td>$1.64</td>
</tr>
<tr>
<td>McDonalds</td>
<td>$1.34</td>
</tr>
<tr>
<td>Altria (Philip Morris)</td>
<td>$1.21</td>
</tr>
<tr>
<td>Coca Cola</td>
<td>$1.2</td>
</tr>
<tr>
<td>PepsiCo</td>
<td>$1.11</td>
</tr>
<tr>
<td>Nestle</td>
<td>$1.07</td>
</tr>
<tr>
<td>Mars</td>
<td>$0.87</td>
</tr>
</tbody>
</table>

Source: Advertising Age
One interpretation of agricultural markets

- Profitability

![Diagram showing a graph with axes labeled 'Size' and 'Profitability'. The graph shows a 'Death Valley' between niche markets and low-cost producers.]
Oligopoly

• Oligopoly characteristics the markets for most agricultural input markets (e.g., fertilizer, fuel, seed, etc.) and most food processors and manufacturers. Its characteristics are:
  – A small number of large firms in the industry
  – Products that may or may not be differentiated
  – An average cost curve that reflects substantial economies of size. This means that the firms in the industry have become large to keep processing and other costs as low as possible.
  – Firms are aware of and probably react to output and prices of the other firms. Because there are only a few firms in this type of industry, they can watch their competitors closely and probably react to any market strategy their competitors choose to pursue.
Oligopoly: Kinked Demand

- There is no generally accepted economic theory for how oligopolies behave. However, one popular theory of oligopoly is called the “kinked” demand curve theory.
- Kinked demand suggests that if a single firm raises prices its competitors will not (elastic demand) but if that firm drops prices all of its competitors will match that price (inelastic demand).
- The result is that there is no incentive for firms to change prices. This results in stable prices and non-price competition.
Non-Price Competition

• Non-price competition is a method for providing incentives to customers to buy a product without changing the price of the product
• Special offers (vacations, gifts, etc.)
• Rebates
• Coupons
• All of these methods offer temporary incentives to customers without reducing the “base” price of the product
Oligopoly: Price Leadership

- Another theory of how firms behave in oligopoly is called “price leadership.”
- Price leadership is where a dominant firm in an industry sets price and others follow.
Conclusions

• Producing a commodity places a firm in the role of a price taker. The firm will have incentives to constantly cut costs by adopting new technology or other cost saving methods. The firms that are the most efficient (least-cost) will survive in the long run.

• Developing products provide more opportunities for firms to improve quality, promote brand image, and certifications. However, there will likely be significant competition from other firms attempting to do the same thing.

• Understanding the market environment (structure) is a critical element to understanding and developing marketing strategies.