Chapter No. 3
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REVIEW OF FACTUAL CASES OF COST-CUTTING DONE BY SUCCESSFUL GLOBAL BUSINESSES

(Based on Secondary Data)
Review of Factual Cases of Cost-Cutting done by Successful Global Businesses

Generally, Business Managers take their decisions about pricing, costs and profits on the basis of Accounting Revenues and Costs. They believe that if revenue exceeds cost, the firm is in good, and efficient conditions.

But recently, new generations of Business Managers trained in Managerial Economics, have realized the importance of optimality. Sheer surplus above cost, creates a deceptive complacency; in fact, attention should be given whether profit is maximized. If the firm obtains maximum revenue by minimum possible cost; the firm is capable of earning maximum profit which is the accepted indicator of efficiency of a modern firm.

In order to attain optimality, the firm has to take care of the ‘MARGINAL ANALYSIS’; which is used in theoretical economics. Marginal Analysis shows that a firm can maximize its profit by equating its marginal cost to its marginal revenue and at that position a firm tends to get maximum revenue within minimum cost.
Case 1

For example, an advertising firm in U.S. realized that by equating its marginal cost to its marginal revenue, the firm could get maximum net benefit.

With each additional TV spot, the firm’s total benefits (Sales or revenue) increases, but the extra benefit, i.e. marginal benefit declines. The reason is that each additional TV spot reaches fewer and fewer additional people and becomes less effective in inducing more consumers to buy the firm’s product. The extra or marginal cost of each TV spot, let us assume, remains constant at $ 4000.

The firm while increasing additional TV spots, found that its Total Benefits went on ‘increasing’, (less than proportionately) and its marginal benefits went on ‘decreasing’. ¹

¹ Dominique Salvator- Microeconomics- Publication
Hadison Wesley- Year 1997- Part one- Page 13
Table 1 Advertising Industry Marginal Benefits and Costs of TV Spots

<table>
<thead>
<tr>
<th>No. of TV Spots</th>
<th>Total Benefits</th>
<th>Marginal benefits</th>
<th>Total Costs</th>
<th>Marginal cost</th>
<th>Net Benefit = Total Benefit - Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$ 20,000</td>
<td>__</td>
<td>$ 4,000</td>
<td>__</td>
<td>$ 16,000</td>
</tr>
<tr>
<td>2</td>
<td>$ 34,000</td>
<td>$ 14,000</td>
<td>$ 8,000</td>
<td>$ 4,000</td>
<td>$ 26,000</td>
</tr>
<tr>
<td>3</td>
<td>$ 42,000</td>
<td>$ 8,000</td>
<td>$ 12,000</td>
<td>$ 4,000</td>
<td>$ 30,000</td>
</tr>
<tr>
<td>4</td>
<td>$ 46,000</td>
<td>$ 4,000</td>
<td>$ 16,000</td>
<td>$ 4,000</td>
<td>$ 30,000</td>
</tr>
<tr>
<td>5</td>
<td>$ 48,000</td>
<td>$ 2,000</td>
<td>$ 20,000</td>
<td>$ 4,000</td>
<td>$ 28,000</td>
</tr>
<tr>
<td>6</td>
<td>$ 49,000</td>
<td>$ 1000</td>
<td>$ 24,000</td>
<td>$ 4,000</td>
<td>$ 25,000</td>
</tr>
</tbody>
</table>


Wall Street Journal has proved that Advertising firm’s optimum position i.e. (Maximum Profit/benefit by equality of Marginal Cost to Marginal Benefit) is when, it gives four TV spots by spending $ 16,000/- (Each spot requires $ 4,000) and earning maximum benefit of $ 30,000 and less than 3 TV spots again bring less net benefit. (viz. $ 26,000 by 2 spots and $ 16,000 by one spot)
The firm does not stop after giving 3 TV spots, but takes a positive chance as to know whether it has reached its optimum position of MC=MR; because by the third TV spot, the firm’s Marginal Benefit is far greater than its Marginal Cost. At this stage, the firm has not earned maximum satisfaction because it has not reached its marginal barrier.  

The concept of MARGIN represents the Key Unifying Concept in microeconomics and it applies to all economic decisions and market transactions. It applies to consumers in spending their income, (Law of diminishing marginal utility) to firms how many workers to be employed, to workers in choosing how many hours to work etc. etc. The marginal analysis has been the essence of Production, Consumption, Exchange, Distribution and Government Finance Theories.  

1 Wall Street Journals of February 8, 1993 and May 31, 1995
2 Dominique Salvator- Microeconomics- Pub Wesley- Ed 1997- Part 1 Page 12
Case 2 Economic Inefficiencies of the Governments and their Consequences

In 1957, Communist Party Chairman Nikita khrushev proudly asserted that the Soviet Union Would bury the U.S. not with atomic warheads but with Superior Productive Power!

Instead in 1989, the Soviet Union and former Eastern European communist regimes collapsed as a result of massive economic failures.

Consumer essential goods were in acute shortage, they were shabby and they were very expensive. Automobiles, refrigerators, TV sets and other consumer durables were primitive by world standards. In computers and machine tools, Soviet Union was a decade behind the U.S., Germany and Japan. Its standard of living was less than third that of the U.S.

These massive economic failures were the direct result of the command economy. Economic decisions were centralized and they were arbitrary and forced on disgruntled people by the regime of dictatorship. Prices were administered; therefore there was no incentive to reduce them by revising or improving the cost and the quality. There were no incentives to enterprises, workers and the managers. ²

² Dominique Salvator- Microeconomics- Publication Wesley- Ed 1997- Part 1
Due to the lack of competition, market economy and critical evaluation of the performance of command economy, the Soviet Russia brought reduced outputs, hyper inflated costs, rising inflation, rising unemployment, rampant corruption of the commissars, huge budget deficits, unsustainable foreign debts. 

In post 1992 era, Russia has abandoned communist ideology by making constitutional provisions and has adopted reforms of privatization, liberalization and globalization. It has adopted competitive market economy. It has allowed private enterprises and businesses. Prices and wages have been freed from Government controls, opening of the economy to competition both within and international; replacing state trading by private markets, right to private property and profits, started a capital market and privatized banks and the most important provision has been introduction of ‘Cost Accounting System’. 

**Specialization and Exchange**

Two important things that greatly increase the efficiency of market economies are ‘Specialization in the production and exchange’. By Division of labor and specialization, efficiency and output can be maximized at reduced costs.

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2 “Accessing the Reform Record in the Transition Economies”. IMF Survey- January 9, 1995 Page 1 to 6
A person, a region or a nation can specialize in the production of those goods and services in which, they have comparative advantage.

A professor may be a very good typist whose speed of typing may be above average. But if he will devote all his spare time in academic pursuits, instead of wasting them in washing clothes or typing manuscript of his article, it will bring him more money and success. One hour of writing an article, may bring him Rs. 2000/- whereas, one hour if he would engage in typing, he will save Rs. 100/- being professional typist’s fee but will lose net Rs. 1900/- by not allowing himself to produce another article.  

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3 Dominique Salvator- Microeconomics- Haddison & Wesley- Ed.1997 Page 16
Case 3 Internationalization of Economic Fraternity and Market

Due to comparative advantage and cost advantage, international specialization has taken place and modern market has been globalized because the goods produced as per the comparative advantage, happen to be inexpensive and qualitative.

All over the World, due to widespread economic reforms implemented, higher income consumers have started purchasing Japanese Toyota, Innova and Honda City, German Mercedes, Italian handbooks, French perfumes and campaigns, Hungarian clothes, Taiwanese calculators, scotch whisky, Swiss chocolates, Canadian fish, Indian Tea and Brazilian coffee.

The interesting fact is that, the products which belong to a particular country, not necessarily are made by all inputs, available in that country. There is a combination of one and more than one countries to produce a popular global brand. e.g. American IBM PC, mostly is manufactured abroad, and more than 1/3rd of IBM revenues and profits are generated abroad.

The strongest competition and challenge faced by IBM today is not from the American Digital Equipment Corporation (DEC) but from Japanese Mitsubishi and Hitachi. General Motors, Ford and Chrysler face increasing competition from Toyota, Nissan and
Honda. U.S. Steel companies almost collapsed during 1980s as a result of rising steel imports from Germany and Japan where steel could be produced at a lower cost than America.

Let us take a concrete example of internationalization of production activity.

The total manufacturing cost of IBM PC was $ 860 in 1985; of which $625 was for parts and components made in other firms of U.S. and abroad. If all the components and spares, Would have been manufactured by IBM itself, the price of IBM PC would have been at least 50% more and IBM would have lost its competitive edge.³

Let us study the detailed Break Up of IBM PC cost in 1985.

Distribution of Manufacturing Costs for the IBM PC in U.S. & Abroad.

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Total manufacturing Cost</td>
<td>$ 860</td>
</tr>
<tr>
<td>Portion made abroad</td>
<td>$ 625</td>
</tr>
<tr>
<td>In U.S. owned other plants</td>
<td>$ 395</td>
</tr>
<tr>
<td>Monochrome monitor (Korea)</td>
<td>$ 85</td>
</tr>
<tr>
<td>Semiconductors (Japan)</td>
<td>$ 60</td>
</tr>
<tr>
<td>Semiconductors (U.S.)</td>
<td>$ 105</td>
</tr>
<tr>
<td>Power supply (Japan)</td>
<td>$ 60</td>
</tr>
<tr>
<td>Graphic printer (Japan)</td>
<td>$ 160</td>
</tr>
<tr>
<td>Floppy disk drivers ((Singapore)</td>
<td>$ 165</td>
</tr>
<tr>
<td>Assembly of disk drivers (U.S.)</td>
<td>$ 25</td>
</tr>
<tr>
<td>Keyboard (Japan)</td>
<td>$ 50</td>
</tr>
<tr>
<td>Care and final assembly (U.S.)</td>
<td>$ 105</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$ 860</strong></td>
</tr>
</tbody>
</table>
Case 4 General Motors decides ‘Smaller is better; by Cost Management’

General Motors, the largest company and automaker of the world, incurred losses of $2 billion in 1990 and an incredible loss of $4.5 billion in 1991! These losses were the result of a bloated Work Force and Top heavy Management, low capacity utilization, too many discussions and lack of coordination, too many models and high cost suppliers.

It used to take, on an average of 48 months (4 years!) to develop a new model, as compared with 38 months at Ford and 37 months at Chrysler and General Motor’s efficiency in assembling vehicles was 34% lower than Ford’s and 21% lower than Chrysler’s. The data on Sales per employee of General Motors was the lowest, as follows. ¹

Total World Sales, Employees and Sales per Employee (1991)

<table>
<thead>
<tr>
<th>Automobile Company</th>
<th>Sales in billion dollars</th>
<th>Employees in thousands</th>
<th>Sales per employee in dollars 1000</th>
</tr>
</thead>
<tbody>
<tr>
<td>General Motors</td>
<td>123.1</td>
<td>756</td>
<td>162.7</td>
</tr>
<tr>
<td>Ford</td>
<td>88.3</td>
<td>333</td>
<td>265.4</td>
</tr>
<tr>
<td>Chrysler</td>
<td>29.4</td>
<td>123</td>
<td>238.8</td>
</tr>
</tbody>
</table>

Source: The Economist, May 2, 1992 page 78
¹ “Automobiles-GM decides smaller is better”- the Margin- November-December 1988- Page 29
As a part of its REORGANIZATION plan to increase efficiency and cost cutting, General Motors shed 74000 workers (50,000 blue collar and 24000 white collar) between 1992 and 1995. It also closed 21 plants, reducing capacity from 7.5 million cars to 5.5 million cars and trucks per year. The size of the car was too big therefore it faced ‘decreasing returns to scale’. On the other hand, Ford’s share of the U.S. Market increased to 26.5% in 1995.

Chrysler having only 10% share of the U.S. Market is happy because its moderated scale brings it full advantage of increasing returns and hence its Sales per employee has consistently remained the biggest. ²

Technological progress is the result of ‘innovations’ which bring development of new and better production techniques to reduce existing costs to make an improved or an entirely new product.

² “GM plans to speed Vehicle Development and Reduce Costs 25 % by 1997’
Case 5

How Ford decided on the characteristics of its model ‘Taurus’!

Firms can learn about consumer’s preferences by conducting or commissioning market studies to identify the most attractive characteristics of a product say a) Styling and b) Performance for automobiles. This idea was developed by Kelvin Lancaster.

Ford used this approach in designing its 1986 Taurus Model. The model regained its status of the ‘Best Selling Car in U.S.’- a position it lost to the ‘Honda Accord’ in 1989. Ford repeated this strategy in its brand new model of 1996 Taurus, at a cost of $ 2.8 billion. It also brought very good profits.¹

Page 94 to 110 &
The Shape of a new machine’, Business Week – July 24, 1995 Page 60 to 66
Case 6 International Convergence of Tastes

A rapid convergence of consumer tastes is taking place in the world today. Tastes in the U.S. affect tastes around the world and tastes abroad strongly influence the tastes in the U.S.

Coca-cola and Jeans are only two of the most obvious U.S. products that have become household items around the world. Pizzahut, Domino Pizza, McDonald’s burger, Adidas sneakers, Walkman’s personal stereos, Toyota and Honda cars, French perfumes, Texas instruments, Canon calculators, Zenith and Hitachi Portable PCs, Xerox and Minolta Copiers can be found all over the world from Canada to New Zealand and Latin America to Russia.

In his article (1983), “The Globalization of Markets’ in the Harward Business Review, Theodore Levitt asserted that consumers from New York to Tokyo want similar branded products and the success of global enterprises depends on Standardized products and reasonable pricing around the world. With growing incomes and education levels, life styles among higher middle class are becoming very much similar. A new want due to working housewives for packaged food, of ‘ready to eat products’, has been emerged in recent years.

The tremendous improvement in telecommunications, transportation, travel and tourism, global job openings’ the cross-fertilization of cultures and convergence of tastes can only be expected to accelerate. ¹

Case 7

U.S. lost its leading position to Japan and Europe in metals, and it totally surrendered its electronics industry to Japan during 1970s and 1980s. U.S. applied its attention to stop its decline due to the international competitiveness. It has made special efforts to reorganize its industries and by 1996, the score card of 13 key American Industries reads as follows.

<table>
<thead>
<tr>
<th>Grade</th>
<th>Industry</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>Pharmaceuticals</td>
</tr>
<tr>
<td>A</td>
<td>Forest Products</td>
</tr>
<tr>
<td>B+</td>
<td>Aerospace</td>
</tr>
<tr>
<td>B</td>
<td>Chemicals</td>
</tr>
<tr>
<td>B</td>
<td>Food</td>
</tr>
<tr>
<td>B</td>
<td>Scientific and Photographic Equipments</td>
</tr>
<tr>
<td>B</td>
<td>Petroleum Refining</td>
</tr>
<tr>
<td>B-</td>
<td>Telecommunications Equipments</td>
</tr>
<tr>
<td>C+</td>
<td>Computers</td>
</tr>
<tr>
<td>C</td>
<td>Industrial and Farming Equipments</td>
</tr>
<tr>
<td>C</td>
<td>Motor Vehicles</td>
</tr>
<tr>
<td>C-</td>
<td>Metals</td>
</tr>
<tr>
<td>D</td>
<td>Electronics</td>
</tr>
</tbody>
</table>

Source: "How American Industry Stacks up"- Fortune, March 9, 1992 Page 30
Case 8 The New Computer aided production Revolution & the International Competitiveness of U.S. firms

Since the early 1990s, a veritable revolution in production has been taking place in U.S. based on ‘computer aided design – CAD’ and ‘computer aided manufacturing – CAM’ which has greatly increased the productivity and international competitiveness of the U.S. firms. CAD allows Research and Development Engineers to design a new product or component on a computer screen, quickly compare it with different alternative designs and test the strength of the correct design. CAM can avoid many production problems, greatly speed up the time, reduce the cost and achieve maximum production efficiency.

This ‘New Digital factory’ an information edge marvel, which is responsible for a quantum leap in the speed, flexibility and productivity of U.S. firms because of its leadership and superiority in computer software and computer networks. For example, as a Motorola sales person specifies an order for a ‘paper’ for a particular consumer, the digitized data flow to the assembly line where production begins simultaneously and completed literally in few minutes! The customer can have a ‘Customized paper’ the next day!! This is the revolution of ‘customized manufacturing’

1 Source- ‘The Digital Factory’- Fortune, November 14, 1994 Page 92 to 110
CAD allows Chrysler to design and build its highly successful NEON subcompact car in **33 months** instead of the usual 45 months. Similarly, scientist at caterpillar, the largest earth moving equipment builder in the world, can use virtual reality to test drive products; before they are built.

CAD can be used to design and simulate entire assembly lines and can be used to send production orders directly to supplier’s machinery, so that, in a sense they become an extension of the firm’s plant.

With the U.S. undisputed superiority in software and the Digital factory, it is unlikely that foreign competitors can easily copy and match the new American Manufacturing Genius anytime soon.¹

¹ Dominique Salvator-Microeconomics- Haddison Wesley 1997 P. Page 199 & 200
Case 9

How Xerox regained international competitiveness

The Xerox Corporation was the first to introduce the copying machine in 1959, based on its patented xerographic technology. Until 1970, Xerox had no competition and thus had no incentive and reason to reduce its manufacturing costs, improve quality and increase customer’s satisfaction due to its despotic monopoly.

Japanese firms entered the market with better and cheaper copiers and began to take over this segment of the market. Xerox underestimated this trend and concentrated in mild and high ends of the market, where profit margins were high. Xerox used large part of that profit to expand in computers and office systems, so remained quite complacent. In 1979, Xerox finally awakened to the seriousness of Japanese threat. Xerox was startled to know that Japanese competitors were producing copiers of higher quality at far lower costs and was on the forward march of capturing the lion’s share of the market.
Faced with this life threatening situation, Xerox with the help of its Japanese subsidiary (Fuji Xerox), mounted a strong response that involved reorganization and integration of development and production, as well as, quality control efforts.

Employee involvement was great, increased inventories and the number of vendor suppliers was greatly reduced. Xerox was able to reverse the trend, maintained its market leadership and re invented itself into digital document company.  

2 “Japan is tough but Xerox prevails”- New York Times- September 3, 1992 Page D1
Case 10 What is an American Car?

A “Buy American” movement swept the county during late 1990s. Detroit’s Free Press reported that in a nationwide poll 51% of those polled, wanted to buy only American products, especially American Cars. The increased desire to buy American car has been stimulated, by the dramatic improvement in the quality of American Cars during 1990s.

But at present problem is that, it has become exceedingly difficult to determine which car is genuinely and purely American. Should a Honda Accord produced in Ohio be considered American? What about a Chrysler mini-van produced in Canada? Is a Kentucky Toyota or Mazda that uses nearly 50% of imported Japanese parts/components, American?

Some think that any vehicle assembled in North America (i.e. Canada, U.S. and Mexico) should be considered American because these vehicles use U.S. made parts. But the United Auto Worker’s Union views cars built in Canada and Mexico, being foreign, take away U.S. jobs. The Union endorses Japanese owned plants located in U.S. as American because they provide jobs to American workers.

The fact is that, in order to fully minimize the product cost; industries have become interdependent globally. ¹

Case 11 Monopoly Profits in the New York Taxi Industry

In order to operate a taxi in many municipalities in the U.S., a medallion or license is needed. Many municipalities have stopped and restricted to issue new licenses; in order to retain the monopoly of original medallion owners.

The number of medallions in New York city has remained constant at 11,787 for more than a half century and the value of a medallion has risen from $10 in 1937 to nearly $ 170,000 today. It is about $90,000 in Boston and $ 25,000 in Chicago; where taxis are less scarce and earning opportunities are relatively less.

New York Municipality allowed a sharp increase in the number of Radio cabs during the 1980s, which can only respond to Radio calls and cannot cruise the streets for passengers. As a natural reaction, Radio cabs have restrained the monopoly of taxi license owners. The pull of competition in recent years have affected and restricted exorbitant rise in the selling price of `medallions’. ¹

¹ “Driving a taxi difficult in the Best of Times, Gets tougher.” New York Times- April 9, 1995 Page 41
Case 12 Score Card on American Industry

U.S. continued to hold supremacy till 1960s in almost all the Key industries of the World. It had enjoyed Grade A which implied a secure dominant position in the World.

U.S. had A Grade in Pharmaceuticals, Forest products, Civilian Aircrafts, computers, telecommunications, electronics, Automobiles and industrial equipments. It has lost 1/3rd of its Airbus market to Europe in 1970s. In chemicals, food and petro-refining, it still shares world leadership with the Europeans, in scientific equipment and telecommunications with Japan and Europe. In computers, it faces stiff competition from Japan. Out of eight key industries in which U.S. had leading position, at present U.S. has retained its dominance only in two key industries viz. Pharmaceuticals and Forest products.

The essence of this analysis is that economy of any country and economic condition of a firm cannot enjoy stability infinitely; because of dynamic changes which are continuous; every economy is vulnerable to the threats from superior economy/superior firm. What is essential in modern management is not complacency but constant vigilance and awareness of the threats. The profits refer to the revenue of the firm from the sale of the output after all costs have been deducted. The introduction of innovations is the single most important determinant of a firm’s long term competitiveness.¹

¹ Dominique Salvator-Microeconomics- Haddison Wesley 1997- Page 199 and 202
Case 13

To reduce costs, firms look far afield

In order to increase productivity and cut down costs to better compete, firms often seek creative insight in industries far afield from their own.

In a time of increased global competition, firms routinely scrutinize competitors, practice in their quest for innovative products and processes.

For example, when South West airlines wanted to improve the turnaround of its aircrafts in airports, it did not examine other airline’s practices but went to the ‘Indianapolis 500’ to watch how pit crews fuel and service racecars in a matter of few seconds. The result was that South West was able to cut its turnaround time by more than 50 %. Such drastic increase in productivity could hardly be accomplished by observing practices of other airlines.
The key to finding useful insights in seemingly unrelated fields is to focus on processes.

For example, a firm seeking to speed its production process might took at Domino’s Pizza, an outfit that takes an order, produces the pizza, delivers it and collects the money— all in less than 30 minutes. A major gas utility firm discovered ways to greatly speed the delivery of its Fuel to customers observing how Federal Express delivers packages overnight.

Similarly, a firm delivering gravel learned how to greatly speed deliveries by having Truck drivers plug a card into a machine requesting the quantity of gravel to load – eliminating the need for the driver to get off the truck and waste a great deal of time filling out order forms, just as Automatic Teller Machines work at banks! ¹

¹ "To compete better, Look far afield." New York Times, September 18, 1994 Page 11
Case 14

Walmart’s preemptive expansion marketing strategy

In the year 2009-2010 Walmart has been chosen as the most successful firm by its sales, profit, brand and worldwide network of more than 2500 discount stores\(^1\). It is the top ranking firm which has beaten automobiles, petroleum, aircrafts, computer, information technology etc. industries and instead of manufacturing, it has proved that Retailing can also become a grand business.

The sole secret of Walmart’s No. 1 position is its continuous effort of cost cutting and sharing it with its customers and multiplying its sales turnover. It spends lowest costs on capital, inventories, logistics, warehousing, distribution and advertising etc. Its policy is well known viz. ‘Every Day, Low Price’ and buyers trust that Walmart will go on reducing the price but not the quality of products.

The Walmart’s principal source of its strength is its excellent supply chain Management and inventory of almost one week and flow of goods from its suppliers, ‘JUST IN TIME’.

\(^1\) Source – Ranking published by ‘Fortune Magazine’. (World top 500 companies)
Walmart, the discount retail store chain was started by Sam Walton in 1969, Walmart continued to earn profits when its competitors were making either razor thin profits or incurring losses. Instead of concentrating in big metros, Walmart undertook a challenging experiment of opening its stores in small towns by relying on its managerial efficiency, low costs and high turnover. Walmart has been ridiculed by local retailers by calling ‘Merchant of Death’ because a large number of competitor retailers collapsed because of the entry of Walmart.

Walmart makes marketing surveys and opens its chain stores so as to preempt the opening of shops of competitor retailers. Once Walmart opens in a town, no rival firm dares to open it’s stores; because Walmart has earned tremendous goodwill and popularity among consumers belonging to various sections of the society. ¹

¹ “Can Walmart keep growing at Breakneck speed?”
Case 15

Coca-cola versus Pepsi War

On April 23, 1985, the Coca cola Company announced that it was changing its 99 years old recipe for coke. Coke is the World’s leading Soft Drink and the company took an unusual risk in tampering with its highly successful product.

Company felt that changing the recipe may ward off the challenge from Pepsi-cola because new coke was made sweeter and less fizzy taste, aimed at reversing Pepsi’s market gains. Coca cola spent over $4 million to develop its new coke and conducted taste tests on nearly 2 lakh consumers over a three year period; and did not declare that it will discontinue producing the ‘Old coke’. 61% consumers approved the taste and quality of the new coke. Company spent over $ 10 million on advertising its new product.

When the new coke was introduced in May, 1985; it unexpectedly faced a violent consumer’s revolt against the new coke. New coke flopped and company was compelled to bring back the old coke to pacify its consumers. The company called old coke by renaming it as ‘Coca-cola classic’ and simultaneously did not withdraw the new coke. The company could sell coke classic and new coca cola, side by side, and increase its previous market share and the dominant lead.
Inadvertently Coca cola discovered that its brand loyalty of its buyers to the 99 years old coke had remained strong. Another fact was noted by the company that market survey based decisions are at times, found wrong; because absolute opinions and comparative opinions differ. The new coke which was approved by 2 lakh consumers, without knowing that it is going to replace the old one!

That is why, market research based launched new products, have, by and large, the failure rate of about 50% in the U.S.

Coca cola introduced ‘Frutopia’ a line of fruit based drinks, new sports elixir Power-Ade and Generation X inspired OK soda while keeping process low to fight competition from Pepsi-its perennial arch rival! ¹

¹ “Ten years later, Coca cola laughs at new coke” New York Ti9mes- April 11, 1995 Page –D4
Case 16

De Beers Diamond Monopoly

In 1887, Cecil Rhodes created the De Beers consolidated Mines Company, which controlled about 90% of the total World supply of rough uncut diamonds with its South African Mines. Today, De Beers produces about half of the World’s diamonds in its mines in Africa, Botswana and Namibia and still markets about 75% of the World’s diamonds through its Central Selling Organization (CSO). Producers in Russia, Australia, Botswana, Angola and other countries sell most of their production to De Beers; which then regulates the supply of cut and polished diamonds to final consumers on the world market; so as to keep prices high.

When there is a recession and demand for diamonds is low, De Beers withholds diamonds from the market in order to avoid further price decline until demand restores. De Beers earns huge monopoly profits but shares it with the members of the cartel. It used to make sales worth $6 million in 1970s but in 1990s, it has crossed its sales over $50 billion. (It’s function is similar to OPEC!).

It has retained its monopoly through the World Wars, 1930s depression, financial and currency crisis, hostile governments etc. When Russia along with Zaire attempted to sell large quantities of industrial diamonds on the market outside the CSO in the early
1980s, De Beers immediately flooded the market from its own stock piles, driving prices sharply down. Thus convincing the new comers to join the cartel and bring back the defectors in its monopoly fold.

In 1992, when diamonds were smuggled from Angola, De Beers purchased all of them by paying off 500 million, to prevent collapse of market price and its monopoly hold.

Recently, Russia demanded 1/3rd share of the sales of rough uncut diamonds from the CSO. But Russia is running out of diamonds to sell, in near future. Therefore, the monopoly of De Beers will continue infinitely; because of its management strategies and tactics.

Business is like a game and war and the players, who can use appropriate tactics are sure to win. ¹

¹ “How De Beers Dominates the Diamonds”. The Economist- February 23, 1980
Page 101 to 102
Case 17

Dell Computer’s Success in mail-order business

Dell Computers of Austin, Texas, a company created by 27 years old Michell Dell in 1984, ended the 1994 fiscal year with revenues of more than $ 3.4 billion, making it the 6th largest computer company in the nation. By offering a 30 day money back guarantee on next day, free on sight service through independent contractors for the first year of ownership and unlimited calls to a toll free technical support line; Dell established a solid reputation for reliability and after sale service.

Dell will even mail a $25 cheque to any customer that does not get a Dell Technician within 5 minutes of calling. Ordering a computer from Dell by mail is now like ordering a ‘Prig Mac’ at McDonald’s – you know exactly what you will get.

By eliminating the middle person, Dell was able to charge lower prices than its larger and more established competitors. For example, Dell’s selling expenses and administrative expenses are 14 cents for each dollar of Sales, compared with 24 cents for Apple and 30 cents for IBM.
Dell ships computers by mail by adding only 2% shipping charge to the sale price.

On receiving a mail order; Dell technicians simply pick up the standard components from the shelf to assemble the particular PC ordered. It is simple, quick and inexpensive. Thus Dell has developed a dominant strategy, to maintain it’s upmanship in the market of PCs.

By doing so, Dell has become a kind of 'HIGHTECH WAL-MART! ¹

¹ Dominique Salvatore- Microeconomics-
Haddison & Wesley- Edition 1997- page 395
Case 18

Computer is in Mail by Nash Equilibrium

Until recently, traditional computer firms such as IBM, Apple, Compac and other always thought the customers were willing to pay a substantial retail mark up for the privilege of being able to go to a store and feel and touch the machine before buying it. Some customers still do the same.

But by reducing fear and uncertainty from ordering computers through the mail, Dell was able to convince a growing number of customers to order directly from Dell by mail in the U.S. Given Dell’s dominant and profitable strategy, IBM, Apple, Compac and Zenith also quickly followed and set up their own mail-order departments.

Their dominant strategy of selling exclusively through retail outlets was known out by ‘Dell; and so now, we can say that the computer industry is in a Nash Equilibrium. Dell still retains almost 50% of the mail order computer business. The Nash Equilibrium is a situation in which each player chooses an optimal strategy, chosen by other player. ¹

¹ “The Computer is in Mail” – Business Week, January 23, 1995 Page 76-77
Case 19

The Airline’s fare war and the Prisoner’s Dilemma

In April 1992, American Airlines, the nation’s largest carrier with a 20% share of the domestic market, introduced a new simplified fare structure that included only four kinds of fares instead of 16 and it lowered prices for most business and leisure travellers.

Coach fares were cut by an average of 38% and first class fares were lowered by 20% to 50%.

Other Airlines quickly announced similar fare cuts. American and other Airlines hoped that the increase in air travel resulting from fare cuts would, more than offset the price reductions and eventually turn losses into badly needed profits because during 1990 and 1991, domestic airlines lost more than $6 million. Pan Am and Eastern Airlines went out of business and continental TWA and America West Filed for bankruptcy protection!
But the few cuts went on rising because of erratic cuts by TWA which stirred the ‘Price-war’ among Airlines. Northwest declared that one adult passenger can take one child free, by purchasing one ticket only! Other Airlines were compelled to announce almost 50% fare cuts.

But even though increased number of travellers brought some dollars; companies incurred heavy losses because the new low fares failed to cover the industry average cost. Thus the industry got confused whether to continue fare cut or whether to raise the fares matching the basic costs. Both options were equally bad! ¹

¹ Dominique Salvator- Microeconomics- Haddison Wesley 1997- page 399
Case 20

Voluntary Export restraints on Japanese Automobiles to the U.S.

From 1977 to 1988, US Automobiles production fell by about one third; the share of imports rose from 18 % to 29 % and nearly 3 lakh automobile workers in the U.S. lost their jobs.

In 1980, the Big Three (General Motors, Ford and Chrysler) Automakers suffered combined losses of $4 billion. As a result, U.S. negotiated an agreement with Japan, that limited Japanese automobile exports to the U.S. to 1.6 million units per year from 1981 to 1983 and to 1.8 million units for 1984 and 1985 will be acceptable to them. Japan agreed to restrict its automobile exports, so as to avoid more stringent measures by the U.S.

U.S. automakers used the time off about 4 years (1981 to 1985) to lower their ‘break-even points’ and improve quality. But the cost improvements were not passed on to consumers and Detroit reaped profits of heavy $ 6 million in higher price autos. The big looser, of course, was the American Public; because of excessive patronage and protection given to automakers.

The U.S. International Trade Commission (US-ITC) estimated that the ‘Agreement’ resulted in a price $660 higher for U.S. Automakers and $1300 higher for Japanese cars in 1984. It also estimated that Agreement caused a loss of $15.7 billion from 1981 to 1984 and
that 44000 U.S. auto jobs were saved at a cost of more than $1 lakh per auto worker; which was about 2 to 3 times more than the yearly earnings of a U.S. Autoworker.

After 1985, the U.S. did not ask to renew the agreement. But Japan unilaterally continued to restrain its auto exports (to 2.3 million from 1986 to 1991 and to 1.6 million afterwards) so as to avoid friction with the U.S.

Since the late 1980s and early 1990s, Japan has been producing an increasing number of automobiles in the U.S. itself, in so called 'transplant factories'!

By 1995, Japan was producing more than 2 million cars in the U.S. and had captured 20% market of the U.S. ¹

The increased efficiency of U.S. automakers; especially Ford and Chrysler, seems now to have arrested and even reversed the growth in the Japanese share of the U.S. auto market.

Thus competitive threat, is a disguised boon to improve the ‘cost-efficiency’ of the firms. ²


² “U.S. Cars Comeback”- Fortune, November 16, 1992 Page 52 to 55
Case 21

Military Strategy and Strategic Business Decisions

According to William Peakock, the president of two St. Louis companies and former Assistant Secretary of the Army under President Carter, ‘Revision making’ in business has much in common with mini strategy and thus can be profitably analyzed using ‘game theory’.

Throughout history, military conflicts have produced a set of Darwinian basic principles that can serve as an excellent guideline. To business managers; about how to compete in the market place. In Business, it is crucial for the organization to have a clear objective and to explain the same to all its employees. McDonald’s success in the market has been due to following the same principle.

Both, business and warfare require the development of an ‘attack strategy’. Competitions cannot be won by remaining passive. Furthermore, both business and warfare require unity of command to pinpoint responsibility. The elements of surprise, secrecy and security are common in both. For example, Lee Iacocca stunned the competition in 1964 by introducing the immensely successful ‘mustang’ car.
Finally, in business as in warfare, spying to discover a rival’s plans or steal a rival’s new technological breakthrough is becoming more common. For getting key persons from rival firms by ‘Head Hunting’ is also systematically conducted.

Today’s business leaders must learn how to tap employee’s ideas and energy, manage large scale rapid changes, anticipate business conditions five or ten years down the road and muster the courage to steer the firm in radical new directions, when necessary. More and more firms are making use of war game simulations in their decision making. ¹

¹ W.E. Peackock—Corporate combat (New York: Facts on File publications, 1984)
Case 22

Price War for the market of international Phone calls in Europe

State telephone monopolies still rule everywhere in continental Europe and they still charge more than twice as much as AT&T charges its American customers for transatlantic tele calls. Naturally, AT&T and British Telecom are creeping into European markets with lower rates. Furthermore, European corporations are bringing great pressure for revising present high rates. As a result, the European Commission decided in 1994 to open the inter telephone market to global competition.

On the other hand, governments have started privatizing their national telephone companies through stock sales. Major European Telephone companies are rushing to form alliances with American Japanese and other European companies. For example, AT&T with its ‘World partners’ British telecom and American MCI, French Telecom, DBT (of Germany) to tie up with American sprint Group and Unisource is the alliance of Dutch, Swedish, Swiss companies and Japan’s NTT. ¹

¹ “Sky-high overseas Phone Bills may drop”- Wall Street Journal, September 20, 1994- Page B2
Case 23

Why Companies fail?

Nearly 1 lakh businesses failed in the U.S. during 1992. Normally, more businesses fail during recession, but even during periods of buoyant economic conditions, a large number of businesses fail. E.g. 50,000 businesses failed during 1989 when economy was in Top Gears.

Although there are many reasons for business failure and the details differ from case to case, general underlying causes can be identified. Failure to understand the core competency, lack of prudence to understand and anticipate competitors surprise moves to start price war by introducing a very successful and innovative technology, conceit and complacency, over confidence and casual attitude to maintain the ‘status quo’ and undertake new product lines in which the company does not have adequate experience and expertise; may be most common reasons of the failure.

Kodak diversified from its core Camera and film business into pharmaceuticals and consumer health products and failed! American Automakers allowed Japan to produce and sell; low priced small cars in U.S. market and were happy to specialize in the production of big/limousines and luxury cars; because of very high
margins of profit. But ultimately, they failed because of the limited scope and size of the big car market.

IBM the Giant computer company was unable to recognize the importance of PC market in the mid 1980s and Microsoft developed the software and Intel supplied the chips for its PCs and captured a vast market of common public.

If the firm is heavily indebted, its sickness continues for longer time and ultimately it fails because it’s current profits cannot adequately repay the huge debt and its equally heavy interest increments. USG Corporation (Chicago based building product company) failed in 1992. Recently Enron also failed because of its financial crisis, which remained covered due to the deliberate fraud by using cosmetic and manipulated company Accounts.

It is often more difficult to keep a business great than to build it. ¹

¹ “Why companies fail?” – Fortune, November 14, 1994 Page 52 and 68
Case 24

Repeated Games and Tit-for-Tat strategy

It is also observed that two duopolistic firms facing prisoner’s dilemma can increase their profits by cooperating.

Axelrod found that in repeated games, the best strategy is that of Tit-for-Tat behavior which means: Do to your opponent what he has done to you. That is begin by cooperating and continue to cooperate as long as your opponent cooperates. If he betrays you, next time you betray him back. If he then cooperates, the next time you also cooperate by forgiving him. Axelrod found through computer stimulated experiments that Tit-for-Tat is the best strategy in repeated ‘Prisoner’s dilemma games’. In some cases, a firm finds advantageous not to cooperate. For example, if a supplier is near bankruptcy, a firm may find every excuse for not paying its bills to the near bankrupt firm, in the hope of avoiding payment altogether, if the firm does go out of business.  

1 R. Axelord- The evolution of cooperation- New York basic Books, 1984
Case 25

Economies of ‘Scope’ of Multi-product Firms

In the real world, we often observe, firms producing more than one product rather than single product are at large Scale. For example, Automobile companies produce cars, vans, and trucks. Computer firms produce desktops and portables, universities produce Teaching, Research and Publishing of books and journals, Chicken farms produce poultry and eggs.

Economies of scope are present if it is cheaper for a single firm to produce various products jointly. Economics of scope exists if the total TC of jointly producing cars © and trucks (T) is smaller than if cars and trucks were produced separately by two firms.

Economies of scope may arise when products can be produced with common production facilities or inputs, thus lowering costs. Cars and Trucks can be produced with the same metal sheet; a small commuter airline may produce its cost by providing passenger and cargo services. Sugar factories can reduce total cost by using its molasses for producing liquors.

Case 26

Cost Minimization in the Short run and in the Long run

The above figure shows that in the short and long run (when L & K both will be varied), the firm can produce 10Q with 5 L & 5 K at the minimum total cost of $100.... (Here point H shows where Isoquant for 10Q is tangent to the isocost of $100). Point D represents the short run equilibrium of the firm, when its isoquant is tangential to the isocost of $80. In this case, the firm will get 4Q by employing 4L & 4K.... but in one long run when both L & K will be changed, i.e.
with SL & SK, the firm can produce 10Q which is a leap which is more than double.

That means, in the long run the firm can produce more than proportionately by the small additions in Capital and Labor. With just one unit of K & L, if added, the firm can produce 10Q which is greater than proportionate to previous production of 4Q.

In the short run, if the firm keeps its Capital K constant (i.e. 4) and employs 7 laborers i.e. 7 L; the firm can produce 10Q. But this combination has greater cost than the equilibrium combination of 5K plus 5L. To sum, long Run costs therefore are the minimum than the short run costs. Combination of 4K plus 7L requires cost of $110, whereas combination of 5K plus 5L brings the same quantity of output i.e. 10Q within minimum cost of $ 100.¹

¹ Dominique Salvator- Microeconomics- Haddison Wesley Edition 1997 Page 224 and 225
Case 27 How do firms get new technology?

Following table provides the results of a survey of 650 executives in 130 industries on the METHODS that U.S. firms use to acquire NEW TECHNOLOGY.

From the table, we see that the most important method of acquiring product and process innovations is by independent research and Development by the firm.

The other methods of acquiring process innovations, arranged in order of decreasing importance are 1) Licensing technology, publications or technical meetings, reverse engineering, (Devising different methods of producing similar product), Hiring employees of innovative firms, patent disclosures (i.e. from the detailed information available from the patent office and develop similar technology or product by not infringing on the patent) and information from conversations with employees of innovating firms. (who may inadvertently disclose secret information)

For product innovations, Reverse Engineering becomes the next best option after the Top ranking option of independent Research and Development. Licensing becomes the third best option, followed by hiring employees and technical meetings.

In both product and process innovations, Three options have the maximum preference and they are i) Independent Research & Development ii) Licensing and iii) Reverse Engineering.  

1 R.E. Levis-“Appropriability; R&D Spending and Technological Performance”. American Economics Review –may 1988-page 423-428