

# Consumers and enterprises as actors on the market

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## Abstract

This conceptual paper discusses the phenomenon of differentiation made possible through branding or innovation or a combination of the two. Differentiation is eventually the driving force for the development of its own negation, commoditization. When customers have endured a commoditized market long enough the opportunities open up for creative destruction, this concept of Schumpeter (1942), means that an entrepreneur invents a completely new way of satisfying the customers' unsatisfied needs, making the industry that no longer bothered about their customers. Many researchers have tried to re/brand destructive innovation as their own, with concepts, such as of "transilience", and "blue ocean strategy", as opposed to 'red ocean strategy'.

The paper focuses on innovation as a differentiation strategy and on temporary monopoly rent as a driver of innovation. Increased competition and shortening and life cycles makes capitalism more volatile and the strategies to reduce the risks involved are discussed. These strategies lead to the real-world implementation of the concentration of capital forecasted by Marx and feared by Schumpeter.

The paper identifies the need to continuously monitor the concentration of capital and to understand individual markets by studying the firm's profit.

## Key words

Market, differentiation, commoditization, innovation, creative destruction, monopoly rent, organic composition of capital, volatility, concentration of capital.

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## 1. Introduction

The “market” concept is central in marketing, but we are often sloppy in defining it and explain the mechanisms regulating markets. Sometimes we use the concept of “market forces” (a legacy from economics), but of what does these forces consist and how can we understand these. Different traditions in marketing rely on different perspectives on how to view the market and the mechanisms regulating it.

First, we give an example, *Winemaking in France*, of how undifferentiated products can be differentiated. Then under *Competition and differentiation* we discuss how competition forces companies in general to differentiate their products and services, to reach higher profits. Neo-classical and classical economy’s view on these issues are discussed and the reasons why marketing is fundamentally classical in its foundations. There are *two ways to differentiate products, Innovation and Branding*. Here we are showing what they achieve for companies in the form of differentiation. Under *Innovation and Monopoly Rent*, we discuss the extra-ordinary profit levels that can be achieved by successful radical innovation. The risks inherent in investing in differentiation leads to increasing volatility are discussed under *The volatility risks and the management of these*. Under the header *Commoditization and creative destruction*, we show how markets mature from competition and enter into a phase of slow change that eventually ends in what is called *Creative destruction*, when the industry is over-run by a newly arising industry.

Commodities, undifferentiated homogeneous goods, satisfy basic human needs; be it a kilo of rice or potatoes to eat, or pine planks to build a house. But most needs are different for different customers, hence if we address these specific needs, we produce products and services which are differentiated, heterogeneous. Differentiation means that the product satisfies the need differently, through innovation, or better, because of quality. The firm that manages to produce such added value and communicate the extra value to customers reap higher profits in the marketplace.

## 2. Winemaking in France

In the 1960s, when I first visited Paris, most people brought their own bottle to the local food retailer and refilled in from a tap, almost as in a gas station. Wine was a commodity, not a differentiated product, and as such quite bad one, also in France.

Although wine making has a history going back more than a couple of thousand years, there were no possibility for customers, apart from a select few of the upper classes, to distinguish the hundred thousand wine peasants that produced wine, and hence buy it because of its quality. The select few, like the most prestigious vineyard in France, *Domaine de la Romanée-Conti* that goes back to 1232, had the royalty and the noblesse as customers.

In 1742 the first attempt to differentiate the vineyards was made in Bordeaux, but it was not until 1855 that an official classification system of Bordeaux wine was made. The same year Burgundy got its first unofficial system, but it was not until 1936 that an official system was introduced. What

the “*appellation contrôlée*”-system did was to classify the land, based on soil type, sun exposition, minerals, and water flow, which together with the climate during the year, give the conditions for wine making. The quality of the wine is primarily the result of the wine-makers efforts and the classification tells nothing about that. But the identification of the land made it meaningful for the wine maker to invest in quality, as the vineyard could be identified.

In the two villages Chassagne-Montrachet and Puligny-Montrachet in the lower central area of Burgundy, there are some 500 ha of land with wine, of which slightly more than 30 ha have the highest classification of “*grand Cru*”. Of four *grand Cru* wines, the best the Montrachet, is the best dry white wine in the world. It is produced on less than 8 ha of land and subdivided in lots owned by 26 producers (2007). On a global market with 26 producers it is possible to differentiate yourself by outstanding quality.

Hence, the region in which the wine is produced tells something about the quality of the wine. The region labelled on the wine bottle signaling this quality. Thus, the wine becomes differentiated into different brands (vineyards), vintages (quality indicator) and regions (quality indicator). Other commodities have become differentiated in this way, especially food products from the agricultural sector, e.g. cheese, meat, etc. In some cases third-party quality inspection and classification has been the bases for such differentiation.

### 3. Competition and differentiation

Markets as we know them are a consequence of industrialization and the capitalistic economic system that replaced the feudalism of the middle ages. The peasant produced either for the nobleman or for his own family, never for a market. The independent artisan did exchange the results of his work for money, but not with the aim to produce profit, just to support the family on a socially acceptable level (Marx, 1867/1970).

For the modern version of the artisan, be it a shoe-repairer or an owner of a taxi, the firm is also a basis of survival, rather than to produce profit and expand. In a favorable business cycle the company might expand slightly, with one or a few employees, and then contract in a less favorable one. In the slow cycle, the owner’s hours of work could expand to 12 hours and in a good cycle diminish to 8 hours. Chayanov (1925/1966) explained the regulating mechanisms in these enterprises to be a socially acceptable subsistence level for the family. This type of companies can exist in sectors of the market characterized by a fragmented economy, no actor is able to differentiate to make substantial profits and outcompete others.

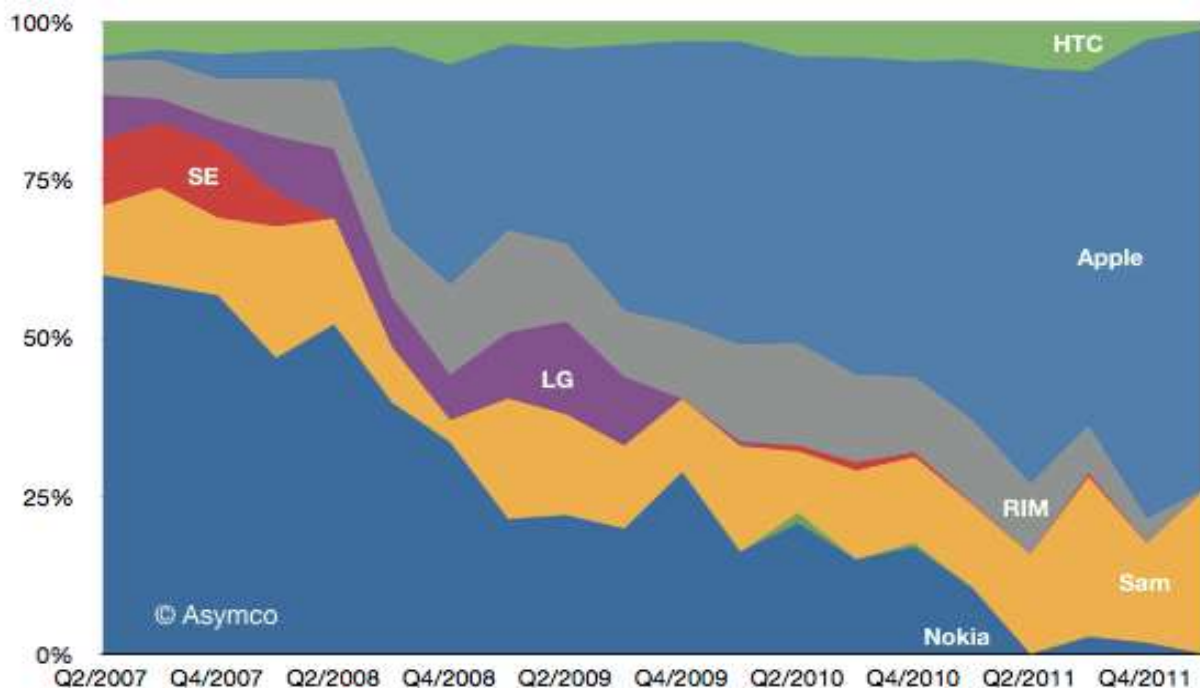
With industrialization markets evolved and companies sold goods for profit. The aim of the company was not to produce goods, but to produce profit. This was not without risk and the profit had to be on certain level to motivate the risk-taking involved. Over business cycles the average profit level has been some 5% over bank interest (cf. Nicholas, 2003:1045), giving an average interest of around 2%.

*Neo-classical economics* presumes that markets are characterized by perfect competition, where no individual or buyer can affect price, i.e. only undifferentiated goods are exchanged on the market. Hence, all companies create average profit. But companies and business administration as their help science, strives to get more profit, not only in absolute figures by growing, but relatively, as a percentage of the company equity, by differentiating products and services.

*Classical economics* (Smith, 1776/1982; Malthus, 1798/1970; Ricardo, 1817/1971; Marx 1894/1970; and others) understood that there is a drive among capitalists to get more than the average profit. They recognized this as monopoly rent, a premium for being different, which meant that profits were re-distributed in the marketplace to the advantage of the company with a unique, and especially the most unique product. To begin this was supposed to be because of monopoly control of natural resources. Ricardo is credited with the clearest analysis of land rent. Marx (1894/1970; 1973) used Ricardo's concept for land rent, but for industrial capitalism. He introduced the concept of redistribution of profits by the organic composition of capital, a measure for how advanced the capital is in employing science and technology. Schumpeter (1942, 1947) used the term monopoly rent in a sense akin to Marx' concept, to explain the "long waves" of capitalism and fundamental effects of entrepreneurial "destructive changes"; when market conditions are fundamentally changed by the innovations of "entrepreneurs" (cf. Elliott, 1980). The entrepreneur gains a temporary monopoly rent by being unique (von Hippel, 1988).

Figure 1

#### Profits in the Mobile Phone Vendor Market



Source: Asymco (28 June 2013).

This can be illustrated by the monopoly rent that Apple was able to gain by the introduction of the iPhone in mid 2007, illustrated in figure 1. In 2006, Nokia catches 60% of the profits in the market for mobile telephone terminals. Four years later, Apple had 75% of the profits and Nokia zero. Two years later Nokia, the monopolist six year earlier, had been forced out of the market.

In spite of what is commonly thought, given the increasing Android sales, Apple has increased its dominance, see table 1. The figure shows that in 2016, Apple took 92% of the profits in the market, although Samsung is the leader in terms of market share but does not earn any money! Google is the profit leader for operating systems (Android), but that does not trickle down to its partners using that operating system. Hence, even if a company has a smaller market share it can catch the lion's share of the profit, because of the monopoly rent gained by differentiation. This also illustrates the important difference between market share, share of total sales in industry, and profit share, share of the total profits in industry. The market share does not tell who the industry leader is.

Table 1

#### Global Smartphone Operating Profit Share in Q3 2016

Global Smartphone Profit by Vendor	Operating profit (US\$, Billions)	Operating Profit Share (%)
Apple	\$ 8.5	91.0 %
Huawei	\$ 0.2	2.4 %
Vivo	\$ 0.2	2.2 %
Oppo	\$ 0.2	2.2 %
Others	\$ 0.2	2.2 %
<b>Total</b>	<b>\$ 9.4</b>	<b>100.0 %</b>

Source: Strategic Analytics (25 November 2016).

Another example is Digital Equipment that in 1986 was number two in the computer market (after IBM), 9 years later it did not exist anymore (Spencer, Kirchhoff & White, 2008).

#### 4. Two elements of differentiation

As indicated by our narrative about French wine making, differentiation by branding is antecedent to exploiting the results of investing in innovation or quality. Branding is a differentiating phenomenon, which is promising quality.

“Firms with strong brands... tend to introduce fewer products and keep those products on their market longer than their weak-brand counterparts.” (De Figueiredo & Kyle, 2006:242).

Firms with strong brands, measured by having high brand equity can capture higher price premiums on brand extensions into nearby product classes than firms without strong brands. (De Figueiredo & Kyle, 2006).

Unless customers can identify the innovator, the investments in innovation are unfruitful.

## 5. Innovation and Monopoly Rent

Innovation makes it possible to reach Abnormal Earnings, AE, during the time that the innovation has not been imitated by competitors. Monopoly rent was used by Malthus (1798/1970), Ricardo (1817/1971), and Marx (1894/1970) to explain land rent and then other monopoly rents. Marx (1894/1970) explained AE as the result of the re-distribution of profit in relation to the organic composition of capital. In this he was a forerunner of the resource-based view (Penrose, 1959/2009), in that it that he focused on the technical resources and the more advanced capabilities of the company reaping monopoly rent. Schumpeter (1942; 1947) applied monopoly rent to innovation, to explain how a temporary monopoly gives the innovating firm a competitive advantage.

“Schumpeter argued that those who succeed at innovating are rewarded by having temporary monopoly control over what they have created. This control, in turn, is the lever that allows innovators to gain an enhanced position in the market and related temporary profits of “economic rents” from their innovations.” (von Hippel, 1988:43, 58).

In accounting literature AE is normally measured by the neo-classic Ohlson model (AbuGhazaleh, Al-Hares & Haddad, 2012; Bernard, 1995; Feltham & Ohlson, 1995; Lo & Lys, 2000; Lundholm, 1995, after Lundholm, 2014; Ohlson, 1995), which calculates the value of the firm as the net present value of future abnormal earnings. The Ohlson model updated the Gordon model (Gordon & Shapiro, 1956) with the Miller & Modigliani model (Miller & Modigliani, 1961).

“Abnormal earnings bear on the difference between market and book values, that is, they bear on a firm’s goodwill.” Ohlson (1995:662).

However, that the model recognizes abnormal earnings is in fundamental conflict with neo-classic economic theory, as it abstracts from the fundamental assumption of perfect markets. The Ohlson model is one of the most cited and respected models in the accounting literature, but it has one major flaw: although it is an empirically well-validated prediction model, it fails to explain *why* these abnormal earnings exist. Classical economics gives such a fundamental explanation. (Philipson, Johansson, & Schley, 2016).

The result of monopoly rent, or abnormal earnings, is rapid, unforeseen changes. In mid-2007 Nokia retained 60% of the profits in the mobile phone vendor market. Then Apple introduced the

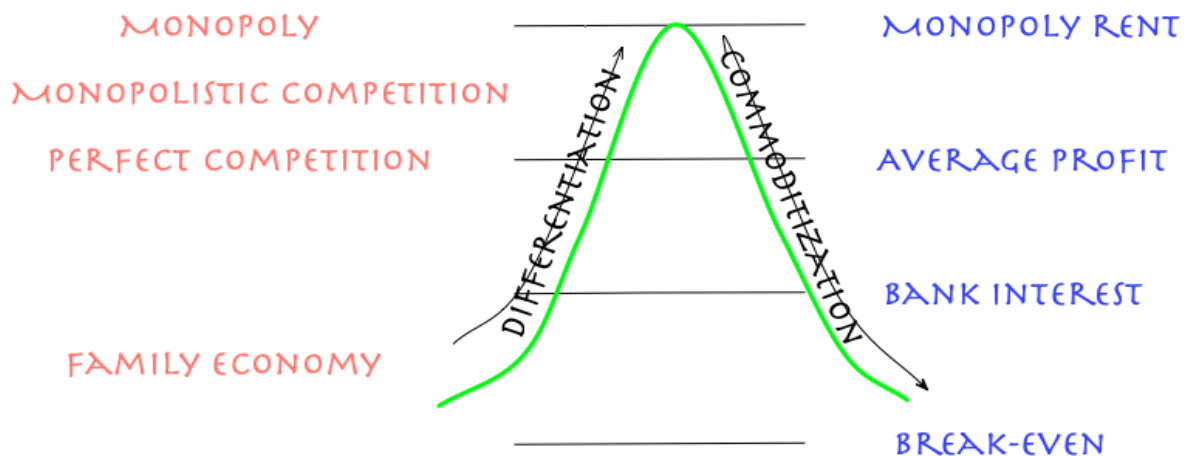
iPhone. Four years later, Apple had 75% of the profits and Nokia zero! In 2013 Nokia ceased as an independent mobile phone manufacturer. In 2016, Microsoft that had bought Nokia, announced that it would close the mobile phone business (although it later emerged as a low-cost phone essentially for emerging markets). From being the leading and dominant player, it was forced out of the market in 6 years.

“...it can always be understood ex post; but it can practically never be understood ex ante...”, Schumpeter (1947:150).

Apple has over the last 15 years managed to have a profit level of around 25%, which is some 18% more than the average profit level.

Figure 2

### Profit level



Source: Own elaboration.

Figure 2 shows the profit level in different types of markets: family economy (subsistence companies), with 0-2% profit, bank interest, 2%, normal or average profit in competitive markets (perfect competition), 5-7%, monopolistic competition, and monopoly, 25%.

We have discussed differentiation and the monopoly rent that can become the result of such differentiation. The monopoly rent is however temporal. Sooner or later competitors will catch up with the monopolist by launching similar or equivalent products. This will start a process of commoditization; the downward slope of the bell-curve in figure 3, increasing price competition, mergers and acquisitions, eventually reaching a monopoly based on cost-effectiveness.

Then there are no incentives for innovation. Customers will become dissatisfied as the product does not adapt to evolving needs. Then the industry is ripe for destruction by a new creative



destruction. Eventually this will also happen to Apple, even though it now has the dominant market share. As we showed, this was what happened to Nokia.

## 6. Volatility risks and the management of these

Capitalism becomes more and more volatile, because the increasing volatility associated with innovation and shorter life cycles (Philipson, 2019) We have now seen the mechanisms behind this spur of innovation and consequent short life cycles.

Destructive innovation covers the following five cases (Schumpeter, 1934:66, after Baumol, 1996):

1. *The introduction of a new offering* is one with which consumers are not yet familiar – or of a new quality of an offering.
2. *The introduction of a new method of production*, one not yet tested by experience in the industry. It might not be founded upon a new scientific discovery and can also exist in a new way of managing the offering commercially.
3. *The opening of a new market* – a market in which the offering does not exist presently.
4. *The conquest of a new source of supply of raw materials or components* – irrespective of whether this source already exists or whether it has first to be created.
5. *The carrying out of the new organization of an industry* – the creation of a monopoly position (for example through trustification) or the breaking up of a monopoly position.

The involved risks are managed on an ever-increasing scale, by:

- An *assortment of products* (shown by Carlin, Haskel & Seabright, 2001:70ff), Branding “...platforms have greater staying power on the market than the individual products.” (De Figueiredo & Kyle, 2006:261). Such an assortment of products means that the company can balance the risks of each individual product. If the assortment is well construed, the products does not contain the same risks.
- Several *plants* with different effectiveness (shown by Carlin, Haskel & Seabright, 2001:70ff), “...a capacity of multi-plant firms to manage the uncertainty of the market environment better than do single plant firms.” (Carlin et al., 2001:82). Workers in Sweden are normally more educated than workers in emerging markets, but their salaries are much higher. Hence, products and components with a high value-added are often produced in plants in Sweden and cost-sensitive products in emerging market countries. Short series are often produced near the selling market, because the company usually has to adopt quickly to changing demand.
- The presence in *different nations*, with different political risks (Gupta, 2013). Many emerging markets involve political risks, such as a military coup d’état in Thailand, social unrest, unclear legal conditions, etc.
- By organized *long-term supply-chain cooperation*. “To find the balance point between imposing and meeting requirements in dialogue with vendors.” (Kjellström, 2019) [emphasis in original]; the supply-chain cooperation allowing a ‘dumper effect’ of volatile



demand, by allowing the end-manufacturer to reduce or increase the amounts bought from co-operating suppliers as a function the evolution of market demand.

- A presence in *several industries*, reducing the risk of creative destruction (Philipson & Oghazi, 2013). This is what corporations do and which eventually leads to the concentration of capital.

## 7. The concentration of capital

These increasing risks are ultimately managed by the concentration of capital. This is one of the most important tendencies in capitalism, as suggested by Marx (1894/1970; 1973).

“Schumpeter’s great fear was that large firms would come to dominate the innovation process through economies of scale and control of resources (Schumpeter, 1942). This, in turn, would lead to the concentration of wealth in the hands of a few large corporations, and necessitate a transition to socialism.” (Spencer & Kirchhoff, 2006:153).

Studying the period between 1890 to 1910, Austrian economist Rudolf Hilferding (1919/2007), German minister of finance 1923 and 1928-29, called this financial capital, i.e. financial corporations owning many businesses, thus balancing off the risks.

Glattfelder (2010) showed that this concentration has now proceeded to such heights that 50 corporations’ control 40% of the global wealth. It shows that although the same risk management effects can be achieved by all types of corporate experience with generalized capital functions (Philipson, 1980; Philipson & Oghazi, 2013), 29 of the 50 corporations are still financial corporations.

A recent study shows an even higher concentration in the US: BlackRock, Vanguard, and State Street (assets management companies) are together the largest shareholder in 88 percent of the S&P 500 firms. (Fichtner, Heemskerk & Garcia-Bernardo, 2017).

Hence, it is no question that Marx, Hilferding, and Schumpeter were right; the concentration of capital is today extreme; but we don’t know the consequences yet. All three of them saw this as a forerunner of socialism, whether with enthusiasm, Marx and Hilferding, or fear, Schumpeter.

## 8. Commoditization and creative destruction

Usually the eruptive innovator is imitated by others that want a share of the monopoly rent, or by lower quality brands that are “eating up” the uniqueness of quality brands, as can be seen in apparel branding over the last twenty years. If the innovator or brander does not manage to re-engineer its uniqueness, competition between the companies, producing the same quality for a lower cost, will increase and will eventually, over mergers and acquisitions, become an oligopoly or sometimes a monopoly, based on economics of scale. Often the new innovation must come “from outside” of the industry, as there are no longer any incentives to innovate. Thus, industries

or business models have a lifecycle, whether it was department stores (150-200 years), landline telephones (125 years), or other industries.

Schumpeter's concept of creative destruction (1942) means that an innovation "changes the game", by launching an offering that makes an industry obsolete as a whole. Well-known examples are the mechanical calculator, which was replaced by the electronic calculator in just a few years and the mobile phone has globally replaced the land line, although that has been a much slower process.

"This is fundamentally different from general equilibrium theory, where competition is almost exclusively price-based. In Schumpeter's view, competition is not to be based solely on price – "the price variable is ousted from its dominant position" (Schumpeter, 1942:84) – but rather on non-price characteristics of a product such as capabilities and performance – shifting the basis of competition from the ability to minimize cost to the ability to innovate." (Spencer & Kirchhoff, 2006:147).

"...a firm's best – most loyal and most profitable – customers are the best precisely because they are heavily invested in the firm's current product offerings." (Christensen, 1997 after Spencer & Kirchhoff, 2006:150).

"...evolutionary technologies are driven often by customer demand for improvements of existing products; these improvements make products better without disturbing current customer behaviours. This type of innovation is often known as "demand-pull" innovation, because it is grounded in market research, identifying improvement desired by existing customers." (Spencer & Kirchhoff, 2006:151)

*Other interpretations of creative destruction* are the neo-classic economist Kirzner (1973, 1997), who based himself on Knight (1921), and Baumol (1993) (all after Spencer et al., 2008:11-13). Abernathy & Clark (1985) tried to appropriate the concept with a new name 'transilience' but were not successful.

Somewhat more successful in branding creative destruction as their own concept were Kim & Mauborgne, in rebranding it as "blue ocean strategy" as opposed to 'red ocean strategy', which take competition head on. These 'blue ocean' strategies are expected to give the company a higher monopoly rent and to be able to retain the temporary monopoly for a longer time. (Chan & Mauborgne, (2004, 2005a, 2005b; Kim & Mauborgne, 2005a, 2005b; Kaplan & Norton, 2008).

## 9. Sustainable creative destruction

Creative destruction must in the future encompass not only the industrialized countries but also the world's poor. If the bottom of the pyramid (Prahalad, 2011), the over four billion people, who live on less than \$2/day, shall be able to raise their living standards radically radical innovations must be made that can make products and services available to a fraction of present costs. Prahalad takes the examples of Tata's car for 2000 USD, cataract surgery for 50 USD, and mobile

phone time for 0.01 USD per minute. By others this has been called frugal innovations (Zeschky, Widenmayer & Gassmann, 2011).

But these new products and services will create real creative destruction, when they are not only available to the Indian or Malawian poor, but also to the equally poor European Roma or the white poor in the US Appalachian Mountains. Poverty and riches are no longer properties of the developing and industrialized countries respectively, but both exist in parallel in all parts of the world.

It is often difficult to innovate for innovators that do not share the needs of the potential customers. Creative destruction for the bottom-of-the-pyramid is more likely to be made by people emerging from the bottom of the pyramid, than people coming out of the US ivy league schools.

## 10. Conclusions and research proposals

Markets are seldom as suggested by neo-classical economists. The strive for monopoly rent and the consequential volatility of markets, the real anarchy of the market, forces solutions of managing the volatility. The concentration of capital, as forecasted by Marx, Hilferding, and Schumpeter is already extreme. It represents an unforeseen planning on the level of capital, limiting the markets to planned “islands” of competing supply-chains. Will this concentration continue?

The concentration of capital must be continuously monitored by research. Will popular demand put limit on this concentration, or will popular influence on the future (democracy) be completely replaced by the planning of a few corporate owners?

To understand the functioning of individual markets, firm’s profit share must be monitored, not the simplistic analysis of market share, which neither tells anything about real market leadership, nor about how the market functions.

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