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## UNIT 7 COST

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### Objectives

The objectives of this unit are to acquaint you with:

- 1 cost levels of Indian industry;
- 1 concept of experience curve; and
- 1 concept of cost leadership.

### Structure

- 7.1 Introduction
- 7.2 Cost Levels in India
- 7.3 Causes and Effects of High Costs in India
- 7.4 Changing Role of Cost in Different Market Conditions
- 7.5 The Experience Curve
- 7.6 Causes of Experience Curve Effect
- 7.7 Additional Considerations for Using Experience Curve Effect
- 7.8 Experience Curve and Competitive Strategy
- 7.9 Experience Curve and its Applicability
- 7.10 Limitations of Experience Curve
- 7.11 Role of Cost in Business Growth
- 7.12 Cost Leadership
- 7.13 Summary
- 7.14 Key Words
- 7.15 Self-Assessment Questions
- 7.16 References and Further Readings

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### 7.1 INTRODUCTION

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Cost analysis occupies an important place in business strategy. In order to gain and sustain competitive advantage, a firm should not only monitor its cost performance but also should endeavour to control it. Several strategic decisions like fixation of competitive prices, provision of after-sale services, quality of the products etc. depend upon relative cost level of the business firm. This unit highlights the elements and role of cost in overall business strategy. The unit begins by acquainting you first with the cost levels for some industries in India. The role of cost in different market conditions is also examined. The unit also discusses experience curve to explain the cost concept.

Michael Porter in his book *Competitive Advantage* suggested three generic competitive strategies aiming to develop a dependable position in the long-run and out-perform the competitors. These three strategies are: Cost Leadership; Differentiation; and Focus.

All the three strategies can either be used individually or in combination to each other. In this unit we would restrict ourselves to cost leadership and discuss different aspects of cost to define cost leadership as a strategy.

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## 7.2 COST LEVELS IN INDIA

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It is widely accepted by the industrialists as well as the planners that Indian economy and industry are becoming increasingly high cost-oriented. This narrowed down our domestic market particularly for consumer durables and also impeded Indian products from competing in the international markets in the 80s but in the post-liberalization era, the scene changed. With multinationals coming to the country, the demand for Indian goods reduced. To understand this observation, let us consider some specific examples of different industrial sectors in India.

### Textile Industry

Clothing is one of the three basic human needs alongwith food and shelter. Further, India was once known all over the world for its fine clothes made from silk and cotton, and was a major supplier of textiles to the rest of the world. But today our own people can't afford to have cloth at reasonable prices because of our high cost of production.

### Tyre and Tube Industry

Road transportation represents an important component in the life-line of economic activity of any country, and tyres and tubes form a significant input of the operating costs in this section. A comparison between the costs for the raw materials which go into the production of tyres and tubes. Again we see that these inputs cost the Indian tyre and tube manufacturers much more, and in turn this is reflected in the tyres and tubes as paid by the prices of transporters. The cost is then passed on to the industrial customers using the services of the transporters. Thus, there is a cascading effect whereby costs get accumulated over different stages and the final consumers have to bear the cumulative costs.

Of course, as regards tyre industry, it is often observed that the leading tyre manufacturers have operated like a cartel in supplying and pricing their products. To make up for shortages and to provide price competition the Government allowed substantial imports of tyres recently.

### Aluminium Industry

In aluminium industry also, considered today the parameter for determining the industrial development of a nation, the Indian costs are much higher than the international prices. This is despite the fact that India has an advantage in this sector because of the natural resources. But, even without the excise duty and taxes, the prices of aluminium in India are higher than in U.K. (indicating international levels).

### Activity 1

Arrange a meeting with the Cost Accountant of the organization in which you are working and try to ascertain the cost level (average cost per unit) of the major product (or service) of your organization for the latest completed year. Is it different from the cost level in previous years? Account for the reasons.

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### 7.3 CAUSES AND EFFECTS OF HIGH COSTS IN INDIA

The cost differences mentioned above for some sectors of the Indian industry are illustrative of a somewhat general situation prevailing in India. A large number of factors go into the high costs of Indian products, such as the growing excise, customs and sales tax levels etc. But a significant component of these high costs may be due to uneconomic production levels, use of obsolete technology, high fixed or variable costs, high break-even points or excessive dependence on imports of semi-finished goods, etc.

It is pertinent for us to consider the effects of such high costs in India. As the component of government imposed levels in the prices increase, the rising prices cause a shrinkage in consumption and demand. For instance, in terms of 1970-71 prices, the average household expenditure on essential consumer goods like sugar, clothing and footwear etc. has actually declined from Rs. 2,802 in 1977-78 to Rs. 2,778. Similarly, for the industrial goods, the household expenditure correspondingly declined from Rs. 1,106 to Rs. 1,092. A recent manifestation of such high cost of production and the corresponding shrinkage in demand created havoc in the Light Commercial Vehicle (LCV) industry where there was an added burden of high exchange rate between Yen and Rupee on the imported components from Japan. The present situation has changed with companies trying to develop products indigenously in an effort to reduce costs.

### 7.4 CHANGING ROLE OF COST IN DIFFERENT MARKET CONDITIONS

Cost is an important aspect of running any business operation. It is a major level for running the business activities, and has its influence on the progress of an organization. Acceleration, stagnation or deceleration in progress are affected by it.

#### Cost in Sellers' Market

While the markets are operating as sellers' markets, the cost may not be considered so critical in determining the profits of a running organization. Under sellers' market conditions, price is fixed on cost plus basis. So whatever is the internal cost, the desired profit margin is added to it by the business firm, and the price is derived accordingly.

Thus, Price of a Product = Internal Cost + Desired Profit Margin.

Here, the price of the product is the derived variable, and the cost is an independent variable. The customer in the market is forced to pay the price so derived by the sellers. If the cost moves up, due to certain unavoidable factors like scarcity of raw material, labour problems or additional taxation, the manufacturer/seller merely takes the boosted cost figures, adds his/her desirable profit margin and sells the goods at the enhanced price. In the sellers' market conditions (say due to shortage in emergency conditions or man-made), the customer has no choice but to buy goods at the new prices. Under these conditions, the seller is not much worried about the costs or their upward movements, as he can pass on these additional burdens to the customers.

#### Cost in Buyers' Markets

On the other hand, as the number of suppliers grow due to conspicuous profits in sellers' markets, the competition from the internal (or external) sources may increase. A surplus supply of goods in the market may be created, if the demand does not move at the corresponding rate. In such conditions the buyers get a choice to pick and choose from. The markets are thus governed by the buyers and the way their

preferences change. Under these competitive conditions, the manufacturer or supplier is no more free to choose whatever price s/he wishes. The equilibrium equation changes to:

$$\text{Profit Margin} = \text{Permissible Price} - \text{Internal Cost}$$

Or

$$\text{Tolerable Cost} = \text{Permissible Price} - \text{Acceptable Profit}$$

Under the new conditions, the price of a product is decided outside the organization in the market place and, not according to the wishes of the manufacturer or supplier.

The price becomes an independent variable decided by the competition in the market place. Each competitor, in general, may choose a different level of acceptable profit for himself or fix the price matching with the market requirements. As the competitors become more and more active there will be a downward push on these permissible profits, unless the firm activates itself for effective cost reduction. Thus, unlike in the sellers' market conditions, now the cost or profit margin becomes the derived variable. If the firm can't do much about the cost of manufacture or supply, then the profit margin also gets fixed by the market forces, and the firm has to decide whether it can survive at the prescribed level.

The other alternative for the organization is to fix a minimum acceptable profit (or contribution), and then determine its tolerable level of cost. The next step is to do a careful introspection and see what are the different variables getting into the cost of goods, and find ways and means to reduce the cost so as to improve its profitability.

One way of doing this is to make use of the Experience Curve, and the other way is to carefully consider its break-even point and operate well above this level.

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## 7.5 THE EXPERIENCE CURVE

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Cost has been correlated with the accumulated experience (of say production) by the Experience Curve Effect. The underlying principle behind the experience curve is that as total quantity of production of a standardised item is increased, its unit manufacturing cost decreases in a systematic manner. The concept of the experience curve was presented by BCG in 1966 and since then it has been accepted as one of the important phenomenon.

The experience curve is a rule of thumb. It says "costs of value added net of inflation will characteristically decline 25% to 30% each time the total accumulated experience has been doubled" (Henderson, 1989). This is also known as learning curve. Initially, this inverse relationship was discovered for the learning costs which are the costs for direct labour input in the manufacturing cost. Thus, as the production of a particular item (such as aircraft components) increased, the quantum of time of direct labour component to make each of these successive items declined. This helped the aircraft manufacturers to predict the cost of man-hours required to manufacture in future, say the number of aircraft, and helped them to fix the price accordingly. The Experience Curve Effect phenomenon, where costs fall with accumulated volume of experience, was known to industrial managers for many years. It took momentum as a tool in business strategy after Boston Consulting Group (BCG) provided the concept.

Let us take an illustration to understand this concept. When one starts the production of a new product (2 units), the unit cost is, say Rs. 100. Then, as the accumulated production volume reaches 4 units, the unit cost is reduced by say 20%, to Rs. 80. Furthermore, as the accumulated production reaches 8 units, the cost gets reduced by another 20%, to only Rs. 64, and so on. This trend has been tabulated in Table 7.1.

Table 7.1: 80% Experience Curve

Cost

Accumulated production		Cost/Unit (Rs.)
2		100
4	$100 \times .80 =$	80
8	$80 \times .80 =$	64
16	$64 \times .80 =$	51
32	$51 \times .80 =$	41
64	$41 \times .80 =$	33
128	$33 \times .80 =$	26
256	$26 \times .80 =$	21
512	$21 \times .80 =$	17
1000	$17 \times .80 =$	13
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The data of this table when plotted on a plain graph, it gives an 80% Experience Curve, as shown in Figure 7.1. The Experience Curve has a hyperbolic shape.

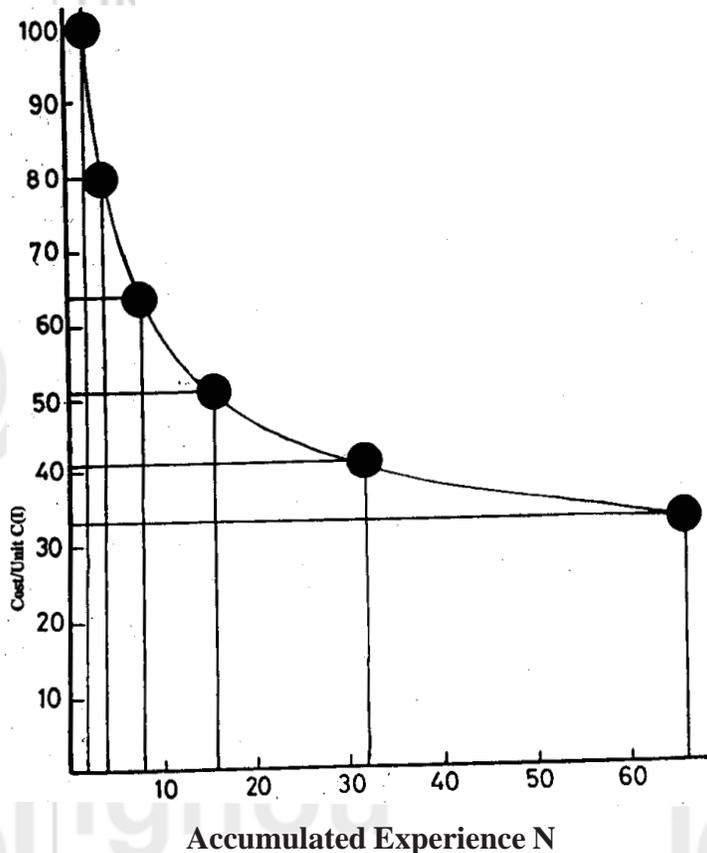


Figure 7.1: Experience Curve

As we have seen in the illustration, the experience curve is a cost relationship but looking at the practical situation, the prices may not go hand in hand with costs in the long run. In every nation, there are certain cases where the prices of a particular commodity or service remain unchanged in terms of their respective currency while the costs decrease. But this case, then is followed by prices falling faster than the costs. This then results in a shift in the market share and leadership of an enterprise. Japan is one country where this unstable pattern rarely occurs.

In the experience curve one thing is to be noted that each element of cost in an end-product experience curve goes down its own independent cost curve and each such

element has its own starting point (Henderson, 1989). Therefore, the slope of each element may be different and each cost element may share experience with other end products. Looking at this explanation, it can be said that an experience curve is an approximation of a trendline.

## **7.6 CAUSES OF EXPERIENCE CURVE EFFECT**

In order to fully utilise the experience curve effect, it is important to fully grasp what causes this effect. With increase in accumulated production of a standardised product, the experience curve effect of systematic reduction in cost is caused due to management synergy, as follows:

### **Improved Productivity of Labour**

As the accumulated production of standardised product increases, the labour force acquires the skills to do their task more efficiently. This may be in the form of memorising the steps involved, or developing reflex actions for doing the needed operations. However, as the experience accumulates, not only the direct labour, but also the supervisory staff as well as managers must successively streamline the needed operation to improve the efficiency.

It is important to note that to consolidate the above gains for a sustained improvement, adequate training facilities have to be provided to the new entrants.

### **Increased Specialisation**

Increased volume of standardised production may also merit specialisation of individual or a group of skills among different employees.

Thus as the production volume increases, individual components may also become viable to be produced in different profit centres. Alternatively, suitable vendors for ancillaries may be developed to shift the overheads and other non-productive expenses away from the organisation. For example, a large vehicle plant can procure engines, transmission train, drive, wheel, gear boxes etc. from outside, and do their assembly only within their plants.

### **Innovation in Production Methods**

With accumulated experience and higher specialisation, the concerned workers are likely to come across innovative ways of improving the production processes.

For instance, Japanese engineering workers evolve unique jigs and fixtures which facilitate their working and smooth flow of operations. However, fixed investments in such jigs and fixtures are viable only at high volumes of production, and they can't be utilised at low production volumes. On enlarged volumes, the unit fixed cost per item reduces substantially, and benefits far exceed the cost.

### **Value Engineering and Fine Tuning**

As the experience with the production as well as usage of a product accumulates, newer ideas based on value engineering may be adopted to cut down the unnecessary material consumption and other under-utilised inputs.

For instance, for conduction of electricity, copper wires are often the preferred choice. However, by now it has been also scientifically demonstrated that in copper conductors, the current flows only on the surface of the conductors. Thus, to save cost without compromising performance, the lead conductors coated on the surface by copper have been successfully substituted with substantial economies in initial costs and replacement costs. But such coating operations would necessarily require high volume of production.

## Balancing Production Line

Sometimes, by mere addition of balancing equipments, substantial increases in capacities can be increased without incurring the proportionate new investments. Thus, all these factors have an accumulated integrated influence of reducing the cost with accumulated experience, and the manager must facilitate and promote these factors to get the desired reduction in cost.

In the absence of the above, cost economies would not come about.

## Methods and System Rationalisation

The standardisation in production, marketing and administrative procedures results in efficiencies over time. Also, more up-to-date technology with better economies of scale can be inducted as the volume increases.

## 7.7 ADDITIONAL CONSIDERATIONS FOR USING EXPERIENCE CURVE EFFECT

The experience curve, in general, is simple approximation of extremely complex real-time interaction of a variety of associated parameters. Therefore, while utilising the experience curve effect for actual day-to-day decision-making, extreme care is necessary to get reliable results.

### Distinguish Experience from Time

Many a time, there is a tendency to substitute passage of time for the experience, and to expect fall in costs related to time, say on an annual basis. For example, a machinery manufacturer makes 1,000 units per year, and the production increases 10% per annum. Now let us also suppose that the production of machine follows the 80% experience curve. Then, the production and the experience or cumulative production would vary as shown in Table 7.2.

**Table 7.2: Production and Experience with Time**

Year	Annual Production	Experience (cumulative)
1st	1000	1000
2nd	1100	2100
3rd	1210	3310
4th	1331	4641
5th	1464	6105
6th	1610	7715
7th	1771	9486
8th	1948	11434
9th	2143	13577
10th	2357	15934

Thus, it takes 10 years to achieve four doublings of the experience, and the annual production level has reached nearly two and a half times mark. The unit cost at the end of this period, should be about 41% of the initial cost. Due to the Experience Effect, it reduces to 80% in 2nd years, 64% in the middle of 4th year and 51% in the early part of the 7th year and so on.

### What is a Unit Experience?

Another important consideration is to carefully define the basic unit of experience. This is particularly so in the recent years when the market segmentation is proceeding at a fast rate. (Thus, one has to make sure that apples are not being compared with potatoes.)

For example, should a vehicle manufacturer consider that all vehicles—trucks, light commercial (LCV) and passenger cars—follow a common experience curve effect, or should these be considered separately on their respective individual experience curves? To focus attention on the segmental specialisation, may be one should take the individual truck or LCV or the passenger car as the unit of analysis rather than collectively as vehicles.

### How to Consider Influence of Time?

As the experience curve effect is to consider cost effects for production of a standardised product, it is important to consider the likely effects of varying short-term fluctuations and inflation. The experience curve effect is a long-run trend, and it will not be able to account for year-to-year variations in costs due to manufacturing bottlenecks, industrial relations problems or other supply-demand mismatches. Similarly, the cost data for experience curve, must be in terms of 'real money' or net of inflation.

The managers planning to use the experience curve effect for building the cost related strategies must keep these additional considerations in mind to derive the desired benefits with accumulated experience. A unit experience must be clearly defined for the concerned business. The experience should be distinguished from certain time-related changes. Further, concerned cost figures must be net of inflation.

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## 7.8 EXPERIENCE CURVE AND COMPETITIVE STRATEGY

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The experience curve relationship provides a good framework for managerial considerations for predicting industrial scenario with respect to future costs, profit margins and corresponding cash flows for the manager's own as well as his/her competitors' operations. Here the only underlying assumption is that the costs and therefore the prices will follow the experience curve effect, which can also be verified and correlated with the trend of the past few years.

For example, the market price of a product P at present is Rs. 100, and it is being manufactured by three companies in the industry, X Co., Y Co., and Z Co., which compete with each other by direct selling. Their annual sales and market shares are shown below:

		X Co.	Y Co.	Z Co.	
Sales Volume	10,000	5,000	2,500	17,500	
Market Share	57%	29%	14%	100%	Total

Let us assume that the slope of the Experience Curve = 80% and the annual growth rate in demand = 20%.

Now, the corporate manager in X Co. also knows his/her cost as Rs. 80.

On the basis of such information s/he has to determine the costs of making these products in Y Co. and Z Co. To do so, s/he knows that his market share is twice that of Y Co., so the cost of Y Co. on the 80% experience curve would be  $80 \times (100/80) =$  Rs. 100. Similarly, the cost of Z Co., with half the market share of Y Co., would be  $100 \times (100/80) =$  Rs. 125. Thus, the costs and the profit margin, at a common price would look like:

	X Co.	Y Co.	Z Co.
Cost/unit	80	100	125
Profit/Loss	20	0	(25)

In other words, the manager in X Co. can determine that while they are selling the product at 20% profit margin, their competitors have little chance of breaking even. Armed with this information s/he can then develop suitable competitive strategies. These strategies may be:

- a) Selling product at most competitive price;
- b) Maximising profits by selling at the highest price the market can afford;
- c) Selling at a higher price initially but crashing the prices later to keep the competition out.

These major strategy options are graphically presented in Figure 7.2.

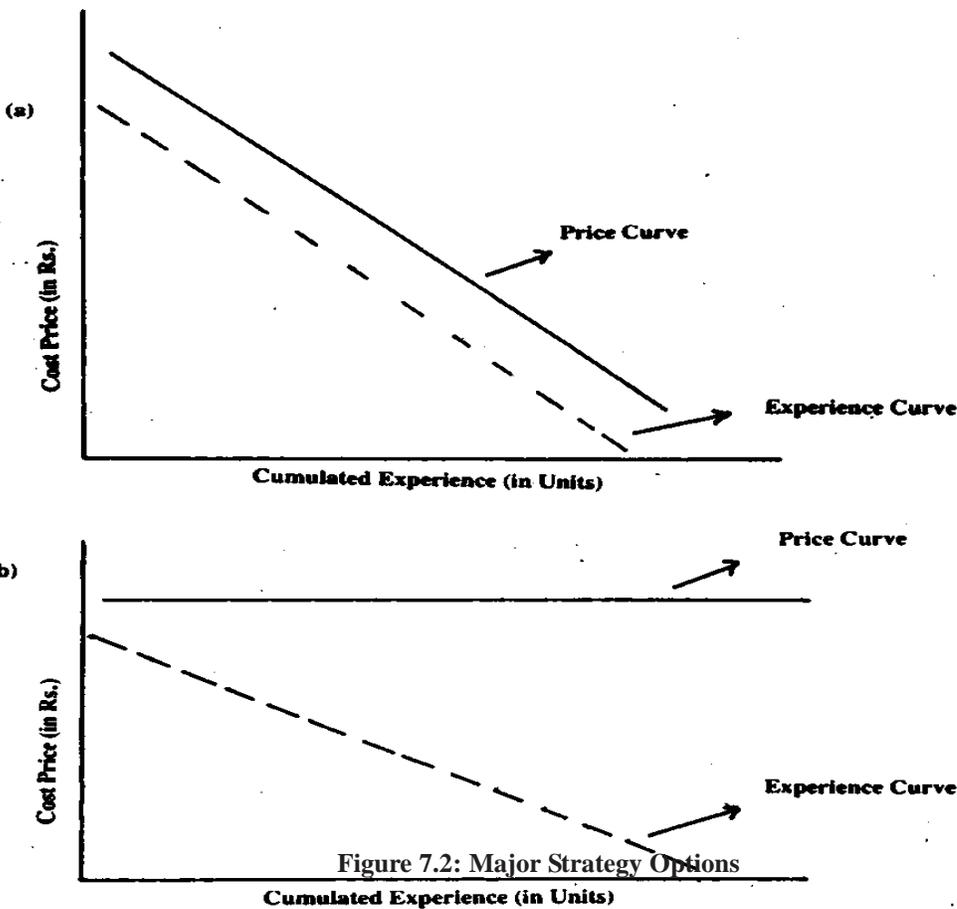


Figure 7.2: Major Strategy Options

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## 7.9 EXPERIENCE CURVE EFFECT AND ITS APPLICABILITY

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The experience curve effect has been demonstrated very well in some segments of the electronics industry where, as the volumes grew, a real decline in cost as well as prices has been observed.

One consequence of this effect has been that in the early stages of the market war in the personal computer business, the manufacturers with high volumes became more aggressive and led the markets with lower costs and prices, whereas the manufacturers with smaller production volumes had uncompetitively higher costs and prices. The latter could not survive in the competitive market arena.

The experience curve effect has some clear implications for manufacturing strategy, so that only a few large plants with standardised products would be able to supply the global market. Further, their marketing efforts should be fully coordinated with their manufacturing plans. On the other hand, with competition, the marketing department is forced to reduce the prices, and the manufacturing department should be ready to supply the higher volume. This demands careful and close linkage with the purchasing department and relationship with vendors for prompt sub-contracting. Further, while prices are lowered the products should not get associated with inferior quality. The quality levels must be carefully guarded. This is how the Japanese have managed to conquer the world markets for their cars, electronic appliances and other sectors. It may however be observed that the relationship implied in the simplistic model of experience curve cannot be applied universally.

To begin with, experience curve effect is applicable only if the demand is sufficiently elastic so that by lowering the prices, it is possible to generate the needed higher demand. Thus larger volumes of goods will be produced and correspondingly the costs will be lowered. The overall contribution and profitability levels are maintained or improved further. Under such a setting, a market leader can push the volumes to such an extreme that he/she markets the products at such low prices that it would become impossible for any new competitor to enter the market and gain volume high enough for him/her to operate viably.

Looked at it from another perspective, in a dynamic competitive market the laggards among the lot, complacent about their comfortable position, will become successively less competitive and more uneconomic and will eventually be driven out. On the other hand, the experience curve effect cannot be utilised if the demand is inelastic so that by lowering the prices, additional demand volumes cannot be generated. As such the costs will not come down but will stay at higher levels. Under such circumstances, the contributions and profit margins will shrink. The company can stay and survive in the market only with low margins. A similar situation will exist when the competition is so severe that it is difficult to increase market volumes dramatically, or increase output significantly to gain major reductions in cost.

Thus, the experience curve effect can damage the company if it is not cautious and careful in its aggressive activities for increasing production of standardised product. And this situation of crisis may arise if the demand falls suddenly in the market. With this the company is forced to reduce its volume of production, and correspondingly its costs will rise. Under such a scenario, if the company is forced to increase its prices, then the demand may fall further. Thus, a recessionary trend may set in.

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## 7.10 LIMITATIONS OF EXPERIENCE CURVE

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The experience curve, a simple conceptual model, has its own difficulties in application, though it might look otherwise. To understand this let us take an example.

While compiling costs, the managers may come to know that the costs of the products manufactured in their plants are not being separately accounted for, and are instead being lumped together department-wise, or division-wise. Over the experience scale also, the systematic cost data may not be available, but may instead be accounted batch-wise or lot-wise. Sometimes, the accounting practices may be changed over the years or the cost allocations may be modified.

For determining the data regarding competitors, the problems are further compounded. Generally, in highly competitive markets, installed production capacities are not disclosed by the manufacturers openly. Besides, each competitor has a different starting point, so the respective cost data may have to be adjusted accordingly. The cost differences between different manufacturers are of critical importance for developing an effective strategic plan, but these are very difficult to obtain in reality.

In terms of the experience curve effect a late entrant, in order to survive in the competitive world, firms must necessarily operate at lower initial cost than the competitors who entered earlier. To be profitable, the late entrants have to learn about the business and develop technological advantage regarding their equipment etc. over their predecessors. They may also acquire the experience of others by offering higher incentives to the experienced employees, thus snatching them from the earlier entrants. A manager must utilise the experience curve effect most effectively, keeping in mind the inherent limitations of the phenomenon as well as the organization under consideration.

The experience curve cannot be termed as a strategy or even a base for formulating a strategy – instead it is a way to understand how the costs in the competitive market may shift. By now we all very well know that strategy is developed based on competitive differences and we also know that no two competitors can have the same way of living. If they do have the same way, then it is not for a longer period of time because having exactly the same ways cannot have competition. This shows that a successful competitor only dominates his/her own segment and this is an observable fact. Similarly, is the fact that experience curve is observable. Thus, it is very clear the main aim of the strategy is to differentiate the segments competitively so as to increase both absolute amount and its value in the marketplace.

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## **7.11 ROLE OF COST IN BUSINESS GROWTH**

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You have noted that costs play an important role in the survival and growth of a business firm. For survival, a business firm must make some profit so that it can sustain its operations on a long-term basis and fulfill its other obligations.

Before a business starts operating, it has to incur certain initial costs for acquiring assets, such as land, building, plant and equipment. These assets have to be installed and commissioned. Then the raw materials are paid for and fed into the machines so that the finished goods can be produced. These are then sold in the market to generate revenue. A part of this revenue is used for repaying instalments towards loans and other borrowings. The shareholders also expect certain returns in the form of dividends on the equity held by them.

Hopefully, after meeting such expenses, the firm is left with some revenue to buy the raw materials and other needed utilities so that it can run the next operating cycle of the business process. The survival and growth of the business firm, to a large extent, depends on what the firm pays for its fixed costs and what contribution it generates after meeting all the expenses.

Apportioning of the fixed costs incurred by the firm in starting a business depends on the volume of its operations. A lower volume of products puts a heavy burden on each unit produced. A larger volume of operations reduces the cost per unit. The total

variable cost, which varies with the volume produced, may also reduce, as a consequence of the Experience Curve Effect.

**Relative Cost Advantage and Competitive Strategy**

Bhattacharyya and Venkataraman have commented on successes of Modis in Tyre industry, Nirma in detergent industry and Hero in cycles, based mostly on relative cost advantages. Modis initially entered only into the largest product segment, i.e. truck tyres and aimed at dominant market share. Their latest technology helped them. They initially priced their products lower than industry leaders, and offered “good value for money” to truck operators. Subsequently they matched the market leaders’ price and displaced by capturing higher market share

Nirma has used relative cost advantages in three areas: production, distribution and promotion. By adopting semi-manual production process and concentrating in the North and West Zone urban markets, and by cost effective distributor incentive schemes and spots on Vividh Bharti (initially), Nirma kept their costs low in three areas and offered a highly price competitive product.

Hero cycles by dropping the irrelevant product attributes and by sub-contracting the production of parts to small units, it achieved cost advantages which helped the company in processing their products very competitively.

**Activity 2**

Think of more such success stories and comment on their competitive strategy.

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**7.12 COST LEADERSHIP**

The firms operating in this highly competitive environment are always on the move to become successful. To strive in this competitive environment the firms should have an edge over the competitors. To develop competitive advantage, the firms should produce good quality products at minimum costs etc. This means that the firms should provide high quality at low cost so that the customer gets the best value for the product he/she is buying. Therefore, it becomes necessary for the firms to have a strategic edge towards its competitors. One such competitive strategy is overall cost leadership, which aims at producing and delivering the product or service at a low cost relative to its competitors at the same time maintaining the quality. According to Porter, following are the prerequisites of cost leadership (Cherunilam, 2004):

- 1) Aggressive construction of efficient scale facilities;
- 2) Vigorous pursuit of cost reduction from experience;
- 3) Tight cost and overhead control;
- 4) Avoidance of marginal customer accounts;
- 5) Cost minimization.

According to Porter cost leadership is perhaps the clearest of the three generic or business level strategies (Bolten & McManus, 1999). To sustain the cost leadership throughout, the firm must be clear about its accomplishment through different elements of the value chain. Figure 7.3 shows a matrix of the three generic competitive strategies and their interrelationship given by Porter.

**COMPETITIVE ADVANTAGE**

Cost

**Lower cost      Differentiation**

Broad Target

1) Cost Leadership

2) Differentiation

COMPETITIVE SCOPE

Narrow Target

3A) Cost Focus

3B) Focused Differentiation

**Figure 7.3: Three Generic Competitive Strategies**

**Source:** Adapted from Porter, E. Michael (1985). *Competitive Advantage – Creating and Sustaining Superior Performance*.

The low-cost leadership strategy at times enables the firm to defend itself against each of five competitive forces. If we see the concept of cost-leadership in the Indian context, we find that it had worked wonders with industries like Reliance, Ranbaxy, Arvind Mills etc.

A cost leader, however, cannot ignore the bases of differentiation (Porter, 1985).

**Activity 3**

Scan the business dailies or any of the business magazines available and prepare a case study of any of the business organization, which has become successful in the recent past by adopting cost leadership strategy.

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Though, low cost can be one of the most important competitive advantages enjoyed by firms all over the globe but it does have its drawbacks. Some of the drawbacks can be listed as follows:

- 1 initiation by the competitive firms;
- 1 threat of competitive firms from other countries;
- 1 firm losing cost leadership due to fast technological changes, which require high capital investment;
- 1 threat by competitors to capture still lower cost segments;
- 1 competition based on other than cost.

Looking at these drawbacks, one can say that cost leadership strategy has to be adopted keeping in mind, the risks involved and develop an overall effective cost-strategy.

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### 7.13 SUMMARY

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The cost levels in Indian industry in general are high and this is having an adverse effect on the demand of the products, both in the domestic and the international markets. To illustrate this point, we cited the examples of cost levels in textiles, tyres and tubes, aluminium industry. A number of factors such as high government levies (excise, custom, and sales tax), uneconomic production levels and high manufacturing costs are responsible for this.

What would be the role of cost depends upon the nature of the market, i.e., whether it is buyers' market or sellers' market. While cost is of critical importance to a producer operating in a buyers' market, it is relatively of little significance where s/he is operating in a sellers' market. The reason being that in the latter case s/he can pass on increase in cost to the buyers. As such s/he has no motivation to control or cut down costs.

The Experience Curve, developed by the Boston Consulting Group, is a method of understanding the behaviour of costs which is based on accumulated experience of the past. As the quantity of production of standardised product increases, the cost per unit goes on declining in a systematic manner. This is known as the Experience Curve Effect. Since experience curve effect is basically a trend effect, as much historical data as is possible should be collected before one sets it to analysis in order to improve its reliability. A number of factors have a bearing on the experience curve. The experience curve effect should be developed in real money terms, that is, after removing the effect of inflation. Further, joint costs should be carefully allocated to different products. Where there is a common cost experience, the costs may be grouped together.

This unit also discusses the concept of low cost competitive strategy known as cost leadership and how it helps the firms to defend themselves against the five competitive forces. Overall the unit deals with cost and its use as a strategy.

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### 7.14 KEY WORDS

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**Experience Curve:** Method of understanding the behaviour of costs which is based on accumulated experience of the past.

**Competitive Strategy:** is business level strategy to succeed in the chosen business.

**Cost-leadership:** is a low-cost competitive strategy.

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### 7.15 SELF-ASSESSMENT QUESTIONS

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- 1) It is often stated that Indian economy is high-cost economy. Do you agree with the statement? Support your answer with some facts and figures.
- 2) What are the causes of high cost levels of Indian products and what are their consequences?
- 3) Examine the role of cost in: (i) sellers' market, and (ii) buyers' market.
- 4) What are the relative merits and demerits of volume strategy of Experience Curve vis-a-vis segmented market niche based strategy?
- 5) Consider the factors due to which the auto manufacturing in India, particularly LCV segment, did not expand as anticipated earlier.
- 6) Enumerate and discuss the products which have followed the Experience Curve Effects, and ones which will not.
- 7) Discuss the concept of cost leadership in the present context.

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## 7.16 REFERENCES AND FURTHER READINGS

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