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Launching Organizations toward Growth and Profit through Focused Innovation: A Critical Study into Powerful Microeconomic Concepts

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***Abstract*-Before takeoff, pilots methodically prepare their aircraft for flight by running down a checklist. Similarly, a comprehensive checklist can be prepared to launch organizations toward growth and profit, through a winning strategy and focused innovation. Such a list would prove useful and gainful if it represents essential innovation tools based on powerful microeconomic concepts. Firms are better advised to invest creative energy in their business design. They have to visually benchmark their "price-cost-value" dimensions against competitors. Analyzing the responses of one's own counterparts or opponents strategically to one's own strategic moves is equally an imperative. Firms that become and remain innovatively focused alone would be able to survive and thrive through wining strategies and enjoy an interesting take off and flight.**

Keywords—Business Model; Economic Value Add; Cost functions; Scale and Scope; and Learning Curves.

I. INTRODUCTION

Successful innovation—the key to competitive growth and profit—rests on disciplined management of the innovative process, from idea conception to customer service. For business managers, who are engaged in a relentless struggle in a competitive landscape, launching their organizations toward growth and profit, through a winning strategy and focused innovation is a must. Firms are required to get ready with a comprehensive checklist of innovation tools based on powerful microeconomic concepts that eventually prove useful and gainful. Management guru Peter Drucker once said that managers have only two functions: *to innovate* (create and bring to market winning new products and services) and *to market* (those products). **[1]** Innovation and marketing together form the core of business strategy. In fiercely competitive global markets, poorly managed companies ultimately shrivel and die. The basic concepts of economics discussed in this Paper can be used effectively to build winning business strategies—to build companies that achieve sustained growth and profit through innovation.

A. Price-Cost-Value as an Interrelated Business Model or Ecosystem

When you see a successful business, then know that someone once made a courageous decision (Peter F. Drucker). Price, Cost, and Value together constitute an 'ecosystem' or interrelated business model. Great managers think in terms of feedback systems, rather than linear cause and effect. Firms are better advised to invest their creative energy in their business design [how they price their product, how they manage the cost of making and selling it, and how they create value for their customers]. They have to visually benchmark their price-cost-value dimensions against competitors. Managers and entrepreneurs seek to build business models that create sustained growth, profitability, and competitive advantage and to build wealth for shareholders, value for customers, and monetary and non-monetary satisfaction for employees. Price, cost, and value are the three pillars of profit. Winning business models excel in each of these three variables and in the ways they interact. Economics can provide powerful tools for guiding managers' decisions regarding price, cost, and value. *It is essential to invest the same level of creativity in an innovative product's business model as is invested in the product itself.* The value-price ecology shows why manager-engineers must be experts in both technology and psychology. Technology drives innovation. Psychology drives the basic understanding of customer wants and needs that underlies innovation. It is not what you, as manager or entrepreneur, think is valuable that matters; it is what the customer perceives is valuable that is crucial. Companies that endure and prevail, through global downturns, are those that can successfully maintain world-class value-creation and cost-reduction capabilities, in parallel rather than in serial fashion, within the same organization while successfully resolving the inevitable tensions and conflicts that arise between strategic plans , operational decisions, and the individuals who make and build them. Great technology is not a *sufficient* condition for business success—as J&J's original 'stent' 1994 proves. **[2]** Nor is great technology a *necessary* condition for business success. There is no superior technology or engineering in Barbie or Dell. But a creative, winning business design *can* be a sufficient condition for business success and profit. And the combination of great technology and a superior business model can prove virtually unbeatable.

B. Hidden Costs and Hidden Benefits

The cost of a thing is the amount of what I call life, which is required to be exchanged for it, immediately or in the long run (Henry D. Thoreau). **[3]** Cynics know the cost of everything, and the value of nothing, as per an aphorism of Oscar Wilde. **[4]** Economics as a discipline understands costs well, and can provide executives and managers with tools that help measure, manage, and reduce them. "Bottom line'

in Intel's and BP's profit and loss statements is not truly the bottom line. One more line must be added, after deducting the imputed opportunity cost of shareholders' capital. Economic Value Add (EVA) **[5]** is net income after tax, minus the opportunity cost of shareholders' equity. What EVA tool says to managers is simply this: *Treat with great respect your shareholders' capital*. It is valuable. It need not remain in your company's pockets. It can migrate elsewhere. So compute its value, and *charge yourself for that value, because that cost is a very real one, even though it is imputed, or estimated, as an 'opportunity cost'.* EVA is a basic concept trademarked by the New York-based consulting company Stern Stewart, which turned into a powerful consulting tool. **[6] Businesses** have to audit their operations, to detect hidden costs [especially, the cost of their shareholders' equity capital] and make them more visible or eliminate them. They have to make sure that every dollar of cost, hidden or visible, has a person directly responsible for them. Whenever they evaluate project proposals, they better take into account hidden benefits [including option value] and try to quantify them. Managers and employees understand that you cannot grow a company solely by shrinking it (reducing its spending). According to Altman, Kaplan, and Corbett, companies that lead in cost discipline make clear the link between cost reduction and future growth**.** **[7]** **In** his book Good to Great, author Jim Collins **[8]** describes 11 'great companies' that outperformed thousands of Fortune 500 firms. One of them is Fannie Mae, a company that began its life in deep trouble. A change in management, and resulting change in measurement, led to a turnaround. The moral here is: Be careful what you measure, and how you measure it: *choose your measures to elicit the behavior and results you seek.*

C. Trade-offs: Optimizing and eliminating them

People face trade-offs …. Life is full of trade-offs—Gregory Mankiw. **[9]** Managers always consider alternatives in their decision choices. They may do so intuitively, balancing costs and benefits. Or they may use other analytical tools, quantifying opportunity costs and relative prices or values. They may accept existing constraints in their trade-off choices. Or, they may defy them and boldly push their organization's capabilities upward, in every direction. Ideally they will be skilled at both. According to a Hebrew saying, smart managers know how to escape from tight spots that wise managers avoid. One may adapt this to read: Smart managers optimize trade-offs that wise, bold ones defy. Hence, it is also imperative that companies identify the major trade-offs facing them by capturing all the gains that accrue to eliminating waste and inefficiency, without trade-offs. In this context, the trade-off decision process should systematically compare costs and benefits of alternative choices, or at least by using the 'even swap' approach. **[10]**

D. Cost functions: 'Survival of the fittest"

It is no denying the fact that a deep understanding of the various cost concepts—average, marginal, total, fixed, variable, and so on—can yield surprisingly powerful insights into the future course of a company and the industry in which it operates. Nothing in the world is more useful, it is said, than good theory and nothing one might add, is less useful, or more destructive, than bad theory. This tool is good theory—the economic theory of highly competitive markets and the theory of cost functions—for building and running a business that would achieve sustained profitability in the long run. Each organic being is striving to increase in a geometrical ratio …. The vigorous, the healthy, and the happy survive and multiply.—Charles Darwin. **[11]** Companies, like Darwin's 'organic beings', are struggling to increase in geometric ratio in competition with other organic beings for resources (market share or sales). More and more organizations will find themselves locked in fierce competitive combat as more countries join the global economy. For good or ill, Darwin's 'survival of the fittest' in the realm of business competition is probably here to stay. Managers who understand it well enough to turn it to their organization's advantage will survive, endure, and prevail. Cost functions—mapping costs, and then acting to reduce them is a key tool here. By visually presenting an organization's cost curves, relative to those of competitors, it is possible to enlist organization-wide support for cost reduction. Survival is a remarkably powerful goal for focusing minds and generating cohesive cost-reducing team-work.

E. People, knowledge, and machines

There are five key elements of all businesses: strategy, structure, reward, process, and people. One version developed by Prof. Jay Galbraith **[12]** arranges these five elements in the shape of a star, with each point linked to each other point. Wise managers choose to place 'people' at the very centre. Great organizations invariably have great people at their core—highly motivated, energetic, creative, and caring employees and managers, from the most junior to the most senior. Strong managers and leaders choose good people, inspire them, then empower them, and let them perform. The resulting 'free lunches', in the end, drive sterling top line growth and bottom line excellence. **[13]** Of all the formulae for managerial excellence, this one is the easiest to state and hardest to implement. Cost per unit of output is simply the inverse of productivity—output per unit of resources (labor or capital). So cost reduction and productivity growth are two sides of the same coin. Productivity measurement can also be looked at in a new way, known as free lunch productivity, and examine how managers can use it effectively to make their organizations profitable and efficient.

F. Scale and Scope: Scaling markets of one

It was the development of new technologies and the opening of new markets, which resulted in economics of scale and scope … that made the large multiunit industrial enterprise come when it did, where it did, and in the way it did. (Alfred D. Chandler). [14} The link between 'Scale' and 'scope', or, volume and variety is exceptionally complex, ranging from hostility to strong complementarity. This create *complexity* with which engineers and managers must struggle,

in order to create a simple, powerful, memorable product offering for customers—one that comprises an experience customers will seek to buy again and again. It is always possible to lower costs by achieving higher volumes of production (scale) or by broadening the range of products and services the company provides (scope), or perhaps by both. It is also possible to scale up best one's organization, and grow it. Firms are expected to be adept at learning and quick to learn. This skill is generally revealed in constantly declining costs as experience builds and cumulative production rises. In his widely-read book Innovation: The Attacker's Advantage, longtime McKinsey consultant Richard Foster notes how innovation is a vital strategy weapon against marketplace incumbents who have leveraged scale economies, size, and learning with experience.**[15]** It always pays to know the price/income sensitivity of demand for their products and track them carefully. Their strategy should be one of seeking to reduce price sensitivity and avoid 'commoditization'.

G. Learning curves are made, not born

Ultimately, management is about attaining and sustaining competitive advantage for which learning curves are vital. The only sustainable competitive advantage is the ability of an organization to learn faster than its competitors—Peter Drucker. In this context, learning curves are essential. Learning curves, like heroes, are made not born. One should not be deceived by the similarity of learning curves across such diverse industries as plastics, cars, aircraft, and electronics. They do not just happen. All of them were built by great managers, who built learning organizations, by telling the truth, and by instilling constant learning and sharing of knowledge as a core company value. Few strategies succeed without such learning. Those who fail to build steep learning curves and then fail to race them down rarely survive to tell the tale. Not only are the companies expected to keep their learning curves steeper than those of their competitors but to know what they, in fact, know. The key management problem is not managing knowledge, but rather using it. **[16]**

H. Where is the money? Markets, demand, and customer intimacy

'Good managers' create winning products; 'Great managers' create whole new industries (S. Mittal, 1994). **[17]** The best way to predict the future is to create it (Peter Drucker). One should know where the money is in industry today and where it will be tomorrow in five years to be able to position their organizations and their products to be there. There is a simple, straightforward logical link between markets, demand, value, profit, and wealth creation. Products and services are bought and sold in markets. In free, open, and competitive markets, customers signal their demand by 'voting' with their dollars, pesos, euros, rupees, or other currency. Those dollars generate sales revenue, which is based on the differential value created by the products consumers buy, *as perceived by those customers.* It is very important to understand that value is always *perceived* value, as seen by the customer or buyer. If it is not perceived, it does not exist. Profit result from unique vale propositions embodied in products whose unit value and price exceed by a wide margin the overall cost of producing them. High profit margins, in turn, build wealth for shareholders because stock prices are driven in large part by those profit margins. The fundamental logic of capitalism: it is a remarkably powerful system for translating the wants and needs of consumers into signals that create the very products and services to satisfy those needs. Large rewards accrue to managers and entrepreneurs who are skilled at understanding customer needs, wants, and preferences and in meeting them even when market research and the customers themselves initially react negatively to their innovations.

I. Calculating risks: Decision-making in an uncertain world

Innovation management is simply a special case of *risk management.* There are three central and key ideas in this context:

First, uncertainty is pervasive and making decisions under uncertainty is unmanageable. The only to make good decisions is to transform uncertainty into risk by measuring and quantifying it. Second, it is risk is that is bought and sold in capital markets and not various types of assets like stocks and bonds. Third, human behavior toward risk and odds is very, very odd (or 'non-rational', to be polite). Managers and engineers who understand these ideas and integrate them in their daily decisions will gain immediate profit and avoid major loss. A pervasive theme of Innovation Management is the vital importance of innovation in building profitable, high-growth business strategies. Innovation is fraught with risk. For example, it is said that only one product out of 100 viable new-product ideas achieves marketplace success. A key aspect of innovation is how the innovation process is managed. The growing pervasiveness and magnitude of uncertainty compels every manager to acquire a toolbox that turns uncertainty into quantitative risk and then helps manage that risk. Evaluating risks appropriately and accurately weighing risks and benefits is equally important for firms. This is required to avoid the many pitfalls associated with psychological biases and fallacies related to people's odd behavior toward odds. One should be consciously aware of the one's own personal affinity for, or aversion to, risk**. [18]**

J. Competing by collaborating

In order to compete successfully, managers need to collaborate—with other managers, suppliers, colleagues, workers, customers, and at times, within legal limits, even with their competitors. Skill in teamwork and cooperation effort is an essential ingredient in every successful competitive strategy. Two thinkers have written major books suggesting that the intimate collaboration that characterized human society enriched our lives and enabled it to remain and gain earlier is being destroyed later by technology and ideology. In *Bowling Alone* **[19]** author Robert Putnam argues that modern society is becoming increasingly impersonal; social contacts, community networks, even friendships, continue to diminish. Increasingly, we even go

bowling—a sport inherently team-oriented—by ourselves. In *Company of Strangers*, Paul Seabright **[20]** asks whether the great 5,000-year-old experiment—collaborative society, where small and large groups join to find win-win outcomes and improve human well-being—is coming to end? There is evidence that the love of friends and family is more important component of our happiness and well-being than even our material wealth and income. It would be truly ironic if a fundamental misunderstanding, that the heart of capitalism is *competition* rather than *collaboration*, weakened the system that has such enormous potential for building individual happiness and freedom. Seeking win-win strategies should become the standard practice in coming up with effective innovative tools. Successful organization excels in all four types of 'competitive collaboration': collaborating with its own industry, its customers, its fellow workers, and managers. **[21]** Analyzing the responses of one's own counterparts or opponents strategically to one's own strategic moves is equally an imperative.

II. Conclusion

Most of the generalizations about innovation are wrong. Great innovation does not follow a single method (Lester Thurow). The new business model will distribute high-quality jobs around the world and deepen international collaboration. Firms that become and remain innovatively focused alone would be able to launch themselves towards growth and profit through wining strategies and enjoy an interesting take off and flight. Engineering, Management, and Economics all intersect at a vital junction—they are each concerned with making effective use of resources. That, in fact, is how Economics is commonly defined: as 'the study of the use of scarce resources which have alternate uses.'[22] By 'scarce', economists mean 'more is wanted and needed than is available'. The language and logic of Economics are powerful aids to engineers and managers in their efforts to innovate and strategize. Making effective use of both of them in a clear, focused, and effective manner is the objective of this Paper.

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