switching costs[1]

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Switching costs are the costs that consumers face in order to change between substitute products. Switching costs arise from all impacts that a substitute can have on the buyer's value chain, including any linkages with the supplier's value chain. They can be the result of investment by the buyer in high-cost specialized equipment, investment in learning how to operate such equipment, or even the result of product specifications, which tie the buyer to particular inputs.

Typical switching costs include the costs of identifying, evaluating, and testing the substitute, the costs of product or process redesign, the costs of purchasing additional equipment, employee retraining costs, and the costs of the technical help needed to affect the changeover. Other indirect costs may arise from the changing role of the user: these include resistance to the substitute and the cost of failure, which includes any costs incurred in switching back.

Switching costs typically change and fall over time. Early adopters of a new substitute have to develop their own technologies, procedures, and standards, and so in effect they subsidize subsequent adopters, who may find it easy to copy the early work.

Similarly, products and processes using substitutes can be redesigned to reduce costs, and thus increase the demand for and acceptability of the substitute, and reduce its costs. The propensity to switch can also change over time, as success with a substitute will induce other companies to try it.

As switching costs can lock-in buyers, they constitute effective barriers to entry (*see* FIRST MOVER ADVANTAGE). Incumbent firms pursue switching costs and new entrants try to challenge them. Establishing high-switching costs, however, may foster inflexibility. IBM, for example, has long strived to make its systems incompatible with those of any other supplier. This strategy has meant that repeat business was almost guaranteed, but as open systems became more commonplace, buyers were reluctant to purchase IBM products for fear that they would be unduly restrained by the company. To overcome switching costs, suppliers of substitute goods may initially have to offer buyers considerable price concessions or extra quality of service, which can mean lower profit margins.

Switching costs are minimized when standards are designed to evolve from one another. The introduction of revolutionary standards would be costly. The pay-off is superior performance against the high cost of switching standards.

The strategic implications of switching costs are that they create imperfections in competitive markets by raising the barriers of change, both in terms of consumers' ability to switch suppliers and in terms of the rate of adoption of new technologies.

ENDNOTES

[1] Original article by Stephanos Avgeropoulos. Updated by Tanya Sammut-Bonnici.

See also *critical mass*; *innovation strategy*; *networks*; *network industry strategies*; *network externalities*; *substitute products*; *technology and standards in network industries*; *R&D strategy*

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