16. Firms and the Creation of New Markets

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1. INTRODUCTION

New markets do not emerge, nor do they appear. They are *made* by the activities of firms. New markets are created when firms correctly sense (by accident or by design) a latent need and communicate their solution to that need: markets spring into being when economic actors shift resources to that firm's solution. The most visible way to create a new market is to offer a product/service that is novel, thereby addressing needs that were not met (and perhaps not even sensed). Much of this chapter focuses on firms' efforts to develop and commercialize new offerings, and on how buyers respond, thereby creating new markets. However, new markets are also created when firms cultivate an underserved clientele with established products. Much of marketing is about how to bring new customers into a developed industry (as opposed to rearranging market shares among existing customers). This chapter will also highlight these market-creation activities.[1]

Capitalist systems exhibit an astonishing ability to create new markets (and, typically, destroy existing ones) based on developing and commercializing innovations. Schumpeter (1943) argued that large firms innovate so well that they raise a society's general standard of living. In the same vein, Schmookler (1966) argues that long-term economic growth is primarily the result of better knowledge of what goods would be useful and how to make them, i.e. invention. There is little argument that innovation, on the whole, increases public welfare: new markets are thought to arise because buyers recognize they will be better off. Breshnahan and Gordon (1996) document why, with a series of innovations that clearly increase buyers' utility. It should be noted, however, that many innovations are not radical but merely incremental, and that their utility is in the eye of the beholder. Although this chapter emphasizes more radical innovation, it will address new products in general.

[1] We define a market as the set of all actual and potential buyers of a product or service. Following Williamson (1996), we define a firm as a governance structure, an organizational construction. We treat an industry as a group of sellers (firms) serving a market. In the standard economic perspective, the market is the main central institution, and the firms' black-box actions derive from markets. Here, we treat the firm (which is not a black box) as the central institution. And we view markets as an outcome of corporate activities. This reversal of the standard set up follows from New Institutional Economics.

C. Ménard and M. M. Shirley (eds.), Handbook of New Institutional Economics, 401–431.

It is less clear how much firms actually benefit from attempting to create new markets via new products. Firms develop and launch new products with the intention of increasing profitability. Schmookler (1966) shows that invention is not primarily a response to intellectual stimuli but is instead an effort to exploit a profit opportunity. But the payoff to the investing firm is highly uncertain. Frequently, developing firms reap heavy costs, but other firms capture the projected benefits—if indeed, these are not competed away in a ruinous race to build new markets and establish dominance. This may explain why Griliches, Hall, and Pakes (1991) find no relationship between a firm's patent counts and its financial performance. Bayus, Erickson, and Jacobson (2003) note that it is an article of faith among businesspeople that new product development (hereafter NPD) is essential to firm performance, but that the evidence is mixed as to why this is true, and how strong and long-lasting is the effect.

In short, NPD is inherently uncertain: new markets frequently do not materialize, nor do anticipated profits. We contend that the creation of new markets via the creation of new products is best understood through the lens of New Institutional Economics (NIE), leaning on the twin pillars of evolutionary reasoning and Transaction Cost Economics (hereafter TCE). From TCE, we adopt the premise that firms intend to be rational but are bounded in their abilities: in particular, critical information is impacted, and decision makers cannot write complex contingent claims contracts that steer toward optimal outcomes. Instead, executives compare concrete, visible alternatives and attempt to foresee which one does the best job of reducing the total of production and transaction costs long term. Further, opportunism is possible, and given a sufficient scale of operation, worth reducing by employing costly governance mechanisms. Coming sections rely on the TCE mechanisms of asset specificity, environmental uncertainty, and internal uncertainty (difficulty of assessing performance using output measures). The control/commitment continuum from arm's-length market contracting to relational governance through to vertical integration will be invoked frequently to explain how firms develop new products in the hope of creating new markets, and how they form relations with economic actors (such as distributors) that are vital to the product's success.

From evolutionary economics (Nelson 1995, Dosi 1997)), we borrow the premise that markets seldom reach equilibrium, and that if they do so, the equilibrium reached is path dependent at the industry level. Further, firms react to uncertainty by developing routines that are difficult to change, routines that reflect the path of their (unique) history. Learning and imitating feature heavily in our analysis.

Strands of these frameworks also appear in a major part of this chapter that reviews how prospects become converted into customers, thereby calling new markets into existence. We rely here on the study of consumer behavior through the combined lenses of sociology, psychology, and economics. We discard the classical economic assumptions that consumers are well informed, rational maximizers of their own utility, capable of reducing multiple attributes of a product to the lowest common denominator of net utility. We accept that buyers have