SWITCHING COSTS

We know that a consumer's willingness-to-pay (WTP) for vacation to Bali may depend on the cost of a vacation to Istanbul. Similarly, the price you are willing to pay for an iPhone 15 will depend on the Galaxy S24 from Samsung, Mate X3 from Huawei, and vice versa. WTP for these high-quality alternatives is less likely to depend on alternatives such as returning to a Motorola flip phone circa 2008 or a landline. (See pictures below.)

In addition to the prices of substitutes, WTP depends on switching costs. In some contexts, switching entails termination fees, closing accounts, changing equipment, and incurring set up costs. Another fundamental source of switching costs is the investments consumers make to learn about and optimize their use of a product. These complementary investments vary in size. Consider a consumer in India who successfully used Pillsbury-branded "cake mixes." He or she may not switch to Tops Cake Mix – a local brand that is of equal quality and less expensive – because the alternative has different instructions.

In the context of tech products, investments by users to optimize those services are far more significant. Forgetting what you had learned and learning what you now need can be a substantial task. For some who are technically adept, switching between Apple products (which use iOS) and Samsung products (which use Android) is not much of an issue.[1] But many will wonder, what about all your apps, your photos and contacts? Am I more likely to retain everything if I stick with the same manufacturer?

Network effects also increase switching costs. Consider Bloomberg and Thomson Reuters' Eikon terminals, which provide real-time market information and connect users to others using the same terminals. Each provides similar features and capabilities, i.e., delivery and analysis of financial information, risk management tools, trade execution, access to auctions, and easy migration of data into spreadsheets. Bloomberg terminals cost $24,000 annually while Reuters options range from $3,000 to $22,000. Investors have yet other options, including Factset, S&P Capital IQ, Morningstar Inc., and YCharts. The annual subscriptions for these services vary greatly, e.g., Factset costs $3,600 annually. Alternatives such as Google Finance and Yahoo Finance are free. The Bloomberg and Reuters example, which we will use again, suggests that switching costs in network settings should take into account the value of being in the network. The higher-priced Bloomberg service has 325,000 subscribers compared to Reuters' 190,000 subscribers.

Switching costs are getting more attention by governments and competition authorities. The question follows, do switching costs prevent competition**?** When firms succeed in gaining a loyal customer base, they have a degree of market power. However, markets with switching costs can be competitive in a dynamic sense because firms compete *ex ante* to secure customers who are subsequently reluctant to switch (rf. Dube et al.). One can assess whether markets are competitive by evaluating prices over time and observing actual switching behavior.

Switching costs are a central feature of digital search and social media platforms, such as Google and Facebook, where users contribute data to the platform but may not be able to migrate that data to a competing platform. For example, a user may upload a variety of data to Facebook, including photos and personal information, but may not be able to easily download that data and move it to another social

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[1] Some claim that switching between phones takes little time. Rf. www.gearpatrol.com/tech/a33218583/switching-to-iphone-ios-from-android/.

media site; instead, the user would have to upload her photos and re-enter her personal information to the new platform. An online seller who has generated hundreds of product reviews and ratings on Amazon may face a similar challenge when considering migrating to a different platform. Other significant factors that contribute to switching costs in digital markets include contracting terms, default settings, and product design that favor dominant platforms.[2]

Could so-called interoperability enhance competition among social media and eCommerce platforms? Consider the effort it took to create your Facebook profile, with all your connections, personal information, pictures, videos and shared links, and the online reputation that results. Such investments make it hard to move away from Facebook into another social media platform. Similarly, it may be difficult for top-rated sellers on Amazon Marketplace to shift to eBay, where they would lack customer reviews. For these reasons, platforms that gained scale and realized network effects may have significant first-mover advantages. However, if you were able to migrate all your data from one platform to another, just as you are able to take your phone number from AT&T to Verizon, switching costs would be reduced, but by how much? Even with operability rules, network effects would remain a consideration. Even if all your data and pictures were transferred easily, how much fun would it be to be the only one among your friends on Platform X?

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Readings:

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[2] https://www.govinfo.gov/content/pkg/CPRT-117HPRT47832/pdf/CPRT-117HPRT47832.pdf

Substitutes no longer