Firms within the same industry sell products that are good substitutes for each other. Yet it is generally the case that no firm within the industry sells a product that is identical to that sold by a different firm. Further, most firms sell products that differ somewhat from each other.

**PRODUCT DIFFERENTIATION**

“Product differentiation” occurs when products sold within the same industry have many small, and sometimes large, differences. Product differentiation occurs within the products sold by a single seller and between the products sold by different sellers.

For instance, Ford sells a range of automobiles: the Focus, the Mustang, the Taurus, the Thunderbird, the Crown Victoria, the Mercury Grand Marquis, and the Mercury Marauder. Further, within each of these lines are many different versions of the same model. For instance, the Ford Focus comes in different body styles: a hatchback, a sedan, and a station wagon. And, finally, within each of these body styles are cars with different features (hatchback with or without cruise control, hatchback with 15 inch wheels or 16 inch wheels, hatchback painted Sangria Red Clearcoat Metallic or painted CD Silver Clearcoat Metallic, and so on).

At the same time, General Motors, Chevrolet, Hyundai, Honda, Toyota, and all the other automakers also sell a range of their own differentiated products. Each of the differentiated products sold by, say, GM differs from the cars sold by Ford.
Product differentiation is found throughout the economy. Within most industries you find a wide range of differentiated products. Think of what you see when you walk through a grocery store: dozens of different soups types sold by many different firms, many different types of milk (1%, 2%, and so on) sold by different dairies.

Generally only within narrow industries in the agricultural sector of the economy do you find firms that sell products that do not differ much from each other. The red delicious apples produced by Farmer Smith are almost identical to the red delicious apples sold by Farmer Diaz. When all the firms within an industry sell a product that is almost identical to each other this is called a “homogenous product.” The opposite of a homogenous product is a differentiated product.

DIMENSIONS OF PRODUCT DIFFERENTIATION

Products can differ from one another along many different dimensions. I will discuss only some of the more important here.

PERFORMANCE AND QUALITY

Firms in the same industry sometimes produce products that differ in performance and/or quality. Sometimes this differentiation occurs by the choice of the firms involved: one firm decides to produce a low cost/low quality product while a second firm decides to produce a higher cost/high quality product. Consumer electronics firms often pursue one or the other approaches. Often the same firm will sell a range of different products that differ in performance or quality.

In other cases, some firms are just better at producing high performance/high quality products than other firms. The rise of the Japanese auto manufacturers in the 1970s was due, in part, to their greater ability to produce cars with significantly fewer defects than the US automakers.

SHOPPING EXPERIENCE

Some stores differentiate the products they sell by providing a better shopping experience. Clean, well-lit, orderly stores can attract consumers. Greater personal service (many sales people who attempt to be pleasant and to help you) differentiates certain retail firms from others. Of course, it is often the case that products sold in such stores cost more than products sold in other stores.

Other stores attempt to provide low-cost products by skimping on what might provide a good shopping experience. Unattractive and poorly organized
$0.99 stores often take this approach. Their service and quality of the shopping experience is low, but prices are also often lower than other stores.

**COST/TIME NEEDED TO OBTAIN THE PRODUCT**

If two stores have identical products and provide identical shopping experiences you will most likely go to the one that is closer to you. Products close by are different—and better—than products far away. I go to our local Hollywood Video not because I like it better than any other video store but simply because it is the closest one. When Blockbuster had a store in the exact same location a few years ago I went to Blockbuster. Now that Hollywood is in the exact same place I go to Hollywood.

Similarly, if a local store and an Internet merchant both sell an identical VCR at the same price, they still sell differentiated products. The difference is how quickly the consumer actually gets the product. The VCR from the local store is most likely available to take away as soon as the buyer pays for it; but you most likely will have to wait for days for the VCR to be delivered by mail from the Internet merchant. This difference in waiting time to get the product can make otherwise identical products different from each other.

**WARRANTIES, GUARANTEES, AND RETURNS POLICIES**

Whenever someone buys a product a chance exists that the product does not live up to his/her expectations. Perhaps the product doesn’t work or perhaps the buyer decides she/he doesn’t really like the product after bringing it home.

Sellers can reduce the cost of this risk to buyers by offering warranties or satisfaction guarantees. They can also have liberal returns policies to convince a potential buyer to take a chance on a product because the buyer will know they can always return the product if they like. A firm can also offer after-sales service to help the customer if the customer has questions about how to use or fix the product.

If two firms sell identical products but one offers, say, a satisfaction guarantee customers likely perceive a difference between what otherwise appears to be an identical product.

**PURE PRODUCT DIFFERENCES**

Often products produced by different manufacturers are simply different with none of them being necessarily “better” in an objective way. For instance, a blue Explorer SUV is not objectively better than a green Explorer. Although some people might prefer a blue car this does not mean that a blue car is better than a green car in any objective sense.
FORCES PROMOTING THE INCREASE AND DECREASE OF PRODUCT DIFFERENTIATION

The extent of product differentiation is not given by nature. Business firms are the main agent in the introduction of product differentiation. Sometimes, though, a firm might desire to reduce the extent of product differentiation. Among the concerns of firms is how product differentiation affects profit.

WHY FIRMS MIGHT ATTEMPT TO REDUCE THE EXTENT OF PRODUCT DIFFERENTIATION

If firms in an industry discover that consumers like some particular feature in the product the firms sell, the firms will all try to introduce this same feature hoping to boost their sales. As many firms introduce this same feature to what they sell, what they sell will become more similar than before. In this case, the extent of product differentiation will fall.

For example, automobiles once were produced without radios. But once automobile manufacturers discovered that car buyers like radios many of them then placed radios in their cars. When it was discovered the many drivers liked tape players, auto manufacturers all started to place tape players in their cars. The same thing is happening in recent years with car CD players.

As a second example: it once was the case that kitchen appliances came in only a few basic colors. But then stainless steel appliances became popular for some well-to-do buyers. Now a number of kitchen appliance manufacturers now carry products that are the color of stainless steel.

Competition for customers can drive firms in the same industry to introduce the same popular features as these firms attempt to sell their products to more and more customers. This process over time tends to make products share many important similarities.

WHY FIRMS MIGHT ATTEMPT TO INCREASE THE EXTENT OF PRODUCT DIFFERENTIATION

Yet other forces push firms to make their products different from those sold by rival firms. Firms that sell products that are very similar are not able to claim that their products are meaningfully different from those sold by rival firms. An example of this might be flour, sugar, or #2 pencils. In this case of nearly identical products firms can hope to increase their sales only by offering a lower price then their rivals. This price competition tends to push the price to quite low levels as all firms in the industry are faced with the need to keep their
products priced at least as low as that sold by rival firms. Price wars can break out in this situation.

When firms do sell products that are very similar to each other, consumers can price compare and possibly play off one firm against another. A lower price again results from this.

Firms, therefore, desire to not sell a product similar to that sold by rivals. If they can firms will introduce modifications of their product that they hope will make their product as good as rivals’ products but at the same time different from rival products.

At the same time, firms might find it profitable to produce many different variations of the same product themselves. If a customer can find the exact same product (produced by the manufacturer) sold at different retail outlets, the customer might be able to play the retailers off against each other. The retailers will not like this situation.

As a result, manufacturers often produce many different versions of the exact same product so that they can provide to different retailers slightly different versions of their product. This makes price comparison difficult—or impossible. This benefits both the retailer and the manufacturers if consumers are unable to price compare.

Product differentiation, then, can help reduce competitive pressure between firms in the same industry. It can also be used to keep customers from engaging in price comparison.

These two aims tend to promote product differentiation and works in the opposite direction of firms attempting to offer the same population features in their products.

**CONCLUSION**

Product differentiation is not obviously good or bad. On the one hand, buyers often appreciate the ability to select from a wide variety of product offerings in order to be better able to select that particular product that best suits their preferences. No everyone wants a cola- or chocolate-flavored product; some want a lime- or vanilla-flavored product.

Yet one motivation of producers in producing a wide variety of slightly different products is to make it difficult to price compare. Because no two DVD players produced by different manufacturers are identical you are not able to simply compare the price to find the best deal. Rather than focus on the absolutely cheapest price you are forced to weigh whether one particular
feature is worth the extra $20 you would have to pay. This focus on different features, rather than on finding the lowest price for identical products, generally helps firms maintain higher prices.

But, rather good or bad, product differentiation is almost inevitable in most industries. At the very least, different locations for stores differentiates the products sold within the stores.