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ASK NUS ECONOMISTS

Why similar firms choose to locate close to each other

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Why do competing fast food companies place their restaurants beside each other?

THIS is an interesting question. Shouldn't fast food restaurants distance themselves from each other in order to reduce competition? The intuition seems reasonable, yet we see similar firms located in close proximity. Why is this so?

Let's consider the question first from a fast food restaurant's perspective. Like most retail stores, a fast food restaurant has two major considerations: price and location. The closer the competitors, the more intense price competition is. The farther the competitors, the more a restaurant is able to exert market power on its local customers in the form of higher prices.

But a restaurant also has to consider how many customers a location will attract, and this, in turn, depends on consumer behaviour. Where do consumers shop? How far do they travel? What costs do they incur?

Now imagine a scenario in which a couple are deciding where to have dinner. One option is to head for an isolated restaurant. If the restaurant is too crowded, or the couple finds that they do not like what is on the menu, then they will have to travel elsewhere. Another option is to go to a place with lots of restaurants to choose from.

It is likely most couples would choose the latter if they are not fixated on a particular cuisine. With several different choices within the same locale, the second option helps the couple find a good match to their preferences without having to travel to different places. In other words, the second option lets them reduce their search costs.

So when restaurants combine their concern for competition and consumer behaviour, the choice of location boils down to a balancing act. Being far away from a competitor may seem great for prices. But go too far and there may not be many customers to sell to.

In economics, such clustering is referred to as agglomeration, and the forces that cause firms to locate close to each other are known as agglomeration economies. Simply put, firms agglomerate when the perceived payoff to agglomeration exceeds the cost. The clustering of restaurants lowers customers' costs of choosing a restaurant. And lowering their costs increases the demand for a cluster of restaurants. But with many restaurants nearby, these outlets will have to compete for customers by lowering prices, offering better service or having cleaner premises. Therefore, a new restaurant will decide to locate in a cluster if the benefit of enjoying more foot traffic from the cluster outweighs the threat of competition.

If we look around closely, we can see agglomeration happens in other retail markets in which customers' search costs are potentially high.

Home decor shops line the Balestier neighbourhood because most home owners would rather make joint purchases in a single shopping trip: buying a kitchen sink together with lighting and possibly a few pieces of furniture. Buying a car involves comparing prices against different models and brands of cars, with the potential to bargain for more: "Really? You can offer me only the sticker price? XYZ Motors across the street was able to give me a 30 per cent discount and include a five-year warranty."

A family with two rambunctious children with a desire to hire a maid would rather hit a mall chock-full of maid agencies and set up interviews with as many of them as possible on one Sunday afternoon.

Agglomeration also appears in many non-retail contexts. The reasons, however, are different. For example, vineyards cluster in Bordeaux because the climate and geography are very favourable to growing grapes. Software firms cluster in Silicon Valley, and movie studios in Hollywood, to take advantage of a specialised labour pool and to benefit from knowledge spillovers.

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