AS Business
Economies of Scale

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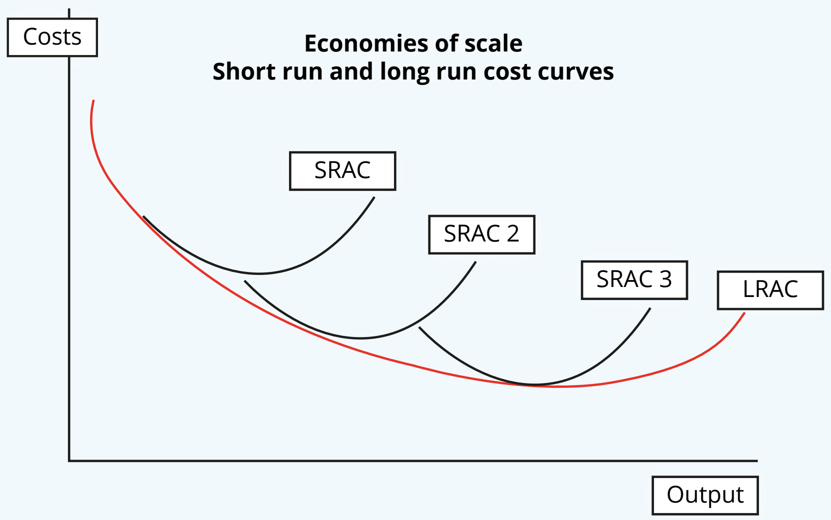
Economies of Scale

Definition: The reduction in average costs of production that occur as a business increases its scale of production.

Costs in the short and long run
In the short run, costs can be both variable and fixed, but in the long run all costs become variable. For example, rent negotiated over a 12 month contract is a fixed cost in the short run – i.e. it does not alter in relation to changes in demand or output. However, if rent rises after 12 months, then it too is regarded as a variable cost. It is this switch to all costs becoming variable that separates the short run from the long run.



Each business' long run average cost curve is made up of a series of short run average cost curves. As a business grows it moves from one short run average cost curve to another short run average cost curve, each one being progressively lower and so reducing average costs of output.

Internal Economies of Scale

Definition: Reductions in average cost per unit of output as a result of increasing internal efficiencies of the business.

There are six types of:

1. **Marketing** – as businesses grow, each pound (£) spent on advertising will have greater benefit for the business – the advertising costs are spread over more units.
2. **Managerial** – able to employ specialist staff, e.g. accountants – likely to work more efficiently and thereby reduce the average costs of producing.
3. **Risk-Bearing** – larger producers can spread their risks so they don't have all their 'eggs in one basket' – diversify into different market so that if one fails you have a back-up.
4. **Financial** – easier to access loans as are able to offer security – negotiate more favourable rates of interest.
5. **Technical** – machinery allows products to be made/ jobs to be performed quicker – more use of division of labour/specialisation.
6. **Purchasing** – as businesses grow, they increase the size of orders for raw materials or components – this may then result in discounts being given and the cost of each individual component purchased will fall.

<u>Economies of Scale</u>

Internal Economies highlight the advantages that a business obtains due to the use of modern techniques.

External Economies are the advantages that a business obtains because of external factors.

External Economies of Scale

Definition: The advantages of scale that benefit a whole industry and not just an individual business, e.g. more skilled workforce, development of industry specific research and component suppliers.

- **Labour** – the concentration of businesses may lead to the build up of a labour force equipped with the skills required by the industry.
- **Supplier economies** – a network of suppliers may be attracted to an area where a particular industry is growing. The setting up locally of supplier businesses, often in competition with one another, reduces buying costs and allows the use of systems such as just-in-time.
- **Educational economies** – local colleges will set up training schemes suited to the largest employers' needs, giving an available pool of skilled labour. This reduces recruitment and training costs for those businesses who make up the industry concerned.
- **Financial economies** – financial services can improve, with banks and other financial institutions providing services that may be particularly geared towards a particular industry. For example, for an industry where cash flow may be a particular problem, debt factoring services may be made available at competitive rates.
- **Commercial services** – a growing industry tends to attract smaller businesses trying to serve its needs. A wide range of commercial and support services can be offered, such as banking, marketing, waste disposal, maintenance and distribution.
- **Co-operation** – businesses located in the same region might join forces to fund a research and development centre for the industry.

Diseconomies of Scale

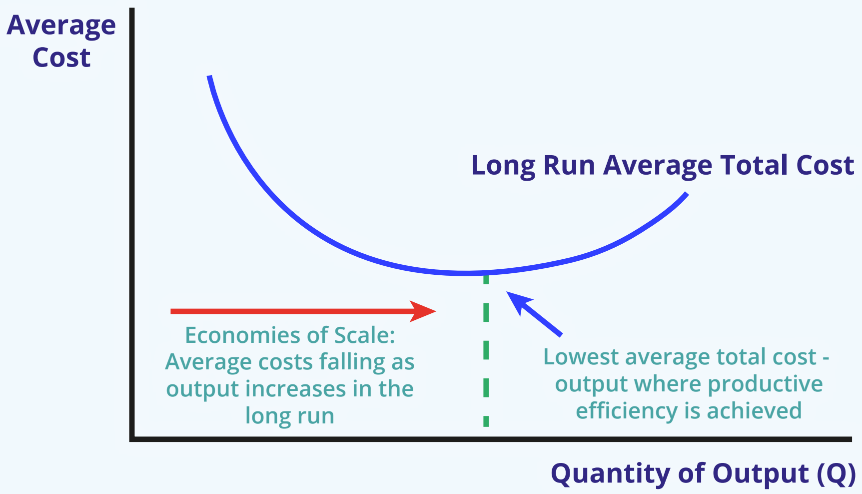
Definition: The factors that cause higher costs per unit of output when the scale of an organisation continues to increase – the causes of inefficiency in large organisations.

When diseconomies occur, the average costs of production rise with output.

Internal Diseconomies of Scale

Definition: Internal diseconomies of scale occur where the average cost (unit cost) increases as output expands (in the long run). These occur when a business becomes very large.

Diagram:



Problems that arise are mainly due to management problems. This may be due to problems in relation to communication, co-ordination, control and employee morale.

- **Communication** – becomes more complex and harder to manage – misunderstandings occur leading to inefficiency.
- **Commitment/motivation** – morale may suffer as individual employees become a minor part of the total workforce, thus feel their views are ignored.
- **Co-ordination** – is more difficult and control is weakened because a large business is divided into departments – time is then spent in meetings which is in itself a cost!

Examples of Diseconomies of Scale

Regulatory Costs	Office Politics / Industrial Relations
The Principal-Agent Problem	Risk Aversion
Waste / Inefficiency in large organisations	Rising Costs of Complexity

External Diseconomies of Scale

External diseconomies of scale may occur from:

- **Overcrowding in industrial areas** – traffic congestion may occur – resulting in late deliveries and staff arriving late for work. Local residents may resent this and public relations may suffer.
- **Increased price of resources** – more businesses in an area means increased demand for labour to work in that industry and the best employees may be harder to recruit and keep. Land, services and materials may all become more expensive as the industry grows and demand for such resources increases.

Why Do Small Firms Continue to Survive?

- They are able to provide a **personal service**, something that is very difficult to do in large organisations. Many people prefer to do business directly with the owner.
- Some entrepreneurs are simply **happy** to remain as a small business. They are content with the current level of profits and wish to avoid the added responsibilities and risks associated with growth and increased size.
- They can be a **lot more flexible** in some circumstances. They can react quickly to changes in market conditions or technology. Management can make decisions quickly without undergoing endless meetings with other departments or divisions of the company.
- **Target market size** – sometimes the potential sales are suited to small businesses, for example dog grooming services or kennels.
- **Serving the local community**. Many small businesses do this and have survived for many years, often being the only one providing such a service in a particular locality.
- **They are often easy to set up**. Set up costs are often relatively low – for example, a painter and decorator can start almost straight away once they have found some customers.
- **Customer loyalty** – even in the modern retailing environment there are customers that remain loyal to local shops and service providers.
- Small businesses **often serve niche markets** – the marketing of products to a particular, small segment of the market. The size of the market itself may dictate the potential for growth.