Unit 14- Economies of scale and Diseconomies of scale

Economies of scale is where the average cost of producing(unit cost) a product reduces in the long run due to bulk production.

There are two types of economies of scale,
1. Internal economies of scale - average cost of producing a product reduces in the long run due to bulk production achieved due to business's own growth.

2. External economies of scale - average cost of producing a product reduces in the long run due to bulk production achieved due to industrial growth

Internal economies of scale

Types of Internal Economies of scale

1. Purchasing /Buying economies
   Large firms buy raw materials in bulk due to high production usually receive a discount (price reduction).Therefore the cost of production reduce and the firm can reduce its average cost
2. Selling economies (Marketing economies)
   The total cost of packing goods, advertising and transporting doesn't vary with number of products it produces. A large output reduces selling cost/ unit as the cost splits among a high number of units
3. Managerial economies
   Large companies are able to attract the best managers because of high salaries they can pay. Employing specialist staff will increase the firm's efficiency
4. Financial economies
   Large firms usually find it easier and cheaper to borrow money .Large firms can borrow money at a low rate of interest, because bank is confident that the loan will be repaid.
5. Technical economies
   Large firms can benefit from better techniques of production. Automated systems and equipment may be very expensive to install, that only large companies can afford it. Automated production lines enable very high production at low unit cost.
6. Research & development economies
   Large firms can afford a research and development department, therefore has the ability to develop more efficient methods of production and reduces average cost of production.
7. Risk bearing economies
   Large firms usually produce a range of products (product diversification) which enables them to spread the risk of trading. If the profitability of one product drops it can shift its resources to the production of more profitable products

External economies of scale

Types of external economies of scale are,

1. Having a skilled labour force-Improved educational facilities, such as new college or university to training people in the skills needed by local businesses

2. Specialist suppliers of raw materials & capital goods are available-The development of supply of components to firms in an industry avoid firms importing them and it reduces their cost.

3. Improved infrastructure -The growth of an industry encourages a government to provide improved communications and transport link (a new railway line) that reduces distribution costs

4. A good reputation -A firm gains reputation by supplying a quality product for a certain period.

Ex: Maldives has a reputation for a popular holiday retort.

The economies of Scale provides the efficiency in a business, it can use less inputs in order to achieve a higher output (can be called as increasing returns to scale).

Ex:

land	labour	capital	output
6	8	4	100
9	12	6	200

Internal diseconomies of scale

The average cost of producing a product rises in the long run due to bulk production achieved due to business's own growth.

1. Difficulties in controlling the firm-When a firm is too large managers may find it difficult to supervise what is happening in the business. Management becomes more complex due to the s ale of operations and layers of management needed and the administrative cost will increase.

2. Communication problems -It is difficult to ensure that every one have full knowledge about duties and responsibilities. They may also not get the opportunity to effectively communicate with their ideas and views to the management team. As a result, work many not carried out properly, it causes inefficiencies which increase the average cost.

3. Poor industrial relations-Large firms are at a risk of worker demotivation which could cause strikes and other industrial actions. Workers feel they aren't belonging to the organization and their problems are not solved.

External diseconomies of scale

The average cost of producing a product rises in the long run due to bulk production achieved due to industrial growth

1. High prices for resources due to high demand(when demand for labour is high, wages goes up)
2. Exploitation of resources
3. Traffic congestion, Environment pollution

The diseconomies of Scale provides the inefficiency in a business, it can use more inputs in order to achieve a lesser output (can be called as decreasing returns to scale).

- Returns to scale concept is being used to explain the long run production behaviors. It has 3 categorizes, namely

1) Increasing returns to scale (Input 10%-Output 15%, efficient, leads to economies of scale)

2) Decreasing returns to scale (Input 10%-Output 5%, efficient, leads to diseconomies of scale)

3) Constant returns to scale (Input 10%-Output 10%)

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20 A large clothing manufacturer expanded by acquiring retail clothing outlets.

Of what is this an example?

A diversification

B external economies of scale

C horizontal integration

D vertical integration

24 The table shows the units of factors of production that a firm needs to employ for two different levels of output.

land	labour	capital	output
5	2	4	10
10	4	8	300

What is the firm experiencing?

A constant returns to scale

B economies of scale

C external diseconomies of scale

D external economies

Question: Expain two Internal diseconomies of scale that a bank can enjoy?