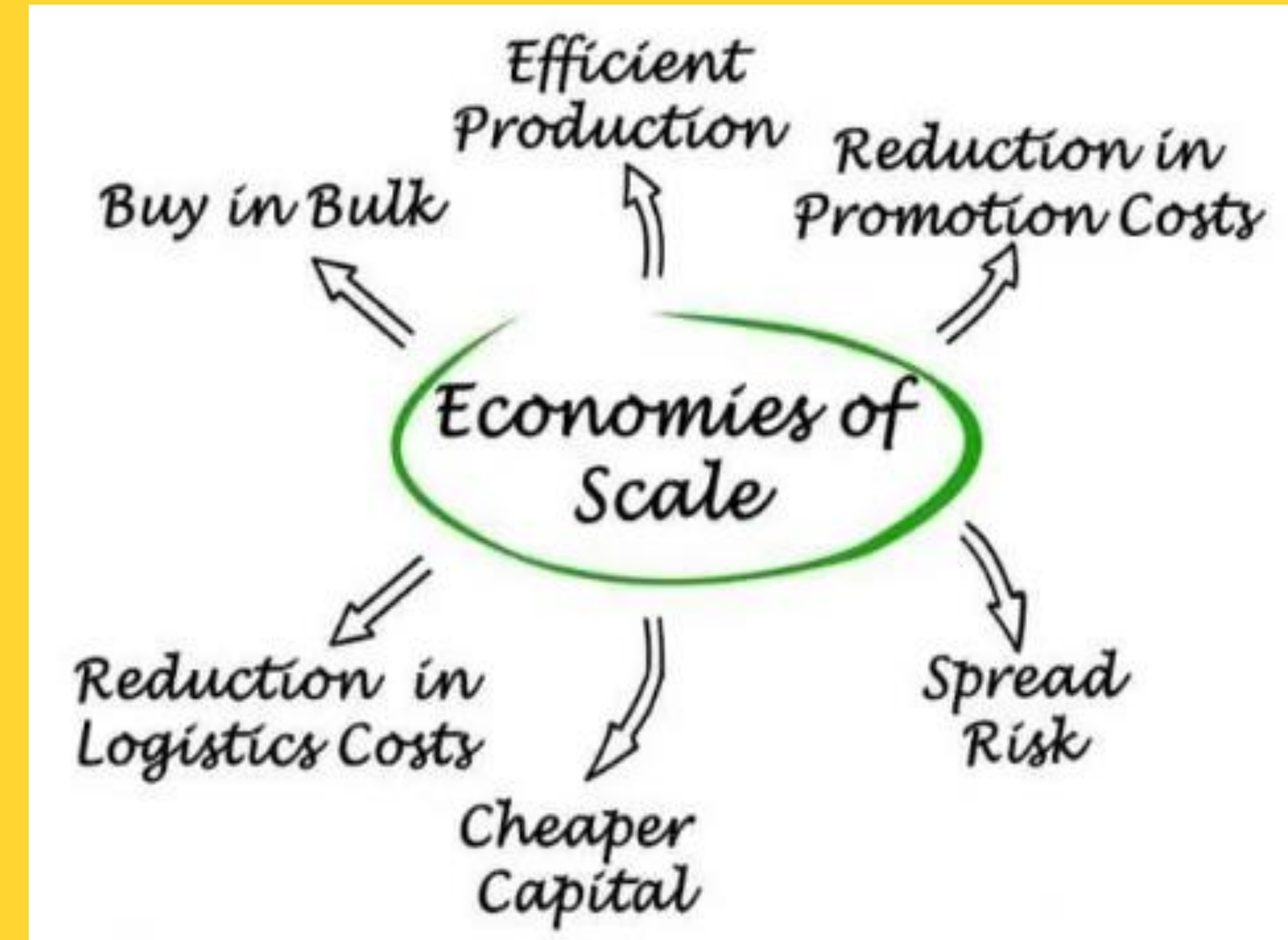
SNS COLLEGE OF TECHNOLOGY

(An Autonomous Institution)

ECONOMIES OF LARGE AND SMALL SCALE

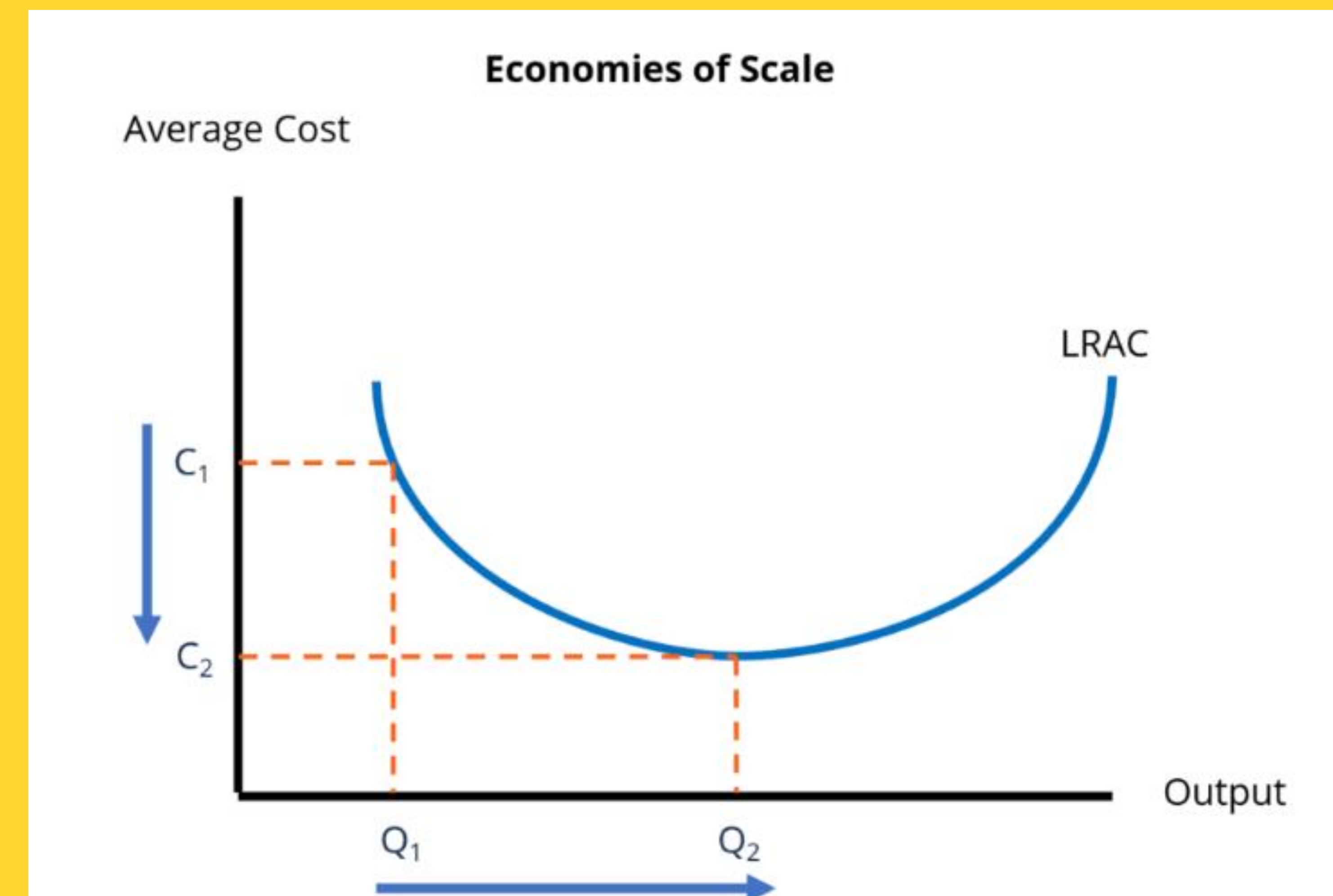
Economies of scale:

- Economies of scale are cost advantages that companies can experience when production becomes more efficient.
- This can happen when production increases faster than costs, allowing the costs to be spread over more goods.
- Larger companies are more likely to have lower cost per unit than smaller companies because they can spread their costs over more units of production.



Effects of Economies of Scale on Production Costs

- It reduces the per-unit fixed cost. As a result of increased production, the fixed cost gets spread over more output than before.
- It reduces per-unit variable costs. This occurs as the expanded scale of production increases the efficiency of the production process.
- The graph above plots the long-run average costs (LRAC) faced by a firm against its level of output. When the firm expands its output from Q1 to Q2, its average cost falls from C1 to C2. Thus, the firm can be said to experience economies of scale up to output level Q2.



Economies of scale can be internal or external:

Internal economies

- These are caused by factors within a single company, such as when a business produces more units of a product or offers more services.
- For example, a pizza place that makes 100 pizzas instead of 10 can lower the cost per pizza, making it more profitable.

External economies:

- These affect the entire industry and can include things like new production methods, transportation modes, government tax breaks, or increased tariffs against a foreign competitor.
- This phenomenon is sometimes called an "agglomeration economy," where businesses are located close to one another and can share resources and efficiencies.

Sources of Economies of Scale

1. Purchasing

Firms might be able to lower average costs by buying the inputs required for the production process in bulk or from special wholesalers. By negotiating with suppliers for volume discounts, the purchasing firm takes advantage of economies of scale.

2. Managerial

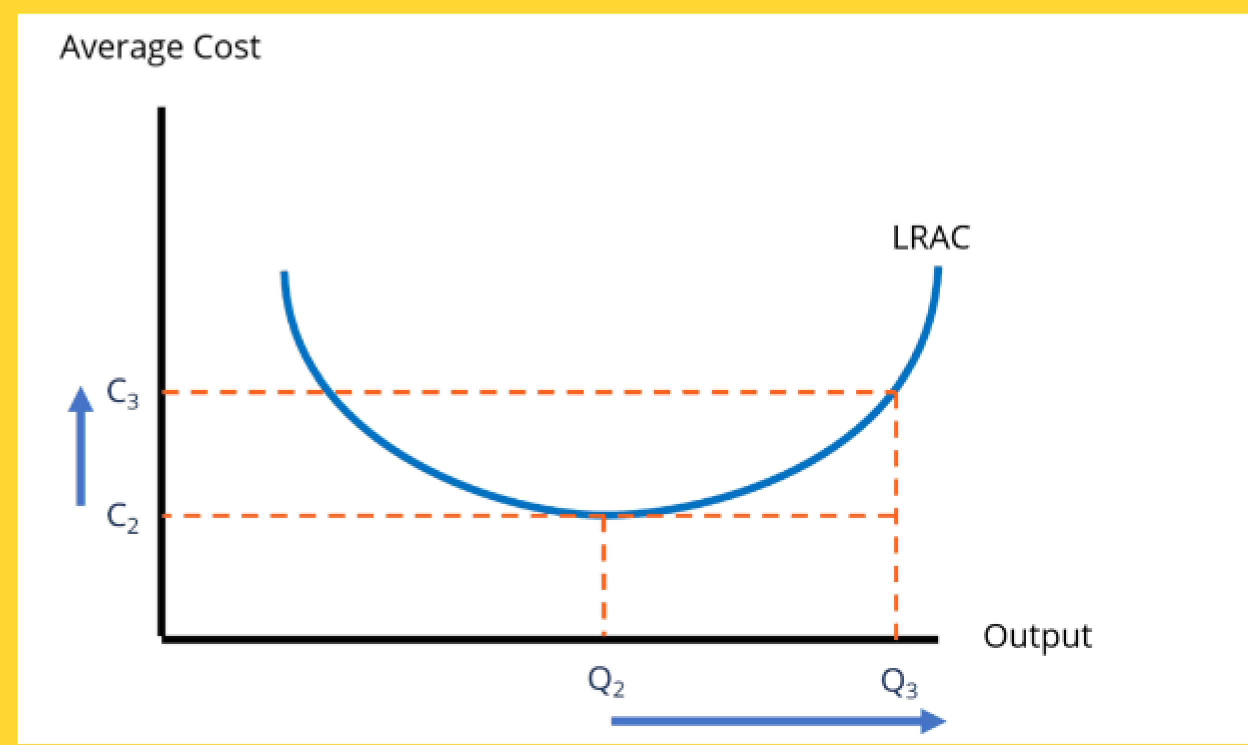
Firms might be able to lower average costs by improving the management structure within the firm. The firm might hire better skilled or more experienced managers.

3. Technological

A technological advancement might drastically change the production process. For instance, fracking completely changed the oil industry a few years ago. However, only large oil firms that could afford to invest in expensive fracking equipment could take advantage of the new technology.

Diseconomies of Scale

- Consider the graph shown above. Any increase in output beyond Q_2 leads to a rise in average costs. This is an example of diseconomies of scale – a rise in average costs due to an increase in the scale of production.
- As firms get larger, they grow in complexity. Such firms need to balance the economies of scale against the diseconomies of scale.
- For instance, a firm might be able to implement certain economies of scale in its marketing division if it increased output. However, increasing output might result in diseconomies of scale in the firm's management division.



THANK YOU