Economies of scale

Introduction

Economies of scale arise when the cost per unit falls as output increases. Economies of scale are the main advantage of increasing the scale of production and becoming ‘big’.

Why are economies of scale important?

- Firstly, because a large business can pass on lower costs to customers through lower prices and increase its share of a market. This poses a threat to smaller businesses that can be “undercut” by the competition.

- Secondly, a business could choose to maintain its current price for its product and accept higher profit margins. For example, a furniture-maker which could produce 1,000 cabinets at £250 each might expand and be able to produce 2,000 cabinets at £200 each. The total production cost will have risen to £400,000 from £250,000, but the cost per unit has fallen from £250 to £200. Assuming the business sells the cabinets for £350 each, the profit margin per cabinet rises from £100 to £150.

There are two main types of economies of scale: internal and external. Internal economies of scale have a greater potential impact on the costs and profitability of a business.

Internal Economies of Scale

Internal economies of scale relate to the lower unit costs a single firm can obtain by growing in size itself. There are five main types of internal economies of scale.

Bulk-buying economies

As businesses grow they need to order larger quantities of production inputs. For example, they will order more raw materials. As the order value increases, a business obtains more bargaining power with suppliers. It may be able to obtain discounts and lower prices for the raw materials.

Technical economies

Businesses with large-scale production can use more advanced machinery (or use existing machinery more efficiently). This may include using mass production techniques, which are a more efficient form of production. A larger firm can also afford to invest more in research and development.

Financial economies

Many small businesses find it hard to obtain finance and when they do obtain it, the cost of the finance is often quite high. This is because small businesses are perceived as being riskier than larger businesses that have developed a good track record. Larger firms therefore find it easier to find potential lenders and to raise money at lower interest rates.

Marketing economies

Every part of marketing has a cost – particularly promotional methods such as advertising and running a sales force. Many of these marketing costs are fixed costs and so as a business gets larger, it is able to spread the cost of marketing over a wider range of products and sales – cutting the average marketing cost per unit.

Managerial economies

As a firm grows, there is greater potential for managers to specialise in particular tasks (e.g. marketing, human resource management, finance). Specialist managers are likely to be more efficient as they possess a high level of expertise, experience and qualifications compared to one person in a smaller firm trying to perform all of these roles.

External Economies of Scale
External economies of scale occur when a firm benefits from **lower unit costs as a result of the whole industry growing in size**. The main types are:

**Transport and communication links improve**

As an industry establishes itself and grows in a particular region, it is likely that the government will provide better transport and communication links to improve accessibility to the region. This will lower transport costs for firms in the area as journey times are reduced and also attract more potential customers. For example, an area of Scotland known as Silicon Glen has attracted many high-tech firms and as a result improved air and road links have been built in the region.

**Training and education becomes more focused on the industry**

Universities and colleges will offer more courses suitable for a career in the industry which has become dominant in a region or nationally. For example, there are many more IT courses at being offered at colleges as the whole IT industry in the UK has developed recently. This means firms can benefit from having a larger pool of appropriately skilled workers to recruit from.

**Other industries grow to support this industry**

A network of suppliers or support industries may grow in size and/or locate close to the main industry. This means a firm has a greater chance of finding a high quality yet affordable supplier close to their site.

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