YESHWANTRAO CHAPHEKAR COLLEGE, PALGHAR

PRESENTATION

ON

CHAPTER- 8

ECONOMIES AND DISECONOMIES OF SCALE

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Meaning of Economies and Diseconomies of Scale.

- It is of two types i.e. internal and external.
- Internal economies and diseconomies are those which a firm reaps as a result of its own expansion.
- External economies and diseconomies are those which a firm reaps as a result of the growth of industry as a whole.
- They are external because they accrue (gather) to the firms from outside.

The internal economies of scale are classified into two-

Internal Economies of Scale

- Real Economies
- Pecuniary Economies

- **Production Economies**
  - **Labour Economies**
  - **Technical Economies**
  - **Inventory Economies**
- **Marketing Economies**
- **Managerial Economies**
- **Transport & Storage Economies**

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Real Economies of Scale

- Real Economies are those which are associated with a reduction in the physical quantity of inputs such as raw materials, various types of labour etc.

- They are mostly associated with indivisibilities of units of factors of production.

Important kinds of Real Economies

1.<u>Production Economies</u> - Production Economies arises from the use of factors of production in the form of –

- i) Labour Economies
- ii) Technical Economies
- iii) Inventory Economics

Continued….

i) <u>Labour Economies</u> –

- As the size of output increases the firm enjoys labour economies due to specialization, time-saving, automation of production process etc.

- As the size of production increases the firm can enjoy the advantages of division of labour and specialization of labour which increases the productivity of the various types of labour.

- The advantages of division of labour is emphasized by **Adam Smith** in his book, “The Wealth of Nations” published in 1776.

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- Division of labour also saves the time lost in changing from one type of work to another.
- Hence, as the size of output increases the unit cost falls.

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ii). **<u>Technical Economies</u>** –

- The technical economies result from the use of specialized capital equipment which becomes possible only when the output is produced on a large scale.

- This will reduce the unit cost of production.

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iii). **Inventory Economies** –

- The role of inventories is to help the firm to meet the random changes in the input and the output sides of the operations of the firm.

- The purpose of inventories is to smooth out the supply of input and outputs.

- As the size of output increases the firm can hold smaller percentage of inventories to meet random changes.

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2. **Marketing Economies** –

- They are associated with the selling of the product of the firm.

- They arise from advertising economies.

- Advertising expenses increase less than proportionately with the increase in output, the advertising cost per unit of output falls as the output increases.

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3. **Managerial Economies** –

- Large scale production makes possible the division of managerial functions.
- There exists a production manager, a sales manager, a finance manager, a personnel manager and so on in a large firm.
- However, all or most of the managerial decisions are taken by a single manager in a small firm.

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- The division of managerial functions increases the efficiency.
- The decentralisation of managerial decision making also increases the efficiency of management.
- Hence, as output increases the managerial costs per unit of output continue to decline.

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4. **<u>Transport and storage Economies</u>** –

- As the output increases, the unit cost of transportation of raw materials, intermediate products and finished products fall.

- This is because a large firm may be able to reduce transport costs by having its own transportation means or by using larger vehicles.

- As the size of the firm increases the storage costs will also fall.

B. Pecuniary Economies

- The firm will be able to get raw materials at lower prices due to bulk buying.
- A large firm can get funds at lower cost, i.e. at lower rate of interest due to its reputation in the money market.
- The large firm may be given lower advertising rates , if they advertise in a large scale.
- Transport rates may be also low if the amount of commodities transport at large.

Internal Diseconomies of Scale

- Internal economies of scale exist only upto a certain size of the plant.

- This plant size is known as optimum plant size.

- If the size of plant increases beyond this optimum size there arise diseconomies of scale, specially from managerial economies.

- It causes diminishing returns to the management.

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- As output grows beyond certain level the top management becomes overburden.
- It reduces the overall efficiency of the management.
- It becomes less efficient as coordinator and ultimate decision maker.

External Economies of scale

- The external economies arise out side the firm as a result of improvement in the industrial in which the firm operates.

- They are external to the firm, but internal to the industry.

- Their effects is to cause a change in the prices of factors employed by the firm.

The important external economies

1.**<u>Cheapening of materials and equipments-</u>**

- Expansion of an industry increases the demand for various kinds of materials and equipment.
- This will lead to large scale of production of materials and equipment.
- Large scale production will reduce their cost of production and therefore its prices.
- Hence, the firm using them will get them at lower prices.

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2.**<u>Growth of Technical know how-</u>**

- Expansion of an industry may lead to the discovery of new technical know-how.
- Due to this the firm may be able to use better machinery which will increase the productivity of the firm and therefore reduce the cost of production.

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3.**<u>Development of skilled labour-</u>**

- As the industry grows the training facilities for labour will increase.
- This helps the development of skilled labour which will increase the productivity of workers in the firms.

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4.**<u>Growth of Subsidiary and Ancilliary Industries-</u>**

- Expansion of an industry may facilitate the growth of subsidiary and ancilliary industries to produce tools, equipment, machine etc and to provide to main industry at the lower prices.
- Firm may also transform the waste of the industry into some useful products.
- This tends to reduce the cost of production.

External Diseconomies of scale

- An increase in the size of industry may raise the prices of some factors like raw materials etc which are in short supply.
- Expansion of an industry may also raise the wages of skilled labour which are in short supply.
- As the size of an industry expands lakes, rivers and seas may be polluted by firms.
- This will create external diseconomies to some other firms or industries. Eg- the fishing industry.
- Pollution of this sort will also create health hazards to the people in the adjoining areas.


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