

# 3.3.3 Economies and Diseconomies of scale

## Economies of Scale

- Left side of LRAC
- Cost benefits enjoyed by a firm as it grows larger
- Increase in the scale of production results in larger increase in output
- Internal and External economies of scale
- Internal economies of scale arise when a firm grows larger and benefits from lower LRAC. Such as purchasing economies of scale (bulk buying), financial economies of scale (lower interest loans), technical economies of scale (doubling dimensions of any object increases volume by 8 times), marketing economies of scale (advertising spread out over larger potential customers), managerial economies of scale (employing more experienced managers for particular parts of business), risk bearing economies of scale (diversification)
- External economies of scale are cost benefits enjoyed by firms in the same industry locating in a near geographical area or can also arise when a whole industry grows larger. These can be things such as improvements in transport (motorway analogy), an area becoming synonymous with a product which reduces advertising (silicon valley), attracting skilled labour, sharing new methods of production

## Minimum efficient scale (MES)

- The output at which firm's LRAC stops falling. The minimum output at which internal economies of scale are fully exploited. LRAC are at a minimum
- If constant returns to scale, LRAC is horizontal
- MES has bearing on number and size distribution of firms in an industry and conc ratio

## Diseconomies of Scale

- Increasing LRAC as output increases
- Right side of LRAC curve
- Internal and External diseconomies of scale
- Internal diseconomies of scale arise when LRAC increases as output increases. These are things such as: X-inefficiency (as size increases, admin costs may increase disproportionately or a lack of competition may excuse costs to rise), poor communication (comms becomes more complex, delays occur), demotivation (lack of identity leads to absenteeism and decreased productivity), poor coordination (occurs with multinationals, productivity may fall)
- External diseconomies of scale are increasing LRAC as industry grows. These are things such as: higher costs if demand by industry firms is high for things such as offices in a

specific area (think of how expensive tech offices are in silicon valley), infrastructure congestion (average costs go up because of increased transport times), demand for raw materials increasing leading to higher material costs