CHAPTER 20 : Firms

Key terms

1. Industry : a group of firms producing the same product.
2. The quaternary sector : covers service industries that are knowledge based.
3. Internal growth : an increase in the size of a firm resulting from it enlarging existing plants or opening new ones.
4. External growth : an increase in the size of a firm resulting from it merging or taking over another firm.
5. Horizontal merger : the merger of firms producing the same product and at the same stage of production.
6. Vertical merger : the merger of one firm with another firm that either provides an outlet for its products or supplies it with raw materials components or the product it sells.
7. Conglomerate merger : a merger between firms producing different products.
8. Rationalisation : eliminating unnecessary equipment and plant to make a firm more efficient.
9. Vertical merger backwards : a merger with a firm at an earlier stage of the supply chain.
10. Vertical merger forwards : a merger with a firm at a later stage of the supply chain.
11. Internal economies of scale : lower long run average costs resulting from a firm growing in size.
12. External economies of scale : lower long run average costs resulting from an industry growing in size.
13. Internal diseconomies of scale : higher long run average costs arising from a firm growing too large.
14. External diseconomies of scale : higher long run average costs arising from an industry growing too large

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1. Classification of firms

1.1 By the stages of production.

• **Primary sector : involved in the extraction and collection of raw materials** such as agriculture, coal mining and forestry.

• **Secondary sector :** involved with the processing of raw materials into finished goods including manufacturing and construction.

• **Tertiary sector :** involved with service industry such as tourism, banking and insurance.

• **Quaternary sector :** a subsection of tertiary sector which is involved with the collection, processing and transmission of information.

1.2 By Ownership of firms

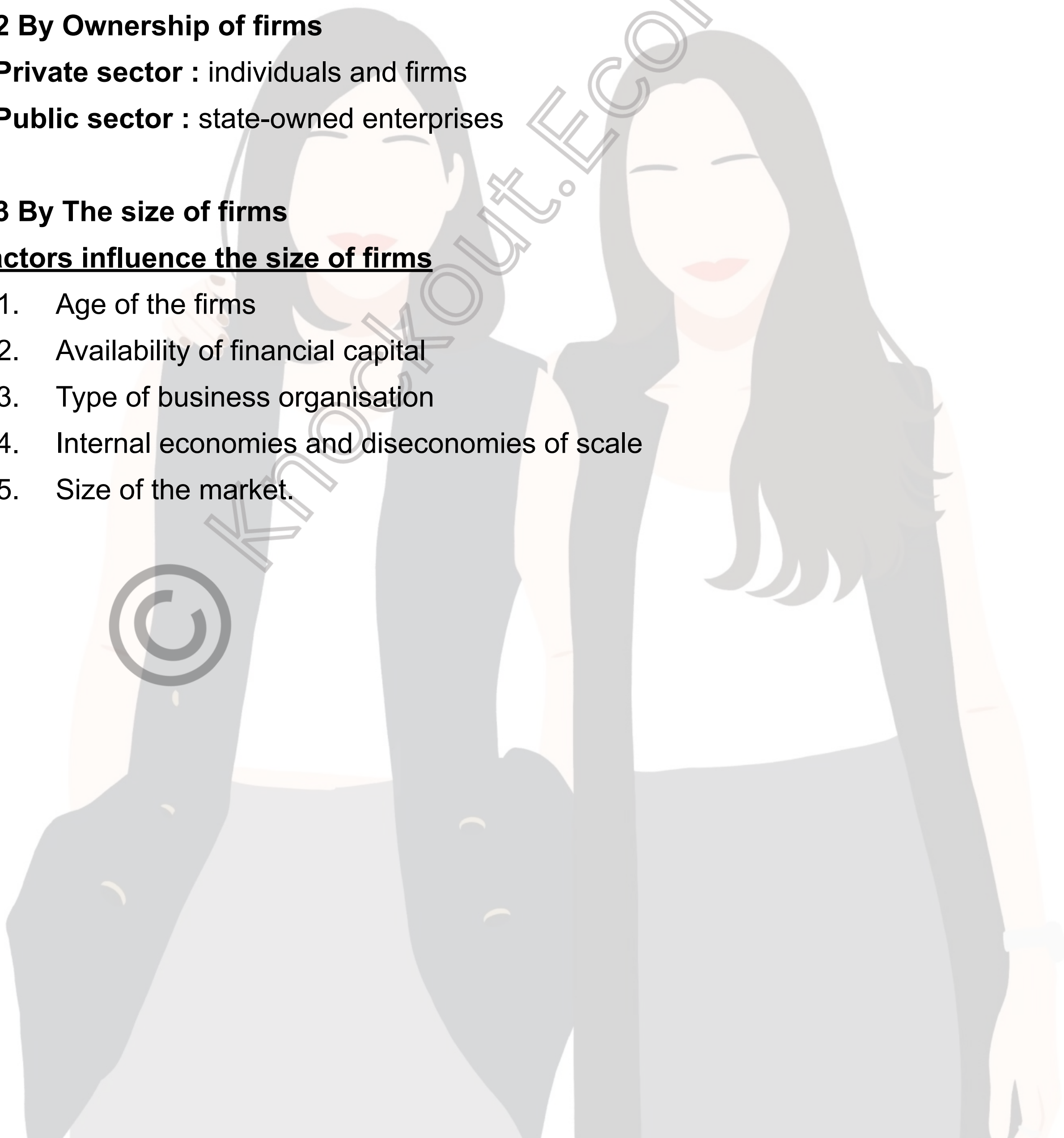
• **Private sector :** individuals and firms

• **Public sector :** state-owned enterprises

1.3 By The size of firms

Factors influence the size of firms

1. Age of the firms
2. Availability of financial capital
3. Type of business organisation
4. Internal economies and diseconomies of scale
5. Size of the market.



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Reasons for being small firms

1. **The small size of the market** such as designer dresses and suits.
2. Small firms can **provide personal services** such as hairdressing.
3. **Owners' preference**; some owners do not want to have management worries from owning large businesses.
4. **Small firms are flexible** to adjust to changes in market condition quickly.
5. Some industries **require little or no capital**, then there are large numbers of small firms.
6. **Lack of financial capital** to expand firms.
7. **Location** : due to high transport cost firms sell products in local areas rather than national markets.
8. Cooperation between small firms : e.g. small farmers may join together to buy seeds and equipment.
9. **Specialisation** : small firms may supply specialist products to large firms.
10. Government support: **government gives subsidy** to small firms to help reduce cost of production.

Reasons for being large firm

1. To gain a lot of profit which could fund **research and development and innovation.**
2. To gain more **market share.**
3. To take **advantages of economies of scale** : Higher production leads to lower average cost e.g. buying raw material in bulk.
4. To become a **monopoly** which has power to **set high prices.**

Disadvantages of being large firm

1. Firms might face diseconomies of scale e.g. communication **diseconomies of scale and labour diseconomies of scale** ⇒ Average cost ↑ ⇒ Price↑
2. Owners might have management worries from operating a large-size business

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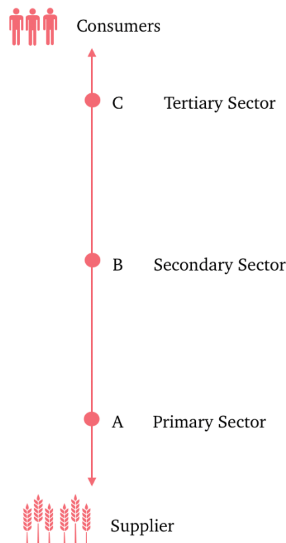
2. Causes of the growth of firms.

1.) Internal growth or natural or organic growth.

⇒ Firms grow by expanding existing production.

2.) External growth

⇒ Firms grow in size by merge or takeover.



3 mains types of merger

3.1) Horizontal merger (A+A or B+B or C+C) : the merger of two firms at the same stage of production

Advantages	Disadvantages
1.Firms can take advantage of economies of scale 2. Rationalisation: merging could enable them to sell off the redundant resources.	1. Firms may experience diseconomies of scale. A large firm can be difficult to control. 2.It is difficult to integrate the two firms with different management structure and culture.

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3.2) Vertical merger : when a firm merges with another firm involved with the production of the same product but at a different stage of production.

- **Vertical merger backwards (B+A) :** when a firm merges with another firm that is the source of its supply of raw materials e.g. a coffee manufacturer merges with a coffee farm.

Advantages	Disadvantages
1.To ensure an adequate supply of good quality raw materials at reasonable price. 2.It is more certain over the production such as quantity, quality and price. 3.To restrict suppliers to supply raw materials to rival firms.	1.There is no competition between suppliers anymore. It may lead to higher raw material costs. 2.There is higher risk from adverse change in supplier as it will affect the whole business. 3.It may cause diseconomies of scale from being large firms.

- **Vertical merger forwards (B+C)** : when a firm merges or takes over a market outlet e.g. a coffee manufacturer buys a coffee shop.

Advantages	Disadvantages
1.To ensure that there are sufficient outlets. 2.To ensure that products are stored and displayed well in high quality outlets. 3.Firms can control after sale service. 4.A merger may help in development and marketing of new products.	1.There is a higher risk from holding high fixed costs. The fortunes of business are tied to the distribution system. 2.Process are independent then a slight disruption will affect the whole. 3.It may cause diseconomies of scale from being large firms.

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3.3) Conglomerate merger : the merger of two firms which make different products e.g. a coffee manufacturer merges with a hotel company.

Advantages	Disadvantages
1.A merger spreads a firm's risks. If the sale revenue from a product falls, the firm still has revenue from other products. 2.It enables a merger to grow even if the market of one of its products is declining. 3.A merger is being larger, it can borrow more money at lower interest.	1.It may cause diseconomies of scale from being large firms. 2.A merger may lack experience in new business. It has a chance to fail.

<u>The effects of merger on consumers</u>

Positive effects	Negative effects
1. A merger can generate economies of scale leading to lower average cost and lower price of products to consumers 2. A merger gains high profit which could generate high quality of products and innovation. 3. A merger can increase its efficiency.	1.It may result in diseconomies of scale leading to higher average cost and higher price of products to consumers 2.It may increase market power to merged firms then they have power to set high prices and limit choice to consumers.

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4. Economies and diseconomies of scale.

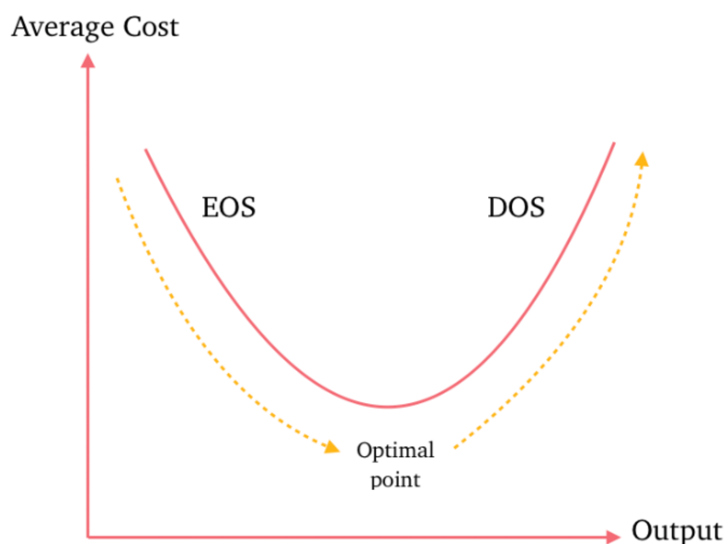
Economies of scale : Lower long run average cost (LRAC)

4.1 Internal Economies of scale :

When a firm grows in size, it leads to lower average cost. It causes downward movement along the average cost curve.

Types of internal economies of scale

1. **Purchasing economies**: buying raw material in bulk at discount.
2. **Marketing economies**: advertising cost per unit falls as output rises.
3. **Managerial economies**: Large firms can employ specialist staff.
4. **Labour economies** : Large firms can engage in division of labour ⇒ Average cost falls.
5. **Financial economies**: It is easier for large firms to raise funds at a cheaper interest rate.
6. **Technical economies**: Large firms can use technologically advanced machinery
7. **Research and development economies**
8. **Risk bearing economies**: Large firms produce a wide range of products ⇒ risk of trading falls.



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4.2 External economies of scale :

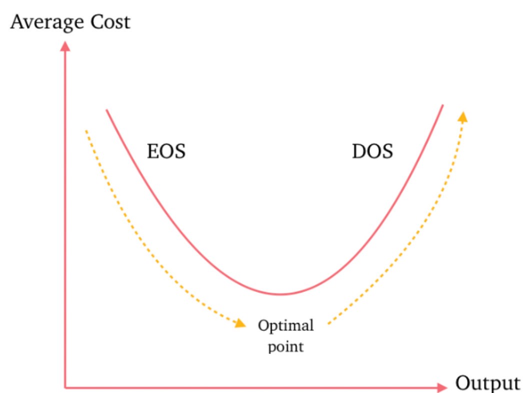
External economies of scale : When industry grows, it leads to lower average cost to firms. It causes the average cost curve to shift down.

Types of external economies of scale

1. A skilled labour force available
2. A good reputation e. g. France-wine.
3. Specialist suppliers of raw materials and Capital goods
4. Specialist services e. g. university
5. Improved infrastructure lowers transport cost for businesses.
6. Sharing knowledge between firms in the industry

Diseconomies of Scale (higher long run average cost (AC))

4.3 Internal diseconomies of scale : When firm grows in size ⇒ AC rises



Types of internal diseconomies of scale

1. Difficulties controlling the firm
2. Communication problems: Large firms have many layer causing difficulties in communication
3. Labour diseconomies: workers in large firms do only a small part of business. It might demotivate them to work efficiently.

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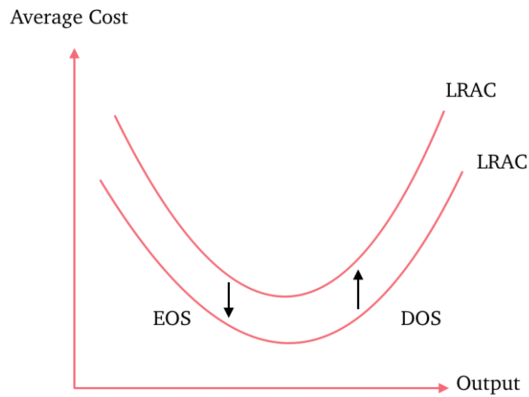
4.4 External diseconomies of scale : When industry growing ⇒ AC rises



Types of External diseconomies of scale.

1. congestion
2. telecommunication deterioration.

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