1. To what extent do economies of scale matter?

*Answers may include:*

Internal economies of scale occur when the long run unit costs fall as a business expands. As a business grows it changes its factors of production in the long run and moves on to a new short run average cost curve. Economies of scale affect the unit costs and therefore the profit margins and pricing of a business. If a business can expand and experience lower unit costs, for example, then it is able to reduce its prices; businesses that have not expanded may struggle to compete because they will not be able to lower their prices given higher unit costs. If the minimum efficient scale MES (the output level at which long run unit costs are first minimized) is high relatively to demand and if the unit costs of not being at the MES are high this means there are likely to be relatively few firms operating in this market. However, if the MES is quite low relative to demand and the cost disadvantage of not being at the MES is relatively low there may be many firms operating in this market. The existence of economies of scale is important therefore in relation to the structure of the industry. Industries such as banking, oil and car manufacturing have high fixed costs and experience large economies of scale; this is why these industries tend to be dominated by relatively few firms.

2. Discuss the potential cost advantages and disadvantages to a business of expanding.

*Answers may include:*

If a business expands then in the long term it may experience internal economies or diseconomies of scale. Internal economies of scale exist when the long run average cost falls; diseconomies of scale exist when the long run average costs rises as a business expands. Economies of scale include: technical, managerial, financial and purchasing (for more on these see chapter 5). Diseconomies of scale include motivation, coordination, control and communication. As a business gets bigger it can be difficult to manage effectively as there are so many people involved in the process. The existence of economies and diseconomies will vary from industry to industry and business to business. The use of budgets, effective communication systems such as regular briefings and updates and good management training can help avoid diseconomies of scale, for example. The existence of high initial costs to set up the business, for example in telecommunications, can lead to substantial economies of scale.
3. Why do marginal costs matter?

*Answers may include:*

Marginal costs measure the extra cost from producing an extra unit of output. They show what happens to total costs. For example, a marginal cost of £50 means that the total costs have increased by £50 with the extra unit. If marginal costs are positive and increasing, total costs are rising at an increasing rate. If marginal costs are constant then total costs are rising at a constant rate. If marginal costs are positive but decreasing then total costs are rising at a decreasing rate.

When deciding whether to produce a profit maximizing producer we will consider the extra costs (MC) and the extra revenue (marginal revenue = MR). If the marginal revenue is greater than the marginal cost then profits will increase if the unit is made. If marginal revenue equals the extra costs then the firm is profit maximizing because there is no extra profit to be made.

The social marginal costs are also important when considering social welfare. If the social marginal benefit of a unit is greater than the social marginal cost then society’s welfare will increase when the unit is produced. If the social marginal benefit equals the social marginal cost then society’s welfare is maximized because it cannot increase more. If social marginal cost is greater than the social marginal benefit then society’s welfare would be increased if less was produced.