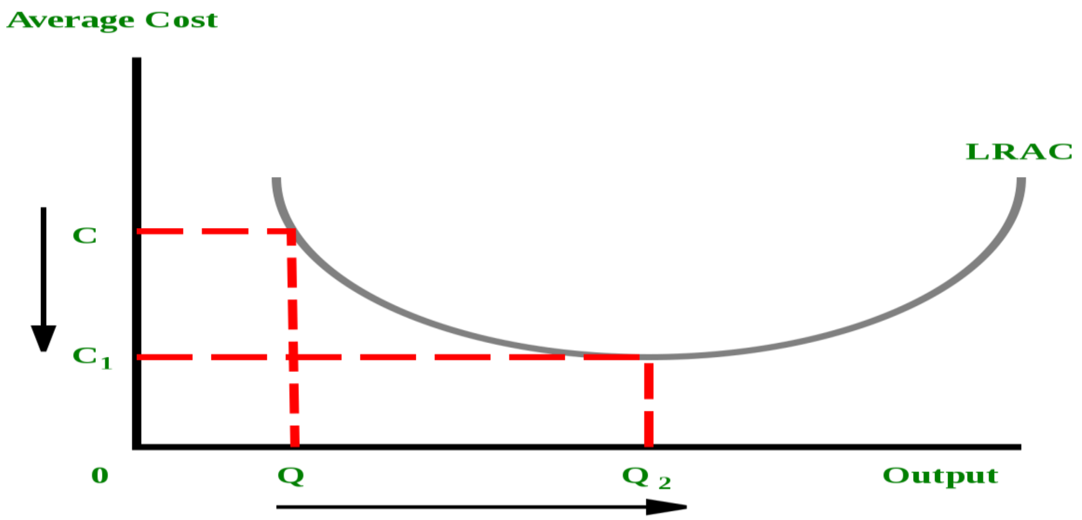
ECONOMIES OF SCALE:

This section deals with the internal economies of scale, i.e. economies which arise from an increase in the firm's plant size. Economiesof scale may also arise from an increase in the number of plantsof a firm, irrespective of whether the firm continues to produce the same product in the new plants or diversifies. Economies ofscale determine the shape of the LAC (long run average cost)curve. However, the position of LAC curve depends mainly on theexternal economies like improvement in technology and changes offactor prices in the industry or the economy.



Economies of scale can be broadly divided into real and pecuniary economies of scale.

Real Economies of Scale :

Real economies of scale can be achieved through the reduction in thequantity of inputs like raw materials, labor and capital. Thereare four main types of real economies:

•Production
•Selling
•Managerial
•Storage and transport

Pecuniary Economies of Scale:

These are economies accruing to the firm due to the discounts it can obtain for its large-scale operations. They can be achieved by:

•Reduction in prices of raw materials, bought at discounts due to large volumes from the suppliers.

•Lower costs of external finance. Banks usually offer loans to large corporations at a lower rate of interests.

•Lower advertising rates may be applicable for larger firms if they advertise at large scales.

•Transport rates are often lower if the amount of goods transported are large.

•Larger firms may be able to pay lower salaries to their employees if they attain a size, which gives them monopolistic power or due to the prestige associated with the employment by a large, well-known firm.

Diseconomies of Scale:

There is a limit to the gains achieved from large scale of operations, which means that there is an optimum level of capacity and any increase in the scale beyond this level leads to diseconomies of scale. They can arise from several sources like managerial difficulties, low employee morale, higher input prices, etc.