



# **MICROECONOMICS - Firms**

By Kru P'Eve and Kru P'Da Knockout.Economics

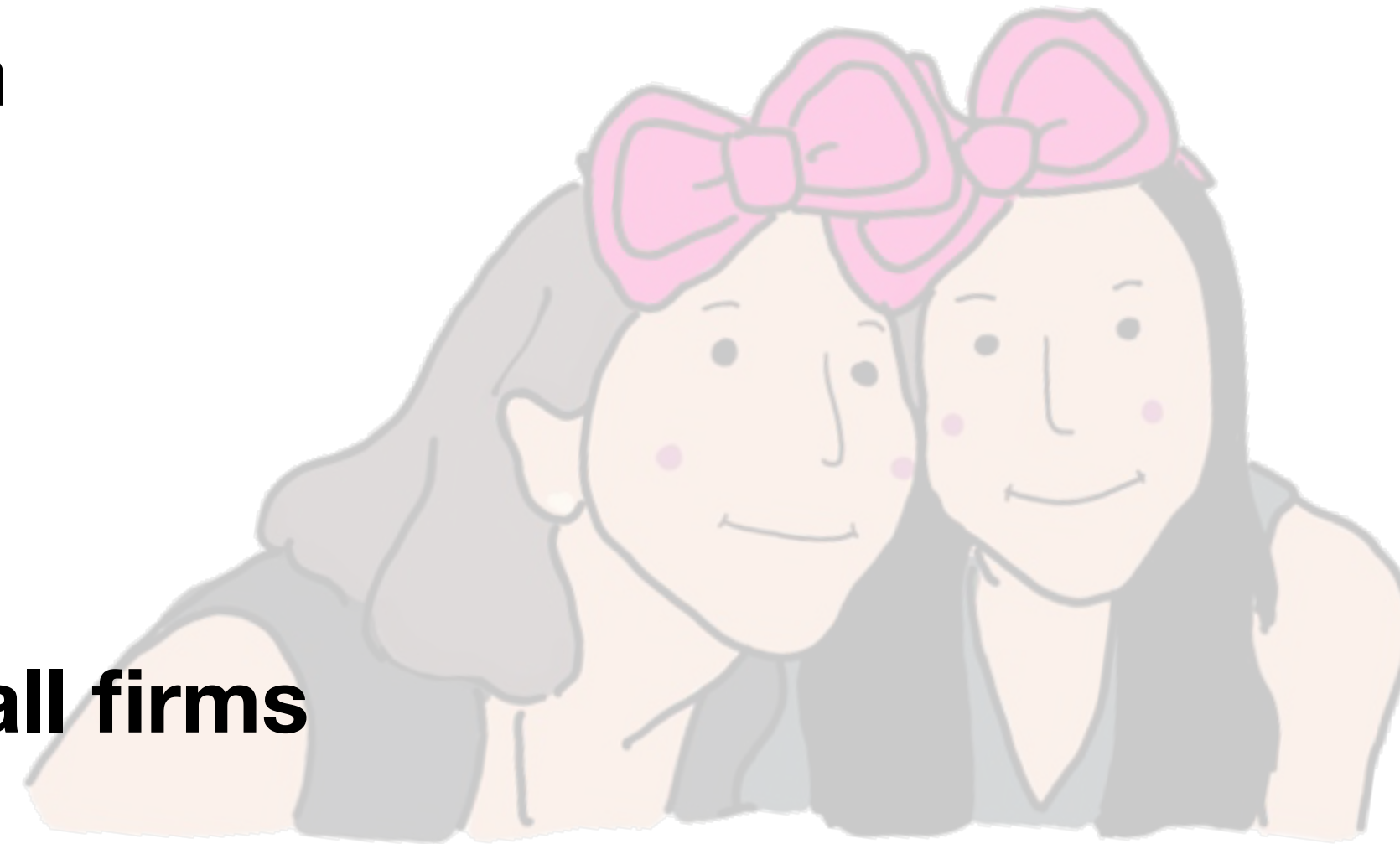
# Overview

## 1. Classification of firms

- The stages of production
- Ownership of firms
- The size of firms

## 2. Reasons for being small firms

## 3. Reasons for being large firms



# 1. Classification of firms

## 1.1 The stage of production

### Primary sector

: involved in the extraction and production raw materials, such as fishing, mining, farming etc.

### Secondary sector

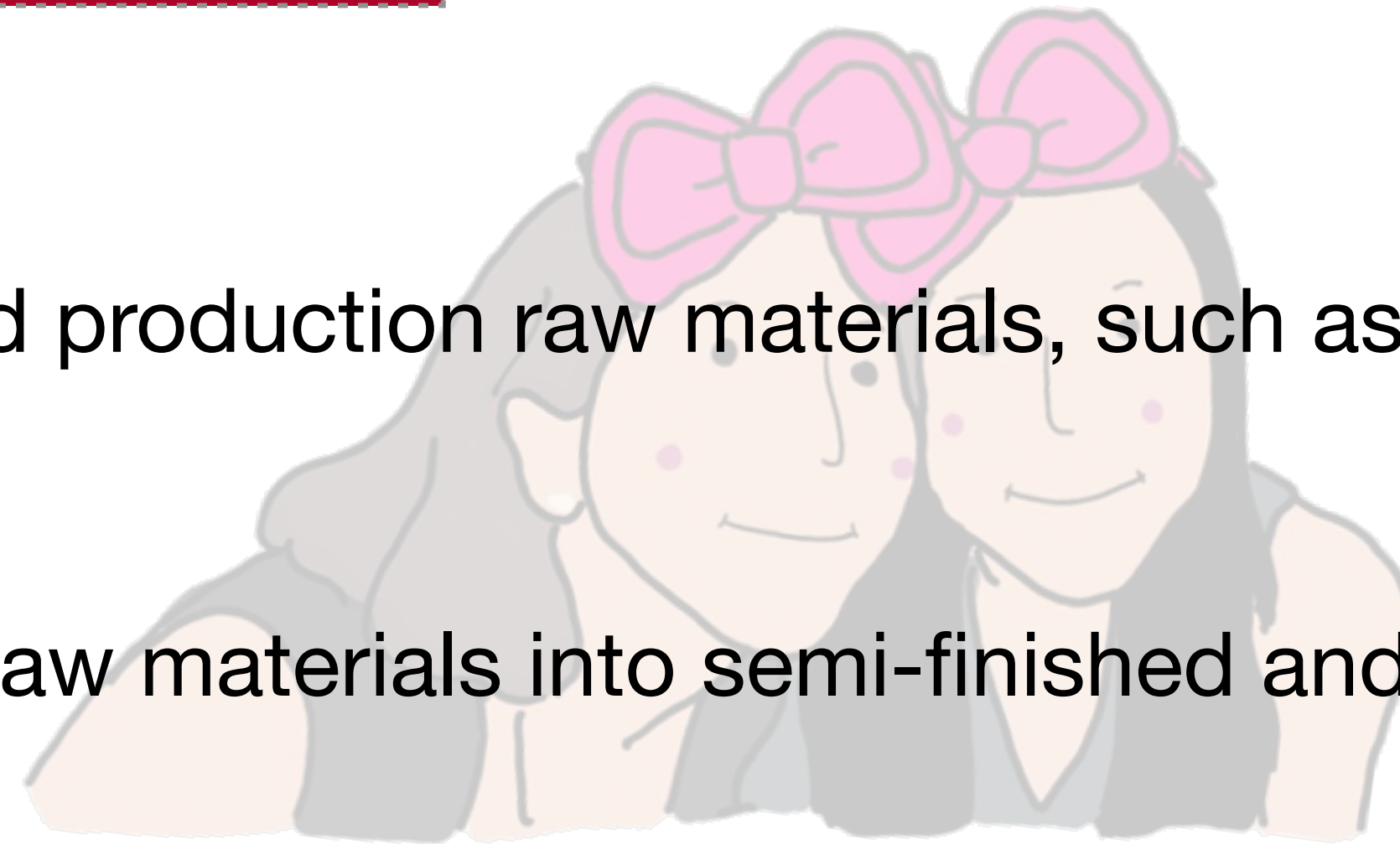
: is in charge of transforming raw materials into semi-finished and finished-goods.

Eg. Manufacturing

### Tertiary sector

: involved in the provision of services to individual or other businesses.

Eg. Banking, Insurance, tourism



# 1. Classification of firms

## 1.2 Ownership

### Private sector

: A part of economy that is managed and controlled by individuals or firms seeking to maximise profit.

### Public sector (State-owned enterprises)

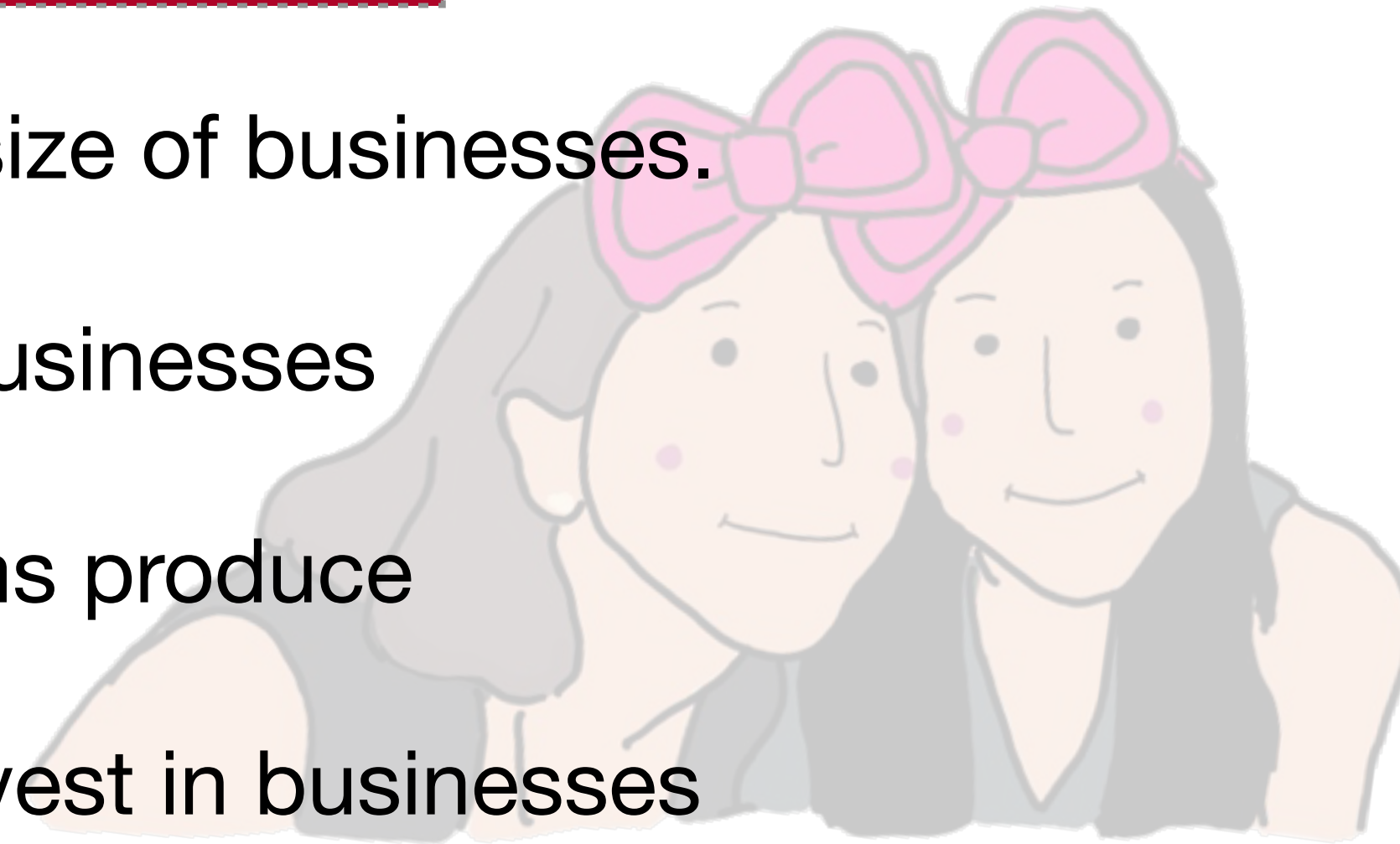
: A part of economy that is managed and controlled by the government.

# 1. Classification of firms

## 1.3 Size of firms

: There are 3 main measures size of businesses.

- The number of workers in businesses
- The value of output that firms produce
- The value of funding that invest in businesses



## 2. Reasons for being small firms

### The small size of the market

- If demand for the product is small, a firm no need to be large
- Eg. Designer dresses

### Preference of consumers

- Small firms provide personal services to consumers.
- Eg. Hairdressing

### Small firms are flexible

- Small firms can adjust to changes in market conditions, consumer preference quickly.

### Limited funding

- Being large firms require high capital.

### Government supports small firms

- Government provides subsidy / tax-exempt to small businesses.

### Specialisation

- Small firms may supply specialist products to large firms

# 3. Reasons for being large firms

## 3.1 To gain higher revenue and profit

- ➔ Being large firms can gain more consumer-based
- ➔ Firms can generate higher revenue and profit
- ➔ High profit could fund in research and development and also innovation.

## 3.2 To gain more market share

- ➔ Firms can easier to access funding
- ➔ Also, Firms can receive higher reputation.



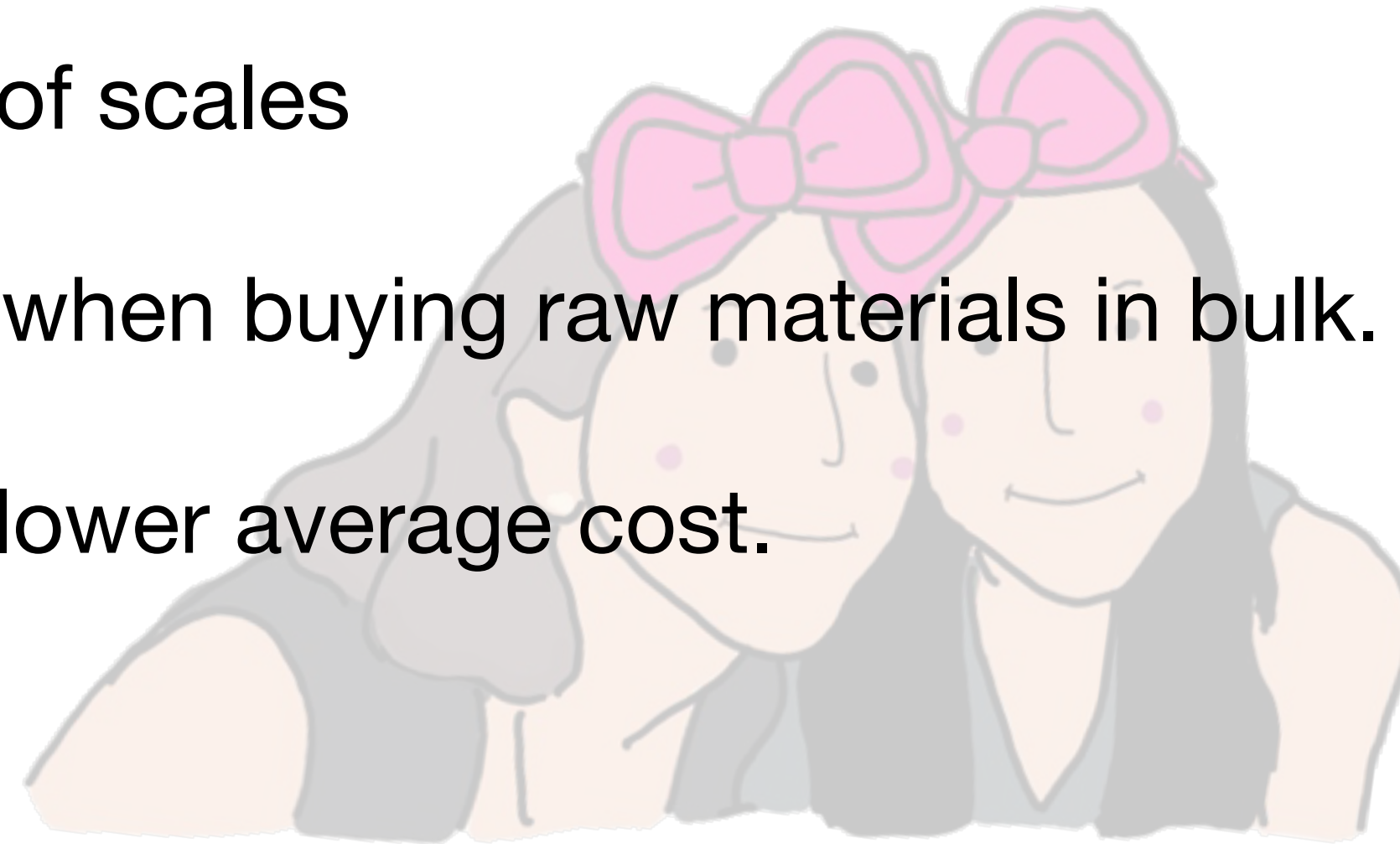
# 3. Reasons for being large firms

## 3.3 Firms can take advantages of economies of scales

- ➔ Eg. Purchasing economies of scales
- ➔ Firms can receive discount when buying raw materials in bulk.
- ➔ Higher production leads to lower average cost.

## 3.4 To become a monopoly

- ➔ Monopoly : only one firm dominates in the market.
- ➔ Firms enable to set high price and gain high profit.



# Knockout Economics



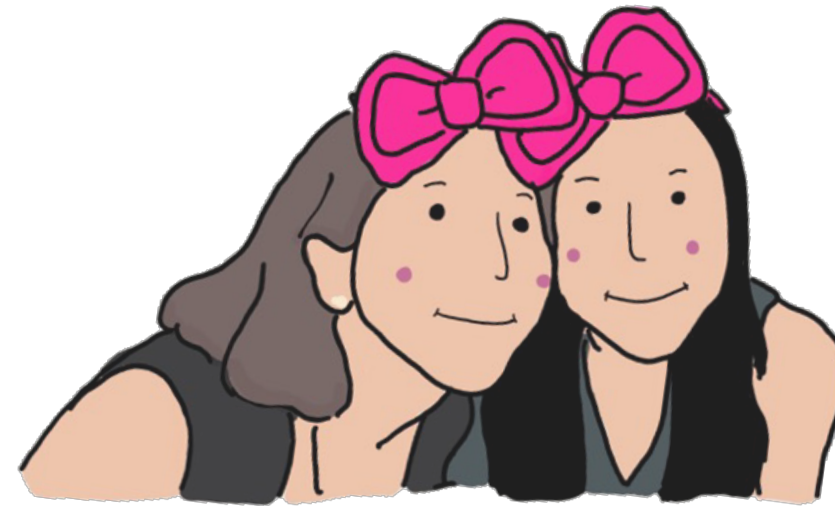
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# **MICROECONOMICS - Growth of firms**

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# Overview

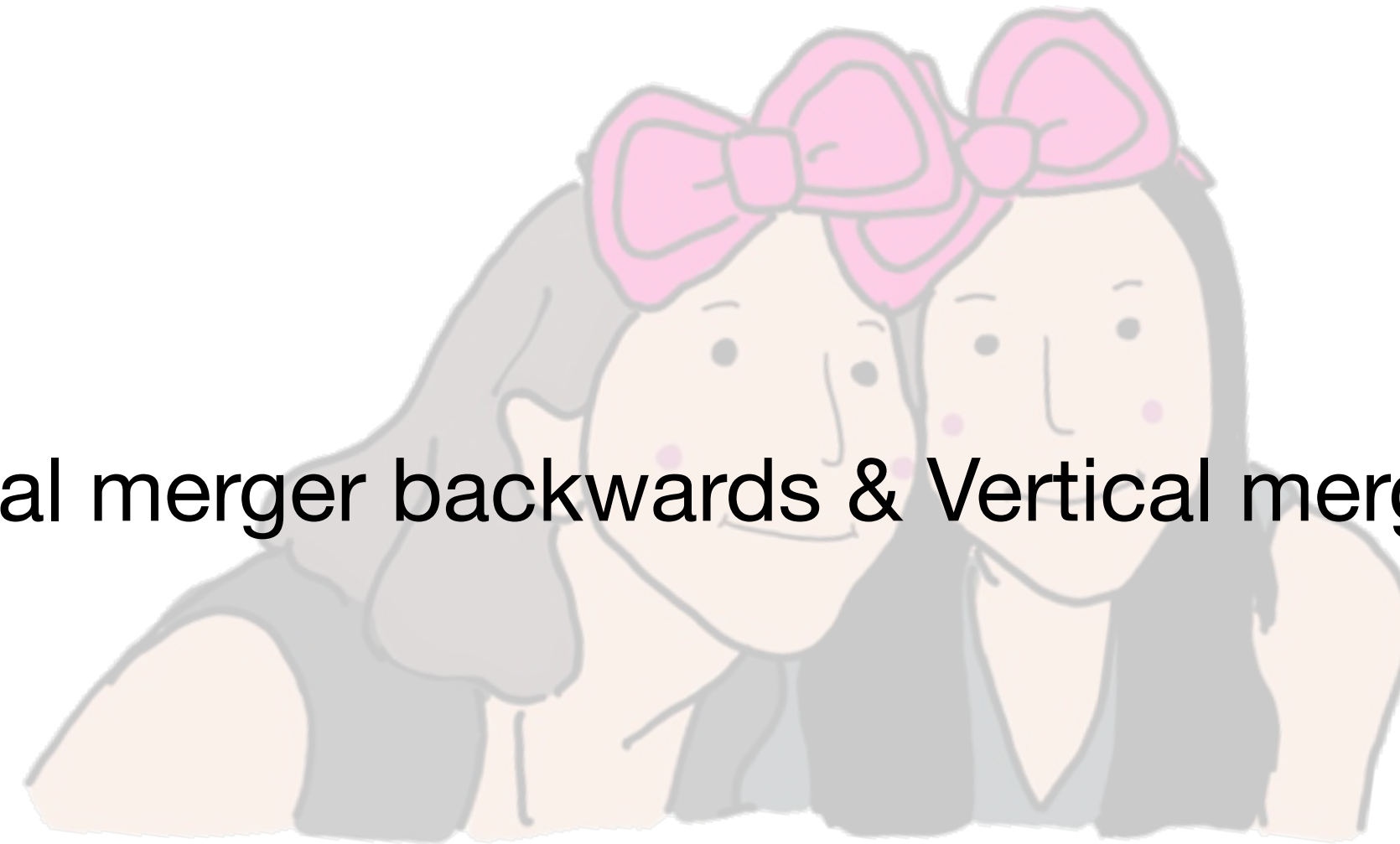
## 1. Overview - Internal growth & External growth

## 2. External growth

2.1 Horizontal merger

2.2 Vertical merger (Vertical merger backwards & Vertical merger forwards)

2.3 Conglomerate merger



## 3. The effect of a merger on consumers

# 1. Overview- Internal & External Growth

## Internal Growth

## External Growth

### Meaning

: an increase in the size of business resulting from expanding existing production plants or opening new ones.

: an increase in the size of business resulting from it merging or acquiring another businesses.

### Methods

- Firms may launch new design, new colour of the products to generate more revenue.

- Firms may expand new branches in new areas.

- Firms may stimulate sales revenue by advertising products.

- **Horizontal merger** : The merger of two firms at the same stage production and same industries.

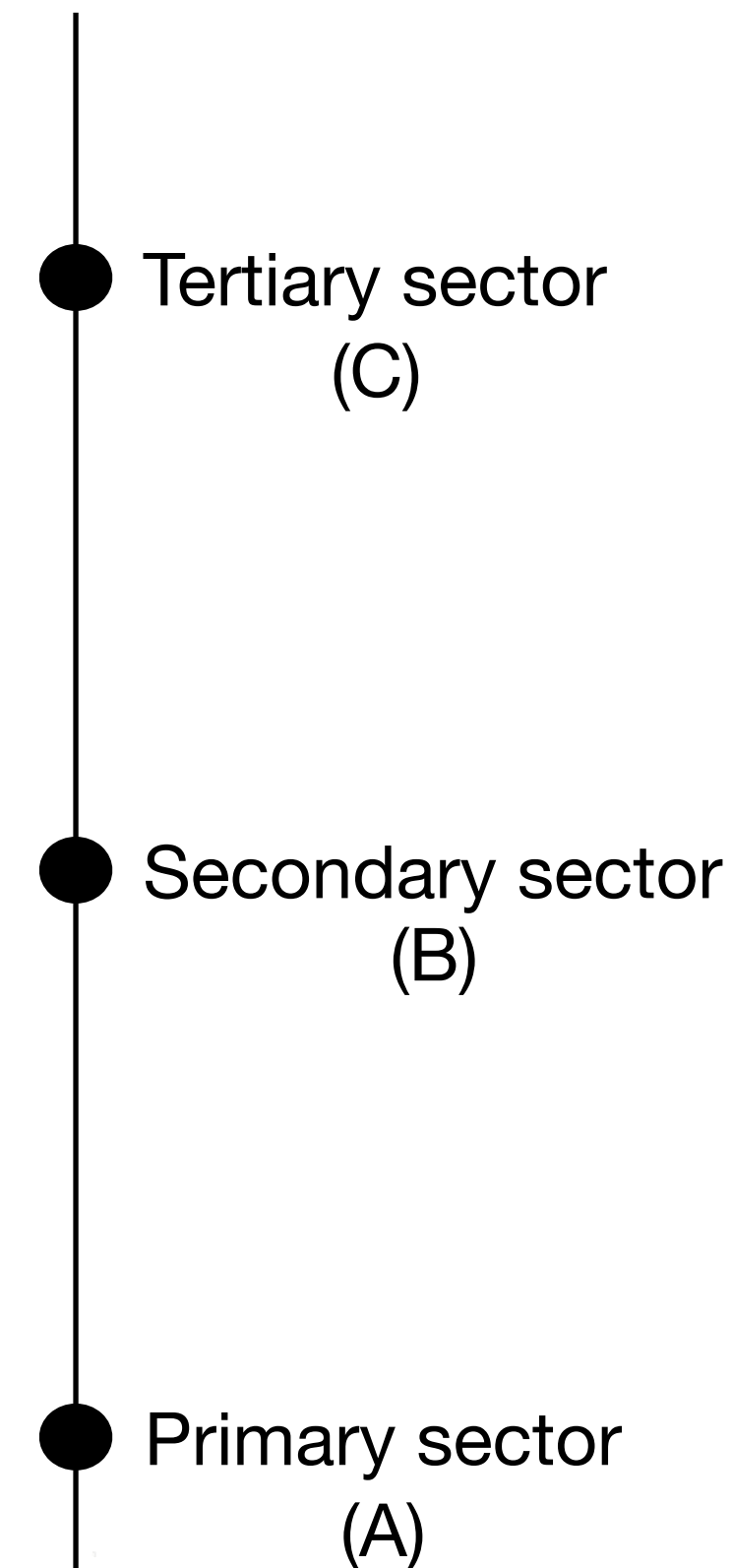
- **Vertical merger** : The merger of two firms at the different stage production and same industries.

- **Conglomerate merger** : The merger of two firms at the different products.

## 2. External Growth



Consumers



Suppliers

### Horizontal Merger

### Backward Vertical Merger

#### Advantages

- Firms can take advantage of economies of scale  
➔ Average cost will be lower.
- Rationalisation  
➔ Merging could make them to sell off the redundant resources.

- Firms can make sure that firms have enough supply of good quality raw material at reasonable price.
- Firms can restrict supplier to supply raw materials to rival firms.

#### Disadvantages

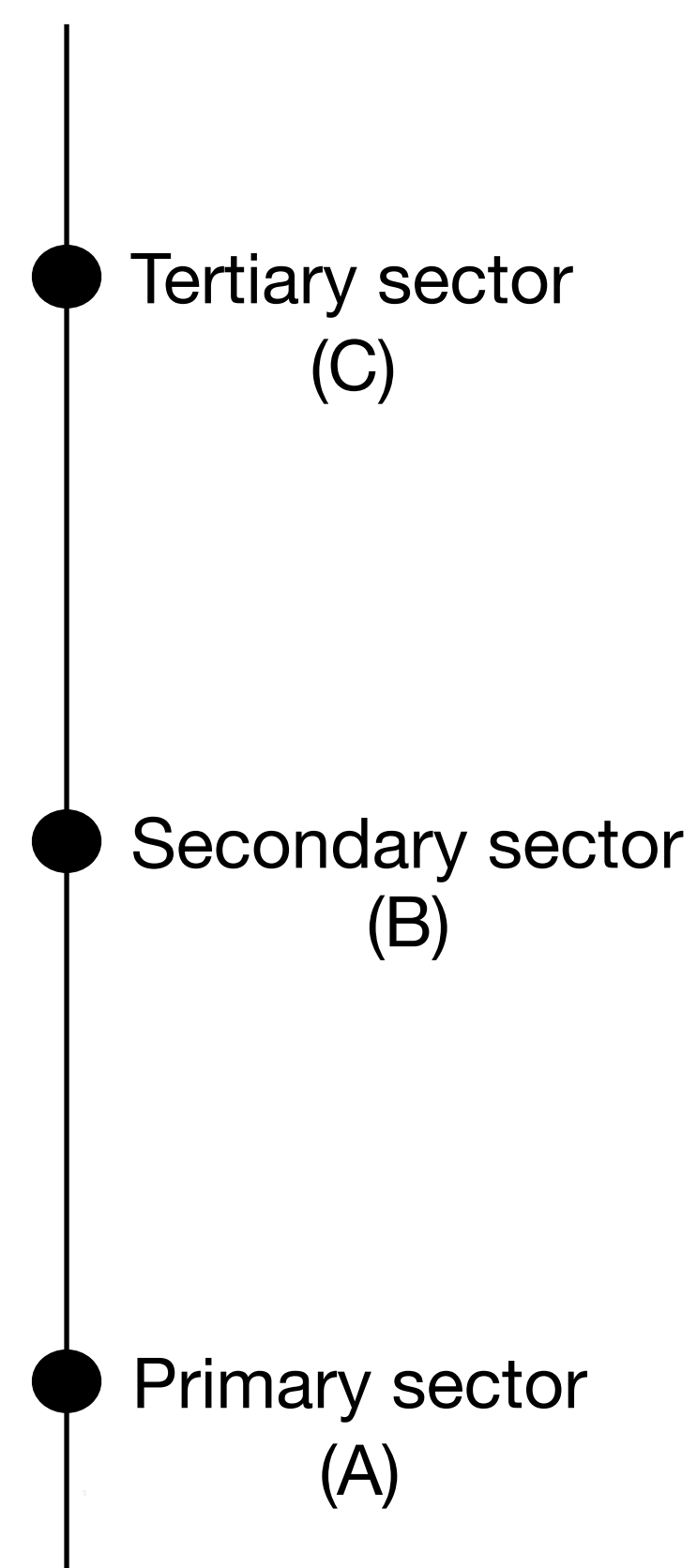
- Firms may experience diseconomies of scale.  
➔ Average cost will be higher.
- It is difficult to control since two firms have different management structures.

- Firms may experience diseconomies of scale.  
➔ Average cost will be higher.
- There will be lack of competition between suppliers  
➔ It may lead to higher cost or low quality of raw material.

# 2. External Growth



Consumers



Suppliers

	Forward Vertical Merger	Conglomerate Merger
Advantages	<ul style="list-style-type: none"> <li>Firms can control quality after sale services.                             <ul style="list-style-type: none"> <li>➔ It leads to high reputation of firms</li> </ul> </li> <li>Merger can make sure that there are sufficient outlets.</li> <li>Merger can improve marketing of new products.</li> </ul>	<ul style="list-style-type: none"> <li>A merger can diversify risk.                             <ul style="list-style-type: none"> <li>➔ If the sale revenue from a one product falls, the firm still has revenue from other products.</li> </ul> </li> <li>Firms can expand in other markets even if one market is likely to decline.</li> <li>Firms become larger and have higher reputation. It can leads to easy to access funding with lower interest rate</li> </ul>
Disadvantages	<ul style="list-style-type: none"> <li>Firms may experience diseconomies of scale.                             <ul style="list-style-type: none"> <li>➔ Average cost will be higher.</li> </ul> </li> <li>Businesses might hold higher fixed cost.</li> <li>Managers of merger firms may lack of experience , for instance, running distribution systems</li> </ul>	<ul style="list-style-type: none"> <li>Firms may experience diseconomies of scale.                             <ul style="list-style-type: none"> <li>➔ Average cost will be higher.</li> </ul> </li> <li>Firms may lack experience in new business.                             <ul style="list-style-type: none"> <li>➔ It is possible to fail.</li> </ul> </li> </ul>

# 3. The effect of a merger on consumers

## Advantages

- Firms can achieve economies of scale.
  - ➔ Average cost of production will be lower.
  - ➔ Firms might transfer benefits to consumers by charging lower price.
- Firms can generate higher profit.
  - ➔ Firms have higher budget to invest in innovation and technology.
  - ➔ As a result, products will have better quality and high innovation.

## Disadvantages

- Firms may experience diseconomies of scale.
  - ➔ Average cost will be higher.
  - ➔ Firms may charge high price to consumers.
- Mergers can increase power of firms in the market
  - ➔ It creates monopoly power in the market.
  - ➔ Firms might set high price and limit choices to consumers.

# Knockout Economics



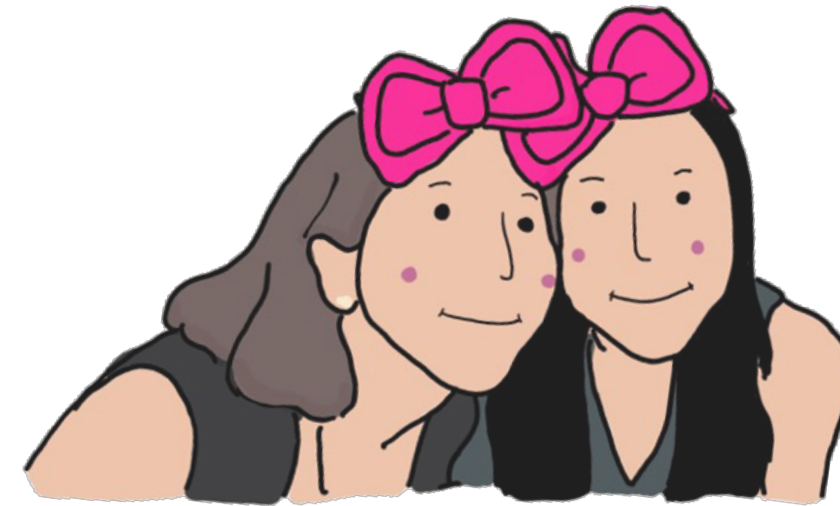
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# **MICROECONOMICS - Economies and diseconomies of scale**

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# Overview

## 1. Economies of scale

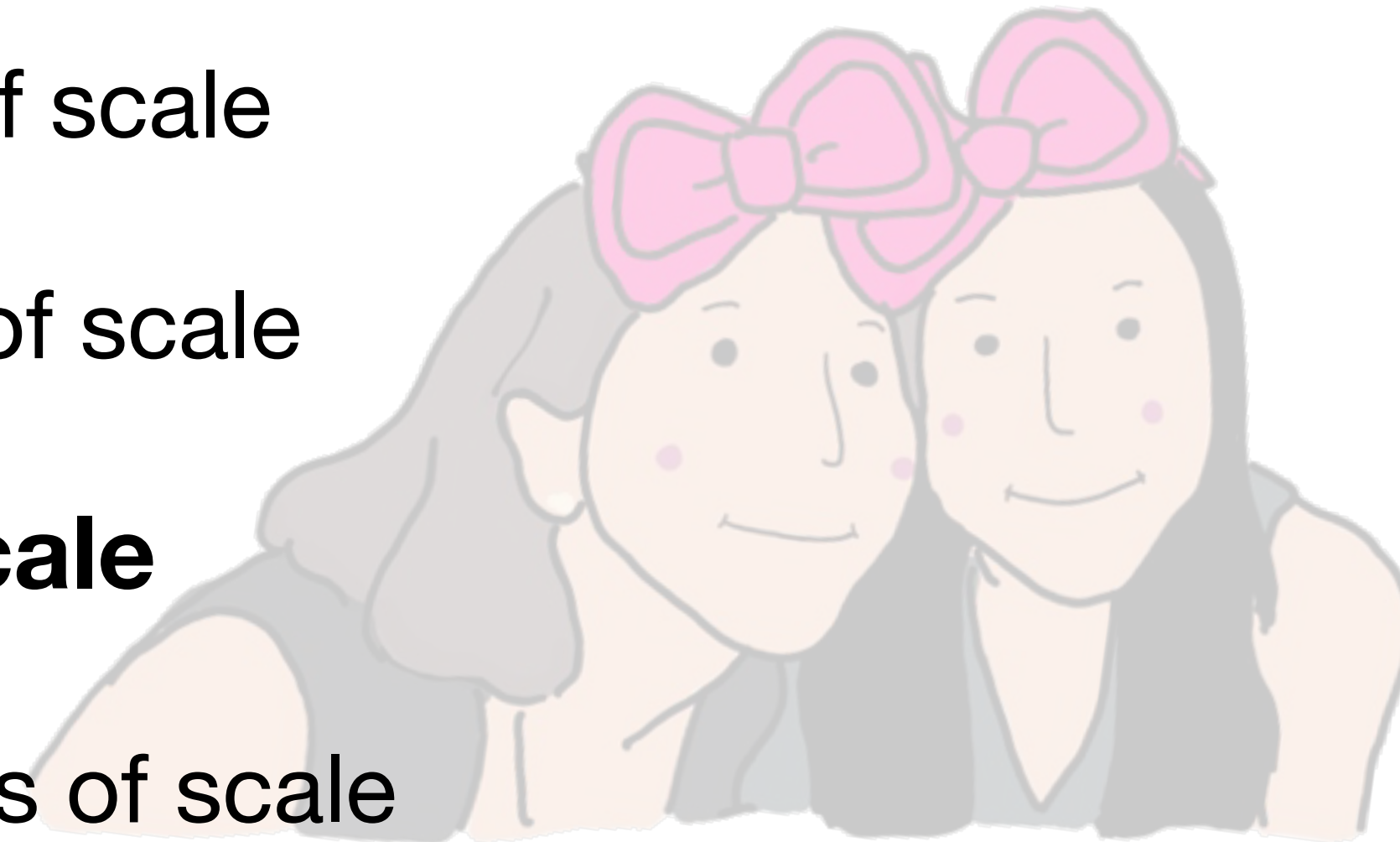
1.1 Internal economies of scale

1.2 External economies of scale

## 2. Diseconomies of scale

2.1 Internal diseconomies of scale

2.2 External diseconomies of scale



# 1. Economies of scale

## Internal Economies of scale

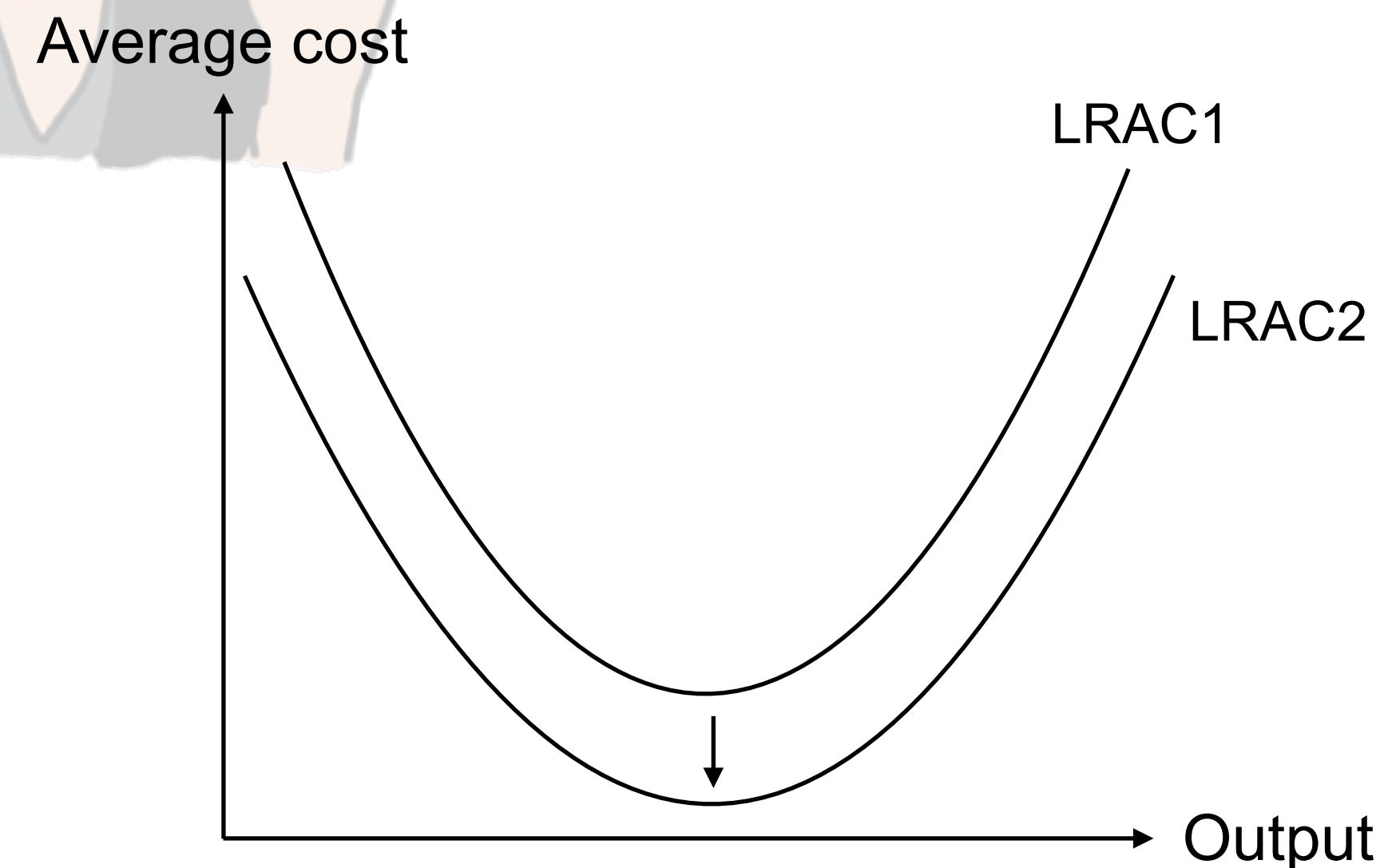
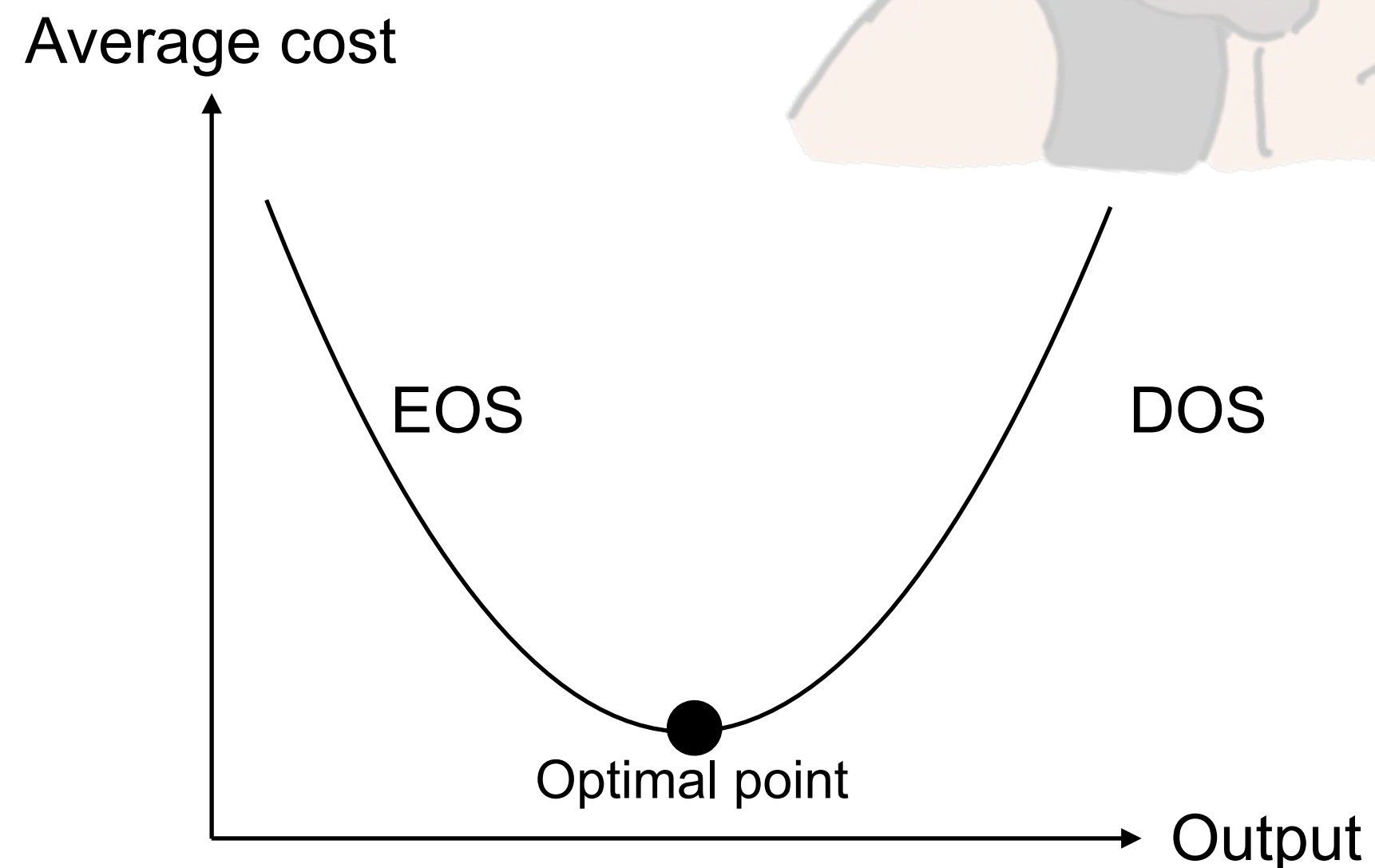
## External Economies of scale

Meaning

: When size of firms becomes bigger, the average cost of production will be lower.

: When the industry grows, the average cost of production will be lower.

Diagram



# 1.1 Internal Economies of scale

## Purchasing Economies of scale

- Buying raw material in bulk at discount

## Marketing Economies of scale

- Advertising cost per unit falls as output rises.

## Managerial Economies of scale

- Larger firms can employ specialist staffs who have higher productivity
  - ➔ Average cost will be lower

## Labour Economies of scale

- Bigger firms can engage in division of labour
  - ➔ Workers focus on particular function and lead to higher productivity
  - ➔ Average cost will be lower

## Financial Economies of scale

- It is easier for bigger firms to access funding with cheaper cost of borrowing.

## Technical Economies of scale

- Large firms have enough funding to invest in advance technology
  - ➔ Higher productivity
  - ➔ Average cost will be lower.

## Research and Development Economies of scale

- A bigger firms can have research & development department
  - ➔ R&D development can develop process of production
  - ➔ Higher productivity
  - ➔ Average cost will be lower.

## Risk bearing Economies of scale

- Larger firms usually produce wide range of products.
  - ➔ If firms cannot sell one product, firms still gain revenue from other products

## 1.2 External Economies of scale

### A skilled labour

- : A firm can recruit workers who have been trained by other firms
- ➔ Reduce training cost / higher productivity
- ➔ Average cost is likely to decrease.

### A good reputation

- : An area can gain a good reputation for a high quality of goods and services
- ➔ Eg. Phuket has a reputation of being a popular holiday resort

### Improved infrastructure

- : Government may support the growth of an industry by improving infrastructure , railway, electricity supplies
- ➔ It can lead to lower transport cost for businesses
- ➔ Average cost is likely to decrease.

## 2. Diseconomies of scale

### Internal diseconomies of scale

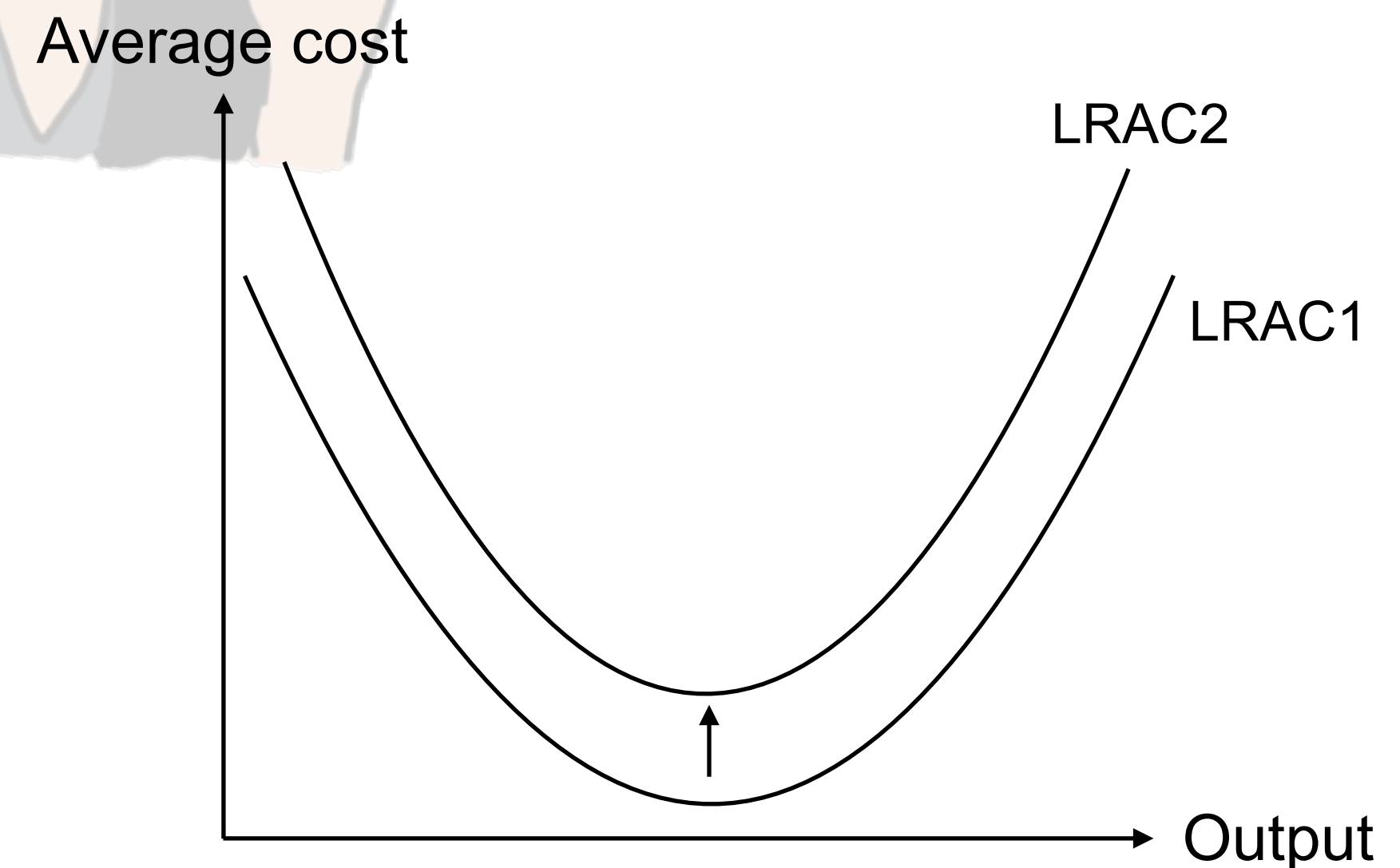
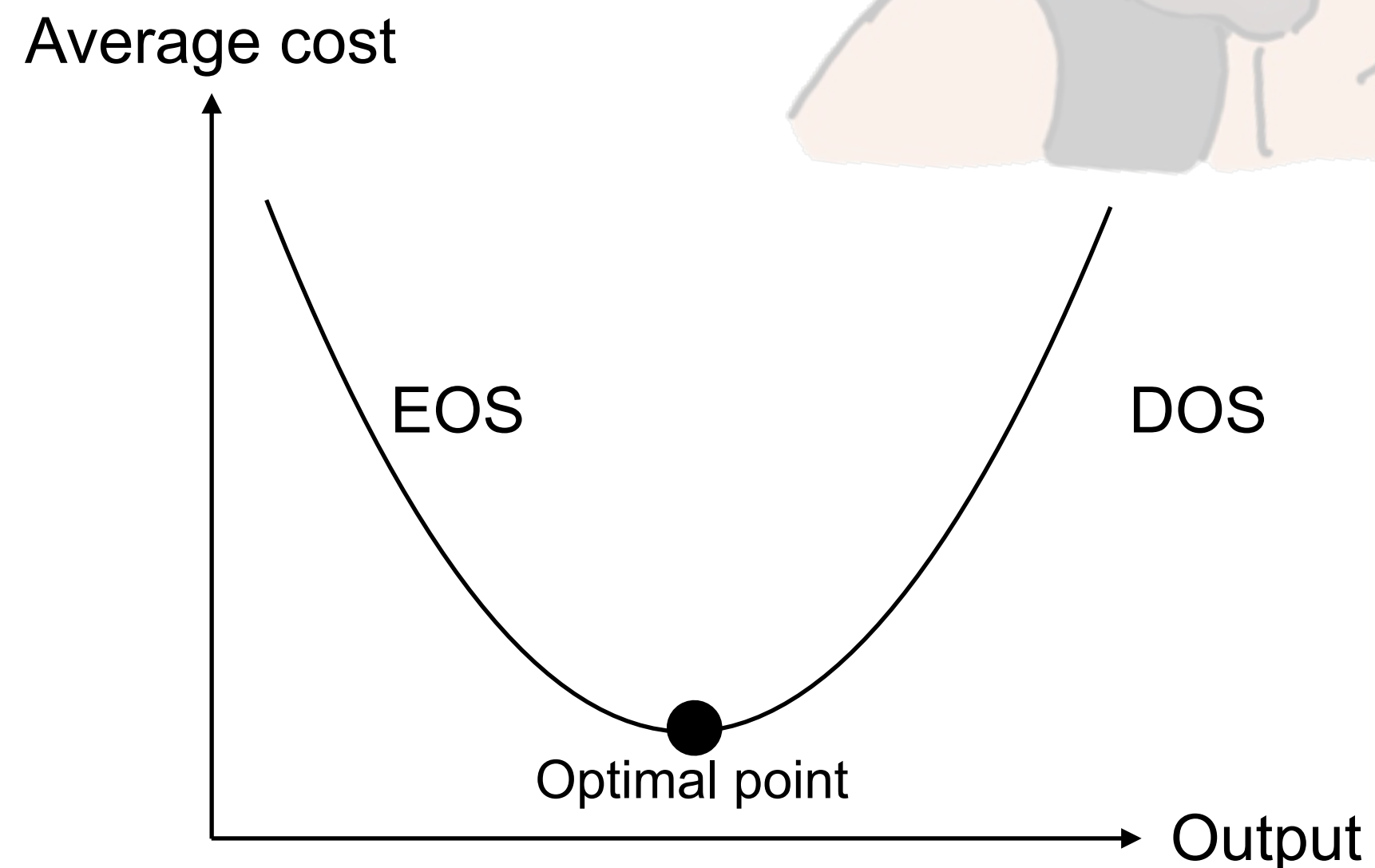
### External diseconomies of scale

#### Meaning

: When size of firms becomes bigger, the average cost of production will be higher.

: When the industry grows, the average cost of production will be higher.

#### Diagram



## 2.1 Internal Diseconomies of scale

### Difficulties controlling the firm

- : Higher layers of management
- ➔ This can increase administrative costs
- ➔ Firms can be slow in decision-making ; as a result ; firms cannot response to changes in market conditions and trends.

### Communication Problem

:It can be difficult to ensure that everyone in the big firm has full knowledge about their functions.

### Poor industrial relations

- :Workers in large firms do only small part of business
- ➔ Employee feel unimportant and low morale.
- ➔ It might demotivate them to work efficiently
- ➔ Average cost is likely to increase.

## 2.2 External Diseconomies of scale

### Congestion

- : When more firms in the areas, there will be an increase number of vehicles
- ➔ This may cause congestion which leads to longer journey times
- ➔ There will be higher transportation costs.

### Increase in competition for raw materials

- : High number of firms (Larger industries) may result in increased in the competition for resources (eg, Capital, Labour etc.)
- ➔ It can lead to high price of resources
- ➔ Average cost is likely to increase.

# Knockout Economics



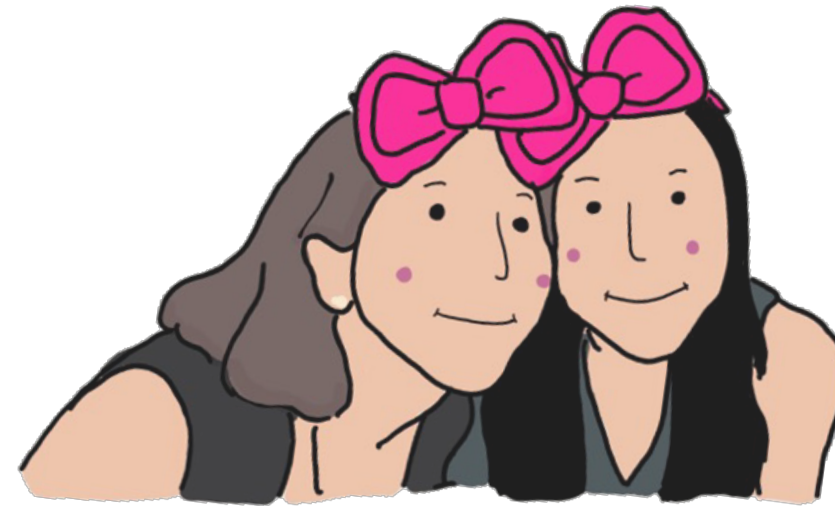
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# **MICROECONOMICS -**

## **Exercises- Firms & Growth of firms**

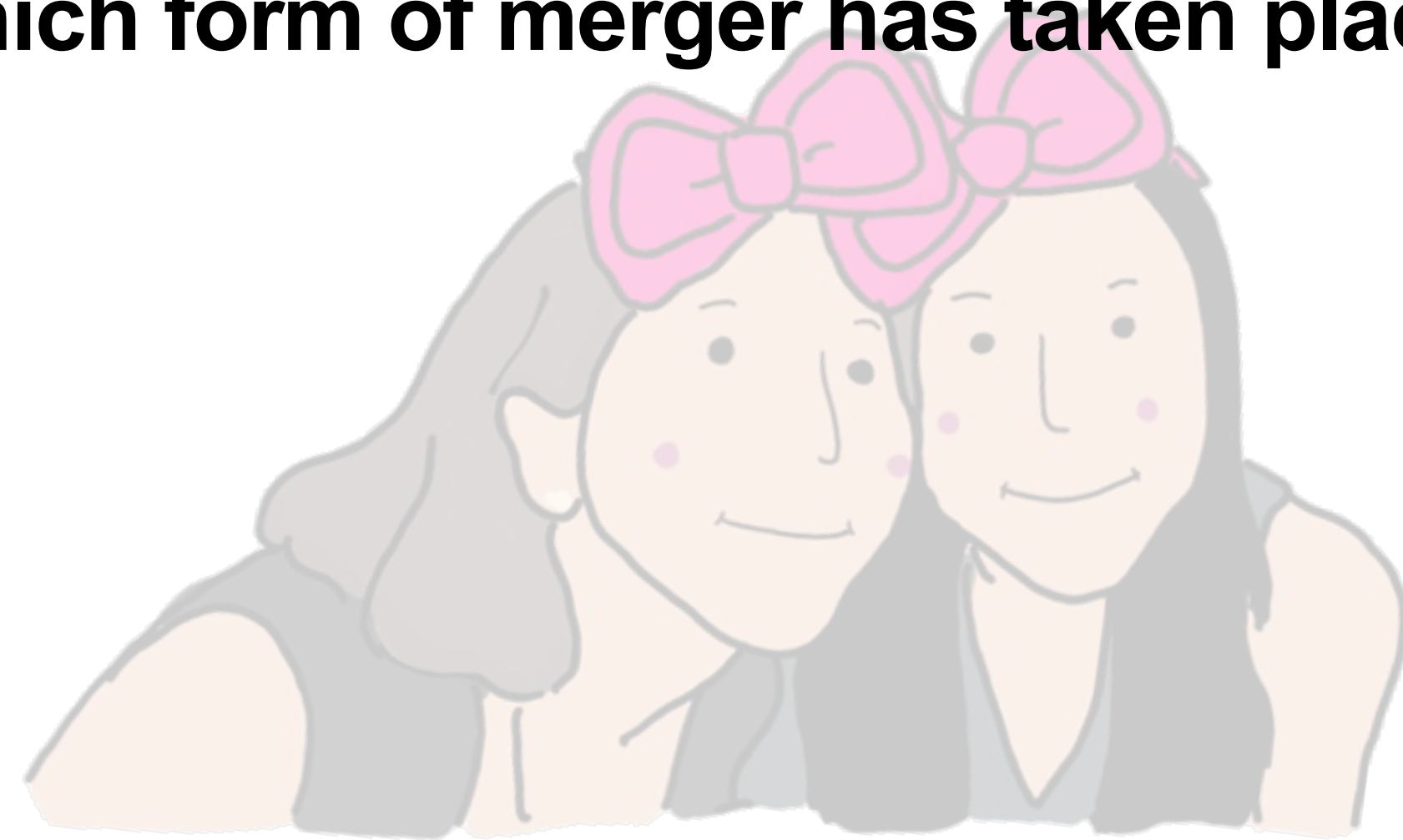
### **Economies and diseconomies of scales**

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## Exercise: MCQ

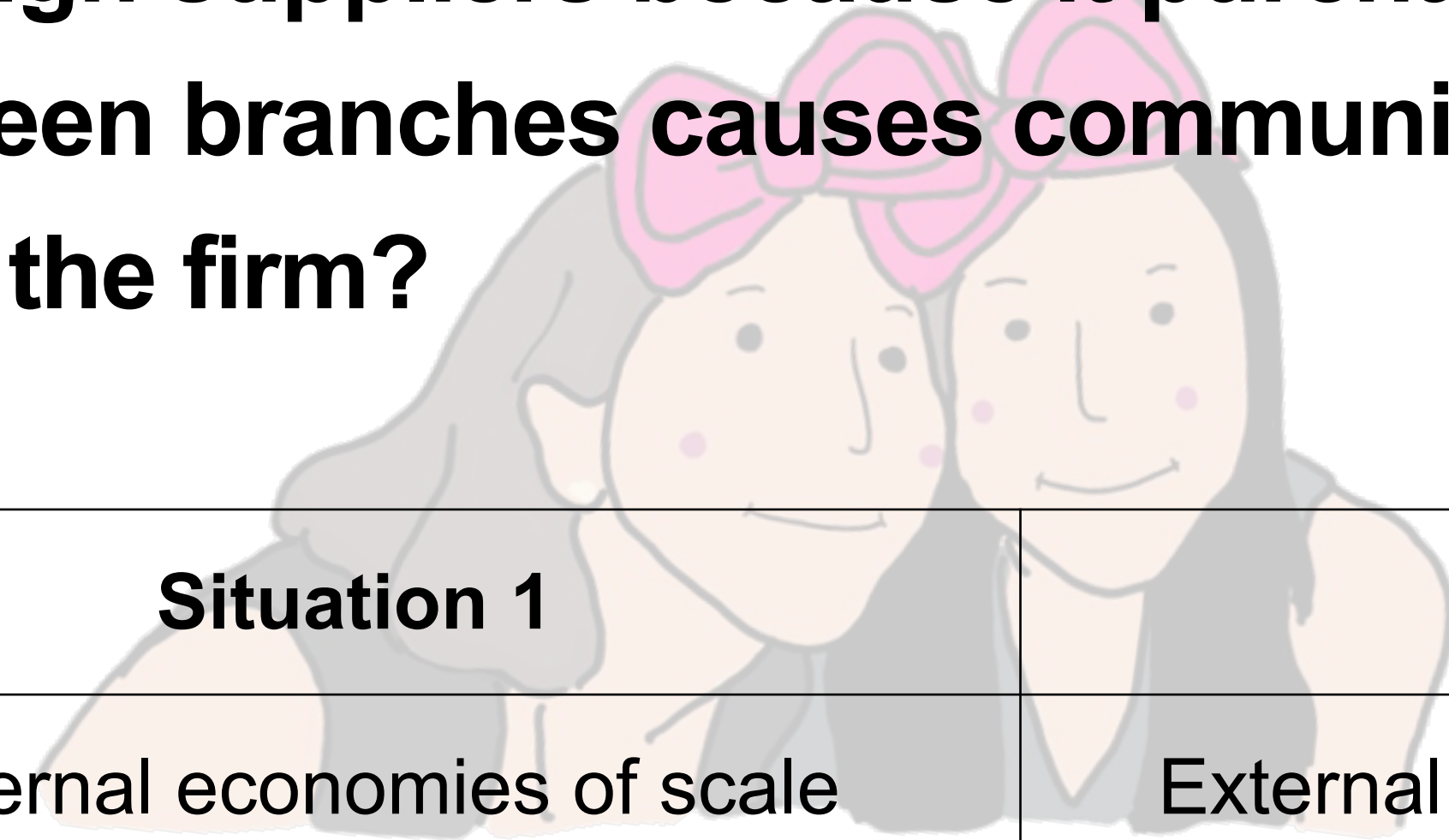
**1. Firms A supplies coffee bean and decides to merger with firm B that also supplies coffee bean. Which form of merger has taken place?**

- A. Conglomerate
- B. Forward vertical
- C. Backward vertical
- D. Horizontal



## Exercise: MCQ

**2. A firm opens new branches in five different cities. As a result, it can negotiate a better deal from its foreign suppliers because it purchases big lots. However, it finds the distance between branches causes communication problems. What describes the result for the firm?**



	Situation 1	Situation 2
A.	External economies of scale	External diseconomies of scale
B.	External economies of scale	Internal diseconomies of scale
C.	Internal economies of scale	External diseconomies of scale
D.	Internal economies of scale	Internal diseconomies of scale

# Exercise: Essay

## 1. Discuss whether consumers benefits from conglomerate mergers [8]

**Command Word:**

**Discuss:** Set out both sides of an argument (For and against)

**For**

**Against**

# Exercise: Essay

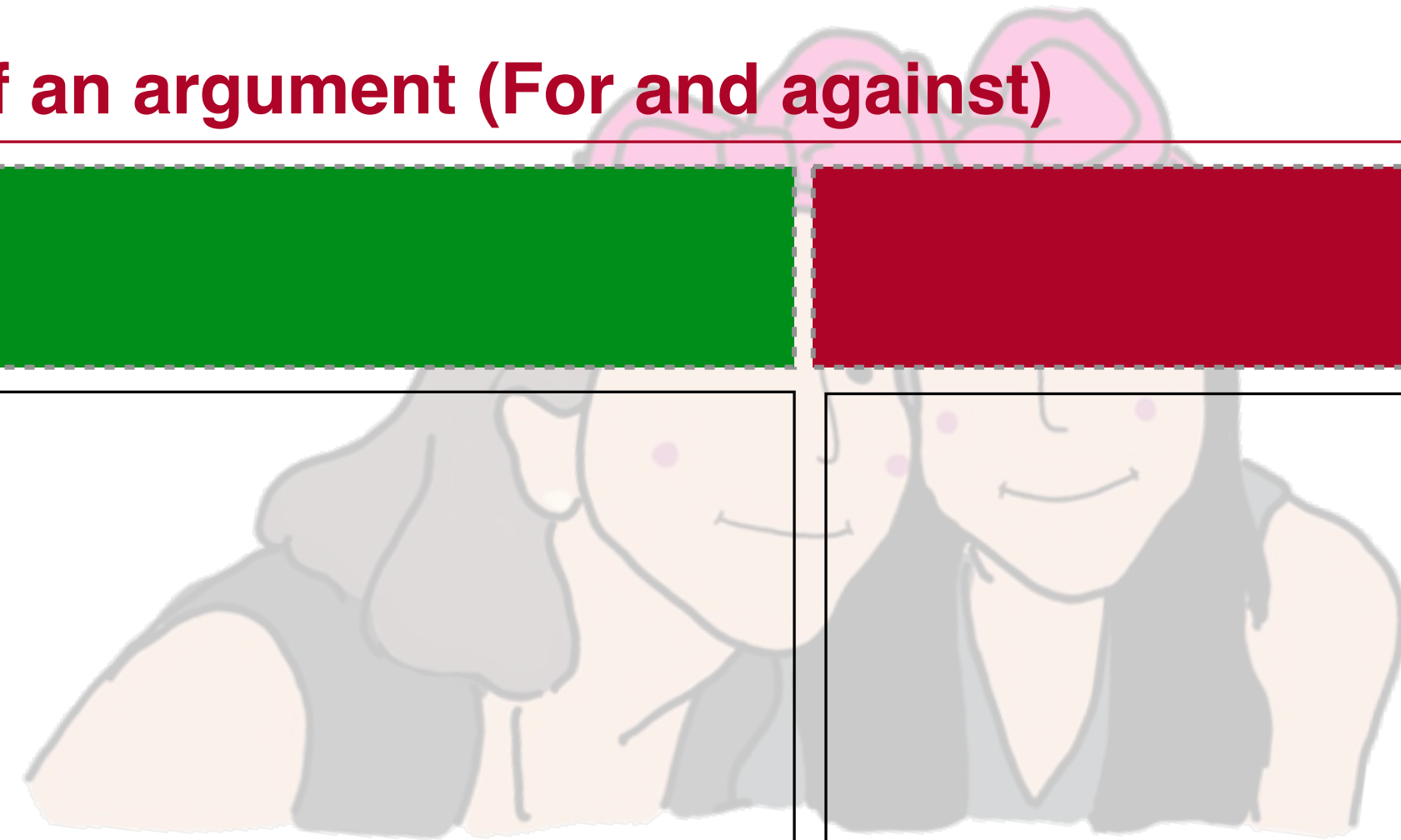
**2. Discuss whether the average cost of production always declines when size of firms becomes larger [8]**

**Command Word:**

**Discuss: Set out both sides of an argument (For and against)**

**For**

**Against**



# Knockout Economics



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