Why do some small firms grow in size essay

A firm, in its economic sense is an organisation / entity which produces goods, most likely to be for the benefit of consumers. Often, for a whole variety of reasons, most notably for the benefit of economic analysis, and government intervention, firms are placed into categories, according to size. A firm can be described as ‘ small’ depending on its number of employees, turnover, size or value of output and perhaps market capitalisation. Most often the factors used will be turnover and number of employees.

Both the Department of Trade and Industry, and the EU agree on the number of employees being under 50, and the turnover as defined by the EU should be under £7million. The Bolton Commission (1973) takes a slightly more specific approach, saying a small manufacturing firm has under 250 employees and a small building firms has under 25 employees, as well as having no ‘ large’ market share and individual management. There are many benefits to staying small, as described in the second part of the question, but many firms if they have the willingness and ability, will grow in size. There are several reasons why this may occur. Firstly and often most importantly, this growth is to take advantage of some economies of scale.

This is graphically shown below in fig 1. 1: Economies of scale only exist in the long run, where all factors of production are variable. They can exist in many different forms: Technical, marketing, transport, increased dimensions, managerial, risk bearing, location, principles of multiples and financial. These all reduce the unit cost of production in different ways, for example increased-dimensions does so as shown below in fig 1. 2. The number of managers required often may not go up if the firm grows, and marketing can be used whether the firm is selling 100 100, 000 units of the product.

The company may expand to allow itself to enter into another market, so that it is able to combat troughs in the business cycle, by producing perhaps an inferior good. A company that makes cars may also decide to start a business that manufactures buses, as that way cars can be sold during a peak, and buses can be sold during a recession, thus protecting itself against a fluctuating economy. Equally, a small firm may want to go into the production of a good which is complementary to its primary good, this would also require a growth in the firm's size. Another reason why a firm may want to expand is because it wants to enter into new markets.

These new markets could be simply another city, or it could be starting international trade, as there may be the demand for the good or service abroad. Equally, there could be increased demand for the good within the country, and if the firm rapidly expands it can satisfy that demand before another firm is able to do so first. The product may have been an invention or idea that was at first unlikely to succeed, but having found a market, the firm needs to grow to exploit the market to its full potential. For this to happen, the firm has to grow into producing enough of the good to be sold abroad, as well as growing the facilities for the increased market, as it will need more employees and contracts for the trade to take place. Often the growth of a firm is not as proactive.

The firm may be growing as a wish to stay in business as opposed to trying to get more business. If, in a particular market there are several firms that are outgrowing a small firm, then the small firm must grow to regain some of the market capitalisation. If it does not do this then it will go under, especially if its products are not seen as a substitute to any of the larger competitors. Being a smaller firm, it may also not be price competitive due to the higher unit costs of production, as discussed above. The reason that really encompasses all of the above reasons for growth in small firms is the need for a greater profit.

Firms ultimately want to maximise on profit, and hopefully go beyond normal profit into super-normal profit margins. This is best shown graphically below in fig 1. 3. Being a smaller firm is limiting, as even the most efficient of small firms cannot compete in making the sort of profits that larger firms are capable of making. Normal profits are made with the intention of paying back those who have deposited money in the business, and represents the opportunity cost of putting money with the firm. Super-normal profit however is money that is left over after all costs are paid, and can be used by the firm for investment, or bonuses or any number of other uses.

If a firm succeeds in its growth, it will move categories and become a ' medium' or a ' large' firm, that has more than 50 or more than 250 employees respectively. They also have turnovers of more than £7million under EU guidelines and also have a larger output and most likely a larger market capitalisation than a ' small' firm. There are far fewer government grants and allowances for larger firms, as the economic advantages of being larger speak for themselves. Firms may decide to become large for any number of different reasons, from simple economies of scale, to simply the need to stay in profit and in business.

However, not all firms even if they have the ability, will choose to grow. Why do other small Firms remain small? Often small firms may, if given the choice, choose to remain small for a number of reasons. They may be in a market where there is low demand, even if they have a large market share. An example of this would be a company who produces equipment for the sport of rackets. Even with the ability to expand, this would be futile as it is a niche market in which demand is not growing.

In this case, to grow would first require a promotion of the sport or the products, or there will be racket surpluses. Secondly, the firm may not want to risk expansion as it may only be money of the entrepreneur that is available to be invested. This entrepreneur may have mortgaged their house against the business, and it is too great a personal risk to over-expand. This ties in with the fact the firm may lack suitable financial security to expand, and may because of minimal assets, may be unable to acquire the funds from a bank to pay for the expansion.

This changes with financial economies of scale as discussed above. A larger firm is also less able to react quickly to changes in demand, and in a rapidly changing market, pragmatism is key. An example of this might be the production of computer hardware. A company that produces hardware may produce surpluses in order to make its supply more elastic, but this will mean that if there is a technological advance, and the equipment is suddenly obsolete, it will have to get rid of the old hardware and get new equipment to produce the latest technology. A smaller firms does not have these problems.

For people who lack motivation or no longer wish to be enterprising, , there may be no need to expand as the firm may have satisfied any promises made to stakeholders who originally invested in the business. They may be acting in the state of mind discussed by Williamson and Baumol who said that life is simply a trade off between work, an inferior good and leisure, a normal good. Once an entrepreneur has fulfilled the aims he laid out when entering the business, there is actually no need to continue to grow. Often the most important reason to remain in the small firm category is the government incentives that small firms receive.

These vary enormously and come in several forms, all of which make running a small firm an easier and more profitable experience. Firstly there are tax incentives, where small firms who make an annual profit of less than £10, 000, since the 2001 budget, do not have to pay corporation tax. Financial incentives, for example the Enterprise Investment Scheme established in 1994 and modified in 1998 allows 20% tax relief on annual investments of up to £150, 000 in small firms, if the investment is held for five years. This is a example of an incentive that aims to help the firms by encouraging investment, and the firms may loose this investment if they decide to grow. There is also a loan guarantee scheme, the government will guarantee a loan on behalf of the firm, and this guarantee will grow depending on the length of the time the loan is for.

This is because it is less of a risk for the government to invest in a more established business. In the last twenty years the government has guaranteed well over £20billion of loans. Venture Capital Trusts started in 1995, and they encourage investment is smaller business as well, by making dividends received immune from income tax. Finally there are tax allowances in the Enterprise Initiative where firms in a development area with less than 25 employees are entitled to a grant.

This scheme existed 1992-1997. It is for the same reason that so many firms choose to grow that many firms equally choose not to grow. Firms may choose to remain small due to economies of scale. They may have already been exploited, and any further expansion could lead to diseconomies of scale as shown below in fig 2.

1. This would mean that the unit cost of production in the long run will start to go up. The reasons why this might occur, could be due to a lack of skills to make the firm larger, meaning that expansion may be required for growth to occur, and so the more employees will have to be taken on. Thus, diseconomies of scale may begin to exist, as the average total cost curve goes past the point where it meets the marginal cost curve, as shown.