Buying small firms for production means

Exam Preparation 4. 2

Question Info:

Sometimes in an industry, a firm buys a smaller competitor that uses similar factors of production. At other times a firm buy another firm that supplies it with the raw materials and other inputs for its production.

Question a)

Explain what is meant by the factors of production.

There are 4 factors of production. Land, Labour, Capital and Enterprise. All of these are scarce resources that a firm needs in order to produce goods and services. Land is the natural resources involved, e. g. oil. Labour is the workforce and staff involved, e. g. pilot. Capital is the man-made machinery involved, e. g. planes. Finally, Enterprise are the decision makers and risk takers that make the business run, e. g. Allan Smith. Similar factors of production mean they are using the similar scarce resources to make their business run.

Question b)

Discuss the reasons why some firms remain small.

There are 4 main reasons why some firms remain small. Firstly, is the size of their market is small, they will remain small. For example, if there are only a few number of consumers willing and able to buy their product, expanding the firm would be pointless. Also, because their market and they themselves are small, they can provide a better and more personal service to their consumers. This allows them to perform better. Furthermore, some small firms produce luxury goods and services for a small market. The market is small because only consumers with high incomes could be willing and able to pay such a high price for these luxury or ‘ exclusive’ goods and services. Examples of this could be, a sports car, designer clothes, jewellery and luxury holidays.

Another reason why firms remain small is due to the fact that their access to capital is limited. What this means is that they do not have many assets and therefore remain small. For example, a bank will not loan to a sole trader who has access to limited capital because the sole trader might not have collateral to offer, they compete against many larger firms and because they might not be able to create enough revenue to pay back the loan. However, many governments realise that providing subsidies and help to these sole traders in the form of maybe providing grants is actually good for the economy. This is because most small firms have to think of very innovative things and new ideas to compete with the other firms in the same line of production and to help boost trade.

Moreover, the introduction of new technology has reduced the scale of production needed. What this means is that small firms that have access to technology can use this to provide goods and services to consumers all around the world without becoming too big.

Finally, it all comes down to what the business owners decide to do with their firms. Some of them may simply just want to remain small. There are many reasons for this but one of the main ones is that by expanding a firm, business owners will have to spend more time on their business and this can become very stressful. Others might lack the skill needed to manage larger firms that employ a lot more people and much more capital.

Question c)

Identify the types of integration in the 2 situations described above.

There are 3 types of integration. There is vertical backwards/forwards integration, there is horizontal integration and finally there is lateral or conglomerate integration. Conglomerate integration is not mentioned in the situation above but it is the integration of two firms that are completely unrelated, however vertical and horizontal integration are. Buying a smaller competitor that uses similar factors of production is also known as horizontal integration because they are neither ahead or behind in the process of production of a good or service (vertical) but are actually in the same line of production (horizontal). At other times a firm buy another firm that supplies it with the raw materials and other inputs for its production. This is known as vertical integration because the firm is either ahead or behind in the line of production of a good or service. A good example is Shell or BP. They both control every step of production from the extraction of crude oil to the consumer. If, for example, Shell was only distributing oil to other companies that sold it to consumers but then decided to buy the firms that sold it to consumers, this would be vertical forward integration. If, however, they decided to buy the firm that extracts crude oil, this is known as vertical backward integration.

Question d)

Discuss whether such integration is always beneficial.

There are both pros and cons of merging with another company, be it vertical or horizontal integration. Firstly, vertical forwards/backwards integration can be very beneficial. By integrating vertically, the transaction costs become lower due to the fact that after the integration, the company becomes a subsidiary company of the firm meaning they have central management and the same communication systems meaning that the overall costs can be controlled and lowered to not only make the costs of production cheaper but also to make the final good or service cheaper for the consumer. Furthermore, after integration, the firm can be assured of the quality of every step of production, ensuring a well-designed and near to flawless end good or service. Another good thing for the firm itself is the fact that by expanding through vertical integration, they become more able to become a monopoly in their market. This is because by controlling the start to finish of a good or service they can also control how well their competition does if they provide them the starting resources in the first place (possibly by raising price).

One disadvantage of vertical integration could be the fact that by expanding their firm size, they also increase their costs because there is more to manage. Another disadvantage is to the competitors and possibly the consumers. By controlling all stages of production, the firm becomes a monopoly which means that competitors will likely fail in doing business which is not good for the productiveness of the economy. Also, because the firm is now a monopoly, they can charge higher prices because demand becomes more inelastic and at the same time offer a smaller variety of products.

Horizontal integration can also be very beneficial. Primarily, by integrating horizontally, the firm has lower costs which leads to more profits and the possibility of lower prices on goods and services. Also, by integrating horizontally, the joint firm can have more to offer in terms of the amount and the different features of goods and services. Moreover, by integrating horizontally, the firm will now have a larger market share, making it compete better against rival or other firms in the same line of production. This in turn results, however in less competition from these other firms and allow the integrated firm to perform better. Finally, by integrating horizontally, the firm will now have access to new markets. This is extremely beneficial for companies that wish to expand overseas and wish to do so immediately and without paying all the expenses.

Along with the advantages, horizontal integration also has its drawbacks. For example, a major drawback for most economies and something discouraged by many governments is the creation of a monopoly due to this horizontal integration. This means, as mentioned in vertical integration, that not only will other competitors perform worse but also the firm will now be able to set their prices much higher for the consumers will also providing a smaller variety of goods and services. Moreover, because the firm has now expanded, it will also become more difficult in managing and will not introduce many new innovations which would be beneficial to the economy. Finally, the merging or acquisition of one firm with another can lead to lower synergy meaning that the firm will be less productive. Also, it is hard to depend on the newly merged firm to work together loyally and have good chemistry increasing productivity. Thus, the merger could backfire instead of helping the firm.

In conclusion, merging or the acquisition of one firm with another can be beneficial but to answer the question, it is not always beneficial and thus should be thought over carefully before deciding to go ahead with the merger.