SECTION 3.5.2

Small firms

Why do so many firms remain small?

Most firms in any national economy are small sole traders or private limited companies owned by one or a small number of shareholders. Some may grow over time into much larger organizations but the vast majority of firms in any economy will remain small.

ACTIVITY 3.19

Staying small

Most firms are small and remain small. Make a list of all the reasons given in the quotes below from owners of small businesses against expanding their businesses

'I can't be bothered to run a larger business. It would be too stressful and take up too much of my time. I am happy being small. I make enough profit and I get to keep it all! My business taxes are also low because I run a small business.'

'I own and run a small restaurant serving a small, local market. There is no point growing larger. I know all my customers and can offer them a good personalized service. Large restaurant chains can't provide this.'

'I work from my home designing and building websites for major business customers all over the world. I don't need to be big. I only need a computer and access to high-speed Internet.'

'We make exclusive and luxury designer knitwear. All our garments are hand-made and sell for between $500 and $1,000 each. Our market is therefore quite limited. Most of our customers are high net-worth individuals, including film, TV and music industry celebrities.'

'My bank wouldn't lend me enough money to finance the purchase of the new premises and equipment I need.'

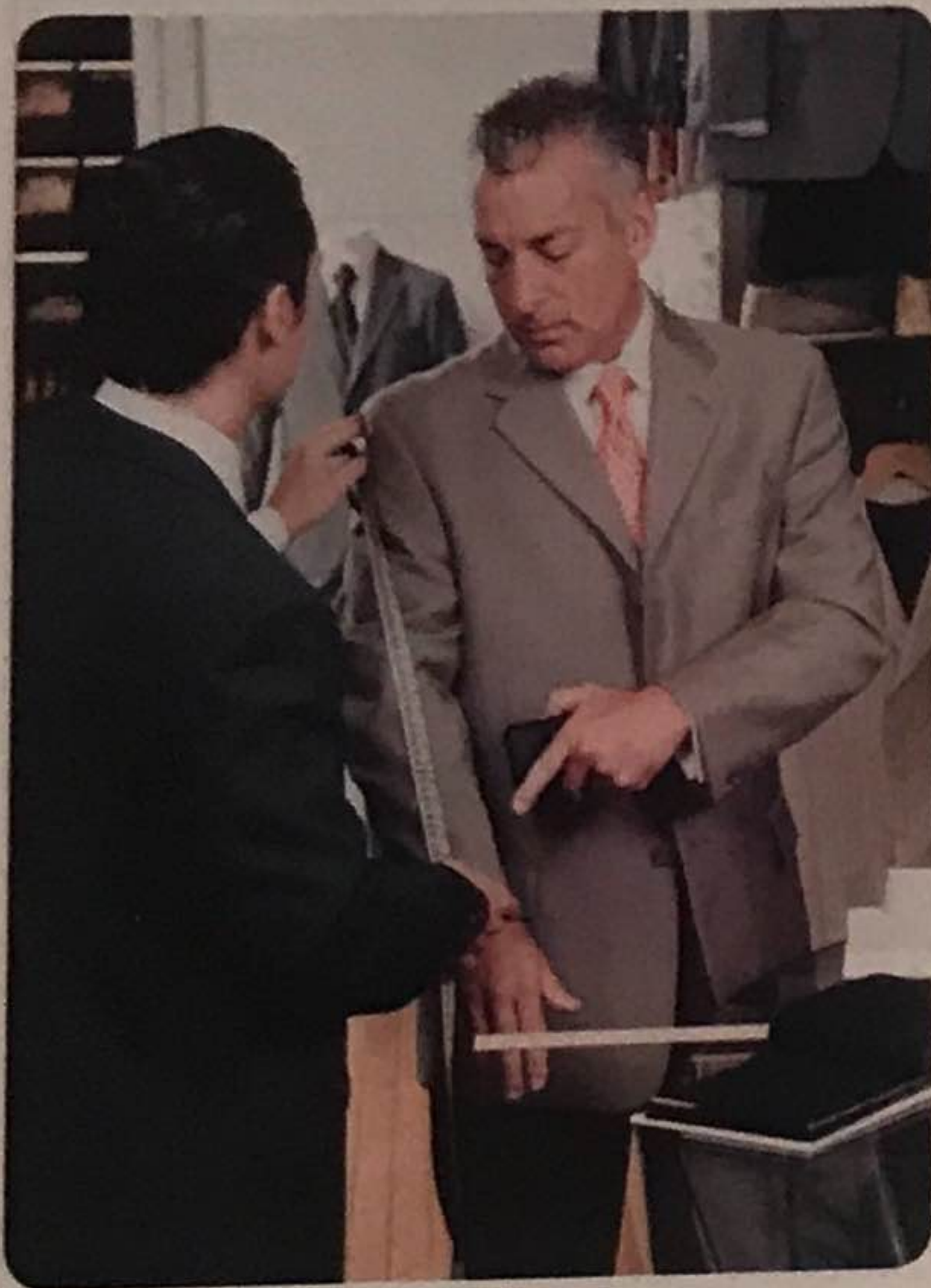
So what explains why so many firms are small and remain small?

1 The size of their market is small

The most efficient size for a firm is closely related to the size of its market. If there are only a relatively small number of consumers willing and able to buy a product there is no point in a firm supplying that market expanding in scale significantly.

There are many examples of sectors in which small firms thrive because the markets they serve tend to be localized. For example, hairdressers, restaurants and cafés, window cleaners, decorators and many hotels, taxi services and shops only supply the villages and towns they are located in. They are also able to offer their customers more innovative and personalized services than large firms that mass produce goods or provide standardized services across all their business locations. For example, tailors can make made-to-measure suits and carpenters can make furniture to order.

Similarly, firms that produce luxury items may have relatively small or niche markets. Only consumers with very high incomes may be willing and able to pay high prices for 'exclusive' products such as designer clothing and jewellery, sports cars and luxury holidays.



▲ Smaller firms usually supply small, local markets and can offer a more personalized goods and services than larger firms

2 Access to capital is limited

Sole traders often have to use their personal savings to set up their firms. Banks are not normally willing to lend money to small, untested business propositions. This is because small firms usually lack assets they can offer as collateral against loans, face fierce competition from larger rivals and may n be able to make enough revenue each month to repay a loan.

Recognizing that lack of capital is a problem for small firms, many governments encourage new start-ups by providing grants to cover the cost premises and equipment, or by subsidizing wages and other costs.

They may also benefit from lower rates of tax on their profits, and can ofter seek help and advice on business issues from specialist advisers employed b government agencies. Governments do this because small firms are often ve innovative: they invent new products that help to boost trade and new processes that other firms can eventually use to increase their productivity. Some small firms will also eventually grow into much larger firms that help create wealth in an economy through additional employment and profits.

3 New technology has reduced the scale of production needed

The size and cost of new technology has reduced significantly over time. M small firms now have access to computers and other modern equipment. Many years ago they would not have been able to afford such equipment. Also, through the internet many small businesses can easily communicate with suppliers and consumers all over the world.

4 Some business owners may simply choose to stay smal

Some entrepreneurs may simply decide they do not want to increase the si of their firm as long as they continue to make a reasonable profit after tax. Running a larger enterprise can also be very time-consuming and stressful. Some entrepreneurs may lack the skills they need to manage and run large firms employing many more people and much more capital.

The vast number of small firms that exist across many industrial sectors in almost every economy can therefore be explained by their advantages and the barriers and disadvantages that ultimately prevent their growth.

▼ Advantages and disadvantages of small firms

Advantages of small firms	Disadvantages of small firms
1 Small firms can usually be set up very easily: ✔ there are normally few legal requirements involved in setting up a sole trader or small, private limited company; ✔ many can be run from home or rented premises with little capital; ✔ some small firms may receive grants from their local or central government to help them set up. 2 Paid managers rather than business owners often run large firms. In contrast, the owners of small firms tend to run them from day-to-day and are their main decision makers. This can be an advantage because:	1 Because owners of small firms usually have full responsibility for running them day-to-day: ✘ they will need to keep accounts, advertise, recruit and manage staff, deal directly with customers and suppliers, and carry out many other tasks. However, few owners have all the skills necessary to run thei firms successfully; ✘ they will often have to work very long hours; ✘ they may have to close their firms and lose revenue when they are sick or on holiday unless they are ab to employ someone else to manage and run their businesses in their absence.

- ✔ they are motivated to run them well because they receive all the profits;
- ✔ decisions can be made and communicated to their employees quickly;
- ✔ they are in closer contact with customers than the owners of larger firms. This can help small firms build up customer trust and personalize their products to better meet their customer's requirements;
- ✔ they are in closer contact with their employees and this can build up trust and loyalty. Employees of small firms may be more motivated as a result even if their wages may be lower than in larger firms.

3 In addition, small firms may be able to react to changes in economic and market conditions more quickly than larger firms because:

- ✔ their owners are their main decision makers and because they are in closer contact with customers they will learn of and understand changes in customer preferences and buying behaviour better and more quickly than in much larger firms;
- ✔ unlike many larger firms, smaller firms usually do not have a significant amount of capital invested in machinery and premises. This means they may be able to change their production processes and products more easily as conditions change.

2 Small firms are usually more vulnerable than larger firms. Many do not survive because:

- ✘ they lack financial resources;
- ✘ they are in competition with many other firms;
- ✘ in the event of failure, sole traders face the additional risk they will have to pay off any business debts from their own personal savings.

3 Small firms find it difficult to raise capital to pay their running costs or to finance their growth:

- ✘ banks and other financial institutions are not as willing to give loans to small firms because they are riskier and have few assets they could sell to pay off their loans in the event of business failure;
- ✘ suppliers may be unwilling to sell their products to small firms on credit terms because of the risk they will be unable to repay them;
- ✘ unlike limited companies, sole traders cannot sell shares.

4 The average cost of delivering a service or producing or selling each product is often much higher for a small firm than for a larger firm because:

- ✘ small firms may be unable to buy in bulk and receive bulk purchase price discounts from their suppliers;
- ✘ they cannot afford to employ specialist equipment and staff that can help them to improve their efficiency and lower their average costs.

CTION 3.5.3–4

Mergers and the causes and forms of the growth of firms

Why do some firms grow in size?

In economics, firms can only grow in size in a time period known as the **long run**. In the long run a firm can expand its scale of production by buying or hiring larger premises and more machinery and equipment. This is because all factors of production can be varied in the long run.

In contrast, in the **short run** capital is a fixed factor of production and cannot be varied. Firms can hire more workers and buy more materials but will only be able to produce more output if they can make more and better use of their existing premises, machinery and equipment.

The difference between the short run and long run can be a matter of days or weeks in some firms. For example, a small firm making and selling greetings cards may be able to buy and install an additional printer relatively quickly. In contrast, it may take a large supermarket chain a year or more to build and fit out a new store.

Not all firms can or should remain small if they are to survive and generate profits. Growing in size can help a firm to reduce its market and financial risks. It may be able to raise more money to finance new, more efficient equipment and to employ more specialist workers. This can help the firm to improve the

quality and appeal of its products, reduce the cost of producing them and increase its sales and profit margins.

However, producing more output means increasing the scale of productio a firm. This can be expensive to achieve. Cost may rise initially and this w reduce profits. However, in the long run a larger firm may enjoy significan cost advantages over smaller firms and capture a much larger market shar both of which should help to it to increase its total profits. ➤ **3.5.5**

There are two main ways a firm can grow in size and expand its scale of production in the long run.

Internal growth

Internal growth or **organic growth** involves a firm expanding its own s of production through investments in new and additional equipment and technology, and increasing the size of its premises. This will increase its fix costs of production. ➤ **3.7.1**

To finance this growth the owners will need to use the profits of the firm, borrow money from banks and other lenders or sell shares in the ownershi their business to other investors. To sell shares a firm must become a joint-stock company. The new investors will become the owners or shareholders the company and be entitled to a share of any profits.

External growth

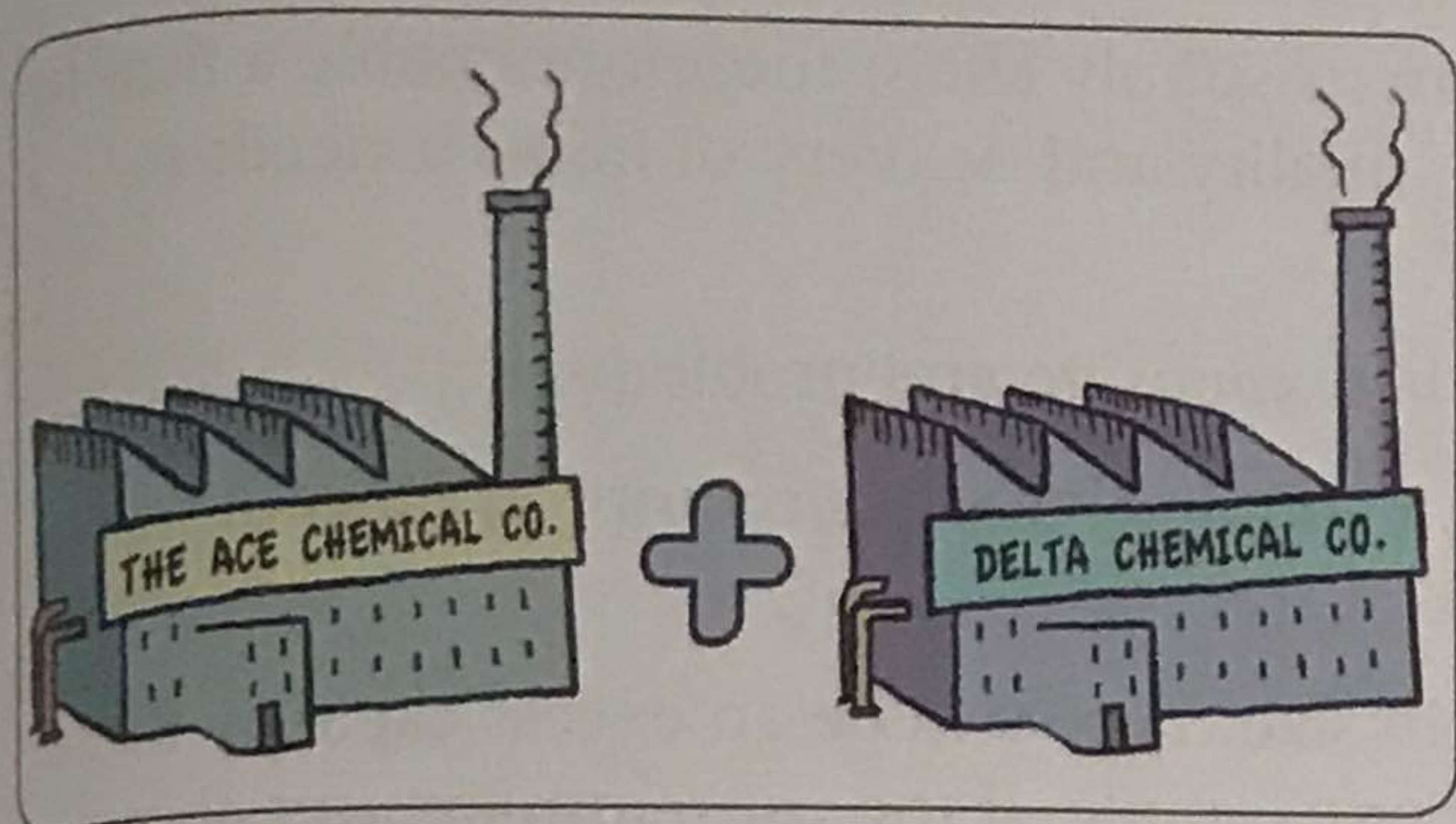
External growth in the size of firms is more common. It involves one or more firms combining their factors of production to form a larger enterprise This is known as **integration** through **merger**.

A **merger** occurs when the owners of one or more firms, usually of a simila size, agree to combine their operations to form a new, larger enterprise.

However, a merger can also result from the **takeover** or **acquisition** of a smaller public limited company by a larger one. This involves the larger company buying up all the shares of the smaller company with or without t agreement of its managers.

▶ ExxonMobil was formed in 1999 following an agreement by US companies Exxon and Mobil to merge their operations. The combined company is now one of the largest in the world and benefits from a large market share and significant economies of scale in oil and gas exploration, production and sales.

Types of merger



▼ Horizontal merger

Integration or mergers between firms can take a number of forms.

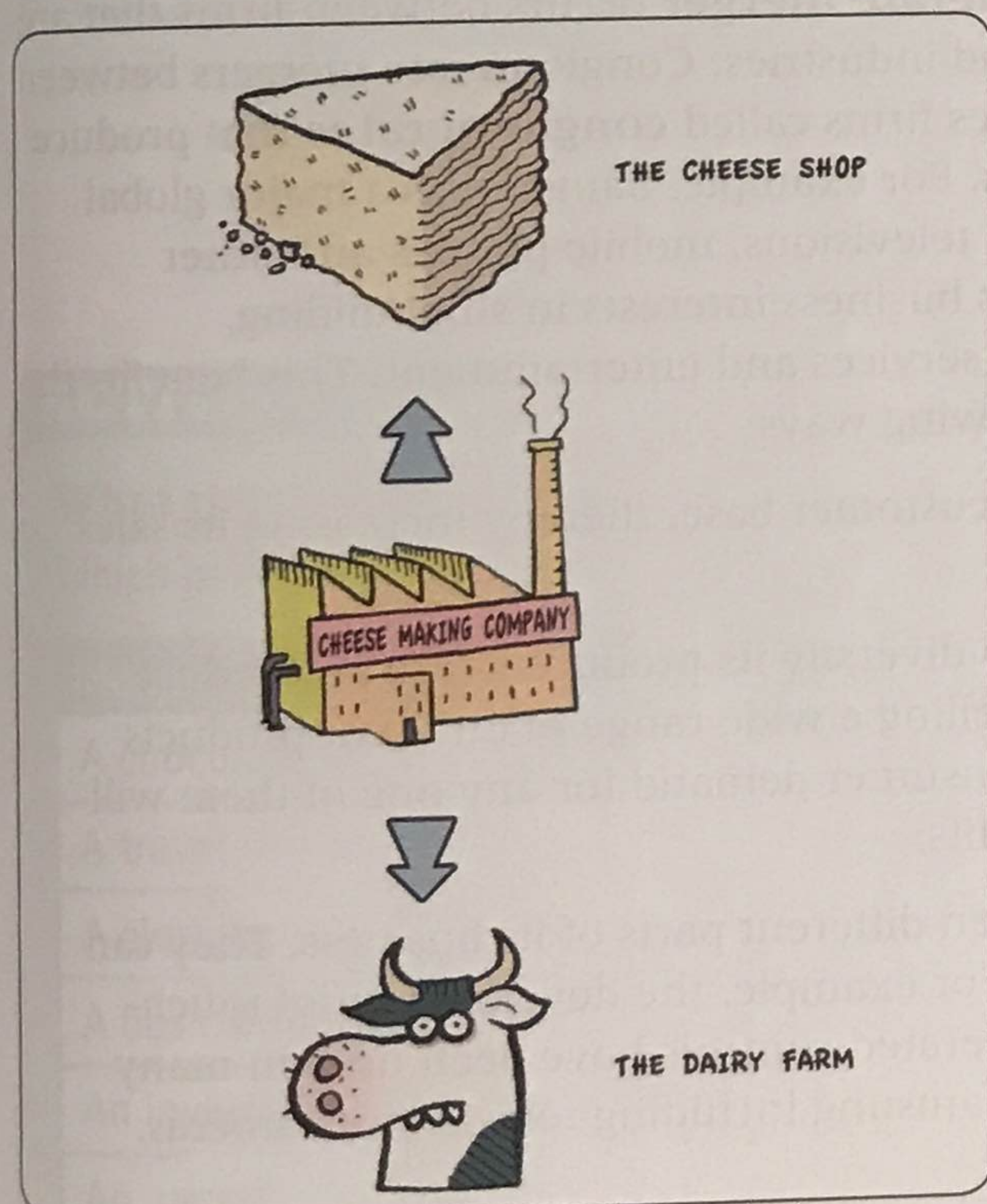
Horizontal merger occurs between firms engaged in the production of the same type of good or service. Most integration between firms is horizontal.

Horizontal mergers can benefit firms in the following ways:

- ✔ The combined business will have a larger market share;
- ✔ It will reduce the number of competing firms in the industry. This is called **consolidation**;
- ✔ Integrated firms may gain a number of cost advantages due to their combined size. These are called **economies of scale**. For example, by merging their finance, purchasing and other administrative functions the new firm can reduce staff and other costs. It may also benefit from price discounts offered by suppliers for the bulk-buying of goods from them;
- ✔ Similarly, if common ownership results in the firms moving closer together geographically then it will reduce their transportation costs.

However, combining horizontally to form a much larger firm can create problems:

- ✘ for the owners and managers because it may become more difficult to coordinate and manage the productive activities of a larger number of workers, especially if they are spread across many different locations. As a result production costs may rise; ➤ 3.5.5
- ✘ for consumers, because horizontal mergers can create large firms able to restrict market supply and competition in order to raise their prices and increase their profits. ➤ 3.8.2



▲ Vertical merger

Vertical merger occurs when firms at different stages in the supply chain for a product merge together. For example, a car manufacturer may combine with a car retailer in order to control the sale of its cars. This involves **forward vertical merger**. The car manufacturer may benefit in the following ways:

- ✔ It can be certain it has a retailer through which it can promote and sell its cars and accessories;
- ✔ It can instruct the retailer not to stock vehicles produced by rival manufacturers;
- ✔ It can absorb the profit made by the retailer on each sale.

Backward vertical merger can also occur between firms when one firm combines with another at an earlier stage in its supply chain. For example, a cheese producer may combine with a dairy farm so that it is guaranteed supplies of milk, and may benefit in the following ways;

- ✔ It can be assured regular and exclusive supplies from the farm. This greatly reduces the risk of production being held up by late deliveries;

- ✔ It can control the costs and quality of supplies from the farm;
- ✔ It can absorb the profits of the farm.

Vertical mergers with other firms in its supply chain therefore enable a firm to have greater control over the cost, quality and delivery of items it needs to either make or sell its products.

However, vertical integration can be expensive and problematic:

- ✘ The takeover of other firms in a supply chain can require significant amount of capital;
- ✘ If the firms differ significantly in size there will be an excess capacity in one part of the supply chain. For example, if the car manufacturer above produces more cars than the retailer can sell or if the cheese maker requires more milk than the farm can produce to keep its existing equipment and workforce fully employed;
- ✘ Once a firm has control over its supply chain in one region or country it cannot easily relocate parts of its supply chain to cheaper locations overseas, for example, where wages or taxes on businesses may be lower. To do so will greatly increase transport costs and reduce supply chain coordination;
- ✘ Running a successful manufacturing firm requires a different set of skills to running a profitable retailer or producer of component parts or natural resources;
- ✘ The different firms may have very different ways of working and interacting with employees and customers. A clash of cultures can lead to misunderstandings, conflict and lost productivity in the merged organization.

Lateral integration or **conglomerate merger** occurs between firms that are involved in unrelated activities and industries. Conglomerate mergers between one or more firms therefore creates firms called **conglomerates** that produce a wide range of different products. For example, Samsung is a major global business group well known for its televisions, mobile phones and other electronic products, but it also has business interests in shipbuilding, construction, chemicals, financial services and entertainment. This benefits the Samsung Corporation in the following ways:

- ✔ It has been able to expand its customer base, thereby increasing its sales and profits;
- ✔ It has allowed the company to diversify its produce range and reduce market risks. Producing and selling a wide range of different products reduces the impact a fall in consumer demand for any one of them will have on its total sales and profits;
- ✔ It can exploit synergies between different parts of its business. They can share ideas and innovations. For example, the development of touch-sensitive screens and voice-operated controls have been used in many different applications within Samsung including televisions, cameras, computers and smartphones.

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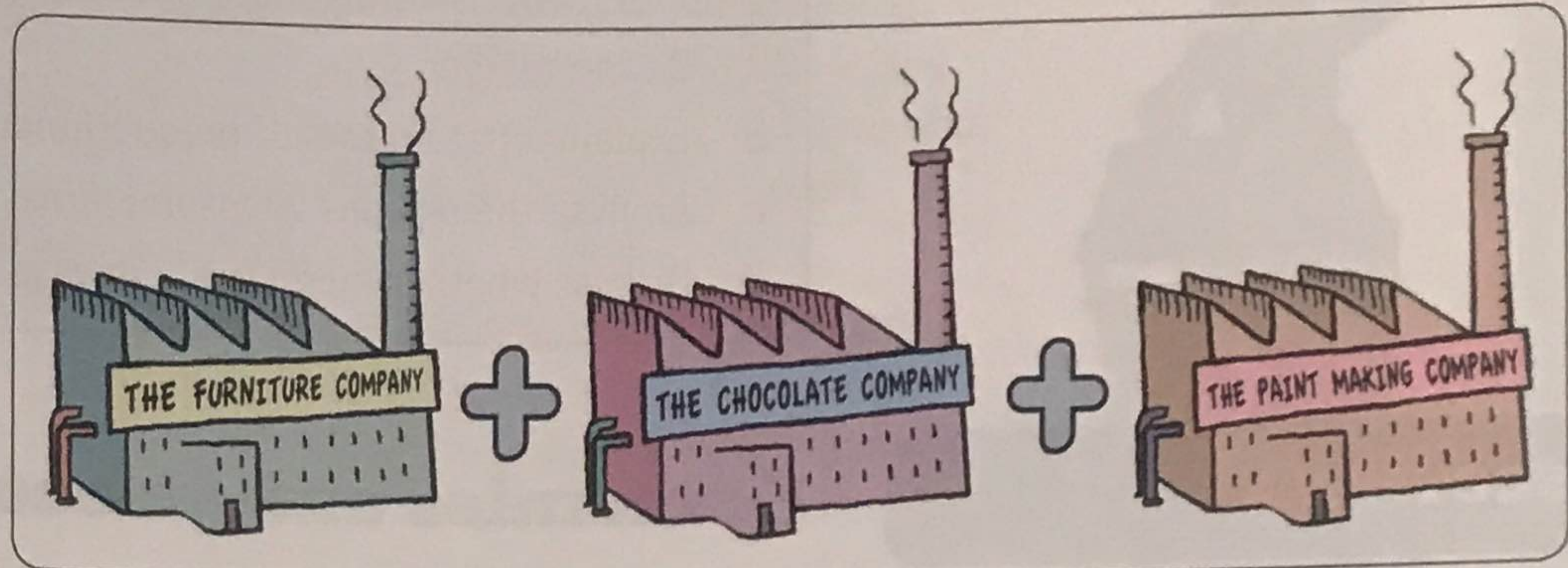
✔ It has enabled the company to achieve significant economies of scale, for example, by spreading the costs of research and development, advertising and workforce recruitment across its different business units. It helps in reducing the production cost per unit and helps in achieving economies of scale.



▲ Conglomerate merger between unrelated firms

However, conglomerate diversification can sometimes create significant problems in a company:

✘ Managers may find it difficult to govern and control a much larger firm made up of very different businesses producing and selling different products to different groups of customers. This can result in mismanagement and misunderstandings between the various parts of the business;

✘ When merging unrelated firms, managers will require a lot of effort to understand the products and operations of each business. This can result in a loss of focus leading to poor performance in all the businesses;

✘ Workforce issues can arise when workers who are used to working for different firms in different industries and who have different skills, attitudes and wages, are brought together into a single organization. As a result, disputes can occur and their motivation and quality of work can suffer.

ACTIVITY 3.20

What type of integration?

Which of the following mergers involve horizontal, vertical or lateral integrations?

Merger or takeover	Horizontal?	Vertical?	Lateral?
A chocolate maker takes over a cocoa plantation		✔	
A travel insurer merges with an online holiday company			
A clothing retailer takes over a clothes manufacturer			
A bus manufacturer merges with a car maker			
An investment bank takes over an electronics producer			
An aircraft maker merges with an aero-engine company			