

Capacity Utilisation

It is normally only when the economy is booming and demand is buoyant that firms are able to operate at full or near full capacity.

Full capacity means that all employed factors of production are being used to their optimum level of efficiency. That is producing the maximum level of output, given the firms current investment levels.

At most other times in the economic or business cycle, firms will be operating below full capacity. This means that they have the capability to produce greater levels of output than they are actually producing. Spare capacity exists.

Problems of Spare Capacity

If the level of spare capacity is material - i.e. large enough to be of concern, then this under-utilisation of factors of production can have major effects on the firm.

These effects include:

Demotivation of staff. Overtime is probably not available, bonuses will be limited, there may be a threat of redundancy. Hygiene and motivators will be compromised (Herzberg)

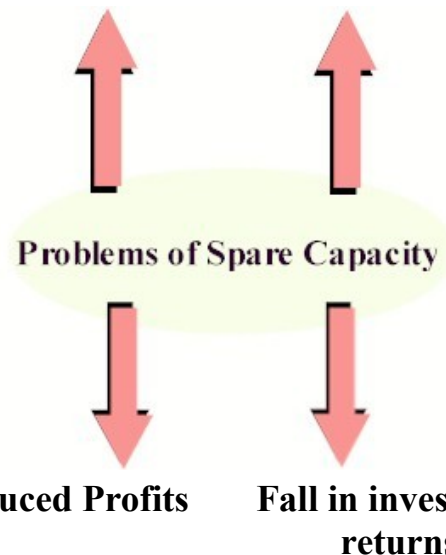
Increased costs to the firm. Firms may be forced to make workers redundant; redundancy payments will have to be made. Also management time will be spent on reorganisation.

Reduced profits. This will limit capital for investment and research and development,

causing a reduction in long-term competitiveness.

Demotivated Staff

Increased costs



Reduced Profits

Fall in investment returns

Lack of return on investment capital. Producer goods will continue to depreciate, even though they are not being used to full capacity. Technology will move on, putting pressure on firms to replace fixed assets that otherwise have plenty of productive potential.

Resolving the problems of capacity under-utilisation.

Given the above situation firms have several options open to them.

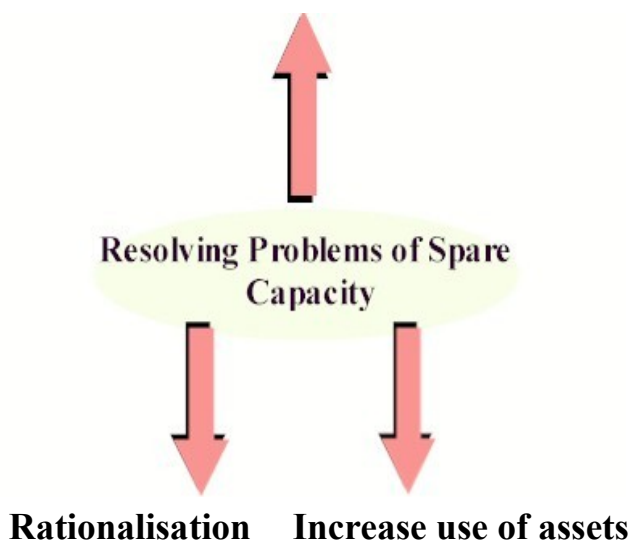
These include;

Sub-contracting of production. This means getting someone else to produce the goods for you. By using sub-contractors there is a reduction in risk to the firm. This risk reduction is achieved through a reduction in capital investment required.

If the firm is not making the goods, it does not have to buy the machines to make the goods, lease the factory space or employ and train the workers.

But sub-contacting can bring problems of its own. Firstly there is a lack of control, especially in regard to quality, secondly, if there are a limited number of potential sub-contractors, then prices of the goods can become prohibitively high, reducing profitability and finally, there can be delays in delivery.

Sub-contracting production



Rationalisation. This means concentrating on core products or services, and disposing of or ceasing production of, those products or services that are not seen as profitable or necessary to the business's long term success. There can be costs to rationalisation, such as writing down (reducing), book value of assets, but it does allow management to concentrate and focus upon the business strengths.

There is a risk though that customers will be lost. Some customers, especially business

customers, who bought into the firm's whole package of products, may be less loyal when 'one-stop shopping' is not now available. Rationalisation also implies redundancy costs.

Increasing the use of assets. This is potentially the most attractive option, as it removes many of the costs of the other methods of rationalisation.

Retailers can sub-let some of their shop floor space - supermarkets could include hairdressers or chemists. Manufacturing firms can expand their ranges (development and marketing investment costs must be considered), they can look for new markets or market niches, or they could sub-contract for other producers.

This increased use of investment goods is often referred to as 'sweating assets'

Over capacity brings with it a number of problems, and the solutions to these problems are often, at least in the short term expensive.

Because of the short term expense of solving problems of over-capacity, firms often try to ride out this type of situation, in the expectation the economy will recover, that markets will recover, and therefore so will demand and output.

Notes