Chapter 11: Multi-Product Firms

I. Specialization and Multi-Product Firms—A Paradox?

The logic of specialization worked out in Chapter 9 seems to imply that firms would specialize and produce only a single product—as most of the models developed to this point have assumed. In the real world, we observe that many firms—especially "small businesses" specialize in providing a single service or a very narrow range of services, as with plumbers, carpenters, computer programmers, cell-network providers, and bicycle shops. However, we also observe firms that provide a variety of services or produce a variety of products. This chapter attempts to explain why multi-product firms exist given the informational advantages of specialization.

There are several possible explanations for the existence of multi-product firms including (1) complementarities in the products and services produced that tend to increase the demand for a firm's services or reduce their costs. Computer manufacturers often provide repair and maintenance services for their computers (but not others) because their customers will purchase more of each when they are produced by the same firm than when they are produced by different firms, because of the reduced transactions costs of doing so or because they know their own equipment and software better than others can, and so they can provide repairs and maintenance services at a lower cost than others can. Other instances include holding companies and conglomerates that own several specialized companies in different industries as portfolios and allocate capital among their in the pursuit of the highest overall risk-adjusted returns on their capital. Examples include Warren Buffet's Berkshire-Hathaway Company or Richard Branson's Virgin Group, as well as corporations such as Sony and General Electric (in the past). Still others include companies that attempt to take advantage of their especially talented teams of engineers or flexible manufacturing expertise that allow them to produce a variety of products at a lower cost (or with less risk) than smaller specialist firms can. And, still others attempt to do so because it produces monopoly power for the firm doing so, and thereby increases its profits because of the result less price-elastic demand curve.

This chapter explores possible demand and production economies associated with broader scope—as opposed to increased scale, per se.

II.