

Tribal Economic Development Principles-at-a-Glance Series

**The Industrial Strategies of
Vertical Integration,
Economies of Scale, and
Economies of Scope**



Tribal Economic Development Principles-at-a-Glance Series

The Industrial Strategies of Vertical Integration, Economies of Scale, and Economies of Scope

This is the 17th in a series of economic development primers produced by the Division of Economic Development (DED), Indian Affairs Office of Indian Energy and Economic Development (IEED), to offer answers to fundamental questions about creating jobs and expanding economies in tribal communities.

If you would like to discuss your tribe's industrial strategies in more detail, please contact the Division of Economic Development at (202) 219-0740.

What is meant by “industrial strategies,” and why should tribal leaders consider them?

Think about the common, age-old expression: “The whole is greater than the sum of its parts.” This expression is relevant for the economic activities that a tribe undertakes because the benefits to the tribal community derived from all of its economic activities taken together are often greater than the benefits of each individual project added together.

To reap the benefits of a tribal economy as a whole, tribal leaders should consider applying “industrial strategies.” Industrial strategies are those that nations often employ which involve considerations beyond the promotion of any particular company. These strategies apply to an entire industry, or even to groups of industries. The “export promotion” and “import substitution” strategies discussed in the 15th primer, *Finding the Best Tribal Economic Development Strategy*, might be regarded as industrial strategies, but there are other important ones, as well.

What is “vertical integration”?

Vertical integration is an industrial strategy where the output from one business is used as an input into another business, thereby offering cost-savings for the combined operation.

For example, suppose there are two potential projects under consideration: one is the development of a new restaurant in the tribal area that would attract both local residents and visitors, and the other is a new grocery store. Both of these establishments could be built separately, in their own buildings and locations, and that is probably what would happen if those involved in each project did not explore the possibility of partnering with one another. On the other hand, what if one large building was constructed where the two operations – the restaurant in one section and the grocery store in another – were part of the same enterprise?

The costs of both operations could be minimized in various ways. One way is that the restaurant could get many of its supplies from the grocery store so that it would not need its own separate inventory, and it would have less waste from the loss of perishable inventory that had not been ordered from the menu (since those supplies might otherwise be sold in the grocery store, or vice

versa). These operations could also save money from sharing the same ground lot and by having the same employees who could shift from one operation to the other as needed, making both operations collectively more efficient. Because of factors like these, the restaurant and grocery store might each be barely profitable when operated separately, but operated together in a coordinated effort they might be highly profitable overall.

Sometimes vertical integration, such as in the above example, is referred to as simply “getting rid of the middle man” (although in other cases it may be a bit more complicated). This strategy is widely used throughout many industries and has helped them become highly successful. So, in considering more than one operation, tribal business planners should explore the possibilities offered by vertical integration.

In the above example, both projects (the grocery store and the restaurant) were considered to start at the same time, but it need not be like this. Alternatively, even if one of the operations already existed and the other added to it later, vertical integration would still be achieved in much the same way.

We should also bear in mind, however, that, while vertical integration is generally beneficial, it does not, in itself, guarantee success. Conversely, it is quite possible for a business to be successful without relying on that particular strategy. Vertical integration is simply an industrial strategy in the business world’s toolbox that tribal leaders should consider when engaging in economic planning.

What are “economies of scale”?

The principle of economies of scale is the idea that, in many cases, the larger the operation is, the cheaper it can be to produce each unit that is sold. Economies of scale are often achieved with the development of infrastructure like transmission lines, roads, internet service, and water and sewer services, among others.

For example, suppose a tribe is considering the production of a 50-machine windfarm, which will require substantial costs in constructing the towers, turbines, and transmission lines that will stretch from the site to the nearest power grid. Suppose the lines have just enough capacity to bring the windfarm’s power to the grid, but for just a slightly higher cost, the tribe could install transmission lines with twice the capacity (the cost of the transmission lines would only be slightly higher because most of the cost is associated with labor needed to construct the lines and the structures that hold them as opposed to the cables’ cost).

The tribe may strategically install the higher-capacity lines with the intention of doubling later on the windfarm’s capacity from 50 to 100 machines. To double the power generated the business would then have to double the number of wind machines, but not double any other costs (since the needed transmission lines to the power grid are already there). In short, the production of electricity would be doubled without having a doubling of the cost of the initial operation. In this sense, the expanded windfarm would be benefitting from economies of scale.

Many economies of scale often exist, as well, in construction (the larger the building, the cheaper the cost per square foot) and in purchasing supplies in bulk. Thus, when tribal development projects are being considered, attention should be given to the right size or “scale” of the project that would yield the best results, and room should be made to allow for further economic growth with minimal additional costs.

There is one note of caution, however, when considering economies of scale. Business operations can also fail by being *too* large, that is, by not adequately accounting for the quantity of a product that will actually sell (or “clear the market”) when more of it is being supplied. For example, a grocery store might be expected to have a certain, maximum number of customers and can, therefore, only expect to sell a certain amount of food. Thus, unlike the windfarm example, when a grocery store is doubled in size, it might have only created excess capacity for which there are insufficient customers. In this case the grocery store could face “diminishing returns” by raising its costs more than it has raised its revenues, thereby making the business less profitable (or not profitable at all).

What are “economies of scope”?

Economies of scope occur when there is a larger variety of goods and services being produced and sold in a particular area, making it easier for consumers in that area to buy a variety of products, and thereby making it more profitable for the businesses involved. Under some circumstances, but not all, the term “economies of scope” might be seen as a fancy term for “one-stop shopping.”

As an example, suppose there is a strip mall outside the tribal area that has both a grocery store and a clothing store, while inside the tribal area there is only a grocery store. People in the tribal area who have to leave it to buy clothes will, after doing so, then find themselves in the same parking lot serving the strip mall’s grocery store. Faced with that convenience, they may then be inclined to buy their food there as well, especially if the tribal grocery store is not on the route they take to return home from their shopping trip. If a clothing store was built adjacent to the tribal area grocery store, then the expanded tribal shopping area would now benefit from economies of scope, making both businesses there more competitive with strip mall businesses outside the tribal area.

Economies of scope can also apply to communities that enjoy having a variety of industries operating in their area. For example, when electrical power, internet service, public water and sewer, and roadways are all available in a particular area, it is much easier for new businesses to establish themselves in the same area and much easier for customers to reach them.

As demonstrated in the examples in this primer, businesses are often dependent on each other in many ways, whether they are in the same “production chain” (as in vertical integration), or simply sharing the same customers in the same strip mall. Tribal economic planning should take these interrelationships into consideration when formulating their economic development plans.