Edexcel Economics AS-level

Unit 3: Business Behaviour

Topic 1: The Firm and its Objectives

1.1 Objectives

Notes

Why some firms tend to remain small and why others grow

- The size of firms can be determined by:
    - **Economies of scale relative to market size:** Large firms might only experience small economies of scale compared to their size, since the extent of economies of scale might be limited in that industry. This could make their costs higher than firms which choose to stay smaller.
    - **Diseconomies of scale:** Larger firms could face high costs because they have grown too quickly. There could be poor organisation, x-inefficiency or because firms in large, formal markets tend to have to pay higher wages.
    - **Small firms as monopolists:** Small firms could hold some degree of monopoly power, since they provide a more personal, local service. Their opening hours might suit a small town, such as those of a corner shop, and some consumer might prefer making smaller purchases, than the larger ones expected at bigger stores. Small firms might also create a **niche market**, where they can use their relatively price inelastic demand to charge higher prices. An example could be a small café over a multinational corporation.
    - **Profit motive:** By growing, firms get the opportunity to earn higher profits. Growing also allows firms to take advantage of economies of scale, providing they do not grow so large that they experience diseconomies of scale.
    - **Market power:** large firms have more dominance over the market, which allows them to gain price setting powers and discourage the entrance of new firms. They might also gain monopsony power, which can allow them to buy their stock at a lower price.
    - **Diversification:** By growing and expanding the product range, firms reduce their risk of making huge losses, since they have areas of the market to fall back on.
    - **Owners:** Managers of the firm might have the motive of larger bonuses, more holidays or more leisure time, which encourages them to expand the firm.

Distinction between public and private sector organisations

- **Public sector:**

- This is when the government has control of an industry, such as the NHS. The railway industry in the UK was nationalised after 1945, so it became part of the public sector.
- There could be natural monopolies in the public sector. For example, only one firm will provide water because it is inefficient to have multiple sets of water pipes.
- Some public sector industries yield strong positive externalities. For example, by using public transport, congestion and pollution are reduced.
- Public sector industries have different objectives to private sector industries, which are mainly profit driven. Social welfare might be a priority of a public sector industry. It could also lead to a fairer distribution of resources.

- **Private sector:**

- This is when a firm is left to the free market and private individuals. For example, British Airways is a private sector firm.
- Free market economists will argue that the private sector gives firms incentives to operate efficiently, which increases economic welfare. Firms have to produce the goods and services consumers want, which increases allocative efficiency and might mean goods and services are of a higher quality. Competition might also result in lower prices. This is because firms operating on the free market have a profit incentive, which public sector firms do not.

Distinction between profit and not-for-profit organisations

- A **profit** organisation aims to maximise the financial benefit of its shareholders and owners. The goal of the organisation is to earn maximum profits.

- A **not-for-profit** organisation has a goal which aims to maximise social welfare. They can make profits, but they cannot be used for anything apart from this goal and the operation of the organisation.

Significance of the divorce of ownership from control: the principal-agent problem

- The **principal-agent problem** can be linked to the theory of asymmetric information. This is when the agent makes decisions for the principal, but the agent is inclined to act in their own interests, rather than those of the principal. For example, shareholders and managers have different objectives which might conflict. Managers might choose to make a personal gain, such as a bonus, rather than maximise the dividends of the shareholders.

- When an owner of a firm sells shares, they lose some of the control they had over the firm. This could result in conflicting objectives between different stakeholders in the firm. If the manager is particularly good, they might require higher wages to keep them in the firm. However, they also need to keep shareholders happy, since they are an important source of investment. It is not always possible to give both the manager a high salary and the shareholders large dividends, since funds are limited.

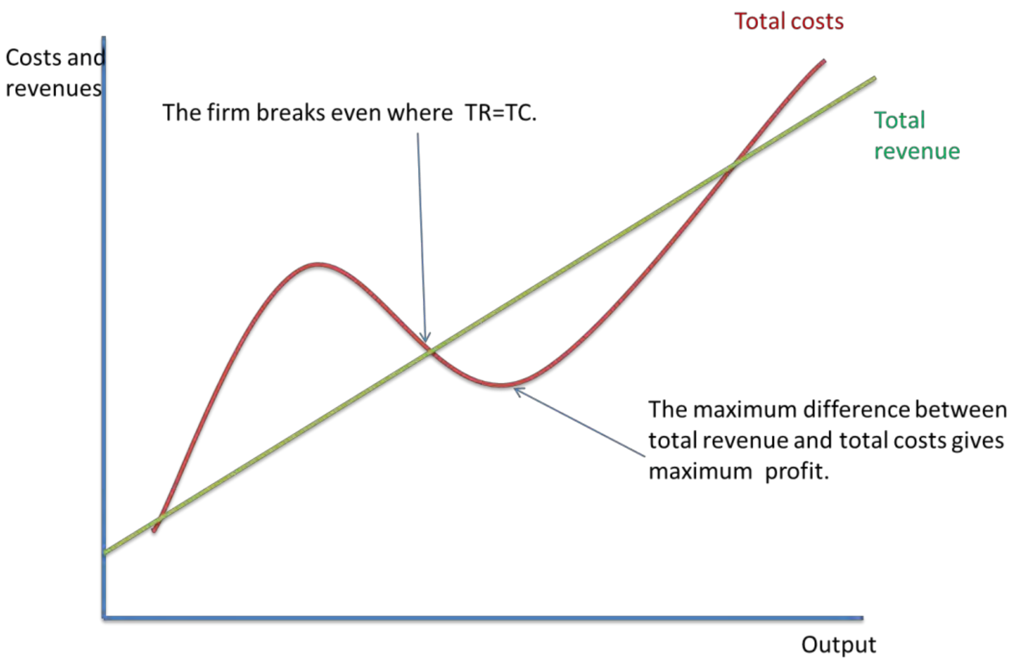
Different business objectives:

Profit maximisation

- Profit is an important objective of most firms. Models that consider the traditional theory of the firm are based upon the assumption that firms aim to maximise profits.
- However, firms can have other objectives which affect how they behave.
- Profit is the difference between total revenue and total cost. It is the reward that entrepreneurs yield when they take risks.

- Firms break even when TR = TC.

- A firm's profit is the difference between its total revenue (TR) and total costs (TC). A firm profit maximises when they are operating at the price and output which derives the greatest profit. Profit maximisation occurs where **marginal cost (MC) = marginal revenue (MR).** In other words, each extra unit produced gives no extra loss or no extra revenue.

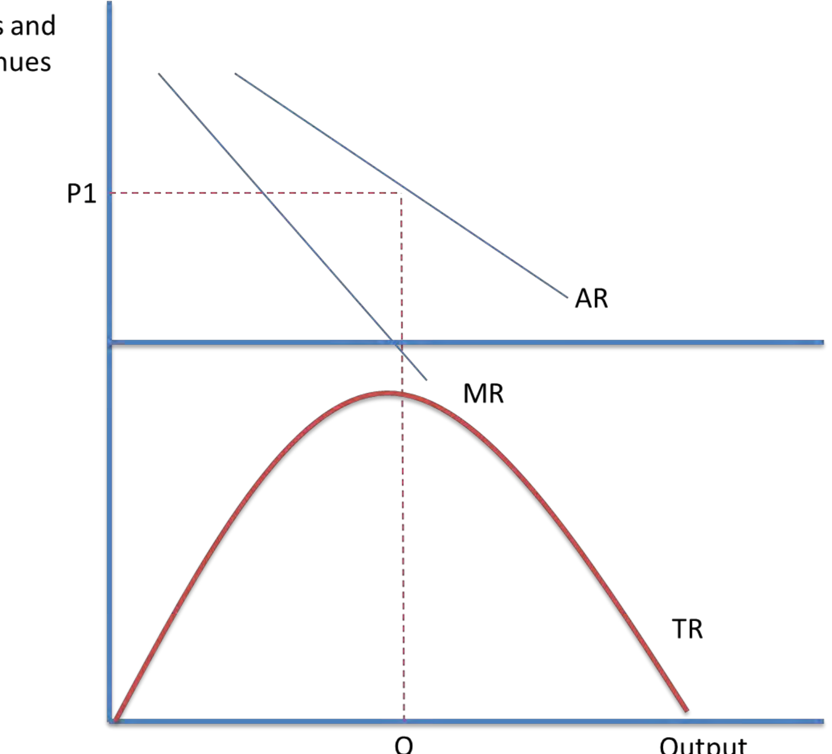


- Profits increase when MR > MC. Profits decrease when MC > MR.
- Some firms choose to profit maximise because:
    - It provides greater wages and dividends for entrepreneurs
    - Retained profits are a cheap source of finance, which saves paying high interest rates on loans
    - In the short run, the interests of the owners or shareholders are most important, since they aim to maximise their gain from the company.
    - Some firms might profit maximise in the long run since consumers do not like rapid price changes in the short run, so this will provide a stable price and output.

- PLCs are particularly keen to profit maximise, because they could lose their shareholders if they do not receive a high dividend. They are more likely to have **short run profit maximisation** as an objective, because they need to keep their shareholders happy.

- **Revenue maximisation**

- Revenue maximisation occurs when MR = 0. In other words, each extra unit sold generates no extra revenue.



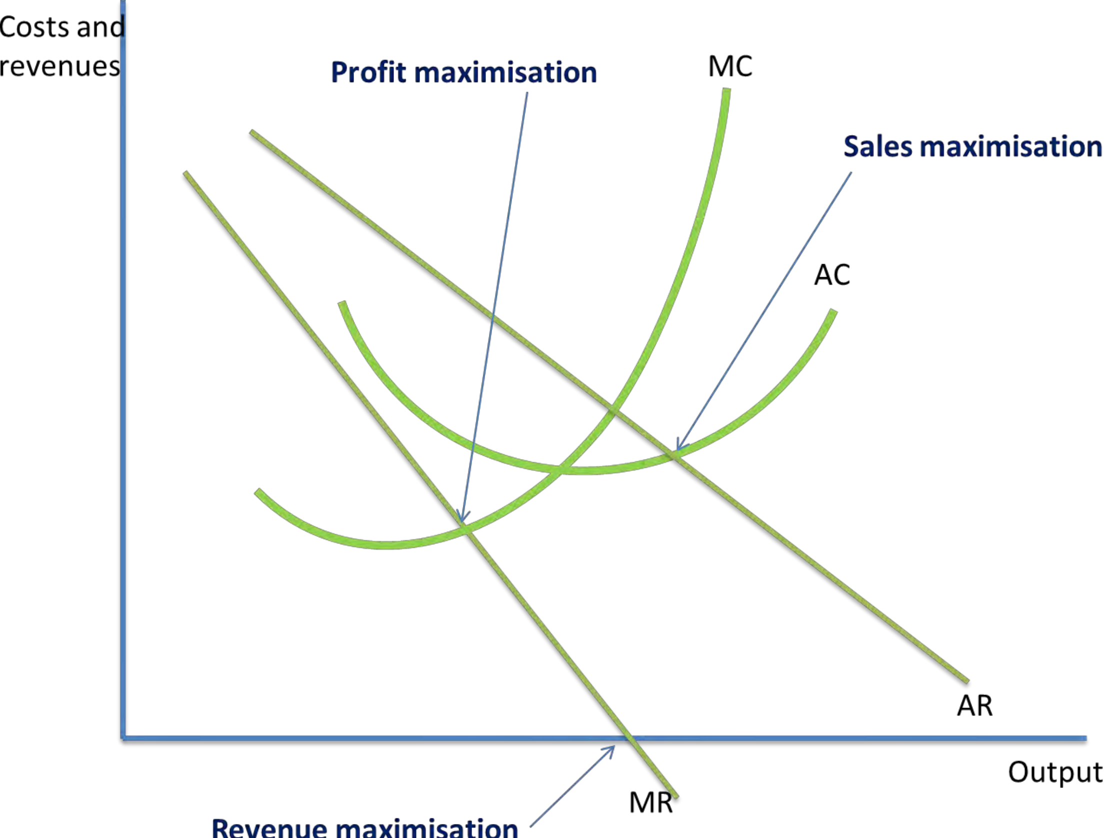
At the point Q P1, the firm is operating at MR=0, where revenue maximises. The curve shows how the point of maximum total revenue is MR =0.

- **Sales maximisation**

- This is when the firm aims to sell as much of their goods and services as possible without making a loss. Not-for-profit organisations might work at this output and price. On a diagram this is where average costs (AC) = average revenue (AR).

  An example of sales maximising is Amazon's Kindle launch. They sold as many Kindles as possible to gain market share, so they can earn more profits in the long run. It helps keep out and deter competitors.

The diagram below summarises each objective.



- **Behavioural theories e.g. satisficing**

- Another objective a firm might have is satisficing. A firm is profit satisficing when it is earning just enough profits to keep its shareholders happy.
- Shareholders want profits since they earn dividends from them. Managers might not aim for high profits, because their personal reward from them is small compared to shareholders. Therefore, managers might choose to earn enough profits to keep shareholders happy, whist still meeting their other objectives.
- This occurs where there is a divorce of ownership and control.