Edexcel (A) Economics A-level

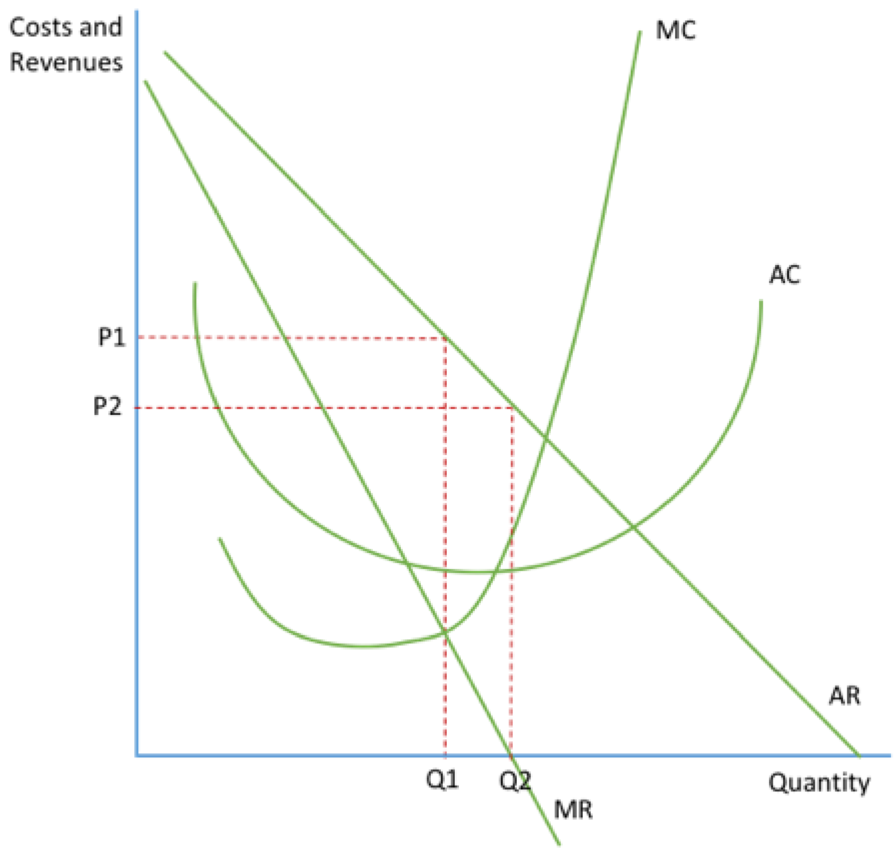
A-level Paper 1: Markets and Business Behaviour

Example answers

‘Revenue maximisation is a more realistic business objective than profit maximisation for many businesses’. To what extent do you agree with this statement? Refer to an industry of your choice

Revenue maximisation is when firms aim to make their revenue as high as possible so produce MR=0. Profit maximising is when they aim to make their profit as high as possible, so produce where MC=MR. I will be referring to the pharmaceutical industry.

For the pharmaceutical industry, profit maximisation is the most realistic objective. This is because they need the money to invest and so therefore with high profits, achieved by profit maximisation, they can be innovative. This helps them to develop new drugs and therefore get ahead of their competition. Without high profits and investment, individual firms will be left behind their competitors. Consumers will not buy out of date drugs when there are newer, more successful drugs. Research and development will develop completely new types of drugs, helping to cure new diseases- which is also an aim for businesses.



At profit maximisation, firms produce where MC=MR at Q1 and price P1 whilst revenue maximisation is Q2 at P2. This means higher output at a lower price and lower profit.

Moreover, profit maximisation is more realistic because it is not a contestable market. A contestable market is where there is a high threat of competition. The pharmaceutical industry is not contestable because there are high barriers to entry. There are legal barriers, such as patents which prevent new firms from joining and copying other firms' products. As a result, they are required to develop their own producers and this is expensive due to the cost of research, which means there are also financial barriers. Revenue maximisation is realistic in the contestable market because if firms profit maximise, new firms will have an incentive to engage in 'hit and run' competition and may take market share, for example in supermarket competition. Therefore, the statement is true depending on whether the market is contestable.

On the other hand, revenue maximisation is realistic for new firms who want to gain market share. It will keep prices low and therefore is good in markets where there is a high price competition, such as in the supermarket. Similarly, it is good for firms who want to force other firms out of business. It keeps prices low and if other firms cannot compete, they will be forced to leave the market. However, in these cases, sales maximisation may be more realistic because this means that they are able to lower prices even further and force more firms out of the market.

Revenue maximisation may also be more realistic due to the divorce of ownership from control. The owners have no say in the running of business and so firms may suffer from the principal agent problem, where the agent (managers) make decisions on behalf of the principal (owner). The agent will aim to maximise their own decisions (assuming all individuals are self-interested) and so will want to maximise their salary. In many firms, this could be through revenue maximisation as this is what the shareholders look at when deciding bonuses. However, it may be profit which shareholders look at in other industries. In the pharmaceutical industry, bonuses may be based on the development of new products, suggesting profit is more realistic since this enables research and development.

Overall, the more realistic option depends on the type of firm. It is realistic for firms with high price competition or in contestable markets, but for monopolies and firms with low contestability as well as those who require high investment, profit is more realistic.

Teacher's comments: 21/25
Could talk about profit satisficing.