Edexcel Economics (A) A-level

Theme 3: Business Behaviour and the Labour Market

3.2 Business Objectives

Detailed Notes

3.2.1 Business objectives

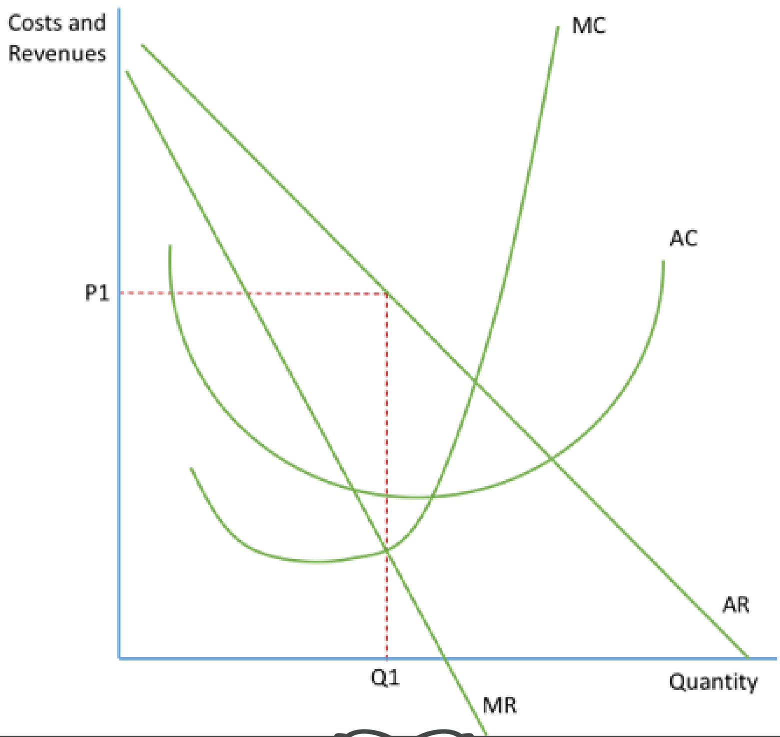
A firm's motives are often determined by who controls it. There are a range of people who could have control: owners or shareholders, directors and managers, the workers (through a trade union), the state (through regulation, taxes/subsidies and direct control), consumers (through their consumer sovereignty- businesses sell what consumers want to buy) and pressure groups.

Profit maximisation:

- Neo-classical economics assumes that the **interests of owners or shareholders** are the most important and therefore the goal of firms is to profit maximise in the short run, in order to maximise owners' returns. It is for this reason that we assume that firms profit maximisation for all market structures in unit 4.
- By short-run profit maximising, firms can also **generate funds for investment** and to help them **survive a slowdown during a recession**.

<u>For example, Apple and pharmaceutical companies are likely to profit maximise since they need the money to reinvest.</u>

In order to short run maximise, firms produce where **MC=MR**. If they produce less than this, then producing more will increase profit since MR would be higher than MC so they're making more in revenue than it costs to produce the good and so producing more would increase profit. If they produce more than this, they would be making a loss on the goods produced above the profit maximising point and so they should decrease production. The diagram shows that the firm will produce at P1Q1: the output is determined by where MC=MR and the price at this output is determined by the AR curve. Cost and revenue diagrams are looked at in more detail in the following units.

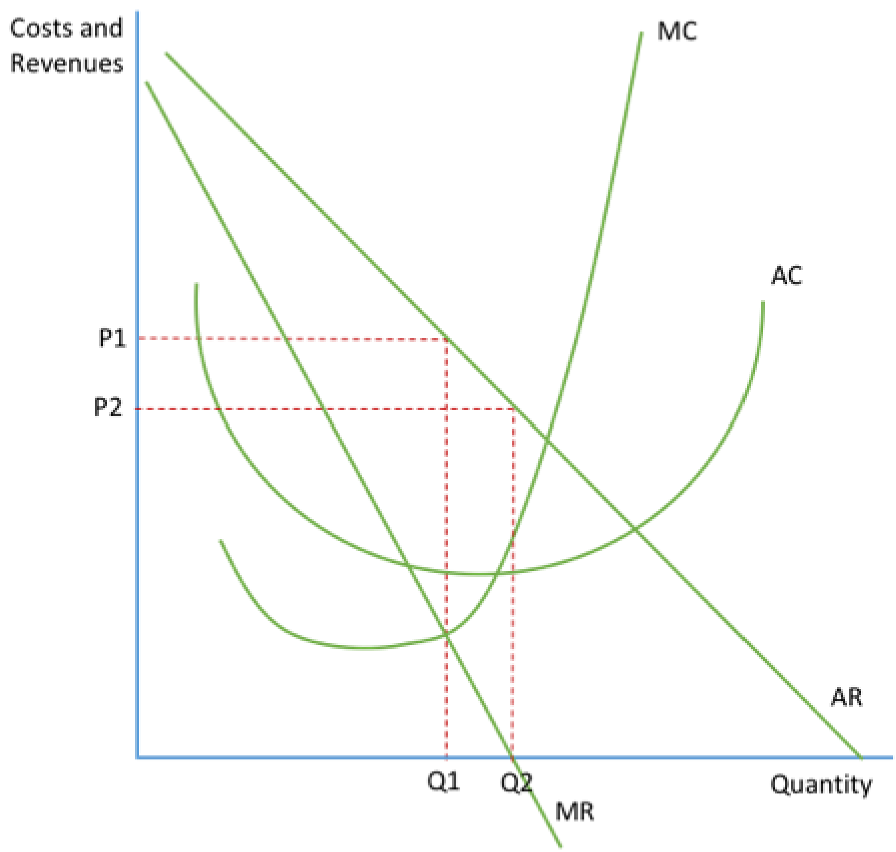


Revenue maximisation:

- William Baumol suggested managers are most interested in their level of revenue since this is what their **salary** depended on.
- Even when their salary is not directly connected to sales revenue, they knew that a growth in revenue was always likely to be a positive for the business. It increases their **prestige** and is used as a justification to shareholders for **managerial rewards**.
- A fall in revenue would be negative as it would not only reduce their salary but could signal the start of a downward spiral for the company. It could lead to a fall in staff and financial institutions may be worried and less willing to lend money.
- As a result, many firms may aim to revenue maximise **as long as they provide some profit for the owners**.

<u>Amazon follow an objective of revenue maximisation, with revenue nearing £120bn in 2015 but profit staying relatively stable. Their aim is to dominate the market.</u>

To revenue maximise, firms would produce where **MR=0**, since if marginal revenue is above 0 producing more would increase revenue. This means they produce Q2P2, whilst profit maximisation would produce at Q1P1. Prices would be lower than when they are profit maximising since they are producing more.

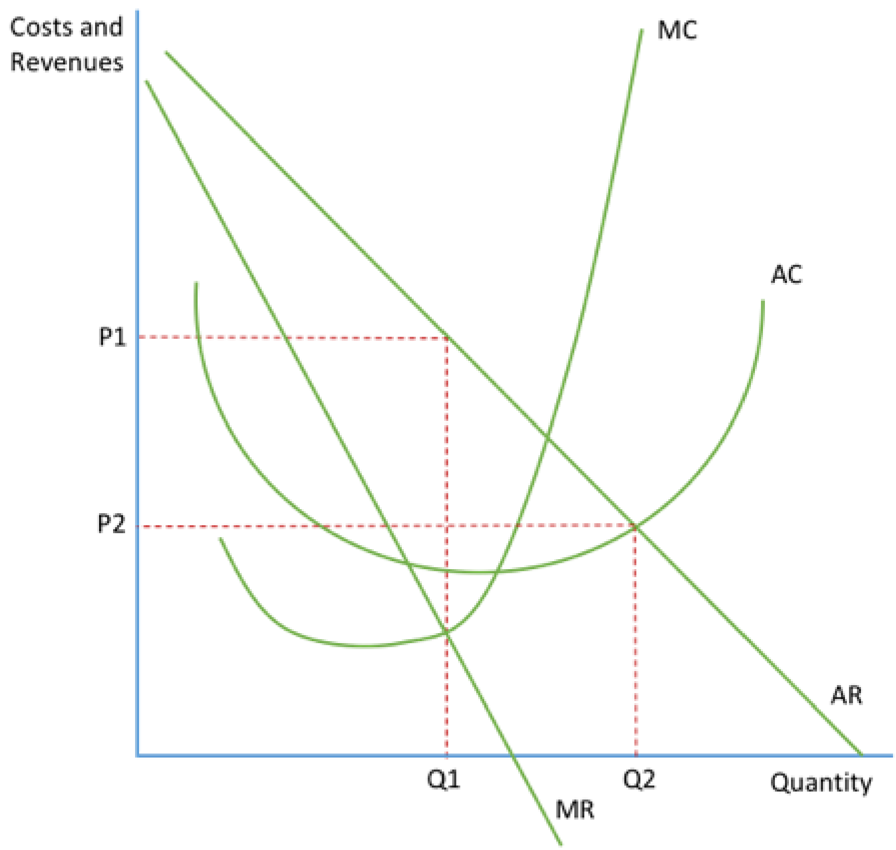


Sales maximisation:

- Robin Marris suggested that managers aim to maximise the growth of their company above any other objective. This is because their **salary** may be linked to the size of the company.
- It is often **easier for people to judge** the level of growth achieved rather than the level of profit. This will increase the prestige of the business.
- Size is often linked to **security** as it is believed large firms can survive rough periods much easier and are less likely to get into financial trouble overnight.
- Growth will also increase **market share**, and may push other firms out of business. It will enable a firm to have more market power and more power over prices.
- This tends to be a **short term strategy**, and in the long term firms are more likely to profit maximise.

<u>Netflix and Spofity follow the objective of sales maximisation, as they are attempting to increase the size of their businesses.</u>

In order to sales maximise, the firm will want to get the highest level of sales possible without making a loss. They will want to ensure sufficient returns to keep the owners happy, so will aim for normal profits. As a result, they produce where **AC=AR** at P2Q2. Prices are lower and output is higher than they would be under profit maximisation.



The problem with both sales maximisation and revenue maximisation is that it necessitates a **fall in price**, which other firms may copy and so there may be no or little increase in revenue or sales: this is important in oligopoly. They also bring lower profits.

Satisficing:

- Due to the **principal-agent problem**, owners and directors will have different goals. Directors will want to maximise their own benefits but will need to make a certain amount of profit in order to keep their jobs, receive benefits and avoid criticism from shareholders/the press.

- Therefore, managers are likely to follow the objective of profit satisficing: they will make **enough profit to keep owners happy whilst following other objectives** and not profit maximising. These other objectives are likely to be their own benefits, for example they may increase their own salaries which increases costs and therefore decreases profit.

- The amount of profit needed will **change year on year** and will depend on the level of profit made by other firms: if everyone else is making a loss, and the firm only manages normal profit then this will be good enough for shareholders but if other firms are making huge profits, shareholders too will expect huge profits.

Other aims:

- **Managerial utility maximisation:** Oliver Williamson said that managers will make decisions to maximise their own satisfaction. This will be dependent on their salary, the number of staff they control, their power over decision making and the other benefits they receive.

- **Marginal cost pricing/allocative efficiency:** Some firms, particularly nationalised industries, aim to maximise social welfare. This will be done by producing where the value society places on the good is equal to the extra cost of producing that good, i.e. MC=AR. This achieves allocative efficiency.