OCR Economics A-level
Microeconomics

Topic 3: Business Objectives

3.1 Business Objectives
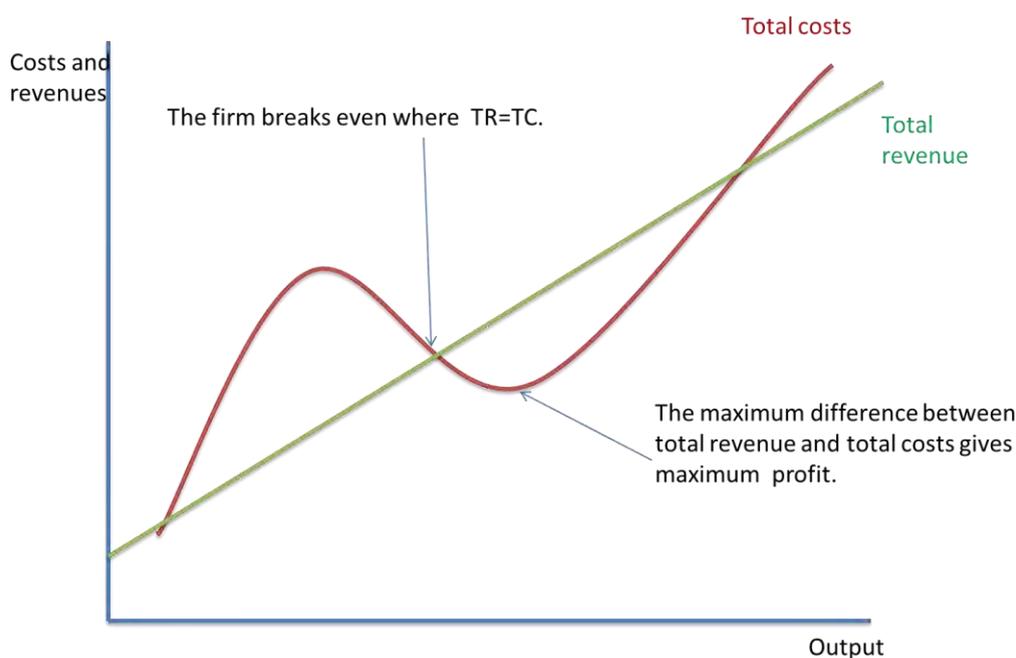
Notes

🔲 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.

Costs and revenues

Total costs

The firm breaks even where TR=TC.

Total revenue

The maximum difference between total revenue and total costs gives maximum profit.

Output

🔲 Profits increase when MR > MC. Profits decrease when MC > MR. 🔲

Some firms choose to profit maximise because:

- o It provides greater wages and dividends for entrepreneurs
- o 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.

🔲 **Normal profit:** Normal profit is the minimum reward required to keep entrepreneurs supplying their enterprise. It covers the opportunity cost of investing funds into the firm and not elsewhere. This is when total revenue = total costs (TR = TC). Normal profit is considered to be a cost, so it is included in the costs of production.

🔲 **Supernormal profit:** Supernormal profit (also called abnormal or economic profit) is the profit above normal profit. This exceeds the value of opportunity cost of investing funds into the firm. This is when TR > TC.

🔲 Alternative maximisation objectives

🔲 Sales revenue maximisation

🔲 Revenue maximisation occurs when MR = 0. In other words, each extra unit sold generates no extra revenue.
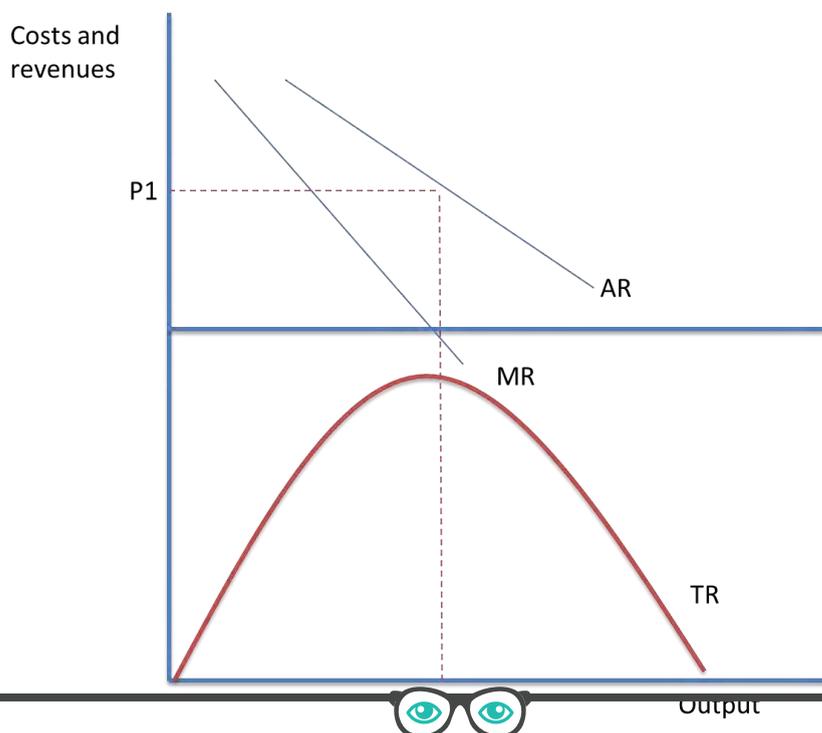
At the point Q P1, the firm is operating at MR=0, where revenue maximises. The curve shows how the point of maximum total revenue is MR =0.

Sales volume 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.
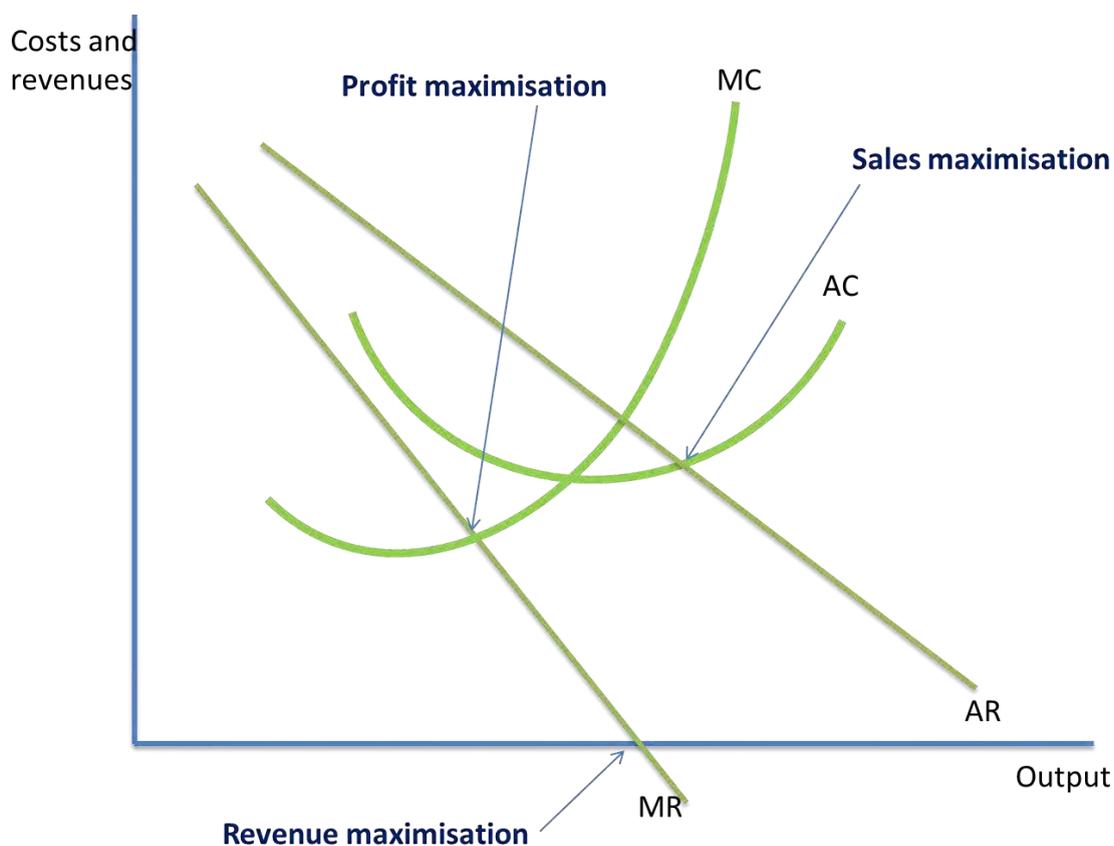
🔲 Growth maximisation

🔲 **Growth:** Some firms might aim to increase the size of their firm. This could be to take advantage of economies of scale, such as risk-bearing or technological. This would lower their average costs in the long run, and make them more profitable. Firms might grow by expanding their product range or by **merging or taking over** existing firms. Large firms are also more able to participate in research and development, which might make them more competitive and efficient in the long run.

🔲 **Increasing their market share:** This helps increase the chance of surviving in the market, and it can be achieved by maximising sales. For example, Amazon aimed to increase their market share in the e-reader market, by trying to sell as many Kindles as possible. They did this at a loss in the short run, but they gained customer loyalty and now they are a leading e-reader producer.

🔲 Utility maximisation

Maximisation for consumers is when consumers aim to generate the greatest utility possible from an economic decision. Firms aim to generate the highest profits possible. A consumer's utility is the total satisfaction received from consuming a good or service. It is assumed that economic agents only act in their own interests.

Some firms might have philanthropic owners who seek to maximise the utility of others.

🔲 Non-maximising objectives

🔲 Profit 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.

■ Social welfare and Corporate Social Responsibility (CSR)

Some firms might take responsibility for consequences on the environment and aim to maximise social welfare. Firms might try and perform more ethically, especially if they have a philanthropic owner.

■ 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.

■ When a manager sells their shares, shareholders gain more control over the decisions of the firm. This could give rise to 'shareholder activism'. This could be to put pressure on the management of the firm or to try and get higher dividends. For example, Sainsbury's shareholders objected the decision to give the chairman a £2.3 billion bonus in 2004.

🔲 The factors which influence the choice of objectives

🔲 The kinked demand curve model
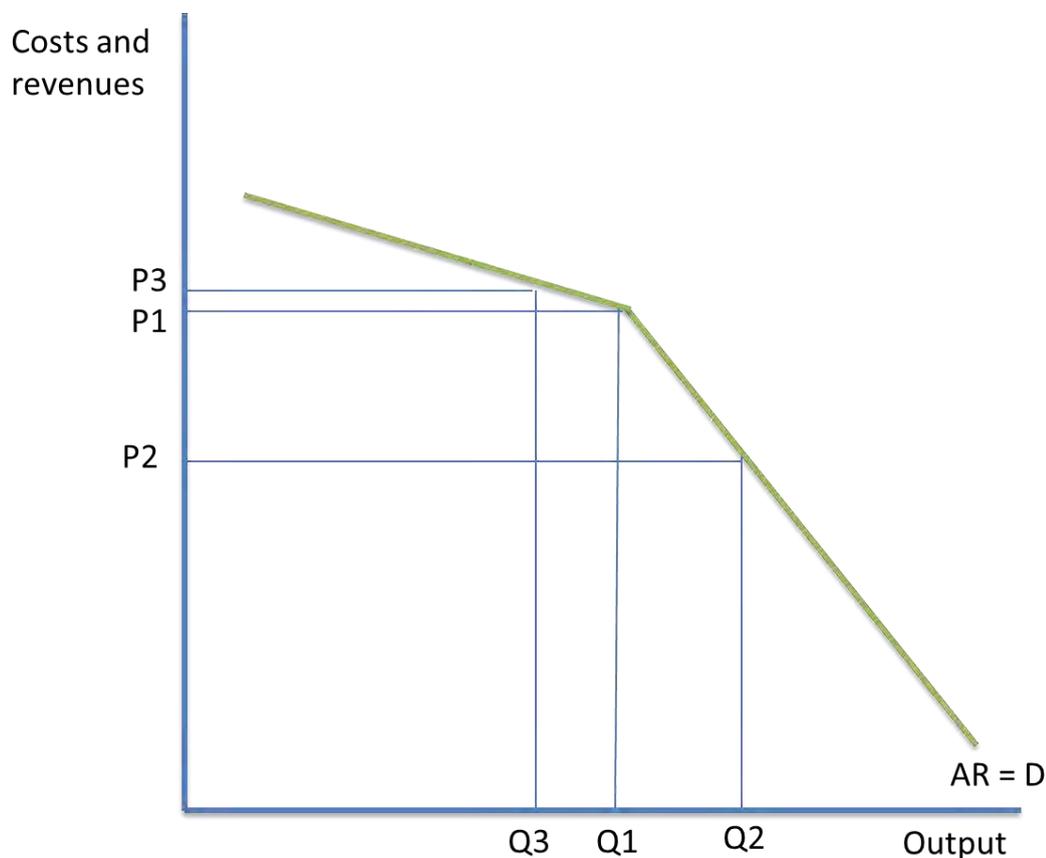
- 🔲 The kinked demand curve illustrates the feature of price stability in an oligopoly. It assumes other firms have an asymmetric reaction to a price change by another firm. It is an illustration of interdependence between firms.
- 🔲 If price increases from P1 to P3, other firms do not react, so the firm which increases their price loses a significant proportion of market share (Q1 to Q3).
- 🔲 If the firm decreases their price from P1 to P2, the firm only gains a relatively small increase in market share (Q1 to Q2).
- 🔲 The first part of the diagram shows a relatively price elastic demand curve. The second part shows a relatively inelastic demand curve.
- 🔲 When firms deviate from the rigid, equilibrium price and quantity, they enter the different demand elasticities.

The significance of interdependence and uncertainty in oligopoly

Game theory is related to the concept of interdependence between firms in an oligopoly. It is used to predict the outcome of a decision made by one firm, when it has incomplete information about the other firm.

It can be explained using the Prisoner's Dilemma, which is a model based around two prisoners, who have the choice to either confess or deny a crime. The consequences of the choice depend on what the other prisoner chooses.

		Prisoner B	
		Confess	**Deny**
Prisoner A	**Confess**	**5 years, 5 years**	**1 year, 10 years**
	Deny	**10 years, 1 year**	**2 years, 2 years**

The two prisoners are not allowed to communicate, but they can consider what the other prisoner is likely to choose. This relates to the characteristic of uncertainty in an oligopoly.

The **dominant strategy** is the option which is best, regardless of what the other person chooses. This is for both prisoners to confess, since this gives the minimum number of years that they have to spend in prison. It is the most likely outcome.

This is still higher than if both prisoners deny the crime, however. If collusion is allowed in this dilemma, then both prisoners would deny. This is the **Nash equilibrium.**

A **Nash equilibrium** is a concept in game theory which describes the optimal strategy for all players, whilst taking into account what opponents have chosen. They cannot improve their position given the choice of the other.

However, even if both prisoners agree to deny, each one has an incentive to cheat and therefore confess, since this could reduce their potential sentence from 2 years to 1 year. This makes the Nash equilibrium unstable.

It essentially sums up the interdependence between firms when making decisions in an oligopoly.