AQA Economics A-level
Microeconomics

Topic 5: Perfect Competition, Imperfectly Competitive Markets and Monopoly

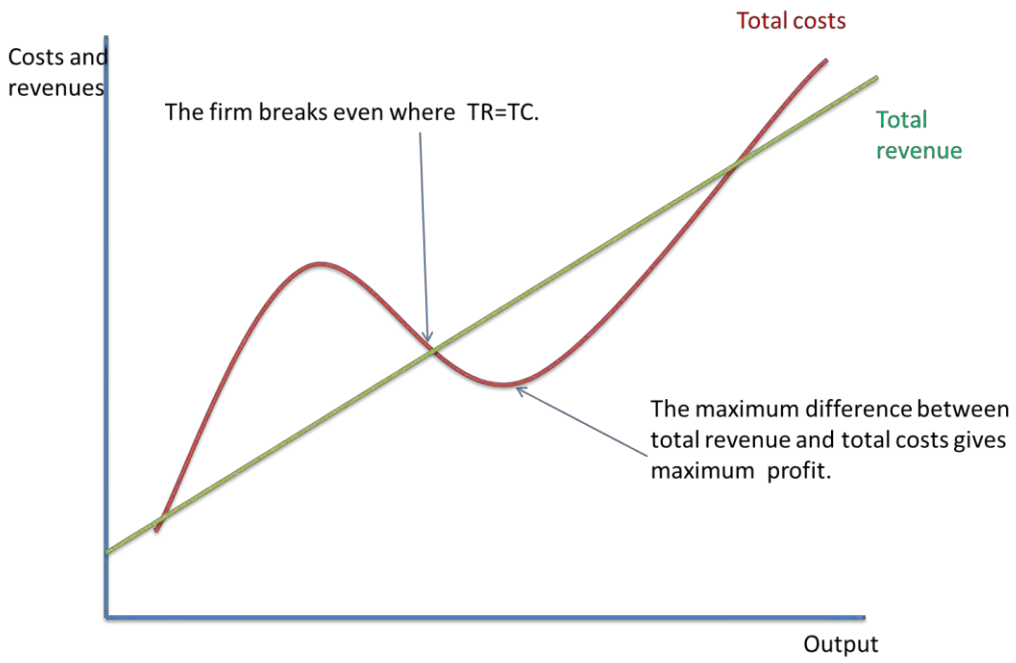
5.2 The objectives of firms

Notes

- 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.

The reasons for and the consequences of a divorce of ownership from control

- 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.

Other possible objectives of a firm

- **Survival:** Some firms, particularly new firms entering competitive markets, might aim to simply survive in the market. This is a short term view. During periods of economic decline such as the 2008 financial crisis, when consumer spending plummets, firms might have survival as their objective, until there is economic growth again. Firms

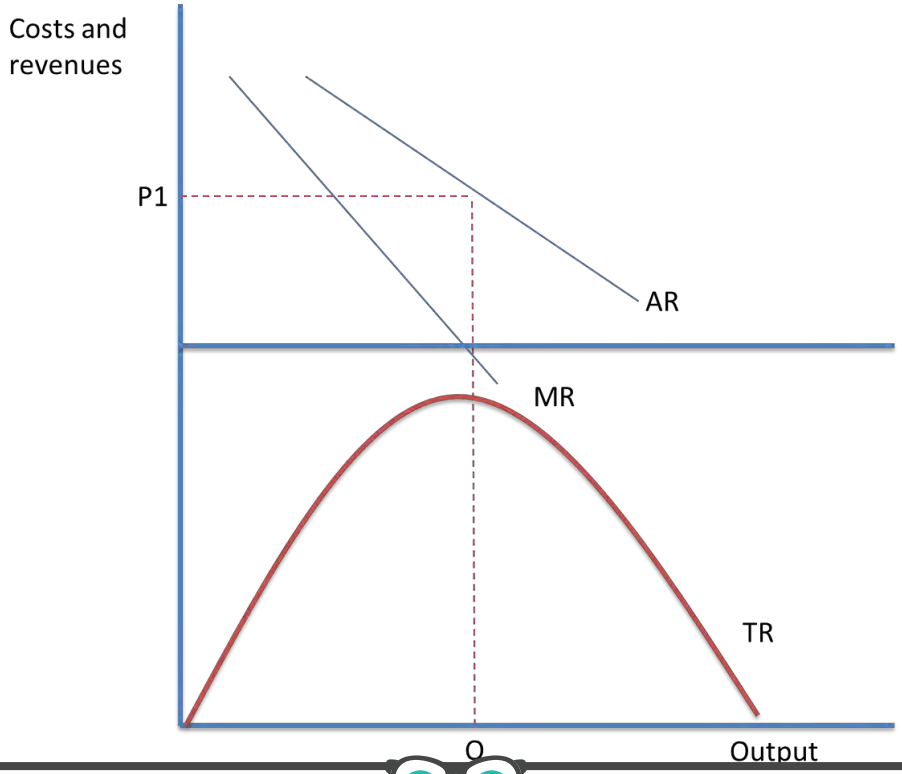
might aim to sell as much as possible to keep their market position, even if it is at a loss in the short run.

- **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.

- **Quality:** Firms might aim to increase their competitiveness by improving their quality. Firms might consider improving their customer service or the quality of the good they produce. This could be achieved through innovation. If firms can gain a reputation for high quality goods, they could potentially charge higher prices, since consumers might be willing to pay more for them.

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

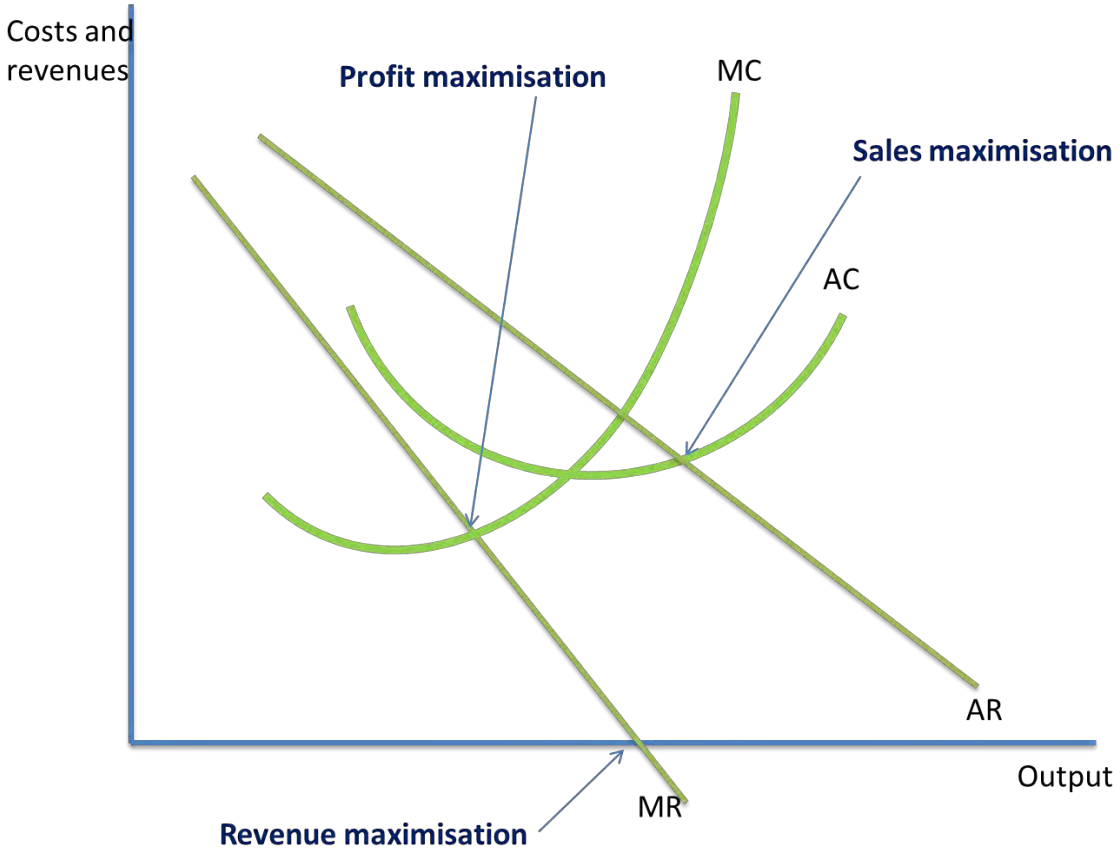


At the point Q P1, the firm is operating at MR=0, where revenue maximises. The curve shows how the point of maximum total revenue is MR =0.

- **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.



- Other objectives of firms include:
    - Society
    - Environmental
    - Ethical where there are philanthropic owners
    - Managerial for personal gains e.g. luxury cars and holidays
    - Worker welfare

The satisficing principle:

- 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.