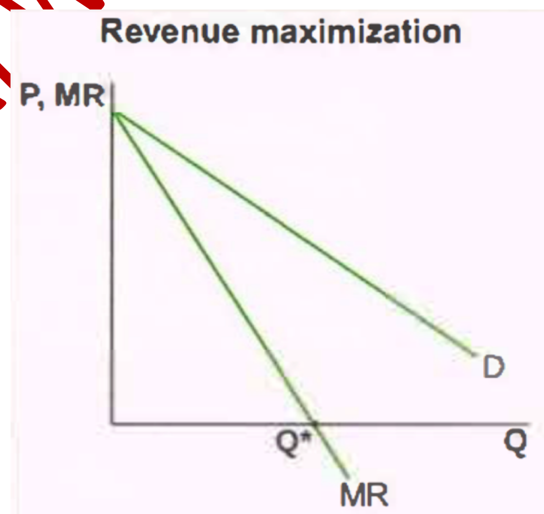
M16 TZ1 Paper 1 (HL)

2. a) Explain why firms may not always pursue the goal of profit maximisation. [10]

Standard economic theory assumes that firms are driven by their goal to maximise profit, where profit refers to economic profit which is total revenue minus (explicit + implicit costs). However, there are alternative goals of firms that they may wish to purse instead.

Firstly, firms may wish to pursue growth maximisation. This is where firms intend to maximise the quantity of output produced rather than profits, as some of this profit is give up for the sake of more growth. Firms may choose to do so in order to achieve greater economies of scale hence lower average costs, greater diversification into other profits and lower risk of take-overs by other firms. In doing so, the firm may also be able to achieve greater market power, which refers to the ability to influence price.

Rather than attempting to pursue the goal of profit maximisation, firms may instead by interested in maximising revenue, where total revenue = price x quantity. With this goal of revenue maximisation, the firm gives the impression of success with larger sales, but also revenues are relatively easier to be measured in comparison with profits. In order to achieve maximum revenue, the firm will produce at quantity Q* where MR = 0. This can be seen in the diagram below.



As shown by this diagram, TR is maximum at Q* where MR = 0. This leads to a higher Q and lower P than in the case of profit maximisation.

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Another alternative goal of firms is managerial utility maximisation. Large firms run by managers who are not owners may try to maximise their personal utility (satisfaction) by giving themselves larger benefits, such as higher salaries, use of luxurious company cars and expense accounts, all of which may work to reduce profits. In doing so, there could be an increase in worker morale and more motivation amongst workers/managers.

Furthermore, firms may wish to keep a corporate social responsibility as a key goal. This involves avoidance of activities that may lead to negative production externalities (such as pollution or environmental degradation) or other undesirable activities (such as use of child labour or hazardous working conditions. Such activities may create a negative image with consumers, which firms wish to avoid. Firms may attract a wider range of consumers, due to

the fact they cater for consumers who prefer to buy goods and services from socially responsible firms.

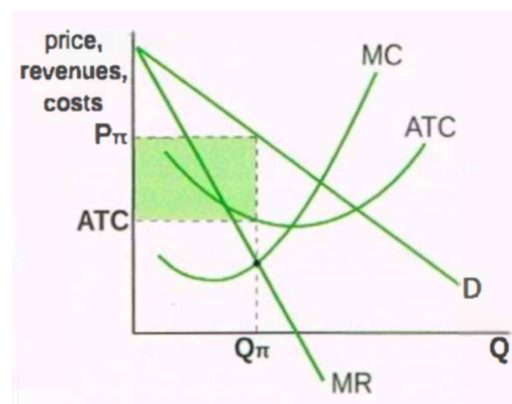
Finally, alternative from maximising behaviour, firms may wish to satisfice. This occurs when firms have many different goals, some of which may conflict, and they may not want to 'maximise' anything (profit, revenue, growth, managerial utility) that could give rise to a significant sacrifice of anything else. They may [refer a strategy that makes comprises among different objectives and achieves a satisfactory outcome with respect to all important goals.

2. b) In monopoly. Economic (abnormal) profit can be earned in both the short run and the long run. Examine the role of barriers to entry in earning economic profit. [15]

Monopolies are a market structure that assumes that there is a single firm, or dominant firm in the market who has the ability to influence price as there are high barriers to entry and no close substitutes. Barriers to entry are important feature of monopolies; they can be defined as factors that prevent or make it very difficult for other firms to enter the industry and begin production. Examples of barriers to entry includes large economies of scale, where average costs fall with increasing output in the long run, legal barriers, such as legislation, branding, aggressive tactics or the control of necessary resources. Monopolies tend to have much higher barriers to entry than other market structures, such as perfect competition, which has none, thereby allowing monopolies to earn positive economic profit (abnormal profit).

Economic profit is described as total revenue minus economic costs (implicit + explicit costs). In a monopoly, the monopolist faces the same costs curves as the perfectly competitive firm but instead faces a downward sloping demand curve. The firm is able to maximise profits at the quantity where MC = MR, earning abnormal profit. This can be seen in the diagram below:

As shown by this diagram, the monopolist maximises profit where MC = MR, producing at quantity Qπ. At this point, Pπ > ATC, therefore the firm earns abnormal profit as shown by the shaded green area.



Because of high barriers to entry, new firms cannot enter the market even if the monopolist is earning abnormal profits. Therefore, it continues to earn abnormal profits in the long run, making short-run and long-run equilibrium of the profit-maximising monopolist the same.

However, in the case of perfect competition, where the model assumes many, small firms with no ability to influence price, homogenous goods, perfect resource mobility and no barriers to entry or exit, the firm can only earn positive economic profit in the short-run.

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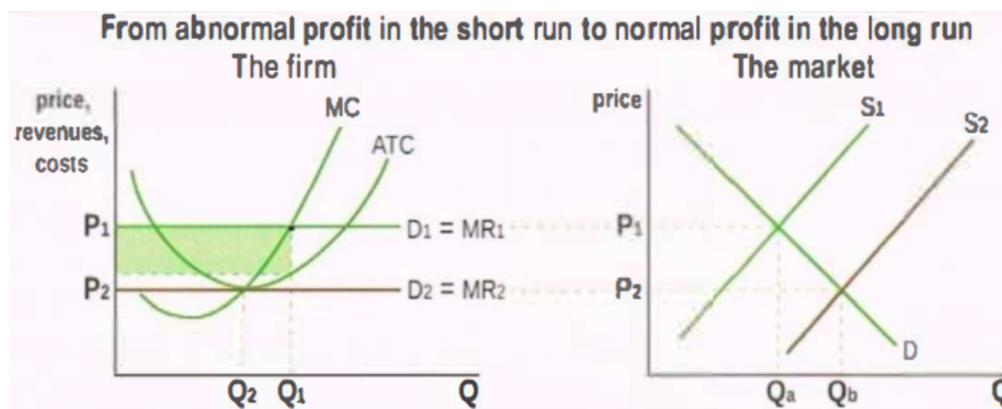
Firms in perfect competition are price takers, meaning they sell all the output it wants at the price determined by the market. Therefore, the demand curve facing the firm is perfectly elastic. Similar to monopolies, the firm maximises profits at the profit-maximising output $Q\pi$ where MC = MR, earning abnormal profits if P > ATC. However, due to the assumption of no barriers to entry, the perfectly competitive firm will earn normal profit (zero economic profit) in the long run. This can be shown in the diagram below:



As shown by the diagram, the firms in the industry are initially accepting price P1 determined by the market, earning abnormal profits (green area) in the short run. When the industry goes into the long run, outsider firms attracted by profits enter the industry, this can occur due to the assumption of no barriers to entry, making it relatively easy for new firms to enter. When this occurs, the market supply curve shifts to the right and the price falls. Market supply increase until the new supply curve S2 gives a price of P2. At P2, abnormal profits are eliminated and all firms in the industry earn normal profit, where P = minimum ATC.
Therefore, the role of barriers to entry are crucial in determining the economic profit earned by the firm in the long run. With the examples explained above, it is clear that with high barriers to entry, the firm is able to earn abnormal profits in both the short-run and the long-run, this is because such barriers to entry make it difficult for new firms to enter the industry and take this abnormal profit. However, in perfect competition, a lack of barriers to entry makes it relatively easy for new firms to enter when there are abnormal profits being made. With this incentive of greater profit, they are able to enter and increase market supply, forcing firms to take the lower price given by the market and earn zero economic profit (normal profit) in the long-run.