Program	**: MBA**
Semester	**: 1st Semester**
Subject Code	**: MB0042**
Subject Name	**: Managerial Economics**
Unit number	**: 7**
Unit Title	**: Objectives of Firms**
Lecture Number	**: 7**
Lecture Title	**: Objectives of Firms**

Objectives of Firms

Objectives

The objectives of this lecture are to:

- explain the background under which a firm lays down its multiple objectives
- explain how modern business units have several objectives instead of having a single objective
- analyse how profit-maximisation is the basic objective of a firm
- determine the suitable objectives from amongst the many objectives that could be adopted by a firm

Lecture Outline

Introduction

- A business firm is an economic unit. It is a producing unit.
- It is a legal entity on the basis of ownership and contractual relationships organised for production and sale of goods and services.
- They can take several forms like sole trader, partnership concern, joint-stock company, cooperatives or even public utilities.
- Each firm lays down its own objectives. The objectives are the end-point towards which rational activity is carried out.
- A modern business unit has multiple objectives and they are multi-dimensional in nature.
- These objectives are determined by various factors and forces like corporate environment, socio-economic conditions, the nature of power in the organisation and extraneous conditions, and constraints under which a firm operates.

Profit Maximisation Model

- Profit-making is one of the most traditional, basic and major objectives of a firm. Profit-motive is the driving force behind all business activities of a company.
- Profit earning capacity indicates the position, performance and status of a firm in the market.
- The profit maximisation model is a very simple and unambiguous model. It is the ideal model to explain the normal behaviour of a firm.

Main propositions of the profit-maximisation model

- The model is based on the assumption that each firm seeks to maximise its profit given certain technical and market constraints.
- The following are the main propositions of the model:
  - A firm is a producing unit which converts various inputs into outputs of higher value, by employing certain techniques of production.

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Profit Maximisation Model

- The basic objective of each firm is to earn maximum profit.
- A firm operates under given market conditions.

The model

- Profit-maximisation implies earning highest possible amount of profit during a given period of time.
- A firm should always give optimum productivity in order to get a huge amount of profit both in the short run and long run depending upon various factors like internal and external.
- In the short run, a firm is able to make only slight or minor adjustments in the production process as well as in business conditions.
- It is to be noted with great care that a firm has to maximise its profits after considering various factors. Such factors include:
  - Pricing and business strategies of rival firms and their impact on the working of the given firm.

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Profit Maximisation Model

Assumptions of the model: The profit maximisation model is based on three important assumptions. They are as follows:

- Profit maximisation is the main goal of the firm.
- Rational behaviour on the part of the firm to achieve its goal of profit maximisation.

Profit maximisation of a firm can be explained in two different ways.

- Total revenue and total cost approach
- Marginal revenue and marginal cost approach

TR and TC approach

- Profits of a firm are estimated by comparing total revenue and total costs. Profit is the difference between TR and TC. In other words, excess of revenue over costs is the profits. Profit = TR – TC. If TR is equal to TC, in that case, there will be breakeven point. If TR is less than TC, in that case, a firm will be incurring losses.

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Profit Maximisation Model

MR and MC approach

- We compare the revenue earned from one additional unit and cost incurred to produce one additional unit of output.
- A firm will be maximising its profits when MR = MC and MC curve cuts MR curve from below.
- If MC curve intersects the MR curve from above, either under perfect market or under imperfect market, then undoubtedly MR equals MC but, total output will not be maximised and hence total profits also will not be maximised. Hence, two conditions are necessary for profit maximisation:
- 1. MR = MC
- 2. MC curve intersects MR curve from below

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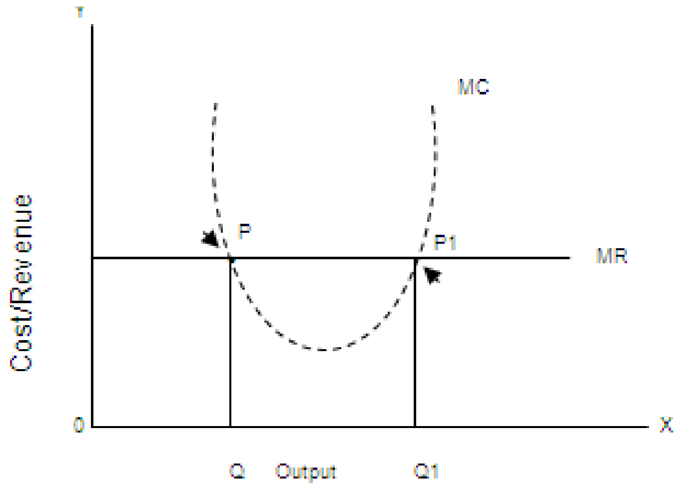
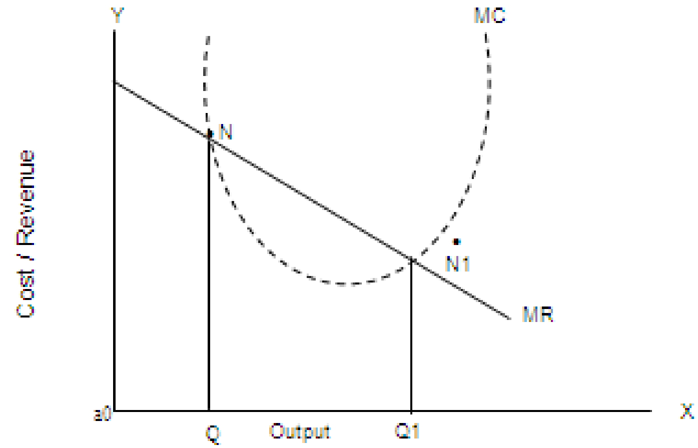
Profit Maximisation Model



Cost/Revenue Curve: "MR = MC"



Cost/Revenue Curve: "MC Intersecting MR from Below"

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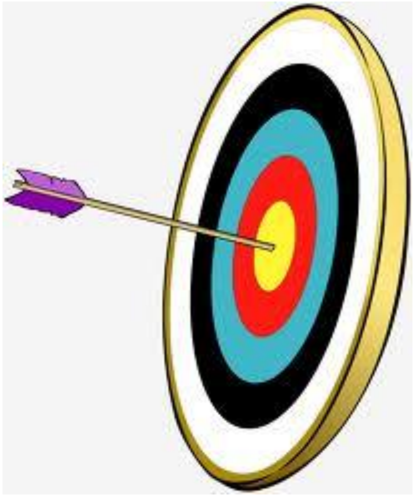
Profit Maximisation Model



Justification for profit maximisation

- Basic objective of traditional economic theory
- Firm is not a charitable institution
- Most realistic prediction of price-output behaviour
- Necessary for survival
- Achievement of other objectives

Criticisms: There are certain short-comings in this model for which it has received criticism. Few reasons for criticism of the model are as follows:

- Ambiguous term
- It may not always be possible
- Separation of ownership and management
- Difficulty in getting relevant information and data
- Conflict in inter-departmental goals
- Changes in business environment

Economist Theory of the Firm

- According to the economist theory of the firm, a firm is a producing unit. It transforms or converts all kinds of inputs into outputs.
- The basic function of a firm is to produce those goods and services which are demanded by consumers in the market.
- A firm is a business unit and it is organised on commercial principles.
- By producing and selling different goods and services, the firm aims at making profits.
- A firm is formed, run and managed by an owner, employer or an entrepreneur who has the following characteristics:
  - He has the legal permission to run an enterprise.
  - He can enter into contract with any group of people who supply productive resources.
  - He can take his own decisions to maximise his economic gains.

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Economist Theory of the Firm

- The traditional or classical firm basically engages itself in various kinds of economic activities which help in maximising its profits. It concentrates on wealth creation and through it, surplus creation.
- Surplus value is nothing but the difference between the value of the final product and the value of various inputs employed in the production process.
- At the equilibrium point, it is said that a firm will be maximising its profits.
- The nature of working of a firm depends on several factors like number of firms in the market, size of the firm, volume of production, entry and exit of firms, degree of competition, existence of alternative substitutes, prices of goods, etc.

Cyert and March's Behaviour Theory

- It is another alternative non-profit maximising theory that has been developed by Cyert and March.
- The theory makes an attempt to explain the behaviour of inter-group conflicts and their multiple objectives in an organisation.
- Basically, this theory explains the usual and normal behaviour of different groups of people who work in an organisation having mutually opposite goals.
- Cyert and March explain how complicated decisions are taken in big industrial houses under various kinds of risks and uncertainties in an imperfect market in the background of limited data and information.
- Cyert and March consider the modern firm as a multi-product, multi-goal and multi-decision making coalition business unit.

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Cyert and March's Behaviour Theory

- Like a coalition government, it is managed by a number of groups.
- The group consists of shareholders, managers, workers, customers, suppliers, distributors, financiers, legal experts, etc.
- Each group is independent by itself and has its own set of objectives and they try to maximise their individual benefits.
- Most urgent demands are highlighted and low priority demands are postponed to later periods.
- The management may honour a few demands of a few groups and postpone the demands of other groups in view of financial constraints
- A strong linkage between the expected and actual demand of each group in the organisation, past success and future environment.
- Cyert and March suggest the following methods to overcome the conflicts of different groups and enable smooth working of the organisation.

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Cyert and March's Behaviour Theory

- Demands of each group may be separated from that of the other and separate attempts must be made to fulfil them so that their impact on the whole organisation may be avoided.
- Cyert and March are of the opinion that out of several objectives, a firm has five important goals. They are as follows:
- Production goal
- Inventory goal
- Sales goal
- Market-share goal
- Profit goal
- One of the demerit of Cyert and March's behaviour is that it fails to analyse the behaviour of the firm, but it simply predicts the future expected behaviour of different groups.

Marris' Growth Maximisation Model

- Profit-maximisation is a traditional objective of a firm. Sales maximisation objective is explained by Prof. Baumol.
- Prof. Marris has developed an alternative growth maximisation model. It is commonly seen that each firm aims at maximising its growth rate, because this goal would answer many of the objectives of a firm.
- Marris points out that a firm has to maximise its balanced growth rate over a period of time.
- Marris assumes that the ownership and control of the firm is in the hands of two groups of people, i.e., owners and managers.
- Managers have a utility function in which the amount of salary, status, position, power, prestige, security of job, etc., are the most important variables.
- Owners are more concerned about the size of output, volume of profits, market share, sales maximisation, etc.

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Marris' Growth Maximisation Model

- Utility function of the owners and that of the managers are expressed in the following manner –
- Uo = f [size of output, market share, volume of profit, capital, public esteem etc.] Um = f [salaries, power, status, prestige, job security, etc.].

Where, Uo is the utility function of owner and Um is the utility function of managers.

- Marris identifies two constraints in the rate of growth of a firm as follows:
- There is a limit up to which the output of a firm can be increased more economically
- The ambition of job security puts a limit to the growth rate of the firm itself, deliberately.

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Marris' Growth Maximisation Model

- The Marris' growth maximisation model highlights the achievement of a balanced growth rate of a firm. Maximum growth rate [g] is equal to two important variables:
  - The rate of demand for the products [gd]
  - Growth rate of capital[gc]
- Hence, Max g = gd = gc.
- The growth rate of the firm depends on two factors- a] the rate of diversification and b] the average profit margin.
- The diversification rate depends on the number of new products introduced per unit of time and the rate of success of new products in the market.
- The rate of capital growth is determined by either issue of new shares to obtain additional funds and external funds and generation of more internal surplus.

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Marris' Growth Maximisation Model

- The Marris' model states that in order to maximise balanced growth rate or reach equilibrium position, there should be equality between the growth rate in demand for the products and growth rate in supply of capital.
- This implies the satisfaction of the following three conditions:
- Management has to maintain a low liquidity ratio, i.e., liquid asset / total assets.
- The management has to maintain a proper leverage ratio between value of debts / total assets, so that it will have enough money to invest in order to stimulate growth.
- Management has to keep a high level of retained profits for further expansion and development but it should not displease the shareholders i.e $\frac{\text{Retained Profits}}{\text{Total Profits}}$ by giving low dividends.

Baumol's Static and Dynamic Models

- Sales maximisation model is an alternative model for profit maximisation.
- This model is developed by Prof. W. J. Baumol, an American economist.
- This alternative goal has assumed greater significance in the context of the growth of Oligopolistic firms.
- The model highlights that the primary objective of a firm is to maximise its sales rather than to maximise its profits.
- It states that the goal of the firm is maximisation of sales revenue subject to a minimum profit constraint.
- The minimum profit constraint is determined by the expectations of the shareholders.
- This is because no company can displease the shareholders.

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Baumol's Static and Dynamic Models

- Prof. Baumol has developed two models. The first is the static model and the second one is the dynamic model.
- The static model
- This model is based on the following assumptions:
- The model is applicable to a particular time period
- The firm aims at maximising its sales revenue subject to a minimum profit constraint.
- The demand curve of the firm slopes downwards from left to right.
- The average cost curve of the firm is U-shaped.

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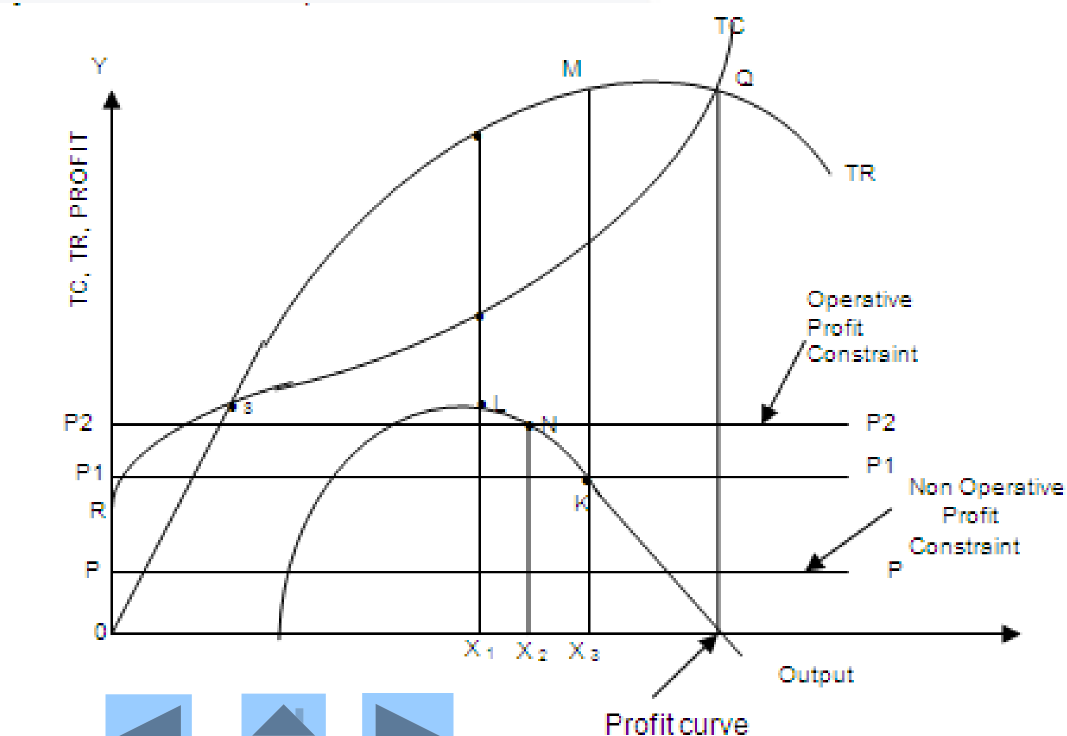
Baumol's Static and Dynamic Models

- At OX_1 level of output, when profit is at maximum, TR is much in excess of TC. If the firm chooses to produce OX_3 output, profit will fall to X3K though the TR is still in excess of TC. Profit constraint is less a OX_2 level of output as the firm earns X_2N prpofit. Depending upon the market conditions, a firm can determine the level of output with minimum profit constraint.



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Baumol's Static and Dynamic Models

Sales maximisation [dynamic model]

- In the real world, many changes take place which affect business decisions of a firm.
- In order to include such changes, Baumol has developed another model, the dynamic model.
- This model explains how changes in advertisement expenditure, a major determinant of demand, would affect the sales revenue of a firm under severe competition.
- There are some assumptions in Baumol's dynamic model. **They are as follows:**
- Higher advertisement expenditure would certainly increase sales revenue of a firm.
- Market price remains constant.
- Demand and cost curves of the firm are conventional in nature.

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Baumol’s Static and Dynamic Models

- Under competitive conditions, a firm in order to increase its volume of sales and sales revenue would go for aggressive advertising.
- This leads to a shift in the demand curve to the right.
- Forward shift in demand curve implies increased advertising expenditure resulting in higher sales and sales revenue.
- A firm that maximises sales would generally incur higher amounts of advertisement expenditure than a firm that maximises profit.
- By introducing a non-price variable into his model, Baumol makes a successful attempt to analyse the behaviour of a competitive firm under oligopoly market conditions.

OLIGOPOLY

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Williamson's Managerial Discretionary Theory

- Prof. O. Williamson. has developed a highly useful and most practical managerial utility model to explain goals of a business firm in recent years.
- In many organisations, we can see that when a firm achieves a certain amount of growth, the top managers concentrate their attention on maximising their self-interest and allow the growth rate to continue.
- Thus, profit maximisation and managers' utility maximisation go together.

Assumptions of the model

The managerial discretionary theory is based on the following assumptions:

- Existence of imperfect markets
- Ownership and management is separated
- A minimum level of profit is to be achieved by a firm to pay dividends to shareholders

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Williamson's Managerial Discretionary Theory

- He is of the opinion that managers, as a powerful group in any organisation, have their own set of utility functions.
- They have certain expectations and demands.
- Generally, they aim at maximising their managerial utility function rather than maximising total profits of the company.
- They feel that a firm is making profits on account of the efforts of top management and so they are entitled to certain special privileges and are eligible to enjoy special benefits.
- The managers' utility function is expressed as U = f [S, M, Id], where

S = Additional expenditure of staff

M = Managerial Emoluments

Id = Discretionary investment

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Williamson's Managerial Discretionary Theory

- The additional staff expenditure [S] includes the wages and salaries paid to the additional staff-members, who have been employed to work under the top management.
- Higher wages or salaries are paid in accordance with their productive ability and professional excellence which certainly would motivate the workers to work more.
- Managerial emoluments [M] include expenses on entertainment, luxurious air-conditioned office, costly company cars and other allowances given to managers.
- Discretionary power of investment expenditure {Id] includes those investment expenses which confer certain personal benefits and satisfaction to managers, for example, expenditure on latest equipments, furniture, decoration materials, etc.

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Summary

- Various alternative objectives of a firm is been discussed.
- The traditional objective is that of profit maximisation. But in recent years, economists have developed various alternative objectives to suit the modern business environment.
- The theory of the firm highlights wealth-maximisation or creation of maximum assets through which it can generate economic surpluses.
- Cyert and March theory concentrates on the behaviour of various coalition partners in an organisation and explain how opposite goals of different groups would affect the decision making of a firm.
- Marris model analyses the rate of growth of a firm by maximising managers' powers and status.
- Baumol analyses the impact of advertisement expenditures incurred by a firm on sales promotion and its impact on total sales revenue of a firm. Williamson studies the impact of managerial utility functions on the performance of a firm.

Check Your Learning

1. What is the main proposition of Profit-maximisation model?

Ans: The model is based on the assumption that each firm seeks to maximise its profit given certain technical and market constraints.

2. List the two models developed by Prof. Baumol.

Ans: The two models developed by Prof. Baumol are:

- Static model
- Dynamic model

Activity

Activity 1

Create a Powerpoint presentation on Marris' Growth Maximisation Model.