

25 marker model answer on business objectives | In the style of AQA Economics A Level

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Consider the following practice question:

Evaluate the view that businesses should always aim to maximise profits. (25 marks)

Essay plan

Intro: define two objectives, state answer to the question.

Analysis point 1 (A1):

- Why businesses should maximise profit – dynamic efficiency and the benefits for the firm.

Evaluation point 1 (E1):

- This depends on how profit is distributed. Profits may only go to shareholders as dividends instead of investment.

A2:

- Why businesses should aim to maximise sales instead
- Economies of scale leading to lower LRAC.

E2:

- However, this depends on the firm size relative to the minimum efficient scale.
- If the firm gets too large relative to its minimum efficient scale, there may be diseconomies of scale.

Conclusion:

- Most firms should maximise profit in the long run to achieve the benefits of dynamic efficiency.
- Yet this may be consistent with maximising sales in the short run.
- Depends on the level of competition intervention.

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Model answer

Introduction

Profit maximisation occurs where marginal revenue (MR) equals marginal cost (MC). Sales maximisation occurs where average revenue (AR) equals average total cost (ATC). I will argue that businesses should always aim to maximise profits in the long run, but this may be consistent with achieving other objectives in the short run.

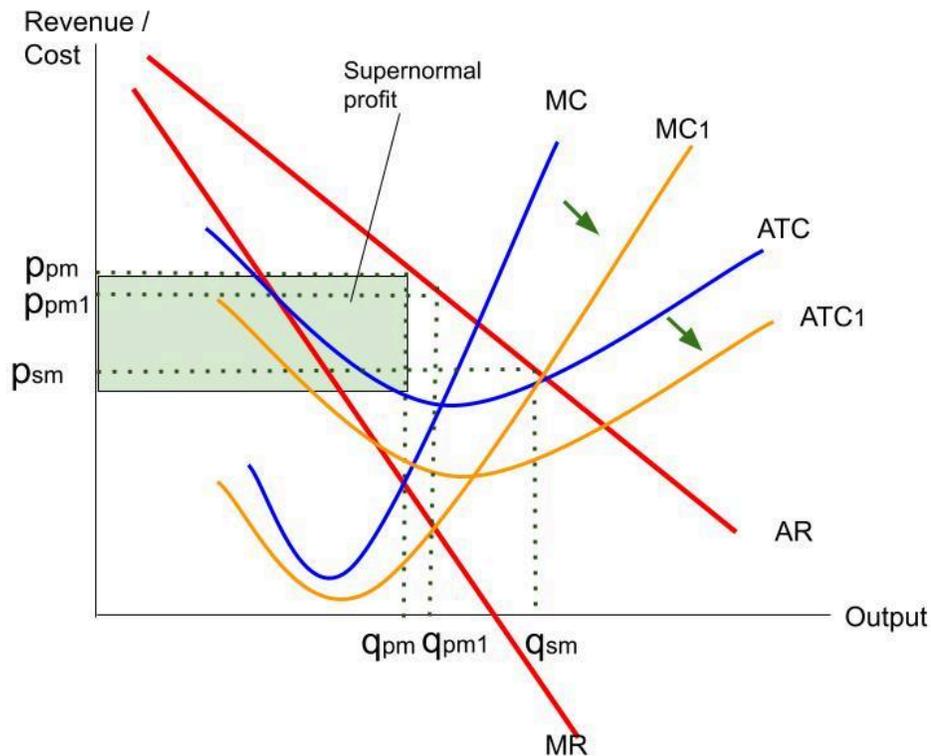
Analysis paragraph 1

Businesses should aim to maximise profits to become dynamically efficient, benefitting the firm's shareholders and customers. This is when firms make supernormal profit which can be reinvested in reducing production costs by becoming more efficient in the production process. Profit maximisation occurs where $MC = MR$ at (Q_{pm}, P_{pm}) . This gives the firm supernormal profits of the green shaded area in the diagram below. Apple is the third most valuable company on the stock exchange, using its high profit margins to attract investors with dividend payments. As a result of high profits, Apple can invest in R&D, with its commitment to invest over \$500bn in the years 2025–2028. This could enable Apple to reduce costs in the production of its M1 chip, reducing costs over time. On the diagram, this could lead to MC falling to MC_1 , or ATC falling to ATC_1 . Firms may pass on the lower costs to consumers with lower prices. This reduces prices for consumers from P_{pm} to P_{pm_1} , increasing consumer surplus. Profits rise over time as a result of falling costs, further increasing dividend payments to shareholders for Apple. Dynamic efficiency could also lead to investment in improved iPhone quality, such as the "Liquid Glass" design. The increase in quality benefits consumers with higher utility from consuming iPhones, while increasing demand by increasing quality, which further increases profits.

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Commentary on analysis paragraph 1

This paragraph fully explains the benefits of dynamic efficiency for firms, a key reason for pursuing profit maximisation.

Dynamic efficiency works through two channels:

1. Investment of supernormal profit in R&D may lead to a more efficient production process, reducing production costs.
2. Investment of supernormal profit in improving the product quality. This may increase demand for the firm's product, increasing firm revenue.

While the paragraph covers both channels, you could focus on one channel in your answer.

For this question on business objectives, it's important to link the effects of investing profits back to the benefits for the firm. In short, the ability to invest profit today allows the firm to

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make even more profit in the future.

The diagram features the area representing supernormal profit. It is extended further with falling costs, illustrating a benefit of dynamic efficiency.

The paragraph features the real world example of Apple, a company making high profits and churning out new products frequently. Apple is a useful example of dynamic efficiency in action. Think about the new features on the latest iPhone models, or consider another firm that you are familiar with.

Evaluation paragraph 1

However, this depends on how firms like Apple allocate their supernormal profits. Initially, profits could go to shareholders rather than being reinvested, in order to maximise shareholder utility instead. Thames Water has been accused of paying high shareholder dividends at the expense of investment into water infrastructure. As a result, even if the firm aims to maximise profits, the level of investment may not increase, so product quality may not improve and costs may not fall over time. This reduces the extent to which consumers benefit from investment with lower prices and lowers the extent to which profits can increase further over time.

Commentary on evaluation paragraph 1

Profit allocation is a critical evaluation point for market structures essays.

The paragraph explains how profit may be allocated instead, with the example of Thames Water being accused of underinvestment in water infrastructure.

This point is also clear as to the specific consequences: So what if profits are not invested? Then, profit maximisation may not generate the increases in quality or falling costs that we associate with dynamic efficiency.

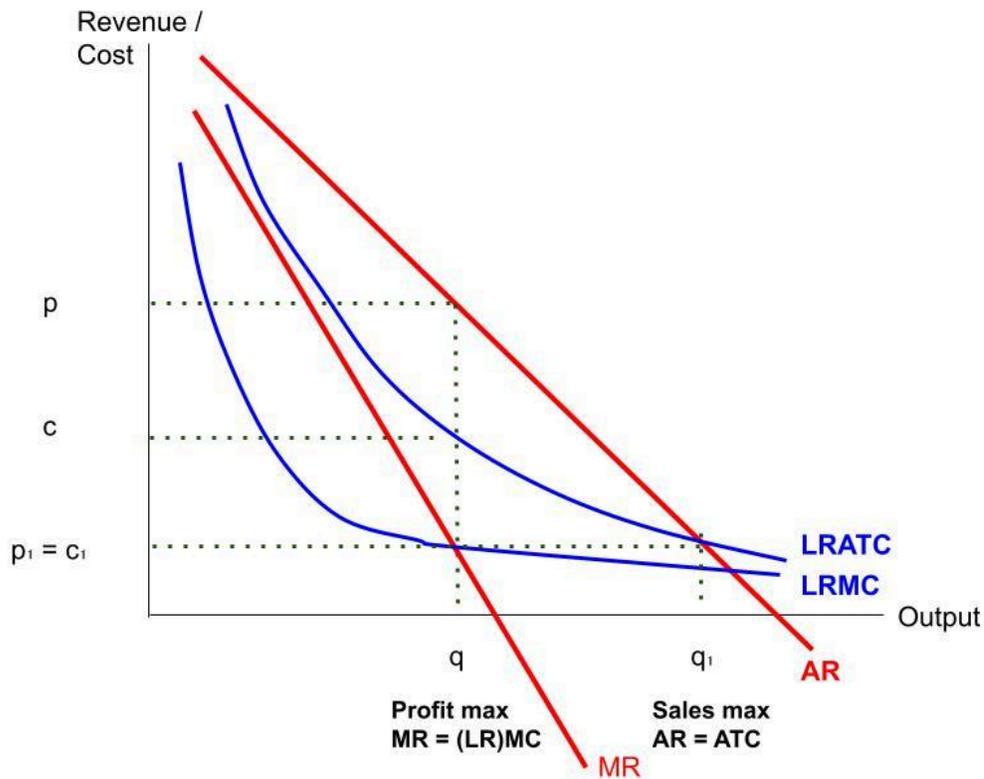
Analysis paragraph 2

Instead of maximising profit, a firm may prefer to maximise sales. Maximising sales enables the firm to achieve economies of scale. Amazon, for example, initially set about maximising sales so it could achieve economies of scale. This included spreading the upfront cost of its distribution centres, Amazon website and robotics investments in its warehouses over a larger amount of output, reducing LRAC (long-run average cost) as output rises. This allows Amazon to sell output at q_1 , where $AR = ATC$, to maximise sales. This allows Amazon to exploit economies of scale, producing nearer its minimum efficient scale compared to under profit maximisation at a lower output level q .

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As a result of economies of scale, Amazon can sell goods at lower prices (p_1 under sales maximisation compared to p under profit maximisation) by passing on lower costs to customers. This increases Amazon's market share and may allow it to acquire monopoly power. This allows Amazon the option to raise prices in the future without much of a fall in demand due to the absence of substitutes, increasing future profit margins. Tech companies such as Spotify and Uber reported losses in their first few years in order to maximise sales ("blitzscaling") to later monopolise the market.

Commentary on analysis point 2

Economies of scale are an important reason why a firm may maximise sales.

A good way to demonstrate economies of scale is the cost-revenue diagram with LRAC-LRMC being downward sloping, like with a natural monopoly. The revenue curves remain the same

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as usual, both downward sloping with MR being twice as steep as AR.

Note when mentioning economies of scale, it is usually advisable to refer to an example of economies of scale. In this case Amazon can spread many upfront costs, such as its distribution centres, over a larger amount of output.

An excellent real world example for market structures essays are the “blitzscaling” companies. Spotify, Uber, many other tech startups and even Amazon (decades ago) engaged in this strategy. This involves making losses or low profits to expand the size of the company more quickly. Only later on, once the firm has achieved market power, would the firm increase prices and make higher profits.

Evaluation paragraph 2

However, this depends on the size of the firm relative to its minimum efficient scale (MES). If firm output exceeds the MES due to a sales-maximisation strategy, the firm could face diseconomies of scale. This is where as output increases, LRAC increases. Bureaucracy in a larger firm, with several layers of management needing to agree to decisions, could slow down decision-making. This could reduce productivity and thus increase the firm’s LRAC. Google and Apple, large tech companies, have been criticised for being slower to innovate, with new iPhone models not having as many new features, and Google being criticised for not improving the user’s search experience. This could be due to the additional bureaucracy in a larger firm. As a result, sales maximisation could increase LRAC, leading to higher prices if passed on to consumers or lower profits over time.

Commentary on evaluation point 2

Note the point is linked to the question on business objectives, frequently mentioning sales maximisation.

The point on diseconomies of scale is explained clearly, with a relevant real world example.

Conclusion

Overall, profit maximisation should be the long-run objective of firms in most cases. Profits give firms the opportunity to reinvest into lowering costs and increasing quality. As a result, consumers benefit from lower prices and higher utility, while firms’ profits rise, increasing producer surplus and achieving an increase in social welfare over time.

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Socially conscious shareholders may demand firms to reinvest their profits, and consumers' expectations of higher quality over time may give firms an incentive to reinvest. Yet in the short run, it may be prudent for firms to pursue other objectives, such as sales maximisation. This allows firms to build economies of scale, brand loyalty and monopoly power, which it can later use to increase profits by engaging in price rises. In a sense, sales maximisation in the short run becomes a means for firms to achieve profit maximisation in the long run.

The choice of business objective depends on the state of competition policy. With the UK's Competition and Markets Authority (CMA) increasingly reviewing tech mergers such as Meta and Giphy, and the attempted acquisition of Activision Blizzard by Microsoft, tech companies may be limited in the extent to which they may raise prices and pursue profit maximisation. In the cases of regulator scrutiny, firms may be able to pursue profit maximisation to a lesser extent and instead engage in satisficing with some profit, but consideration of other stakeholders such as not raising prices too high to consider consumer welfare and regulatory action.

Commentary on the conclusion

The conclusion makes sure to answer the question and provide a justification for the answer.

There is also discussion of what the answer may "depend on". Namely, the level of competition intervention.

This answer above would likely score full marks or close to this.

This answer is a relatively long answer, showing some of the possible points that could be discussed. A shorter answer would also be capable of scoring the highest mark.

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