Alternatives to Profit Maximisation

The traditional theory of the firm tends to assume that businesses possess sufficient information, market power and motivation to set prices or their products that maximise profits. This assumption is now criticised by economists who have studied the organisation and objectives of modern-day corporations.

Why might a business depart from profit maximisation?

There are numerous possible explanations. Some relate o the **lack of accurate and detailed information** required to undertake optimal maximising behaviour. Others concentrate on the **alternative objectives of modern businesses**. We start first with the effects of **imperfect information**.

Imperfect information about demand and costs

Firms might find it difficult to identify their profit maximising output, as they cannot accurately calculate marginal revenue and marginal costs. Often the day-to-day pricing decisions of businesses are taken on the basis of "*estimated* demand conditions" rather than a systematic calculation of a demand curve.

Secondly, most modern businesses are **multi-product firms** operating in a range of separate markets across countries and continents – as a result the volume of information that they have to handle can be vast. And they must keep track of the ever-changing preferences of consumers. The idea that there is a neat, single profit maximising price is redundant.

Behavioural Theories of the Firm

Behavioural economists believe that modern corporations are **complex organizations** made up various stakeholders. **Stakeholders** are defined as any groups who have a vested interest in the activity of a business. Examples might include:

- Employees and managers employed by the firm
- Shareholders – people who have an equity stake in a business
- Customers in the market
- The local community
- The government and it's agencies including local government

Each of these groups is likely to have different objectives or goals at points in time. The **dominant group** at any moment can give greater emphasis to their own objectives – for example price and output decisions may be taken at local level by managers – with shareholders taking only a distant and imperfectly informed view of the company's performance and strategy.

Behavioural Economics

Behavioural economics is a relatively new field of economics which looks directly at the way human behaviour and decision-making is modelled. By integrating economics with psychology, economists can benefit from the experience psychology has in examining our behaviour. Many psychologists are now teaming up with economists in an attempt to study human beings in the economic forum, including the 2002 Nobel Prize winners Daniel Kahneman (a cognitive psychologist) and Vernon Smith (an experimental economist). For the first time, laboratory experiments are being used to provide serious data for economists to study.

Source: Jack Wills, Behavioural Economics and Rational Behaviour, 2003

If firms are likely to move away from pure profit maximising behaviour, what are the alternatives?

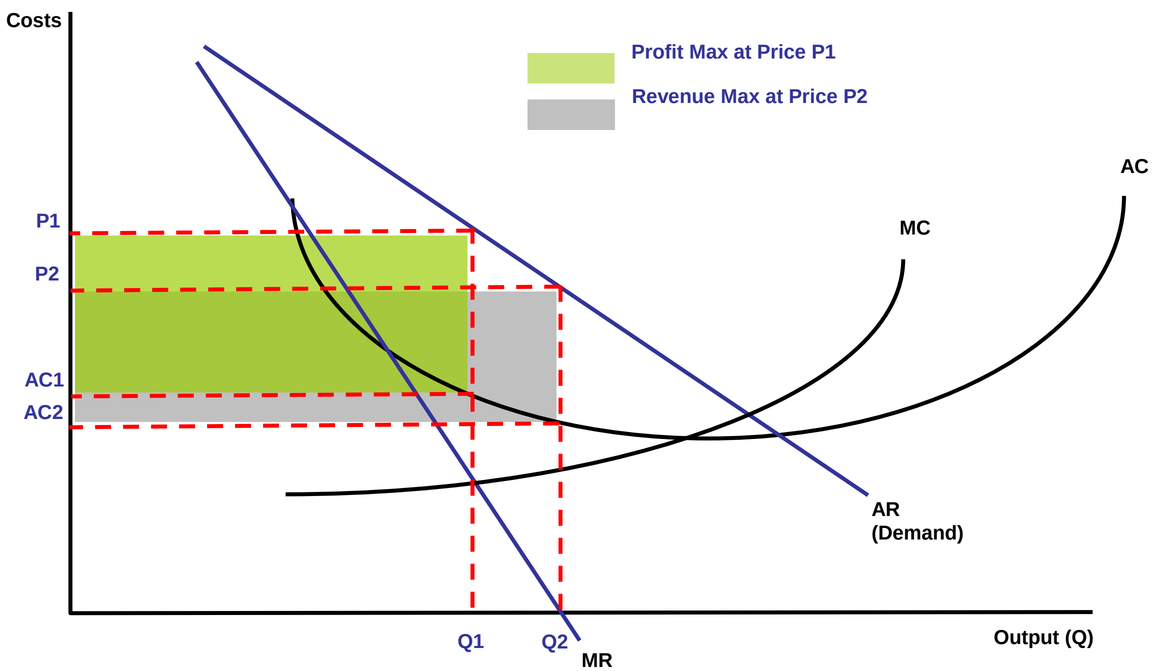
1. **Satisficing behaviour** involves the owners setting **minimum acceptable levels of achievement** in terms of business revenue and profit.

2. **Sales Revenue Maximisation**

The objective of **maximising sales revenue** rather than profits was initially developed by the work of [William Baumol](https://) (1959). His research focused on the behaviour of manager-controlled businesses. Baumol argued that **annual salaries** and **other perks** might be closely correlated with total sales revenue rather than profits. Companies geared towards maximising revenue are likely to make frequent and extensive use of [price discrimination](https://) (or yield management) as a means of extracting extra revenue and profit from consumers.

3. **Managerial Satisfaction model**

An alternative view was put forward by [Oliver Williamson](https://) (1981), who developed the concept of **managerial satisfaction** (or managerial utility). This can be enhanced by raising sales revenue.



Price and output differs if the firm changes its objective from profit to revenue maximisation. Assuming that the firm's costs remain the same, a firm will choose a lower price and supply a higher output when sales revenue maximisation is the main objective.

The profit maximising price is P2 at output Q2 whilst the revenue maximising price is P1 at output Q1.

A change in the objectives of the business has an effect on welfare and in particular the balance between consumer and producer surplus. Consumer surplus is higher with sales revenue maximisation because output is higher and price is lower.

Social entrepreneurs – "not just for profit" businesses

Underneath the surface of an economy dominated by corporate giants, a new breed of business is flourishing, where profit is not always the bottom line; these are entrepreneurs operating for a **social purpose** and not just for profit. A **social enterprise** is a business that has **social objectives** whose surpluses are reinvested for that purpose in the business or the community, rather than being driven by the need to seek profit to satisfy investors. Rather than maximise shareholder value and distribute dividends, a social enterprise is looking to achieve social and environmental aims over the long term.

Examples include

- Café Direct
- Fair Trade
- Traidcraft
- Divine Chocolate
- The Eden Project
- Fifteen Foundation (Jamie Oliver)
- Housing Associations
- Micro-credit developed by the Grameen Bank and its founder, the Nobel-Prize winner Muhammad Yuni

Not for Profit Businesses

These are charities, community organisations that are run on commercial lines - an example is **Network Rail**

Network Rail

- Took over the rail network in October 2002
- Stated purpose is to deliver a safe, reliable and efficient railway for Britain.
- It is a company limited by guarantee – whose debts are secured by the government
- Network Rail is a private company operating as a commercial business and regulated by the Office of Rail Regulation
- Network Rail is a "not-for-dividend" company, which means that all of its profits are invested in the railway network.
- Train operating companies pay Network Rail for use of the rail infrastructure

Businesses required to main a loss-making service on social grounds

A good example here is the Royal Mail which is required to maintain a universal national postal delivery service throughout the UK for a uniform price. Household mail makes a loss, cross-subsidised by business mail – although this market is shrinking for the Royal Mail because of the introduction of fresh competition from Jan 2006. The Post Office Ltd is a subsidiary of the Royal Mail Group plc – it runs substantial losses on the network or rural post offices and has been under great pressure to close hundreds of offices to stem losses