

Main propositions of the profit maximisation model economics essay

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Profit-maximisation implies earning highest possible amount of profit during a given period of time. 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. 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. 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. $\text{Profit} = \text{TR} - \text{TC}$. 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.

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 shortcomings 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

Discuss the various survey methods to forecast demand.

Survey methods help us in obtaining information about the future purchase plans of potential buyers through collecting the opinions of experts or by interviewing the consumers. These methods are extensively used in short run and for estimating the demand for new products. There are different approaches under survey methods. The various approaches under survey

method are: Consumers interview Method Collective Opinion Method Delphi Method or Experts Opinion Method End-Use Method

Consumers Interview Method

In this method, required information regarding their future purchase plans is collected directly from the consumers. Various approaches are used to gather information from consumers. They are: Survey of buyers' intentions through questionnaire. Direct interview method

Survey Of Buyers' Intentions through Questionnaire:

It is one of the oldest methods of demand forecasting. it is also called "opinion surveys". The heart of a survey is the questionnaire. Questionnaire is prepared by an expert body who are specialists in the field of marketing and is distributed among the consumer buyers either through mail or in person by the company and all relevant and correct information are gathered. Questionnaire is collected from the consumers for the purpose of evaluation and is classified, edited and analysed. The information so collected is consolidated and reviewed by the top executives with lot of experience. Finally, a report is prepared and submitted to management for taking final decisions and thus the demand forecast is done.

Direct Interview Method

In this method, customers are directly contacted and interviewed. Direct and simple questions are asked to the customers and are requested to answer specifically about their budget, expenditure plans, particular items to be selected, the quality and quantity of products, relative price preferences and so on for a particular period of time.

Complete Enumeration Method

In this method, all potential customers are interviewed in a particular city or a region and the answers obtained during an interview are consolidated and carefully studied to obtain the most probable demand for a product. This method can be applied only for those products whose customers are located in a small region.

Sample survey method or the consumer panel method

In this method, different cross sections of customers which make up the bulk of the market are selected from the relevant market through some sampling method, are interviewed or surveyed. The selected consumers form a panel. Based on the selected consumers views expressed, the most likely demand is estimated.

Collective Opinion Method Or Opinion Survey Method

This is a variant of the survey method which is also known as " Sales-force polling" or " Opinion poll method". In this method, opinions of sales representatives, professional experts, the market consultants regarding the volume of sales expected in the future are taken. Thus the views of all salesmen are aggregated to get the overall probable demand for a product.

Delphi Method or Experts Opinion Method

This method was originally developed at Rand Corporation in the late 1940's by Olaf Helmer, Dalkey and Gordon. Under this method, outside experts are appointed and the experts are supplied with all kinds of information and statistical data. Opinions and views of experts about the expected future sales of the company are considered. As the experts' opinions are more

valuable, a firm gives more importance to them and prepares their future plan based on the forecasts made by the experts.

End-Use Method

Under this method, the sale of the product under consideration is projected based on the demand surveys of the industries using the given product as an intermediate product. The demand for the final product is the end-user demand of the intermediate product used in the production of the final product. This method is used to forecast the demand for intermediate products, only.

Describe the characteristics of Monopolistic Competition

Existence of a large number of firms - Number of firms producing a product will be large. The size of each firm is small. Market is characterised by imperfections - Imperfections may arise due to advertisements, differences in transport cost, irrational preferences of consumers, ignorance about the availability of different brands of products and prices of products, etc. Free entry and exit of firms - Each firm produces a very close substitute for the existing brands of a product. Element of monopoly and competition - Every firm enjoys some sort of monopoly power over the product it produces. Similar products but not identical - Under monopolistic competition, the firm produces commodities which are similar to one another but not identical or homogenous. Non-price competition - In this market, there will be competition among "Mini-monopolists" for their products and not for the price of the product. Definite preference of the consumers - Consumers will have definite preference for particular variety or brands loyalty owing to the

special features of a product produced by a particular firm. Product differentiation - The most outstanding feature of monopolistic competition is product differentiation. Firms adopt different techniques to differentiate their products from one another. Selling costs - All those expenses which are incurred on sales promotion of a product are called as selling costs. The concept of industry and product groups - The monopolistically competitive industry is a 'group' of firms producing a 'closely related' commodity referred to as "product group". More elastic demand curve - Product differentiation makes the demand curve of the firm much more elastic.

Explain the price elasticity of demand and also its applications.

Price elasticity of demand: is a technical term used by economists to explain the degree of responsiveness of the demand for a product to a change in its price. $EP = (\text{Percentage change in quantity demanded} / \text{Percentage change in price})$ Based on numerical values of the co-efficient of elasticity, we can have the following five degrees of price elasticity of demand

Perfectly elastic demand - A very small change in price leads to an infinite change in demand. The demand curve is a horizontal line and parallel to OX axis. The numerical co-efficient of perfectly elastic demand is infinity ($ED = \infty$). Perfectly inelastic demand - Any change in price, the quantity demanded will be perfectly constant. The demand curve is a vertical straight line and parallel to OY axis. Quantity demanded would be 10 units, irrespective of price changes from Rs. 10.00 to Rs. 2.00. Hence, the numerical co-efficient of perfectly inelastic demand is zero. $ED = 0$.

Relatively elastic demand - If there is a small change in price, then it leads to proportional change in demand. For e. g.,

demand rises by 9 % and price falls by 3%. Hence, the numerical co-efficient of demand is greater than one. Relatively inelastic demand - A huge change in price, say 8 % fall price, leads to less than proportional change in demand, say 4 % rise in demand. Unitary elastic demand - There is proportionate change in price which leads to equal proportional change in demand. For e. g., 5 % fall in price leads to exactly 5 % increase in demand. Hence, elasticity is equal to unity.

Practical application of price elasticity of demand:

Production planning - It helps a producer to decide about the volume of production. If the demand for his products is inelastic, specific quantities can be produced while he has to produce different quantities, if the demand is elastic. Helps in fixing the prices of different goods - It helps a producer to fix the price of his product. If the demand for his product is inelastic, he can fix a higher price and if the demand is elastic, he has to charge a lower price. Thus, price-increase policy is to be followed if the demand is inelastic in the market and price-decrease policy is to be followed if the demand is elastic. Similarly, it helps a monopolist to practise price discrimination on the basis of elasticity of demand. Helps in fixing the rewards for factor inputs - Factor rewards refer to the price paid for their services in the production process. It helps the producer to determine the rewards for factors of production. If the demand for any factor unit is inelastic, the producer has to pay higher reward for it and vice-versa. Helps in determining the foreign exchange rates - Exchange rate refers to the rate at which currency of one country is converted in to the currency of another country. It helps in the determination of the rate of exchange between the currencies of two different nations. For

e. g. if the demand for US dollar to an Indian rupee is inelastic, in that case, an Indian has to pay more Indian currency to get one unit of US dollar and vice-versa. Helps in determining the terms of trade – t is the basis for deciding the ' terms of trade' between two nations. The terms of trade implies the rate at which the domestic goods are exchanged for foreign goods. For e. g. if the demand for Japan's products in India is inelastic, we have to pay more in terms of our commodities to get one unit of a commodity from Japan and vice-versa. Helps in fixing the rate of taxes – Taxes refer to the compulsory payment made by a citizen to the government periodically without expecting any direct return benefit from it. It helps the Finance Minister to formulate sound taxation policy of the country. He can impose more taxes on those goods for which the demand is inelastic and lower taxes if the demand is elastic in the market. Helps in declaration of public utilities – Public utilities are those institutions which provide certain essential goods to the general public at economical prices. The government may declare a particular industry as ' public utility' or nationalise it, if the demand for its products is inelastic. Poverty in the midst of plenty – The concept explains the paradox of poverty in the midst of plenty. A bumper crop of rice or wheat, instead of bringing prosperity to farmers, may actually bring poverty to them because the demand for rice and wheat is inelastic.

Explain the factors determining elasticity of supply

Time period – Time has a greater influence on elasticity of supply than on demand. Generally, supply tends to be inelastic in the short run because time available to organise and adjust supply to demand would be insufficient. Supply would be more elastic in the long run. Availability and

mobility of factors of production - When factors of production are available in plenty and freely mobile from one occupation to another, supply tends to be elastic and vice-versa. Technological improvements - Modern methods of production expand output and hence supply tends to be elastic. Old methods reduce output and supply tends to be inelastic. Cost of production - If cost of production rises rapidly as output expands, then there will not be much incentive to increase output as the extra benefit will be choked off by the increase in cost. Hence, supply tends to be inelastic and vice-versa. Kinds and nature of markets - If the seller is selling his or her product in different markets, supply tends to be elastic in any one of the market because, a fall in the price in one market will induce him or her to sell in another market. Again, if he or she is producing several types of goods and can switch over easily from one to another, then each of his or her products will be elastic in supply. Political conditions - Political conditions may disrupt production of a product. In that case, supply tends to become inelastic. Number of sellers - Supply tends to become more elastic if there are more sellers freely selling their products and vice-versa. Prices of related goods - A firm can charge a higher price for its products, if prices of other products are higher and vice-versa. Goals of the firm - If the seller is happy with small output, supply tends to be inelastic and vice-versa.

Discuss any two law of returns to scale with example.

Three phases of returns to scale

Many economists have questioned the validity of returns to scale on the ground that all factor inputs cannot be increased in the same proportion and the proportion between the factor inputs cannot be kept uniform. But in <https://assignbuster.com/main-propositions-of-the-profit-maximisation-model-economics-essay/>

some cases, it is possible that all factor inputs can be changed in the same proportion and the output is studied when the input is doubled or tripled or increased five-fold or ten-fold. When the quantity of all factor inputs are increased in a given proportion and output increases more than proportionately, then the returns to scale are said to be increasing; when the output increases in the same proportion, then the returns to scale are said to be constant; when the output increases less than proportionately, then the returns to scale are said to be diminishing.

Increasing returns to scale

Wider scope for the use of latest tools, equipments, machineries, techniques etc to increase production and reduce cost per unit. Large-scale production leads to full and complete utilisation of indivisible factor inputs leading to further reduction in production cost. As the size of the plant increases, more output can be obtained at lower cost. As output increases, it is possible to introduce the principle of division of labour and specialisation, effective supervision and scientificAs output increases, it becomes possible to enjoy several other kinds of economies of scale like overhead, financial, marketing and risk-bearing economies, etc, which are responsible for cost reduction.

Constant returns to scale - In case of constant returns to scale, the various internal and external economies of scale are neutralized by internal and external diseconomies. Thus, when both internal and external economies and diseconomies are exactly balanced with each other, constant returns to scale will operate. Diminishing returns to scale - Diminishing Returns to Scale operate due to the following reasons: Emergence of difficulties in co-ordination and control. Difficulty in effective and better supervision. Delays in

management decisions. Inefficient and mismanagement due to overgrowth and expansion of the firm. Productivity and efficiency declining unavoidably after a point.**** EOD ****