A LEVEL ECONOMICS

EXAMPLE ESSAYS

Microeconomics: Theory of the Firm

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Suggest Essay Structure for A Level Economics

Following the tutor2u suggested essay structure and technique can help you to write economics essays that are capable of achieving a top band mark. The key to any successful essay is **PLANNING!**

**INTRODUCTION**

Identify the 3 or 4 key points that you will be writing about in your essay

Write one sentence to summarise your conclusion - use the words from the question to indicate to the examiner that you are focused on the precise question

Use the PECAN PIE and go APE approach (see below!) The final sentence for each point should directly answer the question

**FOR EACH POINT...**

It is VITAL that you reach a judgment to score top marks

Don’t introduce anything new - base your judgment on the arguments you have already made

**PECAN PIE – How to Structure a Point**

An essay needs at least 3 slices of PECAN PIE!

P – clearly state your point in one sentence

E – then explain your point very briefly

CAN – provide contextualised analysis by writing a step-by-step chain of argument and integrating examples

PE – now consider your original point but in evaluation - don’t just focus on disadvantages, generate evaluation, but instead really think about why your point may not be valid – use the go APE strategy.

**Go APE - How to Evaluate Your Point**

Assumptions – consider whether the assumptions that underpin the theory you have used to make your analytical point may not be valid

Perspectives – consider your point from different perspectives

For micro, consider using the mnemonic **PLASTIC** to help you (producers, location, age, skill, time, income level, consumers)

For macro, consider using the mnemonic **TINKER** to help you (trade offs, immediacy, Neoclassical, Keynesian, equity, region)

Go and consider your point in light of evidence, either in favour or against...
In January 2016, the makers of Ray-Ban sunglasses, Luxottica, agreed a merger with a rival eyewear firm, Essilor, worth €46bn. Evaluate the likely advantages and disadvantages for businesses growing in this way.

Firms may grow in a number of ways - internally (organically) or externally by merging or taking over another firm. The Luxottica/Essilor merger is an example of external growth. The key advantage of growth by acquisition is that the firms are likely to achieve cost savings, more quickly than using internal growth. However, external growth is more likely to attract the attention of the competition authorities, and in the long run, may also fail to deliver many of the expected advantages, perhaps resulting in a demerger.

One key advantage of a merger is that it can allow the firms in question to achieve the economic benefits of operating on a large scale more quickly, and with more certainty than via internal growth. A merger takes place when the firms agree to combine their operations in the hope of achieving synergies. These occur when long run average total costs fall as the scale of output rises. Depending on whether the merger is horizontal or vertical, cost savings could come from a number of sources. Luxottica and Essilor are suppliers of broadly similar products so this would be an example of a horizontal merger, allowing greater specialisation and purchasing economies (e.g. UVB reflective film for sunglasses). There might also be advantages from vertical integration by delivering a broader range of products or access to suppliers’ supply chains (e.g. suppliers of glasses cases). Another possibility includes technical economies if the merger allows use of joint discourses of plant and machinery, volume economies or economies of integration of resources.

The impact of economies of scale for the firms is shown on the diagram. The green shaded box shows the total supernormal profit that individual firms can achieve with cost structure AC1. Economies of scale achieved as a result of the merger allow the cost structure AC2 to be reached and profit is considerably larger (as shown by the peach-coloured box). This is a significant advantage to the merged business arising from gains in productive efficiency. The same results might have been achievable with internal growth, but more slowly.

However, the analysis assumes an unchanged demand schedule in the face of the merger, and this may not be so. It is possible that customers for products such as high-end sunglasses value the exclusivity of the brand and would be less likely to purchase from a business that accounts for a large proportion of the market, and this would shift AR inwards. It is possible too that removal of a rival means that there is less incentive to be productively efficient so x-inefficiency may result. Even if the average total cost curve has fallen, the newly merged business may be incurring costs way above it. That said mergers in many industries are expected to achieve more rapid cost savings and profit increases.

The student shows that they have understood the main topic in the question, and used the context. The key arguments are outlined.

The first point builds on the key advantage outlined in the introduction – good structure.

The context is used well here with specific reference to the companies, AND an attempt to use examples from the eyewear industry.

This is an example of a diagram that allows AO3 marks (analysis) rather than just AO1 marks (knowledge) because the diagram is adapted and carefully integrated into the written analysis.

This is an excellent example of evaluating by questioning assumptions.
A significant disadvantage of a business growing by merger is that it may attract the attention of the competition authorities, in a way that internal growth might not. By merging with a rival firm, the market for eyewear has become more concentrated, and contestability has lessened. Given the size of the deal (£46bn), it is likely that the resulting business now has significant monopoly power. This means that the profit maximising firm could restrict output and raise price to achieve higher supernormal profits. It might also be able to price discriminate to raise revenue and profits even further. This is likely to attract the attention of the UK Competition and Markets Authority (CMA) who have a remit to investigate actions which restrict or distort competition. While the business itself may have a lot to gain from increased monopoly power, it is likely to want to avoid an investigation. Investigations take time and cause delay, costs and risks adverse media comment, all of which can negatively impact on profits. If the merger is disallowed, the firms in question may now become the target of a fresh hostile takeover. However, the likelihood of an investigation depends on the size of the market, and the contestability. No information is provided on this, but the risk is higher than with internal growth, so the desirability of growth by merger depends on the degree of risk-aversion of the firm and its owners.

A further disadvantage of growth by merger is that many of the hoped for benefits fail to materialise. It is said that the majority of mergers fall into this category. In behavioural economics terms, it seems that perhaps there is bounded rationality in considering the vast amounts of information available, and some sort of optimism bias at work. There are a number of reasons why this may be so. The cost of the merger itself. If it is debt financed for example, then the need to repay and finance the loan may present a significant burden. It may also be that other parties were interested in the deal. If the price eventually negotiated was too high, it can lead to the so-called winner’s curse. €46bn is a large deal, this is an important consideration. It is possible that rather than bringing the business closer to minimum efficient scale, it actually takes it further away. Diseconomies of scale start to operate for many businesses, post-merger. Integrating systems such as IT proves to be a problem. Also cultural compatibility can be a major cause of failing to work and perhaps personalities of senior managers. Sometimes human capital is lost, if the most skilled labour prefers to work for smaller businesses where there is more autonomy. There are exceptions of course, as in the case of the Luxottica/ Essilor merger, these seem valid concerns. Research by Harvard Business School suggests that between 70% and 90% of mergers fail.

In conclusion, there are a number of possible advantages to businesses from growing from mergers in this industry, no matter how large the amount of such activity. However, there are disadvantages too, and the claim that most merger deals fail to achieve the hoped for benefits seems persuasive. There is nothing obvious about the Luxottica/ Essilor merger which suggests they would be immune from these difficulties. Therefore, it is reasonable to think that the disadvantages of growth by merger, most probably outweigh the advantages than other forms of growth. This is a key advantage of merger.

The use of the word ‘significant’ here is an easy way for students to express a degree of judgement, which is essential in achieving top band responses.

This is an excellent example of a developed chain of analysis being used in evaluation.

A neat end to the paragraph, using “depends on” phrases that are carefully chosen and not “run of the mill”.

A clear judgement is reached, allowing this essay to be awarded a top band mark.
Shares in Premier Foods, the company behind famous brands such as Mr Kipling cakes and Bisto gravy, plummeted following a January 2017 profit warning issued by the firm, in which rising production costs were blamed. Evaluate the view that all businesses should aim to maximise their profits.

Profit is the difference between total revenue and total cost. In traditional economic theory, firms are assumed to maximise profits, but it is arguable in today’s complex and globalised world whether this is the case. This essay will consider three key arguments. First, that profit is the reward for risk taking and is essential to business success. Second, that profit satisficing might be more appropriate as an aim, and finally that perhaps profit maximisation should indeed be the aim, but only in the long run rather than the short run.

Profit is the reward for risk taking and most commercial private sector businesses exist to make profit. Traditional theory assumes that firms will aim to maximise profit. On the diagram below, representing a firm in imperfect competition, profit maximisation is achieved where MR=MC. Output is Q1 and the price level of output the maximum price that can be charged is P1. AR lies significantly above AC at Q1 indicating large supernormal profits are being earned.

Maximising profits achieves a high reward for entrepreneurs and shareholders. In the case of listed companies such as Premier Foods the likely reaction of their share price to poor profit results could lead to shareholder discontent and perhaps a hostile takeover.

Furthermore, maximising profits can provide an important source of finance for further investment by a firm, perhaps crucial in the case of a new small firm without an established track record to obtain a bank loan. Profit is therefore essential to the survival of firms.

However, achieving profit maximisation is not easy. It may be because of lack accurate and timely information on revenue and costs. Indeed, accountants do not monitor marginal costs and revenues. Even if information is available, firms will experience bounded rationality – an inability to handle such large amounts of data and take rational decisions. Firms may adopt instead simple rules of thumb (known as heuristics) such as cost plus pricing in response. While it is lack of profit that has caused difficulty for Premier Foods, its immediate objective is survival, it may not be possible to focus on short run profit maximisation, however important to business success. More generally, the aim of true profit maximisation may be difficult if not impossible to achieve in many businesses.

Secondly for many companies with significant numbers of stakeholders, and control of ownership is divorced from control, profit satisficing might be a better aim. A stakeholder is anyone with an interest or concern in a company. This would include shareholders, managers, employees and...
customers. For large companies such as Premier Foods with perhaps thousands of shareholders, a Board of Directors is appointed to represent their interests, and a team of managers undertakes the day to day running of the business. There is likely to be asymmetrical information with managers possessing a monopoly of the technical knowledge about the business (the so-called principal-agent problem) and additional problems resulting from moral hazard if managers enjoy the reward when risk pays off but do not suffer the costs when they do not. In this situation, managers have different incentives and hence objectives to shareholders and other stakeholders. While various methods can be used to re-align objectives such as profit related pay, there is persuasive evidence of industries where revenue maximisation appears to be the dominant strategy – for example streamed TV and films (which occurs when MR = zero). The situation becomes more complicated when stakeholders such as employees and customers are taken into account. True profit maximisation would mean paying employees the lowest possible wage, and charging customers an ever-varying price. This is not achievable nor desirable. Political and social objectives may come into play for a company such as Premier Foods with growing social concerns over obesity and sugar content. The outcome is likely to be that firms profit satisfice, that is to achieve a level of profit that is likely to be satisfactory to shareholders. On the diagram, this could lie anywhere between profit maximisation and normal profit (where AR = AC). For many firms, the reasons given suggest satisficing is likely to be a better objective than profit maximising.

The preceding argument focused on the short run. In the long run, there may be stronger arguments for firms using more on profit maximisation than the other objectives. Firms are more likely to earn abnormal profits on an ongoing basis when barriers to entry are high and contestability is low. If this is the case, high profit levels may act as a signal to new firms currently outside the market, and compete away from the market in excess of normal. There are many factors influencing the ease with which new firms can enter a market, but if incumbent firms experience significant economies of scale or brand loyalty, for instance, new entrants will be hard put to businesses aiming to maximise long run profits may well adopt short run strategies such as revenue, sales or growth maximisation to be market leaders. On the diagram revenue maximisation occurs where normal profit is earned and sales maximisation where normal profit is earned and sales maximisation in the interest of long run profitability. Examples of this type of behaviour can be seen in the coffee market with Costa Coffee rapidly expanding the number of outlets, undoubtedly at high cost, and Amazon, Spotify and Netflix building (exponentially) the number of active customer accounts. If a market is more contestable however, as it may be for Premier Foods, then a strategy of aiming for profits closer to normal may be more sensible to avoid the entry of new rival firms and hence to maximise longer-term profits.

In conclusion, while profit matters and no business could afford to ignore it completely (even publicly-owned businesses or social enterprises), the view that all businesses should aim to maximise their profits is difficult to sustain. For the reasons given, it may not be possible for them to do so (in the strictest economic sense of the term), although many firms do seem to employ strategies more in line with the profit maximisation goals. It seems unlikely, though, that these are the profit maximisation goals. Firms will, and should be profit seeking, but it seems most probable that the majority of businesses should be aiming to profit satisfice rather than to profit maximise.

The essay is following the same structure as outlined in the introduction.

The technical economics used in this analysis is excellent, and draws on topics from across the course content.

Again, the practicality of profit maximisation is addressed, which shows real engagement with the subject.

Good use of context

The examples and use of the Premier Foods context are helpful in enhancing the quality of the argument.

An excellent conclusion – nothing new is introduced, but overarching statements are made that allow a judgement to be reached.
The company British American Tobacco agreed a takeover deal of its US rival Reynolds in January 2017. This will result in the world’s largest tobacco company. One of the reasons cited for the deal was to benefit from increased economies of scale. Evaluate the view that having a business objective of increased economies of scale is always desirable.

Economies of scale arise when long run average costs fall when firms increase the scale of their production. In reaching a view on whether economies of scale are always desirable, this essay will consider the issue from the perspective of a business itself, but in reality there will be impacts on consumers, competitors, government and society as a whole. This essay will consider first the impact of such an objective on business costs, efficiency and profits, second the risk that pursuing this objective will increase the likelihood instead of experiencing diseconomies of scale and finally the possibility that pursuing this objective might attract unwanted responses from other market participants or competition authorities.

The first reason why such a business objective might be desirable is that the lower cost structure means that total profits rise. On the diagram, at scale of output Q1, a profit maximising firm (equating MR with MC) would earn the profit shown by the green box. However, at a larger scale of output, Q2, costs savings might be possible perhaps due to technical economies such as indivisibilities or volume, or economies of marketing or research and development. This is likely to be especially important for an industry such as tobacco, as new generations of products, such as e-cigarettes, are developed. At scale of output Q2, average costs are lower and the price paid by consumers has fallen to P2, and hence consumer surplus increased (generally an advantage, but perhaps not in this case with cigarettes being a demerit goods), profits have risen significantly as shown by the grey box. Supernormal profits allow greater rewards to be paid to shareholders and can provide an additional source of finance for capital investment in an industry that might find more conventional bank borrowing problematic and expensive.

However, profits will only increase to the extent indicated if the firm in question is x-efficient. x-inefficiency occurs when there is organisational slack (perhaps due to a lack of real competition) and higher wages than necessary are paid, poor staffing, or simply wasteful production. On the diagram, the firm would operate above its average cost curve, rather than below it. This is possible in an industry such as tobacco, which is concentrated, and it makes sense to choose to pay higher wages to avoid further public criticism. More generally, although there are significant economies of scale to
be gained in many industries such as car manufacturing and pharmaceuticals, this is not always the case. In some of the service sectors, for example, the minimum efficient scale (MES) could be low especially if little specialist capital is required. In the UK, the service sector accounts for around 75% of GDP, suggesting that achieving economies of scale may not be essential. So, although lower costs and improved profitability is one reason why an objective of increased economies of scale might be desirable for many firms, it is doubtful if this is always the case.

A second factor with a bearing on whether an objective of increased economies of scale is always desirable is the risk that such a strategy would instead lead to diseconomies of scale. Diseconomies of scale occur when long run average costs rise as the scale of output increases. While technical economies and so on may still be operating, these may now more than offset by difficulties with administration, communication, coordination and motivation. This may be especially so where the scale of output has increased because firms have merged (amicably) or where there has been a takeover as for British American Tobacco and Reynolds. In this case, different corporate cultures can increase the probability of diseconomies of scale arising. Firms may overestimate the likelihood of experiencing economies of scale and underestimate the risk of diseconomies of scale as an example of optimism bias. In industries where there is constant return to scale over large output ranges, the risk will be lower. In this reason why it is doubtful that having an objective of economies of scale is always desirable.

A final factor to be considered is the likely response of other market participants and the competition authorities. Unless total market size is growing (which it is not for tobacco), such a strategy would mean the firm increases the probability of it gaining a larger market share. This is not the only factor to be considered by competition authorities, but it increases the chances of their intervention. The costs and time associated with an investigation, even if there is no further action, is also likely that other market participants will respond, perhaps aggressively, which could also damage the market share of any economies of scale. Where there are significant, the market is likely to be concentrated, decisions of the firms concerned will be interconnected. While game theory throws light on the possible consequences, uncertainty would be significant. While there is evidence of some large businesses pursuing a maximum growth strategy – such as Amazon – it is not sufficiently widespread to provide compelling evidence that having a business objective of increased economies of scale is always desirable.

To claim that having a business objective of increased economies of scale is always desirable would require both robust theoretical evidence in support, together with numerous and credible real world examples of success. While there are some, there are equally compelling arguments against. The number of mergers that take place which fail to produce the expected results is a common argument. For many firms a business objective of increased economies of scale may well be desirable, but it not possible to conclude on the basis of arguments provided that it is always so.
During 2016, the UK’s Competition and Markets Authority conducted an investigation into allegations of cartel activity amongst UK furniture makers. In 2017, two companies – Thomas Armstrong Ltd and Hoffman Thornwood Ltd – were fined £2.8m for fixing prices in the drawer-making industry. The CMA reported that a third company, BHK Ltd, had confessed to cartel activity shortly after the investigation began and would therefore not face fines. Evaluate the view that industry fines are the best way to tackle collusion in oligopolistic markets.

An oligopoly is an imperfect market structure characterised by a high level of concentration. Decisions taken by firms in oligopolistic markets are interdependent, and there may be a strong incentive to collude. A cartel is a formal agreement to collude. This essay will consider three options for tackling such industry conduct: first – do nothing; second, impose a regulatory structure backed by fines, and finally, take measures to reduce the incentives and ability to abuse monopoly power.

Firstly, one option open to competition authorities is to do nothing. Firms in an oligopoly have a strong incentive to reduce the uncertainty inherent in this market structure, by attempting to reach agreements with other firms. This could be agreement on price, output, supplying geographical areas, or who will bid for certain contracts. If the deal holds, the oligopoly essentially becomes a monopoly and a firm with considerable market power because it covers virtually the whole industry. The diagram to the left illustrates these outcomes. The effective monopoly restricts output to Qmon to maximise profit. The associated price Pmon is considerably above the perfectly competitive market price PPC. There is a welfare loss and in static efficiency terms, the outcome is productively and allocatively inefficient. This suggests a case for measures of some sort from the competition authorities, and that deciding not to intervene is not an option.

However, this depends on what the collusion is set out to achieve. Some agreements in oligopoly markets do not have anti-competitive intentions, but aim to achieve benefits from economies of scale e.g. the airline alliances or the various R&D initiatives undertaken in industries such as car manufacturing (e.g. driverless cars and improved vehicle safety). Even when the intention is anti-competitive, it is essential to consider whether the resulting economies of scale or dynamic efficiencies lead to better long run outcomes for consumers. It is also possible that collusive agreements will fail without any intervention. Game theory, especially the Prisoners’ Dilemma game, provides an explanation of why collusion is such a fragile process. While there are strong incentives to collude, the key concepts introduced in the question are described / defined – this is a good and safe way to start.

The student has made the ‘right call’ here in terms of not including a payoff matrix – if this was a homework.
in the first place, there are arguably even stronger incentives to renege on the deal. However, in this case, the cartel among UK furniture manufacturers was intended to be anti-competitive. It is hard to see what possible economies of scale or dynamic efficiencies could result in this case. Here, some means of tackling collusion was necessary.

One means of addressing collusive behaviour used here is an industry fine. The Competition and Markets Authority (CMA) is the government agency in the UK responsible for advising on and implementing competition policy. The CMA uses structure, conduct and performance indicators to assess whether features of the market or behaviour of firms prevent, restrict or distort competition. When the anti-competitive behaviour has already occurred, as was the case with the furniture industry, it is difficult to see what other alternative to fines was available. Since cartels are most definitely illegal, decisive action was necessary. Fines seem to work particularly well when accompanied by a policy of amnesty for the whistle-blower. This reduces the resources that needs to allocate to industry surveillance and investigation and also increases the chances that the collusive agreement will fail, since the incentives to be the first to confess are large. In order for this policy to be effective, the fines need to be sizeable relative to the expected revenue or profits from the anti-competitive behaviour; if fines are too large, then it can drive businesses and make markets even more concentrated (a source of government failure). If this is the case, with clear-cut examples such as price-fixing cartels, or the threat of fines offer a reasonable solution.

Perhaps a more efficient allocation of resources could be achieved if anti-competitive collusion could be avoided in the first place by limiting mergers and promoting contestability. Whilst takeovers may result in economies of scale, it also leads to a more concentrated market and greater monopoly power. Cartels are investigated if they are expected to lead to a substantial reduction in competition. The less concentrated the market, the weaker the incentives to collude. Therefore, preventing mergers would pre-empt the risk of collusion. Similarly, though, few mergers have been blocked by the CMA, including the case of the recent Poundland/ 99P Store merger, caused by investigation were cited as a reason for the resulting poor outcome of apparent diseconomies of scale. One promising might be a policy of increasing market contestability. A contestable market is where low barriers to entry (including sunk cost) allows new entrants to incumbent firms are earning abnormal profit and the threat of entry leads to profits being closer to normal levels. Greater contestability is sometimes achieved via technological progress (as with the telecoms industry) or via government de-regulation (as with airline and regional buses). It is difficult to see how this would have been possible in the case of furniture manufacturers, but generally the policy of increasing contestability has been successful in reducing collusion.

In conclusion, the UK furniture market cartel offers an example of a situation where industry fines would be the best way to tackle collusion in oligopolistic markets. However, there are many actual or potential situations requiring a more sophisticated approach, in part to limit the scope of anti-competitive behaviour and also to recognise that sometimes collusion benefits. With some certainty, it may be concluded that industry fines are not the best way to tackle collusion in oligopolistic markets.
In January 2016, the makers of Ray-Ban sunglasses, Luxottica, agreed a merger with a rival eye-wear firm, Essilor, worth €46bn. Evaluate the likely advantages and disadvantages for businesses growing in this way.

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