

Chapter 1: Introduction

What Is Managerial Economics



1.1 What Is Managerial Economics?

The concept of Managerial Economics applies principles of economic theory and methods to business and administrative decision making. It prescribes rules for improving managerial decisions and also helps managers recognize how economic forces affect organizations and describe the economic consequences of managerial behavior. It links traditional economics with the decision sciences to develop vital tools for managerial decision – making, managerial economics identifies ways to efficiently achieve both business profit and nonprofit goals.

Therefore, managerial economics is relevant to the management of nonbusiness, nonprofit organization such as government agencies, cooperatives, schools, hospitals, museums, and similar institutions. However, this training material focuses primarily on business applications.

Goals of the Firm



1.2 Goals of the Firm

To predict what any firm will do under specific conditions, some sort of assumption must be made about its goals. Managerial Economists assume that the central goal of firms is to maximize economic profit.

$$\text{Economic Profit (EP)} = \text{Total Revenue (TR)} - \text{Total cost (TC)}$$

..... (1)

$$\begin{aligned} \text{Total Revenue} &= (\text{Quantities sold}) (\text{Market Price per unit}) - \text{Total} \\ \text{Cost} &= \text{Explicit cost} + \text{Implicate cost} \end{aligned}$$

..... (2)

Explicit Cost (*Accounting cost*) is the out of pocket paid money to hire labor, purchase raw material; power...etc. **implicit cost** is the unpaid opportunity cost. **Economic profit** is defined as the difference between total revenue and total cost where total cost includes all cost; both explicit and implicit The definition is significantly different from the one used by accountants known as accounting profit or business profit it does not subtract implicit cost (opportunity cost) from total revenue

Therefore:

$$\text{Accounting profit} = \text{Total Revenue} - \text{Explicit Cost} \quad \text{..... (3)}$$

$$\text{Economic Profit} = \text{Total Revenue} - (\text{Accounting cost} + \text{Economic Cost including normal profit}) \dots\dots\dots (4)$$

Managerial Decision-Making Model

1.3 Managerial Decision – Making Model

The management decision-making model is called the "Theory of the Firm". In its simplest version, the firm is thought to have profit maximization as its primary goal, the Firm's owner – manager goal is assumed to be working to maximize firm's profit in the short run. Today the emphasis on profit has been broadened to encompass uncertainty and the time value of money. In this more complete model, the primary goal of the firm is long-term expected value maximization that means the maximization of the value of the firm, as shown in Figure 1.1.

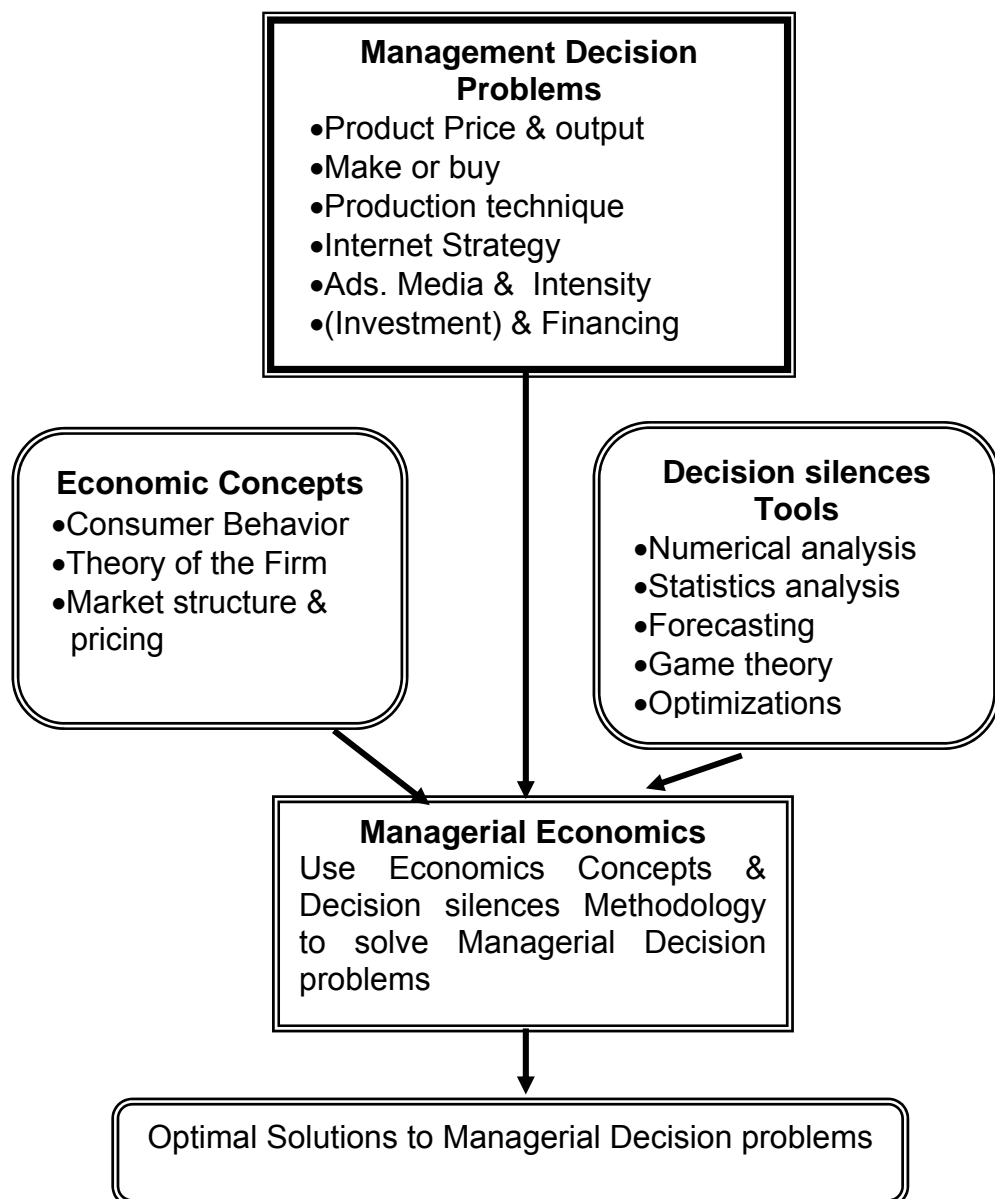


Figure 1.1: Decision-making model

The value of the firm

The value of the Firm

It is the present value of the expected future net cash flows (profits) discounted by the appropriate interest rate.

$$\text{Value of the firm (VF)} = \frac{II_1}{(1+i)} + \frac{II_2}{(1+i)^2} + \dots + \frac{II_N}{(1+i)^N} \dots\dots (5)$$

$$= \sum_{T=1}^N \frac{N \Pi_T}{(I+i)^t} \dots\dots\dots N \dots\dots\dots (6)$$

Where: (Π₁) is expected annual future profit as equal expected future net cash flows. (t) = Number of years & (i) is the discount rate.

To better understand the origins of economic profit, it is necessary to examine related theories and models. Economic profit could be generated by unanticipated changes in demand or cost conditions, (Frictional Model), monopoly power due to barriers to entry in t limit competition, (monopoly Model) innovation protected by patent rights, (Innovation Model) or as a reward for efficiency, compensatory Model).

The Role of Profit

1.4 The Role of Profit



Numerous challenges have been raised to the profit maximization assumption. Some critics say that firm's goal is to maximize its chances of survival others believe that it aims at maximizing profit or / and creating more employment opportunities. Total sales and some economist even claim that firms do not try to maximize any thing at all. However it is reasonable to say that a firm does not always pursue profit maximization at the expense of all other alternative goals. Therefore, his issue still remains an empirical question. In this respect, some empirical researches show that vigorous competition in markets typically forces managers to seek firm's value maximization in their decision making. Also, none of the alternative business goals can substitute the basic long-run value maximization model as a foundation for analyzing managerial decision.

Role of Profit Maximization



Role of Profit Maximization

The rule of profit maximization can be summarized as:

- Managers seeking profit maximization could **enhance firm's capacity** to compete vigorously in highly competitive markets.
- It plays a vital role in **providing incentives for innovation** and productive efficiency.
- **Stockholders are, of course, interested in profit maximization** because it affects their rate of return on their capital share.

- **Managers could maintain their position and financial benefits in the firm** as long as they pursue profit maximization and stockholders interest.
- **Smart manager could seek profit maximization to avoid recent phenomenon** of buyout pressures from unfriendly firms (raiders) with the possibility of being replaced when takeover occurs.
- The value maximization model also **offers insight into firm's voluntary social responsibilities** and plays a role in achieving fair distribution of income, and also through improving efficiency.

Alternative
Objectives of
Firm



1.5 Alternative Objectives of Firm

Some critics' question **why value maximization criterion is used as a foundation for studying firm behavior?** Do managers always seek to optimize best results or merely achieve satisfactory rather than optimal results? It is impossible to give definitive answers to such difficult questions. This dilemma has lead to the development of alternative models of firm behavior.

Some of the more prominent alternatives are models in which firm size or growth maximization is the assumed primary objective of management. There are other models that argue that managers are most concerned with the own personal utility or welfare maximization, Models that treat the firm as a collection of individuals with widely divergent goals rather than as a single identifiable unit are aiming at maximizing stockholders benefits.

These alternative models of managerial behavior have added to our understanding of the firm objective. However, none of them can substitute completely for the basic long-run value maximization model.