I. Demand and Cost Analysis

A. The Nature and Scope of Managerial Economics

Managerial economics – application of economic theory and the tools of analysis of decision sciences to examine how an organization can achieve its aims or objectives most efficiently

1. Decision making process

a. Define the problem

b. Determine the objective

c. Identify possible solutions

d. Select the best possible solution

e. Implement the decision

2. Theory of the firm

* Assume objective of the firm is to maximize value
* Principal-agent problem – agents may seek to maximize their own benefits rather than the benefits of the principals
* Satisficing behavior – managers may not be able to maximize profits but can achieve only satisfactory goals

3. Nature and function of profits

a. Business (accounting) vs. economic profit

* Explicit costs – out-of-pocket costs
* Implicit costs – includes opportunity costs

b. Theories of profit

(1) Risk-bearing theories

* Economic profits needed to encourage activity in areas of above-normal risk

(2) Frictional theory

* Profits result from friction or disturbances from long-run equilibrium

(3) Monopoly theory

* Profits result from monopoly power

(4) Innovation theory

* Profit is the reward for successful innovation

(5) Managerial efficiency theory of profit

* More efficient firms earn profits

c. Function of profit

* Provide signals about what consumers want and don’t want

4. Business ethics

* Source of guidance beyond enforceable law
* Proscribe behavior that entities should not engage in
* Many firms have established codes of conduct
* Still have problems

Ex. – Nestle, Nike, Enron, 2007 financial crisis

* Some people want companies to have a social conscience

5. Other considerations

a. International framework

* More globalization of economic activity

b. Risk and crisis

* Global economy more risky and crisis-prone