

# MANAGERIAL ECONOMICS

## WITH APPLICATIONS

Marilu Hurt McCarty



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## Preface

For many business managers of the coming generation, a course in managerial economics can be the capstone that integrates and actualizes the substance of their business education. Few of the texts now in use achieve this objective. Their theoretical sophistication places them beyond the interests and abilities of many students and their focus on mathematical derivations reduces their practicality. At the same time, the increasing computational capabilities of business managers make the concepts and procedures of managerial economics even more essential and more accessible than ever before.

This text is intended to bridge the gap between academic procedures and managerial practice. It places microeconomic theory and tools in a setting of accounting, statistics, and finance to illustrate the combined use of these techniques in real-world situations. The writing style is low-key. Calculus is used on occasion, but is thoroughly explained by a parallel stress on economic intuition. (Also, there is an appendix to Chapter 1 that covers the basic techniques and notation of the necessary calculus.) Theoretical explanations are clear, and essential mathematical procedures are developed carefully and simply. The final chapters draw together concepts and procedures from throughout the text into an integrated decision-making process.

This text stresses, perhaps more than other texts in this field:

1. An abundance of real-world boxed examples and numerical case studies,
2. In-depth coverage of core topics such as production costs and product market theory,
3. Complete chapter coverage of topics such as business uncertainty, international business, location theory, and non-profit firms,
4. Research examples throughout, providing examples of the most recent findings and their application to managerial economics, and
5. Several end-of-chapter appendices, providing either optional review material or extensive technical coverage of a topic.

The student should be aware that there is an inexpensive, accompanying IBM microcomputer simulation game in managerial economics and a problems-oriented student workbook, both authored by John Conant of Indiana State University.

This text has benefited from an extensive review process, during which the author responded to all reviewer suggestions consistent with the book's fundamental objective and emphasis. The objective is to integrate economic theory with business practice in such a way that theory is seen to be a useful guide to thinking. The emphasis is on decisions: the development of scientific patterns of thought, including the use of mathematical procedures for modelling significant business relationships and planning strategic policy.

The organization of topics is clear and well developed, with a unifying theme throughout and with easy transitions from chapter to chapter and from topic to topic within chapters. The unifying theme involves the inevitability of technical, human, and/or organizational changes, which call for new business strategy and require scientific analysis of business conditions.

Chapter 1 introduces students to the goals of the text, significant definitions, and procedures for building economic models. The appendix to Chapter 1 reviews differential and integral calculus and the use of LaGrangian multipliers. Chapters 2–4 develop the theory of consumer demand, including the determinants of demand, regression analysis to estimate demand, and econometric forecasting to project demand. Chapters 5–9 explore the core of production functions and cost curves, the use of break-even analysis and isoquants for making production decisions, consideration of long-run economies of scale and industry structure, and a demonstration of linear and geometric programming.

Chapters 10 and 11 concentrate on price policy as it relates to industry structure, including the significance of demand elasticity, firm interdependence, multi-product firms, and advertising. Chapters 12–14 develop topics related to long-term capital investment, including the time value of money and internal rate of return, the cost of capital, and risk and uncertainty in planning investments.

Chapters 15–18 include material new to many courses in managerial economics: the relevance of government regulation for managerial decisions, production decisions in not-for-profit firms, the economic theory of location, and managerial decisions in international business. Each of these final chapters reviews concepts and procedures explained in previous chapters and serves as final evidence of the useful integration of theory and practice.

Text chapters include examples, case studies, and exercises illustrating concrete and significant managerial problems. Some examples of these applications are: "Competition Comes to the Airlines," "Kaiser Aluminum Deals with Risk and Uncertainty," "The Rise of the Sunbelt," "Breaking Even in Farming," "Measuring Elasticity of Demand for Electricity," "Extracting Chemicals from Vegetable Oil," "Linear Programming for Managing a Bank's Portfolio," "Market Strategy in Inflation," "Scale Economies and Concentration in U.S. Industries," "Choosing Between Investments with Different Eco-

conomic Lives,” “Corporate Contributions,” “Changing Costs with Changes in Plant Utilization,” and “Choosing Technology for a Foreign Enterprise.”

The positioning of examples and case studies within each chapter is in keeping with the author’s belief that students of complex material need to pause occasionally to reflect on, to apply, and to evaluate material they have read. Nevertheless, these sections are set off so that they can be omitted. Both examples and case studies include thought-provoking questions and exercises, which appear also at the end of each chapter. Suggested answers to selected questions are provided at the end of the text.

The ideas presented in the numerous pedagogical aids help ensure that the reader does not lose track of the book’s base in economic theory. The accompanying instructor’s manual includes a variety of problem sets, providing ample opportunity for practice in the use of mathematical procedures explained in the text.

This textbook is relatively comprehensive and, therefore, lengthy. The decision to include significant amounts of new material was made with the expectation that instructors may be selective in their coverage. For a basic course, the appropriate chapters to cover would be Chapters 1–14, with the possible omission of Chapter 9 (Linear and Geometric Programming) and the possible addition of Chapter 15 (Government and Business). For students with extensive background in finance and statistics, the appropriate chapters would be Chapters 1–11 and Chapters 15–18.

In summary, the text represents a judicious blend of current mainstream thinking with a dash of the new. The base in economic theory is obvious throughout, but the clear intention is to apply the theory in the making of routine and periodical managerial decisions. The approach is contemporary, informative, and interesting and will motivate students to explore the ideas presented further in the business press.

Marilu Hurt McCarty

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# Table of Contents

<b>CHAPTER 1</b>	<b>An Introduction to Managerial Economics</b>	<b>1</b>
	<b>What Is Managerial Economics?</b>	<b>3</b>
	Managerial Economics and Microeconomic Theory	Scientific Decision Making
	Economic Models	
	<b>Managerial Analysis and Marginal Changes</b>	<b>14</b>
	Determining the Zero-Profit Quantity of Output	Determining the Profit-Maximizing Quantity of Output
	<b>A Look Back</b>	<b>18</b>
	<b>A Look Ahead</b>	<b>20</b>
	<b>Case Study 1.1</b> Box Stores: Responding to Change in Food Retailing	<b>4</b>
	<b>Example 1.1</b> Constructing an Economic Model	<b>12</b>
	<b>Case Study 1.2</b> The “Graying” of America	<b>21</b>
<b>APPENDIX 1A</b>	<b>A Review of Differential and Integral Calculus</b>	<b>25</b>
	<b>The Rules of Differential Calculus</b>	<b>27</b>
	Using Derivatives to Locate the Profit-Maximizing Quantity of Output	
	Partial Differentiation	Constrained Optimization Using LaGrangian Multipliers
	<b>Integral Calculus</b>	<b>35</b>
<b>CHAPTER 2</b>	<b>The Theory of Consumer Demand</b>	<b>42</b>
	<b>Purchasing Decisions</b>	<b>43</b>
	Total and Marginal Utility	

	<b>An “Ordinal” Theory of Demand: Indifference Curves</b>	<b>45</b>
	The Budget Line    The Income-Expansion Path	
	<b>Other Factors that Influence Consumer Purchases</b>	<b>59</b>
	Changes in Tastes    Changes in the Availability of Other Goods: Substitutes and Complements	
	<b>A Consumer Demand Curve</b>	<b>61</b>
	<b>Changes in Quantity Demanded</b>	<b>67</b>
	<b>Changes in Demand</b>	<b>68</b>
	<b>KFC Revisited</b>	<b>69</b>
	<b>Example 2.1</b> Using Least-Squares Regression to Estimate the Parameters of a Linear Demand Equation	64
<b>CHAPTER 3</b>	<b>Estimating Demand and Constructing a Demand Curve</b>	<b>73</b>
	<b>A Review of the Factors that Determine Demand</b>	<b>73</b>
	<b>Price Elasticity of Demand</b>	<b>75</b>
	Price Elasticity and Total Revenue    Computing Price Elasticity	
	<b>Changes in Demand</b>	<b>83</b>
	Income Changes and Changes in Demand    Computing Income Elasticity Using Cross-Sectional Data    Including Income in the Demand Function    Changes in Taste and Changes in Demand    Changes in the Prices and Availability of Other Goods and Services	
	<b>Applying the Model of Consumer Demand to Managerial Decision Making</b>	<b>96</b>
	<b>Case Study 3.1</b> Income Elasticities for Selected Goods	89
	<b>Case Study 3.2</b> Demand Elasticities Nationwide	89
	<b>Case Study 3.3</b> Cross Price Elasticity of Demand for Motor Vehicles Relative to the Price of Fuel	96
	<b>Case Study 3.4</b> Measuring Elasticity of Demand for Electricity	100
	<b>Case Study 3.5</b> A Real-World Problem in Consumer Demand	100
<b>APPENDIX 3A</b>	<b>Multiple-Linear Regression Using Least-Squares</b>	<b>107</b>
<b>APPENDIX 3B</b>	<b>Least-Squares Regression for Estimating a Multiplicative Function</b>	<b>110</b>
<b>CHAPTER 4</b>	<b>Forecasting Sales</b>	<b>113</b>
	<b>Macroeconomic Models</b>	<b>114</b>
	Forecasting Business Activity	



	<b>Indicators of Economic Activity</b>	<b>116</b>
	<b>Time Series Analysis</b>	<b>122</b>
	Estimating the Seasonal Factor	Estimating Trend
	Isolating Cyclical Variation	Forecasting Sales
	<b>Exponential Smoothing</b>	<b>134</b>
	A Closing Note	
	<b>Case Study 4.1</b>	Projecting Automobile Sales 117
	<b>Case Study 4.2</b>	An Analytical Model of the Housing Industry 119
	<b>Case Study 4.3</b>	An Indicator of Consumer Sentiment 123
	<b>Case Study 4.4</b>	Forecasting Sales of Productive Equipment 135
	<b>Case Study 4.5</b>	Time Series Analysis of Profit Trends Since World War II 137
<b>APPENDIX 4A</b>	<b>Recent Results of Macroeconomic Forecasts</b>	<b>145</b>
<b>CHAPTER 5</b>	<b>Production Theory</b>	<b>147</b>
	<b>Resources for the Short Run and the Long Run</b>	<b>148</b>
	<b>Production Functions</b>	<b>149</b>
	Some Characteristics of Production Functions	The Form of a Production Function
	<b>Production Functions with Two Variable Resources</b>	<b>161</b>
	Power Functions of More than One Variable Resource	The Elasticity of Production
	<b>Example 5.1</b>	Estimating the Parameters of Linear and Curvilinear Production Functions 162
	<b>Case Study 5.1</b>	Extracting Chemicals from Vegetable Oil 168
	<b>Case Study 5.2</b>	A Production Function for the Nation 170
<b>CHAPTER 6</b>	<b>Costs of Production and Supply in the Short Run</b>	<b>175</b>
	<b>Production Functions and Economic Costs</b>	<b>175</b>
	Production Costs in the Short Run	The Relevant Range of Plant Operation in the Short Run
	<b>Determining the Profit-Maximizing Quantity in the Short Run</b>	<b>188</b>
	Determining Economic Profit in the Short Run	The Shut-Down Point in the Short Run
	<b>Break-Even Analysis</b>	<b>198</b>
	<b>Break-Even Analysis for Non-Linear Costs</b>	<b>203</b>
	<b>Case Study 6.1</b>	Competition Comes to the Airlines 176
	<b>Case Study 6.2</b>	Reducing Quantity of Output When Demand Declines 195

<b>Example 6.1</b>	Using Quadratic Equations to Plan Production	195
<b>Example 6.2</b>	Evaluating a Firm's Profit Position	204
<b>Case Study 6.3</b>	Breaking Even in Farming	205
<b>Case Study 6.4</b>	Break-Even as a Percentage of Plant Capacity	206
<b>Example 6.3</b>	Degree of Operating Leverage and Production of Joint Products	207

## CHAPTER 7

### Planning Production in the Long Run 215

#### The Production Surface 216

Scale Effects in the Long Run    Some Explanations for the Effects of Scale    Scale Effects and Marginal Product

#### Isoquants 220

Isoquants and the Effects of Scale    Constructing an Isoquant

#### Using Isoquants to Plan Lowest-Cost Production 225

The Ratio of Marginal Products    The Ratio of Resource Costs    The Lowest-Cost Combination    Changing the Parameters

#### Determining Maximum Output with a Cost Constraint 232

#### A Firm's Long-Run Expansion Path 235

#### Returns to Scale and Costs of Production in the Long Run 236

#### Long-Run Average Costs 237

Long-Run Average Cost and the Scale of Plant

#### Example 7.1 Making Production Decisions Using a LaGrangian Multiplier 234

#### Example 7.2 Using Production Data to Describe the Effects of Scale 241

#### Example 7.3 Using Short-Run Data for Making Long-Run Plans 242

#### Example 7.4 Deriving a Long-Run Cost Curve 242

## CHAPTER 8

### Long-Run Competitive Equilibrium and Long-Run Supply 251

#### From the Short Run to the Long Run in Competition 252

Scale Adjustments in the Long Run    Scale Effects and Industry Structure

#### The Long-Run Industry Supply Curve in Competition 263

External Economies and Diseconomies    Elasticity of Supply

#### Learning Curves 267

#### Case Study 8.1 The Air Travel Industry Approaches Long-Run Competitive Equilibrium 253

#### Case Study 8.2 Returns to Scale and Competition in U.S. Industry 260

#### Case Study 8.3 Scale Effects in the Life Insurance Industry 261

#### Case Study 8.4 Economies of Scale in the Automobile Industry 270

<b>CHAPTER 9</b>	<b>Linear and Geometric Programming</b>	<b>275</b>
	<b>Choosing the Optimum Product-Mix for Achieving Maximum Profit</b>	<b>276</b>
	Defining the Problem   Graphing the Constraints   The Objective Function   The Corners   Total Profit   Interpreting the Slack Variables	
	<b>Choosing the Lowest-Cost Combination of Resources</b>	<b>284</b>
	The Solution	
	<b>Shadow Pricing and the Dual</b>	<b>290</b>
	<b>Solving the Dual</b>	<b>292</b>
	<b>A More Advanced Decision Model: Geometric Programming</b>	<b>301</b>
	<b>Example 9.1</b> Maximizing Profit at a Publishing Company	285
	<b>Case Study 9.1</b> Linear Programming for Managing a Bank's Portfolio	294
	<b>Case Study 9.2</b> Solving a Non-Linear Problem	297
	<b>Example 9.2</b> Linear Programming Problems in Transportation	298
	<b>Example 9.3</b> A Geometric Programming Problem Containing Three Variables	307
 <b>CHAPTER 10</b>	 <b>Price Policy and Market Power</b>	 <b>314</b>
	<b>Price and Market Structure</b>	<b>314</b>
	Market Structure and the Demand Curve   Using Price Elasticity of Demand to Set Price   Price Discrimination   Mark-Up Pricing	
	<b>Break-Even Analysis for a Monopolistic Firm</b>	<b>322</b>
	Profit-Maximization Through Optimization   Break-Even Analysis Using a Quadratic Cost Equation   Optimization	
	<b>Long-Run Cost Curves in Monopoly</b>	<b>330</b>
	Natural Monopolies   Artificial Monopolies   Alternative Pricing Policies for Natural Monopolies	
	<b>Transfer Pricing in a Vertically Integrated Firm</b>	<b>335</b>
	<b>Example 10.1</b> Mark-up Pricing for a Transportation Firm	323
	<b>Example 10.2</b> Price Discrimination by an Electric Utility	334
 <b>CHAPTER 11</b>	 <b>Price and Output Decisions in Oligopoly and Monopolistic Competition</b>	 <b>339</b>
	<b>Oligopoly</b>	<b>340</b>
	Price and Quantity Decisions in Oligopoly: Duopoly   The Kinked Demand Curve   Price Leadership   Cross Elasticity of Demand: Substitutes   Multi-Product Decisions   Price and Quantity Decisions for the Multi-Product Firm   Joint Products	

	<b>Monopolistic Competition</b>	<b>353</b>
	Advertising	
	Positioning	361
	Case Study 11.1 An Oligopoly (Finally) Faces up to Change	345
	Case Study 11.2 Estimating the Effects of Advertising Expenditures	356
	Example 11.1 A Microeconomic Model of Advertising Expenditures in Monopolistic Competition	357
	Example 11.2 Planning Advertising Through Linear Programming	359
	Case Study 11.3 Changing Market Structures in Telephone Communications	362
<b>CHAPTER 12</b>	<b>Evaluating Investment Proposals</b>	<b>366</b>
	Cash Flow and Profit	368
	The Time Value of Money	370
	The Internal Rate of Return	373
	The Marginal Efficiency of Investment	374
	Present Value and Net Present Value	376
	Comparing Internal Rate of Return and Net Present Value	377
	Evaluating the Effects of Inflation on Investments	382
	Other Methods of Evaluating Investment Proposals	384
	The Profitability Index   Average Rate of Return   Pay-Back Period	
	Present Value of an Infinite Income Stream	388
	Another Look at Sears	390
	Case Study 12.1 Sears Shifts Gears	367
	Example 12.1 Calculating Depreciation Expense	378
	Example 12.2 Using Present Value Tables	386
	Case Study 12.2 Choosing Between Investments with Economic Lives of Varying Lengths	391
<b>CHAPTER 13</b>	<b>Financing Investment Projects: The Cost of Capital</b>	<b>397</b>
	The Market for Investment Capital	399
	The Investment Decision	404
	Using Internal Funds for Investment	408
	Sinking Funds   Equal Contribution Every Year   Annual Payments on a Mortgage	
	A Summary	412
	Case Study 13.1 Ensuring an Adequate Supply of Electric Power	398
	Case Study 13.2 Choosing a Financing Strategy	407

Case Study 13.3 Varying Pension Fund Contributions to Minimize Costs 413

<b>CHAPTER 14</b>	<b>Planning for Uncertain Outcomes</b>	<b>419</b>
	Risk Versus Uncertainty	421
	Risk	422
	Computing and Using Expected Value	Using Probability Distributions
	Conditional Probability	431
	Decision Trees	434
	Adjusting the Discount Factor for Risk	440
	Uncertainty	444
	Case Study 14.1 Kaiser Aluminum Deals with Risk and Uncertainty	420
	Example 14.1 Assessing Probabilities by Using the Normal Distribution	427
	Example 14.2 Using a Decision Tree to Plan Investment	438
	Case Study 14.2 Varying Capital Costs Within a Single Firm	441
	Case Study 14.3 Adjusting the Rate of Discount for a Multi-Divisional Firm	442
<b>CHAPTER 15</b>	<b>Government and Business</b>	<b>449</b>
	Free Markets and the Goals of Regulation	449
	Production at Levels Less than Efficient Equilibrium	452
	Regulating Imperfect Competition: Natural Monopoly	Regulating Monopoly Conduct
	Resale Price Maintenance Laws	Recent Problems with Antitrust Legislation
	Changes in Regulatory Policy: Natural Monopolies	
	Production at Levels Greater than Efficient Equilibrium	457
	Governmental Intervention in the Health Care Industry	An Evaluation
	The Problem of Externalities	460
	Regulation of Production Standards	Some Recommendations
	Case Study 15.1 Deregulation in the Trucking Industry	457
	Case Study 15.2 The Costs of Regulation	464
<b>CHAPTER 16</b>	<b>Production Decisions in Not-For-Profit Firms</b>	<b>468</b>
	Collective Goods and Services	469
	Demand for Collective Goods and Services	Consumer Surplus and the Entry of Private Firms
	Equilibrium in the Market for Collective Goods and Services	Income Elasticity of Demand and Demand for Collective Goods

	<b>Some Comparisons Between For-Profit and Not-For-Profit Firms</b>	<b>472</b>
	The Consequences	
	<b>Cost Effectiveness Through Linear Programming</b>	<b>475</b>
	The Solution    A Change In Resource Price	
	<b>Optimization to Minimize the Public Subsidy</b>	<b>479</b>
	A Sample Problem    Deciding Quantity and Price    Increasing Demand to Reduce Economic Loss	
	<b>Returns to Scale and the Not-For-Profit Firm</b>	<b>486</b>
	Sources of Increasing (and Decreasing) Returns to Scale	
	<b>Maximizing Output with a Budget Constraint</b>	<b>488</b>
	<b>The Economic Impact of Not-for-Profit Firms</b>	<b>491</b>
	<b>Conclusion</b>	<b>492</b>
	<b>Case Study 16.1 Corporate Contributions</b>	<b>493</b>
<b>CHAPTER 17</b>	<b>Managerial Economics and the Theory of Location</b>	<b>498</b>
	<b>The Theory of Location</b>	<b>498</b>
	<b>Scale Economies and Location</b>	<b>500</b>
	External Economies and Agglomeration    Scale Economies and Competition    External Economies and Alternative Technology	
	<b>Transportation Costs</b>	<b>508</b>
	Price Discrimination in Transportation Charges	
	<b>Transportation Charges and Industrial Location</b>	<b>510</b>
	Locational Decisions with More Than One Resource Input	
	<b>The Spatial Distribution of Economic Activity</b>	<b>515</b>
	<b>Case Study 17.1 The Rise of the Sunbelt</b>	<b>499</b>
	<b>Example 17.1 Space Cost Curves and Government Policy</b>	<b>514</b>
	<b>Case Study 17.2 Locational Trends: A Recap</b>	<b>516</b>
<b>CHAPTER 18</b>	<b>Topics in International Business</b>	<b>520</b>
	<b>Exchange Rates</b>	<b>521</b>
	Changes in Exchange Rates    Exchange Rates and Price Elasticity of De- mand for Traded Goods    Currency Appreciation    Recent Behavior of Exchange Rates	
	<b>Exchange Rates and Financial Markets</b>	<b>527</b>
	<b>Direct Foreign Investment</b>	<b>535</b>
	Measuring the Risk of Foreign Investment    Transfer Pricing in a Multi- national Firm	

<b>The Structure of a Multinational Enterprise</b>	<b>539</b>
Financial Structure of a Multinational Enterprise	
<b>Case Study 18.1</b> Exchange Rates and Pass-Through Pricing	528
<b>Case Study 18.2</b> Borrowing Foreign Currencies	530
<b>Example 18.1</b> Hedging and Arbitrage in Foreign Exchange Markets	533
<b>Case Study 18.3</b> Using Foreign Earnings Profitably	539
<b>Example 18.2</b> Choosing Technology for a Foreign Enterprise	541

**SOLUTIONS TO SELECTED EXERCISES      546**

**INDEX                      575**

## An Introduction to Managerial Economics

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Defining the role of a manager is both difficult and quite easy—*difficult* in the sense that a manager's responsibilities range over many varied and complex activities and *easy* in that the important activities can be summed up in one simple phrase. Simply stated, the role of a manager is to make decisions.

Far more than giving orders, evaluating performance, and distributing rewards, the manager's job is to answer important questions. What is to be produced, in what quantities, styles, and models, and for what markets? How should production be carried out, with what resources and technologies, and under what cost conditions? How can the company meet future challenges most effectively, allocating its human and material resources to satisfy immediate and long-range goals?

The manager's role is significant for one important reason: *change*. If circumstances remained the same year after year, managerial decisions might be made once and then implemented again and again without re-examination. In an unchanging business environment, organizations could run themselves, and managers would not be needed. By the same token, unless managers anticipate and plan for change, they are of little value to an organization. Change requires management and, in fact, justifies its existence.

The sources of business change may be classified in three ways: **technical**, **human** or **organizational**, and **financial** or **economic**.

**Technical change.** Changes in the techniques of production are the most obvious sources of change. A technological breakthrough in a particular indus-



try brings changes in industrial processes. For example, the development of industrial robots brought significant changes to the U.S. automobile industry. Substituting robots for high-cost labor helped U.S. auto manufacturers cut production costs and compete more effectively with low-cost auto makers abroad. Changes in the availability and costs of raw materials force changes in methods of production. For example, the recent scarcity of petroleum forced changes in the way many firms use energy. Many manufacturing firms in the United States responded to the high price of purchased energy by arranging to “co-generate” their own power.

**Human or organizational change.** Even more complex than technical changes are changes in the human or organizational environment for production and exchange. Changing consumer markets force changes in the kinds of goods produced for sale. Moreover, as the quality and composition of the workforce change, methods of production must change. Today’s better educated workers respond to different sorts of incentives than did workers of the past. They are more concerned about the quality of work life and more eager to participate in business decisions. Many firms have found that using human resources most effectively requires new concepts in business organization, such as quality circles, participatory management, and profit sharing.

**Financial or economic change.** Finally, an important source of change is the financial or economic characteristics of the markets in which firms operate. The availability of financial capital critically affects a firm’s ability to function, as construction firms learned to their dismay in 1980. The high cost of funds for home mortgages that year forced many small home builders out of business. Other manufacturing firms found themselves with unsold inventory, financed at ever-rising short-term interest rates. In addition, consumer markets are notoriously fickle, yielding welcome profits (as was true for Levi Strauss and Company in 1980) or embarrassing losses (as was true for Del Taco, a regional corporation, in the same year).

To deal effectively with change emanating from only one of the sources described above requires extensive management training and experience. Few managers are fortunate enough, however, to encounter only one area of change at a time! In general, managers are constantly bombarded with new circumstances requiring careful thought and decisive action. (Some managers see new circumstances as “problems”; others view them as “opportunities.”)

Making decisions is especially difficult because there is generally no *absolutely* right or wrong answer. Most decisions involve trade-offs among alternative goals. In this respect, the final answer might be described as “optimum”: the best course of action given all the contradictory circumstances facing the decision maker. Suppose, for example, a necessary raw material used in a firm’s operation rises in price. Production costs increase and profits fall. Managers must decide on an appropriate strategy for dealing with the change. What would you do?

1. *Would you raise the price the firm charges for its product?* Raising your product’s price might cause such a drop in sales that revenue from sales falls. Also, producing a smaller volume could mean that the firm’s plant and equip-