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Managerial Economics

Theory, Applications, and Cases

FIFTH EDITION

MANAGERIAL ECONOMICS

Theory, Applications, and Cases
Fifth Edition

Dedication:

To Edwin Mansfield, a pioneer of managerial economics

MANAGERIAL ECONOMICS

Theory, Applications, and Cases, Fifth Edition Edwin Mansfield, W. Bruce Allen, Neil A. Doherty, and Keith Weigelt

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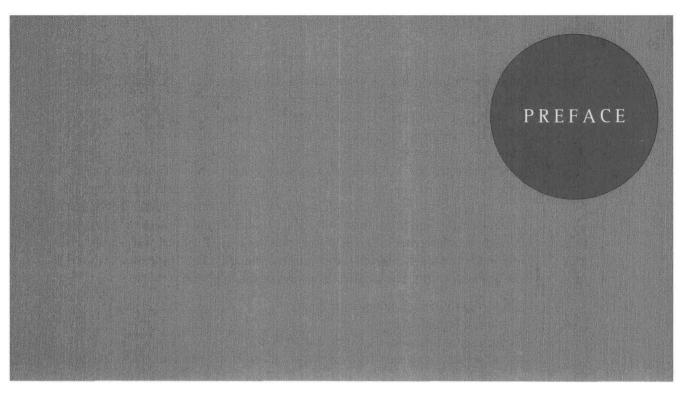
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Recent thought on culture describes it as the process by which knowledge is passed between generations. Most cultures use two devices to learn, teaching and copying, with both being independent of any genetic influences. We've used both in presenting this Fifth Edition of *Managerial Economics*. It is our vision of the future, based on the wisdom of the past.

Succession is an issue many ponder but few act upon timely. It knows no legal bounds, being faced both by families and corporate entities. In the transfer of intellectual property (i.e., ideas), both groups face succession issues. We feel extremely lucky that both the Mansfield family and W. W. Norton acted in a timely manner and fostered the exchange process. We thank both of them for all their helpful advice.

Professor Mansfield was a true pioneer of managerial economics. Before him, most viewed the field as theory with a "wink and nod" link to application. Though this link differentiates managerial from microeconomics, few ventured more than a cursory link to reality. Mansfield's vision changed this by hardwiring theory to practice. Today, this standard still differentiates the two fields. (And, if anything, today's micro textbooks are more applied.) Professor Mansfield instilled each chapter with an actual business situation, and then for good

measure, sprinkled shorter cases throughout the theory. If you needed an example for class, the Mansfield text was a very reliable source.

This pioneering style was likely fueled by his eclectic nature; for only those who integrate ideas across disciplines can marry theory to practice. Professor Mansfield's knowledge covered economics, operations, technology management, and statistics. The three of us joke about how it has taken three to replace what one covered himself-a fact that attests to Ed's breadth of knowledge.

It is upon this legacy that we present the fifth edition. It, like any generational transfer, builds the future on the past. Some things remain the same, others change. Our criteria for justifying changes was whether it helped us better integrate the Mansfield tradition within the changing landscape of what we call the business world. We see five mainstays of this tradition:

- 1. to tightly couple practice to theory;
- 2. to use formal analysis;
- 3. to use mathematics as a tool, not an end:
- 4. to update materials to remain current with the changing business landscape; and
- 5. to listen and learn from the experiences of readers and instructors.

The three of us teach the managerial economics course at The Wharton School. It is required for most MBA students, taken in their first semester. Eight years ago, The Wharton School completely revised its curriculum to better prepare students for the business world. This curriculum change coincided with Wharton's enhanced standing in the rankings of business schools.

Our charge was to develop a class to help students transfer economic principles to the business world, to make economics a decision-making norm (in ten weeks or less), which required impact in both short- and long-term memory. During our six-week run, we could command our share of time and effort as well as any of the other five classes students were taking. So we knew what to expect in the short run. But, what about the long run? When humans process information, they must transfer bytes from short- to long-term memories. Much gets lost in the switch, and that which does never returns unless short-term picks it up again. Ours was the only economics course taken by most students, so our ideas would have to make the switch with seemingly little reinforcing support. In two years, MBA students get bombarded (and often overwhelmed) by millions of information bytes. In school, ideas play the ultimate survivor game you don't just get voted out, you cease to exist.

To make the memory jump to long-term, we felt the course had to accomplish several goals. One was to establish economics as a decision-making framework, to get students to see past the equations and graphs and understand why, as managers, they want to follow its general percepts, like marginal analysis or backward induction. Another message we wanted to convey was the integrative nature of economics-its ideas permeate all business disciplines. So an understanding of economics now will help the student better understand finance and marketing later.

A third goal was to accomplish the above without sacrificing the formal analysis that underlies rational choice. For without it, knowledge is speculative. The objectivity of mathematics brings focus to a business discussion. After all, most managers realize that demand should increase if prices drop, but fewer are able to quantify the sales increase. We wanted to produce managers that could do the latter. Our final goal was to acknowledge that at times managers can be boundedly rational. We wanted to show students how boundedly rational managers might act and help them to understand how behavior is affected.

We kept these four goals in mind in revising this book, and they will direct our future efforts. This edition represents the path we will follow in the future. Though our contributions to this edition are substantial, they represent a beginning toward our goal of producing a book that students use even after they graduate. The most important changes in the Fifth Edition include:

- 1. A New Chapter on Auctions. Recent years have seen an explosion in the use of auctions. New auction businesses like eBay and Priceline.com have attracted millions of customers, and businesses of various sorts have begun to rely on auctions to purchase materials and to buy and sell equipment. More than ever before, modern managers need to know a few things about auctions. How does the design of an auction affect its outcome? What are the best bidding strategies for different types of auctions? How do auctions compare to other types of markets? Such questions are answered in Chapter 15.
- 2. A New Chapter on Moral Hazard and the Principal-Agent Problem. Businesses are driven by incentives. For instance, in the most simple case, classic economic models look at firms as profit maximizers compelled by competition to minimize costs. But this is only part of the story. What about the incentives of employees, managers, and the owners who employ them? Do employees always focus on the economic goals of the firm, or do factors like personal comfort come into play? Or, what if an owner's economic interest in selling her company bumps into the senior manager's desire for job stability? In the real world of business, incentives can become misaligned in countless ways. Chapter 16 looks at two of the most general incentive problems—moral hazard and the principal-agent problem—with applications to executive compensation, conflicts between shareholders and their creditors, and product liability.
- 3. New Cases and Applications. This textbook has long been viewed as the best expression of Edwin Mansfield's special talents as an economist and business consultant. As one who spent a great deal of time applying microeconomics in the business world, Professor Mansfield believed deeply in the power of example. Accordingly, applications have always been used liberally throughout this book. For the Fifth Edition, we have embraced this tradition by introducing a variety of new applications. They are consistently interwoven into

the main body of the text, and they also appear in a variety boxed inserts. Every step of the way, students are presented with economic ideas and their applications and real instances when the ideas at hand have been critical to solving managerial problems. Multiple cases and applications appear in each chapter of the book (see the endpapers). Many of these cases are new or significantly revised in this edition including:

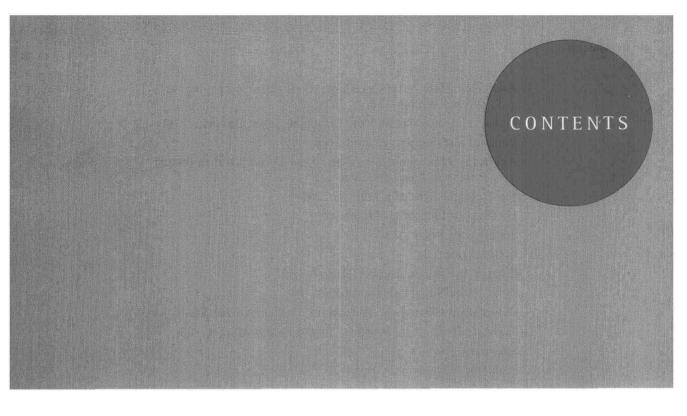
- Shell Gains by Giving Safe-Driving Advice
- Using Patents to Maintain Market Power
- Verizon Local Calling Plans
- Yield Management at American Airlines
- Japan's Tax Man Leans on Foreign Firms
- The Use of Sophisticated Pricing within an Auction Format
- Auction Design at Freemarkets, Inc.
- The Composition of CEO Pay
- Do Directors Act on Behalf of Shareholders or Managers?
- 4. An E-Media Package which addresses the desire of the business student and the need of the business instructor to integrate electronic media into the curriculum. The Fifth Edition comes complete with a power group of electronic ancillaries, including:
 - Spreadsheet Exercises This completely new set of exercises—replacing those offered with the Fourth Edition—is available to qualified adopters free of charge. The exercises consist of 40 Microsoft Excel files. Some of the exercises are tutorial in nature, designed to help students work through various principles and models. Others are set up as labs, suitable for use as homework problems. These exercises have been prepared by Stephen Erfle of Dickinson College.
 - Economics News Server News articles from the New York Times will be e-mailed to a list serve to which students and instructors subscribe. The articles will reach the subscriber as an e-mail message, with a brief opening commentary relating the article to material in the textbook. Approximately two articles will be sent out each week of the academic year.
 - XanEdu Course Pack Edition New for the Fifth Edition, and in partner-ship with XanEdu.Com, Norton will offer a special XanEdu Edition of Managerial Economics (5e). XanEdu.Com, a wing of Proquest Information and Learning, offers electronic course packs for higher education markets, using an archive of articles from thousands of periodicals and content providers. Instructors who order this special edition will provide their students with access to a course pack customized for MEC5. In addition to the specially selected articles, this course pack will include the XanEdu search engine for Proquest's full archive of economics content. Students can search for articles on all sorts of topics related to business and economics.

- **PowerPoint Slides** All the figures in the textbook will be reproduced for PowerPoint and available for download from the book's Internet site.
- 5. **New Four-Color Design.** Along with the book's new emphasis, we introduce a new look. The attractive four-color design of our figures makes it easier for students to understand the relevant concepts. It also signals to teachers that our Fifth Edition warrants a fresh evaluation.

The textbook also continues to be accompanied by the *Study Guide and Case-book*, which for this edition was revised by Thomas Donley of DePaul University, and the *Instructor's Manual and Test-Item File* by Kathryn Nantz of Fairfield University.

Finally, teachers familiar with previous editions will note that two chapters, one on linear programming and another on capital budgeting, have been dropped to make room for new material. Surveys of users of the textbook reported a large majority no longer convering these subjects in their classes. Even so, the chapters from the Fourth Edition are available in electronic form and free of charge to any adopter of the Fifth Edition.

In preparing this Fifth Edition, we benefited from the feedback and suggestions of the following reviewers, survey respondents, and colleagues, to whom we offer our thanks: Sheryl B. Ball, Virginia Polytechnic Institute and State University; Thomas Donley, DePaul University; Stephen Erfle, Dickinson College; Maria Gamba, University of Findley; Susan P. Gilbert, Emory University; Walton Padelford, Union University; Richard Sheehan, Notre Dame University; Robert Stewart, Rutgers University; Ali Tarhouni, University of Washington; Peter Touamnoff, Marquette University; and Chun-sheng Zhou, University of California at Riverside.



PREFACE xix

Part One Introduction 1

Chapter 1

Introduction to Managerial Economics 3

Boeing's Struggle to Retain Market Leadership 4

The Disney Corporation: Expansion of the Magic Kingdom 5

In What Size Production Runs Should Toyota Produce Its Cars? 6

Relationships of Managerial Economics to Other Disciplines 6

The Basic Process of Decision Making 8

The Theory of the Firm 10

The Role of Constraints 12

What Are Profits? 12

Reasons for the Existence of Profit 14

Organizational Factors and "Satisficing" 15

 Analyzing Managerial Decisions: Shell Gains by Giving Safe-Driving Advice 16

Managerial Interests and the Principal-Agent Problem 16 Demand and Supply: A First Look

• Analyzing Managerial Decisions: How Disney Dealt with the Principal-Agent Problem 18

The Demand Side of a Market 20

The Supply Side of a Market 21

Equilibrium Price 23

Actual Price 24

What If the Demand Curve Shifts?

What If the Supply Curve Shifts?

How Russia Glutted the Aluminum Market: A Case Study

• Concepts in Context: Problems in the Potato Market 29 Summary 30

Problems 31

Chapter 2 **Optimization Techniques 37**

Functional Relationships 38

Marginal Analysis 40

Relationships between Total, Marginal, and Average Values 42

The Concept of a Derivative 45

How to Find a Derivative

• Concepts in Context: The Allocation of the TANG Brand Advertising Budget 54

Using Derivatives to Solve Maximization and Minimization Problems 58 Marginal Cost Equals Marginal Revenue and the Calculus of Optimization 62

- Analyzing Managerial Decisions: The Optimal Size of a Nursing Home 63
- Concepts in Context: An Alleged Blunder in the Stealth Bomber's Design Partial Differentiation and the Maximization of Multivariable Functions
- Analyzing Managerial Decisions: The Effects of Advertising on the Sales of TANG 67

Constrained Optimization 68

Lagrangian Multipliers 71

 Consultant's Corner: Planning to Meet Peak Engineering Requirements 73 Comparing Incremental Costs with Incremental Revenues Summary 76

Problems 77

Part Two Demand and Forecasting 81

Chapter 3 Demand Theory 83

Introduction 83

The Market Demand Curve 84

Industry and Firm Demand Functions 88

The Price Elasticity of Demand 90

Point and Arc Elasticities 92

Using the Demand Function to Calculate the Price Elasticity of Demand 93

- Concepts in Context: Fur Demand in Russia 94
 Price Elasticity and Total Money Expenditure 96
 Total Revenue, Marginal Revenue, and Price Elasticity 98
- Analyzing Managerial Decisions: The Demand for Newsprint 100
 Using Price Elasticity of Demand: Application to Phillip Morris 102

Using Price Elasticity of Demand: Public Transit 102

Determinants of the Price Elasticity of Demand 102

Uses of the Price Elasticity of Demand 105

Price Elasticity and Pricing Policy 106

The Income Elasticity of Demand 107

Using the Demand Function to Calculate the Income Elasticity of Demand 109

Cross Elasticities of Demand 110

• Consultant's Corner: Estimating the Demand for Rail Passenger Business by Amtrak 111

The Advertising Elasticity of Demand 113

The Constant-Elasticity Demand Function 113

• Analyzing Managerial Decisions: Price Cutting at the London Times 115 Summary 116

Chapter 4 Consumer Behavior and Rational Choice 123

Indifference Curves 124

117

Problems

The Marginal Rate of Substitution 126

The Concept of Utility 128

The Budget Line 128

The Equilibrium Market Basket 131

• Concepts in Context: Effect of a Time Constraint on Consumer Behavior 133 Maximizing Utility: A Closer Look 134 Corner Solutions 135

Representing the Process of Rational Choice 136

Deriving the Individual Demand Curve 137

Deriving the Market Demand Curve 139

Consumer Surplus 140

Summary 142

• Consultant's Corner: The Trade-off between Risk and Return 143
Problems 144

Chapter 5 Estimating Demand Functions 149

The Identification Problem 150

Consumer Interviews 153

Market Experiments 154

L'eggs: A Market Experiment 154

Regression Analysis 155

Simple Regression Model 157

Sample Regression Line 158

Method of Least Squares 160

Coefficient of Determination 163

Multiple Regression 165

- Consultants Corner: Marketing Plans at the Stafford Company 166
 Software Packages and Computer Printouts 168
- Concepts in Context: How the Japanese Motorcycle Makers Used the Coefficient of Determination 170

Interpreting the Computer Printout 171

- Concepts in Context: Color Balance and Shelf-Life Performance of Polaroid Film 173
- Analyzing Managerial Decisions: How Good Are Ward's Projections of Auto Output? 174

Multicollinearity 178

Serial Correlation 179

Further Analysis of the Residuals 181

Summary 182

 Analyzing Managerial Decisions: How Fed Economists Forecast Auto Output 184

Problems 186

Appendix: The Coefficient of Determination and the Concept of Explained Variation 192

Chapter 6 Business and Economic Forecasting 197

Survey Techniques 198

Taking Apart a Time Series 199

How to Estimate a Linear Trend 202

How to Estimate a Nonlinear Trend 204

Seasonal Variation 205

Calculation of Seasonal Variation 206

 Analyzing Managerial Decisions: Forecasting the Demand for Blood Tests 208

Cyclical Variation 209

Elementary Forecasting Techniques 212

How Leading Indicators Are Used 214

• Consultant's Corner: Deciding Whether to Finance the Purchase of an Oil Field 216

How Econometric Models Are Used 217

 Analyzing Managerial Decisions: Forecasting Shipments of Cement by CEMCO 218

John Hancock and Timberland: A Case Study 218

The Purvere Corporation: A Numerical Example 219

"Study Your Residuals" 221

Summary 222

Problems 223

Appendix: Exponential Smoothing and Forecasting 227

• Managerial Economics in Context: How to Forecast the Sales of Paper, According to McKinsey 230

Part Three Production and Cost 233

Chapter 7 Production Theory 235

The Production Function with One Variable Input 236

• Analyzing Managerial Decisions: Shaquille O'Neal Goes to Los Angeles 241

The Law of Diminishing Marginal Returns 242

The Optimal Level of Utilization of an Input 242

The Rondo Corporation: A Numerical Example 244

• Analyzing Managerial Decisions: How to Determine the Optimal Horsepower for an Oil Pipeline 245

The Production Function with Two Variable Inputs 246

• Analyzing Managerial Decisions: How Nucor Stays on the Production Function 248

Isoquants 249

The Marginal Rate of Technical Substitution 251

The Optimal Combination of Inputs

The Beiswanger Company: A Numerical Example 257

The Miller Company: Another Numerical Example 259

Optimal Lot Size 260

What Toyota Taught the World 264

Returns to Scale 266

• Consultant's Corner: Choosing the Size of an Oil Tanker 267

The Output Elasticity 268

How Firms Obtain Information About the Production Function: Competitive Benchmarking at Xerox 269

Measurement of Production Functions 270

Three Types of Statistical Analysis 272

The Telephone Industry in Canada: A Case Study 273

Poultry Production in the United States: Another Case Study 274

Summary 277 Problems 278

Appendix: Lagrangian Multipliers and Optimal Input Combinations 284

Technological Change and Industrial Chapter 8 Innovation 289

Technological Change 290

Labor Productivity 291

Total Factor Productivity 292

Using Total Factor Productivity to Track Factory Performance 294

Research and Development: A Learning Process 296

Parallel Development Efforts 297

What Makes for Success? 299

• Concepts in Context: Parallel Development Efforts at IBM

Project Selection 300

Innovation 301

Time-Cost Trade-offs 302

The Learning Curve 304

Analyzing Managerial Decisions: The Time-Cost Trade-off Function for Airliners 306

Applications of the Learning Curve 306

Henry Ford's Model T and Douglas Aircraft's DC-9 308 Diffusion Models 308

• Consultant's Corner: How Robots Spread in Japan and the United States 312

Forecasting the Rate of Diffusion of Numerically Controlled Machine Tools 313

 Analyzing Managerial Decisions: The Development and Introduction of Canon's Personal Copier 314

Summary 315 Problems 316

Chapter 9 The Analysis of Costs 321

Introduction 321

Opportunity Costs 322

Concepts in Context: How Harley-Davidson Has Reduced Costs 323
 Short-Run Cost Functions 323

Average and Marginal Costs 326

 Analyzing Managerial Decisions: The Effects of Output on the Cost of Producing Aircraft 331

Long-Run Cost Functions 332

The Crosby Corporation: A Numerical Example 336

 Analyzing Managerial Decisions: Should We Continue to Make Autos from Steel? 337

Economies of Scale in Nursing Homes 338

Measurement of Short-Run Cost Functions: The Choice of a Mathematical Form 341

Nature and Limitations of Available Data 342

Key Steps in the Estimation Process 345

A Hosiery Mill's Short-Run Cost Functions 346

A Transportation Firm's Short-Run Cost Functions 348

Long-Run Statistical Cost Estimation 350

The Long-Run Average Cost Function for Electric Power: A Case Study 352

The Survivor Technique 353

The Importance of Flexibility 355

Economies of Scope 355

Concepts in Context: Economies of Scope in Advertising Agencies 357
 Break-Even Analysis 358

Algebraic Break-Even Analysis 360

• Consultant's Corner: Mr. Martin Gets Chewed Out by the Boss 361
Profit Contribution Analysis 361

Summary 362 Problems 363

Appendix: Break-Even Analysis and Operating Leverage 367

Part Four Market Structure, Strategic Behavior, and Pricing 371

Chapter 10 Perfect Competition, Monopoly, and Monopolistic Competition 373

Market Structure 373

Market Price under Perfect Competition 375

Shifts in Supply and Demand Curves 377

The Output Decision of a Perfectly Competitive Firm 378

Setting Marginal Cost Equal to Price 381

• Consultant's Corner: Forecasting the Price of Salmon 384

Producer Surplus in the Short Run 385

Long-Run Equilibrium of the Firm 387

The Long-Run Adjustment Process: A Constant-Cost Industry 390

The Long-Run Adjustment Process: An Increasing-Cost Industry 391

How a Perfectly Competitive Economy Allocates Resources 393

Price and Output Decisions under Monopoly 394

The Newspaper Industry in Detroit 398

The Raleigh Company: A Numerical Example 399

- Analyzing Managerial Decisions: Franchiser versus Franchisee? 400
- Concepts in Context: Using Patents to Maintain Market Power 401

Two-Part Tariffs 402

Bundling 402

• Concepts in Context: Verizon Local Calling Plans 403

Monopolistic Competition 408

Price and Output Decisions under Monopolistic Competition 409

Advertising Expenditures: A Simple Rule 411

Using Graphs to Help Determine Advertising Expenditure 414

Advertising, the Price Elasticity of Demand, and Brand Loyalty: The Case of the Retail Coffee Market 415

Summary 417

Problems 418

Appendix: Allocation of Output among Plants 423

Chapter 11 Oligopoly 427

The Emergence of Oligopolistic Industries 428

Maturity and Decline of Oligopolistic Industries 430

Collusive Agreements 430

The Breakdown of Collusive Agreements 432

Dissension in the OPEC Oil Cartel 433

- Concepts in Context: Cartels Come in Many Shapes and Sizes 434 Price Leadership 435
- Analyzing Managerial Decisions: Price Cuts for Breakfast 437
 Ajax, Inc.: A Numerical Example 437
- Analyzing Managerial Decisions: Cranberries: Where 34 Percent of the Market Producers Are Price Takers 438

Summary 439 Problems 440

Chapter 12 Game Theory 447

Two-Person Games 448

Nash Equilibrium 449

Carpenter Company and Hanover Corporation: A Numerical Example 451

The Prisoner's Dilemma 455

Does Cheating Pay? 456

A More Sophisticated Analysis 457

Most-Favored-Customer Clauses 458

The Thrust and Parry of Oligopolistic Rivalry 460

The Importance of Commitment 461

• Consultant's Corner: Using a Price Announcement to Preempt a Market 462 When Is a Threat Credible? 463

The Importance of Entry 465

The Deterrence of Entry 465

• Analyzing Managerial Decisions: Difficulties in Formulating Effective Contracts 467

Du Pont's Attempt to Deter Entry into the Titanium Dioxide Industry 468

Advertising to Resist Entry: Maxwell House versus Folgers 468

Preemptive Strategies: The Case of Wal-Mart Stores 469

Representing Games with Game Trees 470

Summary 472

Problems 473