

The background of the book cover is a blue-toned photograph of a mountain range. The mountains are layered, with some peaks in the foreground and others receding into the distance. The sky is a lighter shade of blue, and the overall image has a textured, slightly grainy appearance.

MANAGERIAL ECONOMICS

FIFTH EDITION

MAURICE / THOMAS

MANAGERIAL ECONOMICS

FIFTH EDITION

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To Niccie and Shelly

Our Underlying Philosophy

Three main goals have guided the development of this book from its conception through this newly revised fifth edition.

- Our primary objective has always been to develop and set forth the fundamentals of microeconomic theory while focusing on the use of theory in managerial decision making. Our purpose is to teach business students the economic way of thinking when making business and personal decisions.
- Another related fundamental goal of this text is to show students (future entrepreneurs and business managers) how the theoretical concepts can actually be used and implemented in real-world decision making.
- Finally, our text demonstrates the relation of managerial economics to other courses in a business school curriculum, such as finance, marketing, business policy, and quantitative analysis. Our aim is to reinforce what students have learned in other courses and provide a foundation of analysis for future coursework.

Indeed, these three objectives illuminate the primary distinguishing characteristics of our approach to managerial economics.

Audience

Managerial Economics is essentially an economics text designed especially for business students. A majority of students, including both undergraduates and students in MBA programs, will enroll in

courses with the same title as this book. However, many instructors and students use this text for courses in applied microeconomics.

This text can stand alone in the sense that it contains all of the principles of microeconomics theory needed to understand specific managerial economics concepts; no supplemental text is necessary. By presenting the basic theory and the specific managerial economics constructs together, we demonstrate that managerial economics is simply an application of microeconomics.

Coverage, Pedagogy, and Changes to the Fifth Edition

We stress that the theoretical principles of microeconomics are useful for managerial decision makers. In order to make this crucial point, we emphasize that the principles of microeconomics will invariably enable a manager to make decisions that will lead to economically efficient solutions, maximize profits, or maximize the value of the firm. Using simple numerical examples, we show that the implementation of microeconomic principles is not all that hard. We do point out that the information used in these examples is more complete than would probably be available to actual business decision makers. These examples of the implementation of the theory are designed to teach the economic way of obtaining solutions to problems if complete information is available. In this way, we develop analytical tools that will be useful when making decisions based upon information that is not so complete. To reinforce further the economic way of thinking about business problems, we draw upon articles in publications such as *The Wall Street*

Journal in order to show that actual managers really do use the theoretical principles set forth in the text when making decisions on a day-to-day basis. Almost every one of the chapters includes at least one of these illustrations.

We often relate managerial economics to other courses in business; for example, we use concepts from finance courses in the development of the theories of maximizing the value of the firm and investment. We use marketing concepts in developing the principles of demand forecasting and the effects of advertising. We rely extensively on the concepts developed in courses on quantitative analysis when implementing the theoretical principles of microeconomics.

Because the previous edition of *Managerial Economics* represented a major revision that included a reorganization and some change of emphasis, this edition was not revised as extensively as the last. We have, however, made a few important changes that we believe will make the text easier to follow and more accessible to students. We have also made some additions that we feel are useful. First, we have added a chapter on the fundamentals of risk and uncertainty in the preliminary material (Chapter 6). In that chapter we discuss risk analysis and decision making under uncertainty and risk. We then implement this analysis at several points throughout the text. All of the material on decision making under risk or uncertainty is presented separately so that those who wish to omit it may do so without any loss of continuity. We do think, however, this new material gives an added flavor to the other material on managerial decision making.

The chapters on production and cost have been reorganized in order to present short-run production and cost together in Chapter 10, and long-run production and cost together in Chapter 11. With this restructuring, we can show more easily and directly the relation between a firm's production function and its cost function. This linkage is often not set forth and demonstrated in such a straightforward manner. We have expanded and reorganized the introductory chapter on demand, supply, and market equilibrium. Our aim is to show how ordinary demand and supply functions are derived

from the generalized form of these functions that include variables other than price. Although much of the material in this chapter will be a review for most students, the discussion of the relation between demand curves and the generalized form will give considerable insight into the chapters on demand and supply estimation and forecasting, which include exogenous variables in the equations.

We have also streamlined and tightened most of the material throughout the text. Chapter 4, which discusses optimization theory, has been tightened a great deal. For example, we have dropped the discussion on unconstrained minimization and instead demonstrate that all unconstrained problems can be cast as maximization problems. The emphasis upon optimization as the fundamental underpinning of most managerial decision making is introduced in Chapter 4 and is carried throughout much of the remainder of the text. Chapter 12, which discusses production and cost estimation, has been streamlined primarily by moving Cobb-Douglas estimation to the appendix and using instead the traditional U-shaped or inverted U-shaped functions, which conform to the theoretical functions, as the function to be estimated. Cubic and quadratic functions are used exclusively in the chapters on implementation of the theory of the firm.

We have also placed more emphasis on estimation of firm demand functions rather than market demand function. This type of estimation is more relevant to managerial decision making and does not necessitate the use of the more complex two-stage least squares. Finally, we have made many minor but beneficial changes throughout all of the chapters; for example, we have dropped many out-of-date illustrations and have added a number of new ones to illustrate and reinforce the theoretical and empirical material.

Notwithstanding these changes, many—or perhaps most—aspects of the text remain unchanged, as we continue to focus upon the use of economic theory and empirical analysis in decision making. As noted, we continue to stress the importance of optimization theory and the importance of marginal benefits and marginal cost in decision making. The text continues to focus on the use, understanding,

and interpretation of statistical analysis rather than on calculating the statistical results. We continue to relegate mathematical proofs of the theories and some of the more complex theoretical and empirical estimation to the appendixes. Although the theoretical analysis in the text is rigorous and thorough, only graphical, verbal, and algebraic analysis is used in developing the theories. In this development we frequently refer students back to the fundamentals of the theory of optimization, which provides the foundation of those theories.

We frequently implement the theories using numerical examples in order to reinforce students' understanding and demonstrate that these theories are useful and relevant for business decision making. Many adopters of previous editions have told us that the problems at the end of each chapter are one of the most useful parts of the text, and so we have revised many of these problems. We continue to use technical problems to help students learn mechanics. The applied problems emphasize the use of economics in business decision making and frequently

require the use of hypothetical data to obtain solutions to relevant business problems. In order to make the material less abstract, we continue to use numbers rather than letters in much of the graphical analysis of the theoretical material.

In addition to all changes noted here, we have tried to make improvements in every chapter. These changes are generally designed to reinforce the focus of text, which is that managerial economics is extremely useful for decision making, and to make the material more accessible and easier to digest.

We would like to thank many adopters of the previous edition of this text for useful comments and suggestions. In particular, we want to thank Dr. Ki Soo Kim of the Pusan Fisheries University for his help on the development and exposition of the new material on risk and uncertainty.

*S. Charles Maurice
Christopher R. Thomas*

B R I E F C O N T E N T S

CHAPTER 1 The Scope of Managerial Economics 1

■ PART I PRICE DETERMINATION IN COMPETITIVE MARKETS 13

CHAPTER 2 Demand, Supply, and Market Equilibrium 14

CHAPTER 3 Elasticity and Demand 60

■ PART II SOME PRELIMINARIES 97

CHAPTER 4 Theory of Optimizing Behavior 98

CHAPTER 5 Basic Estimation Techniques 127

CHAPTER 6 Decision Making under Uncertainty and Risk 168

■ PART III DEMAND 195

CHAPTER 7 Theory of Consumer Behavior 196

CHAPTER 8 Empirical Demand Functions 246

CHAPTER 9 Demand Forecasting 282

■ PART IV PRODUCTION AND COST 319

CHAPTER 10 Theory of Production and Cost in the Short Run 320

CHAPTER 11 Theory of Production and Cost in the Long Run 357

CHAPTER 12 Empirical Analysis of Production and Cost 399

■ PART V PERFECT COMPETITION 427

CHAPTER 13 Theory of Perfectly Competitive Firms and Industries 428

CHAPTER 14 Profit Maximization in Perfectly Competitive Markets 476

■ PART VI FIRMS WITH MARKET POWER 501

CHAPTER 15 Market Power and the Theory of Monopoly 502

CHAPTER 16 Imperfect Competition 532

CHAPTER 17 Profit Maximization for Firms with Market Power 582

CHAPTER 18 Multiple Plants, Markets, and Products 602

■ PART VII DECISION MAKING OVER TIME 641

CHAPTER 19 Profit Maximization over Time 642

CHAPTER 20 The Investment Decision 664

APPENDIX: STATISTICAL TABLES 688

APPENDIX: LINEAR PROGRAMMING 694

ANSWERS TO SELECTED TECHNICAL PROBLEMS 708

SUGGESTED REFERENCES 715

INDEX 717

C O N T E N T S

CHAPTER 1 The Scope of Managerial Economics 1

- 1.1 The Role of Managers 2
- 1.2 Managerial Economics and Business Careers 4
 - Business Careers 4
 - Careers in Government 5
 - Careers in Finance 5
 - Careers in Public Administration 6
- 1.3 Purpose of Economic Theory 6
- 1.4 The Purpose of Empirical Analysis 8
- 1.5 Structure of the Text 9

■ PART I PRICE DETERMINATION IN COMPETITIVE MARKETS 13

CHAPTER 2 Demand, Supply, and Market Equilibrium 14

- 2.1 Demand 15
 - The Generalized Demand Function 15
 - Demand Functions 19
 - The Law of Demand 22
 - Shifts in Demand 23
- 2.2 Supply 26
 - The Generalized Supply Function 27
 - Supply Functions 31
 - Shifts in Supply 34
- 2.3 Market Equilibrium 35
- 2.4 Changes in Market Equilibrium 40
 - Changes in Demand (supply constant) 40
 - Changes in Supply (demand constant) 41
 - Simultaneous Shifts in Both Demand and Supply 43
 - Predicting the Direction of Change in Airfares: A Qualitative Analysis 45
 - Advertising and the Price of Potatoes: A Quantitative Analysis 46

- 2.5 Ceiling and Floor Prices 48

- 2.6 Summary 51

CHAPTER 3 Elasticity and Demand 60

- 3.1 The Coefficient of Demand Elasticity 61
- 3.2 Elasticity and Total Revenue 63
 - The Price Effect and the Quantity Effect of a Price Change 63
 - The Coefficient of Elasticity and Total Revenue 66
- 3.3 Factors Affecting Demand Elasticity 67
 - Availability of Substitutes 67
 - Percent of Consumer's Budget 68
 - Product Durability 68
 - Time Period of Adjustment 68
- 3.4 Calculating Demand Elasticity 69
 - Computing Elasticity over an Interval 69
 - Computing Elasticity at a Point 73
 - Elasticity (generally) Varies along a Demand Curve 73
- 3.5 Other Elasticities 75
 - Income Elasticity 75
 - Cross-Price Elasticity 77
- 3.6 Marginal Revenue, Demand, and Elasticity 80
 - Marginal Revenue and Demand 80
 - Marginal Revenue and Elasticity 85
- 3.7 Summary 86
 - Appendix 3A: Linear Demand, Elasticity, and Marginal Revenue 93
 - Appendix 3B: The Special Case of Constant Elasticity of Demand: $Q = aP^b$ 94
 - Appendix 3C: Derivation of $MR = P(1 + 1/E)$ 95

■ PART II SOME PRELIMINARIES 97

CHAPTER 4 Theory of Optimizing Behavior 98

- 4.1 Concepts and Terminology 99
 - Objective Functions 99
 - Activities or Choice Variables 99

Unconstrained and Constrained Optimization	100	CHAPTER 6 Decision Making under Uncertainty and Risk	168
Marginal Analysis	101	6.1 Distinctions between Risk and Uncertainty	169
4.2 Unconstrained Maximization	102	6.2 Decisions Under Uncertainty	170
Maximization with a Discrete Choice Variable	102	The Maximax Criterion	170
Maximization with a Continuous Choice Variable	106	The Maximin Criterion	171
Profit Maximization at Austin Semiconductor: An Unconstrained Maximization Problem	107	Minimax Regret Criterion	172
More Than One Choice Variable	109	Equal Probability Criterion	172
4.3 Constrained Optimization	111	6.3 Measuring Risk with Probability Distributions	173
Marginal Benefit per Dollar Spent on an Activity	111	Probability Distributions	173
Constrained Maximization	112	Expected Value of a Probability Distribution	175
The Optimal Allocation of Advertising Expenditures: A Constrained Maximization Problem	114	Dispersion of a Probability Distribution	175
Constrained Minimization	115	6.4 Decisions Under Risk	178
4.4 Summary	117	Maximization of Expected Value	178
Appendix	125	Mean-Variance Analysis	179
CHAPTER 5 Basic Estimation Techniques	127	Coefficient of Variation Analysis	181
5.1 The Simple Linear Regression Model	128	Which Rule Is Best?	183
A Hypothetical Regression Model	129	6.5 Finding the Optimal Level of a Risky Activity	184
The Random Error Term	130	Maximizing Expected Net Benefits	185
5.2 Fitting a Regression Line	131	Regression Analysis and Maximizing Expected Net Benefits	187
5.3 Testing for Statistical Significance	134	6.6 Summary	189
The Relative Frequency Distribution for \hat{b}	135	Appendix: Maximization of Expected Net Benefit	194
The Concept of a t -Ratio	136	■ PART III DEMAND	195
Performing a t -Test for Statistical Significance	137	CHAPTER 7 Theory of Consumer Behavior	196
5.4 Evaluation of the Regression Equation	140	7.1 Utility	197
The Coefficient of Determination (R^2)	140	The Problem of Measuring Benefits from Consumption	197
The F -Statistic	141	The Utility Function	198
Controlling Product Quality at SLM: A Regression Example	142	Assumptions about Utility Functions	199
5.5 Multiple Regression	143	7.2 Indifference Curves and Maps	200
The Multiple Regression Model	144	Marginal Rate of Substitution	201
A Multiple Regression Consumption Function	146	Indifference Maps	202
5.6 Nonlinear Regression Analysis	147	A Marginal Utility Interpretation of MRS	203
Quadratic Regression Models	150	7.3 The Consumer's Budget Constraint	204
Log-Linear Regression Models	152	Budget Lines	205
5.7 Regression Analysis in Managerial Decision Making	155	Shifting the Budget Line	207
5.8 Summary	156	7.4 Utility Maximization	208
Appendix 5A: Least-Squares Parameter Estimation	164	Maximizing Utility Subject to a Limited Money Income	209
Appendix 5B: Derivation of the Coefficient of Determination (R^2)	165	Marginal Utility Interpretation of Equilibrium	212
Appendix 5C: Some Additional Problems in Regression Analysis	166	Finding the Optimal Bundle of Hot Dogs and Cokes	213
		A General Graphical Summary of Consumer Utility Maximization	214
		7.5 An Individual Consumer's Demand Curve	217

7.6	Substitution and Income Effects	219		Correcting for Seasonal Variation Using Dummy Variables	290
	Substitution Effect	219		The Dummy Variable Technique: An Example	293
	Income Effect	221			
	Why Demand Slopes Downward	224	9.4	Econometric Models	299
7.7	Market Demand Curves	225		Forecasting the Demand Function	300
7.8	Imperfect Information About Price and Quality	227		Simultaneous Equations Forecasts	301
	Consumer Search Theory	227		The World Market for Copper: A Simultaneous Equations Forecast	303
	Consumer Search under Conditions of Risk	229	9.5	Econometric Forecasting Under Risk	304
7.9	Imperfect Information and Advertising	233		Demand Forecasting with Risky Variables	305
	Purely Informative Advertising	234		Simultaneous Equations Forecasts with Risky Variables	306
	Image Advertising	236	9.6	Some Final Warnings	308
7.10	Summary	236	9.7	Summary	311
	Appendix: Utility Maximization Subject to an Income Constraint	245			
CHAPTER 8 Empirical Demand Functions			■ PART IV PRODUCTION AND COST 319		
8.1	Direct Methods of Demand Estimation	247	CHAPTER 10 Theory of Production and Cost in the Short Run 320		
	Consumer Interviews	247	10.1	Some Basic Concepts of Production Theory	321
	Market Studies and Experiments	249		Production Functions	322
8.2	Specification of the Empirical Demand Function	251		Technical Efficiency and Economic Efficiency	322
	A General Empirical Demand Specification	251		Short Run and Long Run	323
	A Linear Empirical Demand Specification	252		Fixed or Variable Proportions	324
	A Nonlinear Empirical Demand Specification	253	10.2	Production in the Short Run	325
8.3	Estimating Market Demand	256		Total Product	325
	The Nature of the Simultaneity Problem	256		Average and Marginal Product	327
	The Identification Problem	258		Law of Diminishing Marginal Product	329
	Estimation of Demand Using Two-Stage Least-Squares (2SLS)	261		Changes in Fixed Inputs	332
	The World Demand for Copper: Estimating Market Demand Using 2SLS	261	10.3	Summary of Short-Run Production	334
8.4	Estimating Demand Facing an Individual Firm	265	10.4	The Nature of Economic Costs	336
	Price-Taking Firms and Price-Setting Firms	265		Explicit and Implicit Costs	336
	Estimating Demand for Pizzas: An Example	269		The Importance of Implicit Costs	338
8.5	Summary	272		Fixed and Variable Costs	339
	Appendix 8A: Derivation of Elasticity Estimates for Log-Linear Demand	278	10.5	Short-Run Total Costs	339
	Appendix 8B: Simultaneous Equations Bias and Two-Stage Least-Squares Estimation	278		A Numerical Example	340
	Appendix 8C: Data Used in Chapter 8 Examples	280		Average and Marginal Costs	342
				General Short-Run Average and Marginal Cost Curves	344
CHAPTER 9 Demand Forecasting 282			10.6	Relations Between Short-Run Costs and Production	345
9.1	Qualitative Forecasting Techniques	283		Total Costs and the Short-Run Production Function	346
9.2	Time Series Forecasts of Sales and Price	286		Average Variable Cost and Average Product	347
	Linear Trend Forecasting	286		Marginal Cost and Marginal Product	348
	A Sales Forecast for Terminator Pest Control	287		The Graphical Relation between AVC , MC , AP , and MP	348
	A Price Forecast: Lumber Prices in Miami	289	10.7	Summary of Short-Run Cost	351
9.3	Seasonal (or Cyclical) Variation	290		Appendix: Mathematical Derivation of Production and Cost Relations	355

CHAPTER 11 Theory of Production and Cost in the Long Run 357

- 11.1 Production Isoquants 358
 - Characteristics of Isoquants 359
 - Marginal Rate of Technical Substitution 360
 - Relation of *MRTS* to Marginal Products 361
- 11.2 Isocost Curves 362
 - Characteristics of Isocost Curves 362
 - Shifts in Isocost Curves 364
- 11.3 Finding the Optimal Combination of Inputs 365
 - Production of a Given Output at Minimum Cost 365
 - The Marginal Product Approach to Cost Minimization 367
 - Production of Maximum Output with a Given Level of Cost 369
- 11.4 Optimization and Cost 371
 - An Expansion Path 371
 - The Expansion Path and the Structure of Cost 373
- 11.5 Returns to Scale 374
- 11.6 Summary of Long-Run Production 375
- 11.7 Long-Run Costs 377
 - Derivation of Cost Schedules from a Production Function 378
 - Economies and Diseconomies of Scale 381
 - Economies of Scope 386
- 11.8 Relations Between Short-Run and Long-Run Cost 388
- 11.9 Summary of Long-Run Cost 390
 - Appendix: Mathematical Derivation of Long-Run Production and Cost Relations 397

CHAPTER 12 Empirical Analysis of Production and Cost 399

- 12.1 Specification of the Short-run Production Function 400
 - Shortcomings of a Linear Specification 401
 - A Cubic Production Function 402
- 12.2 Estimation of a Short-run Cubic Production Function 403
- 12.3 Short-run Cost Estimation: Some Problems with Measuring Cost 406
 - Correcting Data for the Effects of Inflation 407
 - Problems Measuring Economic Cost 408
- 12.4 Estimation of a Short-run Cost Function 409
 - Estimation of Short-Run Costs at Rockford Enterprises: An Example 412
- 12.5 Summary 415

Appendix 12A: The Cubic Production Function 420

Appendix 12B: The Cubic Cost Function 421

Appendix 12C: The Cobb-Douglas Production Function 421

Appendix 12D: Estimation of a Long-Run Cost Function 424

■ PART V PERFECT COMPETITION 427

CHAPTER 13 Theory of Perfectly Competitive Firms and Industries 428

- 13.1 Characteristics of Perfect Competition 429
- 13.2 Basic Principles of Profit Maximization 430
 - Economic Profit and Normal Profit 431
 - Choosing the Level of Output or Input Usage to Maximize Profit 432
 - Choosing Output to Maximize Profit 434
 - Choosing Input Usage to Maximize Profit 434
- 13.3 Demand Facing a Perfectly Competitive Firm 435
- 13.4 Profit Maximization in the Short Run 438
 - The Manager's Output Decision 438
 - The Output Decision: Positive Economic Profit 440
 - The Output Decision: The Firm Operates at a Loss 441
 - The Irrelevance of Fixed Costs 443
 - Summary of the Manager's Output Decision in the Short Run 444
- 13.5 Short-Run Supply for the Firm and Industry 446
- 13.6 Profit Maximization in the Long Run 448
 - Profit-Maximizing Equilibrium for the Firm in the Long Run 448
 - Long-Run Competitive Equilibrium for the Industry 449
 - Long-Run Supply for a Perfectly Competitive Industry 452
 - Rent and Long-Run Competitive Equilibrium 456
- 13.7 Profit-Maximizing Input Usage 458
 - Marginal Revenue Product 459
 - Marginal Revenue Product and the Hiring Decision 460
- 13.8 Maximizing Expected Profit under Risk 464
- 13.9 Summary 467
 - Appendix: Profit-Maximizing Conditions for a Perfectly Competitive Firm 474

CHAPTER 14 Profit Maximization in Perfectly Competitive Markets 476

- 14.1 Implementing the Profit-Maximizing Output Decision 477

- 14.2 Implementing the Profit-Maximizing Output Decision: An Illustration 479
 - Price Forecasts 479
 - Estimation of Average Variable Cost and Marginal Cost 482
 - The Shutdown Decision 482
 - The Output Decision 483
 - Computation of Total Profit or Loss 484
- 14.3 Implementation of the Profit-Maximizing Input Decision 486
- 14.4 Implementing the Profit-Maximizing Input Decision: An Illustration 488
 - Price and Wage Forecasts 488
 - Estimation of Average Revenue Product and Marginal Revenue Product 489
 - The Shutdown Decision 489
 - The Labor Employment Decision 490
 - Computation of Total Profit or Loss 491
 - The Equivalence of Choosing Output or Input Usage 492
- 14.5 Profit-Maximization under Risk 492
- 14.6 Summary 494
 - Appendix: Input Choice with a Cobb-Douglas Production Function 498

■ PART VI FIRMS WITH MARKET POWER 501

CHAPTER 15 Market Power and the Theory of Monopoly 502

- 15.1 Measurement of Market Power 503
 - Elasticity of Demand 503
 - Cross-Price Elasticity of Demand 504
 - The Lerner Index 505
- 15.2 Determinants of Market Power 505
 - Economies of Scale 506
 - Barriers Created By Government 506
 - Input Barriers 507
 - Brand Loyalties 509
- 15.3 Profit Maximization under Monopoly: The Output and Price Decisions 510
 - Demand and Marginal Revenue for a Monopolist 512
 - Maximizing Profit at Southwest Leather Designs: An Example 512
 - Short-Run Equilibrium: Profit Maximization or Loss Minimization 514
 - Long-Run Equilibrium 517
- 15.4 Profit-Maximizing Input Usage 518

- Marginal Revenue Product for a Monopolist 519
- Marginal Revenue Product and the Hiring Decision 519
- Equivalence of Choosing Input Usage or Output to Maximize Profit 521
- Maximizing Profit at Southwest Leather Designs: The Input Choice 522
- Input Demand: Several Variable Inputs 524

15.5 Summary 524

- Appendix: Profit-Maximizing Conditions for a Monopolist 531

CHAPTER 16 Imperfect Competition 532

- 16.1 Monopolistic Competition 534
 - Short-Run Equilibrium 535
 - Long-Run Equilibrium 536
 - Mutual Interdependence in Monopolistic Competition 538
- 16.2 Characteristics of Oligopoly 539
 - Common Characteristics 539
 - Differing Characteristics 540
- 16.3 Noncooperative Oligopoly Behavior 542
 - The Problem with Oligopoly Demand: An Example 542
 - Price Rigidity under Oligopoly 544
 - Nonprice Competition in Oligopoly Markets: Advertising 546
 - Nonprice Competition in Oligopoly Markets: Product Quality 547
- 16.4 Strategic Interaction in Oligopoly Markets 550
 - The Game Theory Approach to Oligopoly Behavior: An Example 551
 - The Prisoner's Dilemma 554
 - An Advertiser's Dilemma 555
 - A Pricing Dilemma 556
 - Reaction Functions 558
- 16.5 Strategic Entry Deterrence 560
 - Entry Limit Pricing 561
 - Capacity Barriers to Entry 562
 - Multiproduct Cost Barriers 563
 - New Product Development as a Barrier to Entry 564
- 16.6 Cooperative Oligopoly Behavior 565
 - Cartel Profit Maximization 566
 - The Problem of Cheating 569
 - Tacit Collusion 571
 - Price Leadership 574
- 16.7 Summary 575
 - Appendix: Profit Maximization for a Cartel 581

CHAPTER 17 Profit Maximization for Firms with Market Power 582

- 17.1 A Guide to Implementing the Profit-Maximizing Output Decision 583
- 17.2 Maximizing Profit At Aztec Electronics: An Example 586
 - Estimation of Demand and Marginal Revenue 586
 - Estimation of Average Variable Cost and Marginal Cost 587
 - The Output Decision 587
 - The Pricing Decision 588
 - The Shutdown Decision 588
 - Computation of Total Profit or Loss 588
- 17.3 Cost-Plus Pricing: An Alternative Pricing Rule 589
- 17.4 Maximizing Oligopoly Profit with a Risky Demand 592
- 17.5 Summary 595
 - Appendix 17A: Estimation of Marginal Revenue with a Log-Linear Demand 598
 - Appendix 17B: Profit-Maximizing Input Usage 599

CHAPTER 18 Multiple Plants, Markets, and Products 602

- 18.1 Multiplant Firms 603
 - Multiplant Production of Mercantile Enterprises 605
- 18.2 Firms with Multiple Markets—Price Discrimination 608
 - Allocation of Sales in Two Markets to Maximize Revenue 609
 - Profit Maximization with Price Discrimination 611
 - Multiple Market Pricing at Galactic Manufacturing 615
- 18.3 Firms Selling Multiple Products 617
 - Multiple Products Related in Consumption 619
 - Producing Multiple Products (substitutes) at Zicon Manufacturing 619
 - Multiple Products That Are Complements in Production 621
 - Multiple Products That Are Substitutes in Production 622
 - Multiple-Product Production at Surefire Products 623
 - Optimal Usage of a Production Facility 625
 - Optimal Usage of a Production Facility at Surefire Products 626
- 18.4 Why Multiple Products? 627
 - Complements in Consumption 627
 - Complements in Production 628
 - Substitution in Consumption and Production 628

- 18.5 Summary 630

Appendix 18A: Mathematical Demonstration of Results 637

Appendix 18B: Multiple Products That Are Complements in Production 638

■ PART VII DECISION MAKING OVER TIME 641

CHAPTER 19 Profit Maximization over Time 642

- 19.1 Net Present Value 643
 - Present Value of a Single Payment in the Future 643
 - Present Value of a Stream of Payments 645
 - Calculation of Net Present Value: An Example 646
- 19.2 Maximizing the Value of the Firm—Another Marginal Rule 647
- 19.3 Maximizing the Value of the Firm Versus Single-period Profit Maximization 648
- 19.4 Some Cases when Value and Profit Maximization are Not Equivalent 650
 - Learning By Doing 650
 - Entry Limit Strategies over Time 652
- 19.5 Conflicts between Shareholders (Owners) and Managers 654
 - Moral Hazard 655
 - Some Solutions to the Agency Problem 656
- 19.6 Summary 659

CHAPTER 20 The Investment Decision 664

- 20.1 Valuing Risky Cash Flows 665
 - Risky Cash Flows 665
 - A Discount Rate Reflecting Risk 665
- 20.2 The Appropriate Discount Rate for a Risky Project 667
 - The Risk-Adjusted Discount Rate 667
 - The Weighted Average Cost of Capital 667
 - Estimating the Probability Distribution of Cash Flows and Discount Rates: A Numerical Example 668
- 20.3 Making Investment Decisions to Maximize the Value of the Firm 670
 - The Expected Net Present Value Rule for Investment 671
 - Investment Decision Making at Trenton Enterprises: An Example 672
- 20.4 Alternatives to the Expected Net Present Value Rule 674

Payback Period	675
Return on Investment (ROI)	676
Internal Rate of Return (<i>IRR</i>)	677
Nonequivalence of <i>IRR</i> and <i>NPV</i> Rules	679
20.5 Capital Rationing	681
20.6 Summary	682
APPENDIX: STATISTICAL TABLES	688
APPENDIX: LINEAR PROGRAMMING	694
ANSWERS TO SELECTED TECHNICAL PROBLEMS	708
SUGGESTED REFERENCES	715
INDEX	717

1

The Scope of Managerial Economics

The fundamental task of a manager is to make decisions. Every type of manager in every type of organization must continually make decisions that affect the performance of the organization. The best—or more precisely, the most successful—managers are those who make decisions that enable the organization to achieve its goals. The objective of managerial economics is to provide a framework for analyzing business decisions. Instead of presenting a detailed list of rules for specific decision-making problems, such as how to design a successful laundry detergent advertisement or how to obtain venture capital, managerial economics addresses the larger economic forces that shape day-to-day decision making. By applying economic theory to business problems, managerial economics develops general principles that can be applied to business decision making. Although economic theory is not the only tool used by successful managers, it is a powerful and essential tool. The objective of this text is to show you how managers can use economics in making decisions that will achieve the firm's goals—in particular, maximization of profit.

As the subtitle of the text suggests, managerial economics focuses on the application of *microeconomic* theory, a basic tool used by economists. Microeconomics is the study and analysis of the behavior of individual segments of the economy: individual consumers, workers and owners of resources, individual firms, industries, and markets for goods, services, and productive resources. Microeconomics is concerned with topics such as how consumers choose the goods and services they purchase and how firms make hiring, pricing, production, and advertising decisions. Let us emphasize at the beginning that while these theories are relatively simple, they are the same theoretical methods used by real-world decision makers.