

MANAGERIAL ECONOMICS

Theory, Applications, and Cases

Edwin Mansfield

SECOND EDITION

Managerial Economics

Second Edition

Edwin Mansfield

Director, Center for Economics and Technology
University of Pennsylvania



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To Katherine . . .
and her parents too

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He is the author of 190 articles and 25 books. His textbooks on eco-

nomics, microeconomics, managerial economics, and statistics have been adopted at over 1,000 colleges and universities, and have been translated for use abroad. He has been on the editorial board of eight journals, including the *Journal of the American Statistical Association*, and has been general editor of a series of books on technological change published by the University of Wisconsin Press. He has received the Publication Award of the Patent Law Association and the Honor Award of the National Technological University for research, teaching, and public service. He was included on the *Journal of Economic Perspectives*' list of 20 most cited economists in the United States.

Preface

The success of the first edition of this book was very gratifying, but, like any new textbook, extensive use in the classroom has produced lots of good ideas for improvements. Many of the hundreds of teachers who adopted the book have provided valuable comments and suggestions, which I appreciate very much. While the book's general structure and approach remain the same in this edition as in the previous one, there are many noteworthy improvements, described below.

New Chapter on Managerial Economics in an International Setting. Without question, the most important feature of this new edition is a chapter on managerial economics in the world economy. Competition in international markets is much rougher than in the past, and managers must be aware of the relevant principles of international economics and how they apply to real-world situations. Despite this fact, which has been trumpeted by many leading managers and teachers, no managerial economics textbook (that I know of) includes an extended discussion of this topic. One important aim of this new edition is to fill that void.

New Introductory Material on Supply and Demand and on Principal-Agent Problems. In Chapter 1, there is now a brief discussion of demand and supply curves and of price determination in competitive markets. This material will provide a useful orientation and review. Also, there is a treatment of principal-agent problems. Given the importance of these topics, it seems appropriate to introduce them at the outset.

More Complete Discussion of Indifference Curves, Pricing Techniques, Externalities, and Public Goods. Based on the reactions of users of the first edition, many teachers would like to have a fuller treatment of indifference curves, which is now included in a new appendix to Chapter 3. Also, a more extensive discussion of the long-run adjustment process and resource allocation under perfect competition is provided in Chapter 10, and new sections on two-part tariffs and bundling have been added. Further, in Chapter 15, there are more complete treatments of externalities and public goods.

Revised Treatments of Game Theory and of Regression Techniques. In Chapter 11, the material on game theory has been reorganized and beefed up; in particular, the discussions of Nash equilibrium and of reaction curves have been extended. In Chapter 4, the material on multiple regression techniques has been simplified. Also, much more emphasis has been put on the use of computer software and the interpretation of computer printouts, rather than on statistical formulas. In Chapter 13, there is a new discussion of the winner's curse.

New Case Studies and Applications. I have found from my own teaching experience, at the University of Pennsylvania (both in the Wharton School and in the College of Arts and Sciences) and at Carnegie-Mellon's Graduate School of Industrial Administration, that existing textbooks do not go far enough in demonstrating how the techniques presented in a managerial economics course are actually used by firms and analysts. In this second edition, there are well over 100 case studies and real-world applications (about 25 percent more than in the previous edition), of which the following are new: (1) The Comeback of the Xerox Corporation, (2) Harley-Davidson versus the Japanese Goliaths, (3) Bantam's Big Bet on Schwartzkopf's Book, (4) How Banc One Deals with the Principal-Agent Problem, (5) The 1991 Collapse of Wool Prices, (6) Why the Drop in the Price of Radio Stations?, (7) How the Japanese Motorcycle Makers Used the Coefficient of Determination, (8) Poultry Production in the United States, (9) The Time-Cost Trade-Off Function for Airlines, (10) Should We Continue to Make Autos from Steel?, (11) Economies of Scope in Advertising Agencies, (12) How Linear Programming Improves Aircraft Operations, (13) Acrimony in the OPEC Oil Cartel, (14) Pricing Electricity by the Hour, (15) Using Simulation Techniques in the Computer Industry, (16) Buying and Selling Pollution Permits at the Chicago Board of Trade, (17) Why Bridgestone Paid \$2.6 Billion for Firestone's Tire Plants, (18) Airbus versus Boeing: Strategic Trade Policy in Action, (19) Is Airbus Playing by the Rules?, (20) Why So Many U.S. Plants Are Located South of the Border, (21) Reorganizing a Firm's Global R and D Network, and (22) A Free Trade Agreement for North America?

Continued Emphasis on a Variety of Types of Cases. As in the previous edition, a variety of types of cases are presented. Some ("Concepts in Context") describe how various important techniques have been used. Others ("Analyzing Managerial Decisions") go further and ask the student to answer questions related to the techniques being described. (Answers to

these questions are included.) In addition, each chapter contains a section ("Consultant's Corner") that provides a brief case, generally based on an actual situation, where the student is asked to provide practical advice to a manager. Answers are provided at the end of the book. Further, each part of the book contains a case ("Managerial Economics in Context") that tries to bridge the material in various chapters, thus helping the student to integrate the material. Answers to these cases too are provided at the end of the book. For all of these types of cases, I have updated the material to make it as timely as possible.

Numerical Examples and Answers to Problems. Because managerial economics centers on the application of quantitative techniques, it is important that the student be ushered through many numerical examples. For example, to understand how price should be set under various sets of circumstances, the student should be given numerical examples that help to lay bare the essence of each price-setting technique. I have included many sections that are devoted entirely to working out such numerical examples. Also, answers to the odd-numbered end-of-chapter problems are included at the end of the book. This provides the student with useful feedback: he or she can see how a problem can be solved and whether he or she really understood the principles involved. In contrast to the previous edition, the answers to the even-numbered problems are in the *Instructor's Manual*, not the study guide, so these problems can be used to test students. New problems have been added, and old ones have been updated if needed.

Chapter on Industrial Innovation and Technological Change. American firms—as well as those in other countries—are constantly faced with decisions concerning innovation and technological change. It is no exaggeration to say that these decisions are among the most important facing any firm, particularly now that the traditional U.S. technological lead over other major countries has evaporated in many industries. Other textbooks in managerial economics devote little or no space to this topic. This is the first—and to date, only—one to provide a full chapter on this score.

Chapter on Oligopoly and Strategic Behavior. Advances in the analysis of strategic behavior have had an impact on thinking in boardrooms as well as classrooms. The previous edition was the first managerial economics textbook to devote a full chapter to oligopoly and strategic behavior. The reaction of instructors was enthusiastic, and we continue this practice in this new edition.

Software Packages. Given the major role played by the computer in today's firms, it is important in any modern managerial economics text that the student be introduced to the software packages available to help solve managerial problems. This is particularly important in the case of regression techniques and linear programming, where few real calculations are carried out any longer by hand. In this book, Chapter 4 and the appendix to Chapter 9 describe leading software packages in detail. Although the material is optional, experience indicates that it will be useful in many classes.

Organization, Coverage, and Level. Although this book contains a number of innovations, its overall organization and coverage is reasonably standard. All the topics usually taken up in a book of this sort are included, and the order in which they appear is similar to that in other books. Those instructors who wish to ignore the material on international economics, industrial innovation, strategic behavior, or software packages will find it easy to do so, since this material—included in Chapter 16, Chapter 7, the latter part of Chapter 11, and segments of Chapters 4 and 9—is self-contained and can be omitted without loss of continuity. Alternatively, some teachers omit Chapters 4, 5, and 9; this too can readily be done. It is important to note as well that this book is designed to be used by students with a wide range of abilities and backgrounds, not just a highly select few.

Mathematical Sophistication. Only a very modest mathematical background is required for an understanding of *Managerial Economics*. The elements of differential calculus that are used are explained in Chapter 2. For many students, this material can be skipped, since they will already have taken calculus courses, or it can be used to review the mathematics they have learned before. The emphasis in this book is on providing students with solid and effective evidence concerning the power and applicability of modern managerial economics and on making sure that they can use these techniques correctly and imaginatively. To accomplish these objectives, it is neither necessary nor appropriate to deluge students with mathematics.

Problems and Problem Sets. While real cases and examples whet a student's interest and sharpen his or her competence and intuition, they ordinarily must be supplemented with a substantial number of problems and problem sets. Besides the numerical examples included in the body of the chapters, there are a substantial number of problems at the end of each chapter. (As pointed out above, the answers to the odd-numbered problems are given at the end of the book.)

Study Guide. Because of the importance of hands-on experience with the techniques of this course, I have written a study guide (*Study Guide and Casebook for Managerial Economics*) to supplement the text. This supplement contains hundreds of problem sets, problems, and review questions (as well as their answers), which should be helpful to students. These problems and questions have been tested for effectiveness in the classroom. A new feature of the second edition is the inclusion of the following eight full-length classroom-tested cases, which should be very helpful and illuminating to students: (1) Apple Computer, Inc., 1987 . . . The Second Decade (by Phyllis Feddeler, Thomas Wheelen, and David Croll), (2) K. M. Westelle and Associates, Inc. (by Rhonda Aull), (3) Production Functions and Cost Functions in Oil Pipelines (by Leslie Cookenboo), (4) A Managerial Application of Cost Functions by a Railroad (by Edwin Mansfield and Harold Wein), (5) Applied CAD Knowledge, Inc. (by John Seeger and Raymond Kinnunen), (6) Catco Electronics Corporation (by Patrick Schul, William Cunningham, and Lynn Gill), (7) The Carriage House Inn (by Michael Ever-

ett), and (8) Revving Up for Relief: Harley-Davidson at the ITC (by Dorothy Robyn with assistance from Don Lippincott).

Instructor's Manual. An *Instructor's Manual* by Craig J. McCann of the University of South Carolina will be available to accompany this text. It includes suggestions for lectures and classroom discussion, as well as a test bank of roughly 700 multiple-choice questions. It should be of great help to many instructors.

In writing this book, I have benefited from the comments and suggestions of many colleagues and students. Particular thanks go to the following teachers who have commented in detail on all or part of the manuscript: Richard S. Bower, The Tuck School; Robert Carbaugh, Central Washington University; Thomas M. Carroll, University of Nevada (Las Vegas); Michael Claudon, Middlebury College; Mark Correll, University of Colorado; Alan Daskin, Boston University; George C. Dery, University of Lowell; Constantine Glezakos, California State University (Long Beach); H. Peter Gray, Rensselaer Polytechnic Institute; Theodore Groves, University of California (San Diego); James Hamilton, Wayne State University; Robert Hansen, The Tuck School; Kevin Hassett, Columbia University; Charles Hegji, Auburn University; George Hoffer, Virginia Commonwealth University; Jack Hou, California State University (Long Beach); Todd Idson, University of Miami; Lowell Jacobsen, William Jewell College; Charles E. Krider, University of Kansas; Michael Magura, University of Toledo; J. Peter Mattila, Iowa State University; Craig J. McCann, University of South Carolina; Marshall Medoff, California State University (Long Beach); Martin Milkman, Murray State University; J. Wilson Mixon, Berry College; Stephen Sheppard, Virginia Polytechnic Institute and State University; Sheldon H. Stein, Cleveland State University; John Clair Thompson, University of Connecticut; Samuel Wagner, Franklin and Marshall College; James Wetzel, Virginia Commonwealth University; and Pamela Whalley, Western Washington University. Also, Anthony Romeo of Unilever and Lorne Switzer of Concordia University suggested useful material and made valuable comments.

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Contents

About the Author	iii
Preface	xix

Part One Introduction

Chapter 1	
Introduction to Managerial Economics	1
Case Study #1: The Comeback of the Xerox Corporation	2
Case Study #2: Harley-Davidson versus the Japanese Goliaths	3
Case Study #3: How Should Heinz Distribute Its Ketchup?	4
Relationships of Managerial Economics to Other Disciplines	5
The Basic Process of Decision Making	7
The Theory of the Firm	9
The Role of Constraints	10
What Are Profits?	11
Reasons for the Existence of Profit	12
Organizational Factors and "Satisficing"	13
<i>Analyzing Managerial Decisions: Bantam's Big Bet on Schwarzkopf's</i>	
<i>Book</i>	14
Managerial Interests and the Principal-Agent Problem	15
Demand and Supply: A First Look	16
<i>Analyzing Managerial Decisions: How Banc One Deals with the</i>	
<i>Principal-Agent Problem</i>	17

The Demand Side of a Market	18
The Supply Side of a Market	19
Equilibrium Price	21
Actual Price	22
What If the Demand Curve Shifts?	23
What If the Supply Curve Shifts?	25
The 1991 Collapse of Wool Prices: A Case Study	26
<i>Concepts in Context: Why the Drop in the Price of Radio Stations!</i>	27
Summary	28
Questions and Problems	29

Chapter 2

Optimization Techniques

32

Introduction	32
Functional Relationships	33
Marginal Analysis	34
Relationship between Total, Marginal, and Average Values	36
The Concept of a Derivative	39
How to Find a Derivative	43
<i>Concepts in Context: The Allocation of the Tang Brand Advertising Budget</i>	48
Using Derivatives to Solve Maximization and Minimization Problems	51
<i>Analyzing Managerial Decisions: The Optimal Size of a Hospital</i>	55
The Marginal-Cost-Equals-Marginal-Revenue Rule and the Calculus of Optimization	56
<i>Concepts in Context: An Alleged Blunder in the Stealth Bomber's Design</i>	57
Partial Differentiation and the Maximization of Multivariable Functions	58
<i>Analyzing Managerial Decisions: The Effects of Advertising on the Sales of Tang</i>	60
Constrained Optimization	61
Lagrangian Multipliers	63
<i>Consultant's Corner: Planning to Meet Peak Engineering Requirements</i>	66
Comparing Incremental Costs with Incremental Revenues	66
Summary	68
Problems	69

Part Two

Demand and Forecasting

Chapter 3**Demand Theory****73**

Introduction 73

The Market Demand Curve 73

Industry and Firm Demand Functions 77

Concepts in Context: Walt Disney Productions and Attendance at Theme Parks 78

The Price Elasticity of Demand 81

Point and Arc Elasticities 81

Using the Demand Function to Calculate the Price Elasticity of Demand 83

Price Elasticity and Total Money Expenditure 85

Analyzing Managerial Decisions: The Demand for Newsprint 87

Total Revenue, Marginal Revenue, and Price Elasticity 88

Determinants of the Price Elasticity of Demand 91

Uses of the Price Elasticity of Demand 92

Price Elasticity and Pricing Policy 93

The Income Elasticity of Demand 94

Using the Demand Function to Calculate the Income Elasticity of Demand 96

Consultant's Corner: Estimating the Quantity Demanded of Fresh Premium Salmon 97

Cross Elasticities of Demand 98

The Advertising Elasticity of Demand 99

Analyzing Managerial Decisions: Using PIMS Data to Estimate Elasticities of Demand 100

The Constant-Elasticity Demand Function 101

Summary 102

Problems 103

Appendix: From Consumer Behavior to Market Demand 107

Chapter 4**Estimating Demand Functions****118**

Introduction 118

The Identification Problem 118

Consumer Interviews 121

Market Experiments 122

L'eggs: A Market Experiment 123

Regression Analysis 124

Simple Regression Model 125

Sample Regression Line 126

Method of Least Squares 128

Coefficient of Determination 130

Concepts in Context: How the Japanese Motorcycle Makers Used the Coefficient of Determination 132

<i>Consultant's Corner: Price and Market Share for a New Electrical Drive</i>	133
<i>Concepts in Context: Color Balance and Shelf-Life Performance of Polaroid Film</i>	134
Multiple Regression	135
Software Packages and Computer Printouts	137
<i>Analyzing Managerial Decisions: How Good Are Ward's Projections of Auto Output?</i>	139
Interpreting the Computer Printout	140
Multicollinearity	144
Serial Correlation	145
<i>Analyzing Managerial Decisions: How Fed Economists Forecast Auto Output</i>	147
Further Analysis of the Residuals	149
The Demand Function for Cigarettes: A Case Study	151
Summary	153
Problems	154
Appendix: The Coefficient of Determination and the Concept of Explained Variation	160
 Chapter 5	
Business and Economic Forecasting	163
Survey Techniques	164
Taking Apart a Time Series	165
How to Estimate a Linear Trend	168
How to Estimate a Nonlinear Trend	169
Seasonal Variation	172
Calculation of Seasonal Variation	174
<i>Analyzing Managerial Decisions: Forecasting the Demand for Blood Tests at North Carolina Memorial Hospital</i>	175
Cyclical Variation	176
Elementary Forecasting Techniques	179
How Leading Indicators are Used	181
<i>Consultant's Corner: Deciding Whether to Finance the Purchase of an Oil Field</i>	182
How Econometric Models are Used	183
The Wharton Econometric Model	184
<i>Analyzing Managerial Decisions: Forecasting Shipments of Cement by CEMCO</i>	185
The Purvere Corporation: A Numerical Example	187
<i>Concepts in Context: How the Cummins Engine Company Forecasts Sales</i>	189
"Study Your Residuals"	191
Summary	192
Problems	193

<i>Managerial Economics in Context: How to Forecast the Sales of Paper, According to McKinsey</i>	198
Appendix: Exponential Smoothing and Forecasting	199

Part Three Production and Cost

Chapter 6	
Production Theory	203
Introduction	203
The Production Function with One Variable Input	203
The Law of Diminishing Marginal Returns	207
The Optimal Level of Utilization of an Input	208
The Rondo Corporation: A Numerical Example	209
<i>Analyzing Managerial Decisions: How to Determine the Optimal Horsepower for an Oil Pipeline</i>	210
The Production Function with Two Variable Inputs	211
<i>Concepts in Context: How Nucor Stays on the Production Function</i>	213
Isoquants	214
The Marginal Rate of Technical Substitution	216
The Optimal Combination of Inputs	218
The Beiswanger Company: A Numerical Example	221
The Miller Company: Another Numerical Example	222
Optimal Lot Size	223
What Toyota Taught the World	227
<i>Analyzing Managerial Decisions: Advantages of Just-in-Time Production</i>	229
Returns to Scale	230
The Output Elasticity	231
<i>Consultant's Corner: Choosing the Size of an Oil Tanker</i>	232
How Firms Obtain Information Concerning the Production Function: Competitive Benchmarking at Xerox	233
Measurement of Production Functions	234
Three Types of Statistical Analysis	236
The Telephone Industry in Canada: A Case Study	237
Poultry Production in the United States: Another Case Study	238
Summary	240
Problems	241
Appendix: Lagrangian Multipliers and Optimal Input Combinations	246

Chapter 7

Technological Change and Industrial Innovation 249

Technological Change 249

Labor Productivity 251

Total Factor Productivity 251

Using Total Factor Productivity to Track Factory

Performance 254

Consultant's Corner: Evaluating a Large-Scale Program of Product and Process Improvement 255

Research and Development: A Learning Process 256

Parallel Development Efforts 257

Concepts in Context: Parallel Development Efforts at IBM 258

What Makes for Success? 259

Project Selection 260

Innovation 261

Do American Firms Neglect Process Innovation? 262

Time-Cost Trade-Offs 263

Analyzing Managerial Decisions: The Time-Cost Trade-Off Function for Airlines 265

Innovation Time and Cost: Japan versus the United States 266

The Learning Curve 268

Applications of the Learning Curve 268

Henry Ford's Model T and Douglas Aircraft's DC-9 270

Technological Forecasting 271

Input-Output Models 273

Diffusion Models 275

Analyzing Managerial Decisions: The Development and Introduction of Canon's Personal Copier 278

Forecasting the Rate of Diffusion of Numerically Controlled

Machine Tools 279

Analyzing Managerial Decisions: The Spread of Industrial Robots in Japan and the United States 280

Summary 282

Problems 283

Chapter 8

The Analysis of Costs 286

Introduction 286

Opportunity Costs 286

Short-Run Cost Functions 287

Concepts in Context: How Harley-Davidson Has Reduced Costs 288

Average and Marginal Costs 290

Analyzing Managerial Decisions: The Effects of Output on the Cost of Producing Aircraft 293

Long-Run Cost Functions 295

<i>Analyzing Managerial Decisions: Should We Continue to Make Autos from Steel?</i>	298
The Crosby Corporation: A Numerical Example	299
Economies of Scale in Producing Methanol from Coal: A Case Study	301
Measurement of Short-Run Cost Functions: The Choice of a Mathematical Form	302
Nature and Limitations of Available Data	305
Key Steps in the Estimation Process	306
A Hosiery Mill's Short-Run Cost Functions	308
A Transportation Firm's Short-Run Cost Functions	309
Long-Run Statistical Cost Estimation	311
The Long-Run Average Cost Function for Electric Power: A Case Study	313
The Survivor Technique	314
The Importance of Flexibility	315
Economies of Scope	317
<i>Concepts in Context: Economies of Scope in Advertising Agencies</i>	318
Break-Even Analysis	320
Algebraic Break-Even Analysis	321
Profit Contribution Analysis	322
<i>Consultant's Corner: An Intrafirm Dispute over a Break-Even Chart</i>	322
Summary	323
Problems	324
Appendix: Break-Even Analysis and Operating Leverage	328

Chapter 9

Linear Programming 332

What Is Linear Programming?	332
Production Planning: One Output	333
How to Obtain a Graphical Solution	338
The Case of Unlimited Resources	340
Production Planning: Multiple Products	342
<i>Concepts in Context: How Linear Programming Improves Aircraft Operations</i>	343
Extreme Points and the Simplex Method	346
<i>Concepts in Context: Using Linear Programming to Choose R and D Projects</i>	348
<i>Analyzing Managerial Decisions: Moving Sand at the Brisbane Airport</i>	349
The Dual Problem and Shadow Prices	351
Relationship between Primal and Dual Problems	352
Slack Variables	353
Algebraic Solution of Linear Programming Problems	353