# Chapter 1

## Introduction to Managerial Economics

### What Is Managerial Economics?

One standard definition for economics is the study of the production, distribution, and consumption of goods and services. A second definition is the study of choice related to the allocation of scarce resources. The first definition indicates that economics includes any business, nonprofit organization, or administrative unit. The second definition establishes that economics is at the core of what managers of these organizations do.

This book presents economic concepts and principles from the perspective of "managerial economics," which is a subfield of economics that places special emphasis on the choice aspect in the second definition. The purpose of managerial economics is to provide economic terminology and reasoning for the improvement of managerial decisions.

Most readers will be familiar with two different conceptual approaches to the study of economics: microeconomics and macroeconomics. Microeconomics studies phenomena related to goods and services from the perspective of individual decision-making entities—that is, households and businesses. Macroeconomics approaches the same phenomena at an aggregate level, for example, the total consumption and production of a region. Microeconomics and macroeconomics each have their merits. The microeconomic approach is essential for understanding the behavior of atomic entities in an economy. However, understanding the systematic interaction of the many households and businesses would be too complex to derive from descriptions of the individual units. The macroeconomic approach provides measures and theories to understand the overall systematic behavior of an economy.

Since the purpose of managerial economics is to apply economics for the improvement of managerial decisions in an organization, most of the subject material in managerial economics has a microeconomic focus. However, since managers must consider the state of their environment in making decisions and the environment includes the overall economy, an understanding of how to interpret and forecast macroeconomic measures is useful in making managerial decisions.

## 1.1 Why Managerial Economics Is Relevant for Managers

In a civilized society, we rely on others in the society to produce and distribute nearly all the goods and services we need. However, the sources of those goods and services are usually not other individuals but organizations created for the explicit purpose of producing and distributing goods and services. Nearly every organization in our society—whether it is a business, nonprofit entity, or governmental unit—can be viewed as providing a set of goods, services, or both. The responsibility for overseeing and making decisions for these organizations is the role of executives and managers.[1]

Most readers will readily acknowledge that the subject matter of economics applies to their organizations and to their roles as managers. However, some readers may question whether their own understanding of economics is essential, just as they may recognize that physical sciences like chemistry and physics are at work in their lives but have determined they can function successfully without a deep understanding of those subjects.

Whether or not the readers are skeptical about the need to study and understand economics per se, most will recognize the value of studying applied business disciplines like marketing, production/operations management, finance, and business strategy. These subjects form the core of the curriculum for most academic business and management programs, and most managers can readily describe their role in their organization in terms of one or more of these applied subjects. A careful examination of the literature for any of these subjects will reveal that economics provides key terminology and a theoretical foundation. Although we can apply techniques from marketing, production/operations management, and finance without understanding the underlying economics, anyone who wants to understand the why and how behind the technique needs to appreciate the economic rationale for the technique.

We live in a world with **scarce resources**[2], which is why economics is a practical science. We cannot have everything we want. Further, others want the same scarce resources we want. Organizations that provide goods and services will survive and thrive only if they meet the needs for which they were created and do so effectively. Since the organization's customers also have limited resources, they will not allocate their scarce resources to acquire something of little or no value. And even if the goods or services are of value, when another organization can meet the same need with a more favorable exchange for the customer, the customer will shift to the other supplier. Put another way, the organization must create **value**[3] for their customers, which is the difference between what they acquire and what they

1. The subfield of economics that studies how decisions in firms are used to allocate scarce resources.
2. The basic principle that individuals cannot have everything that they want and that others want the same things that we want.
3. The difference between what individuals acquire and what they produce; the basis of exchange between individuals and organizations.

produce. The thesis of this book is that those managers who understand economics have a competitive advantage in creating value.

## 1.2 Managerial Economics Is Applicable to Different Types of Organizations

In this book, the organization providing goods and services will often be called a **"business" or a "firm**[4]," terms that connote a for-profit organization. And in some portions of the book, we discuss principles that presume the underlying goal of the organization is to create profit. However, managerial economics is relevant to nonprofit organizations and government agencies as well as conventional, for-profit businesses. Although the underlying objective may change based on the type of organization, all these organizational types exist for the purpose of creating goods or services for persons or other organizations.

Managerial economics also addresses another class of manager: the regulator. As we will discuss in Chapter 8 "Market Regulation", the economic exchanges that result from organizations and persons trying to achieve their individual objectives may not result in the best overall pattern of exchange unless there is some **regulatory guidance**[5]. Economics provides a framework for analyzing regulation, both the effect on decision making by the regulated entities and the policy decisions of the regulator.

4. A for-profit or nonprofit organization that creates and provides goods and services for individuals or other organizations.

5. Information designed to ensure that the behaviors of organizations and people trying to achieve their objectives result in the best overall pattern of economic exchange.

## 1.3 The Focus of This Book

The intent of this book is to familiarize the reader with the key concepts, terminology, and principles from managerial economics. After reading the text, you should have a richer appreciation of your environment—your customers, your suppliers, your competitors, and your regulators. You will learn principles that should improve your intuition and your managerial decisions. You will also be able to communicate more effectively with your colleagues and with expert consultants.

As with much of microeconomic theory, many of the economic principles in this book were originally derived with the help of mathematics and abstract models based on logic and algebra. In this book, the focus is on the insights gained from these principles, not the derivation of the principles, so only a modest level of mathematics is employed here and an understanding of basic algebra will suffice. We will consider some key economic models of managerial decision making, but these will be presented either verbally, graphically, or with simple mathematical representations. For readers who are interested in a more rigorous treatment, the reference list at the conclusion of this text includes several books that will provide more detail. Alternatively, a web search using one of the terms from this book will generally yield several useful links for further exploration of a concept.

A note about economic models is that **models**[6] are simplified representations of a real-world organization and its environment. Some aspects of the real-world setting are not addressed, and even those aspects that are addressed are simplifications of any actual setting being represented. The point of using models is not to match the actual setting in every detail, but to capture the essential aspects so determinations can be made quickly and with a modest cost. Models are effective when they help us understand the complex and uncertain environment and proceed to appropriate action.

6. A simplified representation of a real-world organization and its environment that leads to the understanding of complex and uncertain situations and appropriate action.

## 1.4 How to Read This Book

Like any academic subject, economics can seem like an abstract pursuit that is of greatest interest to economists who want to communicate with other economists. However, while there is certainly a substantial body of written research that may reinforce that impression, this book is written with the belief that economics provides a language and a perspective that is useful for general managers.

All readers have a considerable experience base with the phenomena that economics tries to address, as managers, consumers, or citizens interested in what is happening in their world and why. As you read the book, I encourage you to try to apply the concepts and theories to economic phenomena you have experienced. By doing so, the content of the book will make more sense and you are more likely to apply what you will read here in your future activities as a player in the world of business and economics.