Module ii: fundamental concepts of managerial economics

Business, Management

Module II: Fundamental Concepts of Managerial Economics * Opportunity Costs, Incremental Principle, Time perspective, Discounting and Equi-Marginal principles. * Theory of the Firm: Firm and Industry, Forms of Ownership, Objectives of the firm, alternate objectives of firm. * Managerial theories: Baumol's Model, Marris's Hypothesis, Williamson's Model. * Behavioral theories: Simon's Satisficing Model, Cyert and March Model. * Agency theory. * Opportunity cost principle * Opportunity cost of a decision is the sacrifice of alternative course of action for that decision. It is the problem revenue from alternative sacrificed. * Opportunity cost may be defined as the revenue foregone or opportunity lost by not using the resources in second best alternative use. * Opportunity cost requires measurement of sacrifice. It measures the sacrifice made for making (taking) a decision. * Incremental principle The incremental principle may be stated as follows: A decision is clearly a profitable one if :- * It increases revenue more than costs. * It decreases some cost to a greater extent than it increases others. * It increases some revenues more than it decreases others. * It reduces costs more than revenues. * Time Perspective * The time perspective concept states that the decision maker must give due consideration both to the short run and long run effects of his decisions. He must give due emphasis to the various time periods. * Equi -marginal principal * The principle states that an input should be allocated so that value added by the last unit is the same in all cases. This generalization is popularly called the equi marginal. * Let us assume a case in which the firm has 100 units of labor at its disposal. And the firm is involved in five activities viz., A, B, C, D, and E. The firm can increase any one of these activities by

employing more labor but only at the cost i. e., sacrifice of other activities. * Discounting concept * This concept is an extension of the concept of time perspective. * It is simply that in the intervening period a sum of money can earn a return which is ruled out if the sum is available only at the end of the period. In technical parlance, it is said that the present value of one rupee available at the end of two years is the present value of one rupee available today. * The mathematical technique for adjusting for the time value of money and computing present value is called “ discounting". * Example * Suppose you are offered a choice of Rs. 1000 today or Rs. 1000 next year. Naturally, you will select Rs. 1000 today. That is true because future is uncertain. * Theory of the firm Meaning of a firm A firm is an organization that combines and organizes resources for the purpose of producing goods and/or services for sale. * Firms can be classified as follows * Small, medium and large * Proprietorship (owned individually), partnership (owned by two or more individuals) and corporations (owned by stockholders), and * Public sector, private sector and joint sector. * Economic objectives of a firm * Maximum growth rate * Desires for liquidity * Non-economic objectives of a firm * Survival * Building up public confidence for the product * Welfare * Sound business practices * Progressive management * Baumol’s model (revenue maximizing model) Assumptions * There is a single time horizon of the firm. * The firm aims at maximizing its total sales revenue in the long run subject to a profit constraint. * The firm is oligopolistic whose cost curves are u-shaped and the demand curve is downward slopping. Its total cost and revenue curves are also of the conventional type. * Advertisement is a major instrument of the firm as non-profit competition is the typical form of

competition in oligopolistic markets. * Production costs are independent of advertising. * Price of the product is assumed as constant. * The firm's minimum profit constraint is set competitively of the current market value of its shares. * Baumol's model (revenue maximizing model) Explanation * According to Baumol, with the separation of ownership and control in modern corporations, managers seek prestige and higher salaries by trying to expand company sales even at the expense of profits. * Arguments in support 1) A firm attaches great importance to the magnitude of sales and much concerned about declining sales. 2) If the sales of a firm are declining, banks, creditors and the capital market are not prepared to provide finance to it. 3) Its own distributors and dealers might stop taking interest in it. 4. Consumers might not buy its product because of its unpopularity 5. Firm reduces its managerial and staff with fall in sales. 6. If firm's sales are large, there are economies of scale, the firm expands and earns large profits. 7. Salaries of workers and management also depends to a large extent on more sales and the firm gives them bonus and other facilities. * Marris' model of ' managerial enterprise' * Marris approach is based on the fact that ownership and control of the firm is in the hand of two different sets of people. He suggests that managers have a utility function in which salary, status, power, prestige and security are important variables. Owners of the firm (i. e., shareholders) are however, more concerned about profits, market shares, output, etc. In other words, goals of the managers and shareholders differ from each other. * Two constraints to the achievement of maximization of the rate of growth: * Managerial constraint: The capacity of the managerial team in fact determines the upper limits of growth of the firm. There is a

high possibility that management would lose control over a rapidly growing firm. * Financial constraints: The second constraint on the rate of the growth stems from the voluntary slowing down process by the management itself. This slowing-down process comes from the desire of the management for job security. The management, which holds high the consideration of job security would grow, is such a way that it remains safe on the financial side. * Criticism of Marris' Model 1. Marris assumes a given price structure for the firms. He, therefore, does not explain how prices of products are determined in the market. This is a serious weakness of his model. 2. Another defect of this model is that it ignores the problem of oligopolistic interdependence of firms in non-collusive market. 3. This model also does not analyze interdependence created by non-price competition. 4. The model assumes that firms can grow continuously by creating new products. This is unrealistic because no firm can sell anything to the consumers. 5. The assumptions that all major variables such as profits, sales and costs increase at the same rate is highly unrealistic. 6. It is also doubtful that a firm would continue to grow at a constant rate as measured by Marris. The firm might grow faster now and slowly later on. * Williamson's model of managerial discretion Assumptions * Williamson adopts the same set of assumptions as does Baumol in his Sales Revenue Maximization model, viz. * Market is non-perfectly competitive. * Ownership of the firm and management of the firm are divorced from each other. * A minimum profit constraint is imposed on the managers by the capital market (on shareholders) which cannot be ignored by the management. * In the Williamson's model, managers are free to pursue their own self-interest once they have achieved a level of profit

that will pay satisfactory dividends to shareholders and still ensure growth. The managers' self-interest depends upon many other things besides salary. Further, so far as the goodwill of the firm serves their own ends and ambitions, the managers would be concerned about it; else they would try to bypass it. * Criticism of Williamson's model 1. He does not clarify the basis of the derivation of his feasibility curve. In particular, he fails to indicate the constraint in the profit-staff relation, as shown by the shape of the feasibility curve. 2. He lumps together staff and manager's emoluments in the utility curve. This mixing up of non-pecuniary and pecuniary benefits of the manager makes the utility functions ambiguous. * Behavioral theories of the firm * Satisficing behavior * Cyert and March Model * Satisficing behavior * Simon proposes an alternative model to the profit maximizing one as he believes that the relevant information with the managers is far from complete. The managers take decisions for the future on the basis of incomplete information. * Management, realizing the complexity of calculations, inevitable uncertainties of future and the imperfections of the data that have to be employed in any determination of " optimal" decisions, cannot help but be satisfied with something less; its behavior will be only " satisficing. " * In fact, the management generally is not even certain whether it is maximizing profits or not; instead it aims merely at satisfactory profits. The management determines a ' satisfactory aspiration level' on the basis of its past experience and judgment about future uncertainty. * Criticism of satisficing behavior theory * It is not easy to determine a " satisfactory level". * Simon confuses in the important difference between information about conditions and information about changes in conditions. * When Simon

is talking about ‘ satisficing behavior’, is he referring to mere adjustment to a simple change or to a coordinated or integrated whole of its activities? * Cyert and March Model * Theory focuses on the way decisions are made in the modern large multi-product firm under uncertainty in an imperfect market. They base their theory on the internal structure of such firms and try to analyze the organizational problems which the internal structure of such firms creates and the effects of these problems on the decision-making process. * Cyert and March (1963) make four major research commitments * To focus on the small number of key economic decisions made by the firm. * To develop process-oriented models of the firm. * To link models of the firm as closely as possible to empirical observations. * To develop a theory with generality beyond the specific firms studied. * Agency theory * Suppose you are planning to go for a pleasure trip to Europe the next summer. You can either make all arrangements by yourself, or hire a travel agent to plan your trip. * Similarly, if you want to have LPG connection, you would contact your nearest LPG agent.