CHAPTER 1

Economics and Management

CHAPTER SUMMARY AND TEACHING OBJECTIVES

This is an introductory chapter; the primary focal point is to introduce the role of economics in management.

1. Introduce students to the function of economics in business management.
2. Illustrate the various strategies management gurus suggest companies follow and explain why it is important for executives to assess the economic costs and benefits carefully before going down any one path.

IMPORTANT TERMS

market share percentage of total industry sales made by one company

trade-offs the fact that something is given up when something else is done

marginal the 'next' thing

rational self-interest this is when someone considers the costs and the benefits of a decision

TOPICS AND TEACHING SUGGESTIONS

1. **What Makes a Firm Successful?**

   The objective in this section is to introduce students to the idea that "nothing is free" or "there is no free lunch." By discussing in turn several strategies firms undertake in their search for success, we establish that something must be given up to gain something else. This discussion enables students to realize that there is no simple strategy leading to success.

   Teaching Strategy: List a possible business strategy and ask students to present costs and benefits of the strategy. Create a table of the costs and benefits. Ask the students to provide an example of a firm that appears to have followed the strategy.

2. **The Role of Economics**

   The role of economics is to provide a way to THINK. Economic thinking or decision-making is recognizing that something cannot be acquired without giving up something else. Economists refer to such decision making as comparing costs and benefits and evaluating tradeoffs.

   Teaching Strategy: After examining the various possible business strategies and creating a table of the costs and benefits of each, ask students to name a strategy for which there are no costs. Ask students to name the strategy with the greatest net benefits: They should argue that it depends. *It Depends* is a terrific lesson—it supports the idea that we must *Think*—specifically, think in economic ways.

   Teaching Suggestions: The videos by John Stossel are very entertaining and can be quite useful. They have a free-market bent and often are quite normative. Nevertheless, the tape on "Greed" works very well with this chapter. The videos are available through Laissez-Faire Press. Another set of videos to consider are the "Commanding Heights" set created by PBS. These provide a history of the conflict of ideas regarding free markets and government control and use historical developments to show how the free-market and the planned-economy systems did or did not function. The videos are available through http://www.pbs.org./

3. Our Study of Managerial Economics: How Do We Proceed?

Marginal analysis is the format used by economists to analyze problems. Marginal means 'next' or 'additional'. For example, when economists look at costs we do not look at all past costs in making a decision. We look at the marginal cost. It is generally true that marginal costs rise as more of something is done. It is also the case, that the marginal benefits of more of something decline as the quantity increases. Total benefits of some action are maximized when the marginal cost equals the marginal benefit. A rationally self-interested individual considers the marginal costs and marginal benefits in making a decision.

ANSWERS TO EXERCISES

1. When would being first be a valuable strategy?

   Being a first mover is valuable when the first firm acquires a strategic asset as a result of being first. In other words, when being first provides a brand name or reputation that would not arise if the firm were a second or third mover. Moving first provides benefits when the advantage gained is hard to replicate or when being first provides cost advantages that the later entrants cannot achieve.

2. Would a focus on gaining market share make sense?

   Not necessarily. There is not a strong correlation between market share and profits. It is also the case that larger firms are more costly to manage.

3. Look up the latest *Business Week* best seller's business books list. How many introduce a "quick-fix?"

   Better yet, send the students to Borders or some such book store and have them list the latest 10 business book titles; this can be done online at http://www.bn.com/ or http://www.amazon.com./

4. You are to decide whether to implement "teams" in this course. Describe the costs and benefits of having teams of students work together on papers, exams, and homework. Would you implement teams? Why or why not?

   Benefits to teams:

      Interdependent learning—some must teach others, thereby increasing the learning.

      Comparative advantage—enables specialization and gains from trade

   Potential drawbacks:

      Free riders—some students may shirk and thus increase the burden on others

      Incentive effects other than free riders may be to reduce efforts, to be less creative

5. Is there a relationship between market share and profit? What could account for this relationship?

   There is a relationship between market share and profit. The relationship is not necessarily a strong, direct one, however. For the initial levels of market share, as market share rises so does profit. But there are diminishing marginal returns to market share—as market share rises, then at some level profit remains steady or rises only slightly.

6. In the following table, total cost is listed. Calculate marginal cost.

Quantity	*Total Cost*	*Marginal Cost*
0	*0*	
1	*10*	*10*
2	*20*	*10*
3	*40*	*20*
4	*80*	*40*
5	*130*	*50*
6	*200*	*70*

7. In the following table, total revenue is listed. Calculate marginal revenue

Quantity	*Total Revenue*	*Marginal Revenue*
5	*200*	
10	*350*	*150*
15	*450*	*100*
20	*520*	*70*
25	*580*	*60*
30	*630*	*50*

8. If economics assumes people are self-interested, then according to economics, why would executives, experienced in business and exposed to business practices over many years, be so quick to grab hold of a management fad?

   Being self-interested does not mean that people will not make mistakes or try new things. Everyone looks for easy solutions to problems. Experienced managers may try a fad but if it does not work then it will be dropped. This is the nature of a self-interested manager.

9. What does the phrase "there is no free lunch" mean?

   The phrase "no free lunch" means there is a cost to everything—specifically when one thing is gained, something else must be given up. The PPC exercise presented in Chapter 2 illustrates this point very well.

10. China is the world's most populous nation with 1.25 billion people. Firms look at that population as a huge customer base and are rushing to establish themselves in China. Is this appropriate for all firms? Why or why not?

    China is not an appropriate market for all firms. Any firm must ensure that its product, approach, and distinct capabilities have value in the markets in which it operates.

11. What is meant by the statement "quality is not free"?

    An increase in quality requires the use of resources—resources have to be taken from something else to improve quality. The exercise using production possibilities works very well to demonstrate this. See Chapter 2.

12. How would you describe globalization? Thomas Friedman wrote a book called *The World is Flat* that was published in April 2005. From the title, what would you suggest is his main thesis?

    Globalization refers to lowering of the costs associated with accessing world markets. With the increased ease of international trade, markets are becoming more alike across borders. The Friedman title suggests the ease and interconnectedness that the term globalization refers.

13. Suppose the marginal cost of solving the global warming problem and the marginal benefit of doing so are listed below. How many degrees of temperature to be reduced are the best for society to implement? Explain why.

    .015 – Total benefits to society from temperature reduction are maximized when marginal benefits and marginal costs are equal. This is at .015.

14. An entrepreneur quits a job where she was earning $60,000 per year and starts her own business. In this business she is earning $20,000. What is the cost of the business? Suppose the entrepreneur is so happy being on her own that she thinks it gives her the same joy that a $100,000 job would. What is the cost of the business?

    The cost of any action is what is given up – the opportunity cost. The costs for the entrepreneur are the explicit costs of running the business and the $60,000 she is giving up. This is true regardless of the joy she associates with the freedom of being an entrepreneur.