

MODULE -1 INTRODUCTION

Managerial Economics: Meaning, Nature, Scope, & Significance, Uses of Managerial Economics, Role and Responsibilities of Managerial Economist. Theory of the Firm: Firm and Industry, Objectives of the firm, alternate objectives of firm.

Managerial theories: Baumol's Model, Marris's Hypothesis, Williamson's Model.

Economics is a social science concerned with the production, distribution, and consumption of goods and services.

Economics studies how individuals, businesses, governments, and nations make choices about how to allocate resources. Economics focuses on the actions of human beings, based on assumptions that humans act with rational behavior, seeking the most optimal level of benefit or utility.

Economics can generally be broken down into macroeconomics, which concentrates on the behavior of the economy as a whole (analyzes the decisions made by countries and governments), and microeconomics, which focuses on individual people and businesses (allocation of resources, and prices of goods and services, taxes, regulations and government legislation.).

MANAGERIAL ECONOMICS: MEANING & DEFINITION

- “Managerial economics is concerned with the application of economic concepts and economic analysis to the problems of formulating rational managerial decisions.
- Branch of Economics: ‘Managerial Economics is the study of Economic Theories, Principles and Concepts which is used in Managerial Decision Making.’
- ‘Managerial Economics is the Application of various Theories, Concepts and Principles of Economics in the Business Decisions.’
- It also includes ‘The Application of Mathematical and Statistical tools in Management decisions.’

Definition:

1. “Managerial economics is the study of allocation of resources available to a firm among the activities of that unit” - Hynes.
2. “The integration of economic theory and business practice for the purpose of facilitating decision making and

forward planning by management. – **Spencer and Seligman.**

3. “Managerial economics is the application of economic principles and methodologies to the decision

1

making process within the firm or organization.”-**Douglas.**

4. “Managerial economics applies economic theory and methods to business and administrative decision making.”- **Pappas & Hirschey.**



MACROECONOMICS:

- The study of economic activity by looking at the economy as a whole.
- Macroeconomics analyzes overall economic issues such as employment, inflation, productivity, interest rates, the foreign trade deficit, and the federal budget deficit. ...
- An example of macroeconomics is the study of U.S. employment.

MICROECONOMICS:

- Microeconomics is the social science that studies the implications of incentives and decisions, specifically about how those affect the utilization and distribution of resources.

- Microeconomics shows how and why different goods have different values, how individuals and businesses conduct and benefit from efficient production and exchange, and how individual's best coordinate and cooperate with one another.
- Generally speaking, microeconomics provides a more complete and detailed understanding than macroeconomics.

NATURE OF MANAGERIAL ECONOMICS:

1. **Art and Science:** Management theory requires a lot of critical and logical thinking and analytical skills to make decisions or solve problems. Many economists also find it a source of research, saying it includes applying different economic concepts, techniques and methods to solve business problems.
2. **Micro Economics:** In managerial economics, managers typically deal with the problems relevant to a single entity rather than the economy as a whole. It is therefore considered an integral part of microeconomics.
3. **Uses Macro Economics:** A corporation works in an external world, i.e. it serves the consumer, which is an important part of the economy. For this purpose, it is important that managers evaluate the various macroeconomic factors such as market dynamics, economic changes, government policies, etc., and their effect on the company.

Multidisciplinary: It uses many tools and principles that belong to different disciplines, such as accounting, finance, statistics, mathematics, production, operational research, human resources, marketing, etc.

4. **Prescriptive/Normative Discipline:** By introducing corrective steps it aims at achieving the objective and solves specific issues or problems.
5. **Management Oriented:** This serves as an instrument in managers' hands to deal effectively with business related problems and uncertainties. This also allows for setting priorities, formulating policies, and taking successful decision-making.
6. **Pragmatic:** The solution to day-to-day business challenges is realistic and rational. 7.

It is concerned with the **application of theories and principles of economics.**

SCOPE OF MANAGERIAL ECONOMICS:



3

Managerial economics is concerned with the application of economic concepts and analysis to the problem of formulating rational managerial decisions. There are four groups of problem in both decision making and forward planning.

1. Demand Analysis and Forecasting:

- A firm relies on converting inputs into outputs and generates revenue from them. A clear and accurate estimation of demand ensures a continuous efficiency of the firm. Several external factors like price, income, affect the demand that need to be analyzed.
- Upon analyzing these factors affecting the demand for a product, managers can decide on the production. After estimating the current demands, manager's move ahead to predict future demands for the product. This is referred to as demand forecasting.

2. Cost and Production Analysis:

- Cost Analysis is yet another function of Managerial economics.
- A company makes a profit in two ways: by **increasing the demand or by reducing the cost**. · The determinants of assessing costs, the connection between cost and yield, the gauge of cost and benefit are indispensable to a firm.

3. Pricing Decisions, Policies, and Practices:

- Among the 4Ps of marketing, Price finds an important place. For any firm, Pricing is a very important aspect of Managerial Economics as a firm's revenue earnings largely depend on its pricing policy. However, it is a bit

challenging as other players are competing in the same price segment.

- When pricing a product is done, the costs of production are also taken into account. Managerial

Economics helps the management to go through all the analyses and then price a product. In an oligopoly market condition, the knowledge of pricing a product is essential.

4. Capital Management:

- Every asset a business owns is known as its capital. Capital management thus becomes an important practice.
- Planning and control of capital expenditures is a basic executive function. It involves the Equi-marginal principle.

4

- The prime objective is to ensure the sustainable use of capital. This means that funds should be kept at a bay when the managerial returns are less than in other uses.

5. Profit Management:

- A business firm is an organization designed with an intention to make profits and profits reflect the success of a company. After all the analyses, it all rolls down to profits.
- To maximize profits a firm needs to manage certain things like pricing, cost aspects, resource allocation, and long-run decisions. This would mean that the firm should work from the very beginning, evaluate its investment decisions and frame the best capital budgeting policies. Profit management is considered as a difficult area of managerial economics.

OTHER:

- **Resource allocation:** Scarce resources have to be used with utmost efficiency to get optimal results. These include production programming, problem of transportation, etc.
- **Inventory and queuing problem:** Inventory problems involve decisions about holding of optimal levels of stocks of raw materials and finished goods over a period. These decisions are taken by considering demand and supply conditions. Queuing problems involve decisions about installation of additional machines or hiring of

extra labour in order to balance the business lost by not undertaking these activities.

- **Pricing problems:** Fixing prices for the products of the firm is an important part of the decision

Making process. Pricing problems involve decisions regarding various methods of pricing to be adopted.

- **Investment problems:** Forward planning involves investment problems. These are problems of

Allocating scarce resources over time. For example, investing in new plants, how much to invest, sources of funds, etc.

Study of managerial economics essentially involves the analysis of certain major subjects like:

- Demand analysis and methods of forecasting
- Cost analysis
- Pricing theory and policies
- Profit analysis with special reference to break-even point

5

- Capital budgeting for investment decisions
- The business firm and objectives
- Competition.
- Inflation and economic conditions.

SIGNIFICANCE OF MANAGERIAL ECONOMICS:

- **Business Planning:** Managerial economics assists business organizations in formulating plans and better decision making. It helps in analyzing the demand and forecasting future business activities.
- **Cost Control:** Controlling the cost is another important role played by managerial economics. It properly analyses and decides production activities and the cost associated with them. Managerial economics ensure that all resources are efficiently utilized which reduces the overall cost.
- **Price Determination:** Setting the right price is one of the key decisions to be taken by every business organization. Managerial economics supplies all relevant data to managers for deciding the right prices for products.

- **Business Prediction:** Managerial economics through the application of various economic tools and theories helps managers in predicting various future uncertainties. Timely detection of uncertainties helps in taking all possible steps to avoid them.
- **Profit Planning and Control:** Managerial economics enables in planning and managing the profit of the business. It makes an accurate estimate of all cost and revenue which helps in earning the desired profit. ➤
- Inventory Management:** Proper management of inventory is a must for ensuring the continuity of business activities. It helps in analyzing the demand and accordingly, production activities are performed. Managers can arrange and ensure that the proper quantity of inventory is always available within the business organization.
- **Manages Capital:** Managerial economics helps in taking all decisions relating to the firm's capital. It properly analyses investment avenues before investing any amount into it to ensure the profitability of an investment.
- Assist in Decision Making
- Optimization of Resources

USES OF MANAGERIAL ECONOMICS:

1. **Production Decisions** : Production theory explains the principles in which the business has to take decisions on how much of each commodity it sells and how much it produces and also how much of raw material ie., fixed capital and labour it employs and how much it will use.
2. **Inventory Decisions**: Inventory decisions have a direct impact on production. For example, a decision to increase safety stock means that the production rate must increase until the desired level of safety stock is achieved
3. **Cost Decisions**: Its goal is to advise management on the most appropriate course of action based on the cost efficiency and capability. Cost accounting provides the detailed cost information that management needs to control current operations and plan for the future.
4. **Marketing Decisions**: Marketing decisions are those decisions that are taken by a marketing manager to achieve the ultimate marketing objectives of the organization.

5. **Investment Decisions:** Investment decision refers to selecting and acquiring the long-term and short-term assets in which funds will be invested by the business.
6. **Personnel Decisions:** Personnel decisions are decisions made in organizations that affect people's work lives, such as selection, placement, and discharge. • All business organizations must make personnel decisions about their employees. Some organizations use less formal and scientifically based methods than others.

MANAGERIAL ECONOMIST:

- A Managerial Economist is also termed as an economic advisor or business economist. ● He is responsible for analyzing various internal and external environmental forces that influence the functioning of business organizations.
- Managerial economist makes several successful business forecasts and updates the management team regarding the economic trends from time to time

ROLES AND RESPONSIBILITIES OF MANAGERIAL ECONOMIST:

A managerial economist helps the management by using his analytical skills and highly developed techniques in solving complex issues of successful decision-making and future advanced planning and assists the business planning process of a firm.

● Studies Business Environment

The managerial economist is responsible for analyzing the environment in which business operates. Proper study of all **external factors** that affect the functioning of organization is must for proper functioning. He studies various factors like **growth of national income,**

Competition level, price trends, phases of the business cycle and economy and updates the management regarding it from time to time.

● Analyses Operations Of Business

He analyses the internal operation of business and helps management in making better decisions in regard to internal workings. Managerial economist through his analytical and forecasting skills provides advice to

managers for formulating policies regarding internal operations of the business. ● **Demand Forecasting and Estimation**

Proper estimation and forecasting of future trends helps the business in achieving desired profitability and growth. Managerial economist through proper study of all internal and external forces makes successful forecasting of future uncertainties or trends.

● **Production Planning**

Managerial economist is responsible for scheduling all production activities of business. He evaluates the capital budgets of organizations and accordingly helps in deciding timing and locating of various actions.

● **Economic Intelligence**

He provides economic intelligence services by communicating all economic information to management. Managerial economist keeps management always updated of all prevailing economic trends so that they can confidently talk in seminars and conferences.

● **Performing Investment Analysis**

A managerial economist analyzes various investment avenues and chooses the most appropriate one. He studies and discovers new possible fields of business for earning better returns.

● **Focuses On Earning Reasonable Profit**

He assists management in earning a reasonable rate of profit on capital employed in the business. Managerial economist monitors activities of organizations to check whether all operations are running efficiently as per the plans and policies.

● **Maintaining Better Relations**

A managerial economist maintains better relations with all internal and external individuals connected with the business. It is his duty to develop a peaceful and cooperative environment within the organization and aims to reduce any opposition taking place.

THEORY OF THE FIRM:

The theory of the firm is the microeconomic concept founded in neoclassical economics that states that a firm exists and makes decisions to maximize profits. The theory holds that the overall nature of companies is to maximize profits meaning to create as much of a gap between revenue and costs. The firm's goal is to determine pricing and demand within the market and allocate resources to maximize net profits.

Theory of the firm is related to comprehending how firms come into being, what are their objectives, how they behave and improve their performance and how they establish their credentials and standing in society or an economy and so on.

The theory of the firm aims at answering the following questions:

- Existence – why do firms emerge and exist, why are not all transactions in the economy mediated over the market?
- Which of their transactions are performed internally and which are negotiated in the market?
- Organization – why are firms structured in such a specific way? What is the interplay of formal and informal relationships?
 - Heterogeneity of firm actions/performances – what drives different actions and performances of firms?

FIRM AND INDUSTRY

A **Firm** is a commercial enterprise, a company that buys and sells goods and services to consumers with the aim of making a profit. A business entity such as a corporation, limited liability company, public limited company, sole proprietorship, or partnership that has goods or services for sale is categorized as a firm. An

Industry is an economic activity concerned with the processing of raw materials and manufacture of goods. It can also be said as a sector that produces goods or related services within an economy.

OBJECTIVES OF THE FIRM

1. Profit maximization

2. Sales maximization
3. Utility maximization
4. Increase market share/market dominance
5. Social/environmental concerns
6. Profit satisficing
7. Co-operatives

1. **Profit maximization:** Considering any business that exists, they are usually concerned with maximizing profit. Higher profit means:
 - Higher dividends for shareholders.
 - More profit can be used to finance research and development. Higher profit makes the firm less vulnerable to takeover.
 - Higher profit enables higher salaries for workers.
2. **Sales Maximization:** Firms often seek to increase their market share, even if it means less profit. This could occur for various reasons:
 - Increased market share increases monopoly power and may enable the firm to put up prices and make more profit in the long run.
 - Managers prefer to work for bigger companies as it leads to greater prestige and higher salaries. Increasing market share may force rivals out of business. E.g. the growth of supermarkets has led to the demise of many local shops. Some firms may actually engage in predatory pricing which involves making a loss to force a rival out of business.
3. **Utility maximization:** It means “that managers get satisfaction from using some of the firm's potential profits for unnecessary spending on items from which they personally benefit.” To pursue his goal of utility maximization, the manager directs the firm's resources many ways.
4. **Increase Market Share/ Market Dominance:** This is similar to sales maximization and may involve mergers and takeovers. With this objective, the firm may be willing to make lower levels of profit in order to increase in size and gain more market share. More market share increases its monopoly power and ability to be a price setter.
5. **Social Concern:** A firm may incur extra expense to choose products which don't harm the environment or

products not tested on animals. Alternatively, firms may be concerned about local community / charitable concerns.

Some firms may adopt social/environmental concerns as part of their branding. This can ultimately help profitability as the brand becomes more attractive to consumers.

Some firms may adopt social/environmental concerns on principal alone – even if it does little to improve sales/brand image.

6. **Profit Satisficing:** Profit satisficing is a situation where there is a separation of ownership and control. As a result, the owners are likely to have different objectives to the managers and workers. 7. **Co-operatives:**

Co-operatives may have completely different objectives to a typical business. A co operative is run to maximize the welfare of all stakeholders – especially workers. Any profit the co operative makes will be shared amongst all members.

ALTERNATE OBJECTIVES OF THE FIRM:

- **Economic objectives:**

- Maximize growth rate
- Desire for liquidity

- **Non-economic objectives:**

- Survival
- Retention of Customers
- Innovation
- Recognition
- Optimum Utilization of Resources
- Supplying desired goods at reasonable prices
- Social welfare
- Building up public confidence for the public

MANAGERIAL THEORIES OF THE FIRM:

Managerial theories of the firm place emphasis on various incentive mechanisms in explaining the behavior of managers and the implications of this conduct for their companies and the wider economy. According to traditional theories, the firm is controlled by its owners and thus wishes to maximize short run profits. The more contemporary managerial theories of the firm examine the possibility that the firm is controlled not by its

owners, but by its managers, and therefore does not aim to maximize profits. Although

11

profit plays an important role in these theories as well, it is no longer seen as the sole or dominating goal of the firm. The other possible aims might be sale revenue maximization or growth.

MANAGERIAL THEORIES OF THE FIRM

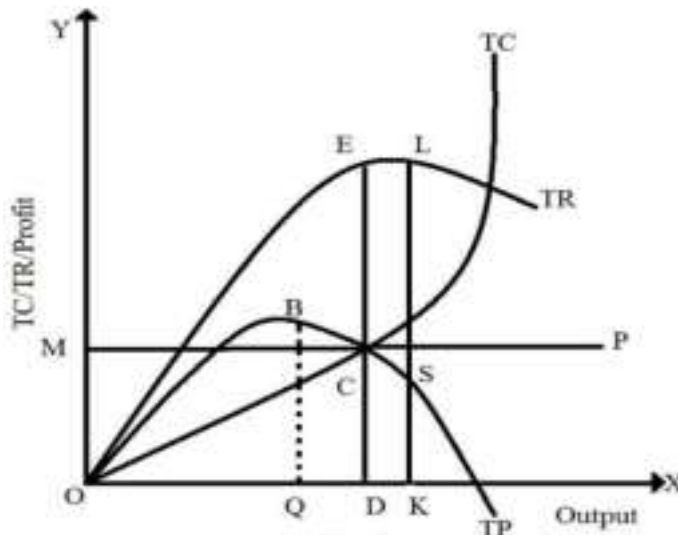
- Baumol's Theory of Sales Revenue Maximization
- Marris Growth Maximization Model
- Williamson's Managerial Discretionary Theory

1. BAUMOL'S THEORY OF SALES REVENUE MAXIMISATION:

Baumol's Model: Baumol's theory of sales revenue maximization was created by American economist William Jack Baumol. It's based on the theory that, once a company has reached an acceptable level of profit for a good or service, the aim should shift away from increasing profit to focus on increasing revenue from sales.

W.J. Baumol suggested Sales Revenue maximization as an alternative goal to profit maximization. Managers only ensure acceptable level of profit, pursuing a goal which enhances their own utility. **Assumption of the Theory:**

1. There is a single period time horizon of the firm.
2. The firm aims at maximizing its total sales revenue in the long run subject to a profit constraint.
3. The firm's minimum profit constraint is set competitively in terms of the current market value of its shares.
4. The firm is oligopolistic whose cost curves are U-shaped and the demand curve is downward sloping. Its total cost and revenue curves are also of the conventional type.



From the above graph considering Output in X axis and TR/TC/profit in Y axis, where TC is the total cost curve, TR the total revenue curve, TP the total profit curve and MP the minimum profit or profit constraint line. The firm maximizes its profits at OQ level of output corresponding to the highest point B on the TP curve. But the aim of the firm is to maximize its sales rather than profits. The sales maximization output is OK where the total revenue KL is the maximum at the sales maximization output OK is higher than the profit maximization output OQ. But sales maximization is subject to minimum profit constraint highest point of TR. This sales maximization output OK is higher than the profit maximization output OQ. But sales maximization is subject to minimum profit constraint. The output OK will not maximize sales as the minimum profits OM are not being covered by total profits KS hence total revenue gets decrease from L to E showing the quantity level showing the quantity of output 'OD'. By the above Baumol justified that sales revenue has to be optimally increased.

ARGUMENTS IN FAVOUR OF MAXIMISATION OF SALES GOAL:

Baumol's argument to justify sales revenue importance.

1. If the sales of a firm are declining then the banks, creditors and the capital market are not prepared to provide finance to the firm anymore.
2. Its own distributors and dealers might stop showing interest on the firm's product in future.
3. Consumers might not buy its product because of its unpopularity and there is a more chance of competitors acquiring the consumers.

13

4. Firm reduces its managerial and other staff with fall in sales.
5. But if firm's sales are large, there are economies of scale and the firm expands and earns large profits.
6. Salaries of workers and management also depend to a large extent on more sales and the firm gives them bonus and other facilities.

Conclusion: This theory states that the sales maximization is to increase the total revenue by money where, Sales can increase up to the point of profit maximization where the marginal cost equals marginal revenue. If sales are increased beyond this point money sales may increase at the expense of profits. If sales are increased beyond this point money sales may increase at the expense of profits.

2. MARRIS'S GROWTH MAXIMIZATION MODEL:

Robin Marris in his book The Economic Theory of 'Managerial' Capitalism (1964) has developed a dynamic balanced growth maximizing theory of the firm. He concentrates on the proposition that modern big firms are managed by managers and the shareholders are the owners who decide about the management of the firms.

The managers aim at the maximization of the growth rate of the firm and the shareholders aim at the maximization of their dividends and share prices. To establish a link between such a growth rate and the share prices of the firm, Marris develops a balanced growth model in which the manager chooses a constant growth

rate at which the firm's sales, profits, assets, etc., grow.

"In Corporate firms, there is structural division of ownership and management which allows managers to set goals which do not necessarily conform to those of the owners.

The shareholders are the owners. Their utility function includes variables such as

- Profits,
- Size of output,
- Size of capital,
- Market share and
- Public image.

The Managers have other ideas. Their utility functions are:

- Salaries,
- Job security,

14

- Power and status

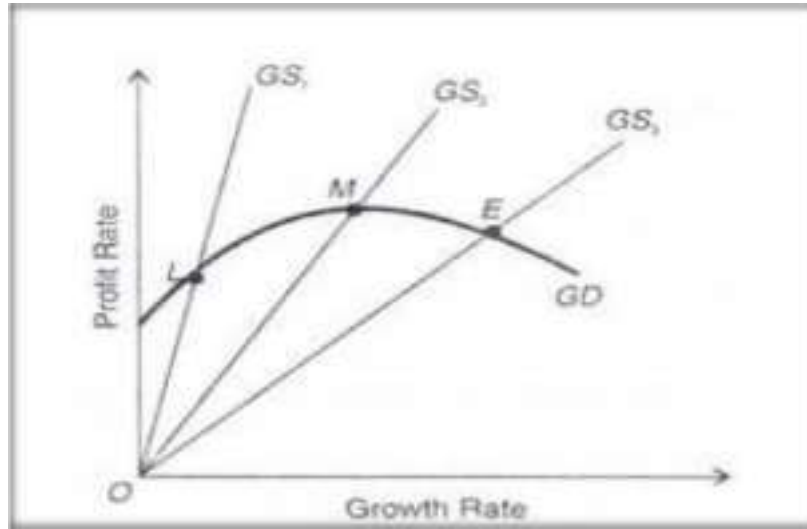
The Marris's model is based on the following assumptions:

- It assumes a given price structure.
- Production costs are given.
- There is no oligopolistic interdependence.
- Factor prices are constant.
- Firms are assumed to grow through diversification.
- All major variables such as profits, sales and costs are assumed to increase at the same rate.

The objective of the firm is to maximize its balanced growth rate.

The Growth itself depends on two factors: First, the rate of growth of demand for the firm's product - GD; and second, the rate of growth of capital supply – GS.

All major variables such as profits, sales and costs are assumed to increase at the same rate.



- According to Marris, there are two different utility functions for the manager and the owner of the firm. The utility function of the manager consists of his emoluments, status, power, job security, etc. On the other hand, the utility function of the owner includes profits, capital, output, market share, etc.
- The firm may grow in size through the creation of new products which create new demands. Marris calls it differentiated diversification. The introduction of new products depends upon the rate of diversification, advertising expenses, R&D expenditures, etc.

15

- Marris establishes the relationship between growth and profits on the demand side through diversification into new products. The links between growth and profits are different at different levels of growth. In this growth-profits relationship, growth determines profits. When the rate of growth of the firm is low, the relationship is a positive one.
- As new products are introduced, the firm expands (grows) and profits increase. With the further increase in the growth rate due to greater diversification into new products, the growth-profits relationship becomes negative. This is because there is the managerial constraint which sets a limit on the rate of managerial growth that restricts the growth of the firm.

The firms' managerial ability to cope with a great number of changes at once is limited. It is not possible to develop a larger management team for the development and marketing of new products.

- The higher rate of diversification requires higher expenditures on advertising and R &D. As a result, beyond a certain growth rate, the higher growth rate leads to a lower rate of profit. This is illustrated in Figure 4 where the GD curve first rises, reaches the highest point M and then starts falling.
- The growth-supply curve will be very steep as shown by GS1 curve. The firm's equilibrium will be at point L where the GS1 curve intersects the GD curve. This is again not the optimal equilibrium point of the firm because here the growth rate is low and profits are below the maximum level.
- Larger retained profits are required by managers to invest larger funds for the growth of the firm. These raise the retention ratio which, in turn, leads to higher profits and higher growth rates until point M of maximum profits is reached.
- This is again not the optimum equilibrium point of the firm because the managers feel that this combination of higher growth rate and higher profits is approved by the shareholders and there is no threat to their job security. They will, therefore, be encouraged to raise the retention ratio further, invest more funds, expand and increase the growth rate of the firm.
- As a result, the growth-supply curve will become flatter and take the shape of GS3 curve as in the figure where it intersects the DS curve at point E. At this point, distributed profits to shareholders fall. But they are adequate to satisfy the shareholders so that there is no fear of fall in the prices of shares and of the threat of take-overs. There is also job security for managers.
- Thus point E is the optimal equilibrium point of the firm. If the managers adopt a higher retention ratio than this, the distributed profits will fall further and the shareholders will not be satisfied which will endanger the job security of managers. The existing shareholders may decide to replace the managers. If the distribution of low profits to shareholders brings a fall in the market prices of shares, it may lead to take-over of the firm.

- Criticism:

- 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.
- . Another defect of this model is that it ignores the problem of oligopolistic interdependence of firms in non collusive market.
- The assumption that all major variables such as profits, sales and costs increase at the same rate is highly

unrealistic.

- It is also doubtful that a firm would continue to grow at a constant rate, as assumed by Marris. The firm might grow faster now and slowly later on.
- Marris lumps together advertising and R&D expenses in his model. This is a serious shortcoming of the model because the effectiveness of these two variables is not the same in any given period.

Conclusion:

- Thus the manager of a firm aims at maximizing his utility, and his utility depends upon the rate of growth of the firm. Though promoting the growth of the firm is the main aim of the manager, yet he is also motivated by his job security. The manager's job security depends upon the satisfaction of shareholders who are concerned to keep the firm's share prices and dividends as high as possible.
- Thus the manager aims at maximizing the rate of growth of the firm and the shareholders (owners) aim at maximizing their profits in the form of dividends and share prices. Marris analyses the means by which the firm tries to achieve its growth-maximization goal.

3. WILLIAMSON'S MANAGERIAL DISCRETIONARY THEORY:

- **Oliver E. Williamson found** (1964) that profit maximization would not be the objective of the managers of a company.
- This theory assumes that utility maximization is a manager's sole objective. However it is only in a corporate form of business organization that a self-interest seeking manager
Maximize his/her own utility, since there exists a separation of ownership and control.
- The managers can use their 'discretion' to frame and execute policies which would maximize their own utilities rather than maximizing the shareholders' utilities.
 - This is essentially the principal-agent problem. This could however threaten their job security, if a

minimum level of profit is not attained by the firm to distribute among the shareholders.

Utility function or "**expense preference**"^[8] of a manager can be given by:

$$U=U(S,M,Id)$$

U denotes the Utility function,

S denotes the “monetary expenditure on the staff” (**not only the manager's salary and other forms of monetary compensation received by him from the business firm**)

M stands for "Management Slack“(non-essential management perquisites such as entertainment expenses, lavishly furnished offices, luxurious cars, large expense accounts, etc. which are above minimum to retain the managers in the firm) and

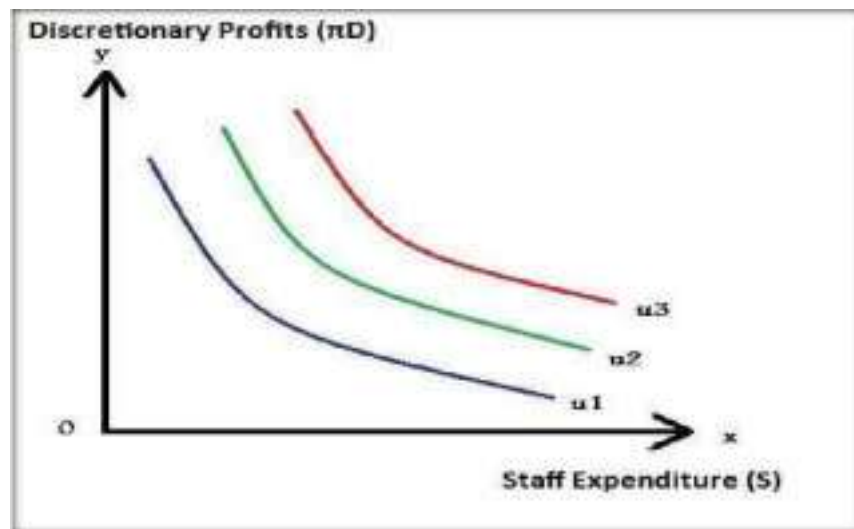
ID stands for amount of "Discretionary Investment". (The amount of resources left at a manager's disposal, to be able to spend at his own discretion. For example, spending on latest equipment, furniture, decoration material, etc.)

Managerial utility function:

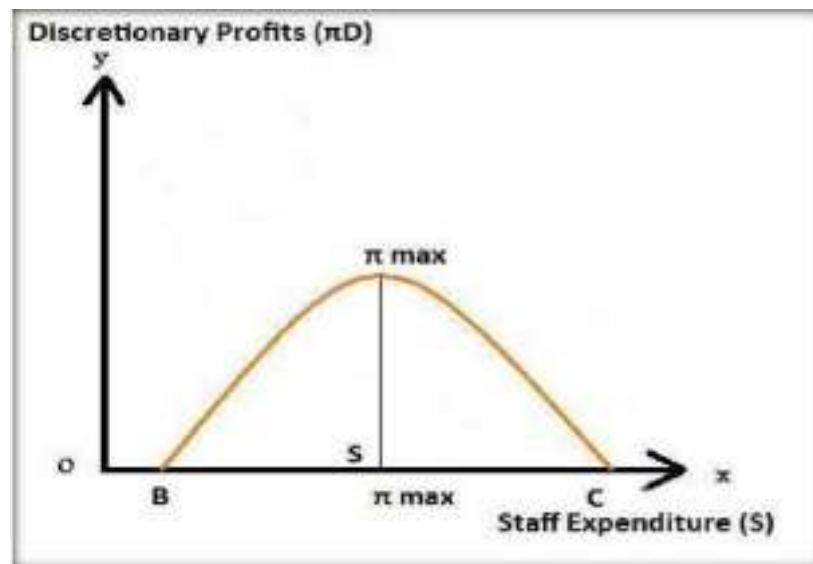
The managerial utility function includes variables such as salary, job security, power, status, dominance, prestige and professional excellence of managers.

The basic assumptions of the model are:

- Imperfect competition in the markets.
- Divorce of ownership and management.
- A minimum profit constraint exists for the firms to be able to pay dividends to their shareholders.



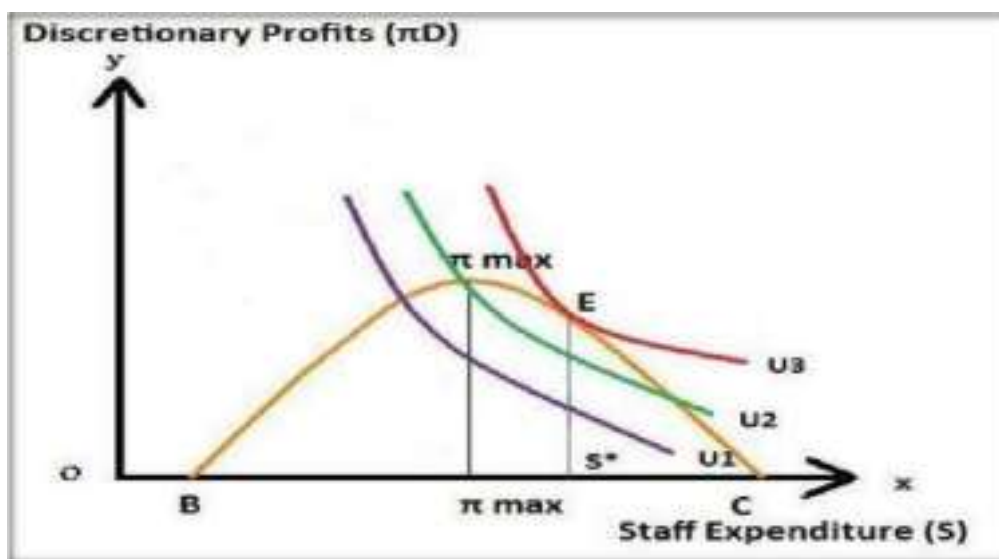
- Fig 1. Shows the various levels of utility (U_1, U_2, U_3) derived by the manager by combining different amounts of discretionary profits and staff expenditure. Higher the indifference curve, higher is the level of utility derived by the manager. Hence the manager would try to be on the highest level of indifference curve possible given the constraints. Staff expenditure is plotted on the x -axis and discretionary profits on the y axis.
- The discretionary profit in this simplified model is equal to the discretionary investment. The indifference curves are downward sloping and convex to the origin. This shows diminishing marginal rate of substitution of staff expenditure for discretionary profits. The curves are asymptotic in nature which implies that at any point of time and under any given circumstance the manager will choose positive amounts of both discretionary profits and staff expenditure



- Assuming that the firm is producing an optimum level of output and the market environment is given, the discretionary profits curve is generated, shown in Fig 2. It gives the relationship between staff expenditure and discretionary profits.
- It can be seen from the figure that profit will be **positive** in the region between the points B and ● Initially with increase in profits, the staff expenditure the discretionary profits also increase, but this is only till the point Π_{max} that is, till S level of staff expenditure. Beyond this if staff expenditure is increased due

to increase in output, and then a fall in the discretionary profits is noticed.

- Staff expenditure of less than B and more than C is not feasible as it wouldn't satisfy the Minimum profit constraint and would in turn threaten the [job security](#) of managers.



- To find the equilibrium in the model, Fig 1. Is superimposed on Fig 2.
- The equilibrium point is the point where the discretionary profit curve is tangent to the highest possible indifference curve of the manager, which is point E in Fig 3. Staying at the highest profit point would require the manager to be at a lower indifference curve U_2 .
- In this case the highest attainable level of utility is U_3 . At equilibrium, the level of profits would be lower but staff expenditure S^* is higher than the staff expenditure made at the maximum profit point.
- As indifference curve is downward sloping, the equilibrium point would always be on the right of the maximum profit point. **Thus the model shows the higher preference of managers for staff expenditure as compared to the discretionary investments**

Arguments:

- In the Williamson theory or model argues that managers have discretion in pursuing policies which maximize

their own utility rather than attempting the maximization of profits which maximizes the utility of owner and shareholders.

20

- Profit acts as a constraint to this managerial behavior in that the financial market and the Shareholders require a minimum profit to be paid out in the form of dividends, otherwise the job Security of managers is endangered.
- In this theory Williamson considered the two important factors namely, staff expenditures on emoluments (slack payments), and funds available for discretionary investment give to managers a positive satisfaction (utility) because these expenditures are a source of security and reflect the power, status, prestige and professional achievement of managers.
- Being the head of a large staff is a symbol of power, status and prestige, as well as a measure of Professional success, because a progressive and increasing staff implies successful expansion of the particular activity for which a manager is responsible within a firm.

Criticism:

● This model 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. ● It lumps together staff and manager's emoluments in the utility curve. This mixing up of non Pecuniary and pecuniary benefits of the manager make the utility function ambiguous.

- This model does not deal with oligopolistic interdependence and of oligopolistic rivalry.

Arguments:

- In the Williamson theory or model argues that managers have discretion in pursuing policies which maximize their own utility rather than attempting the maximization of profits which maximizes the utility of owner and shareholders.
- Profit acts as a constraint to this managerial behavior in that the financial market and the shareholders require a

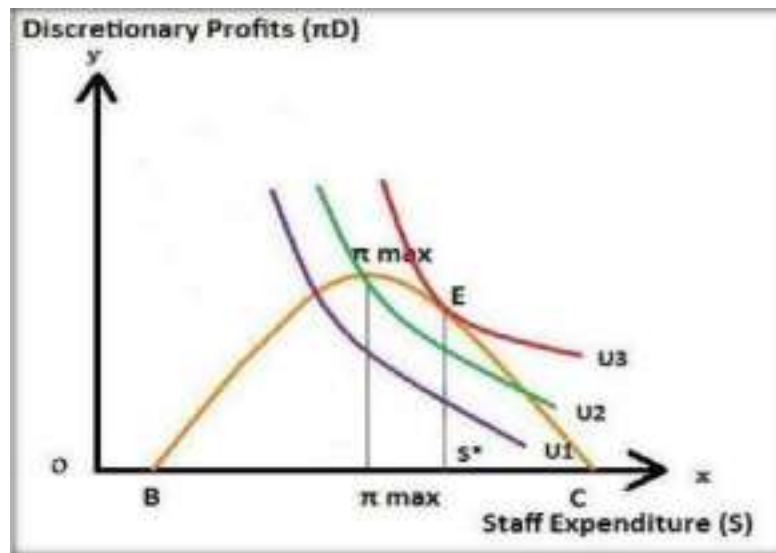
minimum profit to be paid out in the form of dividends; otherwise the job security of managers is endangered.

- In this theory Williamson considered the two important factors namely, staff expenditures on emoluments (slack payments), and funds available for discretionary investment give to managers a positive satisfaction (utility) because these expenditures are a source of security and reflect the power, status, prestige and

21

professional achievement of managers.

- Being the head of a large staff is a symbol of power, status and prestige, as well as a measure of Professional success, because a progressive and increasing staff implies successful expansion of the particular activity for which a manager is responsible within firm.



From the above graph, taking Discretion Profit in Y-axis and Staff Expenditure in X- axis, where U_1 , U_2 , U_3 shows the utility level of the managers with facilities provided by the firm. With the different combination of factors the level of utility changes. Hence the profit of the firm relies on the ideal combination of factors such as Discretion Profit and Staff Expenditure.

Criticism:

1. This model 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. It 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 function ambiguous.
3. This model does not deal with oligopolistic interdependence and of oligopolistic rivalry.

QUESTION BANK:

1. Define managerial economics.3m
2. What is Managerial Revenue and Managerial Cost?3m
3. Explain the concepts of Micro and Macroeconomics.7m
4. Discuss the scope of managerial economics.7m/10m
5. Explain the significance and uses of managerial economics.10m
6. Who is Managerial Economist? Elaborate the roles and responsibilities of managerial economist.10m
7. Discuss the objectives of the firm.7m
8. Explain the Baumol's sales revenue maximization model, with a suitable graph.10m
9. Elaborate the Marris's model? Explain with graph 10m
10. Enumerate the Williamson's Discretionary model with a graph? 1

