Segment: Basics of Managerial Economics

Topic: Meaning and Importance of Managerial Economics

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Introduction

Economics impacts our day-to-day lives. Economics also influences the decisions taken by managers of business firms. Any business is part of an economy. As we know, economic conditions heavily impact business activities and vice versa. The per capita income of the citizens will define the purchasing power based on which, the business enterprises will decide what products to manufacture and sell. A new enterprise has to forecast the demand for the product, which it wants to sell. The day to day product market has to decide a viable price depending upon the interaction between the demand and the supply. Thus, management practitioners and academicians brought economics to their perspective and developed 'Managerial Economics'.

Learning Objectives

At the end of this topic, you will be able to:

- describe the relevance and context for managerial economics
- explain the salient and distinguishing features of the subject
- recognise the role of the Managerial Economist in a business firm
- assess the scope of the subject vis-à-vis business management
- explain the decision-making process
- discuss the decision-making process in day-to-day business.

1. Definitions

In this section, we will discuss a few definitions. Managerial economics is a science that deals with the application of various economic theories, principles, concepts and techniques to business management to solve business and management problems. It deals with the practical application of economic theory and methodology in decision-making problems faced by private, public and non-profit making organisations.

The same idea has been expressed by Spencer and Siegelman, in the following words: "Managerial economics is the integration of economic theory with business practice to facilitate decision making and forward planning by the management". Mc Nair and Meriam say, "Managerial economics is the use of economic modes of thought to analyse business situation". Brighman and Pappas define managerial economics as, "the application of economic theory and methodology to business administration practice". Joel Dean is of the opinion that use of economic analysis in formulating business and management policies is known as managerial economics.

Features of managerial economics: The features of managerial economics are as follows:

- It is more realistic, pragmatic and highlights the practical application of various economic theories to solve business and management problems.
- It is a science of decision-making. It focuses on decision-making process, decision models and decision variables and their relationships.
- It is both conceptual and metric in nature, and it assists the decision-maker through precise and evident measurement of various economic variables and their interrelationships.
- It uses various macroeconomic concepts like national income, inflation, deflation, trade cycles, etc. to understand and adjust its policies to the environment in which the firm operates.
- It also gives importance to the study of non-economic variables having implications on economic performance of the firm. For example, impact of technology, environmental forces, socio-political and cultural factors, etc.
- It uses the services of many other related sciences like mathematics, statistics, engineering, accounting, operation research and psychology to find solutions to business and management problems.

It should be clearly remembered that managerial economics does not provide ready-made solutions to all kinds of problems faced by a firm. It provides only the logic and the methodology to find out the answers, but not the answers themselves. It all depends on the manager's ability, experience, expertise and intelligence to use different tools of economic analysis to find out the correct answers to business problems.

2. Scope of Managerial Economics

In this section, we will discuss the scope of managerial economics. The scope helps in understanding the subject, area of the study, boundaries, and width of the subject. Business economics is comparatively a new and upcoming subject. Consequently, there is no unanimity among different economists concerning the exact scope of business economics. However, the following topics are explained in this course:

1. Objectives of a firm
2. Demand analysis and Forecasting
3. Production and Cost Analysis
4. Pricing Decisions, Policies and Practices
5. Profit Management
6. Capital Management
7. Linear Programming and the Theory of Games
8. Market Structure and Conditions
9. Strategic Planning
10. External environment

Objectives of a firm: Historically, profit maximisation has been considered as the main objective of a business unit. All business organisations have multiple objectives that are multidimensional out of which some are supplementary, and some are competitive. Few others are inter-connected, and few others are opposing. There are various goals like social, economic, organisational, human, and national. All the objectives are determined by various factors and forces such as corporate environment, socio-economic conditions, nature of power in the organisation and external constraints under which a firm operates. However, amid several objectives, even today, the traditional profit maximisation objective has a very high place. All other policies and programmes of a firm revolve around this objective.

Demand analysis and forecasting: Mostly, a firm is a producing unit. It produces different kinds of goods and services. It has to meet the requirements of consumers in the market. The basic problems like what to produce; where to produce; for whom to produce; how to produce; how much to produce and how to distribute them in the market, are to be answered by a firm. Hence, the firm has to study in detail about the various determinants of demand, nature, composition and characteristics of demand, elasticity of demand, demand distinctions, demand forecasting, etc. The production plan prepared by a firm should include all these points.

Production and cost analysis: Production means the conversion of inputs into the final output. It may be either in physical or in monetary terms. Physical production deals with the production of outputs by a firm, by employing different factor inputs in proper proportions. Always, the most basic goal of any firm is to increase the output. Production analysis deals with a production function, laws of returns, returns to scale, economies of scale, etc. Production cost is concerned with the estimation of costs to produce a given quantity of output. Cost controls, cost reduction, cost-cutting, and cost minimisation receive top most priority in production and cost analysis. Maximisation of output with minimum cost is the basic goal of any firm. Cost analysis deals with the study of various cost concepts, their classification and cost-output relationship in the short run and long run.

Pricing decisions, policies, and practices: Pricing decisions means to fix the prices for all the goods and services of any firm. This is based on the pricing policy and practices of that particular firm. Amongst all the policies the most important policy of any firm would be the price setting policy. The pricing decision depends on the revenue (amount), income (level) and profits (volume) earned by a firm. Hence, we have to study price-output determination under different market conditions, objectives and considerations of pricing policies, pricing methods, practices, policies, etc. We also study price forecasting, marketing channel, distribution channel, sales promotion policies, etc.

Profit management: Basically, a firm can be a commercial or a business unit. Consequently, its success or failure is measured in terms of the amount of profit it can earn in a competitive market. The management gives topmost priority to this aspect. There are many theories in profit management, like the emergence of profit, functions of profit and its measurement, profit policies, techniques, profit planning, profit forecasting, and breakeven point.

Capital management: This is one of the essential areas of the business unit. The success of any business is based on proper management and adequate capital investment. Business managers, as part of cost-benefit analysis, have to study the cost of employing capital and the rate of return expected from each project. Under capital management, managers should assess capital requirements, methods of capital mobilisation, capital budgeting, optimal allocation of capital, selection of highly profitable projects, cost of capital, return on capital, planning, and control of capital expenditure, etc.

Linear programming and theory of games: The term linear means that the relationships handled can be represented by straight lines and the term programming implies systematic planning or decision-making. It implies maximisation or minimisation of a linear function of variables subject to a constraint of linear inequalities. It offers an actual numerical solution to the problems of making optimum choices. It involves either maximisation of profits or minimisation of costs.

The theory of games attempts to explain the rationale course of action for an individual firm or an entrepreneur who is confronted with a situation, wherein the outcome depends not only on his actions but also on the actions of others who are also confronted with the same problem of selecting a rational course of action. In short, under the conditions of conflicts and uncertainty, a firm or an individual faces a problem similar to that of the player of any game. Both of these techniques are extensively used in business economics to solve various business and managerial problems.

Market structure and conditions: The information on market structure and conditions of various markets is the most important part of the business. The nature, extent and degree of competition, number of sellers and buyers, etc. determine the nature of policies to be adopted by a firm in the market.

Strategic planning: It provides long term decisions, which will have a huge impact on the behaviour of the firm. The firm fixes up some long-term goals and objectives and selects a different strategy to achieve them. This framework is a recent addition to the scope of business economics with the emergence of MNCs. The perspective of strategic planning is global. The integration of business economics and strategic planning has given rise to a new area of study called corporate economics.

External environment: The external environment has a significant role in managerial economics. Few examples of external environment impacting managerial economics are as follows:

1. Macroeconomic management of the country relating to the economic system, national income, trade cycles, savings and investments and its impact on the working of a firm
2. Budgetary operations of the government and its implications on the firm
3. Knowledge and information about various government policies such as monetary, fiscal, physical, industrial, labour, foreign trade, foreign capital and technology, MNCs, etc. as well as their impact on the working of a firm
4. Impact of liberalisation, globalisation, privatisation and marketisation on the operations of a firm
5. Impact of international changes, the role of international financial and trade institutions in formulating domestic policies of a firm
6. Problems of environmental degradation and pollution and its impact on the policies of a firm
7. Improvements in the field of science and technology and its impact on a firm, etc
8. Socio-political, cultural and other external forces and their influence of business operations

Thus, it is clear that the scope of managerial economics is expanding with the growth of the modern business and business environment.

3. Significance of the Study of Managerial Economics

This section elaborates on the significance of the study of managerial economics. Managerial economics does not give importance to the study of theoretical economic concepts. Its main concern is to apply theories to find solutions to day-to-day practical problems faced by a firm. The following points indicate the significance of the study of this subject in its right perspective:

1. It gives guidance for the identification of key variables in the decision-making process.
2. It helps the business executives to understand the various intricacies of business and managerial problems and to take the right decisions at the right time.
3. It provides the necessary conceptual, technical skills, toolbox of analysis and techniques of thinking , and other such modern tools and instruments like elasticity of demand and supply, cost and revenue, income and expenditure, profit and volume of production, etc to solve various business problems.
4. It is both a science and an art. In the context of globalisation, privatisation, liberalisation and marketisation and a highly competitive dynamic economy, it helps in identifying various business and managerial problems, their causes and consequence, and suggests various policies and programmes to overcome them.
5. It helps the business executives to become much more responsive, realistic and competent to face the dynamic challenges in the modern business world.
6. It helps in the optimum use of scarce resources of a firm to maximise its profits.
7. It also helps in achieving other objectives a firm likes attaining industry leadership, market share expansion and social responsibilities, etc.
8. It helps a firm in forecasting the most important economic variables like demand, supply, cost, revenue, price, sales and profit, etc and formulate sound business policies
9. It also helps in understanding the various external factors and forces which affect the decision-making of a firm.
10. Thus, it has become a highly useful and practical discipline in recent years to analyse and find solutions to various kinds of problems systematically and rationally.

4. Functions of a Managerial Economist

This section elaborates the functions of a managerial economist. Managerial economist is a specialist and an expert in analysing and finding answers to business and managerial problems.

He has in-depth knowledge of the subject. He is an authority and has total command over his subject.

A managerial economist has to perform several functions in an organisation. Decisions making, and forward planning are described as the two major (basic) functions and remaining functions are derived from the two basic functions.

A detailed description of the basic functions is given below for better understanding.

Decision-making: The word 'decision' suggests a deliberate choice made out of several possible alternative courses of action after carefully considering them. The act of making a choice that signifies a solution for an economic problem is economic decision making. It involves choosing a set of alternative courses of action.

Decision-making is essentially a process of selecting the best option out of many alternative opportunities or courses of action that are open to a manager.

The choice made by the business executives are difficult, crucial and have far-reaching consequences. The basic aim of making a decision is to select the best course of action which maximises the economic benefits and minimises the use of scarce resources of a firm. Hence, each decision involves cost-benefit analysis. A slight error or delay in decision making may cause considerable economic and financial damage to a firm. It is for this reason that the management experts are of the opinion that right decision-making at the right time is the secret of a successful manager.

Forward planning: The term 'planning' implies a consciously directed activity with certain predetermined goals and means to carry them out. It is a deliberate activity. It is a programmed action. Planning is concerned with systematically tackling future situations.

Forward planning implies planning in advance. It is associated with deciding the future course-of-action of a firm. It is prepared based on past and current experience of a firm. It is prepared in the background of uncertain and unpredictable environment and guess work. Future events and happenings cannot be predicted accurately. Growing firms devote a significant share of their current output to net capital formation for bolstering the future economic output. A business executive must be intelligent enough to think in advance, prepare a sound plan and take all possible precautionary measures to meet all types of challenges of the future business. Hence, forward planning has acquired greater significance in business circles.

Activity 1: Select any type of business and prepare a plan with the predetermined goals and means to carry them out. List down any 2-3 goals.

5. Summary

Here is a quick recap of what we have learnt so far:

- Managerial economics is a science that deals with the application of various economic theories, principles, concepts and techniques to business management to solve business and management problems.
- Managerial economics does not give importance to the study of theoretical economic concepts. Its main concern is to apply theories to find solutions to day-to-day practical problems faced by a firm.
- A managerial economist has to perform several functions in an organisation. Decisions making, and forward planning are described as the two major (basic) functions and remaining functions are derived from the two basic functions.

6. Glossary

Decision	It is a deliberate choice made out of several possible alternative courses of action after carefully considering them.
Managerial economics	Managerial economics is the integration of economic theory with business practice for the purpose of facilitating decision making and forward planning by the management.
Planning	It is a consciously directed activity with certain predetermined goals and means to carry them out.

7. References

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