

# MANAGERIAL ECONOMICS

## LECTURE 1



Rudolf Winter-Ebmer  
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# Objectives of this course

- How to make good (managerial) decisions
- How to use formal models to analyze the effects of (managerial) decisions

# Preliminaries

- Slides available on my website [hyperlinks in orange](#).
- Discussion forum: I will occasionally post “interesting stuff”
- You should read text before class
- **My personal office hours**: K150D, come by alone or with a friend anytime (If I am not here or superbusy, I will arrange a meeting) or write an email [rudolf.winterebmer@jku.at](mailto:rudolf.winterebmer@jku.at)
- Student tutor Lara Kieberger: [lara.kieberger@gmail.com](mailto:lara.kieberger@gmail.com)

# Grades!

- Regular:
  - End-term exam
- Re-sit exam

You need more than 48 (out of 96) points for a positive grade.

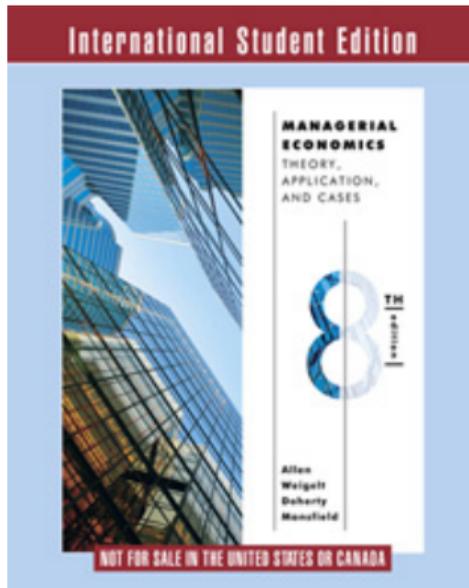
**NB: If you decide to re-sit the exam, you will automatically lose all points you may have obtained from the regular exam!**

# Exams

The exams will have a mix of questions:

- Single choice questions: Choose the correct answer from  $n$  available options.
- True/false questions: Indicate if a statement is true, false or ambiguous.
- Open questions: solve a problem algebraically or answer a question with a written paragraph. I will give you some help for the calculations.

# The Book



## **MANAGERIAL ECONOMICS (8th ed.)** THEORY, APPLICATIONS, AND CASES

W. Bruce Allen | Keith Weigelt | Neil Doherty | Edwin Mansfield

# Who should study Managerial Economics?

- Managers or persons in middle management
- Managers in sales or marketing
- Owners of a firm
- Regulation authorities and relevant governmental bodies (Ministries ect.)
- Politicians who want to understand how businesses react to policies
- Students who want to study business decisions thoroughly

# MANAGERIAL ECONOMICS

- differs from microeconomics
  - Microeconomics focuses on describing behavior
  - Managerial economics is more into giving advice
  
- is an integrative course
  - Combines different aspects of businesses in a single analytical framework
  
- does not answer concrete business questions
  - but gives an analytical framework to understand and
  - handle similar problems
  - in a sense tries to explain a tool box of economic answers

# What do managers manage?

- Make choices that increase the value of the firm.
- The value of the firm is defined as the present value of future profits.
- Present value of expected future profits =

$$\frac{\pi_1}{1+i} + \frac{\pi_2}{(1+i)^2} + \dots + \frac{\pi_n}{(1+i)^n} = \sum_{t=1}^n \frac{\pi_t}{(1+i)^t}$$

- with  $\pi_i$  as profit in period  $i$ .  $\pi_i = \text{Revenue} - \text{cost}$
- What is the value of a firm?
- What for a firm listed on the stock exchange?

# How so?

## ■ Managers influence:

- revenue by managing demand
- cost by managing production
- financial risk (as given by interest rate in equation) by managing finances

## ■ Managers face constraints:

- Available technologies
- Scarce resources
- Legal or contractual limits

# What is profit?

## ■ Two *different* concepts:

### Accounting

- Historical costs
- Legal compliance
- Reporting requirements

### **Economic Profit**

- Market value (i.e., also future uncertain revenues and expenses)
- Opportunity, or implicit, cost
- The measure for managerial decisions!

# The concept of economic profits

- Profit the owner makes over and above what their labor and capital employed in the business *could earn elsewhere!*
  - labor and capital employed in the firm has to be rewarded as in the outside world
  - we typically use wage for owner's time and interest rate for the capital in the firm
- **In competitive industries economic profits are zero.** The costs of operating in the market are contained in the prices
- Economic profits of zero are better than no profits. (Operating a business and recovering the costs, including your wage, is better than no job.)
- What are competitive industries?
  - Standardized products, no risk involved, et cet.
  - But: Pharmaceutical industry, car industry, aircraft building industry, oil producing industry, ... ???

# Where do extra-ordinary profits come from?

- Innovation

- New or better products in terms of functionality, technology or style

- Risk-taking

- Future outcomes and their likelihoods are unknown, as are the reactions of rivals

- Exploiting Market Inefficiencies

- Building barriers to entry, employing sophisticated pricing strategies, diversifying, and making good strategic production decisions

- Learn from the past and your competitors!

# Study demand

- Understand the many factors that influence demand
- The role of managers in controlling and predicting market demand: price, advertising, product quality, and distribution
- Scientific approaches:
  - Theory
  - Experiments
  - Observational data and estimates

# Learn about market structure

Different competitive environments require different strategies:

- prices
- output
- other strategies

# Learn Methods

'Game Theory' is used to study

- decision making
- strategic managerial decisions — managers must consider the responses of their rivals or customers
- auctions: a powerful way of selling
- strategic decisions when faced with incomplete or imperfect information

# Conflicts of interest

The interests of owners and of managers may differ

- The owners ('principals') want managers to maximize the value of the firm
- The managers ('agents') want more compensation and less accountability.
- The divergence in goals is the **principal-agent problem**.

The interests of managers and workers are probably different as well.

# People react to incentives

- **Moral hazard**: when people behave differently when they are not subject to the risks associated with their behavior.
- Managers who do not maximize the value of the firm may do so because they do not suffer as a result of their behavior.

# Advice

If you find the material too difficult or have questions:

1. Read the book.
2. Consult your microeconomics textbook (e.g., Varian or Pindyck and Rubinfeld).
3. Use the discussion forum in KUSSS.
4. Talk to Georgia.
5. See me.

**Have fun — economics is about maximizing utility!**