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0521859816 - Microeconomics for MBAs: The Economic Way of Thinking for Managers
Richard B. McKenzie and Dwight R. Lee
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Microeconomics for MBAs

This is the first textbook in microeconomics written exclusively for MBA students. McKenzie and Lee minimize attention to mathematics and maximize attention to intuitive economic thinking, examining key questions such as "How should organizations and incentives be structured to best encourage profit maximization?" The text is structured clearly and accessibly: Part I of each chapter outlines the basic theory with applications to social and economic policies and Part II applies this basic theory to management issues, with a substantial focus on the emerging subdiscipline of organizational economics. The "Perspective" sections in each chapter provide a new line of argument or different take on a business or policy issue. The accompanying DVD contains video modules in which Professors McKenzie and Lee give a personal tutorial on the key microeconomic concepts which MBA students need to understand, as well as elucidating complex lines of argument covered in the chapters and helping students to review for tests. Throughout the text, McKenzie and Lee aim to infuse students with the economic way of thinking in the context of a host of problems that MBA students, as future managers of real-world firms, will find relevant to their career goals.

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Microeconomics for MBAs

The Economic Way of Thinking for Managers

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CAMBRIDGE
UNIVERSITY PRESS

CAMBRIDGE UNIVERSITY PRESS
Cambridge, New York, Melbourne, Madrid, Cape Town, Singapore, São Paulo

Cambridge University Press
The Edinburgh Building, Cambridge CB2 2RU, UK

Published in the United States of America by Cambridge University Press, New York

www.cambridge.org
Information on this title: www.cambridge.org/9780521859813

First published 2006

Printed in the United Kingdom at the University Press, Cambridge

A catalogue record for this publication is available from the British Library

ISBN-13 978-0-521-85981-3 hardback
ISBN-10 0-521-85981-6 hardback

There is only one difference between a bad economist and a good one: the bad economist confines himself to the visible effect; the good economist takes into account both the effect that can be seen and those effects that must be foreseen.

Frédéric Bastiat (1801–50)
Selected Essays on Political Economy

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PREFACE

Almost all (if not all) textbooks used in MBA students' first course in microeconomics are designed with undergraduate economics majors or first-year PhD students in mind. Accordingly, MBA students are often treated to a course in intermediate microeconomic theory, often full of arcane mathematical explanations. The applications in such standard textbooks deal mainly with the impact of social or government policies on markets, with little discussion of how managers can make better decisions within their firms in response to market forces or how market forces can be expected to affect firms' institutional and financial structures.

This is because much microeconomic theory simply assumes firms into existence, with little or no discussion of why they are needed in the first place. Managers and their staff are assumed to do exactly what they are employed to do by their firms' owners – maximize owners' profits – with no discussion of how firms' organizational structures affect incentives and how incentives affect firms' production and profit outcomes.

That is to say, little is written in standard textbooks used in MBA courses about exactly how real-world firms pursue the goal of profit maximization. And that void in microeconomics textbooks is a real problem for MBA students, for an obvious reason: MBA students have typically come back to school to learn how to improve their management skills, which involves learning about how they can improve their ability to extract more profits from the scarce resources available to the firms where they work (or the firms where they expect to move after graduation). They do not come back to school to become economic theorists. Standard microeconomic textbooks are of little value to MBA students in helping them achieve their career objectives.

MBA students stand a quantum leap apart from undergraduate students, who typically have little idea of what they want to do with their lives, and have far less real-world business experience to which they can relate. MBA students are also sacrificing far more by attending school than undergraduates and must get value for their time spent reading their textbooks and going to class because of the cost of their education, in terms of both their tuition payments and the valuable work opportunities they have to set aside.

Microeconomics for MBAs breaks dramatically from the standard textbook mold. As the title suggests, we have designed this textbook with only MBA students in mind. In Part I of every chapter, we cover standard microeconomic theory in an accessible way, and we provide an array of applications to government policies which MBA students need to understand. After all, managers everywhere face the constraints of government-imposed laws and regulations that are ever-changing, and managers must work to maximize their firms' profits within those constraints. Moreover, professors in marketing, finance, accounting, strategy, and operations research who teach first- and second-year elective courses in MBA programs will expect their students to have a firm grounding in conventional microeconomic theory.

To help students learn the material covered in these pages and lectures, we have provided a set of video modules on a DVD packaged with the textbook and on the Internet that deal with three classes of topics:

(1) Basic economic concepts that all MBA students should understand at some level upon entering their programs of study
(2) Concepts, principles, and modes of analysis that are often hard to comprehend the first time they are presented in the form of written text or lectures
(3) Topics that have a high probability of being covered in examinations.

Of course, these videos can be stopped at any time to allow for note taking, and can be replayed repeatedly.

In Part II of every chapter, we go where other microeconomics textbooks seldom, if ever, go with such completeness. We drop the usual assumption that firms exist and that they automatically maximize owners' profits by simply following maximization rules. Instead, we bring to the forefront of our analysis a crucial problem faced by firms. This problem (dubbed the "principal–agent problem" within the economics profession and in this textbook) is that both owners and workers are more interested in pursuing their own wellbeing than someone else's wellbeing.

Owners ("principals") want to maximize their income stream and wealth through the firms they create by getting the most they can out of their employees. Similarly, managers and line workers (the owners' "agents") seek to maximize some combination of income, on-the-job perks, and job security, which are often in conflict with maximizing profits for the firm's owners. Without effective firm policies that align the incentives of owners and workers (for their mutual benefit), the work in a firm can be a self-destructive tug of war, with the demise of the firm virtually assured in competitive markets.

In this textbook, we focus MBA students' attention on thinking through the complex problems of getting incentives right. This is mainly because there is as much (maybe more) profit to be made from creatively structuring incentives as there can be made from creatively developing products for sale.

Getting hourly and monthly pay systems right is obviously an important means of aligning the interests of owners and managers. However, we also explain how firms' organizational structure, in terms of both people and finances, can affect the alignment of owners' and workers' incentives. And make no mistake about it, both owners and their employees have a stake in finding the right alignment. Workers' jobs can hang in the balance. Owners' investments can hang just as precariously on a cost-effective, balanced alignment of incentives.

Accordingly, this book places a great deal of emphasis on a field within economics that is growing rapidly in importance, especially as the subject relates directly to the business world – and MBA programs: *organizational economics*, which is the study of the design of firms' organizational and financial structures using the analytical tools of microeconomic analysis. The mode of thinking presented in these pages is crucial for managers – MBAs – who want to move up their corporate hierarchy or go off and create successful companies of their own.

In between Parts I and II of every chapter, we have inserted a "Perspective" – that is, a short section that provides a new or different take on a business or policy issue. For example, everyone *knows*, don't they, that the "first mover" in any market has a competitive advantage. In the Perspective for chapter 9, we discuss a startling observation made by management scholars: There is no first-mover advantage.

Each chapter ends with a section that we have titled "The bottom line," mainly because the section contains listings of "key takeaways" – succinct statements of the most important lessons to be drawn from the chapter. We understand that MBA students, you included, face serious time constraints, especially when you are working full time and have family responsibilities. "The bottom line" section is designed to focus your attention when reviewing the material covered in the chapter, with the hope that your time devoted to studying will be made more productive.

The scholarly and policy literature in economics and management relating to most of the topics considered in this volume is massive. We have tried to give credit where credit is due, especially when "classic," path-breaking treatments by distinguished scholars are concerned, but we have tried hold references and footnotes in check in order that the flow of the argument is not constantly disrupted. Still, our references section at the end of the book is extensive. We have also tried to smooth out the flow of the core material by relegating topics that will be only selectively used in classes to appendixes.

Many textbook authors and their publishers play the development of their course books "safe" by taking up only those topics that have become fixtures in the profession's "conventional wisdom." We see such an approach as sucking the life out of a discipline and its treatment in textbooks. Topics that have not yet been fully settled by decades of professional debate can give life to a discipline by showing students how disciplines have an organic quality, in that they are constantly evolving. As a consequence, you can expect many topics in this book to spark lively, and instructive, debates among student team members and between class members and professors in class. That is how we want the book to be received.

We have appended to each chapter a series of Review questions that we expect will activate discussions within your student teams. In addition, we have set up a web site for the book on which we will, from time to time, post interesting pointers and puzzles that have occurred to us after the book went to press. We also expect to post on that web site video commentaries on management issues and related economic policies that are bound to arise while you are reading this book and taking your course.

* * *

You may be interested in knowing that we – the authors of this book – have between us more than seventy-five years of university teaching experience, with most of our teaching careers spent in business schools. For the last fifteen years, we both have taught *only* MBA students. That should tell you that we have a pretty good fix on our readers and their interests, not the least of which is to have a course of study that is intellectually challenging as well as having practical application.

Each year, we often start our MBA courses in microeconomics with a question that puzzles our students, many of whom are mid- and upper-level managers in firms from a broad range of industries who remain employed while completing their MBA programs. The question seems simple on the surface, "Why are you here?" Invariably, the students' interests are piqued, but typically because they are puzzled by the question, which prompts our elaboration, "Why are you here in graduate school getting your MBA?" To be more precise, "Why are you sitting there in your seat in this classroom, all facing this lectern?"

MBA students are rarely reticent, and the answers are quick in coming and are varied: "I'm here to make more money," one student always confesses with an uneasy laugh. But many other answers share a common theme, "To learn how to *do* business" (with the emphasis on "*do*ing business"). That answer is understandable, mainly because MBA students are a focused lot, their eyes typically fixed on one objective – improving their career paths. Also, much business education encompasses instruction in business skills – for example, how to develop business plans and to secure funding for new business ventures. But invariably the answers leave an important part of our question unanswered because the answer – "to learn how to do business" – doesn't explain why our students are in their seats and we behind the lectern.

The problem with the answer is that neither of us – the authors, that is – has ever "done business." We have spent our entire careers in academe, lecturing to students about business, or other social, political, and economic topics. Indeed, there is a very good reason we have never done business: We don't think we would be very good at it if we ever tried. We figure that our fortes are *thinking, studying, and teaching* – not *doing* – business and then writing about what we have been thinking, studying, and teaching.

If our courses were primarily, if not exclusively, supposed to be about *doing* business, should we not change places with our students? They should come up to the lectern, and we should take their seats and listen to what they have to say. After all, they are actually *doing* business and know more about *doing* it than we could ever hope to know.

Understandably, the students become perplexed at our response. We assuage their concerns by pointing out the obvious, that what we will *do* in class is radically different from what they *do* in business. Indeed, the students come to class on a campus removed from their work to get away from what they do at work, and that means getting away from the multitude of details of business dealings that are a part of their everyday, workaday world.[1] In a literal sense, the class is a world apart from the world of business, and intentionally designed that way for one strategic purpose: to take a look at how business is done from a broad perspective without the clutter of details that our students deal with day in and day out.

In no small way, the purpose of our class (or any other business course worthy of academic respect) is to explore ways to *think* creatively about how

[1] (They also want to take courses from professors who haven't been out there in the "real world" *doing* what they have been doing, or else their professors would have little to offer that they didn't already know.)

business is done and can be done better, not to actually *do* business. In this regard, we take to heart an observation made by the late economist Kenneth Boulding:

> It is a very fundamental principle indeed that knowledge is always gained by the orderly loss of information; that is, by conducing and abstracting and indexing the great buzzing confusion of information that comes from the world around us into a form we can appreciate and comprehend. (1970, 2)

The way of thinking we take up in class, and that which Professor Boulding had in mind, is necessarily *abstract* – that is, without the clutter of many business details. We approach thinking with abstractions principally because no one's brain is sufficiently powerful to handle all the complex details of everyday business life. In no small way, productive thought requires that the complexity of business life be reduced enough to allow us to focus on the few things that are most important to the problems at hand by finding meaningful relationships between those things. That is why Professor Boulding insists that knowledge can so often (if not "always") be gained only "by the orderly loss of information."

Without thinking, many business people often spurn theory on the grounds that it lacks practical value. We insist, "not so at all." The abstract way of thinking that we shall develop in this textbook has a very practical, overriding goal, which is to afford students more *understanding* of the business world than they could have if they tried some alternative approach – that is, if they tried to keep the analysis cluttered up with the "buzzing confusion" of facts MBA students leave behind in their workplaces when they set out for class.

There is another highly practical goal to be achieved by theory (or rather *thinking* with the use of theory). If people can *think* through business problems in some organized way, albeit abstractly, they might be able to avoid mistakes when they actually go out and *do* business. In economic terms, business mistakes imply a regrettable misuse and loss of firm resources. *Thinking* before doing offers the prospect of reducing waste in doing business.

Our main interest in posing our initial question to our students – "Why are you here?" – is to stress the obvious: If the class is about *thinking* (not doing), then we – Richard McKenzie and Dwight Lee and students' other professors – have some justification for being in front of the class. Also, if the class is about the thinking process, there must be some method for thinking through problems, business-related or otherwise. The development of that *method* is the focus of our classes and this textbook.

Our goal in this volume is to develop *the economic way of thinking* in the context of a host of problems that MBA students, as future managers of real-world firm, will find relevant to their career goals.[2]

We understand that some readers may worry about our emphasis on theory because they may have read theory-grounded books that seemed sterile or irrelevant, mainly because of the heavy reliance on highly technical mathematics or complicated charts. That will not be the case in this book. The first principle of economics that has guided the development of this book is one that many readers will appreciate: *Keep the theory as simple as possible and illustrate it with real problems.*

This book carries the subtitle *The Economic Way of Thinking for Managers*, for a very good reason: In the following pages, we bring together a host of large and small ideas that economists have developed over the past several decades that have transformed the way we must think about the way the business world works.

Readers' reactions to large and small ideas will, we expect, have changed radically by the time they have read the last words of this volume. Two of those large questions are:

- How should organizations and incentives be structured to best encourage profit maximization?
- How does the competition in the market for goods and in the market for corporate control discipline executives?

The small questions that can be addressed from studying this volume are no less important and can be just as intriguing:

- Should used cars really be expected to be "better deals" than new ones (as so many people seem to think)?
- If competitive markets are expected to "clear" (with quantity demanded equaling quantity supplied), why are so many queues observed in grocery stores and at concerts?
- If queues are not mutually beneficial to buyers and sellers, then why aren't they eliminated?

Readers who think that these questions have simple, obvious, pat answers need to read on.

[2] (*The Economic Way of Thinking* is the title of a book by the late economist Paul Heyne (1994), which influenced a generation of students with its lucid discussion of basic economic concepts, principles, and theories that form a way of gaining insights about the world.)

We expect that readers of this book will end this book the way our students end our courses: changed for life in the way they see the business world around them. But then that is what MBA students typically want – or should want – from every course in their MBA programs. Readers have our best wishes for the journey of a lifetime.

This book was developed over the last several years as we taught our microeconomics courses for our MBA students at the University of California, Irvine and University of Georgia, Athens. Our students have made innumerable and invaluable suggestions for improvement in the book, and we are indebted to them. We are also indebted to Oxford University Press for allowing us to draw freely from our previously published book with the Press, *Managing Through Incentives*. All excerpts from that book have been substantially revised and updated for inclusion in this textbook.

ABBREVIATIONS AND ACRONYMS

CBA	cost–benefit analysis
CEO	chief executive officer
CPI	consumer price index
EPA	Environmental Protection Agency
FCC	Federal Communications Commission
GDP	gross domestic product
GE	General Electric
JV	joint venture
NTB	non-tariff barrier
LAN	local area network
M&A	mergers and acquisitions
MIS	management information system
MSA	Medical Savings Account
MU	marginal utility
ONS	Office for National Statistics
PBS	Public Broadcasting System
PPC	production possibilities curve
PPP	purchasing power parity
PV	present value
R&D	research and development
RPM	retail price maintenance
S&L	savings and loan
SEC	Securities and Exchange Commission