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Subject:

Managerial Economics

Submitted to:

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Q:1(A)

 Managerial economics is a stream of management studies which emphasizes solving [business](https://theinvestorsbook.com/business.html) problems and decision-making by applying the theories and principles of microeconomics and macroeconomics. It is a specialized stream dealing with the organization’s internal issues by using various economic theories. Economics is an inevitable part of any business. All the business assumptions, forecasting and investments are based on this one single concept.

Managerial economics is the study of mangers can apply economic principles and analyses as well as quantitative tools in making an effective business and managerial decisions involving the best use allocation of organization scarce resources to achieve their objective.

Helps in decision making:

1. Establish objective
2. Define the problems
3. Identify factors that affect the problem
4. Specify alternative solutions
5. Collect data and other information’s.
6. Evaluate and screen alternative

Example:

* How to use economic theory to set prices that maximize profits.
* How to use economics theory to choose the cost –maximize production technique for a given scale of output.
* How to use economics theory to select the optimal location for a new restaurant, grocery store, etc...
* How to use economic theory to forecast near –term demand for goods and services.

1: (B)

Profit:

Profit describes the financial benefit realized when revenue generated from a business activity exceeds the expenses, costs, and taxes involved in sustaining the activity in question. Any profits earned funnel back to business owners, who choose to either pocket the cash or reinvest it back into the business. Profit is calculated as total [revenue](https://www.investopedia.com/terms/r/revenue.asp) less total expenses.

1. Profit as a consequence of market imperfection and monopoly:

Where a firm possesses monopoly power, it can restrict output and obtain a higher profit than what it could under competitive conditions. Profit is the result of contrived scarcity. It can exist only in an imperfect market where output is, for various reasons, restricted and the consumers are deprived of the opportunity of alternative sources of supply.

Sources of such power are usually found in legal restrictions, sole ownership of raw-materials or sole access to particular markets. Even some degree of uniqueness in a firm’s product confers some monopoly power. Contrived scarcity must be distinguished from natural scarcity. Natural scarcity exists in the supply of central urban building sites or high grade farm lands. These earn rents rather than monopoly profits, since practically nothing can be done to alter their supply.

2. Profit as the reward for successful innovation:

Innovation refers broadly to any purposeful change in production methods or consumer tastes that increases national output more than it increases costs. The increase in net output is the profit that comes from innovation. It includes not only new products such as synthetic fibers but also new organizations, new markets, new promotion and new raw materials.

It may also include a new way of doing old things or a different combination of existing methods to accomplish new things. To an important degree, innovation has been built into the competitive system complete with research laboratories and advertising staff.

There is an important distinction to be made between invention and innovation. Invention is the creation of something new whereas innovation is the application of an invention to business use. Many inventions never become innovations.

The innovation theory of profit is associated with Schumpeter. The innovator is one who turns a new idea or invention into a commercial proposition. Many try to do this, but only a few succeed. Those who do earn high profits by bringing their new, revolutionary product into the market, do so because the public is attracted by the new and apparently superior product and is willing to pay the innovator a high price for it. Thus, the innovator reaps the profits of innovation.

Following a successful innovation comes a period of adjustment when new competitors come in and sooner or later innovational profits die out. Meanwhile, in a dynamic economy other innovations are hitting the market.

No one of these theories is necessarily correct. All are in some sense complementary, since uncertainty, innovation and monopoly are factors which affect every business in its profit earning capacity and hence in its policy decisions. To a businessman, knowledge of profit theories is quite useful because they throw light on the three important factors giving rise to profits and, thus, enable the phenomenon and quantum of profits in a firm to be examined in a proper perspective.

In practice, business firms may often be required to justify the profits being earned by them. Uncertainty-bearing profits and innovational profits have a justification because they constitute a reward for performing two important productive functions, and can be so defended.

Monopoly profits, however, are generally frowned upon and are often a target of attack. Being a symbol of exploitation, they can hardly be defended in the context of social obligations of business. Often, government has to take measures to regulate monopoly profits by putting legal restrictions such as profit ceilings.

Q :( 2)

Cost:

Cost is the combination of losses of any goods that have a value attached to them by any one individual. Economic cost is used mainly by [economists](https://en.wikipedia.org/wiki/Economist) as means to compare the prudence of one course of action with that of another. The factors to be taken into consideration are money, time, and other resources cost is the sum of explicit cost.

The comparison includes the gains and losses precluded by taking a course of action as well as those of the course taken itself. Economic cost differs from [accounting cost](https://en.wikipedia.org/wiki/Historical_cost) because it includes [opportunity cost](https://en.wikipedia.org/wiki/Opportunity_cost) (Some sources refer to accounting cost as explicit cost and opportunity cost as implicit cost).

**Implicit Cost**  
An implicit cost is present but it is not initially shown or reported as a separate cost.

**Explicit Cost**  
An explicit cost is a cost that is present and it is clearly shown or reported as a separate cost.

**Examples of Implicit Costs and Explicit Costs**  
let’s assume that a company gives a [promissory note](https://www.accountingcoach.com/blog/what-is-a-promissory-note) for 10,000 to a seller of a unique used machine for which the fair value is unknown. The promissory note will come due in three years and it does not specify any interest. Due to the company's weak financial position it would normally have to pay a high interest rate if it were able to borrow money. In this example, the promissory note does not show an explicit interest cost. However, due to the issuer's weak financial position and the seller having to wait three years to collect the money, there has to be some interest cost. In other words, there is some interest cost, but it is implicit. (To record the interest cost, accountants will discount the 10,000 by the approximate interest rate that the maker of the note would normally have to pay.)

If another company with the same financial condition purchased this unique machine by issuing a 7,120 note with a stated interest rate of 12% per year (and the rate is a fair interest rate for the situation), the compounded interest cost of 2,880 is explicit.

Another example of an implicit cost is the [opportunity cost](https://www.accountingcoach.com/blog/calculate-opportunity-cost) of a sole proprietor working in her own business.

For example, Jane works as a sole proprietor and her business reported a [net income](https://www.accountingcoach.com/blog/what-is-net-income) of 30,000 for the year. Since a sole proprietor does not receive a salary or wages, there is no explicit cost reported for Jane's work in her business. However, if Jane is foregoing a salary of 40,000 from another company, this is an implicit cost. When considering this implicit cost, Jane is losing 10,000 by working in her proprietorship.

If Jane operated her business as a corporation, Jane will be an employee of the corporation and her annual salary will be an explicit cost presented as salary expense on the corporation's [income statement](https://www.accountingcoach.com/blog/what-is-the-income-statement).

2. (B)

A standard cost is a carefully predetermined measure of what a cost should be under stated conditions. Standard costs are not only estimates of what costs will be but also goals to be achieved. When standards are properly set, their achievement represents a reasonably efficient level of performance.

Usually, effective standards are the result of engineering studies and of time and motion studies undertaken to determine the amounts of materials, labor, and other services required to produce a product. Also considered in setting standards are general economic conditions because these conditions affect the cost of materials and other services that must be purchased by a manufacturing company.

Manufacturing companies determine the standard cost of each unit of product by establishing the standard cost of direct materials, direct labor, and manufacturing overhead necessary to produce that unit. Determining the standard cost of direct materials and direct labor is less complicated than determining the standard cost of manufacturing overhead.

The standard direct materials cost per unit of a product consists of the standard amount of material required to produce the unit multiplied by the standard price of the material. You must distinguish between the terms standard price and standard cost. Standard price usually refers to the price per unit of inputs into the production process, such as the price per pound of raw materials.

Standard cost, however, is the standard quantity of an input required per unit of output times the standard price per unit of that input.

For example, if the standard price of cloth is 3 per yard and the standard quantity of material required to produce a dress is 3 yards, the standard direct materials cost of the dress is 3 yards x 3 per yard =  9. Similarly, a company computes the standard direct labor cost per unit for a product as the standard number of hours needed to produce one unit multiplied by the standard labor or wage rate per hour.

Q. (3)

Desire v. Demand:

Difference between desire and demand. Desire is whatever we want; demand is whatever we want backed by willingness and ability to pay.  
  
Here's an example: I desire a new bike - either the new De Rosa Idol or a Cufic Absolut with electronic Dura Ace and a set of HED Ardennes wheels would do nicely, thanks - but I do not demand a new bike because, given my existing budget constraint, I do not have the ability to pay for either of the bikes I desire.  
  
That is not entirely accurate, however. In fact, my budget constraint would permit me to afford either of those bikes, but the opportunity costs - no car payments (hence no car), no mortgage payments (hence no house), no college for my daughter, less food for the family, etc... Not to mention the reaction to all those costs of Mrs. Cyclingprof - would be enormous. So, while I do desire a new bike, I do not demand one.

(B)

The demand for a good depends on several factors, such as price of the good, perceived quality, advertising, income, confidence of consumers and changes in taste and fashion.

We can look at either an individual demand curve or the total demand in the economy.

* The individual demand curve illustrates the price people are willing to pay for a particular quantity of a good.
* The market demand curve will be the sum of all individual demand curves. It shows the quantity of a good consumers plan to buy at different prices.

1. Change in price

A change in price causes a movement along the Demand Curve.

For example, if there is an increase in price from 12 to 16 then there will be a fall in demand from 80 to 60.

**How important is price?**

Some goods are more affected by price than others.

* If petrol increases in price, because it is a necessity, there is only a small fall in demand (we say it is [inelastic demand](https://www.economicshelp.org/blog/531/economics/inelastic-demand-and-taxes/)).
* If Volvo water increases in price, there will be a significant fall in demand because people buy cheaper substitutes ([demand is elastic](https://www.economicshelp.org/blog/1108/economics/perfectly-elastic-demand/))

### Shifts in the demand curve

This occurs when, even at the same price, consumers are willing to buy a higher (or lower) quantity of goods. This will occur if there is a shift in the conditions of demand.

Even at the same price of 12, more is demanded.

#### Factors which can shift the demand curve

A shift to the right in the demand curve can occur for a number of reasons:

1. **Income**. An increase in disposable income enabling consumers to be able to afford more goods. Higher income could occur for a variety of reasons, such as higher wages and lower taxes.
2. **Credit facilities**. If it is easier and cheaper to borrow, this may encourage consumers to buy expensive items on credit, for example, cars and foreign holidays.
3. **Quality**. An increase in the quality of the good e.g. better quality digital cameras encourages people to buy one.
4. **Advertising** can increase brand loyalty to goods and increase demand. For example, higher spending on advertising by Coca Cola has increased global sales.
5. **Substitutes**. An increase in the price of substitutes, e.g. if the price of Samsung mobile phones increases, this will increase the demand for Apple iPhones – a major substitute for the Samsung.
6. **Complements.** A fall in the price of complements will increase demand. E.g. a lower price of Play Station 2 will increase the demand for compatible Play Station games.
7. **Weather**: In cold weather, there will be increased demand for fuel and warm weather clothes.
8. **Expectations** **of future price increases**. A commodity like gold may be bought due to speculative reasons; if you think it might go up in the future, you will buy now.

### Fall in demand

A fall in demand could occur due to lower disposable income or decline in the popularity of the good.

Evaluation

* For some luxury goods, income will be an important determinant of demand. E.g. if your income increased you would buy more restaurant meals, but probably not more salt.
* Advertising is important for goods in which branding is important, e.g. soft drinks but not for bananas.

## The law of demand is one of the important law of consumption which explain the functional relationship between price and quantity demanded of a commodity. Dr. Alfred Marshall in his book "Principles of Economics", has explained the consumer's behavior as follows: (B) STATEMENT OF THE LAW: "Other things being equal, the amount demanded increases with a fall in price and diminishes with a rise in price." In other words, other things remaining constant, demand varies inversely with price i.e. when price falls demand expands or (rises) and when price rises, demand contracts or (falls). Marshall's law of demand describes the functional relationship between demand and price. It can be presented as: Dx​=f(Px​) i.e. Demand for x is a function of Price of x. This functional relationship is inverse and negative because larger quantity is demanded when price falls and smaller quantity will be demanded when price rises. (C) Explanation of the law of demand with the help of market demand schedule and diagram (Curve): (1) Market Demand Schedule: It is a tabular representation of various quantities of a commodity demanded by different consumers at different prices during a given period of time. It is a imaginary schedule:

|  |  |
| --- | --- |
| Price of Commodity X (per unit in Rs ) | Total Market Demand (per day) |
| 50 | 100 Units |
| 40 | 200 Units |
| 30 | 300 Units |
| 20 | 400 Units |
| 10 | 500 Units |

## From the above schedule we observe that at a higher price of Rs.50 per unit of commodity X the market demand is low i.e. only for 100 units and at a lower price of Rs.10, the market demand rises to 500 units. This shows a inverse relationship between price and quantity demanded. (2) Market Demand Curve: It is a graphical representation of market demand schedule. Measure price of Y axis and quantity demanded on X axis and plot the schedule on this graph to get the demand curve DD. The demand curve DD slopes downwards from left to right showing a inverse relationship between price and demand. It has a negative slope. (D) Assumption of the Law of Demand: The law of demand is based on the following assumption or conditions: (1) No change in consumer's income: Consumer's income must remain unchanged because if income increases consumer may buy more even at a higher price invalidating the law of demand. (2) No change in the size and composition of population: The size of population, gender ratio and age composition are assumed to remain constant. As such changes are sure to affect demand. (3) No change in consumer's taste, preference, habits and fashions: If the taste changes then the consumer's preference also will change which will affect demand. When commodities go out of fashion then demand will be low even at a low price. (4) No expectation of future price change: The consumers do not expect any significant rise or fall in the future prices. (5) No change in prices of related goods: The law assumes that prices of substitutes and complementary goods remain constant. (6) No change in tax policy of the Government: The level of direct and indirect tax imposed by the government on the income and goods should remain constant.

Thank You sir