8TH EDITION

INTERMEDIATE MICROECONOMICS

HAL R. VARIAN

20 Cost Minimization

Cost Minimization

- A firm is a cost-minimizer if it produces any given output level $y \geq 0$ at smallest possible total cost.
- $c(y)$ denotes the firm's smallest possible total cost for producing y units of output.
- $c(y)$ is the firm's total cost function.

Cost Minimization

- **When the firm faces given input prices $\mathbf{w} = (w_1,w_2,\ldots,w_n)$ the total cost function will be written as**

$$c(w_1,\ldots,w_n,y).$$

The Cost-Minimization Problem

- Consider a firm using two inputs to make one output.
- The production function is
$$y = f(x_1,x_2).$$
- Take the output level $y \geq 0$ as given.
- Given the input prices w_1 and w_2, the cost of an input bundle (x_1,x_2) is $w_1x_1 + w_2x_2$.

The Cost-Minimization Problem

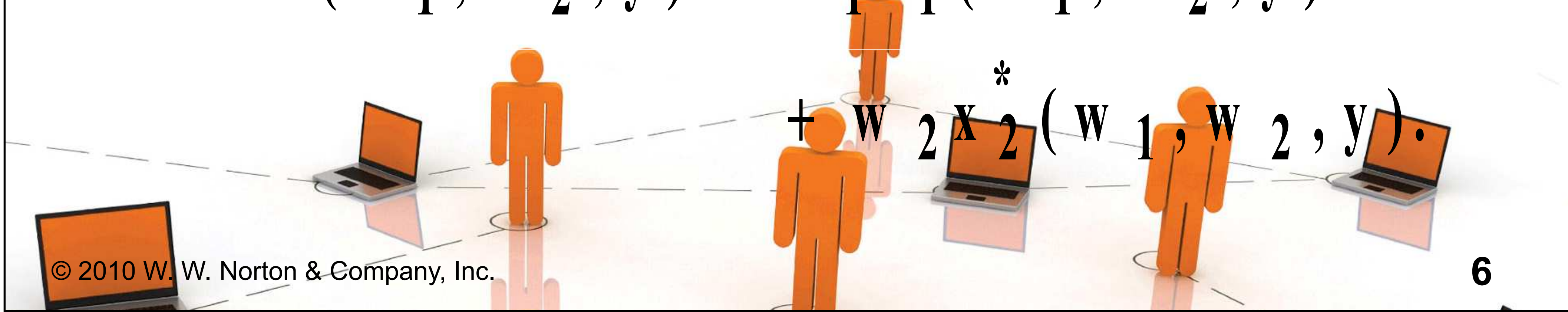
- For given w_1, w_2 and y, the firm's cost-minimization problem is to solve $\min_{x_1, x_2 \geq 0} w_1 x_1 + w_2 x_2$

  subject to $f(x_1, x_2) = y$.

The Cost-Minimization Problem

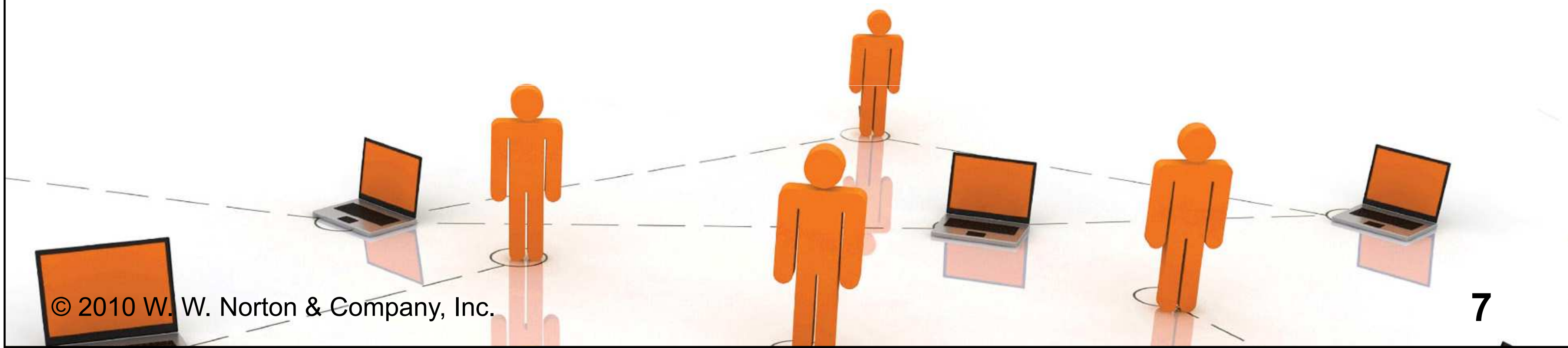
- The levels x_1*(w_1,w_2,y) and x_1*(w_1,w_2,y) in the least-costly input bundle are the firm's conditional demands for inputs 1 and 2.
- The (smallest possible) total cost for producing y output units is therefore

$$c(w_1, w_2, y) = w_1 x_1^*(w_1, w_2, y) + w_2 x_2^*(w_1, w_2, y).$$



Conditional Input Demands

- Given w_1, w_2 and y, how is the least costly input bundle located?
- And how is the total cost function computed?



Iso-cost Lines

- **A curve that contains all of the input bundles that cost the same amount is an iso-cost curve.**
- **E.g., given w_1 and w_2, the \$100 iso-cost line has the equation**

$$w_1x_1 + w_2x_2 = 100.$$

Iso-cost Lines

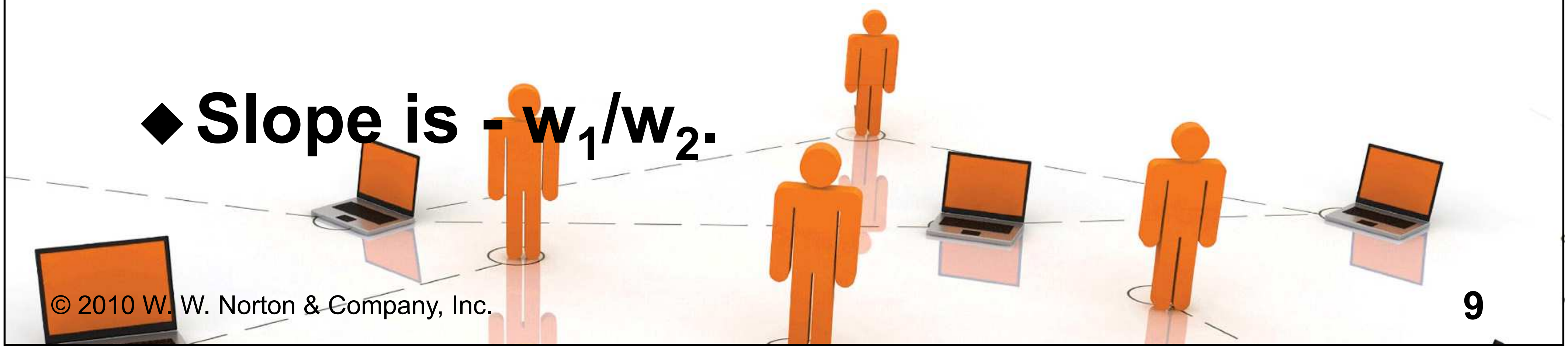
- **Generally, given w_1 and w_2, the equation of the \$c iso-cost line is**

$$w_1x_1 + w_2x_2 = c$$

i.e.

$$x_2 = -\frac{w_1}{w_2}x_1 + \frac{c}{w_2}.$$

- **Slope is $-w_1/w_2$.**



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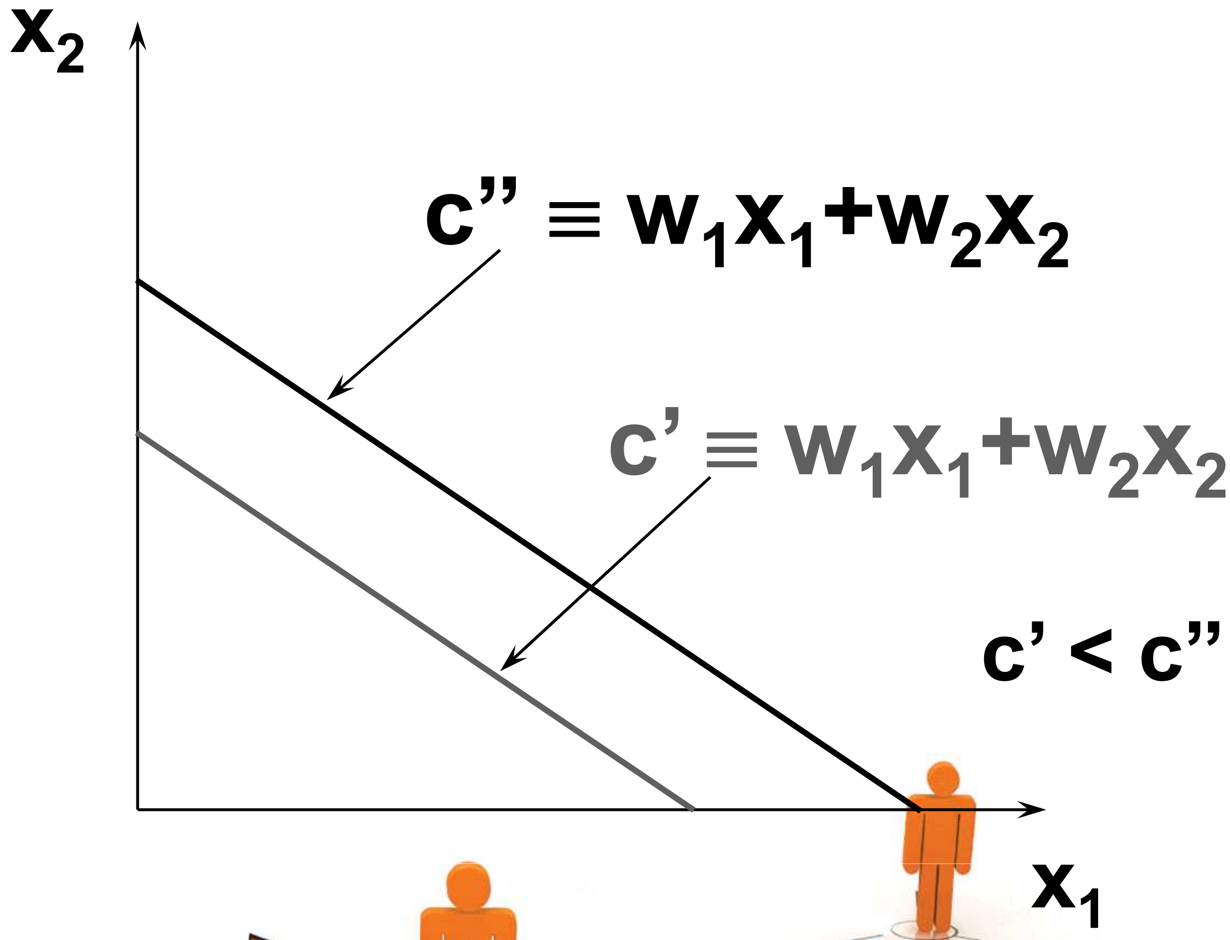

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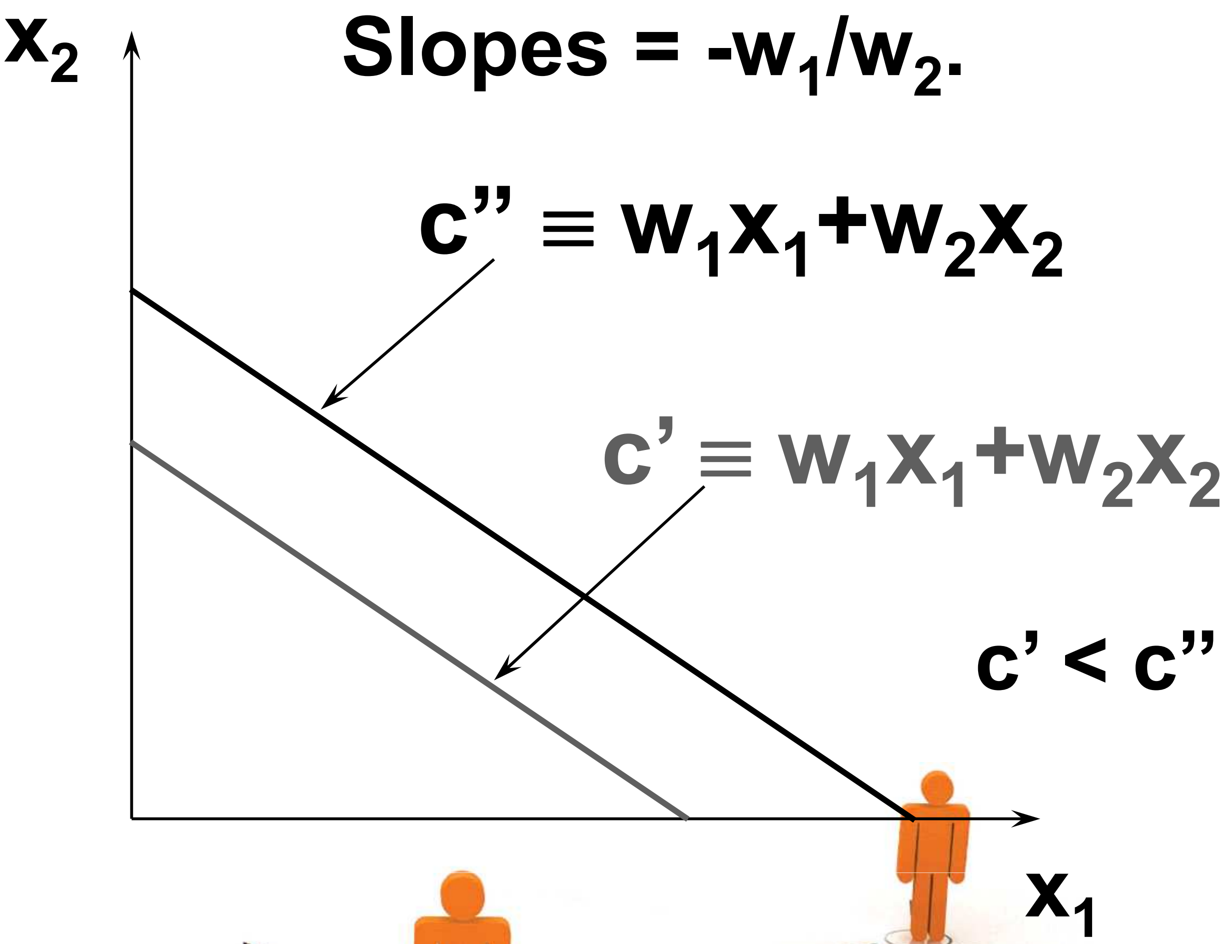
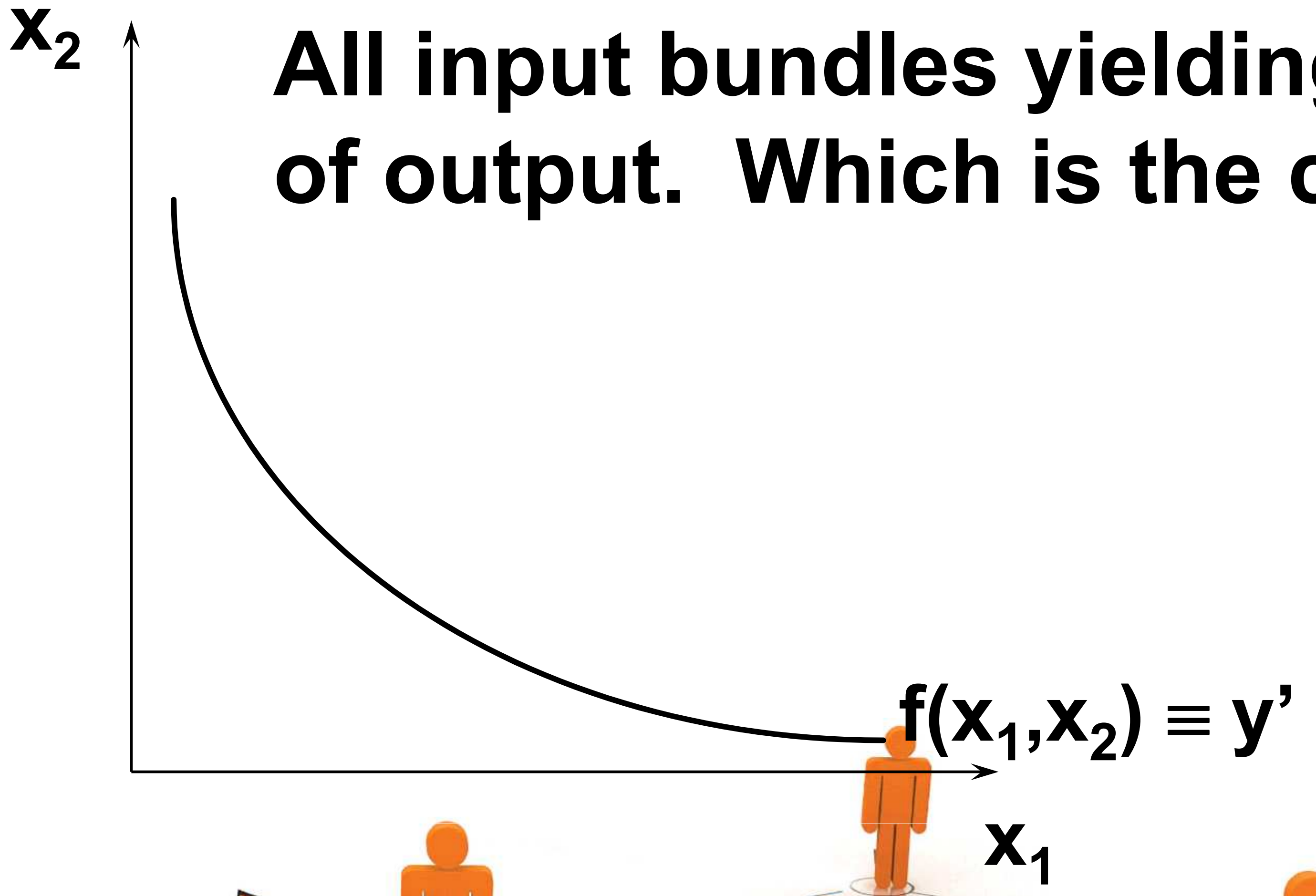


The y'-Output Unit Isoquant

All input bundles yielding y' units of output. Which is the cheapest?



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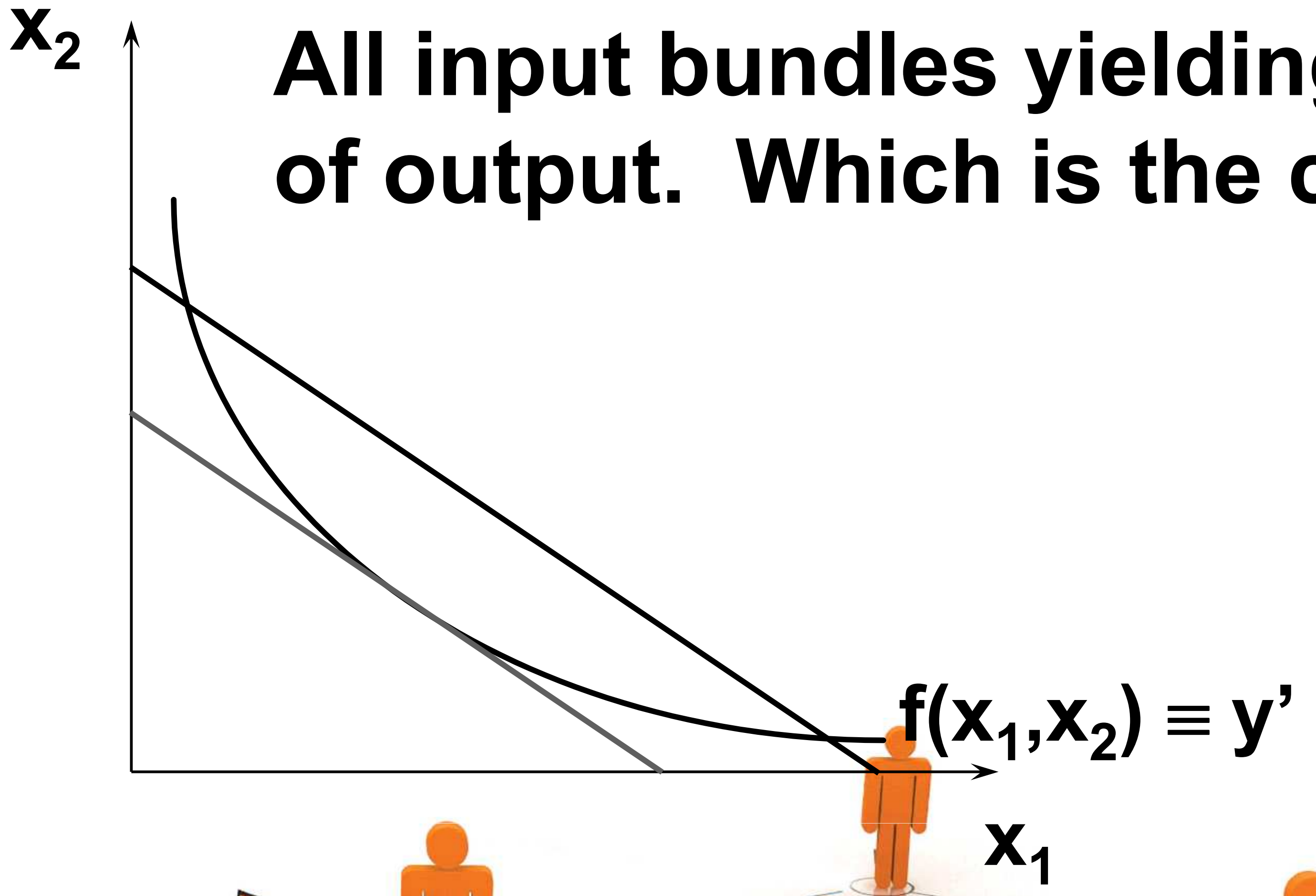

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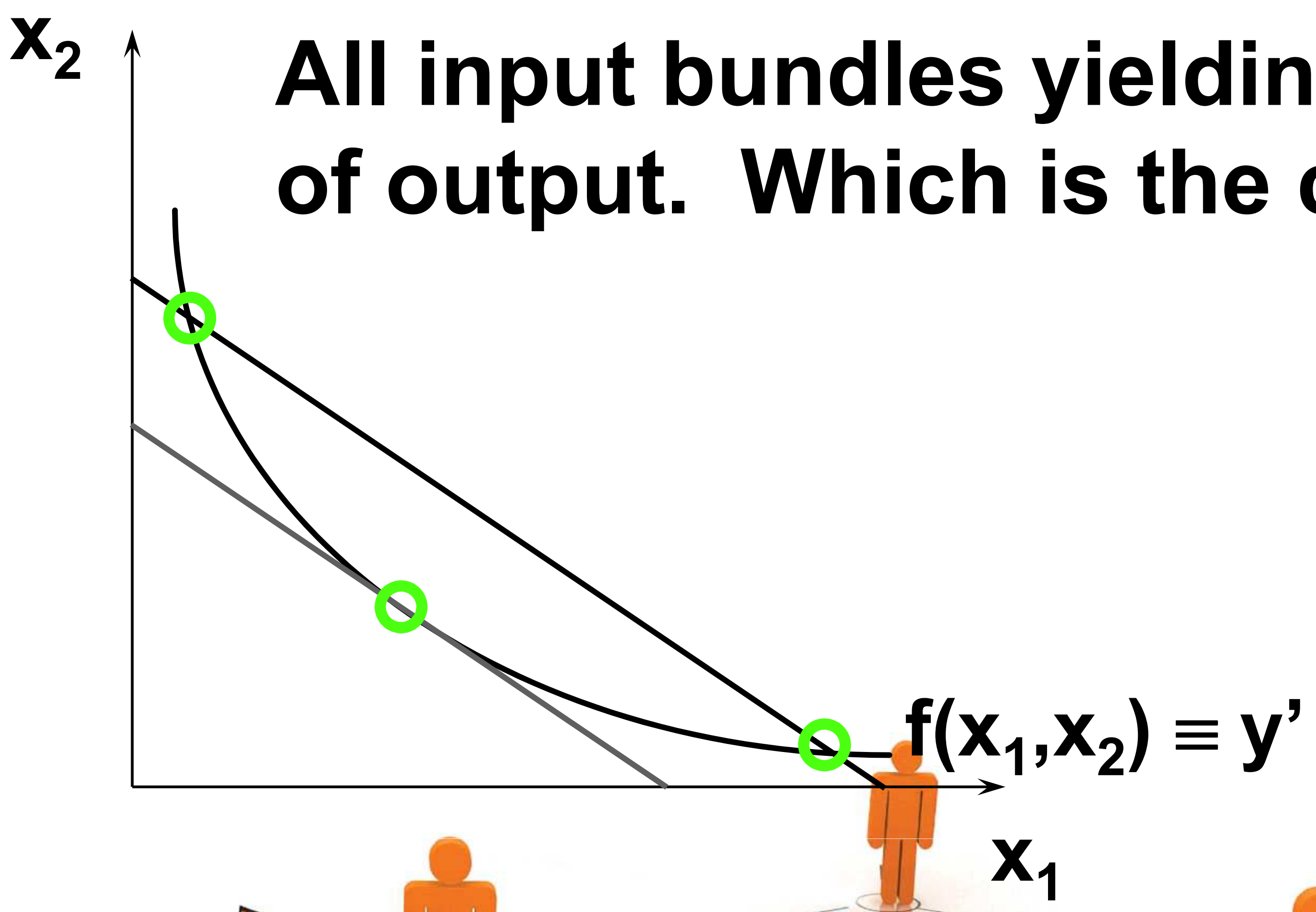

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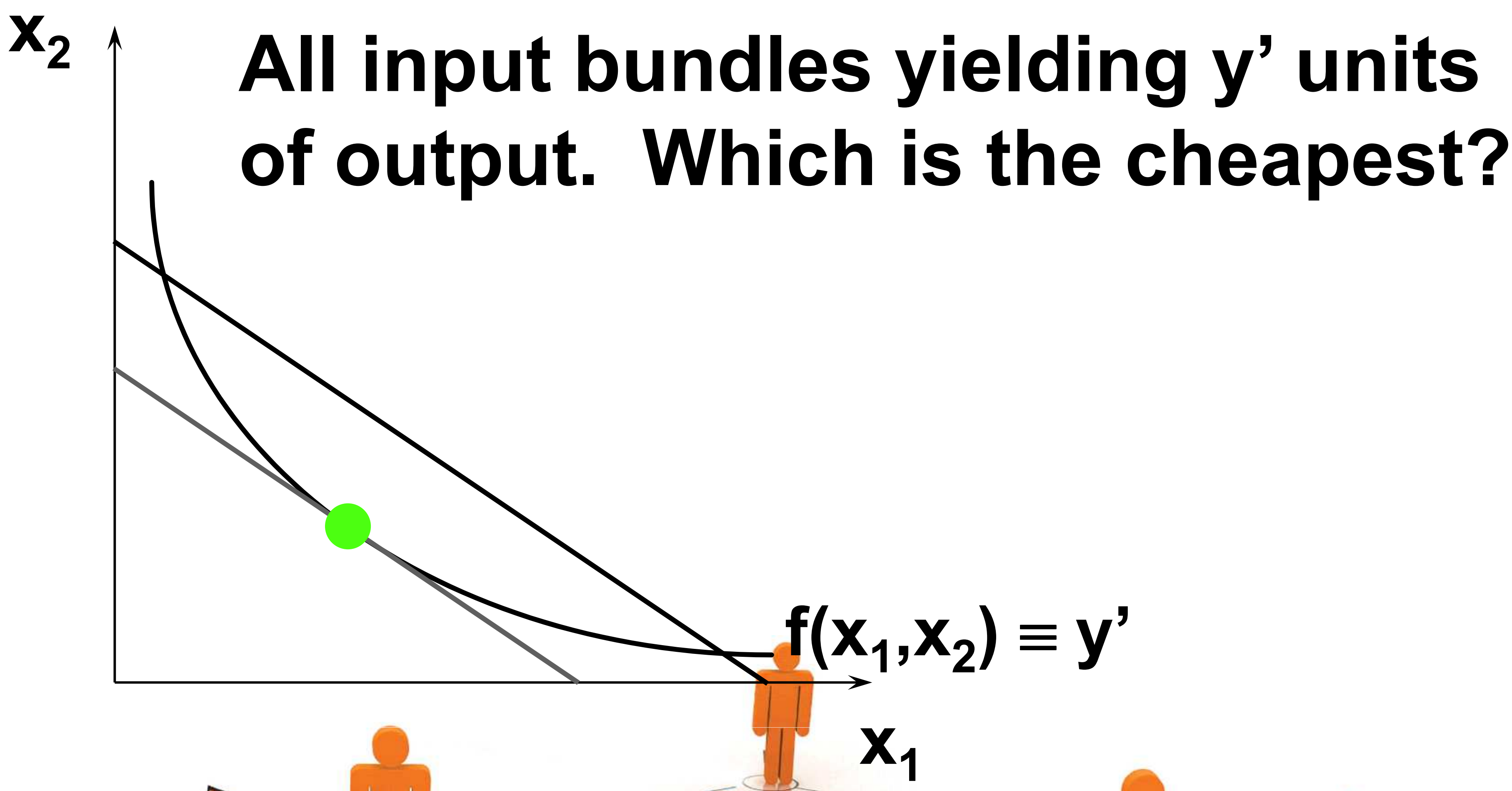

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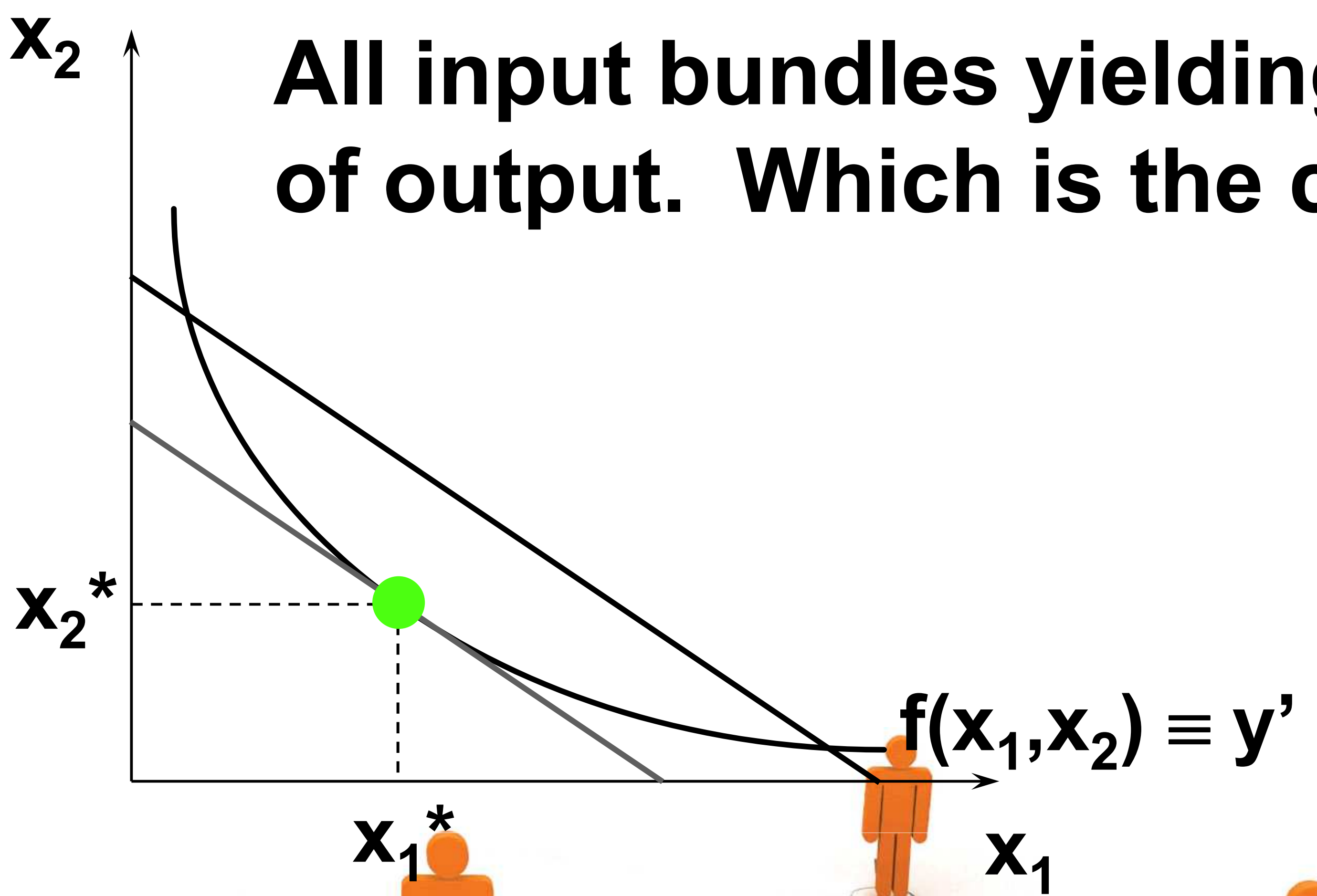
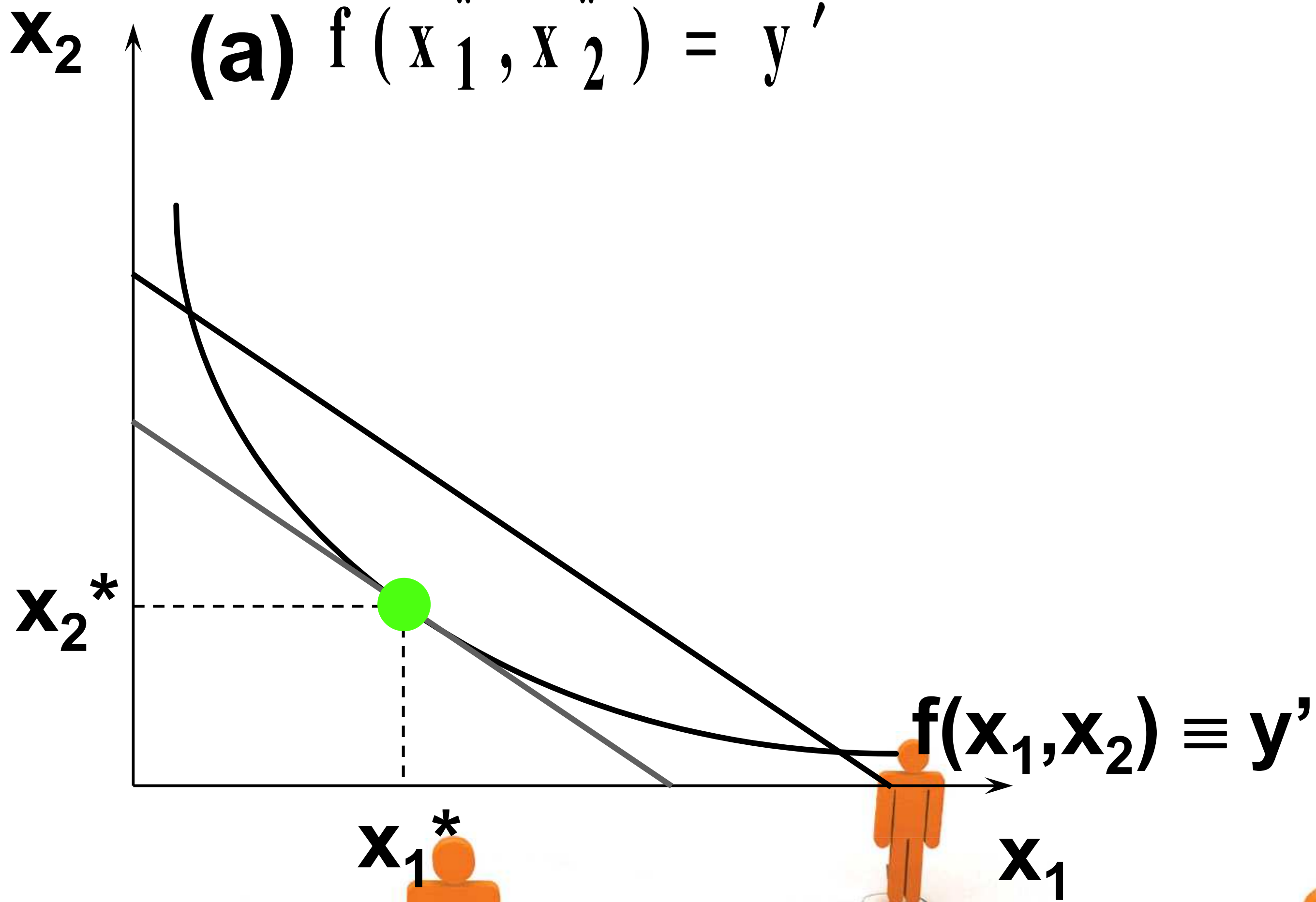


The Cost-Minimization Problem

At an interior cost-min input bundle:

(a) $f(x_1^*, x_2^*) = y'$



The Cost-Minimization Problem

At an interior cost-min input bundle:

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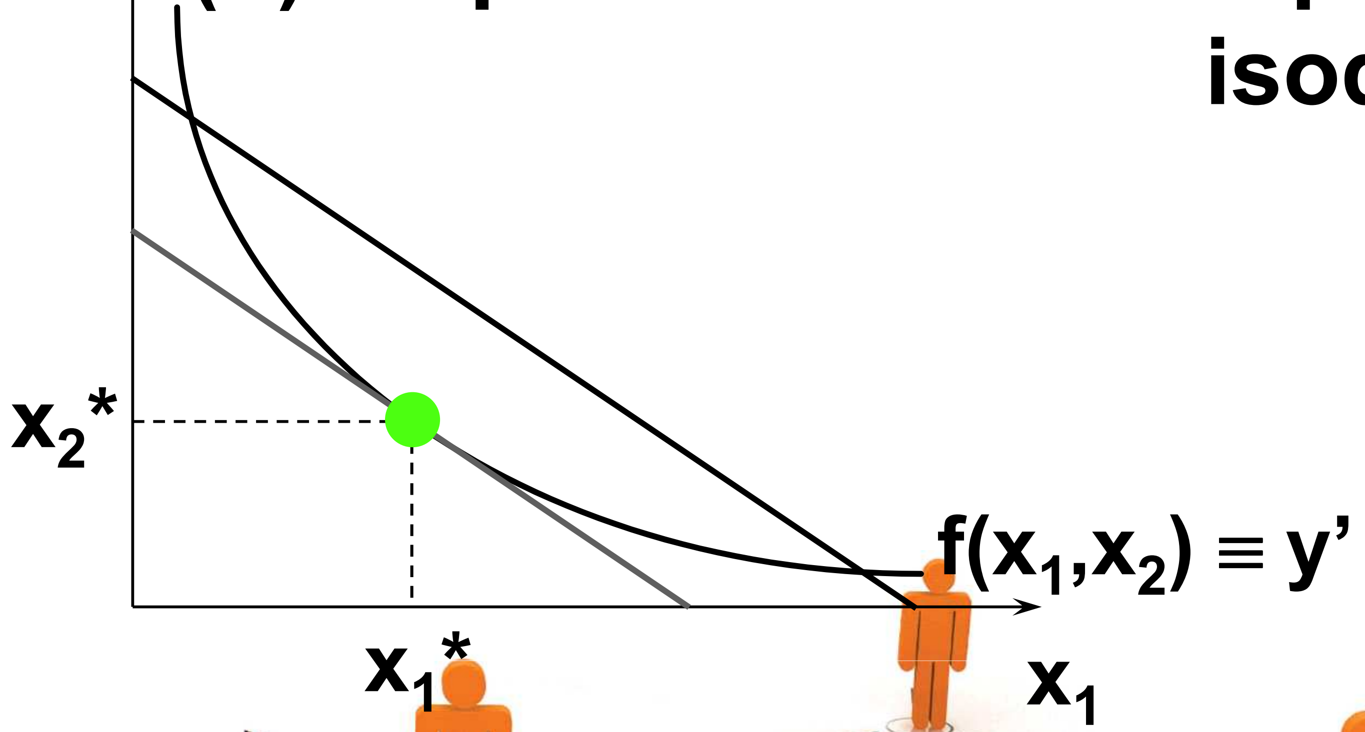
(b) slope of isocost = slope of isoquant



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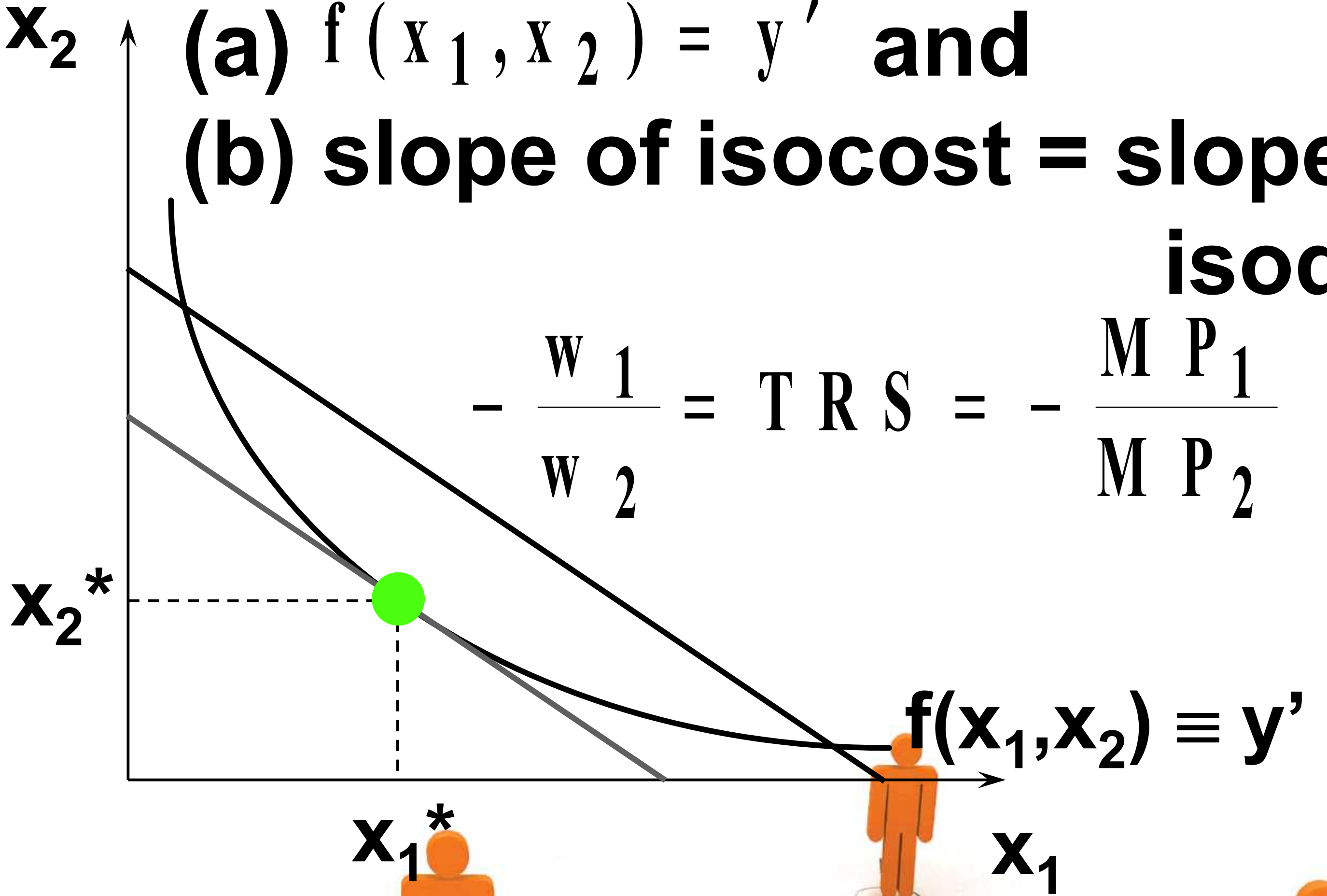
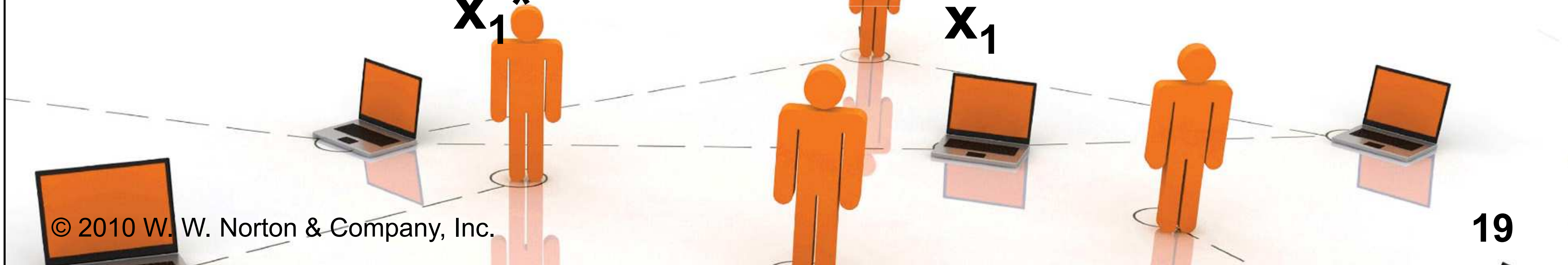
At an interior cost-min input bundle:

(a) $f(x_1^*, x_2^*) = y'$ **and**

(b) slope of isocost = slope of isoquant; i.e.

$$-\frac{w_1}{w_2} = TRS = -\frac{MP_1}{MP_2} \text{ at } (x_1^*, x_2^*).$$





A Cobb-Douglas Example of Cost Minimization

- **A firm's Cobb-Douglas production function is** $y = f(x_1, x_2) = x_1^{1/3} x_2^{2/3}.$
- **Input prices are w_1 and w_2.**
- **What are the firm's conditional input demand functions?**

A Cobb-Douglas Example of Cost Minimization

At the input bundle (x_1^*, x_2^*) which minimizes the cost of producing y output units:

(a)

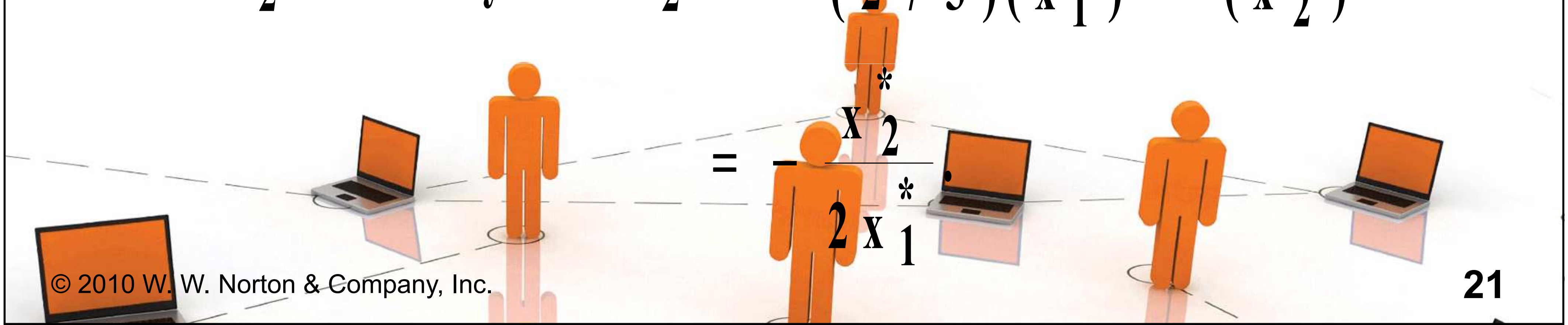
$$y = (x_1^*)^{1/3}(x_2^*)^{2/3}$$

and

(b)

$$-\frac{w_1}{w_2} = -\frac{\partial y/\partial x_1}{\partial y/\partial x_2} = -\frac{(1/3)(x_1^*)^{-2/3}(x_2^*)^{2/3}}{(2/3)(x_1^*)^{1/3}(x_2^*)^{-1/3}}$$

$$= -\frac{x_2^*}{2x_1^*}.$$



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(a) $y = (x_1^*)^{1/3}(x_2^*)^{2/3}$ **(b)** $\dfrac{w_1}{w_2} = \dfrac{x_2^*}{2x_1^*}.$

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From (b), $x_2^* = \frac{2w_1}{w_2}x_1^*.$

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Now substitute into (a) to get

$$y = (x_1^*)^{1/3}\left(\frac{2w_1}{w_2}x_1^*\right)^{2/3}$$

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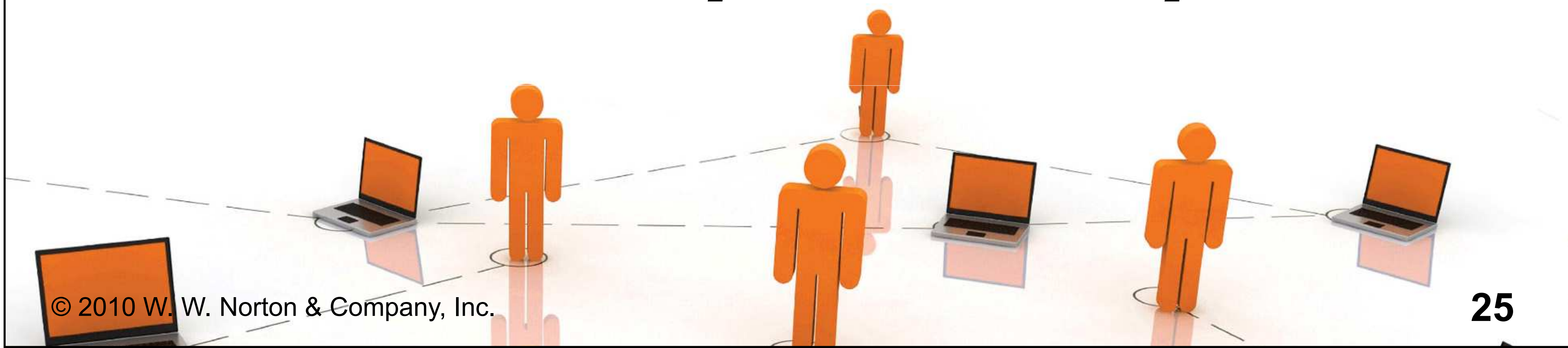

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$$y = (x_1^*)^{1/3}\left(\frac{2w_1}{w_2}x_1^*\right)^{2/3} = \left(\frac{2w_1}{w_2}\right)^{2/3}x_1^*.$$

So $x_1^* = \left(\dfrac{w_2}{2w_1}\right)^{2/3} y$ **is the firm's conditional demand for input 1.**

A Cobb-Douglas Example of Cost Minimization

Since $x_2^* = \dfrac{2w_1}{w_2}x_1^*$ **and** $x_1^* = \left(\dfrac{w_2}{2w_1}\right)^{2/3} y$

$$x_2^* = \frac{2w_1}{w_2}\left(\frac{w_2}{2w_1}\right)^{2/3} y = \left(\frac{2w_1}{w_2}\right)^{1/3} y$$

is the firm's conditional demand for input 2.

A Cobb-Douglas Example of Cost Minimization

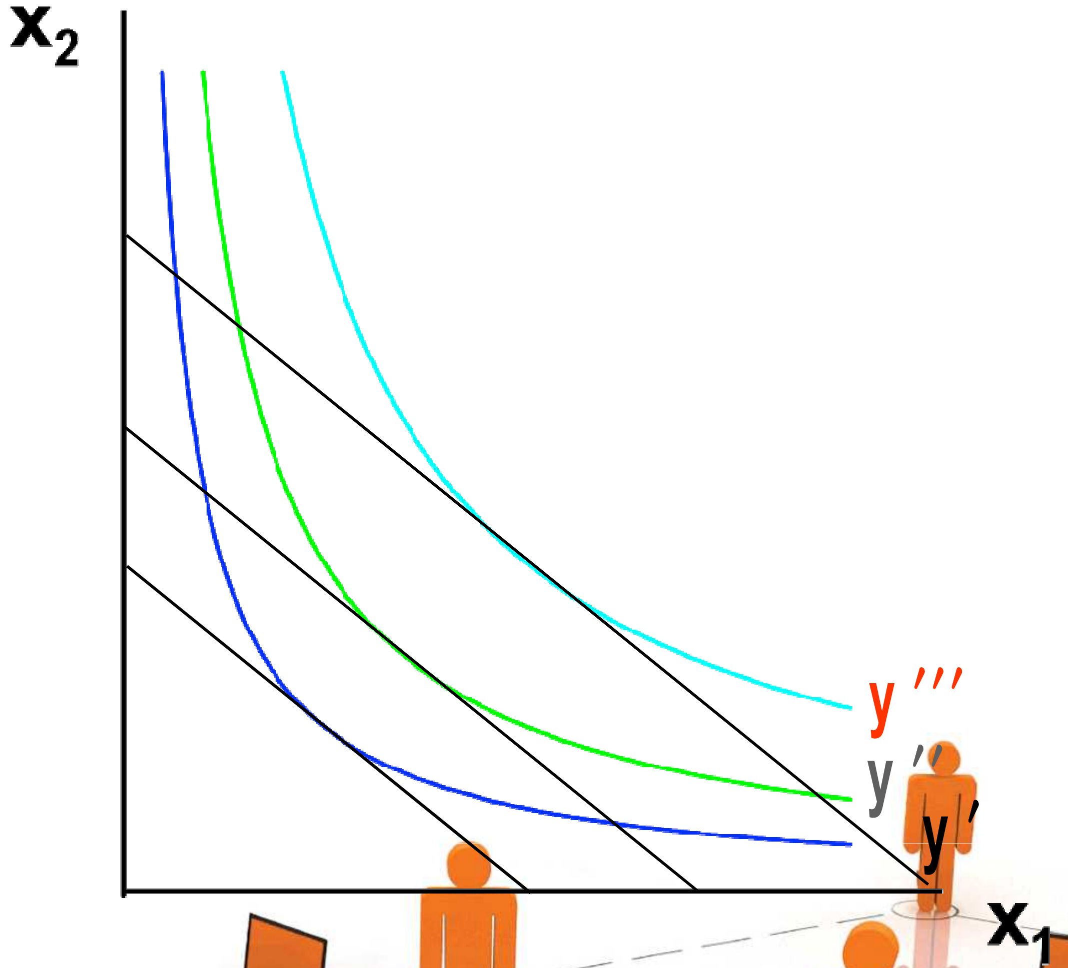
So the cheapest input bundle yielding y output units is

$$\left(x_1^*(w_1, w_2, y), x_2^*(w_1, w_2, y)\right)$$

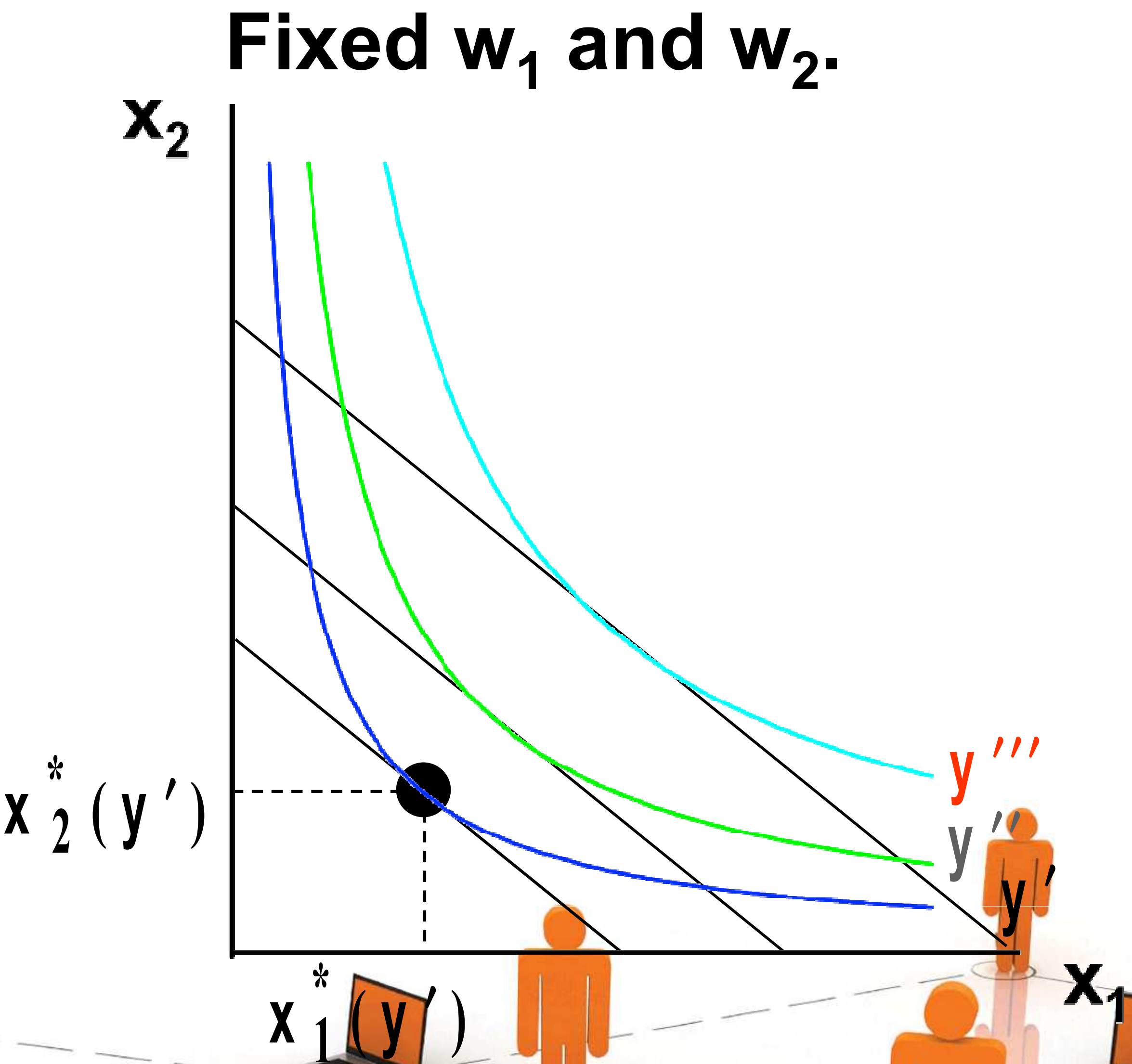
$$= \left(\left(\frac{w_2}{2w_1}\right)^{2/3} y, \left(\frac{2w_1}{w_2}\right)^{1/3} y\right).$$

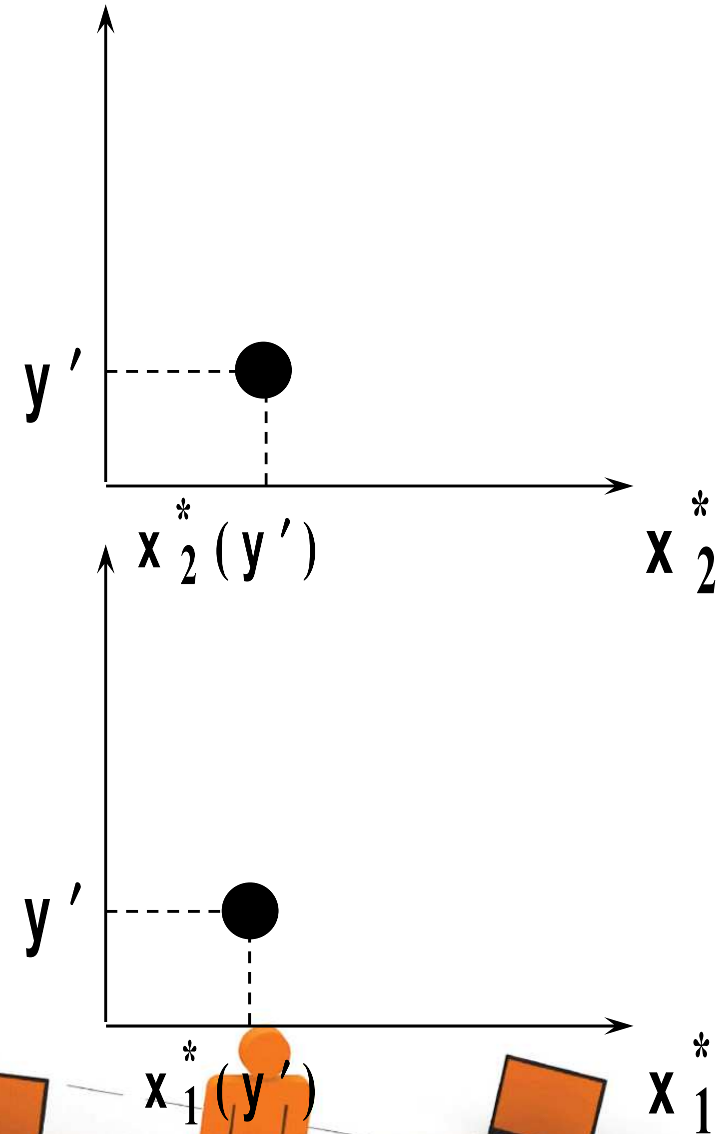
Conditional Input Demand Curves

Fixed w_1 and w_2.



Conditional Input Demand Curves





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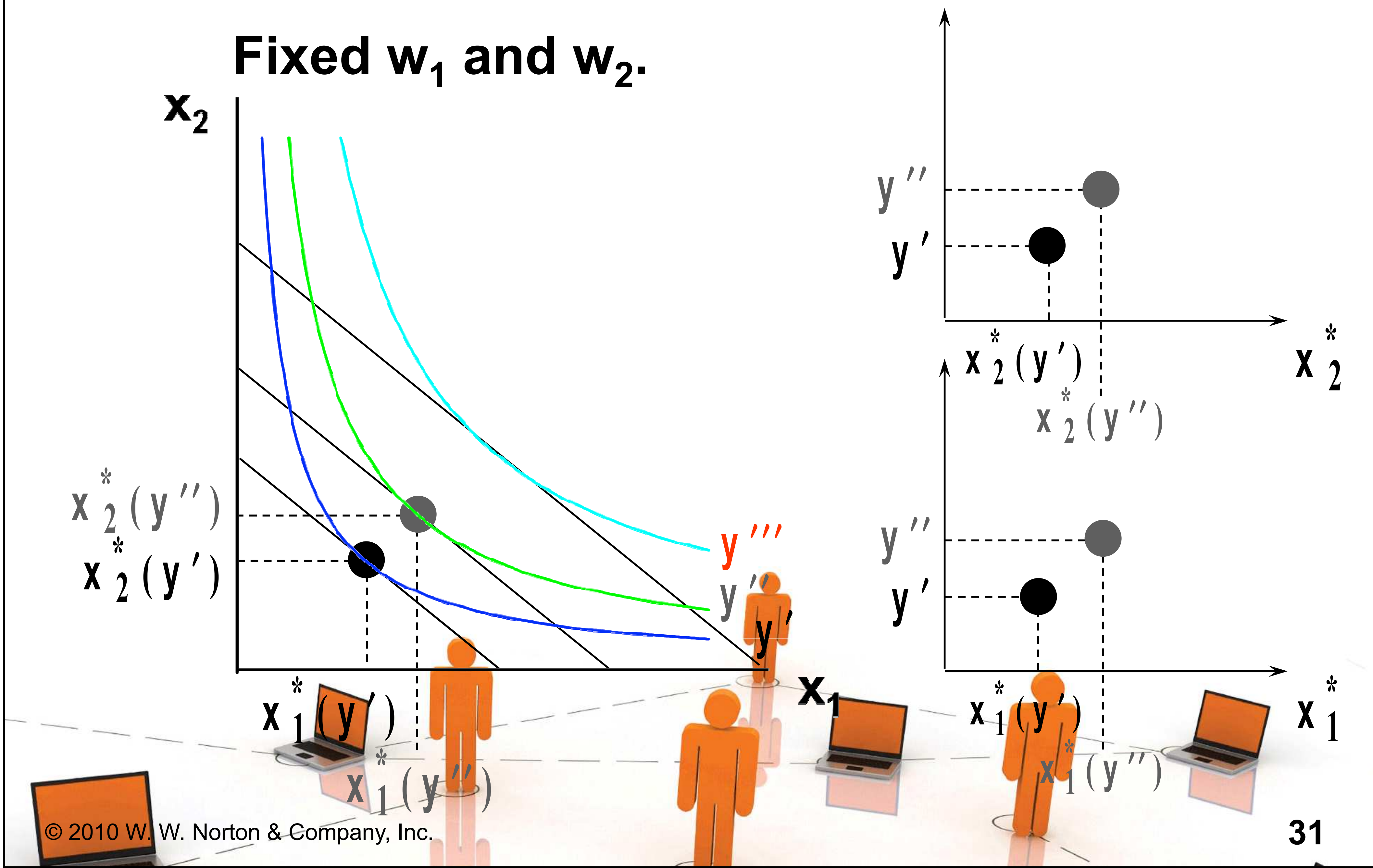

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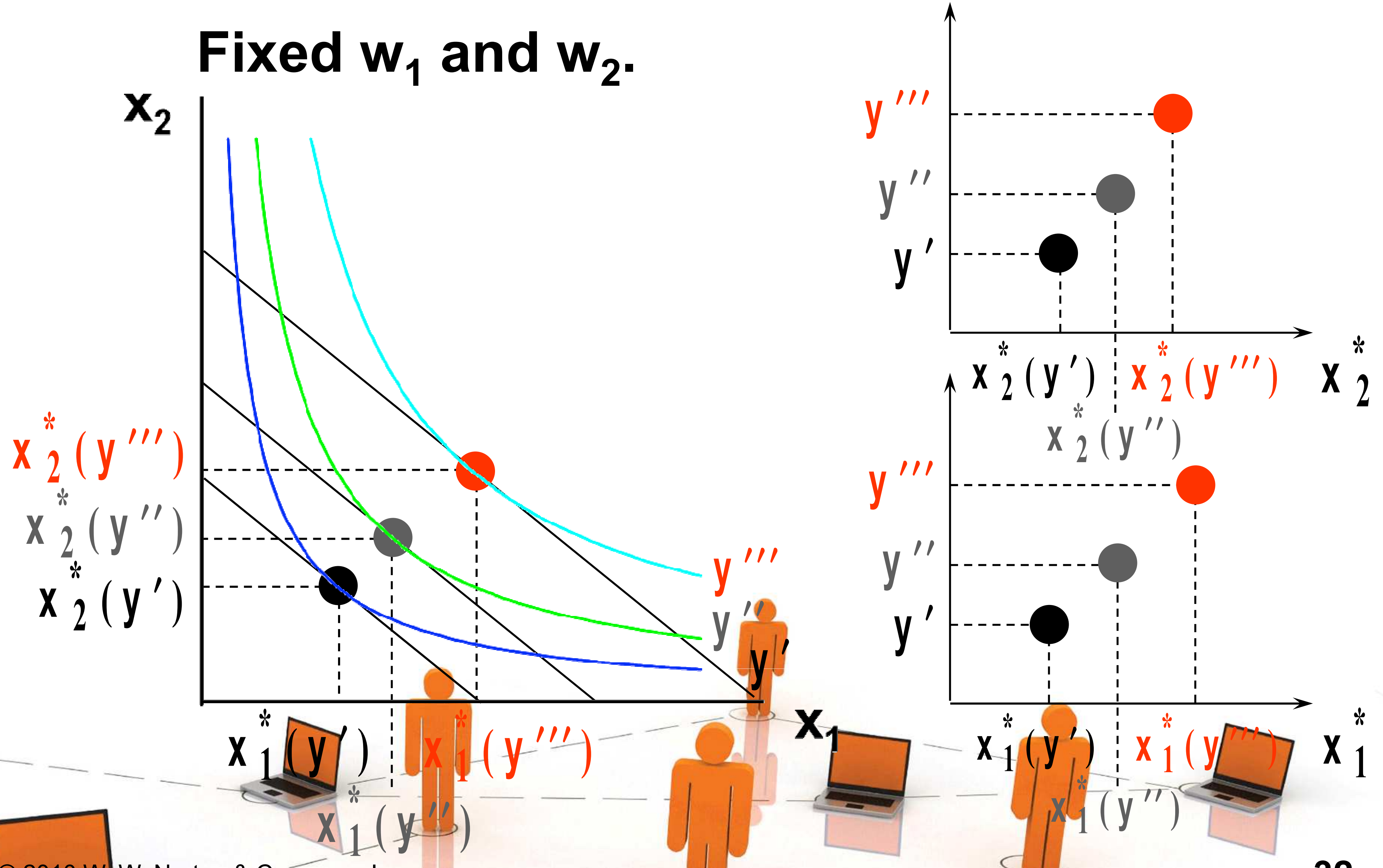

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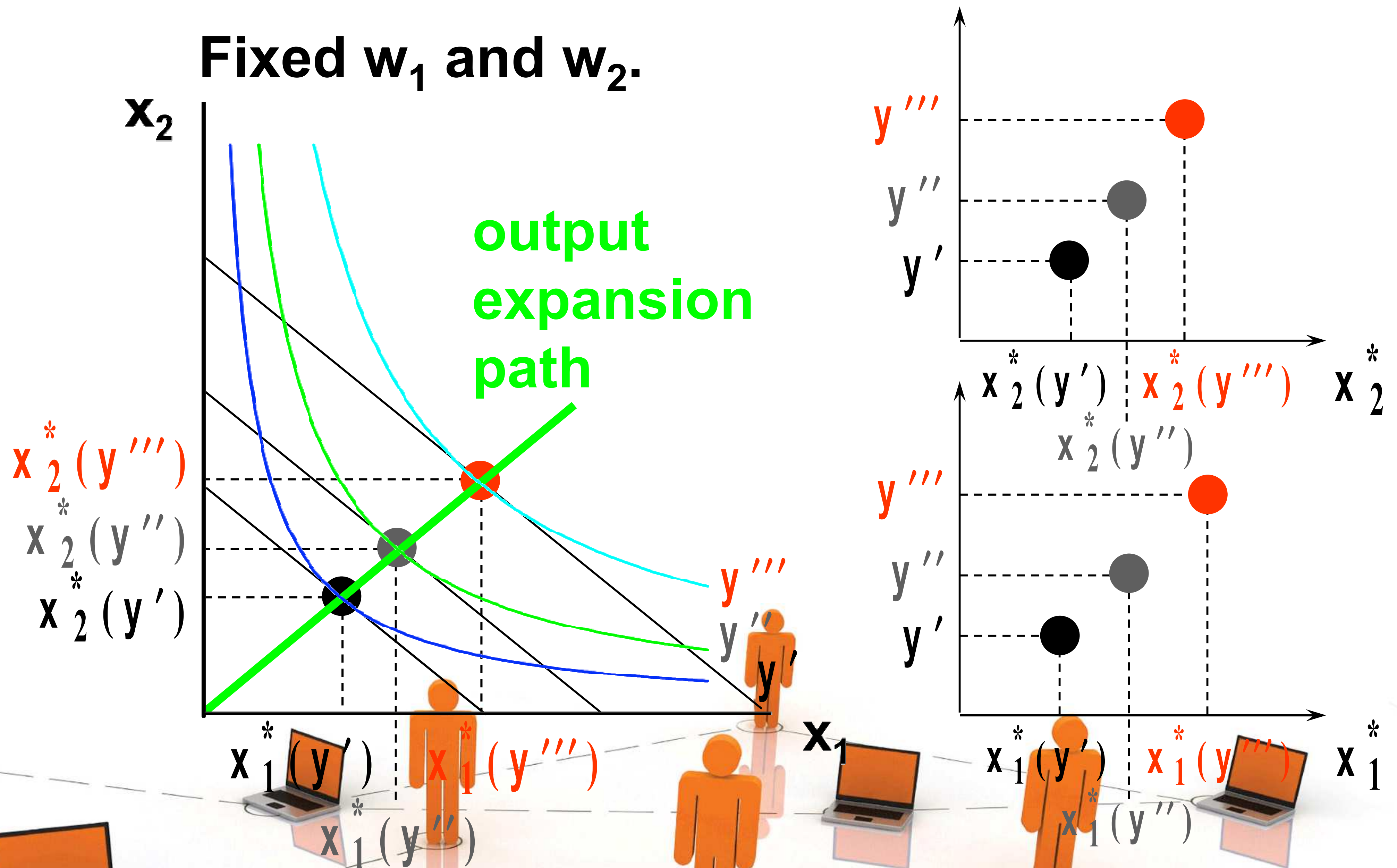

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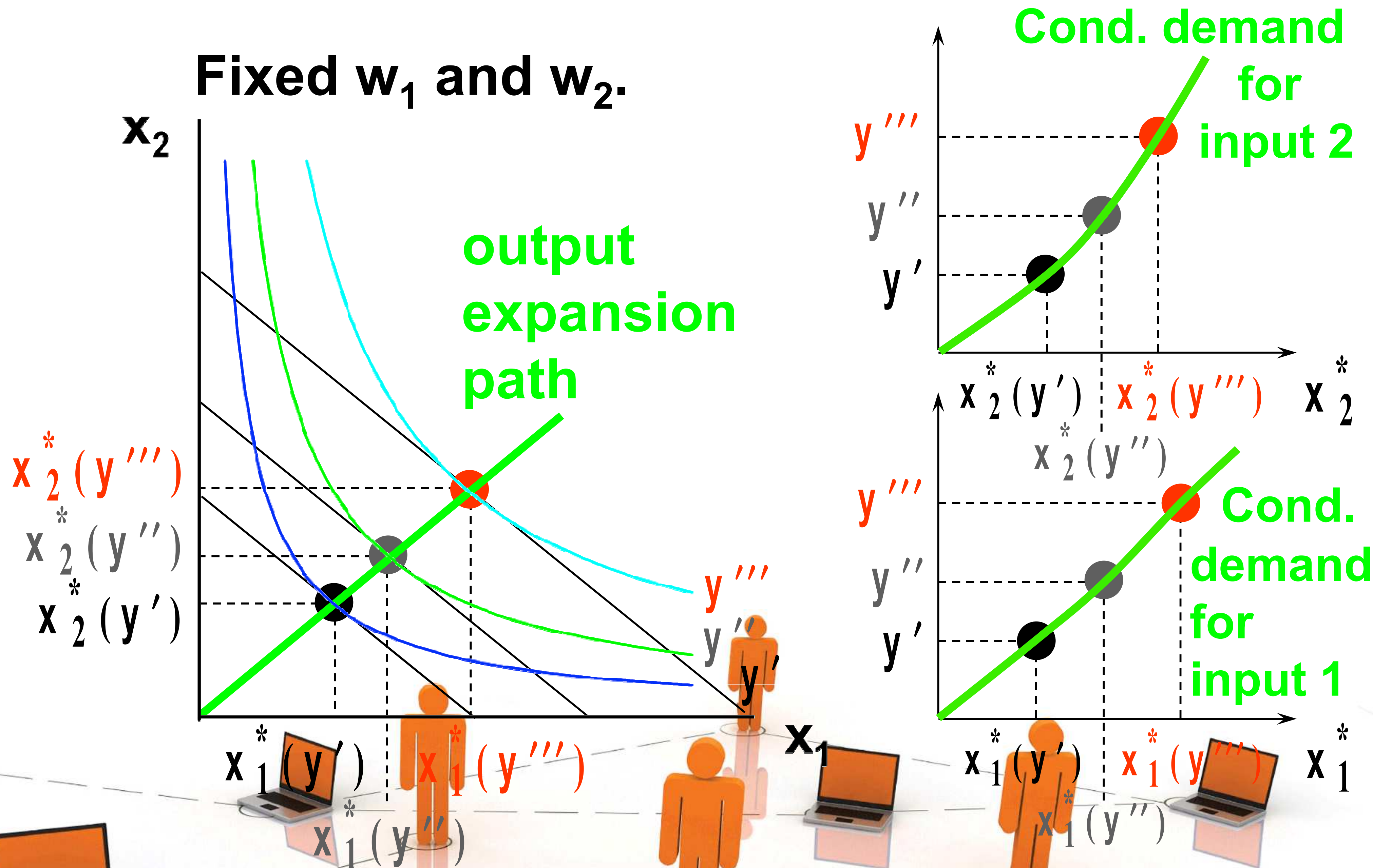


A Cobb-Douglas Example of Cost Minimization

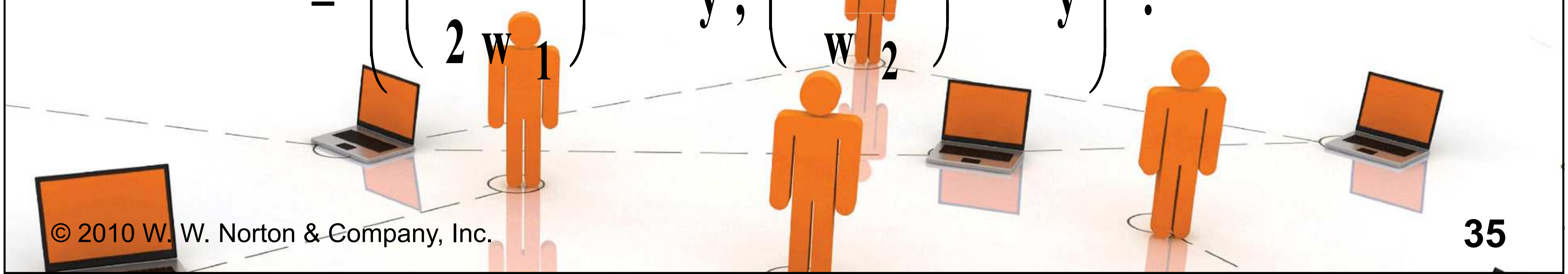
For the production function

$$y = f(x_1, x_2) = x_1^{1/3} x_2^{2/3}$$

the cheapest input bundle yielding y output units is

$$\left(x_1^*(w_1, w_2, y), x_2^*(w_1, w_2, y)\right)$$

$$= \left(\left(\frac{w_2}{2w_1}\right)^{2/3} y, \left(\frac{2w_1}{w_2}\right)^{1/3} y \right).$$



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So the firm's total cost function is

$$c(w_1, w_2, y) = w_1 x_1^*(w_1, w_2, y) + w_2 x_2^*(w_1, w_2, y)$$

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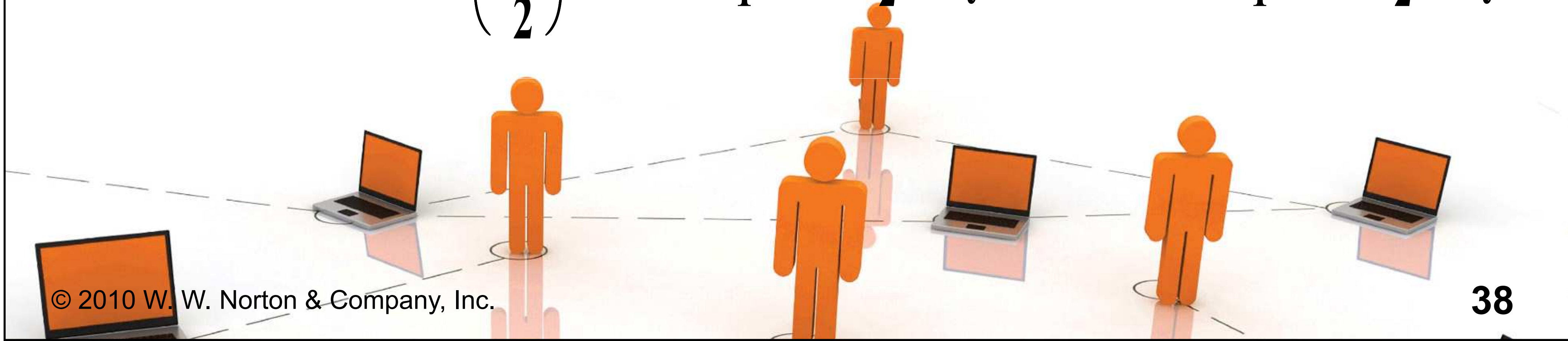
$$= \left(\frac{1}{2}\right)^{2/3} w_1^{1/3} w_2^{2/3} y + 2^{1/3} w_1^{1/3} w_2^{2/3} y$$



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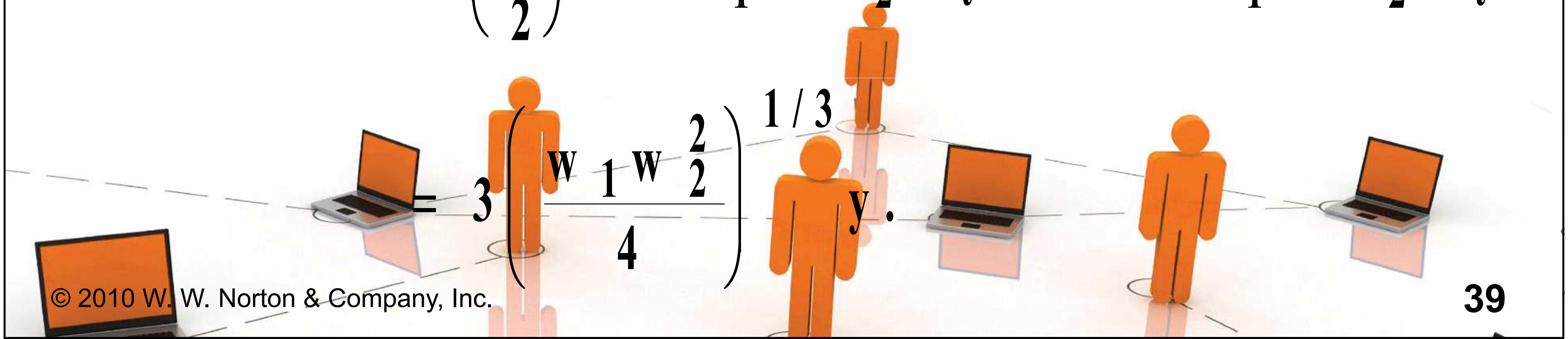
$$= \left(\frac{1}{2}\right)^{2/3} w_1^{1/3} w_2^{2/3} y + 2^{1/3} w_1^{1/3} w_2^{2/3} y$$

$$= 3\left(\frac{w_1 w_2^2}{4}\right)^{1/3} y.$$



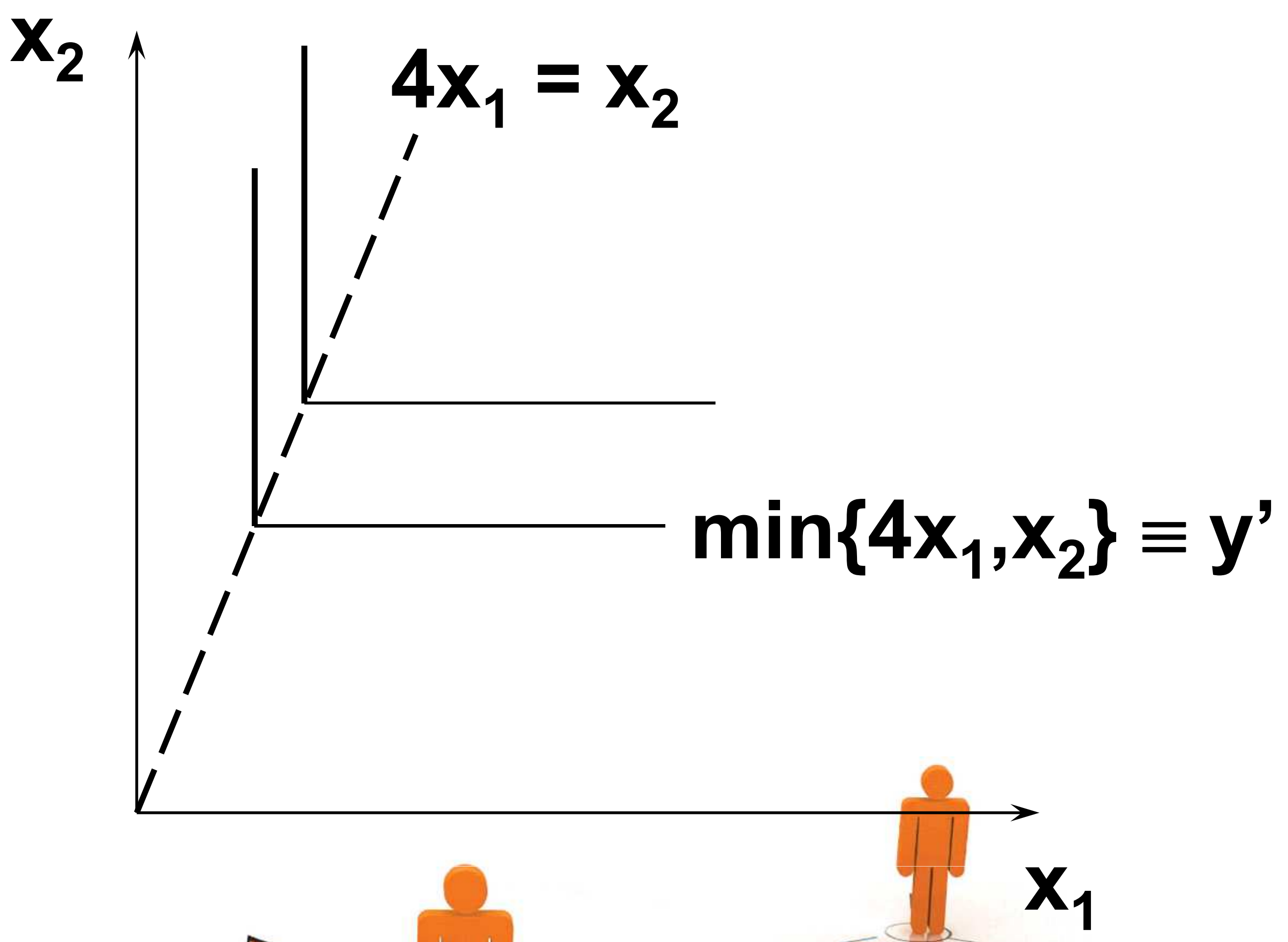
A Perfect Complements Example of Cost Minimization

- **The firm's production function is**

$$y = \min\{4x_1, x_2\}.$$

- **Input prices w_1 and w_2 are given.**
- **What are the firm's conditional demands for inputs 1 and 2?**
- **What is the firm's total cost function?**

A Perfect Complements Example of Cost Minimization



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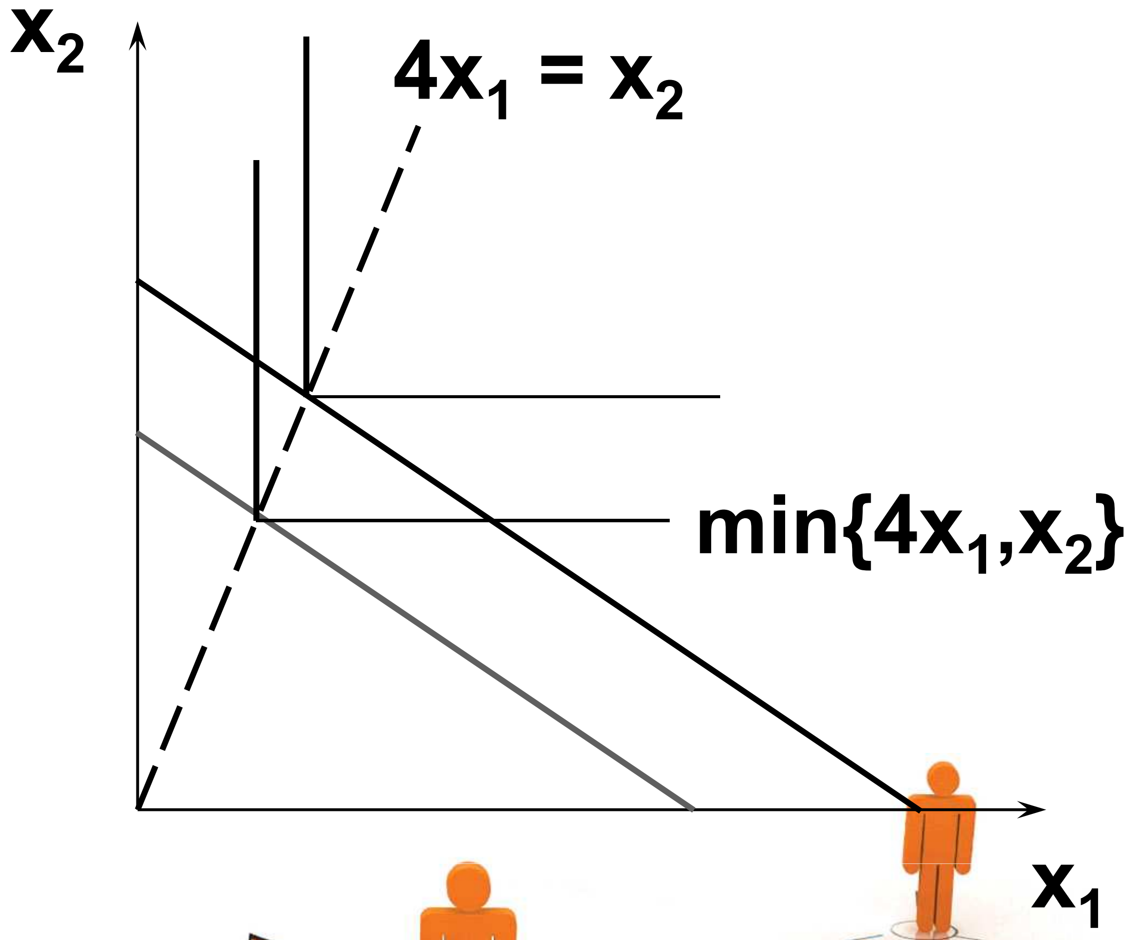

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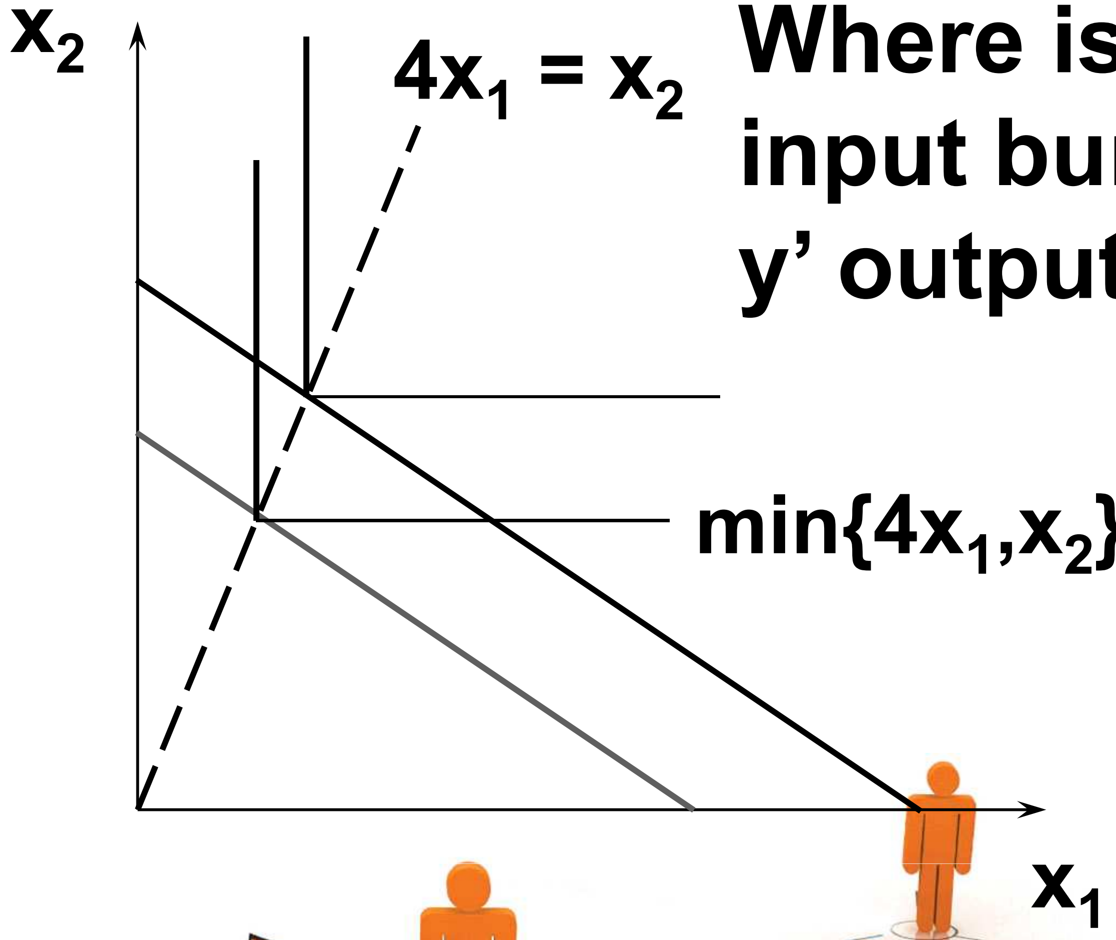

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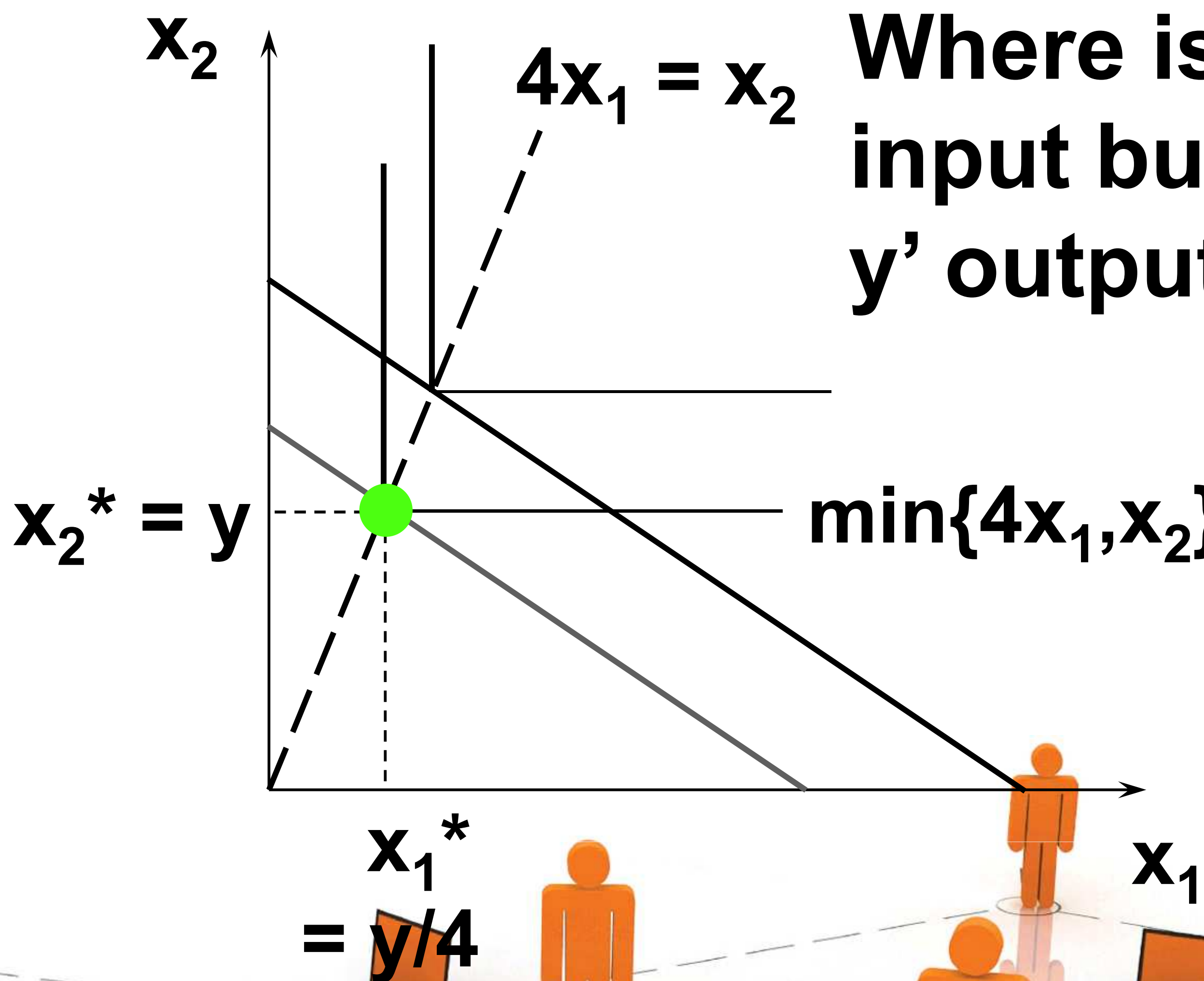

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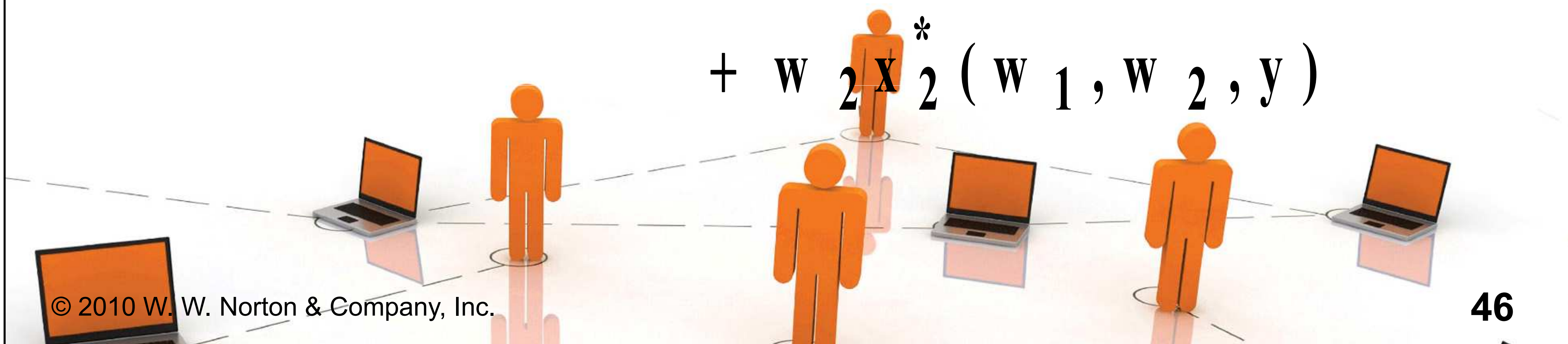

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$$= w_1 \frac{y}{4} + w_2 y = \left(\frac{w_1}{4} + w_2\right) y.$$

Average Total Production Costs

- **For positive output levels y, a firm's average total cost of producing y units is**

$$AC(w_1, w_2, y) = \frac{c(w_1, w_2, y)}{y}.$$

Returns-to-Scale and Av. Total Costs

- **The returns-to-scale properties of a firm's technology determine how average production costs change with output level.**
- **Our firm is presently producing y' output units.**
- **How does the firm's average production cost change if it instead produces 2y' units of output?**

Constant Returns-to-Scale and Average Total Costs

- If a firm's technology exhibits constant returns-to-scale then doubling its output level from y' to 2y' requires doubling all input levels.

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Constant Returns-to-Scale and Average Total Costs

- If a firm's technology exhibits constant returns-to-scale then doubling its output level from y' to 2y' requires doubling all input levels.
- Total production cost doubles.
- Average production cost does not change.

Decreasing Returns-to-Scale and Average Total Costs

- **If a firm's technology exhibits decreasing returns-to-scale then doubling its output level from y' to 2y' requires more than doubling all input levels.**

Decreasing Returns-to-Scale and Average Total Costs

- **If a firm's technology exhibits decreasing returns-to-scale then doubling its output level from y' to 2y' requires more than doubling all input levels.**
- **Total production cost more than doubles.**

Decreasing Returns-to-Scale and Average Total Costs

- If a firm's technology exhibits decreasing returns-to-scale then doubling its output level from y' to 2y' requires more than doubling all input levels.
- Total production cost more than doubles.
- Average production cost increases.

Increasing Returns-to-Scale and Average Total Costs

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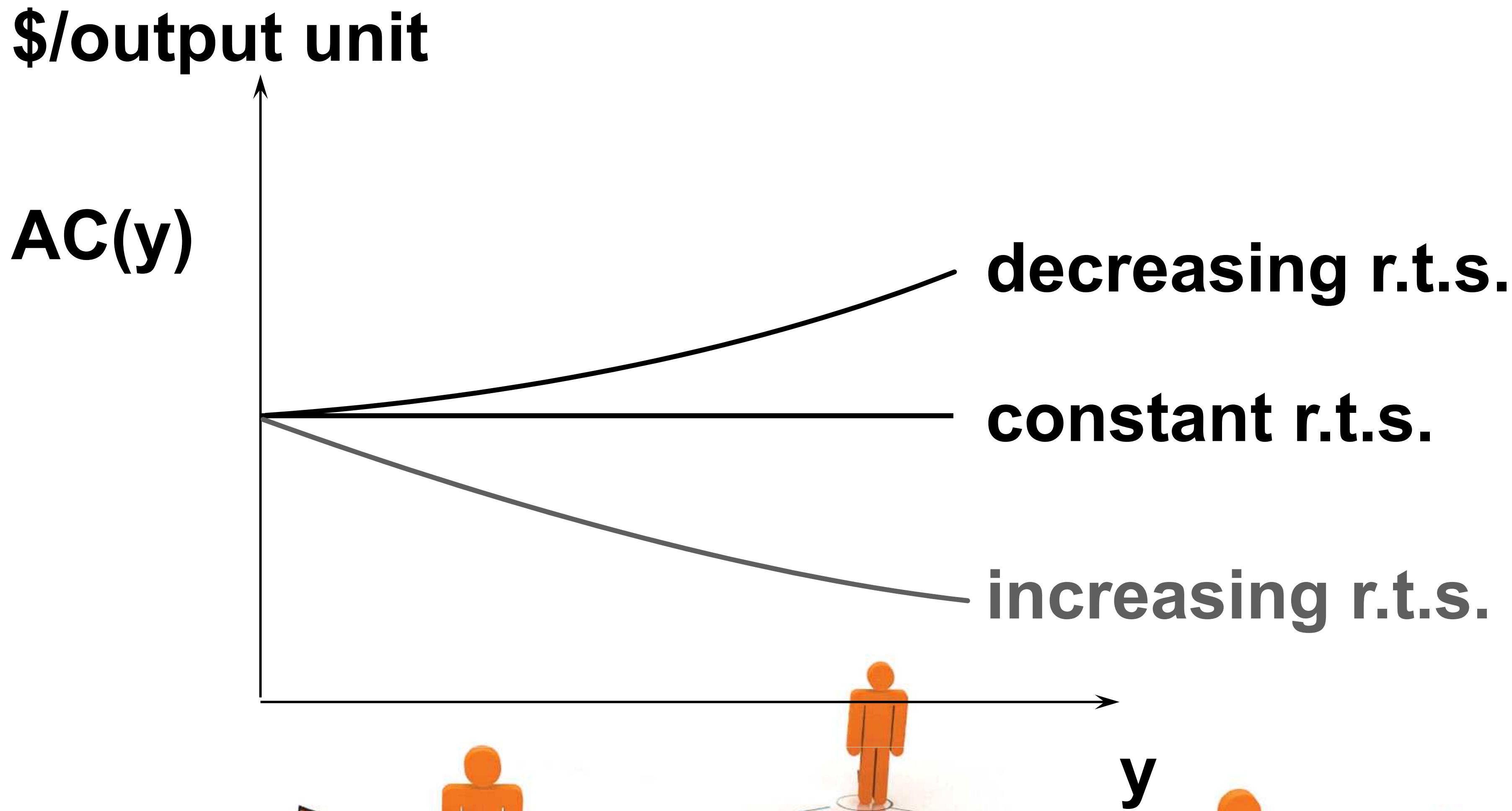
Returns-to-Scale and Av. Total Costs

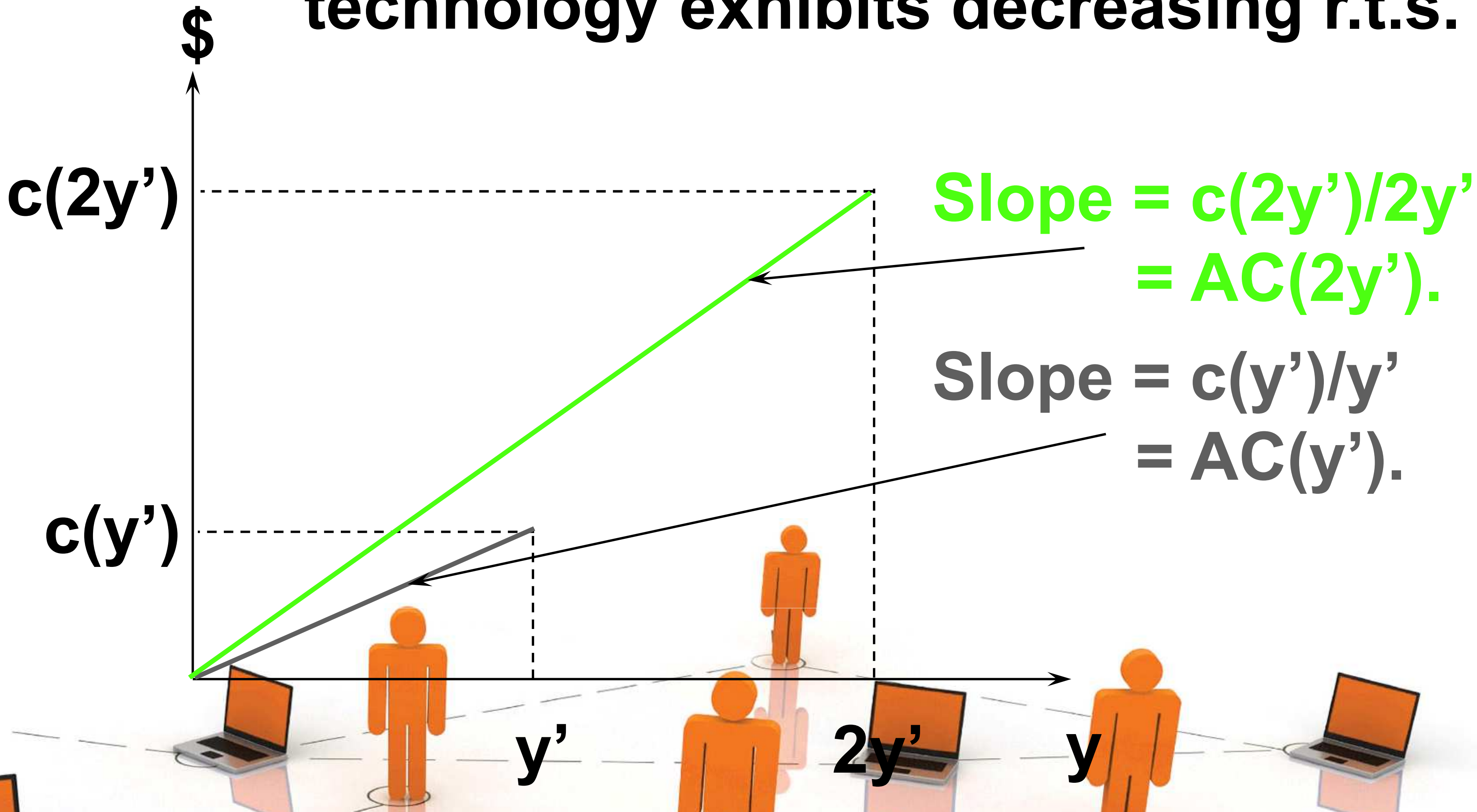


Returns-to-Scale and Total Costs

- **What does this imply for the shapes of total cost functions?**

Returns-to-Scale and Total Costs

Av. cost increases with y if the firm's technology exhibits decreasing r.t.s.



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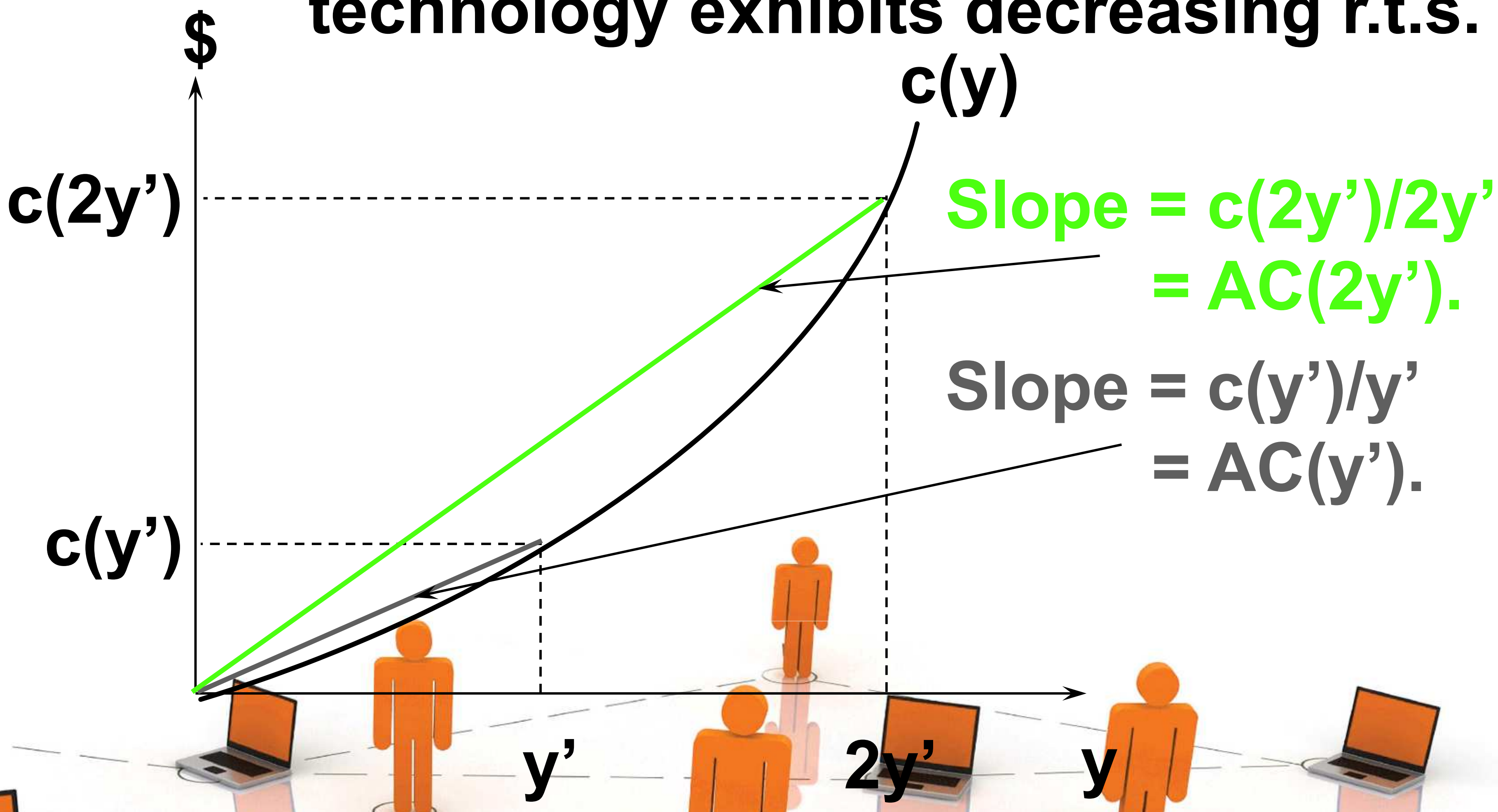

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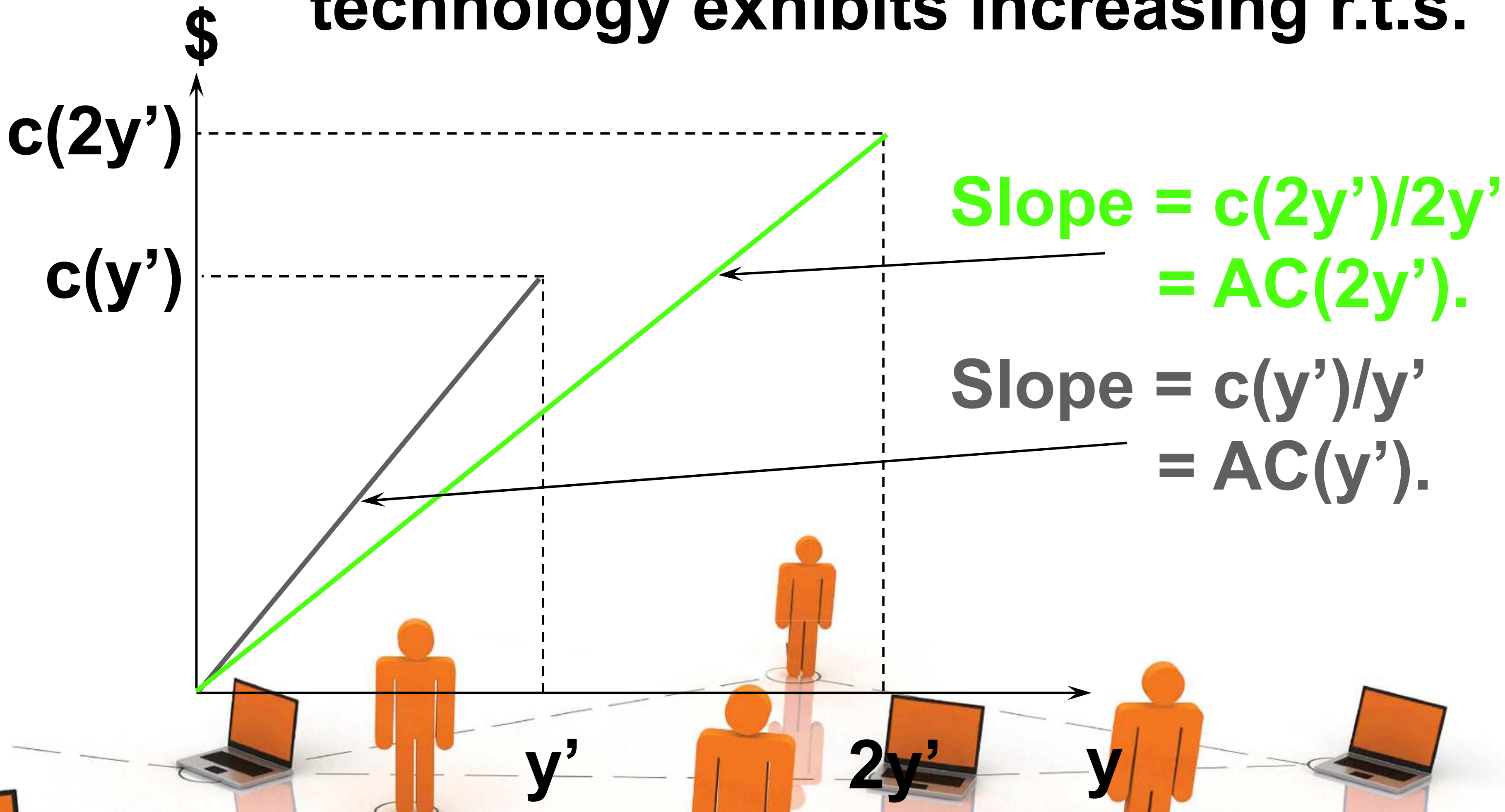
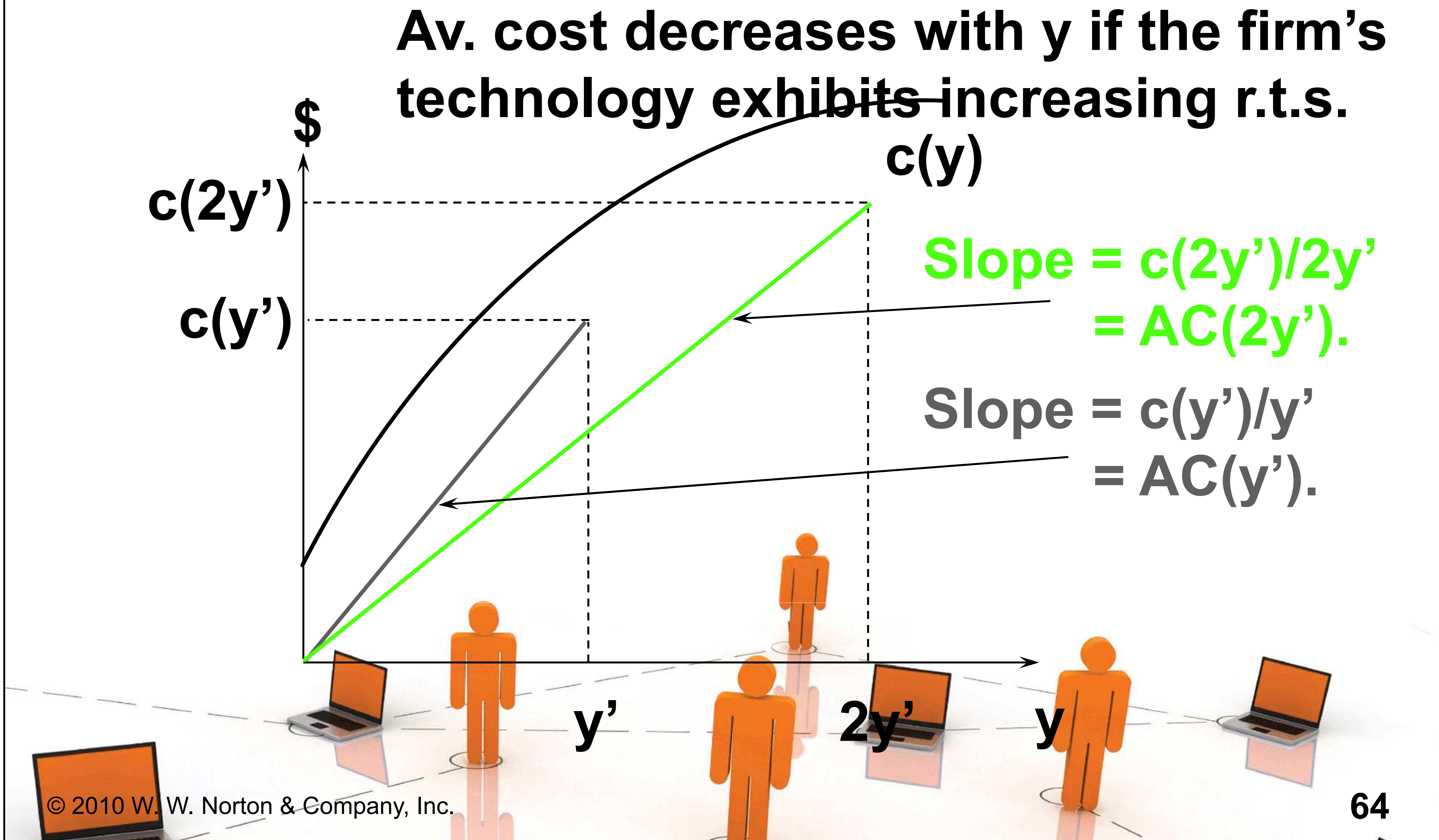
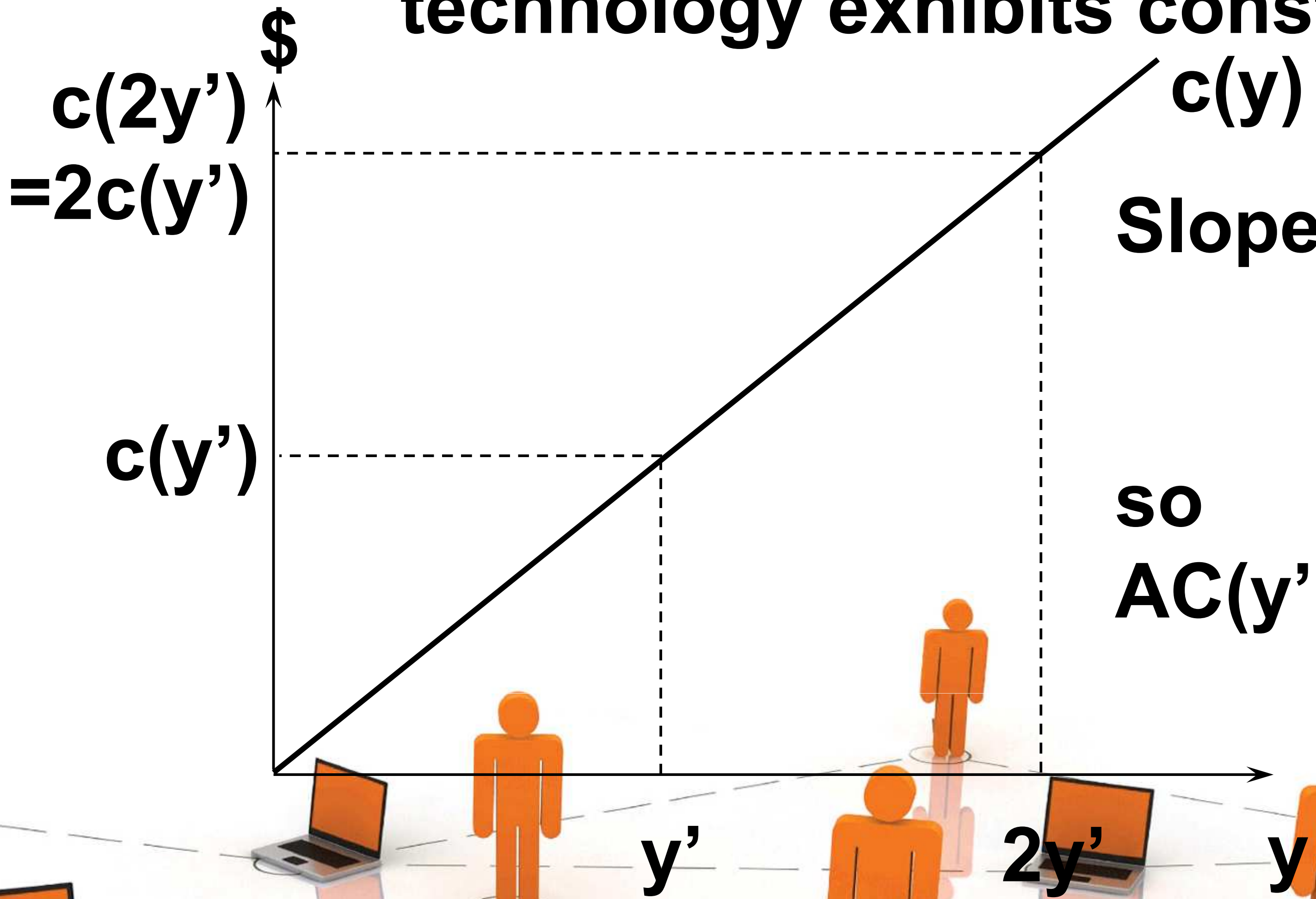


Returns-to-Scale and Total Costs



Returns-to-Scale and Total Costs

Av. cost is constant when the firm's technology exhibits constant r.t.s.



Slope = c(2y')/2y'
= 2c(y')/2y'
= c(y')/y'
so
AC(y') = AC(2y').

Short-Run & Long-Run Total Costs

- In the long-run a firm can vary all of its input levels.
- Consider a firm that cannot change its input 2 level from x_2' units.
- How does the short-run total cost of producing y output units compare to the long-run total cost of producing y units of output?

Short-Run & Long-Run Total Costs

- **The long-run cost-minimization problem is** $\min_{x_1, x_2 \geq 0} w_1 x_1 + w_2 x_2$

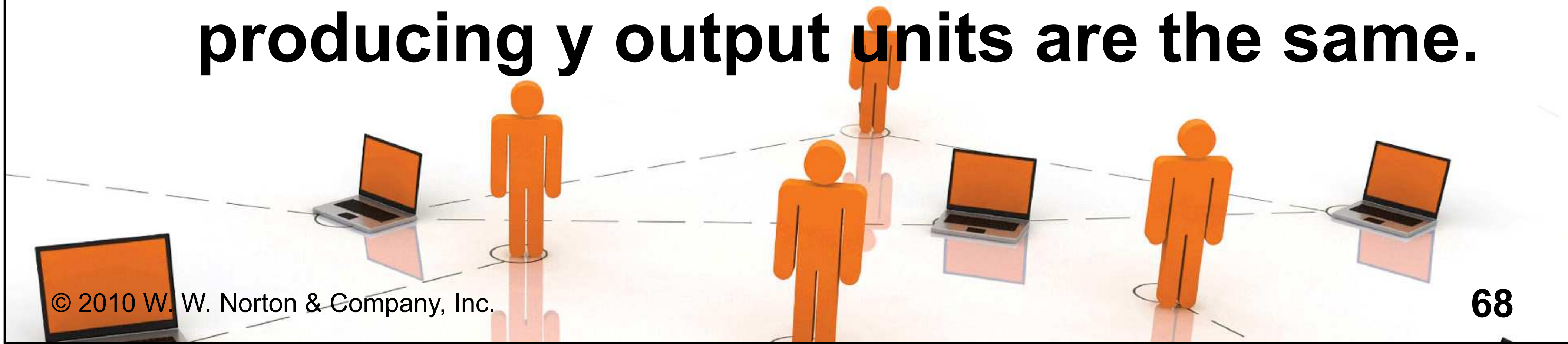
  subject to $f(x_1, x_2) = y.$

- **The short-run cost-minimization problem is** $\min_{x_1 \geq 0} w_1 x_1 + w_2 x_2'$

  subject to $f(x_1, x_2') = y.$

Short-Run & Long-Run Total Costs

- The short-run cost-min. problem is the long-run problem subject to the extra constraint that $x_2 = x_2'$.
- If the long-run choice for x_2 was x_2' then the extra constraint $x_2 = x_2'$ is not really a constraint at all and so the long-run and short-run total costs of producing y output units are the same.

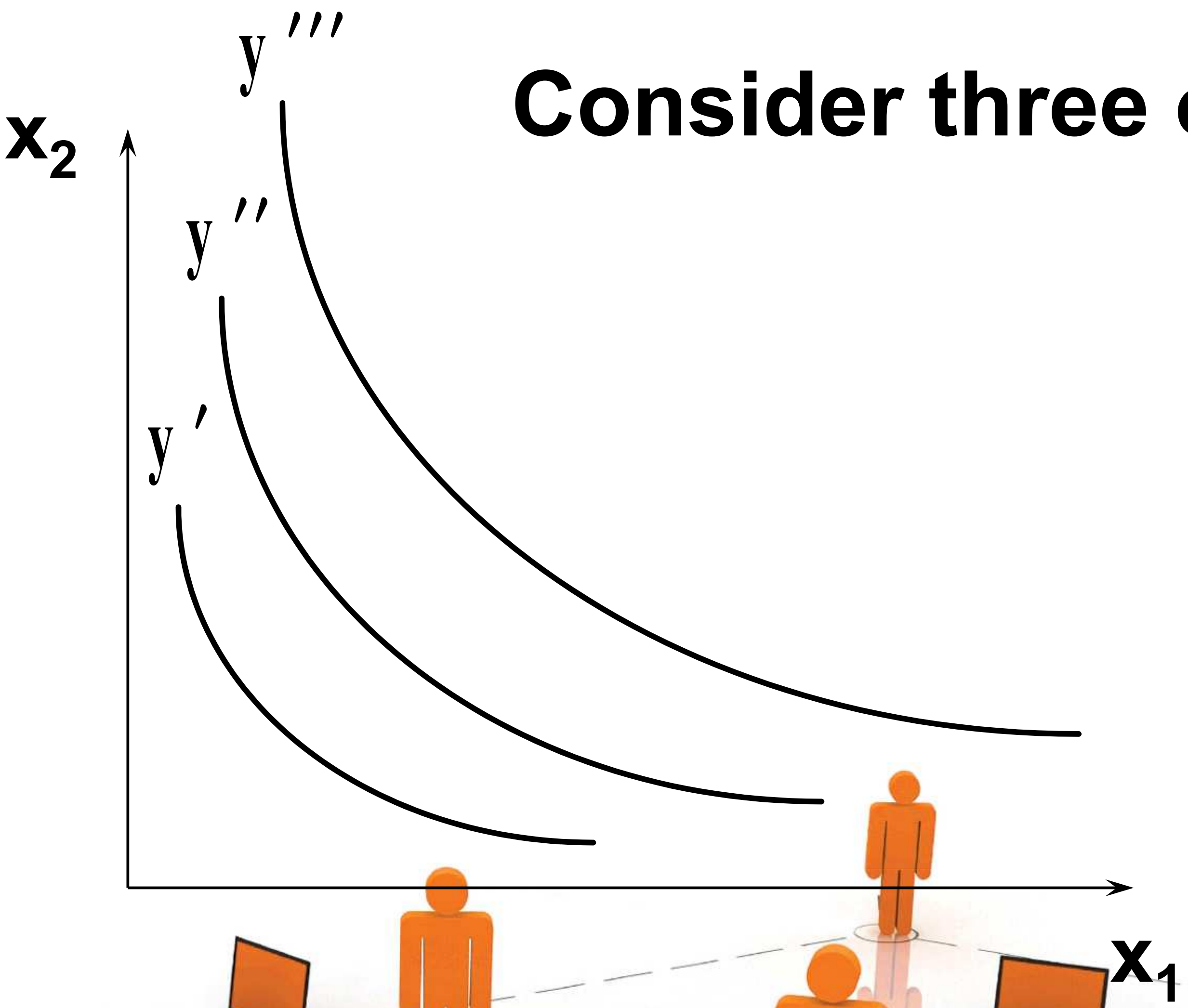


Short-Run & Long-Run Total Costs

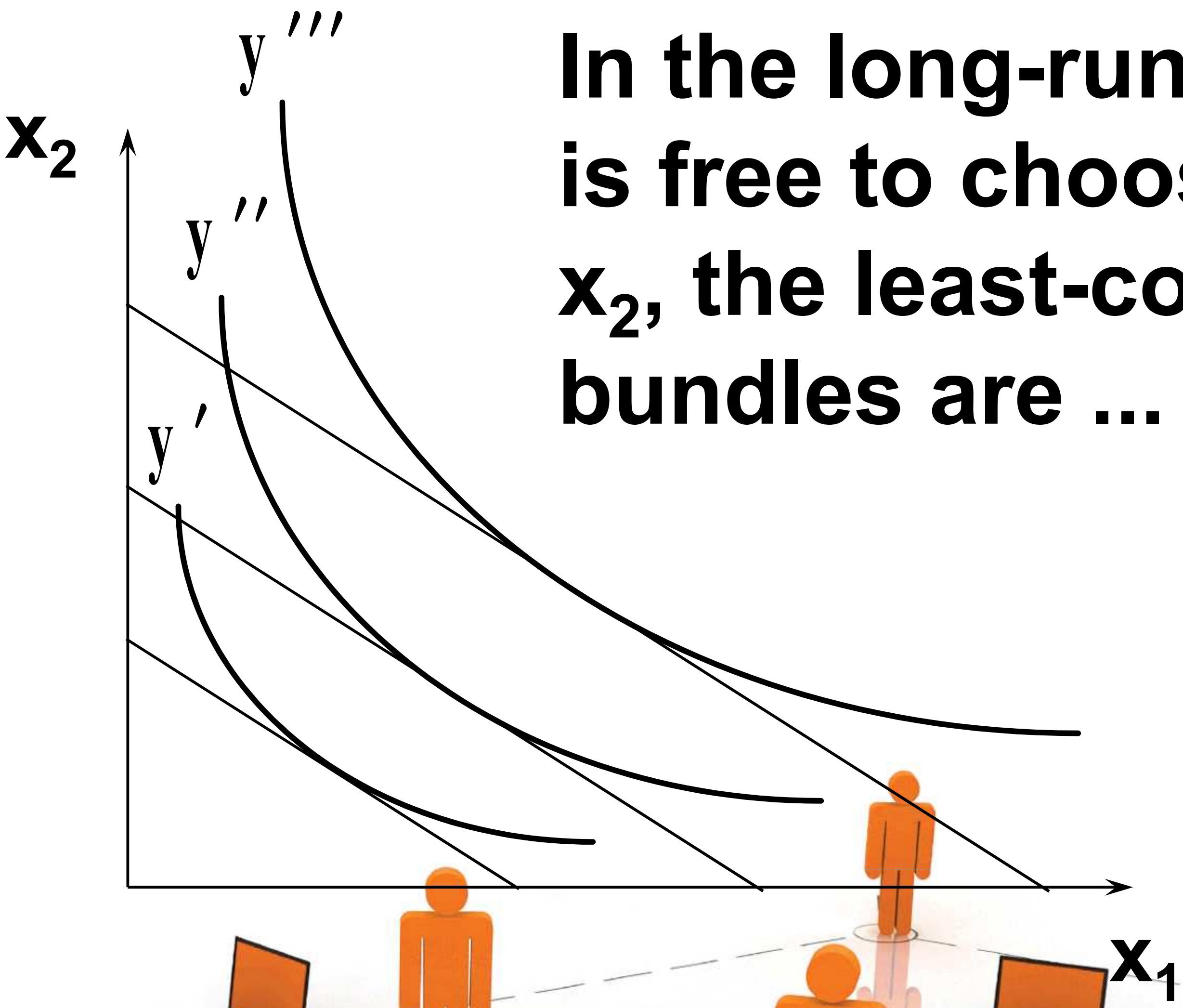
- **The short-run cost-min. problem is therefore the long-run problem subject to the extra constraint that $x_2 = x_2''$.**
- **But, if the long-run choice for $x_2 \neq x_2''$ then the extra constraint $x_2 = x_2''$ prevents the firm in this short-run from achieving its long-run production cost, causing the short-run total cost to exceed the long-run total cost of producing y output units.**

Short-Run & Long-Run Total Costs

Consider three output levels.

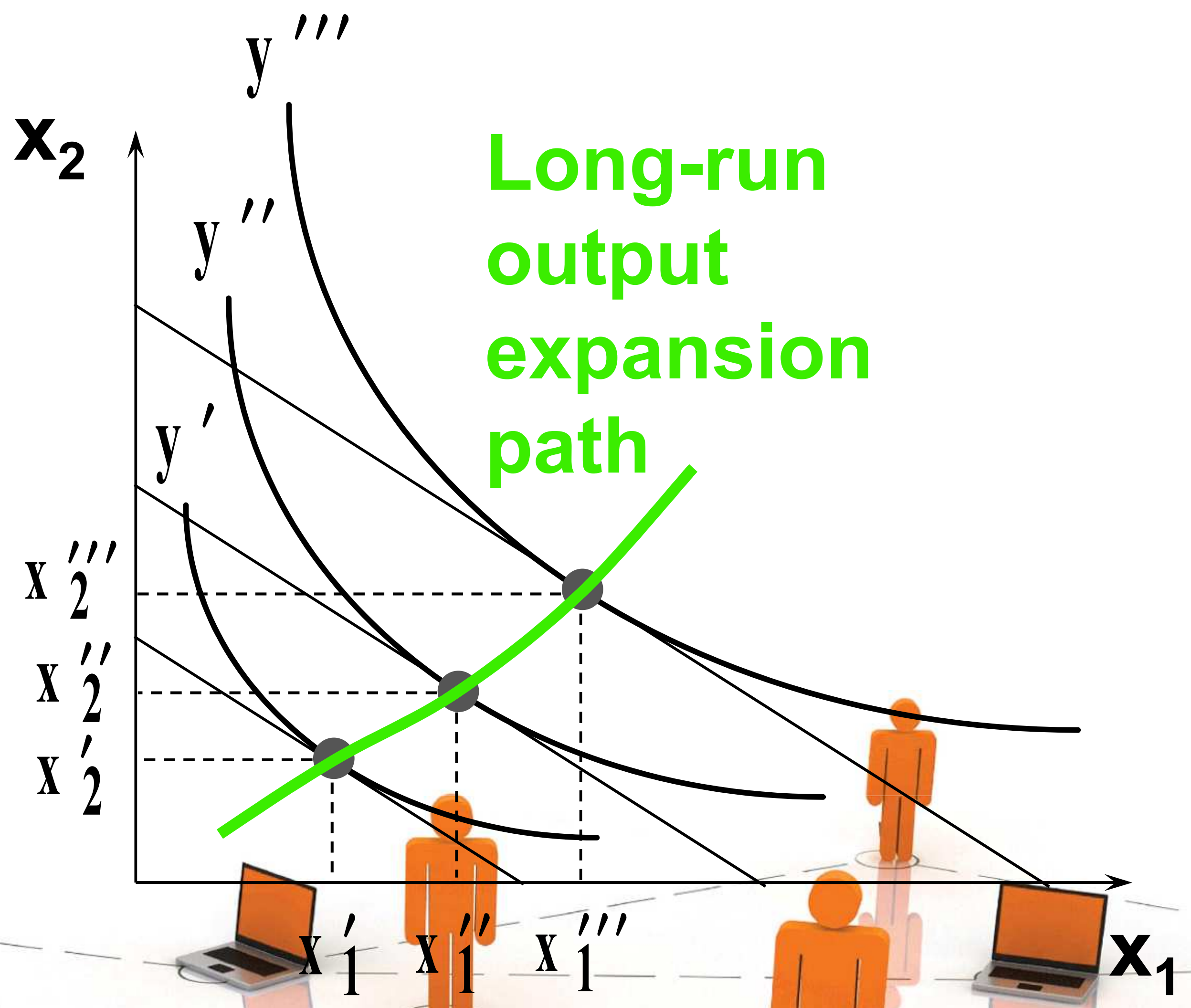


Short-Run & Long-Run Total Costs

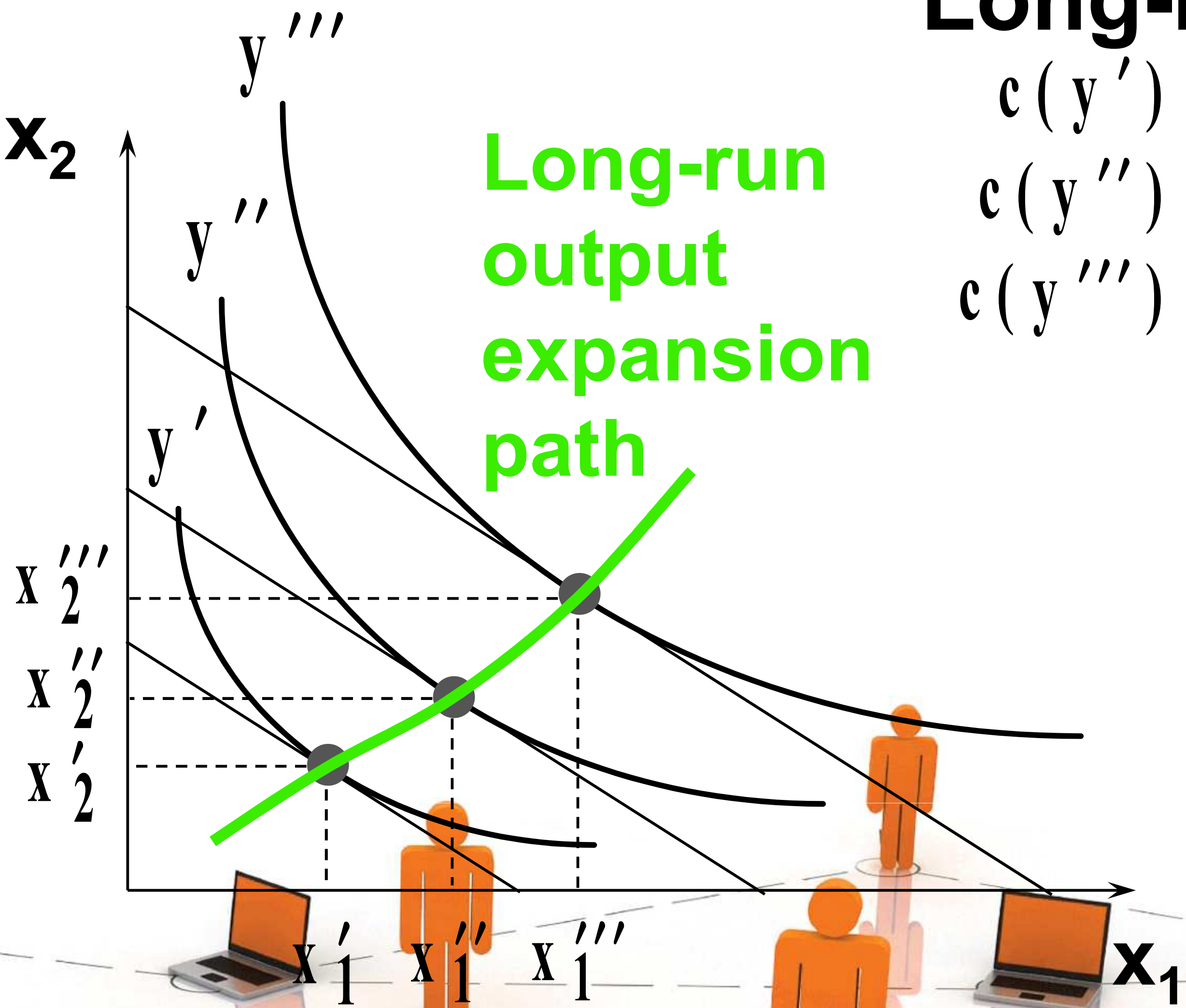


In the long-run when the firm is free to choose both x_1 and x_2, the least-costly input bundles are ...

Short-Run & Long-Run Total Costs



Short-Run & Long-Run Total Costs



Long-run costs are:

$$c(y') = w_1 x_1' + w_2 x_2'$$

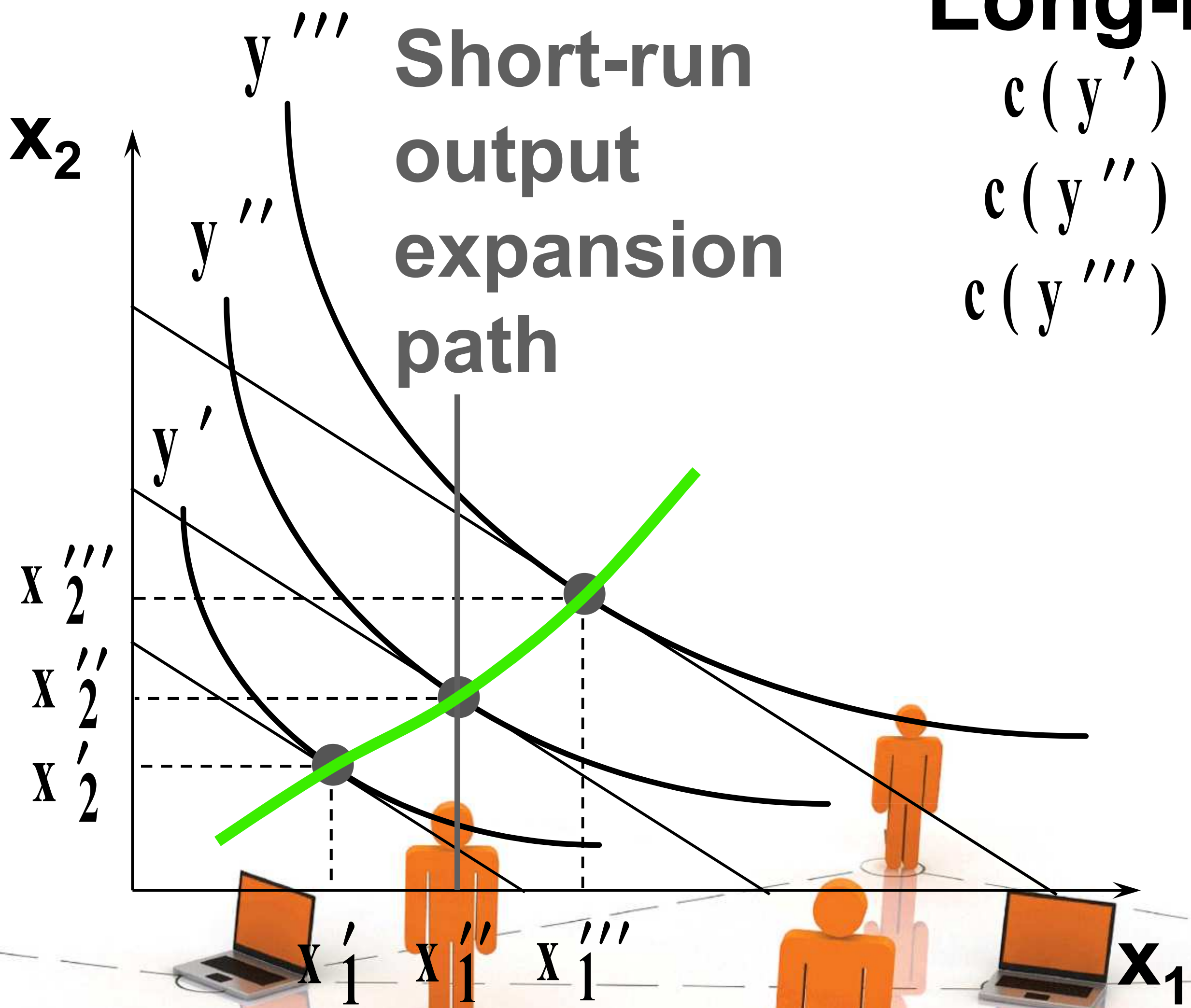
$$c(y'') = w_1 x_1'' + w_2 x_2''$$

$$c(y''') = w_1 x_1''' + w_2 x_2'''$$

Short-Run & Long-Run Total Costs

- **Now suppose the firm becomes subject to the short-run constraint that $x_2 = x_2$".**

Short-Run & Long-Run Total Costs



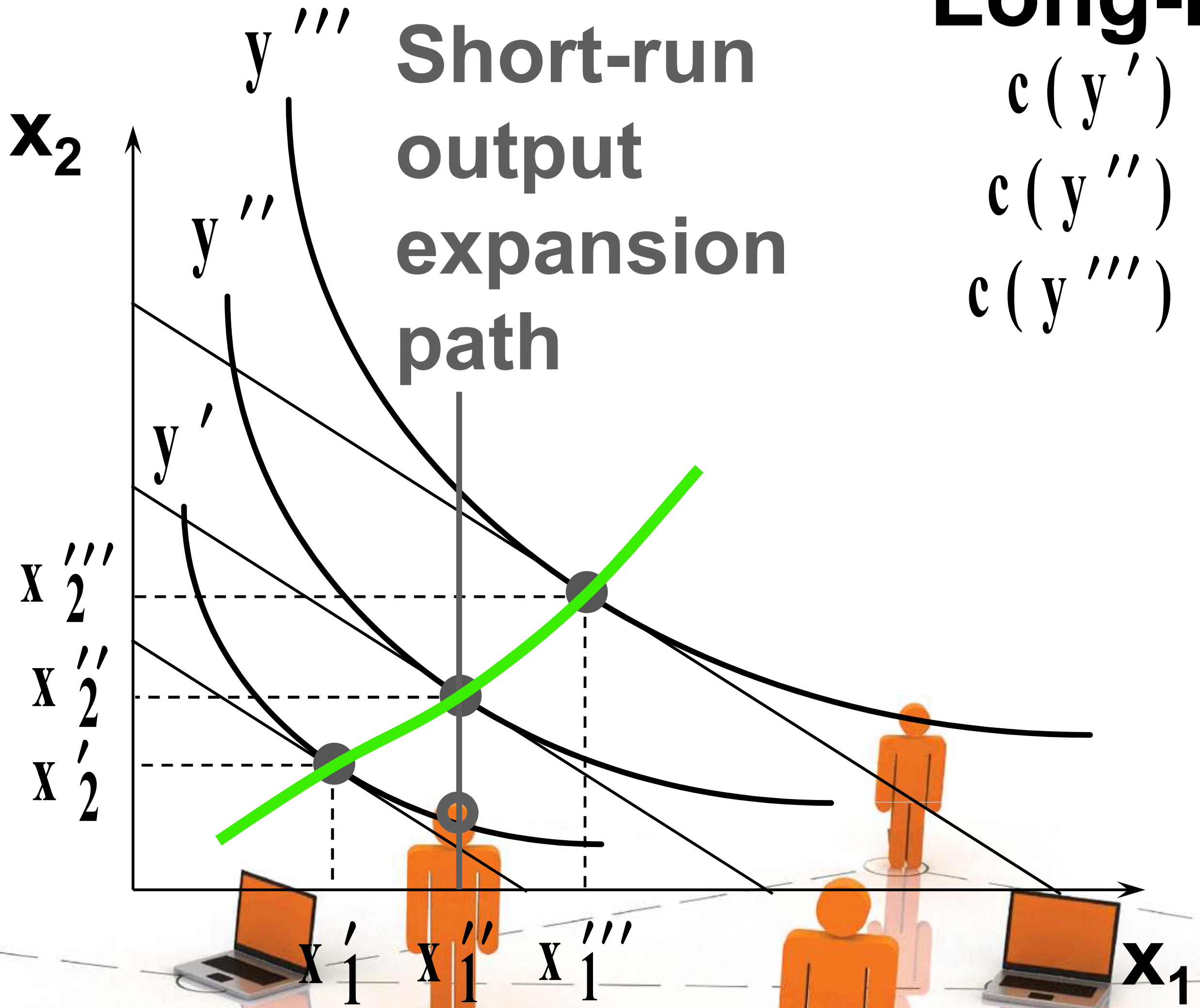
Long-run costs are:

$$c(y') = w_1 x_1' + w_2 x_2'$$

$$c(y'') = w_1 x_1'' + w_2 x_2''$$

$$c(y''') = w_1 x_1''' + w_2 x_2'''$$

Short-Run & Long-Run Total Costs



Long-run costs are:

$$c(y') = w_1 x_1' + w_2 x_2'$$
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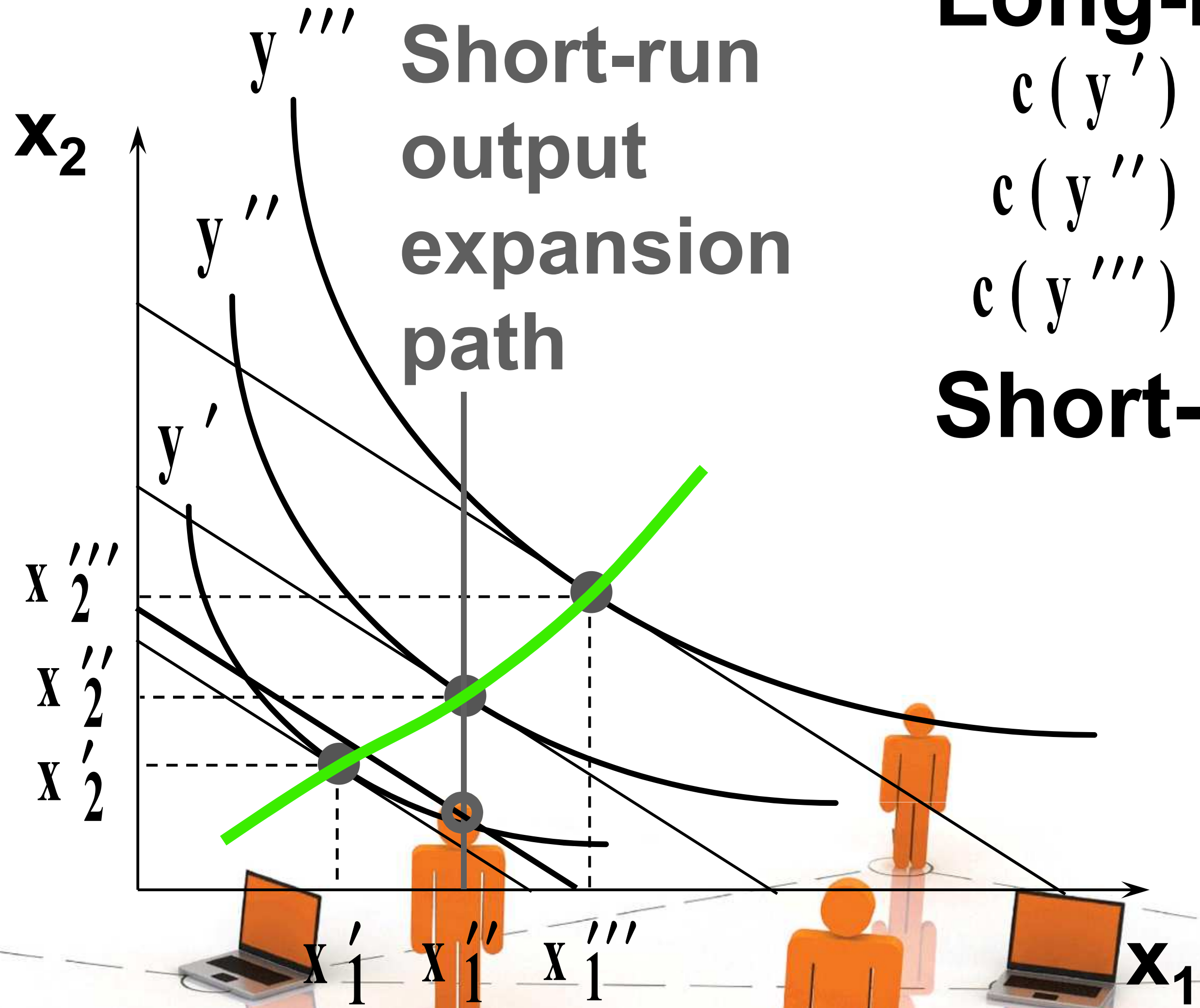
Short-Run & Long-Run Total Costs



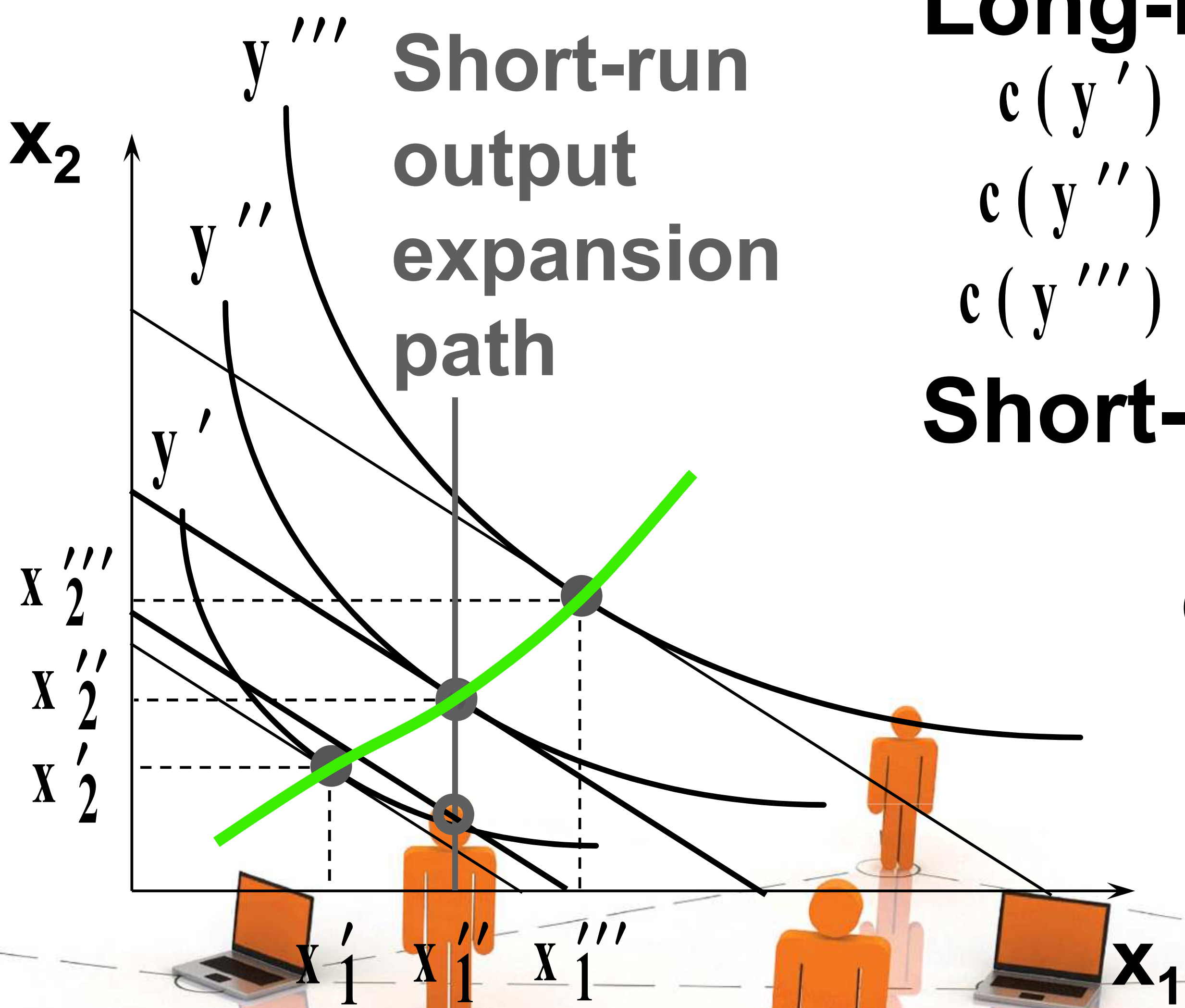
Long-run costs are:

$$c(y') = w_1 x_1' + w_2 x_2'$$
$$c(y'') = w_1 x_1'' + w_2 x_2''$$
$$c(y''') = w_1 x_1''' + w_2 x_2'''$$

Short-run costs are:

$$c_s(y') > c(y')$$

Short-Run & Long-Run Total Costs



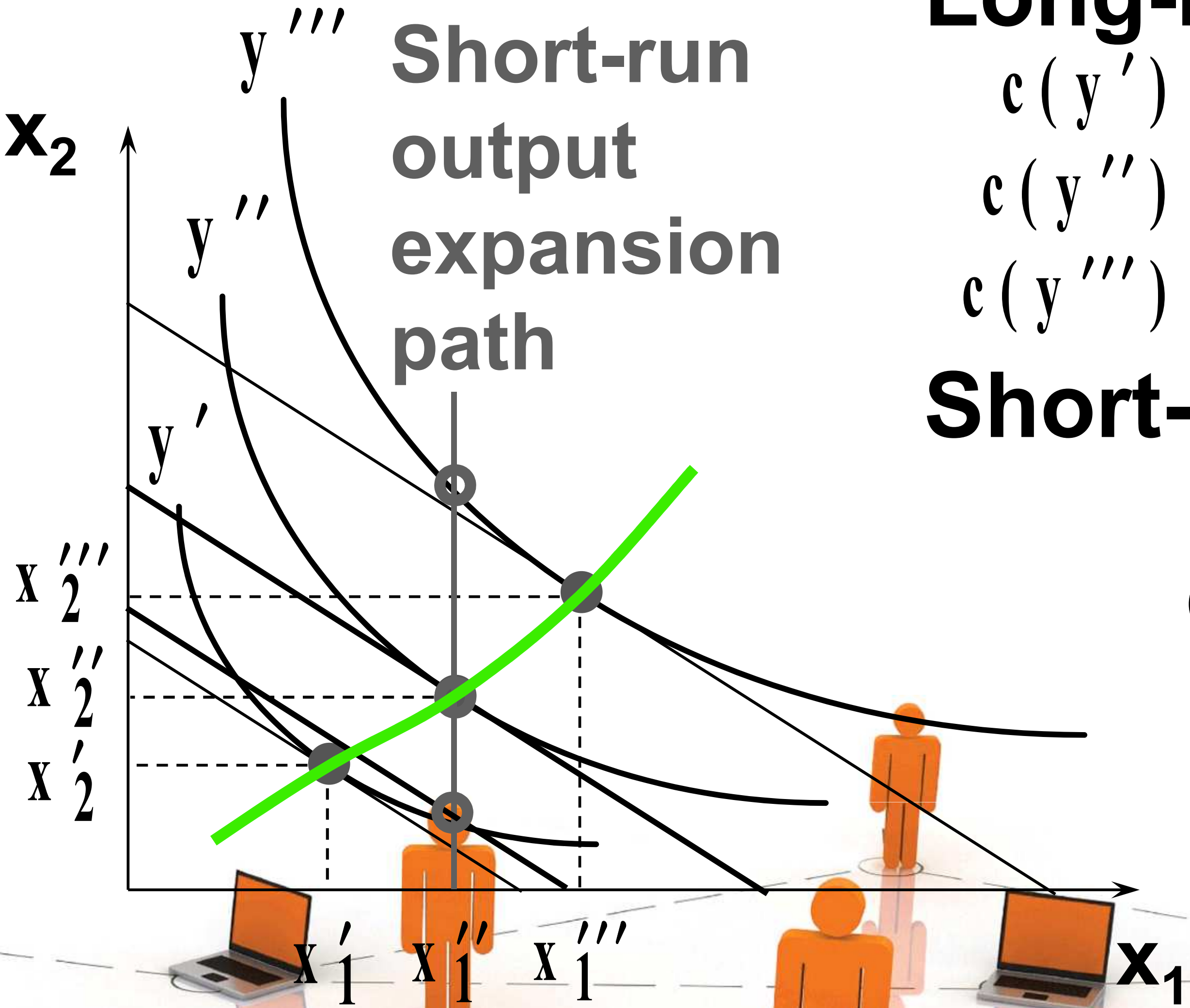
Long-run costs are:

$$c(y') = w_1 x_1' + w_2 x_2'$$
$$c(y'') = w_1 x_1'' + w_2 x_2''$$
$$c(y''') = w_1 x_1''' + w_2 x_2'''$$

Short-run costs are:

$$c_s(y') > c(y')$$
$$c_s(y'') = c(y'')$$

Short-Run & Long-Run Total Costs



Long-run costs are:

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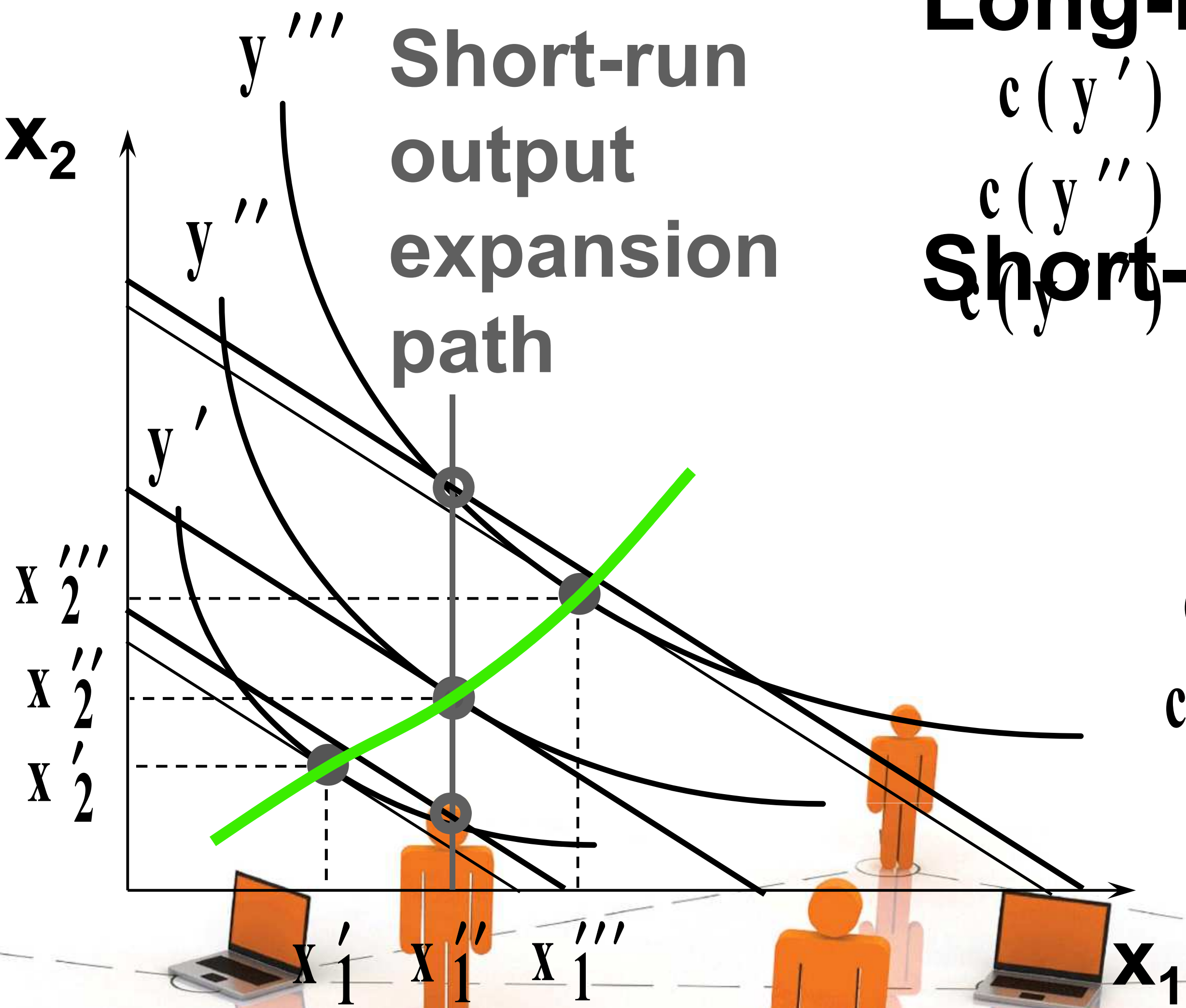
Short-Run & Long-Run Total Costs



Long-run costs are:

$$c(y') = w_1 x_1' + w_2 x_2'$$

$$c(y'') = w_1 x_1'' + w_2 x_2''$$

$$c(y''') = w_1 x_1''' + w_2 x_2'''$$

Short-run costs are:

$$c_s(y') > c(y')$$

$$c_s(y'') = c(y'')$$

$$c_s(y''') > c(y''')$$

Short-Run & Long-Run Total Costs

- **Short-run total cost exceeds long-run total cost except for the output level where the short-run input level restriction is the long-run input level choice.**
- **This says that the long-run total cost curve always has one point in common with any particular short-run total cost curve.**

Short-Run & Long-Run Total Costs

A short-run total cost curve always has one point in common with the long-run total cost curve, and is elsewhere higher than the long-run total cost curve.