Costs and Cost Minimization

1

Explicit Costs and Implicit Costs

Explicit Costs:
Costs that involve a direct monetary outlay.

Implicit Costs:
Costs that do not involve outlays of cash.

2

Economic Costs and Accounting Costs

The relevant concept of cost is **opportunity cost**: the value of the next best forgone alternative.

Economic Costs: Sum of a firm's explicit costs and implicit Costs, which is the same as "**opportunity cost**"

Accounting Costs: Total of a firm's explicit costs

3

Opportunity Cost – Example

Suppose you own a business:
You pay $100,000/year to hire workers and $80,000/year to purchase supplies. You work X hrs/year.

Next Best Alternative:
You work X hrs in a company which pays $100,000 per year.

Opportunity Cost of continuing your own business
= Explicit Costs + Implicit Costs
= 180,000 + 100,000 = $280,000

4

Sunk Costs

Sunk Costs are costs that have been incurred and cannot be recovered. These costs are not part of opportunity costs.

Non-Sunk Costs are costs that are incurred only if a particular decision is made.

Example: Bowling Ball Factory

- It costs $5M to build and has no alternative uses
- $5M is not sunk cost for the decision of whether or not to build the factory
- $5M is sunk cost for the decision of whether to operate or shut down the factory

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Cost Minimization

Cost minimization problem: Finding the input combination that minimizes a firm's total cost of producing a particular level of output.

Cost minimization firm: A firm that seeks to minimize the cost of producing a given amount of output.

Long run (LR): A period of time when the quantities of all of the firm's input can vary.

Short run (SR): A period of time when at least one of its inputs' quantities is fixed.

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Long-Run Cost Minimization

In SR, a firm chooses ONE input, L, with K being fixed.
In LR, a firm chooses TWO inputs, K and L, to minimize its costs, subject to the firm producing a given output.

Cost to the Firm: $TC = wL + rK$

TC:	Total Cost
w:	Price of Labor (wage rate)
L:	Quantity of Labor
r:	Price of Capital (interest rate)
K:	Quantity of Capital

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Isocost Lines

Isocost Line: The set of combinations of labor and capital that yield the same total cost for the firm.

Isocost Equation:
TC = wL + rK
rK = TC – wL
K = TC/r – (w/r)L

Isocost Slope
= – (w/r)

Example
w = $10/hour
r = $20/hour
TC = $1M
⇒ 1M = 10L + 20K
⇒ K = 1 mil/20 – (10/20)L

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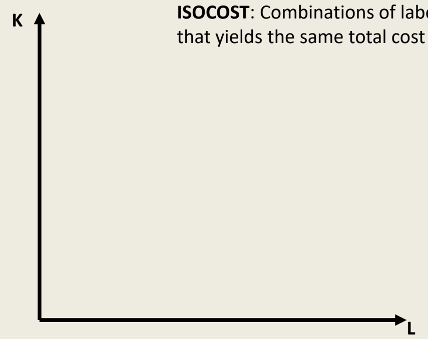
Isocost Lines

ISOCOST: Combinations of labor and capital that yields the same total cost for the firm.



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Cost-Minimization Problem

Suppose that a firm wishes to minimize costs, subject to a given output. Let such output be Q_0.

Production Function: $Q = f(L,K)$

Cost Minimization Problem:

That is, we are looking for K and L on the lowest isocost, such that Q_0 can be produced.

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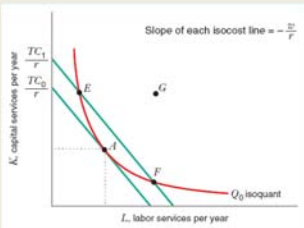
Cost-Minimizing Input Combination

Cost Minimization: looking for K and L on the lowest isocost, such that Q_0 can be produced.



G is Technically Inefficient because less inputs can be used to produce Q_0.

E & F are Technically Efficient because they can be used to produce Q_0; however, they do not minimize cost.

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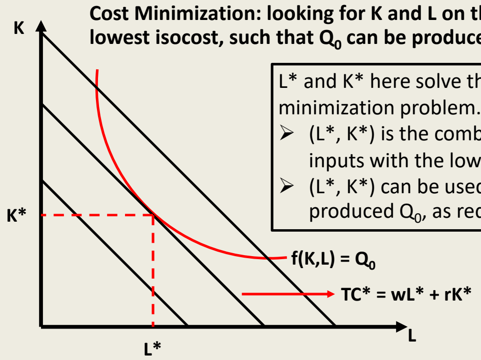
Cost-Minimizing Input Combination

Cost Minimization: looking for K and L on the lowest isocost, such that Q_0 can be produced.



L* and K* here solve the cost minimization problem.

- (L*, K*) is the combination of inputs with the lowest cost.
- (L*, K*) can be used to produced Q_0, as required.

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Golden Rule of Cost Minimization

Solution to Cost Minimization

- Slope of isoquant = Slope of isocost line

i.e. Ratio of marginal products = Ratio of input prices

- This means **"last dollar spent on K gives the same number of marginal products as last dollar spent on L"**.

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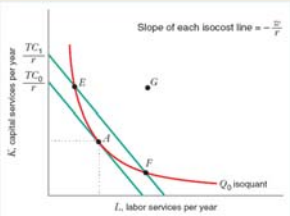
Golden Rule of Cost Minimization

- At point E, Isoquant is **steeper** than Isocost:



One $ on L gives greater output than one $ on K.

The firm can save more by employing **more L and less K.**

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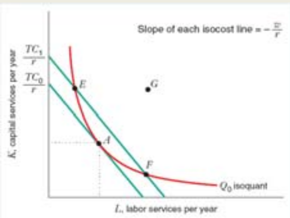
Golden Rule of Cost Minimization

- At point F, Isoquant is **flatter** than Isocost:



One $ on K gives greater output than one $ on L.

The firm can save more by employing **more K and less L.**

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Finding an Interior Cost-Minimization Optimum

Problem The optimal input combination satisfies equation (7.1) [or, equivalently, equation (7.2)]. But how would you calculate it? To see how, let's consider a specific example. Suppose that the firm's production function is of the form $Q = 50\sqrt{LK}$. For this production function, the equations of the marginal products of labor and capital are $MP_L = 25\sqrt{K/L}$ and $MP_K = 25\sqrt{L/K}$. Suppose, too, that the price of labor w is \$5 per unit and the price of capital r is \$20 per unit. What is the cost-minimizing input combination if the firm wants to produce 1,000 units per year?

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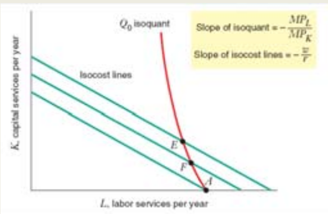
Corner Point Solutions

In some cases, using one input is cheaper than using both inputs, and doing so can still produce the required output.

In such cases, we will have a corner solution.



$$-\left(\frac{MP_L}{MP_K}\right) < -\left(\frac{w}{r}\right)$$

$$\Rightarrow \frac{MP_L}{w} > \frac{MP_K}{r}$$

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Finding a Corner Point Solution with Perfect Substitutes

Problem In Chapter 6 we saw that a linear production function implies that the inputs are perfect substitutes. Suppose that we have the linear production function $Q = 10L + 2K$. For this production function $MP_L = 10$ and $MP_K = 2$. Suppose, too, that the price of labor w is \$5 per unit and that the price of capital services r is \$2 per unit. Find the optimal input combination given that the firm wishes to produce 200 units of output.

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Comparative Statics Analysis of Changes in Input Prices

1. **A change in the relative price of inputs changes the slope of the isocost line.**
2. Given a diminishing $MRTS_{L,K}$, an increase in the price of one input will cause the cost-minimizing quantity of that input to go down.
3. Given that both inputs are perfect complements, an increase in the price of one input will not change the cost-minimizing quantity of that input.

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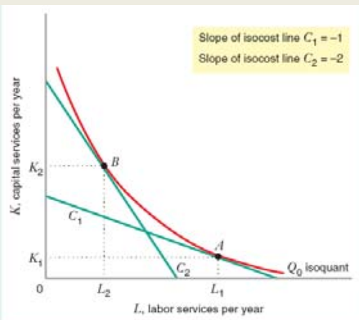
Comparative Statics Analysis of Changes in Input Prices



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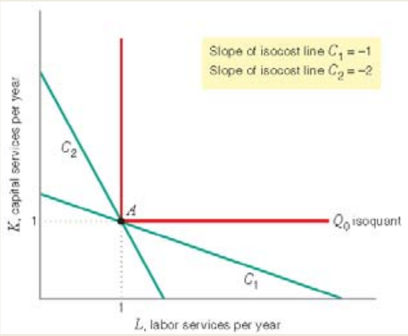
Comparative Statics Analysis of Changes in Input Prices



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Comparative Statics Analysis of Changes in Output

An increase in Q_0 moves the isoquant Northeast.

- **Expansion Path:** A line that connects the cost-minimizing input combinations as the quantity of output, Q, varies, holding input prices constant.
- **Normal Inputs:** An input whose cost-minimizing quantity increases as the firm produces more output.
- **Inferior Input:** An input whose cost-minimizing quantity decreases as the firm produces more output.

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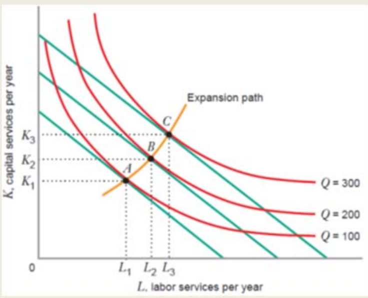
Comparative Statics Analysis of Changes in Output

As output increases, the cost minimization path moves from point A to B to C when **both inputs are normal**.



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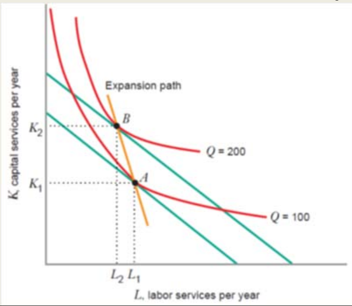
Comparative Statics Analysis of Changes in Output

As output increases, the cost minimization path moves from point A to B when **labor is an inferior input**.



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The Input Demand Curves

Definition: A function that shows how the firm's cost-minimizing quantity of input varies with the price of that input.

Labor demand curve: Shows how the firm's cost-minimizing quantity of labor varies with the price of labor.

Capital demand curve: Shows how the firm's cost-minimizing quantity of capital varies with the price of capital.

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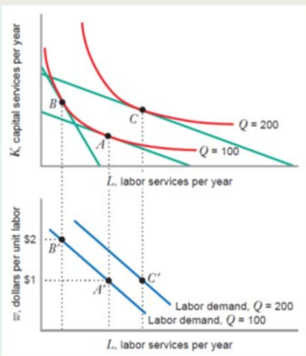
The Input Demand Curves

FIGURE 7.10

Comparative Statics Analysis and the Labor Demand Curve The labor demand curve shows how the firm's cost-minimizing amount of labor varies as the price of labor varies. For a fixed output of 100 units, an increase in the price of labor from \$1 to \$2 per unit moves the firm along its labor demand curve from point A′ to point B′. Holding the price of labor fixed at \$1 per unit, an increase in output from 100 to 200 units per year shifts the labor demand curve rightward and moves the firm from point A′ to point C′.



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The Input Demand Curves

LEARNING-BY-DOING EXERCISE 7.4

Deriving the Input Demand Curves from a Production Function

Problem Suppose that a firm faces the production function $Q = 50\sqrt{LK}$. What are the demand curves for labor and capital?

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Price Elasticity of Demand for Inputs

- Percentage change in the cost-minimizing quantity of labor with respect to a 1% change in the price of labor.

$$\varepsilon_{L,w} = \frac{\Delta L}{\Delta w}\frac{w}{L}$$

- Percentage change in the cost-minimizing quantity of capital with respect to a 1% change in the price of capital.

$$\varepsilon_{K,r} = \frac{\Delta K}{\Delta r}\frac{r}{K}$$

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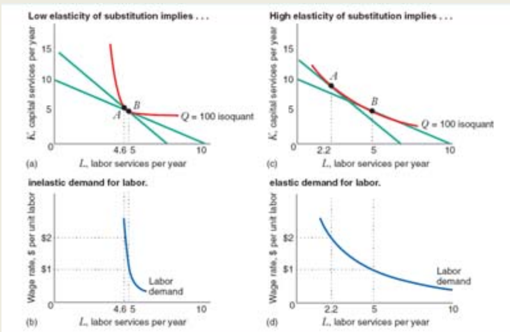
Price Elasticity of Demand for Inputs



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Short-Run Cost Minimization

Total Variable Costs – the sum of total expenditures on variable inputs, such as labor and materials, at the short-run cost-minimizing input combination
Total Fixed Costs – the cost of fixed inputs; it does not vary with output
Sunk vs Non-Sunk – avoidable or not when Q = 0

Short-Run Costs can be classified as:
- Variable and non-sunk (labor and materials)
- Fixed and non-sunk (heating and lighting)
- Fixed and sunk (factory)

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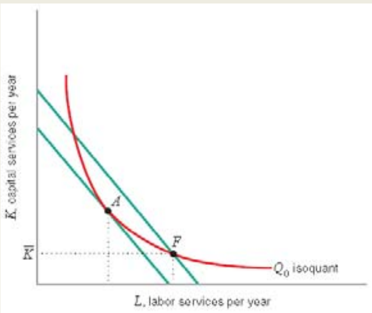
Short-Run Cost Minimization with One Fixed Input



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Short-Run Cost Minimization – Input Demand

- In short run, one input is fixed, e.g. capital $\bar{K}$.
- Firm can vary the other input, labor.
- **The demand for labor will be independent of the price of labor or wage rate.**
- **Short-run demand for labor will depend on quantity produced.**
- As quantity increased, labor used increases holding capital fixed.

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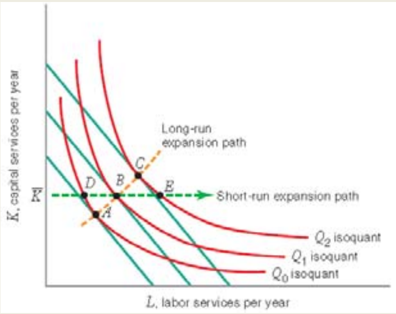
Short-Run Input Demand Vs. Long-Run Input Demand



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Short-Run Cost Minimization with One Fixed Input

LEARNING-BY-DOING EXERCISE 7.5

Short-Run Cost Minimization with One Fixed Input

Problem Suppose that the firm's production function is given by the production function in Learning-By-Doing Exercises 7.2 and 7.4: $Q = 50\sqrt{LK}$. The firm's capital is fixed at $\bar{K}$. What amount of labor will the firm hire to minimize cost in the short run?

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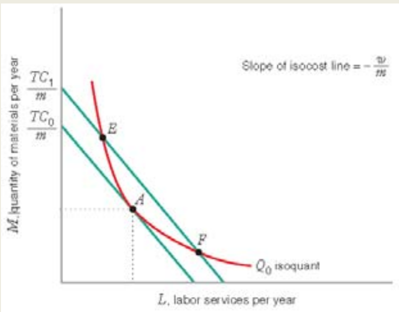
Short-Run Cost Minimization with Two Variable Inputs and One Fixed Input



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Short-Run Cost Minimization with Two Variable Inputs

LEARNING-BY-DOING EXERCISE 7.6

Short-Run Cost Minimization with Two Variable Inputs

Suppose that a firm's production function is given by $Q = \sqrt{L} + \sqrt{K} + \sqrt{M}$. For this production function, the marginal products of labor, capital, and materials are $MP_L = 1/(2\sqrt{L})$, $MP_K = 1/(2\sqrt{K})$, and $MP_M = 1/(2\sqrt{M})$. The input prices of labor, capital, and materials are $w = 1$, $r = 1$, and $m = 1$, respectively.

Problem

(a) Given that the firm wants to produce 12 units of output, what is the solution to the firm's long-run cost-minimization problem?

(b) Given that the firm wants to produce 12 units of output, what is the solution to the firm's short-run cost-minimization problem when $K = 4$?

(c) Given that the firm wants to produce 12 units of output, what is the solution to the firm's short-run cost-minimization problem when $K = 4$ and $L = 9$?

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