Production in the Long-Run

The Long Run: No Fixed Factors

- All inputs are variable
- In making these choice, the profit maximizing firm will try to be technically efficient by using no more of all inputs than necessary
- **Technical efficiency** – when a given number of inputs are combined in such a way as to maximize the level of output
- Technical efficiency is not enough… In order to maximize its profit, the firm must choose from among the many technically efficient options, the one that produces a given level of output at lowest cost

Profit Maximization and Cost Minimization

- Any firm that is trying to maximize its profits in the long run should select the production method that produces its output at the **lowest possible cost**

- This implication of the hypothesis of profit maximization is called cost minimization

Isoquant Analysis

Production In The Long Run

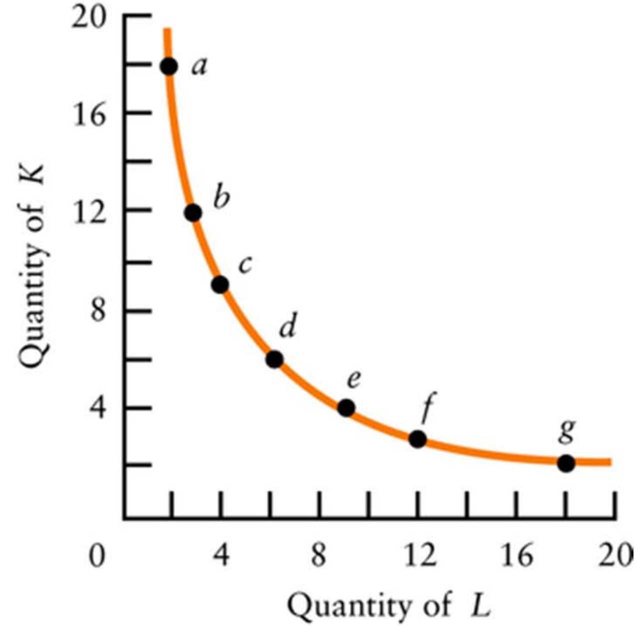
- ***Isoquant:*** the set of all input combinations that yield a given level of output.

- ***Marginal rate of technical substitution (MRTS):*** the rate at which one input can be exchanged for another without altering the total level of output.

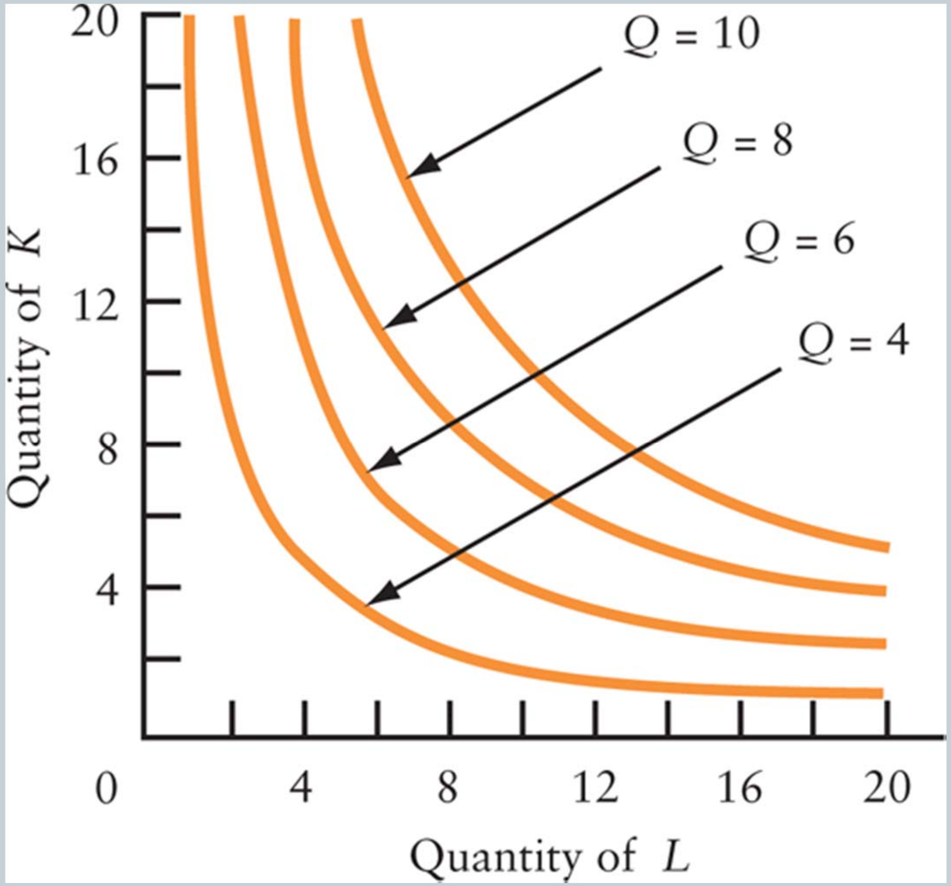
An Isoquant

Alternative Methods of Producing a Given Level of Output

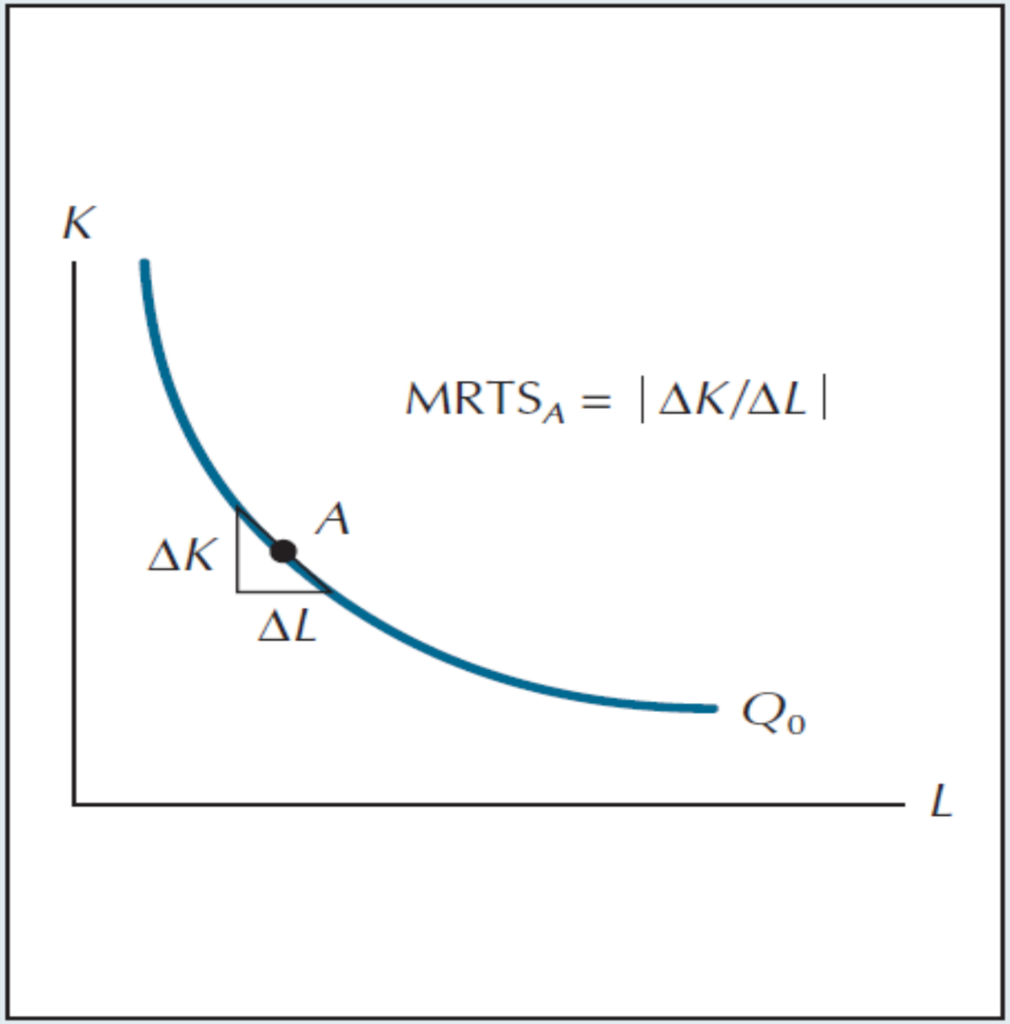
Method	K	L	ΔK	ΔL	Marginal Rate of Substitution (absolute value of $\Delta K/\Delta L$)
a	18	2			
			–6	1	6.00
b	12	3			
			–3	1	3.00
c	9	4			
			–3	2	1.50
d	6	6			
			–2	3	0.67
e	4	9			
			–1	3	0.33
f	3	12			
			–1	6	0.17
g	2	18			



An Isoquant Map



The Marginal Rate of Technical Substitution



Long-Run Cost Minimization

A firm is not minimizing costs if it is possible to substitute one factor for another to keep output constant while reducing total cost:

> The firm should substitute one factor for another factor as long as the marginal product of one factor **per dollar spent on it** is greater than the marginal product of the other factor **per dollar spent on it**.

Using $\boldsymbol{K}$ and $\boldsymbol{L}$ to represent capital and labor, and $\boldsymbol{p_L}$ and $\boldsymbol{p_K}$ to represent the prices for the two factors, cost is minimized when:

$$\frac{MP_K}{P_K} = \frac{MP_L}{P_L}$$

Whenever the ratio of the MP of each factor to its price is not equal for all factors, there are possibilities for factor substitutions that will reduce costs (for a given level of output)

Example

Suppose the marginal product of capital is 40 units of output and the price of one unit of capital is $10. The marginal product of labor is 20 units of output and the price of one unit of labor is $2.

$$\frac{MP_K}{P_K} = \frac{40}{10} = 4 < \frac{MP_L}{P_L} = \frac{20}{2} = 10$$

In this case, the firm can reduce the cost of producing its current level of output by using more labor and less capital.

Another Interpretation

Rearranging terms:

$$\frac{MP_K}{P_K} = \frac{MP_L}{P_L} \quad \Rightarrow \quad \frac{MP_K}{MP_L} = \frac{P_K}{P_L}$$

The ratio of the marginal products on the left side compares the contribution of output to the last unit of capital and the last unit of labor.

The right hand side shows **how the cost of an additional unit of capital compares to the cost of an additional unit of labor**

Example

$$\frac{MP_K}{MP_L} = \frac{40}{20} = 2$$

$$\frac{P_K}{P_L} = \frac{10}{2} = 5$$

The left side of the equation equals 2 but the right hand side equals to 5. The last unit of capital is twice as productive as the last unit of labor but it is five times as expensive.

It will pay the firm to switch to a method of production that uses less capital and more labor.

Only when the ratio of marginal products is exactly equal to the ratio of factor prices is the firm using the cost minimizing production method

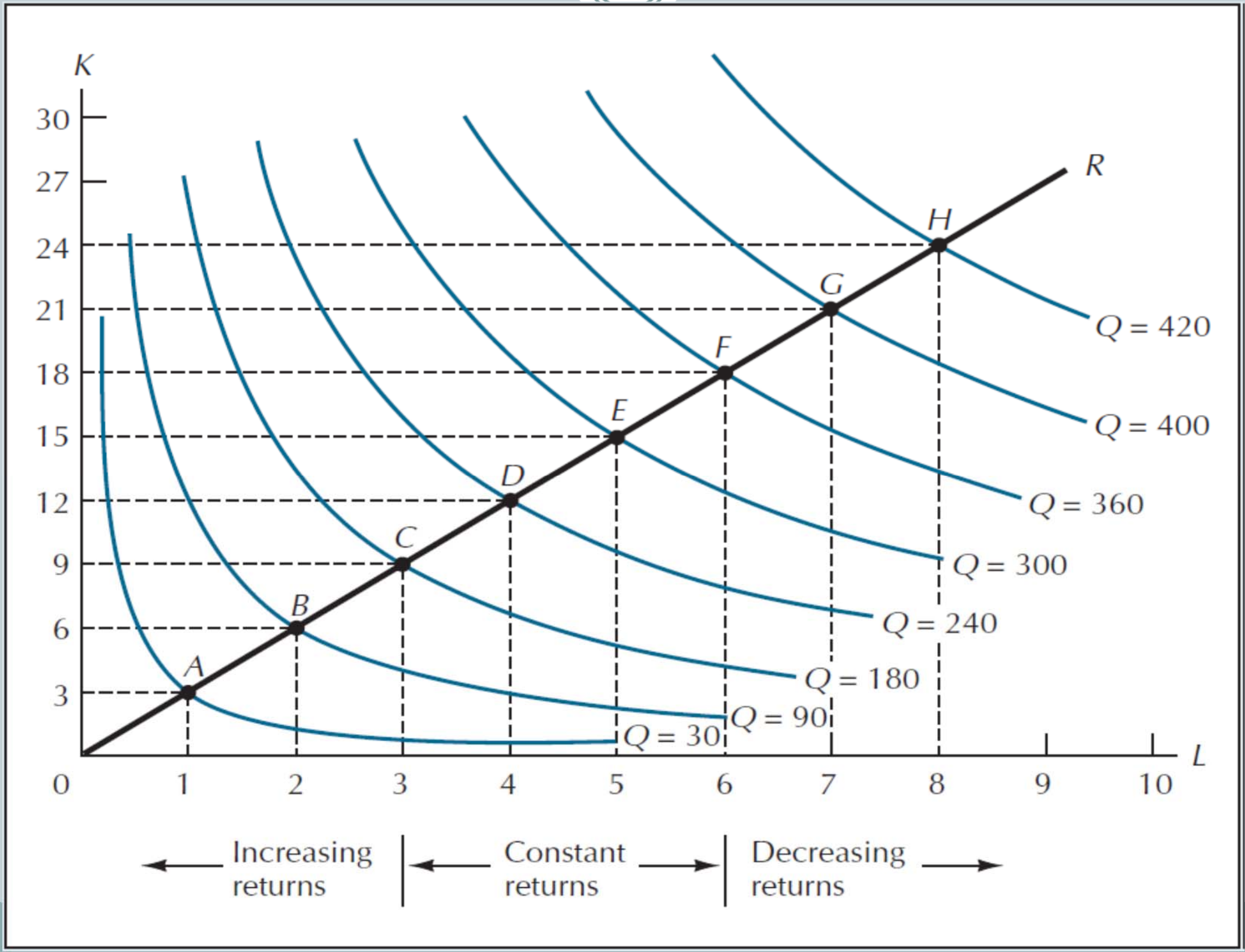
The Principle of Substitution

The **principle of substitution**: firms adjust the quantities of factors in response to changing relative factor prices

Firms use more of the cheaper factor and less of the more expensive factor

The principle plays a central role in resource allocation because it relates to the way in which individual firms respond to changes in relative factor prices that are caused by the changing relative scarcities of factors in the economy as a whole.

Returns to Scale Shown on the Isoquant Map



- The region from A to C exhibits increasing returns to scale

  From B to C both inputs grow by 50 percent while output grows by 100 percent

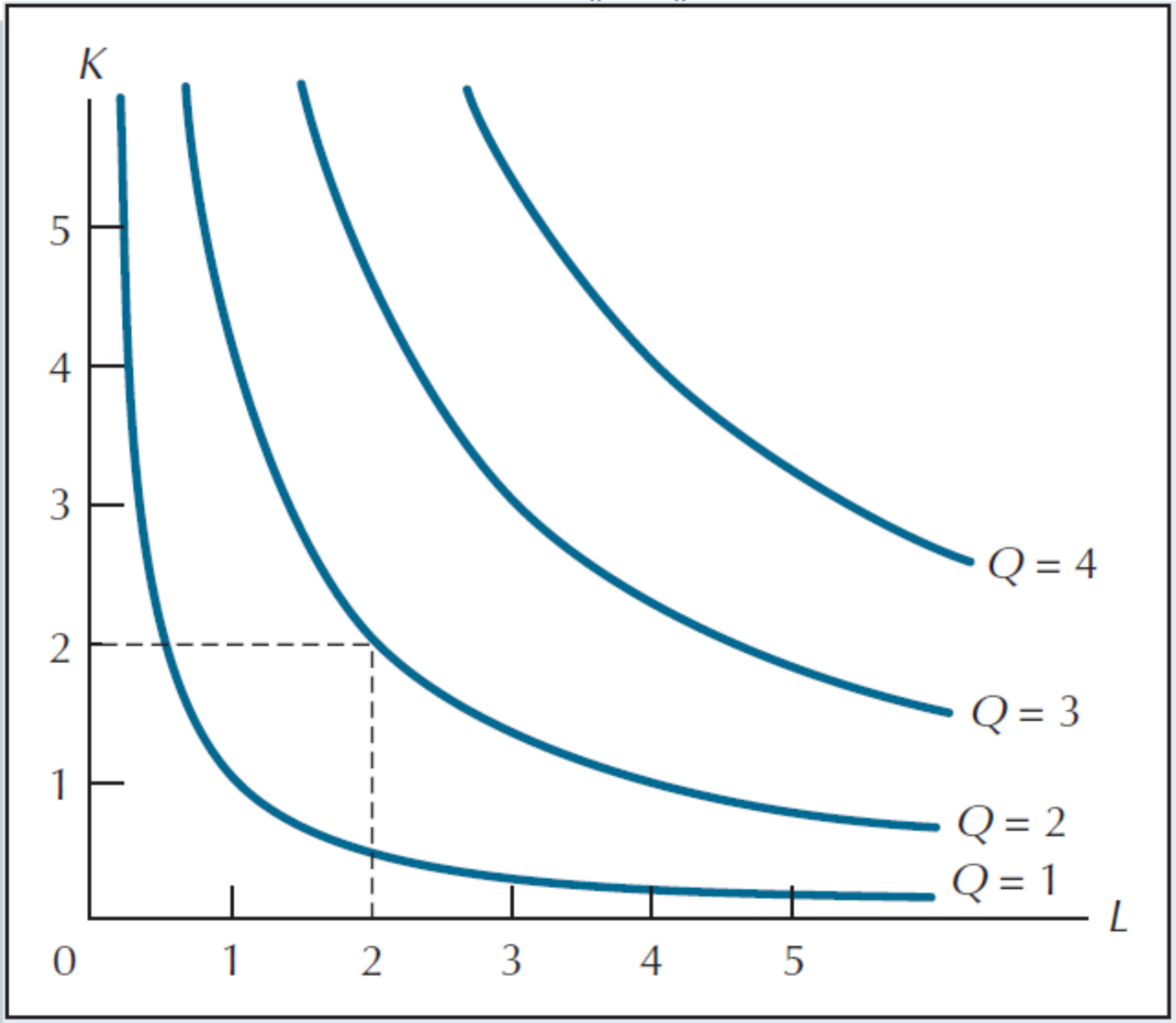
- The region from C to F exhibits constant return to scale

  When we move from D to E, both inputs grow by 25 percent and output also grows by 25 percent

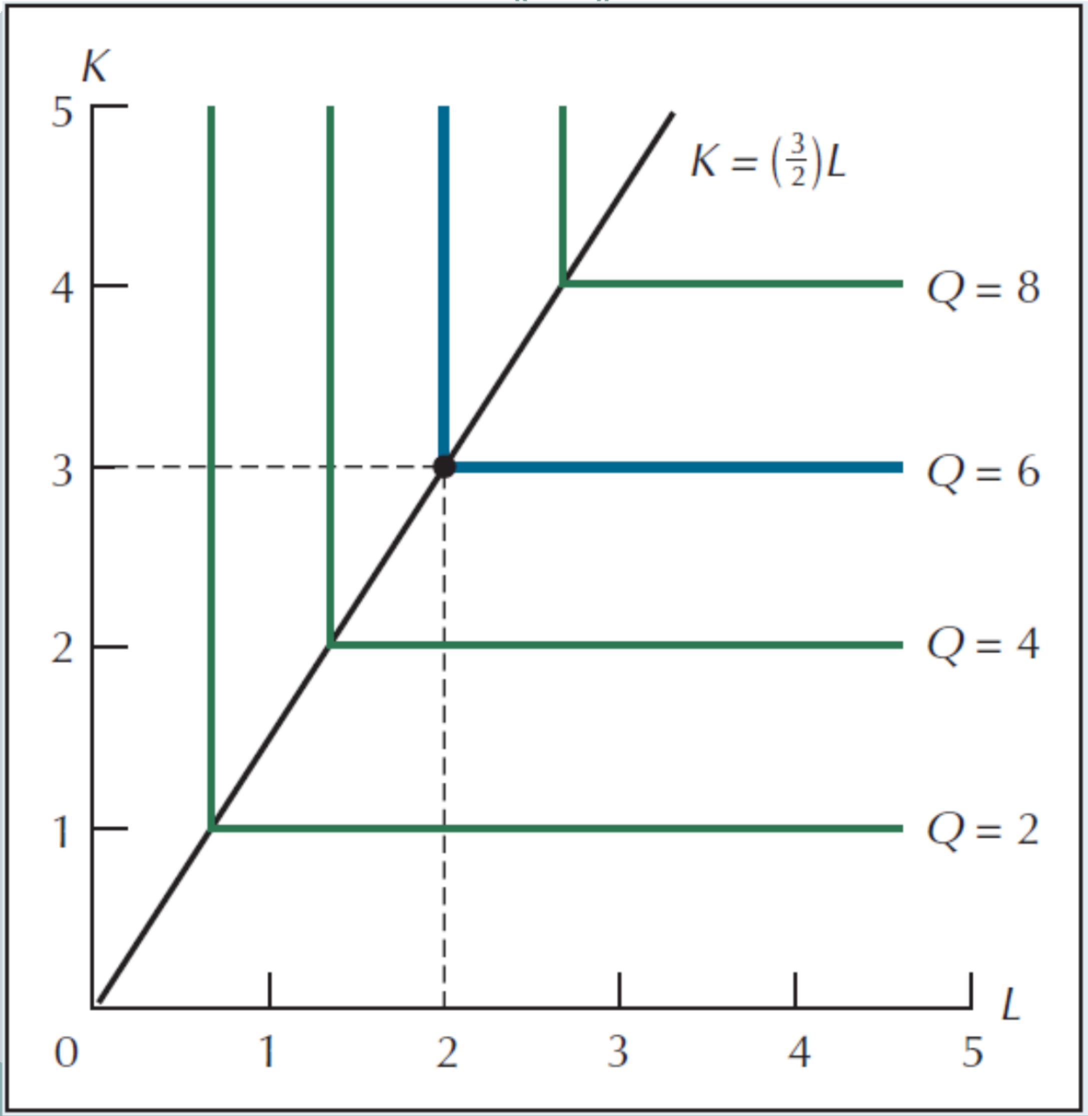
- The region to the northeast of F exhibits decreasing returns to scale

  When we move from F to G, both inputs grow by 16.7 percent and output also grows by only 11.1 percent

Example: Isoquant Map for the Cobb-Douglas Production Function Q = $K^{1/2}L^{1/2}$



Example: Isoquant Map for the Leontief Production Function Q = min (2K,3L)



Sources:

- Lipsey, Ragan, and Storer (2008)
- Frank, R.H. (2010)