

Microeconomics (Production, Ch 6)

Lectures 09-10

Feb 06/09 2017

Production

The **theory of the firm** describes how a firm makes cost-minimizing production decisions and how the firm's resulting cost varies with its output.

The Production Decisions of a Firm

The production decisions of firms are analogous to the purchasing decisions of consumers, and can likewise be understood in three steps:

1. Production Technology
2. Cost Constraints
3. Input Choices

6.1

THE TECHNOLOGY OF PRODUCTION

- **factors of production** Inputs into the production process (e.g., labor, capital, and materials).

The Production Function

$$q = F(K, L) \quad (6.1)$$

- **production function** Function showing the highest output that a firm can produce for every specified combination of inputs.

Remember the following:

Inputs and outputs are *flows*.

Equation (6.1) applies to a *given technology*.

Production functions describe what is *technically feasible* when the firm operates *efficiently*.

6.1 THE TECHNOLOGY OF PRODUCTION

The Short Run versus the Long Run

- **short run** Period of time in which quantities of one or more production factors cannot be changed.
- **fixed input** Production factor that cannot be varied.
- **long run** Amount of time needed to make all production inputs variable.

6.2 PRODUCTION WITH ONE VARIABLE INPUT (LABOR)

TABLE 6.1 Production with One Variable Input

Amount of Labor (L)	Amount of Capital (K)	Total Output (q)	Average Product (q/L)	Marginal Product ($\Delta q/\Delta L$)
0	10	0	—	—
1	10	10	10	10
2	10	30	15	20
3	10	60	20	30
4	10	80	20	20
5	10	95	19	15
6	10	108	18	13
7	10	112	16	4
8	10	112	14	0
9	10	108	12	-4
10	10	100	10	-8

6.2 PRODUCTION WITH ONE VARIABLE INPUT (LABOR)

Average and Marginal Products

- **average product** Output per unit of a particular input.
- **marginal product** Additional output produced as an input is increased by one unit.

Average product of labor = Output/labor input = q/L

Marginal product of labor = Change in output/change in labor input
= $\Delta q/\Delta L$

6.2 PRODUCTION WITH ONE VARIABLE INPUT (LABOR)

The Slopes of the Product Curve

Figure 6.1

Production with One Variable Input

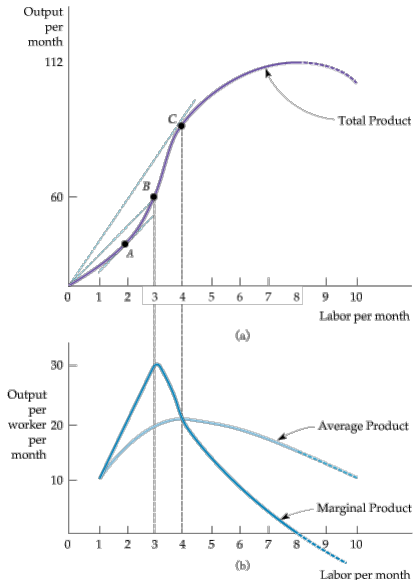
The total product curve in **(a)** shows the output produced for different amounts of labor input.

The average and marginal products in **(b)** can be obtained (using the data in Table 6.1) from the total product curve.

At point A in **(a)**, the marginal product is 20 because the tangent to the total product curve has a slope of 20.

At point B in **(a)** the average product of labor is 20, which is the slope of the line from the origin to B.

The average product of labor at point C in **(a)** is given by the slope of the line 0C.



6.2 PRODUCTION WITH ONE VARIABLE INPUT (LABOR)

The Slopes of the Product Curve

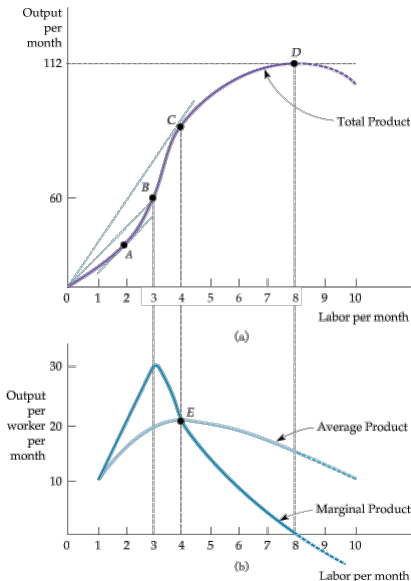
Figure 6.1

Production with One Variable Input (continued)

To the left of point *E* in **(b)**, the marginal product is above the average product and the average is increasing; to the right of *E*, the marginal product is below the average product and the average is decreasing.

As a result, *E* represents the point at which the average and marginal products are equal, when the average product reaches its maximum.

At *D*, when total output is maximized, the slope of the tangent to the total product curve is 0, as is the marginal product.



6.2 PRODUCTION WITH ONE VARIABLE INPUT (LABOR)

The Law of Diminishing Marginal Returns

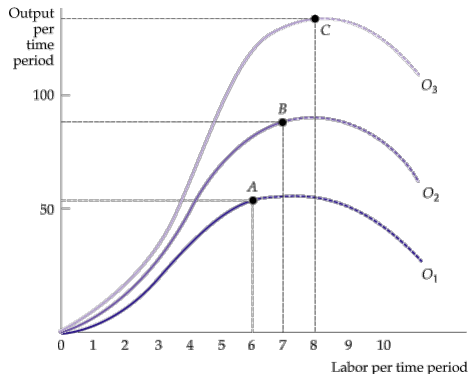
- law of diminishing marginal returns** Principle that as the use of an input increases with other inputs fixed, the resulting additions to output will eventually decrease.

Figure 6.2

The Effect of Technological Improvement

Labor productivity (output per unit of labor) can increase if there are improvements in technology, even though any given production process exhibits diminishing returns to labor.

As we move from point A on curve O_1 to B on curve O_2 to C on curve O_3 over time, labor productivity increases.



6.2 PRODUCTION WITH ONE VARIABLE INPUT (LABOR)

EXAMPLE 6.1

Malthus and the Food Crisis

The law of diminishing marginal returns was central to the thinking of political economist Thomas Malthus (1766–1834).

Malthus believed that the world's limited amount of land would not be able to supply enough food as the population grew. He predicted that as both the marginal and average productivity of labor fell and there were more mouths to feed, mass hunger and starvation would result.

Fortunately, Malthus was wrong (although he was right about the diminishing marginal returns to labor).

TABLE 6.2 Index of World Food Production per Capita

Year	Index
1948-1952	100
1960	115
1970	123
1980	128
1990	138
2000	150
2005	156

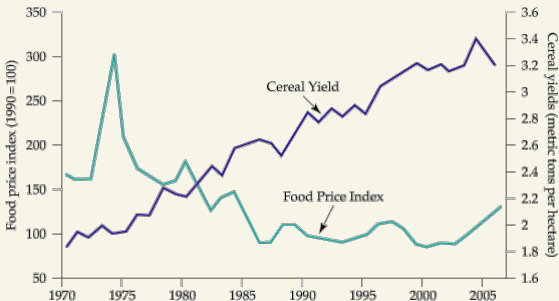
6.2 PRODUCTION WITH ONE VARIABLE INPUT (LABOR)

EXAMPLE 6.1

Malthus and the Food Crisis (continued)

Figure 6.3

Cereal Yields and the World Price of Food



Cereal yields have increased. The average world price of food increased temporarily in the early 1970s but has declined since.

6.2 PRODUCTION WITH ONE VARIABLE INPUT (LABOR)

Labor Productivity

- **labor productivity** Average product of labor for an entire industry or for the economy as a whole.

Productivity and the Standard of Living

- **stock of capital** Total amount of capital available for use in production.
- **technological change** Development of new technologies allowing factors of production to be used more effectively.

6.2 PRODUCTION WITH ONE VARIABLE INPUT (LABOR)

EXAMPLE 6.2

Labor Productivity and the Standard of Living

TABLE 6.3 Labor Productivity in Developed Countries

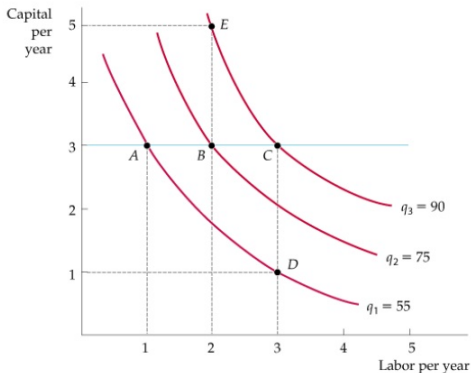
	UNITED STATES	JAPAN	FRANCE	GERMANY	UNITED KINGDOM
	Real Output per Employed Person (2006)				
	\$82,158	\$57,721	\$72,949	\$60,692	\$65,224
Years	<i>Annual Rate of Growth of Labor Productivity (%)</i>				
1960-1973	2.29	7.86	4.70	3.98	2.84
1974-1982	0.22	2.29	1.73	2.28	1.53
1983-1991	1.54	2.64	1.50	2.07	1.57
1992-2000	1.94	1.08	1.40	1.64	2.22
2001-2006	1.78	1.73	1.02	1.10	1.47

The level of output per employed person in the United States in 2006 was higher than in other industrial countries. But, until the 1990s, productivity in the United States grew on average less rapidly than productivity in most other developed nations. Also, productivity growth during 1974–2006 was much lower in all developed countries than it had been in the past.

6.3 PRODUCTION WITH TWO VARIABLE INPUTS

Diminishing Marginal Returns

Holding the amount of capital fixed at a particular level—say 3, we can see that each additional unit of labor generates less and less additional output.



6.3 PRODUCTION WITH TWO VARIABLE INPUTS

Substitution Among Inputs

- **marginal rate of technical substitution (MRTS)** Amount by which the quantity of one input can be reduced when one extra unit of another input is used, so that output remains constant.

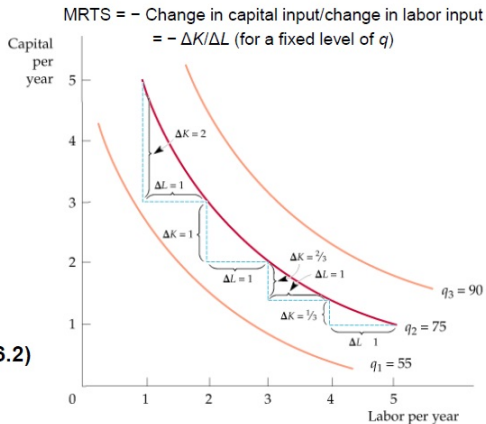
Figure 6.5

Marginal Rate of Technical Substitution

Like indifference curves, isoquants are downward sloping and convex. The slope of the isoquant at any point measures the marginal rate of technical substitution—the ability of the firm to replace capital with labor while maintaining the same level of output.

On isoquant q_2 , the MRTS falls from 2 to 1 to $2/3$ to $1/3$.

$$(\text{MP}_L)/(\text{MP}_K) = -(\Delta K / \Delta L) = \text{MRTS} \quad (6.2)$$



6.3 PRODUCTION WITH TWO VARIABLE INPUTS

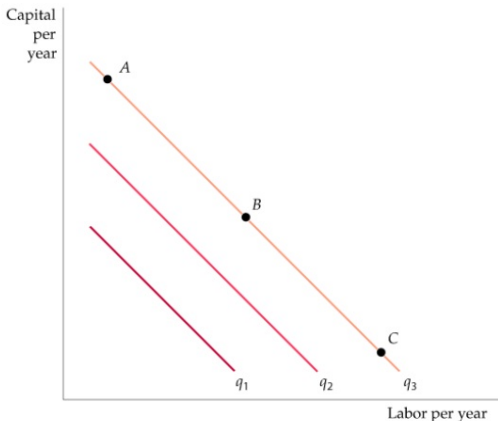
Production Functions—Two Special Cases

Figure 6.6

Isoquants When Inputs Are Perfect Substitutes

When the isoquants are straight lines, the MRTS is constant. Thus the rate at which capital and labor can be substituted for each other is the same no matter what level of inputs is being used.

Points A, B, and C represent three different capital-labor combinations that generate the same output q_3 .



6.3 PRODUCTION WITH TWO VARIABLE INPUTS

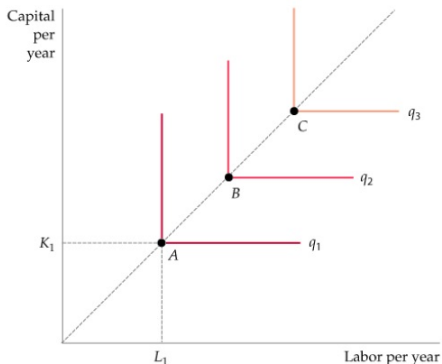
Production Functions—Two Special Cases

- fixed-proportions production function** Production function with L-shaped isoquants, so that only one combination of labor and capital can be used to produce each level of output. The fixed-proportions production function describes situations in which methods of production are limited.

Figure 6.7

Fixed-Proportions Production Function

When the isoquants are L-shaped, only one combination of labor and capital can be used to produce a given output (as at point A on isoquant q_1 , point B on isoquant q_2 , and point C on isoquant q_3). Adding more labor alone does not increase output, nor does adding more capital alone.



6.3 PRODUCTION WITH TWO VARIABLE INPUTS

Isoquants

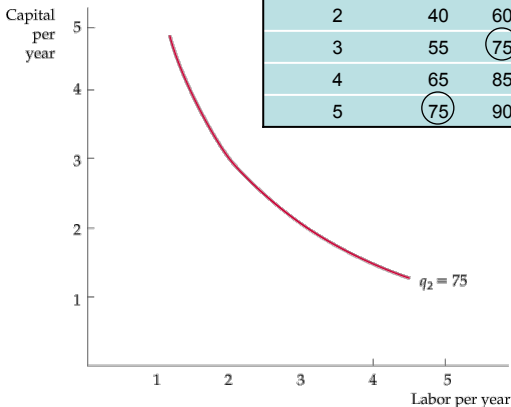


TABLE 6.4 Production with Two Variable Inputs					
Capital Input	LABOR INPUT				
	1	2	3	4	5
1	20	40	55	65	75
2	40	60	75	85	90
3	55	75	90	100	105
4	65	85	100	110	115
5	75	90	105	115	120

- **isoquant** Curve showing all possible combinations of inputs that yield the same output.

6.3 PRODUCTION WITH TWO VARIABLE INPUTS

Isoquants

- **isoquant map** Graph combining a number of isoquants, used to describe a production function.

Figure 6.4

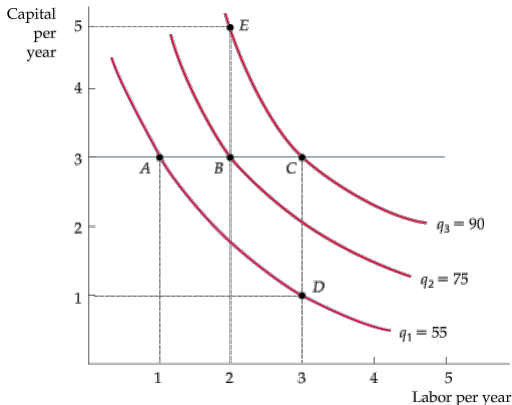
Production with Two Variable Inputs

A set of isoquants, or *isoquant map*, describes the firm's production function.

Output increases as we move from isoquant q_1 (at which 55 units per year are produced at points such as A and D),

to isoquant q_2 (75 units per year at points such as B) and

to isoquant q_3 (90 units per year at points such as C and E).



6.3 PRODUCTION WITH TWO VARIABLE INPUTS

EXAMPLE 6.3

A Production Function for Wheat

Figure 6.8

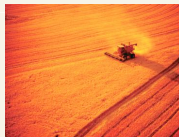
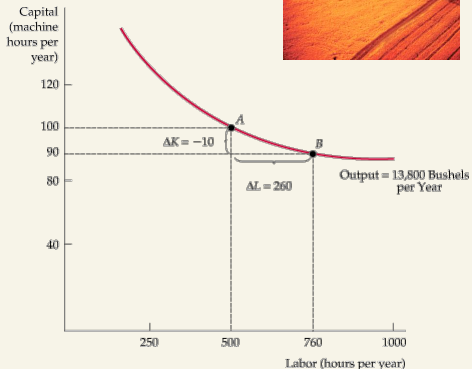
Isoquant Describing the Production of Wheat

A wheat output of 13,800 bushels per year can be produced with different combinations of labor and capital.

The more capital-intensive production process is shown as point *A*,

the more labor-intensive process as point *B*.

The marginal rate of technical substitution between *A* and *B* is $10/260 = 0.04$.



6.4 RETURNS TO SCALE

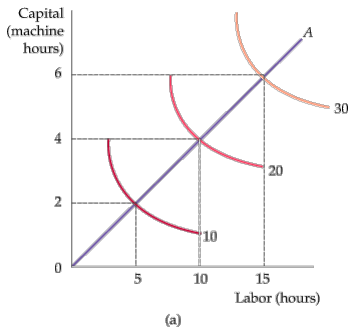
- **returns to scale** Rate at which output increases as inputs are increased proportionately.
- **increasing returns to scale** Situation in which output more than doubles when all inputs are doubled.
- **constant returns to scale** Situation in which output doubles when all inputs are doubled.
- **decreasing returns to scale** Situation in which output less than doubles when all inputs are doubled.

6.4 RETURNS TO SCALE

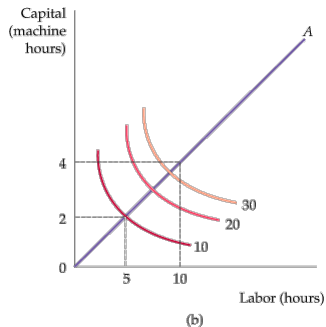
Describing Returns to Scale

Figure 6.9

Returns to Scale



When a firm's production process exhibits constant returns to scale as shown by a movement along line OA in part **(a)**, the isoquants are equally spaced as output increases proportionally.



However, when there are increasing returns to scale as shown in **(b)**, the isoquants move closer together as inputs are increased along the line.

Application 7.3

Returns-to-Scale in Express Package Delivery

It's 4 p.m. and your graduate school applications are due at 10 a.m. the next morning. Like many other applicants, you'll probably call an express package delivery service, such as Federal Express (FedEx) or United Parcel Service (UPS). They will send a truck to pick up your application, take it to a nearby airport, fly it to a sorting facility somewhere in the middle of the country, transport it to the city where the school is located, load it onto another truck, and deliver it to the school's admissions office—all by 10 a.m. the next morning. Guaranteed.

In the second quarter of 2002, three companies and the U.S. Post Office accounted for essentially all of the approximately 260 million overnight package deliveries in the United States. FedEx and UPS together accounted for nearly 75 percent; Airborne Express, for about 20 percent; and the post office, for most of the rest. Why are there so few choices for express package delivery?

The answer to the question is that there are significant increasing returns to scale in express package delivery.

Think about local pickup and delivery. When the number of packages doubles, fewer than double the number of trucks and drivers can do the job. The reason is that delivery routes can become more specialized. For example, a single truck would need to make deliveries all over town. With two trucks, the company will not need to send both trucks all over town. Instead, it might assign one truck to deliver to the northern half of town, and the other to deliver to the southern half. The amount of time spent driving from one delivery stop to another falls, and the number of packages that can be delivered by a truck in one day rises. This effect continues as the number of packages increases. If it gets large enough, each fully loaded truck may be able to make just one stop, delivering to a single business or apartment building.

The presence of increasing returns to scale makes it difficult for new express package delivery companies to enter the market. Their per-unit delivery costs would initially be much higher than those of FedEx and UPS, which have much larger scales of operation.

Ford Model T: assembly line production instead of individual hand crafting (scale economies)



Figure: 1919 Ford Model T Coupe

https://en.wikipedia.org/wiki/Ford_Model_T

Thank You