MICROECONOMICS

Principles and Analysis

THE FIRM: OPTIMISATION

OVERVIEW...

Approaches to the firm's optimisation problem

- Firm: Optimisation
  - The setting
  - Stage 1: Cost Minimisation
  - Stage 2: Profit maximisation

THE OPTIMISATION PROBLEM

- We want to set up and solve a standard optimisation problem.
- Let's make a quick list of its components.
- ... and look ahead to the way we will do it for the firm.

THE OPTIMISATION PROBLEM

- Objectives *-Profit maximisation?*
- Constraints *-Technology; other*
- Method *- 2-stage optimisation*

CONSTRUCT THE OBJECTIVE FUNCTION

- Use the information on prices…
  - w_i •price of input i
  - p •price of output
- …and on quantities…
  - z_i •amount of input i
  - q •amount of output
- …to build the objective function

How it's done

THE FIRM'S OBJECTIVE FUNCTION

- Cost of inputs: $\sum_{i=1}^{m} w_i z_i$ •Summed over all m inputs
- Revenue: pq
- Profits: $pq - \sum_{i=1}^{m} w_i z_i$

•Subtract Cost from Revenue to get

OPTIMISATION: THE STANDARD APPROACH

- Choose q and $\mathbf{z}$ to maximise

$$\Pi := pq - \sum_{i=1}^{m} w_i z_i$$

- ...subject to the production constraint...

$$q \leq \phi(\mathbf{z})$$

- ..and some obvious constraints:

$$q \geq 0 \qquad \mathbf{z} \geq \mathbf{0}$$

- Could also write this as $\mathbf{z} \in Z(q)$
- You can't have negative output or negative inputs

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A STANDARD OPTIMISATION METHOD

- If ϕ is differentiable…
- Set up a Lagrangean to take care of the constraints — $L(\dots)$
- Write down the First Order Conditions (FOC) — $\frac{\partial}{\partial \mathbf{z}} L(\dots) = \mathbf{0}$ (necessity)
- Check out second-order conditions — $\frac{\partial^2}{\partial \mathbf{z}^2} L(\dots)$ (sufficiency)
- Use FOC to characterise solution — $\mathbf{z}^* = \dots$

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USES OF FOC

- First order conditions are crucial
- They are used over and over again in optimisation problems.
- For example:
  - Characterising efficiency.
  - Analysing "Black box" problems.
  - Describing the firm's reactions to its environment.
- More of that in the next presentation
- Right now a word of caution...

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A WORD OF WARNING

- We've just argued that using FOC is useful.
  - But sometimes it will yield ambiguous results.
  - Sometimes it is undefined.
  - Depends on the shape of the production function ϕ.
- You have to check whether it's appropriate to apply the Lagrangean method
- You may need to use other ways of finding an optimum.
- Examples coming up…

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A WAY FORWARD

- We could just go ahead and solve the maximisation problem
- But it makes sense to break it down into two stages
  - The analysis is a bit easier
  - You see how to apply optimisation techniques
  - It gives some important concepts that we can re-use later
- The first stage is ***"minimise cost for a given output level"***
  - If you have fixed the output level q…
  - …then profit max is equivalent to cost min.
- The second stage is ***"find the output level to maximise profits"***
  - Follows the first stage naturally
  - Uses the results from the first stage.
- We deal with stage each in turn

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OVERVIEW...

A fundamental multivariable problem with a brilliant solution

- Firm: Optimisation
  - The setting
  - **Stage 1: Cost Minimisation**
  - Stage 2: Profit maximisation

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STAGE 1 OPTIMISATION

- Pick a target output level q
- Take as given the market prices of inputs $\mathbf{w}$
- Maximise profits...
- ...by minimising costs $\sum_{i=1}^{m} w_i z_i$

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A USEFUL TOOL

- For a given set of input prices **w**...
- …the *isocost* is the set of points **z** in input space...
- ...that yield a given level of factor cost.
- These form a hyperplane (straight line)...
- ...because of the simple expression for factor-cost structure.

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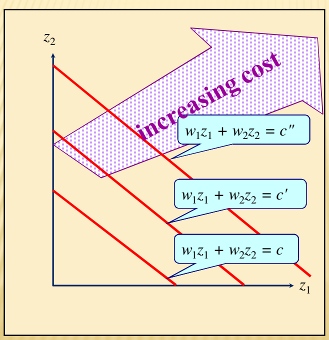
ISO-COST LINES



- *Draw set of points where cost of input is c, a constant*
- *Repeat for a higher value of the constant*
- *Imposes direction on the diagram...*

slope w_1/w_2

Use this to derive optimum

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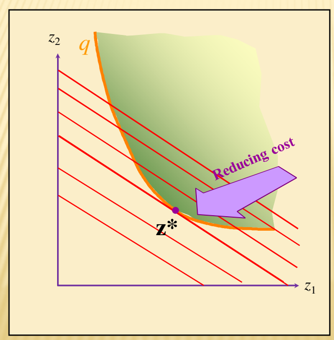
COST-MINIMISATION



- *The firm minimises cost...*
- *Subject to output constraint*
- *Defines the stage 1 problem.*
- *Solution to the problem*

minimise

$\sum_{i=1}^{m} w_i z_i$

subject to $\phi(\mathbf{z}) \geq q$

- *But the solution depends on the shape of the input-requirement set Z.*
- *What would happen in other cases?*

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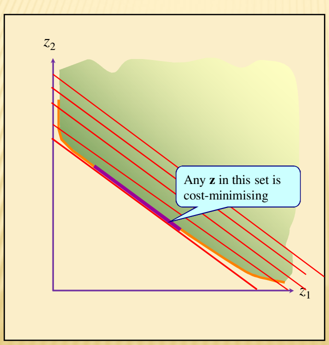
CONVEX, BUT NOT STRICTLY CONVEX *Z*



- *An interval of solutions*

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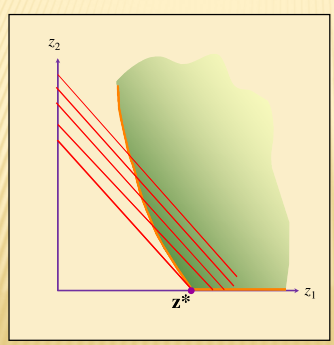
CONVEX Z, TOUCHING AXIS



- *Here $MRTS_{21} > w_1 / w_2$ at the solution.*
- *Input 2 is "too expensive" and so isn't used: $z_2^*=0$.*

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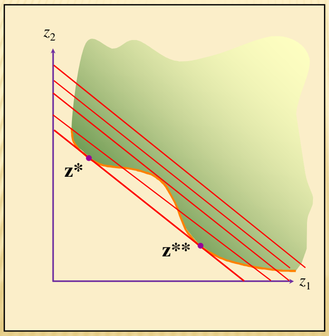
NON-CONVEX Z



- *There could be multiple solutions.*
- *But note that there's no solution point between z^* and z^{**}.*

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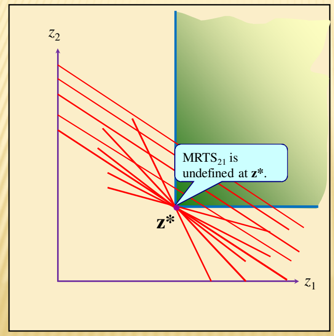
NON-SMOOTH Z



- *z^* is unique cost-minimising point for q.*
- *True for all positive finite values of w_1, w_2*

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COST-MINIMISATION: STRICTLY CONVEX Z

- Minimise

$$\sum_{i=1}^{m} w_i z_i + \lambda[q \le \phi(\mathbf{z})]$$

Lagrange multiplier

- Because of strict convexity we have an interior solution.
- A set of $m+1$ First-Order Conditions

$$\begin{aligned} \lambda^* \phi_1(\mathbf{z}^*) &= w_1 \\ \lambda^* \phi_2(\mathbf{z}^*) &= w_2 \\ \ldots \quad \ldots \quad &\ldots \\ \lambda^* \phi_m(\mathbf{z}^*) &= w_m \end{aligned}$$

one for each input

$$q = \phi(\mathbf{z}^*)$$

output constraint

- *Use the objective function*
- *...and output constraint*
- *...to build the Lagrangean*
- *Differentiate w.r.t. $z_1, \ldots, z_m$ and set equal to 0.*
- *... and w.r.t λ*
- *Denote cost minimising values with a *.*

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IF ISOQUANTS CAN TOUCH THE AXES...

- Minimise

$$\sum_{i=1}^{m} w_i z_i + \lambda[q - \phi(\mathbf{z})]$$

- Now there is the possibility of corner solutions.
- A set of $m+1$ First-Order Conditions

$$\begin{aligned} \lambda^* \phi_1(\mathbf{z}^*) &\le w_1 \\ \lambda^* \phi_2(\mathbf{z}^*) &\le w_2 \\ \ldots \quad \ldots \quad &\ldots \\ \lambda^* \phi_m(\mathbf{z}^*) &\le w_m \end{aligned}$$

$$q = \phi(\mathbf{z}^*)$$

Can get "<" if optimal value of this input is 0

Interpretation

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FROM THE FOC

- If both inputs i and j are used and MRTS is defined then...

$$\frac{\phi_i(\mathbf{z}^*)}{\phi_j(\mathbf{z}^*)} = \frac{w_i}{w_j}$$

- MRTS = input price ratio
  - "implicit" price = market price
- If input i could be zero then...

$$\frac{\phi_i(\mathbf{z}^*)}{\phi_j(\mathbf{z}^*)} \le \frac{w_i}{w_j}$$

- $\text{MRTS}_{ji} \le$ input price ratio
  - "implicit" price ≤ market price

Solution

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PROPORTIES OF THE MINIMUM-COST SOLUTION

- (a) The cost-minimising output under perfect competition is technically efficient.
- (b) For any two inputs, i, j purchased in positive amounts MRTSij must equal the input price ratio wj/wi.
- (c) If i is an input that is purchased, and j is an input that is not purchased then MRTSij will be less than or equal to the input price ratio wj/wi.

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THE SOLUTION…

- Solving the FOC, you get a cost-minimising value for each input…

  $z_i^* = H^i(\mathbf{w}, q)$

- …for the Lagrange multiplier

  $\lambda^* = \lambda^*(\mathbf{w}, q)$

- …and for the minimised value of cost itself.
- The ***cost function*** is defined as

$$C(\mathbf{w}, q) := \min_{\{\phi(\mathbf{z}) \geq q\}} \Sigma\, w_i z_i$$

vector of input prices

Specified output level

INTERPRETING THE LAGRANGE MULTIPLIER

- The solution function:

$C(\mathbf{w}, q) = \sum_i w_i z_i^*$

$= \sum_i w_i z_i^* - \lambda^* [\phi(\mathbf{z}^*) - q]$

At the optimum, either the constraint binds or the Lagrange multiplier is zero

- Differentiate with respect to q:

Express demands in terms of $(\mathbf{w}, q)$

$C_q(\mathbf{w}, q) = \sum_i w_i H^i_q(\mathbf{w}, q)$

$- \lambda^* [\sum_i \phi_i(\mathbf{z}^*)$ …

Vanishes because of FOC $\lambda^* \phi_i(\mathbf{x}^*) =$

- Rearrange:

$C_q(\mathbf{w}, q) = \Sigma_i [w_i - \lambda^* \phi_i(\mathbf{z}^*)]\, H^i_q(\mathbf{w}, q) + \lambda^*$

Lagrange multiplier in the stage 1 problem is just marginal cost

$C_q(\mathbf{w}, q) = \lambda^*$

This result – extremely important in economics – is just an applications of a general "envelope" theorem.

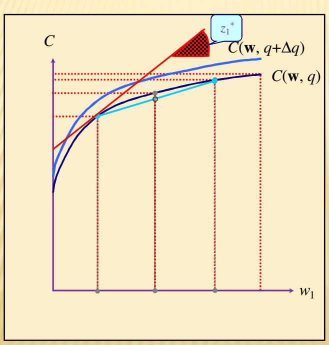
THE COST FUNCTION IS A USEFUL CONCEPT

- Because it is a solution function…
- …it automatically has very nice properties.
- These are true for *all* production functions.
- And they carry over to applications other than the firm.
- We'll investigate these graphically.

PROPERTIES OF THE MINIMUM-COST SOLUTION

- (a) The cost-minimising output under perfect competition is technically efficient.
- (b) For any two inputs, i, j purchased in positive amounts MRTSij must equal the input price ratio w_j/w_i.
- (c) If i is an input that is purchased, and j is an input that is not purchased then $MRTS_{ij}$ will be less than or equal to the input price ratio w_j/w_i.

PROPERTIES OF *C*

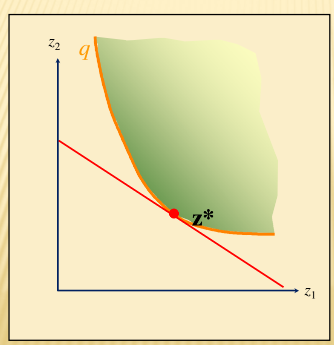


- ***Draw cost as function of w_1***
- ***Cost is non-decreasing in input prices .***
- ***Cost is increasing in output.***
- ***Cost is concave in input prices.***
- ***Shephard's Lemma***

$$C(t\mathbf{w}+[1-t]\mathbf{w'},q) \geq tC(\mathbf{w},q) + [1-t]C(\mathbf{w'},q)$$

$$\frac{\partial C(\mathbf{w},q)}{\partial w_j} = z_j^*$$

WHAT HAPPENS TO COST IF W CHANGES TO *t*W



- ***Find cost-minimising inputs for w, given q***
- ***Find cost-minimising inputs for tw, given q***

- *So we have:*

$C(t\mathbf{w},q) = \Sigma_i t\, w_i z_i^* = t\, \Sigma_i w_i z_i^* = tC(\mathbf{w},q)$

- *The cost function is homogeneous of degree 1 in prices.*

COST FUNCTION: 5 THINGS TO REMEMBER

- Non-decreasing in every input price.
  - Increasing in at least one input price.
- Increasing in output.
- Concave in prices.
- Homogeneous of degree 1 in prices.
- Shephard's Lemma.

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EXAMPLE

Production function: $q \le z_1^{0.1} z_2^{0.4}$

Equivalent form: $\log q \le 0.1 \log z_1 + 0.4 \log z_2$

Lagrangean: $w_1 z_1 + w_2 z_2 + \lambda [\log q - 0.1 \log z_1 - 0.4 \log z_2]$

FOCs for an interior solution:

$w_1 - 0.1\, \lambda / z_1 = 0$

$w_2 - 0.4\, \lambda / z_2 = 0$

$\log q = 0.1 \log z_1 + 0.4 \log z_2$

From the FOCs:

$\log q = 0.1 \log (0.1\, \lambda / w_1) + 0.4 \log (0.4\, \lambda / w_2)$

$\lambda = 0.1^{-0.2}\, 0.4^{-0.8}\, w_1^{0.2}\, w_2^{0.8}\, q^2$

Therefore, from this and the FOCs:

$w_1 z_1 + w_2 z_2 = 0.5\lambda = 1.649\, w_1^{0.2}\, w_2^{0.8}\, q^2$

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OVERVIEW...

Firm: Optimisation

- The setting
- Stage 1: Cost Minimisation
- Stage 2: Profit maximisation

…using the results of stage 1

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STAGE 2 OPTIMISATION

- Take the cost-minimisation problem as solved.
- Take output price p as given.
  - Use minimised costs $C(\mathbf{w},q)$.
  - Set up a 1-variable maximisation problem.
- Choose q to maximise profits.
- First analyse the components of the solution graphically.
  - Tie-in with properties of the firm introduced in the previous presentation.
- Then we come back to the formal solution.

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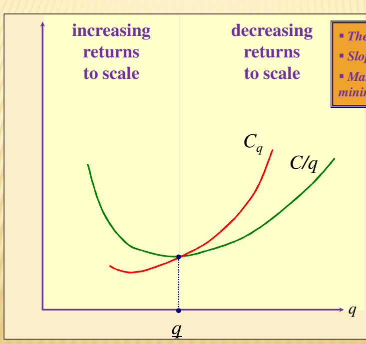
AVERAGE AND MARGINAL COST



- *The average cost curve.*
- *Slope of AC depends on RTS.*
- *Marginal cost cuts AC at its minimum*

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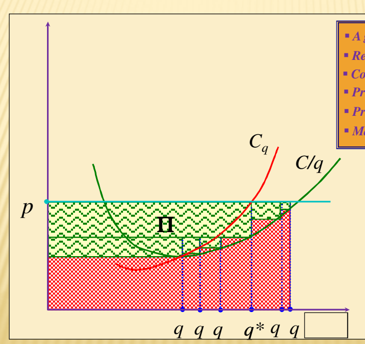
REVENUE AND PROFITS



- *A given market price p.*
- *Revenue if output is q.*
- *Cost if output is q.*
- *Profits if output is q.*
- *Profits vary with q.*
- *Maximum profits*

- *price = marginal cost*

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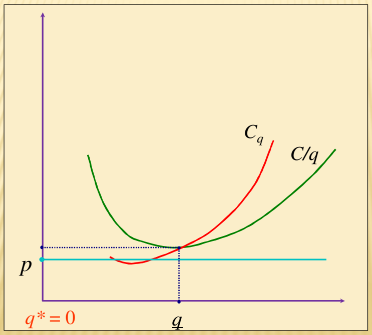
WHAT HAPPENS IF PRICE IS LOW...



- *price < marginal cost*

PROFIT MAXIMISATION

- Objective is to choose q to max:
  $pq - C(\mathbf{w}, q)$ — ***"Revenue minus minimised cost"***
- From the First-Order Conditions if $q^* > 0$:
  $p = C_q(\mathbf{w}, q^*)$ — ***"Price equals marginal cost"***
  $p \geq \dfrac{C(\mathbf{w}, q^*)}{q^*}$ — ***"Price covers average cost"***
- In general:
  $p \leq C_q(\mathbf{w}, q^*)$
  $pq^* \geq C(\mathbf{w}, q^*)$
  covers both the cases: $q^* > 0$ and $q^* = 0$

EXAMPLE (CONTINUED)

Production function: $q \leq z_1^{0.1}\, z_2^{0.4}$
Resulting cost function: $C(\mathbf{w}, q) = 1.649\, w_1^{0.2}\, w_2^{0.8}\, q^2$

Profits:
$pq - C(\mathbf{w}, q) = pq - A\, q^2$
where $A := 1.649\, w_1^{0.2}\, w_2^{0.8}$

FOC:
$p - 2\,Aq = 0$

Result:
$q = p\,/\,2A.$
$= 0.3031\, w_1^{-0.2}\, w_2^{-0.8}\, p$

SUMMARY

- *Key point:* Profit maximisation can be viewed in two stages:
  - Stage 1: choose inputs to minimise cost
  - Stage 2: choose output to maximise profit
- *What next?* Use these to predict firm's reactions