

COST CONCEPT

COST AND TYPES OF COST

- The concept of cost in economics refers to the total expenditure a firm incurs when utilizing economic resources to produce goods and services. Resources in the economy are scarce, and the allocation of them in an efficient manner is an essential step toward maximizing the firm's profit.
- **Profit** is the difference between a firm's revenue and its total cost
- Although a firm might experience high revenues, if the cost of production is high, it will shrink the firm's profit. As a result, firms are concerned about what the expenses will most likely be in the future, as well as the ways in which the company may be able to reorganize its resources to reduce its costs and increase its profitability.
- The **economic cost** is the total expenditure a firm faces when using economic resources to produce goods and services.
- Economic cost involves all the expenses a firm faces, those it can manage, and those beyond the company's control. Some of these economic costs include capital, labor, and raw materials. However, the company may use other resources, some of which have expenses that are not as readily apparent but are still significant.

- **. Outlay costs**

- The actual expenses incurred by the entrepreneur in employing inputs are called outlay costs. These include costs on payment of wages, rent, electricity or fuel charges, raw materials, etc. We have to treat them as general expenses for the business.

- **2. Opportunity costs**

- Opportunity costs are incomes from the next best alternative that is foregone when the entrepreneur makes certain choices.
- For example, the entrepreneur could have earned a salary had he worked for others instead of spending time on his own business. These costs calculate the missed opportunity and calculate income that we can earn by following some other policy.

- **1. Direct costs**

- Direct costs are related to a specific process or product. They are also called traceable costs as we can directly trace them to a particular activity, product or process.
- They can vary with changes in the activity or product. Examples of direct costs include manufacturing costs relating to production, customer acquisition costs pertaining to sales, etc.

- **2. Indirect costs**

- Indirect costs, or untraceable costs, are those which do not directly relate to a specific activity or component of the business. For example, an increase in charges of electricity or taxes payable on income. Although we cannot trace indirect costs, they are important because they affect overall profitability.

- **1. Incremental costs**

- These costs are incurred when the business makes a policy decision. For example, change of product line, acquisition of new customers, upgrade of machinery to increase output are incremental costs.

- **2. Sunk costs**

- Sunk costs are costs which the entrepreneur has already incurred and he cannot recover them again now. These include money spent on advertising, conducting research, and acquiring machinery.

- **1. Private costs**

- These costs are incurred by the business in furtherance of its own objectives. Entrepreneurs spend them for their own private and business interests. For example, costs of [manufacturing](#), production, sale, advertising, etc.

- **2. Social costs**

- As the name suggests, it is the society that bears social costs for private interests and expenses of the business. These include social resources for which the firm does not incur expenses, like atmosphere, water resources and environmental pollution.

- **1. Fixed costs**

- Fixed costs are those which do not change with the volume of output. The business incurs them regardless of their level of production. Examples of these include payment of rent, taxes, interest on a loan, etc.

- **2. Variable costs**

- These costs will vary depending upon the output that the business generates. Less production will cost fewer expenses, and vice versa, the business will pay more when its production is greater. Expenses on the purchase of raw material and payment of wages are examples of variable costs.

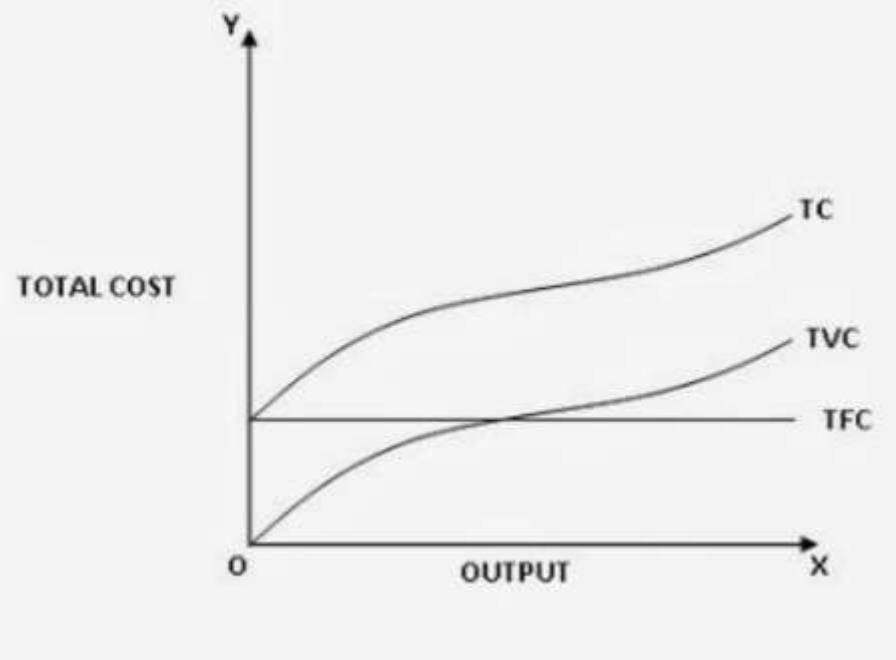
Cost output relationship in short run

- **Short-run cost:**
- Short-run is a period where the time is too short to expand the size of the industry and the increased demand has to be met within the existing size of industry because certain factors cannot be changed in short run.
- So short-run costs are those which vary with the output when fixed plant a capital equipment remains unchanged.

- A change in output is possible only by making changes in the variable inputs like raw materials, labor, etc.
- Inputs like land and buildings, plant and machinery, etc. are fixed in the short-run.
- It means that the short-run is a period not sufficient enough to expand the number of fixed inputs.
- Thus Total Cost (TC) in the short-run is composed of two elements – Total Fixed Cost (TFC) and Total Variable Cost (TVC).
- TFC remains the same throughout the period and is not influenced by the level of activity.
- The firm will continue to incur these costs even if the firm is temporarily shut down.

- Even though TFC remains the same fixed cost per unit varies with changes in the level of output.
- On the other hand, TVC increases with an increase in the level of activity and decreases with a decrease in the level of activity.
- If the the firm is shut down, there are no variable costs. Even though TVC is variable, the variable cost per unit is constant.
- So in the short-run, an increase in TC implies an increase in TVC only.
Thus:
- $TC = TFC + TVC$
- $TFC = TC - TVC$
- $TVC = TC - TFC$
- $TC = TFC$ when the output is zero.

The graph below shows the



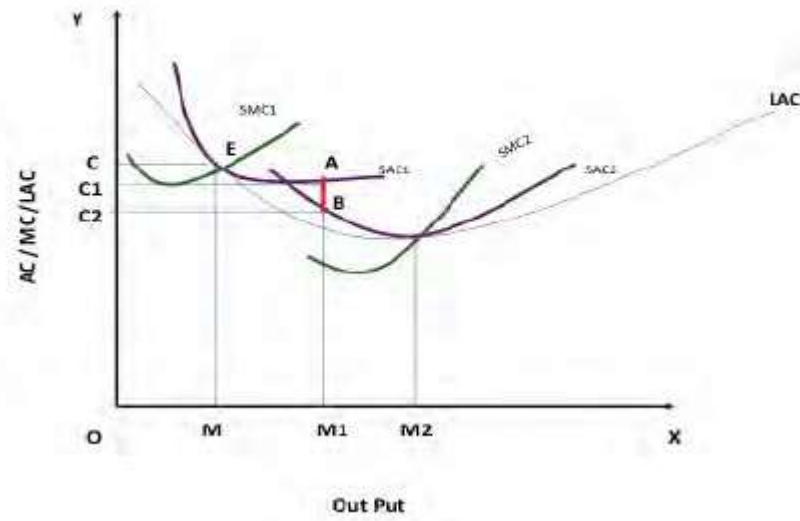
- In the graph X-axis measures output and the Y-axis measures cost. TFC is a straight line parallel to X-axis because TFC does not change with an increase in output.
- TVC curve is upward rising from the origin because TVC is zero when there is no production and increases as production increases.
- The shape of the TVC curve depends upon the productivity of the variable factors. The TVC curve above assumes the Law of Variable Proportions, which operate in the short run.
- TC curve is also upward rising not from the origin but the TFC line. This is because even if there is no production the TC is equal to TFC.
- It should be noted that the vertical distance between the TVC curve and TC curve is constant throughout because the distance represents the amount of fixed cost which remains constant.
- Hence TC curve has the same pattern of behavior as the TVC curve.

Cost Output Relationship In The Long Run

-

In the long run costs fall as output increases due to economies of scale, consequently the average cost AC of production falls. Some firms experience diseconomies of scale if the average cost begins to increase. This fall and rise derives a U shaped or boat shaped average cost curve in the long run which is denoted as LAC. The minimum point of the curve is said to be the optimum output in the long run. It is explained graphically in the chart given below.

Graph - Long Run Average Cost Curve



- **The Types of Revenues**

- **Total revenue:** The total revenue is the total amount a vendor can collect from the sale of commodities or services to the customer. The price of the commodities can be expressed as $P \times Q$, which means the cost price of the commodities multiplied by the amount sold. Therefore, total revenue (TR) is defined as the market cost price of the commodity (p) multiplied by the enterprise's output (q).

- Thus,

- $TR = p \times q$

- Where

- TR-Total Revenue,

- P-Price,

- Q-Quantity.

- **Average revenue:** The average revenue represents the revenue initiated per unit of output sold. The average revenue contributes greatly to the profit of any enterprise. In calculating profit per unit, the average (total) cost is subtracted from the average revenue. It is usually more profitable for an enterprise to manufacture the greatest amount of output.
 - $AR = TR/q = p \times q/q = p$
 - Where
 - AR-Average Revenue,
 - TR-Total Revenue,
 - P-Price
 - Q-Quantity.

- **Marginal revenue:** It is defined as the revenue earned from the sale of a new product or unit. In other words, it is the revenue that a company generates when it sells an extra unit. Management uses it to analyze customer demands, plan the production schedules, and set the prices of products.
- - In accordance with the law of diminishing returns, the margin of revenue remains constant to a certain output level, and slows down as output increases.
 - $MR = \text{Change in total revenue} / \text{Change in quantity}$
 - Where
 - MR-Marginal Revenue,
 - TR-Total Revenue,
 - Q-Quantity.