THEORIES OF COST

Dr Swayam Prava Mishra
Department of A & A Economics
Utkal University
BBSR-04

Cost and types of Cost

- Cost is best described as a sacrifice made in order to get something. In business, cost is usually a monetary valuation of all efforts, materials, resources, time and utilities consumed, risk incurred and opportunities forgone in production and delivery of goods and services.

Various types of Cost:

- **Accounting cost** is the total monetary expenses incurred by a firm in producing a commodity and this is what an entrepreneur takes into consideration in making payments for various items including factors of production (wages and salaries of labour), purchase of raw materials, expenditures on machine, including on capital goods, rents on buildings, interest on capital borrowed, expenditure on power, light, fuel, advertisement, etc.

- The "**economic cost**" is made up of both the explicit and the implicit cost. **Explicit cost** refers to the money expended to buy or hire resources from outside the organization for the process of production. **Implicit cost** refers to the cost of use of the self owned resources of organization that are used in production.
- **Opportunity cost**: This is the cost of the resources foregone, in order to get or obtain another. The opportunity cost of anything is the next best alternative that could be produced instead by the same factors or by an equivalent group of factors, costing the same amount of money.
- **Production cost**: In the production process, many fixed and variable factors (inputs) usually capital equipment are used. They are being employed at various prices. The expenditures incurred on them are the total costs of production of a firm. Such costs are divided into two: total variable cost and total fixed costs.

- **Private costs** are the costs incurred by a firm in producing a commodity or service. The society suffers some inconveniences as a result of the production exercise embarked upon by the firm which are **social costs**.
- **Incremental cost**: This is the change in cost owing to a new decision.
- **Sunk costs:** This refers to all the costs that have been incurred and definitely not recoverable or changeable whether the particular project or business goes on or not.
- **Cost functions** are derived functions. They are derived from the production function which describes the available efficient methods of production at any given period of time. Symbolically, we may write the long-run cost function as:

$$C = f\,(Q,T,Pf,)\text{ and}$$

short-run cost function as; $C = f\,(Q,T,Pf,K)$

Where C is total cost, Q is output, T is technology, Pf is prices of factor inputs, and K is fixed factors of production.

TRADITIONAL THEORY OF COSTS

The traditional theory of costs analyses the behavior of cost curves in the short-run and long-run and arrives at the conclusion that both the short-run and long-run cost curves are U-shaped but the long-run cost curves are flatter than short-run cost curves.

(a) Short run Cost: TC=TFC+TVC

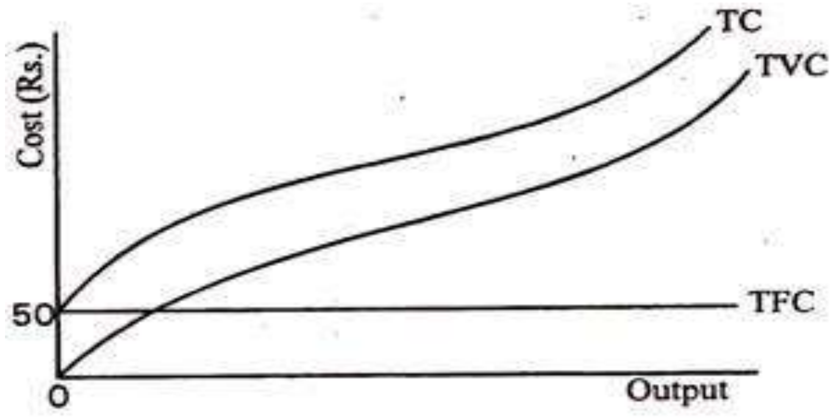

Fig. 7.1. Short-Run Total Cost Curves

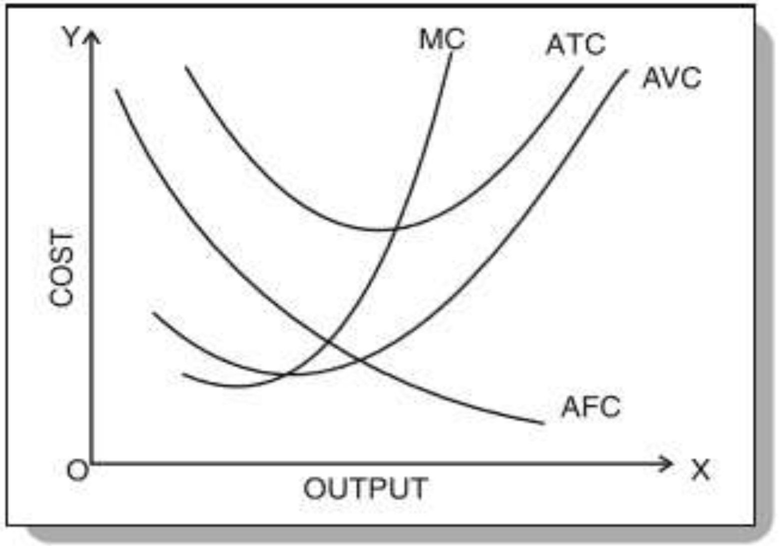

Fig. 1 : Short run Average and Marginal Cost Curves

AFC =TFC/Q; AVC= TVC/Q;

ATC = AFC + AVC

MC= ΔTC/ ΔQ

(b) Long run cost: In the Long-run, there are no fixed factors of production, hence all factors are assumed to be variable.

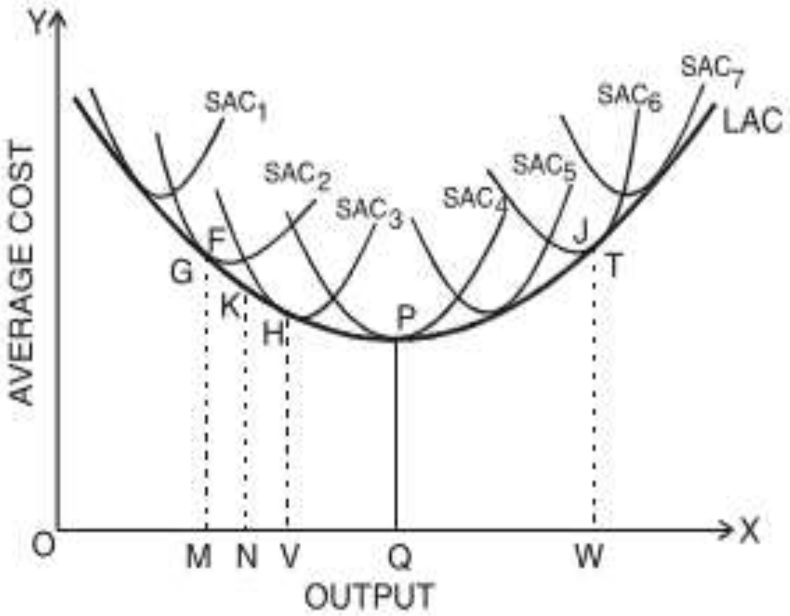

Fig. 2 : Long run Average Cost Curves

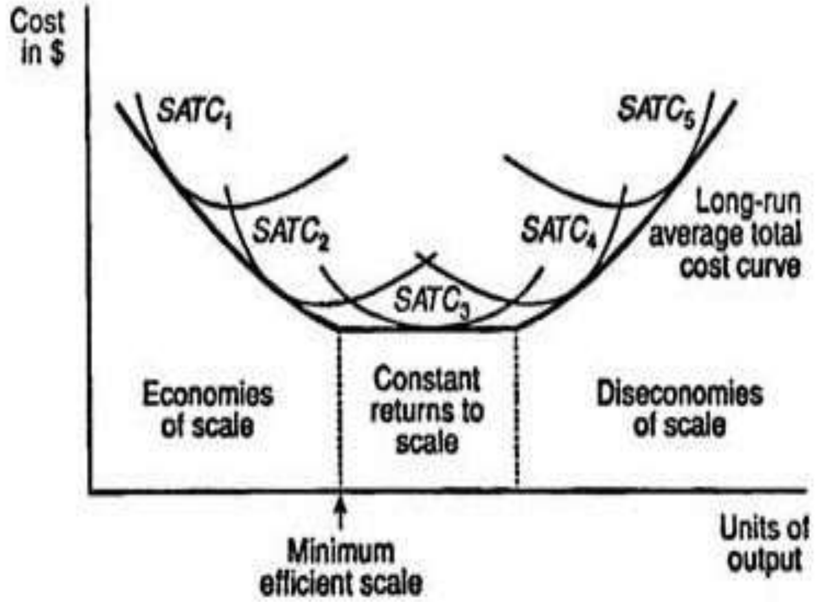

Figure 1
Short- and long-run average total cost curves

MODERN THEORY OF COST

- The modern theory of cost differs from the traditional theory of costs with regards to the shapes of the cost curves.
- (a) Short run cost curves: In the modern theory, the SAVC and SMC curves have a saucer-type shape or bowl shape rather than a U-shape. As the AFC curve is a rectangular hyperbola, the SAC curve has a U-shape even in the modern theory.
- (b) Long run cost curves: It is L shaped due to production and managerial cost; technical progress; learning etc.

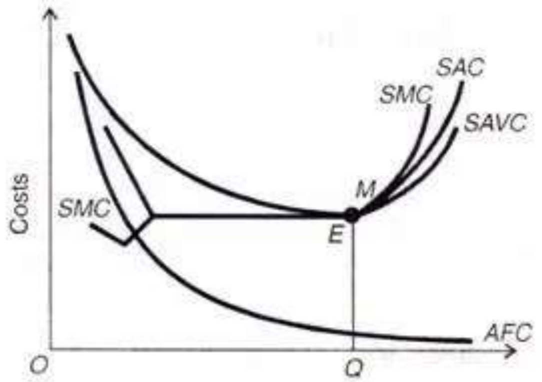

Fig. 8

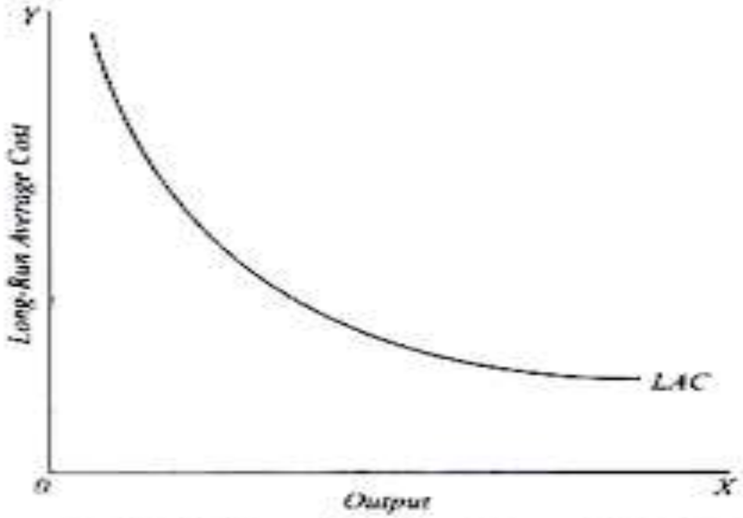

Fig. 19.17. L-Shaped Long-Rum Average Cost Curve

CONCLUSION

The majority of empirical cost studies suggest that the U-shaped cost curves postulated by the traditional theory are not observed in the real world.

References

Modern Microeconomics by A Kourtsoyiannis

THANK YOU