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Cost

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Cost

In production, research, retail, and accounting, a **cost** is the value of money that has been used up to produce something, and hence is not available for use anymore. In business, the **cost** may be one of acquisition, in which case the amount of money expended to acquire it is counted as **cost**.



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The total cost concept is useful in break-even **analysis** and finding out whether a firm is making **profit** or not.

The **average** cost concept is significant for calculating the per **unit profit**.

The **marginal** and **incremental** cost concepts are needed in deciding whether a firm needs to expand its production or not.



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Concept

The cost principle is one of the basic underlying guidelines in accounting. It is also known as the historical cost principle. The cost principle requires that assets be **recorded** at the cash amount (or its equivalent) at the time that an asset is acquired.



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Marginal cost

Marginal, as always in economics, should be read as **EXTRA** . Here, it is the extra cost of one more item of output; or the **CHANGE in total cost divided by CHANGE in output** . Marginal cost is the type of cost to consider in **SHORT-RUN OUTPUT DECISIONS** .

The rules to apply are:

1. If $MC < P$, **increase** output.
2. If $MC > P$, **decrease** output.
3. If $MC = P$, leave output unchanged.

The firm is in **SHORT-RUN EQUILIBRIUM** .



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Variable cost

Variable cost is **the sum of marginal costs** . It is the **total** expenditure on all variable factors of production, such as labor, raw materials and energy. Variable cost is also known as **operating cost** .

If the marginal cost of producing the first unit of output is 10, and the marginal cost of the second item of output is 20, then the **variable cost** of producing two items is 30.



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Fixed cost

Fixed costs are costs which do not change per unit of output. Even if no crops are grown on a piece of land, the bank will insist on a mortgage payment from the farmer; even if no output is produced by a corporation, its bondholders will legally insist on payments of interest.

The only way to avoid these payments is to go out of business; they are accordingly **NOT** considered in making a short-run operating decision, but **ARE** considered in making **LONG-RUN, ENTRY or EXIT decisions**



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AVERAGE COST

Average cost is total cost per unit of output, or **AC = TC/Q**

Average cost plays a major role in **LONG-RUN, ENTRY AND EXIT DECISIONS.**

The basic decision rules are parallel to those for marginal cost:

1. If $AC < P$, the industry is profitable. **ENTER**
2. If $AC > P$, the industry is unprofitable. **EXIT**
3. If $AC = P$, the industry yields **zero profit**.
Remain where you are; firms neither enter nor exit the industry, so this zero profit condition is characteristic of **INDUSTRY EQUILIBRIUM**.



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Total cost

The sum of variable cost and fixed cost is **TOTAL COST**



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The **long run** is the conceptual time period in which there are no fixed factors of production, so that there are no constraints preventing changing the output level by changing the capital stock or by entering or leaving an industry.

Short run, in which some factors are variable and others are fixed, constraining entry or exit from an industry.



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Key Points

In the short run, there are both fixed and variable costs.

In the long run, there are no fixed costs.

Efficient long run costs are sustained when the combination of outputs that a firm produces results in the desired quantity of the goods at the lowest possible cost.

Variable costs change with the output. Examples of variable costs include employee wages and costs of raw materials.

The short run costs increase or decrease based on variable cost as well as the rate of production. If a firm manages its short run costs well over time, it will be more likely to succeed in reaching the desired long run costs and goals.



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