Laxmi Narain Dubey College, Motihari

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Department of Economics

Topic: BASIC COST CONCEPTS

Paper-I: MICROECONOMICS

Part-I

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BASIC COST CONCEPTS

- ✓ The production function is the relationship between the physical inputs and outputs.
- ✓ The money value of all the inputs actually comprises the cost of production.
- ✓ This depends on the techniques of production as well as the factors of production.
- ✓ While discussing cost, it is important to understand some basic concepts associated with it. Let us discuss each of these.

- ➢ **Actual cost and opportunity cost:** Actual costs are the costs which a firm incurs on raw materials, labour, machinery, advertising, and other such expenses. Opportunity cost is the cost of the alternative option, which has been lost by putting the scarce resources in the present option. This cost arises because the resources of the society are scarce.

- ➢ **Variable cost and fixed cost:** Variable cost is the cost which varies with the level of output. It includes cost of raw material, labour, fuel, and others.
  Fixed cost is the cost which does not vary with the level of output. It includes cost of managerial and administrative staff, depreciation of building and machinery, and others.

- ➢ **Explicit and implicit cost:** Explicit costs are incurred by the firm when it buys or hires factors that are required in the process of production. These factors are not owned by the firm. Such costs are depicted explicitly in the expenditure by the firm. They include, for example, wages and insurance. Implicit cost is incurred by the firm when it uses factors that are owned by the firm in the process of production. They include, for example, rent and interest on building and capital owned by the firm. They are also called the imputed cost. While calculating the total cost, both the explicit cost and the implicit cost are included.

- ➢ **Private and social cost:** Private cost is the monetary cost which a firm incurs in the production of a good.Social cost is the real cost which the society incurs in the production of a good, for example, pollution from a factory, which adversely affects the health of people.

- ➢ **Short-run and long-run cost:** Short-run costs are those incurred over the short run, which is that time in which the supply of some of the factors of production is inelastic or fixed, for example, machinery. Long-run costs are those incurred over the long run, which is that time in which the supply of most of the factors of production is elastic. Thus, all the factors of production can be changed in the long run.

THE COST FUNCTION

- ✓ The cost function is a derived function since it is obtained from the production function, which is a technological relationship between the physical inputs and physical outputs in a particular time, given the technology.
- ✓ The element of time is very important in cost theory. Short-run costs are those incurred over the time in which the supply of some of the factors of production are fixed. Long-run costs are those incurred over the time in which the supply of most of the factors of production can change.

- ➢ A short-run cost function can be expressed as:

$$\mathbf{c=f(X, P_F, T, \bar{K})}$$

  where, C is cost, X is output, P_F is price of factor, T is technology, and $\bar{K}$ is fixed factor capital.

- ➢ A long-run cost function can be expressed as:

$$\mathbf{c=f(X, P_F, T)}$$