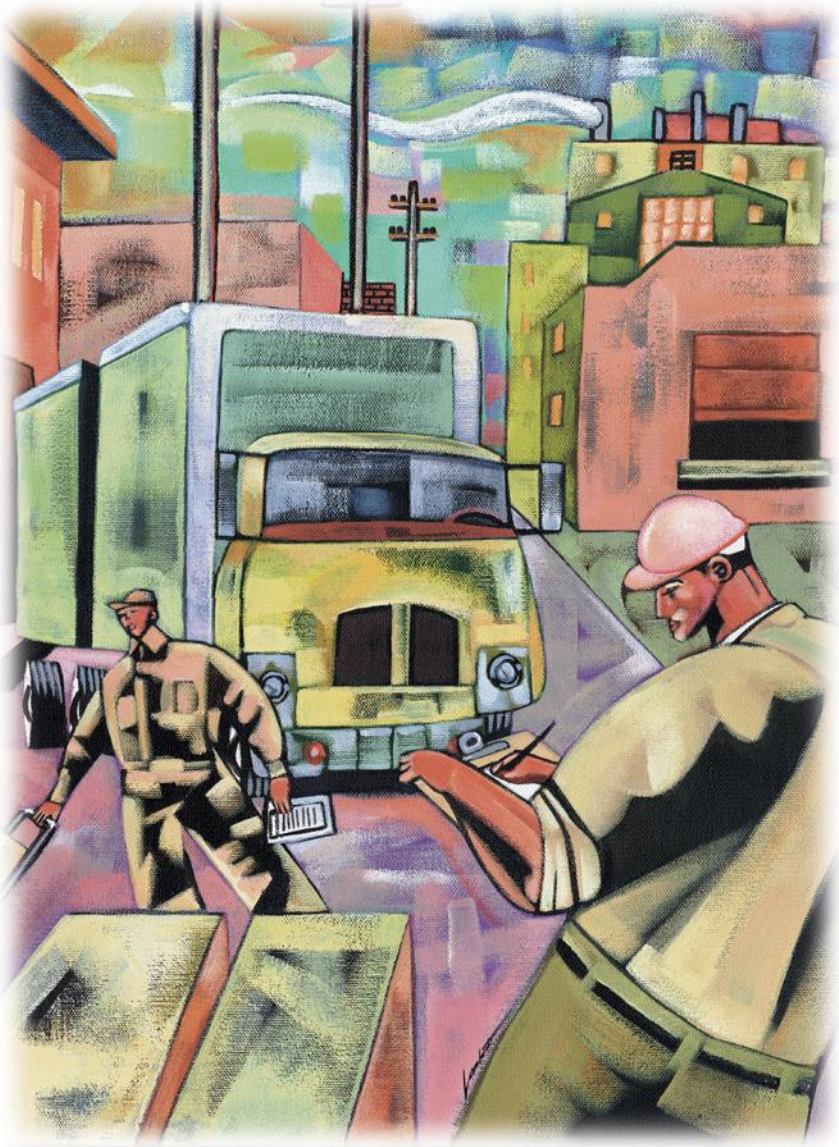


Chapter 13

The Cost of Production

In this chapter you will…

- Examine what items are included in a firm's costs of production.
- Analyze the link between a firm's production process and its total costs.
- Learn the meaning of average total cost and marginal cost and how they are related.
- Consider the shape of a typical firm's cost curves.
- Examine the relationship between short-run and long run costs.

THE COSTS OF PRODUCTION

- *Supply* and *demand* are the two words that economists use most often.
- *Supply* and *demand* are the forces that make market economies work.
- Modern microeconomics is about supply, demand, and market equilibrium.

THE COSTS OF PRODUCTION

- According to the Law of Supply:
  - Firms are willing to produce and sell a greater quantity of a good when the price of the good is high.
  - This results in a supply curve that slopes upward.
- The Firm's Objective
  - The economic goal of the firm is to maximize profits.

Total Revenue, Total Costs, and Profit

- *Total Revenue*
  - The amount a firm receives for the sale of its output.
- *Total Cost*
  - The market value of the inputs a firm uses in production.
- *Profit*
  - The firm's total revenue minus its total cost.

Profit = Total revenue - Total cost

Cost as an Opportunity Cost

- A firm's *cost of production* includes all the opportunity costs of making its output of goods and services.
- Explicit and Implicit Costs
  - A firm's cost of production include explicit costs and implicit costs.
    - *Explicit* costs are input costs that require a direct outlay of money by the firm.
    - *Implicit* costs are input costs that do not require an outlay of money by the firm.

Cost as an Opportunity Cost

- Example:
- Helen uses $300 000 of her savings to buy her cookie factory from the previous owner.
- If she had left her money in a savings account that pays an interest at a rate of 5 percent, she would have earned $15 000 a year.
- Helen by buying a cookie factory has foregone $15 000 a year in interest income.
- This foregone $15 000 is an implicit opportunity cost of Helen's business.
- The accountant will not show this cost.

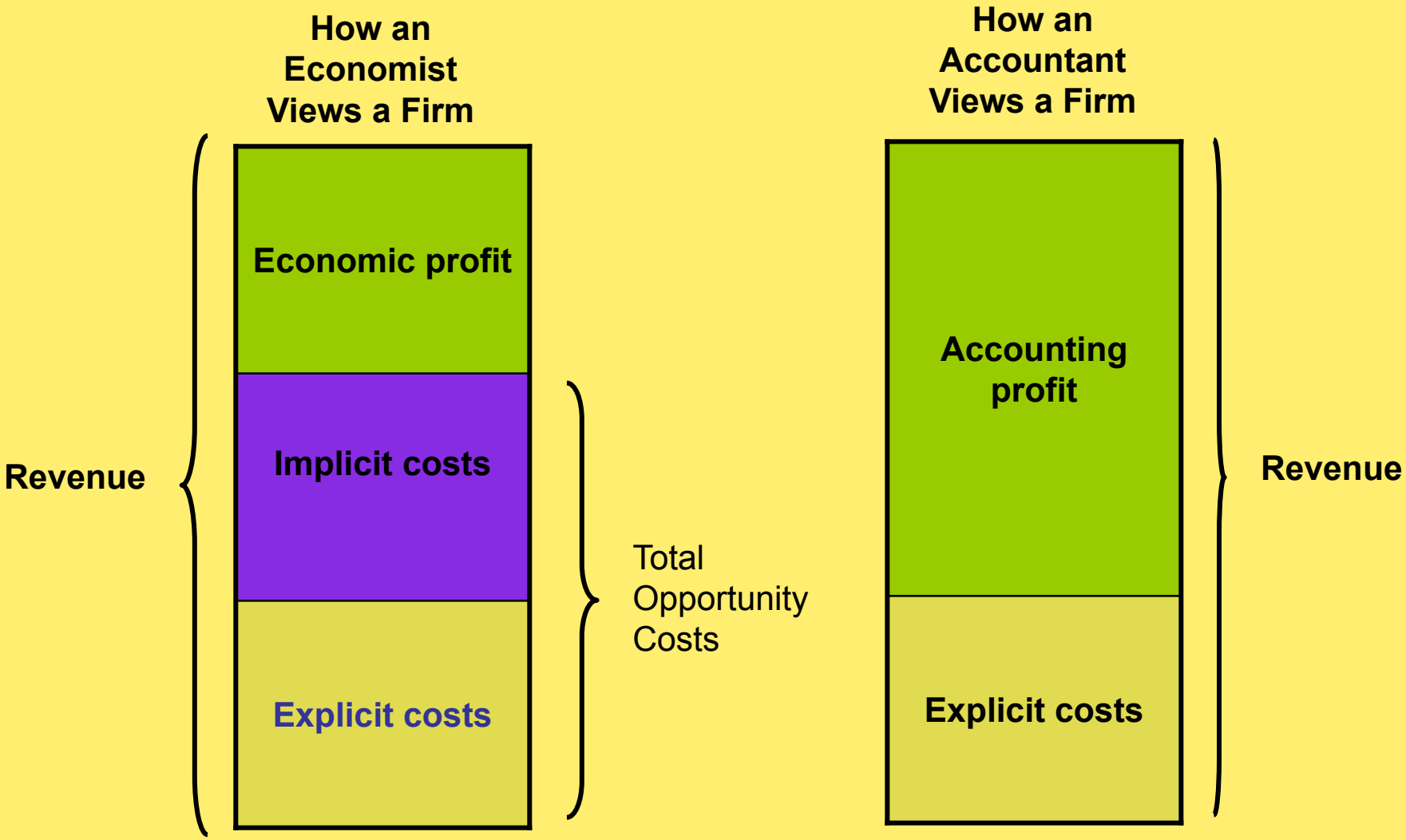
Economic Profit versus Accounting Profit

- Economists measure a firm's *economic profit* as total revenue minus total cost, including both explicit and implicit costs.
- Accountants measure the *accounting profit* as the firm's total revenue minus only the firm's explicit costs.

Economic Profit Versus Accounting Profit

- When total revenue exceeds both explicit and implicit costs, the firm earns economic profit.
  - Economic profit is smaller than accounting profit.

Figure 13-1: Economists versus Accountants



PRODUCTION AND COSTS

- Assumption: The size of Helen's cookie factory is fixed and the quantity of cookies produced can only vary by changing the number of workers.
- This assumption is realistic in the short-run but not the long-run.

Table 13-1: A Production Function and Total Cost: Hungry Helen's Cookie Factory

Number of workers	Output (quantity of cookies produced per hour)	Marginal product of labour	Cost of factory	Cost of worker	Total cost of inputs (cost of factory + cost of workers)
0	0		$30	$0	$30
		50			
1	50		30	10	40
		40			
2	90		30	20	50
		30			
3	120		30	30	60
		20			
4	140		30	40	70
		10			
5	150		30	50	80

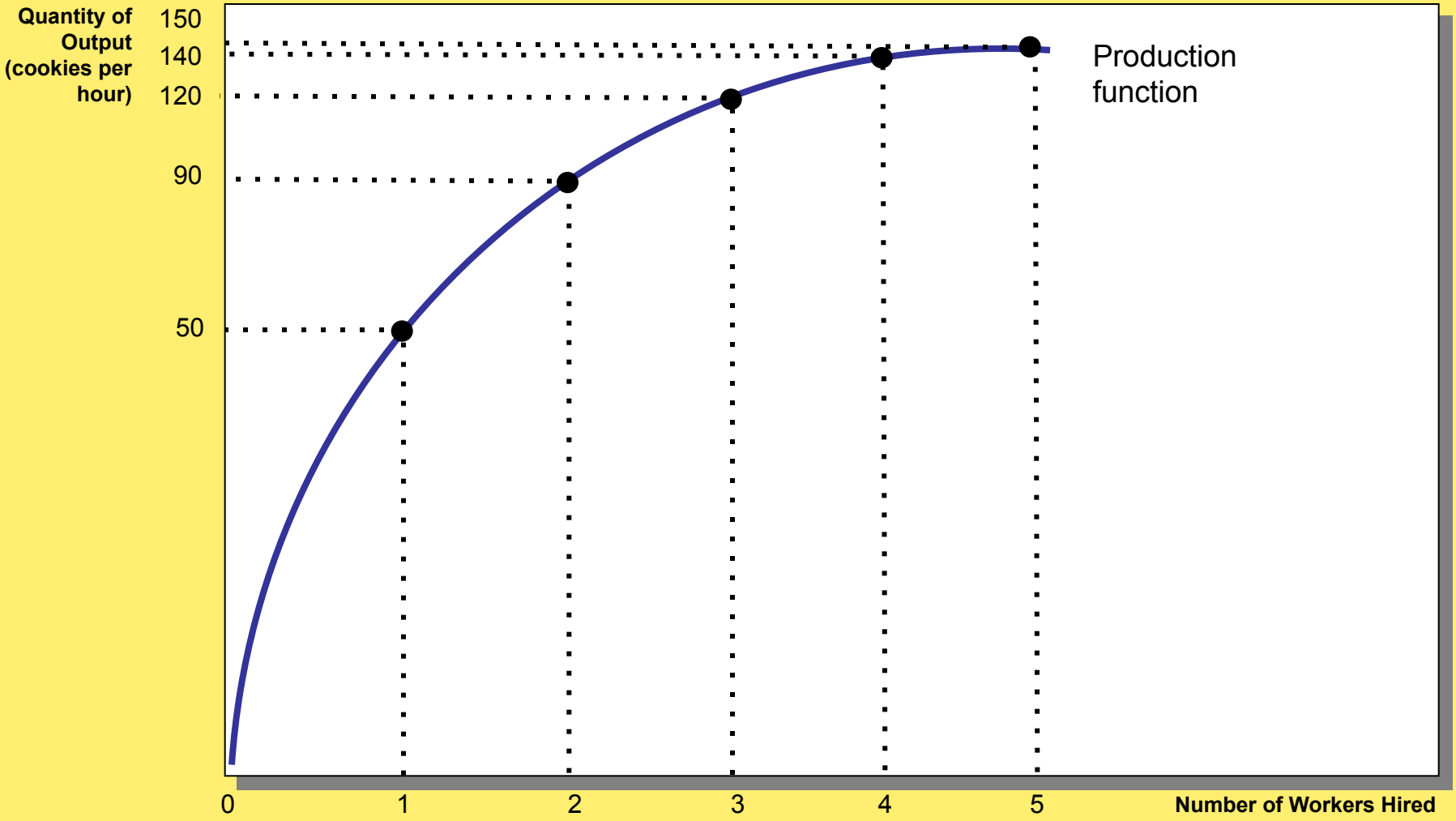
PRODUCTION AND COSTS

- The Production Function
  - The *production function* shows the relationship between quantity of inputs used to make a good and the quantity of output of that good.
- Marginal Product
  - The *marginal product* of any input in the production process is the increase in output that arises from an additional unit of that input.

PRODUCTION AND COSTS

- Diminishing Marginal Product
  - *Diminishing marginal product* is the property whereby the marginal product of an input declines as the quantity of the input increases.
    - Example: As more and more workers are hired at a firm, each additional worker contributes less and less to production because the firm has a limited amount of equipment.

Figure 13-2: Hungry Helen's Production Function



PRODUCTION AND COSTS

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    - Example: As more and more workers are hired at a firm, each additional worker contributes less and less to production because the firm has a limited amount of equipment.

PRODUCTION AND COSTS

- Diminishing Marginal Product
  - The slope of the production function measures the marginal product of an input, such as a worker.
  - When the marginal product declines, the production function becomes flatter.

From the Production Function to the Total-Cost Curve

- The relationship between the quantity a firm can produce and its costs determines pricing decisions.
- See last three columns in Table 13-1.
- The *total-cost curve* shows this relationship graphically.

Table 13-1: A Production Function and Total Cost: Hungry Helen's Cookie Factory

Number of workers	Output (quantity of cookies produced per hour)	Marginal product of labour	Cost of factory	Cost of worker	Total cost of inputs (cost of factory + cost of workers)
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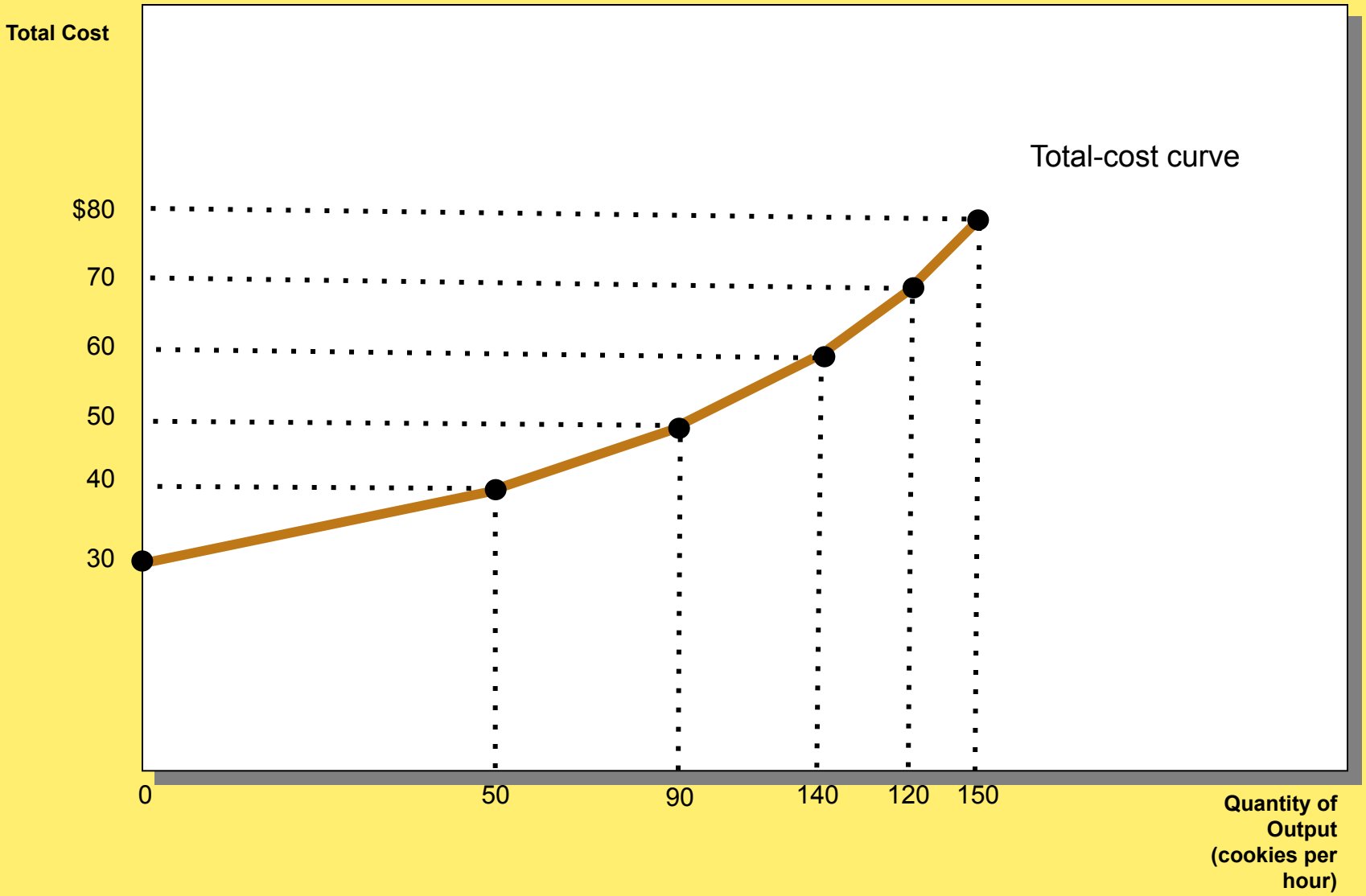
		50			
1	50		30	10	40
		40			
2	90		30	20	50
		30			
3	120		30	30	60
		20			
4	140		30	40	70
		10			
5	150		30	50	80

Figure 13-3: Hungry Helen's Total-Cost Curve



THE VARIOUS MEASURES OF COST

- Costs of production may be divided into *fixed costs* and *variable costs*.
- *Fixed costs* are those costs that do *not* vary with the quantity of output produced.
- *Variable costs* are those costs that *do vary* with the quantity of output produced.

THE VARIOUS MEASURES OF COST

- Total Costs
  - Total Fixed Costs (*TFC*)
  - Total Variable Costs (*TVC*)
  - Total Costs (*TC*)
  - $TC = TFC + TVC$

THE VARIOUS MEASURES OF COST

- Average Costs
  - Average costs can be determined by dividing the firm's costs by the quantity of output it produces.
  - The average cost is the cost of each typical unit of product.

THE VARIOUS MEASURES OF COST

- Average Costs
  - Average Fixed Costs (*AFC*)
  = ATC / Q
  - Average Variable Costs (*AVC*)
  = AVC / Q
  - Average Total Costs (*ATC*)
  = ATC / Q
  - *ATC = AFC + AVC*

THE VARIOUS MEASURES OF COST

- Marginal Cost
  - *Marginal cost* (*MC*) measures the increase in total cost that arises from an extra unit of production.
  - Marginal cost helps answer the following question:
    - How much does it cost to produce an additional unit of output?

THE VARIOUS MEASURES OF COST

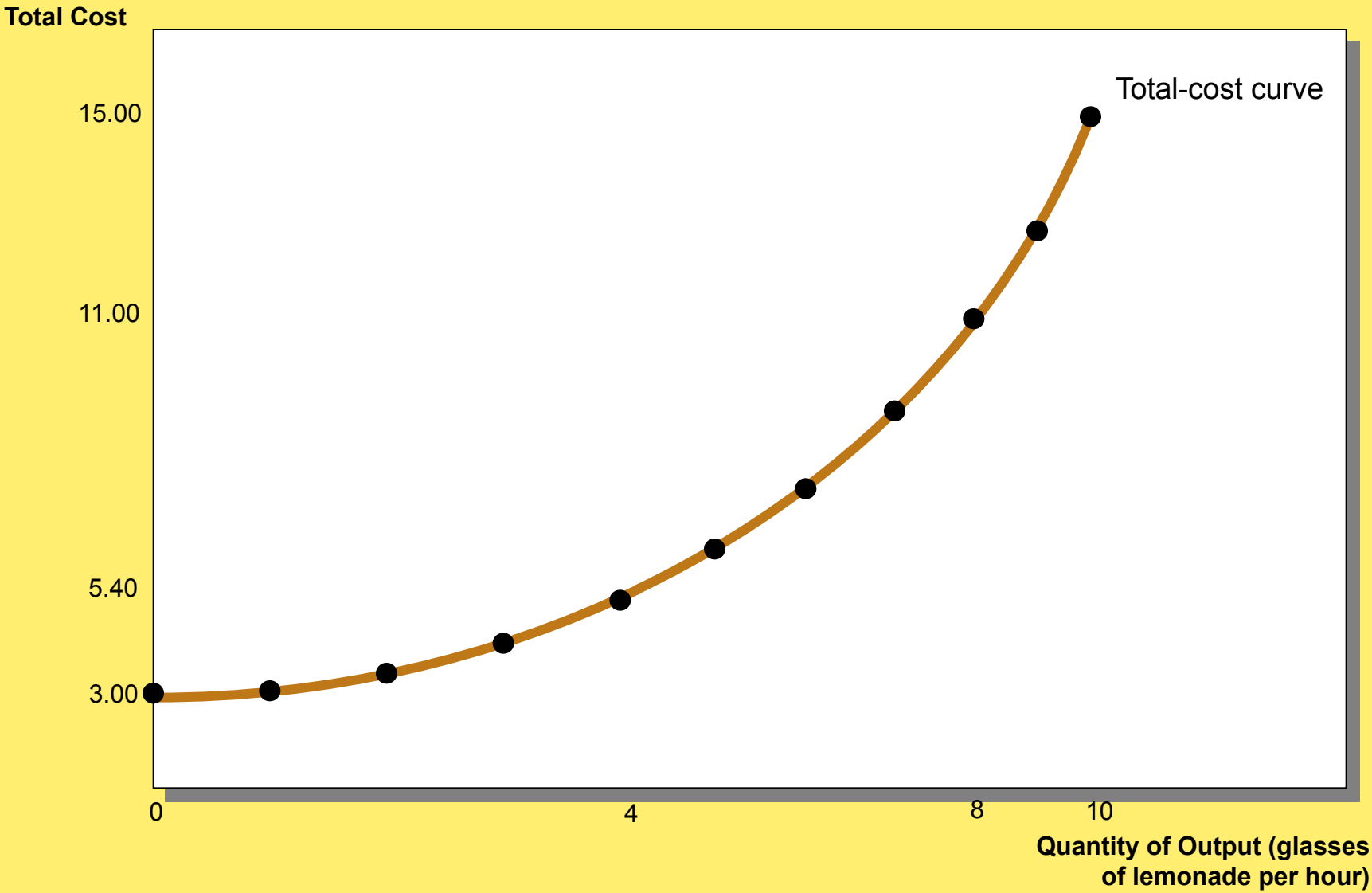
- Marginal Cost
  - *Marginal cost* (*MC*) measures the increase in total cost that arises from an extra unit of production.
  - Marginal cost helps answer the following question:
    - How much does it cost to produce an additional unit of output?

$$MC = \frac{(\text{change in total cost})}{(\text{change in quantity})} = \frac{\Delta TC}{\Delta Q}$$

Table 13-2: The Various Measures of Cost: Thirsty Thelma's Lemonade Stand

Quantity of lemonade (Glasses per hour)	Total Cost	Fixed Cost	Variable Cost	Average Fixed Cost	Average Variable Cost	Average Total Cost	Marginal Cost
0	$ 3.00	$ 3.00	$ 0.00	---------	---------	---------	
							0.30
1	3.30	3.00	0.30	$ 3.00	$ 0.30	$ 3.30	
							0.50
2	3.80	3.00	0.80	1.50	0.40	1.90	
							0.70
3	4.50	3.00	1.50	1.00	0.50	1.50	
							0.90
4	5.40	3.00	2.40	0.75	0.60	1.35	
							1.10
5	6.50	3.00	3.50	0.60	0.70	1.30	
							1.30
6	7.80	3.00	4.80	0.50	0.80	1.30	
							1.50
7	9.30	3.00	6.30	0.43	0.90	1.33	
							1.70
8	11.00	3.00	8.00	0.38	1.00	1.38	
							1.90
9	12.90	3.00	9.90	0.33	1.10	1.43	
							2.10
10	15.00	3.00	12.00	0.30	1.20	1.50	

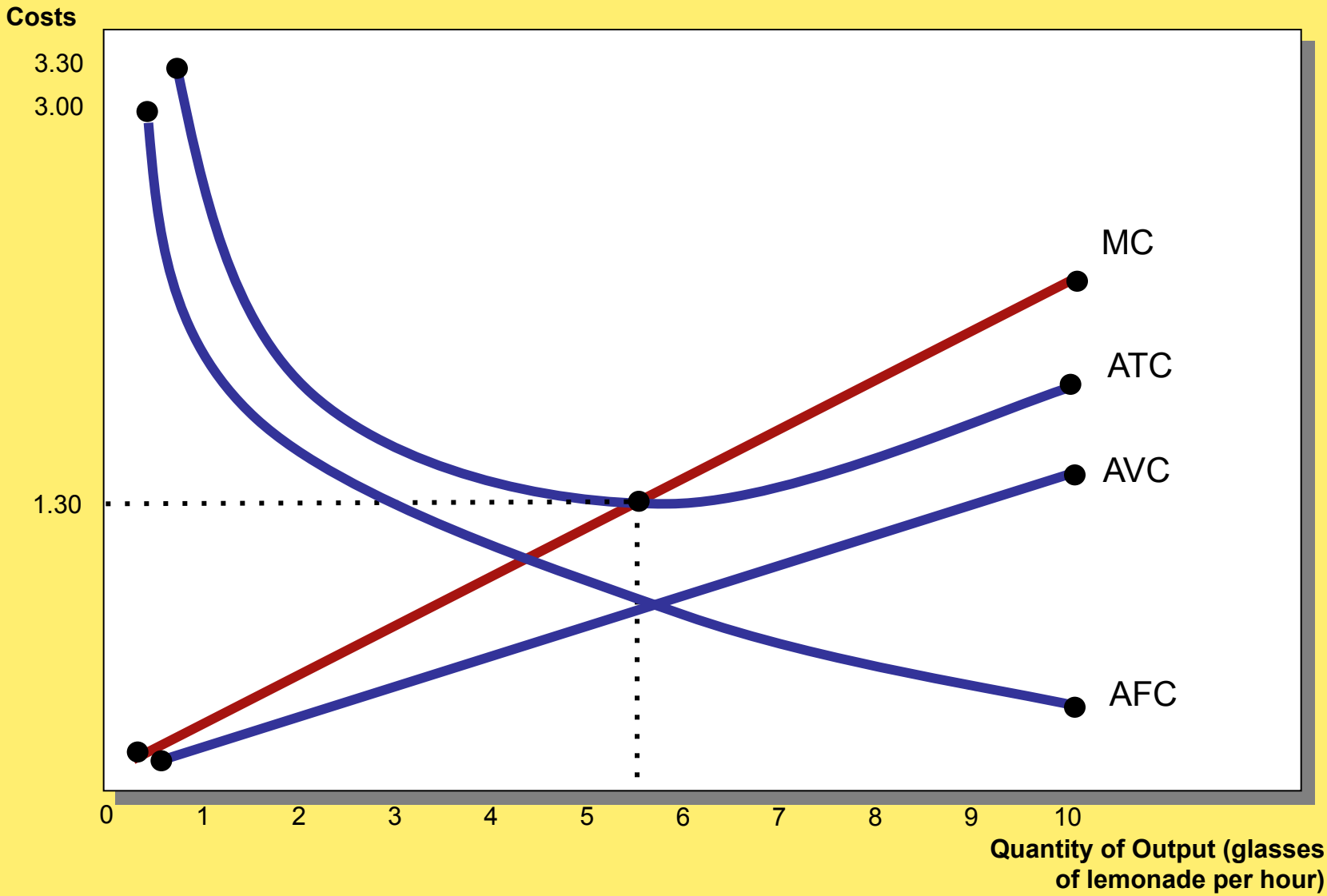
Figure 13-4: Thirsty Thelma's Total-Cost Curve



Cost Curves and their Shapes

- The cost curves shown here for Thirsty Thelma's Lemonade Stand have some features that are common to the cost curves of many firms in the economy.
- Lets examine three features in particular:
  - The shape of the marginal cost curve
  - The shape of the average cost curve
  - The relationship between marginal and average total cost

Figure 13-5: Thirsty Thelma's Average-Cost and Marginal-Cost Curves



Cost Curves and their Shapes

- Marginal cost rises with the amount of output produced.
  - This reflects the property of *diminishing marginal product*.
- The average total-cost curve is *U-shaped*.
- At very low levels of output average total cost is high because fixed cost is spread over only a few units.
- Average total cost declines as output increases.
- Average total cost starts rising because average variable cost rises substantially.

Cost Curves and their Shapes

- The bottom of the U-shaped *ATC* curve occurs at the quantity that *minimizes average total cost*. This quantity is sometimes called the *efficient scale* of the firm.
- Relationship between Marginal Cost and Average Total Cost
  - Whenever marginal cost is less than average total cost, average total cost is falling.
  - Whenever marginal cost is greater than average total cost, average total cost is rising.
  - The marginal-cost curve crosses the average-total-cost curve at the efficient scale.

Typical Cost Curves

- In the previous examples, the firms exhibit diminishing marginal product and, therefore, rising marginal cost at all levels of output.
- Actual firms are often a bit more complicated than this. E.g., diminishing marginal product does not start after the first worker id hired.
- Table 13-3 shows such a firm.

Table 13-3: The Various Measures of Cost: Big Bob's Bagel Bin

Quantity of IBagels (per hour)	Total Cost	Fixed Cost	Variable Cost	Average Fixed Cost	Average Variable Cost	Average Total Cost	Marginal Cost
0	$ 2.00	$ 2.00	$ 0.00	---------	---------	---------	
1	3.00	2.00	1.00	$ 2.00	$ 1.00	$ 3.00	1.00
2	3.80	2.00	1.80	1.00	0.90	1.90	0.80
3	4.40	2.00	2.40	0.67	0.80	1.47	0.60
4	5.20	2.00	2.80	0.50	0.70	1.20	0.40
5	5.80	2.00	3.20	0.40	0.64	1.04	0.40
6	6.60	2.00	3.80	0.33	0.63	0.96	0.60
7	7.60	2.00	4.60	0.29	0.66	0.95	0.80
8	8.80	2.00	5.60	0.25	0.70	0.98	1.00
9	10.20	2.00	6.80	0.22	0.76	1.02	1.20
10	11.80	2.00	8.20	0.20	0.82	1.07	1.40

Figure 13-6a): Big Bob's Cost Curves

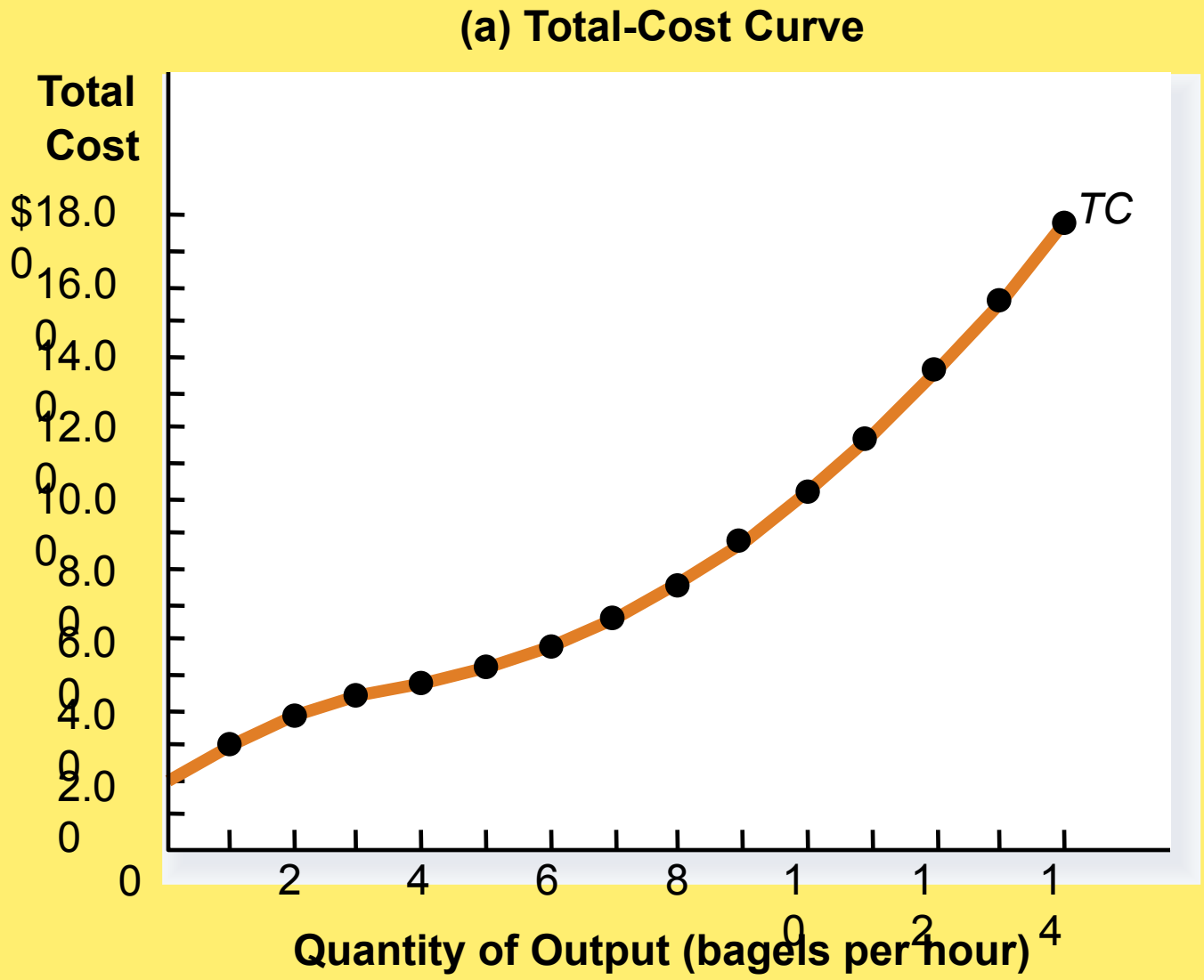
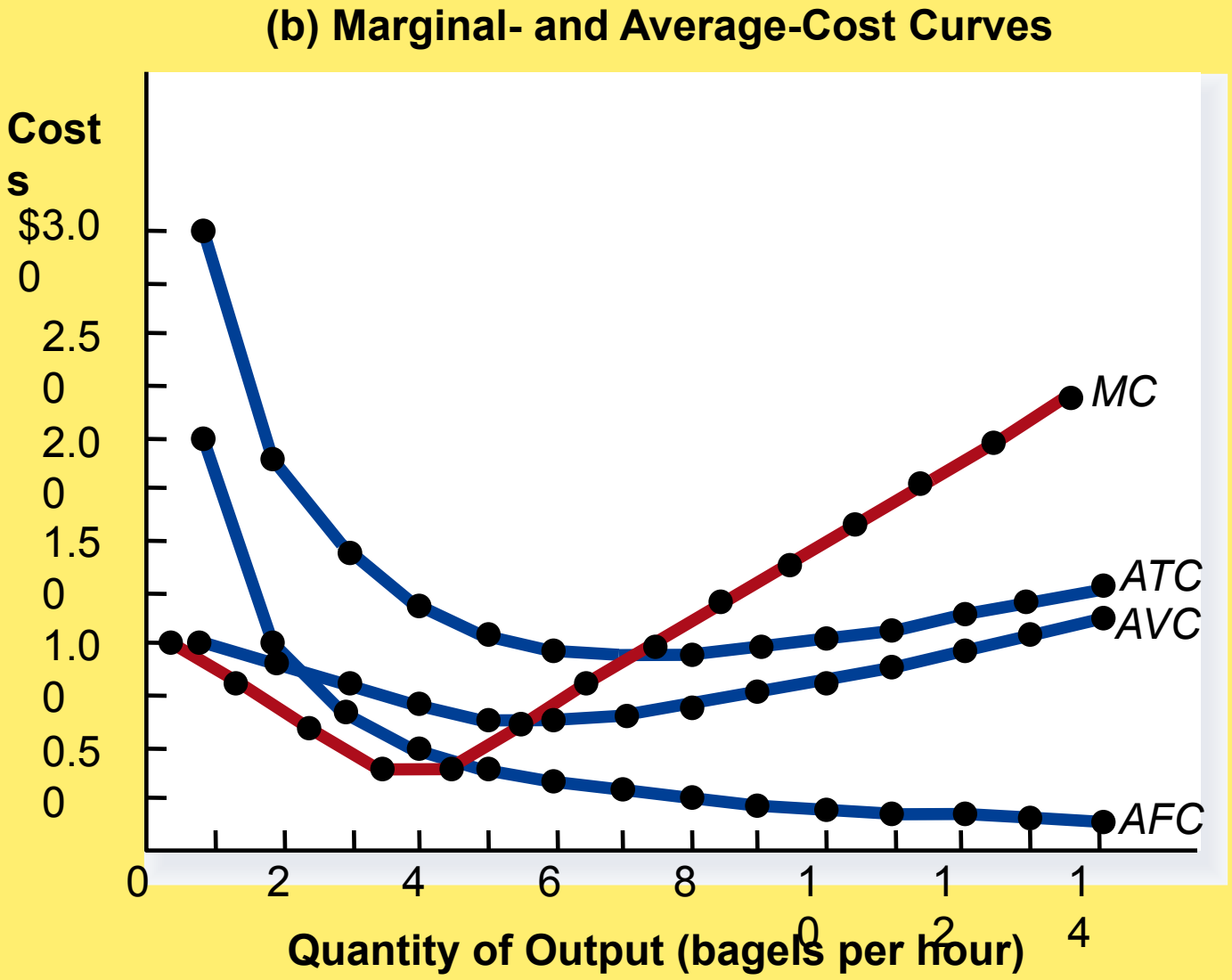


Figure 13-6b): Big Bob's Cost Curves



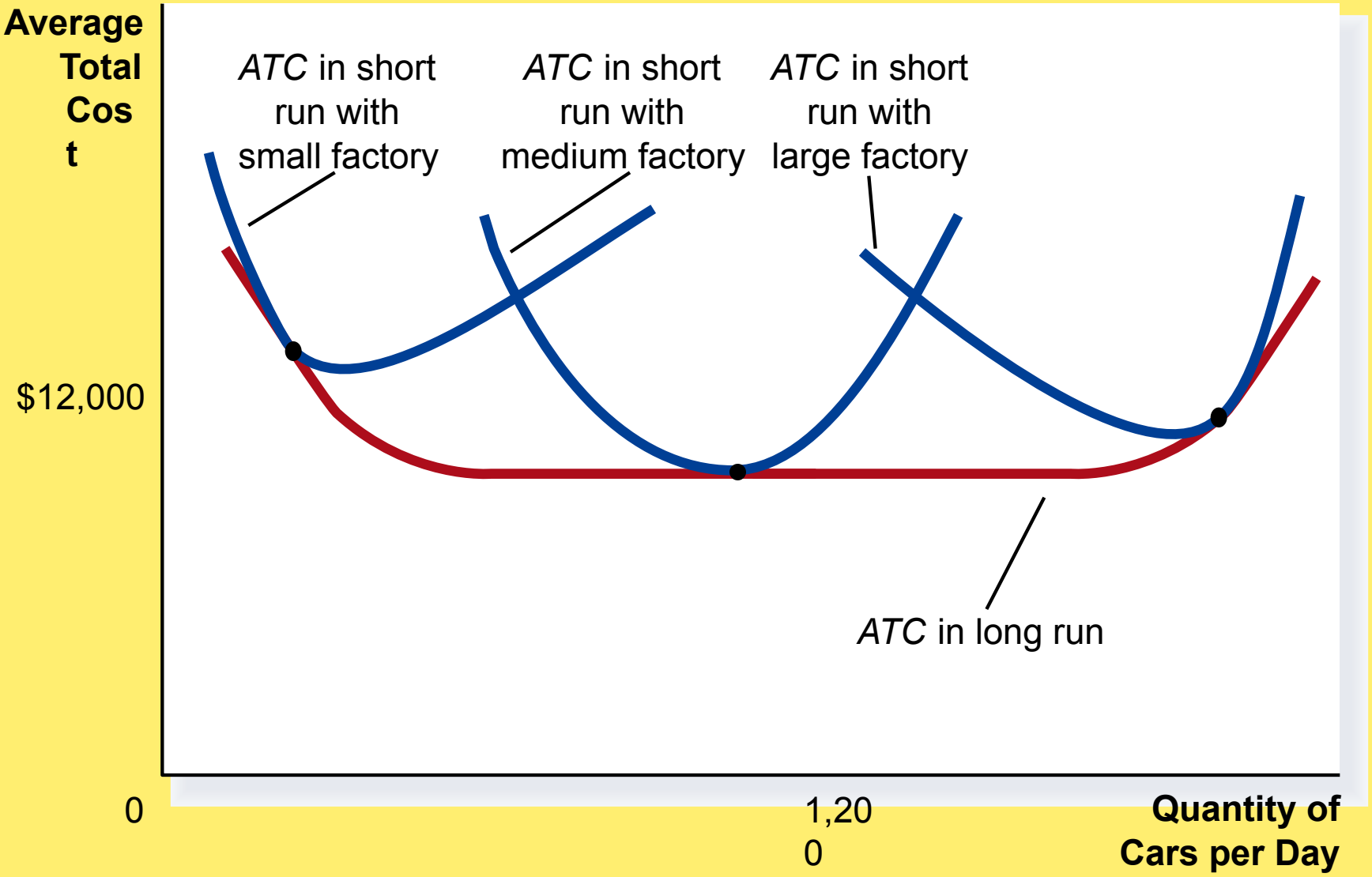
Typical Cost Curves

- Three Important Properties of Cost Curves
  - Marginal cost eventually rises with the quantity of output.
  - The average-total-cost curve is U-shaped.
  - The marginal-cost curve crosses the average-total-cost curve at the minimum of average total cost.

THE RELATIONSHIP BETWEEN THE SHORT RUN AND THE LONG RUN

- For many firms, the division of total costs between fixed and variable costs depends on the time horizon being considered.
  - In the short run, some costs are fixed.
  - In the long run, fixed costs become variable costs.
- Because many costs are fixed in the short run but variable in the long run, a firm's long-run cost curves differ from its short-run cost curves.

Figure 13-7: Average Total Cost in the Short and Long Runs



Economies and Diseconomies of Scale

- *Economies of scale* refer to the property whereby long-run average total cost falls as the quantity of output increases.
- *Diseconomies of scale* refer to the property whereby long-run average total cost rises as the quantity of output increases.
- *Constant returns to scale* refers to the property whereby long-run average total cost stays the same as the quantity of output increases

Summary

- The goal of firms is to maximize profit, which equals total revenue minus total cost.
- When analyzing a firm's behavior, it is important to include all the opportunity costs of production.
- Some opportunity costs are explicit while other opportunity costs are implicit.

Summary

- A firm's costs reflect its production process.
- A typical firm's production function gets flatter as the quantity of input increases, displaying the property of diminishing marginal product.

Summary

- A firm's total costs are divided between fixed and variable costs. Fixed costs do not change when the firm alters the quantity of output produced; variable costs do change as the firm alters quantity of output produced.
- Average total cost is total cost divided by the quantity of output.

Summary

- Marginal cost is the amount by which total cost would rise if output were increased by one unit.
- The marginal cost always rises with the quantity of output.
- Average cost first falls as output increases and then rises.

Summary

- The average-total-cost curve is U-shaped.
- The marginal-cost curve always crosses the average-total-cost curve at the minimum of ATC.
- A firm's costs often depend on the time horizon being considered.
- In particular, many costs are fixed in the short run but variable in the long run.

The End