CHAPTER SEVEN
Theory of Costs

7.1 INTRODUCTION

Costs are expenses of a firm and are derived from a production function. Costs to a firm are the rewards by a firm to the different factors of production that are employed by the firm. So economic costs of any input factor is the payment required to keep that factor in its present employment. Cost curves show the minimum costs of producing the various levels of output. Costs are subdivided into; implicit and explicit costs.

7.1.1 Implicit costs

These are basically social costs. They are those kind of costs that cannot be included in the computation of the firms profits. This is so because, such costs cannot be easily monetized these costs include; noise opportunity costs, time wasted etc.

7.1.2 Explicit cost

This refers to the actual expenditure of a firm that is incurred when purchasing the input factors. These include costs on; raw materials, labour, energy, transport and others. Explicit costs include both fixed costs and variable costs. Supposing a firm employs labour and capital in a production process, then a general cost function can be expressed as:

$C = a + P_L L + P_K K$ where

a: is the fixed cost

P_L is the price of labour

P_K is the price of capital

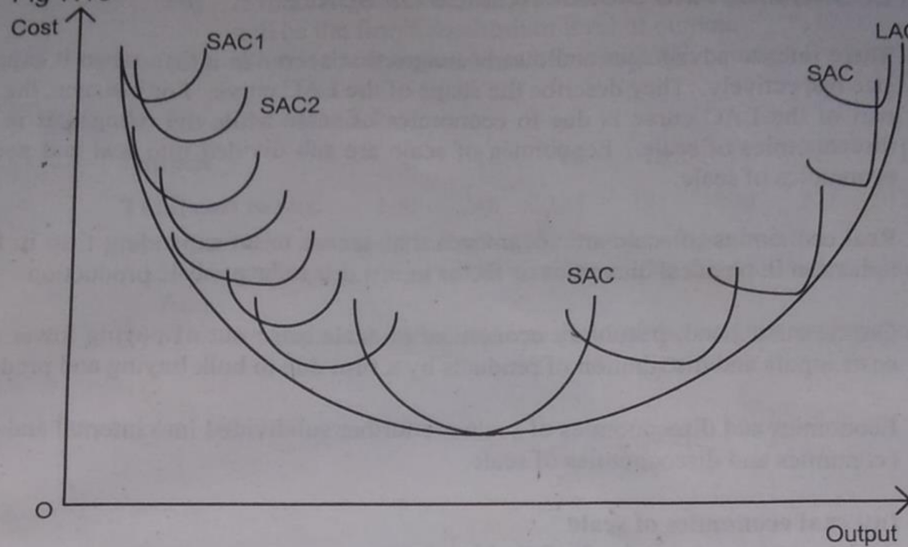
L and K are amount of labour and capital respectively.

7.2 FIXED COSTS (FC)

Traditional economic theory distinguishes between the shortrun and longrun period s. Shortrun period is a period during which some factors are fixed while others are variable. In the longrun however, all factors become variable.

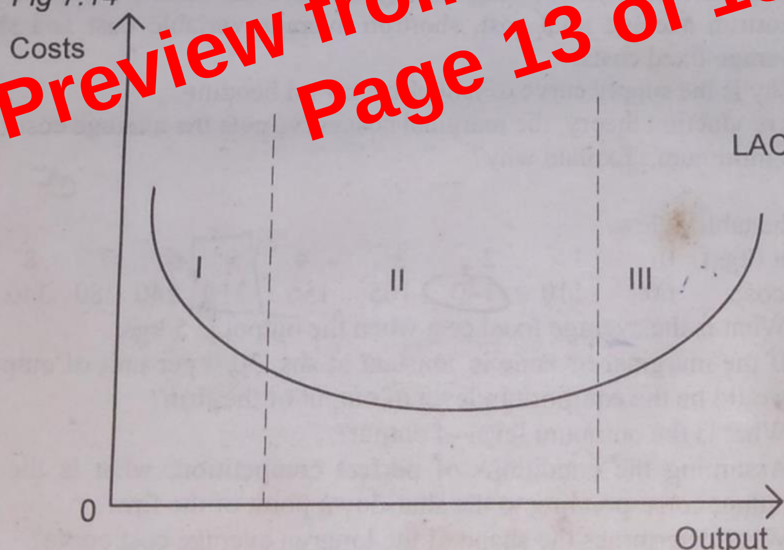
Fixed costs are therefore those costs incurred regardless of the level of output. Fixed costs are at times referred to as supplementary or indirect cost. Such costs include; land rent, house rent, depreciation, salary of top managers, insurance premium and interest. The fixed cost curve is therefore horizontal.

Fig 7.13



Indeed a LAC curve is an envelope curve, for it envelopes all the SAC curves. A LAC curve is U-Shaped and this is due to economies and diseconomies of scale. There are advantages and disadvantages of large scale production respectively, economies are part of returns to scale which on the other hand refers to the changes in output as all factor inputs change in the same proportion. The LAC curve can be divided into three parts.

Fig 7.14



In the first region, average cost is falling as the firm expands its output. This is due to economies of scale. In this region, we have increasing returns to scale. In the second region, there average cost is not changing yet output is increasing. Here we have constant returns to scale. In the third region, output is increasing at increasing average cost. This is due to diseconomies of scale. In this region, we have diminishing returns to scale.