Marginal Cost

Figure 11.4 shows that total variable cost and total cost increase at a decreasing rate at small outputs but eventually, as output increases, total variable cost and total cost increase at an increasing rate. To understand this pattern in the change in total cost as output increases, we need to use the concept of *marginal cost*.

A firm's **marginal cost** is the increase in total cost that results from a one-unit increase in output. We calculate marginal cost as the increase in total cost divided by the increase in output. The table in Fig. 11.5 shows this calculation. When, for example, output increases from 10 sweaters to 13 sweaters, total cost increases from $75 to $100. The change in output is 3 sweaters, and the change in total cost is $25. The marginal cost of one of those 3 sweaters is ($25 ÷ 3), which equals $8.33.

Figure 11.5 graphs the marginal cost data in the table as the red marginal cost curve, *MC*. This curve is U-shaped because when Campus Sweaters hires a second worker, marginal cost decreases, but when it hires a third, a fourth, and a fifth worker, marginal cost successively increases.

At small outputs, marginal cost decreases as output increases because of greater specialization and the division of labor. But as output increases further, marginal cost eventually increases because of the *law of diminishing returns*. The law of diminishing returns means that the output produced by each additional worker is successively smaller. To produce an additional unit of output, ever more workers are required, and the cost of producing the additional unit of output—marginal cost—must eventually increase.

Marginal cost tells us how total cost changes as output increases. The final cost concept tells us what it costs, on average, to produce a unit of output. Let's now look at Campus Sweaters' average costs.

Average Cost

Three average costs of production are

1. Average fixed cost
2. Average variable cost
3. Average total cost

Average fixed cost (*AFC*) is total fixed cost per unit of output. **Average variable cost** (*AVC*) is total variable cost per unit of output. **Average total cost** (*ATC*) is total cost per unit of output. The average cost concepts are calculated from the total cost concepts as follows:

$$TC = TFV + TVC.$$

Divide each total cost term by the quantity produced, Q, to get

$$\frac{TC}{Q} = \frac{TFC}{Q} + \frac{TVC}{Q},$$

or

$$ATC = AFC + AVC.$$

The table in Fig. 11.5 shows the calculation of average total cost. For example, in row *C*, output is 10 sweaters. Average fixed cost is ($25 ÷ 10), which equals $2.50, average variable cost is ($50 ÷ 10), which equals $5.00, and average total cost is ($75 ÷ 10), which equals $7.50. Note that average total cost is equal to average fixed cost ($2.50) plus average variable cost ($5.00).

Figure 11.5 shows the average cost curves. The green average fixed cost curve (*AFC*) slopes downward. As output increases, the same constant total fixed cost is spread over a larger output. The blue average total cost curve (*ATC*) and the purple average variable cost curve (*AVC*) are U-shaped. The vertical distance between the average total cost and average variable cost curves is equal to average fixed cost—as indicated by the two arrows. That distance shrinks as output increases because average fixed cost declines with increasing output.

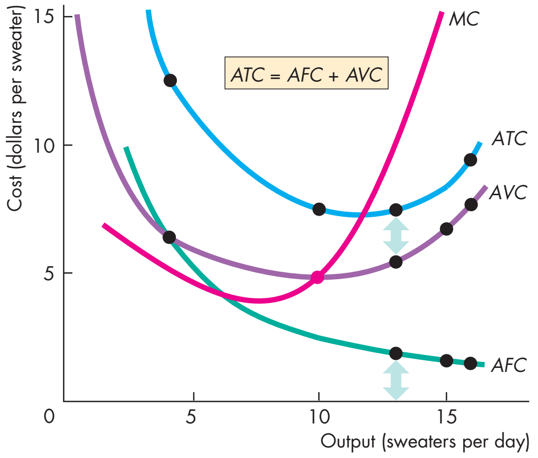
Marginal Cost and Average Cost

The marginal cost curve (*MC*) intersects the average variable cost curve and the average total cost curve *at their minimum points*. When marginal cost is less than average cost, average cost is decreasing, and when marginal cost exceeds average cost, average cost is increasing. This relationship holds for both the *ATC* curve and the *AVC* curve. It is another example of the relationship you saw in Fig. 11.3 for average product and marginal product and in your average and marginal grades.

Why the Average Total Cost Curve Is U-Shaped

Average total cost is the sum of average fixed cost and average variable cost, so the shape of the *ATC* curve

FIGURE 11.5 Marginal Cost and Average Costs



Marginal cost is calculated as the change in total cost divided by the change in output. When output increases from 4 to 10 sweaters, an increase of 6 sweaters, total cost increases by \$25. Marginal cost is \$25 ÷ 6, which is \$4.17.

Each average cost concept is calculated by dividing the related total cost by output. When 10 sweaters are produced, *AFC* is \$2.50 (\$25 ÷ 10), *AVC* is \$5 (\$50 ÷ 10), and *ATC* is \$7.50 (\$75 ÷ 10).

The graph shows that the *MC* curve is U-shaped and intersects the *AVC* curve and the *ATC* curve at their minimum points. The average fixed cost curve (*AFC*) is downward sloping. The *ATC* curve and *AVC* curve are U-shaped. The vertical distance between the *ATC* curve and the *AVC* curve is equal to average fixed cost, as illustrated by the two arrows.

	Labor (workers per day)	Output (sweaters per day)	Total fixed cost (*TFC*) (dollars per day)	Total variable cost (*TVC*) (dollars per day)	Total cost (*TC*) (dollars per day)	Marginal cost (*MC*) (dollars per additional sweater)	Average fixed cost (*AFC*) (dollars per sweater)	Average variable cost (*AVC*) (dollars per sweater)	Average total cost (*ATC*) (dollars per sweater)
A	0	0	25	0	25		—	—	—
						6.25			
B	1	4	25	25	50		6.25	6.25	12.50
						4.17			
C	2	10	25	50	75		2.50	5.00	7.50
						8.33			
D	3	13	25	75	100		1.92	5.77	7.69
						12.50			
E	4	15	25	100	125		1.67	6.67	8.33
						25.00			
F	5	16	25	125	150		1.56	7.81	9.38

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combines the shapes of the *AFC* and *AVC* curves. The U shape of the *ATC* curve arises from the influence of two opposing forces:

1. Spreading total fixed cost over a larger output
2. Eventually diminishing returns

When output increases, the firm spreads its total fixed cost over a larger output and so its average fixed cost decreases—its *AFC* curve slopes downward.

Diminishing returns means that as output increases, ever-larger amounts of labor are needed to produce an additional unit of output. So as output increases, average variable cost decreases initially but eventually increases, and the *AVC* curve slopes upward. The *AVC* curve is U shaped.

The shape of the *ATC* curve combines these two effects. Initially, as output increases, both average fixed cost and average variable cost decrease, so average total cost decreases. The *ATC* curve slopes downward.

But as output increases further and diminishing returns set in, average variable cost starts to increase. With average fixed cost decreasing more quickly than average variable cost is increasing, the *ATC* curve continues to slope downward. Eventually, average variable cost starts to increase more quickly than average fixed cost decreases, so average total cost starts to increase. The *ATC* curve slopes upward.

Cost Curves and Product Curves

The technology that a firm uses determines its costs. Figure 11.6 shows the links between the firm's product curves and its cost curves. The upper graph shows the average product curve, *AP,* and the marginal product curve, *MP*—like those in Fig. 11.3. The lower graph shows the average variable cost curve, *AVC*, and the marginal cost curve, *MC*—like those in Fig. 11.5.

As labor increases up to 1.5 workers a day (upper graph), output increases to 6.5 sweaters a day (lower graph). Marginal product and average product rise and marginal cost and average variable cost fall. At the point of maximum marginal product, marginal cost is at a minimum.

As labor increases from 1.5 workers to 2 workers a day, (upper graph) output increases from 6.5 sweaters to 10 sweaters a day (lower graph). Marginal product falls and marginal cost rises, but average product continues to rise and average variable cost continues to fall. At the point of maximum average product, average variable cost is at a minimum. As labor increases further, output increases. Average product diminishes and average variable cost increases.

Shifts in the Cost Curves

The position of a firm's short-run cost curves depends on two factors:

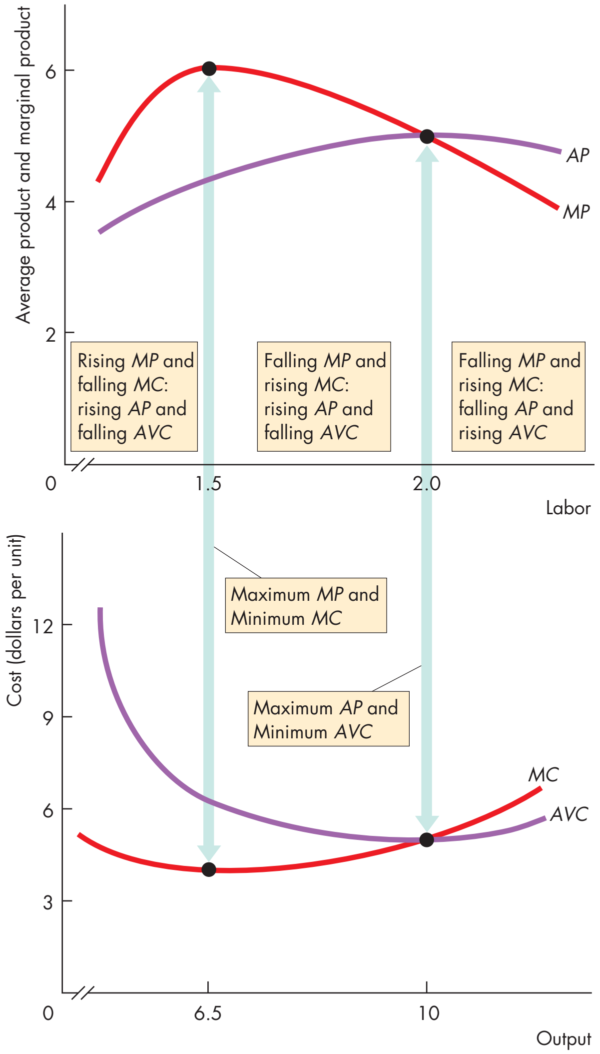
- Technology
- Prices of factors of production

Technology A technological change that increases productivity increases the marginal product and average product of labor. With a better technology, the same factors of production can produce more output, so the technological advance lowers the costs of production and shifts the cost curves downward.

For example, advances in robot production techniques have increased productivity in the automobile industry. As a result, the product curves of Chrysler, Ford, and GM have shifted upward and their cost curves have shifted downward. But the relationships between their product curves and cost curves have not changed. The curves are still linked in the way shown in Fig. 11.6.

Often, as in the case of robots producing cars, a technological advance results in a firm using more capital, a fixed factor, and less labor, a variable factor.

FIGURE 11.6 Product Curves and Cost Curves



A firm's *MP* curve is linked to its *MC* curve. If, as the firm increases its labor from 0 to 1.5 workers a day, the firm's marginal product rises, its marginal cost falls. If marginal product is at a maximum, marginal cost is at a minimum. If, as the firm hires more labor, its marginal product diminishes, its marginal cost rises.

A firm's *AP* curve is linked to its *AVC* curve. If, as the firm increases its labor to 2 workers a day, its average product rises, its average variable cost falls. If average product is at a maximum, average variable cost is at a minimum. If, as the firm hires more labor, its average product diminishes, its average variable cost rises.

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TABLE 11.2 A Compact Glossary of Costs

Term	Symbol	Definition	Equation
Fixed cost		Cost that is independent of the output level; cost of a fixed factor of production	
Variable cost		Cost that varies with the output level; cost of a variable factor of production	
Total fixed cost	*TFC*	Cost of the fixed factors of production	
Total variable cost	*TVC*	Cost of the variable factors of production	
Total cost	*TC*	Cost of all factors of production	$TC = TFC + TVC$
Output (total product)	*TP*	Total quantity produced (output *Q*)	
Marginal cost	*MC*	Change in total cost resulting from a one-unit increase in total product	$MC = \Delta TC \div \Delta Q$
Average fixed cost	*AFC*	Total fixed cost per unit of output	$AFC = TFC \div Q$
Average variable cost	*AVC*	Total variable cost per unit of output	$AVC = TVC \div Q$
Average total cost	*ATC*	Total cost per unit of output	$ATC = AFC + AVC$

Another example is the use of ATMs by banks to dispense cash. ATMs, which are fixed capital, have replaced tellers, which are variable labor. Such a technological change decreases total cost but increases fixed costs and decreases variable cost. This change in the mix of fixed cost and variable cost means that at small outputs, average total cost might increase, while at large outputs, average total cost decreases.

Prices of Factors of Production An increase in the price of a factor of production increases the firm's costs and shifts its cost curves. How the curves shift depends on which factor price changes.

An increase in rent or some other component of *fixed* cost shifts the *TFC* and *AFC* curves upward and shifts the *TC* curve upward but leaves the *AVC* and *TVC* curves and the *MC* curve unchanged. For example, if the interest expense paid by a trucking company increases, the fixed cost of transportation services increases.

An increase in wages, gasoline, or another component of *variable* cost shifts the *TVC* and *AVC* curves upward and shifts the *MC* curve upward but leaves the *AFC* and *TFC* curves unchanged. For example, if truck drivers' wages or the price of gasoline increases, the variable cost and marginal cost of transportation services increase.

You've now completed your study of short-run costs. All the concepts that you've met are summarized in a compact glossary in Table 11.2.

REVIEW QUIZ

1. What relationships do a firm's short-run cost curves show?
2. How does marginal cost change as output increases (a) initially and (b) eventually?
3. What does the law of diminishing returns imply for the shape of the marginal cost curve?
4. What is the shape of the *AFC* curve and why does it have this shape?
5. What are the shapes of the *AVC* curve and the *ATC* curve and why do they have these shapes?

You can work these questions in Study Plan 11.3 and get instant feedback. myeconlab

Long-Run Cost

We are now going to study the firm's long-run costs. In the long run, a firm can vary both the quantity of labor and the quantity of capital, so in the long run, all the firm's costs are variable.

The behavior of long-run cost depends on the firm's *production function*, which is the relationship between the maximum output attainable and the quantities of both labor and capital.

The Production Function

Table 11.3 shows Campus Sweaters' production function. The table lists total product schedules for four different quantities of capital. The quantity of capital identifies the plant size. The numbers for plant 1 are for a factory with 1 knitting machine—the case we've just studied. The other three plants have 2, 3, and 4 machines. If Campus Sweaters uses plant 2 with 2 knitting machines, the various amounts of labor can produce the outputs shown in the second column of the table. The other two columns show the outputs of yet larger quantities of capital. Each column of the table could be graphed as a total product curve for each plant.

Diminishing Returns Diminishing returns occur with each of the four plant sizes as the quantity of labor increases. You can check that fact by calculating the marginal product of labor in each of the plants with 2, 3, and 4 machines. With each plant size, as the firm increases the quantity of labor employed, the marginal product of labor (eventually) diminishes.

Diminishing Marginal Product of Capital Diminishing returns also occur with each quantity of labor as the quantity of capital increases. You can check that fact by calculating the marginal product of capital at a given quantity of labor. The *marginal product of capital* is the change in total product divided by the change in capital when the quantity of labor is constant—equivalently, the change in output resulting from a one-unit increase in the quantity of capital. For example, if Campus Sweaters has 3 workers and increases its capital from 1 machine to 2 machines, output increases from 13 to 18 sweaters a day. The marginal product of the second machine is 5 sweaters a day. If Campus Sweaters continues to employ 3 workers and increases the number of machines from 2 to 3, output increases from 18 to 22 sweaters a day. The marginal product of the third machine is 4 sweaters a day, down from 5 sweaters a day for the second machine.

Let's now see what the production function implies for long-run costs.

TABLE 11.3 The Production Function

Labor (workers per day)	Output (sweaters per day)			
	Plant 1	Plant 2	Plant 3	Plant 4
1	4	10	13	15
2	10	15	18	20
3	13	18	22	24
4	15	20	24	26
5	16	21	25	27
Knitting machines (number)	1	2	3	4

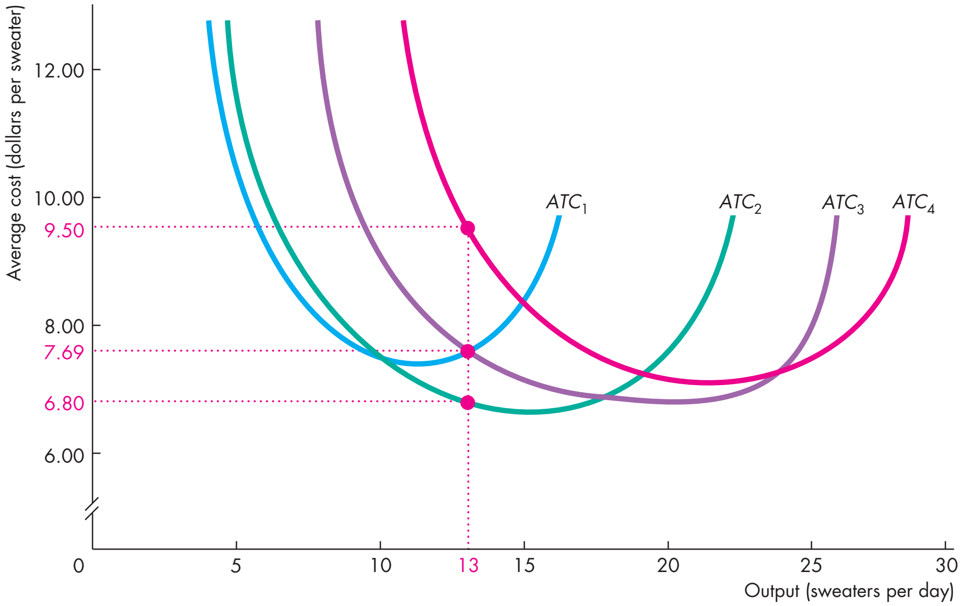
The table shows the total product data for four quantities of capital (plant sizes). The greater the plant size, the larger is the output produced by any given quantity of labor. For a given plant size, the marginal product of labor diminishes as more labor is employed. For a given quantity of labor, the marginal product of capital diminishes as the quantity of capital used increases.

Short-Run Cost and Long-Run Cost

As before, Campus Sweaters can hire workers for $25 a day and rent knitting machines for $25 a day. Using these factor prices and the data in Table 11.3, we can calculate the average total cost and graph the *ATC* curves for factories with 1, 2, 3, and 4 knitting machines. We've already studied the costs of a factory with 1 machine in Figs. 11.4 and 11.5. In Fig. 11.7, the average total cost curve for that case is ATC_1. Figure 11.7 also shows the average total cost curve for a factory with 2 machines, ATC_2, with 3 machines, ATC_3, and with 4 machines, ATC_4.

You can see, in Fig. 11.7, that the plant size has a big effect on the firm's average total cost.

FIGURE 11.7 Short-Run Costs of Four Different Plants



The figure shows short-run average total cost curves for four different quantities of capital at Campus Sweaters. The firm can produce 13 sweaters a day with 1 knitting machine on ATC_1 or with 3 knitting machines on ATC_3 for an average cost of $7.69 a sweater. The firm can produce 13 sweaters a day by using 2 machines on ATC_2 for $6.80 a sweater or by using 4 machines on ATC_4 for $9.50 a sweater.

If the firm produces 13 sweaters a day, the least-cost method of production, *the long-run method*, is with 2 machines on ATC_2.

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In Fig. 11.7, two things stand out:

1. Each short-run *ATC* curve is U-shaped.
2. For each short-run *ATC* curve, the larger the plant, the greater is the output at which average total cost is at a minimum.

Each short-run *ATC* curve is U-shaped because, as the quantity of labor increases, its marginal product initially increases and then diminishes. This pattern in the marginal product of labor, which we examined in some detail for the plant with 1 knitting machine on pp. 254–255, occurs at all plant sizes.

The minimum average total cost for a larger plant occurs at a greater output than it does for a smaller plant because the larger plant has a higher total fixed cost and therefore, for any given output, a higher average fixed cost.

Which short-run *ATC* curve a firm operates on depends on the plant it has. In the long run, the firm can choose its plant and the plant it chooses is the one that enables it to produce its planned output at the lowest average total cost.

To see why, suppose that Campus Sweaters plans to produce 13 sweaters a day. In Fig. 11.7, with 1 machine, the average total cost curve is ATC_1 and the average total cost of 13 sweaters a day is $7.69 a sweater. With 2 machines, on ATC_2, average total cost is $6.80 a sweater. With 3 machines, on ATC_3, average total cost is $7.69 a sweater, the same as with 1 machine. Finally, with 4 machines, on ATC_4, average total cost is $9.50 a sweater.

The economically efficient plant for producing a given output is the one that has the lowest average total cost. For Campus Sweaters, the economically efficient plant to use to produce 13 sweaters a day is the one with 2 machines.

In the long run, Cindy chooses the plant that minimizes average total cost. When a firm is producing a given output at the least possible cost, it is operating on its *long-run average cost curve*.

The **long-run average cost curve** is the relationship between the lowest attainable average total cost and output when the firm can change both the plant it uses and the quantity of labor it employs.

The long-run average cost curve is a planning curve. It tells the firm the plant and the quantity of labor to use at each output to minimize average cost. Once the firm chooses a plant, the firm operates on the short-run cost curves that apply to that plant.

The Long-Run Average Cost Curve

Figure 11.8 shows how a long-run average cost curve is derived. The long-run average cost curve *LRAC* consists of pieces of the four short-run *ATC* curves. For outputs up to 10 sweaters a day, average total cost is the lowest on ATC_1. For outputs between 10 and 18 sweaters a day, average total cost is the lowest on ATC_2. For outputs between 18 and 24 sweaters a day, average total cost is the lowest on ATC_3. And for outputs in excess of 24 sweaters a day, average total cost is the lowest on ATC_4. The piece of each *ATC* curve with the lowest average total cost is highlighted in dark blue in Fig. 11.8. This dark blue scallop-shaped curve made up of the pieces of the four *ATC* curves is the *LRAC* curve.

Economies and Diseconomies of Scale

Economies of scale are features of a firm's technology that make average total cost *fall* as output increases. When economies of scale are present, the *LRAC* curve slopes downward. In Fig. 11.8, Campus Sweaters has economies of scale for outputs up to 15 sweaters a day.

Greater specialization of both labor and capital is the main source of economies of scale. For example, if GM produces 100 cars a week, each worker must perform many different tasks and the capital must be general-purpose machines and tools. But if GM produces 10,000 cars a week, each worker specializes in a small number of tasks, uses task-specific tools, and becomes highly proficient.

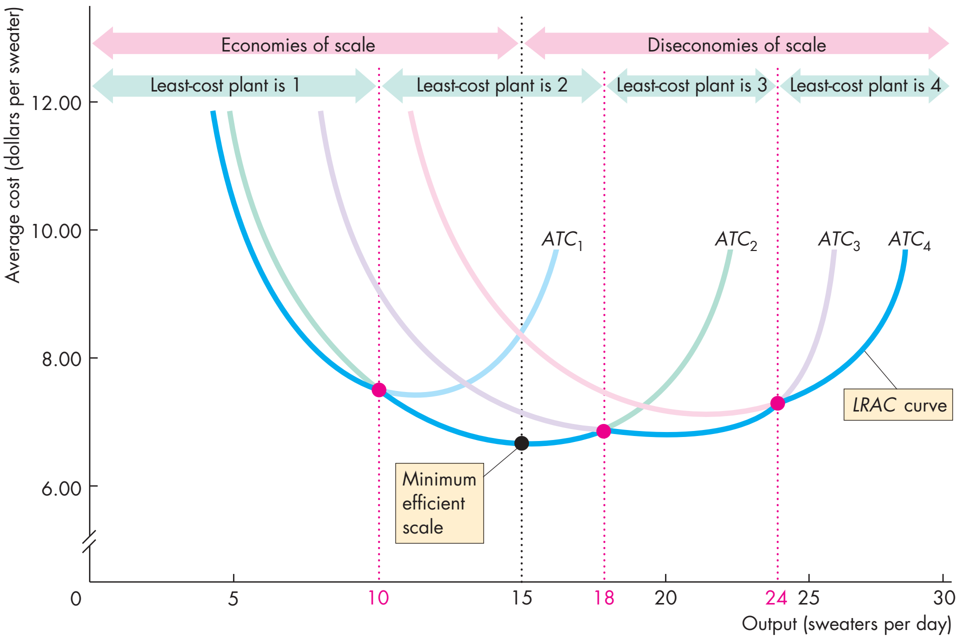
Diseconomies of scale are features of a firm's technology that make average total cost *rise* as output increases. When diseconomies of scale are present, the *LRAC* curve slopes upward. In Fig. 11.8, Campus Sweaters experiences diseconomies of scale at outputs greater than 15 sweaters a day.

The challenge of managing a large enterprise is the main source of diseconomies of scale.

Constant returns to scale are features of a firm's technology that keep average total cost constant as output increases. When constant returns to scale are present, the *LRAC* curve is horizontal.

Economies of Scale at Campus Sweaters The economies of scale and diseconomies of scale at Campus Sweaters arise from the firm's production function in Table 11.3. With 1 machine and 1 worker, the firm produces 4 sweaters a day. With 2 machines and 2 workers, total cost doubles but out-

FIGURE 11.8 Long-Run Average Cost Curve



The long-run average cost curve traces the lowest attainable *ATC* when both labor and capital change. The green arrows highlight the output range over which each plant achieves the lowest *ATC*. Within each range, to change the quantity produced, the firm changes the quantity of labor it employs.

Along the *LRAC* curve, economies of scale occur if average cost falls as output increases; diseconomies of scale occur if average cost rises as output increases. Minimum efficient scale is the output at which average cost is lowest, 15 sweaters a day.

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