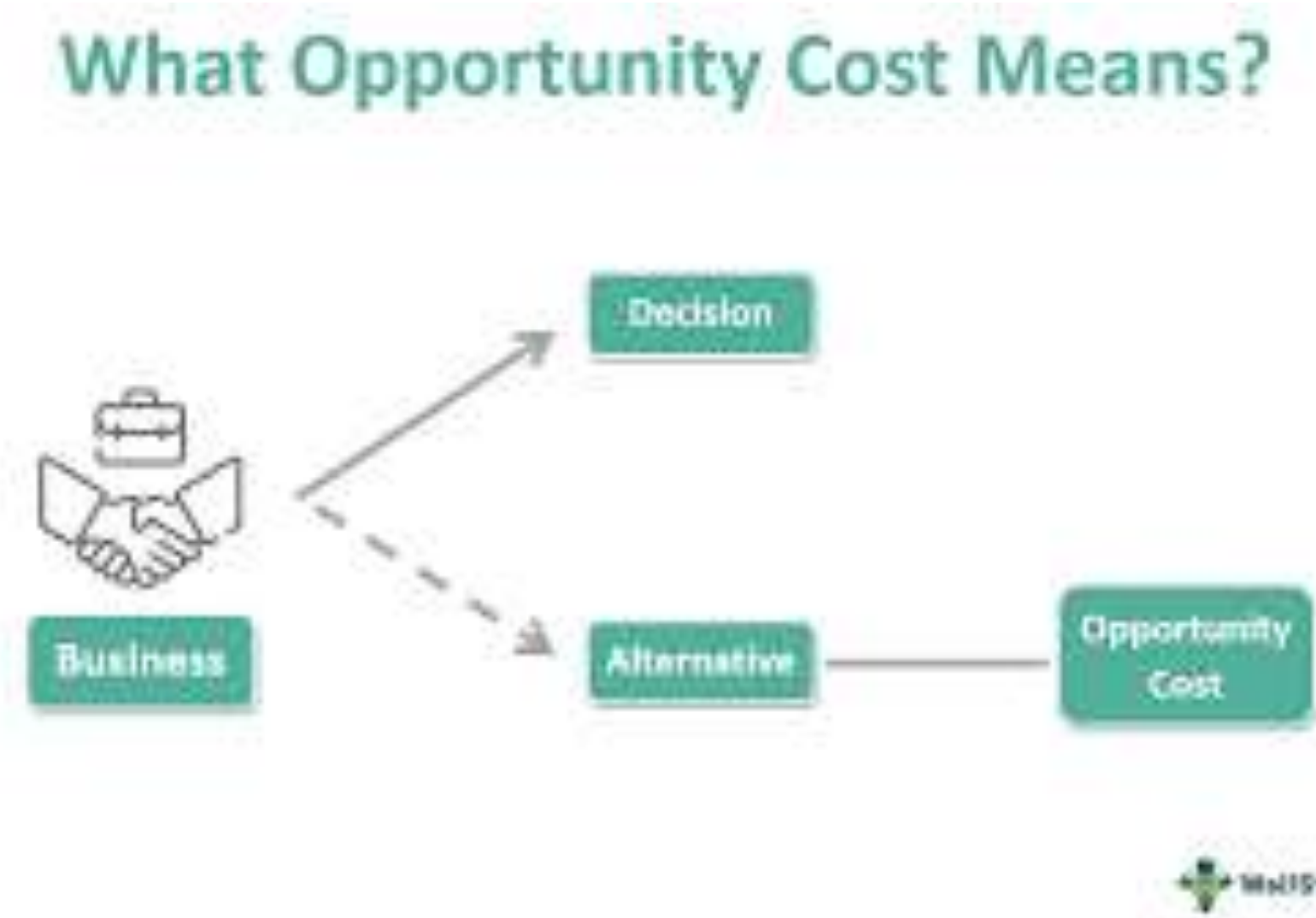
Various Economic Concepts of Cost

Opportunity Cost



Opportunity Cost

Opportunity costs represent the potential benefits that an individual, investor, or business misses out on when choosing one alternative over another.

Opportunity cost is the forgone benefit that would have been derived from an option not chosen.

Opportunity Cost

Formula of Opportunity Cost

Opportunity Cost=FO−CO

where

FO=Return on best forgone option

CO=Return on chosen option

Assume the expected return on investment (ROI) in the stock market is 12% over the next year, and your company expects the equipment update to generate a 10% return over the same period. The opportunity cost of choosing the equipment over the stock market is 2% (12% - 10%). In other words, by investing in the business, the company would forgo the opportunity to earn a higher return.

Least Cost Combination

The firm or the produce seeks to maximize his gains. Given the market prices of the goods he produces and the amount of his total revenue from the sale of goods, he can maximize his profits by minimizing his cost of production.

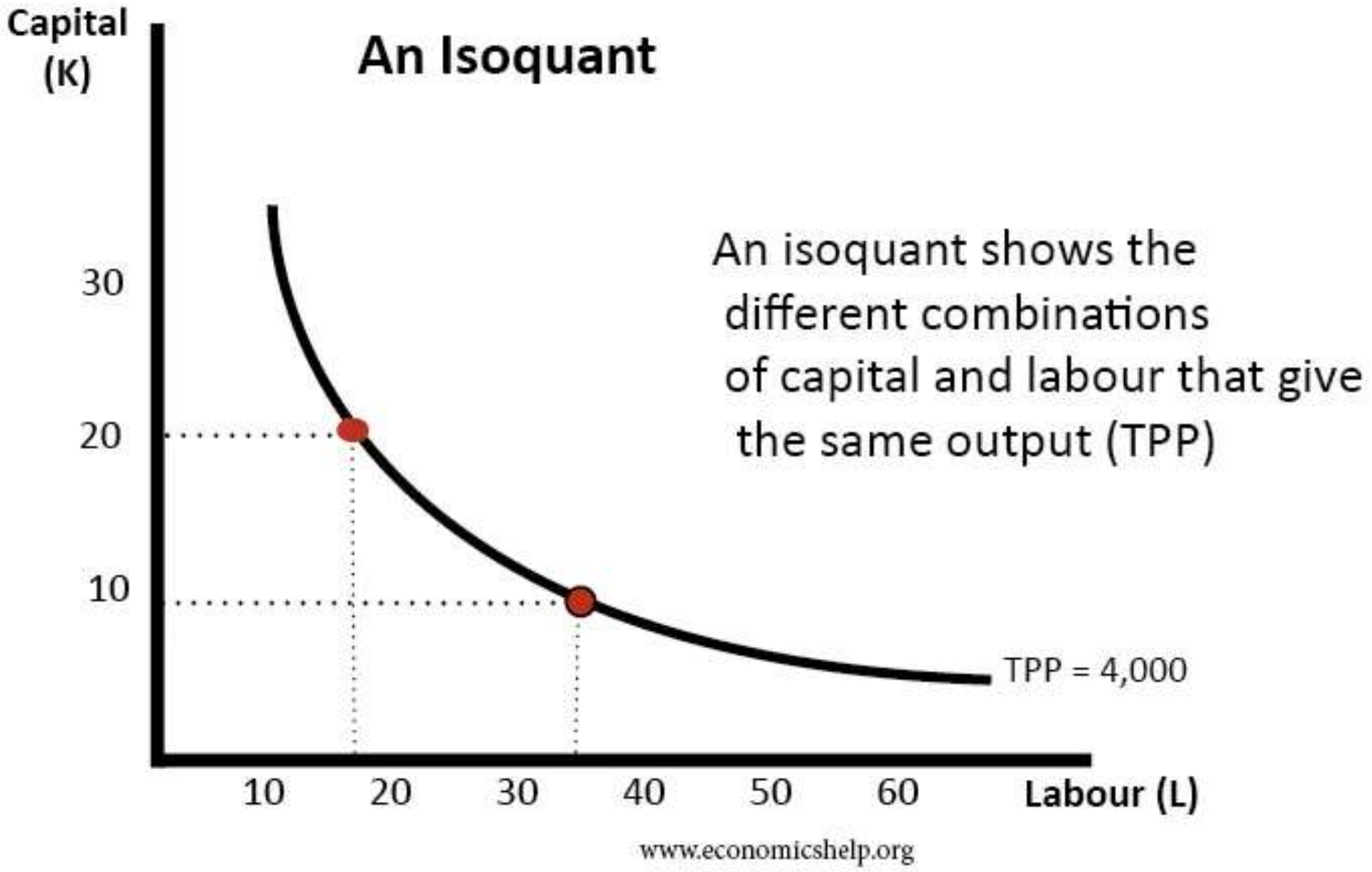
Cost is minimized, when the firm, with its given outlay on inputs, produces maximum amount of output. That is possible. **Successively higher Isoquants show the higher levels of output. Isocost line shows the budget constraint,** i.e. the combinations of inputs that lie within budget or outlay that he can spend on purchase of those inputs.

Least Cost Combination

Now, by joining these two, viz. isoquant and isocost lines in a diagram, we find out the point where they are tangent.

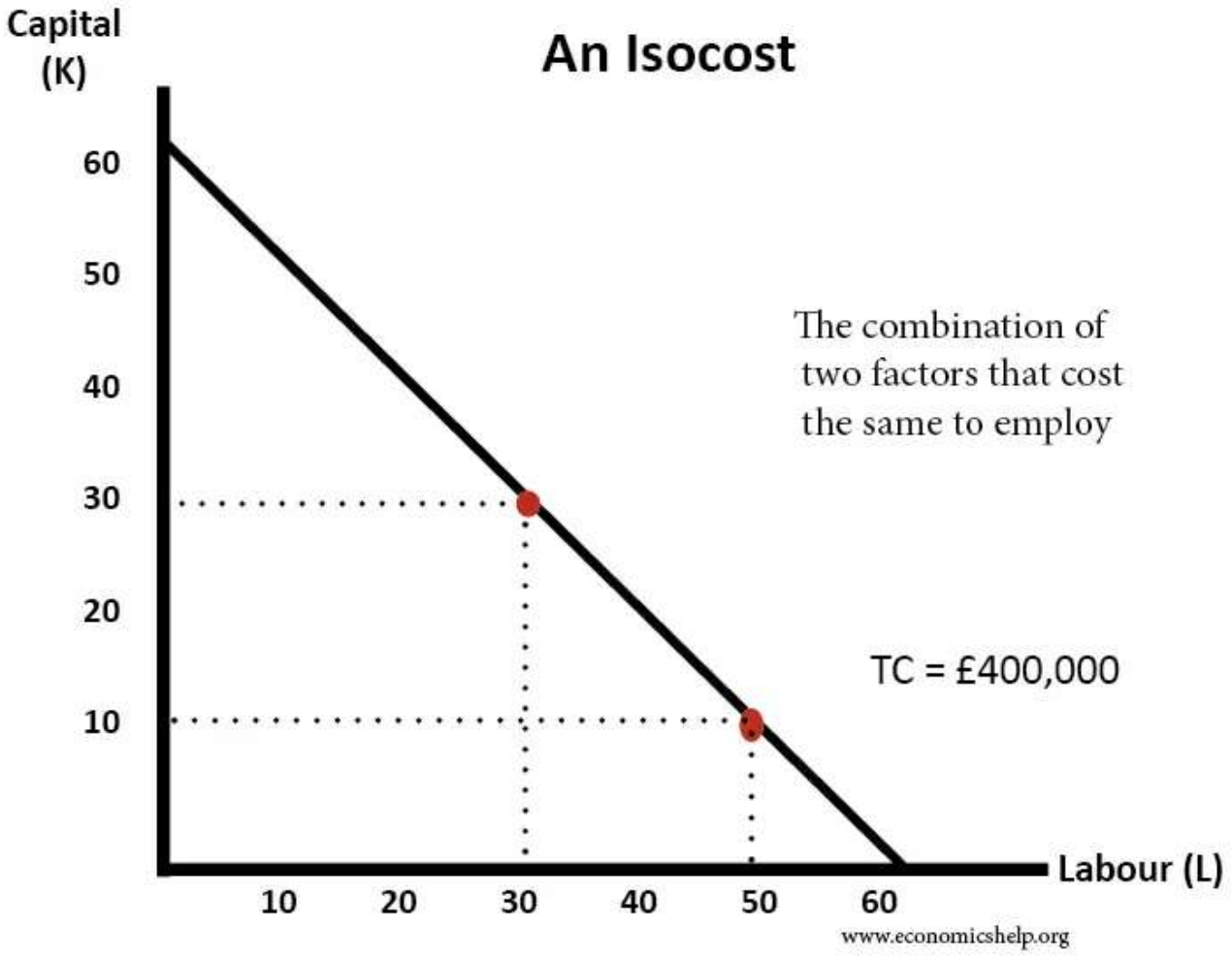
This point of tangency gives the least cost combination or the tangency, the slope of the isoquant (given by $MRTS_{LK}$) is the same as slope of the budget line (given by P_L / P_K) Thus, in equilibrium.

Least Cost Combination



Least Cost Combination

Isocost: An isocost shows all the combination of factors that cost the same to employ.



Least Cost Combination