Mona
Assistant Professor
Department of Economics
Maharaja College,Ara
Veer Kunwar Singh University
B.A. part-1
Paper-1
Topic: Modern Theory of cost
Email address: monapryal2223@gmail.com

Modern Theory of Cost

Long run cost curve is **L - shaped.**
Long run average variable cost is **saucer - shaped**

"George Stigler" **in 1939 told that the short run average variable cost curve has a flat stretch over a range of output which reflects the fact that firms build plant with some flexibility in their productive capacity (reserve capacity)**

Short run cost curves

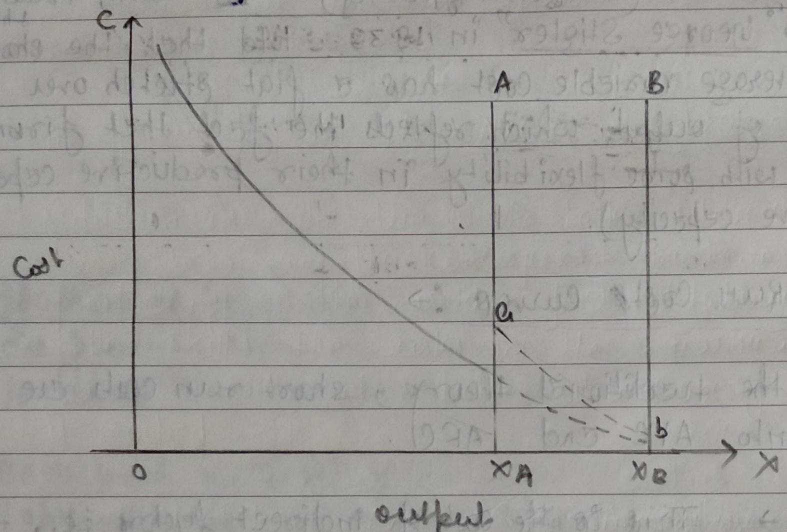
AFC is the cost of indirect factors (the cost of physical and personal organization of the firm).

AVC is the cost of direct factors such as cost of raw materials, fuel etc.

The plant will have a capacity larger than the expected average level of sales because the businessman wants to have some **reserve-capacity** for various reasons like seasonal and cyclical fluctuation etc.

Reserve capacity will give the businessman greater flexibility greater flexibility for repair of broken down machinery without disrupting the smooth flow of production process

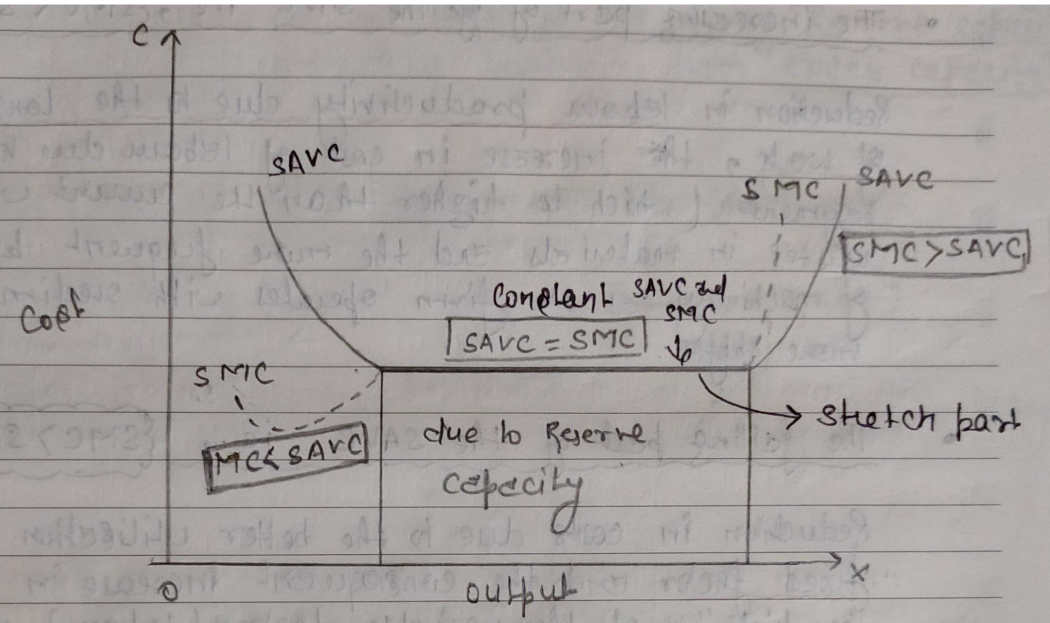
→ Average fixed cost : (Short run).



→ Average variable cost :

SAVC in the modern theory ⇒ Saucer-type shape i.e., it is broadly U-shaped but has a flat stretch over a range of output. Therefore, it looks like a saucer-shape.

Reason of saucer shape → Reserve capacity of the firm



In the given fig.,:

- Over the stretch part : $\boxed{SAVC = SMC}$ ⇒ due to Reserve capacity

  ⇓

  Here, SAVC & SMC remains constant per unit of output.

- To the left of stretch part : $\boxed{SAVC > SMC}$

- To the right of stretch part : $\boxed{SMC > SAVC}$

- **The increasing part of ~~of~~ the SAVC i.e., $\boxed{SMC < SAVC}$ reflects:-**

Reduction in labour productivity due to the longer hour of work, the increase in cost of labour due to overtime payment (which is higher than the current wage), the wastes in materials and the more frequent breakdown of machinary as the firm operates with overtime or with more shifts.

- **The falling part of the SAVC ie., $\boxed{SMC > SAVC}$ reflects:-**

Reduction in costs due to the better utilisation of the fixed factor and the consequent increase in skill and productivity of the variable factor (labour). With the better skills the wastes in the raw materials are also being reduced and a better utilisation of the whole plant is reached.

- Flat stretch of SAVC i.e., $\boxed{SMC = SAVC}$:→ due to Reserve capacity generated by the firm. It is basically planned by the enterpreneur in order to produce more than the expected average demand of the firm.

IMPORTANT NOTES

→ Reserve capacity makes the firm's self-sufficient to meet some seasonal or cyclical fluctuation etc.

→ Reserve capacity provides maximum flexibility in the operation of the firm. 'Reserve capacity' is completely different from "excess capacity".