Understanding Incremental Cost: Definition, Calculation & Business Impact

By THE INVESTOPEDIA TEAM Updated May 20, 2026

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DEFINITION:

Incremental cost refers to the additional expense associated with a company producing one extra unit of a service or product.

KEY TAKEAWAYS

- Incremental cost is the additional cost incurred to produce one more unit of a product.
- Understanding incremental costs can improve production efficiency and influence profit decisions.
- Incremental costs include variable expenses like raw materials, labor, and utilities.
- Fixed costs do not change with production levels and are not part of incremental cost analysis.
- Comparing incremental costs to incremental revenue helps companies maximize profitability.

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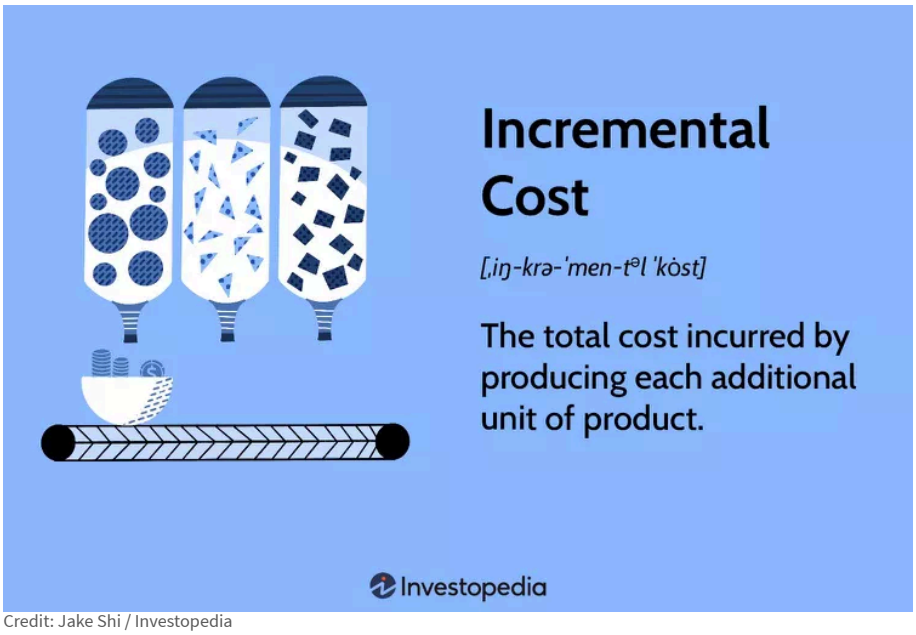
What Is Incremental Cost?

Incremental cost represents the additional expense incurred from producing one more unit of a product. Calculating these costs involves analyzing variable expenses, such as raw materials and direct labor, tied to increased production. By understanding incremental costs, companies can fine-tune efficiency, assess the profitability of business segments, and make informed production decisions.



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Key Concepts of Incremental Cost

Incremental costs are the expenses of making one more unit, and they occur only if production increases. Incremental costs are usually lower than a unit's average cost. Incremental costs are always composed of variable costs, which are the costs that fluctuate with production volumes.

Incremental costs might include the following:

- Raw materials, such as inventory
- Utilities, such as the additional electricity needed to power the equipment
- Wages or direct labor that's only involved in production
- Shipping and packaging

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In other words, incremental costs are solely dependent on production volume. On the other hand, fixed costs like rent and overhead are left out of incremental cost analysis since they don't usually change with production volume. Additionally, fixed costs can be challenging to attribute to a specific business segment. Incremental costs are often referred to as marginal costs.

Advantages of Analyzing Incremental Costs

Understanding incremental costs can help a company improve its efficiency and save money. Incremental costs help determine if a company should make a product or buy it from another source.

Understanding the additional costs of increasing the production of a good is helpful when determining the retail price of the product. Companies look to analyze the incremental costs of production to maximize production levels and profitability. When evaluating a business segment's profitability, only relevant incremental costs tied directly to it are considered.

Analyzing production volumes and the incremental costs can help companies achieve economies of scale to optimize production. Economies of scale occur when increasing production leads to lower costs, as the costs are spread over a larger number of goods being produced. In other words, the average cost per unit declines as production increases. The fixed costs don't usually change when incremental costs are added, meaning the cost of the equipment doesn't fluctuate with production volumes.

Incremental costs matter when making short-term decisions or choosing between options, like accepting a special order. If a reduced price is established for a special order, then it's critical that the revenue received from the special order at least covers the incremental costs. Otherwise, the special order results in a net loss.

IMPORTANT

Incremental cost is also known as marginal cost.

Comparing Incremental Cost and Revenue

Incremental costs help to determine the profit maximization point for a company or when marginal costs equal marginal revenues. If a business is earning more incremental revenue (or marginal revenue) per product than the incremental cost of manufacturing or buying that product, then the business earns a profit.

Alternatively, once incremental costs exceed incremental revenue for a unit, the company takes a loss for each item produced. Therefore, knowing the incremental cost of additional units of production and comparing it with the selling price of these goods assists in meeting profit goals.

Practical Example of Incremental Cost Analysis

Let's say, as an example, that a company is considering increasing its production of goods but needs to understand the incremental costs involved. Below are the current production levels, as well as the added costs of the additional units.

- 10,000 units have a total cost of $300,000, or $30 per unit ($300,000 / $10,000)
- 12,000 units have a total cost of $330,000, or $27.50 per unit ($330,000 / $12,000)

As a result, the total incremental cost to produce the additional 2,000 units is $30,000 or ($330,000 - $300,000).

- The incremental cost per unit equals $15 ($30,000 / 2,000 units).

The reason why there's a lower incremental cost per unit is due to certain costs, such as fixed costs remaining constant. Although a portion of fixed costs can increase as production increases, the cost per unit usually declines, as the company isn't incurring additional fixed costs to produce the added volume.

How Does Understanding Incremental Costs Help Companies?

Understanding incremental costs can help companies boost production efficiency and profitability. It also helps a firm decide whether to manufacture a good or purchase it elsewhere.

What Do Incremental Costs Include?

Incremental costs might include:

- Raw materials such as inventory
- Utilities, such as the additional electricity needed to power the equipment
- Wages or direct labor involved only in production
- Shipping and packaging

Incremental costs depend solely on production volume. They are always composed of variable costs, which are the costs that fluctuate with production volume.

Where Are Incremental Costs Relevant?

Incremental costs are relevant in making short-term decisions or choosing between two alternatives, such as whether to accept a special order.

The Bottom Line

Incremental cost reflects the expense a company incurs to produce one additional unit of a product. By focusing on incremental costs, companies can assess and maximize the profitability of their business segments. Understanding this cost component assists in fine-tuning production strategies, improving efficiency, and informing important pricing and investment decisions.

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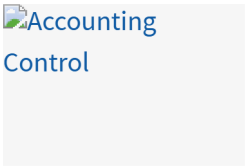

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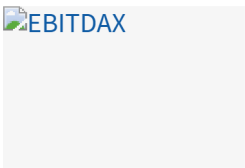

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