Higher

Economics

HSN80013
Unit 1 Topic 3

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Topic 3 – Supply

Theory of Supply

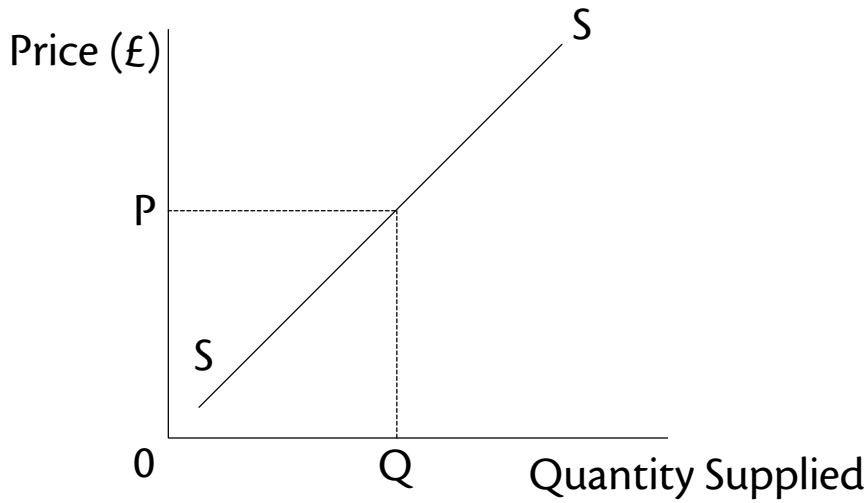
Supply can be defined as the quantity of a product producers are willing to sell to the market at a particular point in time. Like demand, supply can be categorised into either:

- individual supply – the supply of one single producer
- market supply – the supply of all producers within the market

A *supply schedule* can be used to illustrate all the quantities supplied of a particular good at different prices. It is shown in a table format. More commonly, this is shown using a supply curve.

The Supply Curve

A supply curve shows the relationship between the quantities supplied of a product and their price.



The supply curve is based on the *law of supply*. This states that there is a direct relationship between quantity supplied and the price of a good. In general, the quantity supplied of a good will rise as its price rises, ceteris paribus.

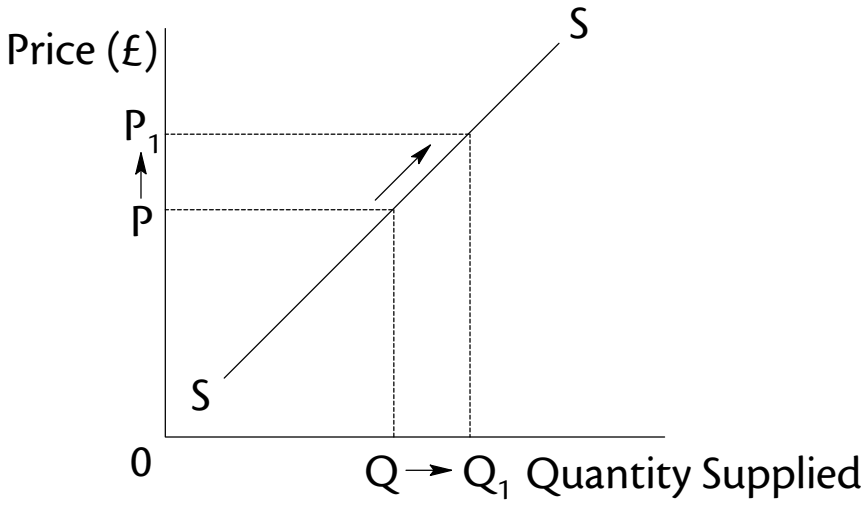
The law of supply is based on three reasons:

- producers aim to maximise their profits; at a higher price, they will supply more of a product as they will receive a greater profit from it
- when output increases, firms costs will rise meaning a higher price is needed to cover these costs
- new firms may enter the market (as it is more profitable)

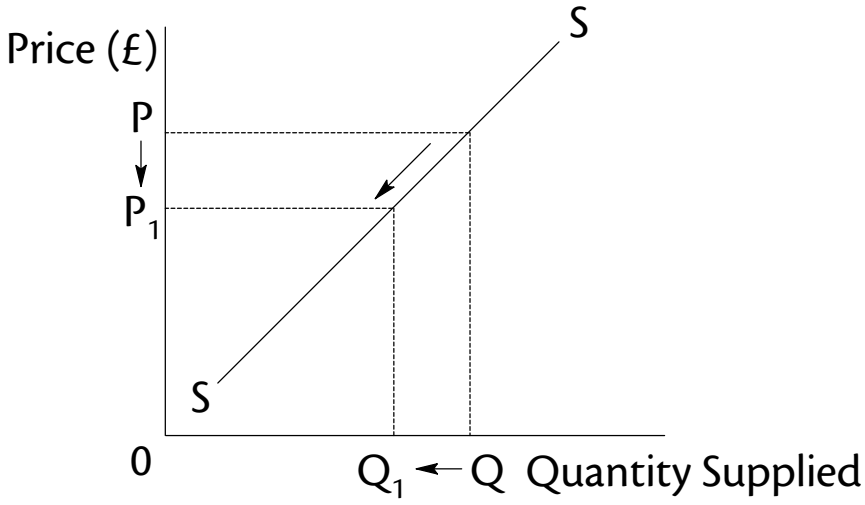
Movements along the Supply Curve

A movement along the supply curve shows supply changing when price changes.

Increasing prices leads to a rise in the quantity supplied. This is known as an *extension* of supply, as shown below.



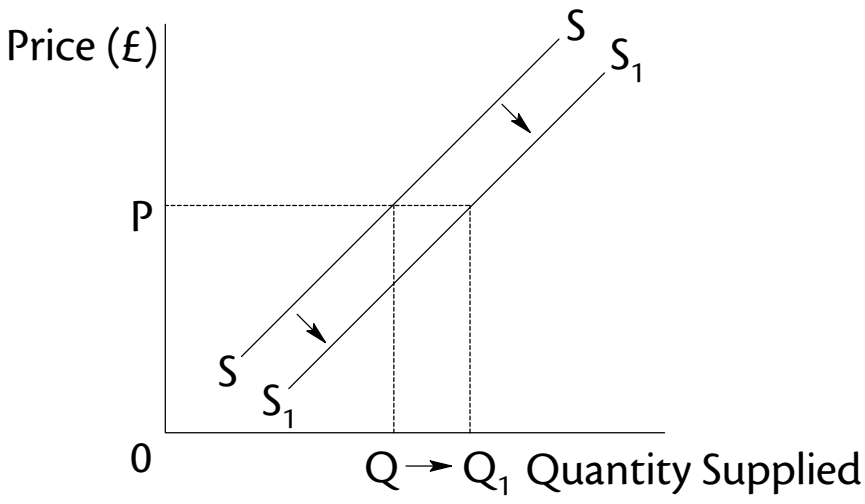
Decreasing prices leads to a fall in the quantity supplied. This is known as a *contraction* of supply, as shown below.



Shifts of the Supply Curve

Factors which determine supply, other than price can be shown by a shift in the supply curve. This means that at every price there will be an increase or decrease in the quantity supplied.

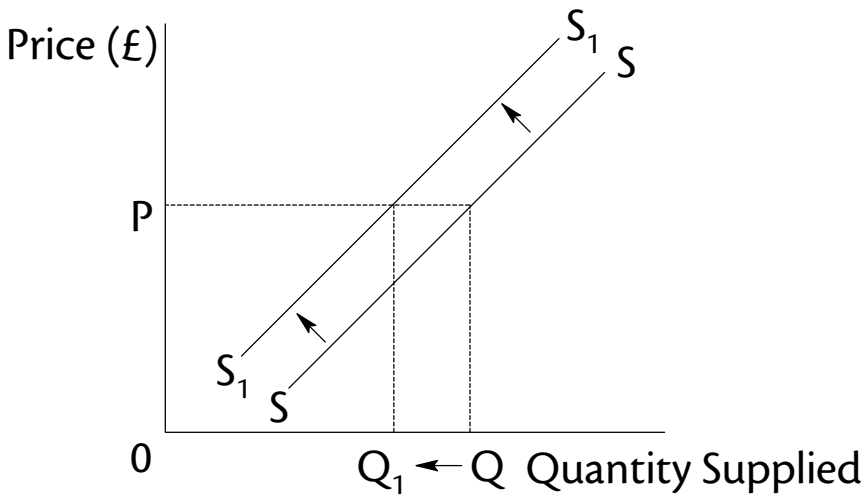
When supply increases the supply curve shifts to the right (SS to S_1S_1), as shown below.



The factors which could cause the supply curve to shift to the right are:

- a fall in the price of a factor of production meaning costs of production are lowered e.g. if raw materials become cheaper more can be supplied at each and every price
- an improvement in technology meaning machinery can be used to produce goods and supply to the market
- an improvement in the weather will help the growth of agricultural products
- increases in subsidies to help producers lower their costs
- falling taxes meaning producers find it cheaper to produce
- lowering of prices of other goods meaning producers move into the production of more popular goods
- good relationships between management and staff means workers are likely to be more productive

When supply decreases the supply curve shifts to the left (SS to S_1S_1), as shown below.



The factors which could cause the supply curve to shift to the left are:

- a rise in the price of a factor of production meaning costs of production are higher e.g. if raw materials become dearer less can be supplied at each and every price
- poor weather could destroy harvests
- decreases in subsidies so producers raise their costs
- rising taxes meaning producers find it dearer to produce
- increase in prices of other goods meaning producers move out of the production of less popular goods
- poor relationships between management and staff means workers are likely to be less productive (loss of morale)

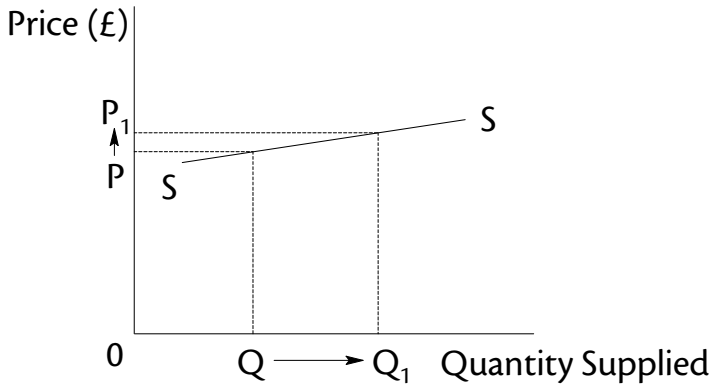
Price Elasticity of Supply (PES)

This is a measure of how responsive supply is to a change in the price of a good. It is measured using the formula:

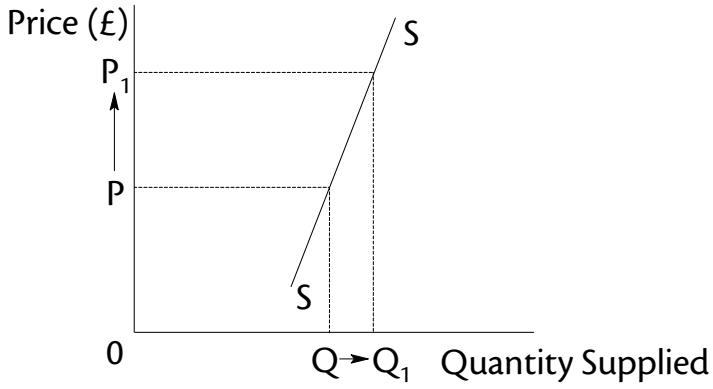
$$\text{PES} = \frac{\text{percentage change in supply}}{\text{percentage change in price}}$$

There are five possible types of price elasticity of supply based on the result of this formula:

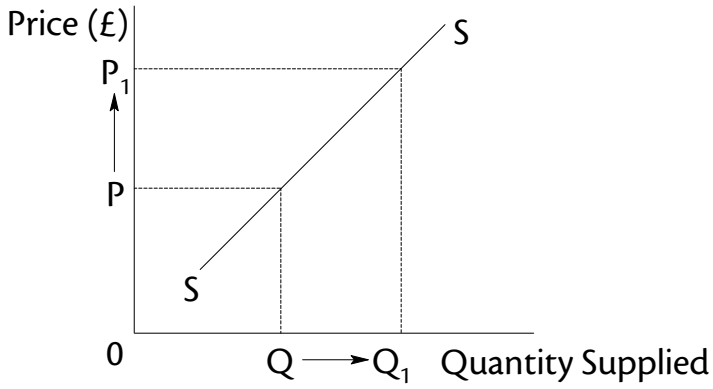
- supply is price elastic when PES > 1; the percentage change in supply is greater than the percentage change in price



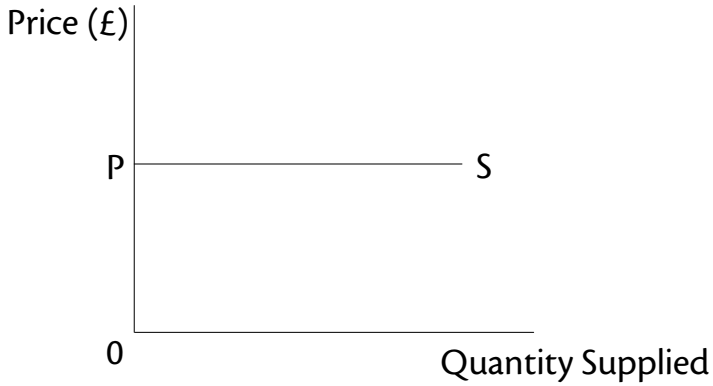
- supply is price inelastic when PES < 1; the percentage change in supply is less than the percentage change in price



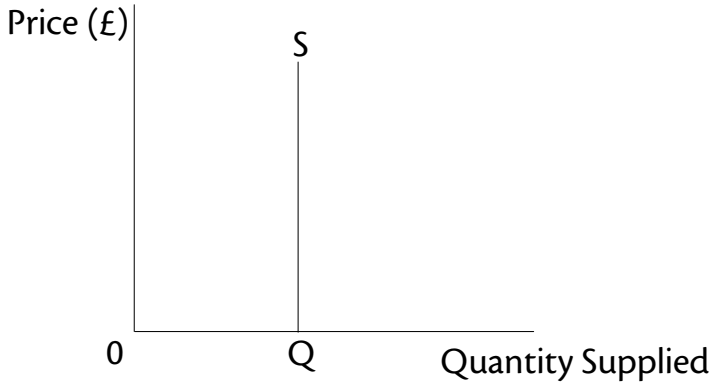
- supply is price unit elastic when PES = 1; the percentage change in supply is equal to the percentage change in price



- supply is perfectly elastic when a percentage change in price leads to a fall in supply to zero



- supply is perfectly inelastic when the percentage change in price is 0; supply will remain the same regardless of price



Factors Influencing Price Elasticity of Supply

There are a number of factors influencing PES:

- the number of firms in the industry – a large number of firms in an industry means supply can easily increase due to a rise in price, PES will be elastic
- mobility of the factors of production – if resources can be easily moved into the production of a particular good PES will be elastic
- spare capacity – if spare raw materials and components are available production can be easily increased in response to a rise in price, PES will be elastic
- storing stock – running down spare stocks after a rise in price means PES will be elastic; alternatively, if no spare stock is available then PES will be inelastic e.g. fresh fish
- length of production – supply will be price inelastic where a good takes a long time to create meaning supply cannot be easily increased due to a rise in price e.g. agricultural produce
- time – investment in education and training by firms will mean that over time production can be increased so PES is elastic