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AS Economics

Supply

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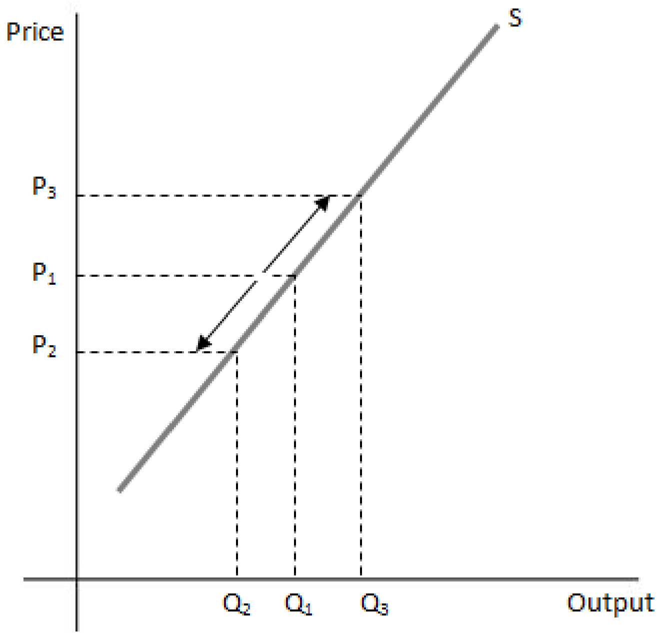
Shape of the Supply Curve

It slopes upwards for two reasons:

1) Rising prices provide an incentive for firms to produce higher quantities.
2) Law of Diminishing Returns – production costs are higher as higher quantities are produced so producers need to charge consumers more.

Movement along the Supply Curve

Increased P → Increased S : expansion/extension of supply.
Decreased P → Decreased S : contraction of supply.



Shifts in the Supply Curve

Shift outwards – increase in supply.
Shift inwards – decrease in supply.

Non price determinants of supply cause shifts:

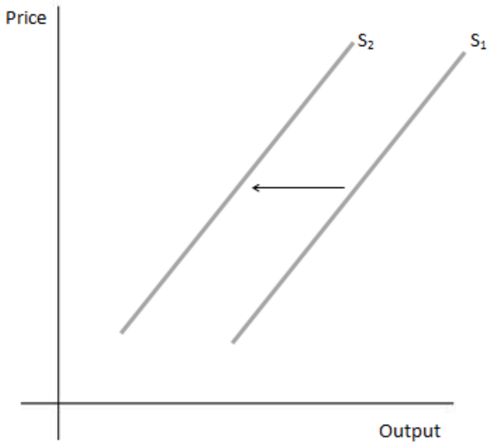
1) Production Costs – increased costs lead to decreased supply and an inward shift.

2) Technology – new technology leads to increased efficiency and decreased costs of production – outward shift in the S curve.

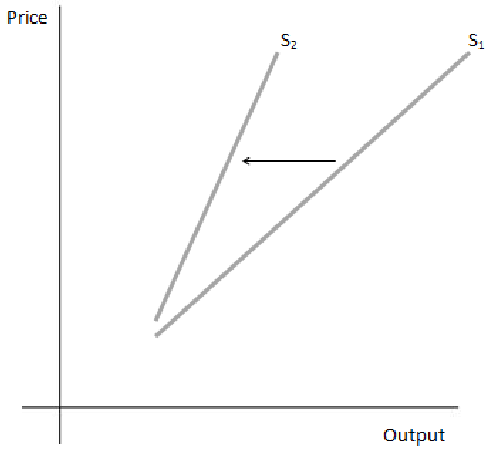
3) Indirect Taxation – increase production costs and decrease supply – specific tax (fixed amount per unit) and ad valorem tax (percentage of total price e.g. VAT.

Specific Tax:

Tax:



Ad Valorem



4) Subsidies – decrease costs of production – increase S.

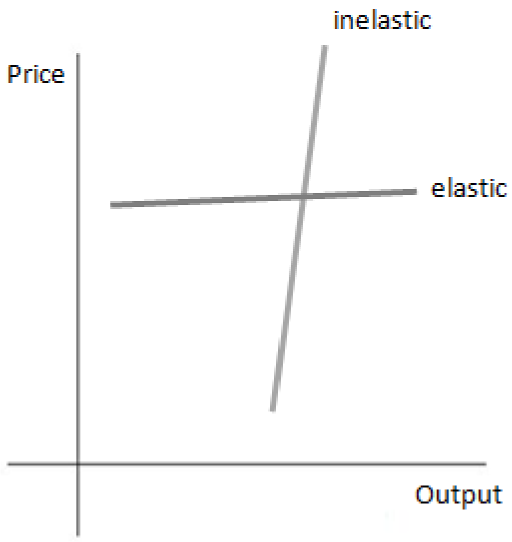
5) Producer Cartels – group together to control P and Q of a good – illegal in the UK. E.g. OPEC (organisation of petroleum exporting countries) can increase or decrease S to control P – HOWEVER only possible to increase supply if there are more reserves.

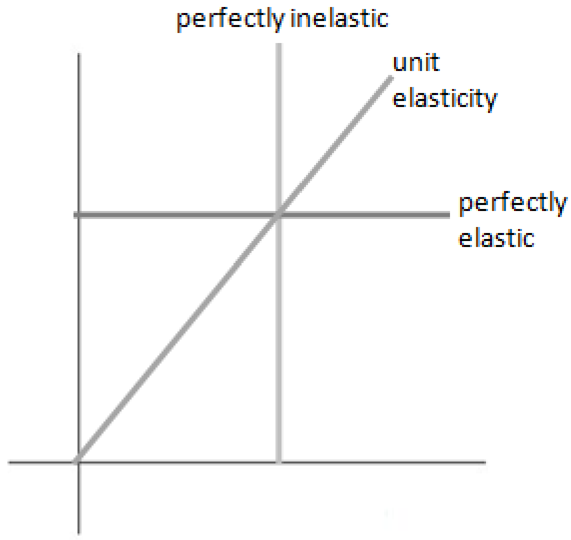
Price Elasticity of Supply (PES)

PES is the responsiveness of the supply of a good to a change in price. The value of PES is usually positive.

$$\frac{\%\Delta QS}{\%\Delta P}$$

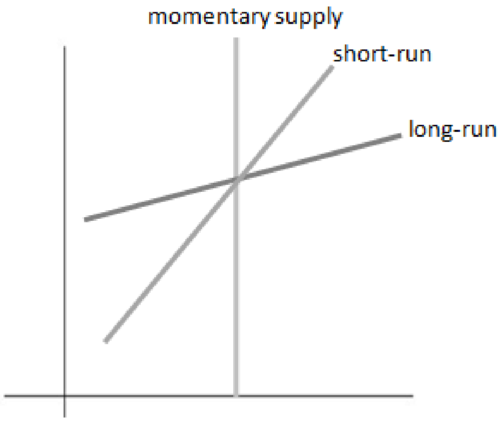
- If PES > 1 the good is price elastic.
- If PES < 1 the good is price inelastic.
- If PES = 1 the good is unit elastic.
- If PES = 0 the good is perfectly inelastic.
- If PES = ∞ the good is perfectly elastic.





Factors affecting PES:

1) Time Scale:
- Short term after a price rise – price elasticity of supply is low – can't quickly increase supply.
- Long term – more price elastic – increasing supply more easily.



True at any point where a supplier is unable to respond to a higher price.

2) Spare Capacity:
- If there are spare resources – supply can be raised to meet an unexpected increase in demand e.g. paying workers to work overtime, therefore PES is higher.
- Firm/industry operating at full capacity – supply is inelastic.
- Recession – lots of spare/unemployed resources – S can be increased more easily.

3) Stocks of raw materials/components/finished products:
- High levels of stocks – firms can increase supply quickly – PES is higher.
- If a good is perishable, e.g. flowers, it can't be stocked for long therefore supply is more inelastic.

4) Factor Substitutability:
- Firm can increase supply by converting factors of production towards the output where P is rising.
- May take time – some factors are more flexible than others, making PES for them higher.

5) Ease of entry into an industry:
- High entry barriers – difficult for new firms to enter even with prices rising – PES is lower.