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Acknowledgements

For Agata, Jann Caesar and Anja

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Supply and the Producer

aims

- To define supply
- To explain economies and diseconomies of scale
- To outline why small firms survive in the Irish economy
- To discuss the factors that influence supply

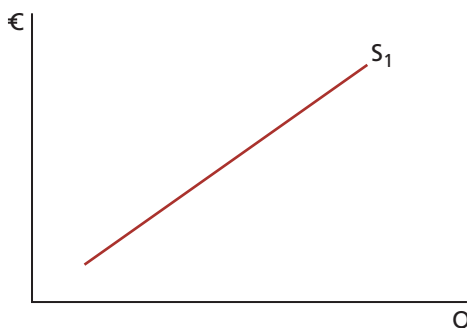
Introduction

Supply means the quantity of a good that producers are willing to sell at any given market price over a period of time.

- **Individual supply** refers to the different quantities one producer is prepared to sell at each price. This can be represented as a list of prices and quantities called a **supply schedule**, or it can be graphed as a **supply curve**.
- **Market (aggregate) supply** is the total combined quantity that all producers are prepared to sell at each price. This can also be represented as a supply schedule or as a supply curve.
- The **Law of Supply** states that as the price offered for a good increases, *ceteris paribus* (all else being equal) more of it will be supplied. This will result in an upward-sloping supply curve:

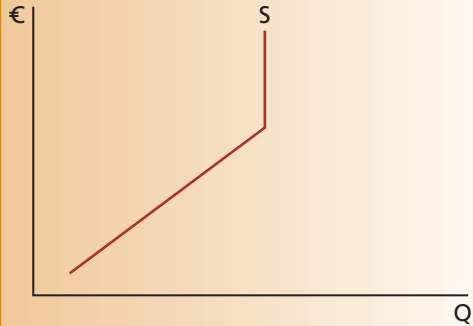


In the Demand chapter (Chapter 2), every mention of 'price' was a reference to the price *charged by the seller*. In this chapter 'price' means the price *offered by the buyer*. In equilibrium, these prices will be the same.

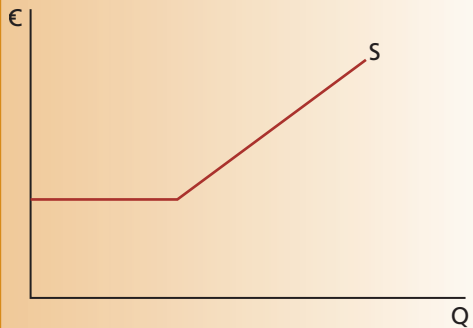


- However, there is a number of other supply curves with which you will need to be familiar:

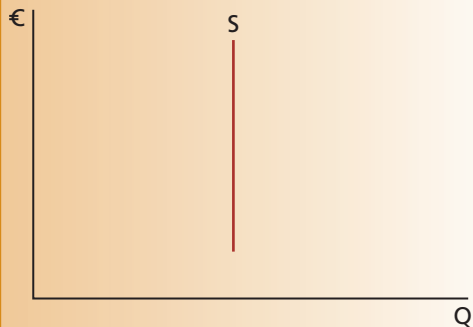
Capacity constraint: Even if a firm wants to expand production, it may reach a point beyond which it doesn't have the resources to grow its supply any further, e.g. if every table at a restaurant is occupied.



Minimum price: In some industries, nothing is produced below a minimum price because costs cannot be covered below that price, e.g. due to minimum wage legislation.



Fixed (perfectly inelastic) supply: Sometimes supply cannot be changed in the short run no matter how much money is offered, e.g. a café runs out of scones and has to turn customers away.



- A **producer** is a firm that sells goods or services in an attempt to satisfy consumer needs and/or wants.
- A **firm** is an individual unit of business that produces output and sells its product to the market (i.e. to consumers) with the aim of making a profit.
- An **industry** is a group of firms that produce the entire output of a particular good, e.g. the mobile phone industry.



- **Private sector** firms are privately owned businesses. There are several kinds:
 - **Sole trader:** owned by a single individual
 - **Partnership:** between 2–20 shareholders
 - **Co-operative:** each member's profit depends on how much business they do with the company
 - **Private limited company (Ltd):** between 1–149 shareholders, who have limited liability
 - **Public limited company (Plc):** at least 7 shareholders, no maximum. Shares can be bought and sold on the stock exchange
- **Public sector** firms are semi-state bodies owned by the government, e.g. Bord na Móna.
- The **optimum size** of the firm is reached when **unit cost** is minimised. The optimum size will vary from industry to industry – a hairdresser can survive in business on a few thousand customer visits a year, a tablet manufacturer has to make and sell millions of units in order to keep afloat.

Economies and diseconomies of scale

Internal economies of scale are forces at work inside a firm that lower the unit cost as quantity produced is increased/as the firm increases in size. These forces are:

- **Construction:** It doesn't cost double to build a factory twice the size. This reduces the unit cost.
- **Technical:** Larger firms can spread the cost of expensive machinery over a larger quantity of units, thus reducing the unit cost.
- **Integrated production:** Larger firms have the money to engage in more than one stage of the production process, reducing unit cost.
- **Labour:** Larger firms can engage in specialisation/division of labour. Output per worker is increased, unit cost is reduced.
- **Production:** Larger firms can operate continuous production, without the time and expense involved in stopping and starting, e.g. a medical devices plant that operates around the clock.
- **Raw materials:** Larger firms waste less raw materials. If they're not used in the production of one good, they can be used in another. This reduces unit cost.
- **Financial:** Larger firms have more credibility and are considered less risky by banks and investors. This reduces unit costs.
- **Purchasing:** Larger firms save more than smaller ones when buying in bulk. The bigger the buyer, generally the bigger the reduction the seller will offer on each unit bought.
- **Distribution:** A large firm with lots of deliveries can have lower unit cost than a small firm with fewer deliveries to make.
- **Marketing:** Costs per unit are lower for larger firms, similar to when purchasing raw materials.

Internal diseconomies of scale are forces at work inside a firm that raise the unit cost as quantity produced is increased beyond a certain point/as the firm increases in size.

These forces are:

- **Communication:** Larger firms are harder to manage. More information is needed to make decisions, and it's harder to communicate with everyone. Unit costs rise.
- **Boredom/low morale:** As a firm grows and engages in more specialisation of labour, jobs may become more mundane. This reduces productivity. Unit costs rise.
- **Workers' expectations:** The larger the firm, the more likely some workers are to believe it has the money to give in to higher wage demands.
- **Conflict:** In bigger firms, workers may feel unimportant as individuals, leading to industrial relations conflict, etc. This drives unit costs up.
- **Layers of management:** Large companies need more supervisors and clerical staff, who are not directly engaged in production, adding to unit costs.

External economies of scale are forces at work outside a firm that lower the unit cost as quantity produced is increased/as the industry increases in size. They affect all firms in the industry simultaneously. These forces are:

- **Outsourcing:** As an industry grows, new firms are set up to provide such spin-off services as recruitment, training and advertising. They also provide component parts and specialised machinery. Outsourcing allows the firms in the industry to concentrate on their core competencies, reducing their unit cost.
- **Marketing:** As an industry grows, firms come together in trade associations or trade fairs to market their collective output. This reduces unit costs.
- **Sharing:** Firms in larger industries sometimes come together to share the burden of research and development, etc. This reduces unit costs.
- **Government:** As the economy grows, the government can provide better infrastructure, benefiting all firms.

External diseconomies of scale are factors outside a firm that raise the unit cost as quantity produced increases beyond a certain point/as the industry increases in size.

They affect all firms in the industry. These forces are:

- **Infrastructure:** As an industry expands, the pressure on a country's infrastructure grows. The government cannot build roads, etc. as fast as output is increasing. Unit costs rise.
- **Raw materials:** As more raw materials are required, they become harder to obtain. The price rises or, alternatively, lower quality raw materials may have to be purchased. Either way, unit costs rise.
- **Labour:** Skilled labour becomes harder to find, so wages rise, or else less skilled workers are hired.

Why small firms can still survive

Despite large firms' economies of scale, small firms often still manage to do very well in Ireland. This is due to:

- **Small market:** Our population of less than 5m people. This may not give large multinationals the economies of scale they need, leaving the market to smaller Irish firms.
- **Transport:** Since Ireland is an island, it is costly to transport many types of goods into the country. This can hand an advantage to home-grown firms.
- **Loyalty and personal attention:** Small firms offer a familiar face to their customers. In close-knit local communities, this favours small local producers.



- **Nature of the product:** Perishable goods and hand-made products may be cheaper to produce locally.
- **Preference for control:** If you own a small business, expanding means sharing control. For this reason, family-owned businesses may prefer to stay small.
- **Finance:** Small businesses cannot expand without capital.

The Supply Function

The Supply Function is as follows:

$$S_y = f(P_y, P_r, C, T, U, Cr., G)$$

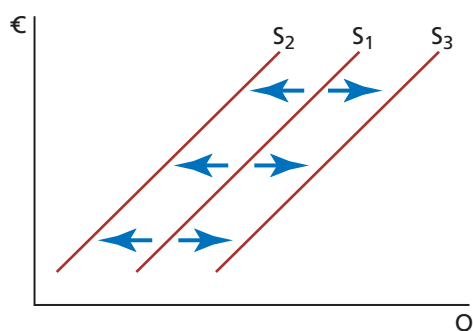
This means that the supply of Good Y depends on (or is a function of):

- The **price** consumers are offering for Good Y (**P_y**).
- The price of **related** goods (**P_r**). **Related goods** are defined as other goods that the producer can offer instead of Good Y, e.g. a pizza company can make either ham

and mushroom or pepperoni pizza. If the price consumers are offering for pepperoni pizza rises, the company will switch some of its limited resources from producing ham and mushroom pizza to pepperoni pizza, **reducing** the supply of ham and mushroom pizza.

- The **Cost of Production (C)**. If the cost of producing Good Y falls, but the price remains the same, the firm will supply more because it's now more profitable, e.g. a fall in the price of a key raw material.
- **Technology (T)**. An improvement in technology can make it possible to produce more of Good Y, e.g. a social media site that allows you to reach more customers. Technology usually doesn't disimprove.
- **Unplanned factors (U)**. These are events outside the control of the producer, and can have either a positive or a negative effect. Two examples are a fire that burns down a factory and therefore restricts production, or, on the other hand, the discovery of a new fuel, which causes the price of oil to fall.
- Availability of **credit (Cr.)**. Firms require credit from banks in order to set up and expand and hence supply the market.
- **Government (G)**. The government can offer incentives to promote a desirable product, e.g. healthy food.

A change in any part of the Supply Function – **except for a change in the price (P_y)** – will cause the supply curve to **shift** either to the right or to the left.



It is vital to remember that a change in the price of the good itself causes a movement **along** the supply curve while a change in any of the other elements of the demand function causes the supply curve to **shift**.

key
point

- Definition of supply
- The Law of Supply
- Economies and diseconomies of scale
- Reasons why small firms survive in the Irish economy
- $S_y = f(P_y, P_r, C, T, U, Cr., G)$



2016, Section B, Question 1 (a)

- (i) Outline four factors that determine the supply of a good or service.
- (ii) Explain the difference between a movement along a supply curve and a shift in a supply curve. Use appropriate diagrams to illustrate your answer.

Marking scheme

- 4 factors @ 5 marks each
- 2 diagrams @ 3 marks and 2 marks
- 2 explanations @ 5 marks each
- 35 marks in total

Answer

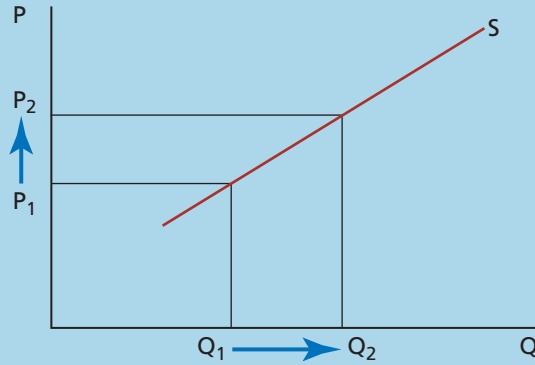
- (i)
 - **Price of the good itself:** The higher the price offered by the consumer, the more will be supplied, provided there isn't a capacity constraint, e.g. as a singer's popularity grows, they hold their concerts in sports stadia rather than in smaller venues.
 - **Price of related goods:** If offered more for an alternative good, firms will produce that good instead, e.g. organic food. The supply curve of the original good shifts left.
 - **Technology:** New technology allows firms to produce more at the same price, e.g. digital movie cameras have made it easier to produce and release films. The supply curve shifts to the right as technology improves.
 - **Unplanned factors:** A positive unplanned factor (e.g. faster production method) will shift the supply curve right, a negative unplanned factor (e.g. a new competitor) will shift the supply curve left.
 - **Government:** The government can offer incentives and grants to promote the production of particular products, e.g. bio-fuels. The supply curve shifts to the right.
 - **Cost:** If a firm cuts production costs, it can produce more, e.g. cheaper fuel lets an airline offer more routes. The supply curve shifts right if costs fall, left if they rise.



Exam Focus: This answer is an example of how it cannot hurt to use examples even if you're not asked for them – provided you don't go over the time. This 20 marker should take you 8 minutes.

(ii) Movement along a supply curve:

If the price consumers are willing to offer for the good increases, the quantity supplied will also increase. This results in an upward-sloping supply curve, as shown.

**Shift in a supply curve:**

If there is a change in any other factor in the supply function, the supply curve will shift either to the left (a decrease in supply) or to the right (an increase in supply).

