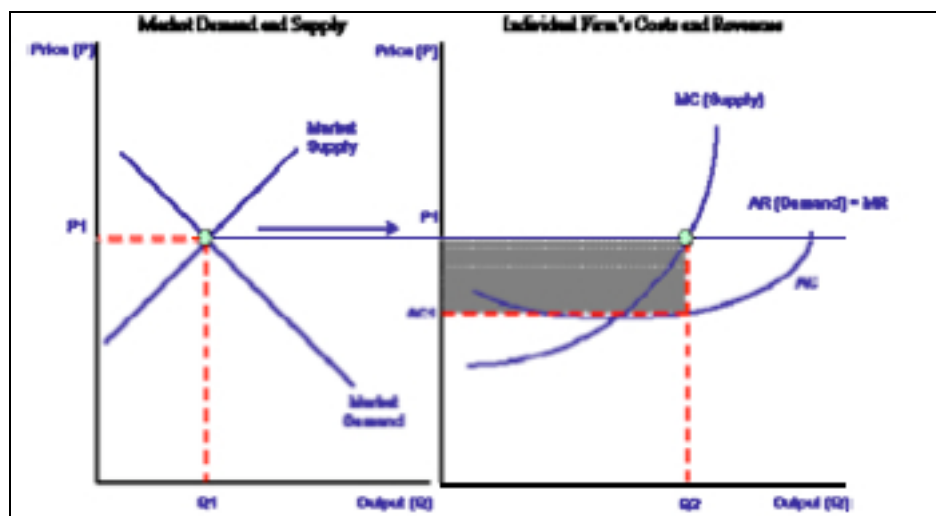


Revision Worksheet: Perfect Competition

Assumptions

- Many small firms
- Firms and consumers have perfect knowledge
- Firms produce an homogeneous product and therefore consumers have no brand loyalty
- No barriers to entry or exit
- Firms are profit maximisers (they produce at the output level where $MC = MR$)
- Firms are price takers, they are too small to influence the industry price
- No externalities arising from production and consumption

Short Run Equilibrium

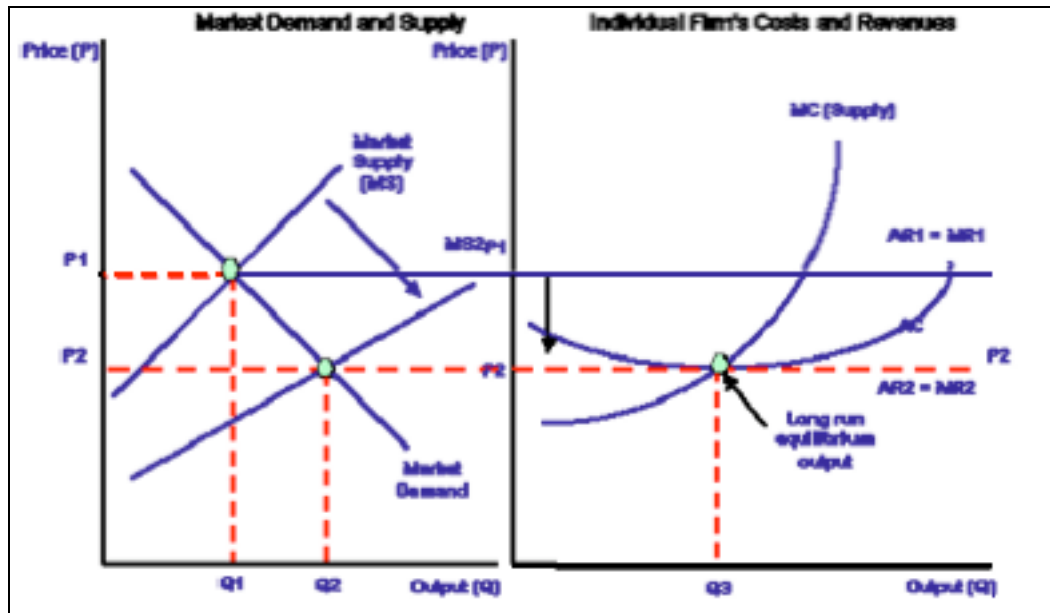


Firms are price takers and therefore have to accept the market price. A perfectly competitive firm's demand curve is perfectly elastic because any firm that raises its price sees demand fall to zero as consumers, with perfect knowledge switch to other producers offering an identical product.

Firms profit maximize at the output level where $MC = MR$. In the diagram above the firm is making **abnormal profits**, in the short run, because $AR > AC$. (It is possible in the short run for the firm to be making losses, in this case at the profit maximizing output level $AR < AC$).

Long Run Equilibrium

Firms making abnormal profit in the short run act as a signal for other firms to join the market. This is very easy to do, as there are no barriers to entry. Market supply thus increases and prices in the market fall until firms in the industry are making normal profits ($AR = AC$). In the diagram below prices fall to P_2 .



If in the short run firms were making losses ($AR < AC$), there would be an incentive for firms to leave (no barriers to exit) and thus market supply would fall until the point in the long run when normal profits are made.

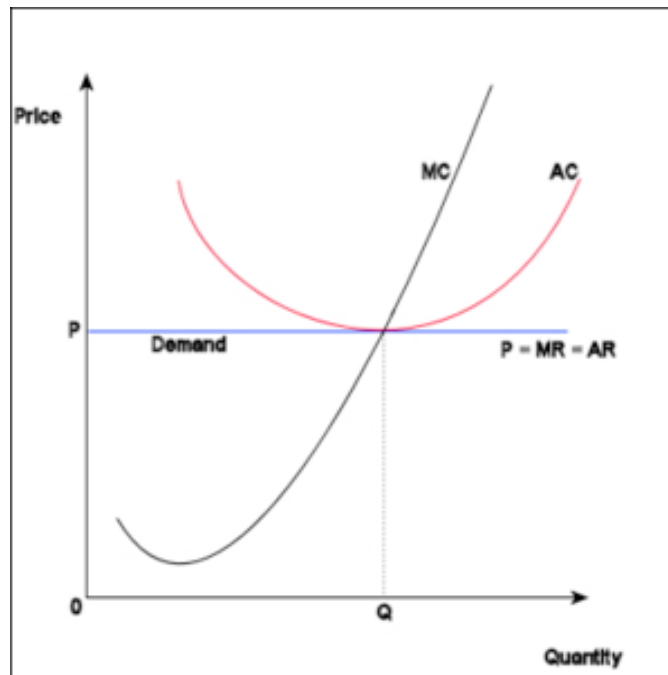
Perfect Competition and Efficiency

Perfect competition is a theoretical model used to compare other market structures with. Although some markets display some of the characteristics of perfect competition they are not the 'perfect' match e.g. potatoes, currency, eBay

One of the major points of comparison is with regards to economic efficiency.

1. **Allocative efficiency.** This type of efficiency is achieved when the firm is charging a price equal to the marginal cost of production ($P = MC$). In both the short and the long run in perfect competition allocative efficiency is achieved.
2. **Productive efficiency.** This is when the firm is producing at an output level that corresponds with average costs being at a minimum ($MC = AC$). This is not the case in the short run but is in the long run in perfect competition.

In the long run a firm in a perfectly competitive market achieves both productive and allocative efficiency.

Long Run Equilibrium showing Productive and Allocative Efficiency

At output Q productive ($MC = AC$) and allocative ($P = MC$) efficiency is achieved.

Question Bank

- 1a) What are the main assumptions made by economists when discussing the model of perfect competition? [10]
- b) Why are these assumptions likely to be unrealistic in practice? [15]
- 2a) Explain how profit is determined in perfect competition [10]
- b) "Whatever the type of market structure, profit maximization will always be the only goal of firms." Discuss [15]
- 3) Draw a diagram to show a perfectly competitive firm making losses.

Other Resources

You Tube video clip revising perfect competition:

<http://www.youtube.com/watch?v=7lhX78vIHSY>

<http://www.tutor2u.net/blog/index.php/ib-diploma/>