Perfect Competition
EE311

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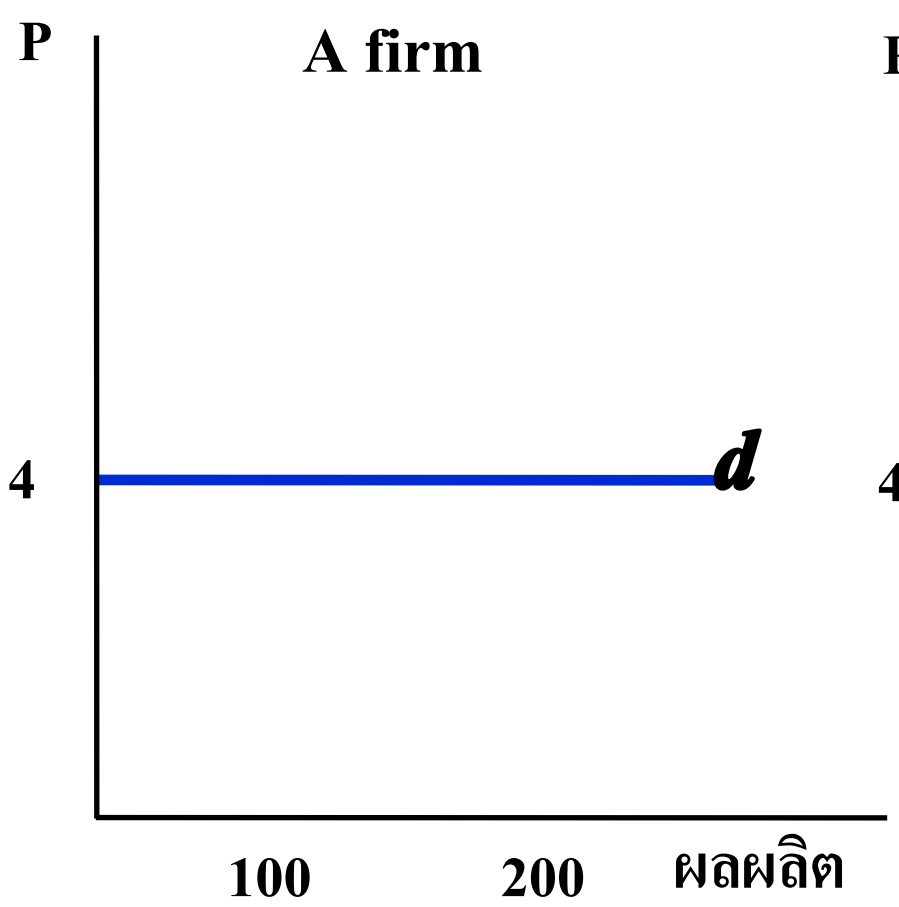
Perfectly Competitive Markets

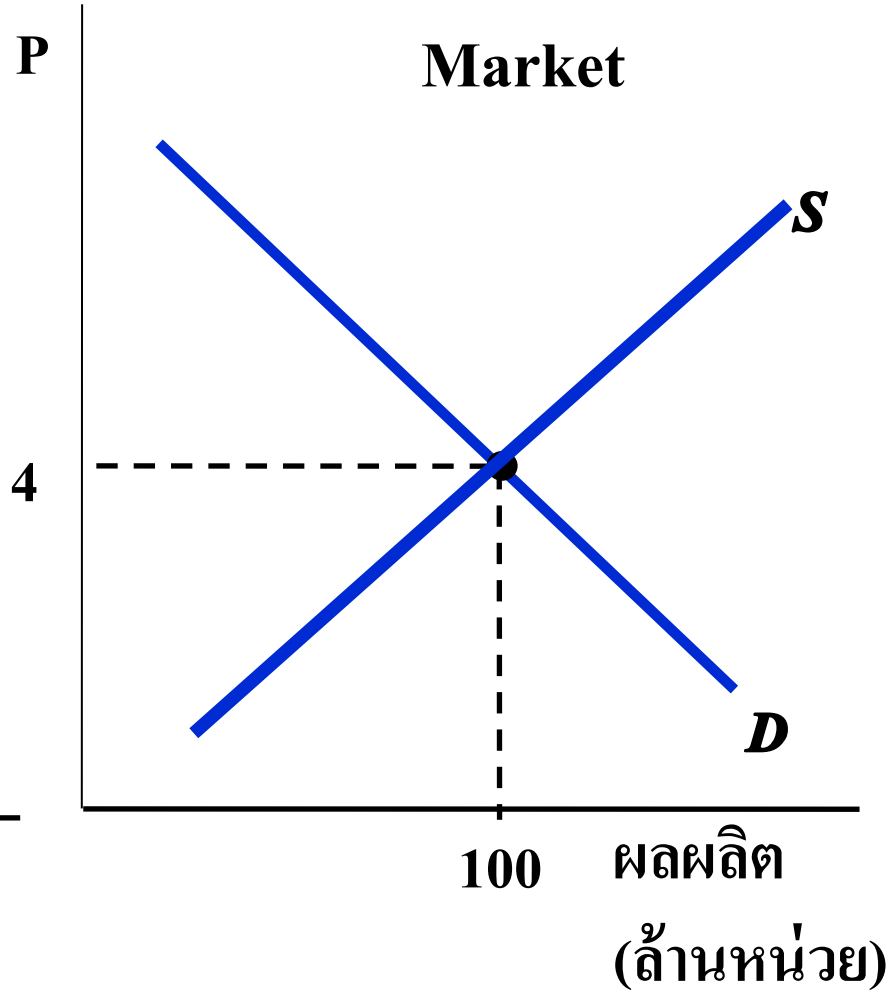
- The model of perfect competition can be used to study a variety of markets (Agricultural products, stock market, exchange rate)
- Basic assumptions of Perfectly Competitive Markets
  - Many small firms -->Price taking
  - Product homogeneity
  - Free entry and exit
  - Perfect information

Perfectly Competitive Markets

1. Price Taking
   - The individual firm sells a very small share of the total market output and, therefore, cannot influence market price.
   - Each firm takes market price as given – price taker
   - The facing demand curve of each firm is horizontal.

Facing demand curve for a competitive firm





Perfectly Competitive Markets

2. Product Homogeneity
   - The products of all firms are perfect substitutes.
   - Product quality is relatively similar as well as other product characteristics
   - Example: Agricultural products, copper ore, lumber
   - Heterogeneous products, such as brand names, can charge higher prices because they are perceived as better

Perfectly Competitive Markets

3. Free Entry and Exit

- When there are no special costs that make it difficult for a firm to enter (or exit) an industry (no laws or regulations, free factor mobility)
  - Buyers can easily switch from one supplier to another.
  - Suppliers can easily enter or exit a market.
    - Pharmaceutical companies not perfectly competitive because of the large costs of R&D required

Perfectly Competitive Markets

4. Perfect Information

- No information cost for buyers and sellers
- Perfect information and homogenous products imply one market price.
- Perfect information and free entry and exit imply zero profit in the long run.
  - Excess profits attract new entry which increases market supply. Price is then decreased until profit is zero.
  - Losses force firms to exit which decreases market supply. Price is then increased until profit is zero.

Profit Maximization

- We can study profit maximizing output for any firm whether perfectly competitive or not
  - Profit (π) = Total Revenue - Total Cost
  - If q is output of the firm, then total revenue is price of the good times quantity
  - Total Revenue (TR) = TR(q)

Profit Maximization

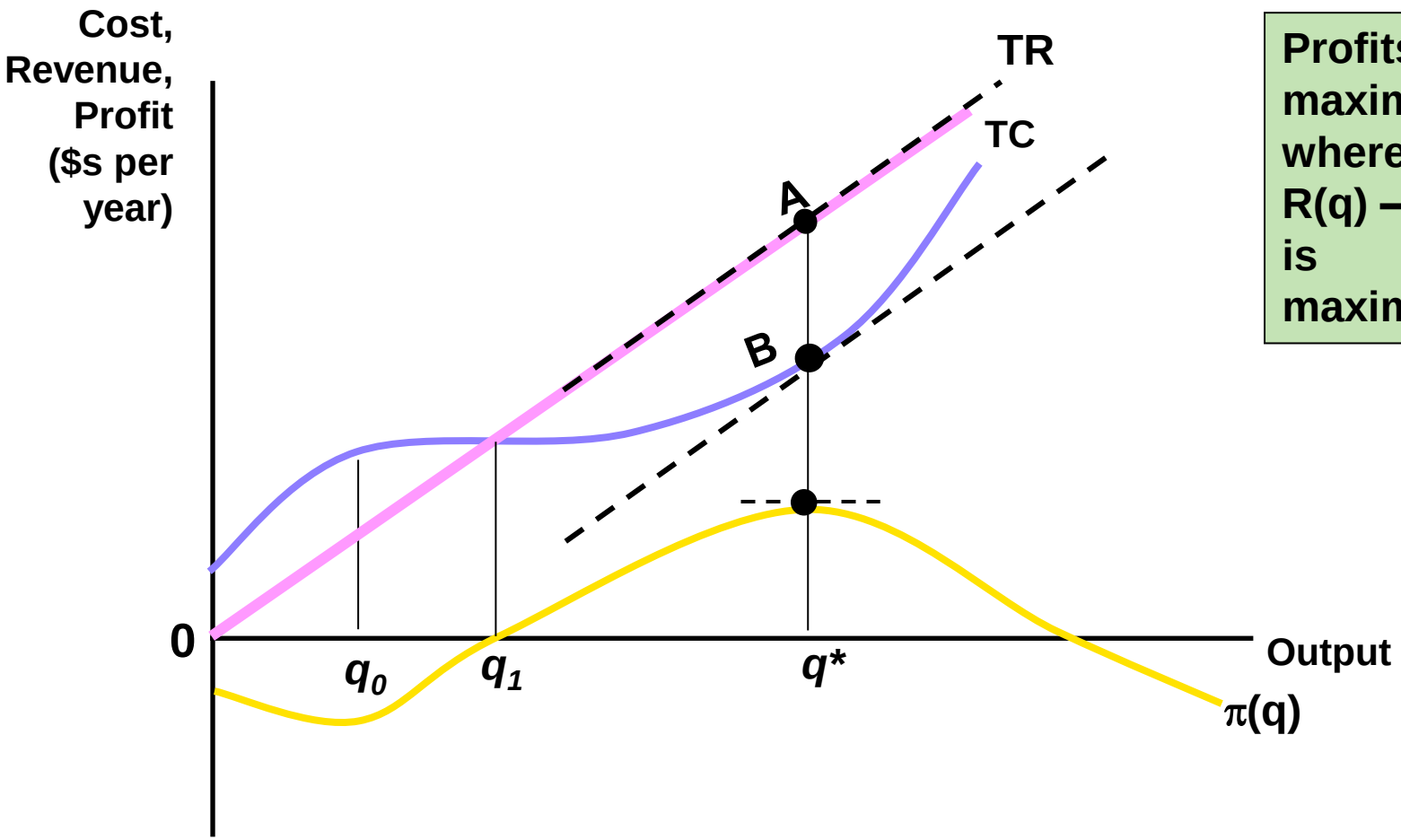
- Costs of production depends on output
  - Total Cost (TC) = TC(q)
- Profit for the firm, π, is difference between revenue and costs

$$\pi(q) = TR(q) - TC(q)$$

- Firm selects output to maximize the difference between revenue and cost

Profit Maximization – Short Run

Profits are maximized where MR (slope at A) and MC (slope at B) are equal or slope of $\pi(q) = 0$



Profits are maximized where R(q) – C(q) is maximized

Profit Maximization

- If the producer tries to raise price, sales are zero.
- Profit is negative to begin with since revenue is not large enough to cover fixed and variable costs
- As output rises, revenue rises faster than costs increasing profit
- Profit increases until it is maxed at q*
- Profit is maximized where MR = MC or where slopes of the TR(q) and TC(q) curves are equal

Profit Maximization

- Profit is maximized at the point at which an additional increment to output leaves profit unchanged

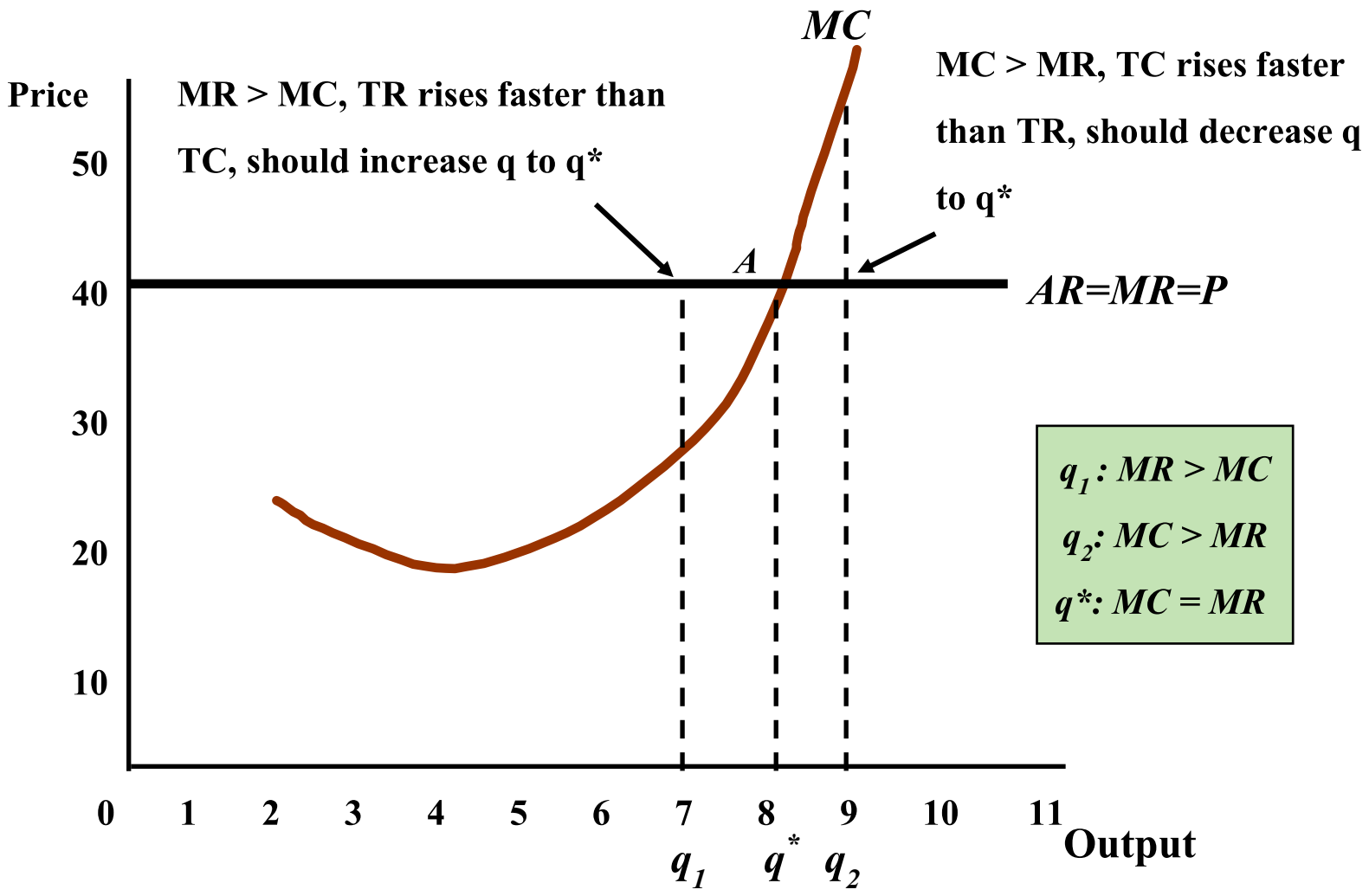
$$\text{Max } \pi = TR - TC$$

$$\frac{d\pi}{dq} = \frac{dTR}{dq} - \frac{dTC}{dq} = 0$$

$$= MR - MC = 0$$

$$MR = MC$$

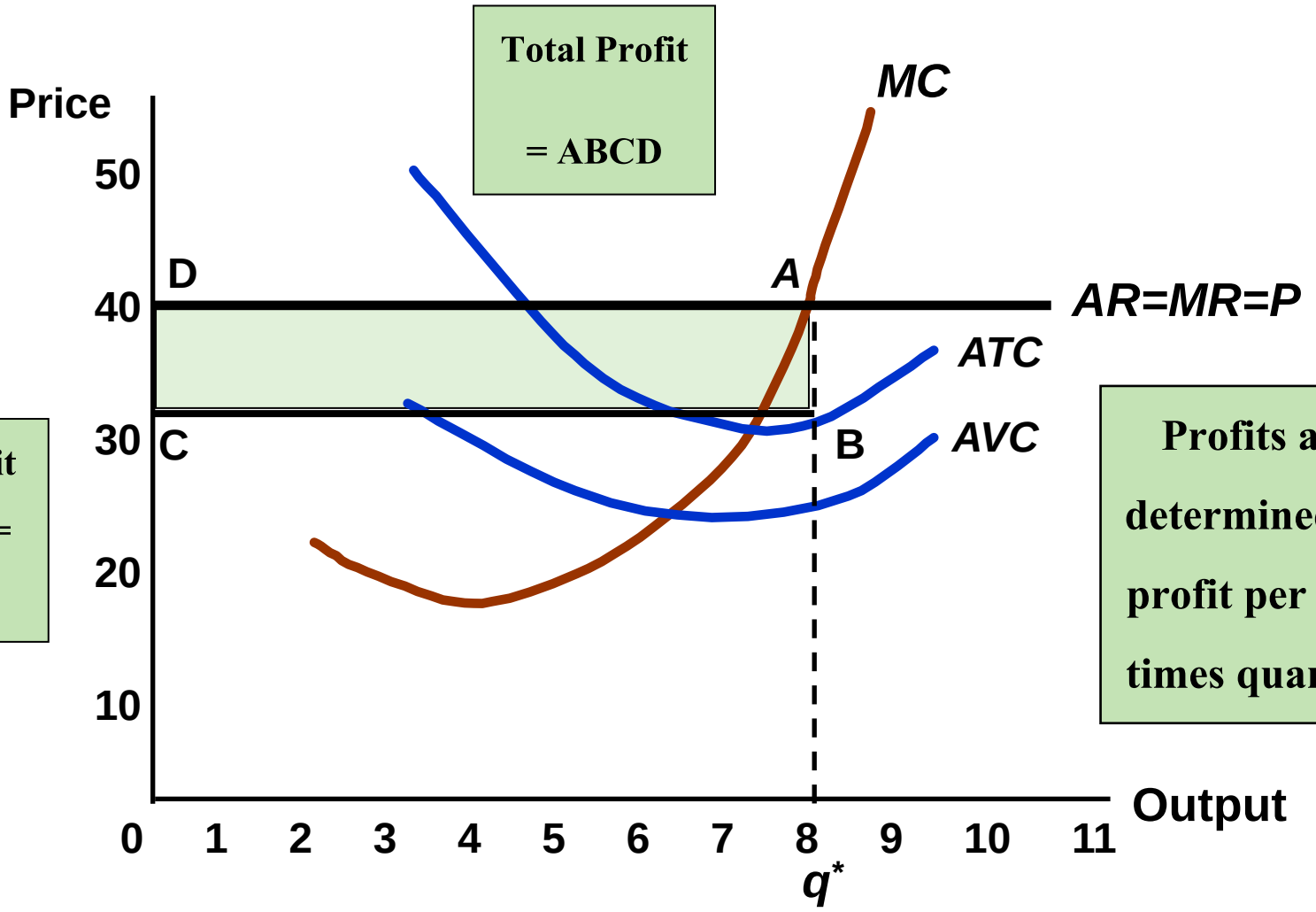
Profit Maximization: MR = MC



Choosing Output: Short Run

- The point where MR = MC, the profit maximizing output is chosen
  - MR=MC at quantity, q*, of 8
  - At a quantity less than 8, MR > MC so more profit can be gained by increasing output
  - At a quantity greater than 8, MC > MR, increasing output will decrease profits

Choosing output: Positive Profits



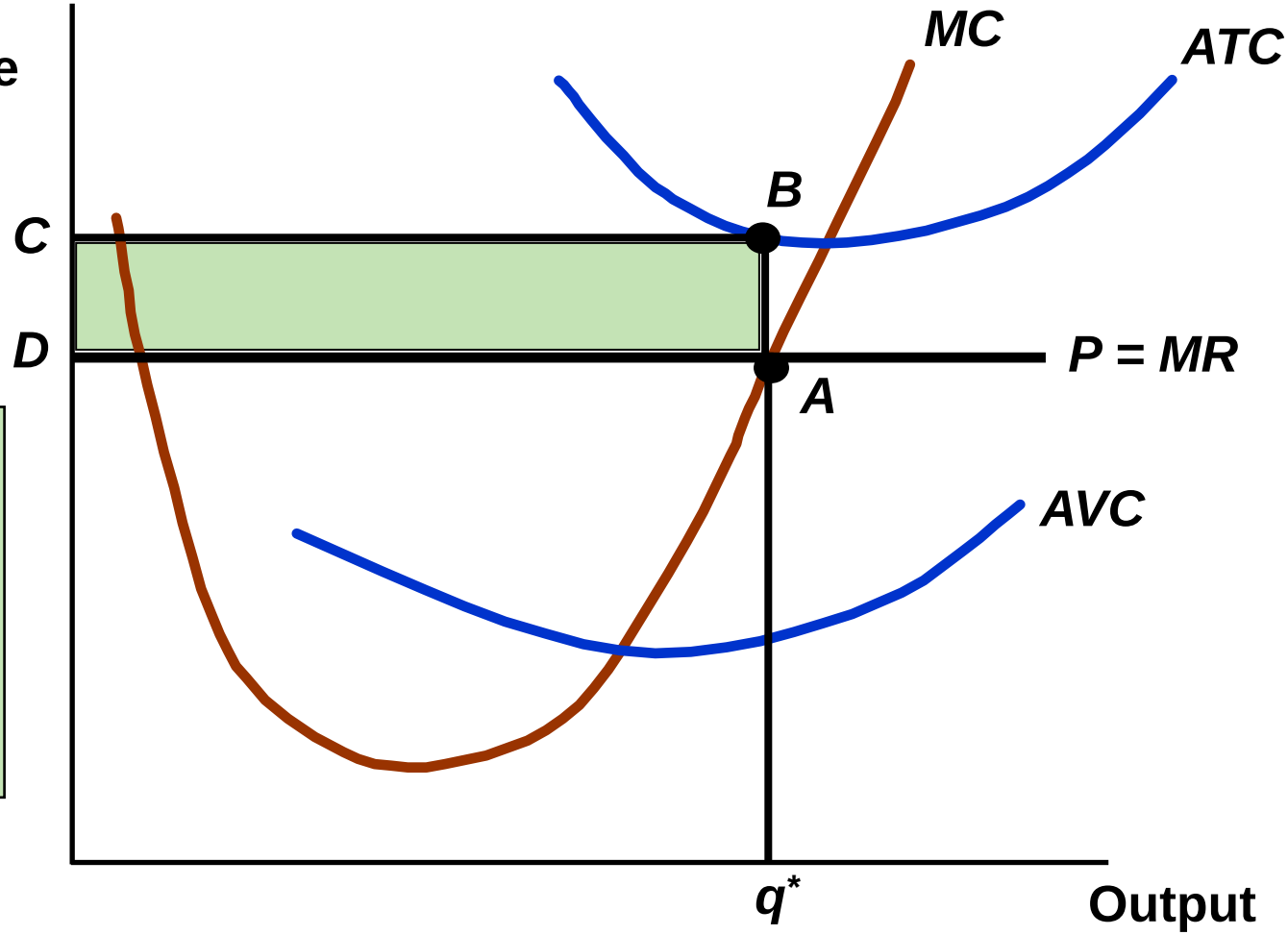
Profit per unit = P - AC(q) = A to B

Profits are determined by profit per unit times quantity

Choosing output: Losses

- A firm does not always make profits
- It is possible for a firm to incur losses if the P < AC at the profit maximizing quantity
  - Still measured by profit per unit times quantity
  - Profit per unit is negative (P – AC < 0)

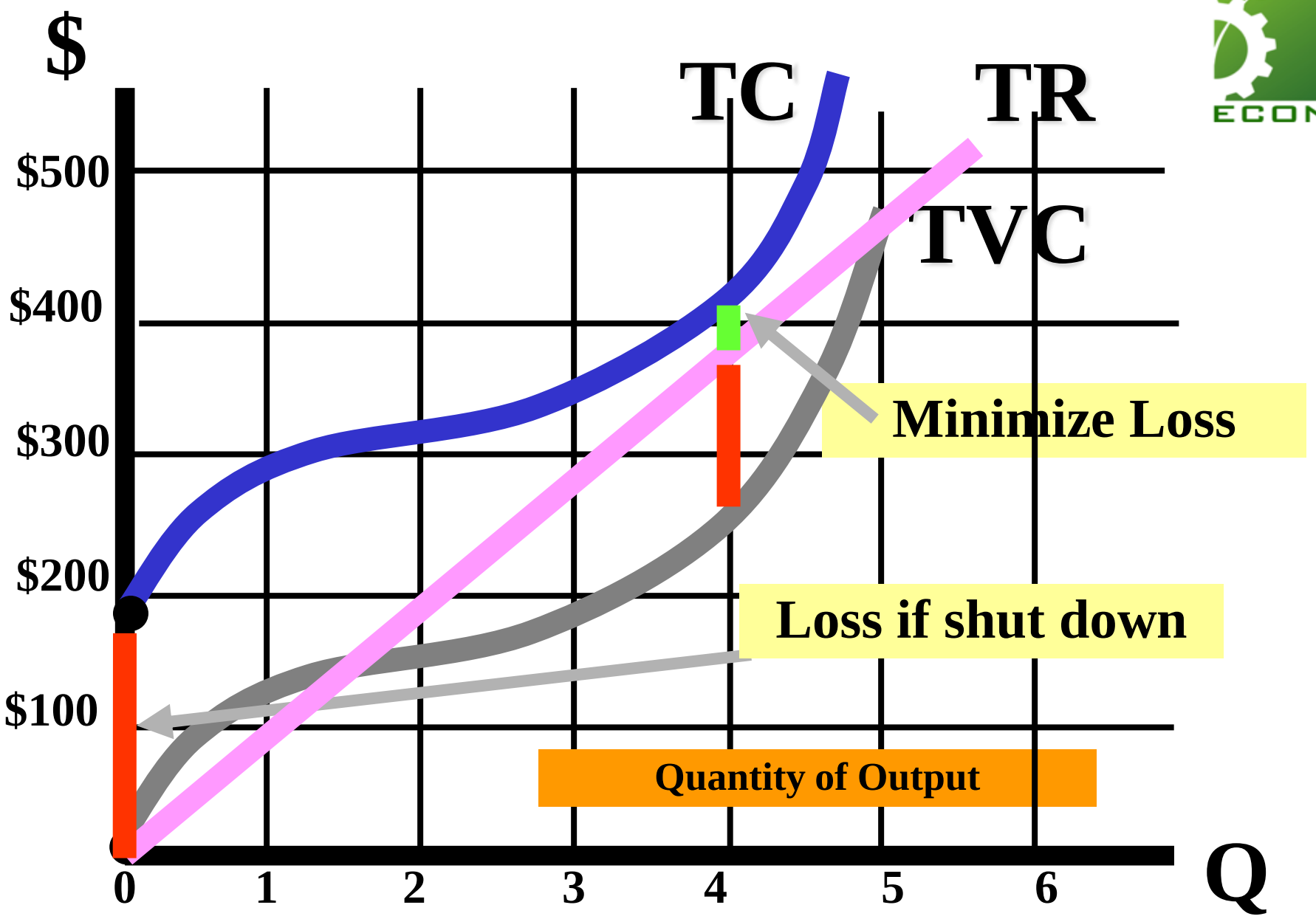
Choosing output: Losses



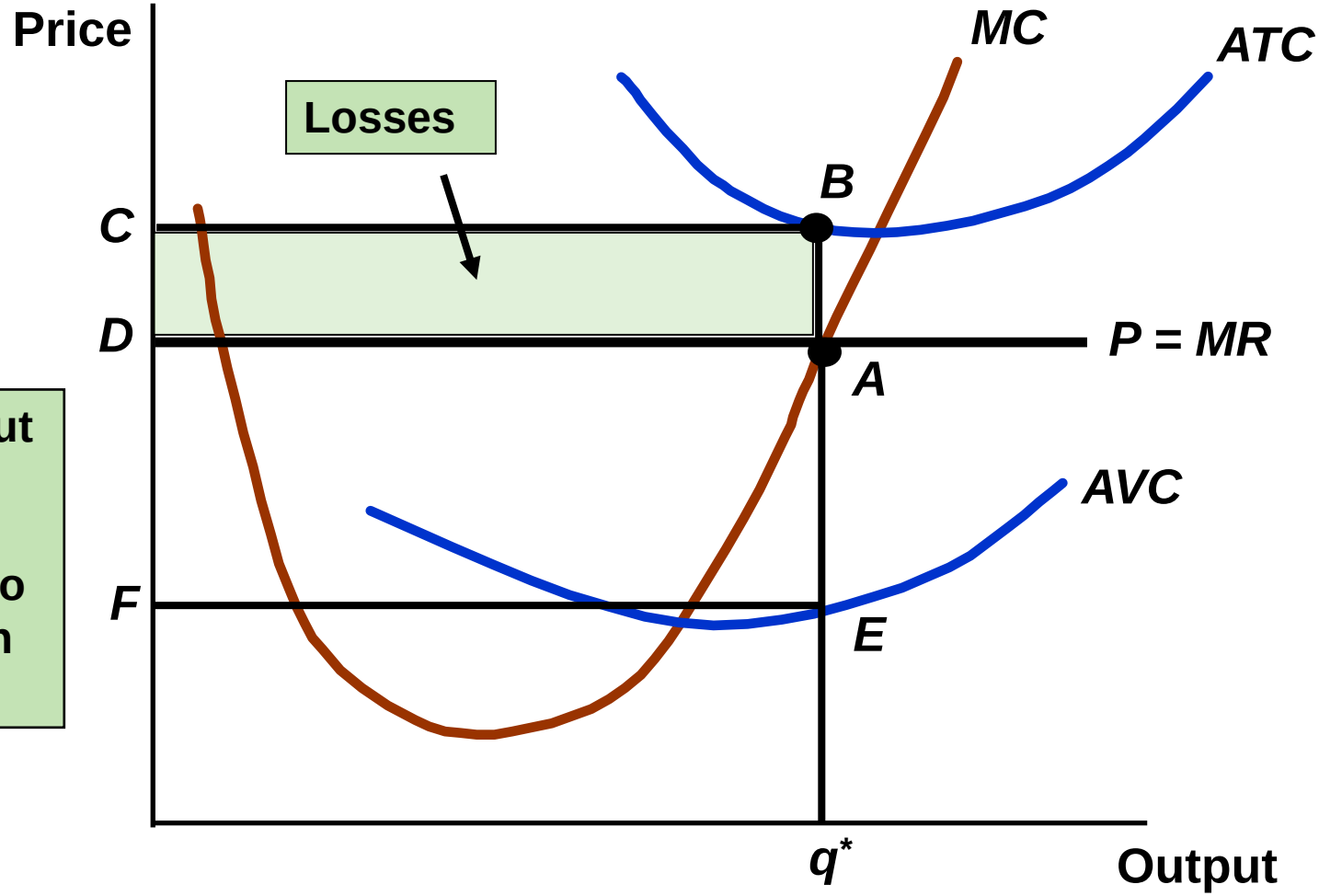
At q^*: MR = MC
and P < ATC
Losses =
(P- AC) x q^*
or area ABCD

Choosing output: Losses

- Why would firm produce at a loss?
  - Might think price will increase in near future
  - Shutting down and starting up could be costly
  - The loss may be smaller than when shut down
- Firm has two choices in short run
  - Continue producing
  - Shut down temporarily
  - Will compare profitability of both choices


$
TC
TR
TVC
$500
$400
$300
$200
$100
Minimize Loss
Loss if shut down
Quantity of Output
0
1
2
3
4
5
6
Q

Choosing output: Losses but should operate



P < ATC but > AVC so firm will continue to produce in short run

When should the firm shut down?

Operate: net revenue = PQ – TVC – TFC.

Shut down: net revenue = – TFC .

It should operate if PQ – TVC – TFC > – TFC

$$PQ - TVC > 0$$

or

$$TR > TVC$$

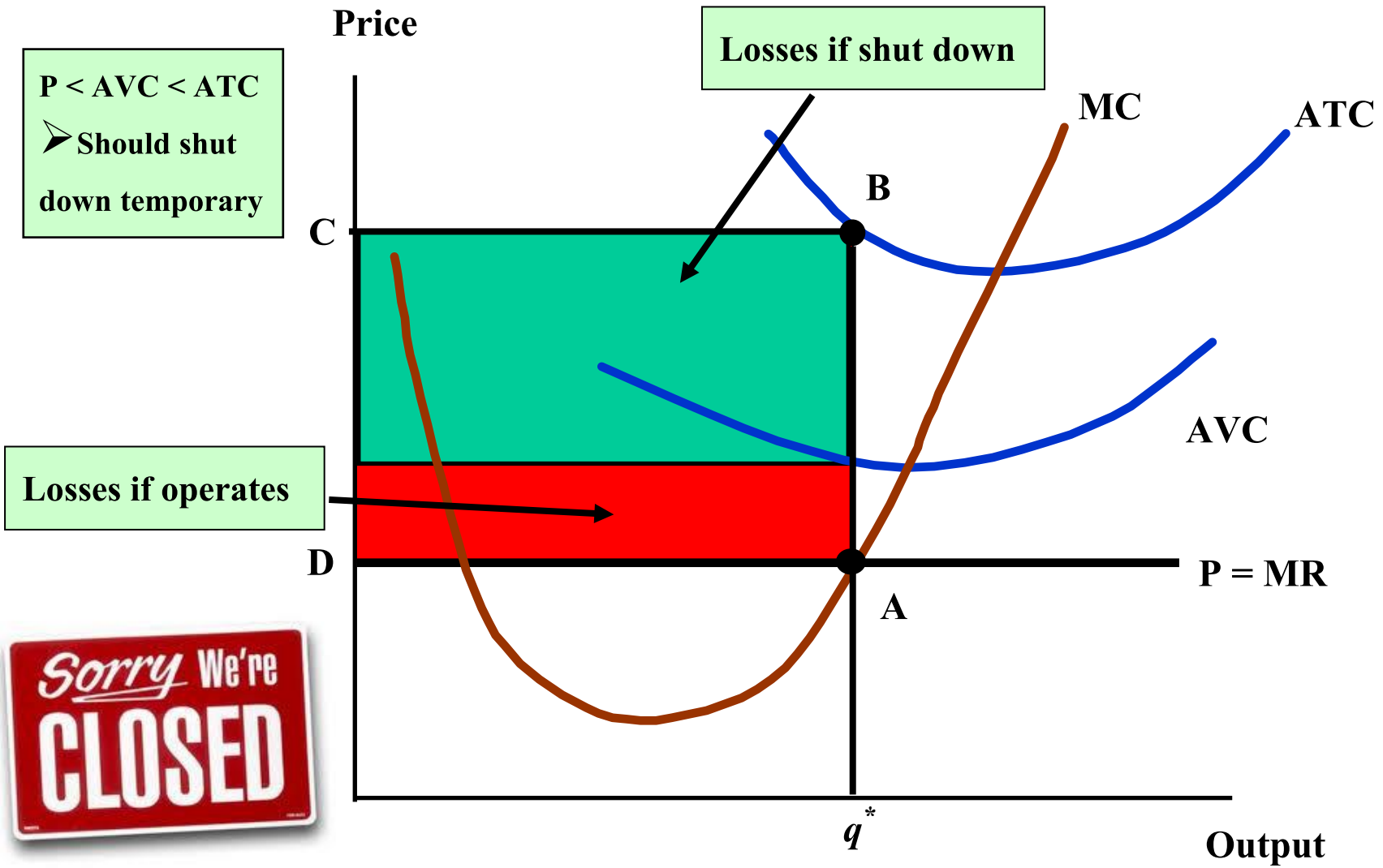
$$P > AVC$$

It should shut down if P ≤ minimum AVC

When should the firm shut down?

- When should the firm shut down?
  - If AVC < P < ATC the firm should continue producing in the short run
    - Can cover all of its variable costs and some of its fixed costs
  - If P < AVC < ATC the firm should shut-down.
    - Can not cover even its variable costs

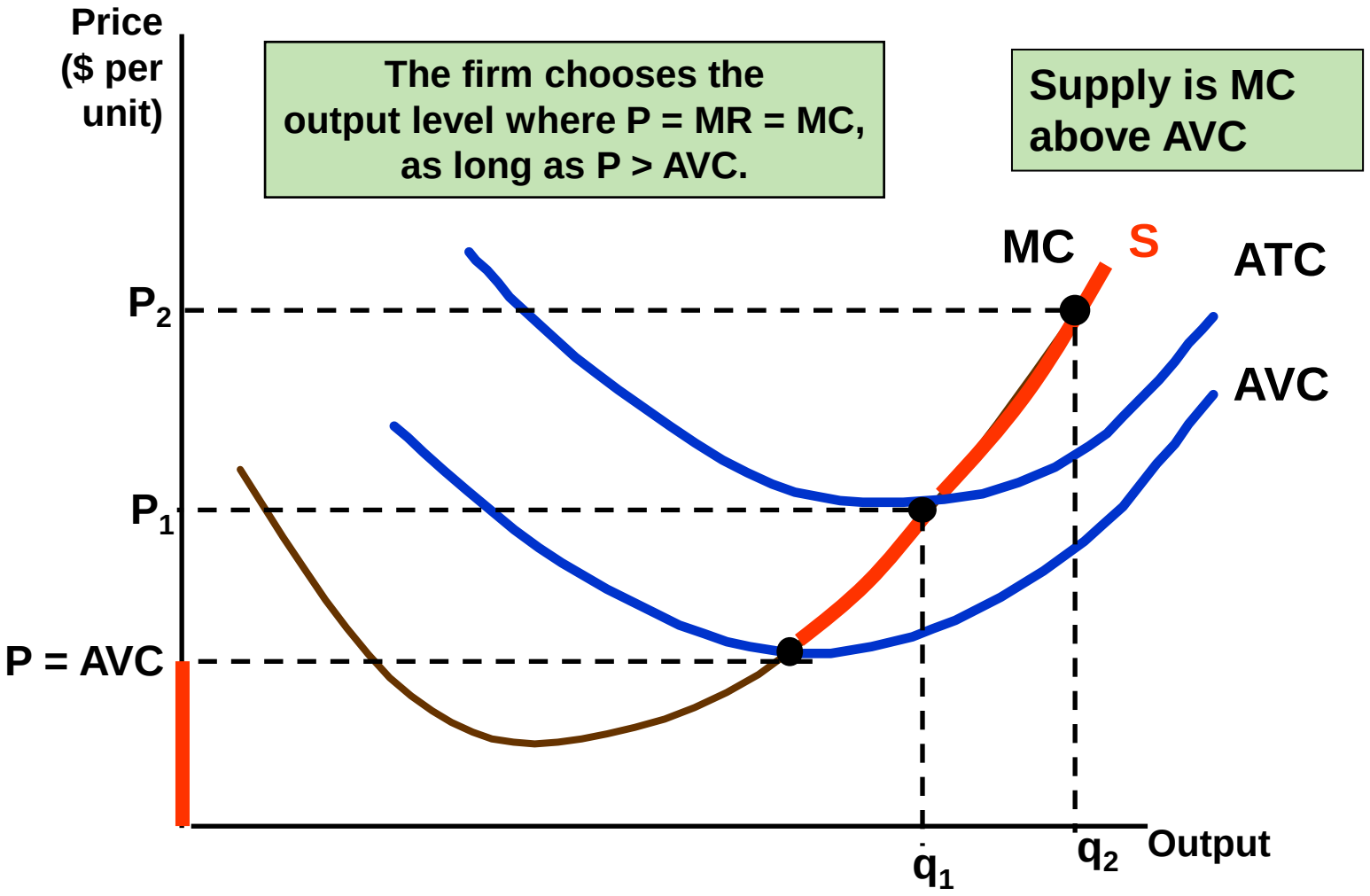
Choosing output: Losses and should shut down



Competitive Firm – Short Run Supply

- Supply curve tells how much output will be produced at different prices
- Competitive firms determine quantity to produce where P = MC
  - Firm shuts down when P < AVC
- Competitive firms supply curve is portion of the marginal cost curve above the AVC curve

A Competitive Firm's Short-Run Supply Curve



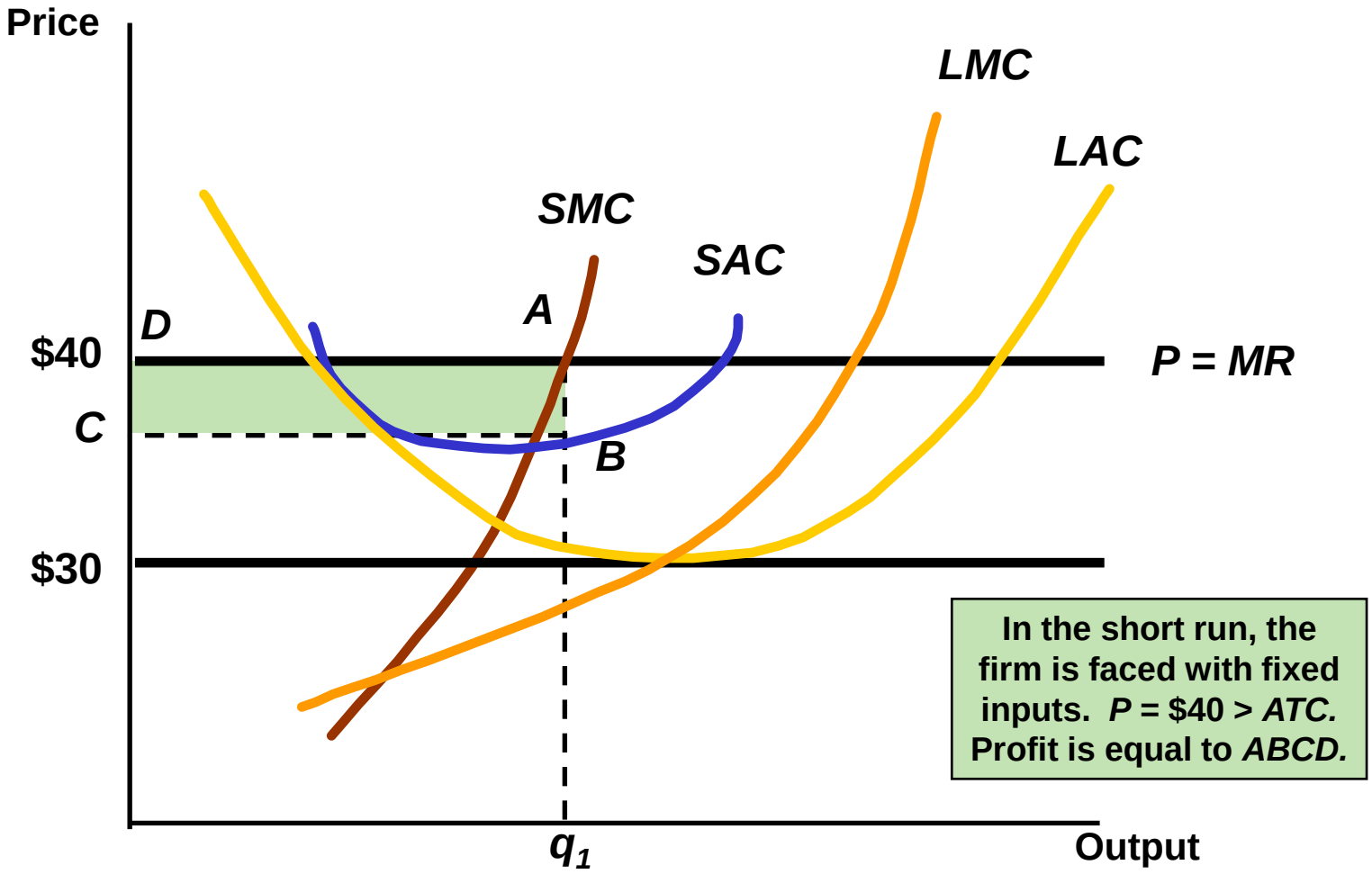
Choosing Output in the Long Run

- In short run, one or more inputs are fixed
  - Depending on the time, it may limit the flexibility of the firm
- In the long run, a firm can alter all its inputs, including the size of the plant.
- We assume free entry and free exit.
  - No legal restrictions or extra costs

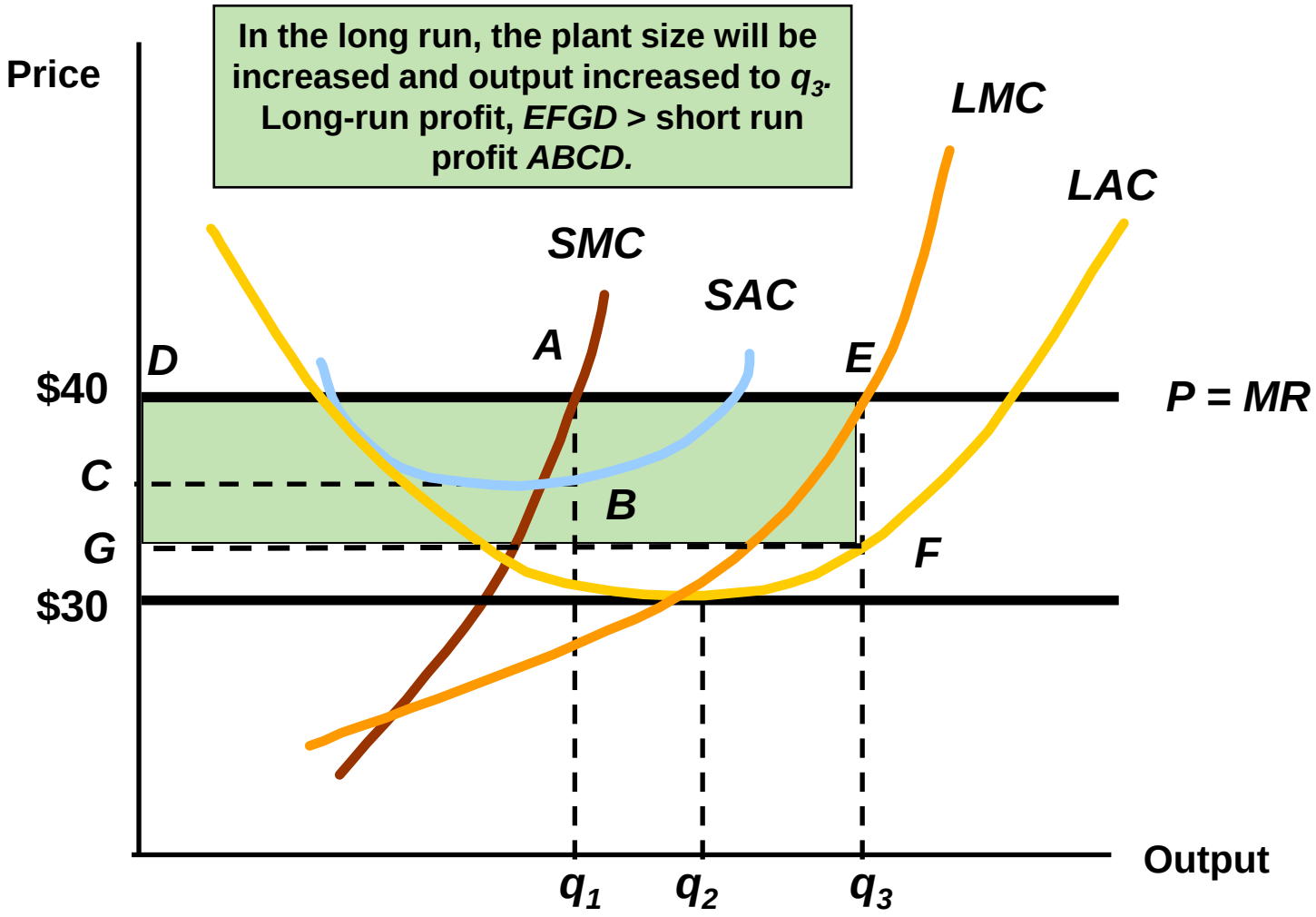
Choosing Output in the Long Run

- In the short run a firm faces a horizontal demand curve
  - Take market price as given
- The short-run average cost curve (SAC) and short run marginal cost curve (SMC) are low enough for firm to make positive profits (ABCD)
- The long run average cost curve (LRAC)
  - Economies of scale to q_2
  - Diseconomies of scale after q_2

Output Choice in the Long Run



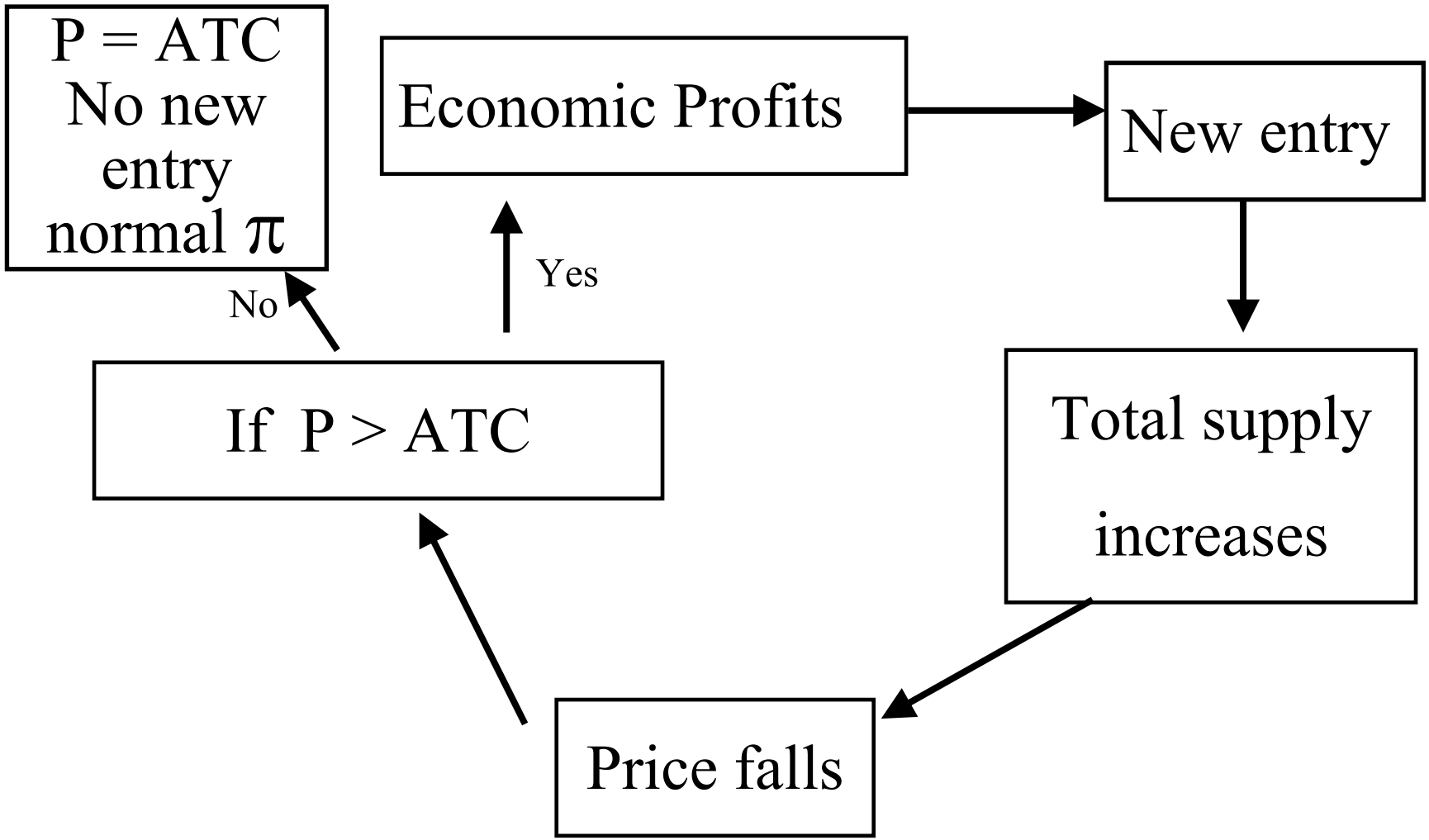
Output Choice in the Long Run



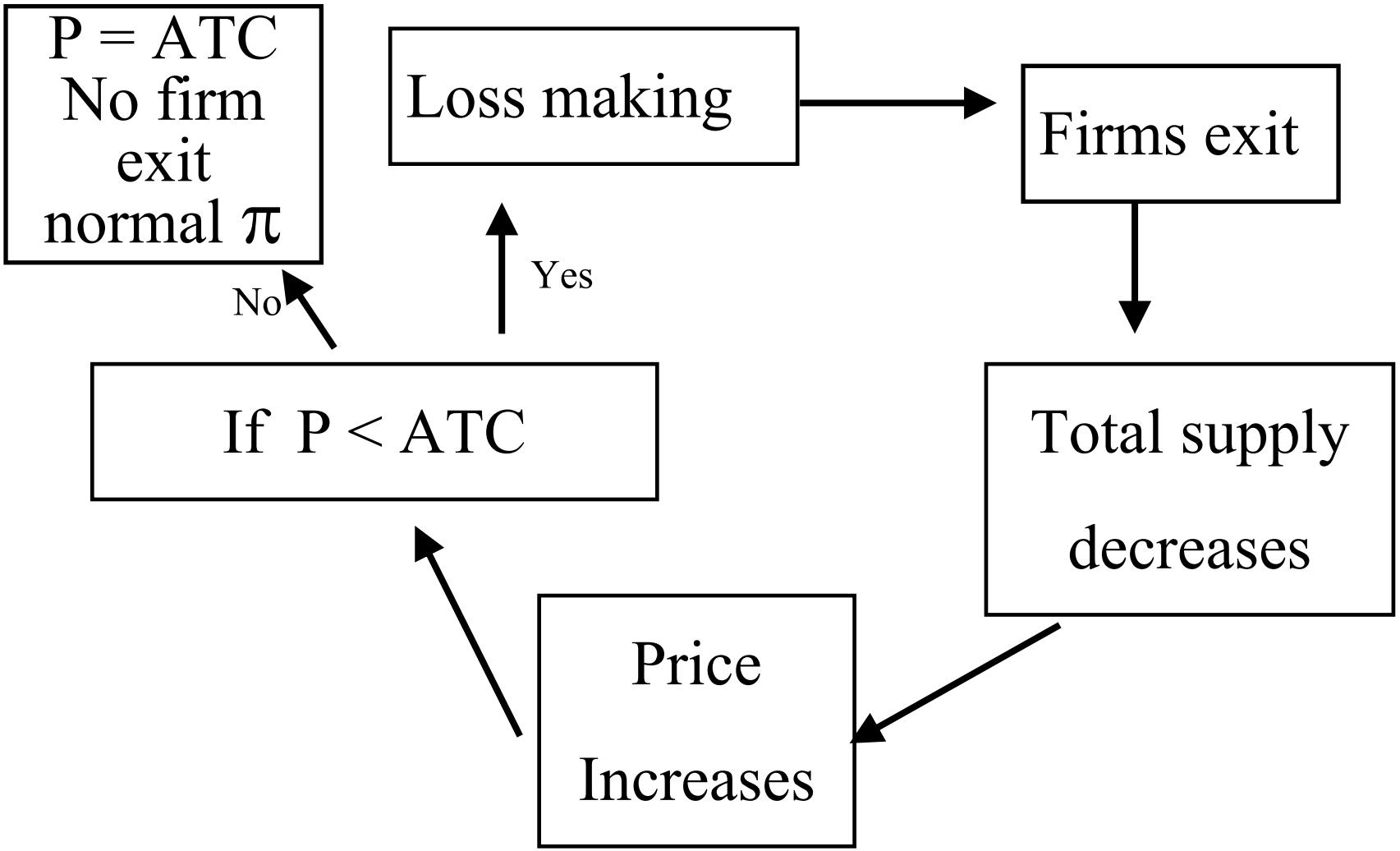
Long-run Competitive Equilibrium

- For long run equilibrium, firms must have no desire to enter or leave the industry
- Zero-Profit
  - A firm is earning a normal return on its own resources
  - Doing as well as it could by using its resources elsewhere
  - Normal profit is firm's opportunity cost of using its own resources instead of using them elsewhere

Long run Equilibrium: New Entry

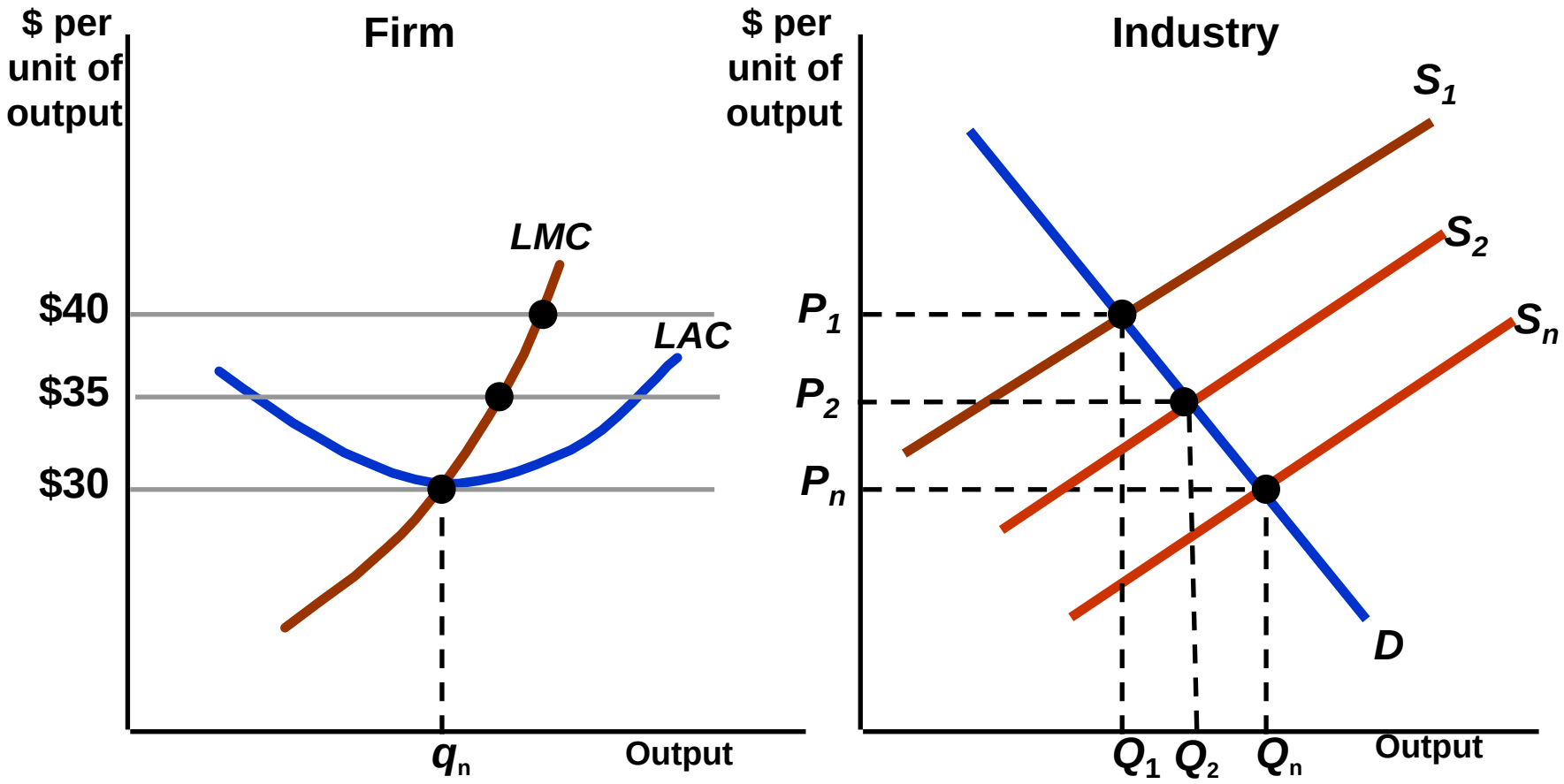


Long run Equilibrium: Exit



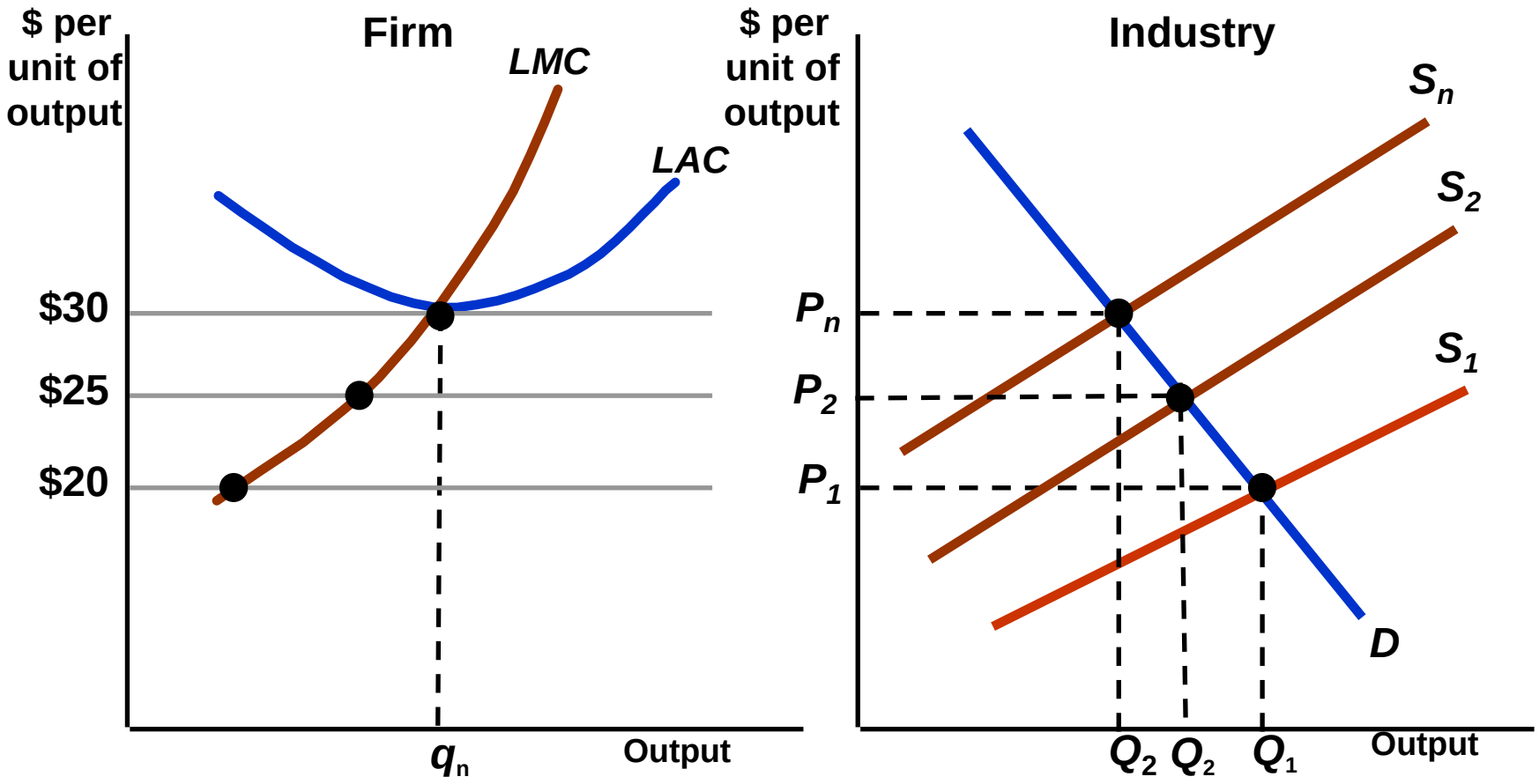
Long-Run Competitive Equilibrium – Profits

- Profit attracts firms
- Supply increases until profit = 0



Long-Run Competitive Equilibrium – Losses

- Losses cause firms to leave
- Supply decreases until profit = 0



Long-Run Competitive Equilibrium

1. All firms in industry are maximizing profits
   - P = MR = LMC = LAC
2. No firm has incentive to enter or exit industry
   - Earning zero economic profits

Efficiency

- Perfectly competitive market is the most efficient market
- Produce at the lowest possible cost
  - P = Minimum LAC or
  - It has productive efficiency
- Generate the highest social welfare
  - D = S and CS + PS are largest
  - P = LMC, marginal benefit = marginal cost
  - It has allocative efficiency