What is Perfect Competition

Perfect Competition is a market structure where there is a perfect degree of competition and single price prevails.

Characteristics of Perfect Competition:

i. There must be **many buyers and sellers**. In such a situation, a single buyer or supplier will not be significant enough to influence the price. In fact price is determined by the market demand and supply and an individual firm is a price taker, unable to influence price.

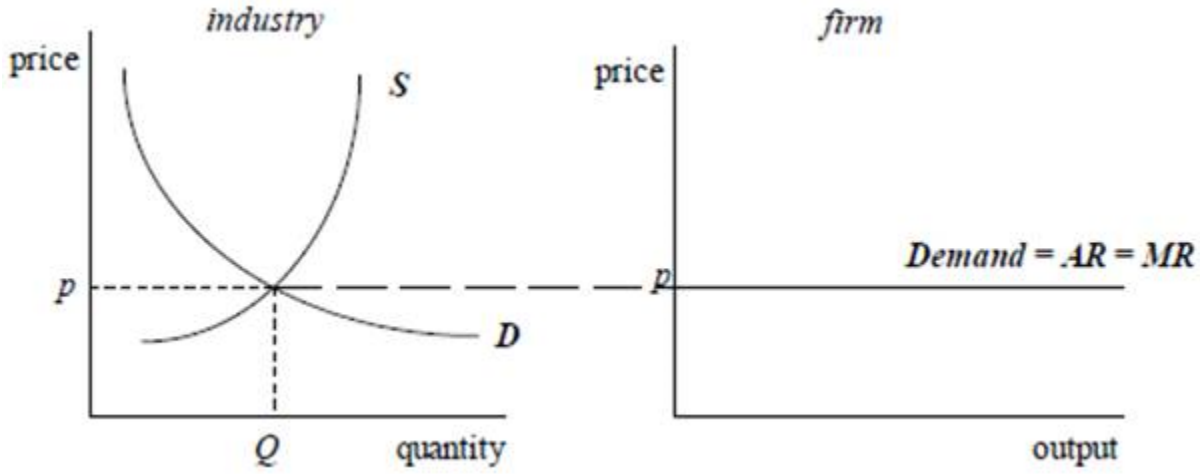
ii. There must be a **low degree of market concentration.** This means that each firm has a tiny share of the market. It follows on from the previous condition, since if there are many firms in the industry, each one will only contribute a small amount of the total market supply

iii. There must **be free entry into and exit from the market**. This means that there must not be anything which makes it difficult for the firms to enter or leave the industry that is to start or stop producing the product

iv. The product must be **homogeneous**, that is identical. There is no branding or advertising. With identical products on offer, consumers will not be concerned about the source of the product

v. Buyers and sellers must be **perfectly informed**. Buyers will know about where the suppliers are and about their products. Sellers will have knowledge about the activities of the rival's production techniques, the availability and price of resources.

WHY FIRM IS A PRICE TAKER AND INDUSTRY IS A PRICE MAKER



Price taker means that an individual firm has no option but to sell at a price determined by the industry. Under perfect competition, an individual firm cannot influence the price on its own as its share in total market supply is negligible. So , firm can neither the supply nor the demand in the market. So, the Firm is a price-taker and the industry is the price-maker.

DEMAND CURVE UNDER PERFECT COMPETITION

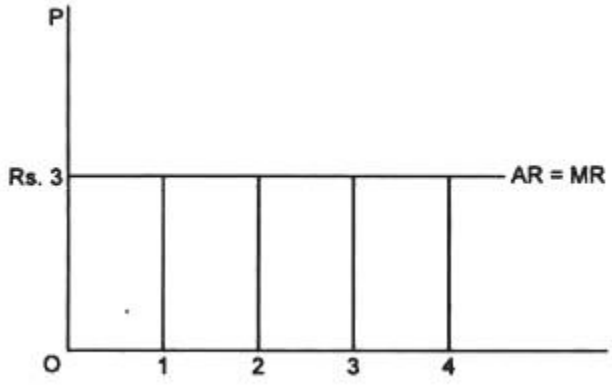


Fig. 7 : Horizontal AR curve & MR curve

IN a case of perfect competition, there are very large number of buyers and sellers selling a homogeneous product at a fixed price by the market. Therefore each firm is a price-taker and faces a perfectly elastic demand curve.(e=infinity)

WHY MR=AR UNDER PERFECT COMPETITION

Here every firm is a price taker. All the firms have to accept that same price as determined by market forces of demand and supply. As a result, uniform price prevails in the market. It means revenue from every additional unit (MR) is equal to the price (AR) of the product. So, MR=AR.

EQUILIBRIUM OF A PERFECTLY COMPETITIVE FIRM :SHORT RUN CASE

the twin conditions of firm's equilibrium under perfect competition are:

(1) MC=MR = Price

(2) MC curve must be rising at the point of equilibrium.

But the fulfillment of the above two conditions does not guarantee that the profits will be earned by the firm. In order to know whether the firm is making profits or losses and how much of them, average cost curve must be introduced in the figure.

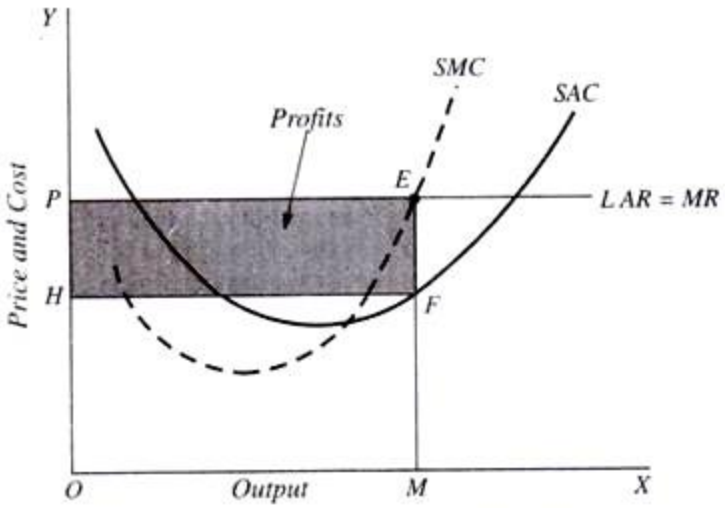


Fig. 23.3. *Short-Run Equilibrium with Profits*

Profit per unit of output is the difference between average revenue (price) and average cost. In Fig. 23.3, at the equi-librium output OM, average revenue is equal to ME, and average cost is equal to MF. Therefore, the profit per unit of output is EF the difference between ME and MF.

The to-tal profits earned by the firm will be equal to EF (profit per unit) multiplied by OM or HF (total output). Thus, the total profits will be equal to the area HFEP. Because normal profits are included in average cost, the area HFEP indicates super-normal profits.

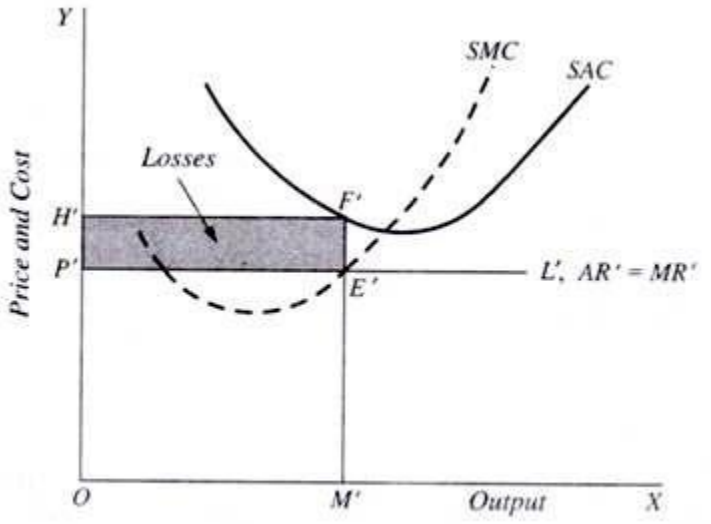
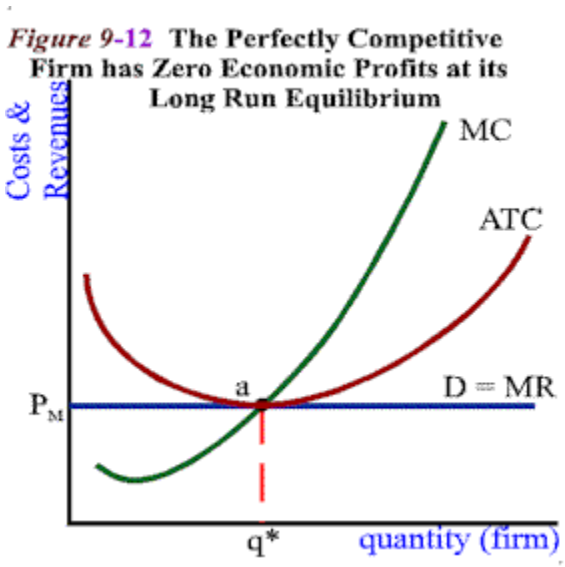


Fig. 23.4. *Short-Run Equilibrium with Losses*

P' L' is the price line which lies below AC curve at all levels of output. The firm will be in equilibrium at point E at which marginal cost is equal to price (or marginal revenue) and marginal cost curve is rising. Firm would be producing OM' output but would be making losses, since average revenue (or price) which is equal to ME' is less than average cost which is equal to MF.

The loss per unit of output is equal to E'F' and total loss will be equal to P'E'F 'FT which is the minimum loss that a firm can make under the given price-cost situation.

LONG RUN EQUILIBRIUM IN CASE OF PERFECT COMPETITION



IN long run free entry and exit features of perfect competition assure us that these profits or losses will disappear.

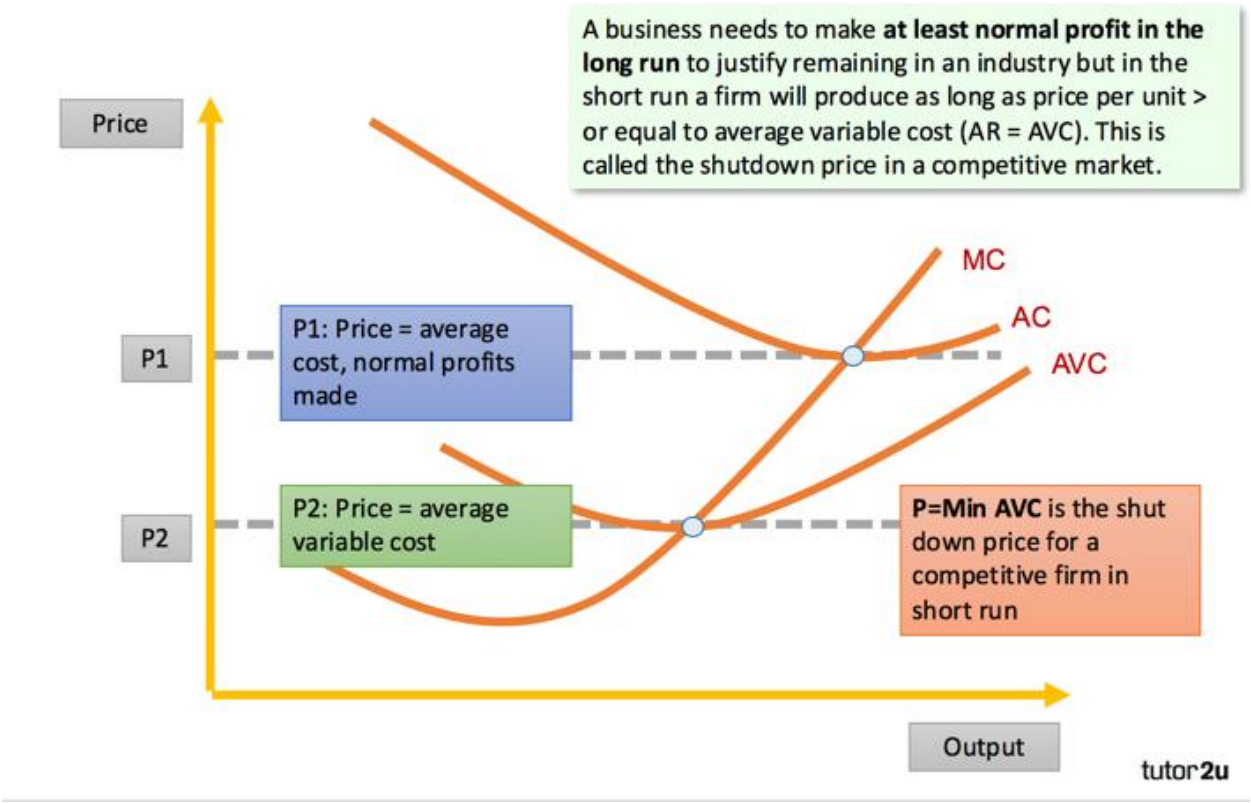
Thus in the long run equilibrium P=AR=MR=AC. And since the equilibrium conditions requires MR=MC,we can say that

P=AR=MR=AC=MC

In other words,in the long run the firm produces at its most efficient level of output where AC is minimized.

SHUTDOWN POINT FOR A PERFECTLY COMPETITIVE FIRM

As price falls to the minimum point of AVC , the firm will stop production which is known as shutdown point.


A business needs to make at least normal profit in the long run to justify remaining in an industry but in the short run a firm will produce as long as price per unit > or equal to average variable cost (AR = AVC). This is called the shutdown price in a competitive market.
Price
MC
AC
AVC
P1
P1: Price = average cost, normal profits made
P2
P2: Price = average variable cost
P=Min AVC is the shut down price for a competitive firm in short run
Output
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