Edexcel Economics A-level

Unit 3: Business Behaviour

Topic 3: Market Structures and Contestability

3.1 Perfect competition

Notes

Characteristics of perfect competition:

- A **perfectly competitive market** has the following characteristics:
    - Many buyers and sellers
    - Sellers are **price takers**
    - Free entry to and exit from the market
    - Perfect knowledge
    - Homogeneous goods
    - Firms are short run profit maximisers
    - Factors of production are perfectly mobile

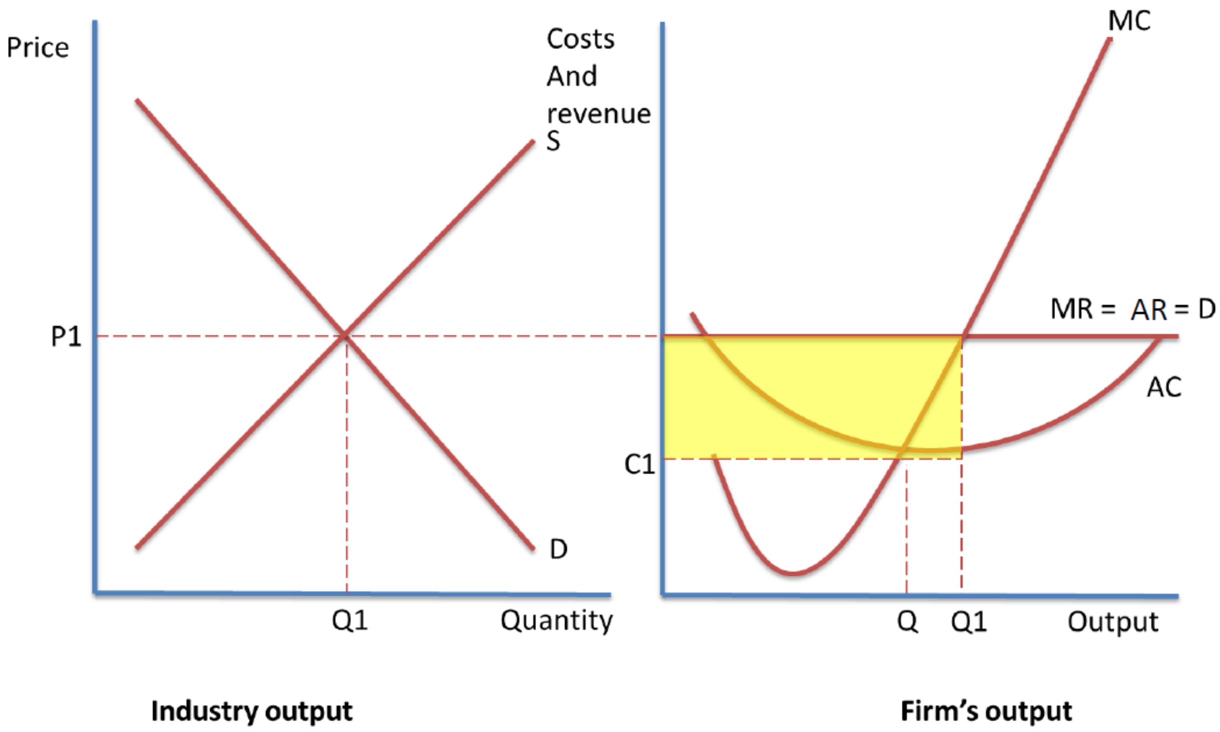
- In this market, price is determined by the interaction of demand and supply.

- In a competitive market, profits are likely to be lower than a market with only a few large firms. This is because each firm in a competitive market has a very small market share. Therefore, their market power is very small. If the firms make a profit, new firms will enter the market, due to low barriers to entry, because the market seems profitable. The new firms will increase supply in the market, which lowers the average price. This means that the existing firms' profits will be competed away.

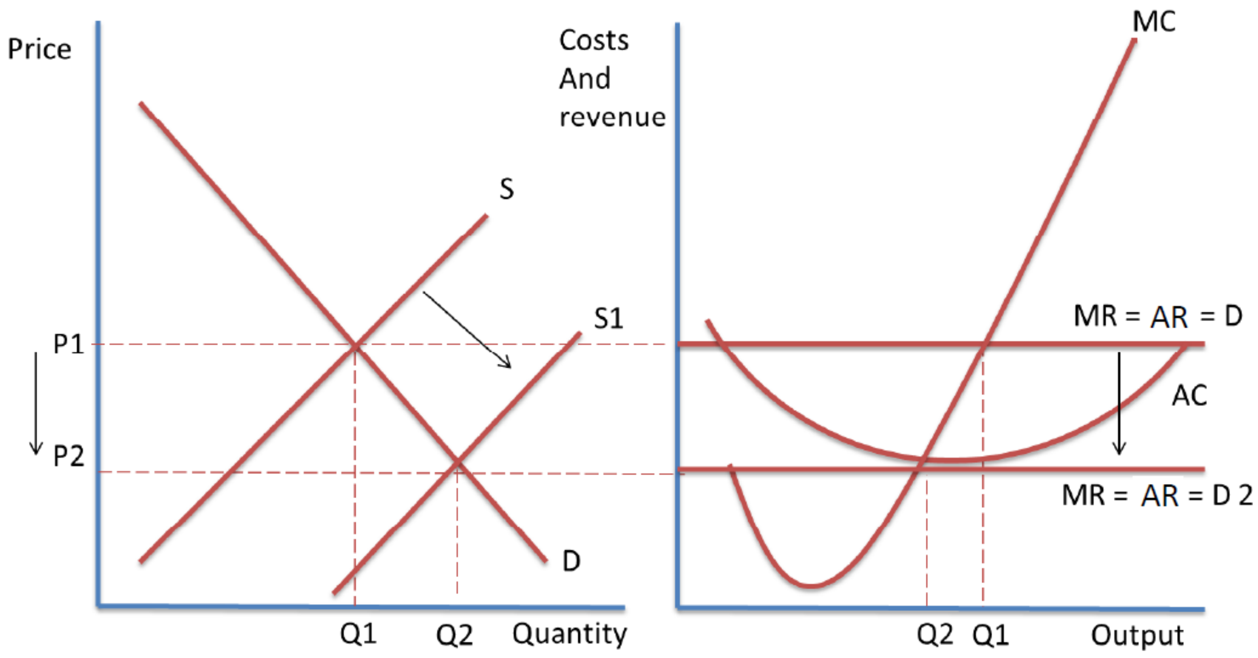
Profit maximising equilibrium in the short run and long run:

- In the short run, firms can make supernormal profits. In the long run where profits are competed away, only normal profits are made.

- The diagram below shows the **short run equilibrium** for a perfectly competitive market. The firm is a price taker, and it accepts the industry price of P1. In the short run, the firm produces an output of Q1. The yellow shaded rectangle shows the area of supernormal profits earned in the short run. It is assumed that firms are short run profit maximisers.



- The diagram below shows the **long run equilibrium** for a perfectly competitive market. The supernormal profits made by existing firms means that new firms have an incentive to enter the industry. Since there are no barriers to entry in a perfectly competitive market, new firms are able to enter the industry.
- This causes the supply in the market to increase, as shown by the shift in the supply curve from S to S1. The price level in the market falls as a consequence. Since firms are price takers, they must accept this new, lower price.
- In the long run, competitive pressure ensures equilibrium is established. The supernormal profits have been competed away, so firms only make normal profits in the long run.
- The new equilibrium at P=MC means firms produce at the new output of Q2 in the long run.



Industry output **Firm's output**

Advantages and disadvantages of a perfectly competitive market:

Advantages	Disadvantages
In the long run, there is a lower price. P =MC, so there is **allocative efficiency.**	In the long run, dynamic efficiency might be limited due to the lack of supernormal profits.
Since firms produce at the bottom of the AC curve, there is **productive efficiency.**	Since firms are small, there are few or no economies of scale.
The supernormal profits produced in the short run might increase dynamic efficiency through investment.	The assumptions of the model rarely apply in real life. In reality, branding, product differentiation, adverts and positive and negative externalities, mean that competition is imperfect.

The distinction between allocative efficiency and productive efficiency

- **Productive efficiency** occurs when resources are used to give the maximum possible output at the lowest possible cost.

- This helps maximise consumer welfare, but it can be wasteful if the goods and services consumers want are not produced.
- Moreover, benefiting one consumer by allocating more resources to them means another consumer loses out. This is because all resources are used to their maximum productive potential, so there is no spare capacity.
- Productive efficiency could be achieved by improving management techniques or employing more advanced technology.

- **Allocative efficiency** occurs when resources are allocated to the best interests of society, where there is maximum social welfare and maximum utility.
- The goods and services consumers want might be produced where there is allocative efficiency, but they also need to be affordable. Productive efficiency helps keep the price down.
- Firms are more allocatively efficient when they produce the goods and services which meet consumer preferences. This helps to maximise consumer satisfaction. Firms which are market-orientated meet this outcome and increase allocative efficiency.