

Topic: Perfect Competition

- Perfect competition is a market structure with homogeneous goods, and many buyers and sellers in the industry. E.g wheat, corn, fruit and vegetable markets
- Watch [perfect competition](#) and summary of [PC](#)

Characteristics of a Perfectly Competitive Market

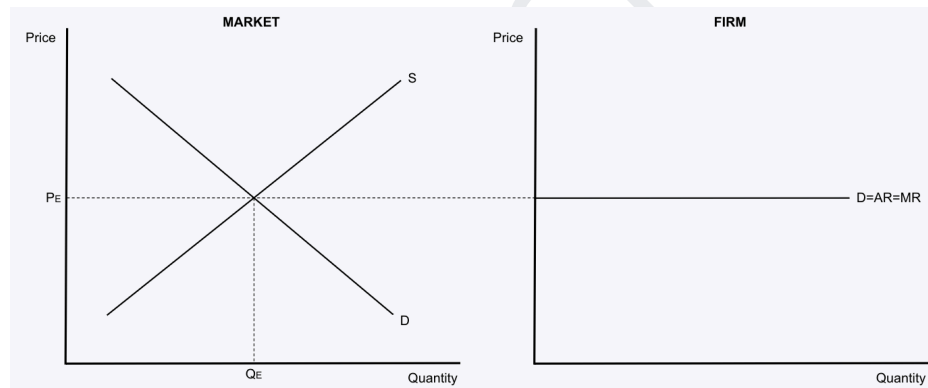
Characteristic	Explanation
Many buyers & sellers	<ul style="list-style-type: none"> • An individual buyer, by his/her own actions, can't influence the market price of the goods in the industry. • An individual seller can't influence the quantity sold by the price it charges for its output in the industry.
Goods are homogenous	<ul style="list-style-type: none"> • The goods which are supplied by the producers are exactly identical. Thus it is pointless for a firm to advertise.
Freedom of entry and exit	<ul style="list-style-type: none"> • No barriers to entry exist within the industry. It is possible for firms to enter/leave the industry as they wish.
Perfect knowledge	<ul style="list-style-type: none"> • Perfect knowledge of profits and prices • Within the industry each firm has very accurate knowledge of profits made by other firms. Consumers has very accurate knowledge of the prices being charged for different products.
Price taker	<ul style="list-style-type: none"> • Each individual firm must accept the price as it is set in the market. • Because each firm supplies such a tiny fraction of the market, it cannot influence the market price. • Demand is perfectly elastic and if price increases above the prevailing market price then quantity demanded would fall to zero.
Each firm attempts to maximise profits	<ul style="list-style-type: none"> • Firms produce where MC = MR. Each firm will attempt to minimise costs of production.

Demand Curve Perfect Competition

- Each firm is selling an identical (i.e. **homogeneous**) product and each firm's quantity sold is small relative to the total market size. Therefore, they are **price takers**.
- Any attempt to undercut the market price will result in complete switching to identical products of competitors.
- Therefore, demand is **perfectly elastic or horizontal** and if price increases above the prevailing market price then quantity demanded would fall to zero.
- **D=AR=MR**

Demand curve for the Firm in Perfect Competition

Average revenue (price)	Quantity demanded	Total revenue	Marginal revenue
10	1		
	2		
	3		
	4		
	5		



Short Run Perfect Competition: SNP's / Abnormal Profits

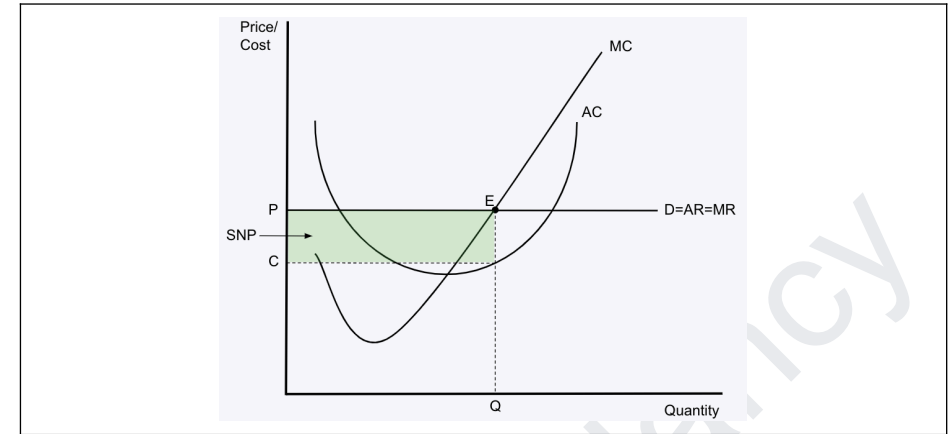
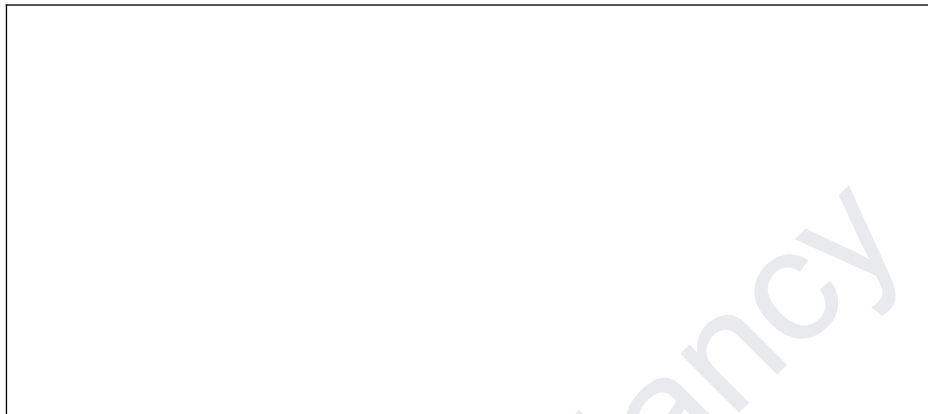


Diagram Analysis

- **Industry explanation:** Incentivised by SNP's (perfect knowledge), **new firms** join the industry (**easy entry** and exit) and supply shifts to the right from $S_1 \rightarrow S_2$
 - Overall quantity in the industry increases from $Q_1 \rightarrow Q_2$
 - The industry price falls from $P_1 \rightarrow P_2$

E – Equilibrium	<ul style="list-style-type: none"> • The firm produces at the profit-maximising level of output, where: MC = MR at Q1
P – Price and output	<ul style="list-style-type: none"> • The firm has no market power and is therefore a price taker, has to accept a price set by the industry (P1) <ul style="list-style-type: none"> ◦ This is due to the large number of firms in the market. • Quantity produced is Q_1
C – Costs	<ul style="list-style-type: none"> • Since AC > AR, the firm cover its total costs and is making a SNP.
S – Supernormal profits / losses	<ul style="list-style-type: none"> • The firm is making SNP because AR > AC at the profit-maximising level of output.
S – Scarce resources	<ul style="list-style-type: none"> • The firm is not producing at the minimum point of the AC curve and is therefore productively inefficient.

Short Run Perfect Competition: Losses

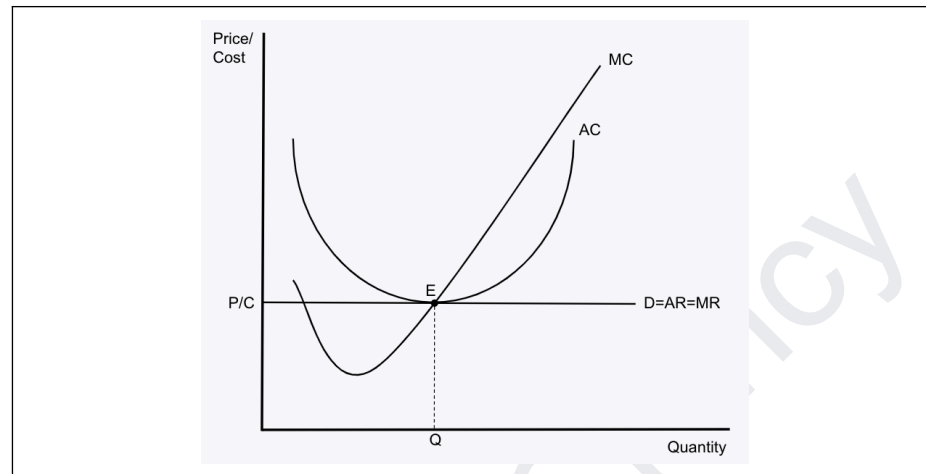


Industry: Move to long run: Due to losses, firms leave the industry (easy entry and exit) and supply decreases from $S_1 \rightarrow S_2$

- Overall quantity in the industry increases from $Q_1 \rightarrow Q_2$
- The industry price rises from $P_1 \rightarrow P_2$

E – Equilibrium	<ul style="list-style-type: none"> ● The firm produces at the profit-maximising level of output, where: MC = MR at Q_1. ● At this output: AR (P_1) < AC (C_1)
P – Price and output	<ul style="list-style-type: none"> ● The firm has no market power and is therefore a price taker. ● This is due to the large number of firms in the market. ● The firm must accept the price set by the industry. <ul style="list-style-type: none"> ○ Therefore: Price is P_1 and Quantity produced is Q_1
C – Costs	<ul style="list-style-type: none"> ● Since AC > AR, the firm does not cover its total costs and is making a loss.
S – Supernormal profits / losses	<ul style="list-style-type: none"> ● The firm is making a loss because AR < AC at the profit-maximising level of output.
S – Scarce resources	<ul style="list-style-type: none"> ● The firm is not producing at the minimum point of the AC curve and is therefore productively inefficient.

Long Run Perfect Competition: Normal Profits



E – Equilibrium	<ul style="list-style-type: none"> ● The firm produces at the profit-maximising level of output, where: MC = MR at Q_1. ● At this output: AR (P_1) = AC (C_1)
P – Price and output	<ul style="list-style-type: none"> ● The firm has no market power and is therefore a price taker. ● This is due to the large number of firms in the market. ● The firm must accept the price set by the industry. <ul style="list-style-type: none"> ○ Therefore: Price is P_1 and Quantity produced is Q_1
C – Costs	<ul style="list-style-type: none"> ● Since AC = AR, the firm covers its total costs and is making a normal profit.
S – Supernormal profits / losses	<ul style="list-style-type: none"> ● The firm is making a normal profit because AR = AC at the profit-maximising level of output.
S – Scarce resources	<ul style="list-style-type: none"> ● The firm is producing at the minimum point of the AC curve and is therefore productively efficient.

No Advertising in Perfect Competition

Firms in perfect competition do not engage in advertising because:

1. Homogeneous Goods

The products offered by all firms in the market are identical (homogeneous). Since there is no differentiation between the goods, advertising would not provide a competitive advantage or attract additional customers to any single firm.

2. Increased Costs with Minimal Additional Revenue

Advertising would increase a firm's costs without significantly increasing its revenue. In perfect competition, firms are price-takers, meaning they cannot charge a higher price than the market price. As a result, the costs of advertising would outweigh any potential benefit.

3. Benefits the Entire Industry

Any advertising done by an individual firm would benefit the entire industry rather than the specific firm. Since all firms sell identical products, increased demand generated by advertising would be distributed among all firms in the market.

Exam Q: 2023

- (a) If a consumer wishes to purchase milk in the Irish market, they are currently faced with an abundance of choice from low-fat milk to super milk to lactose free milk. In the past this market was closer to a model of perfect competition.



Adapted from Irish Times.ie

- (i) Identify three characteristics of a perfectly competitive market.

1.
2.
3.

- (ii) Identify **one** reason why the market for Irish milk can no longer be considered perfectly competitive.

Exam Q: 2022 Deferred Paper

(b) Neo-classical Economists argued that the market structure **perfect competition** would produce the most favourable outcomes for consumers and society.

(i) In the space provided below, explain with the aid of a fully labelled diagram, the long run equilibrium of a firm in perfect competition.

Explanation:

(ii) Explain one possible economic advantage **and** one possible economic disadvantage of perfect competition as a market structure.

Economic advantage:
Economic disadvantage:

(iii) Firms in perfect competition should not engage in advertising. Do you agree or disagree with this statement?

Agree: Disagree:

Outline two reasons for your answer.

1.
2.

(c) In 2013 the EU blocked the takeover of Aer Lingus by Ryanair in an anti-monopoly decision. Adapted from rte.ie

(i) Explain why it is important for **consumers** that bodies like the EU regulate markets.
