Introduction to Economics I
Lecture 10

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Perfect Competition

- A perfectly competitive market is characterized by many buyers and sellers, undifferentiated products, no transaction costs, no barriers to entry and exit, and perfect information about the price of a good.
- The total revenue for a firm in a perfectly competitive market is the product of price and quantity (TR = P * Q).
- The average revenue is calculated by dividing total revenue by quantity.
- Marginal revenue is calculated by dividing the change in total revenue by change in quantity.

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Perfect Competition

- A firm in a competitive market tries to maximize profits.
- In the short-run, it is possible for a firm's economic profits to be positive, negative, or zero. Economic profits will be zero in the long-run.
- In the short-run, if a firm has a negative economic profit, it should continue to operate if its price exceeds its average variable cost.
- It should shut down if its price is below its average variable cost.

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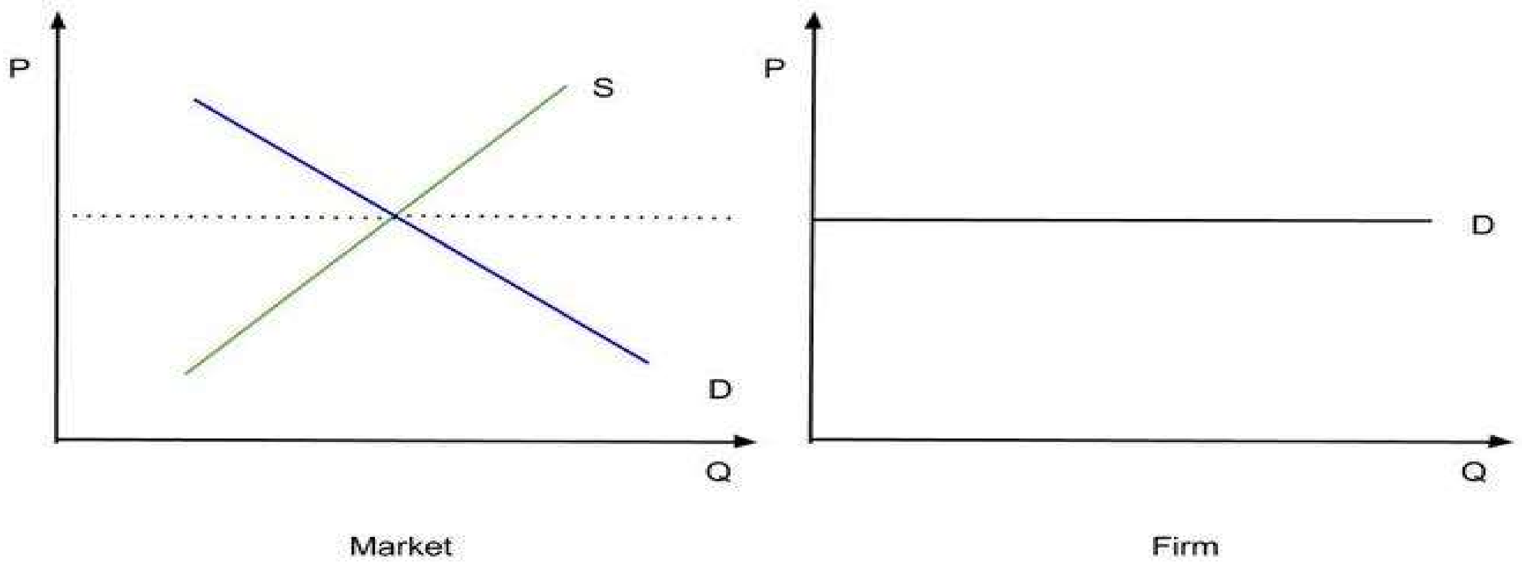
Perfect Competition



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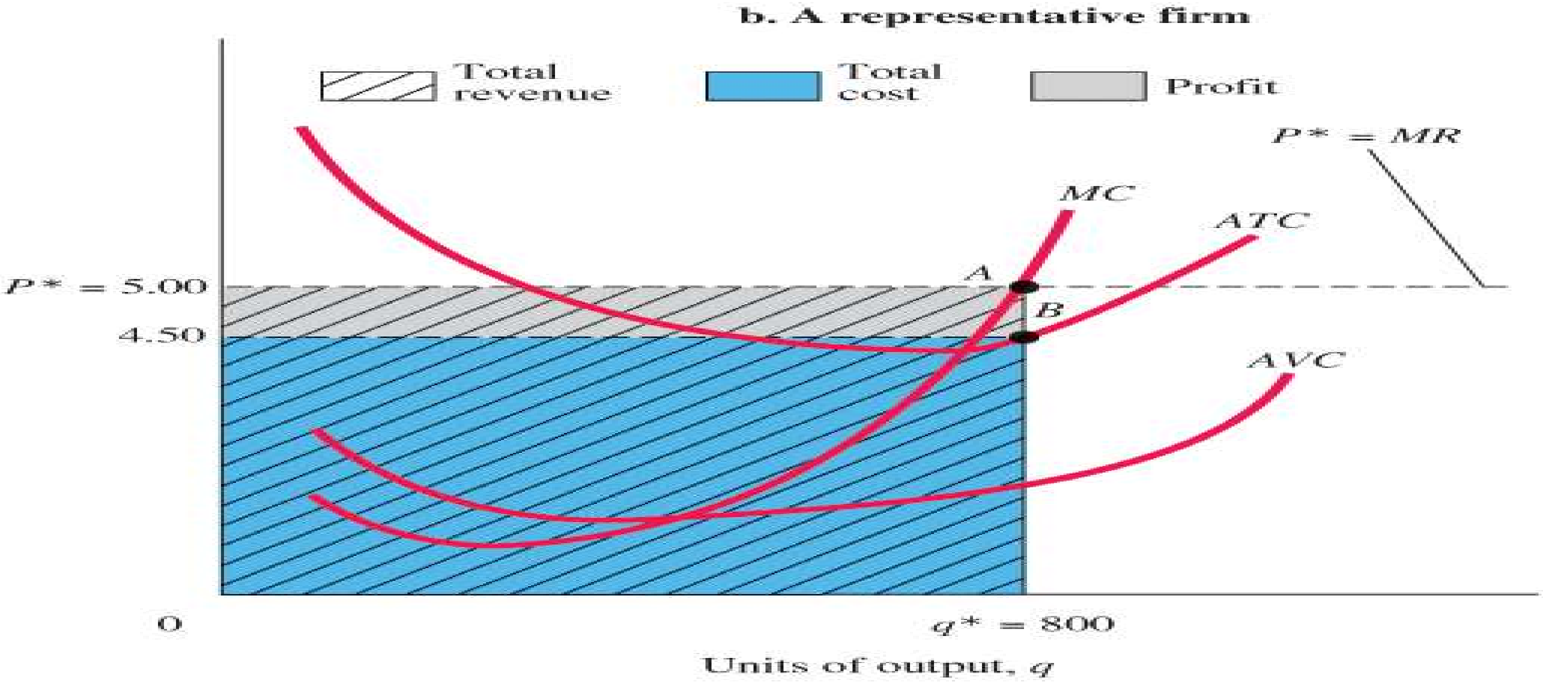
Perfect Competition (Positive Profits in the Short Run)



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Perfect Competition (Positive Profits in the Short Run)

New firms enter the market since there is a positive profit in the industry.

Hence, the economic profit is going to be zero after the entry.

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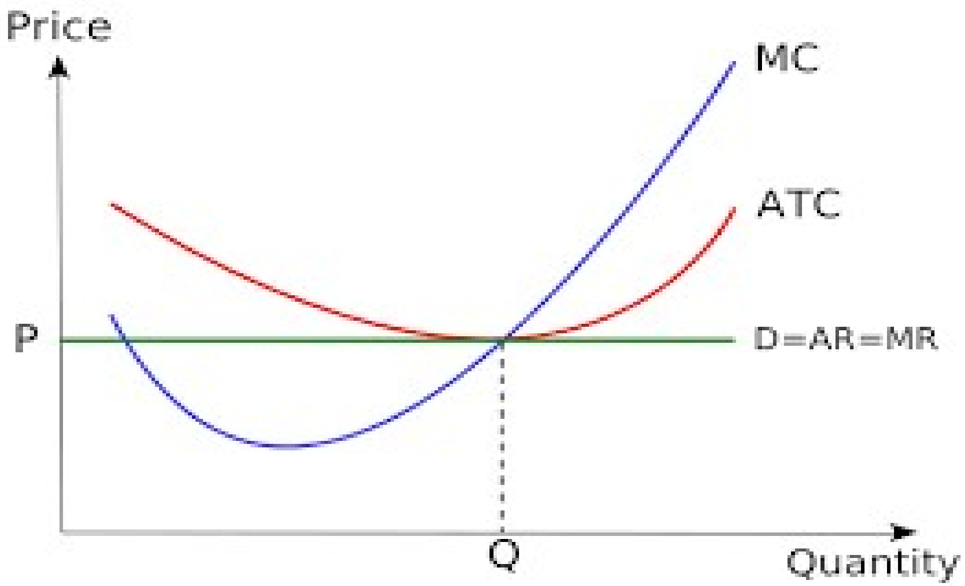
Perfect Competition (0 Economic Profits in the Long-Run)



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Perfect Competition

P=MC=MR is the profit maximizing rule for a firm in a competitive market.

Q is the profit maximizing output level. P is the market price of that good.

In the Long-Run, since ATC=P, then economic profit is zero.

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Perfect Competition

Recall that P=MC is the short-run condition for profit maximization.

- If TR>TVC, then operate in SR and if TR>TC, then continue to operate in LR. Industry expands in this case.
- If TR>TVC, then operate in SR and if TR<TC, then shut down in LR. Industry contracts in this case.
- If TR<TVC, then shut down in SR immediately. Industry contracts in this case.