

PERFECT COMPETITION

SHORT-RUN AND LONG-RUN DECISIONS

CHARACTERISTICS OF A PERFECT COMPETITOR:

- **No barriers to entry or exit**
- **Price-takers (must accept market price at each and every level of output)**
- Homogeneous product
- Perfect knowledge in the market

e.g. Supernormal profits:

Q_e is the point where $MR=MC$, which is the profit-maximising output level.

Attracted by supernormal profits, more firms will enter the industry freely. This will increase the flow of capital into the industry, the supply curve shifts to the right (from S to S_1), and market price falls.

Because perfect competitors are also price-takers (i.e. they must accept market price at each and every level of output), they must accept this new market price, and price falls from $P=AR=MR=D$ to $P_1=AR_1=MR_1=D_1$.

If output remained at Q_e , $MC > MR_1$, which means that the firm would be making a marginal loss on each successive unit of output. So quantity shifts to Q_1 , which is where profit is maximised once again at $MC = MR_1$.

Therefore, in the long-run, a perfect competitor will only earn supernormal profit temporarily, and will always return to the point where normal profits are made.

e.g. Subnormal profits:

Q_e is the point where $MR=MC$, which is the profit-maximising output level.

Deterred by subnormal profits, more firms will leave the industry freely. This will decrease the flow of capital into the industry, the supply curve shifts to the left (from S to S_1), and market price rises.

Because perfect competitors are also price-takers (i.e. they must accept market price at each and every level of output), they must accept this new market price, and price rises from $P=AR=MR=D$ to $P_1=AR_1=MR_1=D_1$.

If output remained at Q_e , $MC > MR_1$, which means that the firm would be making a marginal loss on each successive unit of output. So quantity shifts to Q_1 , which is where profit is maximised once again at $MC = MR_1$.

Therefore, in the long-run, a perfect competitor will only earn subnormal profit temporarily, and will always return to the point where normal profits are made.