

# Economics and perfect competition essay sample



**ASSIGN  
BUSTER**

1. A perfectly competitive firm faces a price of £14 per unit. It has the following short-run cost schedule:

Output	0	1	2	3	4	5	6	7	8	TC (£)	10	18	24	30	38	50	66
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(a) Copy the table and put in additional rows for average cost and marginal cost at each level of output. (Enter the figures for marginal cost in the space between each column.) (b) Plot AC, MC and MR on a diagram.

(c) Mark the profit-maximising output.

(d) How much (supernormal) profit is made at this output? e) What would happen to the price in the long run if this firm were typical of others in the industry? Why would we need to know information about long-run average cost in order to give a precise answer to this question?

(a)

Output	0	1	2	3	4	5	6	7	8	TC (£)	10	18	24	30	38	50	66	91	120
AC (£)	-	18	12	10	9½	10	11	13	15	MC (£)	8	6	6	8	12	16	25	29	

(b) See Diagram 6. 1 below.

(c) Profit is maximised where  $MC = MR$  (point b): i. e. at an output of 5. (d) £20

Profit per unit is given by  $AR - AC$ .  $AR (= MR)$  is constant at £14;  $AC$  at an output of 5 units is £10. Thus profit per unit =  $14 - 10 = 4$

Total profit is then found by multiplying this by the number of units sold: i. e. £4 ( 5 = £20. This is shown by the area abcd.

(e) Supernormal profit would encourage new firms to enter the industry. This would cause price to fall until it was equal to the minimum point of the long-run average cost curve (at that point, there would be no supernormal profit remaining and hence firms would stop entering and the price would stop falling).

2. If the industry under perfect competition faces a downward-sloping demand curve, why does an individual firm face a horizontal demand curve? Because the firm's output makes such an infinitesimally small contribution to total industry output. The firm cannot affect industry price by changing its output. In other words, any change in an individual firm's output would cause such a minute movement along the industry demand curve, that price would not change.

3. If supernormal profits are competed away under perfect competition, why will firms have an incentive to become more efficient? Because if they did not do so, and other firms did, firms would still enter the industry and compete price down. The firms that had not become more efficient would then find themselves making less than normal profit. They would then either have to become more efficient pretty quickly, or go out of business.

4. Is it a valid criticism of perfect competition to argue that it is incompatible with economies of scale? The criticism should really be directed at the market system as a whole: that where significant economies of scale exist, markets are bound to be imperfect. Of course, there may be significant benefits to consumers and society generally from such imperfect markets (see pages 184-5): there are advantages as well as disadvantages of

imperfect markets. What is more, if the market is highly contestable, many of the advantages of perfect competition may be achieved even though the industry is actually a monopoly (or oligopoly).

5. On a diagram similar to Figure 6. 4,; show the long-run equilibrium for both firm and industry under perfect competition. Now assume that the demand for the product falls. Show the short-run and long-run effects. This is illustrated in Diagram 6. 2. The long-run equilibrium is shown where the AR curve is tangential to the LRAC curve (and where, therefore, there is no supernormal profit). If the demand curve now shifts from D1 to D2, the equilibrium price will fall to P2. Less than normal profit will now be made. Firms will therefore leave the industry. As they do, so the industry supply curve will shift to the left, causing the price to rise again. Once the supply curve has reached S2 and price has risen back to P1, long-run equilibrium will have been restored, with the remaining firms making normal profit again.

6. Why is the profit-maximising price under monopoly greater than marginal cost? In what way can this be seen as inefficient? Because profit is maximised where  $MR = MC$ . Under monopoly, AR is downward sloping and MR is therefore less than AR (price). Thus price is greater than MC. This is seen as inefficient, since, other things being equal, if more units were produced, the value of them to consumers (i. e. the price people are prepared to pay) would exceed the marginal cost of producing them: therefore 'society' is losing out by increased production not taking place. These arguments are explored in section 11. 1.

7. On three diagrams like Figure 6. 8, illustrate the effect on price, quantity and profit of each of the following: (i) a rise in demand; (ii) a rise in fixed costs; (iii) a rise in variable costs. In each case show only the AR, MR, AC, and MC curves. See Diagram 6. 3.

8. Think of three examples of monopolies (local or national) and consider how contestable their markets are.

Three examples might include:

- A university refectory: unless the catering is offered on a franchise basis to outside caterers, or, say, to the student's union, the monopoly will not be contestable. There may, nevertheless, be competition from local restaurants, cafés and food shops.
- Bus company operating a particular route: the market may be large enough for only one company, but the market is highly contestable, especially if other bus companies are already established on other routes in the area.
- Local water company: the market is not contestable, because the entry and exit costs would be extremely high. It would be possible through regulation, however, to force local water companies to grant use of their pipelines to other companies provided the various pipe networks are linked between one area and another.