Perfect Competition and Efficiency in the Long Run:

BurkeyAcademy

An Introduction

There are a lot of "Big Ideas" here- logical conclusions that follow from the assumptions of the Pure Competition *Model*

Remember: 1) This is just a MODEL
2) Where the real world differs, real-world results will differ

Pure Competition Assumptions: IF we have:

(1) a large number of firms

(2) selling a standardized product

(3) firms that are price takers rather than price makers

(4) ease of entry into and exit from the industry

(5) perfect information about prices, profits, and quality of goods

Then:

(A) Firms will maximize profits in short run by producing all units where MR =P ≥ MC (Unless P<AVC, then shut down and produce zero)

- **This implies allocative efficiency:**

allocative efficiency - The allocation of resources among *firms* and industries to obtain the production of the products most wanted by society (consumers); the output of each product at which its *marginal cost* and *price* or *marginal benefit* are equal, and at which the sum of *consumer surplus* and *producer surplus* is maximized.

(B) If the price is above the minimum ATC (break even price), firms are making a profit

- In the long run this economic profit, or profit above the minimum needed to make an entrepreneur satisfied, will encourage entry into this industry.
- When more firms enter, the supply curve shifts to the right, lowering the price.

(C) If the price is below the minimum ATC, firms are making an economic loss

- In the long run this economic loss, or inability for the firm to compensate all its factors of production, will encourage firms to exit this industry.
- When firms *exit the industry*, the supply curve shifts to the left, raising the price.

(D) If the price equals the minimum ATC, firms have zero economic profit.

In the long run there is no incentive for entry or exit. So, we also call the break even price the "long run price".

Thus in the long run, pure competition industries also have productive efficiency:

productive efficiency - The production of a *good* in the least costly way; occurs when production takes place at the output at which *average total cost* is a minimum and *marginal product* per dollar's worth of input is the same for all inputs.
This is a similar principle to the "Equal marginal utility per dollar rule", but for firms.