Principles of Economics

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CHAPTER 14

Firms in Competitive Markets

Modified by Joseph Tao-yi Wang

The Big Picture

- Chapter 13: The cost of production
- Now, we will look at firm's revenue
  - But revenue depends on market structure
1. Competitive market (this chapter)
2. Monopoly (chapter 15)
3. Monopolistic Competition (chapter 16)
4. Oligopoly (chapter 17)
  - Are there other types of markets? Yes, not now

In this chapter, look for the answers to these questions

- What is a perfectly competitive market?
- What is marginal revenue? How is it related to total and average revenue?
- How does a competitive firm determine the quantity that maximizes profits?
- When might a competitive firm shut down in the short run? Exit the market in the long run?
- What does the market supply curve look like in the short run? In the long run?

Introduction: A Scenario

- Three years after graduating, you run your own business.
- You must decide how much to produce, what price to charge, how many workers to hire, etc.
- What factors should affect these decisions?
  - Your costs (studied in preceding chapter)
  - How much competition you face
- We begin by studying the behavior of firms in perfectly competitive markets.

5

Characteristics of Perfect Competition

Perfect Competition: There are Perfect Substitutes (if don't buy from you, can buy from her instead)

This is typically resulted from:

1. Many buyers and many sellers.
2. The goods offered for sale are largely the same.
3. Firms can freely enter or exit the market.

- Because of 1 & 2, each buyer and seller is a "**price taker**" – takes the price as given.

6

The Revenue of a Competitive Firm

- Total revenue (*TR*) $TR = P \times Q$

- **Average revenue (*AR*)** $AR = \dfrac{TR}{Q} = P$

- **Marginal revenue (*MR*)**: The change in *TR* from selling one more unit. $MR = \dfrac{\Delta TR}{\Delta Q}$

7

Calculating *TR*, *AR*, *MR*

Fill in the empty spaces of the table.

Q	P	TR	AR	MR
0	$10		n/a	
1	$10		$10	
2	$10			
3	$10			
4	$10	$40		
5	$10	$50		$10

Answers

Fill in the empty spaces of the table.

Q	P	TR = P × Q	AR = $\frac{TR}{Q}$	MR = $\frac{\Delta TR}{\Delta Q}$
0	$10	$0	n/a	
1	$10	$10	$10	$10
2	$10			$10
3	$10	$30	$10	$10
4	$10	$40	$10	$10
5	$10	$50	$10	$10

Notice that *MR* = *P*

MR = P for a Competitive Firm

- A competitive firm can keep increasing its output without affecting the market price.
- So, each one-unit increase in *Q* causes revenue to rise by *P*, i.e., *MR = P*.

MR = P is only true for firms in competitive markets.

Profit Maximization

- What *Q* maximizes the firm's profit?
- To find the answer, "*think at the margin*."
  If *Q* increases by one unit,
  revenue rises by *MR*,
  cost rises by *MC*.
- If *MR > MC*, then increase *Q* to raise profit.
- If *MR < MC*, then reduce *Q* to raise profit.

Profit Maximization

(continued from earlier exercise)

At any *Q* with *MR > MC*, increasing *Q* raises profit.

At any *Q* with *MR < MC*, reducing *Q* raises profit.

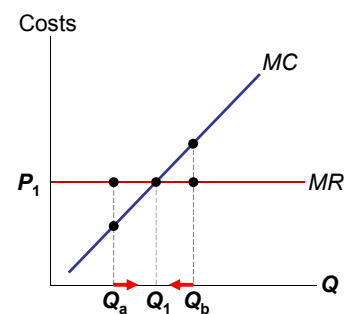| Q	TR	TC	Profit	MR	MC	ΔProfit = MR – MC
0	$0	$5	–$5			
				$10	$4	$6
1	10	9	1			
				10	6	4
2	20	15	5			
				10	8	2
3	30	23	7			
				10	10	0
4	40	33	7			
				10	12	–2
5	50	45	5			

MC and the Firm's Supply Decision

Rule: *MR = MC* at the profit-maximizing *Q*.

At *Q*ₐ, *MC < MR*.
So, increase *Q*
to raise profit.

At *Q*_b, *MC > MR*.
So, reduce *Q*
to raise profit.
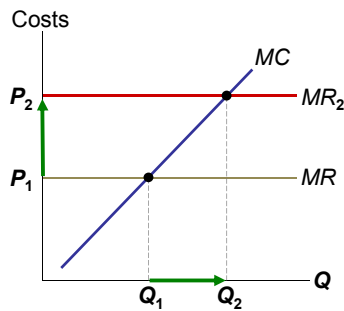
At *Q*₁, *MC = MR*.
Changing *Q*
would lower profit.

MC and the Firm's Supply Decision

If price rises to P_2, then the profit-maximizing quantity rises to Q_2.

The *MC* curve determines the firm's *Q* at any price.

Hence,

the *MC* curve <u>is</u> the firm's supply curve.

Costs

P_2 ———— MR_2

P_1 ———— MR

MC

Q_1 Q_2 Q

14

Shutdown vs. Exit

- **Shutdown**:
  A short-run decision not to produce anything because of market conditions.

- **Exit**:
  A long-run decision to leave the market.

- A key difference:
  - If shut down in SR, must still pay *FC*.
  - If exit in LR, zero costs.

15

A Firm's Short-run Decision to Shut Down

- Cost of shutting down: revenue loss = *TR*

- Benefit of shutting down: cost savings = *VC*
  (firm must still pay *FC*)

- So, shut down if $TR < VC$

- Divide both sides by *Q*: $TR/Q < VC/Q$
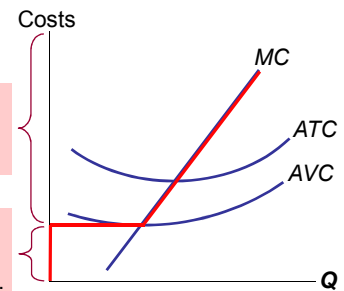
- So, firm's decision rule is:

  Shut down if $P < AVC$

16

A Competitive Firm's SR Supply Curve

The firm's SR supply curve is the portion of its MC curve above...

If *P* > *AVC*, then firm produces *Q* where *P* = *MC*.

If *P* < *AVC*, then firm shuts down (produces *Q* = 0).

Costs

MC

ATC

AVC

Q

17

The Irrelevance of Sunk Costs

- **Sunk cost**: a cost that has already been committed and cannot be recovered

- Sunk costs should be irrelevant to decisions; you must pay them regardless of your choice.

- *FC* is a sunk cost: The firm must pay its fixed costs whether it produces or shuts down.

- So, *FC* should not matter in the decision to shut down.

18

A Firm's Long-Run Decision to Exit

- Cost of exiting the market: revenue loss = *TR*

- Benefit of exiting the market: cost savings = *TC*
  (zero *FC* in the long run)

- So, firm exits if $TR < TC$

- Divide both sides by *Q* to write the firm's decision rule as:
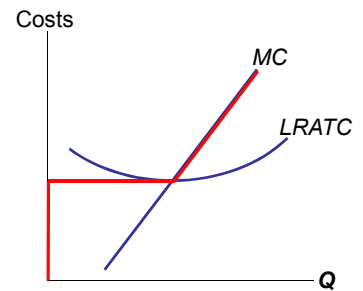
  Exit if $P < ATC$

19

A New Firm's Decision to Enter Market

- In the long run, a new firm will enter the market if it is profitable to do so: if *TR* > *TC*.

- Divide both sides by **Q** to express the firm's entry decision as:
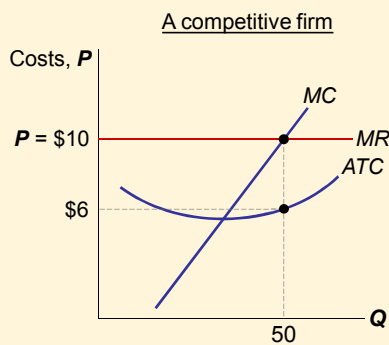
  Enter if **P** > ATC

20

The Competitive Firm's Supply Curve

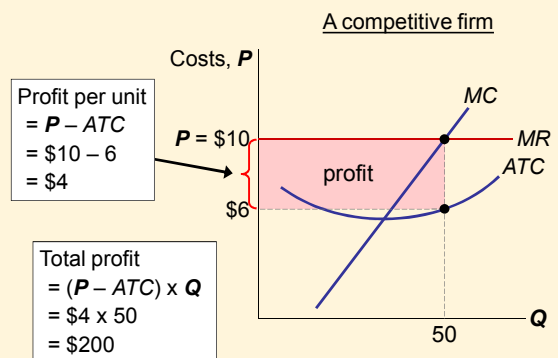The firm's LR supply curve is the portion of its *MC* curve above *LRATC*.

Costs

MC

LRATC

Q

21

Identifying a firm's profit

Determine this firm's total profit.

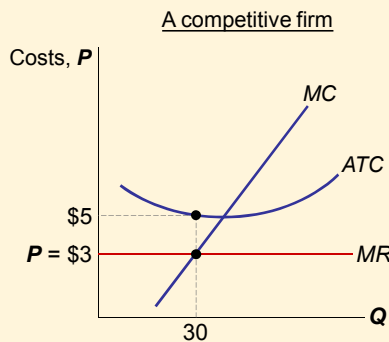Identify the area on the graph that represents the firm's profit.

A competitive firm

Costs, **P**

MC

P = $10 — *MR*

ATC

$6

50

Q

Answers

A competitive firm

Profit per unit
= **P** – ATC
= $10 – 6
= $4

Total profit
= (**P** – ATC) x **Q**
= $4 x 50
= $200

Costs, **P**

MC

P = $10 — *MR*

ATC

profit

$6

50

Q

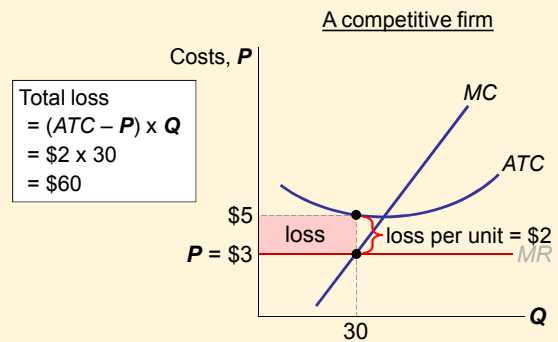### Identifying a firm's loss

Determine this firm's total loss, assuming *AVC* < $3.

Identify the area on the graph that represents the firm's loss.

A competitive firm

Costs, **P**

MC

ATC

$5

P = $3 — *MR*

30

Q

Answers

A competitive firm

Total loss
= (ATC – **P**) x **Q**
= $2 x 30
= $60

Costs, **P**

MC

ATC

$5

loss   loss per unit = $2

P = $3   *MR*

30

Q

Market Supply: Assumptions

1) All existing firms and potential entrants have identical costs.

2) Each firm's costs do not change as other firms enter or exit the market.

3) The number of firms in the market is
   - fixed in the short run
     (due to fixed costs)
   - variable in the long run
     (due to free entry and exit)

26

The SR Market Supply Curve

- As long as $P \geq AVC$, each firm will produce its profit-maximizing quantity, where $MR = MC$.

- Recall from Chapter 4:
  At each price, the market quantity supplied is the sum of quantities supplied by all firms.

27

The SR Market Supply Curve

Example: 1000 identical firms

At each P, market Q^s = 1000 x (one firm's Q^s)

28
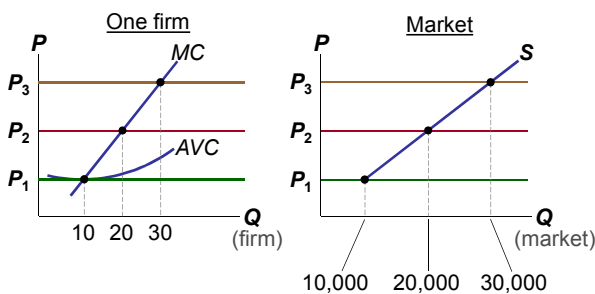
Entry & Exit in the Long Run

- In the LR, the number of firms can change due to entry & exit.

- If existing firms earn positive economic profit,
  - new firms enter, SR market supply shifts right.
  - P falls, reducing profits and slowing entry.

- If existing firms incur losses,
  - some firms exit, SR market supply shifts left.
  - P rises, reducing remaining firms' losses.

29

The Zero-Profit Condition

- **Long-run equilibrium**:
  The process of entry or exit is complete—remaining firms earn zero economic profit.

- Zero economic profit occurs when $P = ATC$.

- Since firms produce where $P = MR = MC$, the zero-profit condition is $P = MC = ATC$.

- Recall that MC intersects ATC at minimum ATC.

- Hence, in the long run, $\boxed{P = \text{minimum } ATC.}$
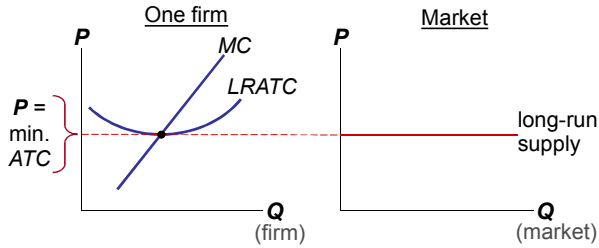
30

Why Do Firms Stay in Business if Profit = 0?

- Recall, economic profit is revenue minus <u>all</u> costs, including implicit costs like the opportunity cost of the owner's time and money.

- In the zero-profit equilibrium,
  - firms earn enough revenue to cover these costs
  - accounting profit is positive

31

The LR Market Supply Curve

In the long run, the typical firm earns zero profit.

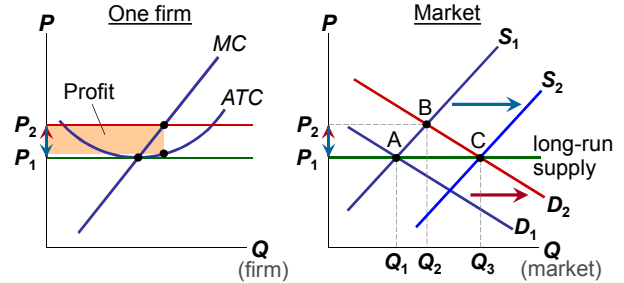The LR market supply curve is horizontal at P = minimum ATC.

One firm

P MC

$LRATC$

P = min. ATC

Q (firm)

Market

P

long-run supply

Q (market)

32

SR & LR Effects of an Increase in Demand

A firm begins in   but then an increase …leading t …driving profits to zero   duce entry, profits for t and restoring long-run eq'm. t, reducing P…

One firm

P MC

Profit ATC

P_2
P_1

Q (firm)

Market

P S_1

S_2

B

P_2 A   C

P_1 long-run supply

D_2

D_1

Q_1 Q_2 Q_3 Q (market)

33

Why the LR Supply Curve Might Slope Upward

- The LR market supply curve is horizontal if
  1) all firms have identical costs, and
  2) costs do not change as other firms enter or exit the market.
- If either of these assumptions is not true, then LR supply curve slopes upward.

34

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1) Firms Have Different Costs

- As P rises, firms with lower costs enter the market before those with higher costs.
- Further increases in P make it worthwhile for higher-cost firms to enter the market, which increases market quantity supplied.
- Hence, LR market supply curve slopes upward.
- At any P,
  - For the marginal firm, P = minimum ATC and profit = 0.
  - For lower-cost firms, profit > 0.

35

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2) Costs Rise as Firms Enter the Market

- In some industries, the supply of a key input is limited (e.g., amount of land suitable for farming is fixed).
- The entry of new firms increases demand for this input, causing its price to rise.
- This increases all firms' costs.
- Hence, an increase in P is required to increase the market quantity supplied, so the supply curve is upward-sloping.

36

CONCLUSION:
The Efficiency of a Competitive Market

- Profit-maximization: $MC = MR$
- Perfect competition: $P = MR$
- So, in the competitive eq'm: $P = MC$
- Recall, MC is cost of producing the marginal unit. P is value to buyers of the marginal unit.
- So, the competitive eq'm is efficient, maximizes total surplus.
- In the next chapter, monopoly: pricing and production decisions, deadweight loss, regulation.

37

Summary

- For a firm in a perfectly competitive market, price = marginal revenue = average revenue.
- If $P > AVC$, a firm maximizes profit by producing the quantity where $MR = MC$. If $P < AVC$, a firm will shut down in the short run.
- If $P < ATC$, a firm will exit in the long run.
- In the short run, entry is not possible, and an increase in demand increases firms' profits.
- With free entry and exit, profits = 0 in the long run, and P = minimum ATC.

Perfect Competition

- Products are Perfect Substitutes
- Result: Price Taking
- P = MR = MC
- SR: Will operate if P > AVC (FC is sunk)
- LR: Will operate at P = ATC
  - Firms enter if P > ATC; exit if P < ATC
- Homework: Mankiw, Ch.14,
  Problem 2, 4, 5, 6, 10, 11