1.1 Perfect competition, imperfectly competitive markets and monopoly: Test Pack

AQA 7136 · Calculator allowed · about 35 minutes

Total Marks

Name: _____ Date: ____ / ____ / _____

Answer ALL questions. Show all your working.

1 Perfect competition.

(a) State three assumed characteristics of a perfectly competitive market. **(3)**

(b) Explain why an individual firm in a perfectly competitive market faces a perfectly elastic (horizontal) demand curve. **(3)**

(Total for Question 1 is 6 marks)

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2 Productive and allocative efficiency.

(a) Define productive efficiency. **(2)**

(b) Define allocative efficiency. **(2)**

(c) Explain why a firm operating in long-run equilibrium under perfect competition is said to be both productively and allocatively efficient. **(5)**

(Total for Question 2 is 9 marks)

3 Monopolistic competition.

(a) State three characteristics of monopolistic competition. **(3)**

(b) Explain why, in the long run, firms in monopolistic competition are expected to earn only normal profit, similar to perfect competition. **(4)**

(Total for Question 3 is 7 marks)

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Mark scheme · 1.1 Perfect competition, imperfectly competitive markets and monopoly: Test Pack

Question 1

(a) many buyers and sellers, each too small to individually influence the market price (firms are 'price takers') **B1**

(a) firms produce a homogeneous (identical) product **B1**

(a) free entry to and exit from the market, i.e. no barriers to entry (allow: perfect information available to all buyers and sellers) **B1**

(a) Answer: Many price-taking firms; a homogeneous product; free entry and exit.

(b) the firm is a 'price taker': it is too small relative to the whole market to influence the market price by changing its own output **M1**

(b) if it raised its price above the market price, it would lose all its customers to identical, perfectly substitutable rival firms **A1**

(b) it can sell as much as it wants at the given market price, so demand for its output is perfectly elastic (a horizontal line at the market price) **A1**

(b) Answer: As a price taker selling an identical product, the firm can sell any quantity at the market price but none above it.

Question 2

(a) occurs where a firm produces at the lowest point on its average total cost curve, i.e. at minimum average cost **B1**

(a) (economy-wide) production occurs on, rather than inside, the production possibility frontier **B1**

(a) Answer: Producing at minimum average total cost.

(b) occurs where price equals marginal cost (P = MC) **B1**

(b) resources are allocated to produce the combination of goods most wanted by consumers, given their willingness to pay **B1**

(b) Answer: Price equals marginal cost (P = MC).

(c) in long-run equilibrium, only normal profit is made (supernormal profit is competed away by free entry of new firms), which occurs where price equals average cost (P = AC) **M1**

(c) free entry and exit force firms to produce at the profit-maximising output where MC = MR, and since the firm is a price taker, MR = AR = P, so MC = P (allocative efficiency) **M1**

(c) competitive pressure from many rival firms also forces firms to minimise costs to survive, pushing output to the point where AC is at its minimum (productive efficiency) **A1**

(c) since P = MC = minimum AC in long-run equilibrium, both allocative efficiency (P=MC) and productive efficiency (minimum AC) hold simultaneously **A1**

(c) this is why perfect competition is often used as a benchmark of economic efficiency against which other market structures, such as monopoly, are compared **A1**

(c) Answer: Long-run entry/exit drives P=AC=minimum AC and MC=MR=P, giving both allocative and productive efficiency at once.

Question 3

(a) many buyers and sellers, but each firm sells a differentiated (not identical) product **B1**

(a) relatively low barriers to entry and exit **B1**

(a) each firm has a small degree of market power (a downward-sloping, but relatively elastic, demand curve), because its product is not a perfect substitute for rivals' **B1**

(a) Answer: Many sellers of a differentiated product; low entry barriers; a small, downward-sloping degree of market power.

(b) low barriers to entry mean that if firms are earning supernormal profit in the short run, new firms are attracted into the market **M1**

(b) entry of new firms increases the range of substitute products available, causing each existing firm's individual demand curve to shift left (and/or become more elastic) as customers are shared among more firms **A1**

(b) this process continues until demand has shifted enough that each firm's average revenue curve is tangential to (just touches) its average cost curve **M1**

(b) at this point price equals average cost, so firms earn only normal profit, removing any further incentive for new entry **A1**

(b) Answer: Entry shifts each firm's demand curve left until AR is tangential to AC, leaving only normal profit.

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