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Perfect competition and Pareto optimality

Dr. Madhumita Das



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The Concept of Efficiency

- Efficiency is one of the central concepts in all of economics.
- In a general sense, an economy is efficient when it provides its consumers with the most desired set of goods and services, given the resources and technology of the economy.
- A more precise definition uses the concept of *Pareto efficiency* (alternatively called *allocative efficiency*, *Pareto optimality*, or sometimes simply *efficiency*).



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Pareto efficiency

- Pareto efficiency (or sometimes just efficiency) occurs when no possible reorganization of production or distribution can make anyone better off without making someone else worse off.
- Under conditions of allocative efficiency, one person's satisfaction or utility can be increased only by lowering someone else's utility.



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Efficiency of Competitive Equilibrium

One of the most important results in all economics is that the allocation of resources by perfectly competitive markets is efficient.

This important result assumes that all markets are perfectly competitive and that there are no externalities like pollution or imperfect information.

In this section, we use a simplified example to illustrate the general principles underlying the efficiency of competitive markets.



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Consider an idealized situation where all individuals are identical. Further assume:

(*a*) Each person works at growing food. As people increase their work and cut back on their leisure hours, each additional hour of sweaty labor becomes increasingly tiresome.

(*b*) Each extra unit of food consumed brings diminished marginal utility (*MU*).

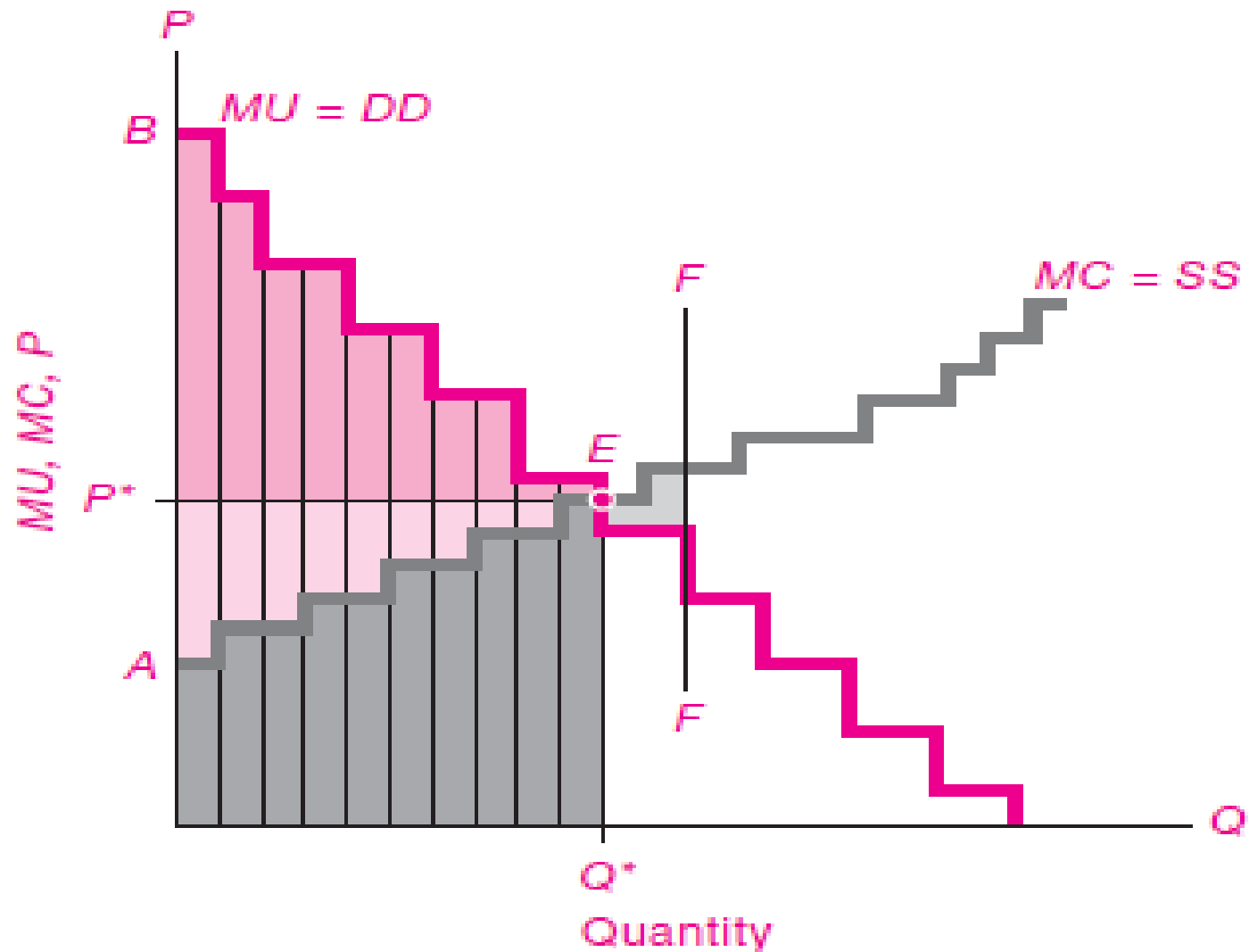
(*c*) Because food production takes place on fixed plots of land, by the law of diminishing returns each extra minute of work brings less and less extra food.



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At Competitive Equilibrium Point E, the Marginal Costs and Utilities of Food Are Exactly Balanced





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Happy Learning

