Perfect competition in economic theory

Finance, Market

Perfect Competition In economic theory, perfect competition describes markets such that no participants are large enough to have the market power to set the price of a homogeneous product. Because the conditions for perfect competition are strict, there are few if any perfectly competitive markets. Still, buyers and sellers in some auction-type markets, say for commodities or some financial assets, may approximate the concept. Perfect competition serves as a benchmark against which to measure real-life and imperfectly competitive markets.

Generally, a perfectly competitive market exists when every participant is a " price taker", and no participant influences the price of the product it buys or sells. Specific characteristics may include: * Infinite buyers and sellers – An infinite number of consumers with the willingness and ability to buy the product at a certain price, and infinite producers with the willingness and ability to supply the product at a certain price. * Zero entry and exit barriers – A lack of entry and exit barriers makes it extremely easy to enter or exit a perfectly competitive market. Perfect factor mobility – In the long run factors of production are perfectly mobile, allowing free long term adjustments to changing market conditions. * Perfect information - All consumers and producers are assumed to have perfect knowledge of price, utility, quality and production methods of products. * Zero transaction costs - Buyers and sellers do not incur costs in making an exchange of goods in a perfectly competitive market. * Profit maximization - Firms are assumed to sell where marginal costs meet marginal revenue, where the most profit is generated. Homogenous products - The qualities and characteristics of a market good or service do not vary between different suppliers. * Non-

increasing returns to scale - The lack of increasing returns to scale (or economies of scale) ensures that there will always be a sufficient number of firms in the industry. * Property rights - Well defined property rights determine what may be sold, as well as what rights are conferred on the buyer. In the short run, perfectly-competitive markets are not productively efficient as output will not occur where marginal cost is equal to average cost (MC= AC).

They are allocatively efficient, as output will always occur where marginal cost is equal to marginal revenue(MC= MR). In the long run, perfectly competitive markets are both allocatively and productively efficient. In perfect competition, any profit-maximizing producer faces a market price equal to its marginal cost (P= MC). This implies that a factor's price equals the factor's marginal revenue product. It allows for derivation of the supply curve on which the neoclassical approach is based. This is also the reason why " a monopoly does not have a supply curve".

The abandonment of price taking creates considerable difficulties for the demonstration of a general equilibrium except under other, very specific conditions such as that of monopolistic competition. By definition a perfectly competitive market is one in which no single firm has to influence either the equilibrium price of the market or the the total quantity supplied in the market. Thus, a firm operating in a competitive market has no incentive to supply at a price lower than market equilibrium price, as it can sell all it wants to supply at equilibrium.

At the same time, the firm cannot sell at price higher than the market price, because it will be able find no buyers at that price, and its sales volume will

drop down to zero. Thus, a firm operating in perfectly competitive market has to accept whatever is the market equilibrium price, and therefore it is called a price taker. In contrast, a monopoly firm is the only supplier in the market and therefore has full control over the market prices and total market supplies.

Therefore, a firm operating in a monopoly market fixes its price in such a way that for the quantity demanded by customers at that market price the marginal revenue of the firm is equal to its marginal costs. In this way way it decides the market price as well as the total quantity if a commodity supplied in the market, and therefore it is called a price maker. Imperfect Competition In economic theory, imperfect competition is the competitive situation in any market where the sellers in the market sell different/dissimilar of goods, (haterogenous) that does not meet the conditions of perfect competition.

Forms of imperfect competition include: * Monopoly, in which there is only one seller of a good. * Oligopoly, in which there are few sellers of a good. * Monopolistic competition, in which there are many sellers producing highly differentiated goods. * Monopsony, in which there is only one buyer of a good. * Oligopsony, in which there are few buyers of a good. * Information asymmetry when one competitor has the advantage of more or better information. There may also be imperfect competition due to a time lag in a market. An example is the " jobless recovery".

There are many growth opportunities available after a recession, but it takes time for employers to react, leading to high unemployment. High unemployment decreases wages, which makes hiring more attractive, but it

takes time for new jobs to be created. A type of market that does not operate under the rigid rules of perfect competition. Perfect competition implies an industry or market in which no one supplier can influence prices, barriers to entry and exit are small, all suppliers offer the same goods, there are a large number of suppliers and buyers, and information on pricing and process is readily available.

Forms of imperfect competition include monopoly, oligopoly, monopolistic competition, monopsony and oligopsony. Pure Competition Pure Competition is a market situation where there is a large number of independent sellers offering identical products. Pure competition is a term for an industry where competition isstagnant and relatively non competitive. Companies within the pure competition category have little control of price or distribution of product. Advertising, market research, and product development play a very little role in these companies/industries.

A market characterized by a large number of independent sellers of standardized products, free flow of information, and free entry and exit. Each seller is a " price taker" rather than a " price maker". Also sometimes referred to as perfect competition, pure competition is a situation in which the market for a product is populated with so many consumers and producers that no one entity has the ability to influence the price of the product sufficiently to cause a fluctuation.

Within this type of market setting, sellers are considered to be price takers, indicating that they are not in a position to set the price for their products outside a certain range, given the fact that so many other producers are active within the market. At the same time, consumers have little influence

over the prices offered by the producers, since there is no singular group of consumers that dominates the demand. In reality, pure competition is more theory than actual fact.

While there are rare situations in which a marketplace functions with pure competition for a short period of time, the situation normally shifts as various factors change the stalemate created by a multiplicity of sellers and buyers. This is often due to the somewhat stringent set of factors that must be present in order for the competition to be considered perfect or pure. There are several essential characteristics that define pure competition. One has to do with the balance of buyers to sellers.

When there is an infinite number of buyers who are willing to purchase the products offered for sale by an infinite number of producers, at a certain price, the opportunity for anyone to take actions that shift the market price is extremely limited. The price remains more or less the same, and the same number of buyers purchase the products from the same range of producers. With pure competition, sellers can easily exit or enter the marketplace, without creating any undue influence on the price. Consumers continue to make purchases at the same rate, even if two companies leave the market and only one new one enters.

The collective producers who are still in the market simply continue to produce enough products to meet consumer demand, without a shift in market price. Businesses engaged in a pure competition market usually structure production so that they incur marginal costs at a level where they can earn the most profit. When the product line is homogeneous, this means the products produced are essentially the same as the product line produced

by other suppliers in the marketplace. Assuming the costs are in line withmarginal revenue, the business can generate a consistent profit for as long as the condition of pure competition is present in the market.