

# Why is perfect competition often described as the ideal market structure?

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Perfect competition is a type of market structure where a large number of small firms producing identical products compete without any significant impact on prices or supply. There several factors which are followed in this particular model. Goods which are produced by the firms don't have any product differentiation, in other words, they are homogenous and could substitutes each other in consumptions. As firms don't have any market power and can't influence prices due to their small size, rival companies won't be following any changes in price, so customers are more likely to switch to another product which is the same and has a lower price if one product would become more expensive. It means that the demand for the product is very elastic. So each small firm is a 'price taker', and market sets the equilibrium price for the product. [pic]On the diagram which represents an industry a market supply curve intersects with market demand curve. The point of intersection is an equilibrium price. By looking at this diagram any small firm might decide to produce more output, as it will be insignificant for the market as long as the price will be the same for all of the output produced. So, as it is seen from the diagram representing firm's supply,  $D = AR = MR$ . It means that if the firm will sell all of its output at the same price  $P$ , average revenue will be the same as marginal revenue-the extra revenue which comes from selling one more unit of output. In highly competitive market situation like perfect competition  $MR = Price$ , however, under imperfect competition for a profit maximizing company,  $MR$  might decrease as output will go up because the price will fall. At point A on the diagram above, output is less than profit maximizing output  $Q^*$ , so profit is less. At point B, profits will decrease because costs to produce the output are higher.

So  $Q^*$  is the output which a profit-maximizing company should produce. So companies operating under perfect competition don't really have a choice on whether to reduce or raise the price for the product. As it was mentioned before, firms can't afford to raise the price as demand is elastic. There is also no point to reduce the price, as the firm can expect its output at the price which is set on the market. So it is quite easy to predict the performance of the firm in the short-term and long-term periods. In contrast, in monopolistic competition where a number of small firms supply similar, but not identical product, a firm can set price different from its competitors without losing its market share. In this type of competition it is possible because demand is less elastic because of the product differentiation, so if the company would raise the price, it will lose some of its customers, not all. So this change in price might increase the total revenue. [pic] From this box diagram it is seen that if the firm will sell less output (box 3) due to raise in price, it will gain more revenue from the higher price charged for the same product (box 2). In other words, the area of  $PVOQ$  can be bigger than the area of  $P^1V^1OQ^1$ . It would not be possible in the perfect competition market, as demand is more elastic because products are homogenous. So it is much more difficult to predict the performance of the firm in both long-term and short-term period. Another assumption which describes the perfect competition is independence of firms' actions. Since there are a large number of companies on the market, it is impossible for the firms to come together and change the market price of the product or make the barriers for the newcomers in order to protect their long-run profit. So there is no possibility for cartels or collusions like in oligopoly. One of the main assumptions of the perfect

competition is a freedom of entering and leaving the market. It means that firms don't have any barriers to enter or leave the market. To compare, in oligopoly, where a few number of firms dominate the market, it would be quite difficult for a new firm to enter the market. One of the reasons is because firms who dominate the market come together and identify different strategies to prevent new firms to come into the market, for example, by cutting the selling price, so that new firms couldn't cover their costs. Even though existing companies will decrease their profit in the short term, they will benefit from it in the long term. As the firms in the market with perfect competition can't make any barriers to prevent new firms coming in, there will be consequences in terms of lower level of profit. In the short-run, it is possible for the firm to make a super-normal profit-which is over the opportunity cost involved in production process. It means that customers are willing to get more of the product. [pic] Diagram above illustrates a short-run equilibrium after demand has increased. MR and price have also increased. A new short-run equilibrium output occurred. Companies start to make super normal profits which is the shaded area on the graph. However this will attract new companies into the market. As there will be more companies producing the same product, the level of profit will go down and only normal profit will achieved. If the situation will continue, only sub-normal profits will be achieved which will force companies to leave the industry and the normal profit will be made again and the long-run equilibrium will be achieved. As it was mentioned before, companies operating under the perfect competition can't control the number of new companies coming into the market. It means that it is impossible for the companies to make super-normal profits

in the long-run-only normal. In comparison, companies which operate in monopoly and oligopoly can make super-normal profit as they can control the number of new-comers. So tough competition forces the companies to produce with minimum costs involved. Therefore, companies will be producing at the point where firm's ATC is minimum. This is the lowest price which will allow them to stay in the business. [pic] A big advantage of operating under perfect competition is that productive efficiency and allocative efficiencies can be achieved. Productive efficiency-is when production costs per unit are minimised and ATC is at the lowest point. On the diagram above, the firm will achieve its productive efficiency when the output=  $q^*$  and price=  $P^*$ . Allocative efficiency-is when available resources are allocated according to the consumers' needs. To achieve allocative efficiency price must equal marginal cost ( $P = MC$ ). In contrast, under monopolistic competition, firm won't be able to achieve productive efficiency because production is higher than average total cost level, and allocative efficiency because marginal cost is lower than the price. To conclude, there are relatively few markets with perfect competition, because to a certain extent, it is quite difficult for buyers and sellers to have perfect information about market and products. Examples of the market with perfect competition are often could be found in agriculture and online businesses such as e-bay, where anyone could sell his product without any barrier. Some economists don't agree with this model because it is not concerned about where the price comes from as if firms or customers can't influence the price who does? It is also criticised for the lack of emphasis on future prices and incomes of the consumers. Reference list Griffiths, A., & Wall, S. (2005)

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