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Perfect Competition

Perfect competition, also known as pure competition, is an idealized market condition in which many sellers compete to offer the best prices, and large sellers have no advantages over smaller ones. Perfect competition rarely occurs in real-world markets, but it provides a useful framework for understanding how supply and demand influence prices and behavior in a market economy.

There are many buyers and sellers in a perfectly competitive market, and prices are determined purely by supply and demand. Companies earn just enough profit to stay in business and no more. Other companies would enter the market and drive profits down if they were to earn excess profits.

Key Points

- Perfect competition is an ideal type of market structure where all producers and consumers have full and symmetric information and no transaction costs.
- There are a large number of producers and consumers competing with each other in this kind of environment.

- Perfect competition is theoretically the opposite of a monopolistic market.
- All real markets exist outside of the plane of the perfect competition model, so each can be classified as imperfect.
- The opposite of perfect competition is imperfect competition, which exists when a market violates the abstract tenets of neoclassical pure or perfect competition.

How Perfect Competition Works

Perfect competition is a benchmark or ideal type to which real-life market structures can be compared. Pure competition is theoretically the opposite of a monopoly, in which only a single firm supplies a good or service. That firm can charge whatever price it wants because consumers have no alternatives, and it's difficult for would-be competitors to enter the marketplace.

There are no monopolies in a perfect competition model. This kind of structure has several key characteristics

- All firms sell an identical product. It's a commodity or homogeneous.
- All firms are price takers. They can't influence the market price of their products.
- Market share doesn't influence prices.
- Buyers have complete or perfect information about the product being sold and the prices charged by each firm in the past, present, and future.
- Capital resources and labor are perfectly mobile.
- Firms can enter or exit the market without cost.

This can be contrasted with the more realistic imperfect competition that exists whenever a hypothetical or real market violates the abstract tenets of neoclassical pure or perfect competition.

All real markets exist outside the plane of the perfect competition model, so each can be classified as imperfect. The contemporary theory of imperfect versus perfect competition stems from the Cambridge tradition of post-classical economic thought.

Characteristics of Perfect Competition

A perfectly competitive market is defined by several factors.

A Large and Homogeneous Market

A large number of buyers and sellers exist in a perfectly competitive market. The sellers are small firms rather than large corporations that are capable of controlling prices through supply adjustments. They sell products with minimal differences in capabilities, features, and pricing. This ensures that buyers can't distinguish between products based on physical attributes, such as size or color, or intangible values, such as branding.

A large population of both buyers and sellers ensures that supply and demand remain constant in this market. Buyers can easily substitute products made by one firm for others.

Perfect Information Availability

Information about an industry's ecosystem and competition constitutes a significant advantage. Knowledge about component sourcing and supplier pricing can make or break the market for certain companies.

Information about patents and competitors' research initiatives can help companies develop competitive strategies and build a moat around their products in certain knowledge and research-intensive industries such as pharmaceuticals and technology.

Absence of Controls

Governments play a vital role in market formation for products by imposing regulations and price controls. They can control the entry and exit of firms into a market by setting up rules to function in it. The pharmaceutical industry must contend with a roster of rules governing the development, production, and sale of drugs.2

These rules require significant capital investments in the form of employees, such as lawyers and quality assurance personnel, as well as infrastructure, such as machinery to manufacture medicines. The cumulative costs add up and make it extremely expensive for companies to bring a drug to the market.

The technology industry functions with relatively less oversight as compared to its pharma counterpart. Entrepreneurs in this industry can start firms with less capital, making it easy for individuals to start a company in the industry.

Such controls don't exist in a perfectly competitive market. The entry and exit of firms are unregulated, and this frees them up to spend on labor and capital assets without restrictions and adjust their output in relation to market demands.

Cheap and Efficient Transportation

Cheap and efficient transportation is another characteristic of perfect competition. Companies don't incur significant costs to transport goods in this type of market. This helps reduce the product's price and cuts back on delays in transporting goods.