UNIT IV

FEATURES OF PERFECT COMPETITION

Introduction

Perfect competition is a state of a market. Anything which facilitates contact between buyers and sellers constitutes a market. It may be a face to face meeting at some place or simply verbal negotiations through telephone, internet, etc.

Conventionally, in microeconmoics the markets are classified into these states: perfect competiton, monopoly, monopolistic competition and oligopoly. There are many criteria of classification, the number of sellers, similarity of products, availability of information, mobility of firms and the inputs engaged in the firm, etc. Whatever the criteria the end result is reflected in one thing : how much influence an individual seller, on his own, is able to exercise on the market. Lower the influence more the competitive nature of the market it indicates. If the influence of an individual seller is zero, or virtually zero, the market is said to be perfectly competitive.

Meaning

Perfect competition can be defined either in terms of its characteristic features, or in terms of the unique end result of these characteristics. Unique in the sense that it is specific to a perfectly competitive market. In terms of its features, a perfectly competitive is a market where there are large number of buyers and sellers, the firms produce homogeneous products, the buyers and sellers have perfect knowledge and the firm are free to entry or make an exit in and out of industry. In terms of the end result of these features which is unique to this market, <u>a perfectly competitive market is one in which an individual firm cannot influence the prevailing market price of the product on its own.</u>

Features and their implications

A perfectly competitive market has the following features:

1. Large number of sellers and buyers

Note that 'large number' is not a specifically defined number. However, it has a specific implication. Let us talk about the large number of sellers first. The words 'large number' imply that the number of sellers is large enough to render a single seller's share in total market supply of the product insignificant. It has a further implication. Insignificant share means that if only one individual firm reduces or raises its own supply, the prevailing market price remains unaffected. The prevailing market price is the one which was set through the interaction of market demand and market supply forces, for which all the sellers and all the buyers together are responsible. One single seller has no option but to sell what it produces at this market determined price. This position of an individual firm in the total market is referred to as **price taker.** This is a unique feature of a perfectly competitive market.

Similarly, the 'large number' of buyers also has the same implication. A single buyer's share in total market demand is so insignificant that the buyer cannot influence the market price on his own by changing his demand. This makes a single buyer also a price taker.

To sum up, the feature 'large number' indicates ineffectiveness of a single seller or a single buyer in influencing the prevailing market price on its own, rendering him simply a price taker.

2. The products of all the firms in the industry are homogenous

It means that the buyers treat the products of all the firms in the industry as homogenous. The products produced by the firms are identical, or treated as identical, or perfectly standardized. The buyers do not distinguish the output of one firm from that of the other.

The implication of this feature is that since the buyers treat the products as identical they are not ready to pay a different price for the product of any one firm. They will pay the same price for the products of all the firms in the industry. On the other hand, any attempt by a firm to sell its product at a higher price will fail.

To sum up, the 'homogenous products' feature ensures a uniform price for the products of all the firms in the industry.

3. Perfect knowledge about markets for outputs and inputs.

The firms have all the knowledge about the product market and the input markets. Buyers also have perfect knowledge about the product market.

Let us take the product market first. The implication of perfect knowledge about the product market is that any attempt by any firm to charge a price higher than the prevailing uniform price will fail. The buyers will not pay because they have perfect knowledge. There is no ignorance factor operating in the market. The sellers do not charge a lower price due to ignorance. The buyers do not pay a higher price due to ignorance. A uniform price prevails in the market.

As regards the knowledge about the input markets, the implicit assumption is that each firm has an equal access to the technology and the inputs used in the technology. No firm has any cost advantage. Cost structure of each firm is the same. All the firms have a uniform cost structure.

Since there is uniform price and uniform cost in case of all firms, and since profits equals cost less price, all the firms earn uniform profits.

4. Freedom to firms to enter or to leave the industry in the long run

Freedom of entry means that there are no artificial barriers and natural barriers in the way of a new firm wishing to enter into industry. The artificial barriers may take the form of patent rights, legal restrictions, etc. The natural barrier may take the form of huge capital expenditure required to start a new firm, which the firm wishing to enter is not able to arrange.

Freedom of exit means no barriers in the way of a firm deciding to leave the industry. Government rules, labour laws, loss of huge fixed capital etc. do not come in the way.

The freedom of entry and exit of firms has an important implication. This ensures that no firm can earn above normal profits in the long run. Each firm earns just the normal profits, i.e. minimum necessary to carry on business. In Microeconomics, normal profits is treated as an opportunity cost, and therefore, counted in calculation of total cost. Since profit equals total revenue minus total cost, normal profit means zero economic profit. Why? Let us explain.

Suppose the existing firms are earning above normal profits, i.e. positive economic profits. Attracted by the positive profits, the new firms enter the industry. The industry's output, i.e. market supply, goes up. The price comes down. New firms continue to enter and the price continues to fall till economic profits are reduced to zero.

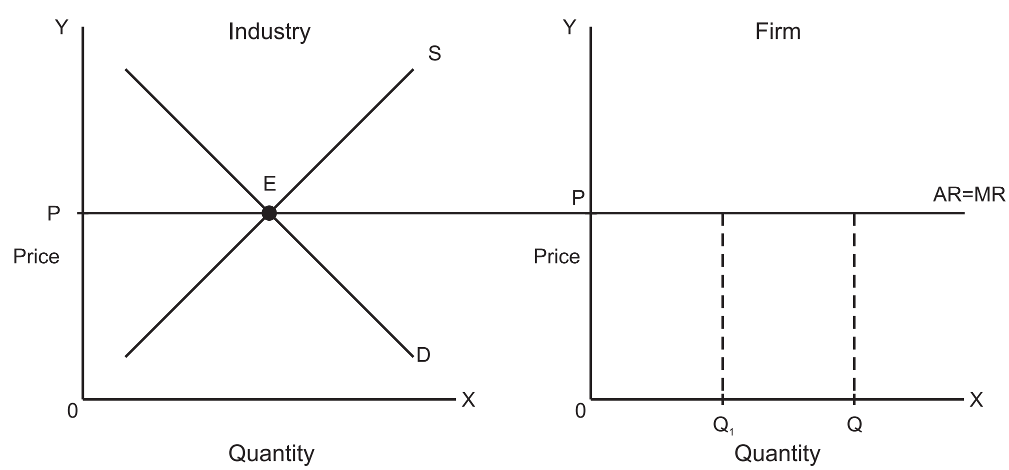
Now suppose the existing firms are incurring losses. The firms start leaving. The industry's output starts falling, price starts going up, and all this continues till losses are wiped out. The remaining firms in the industry then once again earn just the normal profits.

Only zero economic profit in the long run is the basic outcome of a perfectly competitive market.

Average Revenue and marginal revenue curves of a perfectly competitive firm

The forces of market supply (i.e. supply by industry) and market demand (demand by all the buyers) determine the market price. The firm, being a price taker, adopts this price and is free to sell any quantity it likes at this price. The price taker feature determines the shape of the firms AR and MR curves. Refer to the figure -12 b

Figure 12 a **Figure 12 b**



The figure 12a shows the intersection of demand and supply curves at E determining the price OP. The figure 12b shows the adoption of price by the price taker firms who are free to sell any quantity, at this price. This makes the AR curve perfectly elastic and thus parallel to the X-axis. As per the average marginal relationship, when AR is constant, MR must be equal to AR. Therefore, AR curve is also the MR curve of the firm.