## What Is Perfect Competition?

Pure or perfect competition is a theoretical market structure in which the following criteria are met:

* All firms sell an identical product (the product is a "commodity" or "homogeneous").
* All firms are [price takers](https://www.investopedia.com/terms/p/pricetaker.asp) (they cannot influence the market price of their product).
* Market share has no influence on prices.
* Buyers have complete or "perfect" information—in the past, present and future—about the product being sold and the prices charged by each firm.
* Resources for such a labor are perfectly mobile.
* Firms can enter or exit the market without cost.

This can be contrasted with the more realistic [imperfect competition](https://www.investopedia.com/terms/i/imperfect_competition.asp), which exists whenever a market, hypothetical or real, violates the abstract tenets of neoclassical pure or perfect competition.

Since all real markets exist outside of the plane of the perfect competition model, each can be classified as [imperfect](https://www.investopedia.com/terms/i/imperfectmarket.asp). The contemporary theory of [imperfect versus perfect competition](https://www.investopedia.com/ask/answers/032515/what-difference-between-perfect-and-imperfect-competition.asp) stems from the Cambridge tradition of post-classical economic thought.

### **KEY TAKEAWAYS**

* Perfect competition is an ideal type of market structure where all producers and consumers have full and symmetric information, no transaction costs, where there are a large number of producers and consumers competing with one another.
* Perfect competition is theoretically the opposite of a monopolistic market.
* Since all real markets exist outside of the plane of the perfect competition model, each can be classified as imperfect.

## How Perfect Competition Works

Perfect competition is a benchmark, or "ideal type," to which real-life market structures can be compared. [Perfect competition is theoretically the opposite](https://www.investopedia.com/ask/answers/040915/what-difference-between-monopolistic-market-and-perfect-competition.asp) of a [monopoly](https://www.investopedia.com/terms/m/monopoly.asp), in which only a single firm supplies a good or service and that firm can charge whatever price it wants since consumers have no alternatives and it is difficult for would-be competitors to enter the marketplace.

Under perfect competition, there are many buyers and sellers, and prices reflect [supply and demand](https://www.investopedia.com/terms/l/law-of-supply-demand.asp). Companies earn just enough profit to stay in business and no more. If they were to earn excess profits, other companies would enter the market and drive profits down.

### **A Large and Homogeneous Market**

There are a large number of buyers and sellers in a perfectly competitive market. The sellers are small firms, instead of large corporations capable of controlling prices through supply adjustments. They sell products with minimal differences in capabilities, features, and pricing. This ensures that buyers cannot 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. As such, buyers can easily substitute products made by one firm for another.

### **Perfect Information Availability**

Information about the ecosystem and competition in an industry constitutes a significant advantage. For example, knowledge about component sourcing and supplier pricing can make or break the market for certain companies. In certain knowledge- and [research-intensive](https://www.investopedia.com/terms/p/pricetoresearchratio.asp)industries, such as pharmaceuticals and technology, information about patents and research initiatives at competitors can help companies develop competitive strategies and build a moat around its products.

In a perfectly competitive market, however, such moats do not exist. Information is equally and freely available to all market participants. This ensures that each firm can produce its goods or services at exactly the same rate and with the same production techniques as another one in the market.

### **Absence of controls**

Governments play a vital role in market formation for products by imposing regulation and price controls. They can control the entry and exit of firms into a market by setting up rules to function in the market. For example, the pharmaceutical industry has to contend with a roster of rules pertaining to research, production, and sale of drugs.

In turn, these rules require big [capital investments](https://www.investopedia.com/terms/c/capital-investment.asp)in the form of employees, such as lawyers and quality assurance personnel, and 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.

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

Such controls do not exist in a perfectly competitive market. The entry and exit of firms in such a market 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. In this type of market, companies do not incur significant costs to transport goods. This helps reduce the product’s price and cuts back on delays in transporting goods.

## Examples of Perfect Competition

As mentioned earlier, perfect competition is a theoretical construct and does not exist in reality. As such, it is difficult to find real-life examples of perfect competition but there are variants present in everyday society.

Consider the situation at a farmer’s market, a place characterized by a large number of small sellers and buyers. Typically, there is little [differentiation](https://www.investopedia.com/terms/p/product_differentiation.asp) between products and their prices from one farmer’s market to another. The provenance of the produce does not matter (unless they are classified as organic) in such cases and there is very little difference in the packaging or branding of products. Thus, even if one of the farms producing goods for the market goes out of business, it will not make a difference to average prices.

The situation may also be relatively similar in the case of two competing supermarkets, which stock their aisles from the same set of companies. Again, there is little to distinguish products from one another between both supermarkets and their pricing remains almost the same. Another example of perfect competition is the market for unbranded products, which features cheaper versions of well-known products.

Product knockoffs are generally priced similarly and there is little to differentiate them from one another. If one of the firms manufacturing such a product goes out of business, it is replaced by another one.

The development of new markets in the technology industry also resembles perfect competition to a certain degree. For example, there was a proliferation of sites offering similar services during the early days of social media networks. Some examples of such sites are Sixdegrees.com, Blackplanet.com, and Asianave.com. None of them had a dominant market share and the sites were mostly free. They constituted sellers in the market while consumers of such sites, who were mainly young people, were the buyers.

The startup costs for companies in this space were minimal, meaning that startups and companies can freely enter and exit these markets. Technologies, such as PHP and Java, were largely open-source and available to anyone. Capital costs, in the form of real estate and infrastructure, were not necessary. (Facebook's [[FB](https://www.investopedia.com/markets/quote?tvwidgetsymbol=fb)] Mark Zuckerberg started the company from his college dorm.)

## What Are the Disadvantages of Perfect Competition Models?

Perfect competition establishes an idealized framework for establishing a market. But that market is flawed and has a couple of disadvantages. The first one is the absence of innovation. The prospect of greater market share and setting themselves apart from the competition is an incentive for firms to innovate and make better products. But no firm possesses a dominant market share in perfect competition.

Profit margins are also fixed by demand and supply. Firms cannot thus set themselves apart by charging a premium for their product and services.

For example, it would be impossible for a company like Apple Inc. ([AAPL](https://www.investopedia.com/markets/quote?tvwidgetsymbol=aapl)) to exist in a perfectly competitive market because its phones are pricier as compared to competitors. The second disadvantage of perfect competition is the absence of economies of scale. Limited to zero profit margins means that companies will have less cash to invest in expanding their production capabilities.

An expansion of production capabilities could potentially bring down costs for consumers and increase profit margins for the firm. But the presence of several small firms cannibalizing the market for the same product prevents such an occurrence and ensures that the average firm size engaged in the market remains small.

## Do Firms Make Profits in a Perfectly Competitive Market?

The short answer to that question is no. Profits may be possible for brief periods in perfectly competitive markets. But the market’s dynamics cancel out the effects of positive or negative profits and bring them towards an equilibrium. Because there is no information asymmetry in the market, other firms will quickly ramp up their production or reduce their manufacturing costs to achieve parity with the firm which made profits.

The [average revenue](https://www.investopedia.com/terms/a/arpu.asp) and marginal revenue for firms in a perfectly competitive market are equal to the product’s price to the buyer. As a result, the perfectly competitive market’s equilibrium, which had been disrupted earlier, will be restored. In the long run, an adjustment of supply and demand ensures all profits or losses in such markets tend towards zero.

## Does Perfect Competition Exist in the Real World?

Real-world competition differs from this ideal primarily because of [differentiation in production, marketing, and selling](https://www.investopedia.com/terms/p/product_differentiation.asp). For example, in agriculture, the owner of a small organic products shop can talk extensively about the grain fed to the cows that made the manure that fertilized the non-GMO soybeans—that's differentiation. Through marketing, companies seek to establish "brand value" around their differentiation and advertise to gain pricing power and market share.

Thus, the first two criteria—homogeneous products and price takers—are far from realistic. Yet, for the second two criteria—information and mobility—the global tech and trade transformation is improving information and resource flexibility. While the reality is far from this theoretical model, the model is still helpful because of its ability to explain many real-life behaviors.

### **Barriers to Entry Prohibit Perfect Competition**

Many industries also have significant [barriers to entry](https://www.investopedia.com/terms/b/barrierstoentry.asp), such as high startup costs(as seen in the auto manufacturing industry) or strict government regulations (as seen in the utility industry), which limit the ability of firms to enter and exit such industries. And although consumer awareness has increased with the information age, there are still few industries where the buyer remains aware of all available products and prices.

As you can see, there are significant obstacles preventing perfect competition from appearing in today's economy. The agricultural industry probably comes closest to exhibiting perfect competition because it is characterized by many small producers with virtually no ability to alter the selling price of their products. The commercial buyers of agricultural commodities are generally very well-informed and, although agricultural production involves some barriers to entry, it is not particularly difficult to enter the marketplace as a producer.

## Frequently Asked Questions

### **What is perfect competition?**

In economic theory, perfect competition occurs when all companies sell identical products, market share does not influence price, companies are able to enter or exit without barrier, buyers have “perfect” or full information, and companies cannot determine prices. In other words, it is a market that is entirely influenced by market forces. It is the opposite of imperfect competition, which is a more accurate reflection of a current market structure.

### **What is an example of perfect competition?**

Consider a farmers market where each vendor sells the same type of jam. There is little differentiation between each of their products, as they use the same recipe, and they each sell them at an equal price. At the same time, sellers are few and free to participate in the market without any barrier. Buyers, in this case, would be fully knowledgeable of the product’s recipe, and any other information relevant to the good.

### **What is the difference between perfect competition and imperfect competition?**

While perfect competition is an idealized market structure in which equal and identical products are sold, imperfect competition can be found in monopolies and real-life examples. For instance, imperfect competition involves companies competing for market share, high barriers to entry, and buyers lacking complete information on a product or service. Unlike perfect competition, however, this creates the incentive to innovate and produce better products, in addition to increased profit margins due to the influence of supply and demand.