The notion of perfect competition for consumers and producers, and the role of price flexibility in such a context

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I. Introduction

The aim of this paper is to clarify the notion of perfect competition for both consumers and producers, with clarifying the role of price flexibility in the perfect competition.

The market in economics is the place where sellers of goods and services meet the buyers of these goods and services where there is a likely possibility for a transaction to take place. Economists assume that there are a number of different buyers and sellers in the marketplace; this means that we have competition in the market, which allows price to change in response to changes in supply and demand. Furthermore, for almost every product there are substitutes, so if one product becomes too expensive, a buyer can choose a cheaper substitute instead.[1]

Competition has two very different meanings; in ordinary discourse, competition means personal rivalry, with one individual seeking to outdo his known competitor. In the economic world, competition means almost the opposite. There is no personal rivalry in the competitive market place. There is no personal chaffer. The wheat farmer in a free market does not feel himself in personal rivalry with, or threatened by, his neighbour, who is, in fact, his competitor. The essence of a competitive market is its impersonal character.[2]

The basic principle in markets is easily stated: a commodity should be produced if the costs can be covered by the sum of revenues and a properly defined measure of consumer's surplus. The optimum amount is then found by equating the demand price and the marginal cost. Such an optimum can be realized in a market if perfectly discriminatory pricing is possible.[3]

There are four types of markets; Monopoly, Oligopoly, Monopolistic Competition and Perfect Competition. Monopoly is a market where is only one producer or supplier for the good or the service, while Oligopoly is the existence of only a few companies in a sector or

[1]ReemHeakal, *"Economics Basics: Monopolies, Oligopolies and Perfect Competition",* available at: http://www.investopedia.com/university/economics/economics6.asp accessed on Feb. 20, 2014.
[2]Milton Friedman, Rosa Friedman, "*Capitalism and Freedom*". Chicago: University of Chicago Press, (2002), 102.
[3]Avinash K. Dixit, Joseph E. Stiglitz, *"Monopolistic Competition and Optimum Product Diversity"*, USA: University of Warwich and Stanford University,(1977), 297.

industry to provide the good or the service, the Monopolistic Competition exist when there are large numbers of relatively small firms, with almost similar goods and services with slight differences often, and lastly the Perfect Competition market is a market that has many buyers and sellers, many products that are similar in nature.

The second part of this paper will explain the meaning of the market from economic aspect, and then explaining the meaning and the main characteristics of the four types of markets. The third part will be about the notion of perfect competition for consumers and producers, and the way to determine the prices in the perfect competition market, the last part will be about the role of price flexibility in the perfect competition.

II. Types of markets

This part of the paper will explain the meaning of the market, and the four types of Markets: Monopoly, Oligopoly, Monopolistic Competition and Perfect Competition, it will elucidate their meaning, their main characteristics and their relation with the competition.

The market in economics is usually defined as: "any place where the sellers of particular good or service can meet with the buyers of that good and service where there is a potential for a transaction to take place." [4]There are several types of markets:

a. Monopoly

Samuel Dodd defined a monopoly as "a grant by the Government for the sole buying, working, making or using of anything"[5]. Monopoly exists when a specific individual or enterprise has sufficient control over a particular product or service to determine significantly the terms on which other individuals shall have access to it. Monopoly raises two classes of problems: first, the existence of monopoly means a reduction in the alternatives available to individuals. Second, the existence of monopoly raises the issue of the social responsibility. [6] This means that in monopoly market, there is no competition; there is only one seller or

[4]Iain MacGill, *"From Energy Consumers to Prosumers Engagement of users in both self generation and energy management",* Australia: Centre for Energy and Environmental Markets, UNSW, EUAA Conference, (Oct. 2013), 11.
[5]Samu El C. T. Dodd*, "Combinations: Their uses and Abuses, with a history of the standard oil trust",* New York: G. F. Nesbitt & Co., (1888), 5.
[6] Milton Friedman, Rosa Friedman, "*Capitalism and Freedom*",102.

producer for the goods, and that the entrance of a new competitor to this market is very hard due to the nature of the goods and resources, the high costs and the governments regulations.

A monopoly granted either to an individual or to a trading company, has the same effect as a secret in trade or manufactures. The monopolists, by keeping the market constantly under stocked by never fully supplying the effectual demand, sell their commodities much above the natural price, and raise their emoluments, whether they consist in wages or profit, greatly above their natural rate, in other words in monopoly markets the sold goods have no close substitute which leads to a rise in the price of the goods in the monopoly market to reach the highest price which can be got, meanwhile the natural price, or the price of free competition, is the lowest which can be taken.[7]

b. Oligopoly

Oligopoly can be defined as a market model of the imperfect competition type, assuming the existence of only a few companies in a sector or industry, from which at least some have a significant market share and can therefore influence the production prices in the market.[8]

Like a monopoly, an oligopoly has high barriers to entry, the products that the oligopolistic firms produce are often nearly identical and therefore, the companies, which are competing for market share, are interdependent as a result of market forces.[9]

c. Monopolistic Competition

Monopolistic competition is a market structure characterized by a large number of relatively small firms. While the goods produced by the firms in the industry are similar, slight differences often exist. As such, firms operating in monopolistic competition are extremely competitive but each has a small degree of market control.[10] In monopolistic competition firms can behave like monopolies in the short-run, including using market power

[7]Adam smith, *"Wealth of Nations*", edited by C. J. Bullock. Vol. X. The Harvard Classics. New York: P.F. Collier & Son,(2001). 56.
[8]Lucie SEVEROVÁ, Lenka KOPECKÁ, Roman SVOBODA and Josef BRČÁK, "*Oligopoly competition in the market with food products*", Faculty of Economics and Management, Czech University of Life Sciences, Prague, Czech Republic,(2011), 580–588.
[9]ReemHeakal, *"Economics Basics: Monopolies, Oligopolies and Perfect Competition"*.
[10]Monopolistic Competition", Amos Web Encyclonomic, available at:http://www.AmosWEB.com accessed on Feb. 17, 2014.

to generate profit. In the long-run, other firms enter the market and the benefits of differentiation decrease with competition. [11]

The main characteristics of monopolistic competition are: large number of small firms, similar, but not identical products, relatively good, but not perfect resource mobility, and extensive, but not perfect knowledge of prices and technology.[12] Moreover in monopolistic competition there is competition on product quality, price, and marketing, and firms are free to enter or exit the industry.

d. Perfect Competition

Perfect competition is characterized by many buyers and sellers, many products that are similar in nature, as a result, many substitutes. Perfect competition means there are few, if any, barriers to entry for new companies and prices are determined by supply and demand.[13]The later parts of the paper will elaborate in the relation between competition with consumers and producers, then in the role of price flexibility in such a context.

III. The notion of perfect competition for consumers and producers

This part of the paper will explain the meaning and the main characteristics of the perfect competition market, then it will explain the notion of perfect competition for both consumers and producers, and how the prices being determined in this market.

A perfectly competitive market is a hypothetical market where competition is at its greatest possible level. Classical economists argued that perfect competition would produce the best possible outcomes for consumers, and society.[14]

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[11] *"Monopolistic competition",* available at: http://www.princeton.edu/~achaney/tmve/wiki100k/docs/Monopolistic_competition.html accessed on Feb. 25, 2014.
[12] Ibid.
[13] ReemHeakal, *"Economics Basics: Monopolies, Oligopolies and Perfect Competition".*
[14] "*Perfect Competition",* available at: http://www.economicsonline.co.uk/Business_economics/Perfect_competition.html accessed on Feb. 20, 2014.

Perfectly competitive markets exhibit the following characteristics:

- **Many sellers** each of them produce a low percentage of market output and cannot influence the prevailing market price.
- **Many individual buyers**, none has any control over the market price.
- **Perfect freedom of entry and exit the industry**, firms face no sunk costs and entry and exit from the market is feasible in the long run.
- **Perfect knowledge**, consumers have all readily available information about prices and products from competing suppliers and can access this at zero cost.
- **Perfectly mobile factors of production**, land, labour and capital can be switched in response to changing market conditions, prices and incentives.
- **No externalities** arising from production and/or consumption.[15]

Furthermore, a recent factor that entered the perfect competition world is the Internet. Internet played a direct role on the perfect competition; markets have become more competitive because of the advances on web technology. It has reduced barriers to entry for firms wanting to compete with well-established business, for example specialist toy retailers are better able to battle for market share with the dominant retailers such as Toys R Us and Wal-Mart.

The ability of consumers to find information such as prices for many goods and services is considered as the most important features of the Internet market. The price comparison web sites themselves have come under criticism because of the huge number of price comparison sites in all the fields on the Internet.

For example the sites offering to compare hundreds of diverse motor insurance policies or mortgage products draw information from the insurance and mortgage brokers but might use limiting assumptions about the different types of consumers looking for the best price, Resulted in a range of prices facing the consumer that don't exactly reflect their precise needs and consumers for example may only realize this after making a claim on an insurance policy bought through internet which happened not to deliver the specific cover they needed. And there is a monopoly power in the market for price comparison sites too!

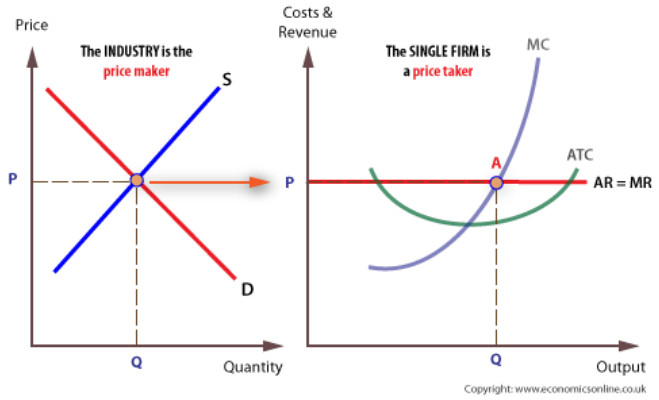
[15]Geoff Riley, "*Perfect Competition - Economics of Competitive Markets*", available at: http://tutor2u.net/economics/revision-notes/a2-micro-perfect-competition.html accessed on Feb. 19, 2014.

Moneysupermarket.com presently has around 40% of the overall comparison site market, with Confused.com its nearest rival with a share of about 10%.[16]

The perfect competition market is a market in which all market participants are price takers.

The firm as price taker

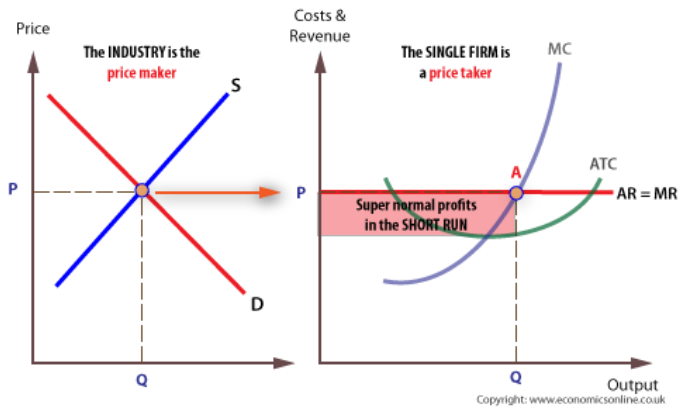
The single firm takes its price from the industry and the market, and is consequently referred to it as a "price taker". The industry is composed of all firms in the industry and the market price is where market demand is equal to market supply. Each single firm must charge this price and cannot diverge from it.



Equilibrium in perfect competition

In the short run

Under perfect competition, firms can make super-normal profits or losses.

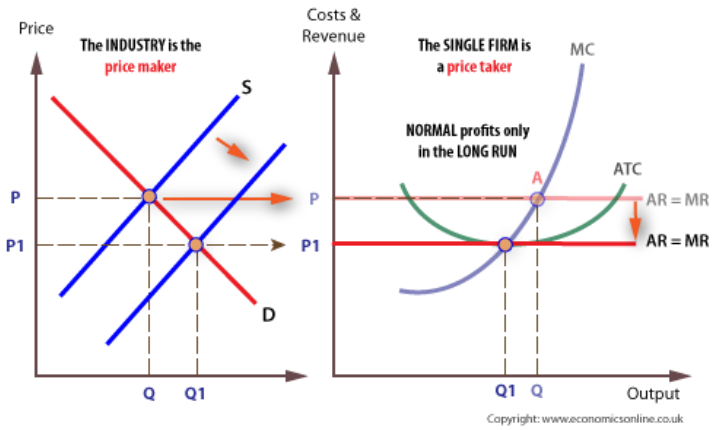


[16]Ibid.

In the long run

In the long run firms are attracted into the industry if the incumbent firms are making supernormal profits. This is because there are no barriers to entry and because there is perfect knowledge in the market. The effect of this entry into the industry is to shift the industry supply curve to the right, which drives down price until the point where all super-normal profits are exhausted.

If firms are making losses, they will leave the market as there are no exit barriers, and this will shift the industry supply to the left, which raises price and enables those left in the market to derive normal profits.



The super-normal profit derived by the firm in the short run acts as an incentive for new firms to enter the market, which increases industry supply and market price falls for all firms until only normal profit is made.[17]

IV. The role of price flexibility in such a context

This part of the paper will show whether there is a price flexibility or not in the perfect competition, and will show the reason for this condition.

In perfect competition market, there is no price flexibility; prices are determined by the market itself. By the relation between supply and demand in this market, and producers

[17] "*Perfect Competition*", available at: http://www.economicsonline.co.uk/Business_economics/Perfect_competition.html accessed on Feb. 20, 2014.

cannot determine the prices. In other words, producers and consumers in the perfect competition market are “price takers” rather than “price makers” [18]

Perfect competition features many sellers selling an identical product, in addition to easy entry and exit in the long run. Since there are a large number of sellers all selling an identical product, each firm has no price-setting power. The firm is only a price taker. Each individual firm has no influence on the market price. In other words, regardless of how much output the firm sells (or none at all) the market price is still the same. No single firm is large enough to influence the market price through its own output. As a result, each firm’s demand curve is horizontal.

The positive way of looking at this is that the firm can sell as much output as it wants at a given market price; in contrast, a firm with market power must lower the price in order to sell more output. The negative way of looking at this is that the firm can’t raise price at all. If a single firm charges a price even slightly above market price, it will sell nothing since there are a large number of firms selling an identical product at the market price. On the other hand, the firm has no reason to lower price either since it can sell as much as it wants at the market price.[19]

If a producer decided to sell in a lower price than the market price he will lose because the cost will be higher than this price, and if he decided to sell with a higher price, no consumer will buy from him, because consumers would pay the less money they can for the identical goods.

V. Conclusion

This paper aimed to explain the notion of perfect competition for consumers and producers, and the role of price flexibility in such a context, it provided a definition of the market from economics view, and then explained the four types of Markets: Monopoly, Monopolistic Competition, Oligopoly and Perfect Competition.

[18]Frank M. Machovec,*" Perfect Competition and the Transformation of Economics",*New York and London: Routledge, (1995), 96.
[19]Michael Malcolm, "*Perfect Competition",* (Jun. 18, 2011), available at: http://gatton.uky.edu/faculty/sandford/401_f12/perfectcompetition.pdf ,accessed on Feb 22. 2014, 1.

The paper then presented the notion of perfect competition for consumers and producers and how the perfect competition market is a market in which all market participants are price takers rather than price makers, and that only the market in the relation between the supply and demand determine the prices in this market.

And in the last part of the paper it was shown that in perfect competition market, there is no price flexibility; prices are determined by the market itself, by the relation between supply and demand in this market.

Many scholars concluded their researches that there is no such thing as "pure" perfect competition; every producer has some effect, however tiny, on the price of the product he produces. The important issue for understanding and for policy is whether this effect is significant or can properly be neglected, as the surveyor can neglect the thickness of what he calls a "line."[20]

Very few markets or industries in the real world could be perfectly competitive. For example, how homogeneous is the output of real firms, given that even the smallest of firms working in manufacturing or services try to differentiate their product.

Although unrealistic, it is still a useful model in two respects. Firstly, many primary and commodity markets, such as coffee and tea, exhibit many of the characteristics of perfect competition, such as the number of individual producers that exist, and their inability to influence market price. Secondly, for other markets in manufacturing and services, the model is a useful yardstick by which economists and regulators can evaluate levels of competition that exist in real markets.[21]

[20]Milton Friedman, Rosa Friedman, "*Capitalism and Freedom*", 102-103.
[21]George Higson, "*Business Economics, Enterprise, efficiency and regulation",* Economics online Ltd, (2011), 47.

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