

Perfect Competition vs Imperfect Competition

Firm behavior in **competitive** markets is probably one of the most fundamental subjects in economics. That is mainly _____ the fact that most markets we **encounter** in reality are competitive, **at least** to a certain degree. Competition is characterized by a multitude of firms offering the same (or a similar) good or service or a close **substitute**.

In general, it can be said that the more similar the goods or services are, the more competitive the markets will be. However, the competitiveness of a market is still highly **dependent** on firm behavior. For example, companies **engaging** in **collusive** behavior may result in a significant **impediment** to competition. For now, we will assume that firms do not **engage** in such activities.

As mentioned above, competitive markets may **experience** different degrees of competition. To explain the principle of competitiveness, it is useful to **distinguish** between two different market structures: perfect competition and imperfect competition.

Perfect competition

As the name suggests, perfect competition is considered the purest form of competition. For a market to be perfectly competitive, the following **criteria** need to be met:

The goods that are sold need to be **homogeneous**. In other words, they need to be exactly the same and can thus be substituted at no **cost**.

There must be no **preferences** between different sellers. For the customers it should not matter from which seller they buy their products.

No actor should have the ability to **affect** the market price. That means, **both** buyers and sellers do not have any market **power** and can thus be considered price takers.

Looking at these **criteria**, it becomes apparent, that they will hardly ever be met in reality. Even so, an example that comes fairly close to perfect competition is the market for rice. There are thousands of buyers and sellers and the products are mostly **identical**. But it will never be perfectly competitive, as there will always be minor differences in products, preferences between sellers and so on. However, at this point it is important to note that the idea behind perfect competition as a **theoretical** construct is to help explain various market mechanisms and **economic** behavior. So even though we may not find perfectly competitive markets in reality, the concept is still extremely relevant.

Imperfect competition

In contrast to perfect competition, imperfect competition is a fairly common market structure in practice. It is defined by the following characteristics:

The goods which are sold are differentiated. That means, even though they mostly satisfy the same needs, there are minor differences that allow customers to distinguish the products from one another.

Due to the differentiated goods, customers develop preferences for some sellers. Thus, they are willing to spend more money on goods from specific sellers.

As a result, the sellers may exert a certain degree of market power and charge a price premium. Hence, they can directly influence the market price to a limited degree and are no longer pure price takers.

Although imperfect competition is sometimes also referred to as monopolistic competition, they are not the same. Imperfect competition is a generic description of all market structures that lie anywhere between perfect competition and a monopoly. Thus, monopolistic competition is a type of imperfect competition along with oligopolistic market structures.