Economic review

A perfectly competitive market

Decisions made by firms are taken in the context of the market in which they operate. The model of perfect competition sets out how firms choose output in a competitive environment, based on some key assumptions. For more discussion of perfect competition, see the article by Caroline Elliott on pages 11–13

Assumptions

- Participants
- Perfect information
- A homogeneous product
- Firms aim to maximise profits
- No barriers to entry or exit
- No externalities

Outcomes

- With many buyers and sellers, no individual trader can influence price
- With perfect knowledge of market conditions, consumers all pay the same price and firms are price takers
- With identical products, consumers will not favour one producer over another and quality is constant
- If firms maximise profits, their decisions can be readily analysed — they will choose output such that $MC = MR$
- If firms are free to enter or exit the market, supernormal profits will be competed away
- Externalities interfere with allocative efficiency
- Firms achieve productive efficiency in the long run, producing at minimum average cost
- Resources are allocated such that there is allocative efficiency with price equal to marginal cost

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