

# According To The Elimination Principle, Firms Making An Above-normal Profit In A Competitive Market Will:

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In the realm of perfect competition, the behavior of firms earning above-normal profits is governed by the well-established Elimination Principle. This economic concept explains the natural adjustments within a competitive market that tend to eliminate abnormal profits over time. Understanding this principle is vital for comprehending how markets self-regulate and how firm profitability influences market dynamics. In this article, we delve into the core ideas behind the Elimination Principle and explore its implications for firms operating in perfectly competitive markets.

## Understanding the Elimination Principle in Competitive Markets

The Elimination Principle suggests that in a perfectly competitive environment, firms earning abnormal or above-normal profits will face intense market pressures that ultimately erode these profits. This process ensures that, in the long run, firms earn only normal profits – the minimum level needed to keep resources allocated efficiently.

### What Are Above-normal Profits?

- **Definition:** Above-normal profits, also known as economic profits, occur when a firm's total revenue exceeds its total costs, including opportunity costs.
- **Significance:** Such profits indicate that a firm is earning more than what is necessary to cover all costs, attracting new entrants into the market.
- **Temporary Nature:** In perfect competition, these profits are typically temporary due to the market adjustments driven by the Elimination Principle.

# The Mechanism of Market Entry and Exit

In a perfectly competitive market, profits serve as signals for potential entrants:

1. **Attractive Profits Draw New Firms:** When existing firms earn above-normal profits, they signal lucrative opportunities, prompting new firms to enter the market.
2. **Increased Market Supply:** Entry of new firms increases the total supply of the product, which exerts downward pressure on prices.
3. **Falling Prices Reduce Profits:** As supply increases, prices tend to fall toward the level of normal profits, squeezing out abnormal profits.
4. **Market Equilibrium Restores Normal Profits:** The process continues until profits are eliminated, and firms earn only normal profits.

## The Role of Competition in Eroding Above-normal Profits

Competition acts as the primary force that drives the elimination of abnormal profits:

### Entry of New Firms

- When firms see high profits, barriers to entry are minimal in perfect competition, encouraging new firms to enter.
- New entrants increase market supply, leading to a decrease in market prices.
- This process continues until the excess profits are eliminated, stabilizing the market.

### Increased Supply and Price Reduction

- The entry of firms causes a rightward shift in the industry supply curve.
- The increased supply results in a reduction in market price, approaching the level of average total cost.
- At this point, firms' profits are driven down to a normal level, where total revenue equals total costs.

## Firms Exiting the Market

- If some firms are unable to sustain normal profits due to high costs or inefficiency, they may exit the market.
- Market exit reduces supply, which can lead to an increase in prices, balancing the market again.
- This exit process also contributes to restoring equilibrium in the long run.

## Long-Run Equilibrium in Perfect Competition

The long-run outcome governed by the Elimination Principle results in a stable market where firms earn only normal profits.

## Characteristics of Long-Run Equilibrium

- **Normal Profits:** Firms earn just enough to cover all opportunity costs, including a normal return on investment.
- **Productive Efficiency:** Firms produce at the lowest point on their average total cost curve, minimizing costs.
- **Allocative Efficiency:** Price equals marginal cost ( $P = MC$ ), ensuring resources are allocated optimally.
- **No Incentive for Entry or Exit:** Since profits are normalized, there's no further incentive for firms to enter or leave the market.

# Graphical Representation

While a visual graph cannot be displayed here, the typical representation includes:

- Short-run equilibrium showing firms earning above-normal profits where price exceeds average total cost.
- The long-run supply curve shifting outward as new firms enter, pushing prices down.
- Adjustment until the price stabilizes at the point where average total cost equals price, reflecting normal profits.

## Implications of the Elimination Principle for Firms and Market Efficiency

Understanding the Elimination Principle helps explain the self-correcting nature of competitive markets.

### For Firms

- **Incentive to Improve Efficiency:** Firms that cannot operate at the lowest cost are driven out of the market, encouraging efficiency.
- **Limited Long-Run Profits:** Firms cannot sustain above-normal profits indefinitely, fostering a focus on cost minimization and innovation.
- **Market Entry and Exit Dynamics:** Firms continuously evaluate profitability and adjust their operations accordingly.

### For Market Efficiency

- The process ensures resources are allocated where they are most valued, maximizing total welfare.
- Prices reflect true marginal costs, leading to optimal consumption and

production decisions.

- The elimination of abnormal profits maintains competitive discipline and prevents monopolistic behaviors.

## **Exceptions and Limitations of the Elimination Principle**

While the Elimination Principle is a fundamental concept, real-world markets may exhibit deviations due to various factors.

### **Market Barriers**

- High startup costs, legal restrictions, or control over essential resources can prevent new firms from entering, allowing above-normal profits to persist.

### **Market Imperfections**

- Information asymmetries, product differentiation, and brand loyalty can reduce the competitive pressures that eliminate abnormal profits.

### **Short-Run vs. Long-Run Perspectives**

- In the short run, firms may enjoy above-normal profits due to temporary factors, but these are usually eroded over time as per the Elimination Principle.

## **Conclusion**

The Elimination Principle is a cornerstone of perfect competition theory,

illustrating how market forces naturally work to eliminate above-normal profits in the long run. Firms earning such profits attract new entrants, increase supply, and push prices down until only normal profits remain. This self-correcting mechanism promotes resource efficiency, stabilizes markets, and ensures that consumer welfare is maximized. While certain market imperfections can temporarily allow firms to sustain above-normal profits, the fundamental tendency in a perfectly competitive environment remains that abnormal profits are ultimately eliminated, reinforcing the importance of efficiency and competitive discipline in economic markets.

By understanding these dynamics, policymakers, entrepreneurs, and consumers can better appreciate the forces shaping market outcomes and the importance of fostering competitive conditions for long-term economic stability and growth.

## **Frequently Asked Questions**

### **What does the Elimination Principle imply for firms earning above-normal profits in a competitive market?**

The Elimination Principle suggests that firms making above-normal profits will attract new entrants into the market, which increases supply and drives prices down until only normal profits are earned.

### **How does the Elimination Principle ensure long-term equilibrium in perfect competition?**

It ensures long-term equilibrium by eliminating abnormal profits through entry of new firms, restoring profits to normal levels and maintaining market stability.

### **What role do barriers to entry play in the Elimination Principle for above-normal profits?**

Barriers to entry prevent new firms from entering the market, which can allow firms to sustain above-normal profits longer, but in perfectly competitive markets, barriers are minimal, leading to eventual elimination of such profits.

### **According to the Elimination Principle, what happens to firms with below-normal profits in a competitive market?**

Firms experiencing below-normal profits will gradually exit the market,

reducing supply and helping to restore market equilibrium where remaining firms earn normal profits.

## **Why is the elimination of above-normal profits important for the efficiency of a perfectly competitive market?**

It promotes allocative and productive efficiency by ensuring resources are not diverted to unprofitable activities and that firms operate at their lowest cost, benefiting consumers with fair prices.

## **Additional Resources**

Elimination Principle in Competitive Markets: How Firms Earning Above-normal Profits Are Driven Towards Equilibrium

In the intricate world of microeconomics, understanding how firms behave in competitive markets is essential for grasping the dynamics that shape industries, influence pricing, and determine market efficiency. Among the foundational theories explaining this behavior is the Elimination Principle, which offers a compelling insight into the fate of firms that enjoy above-normal profits. This principle essentially states that in a perfectly competitive environment, firms earning above-normal profits will, over time, be driven out of the market or will see their profits diminish to normal levels due to the forces of entry and exit.

This article delves deep into the Elimination Principle, unpacking its implications, mechanisms, and the nuanced ways it influences firm behavior in competitive markets. We will explore how this principle operates, its theoretical underpinnings, and real-world applications, all presented with clarity and thoroughness suitable for economics students, professionals, and enthusiasts alike.

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## **Understanding the Elimination Principle**

The Elimination Principle is rooted in the core assumptions of perfect competition, where numerous small firms operate in a market with free entry and exit, perfect information, and homogeneous products. Under these conditions, the market tends toward an equilibrium where firms earn just enough to cover their opportunity costs—what economists term normal profit.

Normal profit is the minimum level of profit necessary for a firm to remain in business in the long run—covering costs like wages, rent, and capital costs—but no more. When firms earn above-normal profits, it signals that

there are opportunities for additional entrants to profit from the market.

The key assertion of the Elimination Principle is:

In a competitive market, firms earning above-normal profits will attract new entrants, which will increase supply, reduce prices, and eventually erode those excess profits, pushing firms toward normal profit levels.

This self-correcting mechanism ensures that, over time, market efficiency is maintained, and resources are allocated optimally.

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## **Mechanics of the Elimination Principle**

Understanding how the Elimination Principle works requires exploring the dynamic interplay between firm profits, market entry, and market supply.

### **1. Entry of New Firms**

- When existing firms in a market enjoy above-normal profits, it acts as a signal to potential entrants.
- These profits serve as a profit incentive, encouraging new firms to enter the industry.
- Entry can be facilitated by low barriers, minimal startup costs, and accessible information, which are typical of perfect competition.

### **2. Increased Market Supply**

- As new firms join, the total supply of the product increases.
- The supply curve shifts outward, leading to a lowering of market prices.
- Consumers benefit from lower prices, but existing firms experience a reduction in their profit margins.

### **3. Erosion of Above-normal Profits**

- The increased competition and lower prices diminish the ability of firms to sustain above-normal profits.
- Firms may see their profits decline to the level of normal profit.
- If profits fall below the normal level, firms will find it unprofitable to stay in the market and will begin to exit.

## **4. Exit of Firms**

- Firms experiencing persistent losses (below-normal profits) will exit the industry.
- The reduction in supply from exiting firms causes prices to rise again.
- The market stabilizes at a point where remaining firms earn normal profits, and no further entry or exit occurs.

## **5. Long-Run Equilibrium**

- The process of entry and exit continues until profits are driven down to the normal profit level.
- At this point, the market reaches long-run equilibrium, characterized by:
  - Firms earning just enough to cover costs.
  - No incentive for new firms to enter.
  - No firms to exit, maintaining a stable industry.

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## **Implications of the Elimination Principle**

The Elimination Principle has profound implications for how markets function and how firms strategize in a competitive environment.

### **1. Price and Output Determination**

- Prices tend toward the minimum point of the average cost curve in the long run.
- Firms produce at the efficient scale, minimizing costs and ensuring resources are allocated efficiently.

### **2. Market Efficiency**

- The principle ensures allocative and productive efficiency.
- Resources are allocated optimally because only the most efficient firms survive.
- Excess profits are eliminated, preventing market distortions.

### **3. Limitations and Real-World Deviations**

- Real-world markets often deviate from perfect competition; barriers to entry, product differentiation, and imperfect information can prevent the full operation of the Elimination Principle.
- Firms with market power or brand loyalty can sustain profits above normal levels longer.
- Regulatory environments and patents can also hinder the free flow of entry and exit.

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## **Illustrative Example: The Coffee Industry**

To contextualize the Elimination Principle, consider the global coffee industry—a competitive market with numerous small producers, importers, and retailers.

- Suppose a new coffee farm adopts innovative, cost-effective farming techniques, enabling it to produce coffee at a lower cost than existing farms.
- This farm can sell coffee at a lower price and still earn above-normal profits.
- Seeing this opportunity, other farmers and new entrants enter the market, increasing supply.
- As supply increases, coffee prices decline.
- Existing farms' profits decrease, approaching the normal profit level.
- Less efficient farms, unable to compete at the lower prices, may exit the market.
- The industry stabilizes at a point where only the most efficient producers survive, earning normal profits.

This example underscores how above-normal profits attract entry, which in turn erodes those profits—a classic demonstration of the Elimination Principle in action.

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## **Limitations and Criticisms of the Elimination Principle**

While the Elimination Principle provides a robust theoretical framework, real-world markets often exhibit behaviors that challenge its assumptions.

Key limitations include:

- **Barriers to Entry:** High startup costs, patents, or regulatory hurdles can prevent new entrants, allowing firms to sustain above-normal profits.

- Product Differentiation: Firms with differentiated products or strong brand loyalty can maintain above-normal profits despite competitive pressures.
- Imperfect Information: Asymmetries and lack of information can lead to delayed entry or exit, disrupting the self-correcting mechanism.
- Market Power and Monopolistic Practices: Firms with significant market power can sustain profits above normal levels without facing intense entry pressures.

Critics argue that these factors mean the Elimination Principle is more applicable to idealized markets than to many real-world situations.

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## **Conclusion: The Dynamic Dance Toward Equilibrium**

The Elimination Principle encapsulates a fundamental truth about competitive markets: profit incentives drive market adjustments. Firms earning above-normal profits act as catalysts for new entrants, which increase supply and push prices down, ultimately eroding those excess profits. This process ensures that, over time, markets tend toward a state where firms earn only normal profits, signaling an efficient allocation of resources.

However, understanding the principle also requires recognizing its limitations and the myriad factors—such as market imperfections, strategic behaviors, and regulatory environments—that can influence its operation. Despite these complexities, the Elimination Principle remains a cornerstone of microeconomic theory, illustrating the self-regulating nature of perfectly competitive markets and the relentless pursuit of efficiency.

In essence, it portrays a marketplace where only the most efficient survive, and excess profits are transient, serving as both a motivator for innovation and a mechanism for correction—a testament to the dynamic equilibrium that underpins free markets.

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