ECON 224, Professor Hogendorn, Fall 2012

First Quiz Answers

1. *Boatshoes_a.*

(a) Here the key thing is that 4 firms make $150 million which exceeds fixed costs, but it must be that 5 firms would makes less than the fixed costs or else a fifth firm would enter.

(b) First, note that boat shoes are clearly a positive natural monopoly since there exists more than one profitable firm. But this question is about normative natural monopoly. Boat shoes require substantial fixed costs in designing a shoe and establishing a brand. In the case of companies that produce their own shoes, they also require substantial fixed investments in production facilities. Once these investments are made, the marginal cost of producing another pair of shoes is comparatively low. This suggests that the AC curve slopes down in Q for all levels of output, that economies of scale are never exhausted, and that the industry is a normative natural monopoly.

On the other hand, one could argue that the fixed costs of setting up a boat shoe company are quite low, especially since it is possible to outsource production and many other aspects of the business. Also the market is very large, so any fixed costs are easily spread over a large number of sales. Furthermore, what fixed costs there are are primarily associated with brand, indicating that consumers value product differentiation in this industry, and the good is not really homogeneous. These considerations suggest that AC is flat or possibly rising if there are diminishing returns as the brand gets larger.
(c) The FTC and DOJ are empowered to review mergers for anti-competitive effects under the Clayton Antitrust Act. The Act requires that merging firms not create an oligopolistic market structure that will hinder an efficient market outcome. The process is formalized through a filing under the Hart-Scott-Rodino Act, which also allow the authorities to follow up with further investigation if necessary. In this case there were no follow-up questions, but even so the HSR filing cost “millions of dollars” in lawyers’ fees according to the CEO of Sperry.

Using the HSR information and other market data, the authorities determine whether the merger will be anti-competitive. They calculate the diversion ratio, which tells what percent of Sperry customers would choke Sebago as their next-best choice of shoe if Sperry raised its price. In this merger, the diversion ratio was probably not too high given the many other choices of boat shoes, including smaller brands as well as the big four. The authorities will also consider whether there are other firms that could potentially enter the boat shoe industry if Sperry and Sebago raised prices. They probably concluded that any shoe company could start a boat shoe line without much difficulty, suggesting robust potential for entry.

In their HSR filings, Sperry and Sebago probably listed cost-reducing efficiencies from the merger, suggesting that total welfare might increase after the merger. But these arguments would only be persuasive if these efficiency gains were specific to this merger and not just due to larger size or ongoing technological change. Since the merged brands can combine resources both on the production and sales side, those efficiencies would indeed be merger specific.