ECON 224, Professor Hogendorn

Problem Set 6 Answers

1. The problem with this plan is that the highest bidder would have to get the maximum possible profit out of the franchise. But (assuming uniform pricing) that profit is the monopoly profit, which is achieved when quantity is set by marginal revenue equals marginal cost. This results in a very high price and a lot of deadweight loss.

2. In ruinous competition, firms lower their price toward marginal cost, eventually leading to prices that are below average cost. This will eventually cause the firms to go bankrup, but since they have large sunk costs that cannot be used for any other purpose, they are simply reorganizaed in bankruptcy and continue to operate as ruinous competitors.

3. At one time, the northeastern railroads almost all went bankrupt at the same time. This was partly because there was a very sharp decline in demand which in turn disrupted a complicated regulatory system that cross-subsidized long-distance passenger service, commuter rail, and lightly-used branch lines from high freight rates. After the decline in demand, railroads could no longer afford these required services. The government created a new government-owned corporation called Conrail to continue operating the railroads, and it split off long-distance passenger rail to AMTRAK, commuter service to local commuter rail authorities, and allowed Conrail to abandon many of the branch lines.

4. Some utilities executives may feel this way! But really the idea is to raise the price to account for inflation according to a retail prices index, but also lower the price by an X factor that accounts for

overall productivity improvements. Any additional productivity improvements beyond X become part of the utlitity's profits, so there should be good incentives to increase productivity.