

Suggested Solutions for Business Case Questions for Thought

This section offers suggested answers to the *Questions for Thought* at the end of each chapter's business case.

|| CHAPTER 1

1. Explain how each of the twelve principles of economics is illustrated in this case.

Suggested Solution

1. Principle 1: People must make choices because resources are scarce. Neither money nor time is unlimited; they are both scarce resources. Priceline caters to customers who have chosen to sacrifice some of their preferences about convenience or quality in order to get a lower price.

Principle 2: The opportunity cost of an item—what you must give up in order to get it—is its true cost. The true cost of an empty airplane seat or an empty hotel bed is the revenue the airline or hotel could have earned from the next best use of that seat or bed—namely, the revenue earned from a paying customer.

Principle 3: “How much” is a decision at the margin. How much more a customer is willing to pay for a ticket to a destination depends upon how much time and inconvenience is saved by purchasing the higher priced ticket.

Likewise, how much more a customer is willing to pay for a ticket purchased well in advance of his travel date depends upon how much more security he gains by advance planning rather than waiting to purchase. The same principle applies to decisions about the quality and location of hotels, and so on.

Principle 4: People usually respond to incentives, exploiting opportunities to make themselves better off. Priceline was successful because its customers—travellers, airlines, and hotels—were exploiting opportunities to make themselves better off by using its services. Priceline also responded to incentives to make itself better off by expanding into new profitable markets such as Europe.

Principle 5: There are gains from trade. Travellers gain from using Priceline's networks of hotels to find a hotel rather than doing the research themselves. They gain from using Priceline's services to book a flight rather than contacting each airline individually. Also, travellers gain by using the services of airlines and hotels, rather than transporting themselves or pitching a tent overnight to sleep in. Hotels, particularly in Europe, gain from using Priceline's network rather than trying to contact potential customers directly.

Principle 6: Because people respond to incentives, markets move toward equilibrium. Expedia and Orbitz moved into the online travel service industry in order to exploit opportunities that had been pioneered by Priceline. In this way, the market for online travel services will move toward equilibrium until there are no more opportunities for new travel service companies to exploit.

Principle 7: Resources should be used efficiently to achieve society's goals. Priceline exploited an opportunity to use resources more efficiently. It is inefficient to have empty hotel rooms and airline seats if someone is willing to pay some price to use them on short notice.

Principle 8: Because people usually exploit gains from trade, markets usually lead to efficiency. It is inefficient to have planes flying with empty seats and hotels with unoccupied beds. Thus, introducing a market for those items—which is what Priceline did—improves efficiency.

Principle 9: When markets don't achieve efficiency, government intervention can improve society's welfare. It would have been inefficient to have major airlines fail because of the public's temporary fear of flying. Vast resources would have been wasted as pilots and support staff lost their jobs, planes were mothballed, necessary trips cancelled, and so on. It improved efficiency for the government to step in and temporarily aid the airline industry so that it could survive the temporary downturn.

Principle 10: One person's spending is another person's income. In the aftermath of the attacks of September 2001, as people stopped spending on items like travel, the income of airline workers was severely reduced.

Principle 11: Overall spending sometimes gets out of line with the economy's productive capacity. The overall economy went into a slump after the attacks of September 2001 as the economy's productive capacity exceeded its spending.

Principle 12: Government policies can change spending. The US\$15 billion aid appropriation by the U.S. Congress was spent on stabilizing the airline industry and prevented major airline failures.