

## MEMORANDUM

TO: Professor Michael Oakes

FROM: David Ricardo

DATE: January 9, 2006

SUBJECT: Analysis of “Independence Air Will Close After Failing to Draw Firm Bid”  
*The Wall Street Journal*, 01/03/06, page A4

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## SUMMARY

This article explains that while Independence Air, a commuter airline, had high hopes that another company would make an offer to buy it, no such company stepped forward. As a result, Independence Air is moving forward with bankruptcy procedures and will begin liquidating (selling off) its assets. The company had what the article called a “flawed business strategy” based on using smaller planes that were actually 30% more expensive per passenger seat. That strategy plus the rise in fuel prices in recent doomed it.

## ANALYSIS

The story on Independence Air’s story illustrates a couple of key economics concepts:

1. Assuming the reporter’s assessment of the flawed strategy is true, Independence Air’s costs would have been significantly higher than its competitors. Though the airline industry is not a great example of a perfectly competitive market, it’s still a very competitive one. Microeconomics suggests that firms in competitive markets will always face pressure to reduce their costs through innovation of products, services or business processes. The high cost producer will be in trouble, because it will not be able to match the lower prices of competitors. This seems to be what happened to Independence Air.
2. While the bankruptcy and sale of assets will cause at least short-term harm to the company’s employees (2,500 of the 2,800 will be loose their jobs soon), this is an example of how markets allocate resources to those who value them most highly. The assets – office equipment, airport gates, computer systems, and any purchased aircraft – are “lowly” valued at a high-cost, now bankrupt airline. Buyers will appear that can make better use of these assets, and bankruptcy speeds this reallocation. Even the employees are essentially re-allocated. Some will enter new industries, and others may seek more training or education. Many, however, will go to other airlines that will obviously (by virtue of offering them jobs) value them more highly than does Independence Air does.