Price Competition and Endogenous Product Choice in Networks: Evidence from the U.S. Airline Industry

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Abstract

The recent merger waves in the airline industry have received attention by researchers and the general public alike. Most academic studies have analysed the problem using demand/supply or entry models. These contributions assume that the airlines' entry decisions in markets are exogenous, or that the airlines' entry decisions are independent across markets. Instead, we estimate a two-stage model where airlines choose their entire networks of markets to be served in the first stage and then compete in prices in the second stage. The two-stage framework allows us to make counterfactual exercises which robustly predict changes not only in prices and markups, but also in how airlines adjust their networks of served markets. We estimate the model using cross-sectional data on the US airline industry and use our results to evaluate a merger between American Airlines and US Airways.