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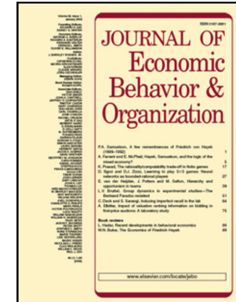

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Collusion, Profitability and Welfare: Theory and Evidence

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Highlights:

- I examine how structural industry characteristics affect the magnitude of the welfare effect of collusion
- The theory is consistent with evidence from a natural experiment of policy reform, the introduction of cartel law in the UK in the late 1950s
- Price-cost margins declined after the breakdown of cartels in low-capital and larger-sized industries relative to capital-intensive and smaller-sized ones
- The welfare loss from collusive pricing may be relatively small in certain types of industries where collusion often occurs in practice

Abstract: In a differentiated oligopoly model with free entry, the static welfare loss from collusion is larger the lower the entry cost, the larger the market size and the higher the degree of product differentiation. The cartel overcharge is larger the lower the entry cost and the larger the market size, and is independent of the degree of product differentiation. These theoretical results are consistent with evidence from a natural experiment of policy reform, the introduction of cartel law in the UK in the late 1950s. Price-cost margins declined after the breakdown of cartels in low-capital and larger-sized industries relative to capital-intensive and smaller-sized ones. There is weaker evidence of a fall in price-cost margins in consumer good and advertising-intensive relative to producer good and low-advertising industries. Crucially, these effects are not observed for industries not affected by the cartel law.

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