HOW MARKET FRAGMENTATION CAN FACILITATE COLLUSION

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Abstract
When regulated markets are liberalized, economists always stress the benefits of fragmenting existing capacities among more firms. This is because oligopoly models typically imply that a larger number of firms generates stronger competition. I show in this paper that this intuition may fail under collusion. When individual firms are capacity constrained relative to total demand, the fragmentation of capacity facilitates collusion and increases the highest sustainable collusive price. This result can explain the finding in Sweeting (2005) that dramatic fragmentation of generation capacity in the English electricity industry led to increasing price cost margins. (JEL: J1, J11)

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