Cutting Out the Middleman: The Structure of Chains of Intermediation*

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July 2021 [Please click for most recent version]

Abstract

Distribution of goods often involves chains of intermediaries engaged in sequential buying and reselling. Why do such chains arise, and how do they affect consumers and their ability to gain from trade? We show that the existence of internal economies of scale in trade logistics is a sufficient mechanism to yield chains with multiple intermediaries, and that this suggests consumers in developing countries are more likely to be served via long chains. Contrary to common wisdom, cutting middlemen out can, but does not necessarily, benefit consumers. Instead, there is a fundamental tradeoff between costs and entry that means even pure reductions in trade costs can have perverse effects. The proposed mechanism is simple, but can account for empirical patterns in wholesale firm size, prices and markups that we document using original survey data on imported consumer goods in Nigeria. We estimate a structural version of the model for distribution of Chinese-made apparel in Nigeria, and describe endogenous restructuring of chains and the resulting impacts on consumer welfare in response to counterfactual changes in regulation, e-commerce technologies, and transport infrastructure.

*We thank Treb Allen, David Atkin, Kyle Bagwell, Andy Bernard, Lorenzo Casaburi, Arun Chandrasekhar, Davin Chor, Cecile Gaubert, Sam Kortum, Nina Pavcnik, Andres Rodriguez-Clare, and Ina Simonovksa for their helpful comments. This work would not be possible without the excellent research assistance of Hakeem Bishi, Yemi Ogundare, Samuel Adesanya, Nicole Wilson, Sheah Deilami-Nugent, and the Lagos Trader Project enumerator team.

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