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Antonella Nocco, Gianmarco I.P. Ottaviano, Matteo Salto

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Monopolistic Competition and Optimum Product Selection: Why and how heterogeneity matters*

Antonella Nocco, Università del Salento
Gianmarco I.P. Ottaviano, LSE and University of Bologna
Matteo Salto, European Commission

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Abstract

After some decades of relative oblivion, the interest in the optimality properties of monopolistic competition has recently re-emerged due to the availability of an appropriate and parsimonious framework to deal with firm heterogeneity. Within this framework we show that non-separable utility, variable demand elasticity and endogenous firm heterogeneity cause the market equilibrium to err in many ways, concerning the number of products, the size and the choice of producers, the overall size of the monopolistically competitive sector. More crucially with respect to the existing literature, we also show that the extent of the errors depends on the degree of firm heterogeneity. In particular, the inefficiency of the market equilibrium is largest when selection among heterogenous firms is needed most, that is, when there are relatively many firms with low productivity and relatively few firms with high productivity.

Keywords: monopolistic competition, product diversity, firm heterogeneity, selection, welfare.
J.E.L. Classification: D4, D6, F1, L0, L1.

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