When Is Monopolistic Competition the Relevant Market Structure?∗

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Abstract

We consider a differentiated market involving a handful of oligopolistic firms and a wide range of monopolistically competitive firms. Under various specifications of preferences, we show that the presence of small non-strategic firms is sufficient for the strategic interactions among oligopolistic firms to be diluted when the monopolistically competitive firms can freely enter and exit the market in response to oligopolistic firms’ decisions. Furthermore, the oligopolistic firms behave like monopolists which face demands encapsulating monopolistically competitive firms’ reactions. This has a far-reaching implication for the anti-trust policy: oligopolistic firms’ equilibrium strategies are independent from the number of such firms. Our results hold for heterogeneous firms.

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1 Introduction

Many industries involve a handful of big/multi-product firms, which are able to manipulate the market outcome, as well as a vast number of small/single-product firms, which are unable to exert an appreciable influence on the market; the best they can do is to adjust optimally to big firms’ actions. Evidence is provided by laws passed in many countries, which all aim to protect small businesses against large competitors. Yet, to the best of our knowledge, such a mixed market structure has been overlooked in the literature. This paper shows that neglecting the presence of a competitive fringe is unwarranted because the presence of small and non-strategic firms may deeply affect the way the market works.

Our aim is to study a mixed market structure that blends oligopolistic and monopolistically competitive firms, i.e. firms that differ in “kind.” This difference is captured by assuming that the big firms are described by *atoms* because they are able to influence the market, whereas the small firms are treated as a continuum of *negligible* agents who have no impact on the market (Aumann, 1964). Furthermore, because they bear large sunk costs, big firms are driven by commitments that do not apply to small firms which display a more versatile and flexible behavior. Accordingly, the market process is described by a two-stage game in which the big firms move first by choosing their prices (or outputs), whereas the small businesses react by entering or exiting the market according to the zero-profit condition.

Because the field of monopolistic competition has been very much dominated by the Dixit-Stiglitz (1977) model, we find it natural to begin with the CES utility function. Under these preferences, we show that the size of the competitive fringe acts as a buffer that allows the big firms to behave like quasi-monopolists. Furthermore, as long as the entry of multi-product firms does not drive the competitive fringe out of business, firms’ equilibrium strategies are independent from the number of big firms. In contrast, when the competitive fringe vanishes, multi-product firms compete strategically. All of this has a far-reaching implication: the presence of the competitive fringe washes out the strategic interactions among big firms. In other words, monopolistic competition à la Dixit-Stiglitz emerges as the actual market structure in an environment involving different kinds of firms. The CES displaying very special features, it is critical to investigate the robustness of those results. First, we show that they hold for heterogeneous firms à la Melitz (2003), be they big or small. Second, we turn to the case of additive preferences, which have the merit of providing new impetus to empirical analysis (Houthakker, 1960). This is an important issue because the CES equilibrium price and output are independent from the market size, whereas alternative specifications of additive preferences generate either pro-competitive effects (equilibrium prices are lower in a bigger market) or anti-competitive effects (prices are higher in a bigger market), thus implying that the generalization of the above results to general additive preferences is far from being straightforward (Zhelobodko et al., 2010). Rather unexpectedly, *all the results obtained under the CES remain valid under general additive preferences*. This extension is appealing from the empirical point of view because alternative preference specifications will typically provide theoretical predictions that are sufficiently simple to be tested, sufficiently general to make sense on an empirical level,
and precise enough to allow one to discriminate between different explanations of firms’ behavior.

The common thread of our approach is the existence of a market statistic, the marginal utility of income, which subsumes firms’ behavior. More precisely, what drives our results is the fact that the value of this statistic is determined by the entry or exit of small firms. In other words, the marginal utility of income is independent from the big firms’ actions. Since the big firms correctly anticipate the second stage outcome, they accurately treat this statistic as a parameter. In doing so, they face demands that no longer depend on the other big firms’ strategies, which leads them to compete non-strategically! The market outcome with multi-product firms is thus formally identical to the one that a vast number of single-product firms would generate. This result is important because our paper provides sound theoretical foundations to the use of monopolistic competition in many empirical analysis (Bernard et al., 2007). Our approach also has implications for the so-called “new new trade theory.” For example, heterogeneity à la Melitz has been criticized for modeling firms as different “in size but not in kind” (Neary, 2010). Our analysis shows that differences in kind are immaterial under additive preferences. Indeed, despite the fundamental difference in kind stressed here between large and small firms, in equilibrium they all adopt the same pricing rule and non-strategic market behavior.

When preferences are non-additive, we show that large and small firms interact in more convoluted ways. This breaks the stabilizing impact of the competitive fringe once the big firms’ behavior impacts on the pricing behavior of the small ones. Consequently, the way the “kind” of firms matters for the market outcome depends on the nature of individual preferences.

The remainder of the paper proceeds as follows. Section 2 presents the basic model. In Section 3, we prove our main results under the CES. Section 4 extends the analysis to cope with heterogeneous firms à la Melitz. In the subsequent section, we show that the results of Section 3 can be generalized to the case of general additive preferences. Section 6 illustrates the role played by this assumption by showing that our results do not necessarily hold when preferences are non-additive. Section 7 concludes.

2 The basic model

The economy involves one horizontally differentiated good and one production factor - labor. As mentioned in the introduction, our aim is to study a mixed setting in which big and small firms adopt different market behaviors: big (oligopolistic) firms can manipulate the market aggregates; small (monopolistically competitive) firms are unable to influence market aggregates, but react to big firms’ behavior through entry or exit. Recall that our goal is to model big and small firms as firms different in kind. We capture this difference by assuming that the supply side of the economy involves (i) a continuum of single-product (SP-) firms and (ii) multi-product (MP-) firms, where firm . The purpose of this assumption is to allow each MP-firm to manipulate the market outcome. The endogenous determination of the size of firms’
product ranges is beyond the scope of this paper. Following the terminology used in the dominant firm model, the continuum of small firms will be referred to as the competitive fringe.

On the demand side, there are $L$ consumers who share the same CES preferences given by

$$U = \int_0^M x_i^\rho \text{d}i + \sum_{j=1}^N \int_0^{n_j} X_{jk}^\rho \text{d}k$$

with $0 < \rho < 1$. In (1), $x_i$ is the quantity of the variety provided by the SP-firm $i$, while $X_{jk}$ is the quantity of the variety $k$ provided by the MP-firm $j$. Alternatively, preferences could be described as follows (Shimomura and Thise, 2009):

$$U = \int_0^M x_i^\rho \text{d}i + \sum_{j=1}^N X_j^\rho.$$  \hfill (2)

Under this specification, a big firm supplies a single variety that affects positively consumers’ behavior, while small firms remain negligible. In what follows, we will focus on (1). It is worth stressing, however, that the both specifications lead to the same qualitative results.

Each consumer supplies inelastically one unit of labor and owns $1/L$ of each firm. The labor market is perfectly competitive and labor is the numéraire. Each consumer maximizes her utility (1) subject to the budget constraint

$$\int_0^M p_i x_i \text{d}i + \sum_{j=1}^N \int_0^{n_j} P_{jk} X_{jk} \text{d}k \leq y \equiv 1 + \frac{1}{L} \sum_{j=1}^N \Pi_j + \frac{1}{L} \int_0^M \pi_i \text{d}i$$  \hfill (3)

where $p_i$ denotes the price of the variety produced by the SP-firm $i$ and $P_{jk}$ the price of variety $k$ produced by the MP-firm $j$, while $\Pi_j$ stands for the profit earned by the MP-firm $j$ and $\pi_i$ for the profit made by the SP-firm $i$. Observe that the income (or expenditure) $y$ is endogenous and determined at the market equilibrium through the redistribution of profits.

Let $\sigma = 1/(1-\rho)$ be the elasticity of substitution across varieties. First-order conditions for utility maximization with respect to each variety $i \in [0, M]$ and each variety $k \in [0, n_j]$ of firm $j = 1, ..., N$ yields the following consumer demand functions:

$$d(c) = \left(\frac{\lambda p_i}{\rho}\right)^{-\sigma} \quad D(c) = \left(\frac{\lambda P_{jk}}{\rho}\right)^{-\sigma}$$

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2. Throughout the paper, variables associated with MP-firms are described by capital letters and those corresponding to SP-firms by lower case letters.
3. This assumption involves no loss of generality because the structure of firms’ ownership does not matter for our results.
where

\[ \lambda = \frac{\rho}{Y^{1-\rho} \mathbb{P}}. \]  

(4)

is the Lagrange multiplier, that is, the marginal utility of income. In (4), \( Y = Ly \) is the total income and \( \mathbb{P} \) the total price index that satisfies

\[ \mathbb{P}^{1-\sigma} = \int_0^M p_i^{1-\sigma} \, di + \sum_{j=1}^N \int_0^{n_j} P_{jk}^{1-\sigma} \, dk \equiv \mathbb{P}_{mp}^{1-\sigma} + \mathbb{P}_{sp}^{1-\sigma} \]  

(5)

in which \( \mathbb{P}_{sp} \) stands for the price index in the SP-subsector (with the subscript \( sp \)) and \( \mathbb{P}_{mp} \) for the price index in the MP-subsector (with the subscript \( mp \)). Through the redistribution of the equilibrium profits, the total income is endogenous. Plugging (4) into the demand functions, we obtain the CES market demand functions:

\[ d(p_i) = Ld_c(p_i) = \frac{Y}{\mathbb{P}} \left( \frac{P_{ij}}{\mathbb{P}} \right)^{-\sigma} D(P_{jk}) = LD_c(P_{jk}) = \frac{Y}{\mathbb{P}} \left( \frac{P_{jk}}{\mathbb{P}} \right)^{-\sigma}. \]  

(6)

Let \( c \) be the marginal cost and \( f \) the fixed cost of a SP-firm. Small firm \( i \)'s profits are given by

\[ \pi_i = (p_i - c) d(p_i; \mathbb{P}, Y) - f. \]

Letting \( C_j \) be the marginal cost and \( F_j \) the fixed cost of the MP-firm \( j \), its profits are:

\[ \Pi_j = \int_0^{n_j} (P_{jk} - C_j) D(P_{jk}; \mathbb{P}, Y) \, dk - F_j. \]

Hence, MP-firms are heterogeneous, whereas SP-firms are homogeneous. We will see in Section 4 how this assumption may be relaxed. The strategy of a SP-firm is its price level \( p_i \), while the strategy of a MP-firm is a price schedule \( P_{jk} \) defined on the interval \([0, n_j] \).

The SP-firm \( i \) being negligible, its behavior does not affect the market. In contrast, since the MP-firm \( j \) is an atom of mass \( n_j \), it influences the market when it changes its prices on a positive measure set of varieties, even though any single variety provided by this firm has a zero impact. As discussed in the introduction, the second feature that distinguishes big and small firms is the order in which they move. Our setting thus bears some resemblance with the dominant firm model in which one large firm chooses its output, anticipating the reaction of a given competitive fringe (Markham, 1951; Kydland, 1979). Besides the emphasis put on product differentiation, our setting extends this model in fundamental ways that yield new and unexpected (at least to us) results.\(^4\)

\(^4\)Although we believe that a sequential game does capture an essential difference between firms that differ in kind, it is worth stressing that several of our results are changed when all firms move simultaneously. Since the small firms’ equilibrium strategies of the simultaneous game must solve the equilibrium conditions of the second stage, the equilibrium marginal utility of income is the same in both the sequential and simultaneous games. However, the big firms do not treat this statistic parametrically when they choose their strategies in the simultaneous game. Everything else being equal, they try to reduce the marginal utility of money, which allows them to have higher mark-ups. Consequently, big firms behave strategically, as in Shimomura and Thisse (2009) and Parenti (2010).
3 The market outcome

Because the game is sequential, we seek a subgame perfect Nash equilibrium and solve the
game by backward induction.

Stage 2. Observe that $P_{mp}$ encapsulates the price choices made by all MP-firms in the
first stage of the game. Since each SP-firm is negligible, it accurately treats $P_{mp}$ and $Y$ as
parameters. This yields the equilibrium price:

$$p_i^* \equiv p^* = \frac{\sigma}{\sigma - 1} c.$$ 

Therefore, for a given mass $M$ of small firms, (5) may be rewritten as follows:

$$P^{1-\sigma} = M \left( \frac{\sigma}{\sigma - 1} c \right)^{1-\sigma} + P^{1-\sigma}_{mp}. \tag{7}$$

By definition of monopolistic competition, free entry and exit prevails in the SP-
subsector to reflect the high turnover of small firms. As usual, the resulting zero-profit
condition allows one to determine the equilibrium output of a SP-firm:

$$q_i^* \equiv q^* = \frac{f(\sigma - 1)}{c}.$$ 

Hence, the small firms’ equilibrium price and output are independent from the big firms’
choices, which implies that the MP-firms influence the competitive fringe through the mass
of SP-firms only.

It remains to determine the equilibrium mass of SP-firms, $M^*$, conditional upon $P_{mp}$
and $Y$. To this end, we consider the market clearing condition for variety $i \in [0, M]$:

$$\frac{Y}{P^{1-\sigma}} \left( \frac{\sigma}{\sigma - 1} c \right)^{-\sigma} = d(p^*) = q^* = \frac{f(\sigma - 1)}{c}$$

which yields

$$P^{1-\sigma} = \frac{Y}{\sigma f} \left( \frac{\sigma}{\sigma - 1} c \right)^{1-\sigma}. \tag{8}$$

Using (7) and (8), the equilibrium mass of SP-firms is given by

$$M^* = \frac{Y}{\sigma f} - \left( \frac{\sigma - 1}{c\sigma} \right)^{1-\sigma} P^{1-\sigma}_{mp}.$$ 

When profits are not redistributed to the workers, (8) shows that the SP-subsector acts
as a buffer stabilizing the total price index at a constant value through a change in the
equilibrium mass $M^*$ of SP-firms. In this case, an external shock (e.g. the entry of a big
firm) that makes a subsector more (less) aggressive translates into less (more) competition
in the other subsector. More generally, the equilibrium mass of SP-firms is such that the
decisions made by the MP-firms affect the total price index through the income effect only.

**Stage 1.** The MP-firms choose their price schedules, anticipating the SP-firms’ optimal
responses. In particular, the MP-firms know that the mass of SP-firms will be adjusted for
the total price index to remain equal to (8). Substituting (8) into \( D(P_{jk}) \), we obtain what
we call the *adjusted demand* for firm \( j \)'s variety \( k \):

\[
D(P_{jk}) = \sigma f \left( \frac{\sigma}{\sigma - 1} c \right)^{\sigma - 1} P_{jk}^{-\sigma}. \tag{9}
\]

Hence, because the MP-firms anticipate the adjustment in the SP-subsector, in the first
stage these firms face the adjusted demand (9), which is independent from \( P \) and \( Y \) unlike
the market demand (6). Indeed, the former encapsulates the reactions of the SP-firms to
the MP-firms’ actions, whereas the latter does not.

Since firm \( j \)'s marginal cost is the same across its varieties and each variety is negligible
within its product line, in equilibrium it must be that \( P_{jk} = P_j \).\(^5\) Therefore, this firm’s
profits may be rewritten as follows:

\[
\Pi_j = n_j (P_j - C_j) D(P_{jk}) - F_j = n_j (P_j - C_j) \sigma f \left( \frac{\sigma}{\sigma - 1} c \right)^{\sigma - 1} P_j^{-\sigma} - F_j
\]

which depends only upon the common price \( P_j \) set by firm \( j \). Hence, this firm’s equilibrium
price is given by

\[
P_j^* = \frac{\sigma}{\sigma - 1} C_j.
\]

This expression has the following far-reaching implication: *the MP-firms adopt the same pricing rule as the SP-firms*, the reason being that each big firm chooses its price
schedule as if it were a monopolist facing its varieties’ adjusted demands. Furthermore,
when choosing its price, a MP-firm does not have to care about the equilibrium value of
the total income because \( D(P_{jk}) \) is independent from \( Y \). Accordingly, despite the fact that
big firms are atomic players, the presence of a competitive fringe is sufficient to trigger the
disappearance of all forms of strategic interactions through the adjustment of the mass
of small firms. This effect includes the interactions among big firms that affect the total
price index, as well as the indirect interactions channeled by the redistribution of profits.
Consequently, as long as the market accommodates a competitive fringe, we may conclude
that both big and small firms adopt the same non-strategic market behavior. In contrast,
when the entire competitive fringe has vanished, \( (M^* = 0) \), the big firms become strategic
because both the price index and the total income vary with their price choices. To put it
differently, we are back to the world of oligopoly theory. Note also that big firms’ markups
are lower in the presence of a competitive fringe than in a pure oligopolistic market. This
is because (i) these firms behave like SP-firms, and (ii) monopolistic competition is here
the limit of an oligopolistic market in which the number of firms is arbitrarily large. Since

\(^5\)Hence, (2) may be viewed as a special case of (1) in which \( n_j = 1 \) for all \( j \).
everything works as if the market would operate under monopolistic competition, markups are constant under CES preferences. In particular, markups are independent of the characteristics of the SP-subsector and of the number of MP-firms. Hence, we may conclude that a competitive fringe stabilizes competition among big firms.

The above discussion is summarized as follows.

Proposition 1. When the market involves a fixed number of big firms and a competitive fringe governed by free entry and exit, all active firms adopt the same pricing rule. Furthermore, in equilibrium, each firm, either big or small, behaves like a monopolist facing its (adjusted) demand.

To sum-up, once the value of $M$ is endogenous, the strategic interdependence among big firms is dissolved in an ocean of firms that all adopt the pricing behavior of small firms. This provides a strong justification for the use of monopolistic competition in modeling imperfect competition since in the real world few sectors have a competitive fringe. Observe that increasing returns and product differentiation are needed for that to be true. Indeed, under constant or decreasing returns, the mass of small firms would be infinite when entry is free. Furthermore, firms’ operating profits must be positive to cover their fixed costs. This shows how our setting differs from that of the dominant firm where small firms, the total mass of which is fixed, operate under decreasing returns and supply the same homogeneous good as the big firm.

The following two comments are in order. First, it is well known that the distinction between quantity or price competition is immaterial in monopolistic competition. In our setting, the market outcome is the same regardless of the strategy - quantity or price - used by big firms. In other words, Bertrand and Cournot competition yields the same market outcome. This strikingly differs from what we know in oligopoly theory and shows once more how a market involving big and small firms may obey very new rules. Second, unlike the oligopoly case, (9) implies that both the equilibrium price and profits of a big firm are independent from the size of the economy. In contrast, the size of the competitive fringe increases with the size of the economy.

It is tempting to believe that the above analysis is an artefact of the CES, which is known to yield fairly peculiar results. In addition, even though the big firms are heterogeneous, the small firms have been assumed to share the same marginal cost, while the empirical trade literature stresses the importance of firms’ heterogeneity. We show below that the homogeneity assumption does not drive our main results, while we turn to the case of more general preferences in Section 5.

4 Heterogeneous firms

In this section, we assume that the SP-firms are heterogeneous in the sense of Melitz (2003). What makes our analysis potentially richer is that, in our setting, the cost cutoff could be influenced by the behavior of the MP-firms.
Prior to entry the SP-firms face uncertainty about their marginal cost. To enter the market, the SP-firms must bear a sunk cost \( f_e \). After entry, the SP-firm \( i \) observes its marginal cost \( c_i \), which is drawn randomly from the distribution \( \Gamma(c) \), the density of which is denoted by \( \gamma(c) \). When this firm decides to produce, it also incurs a fixed production cost \( f \), so that its production cost function is given by \( f + c_i q_i \). Under monopolistic competition, firm \( i \) sets a price equal to

\[
p_i^* = \frac{\sigma}{\sigma - 1} c_i.
\]

Since the equilibrium output is given by

\[
q_i^* = \frac{Y}{p^*^{\dagger} - \sigma} \left( \frac{\sigma c_i}{\sigma - 1} \right)^{-\sigma}
\]

the equilibrium profits are as follows:

\[
\pi^*(c_i) = \frac{p_i^* q_i^*}{\sigma} - f = \frac{Y}{\sigma} \left( \frac{\sigma}{\sigma - 1} \right)^{1-\sigma} - f.
\]

Because \( \pi(c_i) \) is strictly decreasing in \( c_i \), there is a unique cutoff \( \bar{c} \) such that all firms having a marginal cost exceeding \( \bar{c} \) decide not to produce and exit the market without incurring the fixed production cost \( f \). Therefore, we may set \( \pi(c) = 0 \) for \( c > \bar{c} \). The resulting truncated density of active firms is given by

\[
\tilde{\gamma}(c) = \frac{\gamma(c)}{\Gamma(\bar{c})}
\]

if \( c \leq \bar{c} \) and \( \tilde{\gamma}(c) = 0 \) otherwise. Last, a firm enters when its expected profit net of entry cost is nonnegative. Therefore, if \( M_E \) firms enter, there will be \( \Gamma(\bar{c}) M_E \) active firms.

Because all SP-firms face the same uncertainty, free entry implies that the expected profit is equal to zero in equilibrium:

\[
\mathbb{E}_\gamma(\pi) = \int_0^\infty \pi(c) \gamma(c) dc = \int_0^\bar{c} \pi(c) \tilde{\gamma}(c) \Gamma(\bar{c}) dc = \Gamma(\bar{c}) \mathbb{E}_\tilde{\gamma}(\pi) = f_e
\]

which implies

\[
\mathbb{E}_\tilde{\gamma}(\pi) = \frac{f_e}{\Gamma(\bar{c})} \equiv g(\bar{c}). \tag{11}
\]

Let \( \bar{p} \) and \( \bar{q} \) be the equilibrium price and output of a firm having the cutoff marginal cost \( \bar{c} \). Using (10), we have

\[
\frac{\mathbb{E}_\tilde{\gamma}(p_i^* q_i^*)}{\bar{p} \bar{q}} = \frac{\mathbb{E}_\tilde{\gamma}(c_i^{1-\sigma})}{\bar{c}^{1-\sigma}}.
\]

Since

\[
\pi^*(c_i) = \frac{p_i^* q_i^*}{\sigma} - f
\]
and 

\[
\frac{\bar{p}q}{\sigma} = f
\]

we can rewrite \(E_\gamma(\pi)\) as follows:

\[
E_\gamma(\pi) = E_\gamma \left[ \frac{p^*_i q^*_i}{\sigma} - f \right] = \left[ \frac{E_\gamma(c^*_1 - \sigma \bar{c})}{\bar{c}^{1-\sigma}} - 1 \right] f \equiv h(\bar{c})
\]

which depends only upon \(\bar{c}\).

Inspecting (11) shows that \(g(c)\) decreases with \(c\) from infinity to zero. Furthermore, Melitz (2003, p.1704) shows that \(h(c)\) increases with \(c\) for most standard probability distributions. Hence, the value of \(\bar{c}\) is uniquely determined by the intersection of the two loci \(g\) and \(h\). Since the functions \(g\) and \(h\) are determined only by the properties of the density function \(\gamma\) and the parameters \(f\) and \(f_e\), the cutoff cost \(\bar{c}\) is independent from the big firms’ behavior.

Using \(\pi(\bar{c}) = 0\), we have

\[
\frac{\bar{p}q}{\sigma} = \frac{Y}{\sigma} \left( \frac{\sigma \bar{c}}{\sigma - 1} \right)^{1-\sigma} = f
\]

which implies that the total price index is given by

\[
\bar{p}^{1-\sigma} = \frac{Y}{\sigma f} \left( \frac{\sigma \bar{c}}{\sigma - 1} \right)^{1-\sigma}
\]

which is identical to (8) but in which \(c\) is replaced by \(\bar{c}\). Even though the total income depends on big firms’ behavior through the redistribution of profits, we obtain a result identical to Melitz (2003).

Although the entrants make either positive or negative profits net of sunk costs \(f_E\), the overall profits earned by the mass \(M_E\) of firms is zero. Indeed, the free entry condition implies

\[
E_\gamma(\pi) = f_E.
\]

It then follows that

\[
M_E f_E = \frac{M^*}{\Gamma(\bar{c})} E_\gamma(\pi) = M^* E_\gamma(\pi) = \int^M \pi^*(c_i) \, dc_i.
\]

Hence, as in Section 3, the total income is determined by the profits earned by the MP-firms only. Consequently, small heterogeneous firms keep playing the role of a buffer. This highlights how free entry and exit among SP-firms is the key-assumption in our analysis, as discussed in the preceding section.

To sum up,

**Proposition 2.** When small firms are heterogeneous à la Melitz, Proposition 1 still holds.

The equilibrium mass \(M_1^*\) of SP-firms that enter the market is determined by the behavior of the MP-firms, very much as \(M^*\) is determined in the homogeneous firm case. Since the share \(1 - \Gamma(\bar{c})\) of active firms is constant, the mass of small firms that are active is given by \(M^* = \Gamma(\bar{c}) M^*_E\), thus implying that a shock on the MP-firms (e.g. the entry of a big firm) affect \(M^*_E\) and \(M^*\) proportionally.
5 General additive preferences

The purpose of this section is to generalize Proposition 1 to the case of general additive preferences:

$$U = \int_0^M u(x_i) \, dx + \sum_{j=1}^N \int_0^{n_j} U_j(X_{jk}) \, dk$$

where \( u \) and \( U_j \) are thrice continuously differentiable, strictly increasing and concave, with \( u(0) = U_j(0) = 0 \). Note that (13) allows for the utility of a SP-variety to differ from that of an MP-variety. The aim is to capture the idea that big and small firms may provide their customers with specific attributes. Hence, varieties do not enter symmetrically into individual preferences. Furthermore, besides the CES discussed in Section 2, another special case of (13) is given by the CARA utility proposed by Behrens and Murata (2007) to model preferences in monopolistic competition:

$$u(x) = 1 - \exp(-\alpha x) \quad \alpha > 0.$$ 

Apart from the generalization of preferences, the model is the same as the one described in Section 2.

Let \( y \) be the consumer income defined in (3), \( P_j \) the price function set by the MP-firm \( j \) and \( p_i \) the price chosen by the SP-firm \( i \). Denoting by \( \lambda \) the Lagrange multiplier, the utility-maximizing conditions yield the inverse demand functions:

$$p_i(x_i) = \frac{u'(x_i)}{\lambda} \quad P_jk(X_{jk}) = \frac{U_j'(X_{jk})}{\lambda}$$

which means that the individual demand for any specific variety depends only upon its price and the marginal utility of income \( \lambda \). Therefore, the marginal utility of income captures all the market ingredients that matter to consumers (and firms), very much as (4) in the Dixit-Stiglitz model. In addition, the strict concavity of \( u \) implies that the conditions (14) are sufficient for the consumer optimization problem to have a unique solution. As in the foregoing, the game is solved by backward induction.

**Stage 2.** As in Section 2, assume that the SP-firms share the same marginal cost \( c \) and fixed cost \( f \). Therefore, firm \( i \)'s profits are given by

$$\pi_i = \left[ \frac{u'(x_i)}{\lambda} - c \right] Lx_i - f.$$ 

Using the “relative love for variety” \( r_u(x_i) \) introduced by Zhlobodko et al. (2010):

$$r_u(x_i) \equiv -\frac{x_i u''(x_i)}{u'(x_i)}$$

we may state the equilibrium conditions in a very simple way. At a symmetric equilibrium, the first-order condition for profit-maximization may be written as follows:

$$p^* = \frac{c}{1 - r_u(x^*)}.$$ 

(15)
Combining this condition with the zero-profit condition yields the equilibrium output $q^* = Lx^*$, where $x^*$ is the solution to

$$
\frac{x^*r_u(x^*)}{1 - r_u(x^*)} = \frac{f}{cL}.
$$

(16)

As shown by Zhelobodko et al. (2010), the equation (16) has a unique solution when (i) profits are concave ($r_u' < 2$), (ii) varieties are gross substitutes ($r_u < 1$) and (iii) the marginal revenue ($(x_iu''(x_i) + u'(x_i))/\lambda$) intersects once the horizontal line $c$ for all admissible $\lambda$. Moreover, since the equations (15) and (16) do not depend on $\lambda$, the decisions made by the SP-firms are independent from what the MP-firms do.

Using (14) and (15), it is readily verified that the equilibrium value of the statistic $\lambda$ is given by

$$
\lambda^* = \frac{u'(x^*)[1 - r_u(x^*)]}{c}
$$

(17)

which is independent from the MP-firms’ actions. In other words, when the big firms change their prices or outputs, only the mass of small firms is affected for the marginal utility of income to remain constant. Furthermore, the marginal utility of income is independent from the big firms’ actions. Thus, our setting may be viewed as a special aggregative game (Anderson et al., 2010) in oligopoly theory, in which the value of the marginal utility of income is the aggregate of the sole small players’ actions.

**Stage 1.** Since the MP-firm $j$ anticipates the equilibrium values of $p^*$ and $q^*$, this firm is able to compute the resulting value of $\lambda^*$ and to determine the adjusted inverse demand for its variety $k$:

$$
P_{jk}(X_{jk}) = \frac{U_j'(X_{jk})}{\lambda^*}
$$

which depends only upon the individual consumption of this variety since $\lambda^*$ is already determined. In other words, all the properties shown in Section 3 remain valid.

Consequently,

**Proposition 3.** Under general additive preferences, Proposition 1 still holds.

In particular, when preferences are additive, the presence of a competitive fringe operating under free entry and exit is sufficient to make the big firms’ market behavior non-strategic. Note also that Proposition 3 can be generalized to the case of heterogeneous firms à la Melitz, but additional conditions on the non-CES utility $u$ must be imposed for the cutoff cost to be unique.

**Stability in competition** To better understand the role of the competitive fringe in stabilizing competition, consider the symmetric equilibrium $(\bar{p}, \bar{x})$ of the SP-subsector prevailing before a shock on big firms’ costs and/or demands, and let $(\tilde{p}, \tilde{x})$ be the equilibrium prevailing after the shock. These two equilibria must satisfy the zero-profit condition:

$$
\pi = [p(x) - c]Lx - f = 0.
$$
Since the inverse demand
\[ p(x) = u'(x)/\lambda \]
must be met in equilibrium, the shock to the MP-subsector may influence SP-firms’ profits only through an upward (downward) shift of the inverse demand caused by a change in the value of \( \lambda \). Hence, operating profits are increased (decreased) after the shock, which implies that the zero-profit condition cannot hold at \((\bar{p}, \bar{x})\). This means that \( \lambda \) must be the same before and after the shock, which implies that the inverse demands for the MP-varieties are the same. When the mass of small firms remains the same after and before the shock, the value of the marginal utility of income is increased or decreased depending on the nature of the shock. Once small firms are free to enter or exit the market, their mass is determined by the zero-profit condition which restores the pre-shock value of \( \lambda \).

We now want to stress that the above argument can be applied to more general settings. To be precise, consider an general preference model that generates small firms’ demand schedules \( d_i(p_i; \Lambda) \), where \( \Lambda \) is the vector of market statistics treated parametrically by small firms. For example, under additive preferences, we have \( \Lambda = \lambda \). Additional examples are provided in the next section.

Let \( \mathbf{a} \) be the vector of exogenous parameters affecting big firms’ behavior, thus making \( \Lambda \) dependent on \( \mathbf{a} \). Examples include parameters affecting big firms’ cost \( (C_j) \) and demand \( (U_j) \) and number \( (N) \) only. Consider a shock on \( \mathbf{a} \) which changes the vector \( \Lambda(\mathbf{a}) \) and assume that the shift of any small firm’s demand is such that, everything else being equal, the pre-shock demand \( d_i(p_i; \Lambda(\mathbf{a})) \) does not intersect the after-shock demand \( d_i(p_i; \Lambda(\mathbf{a}')) \). Formally, this no-crossing condition may be stated as follows:

\[ \Lambda(\mathbf{a}') \neq \Lambda(\mathbf{a}) \Rightarrow d_i(p_i; \Lambda(\mathbf{a})) > d_i(p_i; \Lambda(\mathbf{a}')) \quad \text{or} \quad d_i(p_i; \Lambda(\mathbf{a})) < d_i(p_i; \Lambda(\mathbf{a}')) \quad \text{for all} \ p_i > c. \]

Slightly extending the above argument shows that, under the no-crossing condition, the SP-demand functions remain the same for both the pre- and aftershock operating profits to be equal to \( f \). Thus, we have:

**Proposition 4.** Consider a preference structure such that the SP-demand schedules satisfy the no-crossing condition. Any exogenous shock affecting big firms’ behavior triggers the entry or exit of small firms for the after-shock values of market statistics and small firms’ prices to be equal to their pre-shock values.

This proposition extends our main results to non-additive preferences compatible with the no-crossing condition. In particular, it implies that big firms do not behave strategically.

### 6 Quadratic utility

In this section, we consider a well-known example of not additively separable preferences. Specifically, the model is identical to the one presented in Section 2, except that individual preferences are described by the quadratic utility with cross-effects (Ottaviano et al., 2002):

\[
U = X - \frac{\gamma}{2} \left( \int_0^M x^2_i\,di + \sum_{j=1}^N \int_0^{n_j} X_{j,k}^2\,dk \right) - \frac{X^2}{2} \quad \text{(18)}
\]
where the market statistic
\[ X = \int_0^M x_i \, di + \sum_{j=1}^N \int_0^{n_j} X_{jk} \, dk \]
is the total consumption index, \( \gamma > 0 \) measuring the intensity of consumers’ love for variety.\(^6\)

First-order conditions for utility maximization with respect to each variety \( i \in [0, M] \) and each variety \( k \in [0, n_j] \) of firm \( j = 1, \ldots, N \) yield the individual inverse demand functions:
\[ \lambda p_i = 1 - \gamma x_i - X \quad \lambda p_{jk} = 1 - \gamma X_{jk} - X. \]
where \( \lambda \) is again the marginal utility of income.

Using these conditions and the budget constraint, we can determined the equilibrium value of \( \lambda \) as follows:
\[ \lambda^* = \frac{\gamma (\gamma + M + \sum n_j) Y - \gamma \mathbb{E}(P)}{\mathbb{E}^2(P) - (\gamma + M + \sum n_j) \mathbb{E}(P^2)} \]
where \( P \) is the price profile of all varieties. Therefore, \( \lambda^* \) depends on the price moments \( \mathbb{E}(P) \) and \( \mathbb{E}(P^2) \) as well as on the income \( Y \). Since the MP-firms produce a strictly positive mass of varieties, \( \lambda^* \) can be impacted by the MP-firms’ strategies chosen in the first stage through the prices’ moments. On the contrary, the SP-firms will keep treating \( \lambda^* \) as given because they are negligible to the market.

After rearrangement, this yields the following expressions for the demand functions:
\[ p_i = \frac{1 - X - \gamma x_i}{\lambda^*} \quad p_{jk} = \frac{1 - X - \gamma X_{jk}}{\lambda^*}. \quad (19) \]

**Stage 2.** Since each SP-firm is negligible, it accurately treats both \( X^* \) and \( \lambda^* \) as given. Therefore, the equilibrium output is given by
\[ q_i^* \equiv q^* = \frac{L}{2\gamma} (1 - X - \lambda^* c) \]
and the equilibrium price by
\[ p_i^* \equiv p^* = \frac{1 - X + \lambda^* c}{2\lambda^*}. \]

Conditional upon \( \lambda^* \), the zero-profit condition determines the equilibrium value of the total consumption index \( X^* \):
\[ \frac{L\lambda^*}{4\gamma} \left( \frac{1 - X^*}{\lambda^*} - c \right)^2 + f = 0 \Rightarrow X^* = 1 - \lambda^* \left( c + 2 \sqrt{\frac{\gamma f}{\lambda^* L}} \right) \quad (20) \]
\(^6\)Without loss of generality, the coefficients of \( X \) and \( X^2 \) have been normalized to 1.
which depends on $\lambda^*$. It is worth stressing the difference this setting and the one presented in the previous sections. The marginal utility of income is not anymore determined by the SP-firms only because it now depends on the actions chosen by all (big and small) firms through $X^*$.

**Stage 1.** The MP-firms face the inverse demand given by

$$P_{jk}[X_{jk}; X^*(\lambda^*)] = \frac{1 - X^*(\lambda^*) - \gamma X_{jk}}{\lambda^*}.$$  

Because the MP-firm $j$ accurately anticipates the value of $X^*$, the adjusted demand for its variety $k$ is obtained as follows:

$$P_{jk}(X_{jk}; \lambda^*) = 2\sqrt{\frac{\gamma f}{\lambda^* L}} - \frac{\gamma}{\lambda^*} X_{jk}.$$  

Since every MP-firm $j$ influences the value of $\lambda^*$ through the price moments, this firm understands it can manipulate $\lambda^*$ in the first stage game. Therefore, big firms’ actions affect their adjusted demands, which implies that these firms compete strategically. In this case, their actions also affect the small firms’ choices, not just their mass. This example shows that Proposition 1 need not hold under non-additive preferences, thus highlighting the role of additive preferences in stabilizing competition in markets with big and small firms.

However, things become very different when (18) is embedded into a quasi-linear upper-tier utility:

$$U = X - \frac{\gamma}{2} \left( \int_0^M x_t^2 dt + \sum_{j=1}^N \int_0^{n_j} X_{jk}^2 dk \right) - \frac{X^2}{2} + H$$

where $H$ is the numéraire, very much like in several partial equilibrium analysis. If each consumer is endowed with a quantity of the numéraire sufficiently large for the equilibrium consumption of this good to be positive, the marginal utility of income is fixed and equal to 1. As shown by (20), the equilibrium value $X^*$ is constant and independent from the choices made by the MP-firms. Consequently, Proposition 1 holds true in the linear-quadratic utility case. This is because the marginal utility of income is fixed ($\lambda = 1$), while a firm’s demand is shifted upward or downward with the total output ($\Lambda = X$). Thus, the no-crossing condition is guaranteed.

By way of contrast, in the quadratic case (18), we have seen that $\lambda$ and $X$ are interdependent so that $\Lambda = (\lambda, X)$. Would an external shock shift $\lambda$ and $X$ in the same direction, the no-crossing would hold. However, (20) shows that they move in opposite directions, thus showing why Proposition 1 does not hold under (18).

The left and right panels of Figure 1 illustrate the differences between the quadratic and linear-quadratic cases, respectively. In the former one, (19) shows that a simultaneous change in $\lambda$ and $X$ modifies demands through a rotation and a shift of the corresponding curves. This changes both the slope and the intercept of the demand schedules, thus
Figure 1: Equilibria without and with price stabilization

violating the no-crossing property. In the latter one, $\lambda$ is fixed so that a change in $x$ triggers an upward or downward parallel shift of the demand schedule. Hence, only the intercept of demands is modified, which prevents the pre-shock and post-shock curves to intersect.

The above discussion has an important methodological implication: modeling competition in an industrial sector that has a competitive fringe by means of a pure oligopoly setting may yield dubious results.

7 Concluding remarks

We would be the last to claim that oligopoly theory is irrelevant. Instead, our aim was to show that differentiated markets involving a few big firms endowed with market power as well as a competitive fringe may be accurately described by monopolistic competition settings. In particular, when the no-crossing condition holds, small firms’ equilibrium price and output are stable in response to any shock affecting big firms. Furthermore, when preferences for the differentiated good are additive, (i) the marginal utility of income captures all the market ingredients that matter to consumers and firms; (ii) any firm, either big or small, either homogeneous or heterogeneous, adopts a non-strategic market behavior, meaning that its profit-maximizing strategy is independent from the actions taken by its competitors; and (iii) when firms are heterogeneous, the average productivity within the competitive fringe is independent from the big firms’ behavior.

To conclude, observe that our analysis highlights the fact that small firms enter or exit the market in response to an external shock in a way such that big firms have no incentives to deviate from the strategies adopted before the shock. Thus, we shed new light on the
well-documented stickiness of prices on several markets.

References


