

Growth and imperfect competition on factor markets: Increasing returns and distribution

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Abstract

Although seldom modeled outside the monopolistic competition framework, market incompleteness and imperfect competition are central to the new growth theories. We propose here a strategic model of imperfect competition with endogenous growth and endogenous market structure where we focus on labor market issues. For growth to be possible, we assume increasing returns at the firm level. Due to heterogeneity on the labor market, the market structure is not degenerate. Then, because of increasing returns, short-run efficiency is maximized under monopoly and free entry implies too many firms in the market. However, in the long run competition can generate growth through a distribution effect, whereas a monopoly leads to a zero-growth steady state. Thus, there is a trade-off between static and dynamic efficiency. This trade-off implies the existence of a growth-maximizing degree of competition in our economy. © 2000 Elsevier Science B.V. All rights reserved.

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1. Introduction

What are the macro-economic effects of dynamic imperfect competition? This question is clearly at the heart of contemporary economic theory. Static micro-economic theory is overwhelmingly favorable to competition. A higher degree of competition is in general associated with higher welfare as can be found in any standard textbook. However, most existing dynamic analyses tend to argue against competition. Their general line of argument is the following: a monopoly is likely to be more efficient in the long run because of its better ability to internalize the dynamic effects of its actions. In particular, the benefits of cost reduction do not accrue to the consumers but to the monopolist, thus giving it an ex-ante incentive to reduce costs. To analyze the links between imperfect competition and growth and to overcome this argument, several approaches are possible.

A first line of research in R&D models of growth has been to liken the number of firms to the number of intermediate goods.¹ The implications of this assumption have been pursued by Smulders and Van de Klundert (1995) in a model where firms behave strategically. This paper disentangles nicely the different effects of R&D-led competition on growth. However, a first problem with this approach is that this is not at all clear why products and firms should be equated. The other issue is that such a framework is probably more relevant to developed economies than developing ones for which R&D may not be that crucial. Moreover, even in developed economies, R&D may not be the sole engine of growth (Jovanovic, 1997).

The second possible approach is the one which looks inside the firm. Because of agency problems, managers in monopolies will not make enough efforts to minimize costs. So when financial discipline, normally imposed by the shareholders, is not available, product market competition will act as a substitute. This is the basic thrust of Aghion et al. (1995, 1997). Using a Schumpeterian framework, they show that agency effects, when sufficiently important, can reverse the usual Schumpeterian result where monopolies are beneficial for growth. In these papers however, the market structure is exogenous and strategic interactions between firms are ignored.

The line of investigation we propose here builds on a different type of argument. The key point we want to underline is that competition may enhance growth when it distributes income to people who will make a more productive use of it. In other words, *competition may favor growth because it distributes income more 'efficiently'*. This focus on distributive issues also suggest a shift of attention from product market competition to factor market competition.

¹ This assumption is present in most models of R&D led growth (Grossman and Helpman, 1991; Romer, 1990).

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