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INVESTMENTS IN PRODUCTIVITY UNDER MONOPOLISTIC COMPETITION: LARGE MARKET ADVANTAGE

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The cross-countries differences in productivity and quality are noticeable and allow for various explanations. In this theoretical project we study the impact of the market size on investments in productivity and quality. Is it true that in a bigger market firms make bigger investments? How firms' investments correlate with competetiveness, measured by Herfindal-Hirshman Index or by markup? In a heterogenous industry, do more productive firms make bigger investments, or less efficient firms invest more, to compensate initial infficiency? First of all, for policy-making our topic may be interesting because of new qualitative understanding of big-country advantages and similar gains from trade. Indeed (unlike Melitz (2003)) we show that gains from trade liberalization consist not only in additional product diversity and “best firms selection” but also in fostering R&D, and thereby productivity and quality. Our classification of markets suggests that there can be industry-specific gains from trade liberalization, that allow to detect industries most favorable for liberalization. Second, some modernizing countries (like Russia) do practice active industrial policy including governmental aid or preferences to some industries: automobiles, agriculture, etc. For such policy it can be interesting, that market outcome in sectors of different kind can include too many or too few firms in the industry, compared to social optimum, in the spirit of Dixit and Stiglitz. If their hypothesis will turn out holding under our more broad setting, then we find additional reasons for industry-specific industrial policy for those industries where the number of firms appears insufficient or excessive. In this case, a theorist should recommend regulations hampering/fostering entry into certain industries satisfying our criterion of “efficient number of competitors” connected with the demand elasticity.