How Costly Are Markups?

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Abstract

We study the welfare costs of markups in a dynamic model with heterogeneous firms engaged in monopolistic competition. In our model more efficient producers have larger market shares, charge higher markups, and produce too little relative to the social optimum. We decompose the costs of markups into three sources: i) a uniform output tax levied on all producers, ii) misallocation of factors of production across producers, iii) inefficiently low entry. The uniform tax distortion is the largest source of losses in our economy. Losses from misallocation are relatively low because very efficient producers face strongly diminishing returns and the gains from reallocating factors of production to them are low. Policies that subsidize firm entry have a relatively modest impact because while competition reduces individual producers' markups, it also reallocates market shares towards the larger producers and consequently does not reduce the aggregate markup distortion. Size-dependent policies that reduce concentration can reduce the aggregate markup but greatly increase misallocation, causing large aggregate efficiency losses.

Keywords: concentration, misallocation, firm dynamics.

JEL classifications: D4, E2, L1, O4.

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