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Title: Anatomy of Market Failures in Monopolistic Competition

Abstract: Two remarkable features of the Dixit-Stiglitz monopolistic competition model under CES are the markup rate invariance and the optimality of the free-entry equilibrium. Neither of these features is robust. Under non-CES, equilibrium entry caused by a larger market size/entry cost ratio could make the markup rate go down (procompetitive entry) or up (anticompetitive entry). Furthermore, equilibrium entry can be excessive or insufficient. In our previous work, we showed, under the three classes of homothetic demand systems, H.S.A., HDIA, and HIIA, that entry is procompetitive iff Marshall's 2nd law holds and that procompetitive entry is always excessive. Here, we study two parametric families of homothetic demand systems outside of the three classes, and show that, in the presence of demand elasticity dispersion, the composition effect can make procompetitive entry insufficient. In particular, we show that there is a critical level of demand elasticity dispersion at which the equilibrium entry is procompetitive and optimal. Above (below) the critical level, equilibrium entry is procompetitive and insufficient (procompetitive and excessive).