Free Entry, Market Diffusion, and Social Inefficiency with Endogenously Growing Demand

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Abstract

This paper analyzes market diffusion in the presence of oligopolistic interaction among firms. The market demand is positively related to the past market size because of consumer learning, networks, or bandwagon effects. Firms enter the market freely in each period with fixed cost and compete in quantities. We demonstrate that free entry leads to a socially inefficient number of firms over time and that the nature of the inefficiency changes as the market grows. Initially the number of firms is insufficient but eventually it is excessive. This is in contrast with previous findings in the theoretical literatures.

JEL Classifications Code: D11, L11, L14.
Keywords: Free Entry; Market Diffusion; Intertemporal Externalities; Entry Regulation.

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