

# Innovation and Distribution: A General Equilibrium Model of Manufacturing and Retailing

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## Abstract

Retailing constitutes a large sector. It accounts for approximately 20% of a country's gross domestic product, 1.3 times the typical size of the manufacturing sector. This holds true across nations regardless of differences in income, size, development, and (proxies for) entry cost and consumer travel cost. This paper proposes a free-entry theory of retailing and manufacturing. The theory predicts that, despite its cost, the entry of a retail sector raises entry and product innovation by manufacturers. It further proposes a mechanism of vertical pricing power based on the upstream or downstream scarcity of variety implied by the cost of production versus distribution. Finally, the theory makes a quantitative prediction about the size of the retail sector. At consensus estimates of the demand for variety from the literature on trade, the general equilibrium in the theory mimics the empirical regularities in the first two sentences.

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